TAX REFORM

UPDATE ON TAX REFORM LEGISLATION

FEBRUARY 20, 2018

“The United States is open for business!” — President Trump at Davos, Switzerland

The view from the outside looking in

The 2017 U.S. tax reform bill commonly known as the Tax Cuts and Jobs Act (the “TCJA”) provides immediate incentives for non-U.S. companies to invest in U.S. production facilities. The greater their U.S. capital investment, the more favorable the effective tax rate. And, if the investing companies select their new U.S. location strategically, they will find that state and local governments are competing against each other by offering their own tax incentives in exchange for the creation of new jobs.

The ideal candidate for these incentives is a capital-intensive business that wants its products to reach North American markets more efficiently. These businesses normally choose to form a U.S. “C” corporation through which to engage in business. Depending on their products, processes and customers, they may use multiple U.S. subsidiary corporations, and they may also use the U.S. facility as a base for export sales.

Relevant U.S. tax incentives

Reduced corporate income tax rate and simplification

The TCJA permanently reduces the federal corporate income tax rate to a flat rate of 21%. It also simplifies the U.S. tax system by eliminating the previous graduated tax rates and corporate alternative minimum tax. This means that after U.S. corporations take advantage of accelerated depreciation and various tax credits, they can actually lower the effective tax rate on IFRS or GAAP earnings below 21%.

New rules for expensing and depreciating capital expenditures

Perhaps the most dramatic tax deferral benefit of the TCJA is that from 2018 until 2022, certain types of new and used tangible personal property qualify for 100% expense treatment in the year the property is placed in service. Reduced percentages also are available if the property is placed in service between 2023–2026. Buildings and improvements do not qualify for 100% expensing, but

This newsletter is intended as an information source for the clients and friends of Nixon Peabody LLP. The content should not be construed as legal advice, and readers should not act upon information in the publication without professional counsel. This material may be considered advertising under certain rules of professional conduct. Copyright © 2018 Nixon Peabody LLP. All rights reserved.

they can be depreciated at a faster rate than under previous tax law.

The conditions which must be satisfied in order for property to qualify for 100% expensing (i.e. to be "Qualified Property") include the following:

- Qualified Property includes tangible depreciable property with a typical useful life of 20 years or less (e.g., most machinery or equipment), most computer software, and certain building improvements. If a corporation wants to claim 100% expensing on a building improvement, it may not claim an exemption from the 30% limitation on business interest expense (see below for details on the exemption).
- Qualified Property must be acquired and placed in service after September 27, 2017 and before January 1, 2027. There may not have been a binding agreement in existence on September 28, 2017, to acquire the property.
- Qualified Property must satisfy one of the following two tests:
  - The original use of the "new" property begins with the taxpayer (i.e., the new U.S. corporation); or
  - "Used" property must be acquired by the new U.S. corporation in a purchase from an unrelated third party. It may not be transferred by an affiliate in a substituted basis transaction.

Finally, the annual allowance for section 179's 100% expensing has been increased from $500,000 to $1 million and the phase-out level for 100% expensing has been increased from $2 million to $2.5 million. The definition of "qualified Section 179 property" has been expanded to include roofs, HVAC systems, fire protection and alarm systems and certain other items for non-residential property as well as beds, furniture and the like for hotels and apartment buildings.

A special provision for companies engaged in a "real estate trade or business" now enables them to waive certain accelerated depreciation benefits in exchange for an exemption from the overall limitation on the deductibility of interest expense (discussed below).

Repeal of Section 199 deduction

The TCJA repeals the Section 199 "domestic production activities deduction" after 2017. Congress believes that the substantial reduction in the corporate income tax rate will provide an even better tax incentive than the Section 199 deduction.

Interest expense deduction limitation

The TCJA imposes significant restrictions on the deductibility of interest expense. The business interest deduction is limited to 30% of EBITDA for 2018–2021, and to 30% of EBIT thereafter.[1] Any

---

[1] Generally, EBITDA means earnings before interest, taxes, depreciation and amortization and EBIT means earnings before interest and taxes. Because EBIT is calculated by taking into account adjustments

“excess interest” in a given year may be carried forward and deducted in a later year subject to the same limitations.

Corporations whose gross receipts are under $25 million (determined on a consolidated or combined basis) are exempted from these rules. It is up to the IRS to provide guidance on how the $25 million limitation will be determined, how the election to opt out of these rules will be made and what it will mean (e.g., will it be entity by entity, how long before the election can be changed, etc.).

As noted above, corporations engaged in a “real property trade or business” may elect to be exempt from the limitation on interest deductions in exchange for waiving their right to certain accelerated depreciation deductions. Obviously, the extent to which the company is debt-financed will determine whether this election is beneficial.

Limitation on Net Operating Losses (“NOLs”)

The TCJA imposes a new limitation on NOLs. NOLs can no longer be carried back but can be carried forward indefinitely. NOL carryforwards can only be used to offset up to 80% of taxable income per year.

The limitation on NOLs means that starting with the 2018 tax year, corporations cannot fully offset their taxable income with prior year losses. In effect, they will be subject to a 4.2% minimum tax rate for any profitable tax year (i.e., 21% tax on at least 20% of taxable income).

Relevant international provisions

Participation exemption system

The TCJA provides a 100% deduction for the foreign-source portion of dividends received by a U.S. corporation that owns at least 10% of the stock of the distributing foreign corporation. In order to qualify for the 100% deduction, the dividend income cannot be attributed to income that is effectively connected with a U.S. business. Furthermore, the dividend income cannot be from a domestic corporation that is 80% owned by the distributing foreign corporation. Finally, the U.S. corporation needs to hold the stock of the distributing foreign corporation for at least one year in order to qualify for the 100% deduction.

Base Erosion Anti-Abuse Tax (“BEAT”)

A U.S. corporation that makes deductible payments to foreign affiliates totalling 3% or more of

---

for depreciation and amortization (i.e., it will be a lower number than EBITDA), the amounts companies may deduct for business interest will be more constrained for tax years 2022 and thereafter.

such corporation's total deductions for the year will be subject to a 10% minimum tax on its income (calculated without regard to the deductions attributable to the related party payments).[2] The payments that might trigger the BEAT liability include interest payments, royalty payments and payments for the purchase of depreciable property.

Foreign-Derived Intangible Income ("FDII")

The TCJA imposes a 13.125% effective tax on "foreign-derived intangible income," loosely defined as income above 10% of revenue (deemed to be the normal rate of return on tangible assets). This rate will go up to 16.406% in 2026. "Foreign-derived intangible income" is a bit of a misnomer. It primarily encompasses a U.S. corporation's income from the sale of tangible goods and services abroad.

Impact on state income taxes

Because federal taxable income is the starting point for most state income tax determinations, the TCJA's provisions will automatically become effective in most states (what is known as "rolling conformity"). However, some states do not include a rolling conformity provision, so their method of calculating deductions or depreciation may be different than those enacted by the TCJA. We expect many states will change their laws in 2018 to reverse the tax reductions that result from rolling conformity. Potential foreign investors should keep an eye on each state's income tax provisions when selecting a location for their business.

For more information on the new tax law and its application to your tax equity transactions, please contact your regular Nixon Peabody attorney or:

Kenneth H. Silverberg, 202-585-8322, **ksilverberg@nixonpeabody.com**
Sean Clancy, 202-585-8332, **sclancy@nixonpeabody.com**
Frank J. Emmons, 312-977-4644, **fjemmons@nixonpeabody.com**
Shahzad Malik, 213-629-6039, **smalik@nixonpeabody.com**
Praveen Ayyagari, 202-585-8025, **payyagari@nixonpeabody.com**
Brian W. Mahoney, 585-263-1771, **bmahoney@nixonpeabody.com**

---

[2] The 10% rate applies beginning in 2019 following a 5% transition rate that applies in the 2018 tax year.