Business Tax Reform All but Certain in US, Europe

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Contributing Partners

James Anderson
London

Alex Jupp
London

Sally A. Thurston
New York

Associate

Robert C. Stevenson
Washington, D.C.

Law Clerk

Karim J. Kentfield
New York

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

United States

The prospects for business tax reform in the United States were greatly enhanced by the 2016 election results. Reform under Republicans, who control both the White House and Congress, could dramatically impact the cross-border tax planning of both U.S. and foreign-parented multinational groups, requiring multinationals to rethink all aspects of their corporate structures, including capital and supply-chain structures, and the locations of their earnings and operations. Changes in the taxation of domestic and foreign corporate earnings also could facilitate M&A activity by enhancing U.S. multinationals' access to their foreign cash.

The business tax reform proposals set forth during President Donald Trump's campaign and in the House Republican proposal known as the "Blueprint" differ in certain respects but have common themes. Both proposals feature a significantly reduced corporate tax rate (15 percent under President Trump's proposal, 20 percent under the Blueprint). Moreover, both proposals include the ability to deduct capital expenses (at the price of forgoing interest deductions). Each proposes a one-time transition tax on accumulated foreign earnings — the Blueprint at 8.75 percent on earnings held in cash or equivalents and 3.5 percent on all other earnings, the Trump plan at a 10 percent rate. The Blueprint allows companies to pay the resulting tax liability over an eight-year period.

There also are important differences between the proposals. Most notably, the Blueprint imposes a tax on cash flow (not income) akin to a value-added tax (VAT) but with a deduction for wages. This "destination-based" tax exempts all foreign sales and services revenue from U.S. tax, while such revenue generated in the U.S. is subject to full U.S. tax. To this end, the Blueprint does not provide a deduction for the cost of imported goods or services nor for royalties and other payments to non-U.S. taxpayers. However, all payments to U.S. taxpayers are deductible, even if related to export sales that are exempt. These "border adjustments" would effectively tax imports while exempting exports, thus providing an incentive to locate business activities in the United States.

President Trump's proposal has no such destination-based tax or exemption. In lieu of border adjustments, Trump has proposed a 35 percent tax to be directly imposed on imports by U.S. taxpayers who move their manufacturing operations overseas. While both President Trump and Treasury secretary nominee Steven Mnuchin have indicated that "border adjustments" are too complicated, President Trump has said they remain an option. If border adjustments are not included in the Republican tax reform plan, then other means of paying for an overall reduction of rates will be necessary.

In addition, the Blueprint would introduce a territorial tax system under which 100 percent of dividends paid by foreign subsidiaries to their U.S. parents would be exempt from U.S. federal income tax. President Trump's proposal originally would have imposed an immediate 15 percent tax on all income earned by foreign subsidiaries of U.S. corporations; whether he continues to support immediate taxation is unclear.

The Trump proposal is expected to be scored by the Joint Committee on Taxation to reduce corporate tax revenues substantially on both a near- and long-term basis. The Blueprint is expected to reduce corporate tax revenues over a potentially lengthy transition period. Moreover, the Blueprint represents a fundamental departure from our existing income tax system and could benefit taxpayers in certain industries (for example, exporters of U.S.-manufactured goods) at the expense of others (for example, businesses

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such as retailers that rely heavily on imports). It is uncertain whether Congress would ultimately approve either proposal in its current form.

Kevin Brady, chairman of the House Ways and Means Committee, has said that work is currently in progress on the Blueprint, and a tax reform bill is expected to be introduced early this year. The Trump administration likely will release its own proposals at the time that it releases its fiscal 2018 budget — likely by late February or early March 2017. Assuming alignment between the Trump administration and House Republicans, a House bill would then be considered in committee in the spring or early summer. If passed by the House, it would next be reviewed by the Senate, which has not suggested its own tax reform proposals. The Senate can be expected to suggest substantial changes to anything coming from the House. Assuming the two chambers can come to an agreement in conference, it is possible that a bill could be enacted by the end of the year or early in 2018. If that timetable holds, while most aspects of the reform would likely only apply prospectively, certain provisions — notably the transition tax on foreign earnings — could take into account transactions undertaken as early as January 1, 2017. Other provisions, such as the nondeductibility of interest rate reductions and border adjustability, could be phased in over time.

The prospect for tax reform likely will slow further the pace of so-called "inversion" transactions — cross-border mergers and acquisitions using a foreign-parented structure, although certain transactions with a sufficiently compelling business case may continue to move forward. These transactions already had been impacted by recent regulatory efforts by the Treasury Department and the Internal Revenue Service to reduce or eliminate many of the tax benefits associated with them. Further, Republicans have indicated that tax reform, rather than additional punitive rules, is the best way to stop inversion. For example, Mnuchin has said that lowering rates would have a significant impact on stopping inversions. Accordingly, the fate of guidance in this area — in particular, the recently issued final regulations under Section 385 dealing with intercompany indebtedness — is unclear. (Chairman Brady already has stated that these regulations could be revoked under a Trump administration.) Until the possibility and boundaries of tax reform become more certain, taxpayers must assume these regulations will remain in place while planning for a distinctly different tax future.

Europe

Europe has started to see significant policy development and statutory implementation at national levels for initiatives aimed at increasing regulatory oversight of cross-border transactions and pushing for transparency and proposals to combat base erosion and profit shifting (BEPS). These initiatives are in relation to specific action plans created as part of the Organisation for Economic Co-operation and Development's (OECD) BEPS project and, more generally, by jurisdictions looking to curb perceived abuses in cross-border transactions. (Critics contend that such transactions aim to materially reduce the corporate tax rate.)

Notably, the European Union has gone significantly further than the OECD action plans and is channeling the widespread political interest in curbing corporate abuses to advance its long-held goal of harmonizing corporate tax rules within the EU — this, despite tax not being a designated competency for the EU. The so-called "common corporate tax base" is scheduled to be in force by 2019 and a "consolidated common corporate tax base" (CCCTB) by 2021. Additionally, the EU is aiming for a holistic solution for BEPS issues by taxing multinationals' profits specifically where value is created — payroll and the customer base.

The CCCTB seeks to remove tax competition within the EU, save for rate arbitrage, and eliminate the tax benefits of corporate entities in jurisdictions where they have no material human presence or customers. The CCCTB was developed in the same year as the EU's Anti Tax Avoidance Directive (ATAD), which, among other measures, contains significant anti-hybrid mismatch legislation aimed at strengthening tax avoidance rules. Recently proposed amendments would extend the EU anti-hybrids legislation globally, provided at least one party is EU-based. If implemented, these measures will become significant factors in the evaluation of the tax benefits of acquisitions for boards of acquiring companies, including reconsidering the traditional architecture of transactions and integration of cash flows and supply chains through tax-advantaged structures.

Also impacting the tax environment is the EU's state-aid challenges relating to multinationals' cross-border tax planning. These are a series of high-profile challenges from the European Commission in which it alleges that unfair competition has developed between businesses due to advantageous tax rulings or regimes across EU jurisdictions. The possibility of such challenges for future cross-border M&A means that companies must now consider whether their tax structuring might infringe on EU competition law. Boards also should re-evaluate their structuring to determine whether prior planning would provoke a negative stakeholder reaction if it were brought to light by a state-aid challenge.

Meanwhile, Brexit's effect on tax policy, though certain to be material, remains unclear. Much of the change to come will depend on the terms of the U.K.'s negotiations with the EU, but it looks like the government is targeting a very clean break from the trading bloc. Areas of impact for multinationals are expected to include VAT (a new U.K. system will have to be introduced) and the taxation of upstreamed dividends and interest from EU subsidiaries to U.K. holding companies. It has been argued that departure from the EU will ease issues such as state aid for preferential tax regimes and applicability of anti-abuse legislation under ATAD, but these may be superficial advantages if the terms of Britain's exit include restrictions, which are not uncommon in trade treaties, on U.K. state aid and continued maintenance of a material corporate tax regime, both of which have already been mentioned by some EU jurisdictions as the conditions of a deal. In any event, the U.K. already has instituted its own version of BEPS-related changes, such as its diverted profits tax, anti-hybrid mismatch rules, country-by-country reporting and proposed limitations on interest deductibility to 30 percent of EBITDA (earnings before interest, tax, depreciation and amortization), and it is hard to see these being quickly changed.