Tax Reform – Effects on Inbound Foreign Investment

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With the passage of the Tax Cuts and Jobs Act (the Act) into law, it is appropriate to now attempt to evaluate the effects of the reform on the tax planning for inbound foreign direct investment.

This summary focuses on the U.S. tax changes reflected in the Act to be considered by a foreign-owned U.S. enterprise that intends to conduct business activities in the United States. The summary assumes that the foreign owner is a company treated for U.S. tax purposes as a corporation and that it is entitled to the benefits of any U.S. income tax treaty existing between the U.S. and the foreign jurisdiction.

The first part of the summary details the tax changes contained in the Act bearing upon the choice of entity, its capitalization and the repatriation of its profits to its foreign owner. The second part details the changes in the Act relating to the taxation of the operation of the U.S. enterprise.

Status Under Prior Law

Under prior 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 Act Relating to Organization of U.S. Business

The dramatic reduction of the corporate tax rate to 21% is the bedrock corporate provision of the Act. 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 21% tax rate, it may not be advantageous to reduce the income of the U.S. corporation by leveraging its operation with debt, as the tax rate in the foreign owner's jurisdiction may be higher than 21% and (as noted below) some of the interest may not be deductible in certain cases. 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 Act, the current law tax benefits of leverage and certain outbound payments would be curtailed in some cases by certain new provisions. One such provision includes 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 whom the interest is paid. Use of leverage with respect to certain types of investments, however, such as qualifying real estate activities, may still remain beneficial.

Payment of dividends, on the other hand, may become more attractive—especially where the normal 30% U.S. withholding tax can be reduced or eliminated via an applicable tax treaty. 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.

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Finally, while the previously proposed 20% excise tax on certain payments to related foreign entities was eliminated, the Act also includes a base erosion and anti-abuse minimum tax applicable to certain deductible payments (and other items) incurred by a U.S. corporation to a related party that is a foreign person. The tax applies to U.S. corporations that are part of a group that has average gross receipts for a three-year period of at least $500 million and meets other conditions.

Tax Changes Related to Operations of U.S. Business

Among the changes in the Act relating to business operations are the following:

- The U.S. corporate alternative minimum tax (AMT) was repealed and net operating losses incurred after 2017 no longer expire but those losses can only offset 80% of taxable income in a year.
- There are certain limitations on the deductibility of qualified fringe benefits (i.e., entertainment expenses, meals provided to employees, transportation).
- The deduction for income attributable to domestic production activities is repealed for taxable years beginning after December 31, 2017.
- The rules governing the deductibility of compensation paid to covered employees of a publicly-held U.S. corporation (e.g., CEO, top executives) have been modified. These changes mean that the compensation deduction for all covered employees for any year in which they are a covered employee and any future year would be limited to $1 million USD.
- The expensing of 100% of the cost of new investments in qualified depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023 is permitted.

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 this legislation and how you can position your business to address the changes ahead. For more information on the Act and how it may impact other areas of taxation, please see our recent Tax Release.

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