

US Tax Reform: Key Business Impacts, Illustrated With Charts and Transactional Diagrams

Appendix at pages 34-43 includes a series of transactional diagrams outlining the main structuring issues in the international context.

Key Points:

- The legislation alters fundamental aspects of US business taxation effective immediately.
- The legislation significantly affects companies across a variety of sectors.
- The changes necessitate a careful review of many existing business structures and financing arrangements as well as considerations in future structuring.

On December 22, 2017, President Trump signed into law H.R. 1, informally known as the Tax Cuts and Jobs Act¹ (the [Act](#)). The Act, the most comprehensive tax legislation in a generation, changes key features of US tax law.

This *White Paper* analyzes and illustrates aspects of the Act relating to a range of business issues and business entities, organized as indicated in the Table of Contents on page 2.

Latham & Watkins has published additional materials analyzing the impact of the Act on [leveraged finance](#), as well as how previous iterations of the Act addressed [private investment funds and asset managers](#), [executive compensation](#), and [renewable energy](#). Latham will continue to provide insights and resources, including worthwhile third-party content, through the [Latham & Watkins US Tax Reform Resource Center](#).

¹ The Act is Public Law No. 115-97. Shortly before final Congressional approval of the Act, the Senate parliamentarian ruled that the previously attached short title, the “Tax Cuts and Jobs Act,” violated procedural rules governing the Senate’s consideration of the legislation. Accordingly, the Act no longer bears a short title, although commentators likely will continue to refer to it as the Tax Cuts and Jobs Act.

Table of Contents

I. Reduced Tax Rate for Corporations.....	2
II. Reduced Tax Rates for Pass-Through Entities.....	4
III. Interest Deductibility Limitation	7
IV. Full Expensing of Costs for Certain Capital Investments	11
V. Changes Relating to Corporate Net Operating Losses	12
VI. International Tax Reform.....	13
A. Participation Exemption for Dividends from Foreign Subsidiaries	14
B. Participation Exemption on the Sale of a Foreign Subsidiary.....	15
C. Modified Subpart F/CFC Regime — Includes Minimum Tax.....	16
D. Minimum Tax on Foreign Earnings of US-Based Multinationals	17
E. Base Erosion and Anti-Abuse Tax: New Tax If a US Affiliate Engages in Transactions with a Non-US Affiliate in a Multinational Group	19
F. Taxation of Foreign-Derived Intangible Income.....	20
G. One-Time Tax on Accumulated Offshore Earnings (Section 965 Transition Tax).....	20
H. Other Important International Tax Changes	22
VII. Energy Impact	23
VIII. REITs	25
IX. Renewable Energy.....	26
X. Private Investment Funds.....	30
Appendix: International Structuring, Transaction, and Deal Negotiation Considerations	34

I. Reduced Tax Rate for Corporations

The Act permanently reduces the top corporate income tax rate from 35% to 21%. The 21% rate is effective January 1, 2018 with non-calendar year corporations subject to a blended rate for the taxable year that includes January 1, 2018. In addition, the Act eliminates the corporate alternative minimum tax (AMT).

Observations:

The reduction in the corporate income tax rate will have a number of significant business impacts, including:

- Increasing the valuation of most companies with material US operations
- Increasing the frequency and altering the structure of M&A transactions
 - A key dynamic in this regard is that corporations may now be more willing to sell assets, divisions, and subsidiaries in light of the materially reduced corporate tax leakage associated with these transactions, combined with the ability of purchasers to now access cash previously trapped offshore (see Part [VI.A](#), below) and, depending on the transaction structure, being able to immediately deduct the cost of acquired qualifying tangible property (see Part [IV](#), below).
 - In particular, sale-leasebacks may become more desirable in light of these changes along with the ability of a taxpayer to potentially replace interest not immediately deductible with deductible rent payments (see Part [III](#), below).

- Reducing the tax burden of operating in corporate form, which may impact choice-of-entity decisions
 - Under the Act, corporations are still subject to a double tax regime that potentially taxes income at a combined tax rate higher than that imposed on all other business forms. However, corporate income is now subject to only a 39.8% combined federal rate, resulting from the corporate rate of 21% combined with a 23.8% effective tax rate (20% regular dividend rate + 3.8% Medicare surtax rate) on dividends received by non-corporate shareholders (21% + 23.8% (1 - 0.21)).
 - In addition, there may be instances where the tax at the shareholder level is never imposed (e.g., tax-exempt stockholder, “qualified small business stock,” step-up at death, etc.) or not imposed for many years. As a result, the corporate form could be more tax efficient in some instances. Note also that the lower corporate rate is permanent (but with the perennial risk that the rate could be subsequently increased), while the special pass-through deduction (see Part [II](#), below) and lower individual rates are temporary.
 - The tax leakage associated with blocker corporations in private equity structures may be materially reduced (see Part [X](#), below).
 - The tax treatment of corporations has changed significantly, often favorably, under many of the new international provisions.
 - The chart at the end of this Part [I](#) illustrates business tax rates under prior law and the Act. However, the choice of entity form is very dependent on particular facts and circumstances, so taxpayers will need to continue to work closely with their tax advisers in making this decision.
- Increasing the after-tax cost of interest expense and thus potentially affecting company capital structure decisions (see Part [III](#), below)
- Putting the United States on a more competitive footing in its corporate tax rate as compared to the rates of tax imposed by other OECD countries
- Diminishing the value attributed to previously incurred net operating losses (NOLs) and other deferred tax assets

Figure 1: Comparison of Prior Law and Post-Act Federal Effective Tax Rates Applicable to Corporations and Pass-Through Entities*				
	Prior Law		The Act	
	Corporations	Pass-Throughs	Corporations	Pass-Throughs
Business Income	\$100	\$100	\$100	\$100
Deductions	-	-	-	Up to 20%
Taxable Income	\$100	\$100	\$100	\$80
Tax Rate	35%	39.6%	21%	37%
Entity Net Income	\$65	\$60.40	\$79	\$70.40
Tax Rate on Distributed Income	20%	-	20%	-
Owner Net Income	\$52	\$60.40	\$63.20	\$70.40
Effective Tax Rate	48%	39.6%	36.8%	29.6%

* Figure 1 omits the impact of the 3.8% Medicare surtax, which applies to corporate and REIT dividends and, in some cases, pass-through income (such as that relating to a passive activity). It is assumed that the owners are not corporations.

II. Reduced Tax Rates for Pass-Through Entities

Historically, income earned by both pass-through entities (such as partnerships and S corporations) and sole proprietorships was taxed at the rate applicable to their owners, regardless of whether such income was business or investment income. As such, the tax rates applicable to such “pass-through income” for non-corporate owners would otherwise be unaffected by the Act’s reduction in the corporate tax rate from 35% to 21%. However, one of the key premises of the Act is that corporate and non-corporate business income should be treated more similarly, and to effectuate that premise the Act adopts an entirely new Section 199A,² which provides a special deduction for certain types of pass-through income, as follows.

Under the Act, individuals (as well as trusts and estates) are generally allowed to deduct up to 20% of “qualified business income” (QBI) from a partnership, S corporation, or sole proprietorship (and hence for individuals who will now pay tax at the new top marginal rate of 37%, the deduction generally results in a top 29.6% tax rate on QBI).³ QBI generally means income with respect to a taxpayer’s conduct of a trade or business within the US, but it excludes various types of investment income, as well as compensation income.⁴ The provision is generally applied at the partner/shareholder level, and it sunsets on December 31, 2025.

The Act contains various limitations on the pass-through deduction. Specifically, for a given taxpayer, (a) losses with respect to one business appear to generally reduce the amount of the pass-through deduction otherwise available with respect to other businesses and (b) net loss for all businesses for a given year carry over and thereby may reduce the pass-through deduction for the succeeding year. In addition, the

² All references to “Section” are to sections of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated.

³ The foregoing percentages do not take into account the possible application of the 3.8% Medicare surtax.

⁴ Specifically, the Act excludes reasonable compensation paid by the business to the taxpayer, any guaranteed payment paid to a partner for services rendered with respect to the business, and (to the extent provided in regulations) any amounts paid or incurred by a partnership to a partner who is acting other than in his or her capacity as a partner for services.

pass-through deduction for a given year is generally limited to 20% of the excess of the taxpayer's taxable income for the year over any net capital gain for the year.

The Act contains two additional types of limitations on the pass-through deduction, limitations which phase in only above certain income levels.⁵ The first limitation excludes income with respect to certain personal services businesses (including health, law, accounting, consulting, actuarial science, the performing arts, athletics, and various investment and financial services, as well as any business in which the principal asset is the reputation or skill of one or more of its employees) or the performance of services as an employee. The second limitation restricts the amount of the deduction for a given business to the greater of (a) 50% of the W-2 wages paid by the business or (b) the sum of (i) 25% of the W-2 wages paid by the business and (ii) 2.5% of the unadjusted basis immediately after acquisition of certain tangible depreciable property held by (and available for use in) the business at year-end and for which the depreciable period has not ended. Thus, for a given business, both the amount of wages paid to employees in that business and the amount of capital invested in depreciable property will be key governors on the amount of the pass-through deduction available with respect to that business.

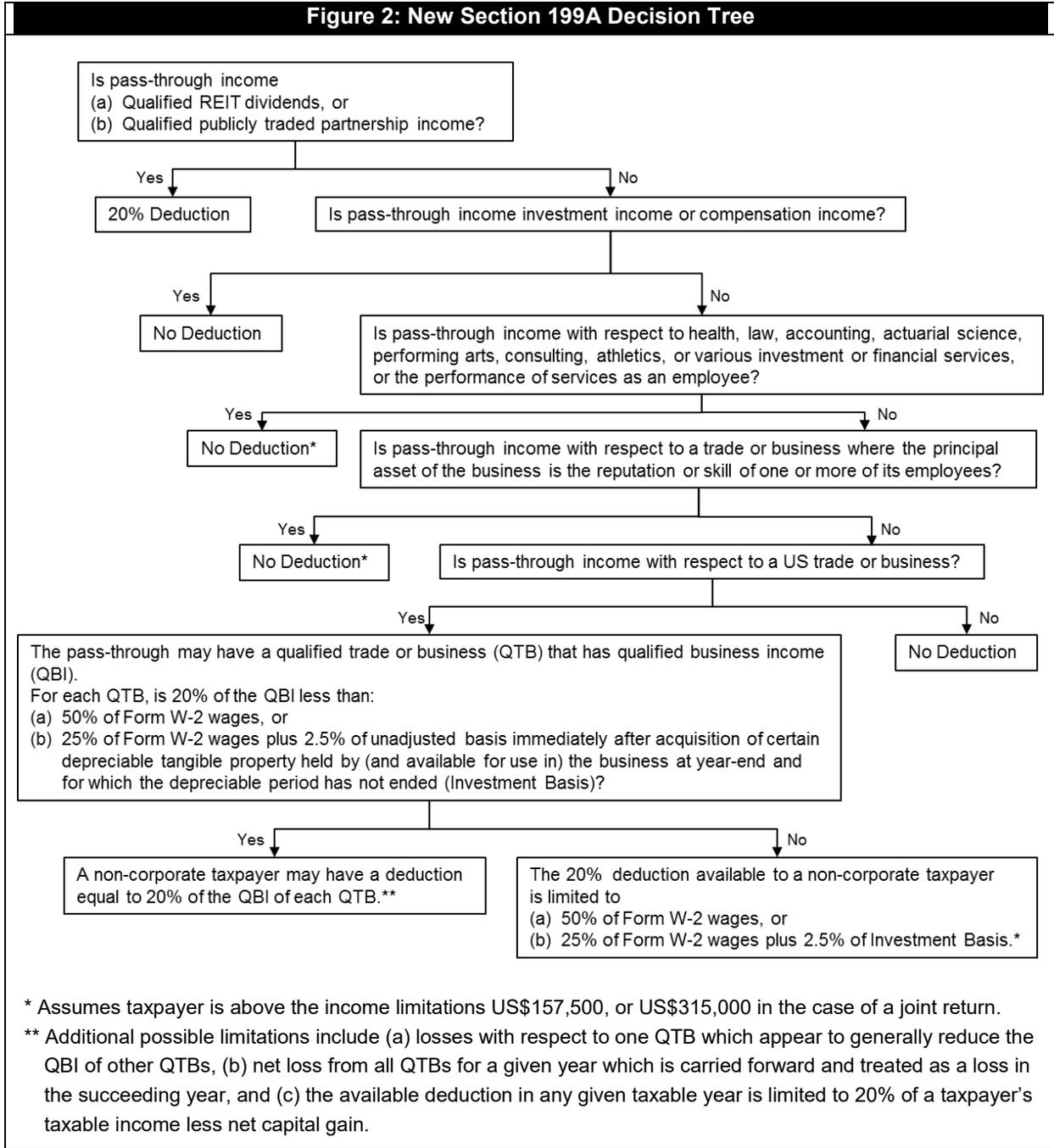
Finally, in addition to the 20% pass-through deduction described above, new Section 199A also permits a deduction for 20% of a taxpayer's "qualified REIT dividends" as well as 20% of a taxpayer's "qualified publicly traded partnership income." Significantly, these components are not subject to the limitations set forth above based on the amount of wages paid or the amount of capital invested (see Parts [VII](#) and [VIII](#), below).

Observations:

Although the Act meaningfully lowers the top rate on qualified non-corporate business income to 29.6% as noted above, this rate remains well above the new corporate rate of 21%. By comparison, prior to the Act, the top rate on pass-through income was the top individual rate of 39.6% as compared to the corporate rate of 35%. The increased differential that now exists between corporate business income and non-corporate business income could potentially incentivize certain businesses to consider operating in a corporate form. Having said that, the foregoing does not take into account the second level of tax that exists when cash is extracted from a business operating in corporate form (see Part [I](#), above).

The change in rates generally under the Act, including the new pass-through deduction, may necessitate some rethinking of the tax distributions provisions often contained in partnership agreements (as well as in credit agreements for partnership borrowers). These provisions are generally drafted to use the highest combined maximum federal, state, and local individual tax rate to determine the amount of permitted tax distributions. However, these provisions were drafted in an environment where the top individual tax rate was 39.6%, the top corporate rate was 35%, and state and local taxes were deductible, and so the differences between individual and corporate rates in various jurisdictions were not especially significant. Now, however, the top individual tax rate is 37% (or possibly 29.6% to the extent the pass-through deduction is available for a given partner), the top corporate rate is 21%, and the deductibility of state and local taxes for individuals is significantly limited — all of which together could result in greater overpayments to certain partners compared to the traditional approach of using the highest combined individual rate to calculate tax distributions for all partners (see Part [I](#), above).

⁵ The threshold amount is US\$157,500 (or US\$315,000 in the case of a joint return). The phase-in occurs proportionately as taxable income exceeds the threshold by US\$50,000 (US\$100,000 in the case of a joint return).



For the impact of changes to the taxation of pass-through business income on private investment funds and asset managers, see Part X, below. For further discussion of the legislation's impact on tax distribution provisions, see Latham's December 2017 *Client Alert*, [US Tax Reform: Opportunities and Challenges for Leveraged Finance](#).

III. Interest Deductibility Limitation

The Act limits interest deductibility for corporations and pass-through entities by imposing a 30% cap on net business interest, effective for taxable years beginning after December 31, 2017. There is no grandfathering provided for existing debt and no transition period.

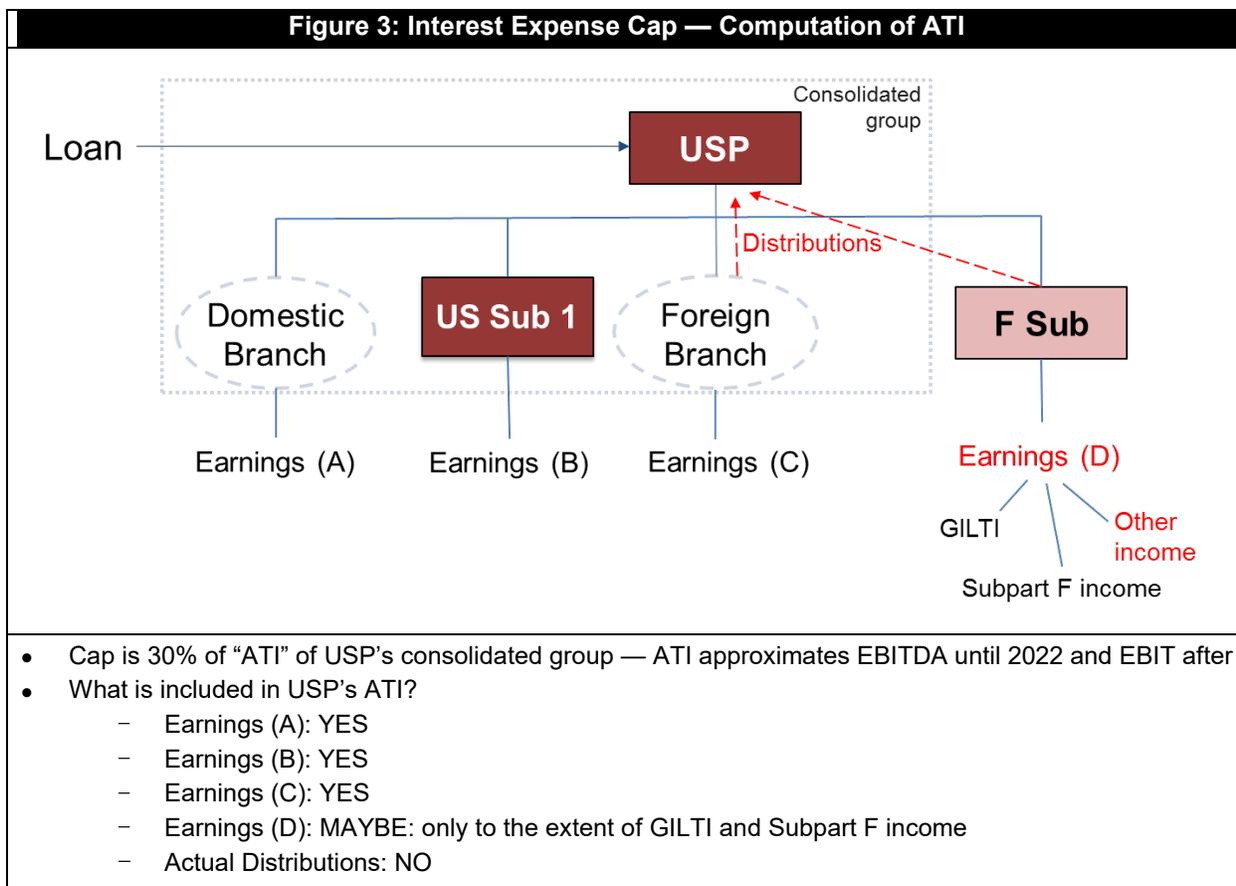
Under previous law, the gross amount of business interest expense was generally deductible in computing net taxable income. While some limitations were imposed on such deductions, those limitations applied solely based on specified characteristics of debt, and for such debt only. For example, Section 163(j), as in effect prior to the amendment by the Act, contained an “earnings stripping” rule that limited interest deduction on related party debt or on debt guaranteed by certain related parties, if the debtor corporation was thinly capitalized. In addition, deductions for interest paid on a debt instrument may be limited (1) when the yield on a discount debt instrument exceeds a certain threshold (in the case of “applicable high yield discount obligations” under Section 163(i)), or (2) when the interest is payable in equity (in the case of “disqualified debt instruments” under Section 163(l)).

The Act amends Section 163(j) to replace the “earnings stripping” limitations, which were applicable only in the international context, with a general cap on net business interest expense equal to 30% of adjusted taxable income (ATI).⁶ All other interest expense limitations based on specified characteristics of the debt instrument remain, and the 30% cap applies on top of those limitations. In computing ATI for this purpose, any non-business income, gain, loss, and deduction are excluded, and business interest expense, NOLs, and, solely for taxable years beginning before January 1, 2022, depreciation and amortization are added back. As such, ATI approximates EBITDA (for years before 2022) and EBIT (for years after 2022),⁷ computed ignoring all non-business items. A consolidated group is treated as a single taxpayer for purposes of computing the 30% cap limitation. In addition, ATI includes earnings regardless of whether they are earned in the United States or abroad, as long as such earnings are included in the borrower’s taxable income. To that end, Subpart F income⁸ and global intangible low-taxed income (or GILTI, discussed in more detail in Part [VI.C](#), below) would increase ATI, but receipt of any dividends exempt under the new participation exemption would not increase ATI. The disallowed net business interest expense can be carried forward indefinitely.

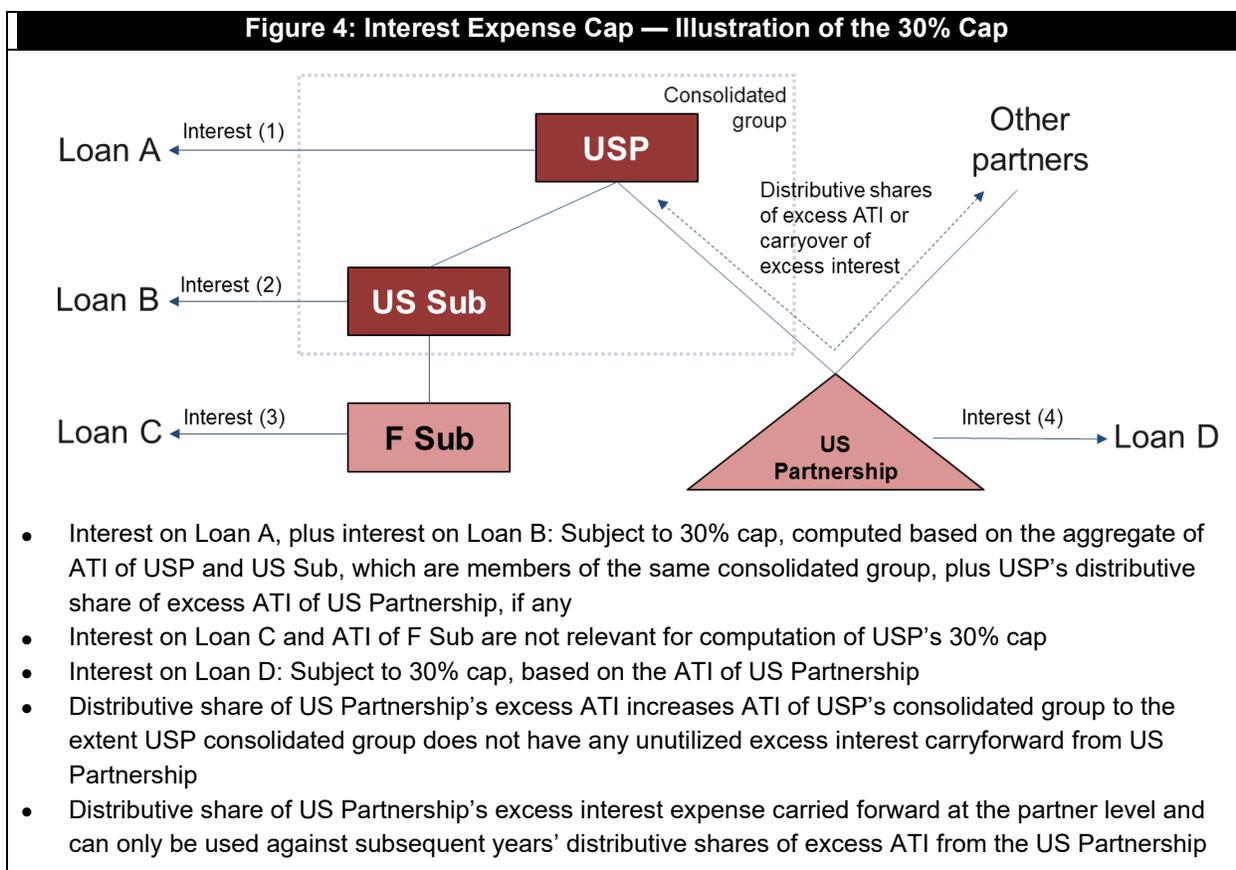
⁶ Businesses with annual gross receipts of less than US\$25 million are exempt from this limit. Certain electing real property businesses, farming businesses, and other designated businesses are also exempt.

⁷ This approximation assumes that the debtor does not have large book to tax timing or permanent differences (e.g., significant amounts of nondeductible penalties).

⁸ Subpart F income refers to inclusions into taxable income by a 10% US shareholder of a CFC under a set of complicated rules contained in Subpart F of the Code. The rules generally target passive income or income being shifted to a location outside of the United States without a sufficient business reason, although the rules are mechanical and are broad in their application.



For partnership debt, the general 30% cap would apply at the entity level. Any net business interest expense of the partnership in excess of the cap is not currently deductible by a partner but may be carried forward and deducted in a succeeding year, but only to the extent the partner is allocated “excess taxable income” above the 30% cap in a later year from the same partnership that generated the disallowed interest deduction (and the partner satisfies other limitations on deductibility of interest at the partner level). The excess taxable income above the 30% cap is also allocated to the partner, and increases the partner’s ATI available to offset interest unrelated to the partnership, to the extent such partner does not use it to deduct carried over disallowed interest from the same partnership’s prior years. The Act also allows a partner to increase basis in its partnership interest upon a disposition for the excess business interest previously incurred that has not yet been utilized.



Observations:

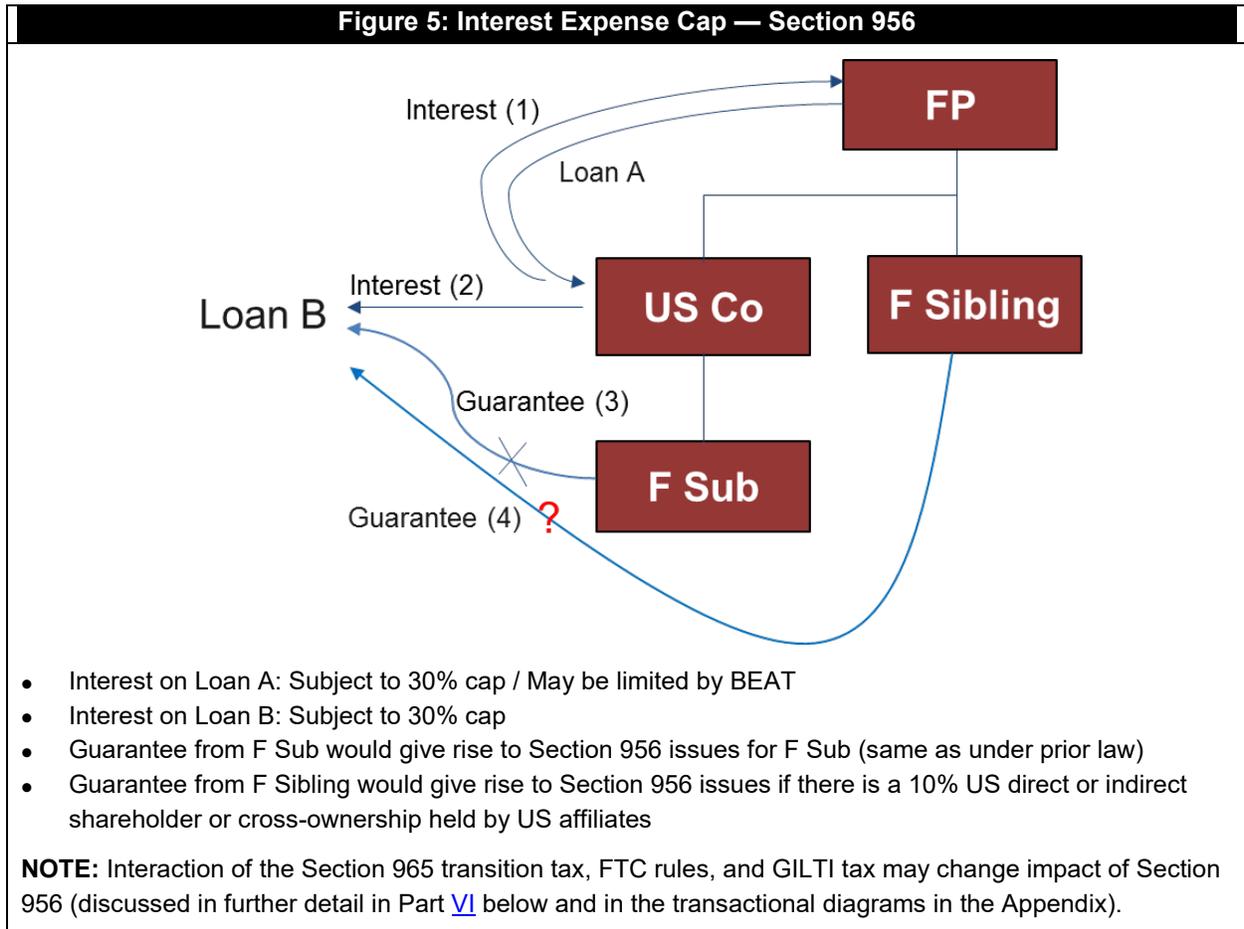
The 30% cap will most likely have an impact on companies primarily relying on interest deductions to reduce their net taxable income or companies operating at a loss for extended periods of time.

- Because the 30% cap is effective in 2018, with no grandfathering for existing debt, borrowers may want to reevaluate their existing capital structure immediately. Leveraged companies that were not previously paying significant US income tax now may face a substantial increase in their taxable income due to the 30% cap. Due to the reduction in US tax rates, the impact of such increase on the overall US tax burden of those companies would depend on their specific situation.
- Because the provision only limits "net" interest expense (rather than gross interest expense), it will not affect banks (or other financing vehicles) that borrow to earn business interest income. On the other hand, borrowers whose business earnings consist primarily of non-interest income from business operations, or dividends and trading gains, may not be able to fully utilize interest expense incurred to finance such non-interest business income.
- The 30% cap generally does not apply to nominally non-interest expenses, including embedded interest in derivative instruments or contracts (unless such instruments or contracts are treated in whole or in part as debt, or integrated with debt, for US federal income tax purposes), even if such expenses may represent financing costs and/or time value of money that are akin to interest. For example, leasing or rental expenses as well as periodic payments made under certain swaps, non-equity forward contracts, or other derivative instruments, properly characterized as non-debt for tax

purposes — to the extent they are not limited by any other provision of the law — presumably will continue to be deductible. As a result, where flexibility exists, taxpayers may consider alternative financing structures, such as a sale-leaseback transaction, that may provide maximum current deductions instead of simply relying on a traditional bond or bank financing. In addition, borrowers may reconsider integrating debt with hedges (e.g., qualifying swaps or other derivative instruments), if the payment on the hedge would otherwise be deductible currently.

- While all interest earned and paid by a corporation likely will be treated as business interest under the 30% cap, partnerships carrying out a trade or business that also have investment assets will be required to appropriately allocate interest to their trade or business. This may provide planning opportunities for such partnerships. If a partnership is a pure investment partnership with no trade or business, likely none of its deductions would be subject to the 30% cap on business interest at the partnership level.
- Companies that generate NOLs (before net business interest expense) may benefit from the fact that the Act treats disallowed net interest expense as a separate tax attribute, rather than merely an increase to that year's NOL. Disallowed net interest is carried over indefinitely, similar to NOLs generated beginning 2018. However, in any future year, a taxpayer would be allowed to reduce its taxable income first by the amount of carried over disallowed interest, subject to the 30% cap for that year, before applying the 80% of taxable income limitation on NOL carryover deduction (see Part [V](#) below). Consequently, the taxpayer would pay less in cash taxes for a particular tax year, because currently deductible carryovers in the aggregate would exceed the permissible NOL deduction of only 80% of pre-NOL taxable income that would result if disallowed net interest expense were treated as part of the NOL. Under US GAAP, disallowed net interest expense would generally be treated as a timing item, similar to a NOL, and give rise to a deferred tax asset, which may be subject to valuation allowance.
- Even though the proposed limitation on interest deductibility reduces cost advantages that a debt financing may have compared to an equity financing, a debt financing still offers a variety of benefits that an equity financing does not offer. For example, investors with other business interest expense may prefer to invest in debt rather than equity if the debt generates business interest income that would reduce their net interest expense and allow them to use interest deductions that otherwise would be disallowed by the proposed limitations. For issuers, interest payments would still generate deductions, albeit limited under the Act. In addition, it may be easier for interest payments to qualify for full exemption from or reduction in US withholding tax than dividend payments when paid to non-US investors.
- The 30% cap on business interest expense, combined with the decrease in the tax rate may incentivize multinational groups with significant leverage to move debt to their foreign affiliates, particularly if such affiliates are subject to foreign tax rates higher than the new US tax rates. Overseas debt may be especially appealing given the move to a modified territorial international tax system, described below, because paying any amount of tax in a foreign country could become an incremental tax cost, since the benefits of foreign tax credits (FTCs) that can be used to offset a US tax are now significantly limited.
- Decreased US tax rates and the 30% cap will provide an additional incentive for certain US issuers/borrowers to favor debt paying lower rates of interest, even if that results in additional secured debt, floating rate debt, or debt with shorter maturities. Similarly, issuances of convertible debt with lower interest rates or preferred stock may become more desirable.

- The interaction of the 30% cap interest limitation, the interest limitation that may be imposed by the Base Erosion and Anti-Abuse Tax (BEAT), the expansion of the controlled foreign corporation (CFC) rules, and the retention of Section 956 (all discussed below in Part VI), may provide incentives to foreign-parented multinationals to decrease the amount of third-party as well as intragroup leverage in their US subsidiaries.



IV. Full Expensing of Costs for Certain Capital Investments

The Act generally provides for full expensing for “qualified property” (generally, tangible property with a recovery period of 20 years or less and certain computer software) acquired and placed in service after September 27, 2017 and before January 1, 2023, as opposed to prior law, which permitted immediate expensing in limited instances and otherwise required basis recovery over the property’s statutory useful life. Importantly, this favorable rule applies to used property that is acquired from an unrelated party and has not been previously used by the taxpayer. A taxpayer may elect out of expensing on a class of property basis each year that such property is placed in service. The Act annually steps down the first year deduction or “bonus” percentage for several years beyond 2022.

Observations:

- The cost of capital investments will generally be significantly reduced as a result of immediate expensing in light of the accelerated tax savings (although the nominal tax savings is less in light of the lower business tax rates compared to prior law).
- Because this provision applies to used property, it may in some instances make asset acquisitions (actual or deemed) more desirable as a result of the purchaser being able to immediately deduct the portion of the purchase price allocable to qualified property, particularly in more capital-intensive industries. Expensing may be most valuable for non-corporate purchasers that will now be subject to materially higher tax rates than corporations.
- If a corporate consolidated tax group is selling a subsidiary (which now may be more common in light of the dramatically lower corporate tax rate), a deemed asset sale as a result of a stock sale including a Section 338(h)(10) or Section 336(e) election could be more desirable as a result of expensing being available to the purchaser. In addition, a corporate seller may be largely indifferent to the allocation of purchase price amongst the assets sold (or deemed sold) because all of its income and gain will be subject to the same 21% tax rate, whereas a non-corporate seller may be taxed at higher ordinary income rates with respect to gain on sale of tangible property under the depreciation recapture rules.
- As noted in more detail in Part [V](#) below, corporations that would otherwise be generating a NOL in their current taxable year could in some instances be better off on an after-tax basis by deferring capital investments/expensing to their subsequent taxable year (or electing out of expensing with respect to one or more classes of property for the NOL tax year).
- The tax benefits of a sale-leaseback transaction noted above in Parts [I](#) and [III](#) may be further enhanced to the extent the property is eligible for immediate expensing by the purchaser-lessor.

V. Changes Relating to Corporate Net Operating Losses**NOL Carrybacks Repealed**

Subject to limited exceptions, the Act repeals the two-year carryback period for NOLs arising in taxable years ending after December 31, 2017.

NOL Carryforwards: Unlimited Duration, Cap on Taxable Income Offset

The Act permits NOLs to be carried forward for an unlimited period as opposed to 20 years under prior law (with the same effective date as described in the preceding paragraph). Further, with respect to NOLs arising in taxable years beginning after December 31, 2017, the Act imposes an annual limit of 80% on the amount of taxable income that such NOLs can offset (effectively resulting in a minimum tax of 4.2% ($21\% * (1 - 0.80)$)), but no such limitation is imposed on the use of NOLs that arose in earlier taxable years.

Observations:

- Taxpayers should now carefully consider the timing of income and deductions (including as a result of full expensing of qualifying capital investments) in light of the NOL carryback repeal and the 80% income offset limitation (and the interest deductibility limitation discussed in Part [III](#) above). For instance, if a corporation is experiencing a loss in its current year and anticipates generating income in the subsequent year, it might be beneficial to defer deductions (including capital investments or

electing out of immediate expensing with respect to certain capital investments) to the subsequent year or accelerate income into the current year to mitigate the adverse timing effect of the 80% NOL income offset cap.

- Example: Instead of a NOL of \$1,000 in year 1 and income of \$1,000 in year 2 of which \$800 can be sheltered by the NOL leaving net taxable income of \$200, cash tax liability of \$42 (at 21% tax rate) in year 2 and a \$200 NOL carryforward to year 3, deferring \$200 of deductions from year 1 to year 2 would result in year 2 net taxable income of only \$160 ((\$1,000 - \$200) - \$640 NOL offset), cash tax liability of \$34, and a \$160 NOL carryforward (\$800 - \$640) to year 3.
- The repeal of NOL carrybacks could have a significant adverse effect on the most cyclical companies that have periods of both large income and loss generation, as these companies will no longer be able to immediately monetize their tax losses by carrying them back to preceding taxpaying years for refunds. Instead, these companies will only be able to carry forward the NOLs and such NOLs will not be able to zero out taxable income that is generated in the future.
- Another impact of the NOL carryback repeal will be with respect to sales of profitable companies — most often between private equity firms — where the transaction often generates a NOL in the short period ending on the closing date because of large transaction deductions arising from cashing out options, refinancing debt, and paying banking and other professional fees. It is common for buyers and sellers today to negotiate the rights to tax refunds arising from such a short period NOL, but under the Act such refunds will now be limited to estimated tax payments made in the short period.
- The changes in the NOL rules could have significant financial accounting implications as deferred tax assets associated with NOLs (including valuation adjustments) would essentially be recomputed under GAAP in light of the change in corporate tax rates, the unlimited carryforward period, and the offset cap.

VI. International Tax Reform

The Act enacts the most sweeping international tax reforms in decades, fundamentally altering the framework by which US and non-US headquartered businesses are taxed. These changes fall into five fundamental categories:

- A partial participation exemption system for profits derived by US-based multinationals from foreign subsidiaries, eliminating the friction of a US tax upon repatriation of overseas profits
- A minimum tax on foreign earnings of US-based multinationals with foreign subsidiaries
- A base erosion tax on transactions between US and non-US affiliated corporations, in structures involving US and non-US headquartered groups
- A one-time tax on the estimated US\$2-3 trillion of overseas earnings accumulated by US-based multinationals, payable over eight years, and thus allowing those profits to be repatriated without further US tax
- Several other changes across the US international tax regime addressing the source of income, FTCs, deductibility of payments, and other issues, including ownership and transfers of intangible property

Note: See Appendix at pages 34-43 for a series of transactional diagrams on key structuring and deal negotiation issues in the international context.

A. Participation Exemption for Dividends from Foreign Subsidiaries

The Act enacts a long sought after, but only partial, “territorial” regime — subject to the important features discussed below regarding the retention of Section 956 and a minimum tax on foreign earnings — for income earned by foreign subsidiaries of US-parented multinational corporations. Importantly, the exemption of foreign profits would not only apply to controlled foreign corporations⁹ (CFCs), but would also apply to earnings of a foreign corporation which is as little as 10% owned by a US corporate shareholder. The Act provides a 100% dividends received deduction (DRD) to a US corporate shareholder for the foreign-source portion of dividends received from a “specified 10-percent owned foreign corporation.” These provisions are effective for taxable years beginning after December 31, 2017. The key points of the territorial regime are:

- A specified 10% owned foreign corporation is any foreign corporation (other than a passive foreign investment company (PFIC) that is not also a CFC) with respect to which there is at least one domestic corporate shareholder which owns at least 10% of the stock.
- The foreign-source portion of dividends includes only undistributed earnings and profits (E&P) that are not attributable to US effectively connected income (ECI) or dividends from an 80%-owned US corporation, determined on a pooling basis.
- No FTC is allowed for the exempt portion of any dividend and the US recipient’s FTC limitation computation does not include the exempt portion of such dividend.
- Solely for purposes of determining a loss, the basis of a specified 10% owned foreign corporation must be reduced by the exempt portion of a dividend.
- Generally, a one-year holding period (subject to tolling if the stock is hedged) is required in order to claim the DRD.
- The DRD is not available for any dividend received by a US shareholder from a CFC if the dividend is a “hybrid dividend.” A hybrid dividend is an amount received from a CFC for which a deduction would be allowed under this proposal and for which the specified 10% owned foreign corporation received a deduction from taxes imposed by a foreign country.

Observations and Important Caveat:

With the change to a system by which profits of a foreign subsidiary are excluded from taxation on repatriation, the very notion of deferred offshore earnings, a fundamental part of the US international tax system for decades, has fundamentally changed. Subject to the next paragraph regarding retention of Section 956, earnings of a foreign subsidiary will either be (1) taxed currently to the US corporate shareholder under a modified Subpart F regime or GILTI (each, discussed below), or (2) exempt from US tax when earned, but in each case not subject to US tax upon repatriation as a dividend.

One surprise in the Act, however, is that unlike the initial House and Senate proposals, the Act does not repeal or amend Section 956. Section 956 generally requires that a US shareholder include in income (after the Act, at a maximum 21% rate for a corporation) the earnings of a CFC which are invested in

⁹ Generally more than 50% owned by vote or value by 10% US shareholders.

certain US property, including loans or credit support to debt of a related US borrower. The retention of Section 956 under the new partial territorial regime means that, going forward, Section 956 inclusions are subject to the regular tax at the level of US shareholders while actual dividends are exempt if paid to 10% US corporate shareholders. The exact interaction between the application of Section 956 and the other rules discussed below (DRD, GILTI, and the Section 965 Transition Tax) raises a number of questions (see Figures [A-10](#), [A-11](#), and [A-12](#) in the Appendix).

B. Participation Exemption on the Sale of a Foreign Subsidiary

By providing an exemption for dividends from foreign subsidiaries, the Act provides an indirect mechanism for a potential complete or partial participation exemption on a US corporation's direct or indirect sale of a foreign subsidiary. However, the Act does not provide a specific exemption of gain realized from a sale of a foreign subsidiary from US taxation. Only to the extent that the gain on the sale of a foreign subsidiary is characterized as a dividend under the rules of Section 1248, would such gain qualify for the exemption described in the prior paragraphs. Section 1248 generally provides that the gain on the sale of CFC stock is treated as a dividend to the extent of the undistributed and untaxed earnings of the CFC.

Thus, upon the sale of a CFC, an exemption from gain would be available to the extent that the gain is treated as a dividend, as such dividends qualify for the exemption system described above.

To the extent that the gain on the sale is treated as capital gain, it would not qualify for the participation exemption and thus (in the case of a US seller) would be taxable gain or (in the case of a CFC selling a lower-tier CFC) would continue to be treated as Subpart F income.

Observations:

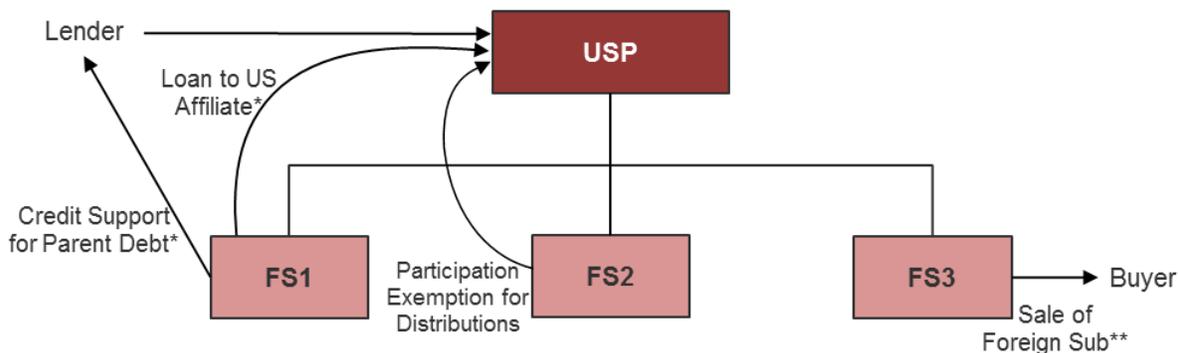
- Presumably, as divestitures of foreign subsidiaries are negotiated, buyers and sellers will consider Section 338 elections on the part of a buyer, thus converting what otherwise would be capital gain into ordinary dividend income in the hands of the seller (see Figures [A-6](#) and [A-7](#) in the Appendix). The deemed sale gain from any such election may be subject to the minimum tax (under the new GILTI) discussed below.

Figure 6: Territorial System for Future Foreign Earnings — A New Era

The Act replaces the worldwide tax system with a 100% exemption for dividends from foreign subsidiaries (in which USP owns at least a 10% stake).

The Act eliminates the “lock-out effect” (earnings of US multinationals locked out of US due to tax on repatriation).

Section 956 is not repealed or amended.



* Foreign subsidiary credit support for US Parent debt, or loans to US Affiliates, potentially taxed at 21% (less FTC)

** Participation Exemption to extent of Section 1248 (dividend) characterization
Same rule applies on sale of lower-tier CFCs

Note: By retaining the general framework of Subpart F and Section 956, but allowing the Participation Exemption for actual distributions, the Act creates a number of issues with regard to the timing and inclusion of foreign earnings. For example, an inclusion under Subpart F generally takes precedent over distributions, resulting in a potential 21% tax on those foreign earnings.

C. Modified Subpart F/CFC Regime — Includes Minimum Tax

For more than 50 years, US shareholders of a CFC have been taxed currently (1) on certain Subpart F income (such as passive income or foreign base company sales or services income), and (2) on non-Subpart F earnings in the case of investments in certain US property, such as a loan (or credit support) by a CFC to a US shareholder or other related US person.

There are three key points with regard to the CFC rules under the Act:

- As a general matter, the Subpart F/CFC rules remain. For example, US shareholders will continue to currently include foreign personal holding company income, foreign base company sales income, and foreign base company services income.
- The concept of Subpart F income is expanded, as the Act uses the mechanism of an income inclusion similar to current Subpart F to target perceived income shifting and high returns on foreign operations, which are not otherwise subject to US tax. In short, Subpart F’s approach to an inclusion of a pro rata share of income by a US shareholder would be expanded to impose a minimum tax on foreign earnings of US-parented groups.

- The Act does not repeal Section 956 (which applies when overseas earnings are invested in US property or provide credit support for US debt). As a result, overseas earnings that could be distributed to US corporate shareholders without US tax under the participation exemption would actually be subject to US tax at the regular 21% corporate rate if they become subject to Section 956. The retention of Section 956 as it applies to corporate taxpayers leaves open a number of technical issues, particularly with the FTC, as previous iterations of the Act, which eliminated Section 956 as to US corporate shareholders, had assumed that the credit under Section 960 would apply only to the inclusion of current earnings under Subpart F and the new category of GILTI.

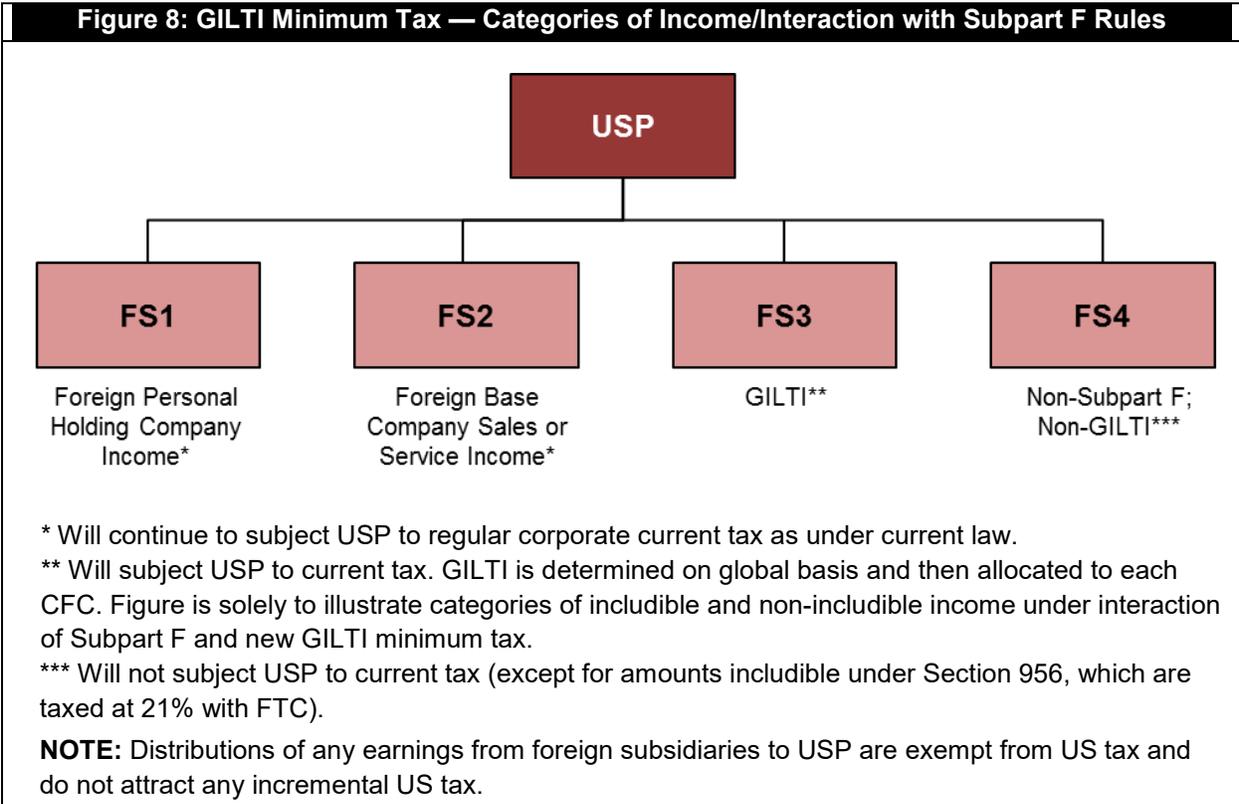
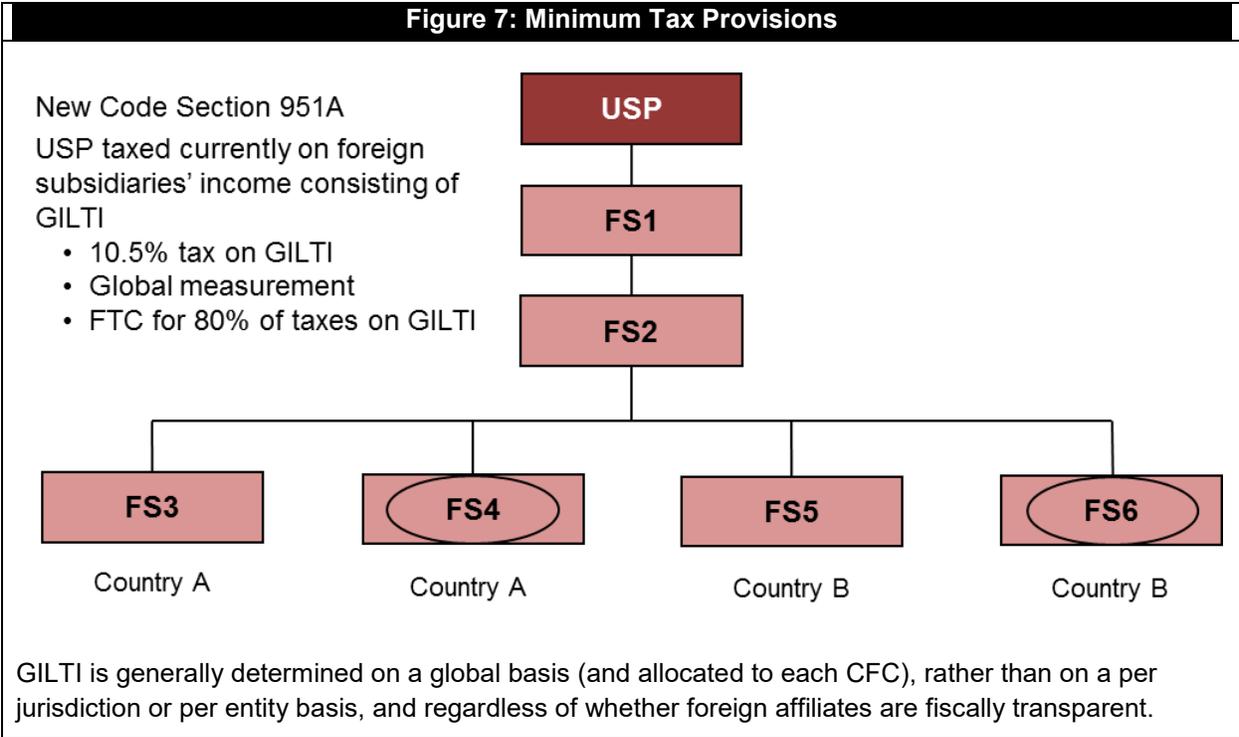
In addition, the Act modifies stock attribution rules for determining status as a CFC so that stock owned by a foreign person may be attributed to a US person for purposes of determining whether a foreign corporation is a CFC, and eliminates the requirement that the foreign corporation be controlled for 30 days before Subpart F inclusions apply. The downward attribution provision is effective retroactively, for the last taxable year of the CFC beginning before January 1, 2018 (*i.e.*, generally for the 2017 calendar year), while the elimination of the 30-day control requirement is effective for taxable years beginning after December 31, 2017.

D. Minimum Tax on Foreign Earnings of US-Based Multinationals

Under new Section 951A of the Act, a 10% US shareholder of a CFC must include in income for a taxable year its share of the CFC's GILTI. Key provisions of the tax are:

- GILTI will generally equal (i) the aggregate net income of the CFCs¹⁰ reduced by (ii) 10% of the CFCs' aggregate basis in associated tangible depreciable business property minus certain interest expense allocable to (i).
- With respect to 10% shareholders that are corporations, FTCs, in a separate basket, will generally be available for 80% of the foreign taxes imposed on the income included as GILTI. No carryover is allowed for excess credits.
- While a GILTI inclusion by a US shareholder is taxable at the regular 21% corporate rate, the amount of the inclusion is equal to 50% of GILTI, thus resulting in an effective rate of 10.5%. The new tax benefits available for certain foreign-derived intangible income, described below, provide the mechanism for this computation, by essentially providing for a deduction equal to 50% of GILTI, to be reduced after 2025. This GILTI regime is effective for taxable years beginning after December 31, 2017.

¹⁰ Income in this inclusion category is calculated without regard to ECI, Subpart F income, and certain income that qualifies for specified exceptions to Subpart F (for example, under Section 954(b)(4)).



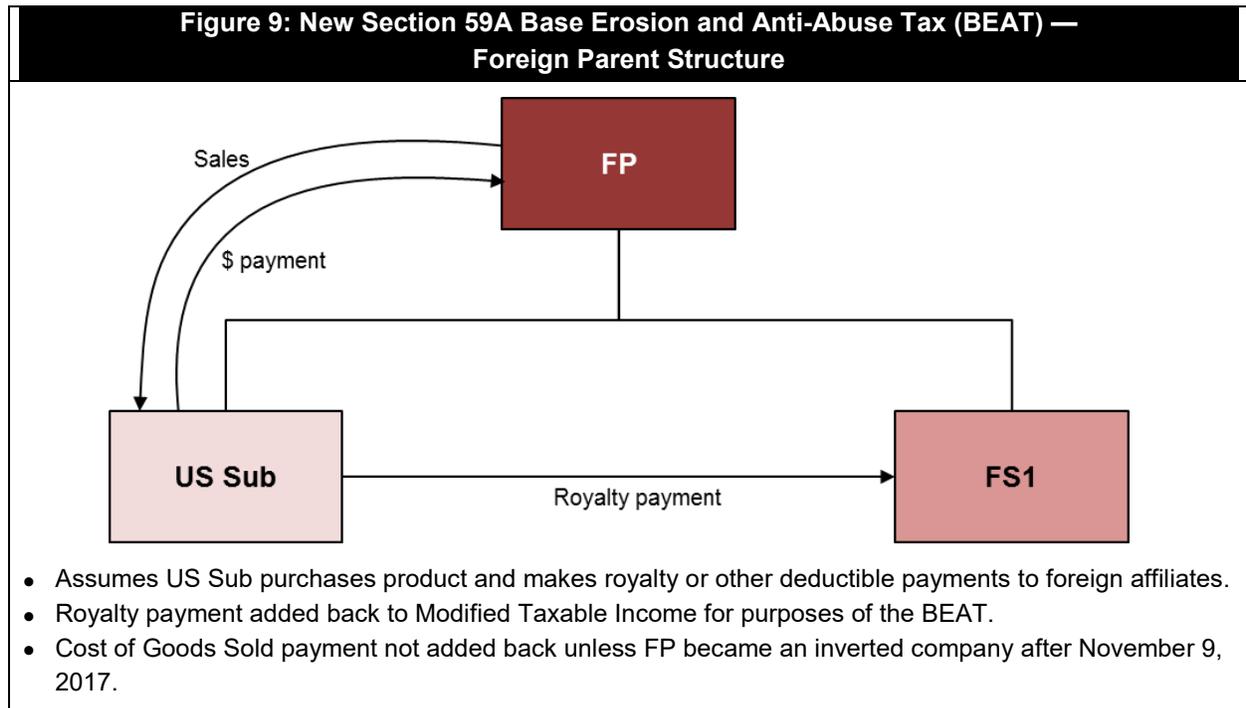
E. Base Erosion and Anti-Abuse Tax: New Tax If a US Affiliate Engages in Transactions with a Non-US Affiliate in a Multinational Group

The Act creates a new Base Erosion and Anti-Abuse Tax (BEAT) to limit tax benefits of transactions between US and non-US affiliates in a multinational group that purportedly result in so-called “base erosion,” regardless of whether such transactions artificially reduce the US tax base through transfer pricing and other abusive arrangements. The BEAT applies to both US-parented and non-US parented structures.

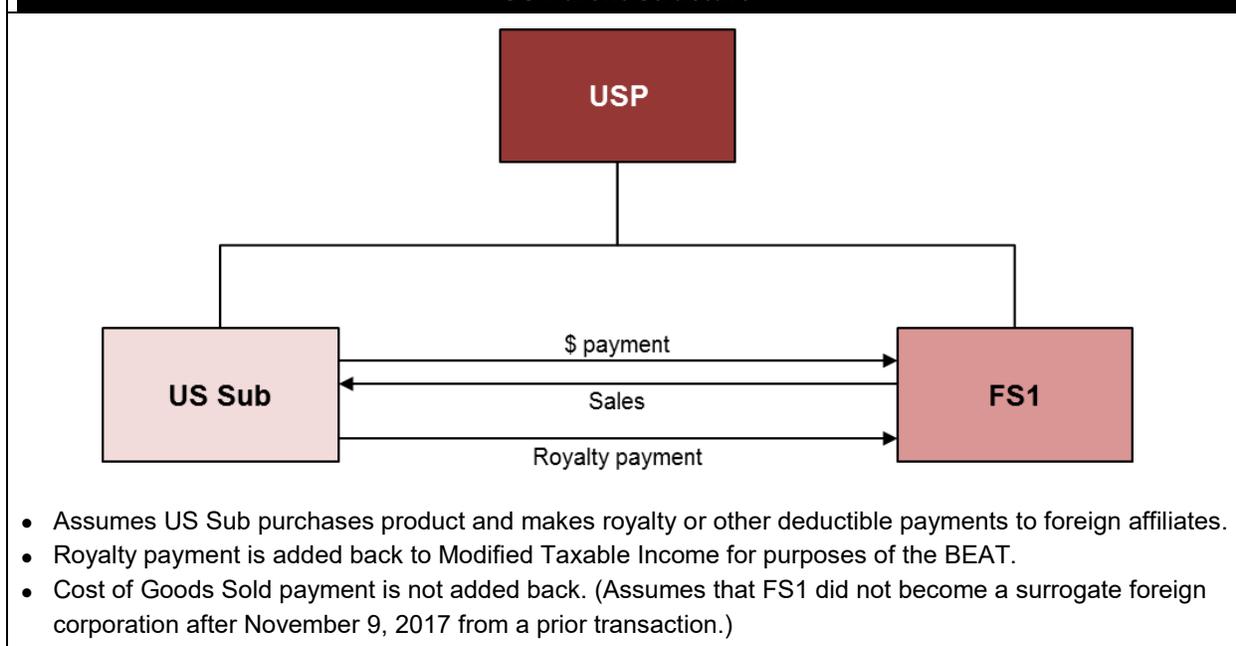
The BEAT applies to US corporations that have made related party deductible payments totaling 3% or more of such corporation's total deductions for the year (or 2% for banks and securities dealers). The corporation must determine its “modified taxable income” by adding back to its adjusted taxable income for the year all deductible payments made to a foreign affiliate for the year.

The excess of 10% of the corporation's modified taxable income over its regular tax liability for the year (as adjusted for certain credits) is generally the amount of base erosion minimum tax owed. The 10% rate applies beginning in 2019 following a 5% transition rate that applies in the 2018 taxable year, and the rate rises to 12.5% in taxable years beginning after 2025. The rate applicable to banks and securities dealers for any year is one percentage point higher than the generally applicable rate. A number of special rules apply for certain derivative payments made by financial institutions.

The payments that must be added back generally include those payments to a related foreign person and with respect to which a deduction is allowable (including interest), or with respect to the purchase of depreciable property. The amount added back is reduced to the extent the payment to the foreign person is subject to US withholding tax or is a payment for services eligible for the service cost method of Section 482. Cost of goods sold payments are added back only in the case of payments to a foreign corporation which becomes a surrogate foreign corporation (an inversion) after November 9, 2017. These provisions are effective for payments paid or accrued in taxable years beginning after December 31, 2017.



**Figure 10: New Section 59A Base Erosion and Anti-Abuse Tax (BEAT) —
US Parent Structure**



F. Taxation of Foreign-Derived Intangible Income

The Act includes an incentive for US companies to sell goods and provide services to foreign customers. Under the Act, income from the sale of goods and services abroad is effectively taxed at approximately 13%. This concept of foreign-derived intangible income (FDII) is based on a series of complex definitions, and generally includes the excess returns over 10% of aggregate basis in associated tangible depreciable business property. As noted above, the FDII provision also sets the mechanism for a deduction equal to 50% of GILTI, thereby reducing the tax rate on GILTI to an effective rate of 10.5%. The rules regarding FDII apply to taxable years beginning after December 31, 2017. The tax benefits for foreign derived intangible income (and GILTI) under this section are reduced in taxable years beginning after 2025.

G. One-Time Tax on Accumulated Offshore Earnings (Section 965 Transition Tax)

US-based multinationals have an estimated US\$2-3 trillion of earnings accumulated in foreign subsidiaries. Those earnings have not been subject to US tax but, if repatriated under pre-Act law, were subject to the statutory 35% corporate tax rate less any allowable FTC. Partially in recognition of this “lock-out effect,” Congress in 2004¹¹ allowed an elective conditional repatriation at a rate of 5.25%, which prompted US-based multinationals to repatriate an estimated US\$350 billion of overseas earnings.

As part of the transition to a partial participation dividends-received deduction tax regime, the Act adds new Section 965, which imposes a **mandatory** one-time tax on a US shareholder’s pro rata share of its foreign subsidiaries’ post-1986 undistributed E&P. The Act measures the earnings as of November 2, 2017 or December 31, 2017, whichever is higher. A US shareholder (or affiliated group) reduces the amount of undistributed E&P subject to the tax by E&P deficits of other foreign subsidiaries.

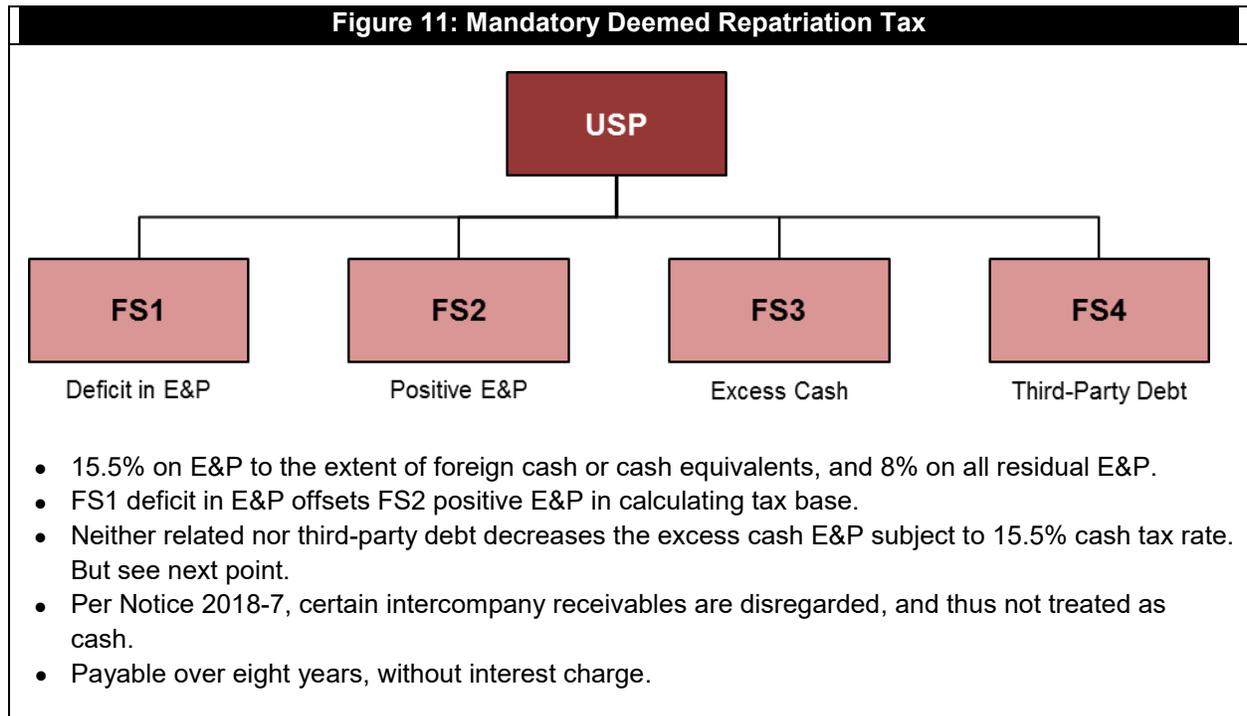
¹¹ See the American Jobs Creation Act of 2004 (P.L. 108-357).

The Act imposes the repatriation tax at two different rates: 15.5% on E&P to the extent of foreign cash and other liquid assets, and 8% on all residual E&P. The cash position would be determined based on the average of the prior two years, or at the end of the taxable year of inclusion, whichever is greater.

Other features of the Section 965 Transition Tax include:

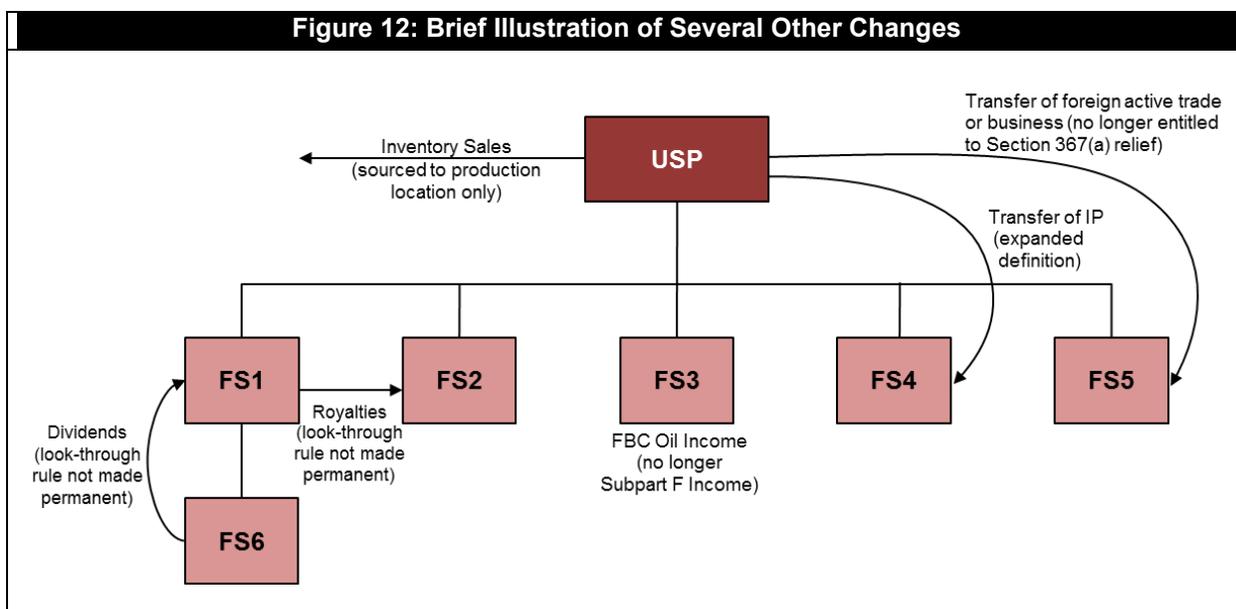
- FTCs would be partially available.
- The Act permits a US shareholder to elect to pay the liability imposed under the tax over a period of up to eight years, without any interest charge.
- These earnings may be immediately repatriated without additional US tax, as distributions would be treated as previously taxed income.
- The Act accelerates the deferred tax liability upon certain events. In addition, a particularly harsh anti-inversion provision would require the US corporation to pay the full 35% rate on the deferred foreign earnings (less the taxes it already paid), if the US corporation inverts within 10 years after enactment, or otherwise becomes an “expatriated entity.” No FTCs would be available in the case of a US corporation becoming subject to this anti-inversion rule.

The IRS issued Notice 2018-7 (the Notice) on December 29, 2017. The Notice describes a number of matters on which the IRS intends to issue regulations under Section 965. Several of the areas addressed in the Notice concern technical rules on tax accounting periods for a US shareholder and a 10% owned foreign subsidiary. Two important rules concern the measurement of the amount of cash a foreign corporation holds on the relevant measurement date. One such rule disregards certain intercompany payables and receivables, and thus avoids a situation where a loan from one foreign affiliate to another might increase the cash position of the lender (since receivables are generally treated as cash) even though the borrower had invested the proceeds in operations. Another rule provides that certain financial derivatives are treated as cash to the extent the derivative is integrated into a bona fide hedging transaction.



H. Other Important International Tax Changes

- Indirect tax credits under Section 902 are repealed. Because, as noted, the concept of deferred foreign earnings no longer exists, FTCs are only available under Section 960 to the extent foreign taxes are imposed on Subpart F income or GILTI (subject to a special basket and no carryover rule) that is included in a US shareholder's gross income. FTCs will remain quite relevant under Subpart F, including of course Section 956, and GILTI.
- The Act does not make permanent the look-through rule of Section 954(c)(6), allowing payments between CFCs to avoid Subpart F characterization. Presumably, Congress will deal with this in an "extenders" bill to prevent expiration of Section 954(c)(6) after 2019.
- The definition of a 10% US shareholder for purposes of the CFC rules is expanded to include a US shareholder that owns (directly, indirectly, or by attribution) 10% or more of the value or voting power (only voting power was considered under prior law).
- The source of income from sales of inventory will be determined solely on the basis of production activities.
- Foreign base company oil-related income is eliminated as a category of foreign base company income.
- For purposes of determining the value of intangibles in transfer pricing situations, workforce in place, goodwill (both foreign and domestic), and going concern value are intangible property. The Act also addresses the authority of the IRS to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of US operations and to intercompany pricing allocations.
- The Act denies a deduction for any disqualified related party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity. For example, any interest or royalty paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country.
- Any individual shareholder who receives a dividend from a corporation which becomes a surrogate foreign corporation as defined in Section 7874(a)(2)(B) after November 9, 2017, other than a foreign corporation which is treated as a domestic corporation under Section 7874(b), is not entitled to the lower rates on qualified dividends.
- The Act repeals the active trade or business exception, which allows the transfer to a foreign corporation of certain foreign businesses without a toll charge.
- The Act makes certain changes with respect to pre-2018 unused overall domestic losses.



VII. Energy Impact

The general business provisions of the Act (e.g., on interest deductibility, full expensing, and the changes to the international tax system) are not expected to uniquely affect master limited partnerships (MLPs), publicly traded partnerships (PTPs), their unitholders, or the broader energy industry. See Parts [III](#), [IV](#), and [VI](#), above, for more detailed discussions of the Act's provisions with respect to interest deductibility, full expensing, and international tax.

Master Limited Partnerships and Publicly Traded Partnerships

MLPs and PTPs will continue to enjoy their tax-advantaged status under the Code. The Act does not eliminate or curtail, in any way, the "qualifying income exception" provided by Section 7704 that allows certain MLPs and PTPs to be classified as partnerships for US federal income tax purposes. As such, income earned by an MLP or PTP will continue to be passed through to its owners without being subject to an entity-level US federal income tax.

As discussed in more detail above in Part [II](#), the Act applies a lower US federal income tax rate to income earned in pass-through entities by providing taxpayers a deduction equal to up to 20% of their qualified business income, which deduction will result in a maximum applicable US federal income tax rate of 29.6% if the maximum deduction is available (see Figure [1](#), above). This deduction, however, is subject to a Form W-2 wage limitation that is similar in design and scope to the wage limitation applicable to the deduction previously offered to taxpayers for certain manufacturing activities under Section 199.¹² The Act, however, exempts MLPs and PTPs from the application of the Form W-2 wage limitation.

The Act clarifies that a foreign investor will realize "effectively connected income" (ECI) upon disposition of a partnership interest, including an interest in an MLP or PTP, to the extent that such investor would be allocated ECI were the partnership to dispose of its assets in a taxable transaction. The Act further requires a transferee of a partnership interest to withhold 10% of the amount realized on the disposition of

¹² The Act repeals Section 199 for taxable years beginning after December 31, 2017.

a partnership interest where any portion of the gain would be ECI. Reacting swiftly, the IRS has suspended the withholding requirement with respect to dispositions of interests in MLPs and PTPs while regulations can be developed to address unique withholding issues raised by MLPs and PTPs.

Observations:

The beneficial rate afforded to pass-through entities under the Act should generally be available to all unitholders of MLPs and PTPs. Notably, MLPs and PTPs are exempt from the application of the Form W-2 wage limitation. As such, all unitholders of MLPs and PTPs should enjoy the beneficial deduction offered by the Act. When combined with the reduced US federal income tax rate offered to corporations under the Act, this framework maintains the rate differential that existed between pass-through income and corporate income under prior law.

Figure 13: A Comparison of the Rate Differential from Corporations to MLPs*						
	C-Corp	C-Corp Investor Dividend Rate	Total Effective C-Corp Rate to Investor (A)	Highest Marginal Individual Rate	Total Effective Rate to MLP Investor (B)	MLP to C-Corp Benefit (A)-(B)
Prior Law	35.0%	20.0%	48%	39.6%	39.6%	8.4%
The Act	21.0%	20.0%	36.8%	37.0%	29.6%	7.2%

* Figure 13 omits the impact of the 3.8% Medicare surtax.

Oil & Gas Taxation

The broader oil and gas industry fares well under the Act, and most provisions specific to the taxation of natural resources remain unchanged. Historically, the oil and gas industry has faced the potential elimination of several important benefits — namely, the deduction for intangible drilling costs (IDCs), the availability of percentage depletion, the exception to passive loss treatment for certain working interests and favorable geological and geophysical recovery periods. All of those benefits remain untouched under the Act. The Act restricts like-kind exchange transactions to those involving “real property,” (described below under Part [VIII](#)).

The Act opens the Arctic National Wildlife Refuge (ANWR) to oil and gas exploration activities, including drilling activities, by authorizing at least two ANWR area lease sales during the next 10-year period.

Observations:

Though like-kind exchange transactions may be restricted to those involving real property, operating and non-operating interests in oil and gas reserves have typically qualified as real property for these purposes and are expected to continue to do so under the Act. Thus, this transaction should remain a viable planning tool for the oil and gas sector.

The repeal of the corporate AMT should generally be favorably received by the oil and gas industry. Due to the capital-intensive nature of oil and gas exploration companies, many such companies have historically been AMT taxpayers. The Act also provides that existing AMT credit would be refundable, which, coupled with the repeal of the AMT, should free up significant capital for additional growth.

VIII. REITs

While the Act will have a material effect on the taxation of REITs, it generally does not change the overall manner in which REITs or their shareholders are taxed.

Dividends

“Qualified REIT dividends” are subject to tax at the same rate as a partner’s allocable share of income earned by a pass-through entity, without regard to the limitations based on wages or invested capital (as described above in Part [II](#)). Qualified REIT dividends are dividends paid by a REIT, other than capital gain dividends or dividends attributable to “qualified dividend income” received by the REIT, the tax treatment of which were not changed by the Act. Accordingly, to the extent a REIT shareholder receives dividends attributable to rental income received by the REIT, the shareholder generally will pay tax on the dividend at the same rate that would apply to a partner’s allocable share of rental income earned by a partnership — a tax rate of 29.6% for individuals who would otherwise pay tax at the new top marginal rate of 37%. If dividend income relates to other types of income derived by the REIT, such as interest, the dividends would also be taxed at the pass-through rate, which may be lower than the rate applicable to such income if it were earned directly. See the columns labeled “Pass-Throughs” in Figure [1](#) for a description of the calculation of this tax rate in the context of pass-through entities (as compared to the tax rate under prior law), which tax rate also applies to ordinary dividends paid to REIT shareholders.

The lower tax rates may also benefit certain non-US shareholders of REITs. Under the Foreign Investment in Real Property Tax Act (FIRPTA), subject to certain exceptions (e.g., with respect to certain owners of publicly traded REITs or “domestically controlled” REITs, among others), a non-US shareholder of a REIT generally is subject to tax in the same manner as a US person on dividends received from a REIT that are attributable to gain from the sale or exchange of US real property interests and upon the sale of REIT stock. Although the Act does not change these rules, to the extent a non-US person is subject to tax on dividends attributable to gain from the sale or exchange of US real property interests or a sale of the stock, the amounts will be taxable at the new lower tax rates. In addition, such dividends will be subject to withholding at a rate of 21% (as compared to 35% under prior law).

Interest Deductibility and Expensing

The Act limits the ability of corporations and partnerships to deduct net interest expense (as described above in Part [III](#)). The Act provides special rules for interest paid in connection with a “real property trade or business” (generally, any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business), which should include most equity REITs. It is not entirely clear how these rules should be applied to groups of affiliated entities, including where borrowing occurs at one entity and real estate assets are owned by affiliates. In general, these provisions may be of less significance to mortgage REITs to the extent that they do not have net interest expense.

Under the Act, net interest expense remains fully deductible for entities engaged in a real property trade or business that elect to be exempt from the new rules. However, if making such an election, the taxpayer must use the alternative depreciation system (ADS) for non-residential real property, residential rental property, and qualified improvement property, likely increasing the depreciable lives of certain assets.

In general, the immediate expensing (described above in Part [IV](#)) does not apply to property used in a real property trade or business (e.g., buildings or other structures) but may apply to certain improvements made to nonresidential real property, where the taxpayer does not elect out of the rules limiting the deductibility of interest.

Like-Kind Exchanges

Section 1031 generally allows a taxpayer to exchange property used in a trade or business or held for investment for “like-kind” property without currently recognizing gain or loss. The Act amends Section 1031 to permit exchanges of real property only. While this change is generally favorable for REITs and other real estate owners relative to taxpayers that own non-real estate assets, to the extent a REIT owns a material amount of personal property associated with its real property, the like-kind exchange provisions will be less beneficial than under prior law.

The amended provisions generally would apply to exchanges completed after December 31, 2017, unless the property was disposed of or received in the exchange on or before such date.

International Provisions

The Act imposes a mandatory tax on a US shareholder’s pro rata share of its foreign subsidiaries’ undistributed E&P (as discussed above in Part [VI.G](#)). Such income will be excluded for purposes of the REIT gross income tests. In addition, REITs may elect to meet the distribution requirement with respect to such income over an eight-year period.

The Act further requires a 10% US shareholder of a CFC, including a REIT, to include in income for a taxable year its share of the CFC’s GILTI. GILTI is generally the aggregate net income of the CFC reduced by 10% of the CFC’s aggregate basis in associated tangible depreciable business property (as discussed above in Part [VI.D](#)). However, because REITs are not permitted to deduct any portion of such inclusions in determining their REIT taxable income, and REITs may not benefit from tax credits available with respect to the foreign taxes imposed on the income included as GILTI, a REIT’s distribution requirement may be increased as a result of these inclusions. Moreover, the Act does not indicate how these amounts should be treated for purposes of the REIT gross income tests.

Observations:

One of the most helpful legislative aspects of the Act related to REITs is the treatment of REITs as pass-through entities for purposes of determining the tax rate applicable to dividends paid to REIT shareholders. This change goes a long way toward preserving the tax advantages associated with investment in a REIT as compared to a “regular” C-Corp, and continues to tax shareholders of a REIT in a manner similar to investors in pass-through entities, consistent with the Congressional purpose that resulted in the creation of the REIT vehicle. However, the other provisions generally described above may have significant consequences for certain REITs, depending on their particular circumstances. See [Figure 13](#) for a comparison of the effective tax rate under the Act applicable to MLPs (as compared to C-Corps), which MLP effective tax rate (and comparison) are equally applicable to ordinary dividends paid to REIT shareholders.

IX. Renewable Energy

The renewable energy industry retained the key tax credits that subsidize projects in the sector, but the Act made a number of notable changes that could affect industry participants in ways that are still unclear.

Broadly speaking, a number of provisions in the Act will increase the after-tax returns available to project owners, including lower corporate and pass-through tax rates (see Parts [I](#) and [II](#), above) and a broad provision allowing all new and most used assets to qualify for an immediate 100% write-off (see Part [IV](#), above).

Other parts of the Act cut the other way. Owners of heavily leveraged projects will now face new limits on the deductibility of interest and the use of NOLs (see Parts [III](#) and [V](#), above), while large multinational investors will need to consider the impact of the new Base Erosion and Anti-Abuse Tax (BEAT) on the value of the tax benefits generated by project investments (see Part [VI.E](#), above).

The new tax rules will usher in a new set of market conditions, as sponsors and investors reassess how best to optimize capital structures in search of the lowest after-tax cost of capital. These rules may also cause renewable and energy assets to migrate to new owners who are better equipped to adapt to the new tax regime. The variables at play will include whether to hold assets in corporate or pass-through entities; how best to capitalize projects through a combination of equity, debt, and tax equity; and how to allocate a new subset of risks relating to the uncertain future value of tax credits among buyers, sellers, and tax equity investors.

On balance, the renewable energy industry avoided most of the proposals that would have dramatically affected the market. Earlier legislative proposals to retain the corporate AMT while reducing the regular corporate tax, to reduce production tax credits by one-third, and to codify a potentially stricter “start of construction” rule were all eliminated in the Act. The BEAT provision, first proposed by the Senate in a form that would have eviscerated the value of renewable tax credits for many market participants, was significantly scaled back in the Act, albeit temporarily. The BEAT rules now generally limit the tax claw-back to only 20% of the value of production and investment tax credits through 2025. Each potential tax equity provider will now have to calculate the effect of this claw-back on its future ability to realize the after-tax value of any tax equity investments.

Renewable Energy Tax Credits

Tax credits for wind and solar projects are unaffected by the Act. The production tax credit retains its current phase-out period for wind projects that begin construction by the end of 2019. Current IRS guidelines that outline the requirements for starting construction remain in effect. Solar tax credits remain at 30% for projects under construction by the end of 2019 with a gradual phase-down to 10% for projects that begin construction in 2020, 2021, or 2022.

Lower Corporate Tax Rate

The Act reduces the corporate tax rate from 35% to 21% starting in 2018 (as explained in more detail above in Part [I](#)). The reduced corporate tax rate may have a pronounced effect on the development and financing of renewable energy projects in the United States.

A lower tax rate will reduce the value of tax deductions and correspondingly increase the cost of tax equity. Most tax equity transactions calculate the investor’s return by referencing an after-tax internal rate of return that will now attribute less value to tax depreciation deductions. Consequently, the renewable energy industry could see a number of effects from this change. First, and most obvious, a lower corporate tax rate may reduce the number of tax equity investors interested in financing renewable energy projects. Corporate investors may have less tax liability to shield, or may be unable to fully realize the value of the tax shield generated by the investment due to the BEAT rules or other limitations.

Second, tax equity transactions that have already closed may contain contractual provisions requiring immediate adjustments to the economic terms of the arrangement to preserve the tax equity’s expected return thresholds. Those arrangements that do not have immediate adjustments will likely still require larger shares of operating cash flow to be distributed to the tax equity if its return thresholds are unmet after a prescribed period of time, such as an “expected flip date.” This dynamic may impact the amount of cash flow available to service debt on back-leveraged loans or to pay equity distributions on mezzanine or

other “upper-tier” investments. A lower tax rate should have minimal impact (or in some cases even benefit) those transactions that are further along and have exhausted all or most of the tax deductions from the project.

Third, tax equity transactions that have not yet closed, including those with outstanding debt and/or tax equity commitments, may need to resize the cost and availability of tax equity. A reduction in the size of the equity commitment may impact the sizing of the debt commitment, a portion of which typically bridges the tax equity investment.

Full Expensing (Bonus Depreciation)

Almost all investment property is eligible for a 100% bonus depreciation under the Act (further details are provided above in Part [IV](#)).

Determining the date on which property is “acquired” will become important when applying the new expensing rules. Property is acquired no later than when a binding written contract is first put in place to buy the property. Each turbine in a wind farm should be tested separately under this standard. A special rule may allow taxpayers to consider a wind turbine as “acquired” no earlier than when it has incurred 10% of the costs of the turbine.

In anticipation of a reduced corporate tax rate, many renewable energy projects have been taking advantage of the 50% bonus depreciation under current law to increase the value of tax benefits transferred to tax equity investors. The larger 100% bonus depreciation may be too large of a deduction for tax equity investors to use under partnership tax rules. A tax equity investor generally is not permitted to claim deductions that exceed its capital investment, unless the investor agrees to future capital call obligations in the form of a deficit restoration obligation. Even then, tax deductions that exceed the tax equity investor’s tax basis in its investment are deferred until later in the deal, making them less valuable than deductions that can be immediately claimed and utilized.

Project owners may be able to best monetize these new, larger tax benefits by using sale-leaseback structures rather than the more common partnership tax equity structures. In a sale-leaseback structure, an investor who can better use the tax benefits purchases and then leases the asset back to the seller. The value of the tax benefits is used to subsidize the financing rate under the lease. This structure may widely benefit a broad range of assets in the power and renewables sector. A sale-leaseback may also be beneficial to highly leveraged companies that are capped out of the interest deductions they may claim under the new rules described below. Substituting rental expense for interest deductions may be the most optimal after-tax capital structure for these companies.

Base Erosion and Anti-Abuse Tax

The BEAT (discussed in detail in Part [VI.E](#), above) has particular significance to the renewable energy and tax equity industries.

While the BEAT is not aimed at the renewable energy industry or renewable energy tax credits, the BEAT may affect the value of tax credits to multinational banks and other corporations that invest in renewable energy projects, if the investor is unable to offset its BEAT liability with renewable energy tax credits. Under the bill, only 80% of the value of renewable energy tax credits may be used against the BEAT in each year through 2025. After 2025, none of the renewable energy tax credits may be used against a taxpayer’s BEAT liability.

How much this will matter to tax equity investors will depend on whether the tax equity investor anticipates being subject to the BEAT in any year in which it plans to claim tax credits, and how much BEAT it projects it will have to pay in each of those years. This computation depends on a myriad of factors and future transactions and, for most investors, will be difficult to project with accuracy.

Many large companies reduce their regular tax liability through the use of tax credits, including renewable energy tax credits. For those companies that are subject to the BEAT, there is no value in reducing their regular tax liability below their BEAT liability through the use of renewable energy tax credits because the higher BEAT would nullify the effect of any reduction.

The bill temporarily “fixes” this problem by allowing up to 80% of the renewable energy tax credits to be claimed against the BEAT through 2025. The fix may not be enough for tax equity investors to fully value tax credits in current transactions.

Some investors may still project that they will lose up to 20% of the tax credit value in any given year. There is no carryforward for tax credits that cannot be used to offset the BEAT. Also, unless the law is changed in the future, the value of all tax credits may be lost starting in 2026, when no part of the renewable energy tax credits may be used to offset the BEAT and the BEAT rate will be at its highest level.

How the tax equity market will solve this issue is not yet clear. Some transactions may be structured with shorter “flip” tenors, so that the investors limit exposure to tax credits generated after 2025. Other market participants may migrate to pay-go structures in which tax credits are monetized based on the facts at the time the credits are generated. Changing the risk allocations around the BEAT will likely ripple through a project’s capital structure, putting increased pressure on construction loan take-out commitments and back-leverage sizing and pricing metrics.

Interest Deduction Limitation

The new limitation on interest deductibility (discussed above in Part [III](#)) is likely to affect power and renewable assets that are typically highly leveraged and often held in partnership form.

As previously noted, the new business interest deductibility limitation applies both at the corporate level and to each partnership that pays interest under a loan.

If the limitation applies to a partnership, the net business interest is not deductible until future income is earned by that partnership.

This limitation may affect the after-tax returns of projects that are highly leveraged, especially those that are held in partnership form. Project sponsors with significant project leverage may choose to replace debt with other forms of capital, such as preferred equity or lease equity to avoid these limitations. Project sponsors may also consider aggregating multiple projects or portfolios with varied degrees of leverage into one partnership in an effort to increase taxable income and the corresponding interest deduction.

X. Private Investment Funds

The Act changes the holding period requirements relating to carried interest for taxable years beginning after December 31, 2017. While the Act is likely to have significant consequences for fund portfolio companies and, in some cases, blocker corporations and leveraged investment vehicles formed by funds, the Act seems unlikely to result in fundamental changes to the manner in which most private investment funds and sponsors are structured.

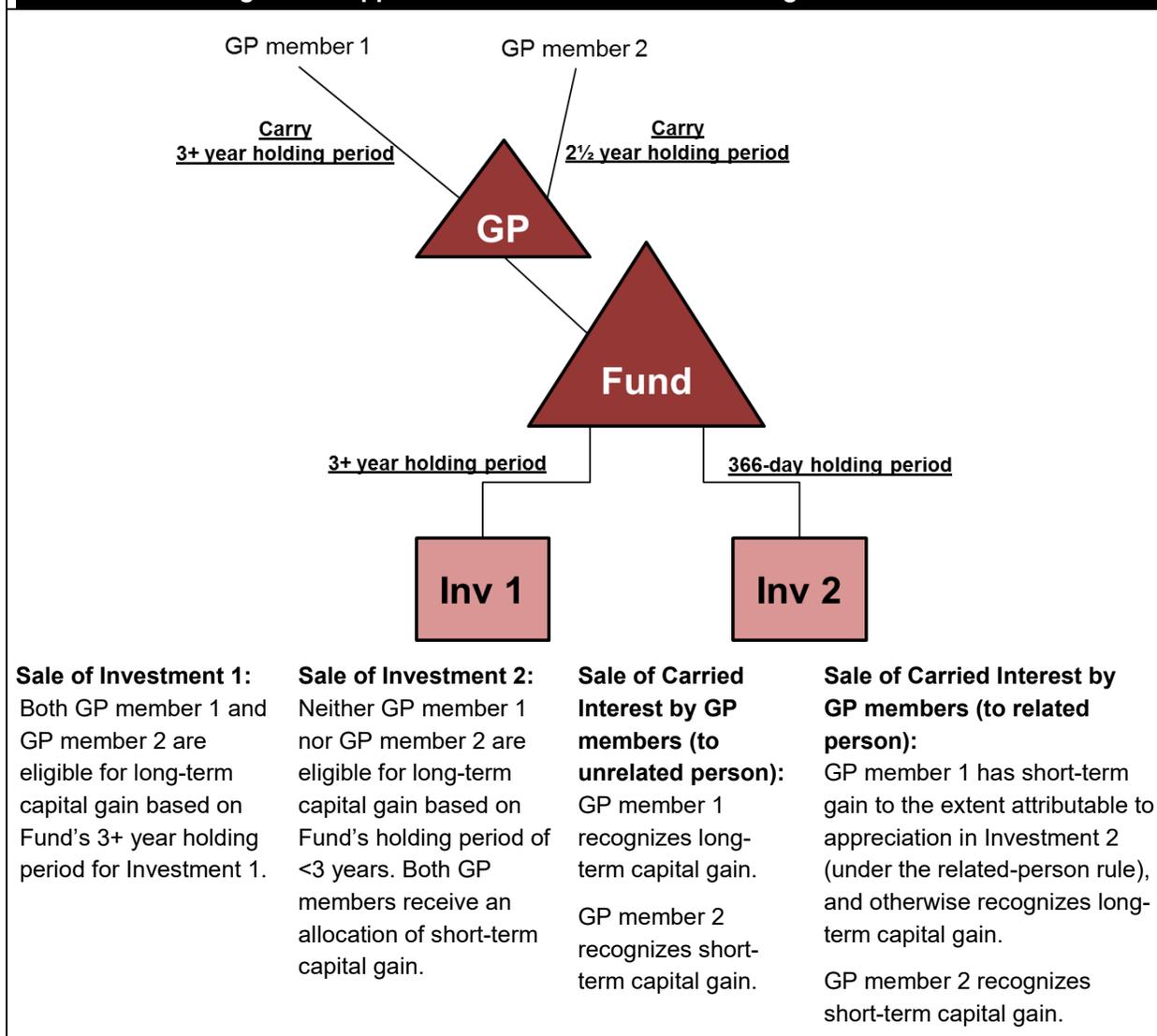
Carried Interest

Generally, the Act imposes a three-year holding period requirement for long-term capital gains treatment on carried interest. Gains that do not satisfy the three-year holding period requirement are treated as short-term capital gains taxed at ordinary income rates.

The provision does not apply to interests (i) held by a corporation or (ii) that provide for a return commensurate with capital contributions made by the interest holder, or with amounts included in the holder's income as compensation under Section 83. The three-year holding period requirement only recharacterizes long-term capital gains, and therefore appears to leave intact preferential rates on qualified dividend income with respect to carried interest. Special rules apply when carried interest is transferred to a related person (generally defined for this purpose as family members and certain persons who performed services in the same trade or business as the carry transferor within the prior three years).

The Act does not contain the broad changes to carried interest taxation included in prior legislative proposals, such as recharacterizing all income from carried interest as ordinary income. Like most prior proposals addressing carried interest, the Act leaves unchanged the position under prior law that the receipt of a profits interest in a partnership in exchange for services is not a taxable event to the recipient if certain conditions are satisfied.

Figure 14: Application of Carried Interest Holding Period Rules



Changes in Corporate and Pass-Through Tax Rates

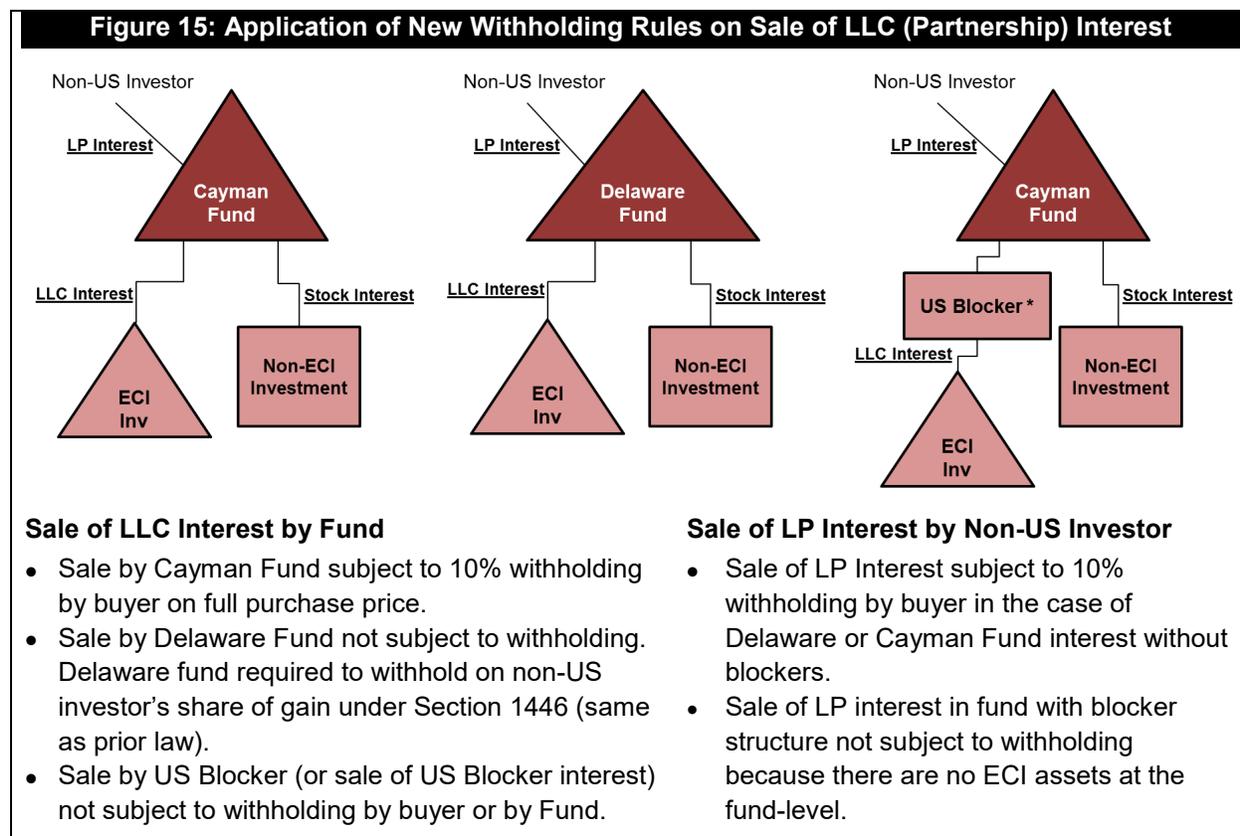
Generally, the Act's lower corporate tax rate would reduce (relative to prior law) the inherent tax inefficiency of using US blocker corporations in structuring alternatives for tax-exempt and non-US investors. Although the limitations on business interest deductions (discussed above in Part III) may limit investors' ability to reduce the effective tax rate of a US blocker corporation through shareholder debt, the overall effective tax rate of a US blocker corporation would likely be lower in many cases than under prior law.

Individual fund investors may benefit from the preferential rates on pass-through business income under new Section 199A with respect to portfolio companies structured as partnerships (rather than corporations) for tax purposes. It appears that while carry plan participants could also benefit from the lower pass-through rates on business income from pass-through portfolio companies, the limitations that apply on the pass-through deduction could result in the deduction not being available to carry plan participants. Owners of fund management companies, however, generally would not receive preferential

rates on the management company net income under the Act, since fund management companies typically engage in one of the “specified service trades or businesses” that are ineligible for the special pass-through business deduction under the Act. See the discussion in Part II above for more details on the reduced tax rates for pass-through entities.

Non-US Partners’ Treatment of Gain on Sale of Partnership Interests

Under the Act, gain recognized by a non-US investor on the sale of a partnership interest (including an LLC taxed as a partnership) is subject to US tax as “effectively connected income” (ECI) in proportion to the US business assets held by the partnership. This effectively codifies the IRS’ longstanding position, which was recently called into question when the Tax Court held against the IRS on this issue in *Grecian Magnesite Mining, Industrial & Shipping Co., SA v. Commissioner* (149 T.C. No. 3 (July 13, 2017)) and is effective for sales, exchanges, and dispositions that occur on or after November 27, 2017. (For further detail on the *Grecian Magnesite* decision, see Latham’s July 2017 *Client Alert*, [US Tax Court Exempts Gain on Sale of a Partnership Interest](#)). The Act also requires a buyer of an interest in a partnership with ECI assets to withhold 10% of the seller’s amount realized unless the seller certifies its status as a US person. If the buyer fails to satisfy these withholding requirements, the partnership must withhold from distributions to the buyer the amount (plus interest) that the buyer failed to withhold on the purchase. The withholding rule is effective for sales, exchanges, and dispositions that occur after December 31, 2017.



International Tax Provisions and Broader Scope of CFC Rules

The Act makes fundamental changes to international tax rules (discussed in detail above in Part [VI](#)) that are likely to have significant effects on a fund's portfolio companies with international operations. Moreover, changes in the constructive ownership rules and in the definition of "United States shareholder" for purposes of applying the CFC rules increase the possibility that foreign corporations owned by a fund would be treated as CFCs, and that US investors would be treated as US shareholders subject to the CFC anti-deferral rules. For example, the changes to the constructive ownership rules could be applied to treat any foreign portfolio company owned by a non-US fund as a CFC, if the fund (or a parallel fund with the same investor base) also owns a US portfolio company. CFC status may result in "phantom" income to investors that are US shareholders and in additional tax reporting obligations.

Unrelated Business Taxable Income

The Act requires tax-exempt investors to determine their unrelated business taxable income (UBTI) separately for each unrelated trade or business. This generally prevents losses from one UBTI activity of a tax-exempt investor from offsetting income from a different UBTI activity. The new rule could make it more attractive for tax-exempt investors to hold multiple investments through a single blocker (especially in light of reductions in corporate tax rates) because a blocker corporation — unlike a tax-exempt investor investing directly in a fund — would be able to net income and losses that would have been UBTI from separate investments. This rule is generally effective for taxable years beginning after December 31, 2017.

Next Steps

Now that the Act has become law and many of the changes are effective, companies will be well-advised to immediately review their existing structures and consider the impact of the new provisions on their business, future structuring, and tax planning. While legislative technical corrections and Treasury and IRS guidance may alter certain aspects of the Act, companies will need to make decisions both for day-to-day operations and long-term outlook based on the interpretations currently available.

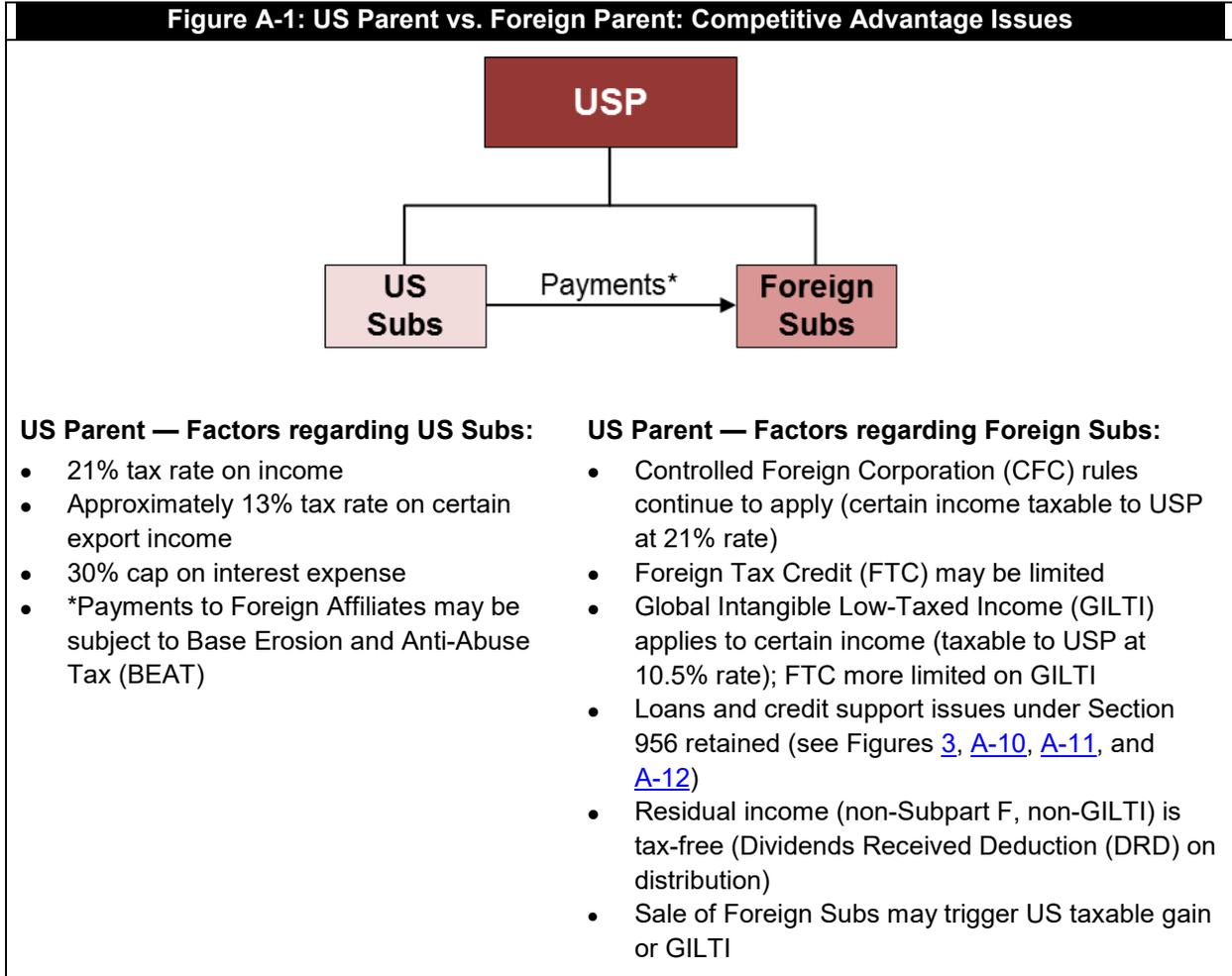
Please see the following Appendix for a series of diagrams illustrating the Act's potential impact on various structuring and transactional considerations.

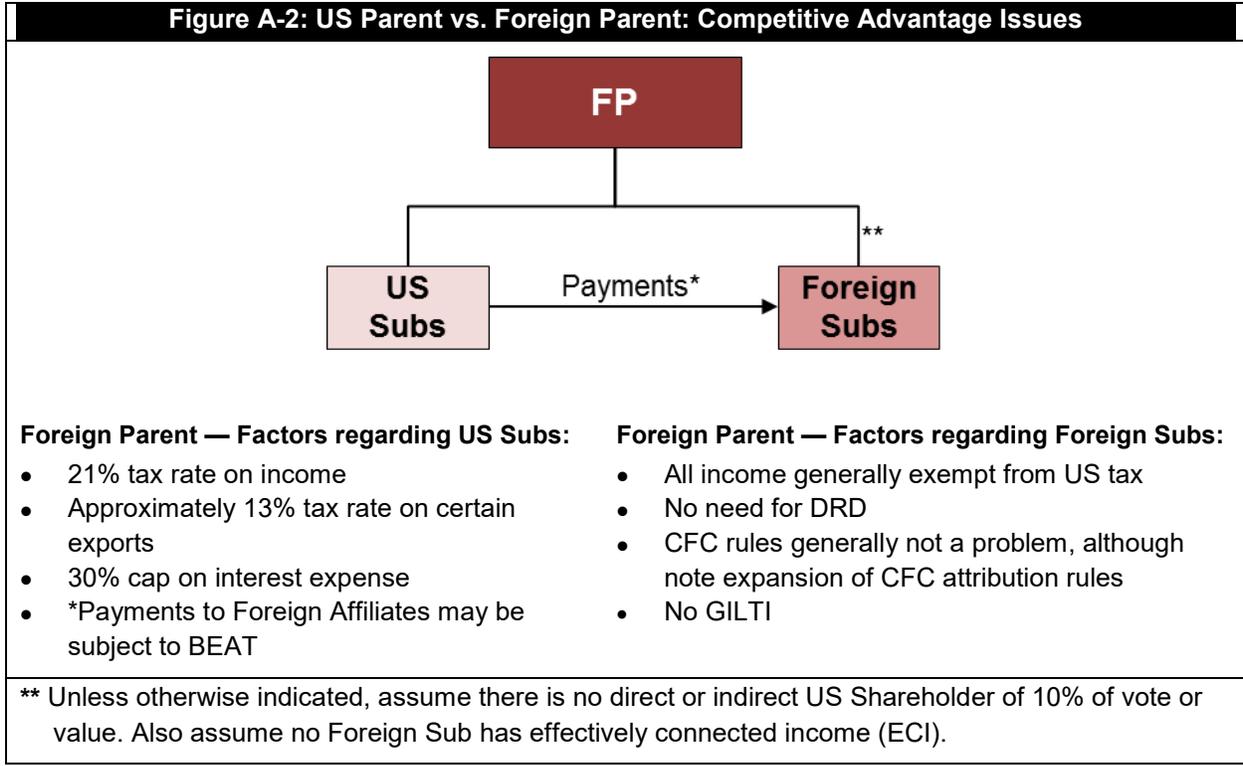
If you have questions about this *White Paper*, please contact one of the authors listed after the Appendix or the Latham lawyer with whom you normally consult.

APPENDIX: International Structuring, Transaction, and Deal Negotiation Considerations

The Act requires reconsideration of a number of fundamental issues in cross-border structures and deals. The diagrams below illustrate how the Act will affect several transactional scenarios.

WHAT ARE THE COMPETITIVE ADVANTAGES OF A US PARENT VS. A FOREIGN PARENT?



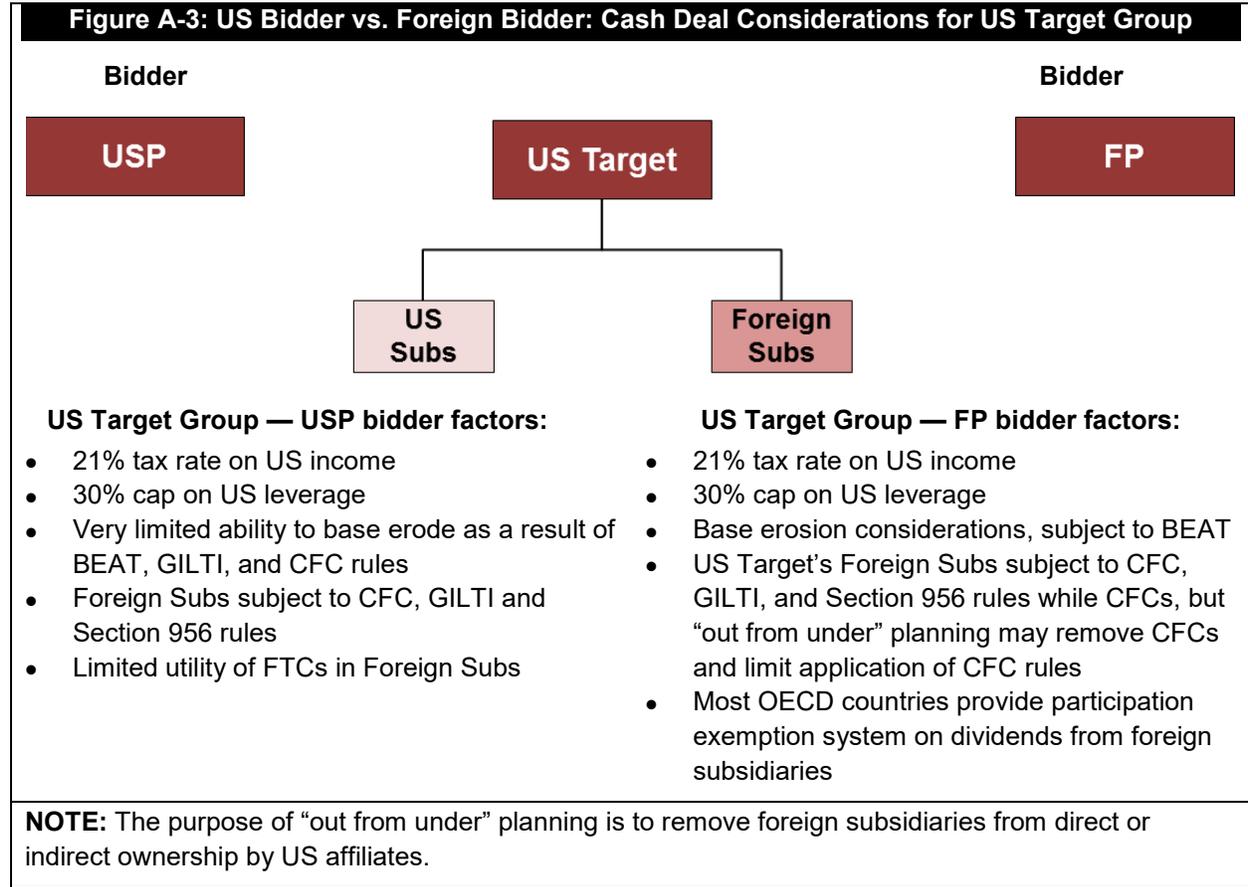


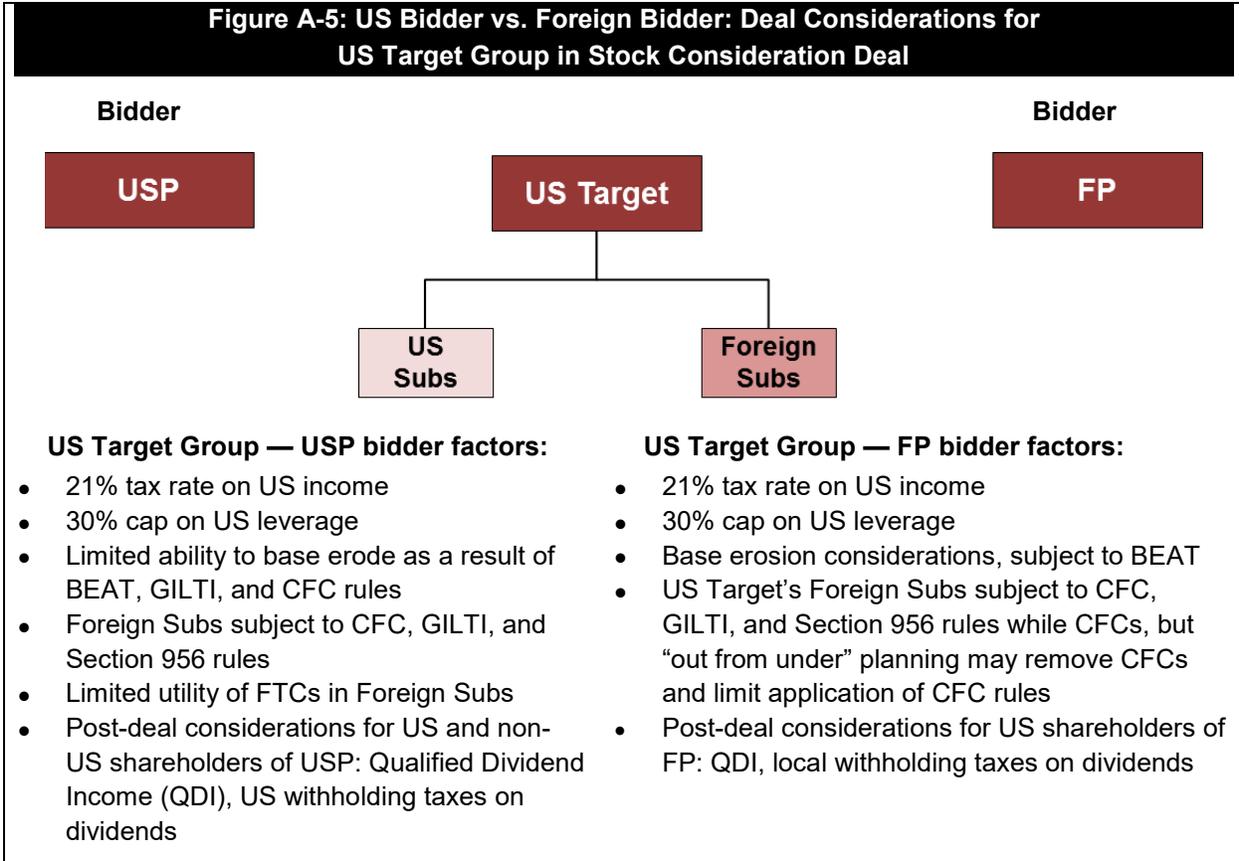
Important Note Regarding US Anti-Inversion Rules:

The US anti-inversion rules have been subject to extensive commentary (for further detail, see Latham’s April 2016 *Client Alert*, [Treasury Issues Stringent Inversion Regulations, Proposes Far-Reaching Related-Party Debt Rules](#)). It is important to remember that the detailed and generally restrictive rules regarding the application of the anti-inversion ownership tests under Section 7874, including the relatively harsh Obama Administration regulatory framework, remain fully in place at this time. In other words, it is just as difficult for a US corporation to combine with a foreign corporation and seek a new parent corporation to qualify as a foreign resident under Section 7874 post-Act as it was pre-Act.

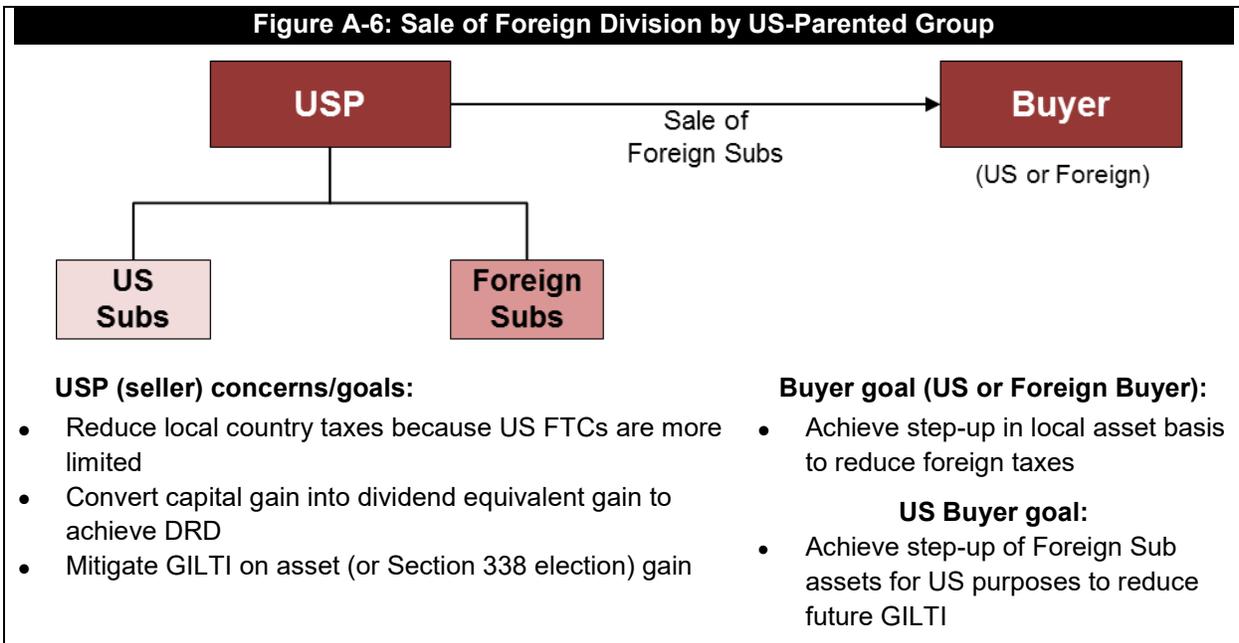
Executives, dealmakers, and venture capitalists should keep the point in mind as they look to structure deals and new ventures, as the prohibitions against “exiting” the United States remain as restrictive as ever. Indeed, this point may become more of a topic of discussion as the Act settles into law and the business community considers the long-term sustainability of the new law and the potential for a shift in tax rates or other changes due to future political changes.

WHAT ARE THE ISSUES REGARDING COMPETITIVE ADVANTAGES FOR A US BIDDER VS. A FOREIGN BIDDER FOR A US TARGET GROUP?





NOTE: An overriding consideration in any deal with a foreign bidder for a US target with share consideration is the anti-inversion rules, which limit the level of ownership that the US Target shareholders can have in FP (see discussion on page 35, above).



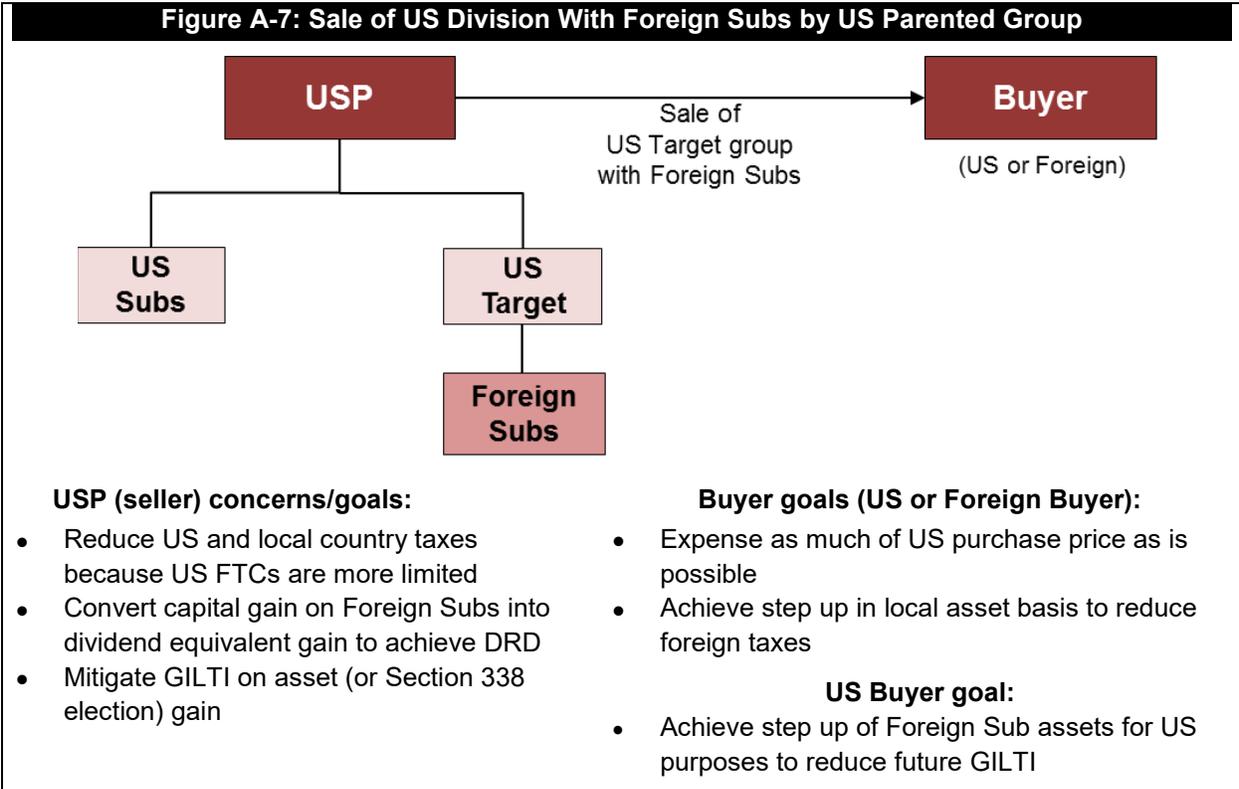
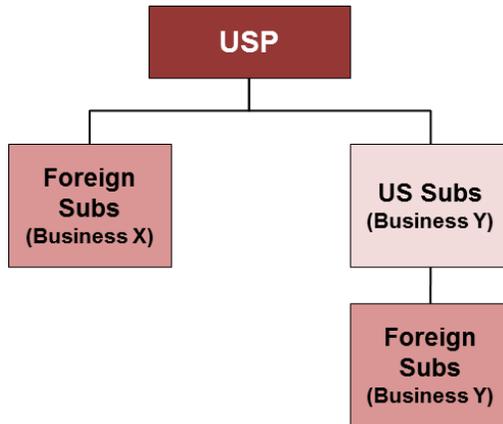


Figure A-8: Deal Issues Related to Repatriation Tax



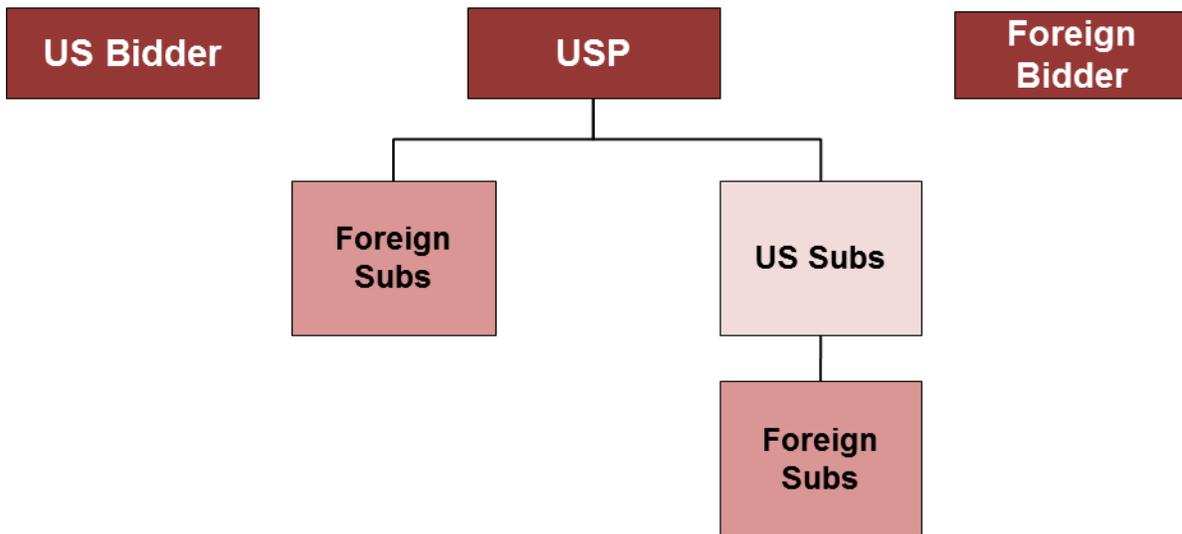
In 2017, USP Group includes in income the accumulated, untaxed earnings of all Foreign Subs:

- 15.5%/8% rates
- Payable over 8 years
- Partial FTCs
- Complex calculations taking into account earnings, deficits, Foreign Subs owned through different US chains, etc.

Issues for a Buyer of USP or of US Subs (Business Y only) with respect to Section 965 transition tax:

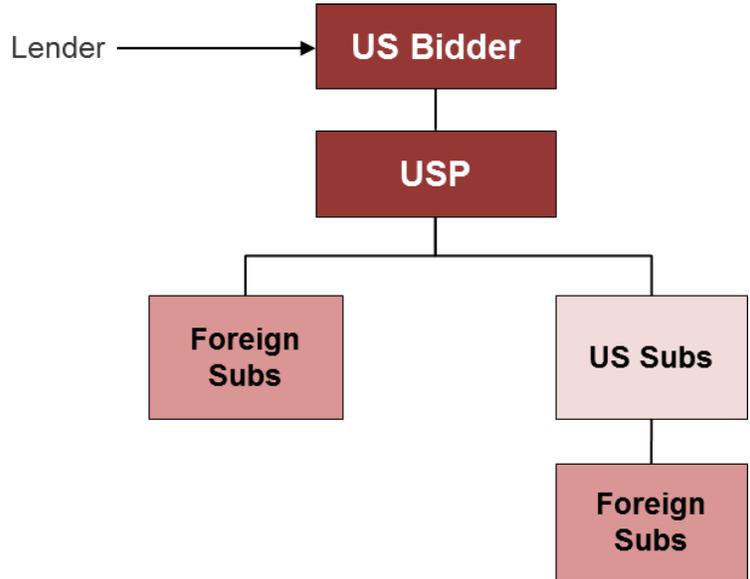
- Diligence 2017's calculations
- Consider inherited (embedded) liability
- Recapture at 35% rate/No FTCs in certain inversions
- Same general issues can result if USP spins US Sub (US Sub will carry this embedded liability for 2017 repatriation tax)

Figure A-9: Credit Support in US Acquisitions: Act Retains Section 956



Both the US Bidder and Foreign Bidder competing in this transaction need credit support.

Figure A-10: Act Retains Section 956 — Impact on Foreign Credit Support in US Acquisition in Which US Bidder Acquires USP

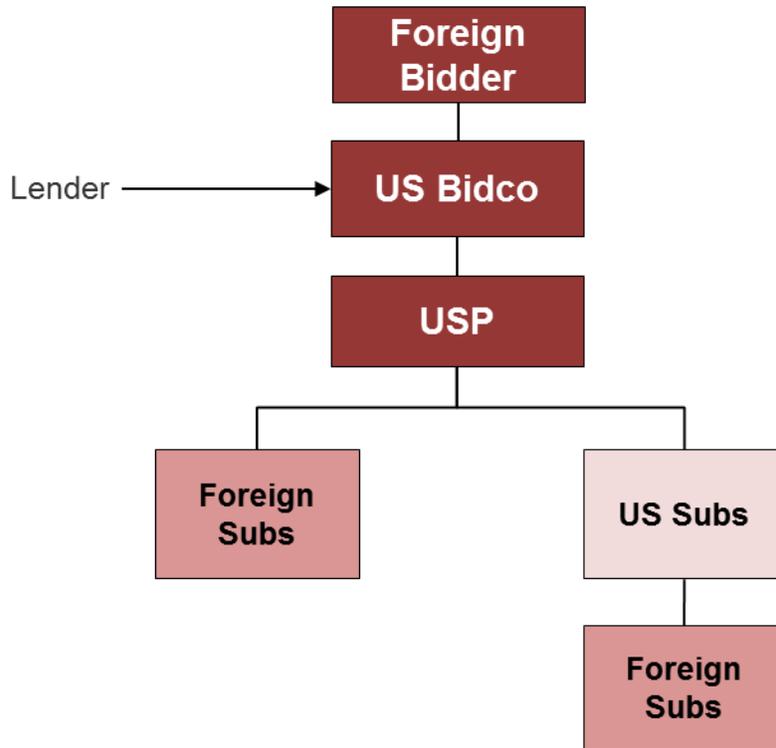


Section 956 applies to potentially cause a deemed dividend to USP Group (taxed at up to 21% and ineligible for DRD) for previously undistributed overseas earnings of Foreign Subs.

Mitigating factors to Section 956 inclusion include:

- Previously taxed income pool as a result of Section 965 transition tax
- FTCs
- Certain earnings would already be taxed at 10.5% under GILTI rules

Figure A-11: Act Retains Section 956 — Impact on Foreign Credit Support in US Acquisition in Which Foreign Bidder Acquires USP (via US Bidco)

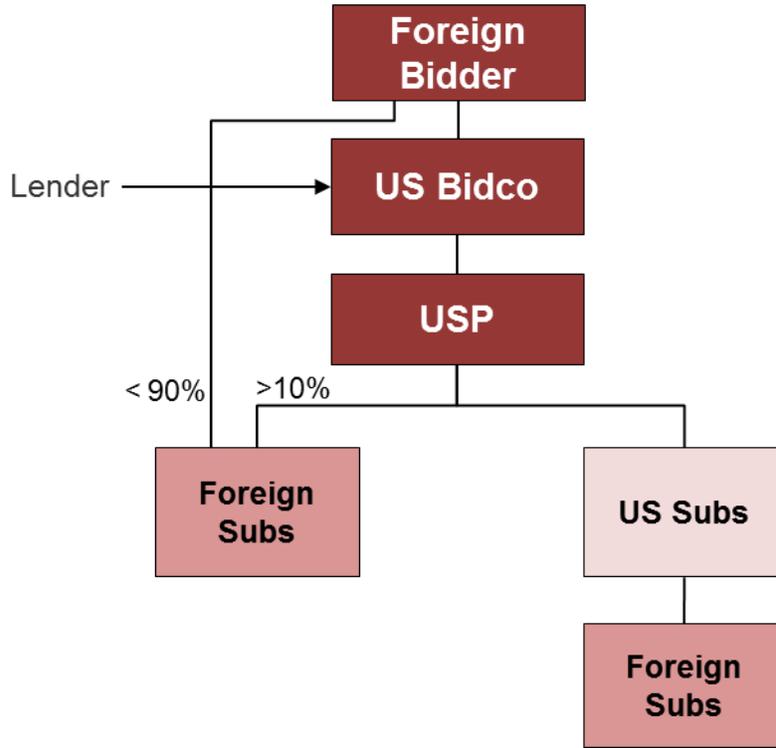


Section 956 applies to potentially cause a deemed dividend to US Bidco Group (taxed at up to 21% and ineligible for DRD) for previously undistributed overseas earnings of Foreign Subs.

Mitigating factors to Section 956 inclusion include:

- Previously taxed income pool as a result of Section 965 transition tax
- FTCs
- Certain earnings would already be taxed at 10.5% under GILTI rules
- “Out from under” planning may remove CFCs from direct ownership by US affiliates and limit the impact of application of Section 956 rules if there is otherwise no direct or indirect US Shareholder of 10% of vote or value.

Figure A-12: Act Retains Section 956 — Impact on Foreign Credit Support in US Acquisition in Which Foreign Bidder Acquires USP (via US Bidco) and Co-Owns Foreign Subs With USP



For so long as there is a 10% or greater direct or indirect US owner, Section 956 would remain a potential issue due to expanded application of CFC attribution rules.

If you have questions about this *White Paper*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Michael J. Brody

michael.brody@lw.com
+1.213.891.8724
Los Angeles

Joseph M. Kronsoble

joseph.kronsoble@lw.com
+1.312.876.7657
Chicago

Alan Van Dyke

alan.vandyke@lw.com
+1.312.876.6539
Chicago

Cheryl M. Coe

cheryl.coe@lw.com
+1.202.637.2157
Washington, D.C.

Jiyeon Lee-Lim

jiyeon.lee-lim@lw.com
+1.212.906.1298
New York

Jim Cole

james.cole@lw.com
+1.713.546.7435
Houston

Nicholas J. DeNovio

nicholas.denovio@lw.com
+1.202.637.1034
Washington, D.C.

Julie M. Marion

julie.marion@lw.com
+1.312.876.7700
Chicago

Bryant P. Lee

bryant.lee@lw.com
+1.713.546.7480
Houston

C. Timothy Fenn

tim.fenn@lw.com
+1.713.546.7432
Houston

Ana G. O'Brien

ana.o'brien@lw.com
+1.213.891.8721
Los Angeles

Patrick Allan Sharma

patrick.sharma@lw.com
+1.213.891.7934
Los Angeles

Gregory T. Hannibal

greg.hannibal@lw.com
+1.212.906.1606
+1.646.573.0199
New York

Elena Romanova

elena.romanova@lw.com
+1.212.906.1644
New York

Thomas H. Halpern

Knowledge Management Counsel
thomas.halpern@lw.com
+1.213.891.8684
Los Angeles

Eli M. Katz

eli.katz@lw.com
+1.212.906.1620
New York

Laurence J. Stein

larry.stein@lw.com
+1.213.891.8322
Los Angeles

You Might Also Be Interested In

[Latham & Watkins US Tax Reform Resource Center](#)

[US Tax Reform: Opportunities and Challenges for Leveraged Finance](#)

[Tax Reform Update — Impact on Renewable and Energy Projects](#)

[Update: Executive Compensation Ramifications of Proposed Tax Cuts and Jobs Act](#)

White Paper is published by Latham & Watkins as a news and analysis reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to the firm's global client mailings program.