Decisions, Decisions – Capital Structures after the TCJA

TEI-SJSU High Tech Tax Institute
November 5, 2018

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Introduction: Purposes of This Session

- Explore how TCJA may impact debt and equity capital structures (both internal and external)
- Focus on:
  - Choice of Entity for Domestic and Foreign Business
  - Choice of Debt v Equity
  - Tax Attributes
  - Anti-hybrid Considerations

Post-tax reform - Current state

- Tax-efficiently managing worldwide capital is an increasingly complex challenge given US tax reform and other significant changes
  - Final and temporary section 385 debt-equity regulations, proposed withdrawal of section 385 documentation rules
  - Section 267A anti-hybrid provisions
  - Section 163(j) interest expense limitation rules
  - Base-erosion anti-abuse tax (“BEAT”) for payments to foreign affiliates
  - Global intangible low-tax income (“GILTI”) tax on foreign financing transactions of US multinationals
  - Base erosion and profit shifting (“BEPS”) initiative impact on foreign law
- Managing the tax implications of these provisions is critical in creating a tax-efficient capital structure in the current tax environment

Choice of Entity – General Considerations

Key Changes in TCJA Relevant to Choice of Entity

- Reduction of corporate tax rate
- Disallowance of state/local deduction for individuals
- Broader limitation on interest deductions
- Introduction of 199A deduction
- Disallowance of miscellaneous itemized deductions
- Revised international regime (GILTI, FDII, 245A)

Reasons to maintain/seek flowthrough treatment:

- Ability to claim 199A deduction
  - 20% deduction for qualified business income of flow-through businesses, producing ETR of 29.6% for owners
  - Limited to (i) 50% of W-2 wages, or (ii) 25% of wages plus 2.5% of basis in qualifying property
  - Requires a "qualifying business", which excludes a business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, a business where the "principal asset" of the business is the "reputation or skill" of one or more of its employees or owners, certain investment management businesses, and certain securities and commodities trading and dealing businesses.
- Ability to raise financing via preferred partnership equity without 163(j) limitations
- Potential concerns re: PHC or AET impacts on corporate structure
- Avoidance of double taxation, even at reduced rates; concerns re: stability of corporate rates
- Basis step-up on later sale

Reasons to consider corporate status:

- 21% corporate rate reduces "double tax" pain.
  - 21% corporate tax plus 20% "qualified dividend" tax on distributions (21% of 79%) = 36.8%, plus Medicare tax. (Also consider state tax impact.)
- Section 250 (GILTI and FDII) deduction
- Deductibility of state/local taxes
- Deductibility of miscellaneous itemized deductions
- 245A deduction for foreign operations

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Choice of Branch or Corporate Form for Foreign Business

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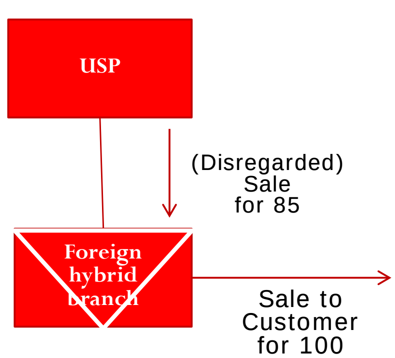
Overview on choice of foreign entity

- Prior to TCJA, operating a foreign business in branch form meant:
  - Income/losses reported on owner's tax return [subject to rules on DCLs]
  - Direct foreign tax credits under Sec 901
  - Foreign currency gain/loss under Sec 987 / "regulations"
  - Incorporation of branch generally tax-free under "active trade or business" exception to Sec 367(a) – but taxable to extent of outbound transfers of intangibles, branch loss recapture under Sec 367(a)(3)(C), and OFL/SLL recapture under Sec 904(f)(3).
  - Conversion of wholly-owned foreign subsidiary to foreign branch of US corporation ended deferral – "all earnings and profits" amount included as deemed dividend under Reg 1.367(b)-3(b) with credits under Sec 902.

- Principal changes under TCJA
  - Foreign branch income excluded from FDII
  - Taxes attributable to foreign branch income in new Sec 904 basket
  - Sec 367(a) ATB exception repealed, and new Sec 91 replaces/expands branch loss recapture rule of Sec 367(a)(3)
  - "All earnings and profits" deemed dividend eligible for Sec 245A DRD

Exclusion of foreign branch income from FDII

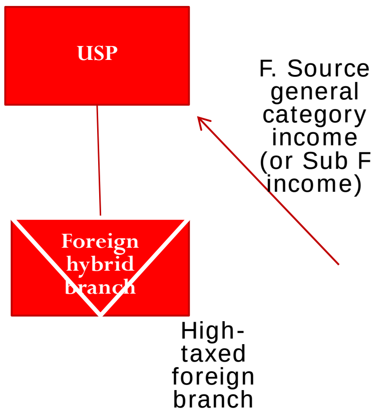


- Foreign branch income defined in IRC 904(d)(2)(J) as "business profits …attributable to" one or more QBUs in one or more foreign countries.
- QBU as defined in IRC 989 (relating to foreign currency transactions)
- Attribution of business profits to be determined under regulations.

- Q: What are the business profits attributable to the foreign QBU?

- Would the answer be different if the foreign hybrid branch engaged in solicitation/ support activities leading to the sale, but contract of sale was between customer and USP?

Foreign branch income basket for foreign tax credit

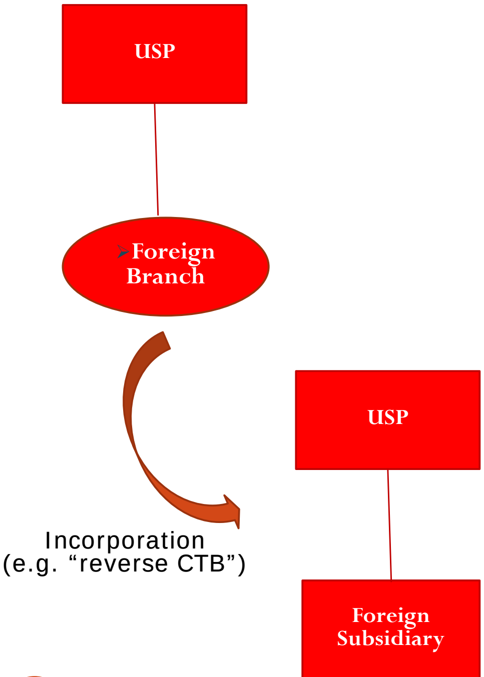


- Separate FTC basket for business profits (non passive income) attributable to a foreign branch has structuring implications.
- Legislative history sparse, but apparent purpose to avoid cross-crediting.
- Issue of FTC carryforwards attributable to foreign branch business but earned prior to effective date of TCJA changes.
- Statutory glitch: Sec 904(d)(2)(H) (income tax base differences): foreign taxes paid with respect to item that is not income for US tax purposes is assigned to 904(d)(1)(B) category, which (after TCJA) now refers to foreign branch income.

Incorporating a foreign branch

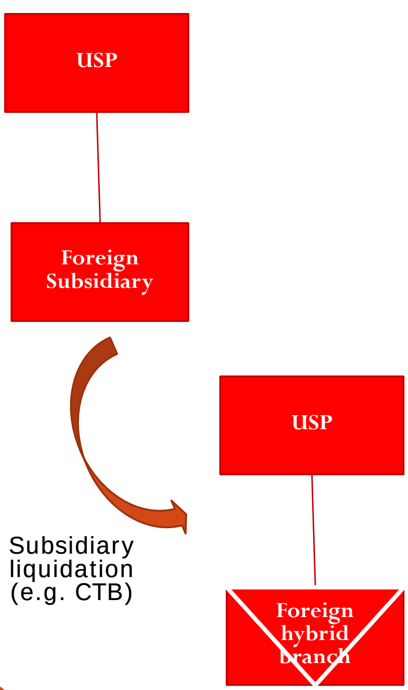
- No active trade or business exception to Sec 367(a)
- "Intangible property" (for purposes of Secs 367(d) and 482) expanded to include "goodwill, going concern value, or workforce in place…or other item the value or potential value of which is not attributable to tangible property or the services of any individual."
- Under new Sec 91, transfer by a domestic <u>corporation</u> of substantially all assets of a foreign branch to a specified 10-percent owned foreign corporation (with respect to transferor) triggers income inclusion of excess of deductible branch losses incurred after 12/31/2017 over Sec 904(f)(3) OFL recapture amount.
  - Inclusion under Sec 91 is reduced by gain otherwise recognized by transferor corporation (e.g. under Sec 367(d) or 367(a)).
  - Note that inclusion is not limited to amount of gain realized.
  - Income inclusion under Sec 91 is domestic sourced.
  - For non-corporate domestic transferors, changes to Sec 367 are relevant but Sec 91 does not apply.

Incorporating a foreign branch – *Income recognition*



- Sec 367(d) re-casts transfer of "intangible property" as sale for contingent amount.
  - Now includes goodwill, etc.
- Reg. 1.367(a) – 3 on transfers of stock by a US person to a foreign corporation continues to apply.
  - Thus, for example, if appreciated stock of a wholly-owned foreign subsidiary is transferred with the branch assets, transfer may be tax-free (subject to GRA).
  - Q: Do indirect stock transfer rules still make sense?
- Sec 367(a) gain on any other appreciated assets.
- Other considerations:
  - gain/loss on deemed termination of QBU (if functional currency of branch not USD);
  - OFL/SLL recapture (904(f))
  - DCL recapture
  - Section 91 inclusion
- Consequences for timing of incorporation

Subsidiary liquidation to form foreign branch



- Sec 367(b) continues to apply to inbound liquidations under Sec 332.
  - Under Reg 1.367(b) – 3(b)(3), USP must include in income as a deemed dividend the "all earnings and profits amount"
  - After TCJA, likely that significant portion of all earnings and profits amount will be PTI – *i.e.*, Sec 965 PTI, GILTI PTI or "traditional" PTI – thus excluded from income under Sec 959.
  - Deemed dividend amount should be eligible for DRD under Sec 245A (assuming earnings of foreign subsidiary are ECI/dividends from 10/80 companies and assuming stock of foreign subsidiary not a hybrid instrument)

  - Need to consider Sec 1059 [reduction in basis/gain by <u>untaxed portion</u> of dividend in the case of extraordinary dividends on (a) stock held < 2 years or (b) certain disqualified preferred stock]

  - Consequences for timing of liquidation.

GILTI considerations for choice of entity for foreign business

- If foreign operation conducted through CFC, US shareholders will be subject to tax on GILTI.
  - For US corporate shareholders (≥ 10% interest), indirect FTCs available under Sec 960 (after haircut to 80%).
  - FTCs attributable to all GILTI inclusions are in a single basket under Sec 904(d)(1).

- CFC vs branch operations – initial assessment
  - Income earned through foreign branch subject to full US tax without FDII benefit;
    - Direct FTCs, but in separate foreign branch basket.
  - Income earned through CFC subject to GILTI as well as Subpart F rules;
    - Indirect FTCs for US corporate parents up to 80% of foreign taxes, in GILTI basket.

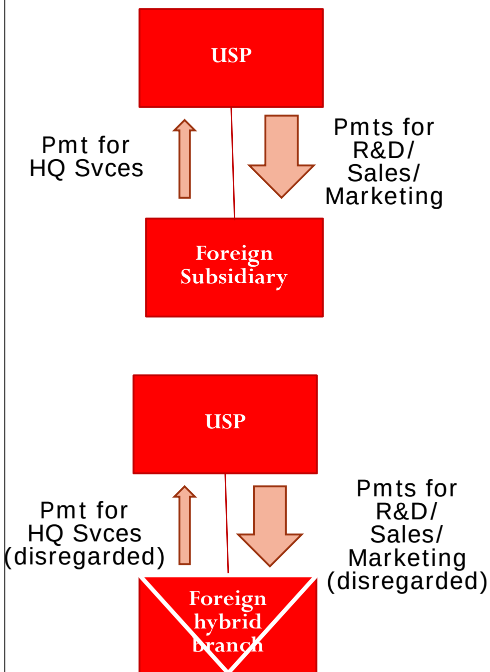
  - Incorporation of foreign branch generally fully taxable.
  - Liquidation of foreign corporation into corporate parent often tax-free.

BEAT considerations for choice of entity for foreign business

- Under Sec 59A (BEAT), an "applicable taxpayer" [*i.e.*, corporation (except for RIC, REIT, S corp) with high gross receipts and high "base erosion percentage"] is subject to additional (5% for years starting in 2018; thereafter 10%) "base erosion minimal tax" based on the amount of "base erosion payments".
  - Base erosion payments include most deductible payments to a foreign related party and payments for purchase of depreciable property.

  - Will have to await guidance on whether and when netting is allowed.
    - E.g., payments for intercompany services; intercompany loans; cost sharing.

BEAT considerations – *Example*



- In the top picture, US parent corporation engages foreign subsidiary to perform R&D services in addition to certain sales and marketing functions and pays arm's length fee for the services; foreign subsidiary in turn pays for certain headquarters services.
- In the bottom picture, there is no base erosion payment, so no BEAT liability.

- Choice of entity depends on on income earned by the foreign business, foreign taxes by basket, whether USP is applicable taxpayer, amount of base erosion payments, etc.
- No one-size-fits-all:
  - Need careful modeling with attention to unknowns
  - In the case of large foreign cost centers, higher chance that branch form yields better result.

Other considerations and summary for choice of entity for foreign business

- Under CTB regime, choice of entity for foreign operations often turned on US tax consequences.
- Still largely the case, but need to consider:
  - Increasing adoption of anti-hybrid rules
  - Increasingly assertive foreign audits
    - US competent authority may not be available in the case of tiered foreign structures
    - Broadening of definition of PE in many tax treaties (excluding US treaties) as a result of MLI OECD's BEPS project.

Choice of Debt vs Equity

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Overview of the expanded § 163(j)

- Under § 163(j), deduction for business interest expense is limited to the sum of: (i) business interest income + (ii) 30% of adjusted taxable income
  - For tax years beginning before Jan. 1, 2022, adjusted taxable income generally approximates EBITDA
  - For tax years beginning on or after Jan. 1, 2022, the limitation becomes more stringent; adjusted taxable income generally approximates EBIT
- Disallowed deductions can be carried forward indefinitely
- Exemptions for taxpayers with average annual gross receipts of $25 million or less (3-year lookback on a global basis) and certain trades and businesses (including real estate, farming and public utilities businesses). § 163(j)(3)

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Section 163(j) Notice 2018-28

- IRS and Treasury announced intent to issue proposed regulations under new section 163(j)
  - Treatment of interest disallowed under old section 163(j) and interaction with section 59A
    - Carried forward as business interest to the taxpayer's first taxable year beginning after December 31, 2017
    - Carried forward amounts will be subject to potential disallowance under new section 163(j)
    - Carried forward amounts paid to a non-US related party will be considered BEAT payments
  - No carry forward of excess limitation from old section 163(j)
  - All C Corporation interest income or expense amounts are allocable to a trade or business
  - New section 163(j) limitation applies at the consolidated group level
    - Intercompany obligations (as defined in Treas. Reg. § 1.1502-13(g)(2)(ii)) will be disregarded
    - No super-affiliation rule
  - Deferrals under new section 163(j) do not affect earnings and profits calculations for C Corporations
  - Rules for determining partnership interest income
- The 1991 proposed regulations under section 163(j) will be withdrawn
- Taxpayers may rely on the rules in Notice 2018-28 while the proposed regulations are pending

Interest Deductions: Potential Impact

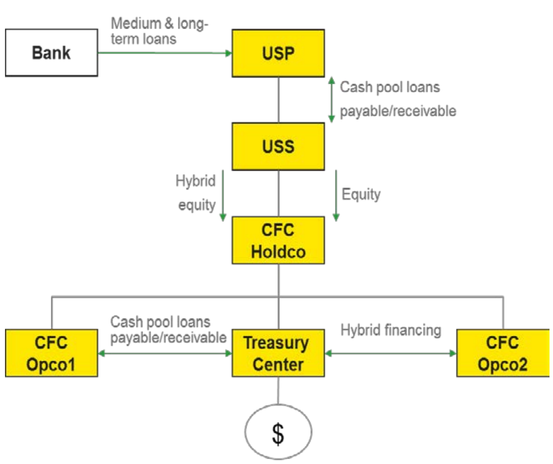
- No grandfathering rule
  - Need to immediately analyze capital structure
  - Impacts both pending and closed M&A deals
- May not affect investment grade issuers until 2022
  - Incentive to accelerate investments into pre-2022 years (pre-EBIT)
- Acquisition of highly leveraged targets, or sales of low-leverage / steady-earning businesses may cause thin cap rules to apply
- For U.S. parented groups subject to non-U.S. tax
  - May create incentive to fund investments in non-U.S. subsidiaries through debt push down and to have non-U.S. subsidiaries borrow to pay dividends

Interest Deductions: Strategies

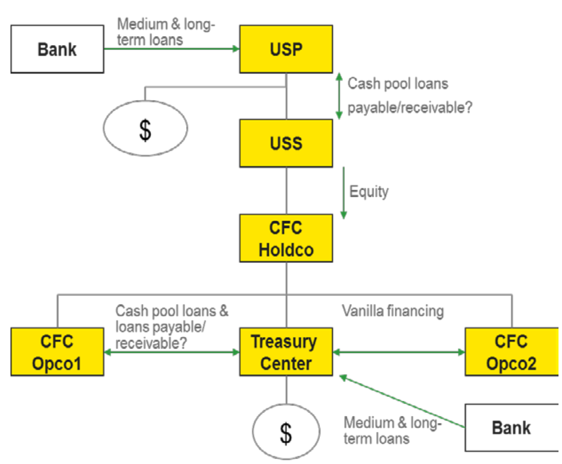
- Pay down or redeem outstanding debt
  - Potential use of repatriation cash (and to offset transition tax)
  - Advantageous in advance of EBIT rule in 2022
- Internal restructurings
  - Debt pushdowns – actual or constructive (utilizing 245A)
  - Foreign parent guarantees, co-borrower arrangements?
  - Bring foreign subsidiaries with steady earnings into the U.S. (also addresses BEAT)
  - Structuring of "exempt businesses" into nonconsolidated entities, or structuring high-earning vs low-earning business lines in a similar manner
- Change type of debt/financing used:
  - Leasing transactions; short-term debt; preferred stock
  - Convertible debt may be more attractive than high-yield on balance
- Use of swaps to hedge rates

Examples
US multinational

Typical current state

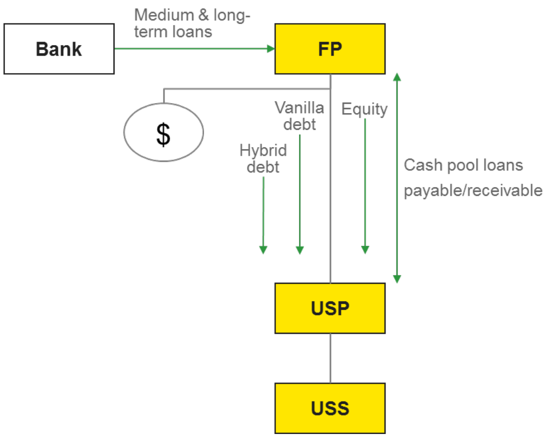


Future state?

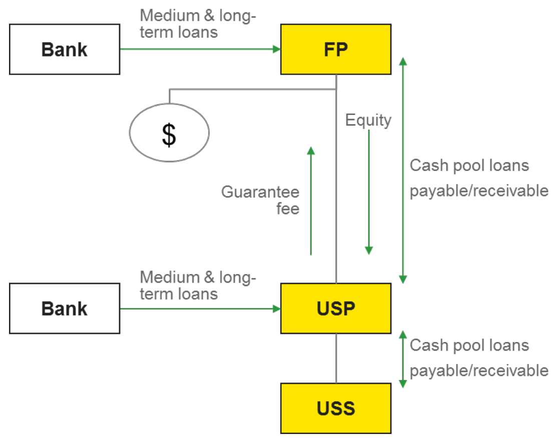


Examples
Foreign multinational

Typical current state



Future state?



New Considerations around Tax Attributes Post-TCJA

Overview

- Changes to US NOL provisions
  - No NOL carryback
  - Indefinite NOL carryforward but only eligible to offset 80% of taxable income
- Tax Basis
  - Importance of expense allocation
  - Less focus on return of capital planning
- E&P / PTI
  - 245A DRD raises 1059 considerations
- Foreign tax credits
  - Repeal of 902 and proposed regulatory repeal of 956
    - Affirmative use of Sub F for 960 credits
    - Increased focus on foreign tax savings, e.g., by way of local debt pushdown

Changes to US NOL Rules

- Old rules generally apply to pre-2018 NOLs used in post-2017 years
  - 2-year carryback (or longer in some cases); 20-year carryforward
  - Section 382 limitations
  - However, no more 90%-of-taxable-income limitation for corporations, since corporate AMT is repealed
- New rules apply to NOLs generated in 2018 and later years
  - Generally, no NOL carryback
  - Indefinite NOL carryforward but only eligible to offset 80% of taxable income
  - Section 382 basically unchanged; <u>except</u> 163(j) disallowed interest expense carryovers now treated as pre-change losses
- Unusual effective date for no-carryback / indefinite carryover rule – NOLs arising in tax years "ending after" Dec. 31, 2017

Changes to Tax Basis

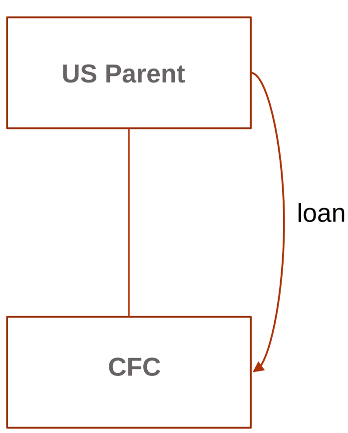
- Before 2018, tax basis in first-tier CFCs generally viewed as helpful
  - Disadvantageous in allocating expenses based on assets
  - But helpful in allowing tax-free repatriation, sec. 301(c)(2)

- After 2017, tax basis in first-tier CFCs generally unhelpful
  - Tax-free repatriation does not require special planning
  - Still disadvantageous for expense allocation purposes
  - Helpful only in sale scenario
  - Note GILTI proposed sec. 1.951A-6(e) basis reduction of tested loss CFC – occurs immediately before disposition of CFC's stock

- Solely for purposes of determining loss on sale of CFC, new 961(d) reduces basis immediately before sale by dividends subject to 245A

- PTI basis rules take on increased importance
  - 961(a)/(b) for U.S. basis in first-tier CFC
  - 961(c) for lower-tier, applies solely for Subpart F (and GILTI?) purposes

Example – Funding CFC with Debt



- Absence of capital contribution results in lower stock basis

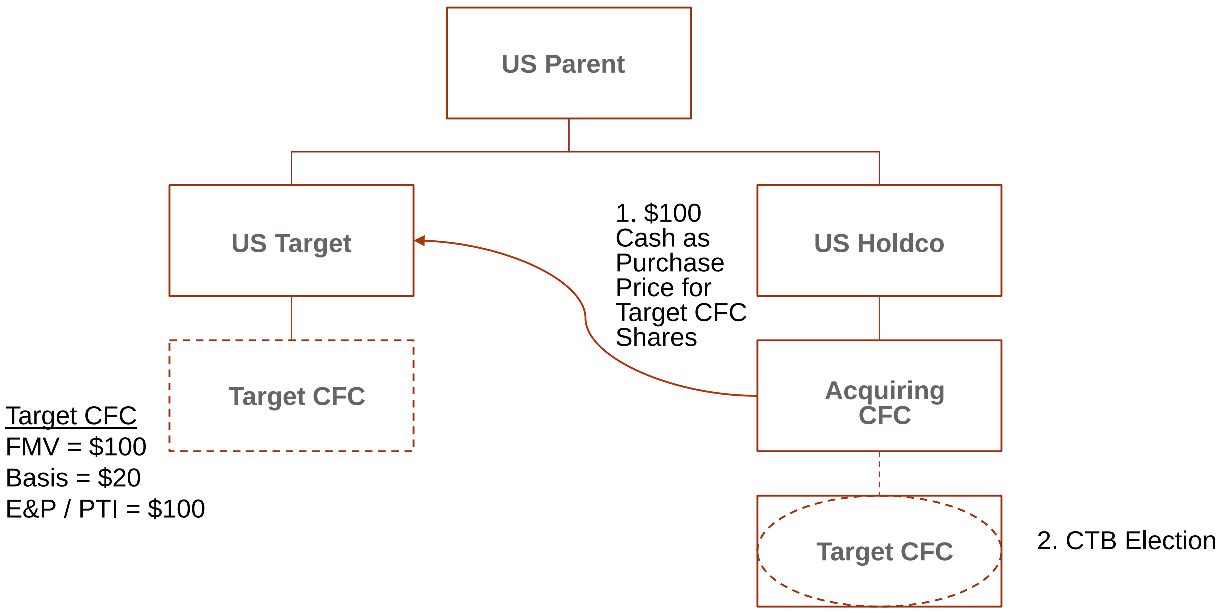
- Debt receivable is likely a foreign source asset, sec. 1.861-12T(d), but in what basket?

- Interest income flows into U.S. tax return
  - but foreign source interest income potentially frees up both FTCs and sec. 163(j) disallowed interest expense

- At CFC level, interest expense is deductible against Subpart F income and GILTI
  - but interest paid to U.S. parent and allocable to tested income reduces NDTIR

- Again, there are no "one size fits all" answers. Modeling the various impacts of debt vs. equity capitalization will be of critical importance.

Example – Basis & E&P Considerations



Key Considerations re 1059

- Gain recast as $80 dividend
  - If $80 is sourced from Target CFC's untaxed E&P
    - 245A DRD applies to $80 dividend
    - The deemed section 356 dividend is treated as a redemption under section 1059(e)(1)(B) which could be an extraordinary dividend if such redemption is not pro rata to all shareholders
  - 1059(a) produces $60 of gain ($80 DRD - $20 stock basis)?
- Pro rata redemption or non pro rata redemption under principles of Clark?
  - Pro rata if $80 dividend is sourced from Target CFC's untaxed E&P under Atlas Tool
  - Non pro rata if $80 dividend sourced from Acquiring CFC's untaxed E&P under Davant and Rev. Rul. 70-240?
  - Pro rata redemption if US Parent directly owns Target CFC and Acquiring CFC
  - PTI – avoid 245A and 1059 if the whole distribution is excluded from income under 959(a)?
- Alternative Hypotheticals
  - Assume Target CFC basis is $80
    - 1059(a) produces $20 of stock basis reduction
  - Assume Target CFC basis is $100
    - avoid section 245A and 1059(e) because no gain recast as a dividend
  - What if no CTB election? Interaction of 1059 and 304?
  - Are the results different if seller is a CFC?

Repeal of 902 (and 956?)

- Sec. 902 repeal means dividends from foreign corporations never carry indirect FTCs. Indirect FTCs are only available under 960:
  - 960(a) – with Subpart F income or 956 inclusion
  - 960(b) – with PTI distribution
  - 960(d) – with GILTI inclusion

- Except in these three cases, foreign taxes paid by a CFC (or other foreign corporation) generally are inert, and have no impact on U.S. tax liability.

- After the year it is earned, CFC E&P is also of reduced importance.
  - Untaxed E&P can be brought up under 956, with FTCs. Treasury has proposed to repeal 956 for corporate U.S. shareholders. Does Treasury have the authority to do this?
  - E&P could also have significant impact when repatriated as PTI. Sec. 986(c) gain or loss will be recognized. FTCs could be available.
  - Live E&P dividends carrying a 245A DRD will be rare.

Planning into Subpart F?

- With the U.S. tax rate at 21%, planning into Sub-F may carry certain advantages.

- The 954(b)(4) election allows the exclusion from Sub-F of income subject to a foreign tax rate of 18.9% or higher.

- Even without the election, Sub-F may be better than GILTI for some companies.
  - Subpart F income and associated FTCs are general (or possibly passive) basket, with a 10-year carryover. Non-Subpart F income generally will be GILTI, with FTCs haircut by 20% and no carryovers.
  - BEAT position must be considered. BEAT does not allow FTCs.
  - Some risk that 21% rate is temporary.

- Again, there is no "one size fits all" solution.

Anti-Hybrid Considerations

Overview of § 267A

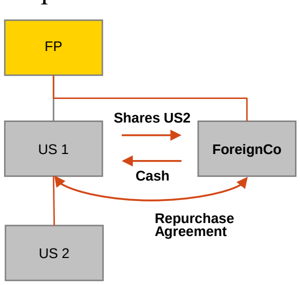
- No deduction for interest or royalty paid to any disqualified related party amount paid/accrued pursuant to a hybrid transaction or by, or to, a hybrid entity
  - A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that:
    - (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes or is subject to tax, or
    - (2) such related party is allowed a deduction with respect to such amount under the tax law of such country
  - Does not include any payment to the extent such payment is included in the gross income of a United States shareholder on a current basis

§ 267A Regulatory Authority

- The grant of regulatory authority is extensive and includes
  - denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity,
  - the application to branches and domestic entities and certain structured transactions,
  - denying all or a portion of a deduction claimed for an interest or a royalty payment that is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%,
  - denying all of a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system which provides for the exclusion or deduction of a substantial portion of such amount,
  - determining the tax residence of a foreign entity if the foreign entity is otherwise considered a resident of more than one country or of no country, and
  - exceptions to the general rule set forth in the provision

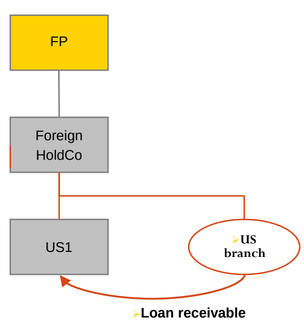
Section 267A
Common structures

Repo transactions



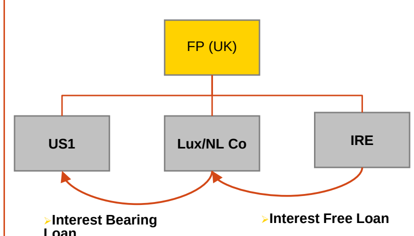
Disqualified Related Party Amount	Y
Hybrid transaction	Y
Hybrid entity	N/A
Category of regulation (1–7)	N/A

US branch structure



Disqualified Related Party Amount	Y ?
Hybrid transaction	N
Hybrid entity	N
Category of regulation (1–7)	2

Interest free loan

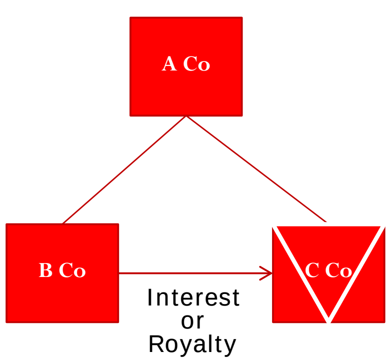


Disqualified Related Party Amount	N ?
Hybrid transaction	N ?
Hybrid entity	N
Category of regulation (1–7)	1,3,4,5 ?

ATAD and other Non-U.S. Anti-Hybrid Considerations

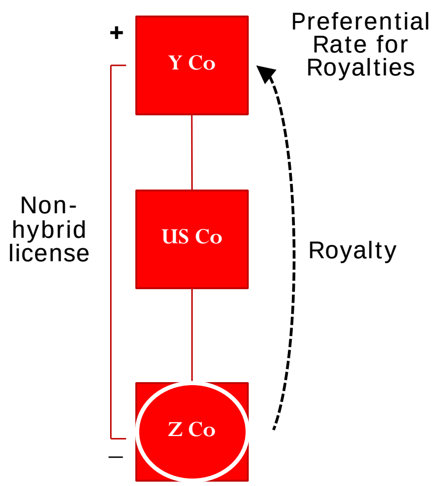
- ATAD adopted June 2016; effective January 1, 2019
- Anti-hybrid proposal presented October 2016, approved in 2017, and must generally be implemented by 12/31/2019 (effective 1/1/2020), though "reverse hybrid mismatches" delayed under 1/1/2022
- Flags concerns around "double deductions," "deductions without inclusions," or "nontaxation without inclusion"
- Can arise from hybrid entity mismatches, hybrid instrument mismatches, hybrid transfers, or hybrid permanent establishment mismatches, "imported mismatches" or dual resident mismatches
- As a result, overall scope exceeds that of 267A

§267A(d)(2) - Definition of Hybrid Entity



- Section 267A(d)(2) defines a hybrid entity as an entity treated as fiscally transparent for purposes of the tax law of the foreign country of which the entity is resident for tax purposes or is subject to tax, but not so treated for U.S. tax purposes
  - Does this definition work? Should the definition look to country of organization rather than residence since reverse hybrids are typically not tax resident in any country?
  - Does US perspective makes sense in all cases or should investor country perspective be determinative?

§267A - Connection Between Hybridity and No Inclusion



- What if all countries view as a license/royalty?
- Conference report discusses disallowing deductions where hybrid nature is what causes application of preferential regime
- What if, instead, US Co paid the royalty directly (not through Z Co DE)?

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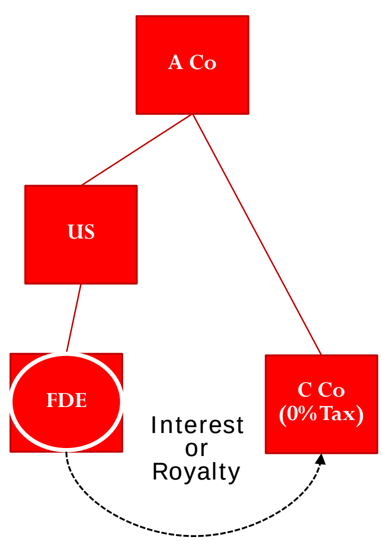
What if Payee Country Does Not Impose Any Tax?



- Does the lack of any tax imposed on the hybrid payment result in "no inclusion" by the related party under the tax laws of the jurisdiction in which it is resident?

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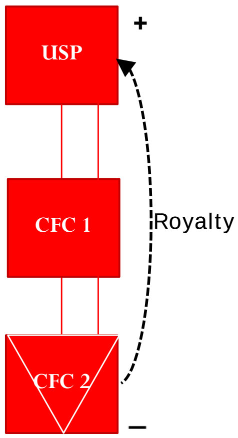
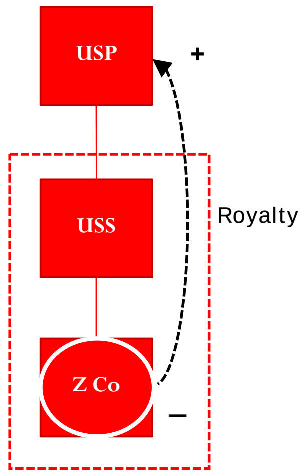
Can the U.S. be the "No Inclusion" Jurisdiction?



- If royalty is eligible for FDII deduction, does the 250A deduction turn the payment into a "disqualified related party amount" in whole or in part?



- Does USS's deduction make USP's income "no inclusion" income?
- Definition of related person
- Consider consolidated return regulation matching rule

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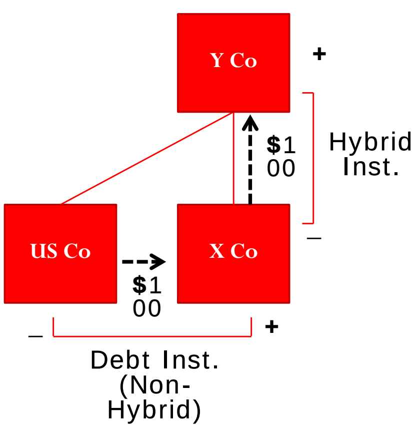
§267A - Conduit Arrangements



- What if Country Y and Country X have not adopted hybrid mismatch rules?
- Regulatory grant of authority to address conduit arrangements under section 267A(e)(1)

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