Decisions, Decisions – Capital Structures after the TCJA

TEI-SJSU High Tech Tax Institute
November 5, 2018

Nate Giesselman
Skadden, Arps, Slate, Meagher & Flom LLP

Adam Halpern
Fenwick & West LLP

Kirsten Malm
EY

John G. Ryan
Morgan, Lewis & Bockius LLP

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-

Reasons to consider corporate status:

21% corporate rate reduces "double tax" pain.

Choice of Branch or Corporate

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 [illegible]

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)

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 corporation of substantially all assets of a foreign branch to a specified 10-percent owned foreign corporation (with respect to

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 3su -50iquidation to form foreign branch

GILTI considerations for choice of entity for foreign business

If foreign operation conducted through CFC, US shareholders will be subject to tax on GILTI.

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

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 rul(-)T2nt

Choice of Debt vs Equity

19

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)

20

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)

Interest Deductions: Potential Impact

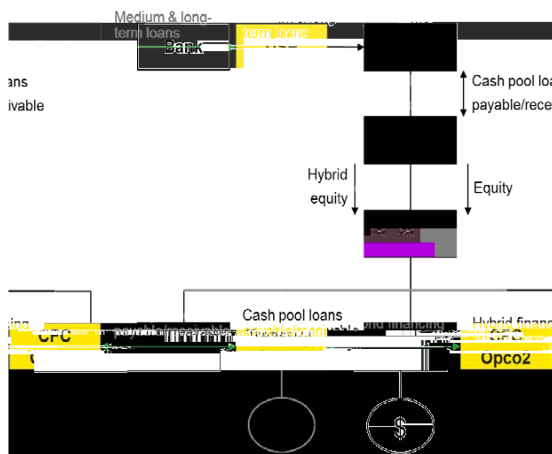
- No grandfathering rule
  - Need to immediately analyze capital structure
  - Impacts both pending and closed M&A deals
- May not affect investment grade issuers until 2022
  - Incentive to accelerate investments into pre-2022 years (pre-EBIT)
- Acquisition of highly leveraged targets, or sales of low-leverage / 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

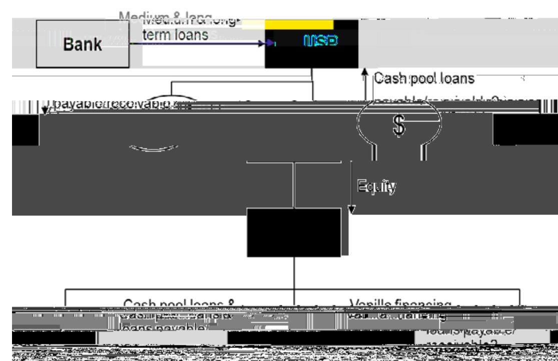
Pay down or redeem outstanding debt

Examples
US multinational

Typical current state

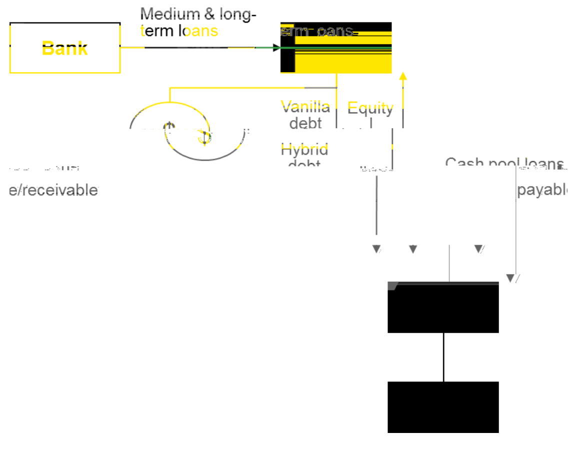


Future state?

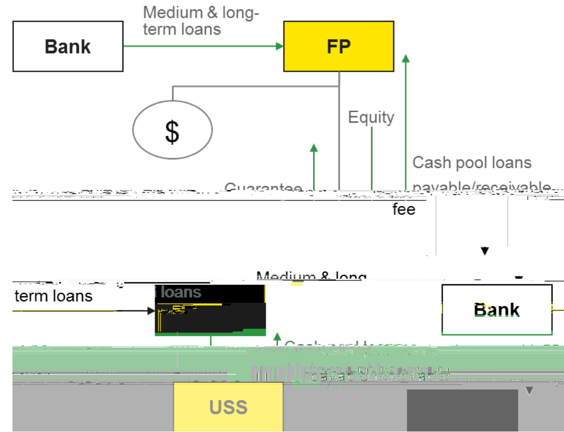


Examples
Foreign multinational

Typical current state



Future state?



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; except 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)

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 th843(ifi)3.4(r)12.8(e)0su.6(l)0ts diffIntere-3.05922.7(0 91.3(i)-)1.Interiia .8(C)1.2(FC)1304?

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

35

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

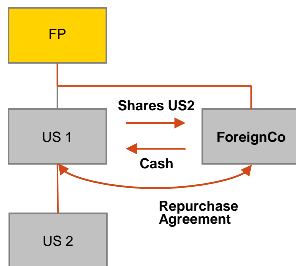
(2) such related party is allowed a deduction with respect to such amount under the tax law of such country

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

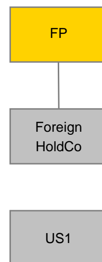
Section 267A Common structures

Repo transactions



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

US branch structure



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

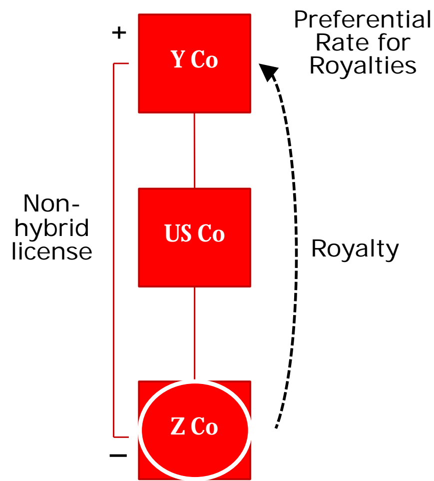
ATAD adopted June 2016; effective January 1, 2019

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"

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

§267A - Connection Between Hybridity and No Inclusion



What if all countries view as a license/royalty?

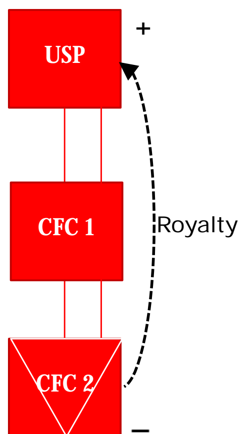
Conference report discusses disallowing deductions where hybrid nature is what causes application of preferential regime

What if, instead, US Co paid the royalty directly (not through Z Co DE)?

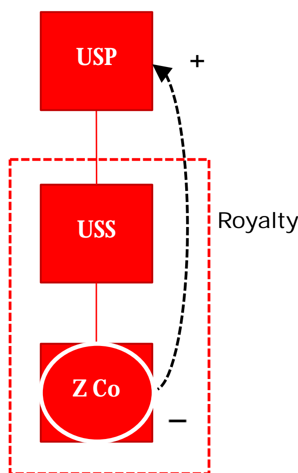
41

What if Payee Country Does Not Impose Any Tax?

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?

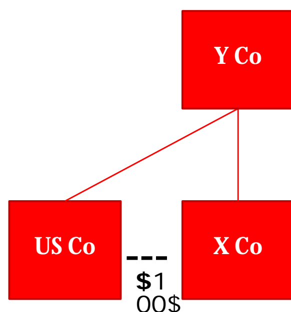


Does USS's deduction make USP's income "no inclusion" income?

Definition of related person

Consider consolidated return regulation matching rule

§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)