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# *US tax reform impact on non-US headquartered companies doing business in the United States*

February 2, 2018

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## *In brief*

The 2017 tax reform reconciliation act (the Act) – the most significant overhaul of the US tax code (the Code) since 1986 – lowers corporate and individual rates, implements a territorial taxation system, limits the interest rate deduction for corporations, creates new taxes, and adds numerous new rules. Non-US headquartered companies doing business in the United States (US inbound companies) need to understand which provisions are relevant to their businesses and how these provisions will impact the cost of doing business.

While the Act reduces the corporate income tax rate to 21 percent, which is closer to the OECD average, provisions such as the base erosion and anti-abuse tax (BEAT), limitation of the interest deduction and limitation of the net operating losses (NOLs) to 80 percent of income may increase the cost of doing business in the United States. This article discusses some of the provisions in the Act and how they might affect non-US headquartered companies doing business in the United States.

For a detail explanation of the international provisions in the Act, please see *PwC's Tax Insights: [Republican tax bill will significantly impact US international rules.](#)*

For a detailed explanation covering all of the provisions of the Act, please see *PwC's Tax Insights: [Congress gives final approval to tax reform conference committee agreement.](#)*

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## *In detail*

### **Base erosion and anti-abuse tax**

While the new corporate tax rate of 21 percent appears favorable to many US inbound companies, the base erosion and anti-abuse tax (BEAT) may diminish the benefit of the rate cut.

The BEAT is a minimum tax targeting base erosion by imposing a minimum corporate

tax liability on corporations (other than a RIC, REIT or S corporation) with average annual gross receipts for the three-year period ending with the preceding taxable year of at least \$500 million and that make certain base eroding payments to related foreign persons for the taxable year of three percent (two percent for certain banks and securities dealers) or more of all their deductible expenses (other than

the net operating loss deduction, the new dividend received deduction for foreign source dividends, the new deduction for foreign-derived intangible income and the new global intangible low-taxed income, qualified derivative payments, and certain payments for services). The BEAT is effective for base eroding payments paid or accrued in tax years beginning after 2017.

The BEAT will be imposed to the extent that 10 percent (five percent for taxable years beginning in the 2018 calendar year) of the modified taxable income (generally, taxable income adding back any base eroding tax benefit plus the base erosion percentage of the NOL deduction) exceeds the taxpayer's regular tax liability over the sum of the credit allowed under Section 38 for the taxable year that is properly allocable to the research credit, plus the portion of the applicable Section 38 credits not in excess of 80 percent of the lesser of the amount of such credits or the base erosion minimum tax amount (without regard to such credits).

A base eroding payment generally is any amount paid or accrued by the taxpayer to a related foreign person that is either deductible or for acquiring property subject to depreciation or amortization and reinsurance payments. A base erosion payment will include any amount that constitutes reductions in gross receipts of the taxpayer that is paid or accrued by the taxpayer with respect to (i) a surrogate foreign corporation that is a related party of the taxpayer, but only if such person first became a surrogate foreign corporation after November 9, 2017, or (ii) a foreign person that is a member of the same expanded affiliated group as the surrogate foreign corporation. Cost of goods sold is not a deductible payment and would not be a base erosion payment, except when made to a surrogate foreign corporation (or a related foreign affiliate).

A base erosion payment will not include any amount paid or accrued by a taxpayer for services if such services meet the requirements for eligibility for use of the services cost method described in Treas. Reg. Sec. 1.482-9 (dealing with transactions between related parties) without

regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure and only if the payments are made for services that have no markup component.

**Observation:** The BEAT essentially ensures that both US corporations and non-US corporations doing business within the United States pay a 10 percent minimum tax (five percent for 2018) if they are making significant base-eroding payments. This tax will especially impact US inbound companies that have intercompany debt, rely on services from affiliates outside the United States or have intellectual property held by a foreign affiliate. Inbound companies may need to re-evaluate their supply chains and their principal structure as well as where they locate their revenue-producing intellectual property in light of this new tax. Whether through increased tax compliance costs or through restructuring costs, the BEAT represents a potential increase in the cost of doing business for US inbound companies.

#### **Interest deduction limitation**

The Act amends Section 163(j) of the Code to limit US net business interest expense deductions to 30 percent of adjusted taxable income (ATI) of the taxpayer for the taxable year. The provision would be effective for taxable years beginning after 2017.

The new Section 163(j) interest limitation broadly applies to the 'business interest' of any taxpayer (regardless of form) and regardless of whether the taxpayer is part of an 'inbound' group or an 'outbound' group. ATI is approximately equivalent to earnings before interest, taxes, depreciation, and amortization until January 1, 2022, when ATI approximately would be equivalent to earnings before interest and taxes.

Disallowed business interest expense can be carried forward indefinitely. Special rules apply to partnerships to address computation of the limitation at the partnership level and ability for excess taxable income, if any, to be passed up to the partners of the partnership.

**Observation:** Since many US inbound companies finance their US operations with debt from related parties, they may need to reevaluate their capital structure to consider minimizing the impact of the interest limitation rules. With debt carrying less of a tax benefit, alternative methods of financing may become more desirable.

#### **Restrictions related to hybrid transactions and hybrid entities**

The Act adds new Section 267A to the Code, denying a US deduction for interest and royalty payments paid or accrued by a US corporation to a related foreign party pursuant to a hybrid transaction or made by, or to, a hybrid entity, to the extent that there is no income inclusion by the foreign related party under the tax laws of its country of residence or the related party is allowed a deduction with respect to such amount under the tax laws of its country of residence. Broad regulatory authority is provided to address several other cases, including conduit arrangements that involve hybrid entities or transactions, branches structured transactions, certain tax preference items, participation regimes, and dual resident entities.

These new restrictions are consistent with the OECD's BEPS Action 2 (Hybrid Mismatch Arrangements) report on hybrid transactions. The provision would be effective for taxable years beginning after 2017.

**Observation:** The Act will eliminate current tax benefits for certain hybrid debt transactions that typically allow a US corporation a deduction for interest expense (subject to any applicable interest limitations) while the related foreign corporation typically does not have an income inclusion because the payment is viewed as a dividend (rather than interest income) and subject to low or no tax under a participation exemption regime. US inbound companies that finance their operations via hybrid transactions and/or entities will need to review their capital structure to determine how they may be impacted by these new restrictions. These new hybrid rules in conjunction with the interest deduction limitation discussed create new restrictions and costs that likely will increase the cost of doing business in the United States for global companies.

### **Mandatory repatriation toll charge**

The Act imposes a ‘toll charge’ on a US shareholder’s share of certain non-US subsidiaries’ previously untaxed non-US earnings (determined as of November 2, 2017 or December 31, 2017, whichever is higher) as part of the transition to a territorial tax system. Generally, the post-1986 earnings and profits (E&P) of a controlled foreign corporation (CFC) and certain non-CFCs with a 10 percent US shareholder will be within the scope of the toll charge. The US shareholder’s toll charge inclusion amount is treated as additional subpart F income, which may be reduced by the US shareholder’s share of any E&P deficits of certain non-US subsidiaries.

The rates are set at 15.5 percent for cash or cash-equivalents and eight percent for illiquid assets.

**Observation:** The toll charge would affect US inbound companies

operating in the United States through a US group that itself has underlying non-US operations – known as a ‘sandwich structure.’ The tax will be due regardless of a desire to make an actual dividend distribution to the US entity.

While the tax may increase the cost of doing business for US inbounds in sandwich structures, any cash brought back into the United States under the new territorial system also may allow these companies access to cash to invest further in their operations. Alternatively, these companies may find their cash ‘trapped’ in the United States under the new territorial system, and attempts to bring that cash back to its non-US parent or non-US affiliates where it may earn a higher return may incur additional tax.

### **Stock attribution**

Under previous law, non-US subsidiaries of non-US parented groups that are not held under US entities were not treated as CFCs. The Act would treat foreign subsidiaries (but not the foreign parent) of foreign-parented groups with at least one controlled US subsidiary or an interest in at least one US partnership as a CFC, even if they are not held under a US entity.

One major impact of this rule is to cause the foreign brother/sister entities of US corporations held by a foreign parent to be treated as CFCs. Although the US corporation would not be subject to a Subpart F inclusion (which still requires direct or indirect ownership), treating the foreign entities as CFC created a reporting issue.

However, the Treasury and IRS released guidance in mid-January stating reporting would not be required to the extent there was no direct or indirect US shareholder. Thus, inbound companies that are not

in sandwich structures are not required to file Form 5471 (a CFC information return) for the foreign brother/sister entities that are deemed to be CFCs under the expanded attribution rule. Accordingly, global companies doing business in the United States where there is no direct or indirect US shareholder benefit from this guidance because they will not be required to file Forms 5471 nor be subject to the fines if the forms are not filed.

### **Sale of partnership interests**

The Act adds new Section 864(c)(8), treating a foreign partner’s gain or loss from the sale or exchange of a partnership interest as effectively connected with a US trade or business to the extent the partner would have had effectively connected gain or loss if the partnership had sold all of its assets in a taxable sale at fair market value and allocated the gain or loss to the foreign partner in the same manner as non-separately stated income and loss. The Act applies to a foreign partner that directly or indirectly owns an interest in a partnership that is engaged in a US trade or business. The US Treasury is provided authority to issue regulations addressing nonrecognition transactions. Under new Code Section 1446(f), the transferee in a sale or exchange is required to withhold 10 percent of the amount realized.

New Section 864(c)(8) is effective for sales, exchanges, and dispositions after November 27, 2017. Withholding applies after December 31, 2017.

**Observation:** US inbound companies will have to pay close attention to the new withholding provision and whether additional guidance is issued. The IRS on December 29 issued Notice 2018-08, providing that withholding on dispositions of interests in publicly

traded partnerships under new Section 1446(f) is suspended until additional guidance is issued. There has been no guidance issued with respect to partnerships that are not publicly traded. Thus, while there is a statutory requirement to withhold on dispositions of non-publicly traded partnerships engaged in a trade or business, it remains unclear how to remit such amounts and what form to use.

### ***Full expensing of certain property***

The Act allows taxpayers to expense immediately the entire cost of certain depreciable assets acquired and placed in service after September 27, 2017 and before January 1, 2023 (with an additional year for certain aircraft and longer production period property). For qualified property placed in service in calendar years

2023, 2024, 2025, and 2026 (2024, 2025, 2026, and 2027 for certain aircraft and longer production period property), the applicable percentage is reduced to 80 percent, 60 percent, 40 percent, and 20 percent, respectively.

The Act also allows otherwise qualified used property that has not been used by the taxpayer at any time prior to the acquisition and that meets certain other requirements to be fully expensed. Taxpayers that do not wish to fully expense their eligible property may elect not to do so.

**Observation:** US inbound companies with significant depreciable assets in the United States likely will benefit from the full expensing provision. Additionally, this provision may create an incentive for these companies to expend more capital to expand their operations within the United States.

### ***The takeaway***

The Act creates favorable investment conditions for many non-US headquartered companies doing business within the United States through the lower corporate income tax rate and the ability to fully expense certain property. These benefits, however, may be offset at least in part by other provisions in the Act, such as the BEAT, the reduction in the interest expense deduction, and the repatriation toll charge for companies operating in a sandwich structure. US inbound companies will have to closely review their business operations and structures to determine how they may be impacted by the Act and whether appropriate restructuring could create a better return on investment.

### ***Let's talk***

For a deeper discussion of how this might affect your business, please contact :

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