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US Tax Reform and Cross-Border M&A: Considering the Impact, One Year In

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Many of the core provisions in the Tax Cuts and Jobs Act (TCJA) — including the corporate tax rate reduction and the fundamental reworking of the U.S. international tax regime — were geared toward addressing the uncompetitive nature of the U.S. corporate tax system and its perceived role in so-called inversion transactions that had gained attention in the period leading up to the enactment of the TCJA.

With that background and a year's worth of experience under the TCJA, we can begin to assess the TCJA's impact on the structuring of cross-border M&A. The carrot-and-stick approach that the TCJA adopted with respect to inversion transactions specifically, and cross-border business activities more generally, means that the incentives driving the structuring of cross-border M&A are less certain that under pre-reform law and certainly do not point clearly in a single direction.

Ultimately, though, the TCJA's ability to fundamentally reshape the incentives driving the structure of cross-border M&A requires a global view. These drivers are not simply a function of the U.S. tax regime; they also reflect the attractiveness of the U.S. relative to other leading headquarter jurisdictions and their tax regimes. In light of broader global changes that continue to roil the international tax landscape, we appear to be facing an ongoing period of instability that will continue to shape the tax planning priorities of multinational corporations and the structuring of cross-border M&A.

Cross-Border M&A: The TCJA's Carrot-and-Stick Approach

Several new features of the U.S. international tax system introduced as part of the TCJA were meant to act as "carrots and sticks" to encourage U.S.-parented multinational companies to remain U.S.-headquartered and to locate business activity in the United States.

The largest benefit, and the centerpiece of the legislation, was the reduction of the U.S. federal corporate tax rate from 35 percent to 21 percent, bringing it more in line with the statutory rates of other member countries of the Organisation for Economic Cooperation and Development. The TCJA also provided an exemption from U.S. federal income tax for dividends received from foreign subsidiaries. In addition, the foreign-derived intangible income (FDII) regime introduced a reduced rate of tax on certain income from export sales and the sale or license of certain intellectual property to foreign persons, as part of an effort to incentivize investment in the United States and mitigate the incentives to earn income offshore.

The sticks, or possible detriments, include the new global intangible low-tax income (GILTI) and base erosion anti-avoidance tax (BEAT) regimes. GILTI is in effect an annual minimum tax imposed on U.S. parent companies with respect to much, if not all, of the earnings of their foreign subsidiaries. In concept, GILTI is intended to impose U.S. tax at a reduced rate of up to 10.5 percent on foreign income subject to low rates of foreign tax at or below 13.13 percent. In practice, given the precise mechanics of the regime, many U.S. multinational companies have come to realize that it can result in U.S. tax even on foreign income that is subject to meaningfully higher rates of local tax.

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BEAT is an alternative tax intended to mitigate erosion of the U.S. tax base by essentially imposing a minimum tax on deductible payments made by U.S. corporations to related foreign parties. Payments subject to BEAT generally include items such as interest, payments for services, royalties and depreciable assets; they generally do not include the cost of goods sold.

The TCJA also introduced a variety of changes intended to strongly discourage so-called inversion transactions (defined technically for this purpose as acquisitions by foreign corporations of U.S. corporations in which, following the acquisition, the former shareholders of the U.S. corporation own at least 60 percent and less than 80 percent of the stock of the foreign acquirer) by imposing new penalties on inverted companies. First, individual shareholders of newly inverted companies are permanently ineligible for the qualified dividend income rate of 23.8 percent on dividends received from such foreign corporations. Instead, those dividends would be taxed at ordinary rates. Second, if the TCJA's one-time transition tax on accumulated foreign earnings applied to a U.S. corporation and that corporation inverts within 10 years after enactment of the TCJA, the U.S. corporation's transition tax is recomputed at a 35 percent rate, compared to the reduced 8 percent and 15.5 percent rates that had otherwise applied.

Finally, the TCJA introduced new rules that make it more difficult to engage in post-inversion tax planning, even for U.S. corporations that inverted prior to the TCJA's enactment. For inverted companies, BEAT disallows not only deductible payments made to foreign related persons but also the cost of goods sold with respect to purchases from those related parties, potentially making BEAT far more onerous for inverted companies.

Structuring Cross-Border M&A: How Have the Incentives Changed?

If one of the goals of U.S. corporate tax reform was to put an end to inversion transactions and make the U.S. more attractive for businesses, its track record is likely to be mixed, given the features of the legislation noted above.

Many of the advantages that foreign-parented multinational groups previously enjoyed have been curtailed by the TCJA, thereby reducing the incentives to relocate to a foreign jurisdiction in the context of a cross-border M&A transaction. The reduced U.S. tax rate and dividend exemption system make it less costly to remain U.S.-parented, while the BEAT regime and new limitations on interest expense deductions reduce the benefits foreign-parented companies previously had. In addition, the inversion-specific penalties can make transactions that fall within the ambit of those rules cost-prohibitive.

But certain material advantages remain for foreign-parented companies — most notably the ability to conduct non-U.S. business operations outside the potentially onerous GILTI regime. To the extent that one of the drivers of cross-border M&A pre-TCJA was the desire to grow non-U.S. businesses outside the U.S. tax system, the TCJA may have magnified that incentive through the introduction of the GILTI regime. Furthermore, the stability of U.S. tax reform, including the long-term viability of the reduced 21 percent statutory tax rate and the beneficial reduced rate for FDII, remains a concern, particularly in light of political divisions in the United States. Given these uncertainties, U.S. companies planning to combine with a foreign company in a cross-border M&A transaction will want to carefully consider which company should be the acquirer, particularly in mergers of equals and other deals that — with careful structuring — can avoid inversion-specific penalties.

Beyond the US: Creeping Global Changes in Corporate Taxation

In the face of U.S. tax reform and ongoing political dissatisfaction with the current approach to taxation of cross-border commerce, several countries, including the United Kingdom and other European Union countries, are exploring new approaches to business taxation. These include special regimes to tax digital commerce, an increased focus on taxation that relies on market-based allocations of income, expansion of controlled foreign corporations and anti-base erosion regimes that resemble the new U.S. approach, and ongoing efforts to target perceived abuses of the current international tax structure. How these regimes develop over the next several years will drive the incentives (or lack thereof) for corporations to relocate to new jurisdictions and to structure their M&A accordingly.

The TCJA may represent a once-in-a-generation rethinking of the U.S. corporate tax system, but the global changes in corporate taxation appear to just be beginning. The uncertainty surrounding the structuring of cross-border M&A appears certain to persist.

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