How Taxpayers Are Taking To Tax Reform So Far

By **Nickolas Gianou and Sally Thurston** (August 9, 2018, 6:19 PM EDT)

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Less than a year after the most significant U.S. tax reform legislation since 1986 was signed into law, it is still too early to predict the long-term effects. A number of technical uncertainties remain and taxpayers are continuing to evaluate how best to respond to even those portions of the Tax Cuts and Jobs Act that are relatively well-understood. Many appear wary that a future administration could do away with the act's low tax rates and other incentives.

While the effects of the act on taxpayer behavior have not been as drastic as some expected, taxpayers have begun to adjust and will continue to do so as guidance is released on some of the more uncertain provisions. A number of significant trends have begun to emerge, including those outlined below.

Increase in Use of Corporations

As a result of the act's significant reduction in the corporate tax rate — from 35 percent to 21 percent — many taxpayers that previously would have chosen without hesitation to hold their businesses in pass-through form are now considering incorporating them. Under the act, most individuals and other noncorporate taxpayers are generally subject to an effective overall tax rate of 36.8 percent on income earned through a corporation, consisting of (1) at the corporate level, the new 21 percent corporate rate plus (2) at the shareholder level, the favorable 20 percent "qualified dividend" rate on dividends of the corporation's net — i.e., after-tax — earnings, if and when they are distributed. This is lower than the act's maximum 37 percent individual rate on ordinary income, not to mention that the shareholder-level tax can usually be deferred if the corporation retains its earnings rather than distributing them as dividends. Moreover, the act permits corporations — but generally not individuals — to continue to deduct state and local income taxes.

As a result, the prospect of the "double taxation" that results from holding a business in corporate form is no longer as daunting as it once was. Additionally, the simplified reporting available to corporate shareholders — who receive 1099 tax forms showing dividend income rather than complicated K-1s reporting pass-through business income — can expand the universe of investors that are willing and able to hold the entity's interests. Foreign and tax-exempt investors, in particular, generally have an easier time holding corporate stock than partnership interests.

So far, however, most taxpayers have been reluctant to pull the trigger on the corporate holding company structure. For many, the pass-through form remains the more tax-efficient option — at least through 2025 — as a result of the new 20 percent deduction for most types of pass-through business income earned by noncorporate taxpayers. Others are wary of the potential for the corporate rate to increase once again under a future administration and the difficulty of responding to such an increase, given the general inability to leave corporate solution on a tax-free basis once it has been entered. Still, a few businesses have decided to take the leap. Perhaps the most notable examples are KKR & Co. LP and Ares Management LP, two publicly traded investment management firms that have decided to convert from partnership to corporate status. The conversions are expected to allow the firms to attract new investors that were previously unwilling to buy partnership interests, thereby increasing their stock price. We expect public and private taxpayers alike to continue to evaluate closely the opportunities to incorporate.

Effects on Capital Structure

Taxpayers are rethinking their capital structures. Prior to the act, they generally had an incentive to capitalize themselves with a significant amount of debt — both third-party borrowings and, in the case of businesses held in corporate form, shareholder debt. But the act contains a number of provisions that limit the benefits of leverage, leading many taxpayers to focus more heavily on equity capitalization.

For example, new Internal Revenue Code Section 163(j) imposes significant limitations on the deductibility of interest expense. Partnerships, especially, need to closely analyze this provision, which contains a set of complex and potentially burdensome partnership-specific rules. Some partnerships that are within the scope of Code Section 163(j) have found that preferred equity is a better method of capitalization, as coupon payments on a partnership preferred equity instrument are not limited by the rules and have a similar tax profile to interest deductions.

Similarly, the reduction in the corporate tax rate has made interest deductions less valuable than prior to the act, a consideration especially relevant in the case of shareholder debt. Foreign investors, for example, commonly invest in U.S. businesses through leveraged corporate "blockers." Prior to the act, this could be efficient even if the investor was not subject to a reduced rate of withholding on interest payments under a treaty or other exemption: The 35 percent benefit of a corporate-level interest deduction was worth the cost of a 30 percent withholding tax at the shareholder level. But in light of the new 21 percent corporate rate under the act, many foreign investors that are not eligible to reduce the 30 percent withholding rate by treaty (or otherwise) have limited or forgone the use of shareholder debt in favor of — or have recapitalized existing shareholder debt into — equity. Although dividends on equity are generally subject to the same 30 percent withholding tax as interest on debt — only without the benefit of an interest deduction — equity capitalization provides more flexibility to retain earnings in advance of a potentially tax-efficient exit.

In many cases, shareholder or third-party debt leverage will continue to make sense. But we expect investors to continue to scrutinize their capital structures and, in appropriate circumstances, choose a more equity-focused structure than would have been optimal under prior law.

Effects on Deal Structure

A key tax question in any M&A transaction is whether the buyer will purchase stock or assets. Buyers typically prefer asset sales in order to obtain a basis step-up, whereas sellers often prefer stock sales so that they do not have to bear the two layers of tax that an asset sale generally triggers.

The act has eased this inherent tension between the interests of buyers and sellers in two ways. First, it has decreased the costs of an asset sale to the seller via the reduction in the corporate rate. Second, it has increased the benefits of an asset sale to the buyer by significantly expanding the ability of the buyer to deduct immediately its costs of acquiring the assets under the bonus depreciation rules. Although it is still too soon to precisely measure the act's effect on the frequency of asset sale transactions, asset sale transactions are likely to be more viable than prior to the act.

Access to Offshore Trapped Cash

The act included a mandatory one-time tax imposed on the previously untaxed earnings that U.S. corporations and certain other U.S. taxpayers had accumulated through their foreign subsidiaries since 1986. Because those earnings have been taxed, taxpayers are now free to repatriate them to the United States without incremental liability. To date, most corporations appear to be using the bulk of their repatriated earnings to fund debt service and dividend payments and stock repurchases at record levels. Anecdotally, access to previously "trapped" cash also appears to have facilitated M&A activity, particularly in the United States, since multinationals now have ready access to cash that previously could only be accessed easily for foreign acquisitions.

Impact on US Investment and Jobs

Since enactment, several large companies have announced plans for future investment in new U.S.-based facilities with associated jobs targets. In addition, the act appears to be incentivizing corporations to increase capital expenditures, likely as a result of the savings from the lower corporate tax rate and the increased ability to immediately deduct capital expenditures under the revised bonus depreciation rules.

Even so, the United States has not yet seen a significant uptick in U.S.-based manufacturing and other jobs, notwithstanding the lower general corporate rate and the other incentives in the act to create jobs — such as the favorable tax rate applicable to foreign derived intangible income, or FDII, which acts as an export subsidy. It is likely too soon to evaluate accurately the job-creating effects of the act, given the time and expense it takes to bring jobs back onshore or create new ones. Nonetheless, multinationals need a degree of certainty that the new U.S. tax system will be permanent before embarking on that kind of large-scale undertaking. Taxpayers continue to be concerned that a change in administration could result in the elimination of certain favorable benefits under the act and an increase in tax rates going forward, particularly if deficit pressures mount. In addition, although the U.S. federal corporate tax rate is now a competitive 21 percent, state and local tax rates have not decreased, meaning that the U.S. may continue to be perceived as a relatively high tax jurisdiction in which to operate, at least compared to certain jurisdictions like Ireland or the U.K. Consequently, many multinationals appear to be taking a wait-and-see approach while they evaluate what activities could be moved or developed onshore.

Uncertainty in Application

The U.S. Treasury Department and the Internal Revenue Service have made significant strides in attempting to put forth timely and helpful interpretive guidance on a myriad of cross-border and other issues arising under the act. To date, most of that guidance has centered around the transition tax, as most taxpayers were required to make a down payment toward the tax in April 2018. Treasury and IRS officials have recently discussed several regulation projects regarding the global intangible low-taxed income, or GILTI, regime, the FDII regime, the base erosion anti-avoidance tax and a number of the domestic provisions of the act, with an ambitious target of proposing regulations on a staggered basis on all of these issues throughout the summer and fall, and in any event by November 2018.

Multinationals are particularly concerned that the GILTI tax — which was understood to operate as a minimum tax on offshore low-taxed income — may not work the way it was described. Under the GILTI regime, Congress anticipated that if a foreign subsidiary was subject to local country tax at a rate less than 13 1/8 percent, a 10.5 percent rate of U.S. tax would apply on the difference and that no residual U.S. tax would apply if local country taxes are in excess of 13 1/8 percent. But in light of the complexities associated with overlaying the United States' existing foreign tax credit system onto the GILTI regime, taxpayers and the tax administration are finding that the rules do not work this way. U.S. multinationals with operations in non-U.S. jurisdictions with tax rates near or above 13 1/8 percent are fearful that they will be unable to credit local country taxes in full against their GILTI tax liability, resulting in current tax rates on those earnings that are higher than they were under prior law after taking into account the previous ability to defer U.S. tax on those earnings. In fact, the GILTI regime appears to create a perverse incentive for some multinationals to move certain offshore supply chain activities to countries that impose little or no income taxes in order to ensure that a top tax rate of 10.5 percent will apply to those activities.

Although Treasury and the IRS have been discussing this issue with many taxpayers and seem open to addressing taxpayer concerns, they may not be inclined or able to alleviate the problem in its entirety. In the meantime, taxpayers anxiously await guidance on this important topic.

To Invert or Not to Invert

The act does not appear to have incentivized non-U.S. corporations that previously engaged in inversion transactions to engage in so-called "reversions" — transactions intended to bring the tax residence of the group back into the United States — in order to take full advantage of the new U.S. regime. While there are several reasons for this, the impact of the GILTI tax, coupled with the concern that the low rates and incentives under the act may not be permanent, may be the primary causes.

Conversely, although the act contained several provisions intended to punish companies that inverted after enactment, there remains a sweet spot where a U.S. corporation can combine with a strategic merger partner under a non-U.S. parent company in a transaction that is not viewed as an inversion — where ownership by former U.S. shareholders of the U.S. company is between 50 percent and 60 percent of the combined entity — in order to ensure that the non-U.S. operations of that merger partner do not come within the U.S. tax net. Consequently, as was true prior to the act, the United Kingdom, Ireland and other jurisdictions still appear to have a tax advantage over the United States in these situations.

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