Key Takeaways

Skadden

Prospects for US Business Tax Reform: What You Need to Know

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On February 16, 2017, Skadden hosted a webinar titled "Prospects for U.S. Business Tax Reform: What You Need to Know." The Skadden panelists were M&A partner Stephen Arcano; global tax co-head Eric Sensenbrenner; and tax partners Sally Thurston, Nathaniel Carden and Christopher Bowers.

Overview

Mr. Arcano began the discussion with some observations about the prospects of tax reform. He noted that some form of corporate tax reform seems likely, but the impact on companies would vary depending on the specific proposal. With respect to deal activity, Mr. Arcano noted that repatriation of offshore cash could positively impact deal activity, while the potential loss of interest deductibility could affect how companies approach deal financing.

Mr. Sensenbrenner discussed the recent history of tax reform, explaining that corporate tax rate reduction is one of the principal overall goals of the proposals.

With respect to impact on mergers and acquisitions, Mr. Sensenbrenner noted that there are near-term considerations related to potential tax reform. For example, deal modeling would likely need to consider how potential tax reform impacts deal synergies, particularly where there are geographically diverse operations in companies.

Transition Tax

Mr. Sensenbrenner said tax reform is likely to include a one-time transition tax on offshore earnings at a rate lower than the corporate tax rate. Cash and cash equivalents also would be taxed at a higher rate than noncash items, and the tax could be paid over a period of years.

Mr. Sensenbrenner explained that there is an expectation that a transition tax would facilitate accessing capital trapped offshore in the short term, leading to increased shareholder earnings as well as other potential capital investments or mergers and acquisitions in the United States. He also noted that for certain companies, there may be short-term liquidity constraints as a result of the transition tax, to the extent those companies have reinvested offshore earnings in their foreign operations.

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Tax Reform Proposals

Mr. Sensenbrenner noted that there are two plans being discussed for comprehensive tax reform: the Trump administration's proposal and the House Republican proposal, known as the "Blueprint." (See chart below.) Additional proposals include a tax integration regime, shareholder-level tax reform (which would eliminate corporate tax entirely) and former U.S. House Ways and Means Committee Chairman Rep. Dave Camp's tax reform proposal.

US Tax Environment: Current Law and Reform Proposals

Policy	Current Law	Trump Proposal	House "Blueprint"
Corporate Tax Rate	35%	15%; corporate alternative minimum tax (AMT) eliminated	20%; corporate AMT eliminated
Taxation of Future Foreign Earnings	Taxed under Subpart F or when repatriated to the U.S.	Proposed immediate world-wide taxation and repeal of deferral; unclear if he still supports	Territorial system; 100% exemption for dividends paid from foreign subsidiaries
Mandatory Tax on Untaxed Accumulated Foreign Earnings	N/A	10% on all earnings	8.75% for cash and cash equivalents; 3.5% otherwise; payable over 8 years
Cost Recovery	Depreciation of plant and equipment	Election for expensing for manufacturers	100% expensing, except for land
Interest	Fully deductible	Manufacturers that elect to expense capital investment cannot deduct corporate interest expense	No current deduction allowed for net interest expense
Other Business Incentive Provisions	Permanent research and development (R&D) credit; manufacturing deductions; other provisions expiring after 2019	Generally eliminated, except for R&D credit	Generally eliminated, except for R&D credit
Foreign Tax Credit	Generally available	Generally available	No foreign tax credit (including Puerto Rican excise tax)
Other	—	35% border tax on U.S. companies manufacturing abroad but importing products for sale in the U.S.	Border adjustment

Trump Administration Plan

Mr. Bowers provided an overview of the Trump administration's tax plan, pointing out that the administration intends to issue a "Green Book" proposal in the next several weeks. Based on campaign statements, Mr. Bowers said the Trump administration plan may include (i) a corporate tax rate reduction to 15-20 percent; (ii) an election to immediately expense capital investments at the cost of losing interest expense deductions; (iii) simplification/elimination of common business tax benefits; and (iv) a border tax of 35 percent for U.S. companies manufacturing goods abroad and importing them for sale in the United States.

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Blueprint

The Blueprint would reduce corporate tax rates to 20 percent and implement a destination-based cash flow (DBCF) tax, Mr. Bowers explained. He said the DBCF tax would allow for immediate expensing of capital investments as opposed to deductions spread over a period of time, with no deduction for interest expense.

Mr. Bowers also explained that the DBCF tax would include a border adjustment, which would tax income from sales to U.S. taxpayers and allow deductions for any expenses paid to U.S. taxpayers. Furthermore, income from non-U.S. taxpayers would be excluded from the tax base, as would any expenses paid to non-U.S. taxpayers. Mr. Bowers noted that the DBCF tax would result in net operating losses (NOLs) for net exporters, while net importers would encounter high tax rates.

Blueprint Impact on Industries: Importers and Exporters

Ms. Thurston provided an overview of how industries that are reliant on imports would be affected by the House Republican proposal. She explained that the Blueprint's initial negative impact on importers is expected to be offset by the appreciation of the dollar, thereby reducing import costs to that extent. Ms. Thurston further explained that while most economists agree that there should be some dollar appreciation, whether the appreciation would fully offset increased tax costs to affected importers remains unclear. Ms. Thurston cautioned that to the extent that dollar appreciation does not actually offset the tax implications, consumers may bear the cost of the border adjustment tax. She gave an example of how the border adjustment calculation might apply to imported goods and used the example to demonstrate how the DBCF tax rendered U.S. transfer pricing issues moot.

With respect to exporters, Ms. Thurston explained that the DBCF tax could give rise to NOLs for those industries that are net exporters. She further explained that these NOLs would be carried forward with an interest factor and posed the question of whether such losses would be allowed to be monetized. Allowing NOLs to be monetized would in effect create an export subsidy. Ms. Thurston then gave an example of how the proposed tax reform treatment would apply to exported goods.

Blueprint Impact on Financial Industries

Mr. Bowers outlined the potential impact of the House proposal on the financial services industry, whose business consists of significant interest expense and interest income. Mr. Bowers explained that the Blueprint does not discuss details related to how the financial services industry would be taxed under the DBCF tax regime. He stated that further analysis was needed to determine what could constitute a "service" in the financial industry and how the border adjustment tax would apply in a nondistortive manner to any deemed "service" in the financial industry.

Prospects for Reform

Mr. Carden reiterated some of the overall goals of tax reform, including: (i) boosting U.S. competitiveness in the international arena, (ii) incentivizing behavior (*e.g.*, encouraging manufacturing in the U.S.), and (iii) simplifying the tax code.

Mr. Carden then discussed how the House proposal has several open issues. For example, the border adjustment could cause imports to be heavily taxed and exports to be undertaxed. Additionally, Mr. Carden explained that the DBCF tax could be viewed either as a value-added tax (VAT) or a modified income tax, giving rise to several considerations, including that the characterization of the DBCF tax could create uncertainty with trade agreements under the World Trade Organization (WTO). Under the existing regime, he explained, border-adjusted VATs are permissible, but income taxes that penalize imports or subsidized exports are not, so the WTO's treatment of the DBCF tax (as a VAT or income tax) could have significant trade implications. He also suggested that income tax treaties may not apply to the DBCF tax depending on whether the DBCF tax is considered an income tax. This uncertainty of characterization also creates questions as to whether the DBCF tax would be reported as income tax or as an operating expense for financial purposes.

Mr. Carden described the uncertainties related to foreign government responses to the DBCF tax and the border adjustment under the House proposal. Implementation of the Blueprint could lead to the United States becoming an attractive jurisdiction for multinational companies, which could lead foreign governments to take protective measures in response to profit-shifting.

With respect to enforcement, Mr. Carden explained that there are open issues related to the determination of where a sale takes place for purposes of the DBCF tax as well as complications in enforcing the rules.

Mr. Carden also indicated that the legislative process could impact the likelihood of tax reform enactment, thereby complicating comprehensive tax reform efforts. If comprehensive reform is not passed, Mr. Carden explained, certain specific tax reforms could be enacted, such as lowering the tax rate and/or implementing a repatriation holiday or reform.

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Impact on Markets

M&A Activity

Mr. Arcano described possible impacts of tax reform on markets. He said any reform is likely to be implemented over time, thus mitigating some of the impact.

Deal structures would likely not change dramatically in the short term, depending on the rules enacted and the timing of their enactment, he said. Potential elimination of interest deductions would impact how debt is utilized.

Mr. Arcano explained that the impact of tax reform on acquisition target valuations would be nuanced and target-specific. He suggested that before any tax reform is enacted, potential acquirers model different scenarios to determine target value based on different tax reform scenarios.

Mr. Arcano stated that mergers and acquisitions activity is not ultimately driven by tax structures but rather by business fundamentals such as the need for economic growth. Mr. Arcano said tax reform would likely advantage certain types of deals in certain industries, but the impact would likely be secondary to the fundamental economics of competitive experiences during mergers and acquisitions activity.

Capital Markets

With respect to the impact of tax reform on capital markets, Mr. Arcano noted that much of the analysis is focused on how, and over what period of time, the elimination of the deduction would be transitioned. He recommended that during and prior to any transition period of tax reform policies, companies examine the impact of the loss of interest deductions on their capital structures.

Mr. Arcano concluded the discussion by indicating that while comprehensive tax reform is likely to have an impact on market activity, the magnitude of the impact is currently difficult to determine.