KNOWLEDGE FOR ACTION

PROTECTING THE US BASE: INTEREST LIMITATIONS

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My assignment as of 10/31/2017

…participate in a session on "Economic consequences of limiting base erosion with inbound investment," where you could talk about thin capitalization rules, withholding taxes on interest, rents and royalties, and **other cool things…**

My assignment as of 12/22/2017

“new” 163(j)

Details

- Taxpayers may only deduct "net interest expense" up to 30% of a measure of income
  - It is a function of EBITDA – earnings before interest taxes depreciation and amortization thru 2021
  - But a function of EBIT – earnings before interest and taxes beginning in 2022
  - These are income measures based on the tax return - not GAAP-based financial numbers
  - Interest expense can be used without limit to shield interest income

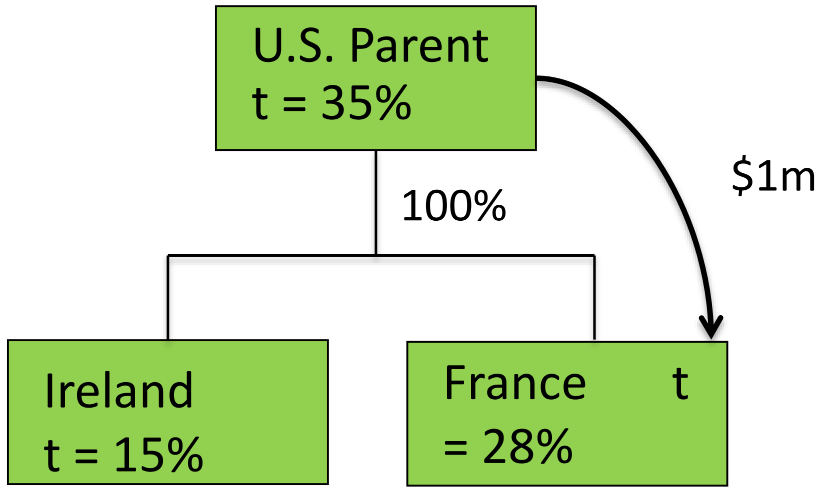
- Limitation also applies at the pass-through level rather than at the owner level as is typical of separately stated items

“new” 163(j)

- **Not a thin capitalization rule**
  - **Example**

Leverage Inside the Multinational: Part 1

France needs cash.

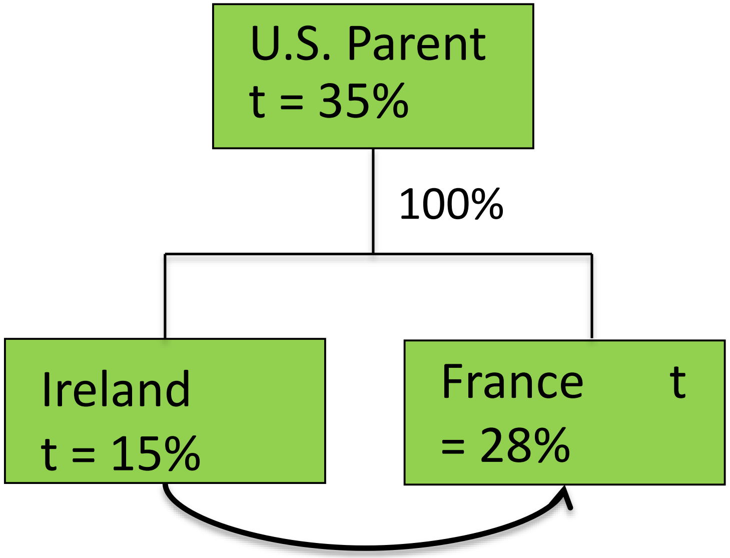


Option 1:
France borrows $1m at 5%. Results in $14K of tax savings

Option 2:
U.S. borrows $1 million and contributes capital to France. Results in $17.5K in tax savings.

Leverage Inside the Multinational: Part 2

France is fine.



$1m

Option 1:
Status quo.

Option 2:
Ireland lends $1 million to France.
Results in $6.5K in world wide tax savings.

“new” 163(j)

- Not a thin capitalization rule
  - Example
  - Some bite

Typical Thin Capitalization Regime Canada

- Limits deductions of interest payments made to certain foreign 25% or greater owners

- Ratio tests using debt to equity - 1.5: 1

- Any disallowed interest will is reclassified as a dividend
  - Depending upon treaty and ownership
    - Interest withholding tax rates – 0% or 10%
    - Dividend withholding tax rates – 5% or 15%

“new” 163(j)

- **Not a thin capitalization rule**
  - **Example**
  - **Some bite**
- **The U.S. has adopted a limit on the amount of interest that can be deducted regardless of whether the source of the debt is a related party**
- **When I read the new 163(j), it seemed so familiar…like the “Zinsschranke”**
  - **the U.S. basically adopted Germany’s interest limitation rules only with fewer “outs”**

New 163(j)	Zinsschranke
Under $25 million in gross receipts	Under €3 million in interest
Real Estate/Farming can opt out	Only applies to consolidated groups
	Safe harbor equity ratio

Potential Firm Response

- Research on changes in thin capitalization provisions suggests that firms will attempt to push the debt (or interest) into different jurisdictions.
- We also know that limits on external debt are more binding that limits on related party debt.
- But the U.S. hasn't adopted a thin cap rule. All interest – regardless of the leverage ratio – will be subject to limitations.
- Also, it is an "equal opportunity" provision. All taxpayers with U.S. investment – inbound and outbound – are going to be subject to 163(j).
- But firms may not even get to keep 30% of EBITDA/EBIT due to BEAT and GILTI

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Example of Base Erosion Anti-Abuse Tax (BEAT)

Item	Formula	US Parent
1 Gross income of US corporation		$1,000
2 Deductions allowable to US corporation		$800
3 Taxable income of US Corporation	L1-L2	$200
4 US source		$150
5 Foreign source (GILTI, subpart F, branches)		$50
6 US tax before credits	21%*L3	$42
7 Foreign tax credit		$10
8 R&E credit		$5
9 Regular US tax after credits	L6-L7-L8	$27
10 Base erosion tax benefit wrt base erosion payments[1]		$200
11 Modified taxable income	L3+L10	$400
12 10% of modified taxable income[4]	10%*L11	$40
13 Regular US tax less credits other than R&E credit[3]	L8+L9	$32
14 BEAT	Max(0,L12-L13)	$8

[1]Base erosion payments are payments to related foreign persons that result in a US tax deduction. COGS are not treated as base erosion payment except where foreign person is a surrogate foreign corporation (or related foreign person).

[2]BEAT generally does not apply if average annual gross receipts for the prior 3 years are less than $500M or base erosion tax benefit is less than 3% of deductions allowable to US corp.

[3]Research credit and capped amount of certain other general business credits are not added back to regular tax for tax years beginning after 12/31/25.

[4]The BEAT rate generally is 5% for the first tax year beginning after 12/31/17, then increases to 10% for the next 7 years, and increases again to 12.5% of tax years beginning after 12/31/25.

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Example of Calculation of US Tax on GILTI

	Item	Formula	CFC1	CFC2	US Parent No exp. Alloc.	US Parent With exp. Alloc.
1	Tested Income[1]		$200	$200	$400	$400
2	Tested Loss		$0	$0	$0	$0
3	Net CFC Tested Income				$400	$400
4	Tested Foreign Income Taxes		$25	$35.43	$60	$60
	Foreign effective tax rate on tested income	L4/(L1+L4)	*11.1%*	*15.0%*	*13.125%*	*13.125%*
5	Qualified Business Asset Investment[2]		$1,400	$200	$1,600	$1,600
5a	Int. exp. related to int. not included in tested inc.				$20	$20
6	Net deemed tangible income	(10%*L5)-L5a			$140	$140
7	GILTI	Max(0,L3-L6)			$260	$260
8	Inclusion percentage	L7/L3			65%	65%
9	Deemed Paid Credit before 20% haircut	L8*L4			$39	$39
10	Deemed Paid Credit after 20% haircut	80%*L9			$31	$31
11	Grossed up GILTI	L7+L9			$299	$299
12	50% Deduction[4]	50%*L11			$150	$150
13	Taxable income before expense alloc.	L11-L12			$150	$150
14	Expenses allocated to GILTI basket[5]				-	$50
15	GILTI for FTC limitation	L13 - L14			$150	$100
16	FTC limitation[6]	21%*L15			$31	$21
17	US tax before credit	21%*L13			$31	$31
18	Foreign tax credit[3]	Min(L10,L16,L17)			$31	$21
19	US Tax on High Return Amount	L17-L18			**$0**	**$11**

[1] Gross income reduced by ECI, subpart F income, income that would be subpart F but for high-tax exception, and FOGEI, less allocable deductions.

[2] Average of end-of-quarter adjusted bases in tangible depreciable property that generates tested income or loss, determined under ADS.

[3] A separate foreign tax credit limitation applies to GILTI income, with no carryforward or carryback of excess credits.

[4] The deduction is reduced to 37.5% for tax years beginning after 12/31/25.

[5] Interest, stewardship and research expenses allocable to income in the GILTI basket.

[6] Assumes US parent tax before credits is 21% of US parent taxable income.

Problems?

- Bad years mean no/limited interest deductions
  - But this implies a trade-off between net operating losses and deferred interest expense
  - Will deferred interest expense be subject to IRC 382?

- Large cap-ex in 2022 and beyond will limit interest

- Does this exacerbate the incentive to invest outside of the U.S.?
  - Clearly, it incentivizes firms to move excess interest abroad.
    - But isn't this exactly the point of the provisions?
  - Will lenders give the same terms to subs as parents?
  - How many firms will be constrained by the new rules?

- Silver lining – per a dollar of interest, firms are only losing on the deferral of $0.21 v. $0.35

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Questions?

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