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La Reforma Fiscal en Estados Unidos

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Agenda

- U.S. legislative process and outlook
- Options for tax reform (Trump tax proposal, House Republican Blueprint)
- Specific US tax reform provisions, if enacted, that may have the greatest potential impact on US business and inbound investors
- Modeling the impact of US tax reform proposals

US legislative process and tax reform

How a tax bill becomes a law (regular process)

Article 1, Section 7 of the U.S. Constitution states "All Bills for raising Revenue shall originate in the House of Representatives; but the Senate may propose or concur with Amendments as on other Bills."

Proposal
- A tax policy idea is proposed by the Committee or a Representative / Senator

- The proposal is analyzed and further developed with the advice and counsel of the Joint Committee on Taxation (JCT)

Drafting of a Bill
- Member or Committee staff, Legislative Counsel and JCT convert the proposal into legislative text

Representative
- Introduces bill in the House

House Ways & Means Committee
- Committee hearings are held
- Bill is marked up and possibly amended
- Simple majority needed to approve
- Bill is reported and placed on legislative calendar

Senator
- Introduces bill in the Senate

Senate Finance Committee
- Committee hearings are held
- Bill is marked up and possibly amended
- Simple majority needed to approve
- Bill is reported and placed on legislative calendar

- House Rules Committee Provides for how the bill would be considered on the House floor

House Floor
- Bill is debated and possibly amended
- Speaker must allow a floor vote
- Simple majority needed to pass

- Senate Majority Leader calls the bill up for consideration.
- 3/5 majority needed to proceed to consideration

Senate Floor
- Bill is debated and possibly amended
- 3/5 majority needed to end debate
- 3/5 majority needed to pass

House/Senate Joint Conference Committee
- A conference committee is formed to reconcile the differences between the House and Senate bills and combine the bills into an agreeable form, the conference report

House and Senate Final Vote
- 3/5 majority needed to proceed to consideration of conference report in the Senate
- Final vote and passage of conference report in each chamber
- Conference report is privileged and not subject to amendment in either chamber

President
- The President can sign bills that have been passed by both chambers into law
- The President can reject a bill with a veto; Congress can override a veto by passing the bill in each chamber with a 2/3 majority
- Once the President signs the bill (or the President's veto is overridden) it is considered enacted

Legislative paths available for tax reform in 2017

Regular legislative process	
Benefits	• Legislation can be enacted permanently • No artificial restrictions on which measures can be included
Limitations	• 60 votes needed at every step in the Senate (i.e., to begin debate, vote on amendments, vote on passage, to conference, etc).
Budget reconciliation process	
Benefits	• Requires only simple majority vote at every step in the Senate (no filibuster allowed) • Expedited consideration (time limits for amendments and overall debate)
Key Limitations	• Legislation that increases the deficit outside of the budget window (typically 10 years) is subject to automatic sunset or other measures to avoid long term deficit effect • 60-vote Senate super-majority required to waive deficit rule • Senate rules also require reconciliation to be used only to enact measures that have a fiscal effect on the federal budget

Looking back to past reform efforts

Tax Reform Act of 1986 (H.R. 3838)

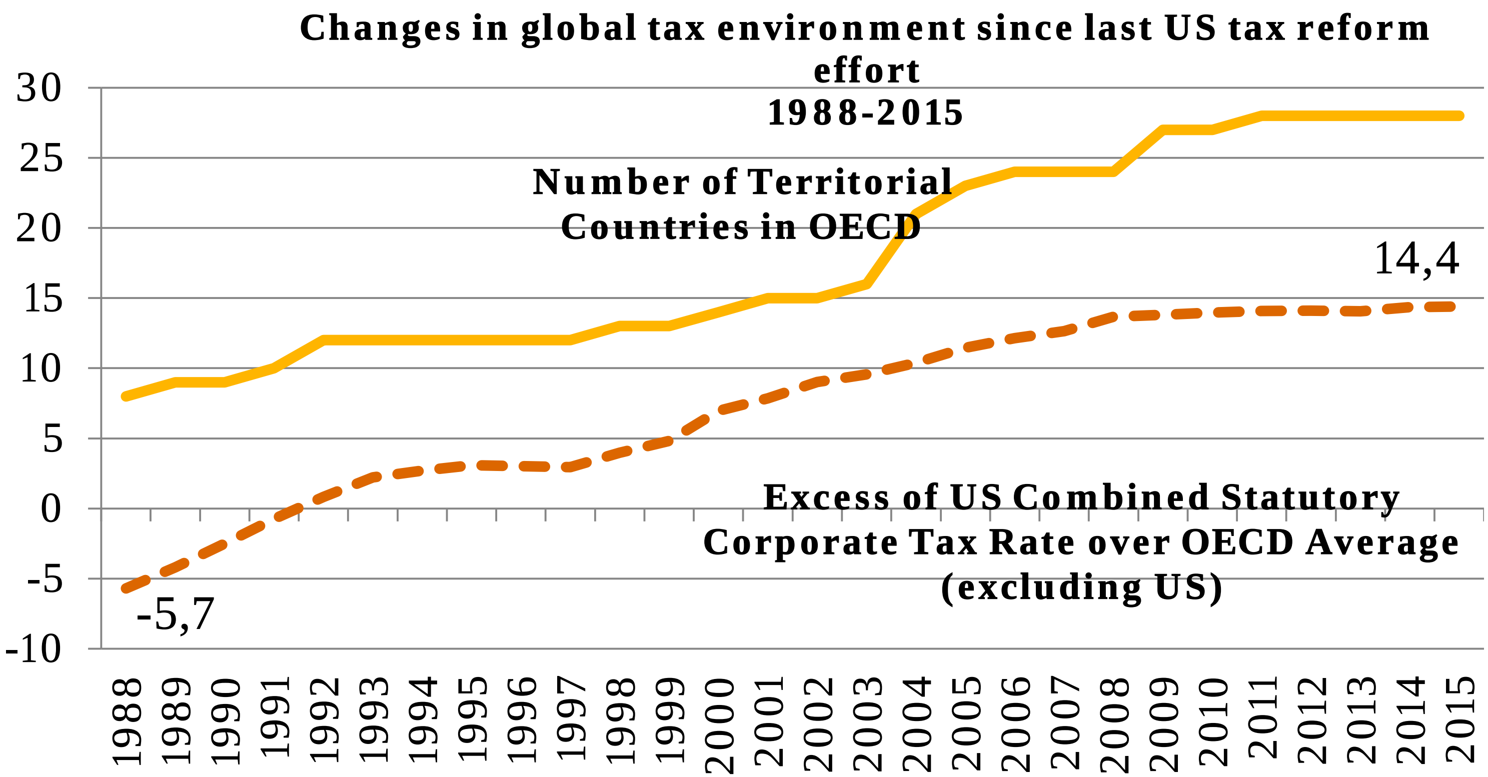
- **Treasury I - November 1984**
- Treasury II – May 1985
- Ways and Means hearings – 30 days of hearings between February and July 1985
- Ways and Means markup – 26 days of markup sessions between September and December 1985
- House passage of H.R. 3838 on December 17, 1985
- Finance Committee hearings – 36 days of hearings between May 1985 and April 1986
- Finance Committee markup – 17 days of markup sessions between March and May 1986

- Senate passage of H.R. 3838, as amended – on June 24, 1986, after 12 days of floor action
- House/Senate Conference Committee – 4 days of formal conference committee meetings between July and August 1986
- House final passage of H.R. 3838 on September 25, 1986
- Senate final passage of H.R. 3838 on September 25, 1986
- **President Reagan signs H.R. 3838 into law – October 22, 1986**

US tax reform options: compare and contrast for US businesses and inbound US investors

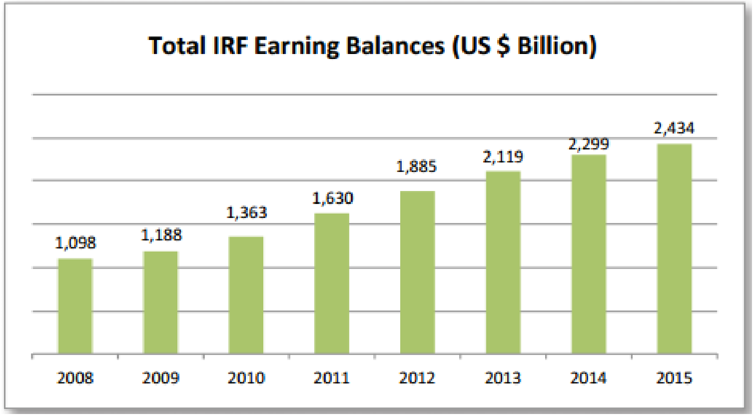
Case for US tax reform

High statutory corporate tax rate and uncompetitive international tax system



A 'perfect storm' for business tax reform?
Pre-election focus on divided government and opportunity for incremental reform

"I think the combination of Europe moving pretty aggressively on the state aid issue and the...bipartisan desire to find a way to pay for more aggressive infrastructure creates perhaps the perfect storm where you can overcome the inertia of inaction." – Treasury Secretary Jack Lew (October 6, 2016)



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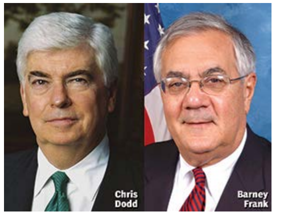
"We feel there's one catch phrase that sums up EU State aid rulings."

President-elect Trump's first 100 days agenda
Tax reform may have to compete with other Administration priorities



- Tax reform
- Health care reform (ACA repeal and replace)
- Infrastructure
- Trade (NAFTA, Trans-Pacific Partnership)
- Financial regulation (D0dd-Frank)
- Energy (Keystone pipeline)
- Environmental de-regulation
- Immigration

House GOP Blueprint
Background

- "A Better Way Forward on Tax Reform" was released June 24, 2016
  - 35-page tax reform Blueprint is a high-level overview
  - Reforms individual and corporate income tax; repeals estate and ACA taxes
  - Intended to be revenue neutral
    "*… including the positive revenue effects from the economic growth that would result from a simpler, more pro-growth tax code*"
- Represents fundamental reform of the current US income tax system:

  "*Because this Blueprint reflects a move toward a cash-flow tax approach for businesses, which reflects a consumption-based tax, the United States will be able to compete on a level playing field by applying border adjustments within the context of our transformed business and corporate tax system. … This will eliminate the incentives created by our current tax system to move or locate operations outside the United States. It also will allow U.S. products, services, and intangibles to compete on a more equal footing in both the U.S. market and the global market.*"

House GOP Blueprint

Business taxation – Domestic provisions

- **Corporate tax rate**: Reduced to 20% without phase in.
- **Corporate AMT**: Repealed.
- **Capital cost recovery**: Investments that are depreciated or amortized under present law would be expensed.
- **Interest expense**: Net interest expense would not be deductible, but would carry forward indefinitely.
- **Accounting:** Extent of cash receipts and disbursements method is unclear.
- **Inventory:** Blueprint retains LIFO and would *"evaluate options for making the treatment of inventory more effective and efficient"*
- **Banks**: Special rules would be developed for financial intermediaries.
- **Credits**: All credits repealed other than the R&D credit and (presumably) the credit for foreign taxes on any income that remains subject to US tax.
- **Sec. 199**: The domestic production activities deduction would be repealed.
- **NOLs:** NOLs would be carried forward with interest but cannot offset more than 90% of income before NOLs. No carryback.

House GOP Blueprint

Business taxation – Transition rules

- No transition rules have yet been specified for:
  - Existing basis in depreciable or amortizable property
  - Accumulated inventory
  - Interest expense on existing debt
  - Carryover of unused NOLs, GBCs, FTCs, and AMT credits
- Blueprint states:

  "a smooth transition from the current system to the new system will be necessary. The Committee on Ways and Means will craft clear rules to serve as an appropriate bridge from the current tax system to the new system, with particular attention given to comments received from stakeholders on this important matter."

House GOP Blueprint

Business taxation – International provisions

- **Territorial system**
  - Dividends from foreign subsidiaries of US corps. would be 100% exempt.
  - No limit on deduction of domestic expenses allocable to exempt dividends.
  - Presumably no credit or deduction for foreign taxes on exempt dividends.
  - Unclear how S corporations would be taxed
- **Direct foreign branches**: Not discussed, but presumably foreign branch receipts and expenses are outside of tax base.
- **Subpart F**: Repealed except for FPHCI (unclear how broadly this would apply).
- **Deemed repatriation**: Tax on accumulated deferred foreign E&P:
  - Taxed at an effective rate of 8.75% to the extent held in cash and equivalents and 3.5% otherwise. Payment of tax spread over 8 years.
  - No details are provided regarding the definition of cash equivalents or whether tax is limited to post 1986 E&P, deficits may be netted, tax is applicable to non-controlled foreign corporations, or applicable to S corps.

House GOP Blueprint

Border Adjustment Rules

- Little detail provided: *"border adjustments exempting exports and taxing imports"*
- Based on prior proposals and academic discussion, we assume border tax adjustments would work as follows, but we won't know until details are released:
  - Export receipts (products, services and intangibles) are excluded from income
    - Note: Expenses allocable to exports are deductible (unless imported)
  - Payments for imports (products, services and intangibles) are not deductible
    - Note: It is unclear how tax is collected on imports by tax exempt persons.
- Observations:
  - In general, tax base is *domestic* receipts less *domestic* expenses plus net interest income (and perhaps other portfolio investment income)
  - Many issues will need to be addressed, including treatment of Puerto Rico, foreign source interest income, military exports, international transportation, international communications, e-services, "use and enjoyment" rules, etc.
  - Economic effects discussed below.

House GOP Blueprint

Price, wage, exchange and interest rate impacts (cont'd)

Table 1. Profit and Loss Statement: Importer

Item	Tax with no border adjustment	Tax with border adjustment		
		No economic response	25% dollar appreciation	25% domestic price level increase
Revenues				
Domestic Sales	$1,000	$1,000	$1,000	$1,250
Foreign Sales	$0	$0	$0	$0
Costs				
Domestic inputs	$300	$300	$300	$375
Foreign inputs	$300	$300	$240	$300
Pre-tax income	$400	$400	$460	$575
Taxable income	$400	$700	$700	$875
Tax @ 20%	$80	$140	$140	$175
After-tax income	$320	$260	$320	$400
Pre-reform prices				$320
Effective tax rate	20%	35%	30%	30%

Trump Administration Tax Principles (as of April 26, 2017)

Corporate

- Lower the corporate rate from 35% to 15%
- Repeal the corporate AMT
- Deemed repatriation at 10% rate but subject to negotiations with Congress
- Repeal most tax expenditures other than R&D credit
- Election for US manufacturers to expense capital investment in lieu of interest deductions. Revocable within first 3 years (potentially requiring adjustment for prior years), then irrevocable

Trump Administration Tax Principles (as of April 26, 2017)

Noncorporate business

- Pass-through "small and medium size" businesses may elect 15% rate, but large pass-throughs potentially would be subject to dividend tax

Individuals

- Reduction of tax brackets from 7 to 3
- Reduction of top tax rate from 39.6% to 35% (vs. 25% and 33%)
- Repeal of AMT
- Doubling the standard deduction and higher tax credits for child and dependent care expenses
- Restoration of 20% capital gains and qualified dividends tax rate
- Repeal of the estate tax

US tax reform proposals impacting inbounds

Issues for US inbound companies

- The new reform will likely <u>fundamentally impact how foreign headquartered companies invest in the US</u>.
- Given how many variables are at play, a foreign MNC should consider <u>modeling the impact of the proposals</u> on their current structure to determine if they are better or worse off than under present law and what is driving the results.
- A foreign MNC <u>may be able to reduce adverse federal tax impacts</u> under the new reform.
- As states of the US are not required to follow federal income tax treatment in taxing businesses operating in their state, how each state will address the new federal tax reform will provide added complexity to US tax planning (as well as tax compliance) as companies <u>consider potential state impacts of these new rules.</u>

Issues for US inbound companies

Impact of loss of net interest expense deduction

- Trump plan election vs. House GOP Blueprint denial
- Treatment of pre-enactment debt?
- Impact on 385 regulations?

Issues for US inbound companies

Impact of loss of deduction for imports

- As some foreign headquartered MNCs that invest in the US may have a higher proportion of foreign inputs, the denial of a deduction for the cost of imports could have a significant impact on tax liability.
- Current supply chains, operating models and pricing strategies will need to be re-evaluated and principal functions potentially re-aligned as foreign based companies consider how to minimize the import tax under the new reform.
- Can supply chain activities be shifted to the US to avoid loss of deduction for imports?

Issues for US inbound companies

Expensing of investments

- Full expensing of tangible personal property and intangibles may have significant impact, especially around a foreign headquartered MNC's overall IP strategy, requiring evaluation of whether to on-shore IP and principal functions to the US (e.g., R&D activities).
- Can imports of capital equipment be accelerated to avoid loss of capital cost recovery?

IP Planning

- Can IP be transferred to the US to eliminate foreign tax on IP income (with no increase in US tax) and before the effective date of the Blueprint to avoid loss of amortization deductions?
- Foreign exit taxes need to be taken into account.

Issues for US inbound companies

Deemed repatriation of deferred foreign earnings

- The current worldwide tax system will be replaced with a territorial tax system and a tax on historic foreign earnings that have not previously been subject to US tax.
- <u>Foreign headquartered MNCs with foreign subsidiaries under their US groups will be subject to this repatriation tax.</u>
- Are there opportunities to reduce exposure to the deemed repatriation tax?
- <u>E&P studies and other planning to minimize E&P</u> in the foreign subsidiaries <u>may help to minimize the deemed repatriation tax</u>.

Issues for US inbound companies

Withholding taxes

- The new proposals do not address the impact of US withholding taxes on dividends, interest, royalties and other payments by the US group to its foreign parent or affiliates.
- Existing rules may continue to apply, including treaty relief where available.
- Foreign MNCs and their US groups will need to consider the cost of any US withholding taxes on their revised business model given other US deductions under the reform (e.g., interest) may not be available.

What actions should you consider?

- Re-evaluate capital structure due to net interest deduction.
- Model to evaluate the potential benefit of bringing to the US the IP, R&D and other activities in conjunction with the border adjustable tax regime;
- E&P planning (accounting method studies, restructurings, etc); minimize E&P with accounting methods to minimize deemed repatriation tax for foreign subs.
- Evaluate impact of lower tax rate vs. import penalty resulting from the border adjustable tax regime.
- Domestic accounting methods planning; accelerate deductions into higher rate years; defer revenue into lower rate years.
- Think about full expensing of intangibles for deal structuring.

Final Thoughts and Questions