Analysis

US tax reform: practical aspects

Speed read

US tax reform has introduced fundamental changes, including new concepts like BEAT and GILTI, tightened interest deductibility and hybrid rules. BEAT is truly novel and all companies with significant US operations should consider its effect. Its minimum tax concept is likely to be most concerning for multinational companies providing services. Meanwhile, the stricter interest deductibility rules bring the US into line with BEPS Action 4. Relatively limited hybrid rules have also been introduced. UK professionals advising businesses with large US operations should devote time to understanding the rules and work with affected businesses to analyse their impact.

Mark Saunderson
Deloitte
Mark Saunderson is an international tax partner at Deloitte, based in London, who focuses on providing UK tax advice to US headquartered multinational groups. He has worked in this field for more than 15 years, two of which were spent in Deloitte's New York office. Email: marksaunderson@deloitte.co.uk; tel: +44 20 7007 7018.

Miles Humphrey
Deloitte
Miles Humphrey is an international tax partner at Deloitte. He has over 17 years of experience advising clients on various UK tax issues, and has spent a significant part of his career in the US. Miles works with clients across all industries and specialises in cross-border tax issues. Email: milhumphrey@deloitte.com; tel: +1 212 436 6184.

A lot can change in 31 years. Back in October 1986, the Berlin Wall was still standing, Oprah Winfrey had just launched her TV show and England had recently been knocked out of the World Cup (perhaps some things never change).

October 1986 was also when President Reagan signed comprehensive reform of the US tax system into law. For the next 31 years, whilst the world changed around it, the fundamental structure of the US tax system was largely frozen.

When the 1986 reforms were enacted, the US tax system was in the vanguard of developed economies' tax systems, with features including controlled foreign corporation rules, a federal corporate tax rate of 35%, a credit system limiting double taxation on international income, and limited interest deductibility restrictions.

However, over the next 31 years most economies grew and changed their tax systems significantly, in some cases catching up with the US and in others overtaking it, with many adopting a territorial approach as compared to the US worldwide taxation system. Whilst for many years there was general agreement that the US tax system needed reform, it was only in late 2017 that this was brought to fruition.

In addition, the US's introduction of the check-the-box entity classification rules in the 1990s had a significant impact on the international tax framework, arguably contributing to the base erosion and profits shifting (BEPS) project – another driver of significant change to the international tax environment.

US tax reform was finally enacted in December 2017. As a result, UK practitioners advising clients with US operations are adapting to a new environment, with novel concepts like the base erosion anti-abuse tax (BEAT) and global intangible low taxed income (GILTI), a far lower corporate tax rate of 21%, tighter interest deduction rules, an exemption system for foreign dividends, a transition tax and various other measures.

This article focuses on the likely impact of US tax reform on larger businesses, both UK companies with US operations and US companies with UK operations.

We have focused on three of the main changes that will affect many businesses: the new concept of BEAT; the stricter interest deductibility rules; and the hybrid rules.

Base erosion anti-abuse tax

BEAT is wholly new – we are not aware of any other major tax system with anything quite like it. Its effect is to levy additional tax in the US or, potentially, to encourage businesses to change their models, such that more activity takes place in the US (also generating more US tax, with the presumed additional benefit of adding jobs).

BEAT operates by effectively introducing a minimum taxation concept, requiring many companies to perform a separate calculation of their taxable income, stripping out many cross-border intercompany payments (unless an exception applies). The resulting 'modified taxable income' (MTI) is then taxed at 5% this year (and 10% thereafter); and the result is compared to the company's regular US tax liability – with any excess being the BEAT due.

Some US commentators make the point that conceptually BEAT has some similarities with diverted profits tax (DPT). However, BEAT and DPT operate very differently. For one thing, BEAT has no interest in the amount of substance in the company receiving the payment, or in the business rationale for the transactions. Even more fundamentally, it is irrelevant how the payment is treated by the recipient country, and therefore BEAT could apply in the same way to payments made to a high tax country as to a haven.

BEAT has two main carve-outs:

- it only applies to groups with at least $500m of gross receipts in the US; and
- it only applies where the US company makes payments to related parties above a certain threshold of its total tax deductions (3% for most companies, and 2% for financial institutions).

BEAT is likely to be a key factor for groups that breach these carve-outs.

The particular impacts of BEAT to certain business models

However, BEAT will have a bigger impact on some industries than others. This is because certain payments do not need to be eliminated in calculating MTI; most notably, where payments made by US companies are classified as cost of goods sold (COGS).

There is no equivalent measure for payments made in respect of services. As a result, BEAT will be a much larger factor for companies in the services sector.

To illustrate this, consider the following:

- **A manufacturing company selling goods to customers:** A US group company enters into a contract and buys products from overseas group companies. The amounts at stake could be large; however, for the purposes of calculating the company's BEAT it should not need to eliminate the cross-border payments made to related parties, since they should be classified as COGS and should therefore meet the exception.
- **A company providing services to customers:** A US group

company enters into a contract, but in this case the company needs to subcontract part of the work to overseas group companies. Since the group follows appropriate transfer pricing policies, the US company pays for the services it receives at arm's length prices. The amounts at stake could again be large; however, because the payments will not be classified as COGS they must be eliminated from the BEAT calculation, making it more likely that BEAT will become payable.

In addition, non US-parented groups in the services sector could suffer more than US-parented groups, where their business model involves payments being made to the parent jurisdiction (for example, companies in the banking and insurance sector).

For completeness, certain types of low value support payments can be ignored if the US company is making such a payment at cost, rather than to reflect any form of profit reward for the service provider. Certain qualified derivative payments can also be ignored.

Groups affected by BEAT are likely to consider their business model and whether this could be adapted. For instance, some groups may review which group companies should contract with US customers; other groups may consider onshoring services to the US, such that payments need not be made to non-US group companies. Alternatively, if services need to be brought in from outside the US, then others may consider purchasing such services from third parties.

Given the complex business structures that exist in many groups with US operations, it is likely that a period of reflection will be needed to determine whether the current business model creates an exposure; and, if so, whether the amount at stake is material enough to encourage changes to be made.

The impact of BEAT on financing structures

In addition, amounts paid by US companies in respect of financing costs must also be eliminated in calculating MTI and therefore US businesses with interest owed to other members of the group could see a major impact. Many groups will therefore want to consider whether the financing of their US operations remains appropriate and, possibly, whether existing financing could be unwound. Alternatively, a UK parented group that made loans to US subsidiaries may consider whether the US could borrow directly from a bank and use the funds to repay the intragroup debt – this should help the BEAT position, although the interest deductibility position will still need careful review.

Enhanced interest deductibility restrictions

BEPS Action 4 relates to interest deductibility, which was given effect in the UK through the corporate interest restriction rules.

US tax reform also includes legislation giving effect to Action 4, by reissuing the existing Internal Revenue Code (IRC) s 163(j) rules. Previously, this provision had the general effect of disallowing interest where the net interest expense to related parties exceeded 50% of a US company's EBITDA (with various tax adjustments). These rules have now been significantly strengthened to reduce the maximum interest expense to 30% of adjusted taxable income (ATI), broadly equivalent to EBITDA.

In addition, the previous carve-out restricting the impact of the s 163(j) rules to interest accrued to connected parties has been removed. As a result, any interest, including interest paid to third party banks, is potentially within scope and it is therefore quite possible for a US company to be denied a deduction for bank debt. This is similar to the UK's corporate interest restrictions rules.

The 30% of ATI/EBITDA cap is also subject to a further restriction. This only applies for a few years, and for periods starting on or after 1 January 2022 the restriction will become 30% of EBIT.

Where a disallowance arises, the restricted amounts can be carried forward indefinitely, mirroring the UK. However, unlike the UK rules the US version does not contain provisions to carry forward excess capacity.

The scope of the revised IRC s 163(j) is narrower than the UK's provisions; for example, whilst the UK's definition of interest is relatively broad and includes items like debt factoring, the US's definition does not. In addition, the new rules only apply to US businesses with gross receipts in excess of $25m and do not apply to certain property and utility companies.

We would expect the effect of the IRC s 163(j) rules to result in increased disallowances for many. We would also expect disallowances to increase from 2022, as a result of the change in the cap to a percentage of EBIT. As a result of this, we expect companies to review their financing arrangements, to determine the impact of the rules. Such a review would best be conducted in tandem with a review of the BEAT position.

Introduction of the hybrid rules

The final topic for this article relates to the measures in respect of hybrids. These changes import some of the BEPS Action 2 proposals, but in a relatively limited way. The rules apply to hybrid entities and hybrid instruments where a deduction/non-inclusion or double deduction situation exists. However, they currently only have effect for interest and royalties. We use the word 'currently', since the rules provide authority for regulations to be issued to broaden the scope of the rules; for instance, such that they cover conduit arrangements or branch situations.

The overall effect of this change is to align the US with the changes being implemented by other OECD members. However, in practice the effect of these rules may be more limited than the introduction of similar rules in other countries. This is partly because their scale is quite narrow and partly because many hybrid arrangements have been caused by the US's check-the-box rules, and therefore the impact has already been dealt with by legislation that has either been implemented or has been announced (e.g. in the EU's Anti-Tax Avoidance Directive (ATAD) and ATAD II).

What should UK professionals do?

The scale of US tax reform is vast: it reflects a wholesale reimagining of much of the US international tax system, with the effect that many of the certainties that existed in the past are no longer relevant.

It is highly likely that larger businesses will already have reviewed the impact of US tax reform on their structure, particularly in respect of transition tax. However, with reform of this magnitude it is inevitable that the full effect of the changes will only become known in future months (and, possibly, years).

As a result, UK professionals working with groups with a US presence would be well advised to undertake the following:

- devote time to understanding the rules;
- work with affected businesses to analyse the implications and the potential costs of the reform; and
- consider the potential impact of changes to business models that may be proposed in light of tax reform, in order to analyse the UK tax implications. ■

▶ US tax reform: examining the Tax Cuts and Jobs Act of 2017 (Donald L. Korb & Andrew Solomon, 11.1.18)