

With the Senate's passage of a tax reform bill, the likelihood of the enactment of comprehensive tax reform has increased although the House and Senate bills must still be reconciled in conference. Nevertheless, it is appropriate to now attempt to evaluate the effects of the proposed reform on the tax planning for inbound foreign direct investment.

Current Status – Limitation of U.S. Tax

Under present law, by virtue of the top 35% tax rate applicable to U.S. corporations, tax planning by foreign owners of U.S. corporate subsidiaries often entailed various tax strategies to limit or reduce U.S. taxable income of these subsidiaries. This was accomplished by, for example, the payment of deductible expenses (e.g., interest, royalties) to the foreign parent, often with income tax treaty rate reduction of the otherwise applicable statutory 30% withholding tax on these payments. In addition, other strategies, including IP migration and *skinny distributors* for inbound sales were employed to limit income earned by the U.S. corporation.

Key Effects of the Proposed Tax Reform

The dramatic reduction of the corporate tax rate to 20% (or so) is the bedrock provision of both bills and is unlikely to be significantly changed in conference. With this new low corporate rate enacted, much of the existing tax planning would be turned on its head. The historic preference (in most cases) for debt rather than equity financing should be reconsidered. At a 20% tax rate, it may not be advantageous to reduce the income of the U.S. corporation by leveraging its operation with debt since the tax rate in the foreign owner's jurisdiction may be higher than 20%. Debt financing may, however, still provide planning benefits since the repayment of debt principal is a way to repatriate earnings to the foreign owner without incurring tax on the payment in the owner's jurisdiction.

Under the tax reform proposals, the current law tax benefits of leverage and certain outbound payments would be significantly curtailed in many cases by several anti-base erosion provisions. These include repealing and replacing the current law *thin capitalization* interest-stripping provision with a new rule limiting the interest deduction for net business interest expense to 30% of adjusted taxable income without regard to whether the interest is paid to a related person or subject to U.S. tax. Both bills also include a global limitation that would limit interest expense deductions of domestic corporations that are members of certain groups that include companies organized outside the U.S. Use of leverage with respect to certain types of investments, however, such as qualifying real estate activities, may remain beneficial if proposed tax reform is enacted.

Payment of dividends, on the other hand, may become more attractive. The fact that dividend payments are not deductible will be less significant with the new lower tax rate and in many countries with a *participation exemption* tax system, the receipt of dividend income may be tax-free to the foreign parent.

Finally, should any form of either the House bill's 20% excise tax on certain payments to related foreign corporations or the Senate bill's 10% base erosion anti-abuse minimum tax on U.S. corporations with certain payments to foreign affiliates survive conference, this potential tax cost will need to be borne in mind in relation to the U.S. operation.

The Takeaway

The changes described above stand to significantly affect the tax planning for inbound foreign investment, and it will be necessary to rethink the traditional planning techniques previously used for such investments. Please contact us if you wish to discuss the potential effects of the pending legislation and how you can position your business to address the likely changes ahead. For more information on these bills and how it may impact other areas of taxation, please see our recent [Tax Release](#).

For further information, please contact your Andersen Tax advisor.