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How Donald Trump's election changes the Global Tax Landscape

The implications of US tax reform under a Trump presidency go far beyond the US

2016 has brought a number of shocks to the global system. The latest of these – the election of Donald Trump as US president – brings the prospect of major changes in US tax policy and legislation. The mooted changes include sharp cuts in tax rates – especially corporation tax – and actions both to discourage tax inversions by US companies, and also to drive the repatriation of US corporate profits held as cash offshore.

The cross-border and even global nature of these actions means their effects would be felt by governments and companies far beyond the US. James Wilson, a UK Corporate Tax partner based in New York, commented: "To date in 2016, we've spent a lot of time thinking about Brexit. Now it's time to look at the implications for the international tax environment of Donald Trump's election. It's not just the US that will be impacted by the very real potential for US tax reform."

The process for creating US tax policy and legislation is complex and multi-party

The US tax environment is statute-driven, with legislation passed by Congress and signed by the President. The Treasury/IRS can issue regulations under the statutes: these regulations may be either "interpretive" – representing a judgement call by the Treasury – or "legislative", following a grant of authority by Congress. In terms of how an idea becomes statutory law in the US, the House of Representatives, Senate and White House all have a role to play, with the Senate passing laws either through a filibuster-proof 60 votes or a reconciliation process.

For a Trump presidency, problems in getting bills through Congress are more likely to arise in the Senate than the House of Representatives. "The Republicans have a big enough majority in the House of Representatives," commented Alexandra Minkovich, Of Counsel to the Washington DC office. But she cautioned that Republicans have a much smaller majority in the Senate and may need to work with Senate Democrats to accomplish tax reform. The process of US tax reform is further complicated by the diverse range of players involved, each with their own agendas – with key individuals across Team Trump and both houses of Congress. There's also the Joint Committee on Taxation (JCT), a committee of staff members

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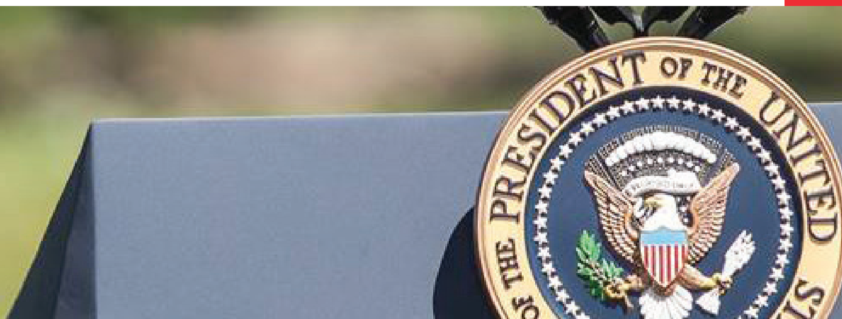

who advise Congressional tax writers on legislative language and estimate the costs of legislation.

Despite the complexity, some degree of reform will be navigated through Congress by end-2017

In an interactive poll of the attendees at our seminar using the "Slido" app, some 86% thought there would be no US tax reform by end-2017. Yet the speakers, applying their deep understanding of US policy making, felt the chances of legislative change at some point next year were high – although the resulting reforms may fall short of the more radical proposals now on the table.

"I think the likelihood of tax reform in 2017 is just over 50%," commented New York Partner Thomas May. "For the first time in many years we have both houses of Congress and the White House controlled by a single party, and the Democrats also want tax reform. So it all seems to be aligning. But as we've seen so often before, it comes down to the detail." Alexandra Minkovich was more bullish, pointing out that the Republicans are keen to get some legislative wins and end the perception that they're the party of 'no'. "I think we will have a document passed in 2017 that's entitled 'tax reform'," she said. "It could be a simplistic tax change – but there will be a piece of legislation."

A key factor determining how far-reaching the tax reform may be is whether the legislation is bipartisan or passed by reconciliation. A useful pointer will be what happens with healthcare – an area where the Republicans want to repeal the Affordable Care Act, commonly known as 'Obamacare'.

Key US tax problems to fix: the "foreign advantage", inversions and overseas profits

A key criticism of the current US tax regime is that it gives an advantage to companies with their tax domicile outside the US – a trait that has encourage the flow of tax inversions in recent years. Presenting a comparison of the effective tax rates (ETRs) for US multinationals before and after inversion to a lower-tax domicile, London Partner Mark Bevington commented: "There's some evidence of a gradual decline in ETRs for companies that have inverted. This suggests that the theoretical 'foreign advantage' does play out in practice in US multinationals that have inverted."

With inversions becoming a highly political issue, responses to date have included the US Treasury's "Section 385" regulations – although some believe the Treasury overstepped its authority with these. It's interesting to note that the UK tax regime in 1997 was very similar to the US's today, and was prompting UK companies to invert out of the UK. The UK regime has moved to a low-rate, territorial

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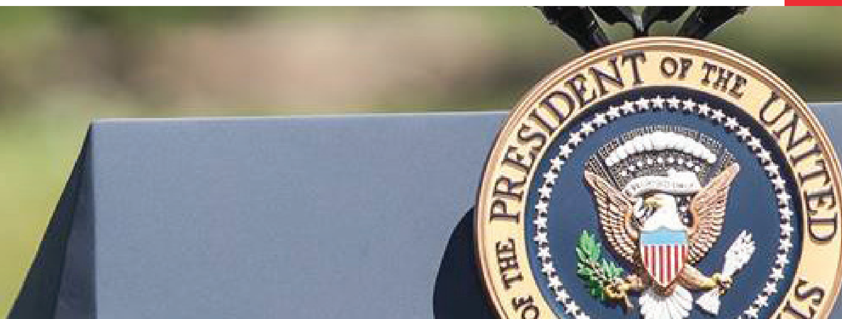

system with light-touch CFC rules, and some expatriated companies have reverted to the UK. If the US is to achieve a similar outcome, a key factor may be its approach to taxing US multinationals' profits booked offshore.

"There's a general bipartisan consensus that repatriation is something that ought to happen," commented Alexandra Minkovich. "So the questions are, what is the rate? Is it a graduated rate? And what do you use the funds that the government raises through repatriation to pay for?" The current proposal is to implement a "deemed" repatriation of foreign earnings for tax purposes – a step that members of our panel expect to see in 2017. In general, the Republicans would like to use the funds to lower corporate tax notes, while the Democrats (and perhaps President-elect Trump) would prefer investment in infrastructure. So there are grounds for negotiation.

There are significant differences between the Trump tax agenda and the Republican-led House Blueprint

A further factor is that two key parts of the tax Blueprint issued by the Republican-dominated House of Representatives in the summer of 2016 are optional or missing in the Trump proposals. One is moving income tax to a consumption tax – meaning a building could be expensed from year one, but without the current deductions for interest expenses. The second is the proposal for a border adjusted tax, from which gross revenues from exports would be exempt but which would be levied on imports.

"There would be some big losers from a border adjusted tax," commented Washington, DC Partner Joshua Odintz. "Like retailers who import goods, contract manufacturers, and car companies with engines made in Mexico and Canada. These types of losers will begin to weigh in against the border adjusted tax."

Deemed repatriation could trigger a surge in US M&A – both domestic and outbound...

Deemed repatriation of foreign earnings and profits could act as an incentive for US multinationals to acquire businesses and other assets before the new tax rules come in, in order to convert cash into non-cash holdings. One result may be more US domestic M&A activity: US groups have previously struggled to use offshore cash to make acquisitions within the US – but if it's being repatriated and taxed anyway, they may as well use it. However, in the repatriation holiday in 2004, most of the repatriated cash was returned to shareholders in the form of share repurchases.

Whatever US companies decide to do with the repatriated cash, there's

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no doubt they are eager to have the opportunity to use it as they choose. Thomas May commented: "The single biggest issue with the US tax system is the inability to access foreign cash. If you took that issue away, US multinationals would be extremely happy with having access to that cash to do M&A – or anything else they decided on."

...With UK companies potentially in the sights of US acquirers

With US multinationals gaining access to their foreign cash piles through deemed repatriation, UK acquisition targets may become particularly attractive. "In terms of takeover vulnerability, look at the dollar/sterling exchange rate," commented London partner Kate Alexander. "Plus there will be a fundamental change in value, with US companies becoming more valuable as a consequence of US tax rates falling."

At the same time, the loss of previously-available tax deductions may significantly push up the ETRs of UK multinationals operating and borrowing in the US. This may reduce the value of UK companies at the very moment when the value of US competitors is rising – further encouraging inbound M&A from the US into the UK. Also, US companies that hold off from acquiring UK businesses risk seeing sterling recover in 2017, thus also increasing the dollar price of those assets. So there's an incentive to move fast.

Costs of funding may rise, as external debt becomes less tax-attractive

As well as experiencing rises in their ETRs, UK multinationals may also find that the US tax changes drive significant changes in how and where they raise capital. Historically, UK plcs have used debt to earnings-strip the US, often getting to an ETR of much less than 15%. But changes to US rules for interest deductibility could make external debt far less attractive, an effect that will not be fully offset by expensing of capital investment. Kate Alexander comments: "Companies are going to have to look closely at sources of funding and where they issue paper, because the whole cost of capital could potentially be changing over the coming 12 months."

The ground is shifting on IP holding and exploitation

Under the current Trump proposal, there would be no tax benefit to US companies in holding intellectual property (IP) offshore, regardless of the rate, because the tax on foreign earnings would always be topped up to 15%. Meanwhile, the House Blueprint proposals would incentivise onshoring to a foreign jurisdiction if the rate were lower than the effective rate from holding the IP in the US. At

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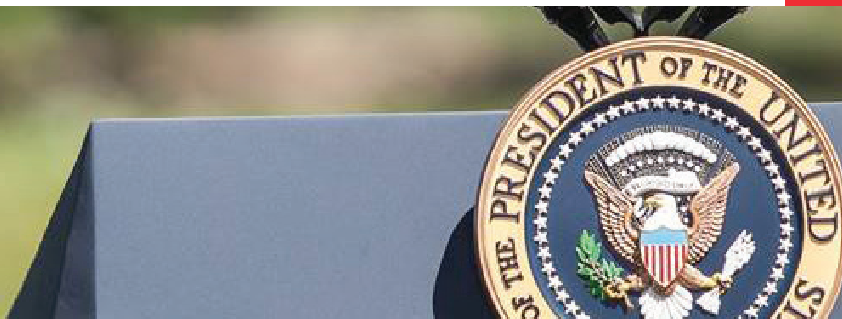

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current rates, there are only a handful of likely contenders – such as Ireland and, more especially, Singapore.

So the plans put "nowhere income" IP holding companies under threat for groups headquartered in the US. While not in the current proposals, there could also be scope for a US "patent box" and other measures to encourage US-based R&D – moves that would mirror a growing drive by other countries worldwide to attract IP and R&D. Joshua Odintz commented: "I think there will be a race internationally to continue to attract these activities, in the hope that the IP will lead to more real activity...Clearly, there will be some effort to protect IP already in the US, and get more IP back into the US."

We could be entering a new global era of tax competition

US multinationals' decisions over issues such as moving IP back to the US or keeping it in a foreign jurisdiction would appear to be very sensitive to the US corporate tax rate that is ultimately adopted. With Donald Trump having talked about a cut from 35% to 15%, there are also wide variations in the possible size of the headline rate reduction. A Slido poll of the delegates at the seminar found that 56% believed the new rate would be about 20%, with a further 25% going for a 25% rate. Only 9% thought the rate would fall as far as 15%.

Going forward, there's clear potential for a race to the bottom as other jurisdictions react to any US rate reduction – possibly heralding a new era of tax competition. The expectation at the seminar was that if the US goes to 20%, the UK will probably stick at about 17%. But tax competition could go much further: there's talk of the US withdrawing funding from the OECD – the US pays 25% to 30% of the OECD's annual costs – and backsliding on BEPS. Other countries might also target US multinationals' efforts to expatriate cash. "The genie is out of the bottle, and countries are looking for revenue," said Joshua Odintz. "And there's a big pot of cash offshore."

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The Change That Changes Everything

SPEAKERS

KATE ALEXANDER
Partner
London
+ 44 20 7919 1908
Kate.Alexander
@bakermckenzie.com

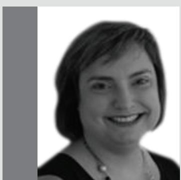
Kate specialises in UK and international taxation. She is an expert in the UK CFC regime, loan relationship anti-avoidance provisions and the proposed interest limitation rules. Additionally, Kate specialises in the taxation of intangible property, including the UK Patent Box, and she regularly assists multi–national companies with the design of their global holding and financing structures.

MARK BEVINGTON
Partner
London
+ 44 20 7919 1453
Mark.Bevington
@bakermckenzie.com

Mark focuses his practice on UK and international taxation, most particularly the taxation of intangible property, including relevant UK regimes, international structuring, and hub structures. Additionally, Mark focuses on broader UK domestic planning and has considerable experience in tax litigation, dispute negotiation and pension deficit restructuring.

THOMAS MAY
Partner
New York
+ 1 212 891 3983
Thomas.May
@bakermckenzie.com

Tom has extensive experience in international and domestic taxation. He frequently advises on domestic and international mergers and acquisitions, post-acquisition and pre-disposition restructurings, as well as joint ventures
and strategic alliances. He also has extensive experience in the areas of foreign tax reduction, subpart F and PFIC planning, foreign tax credit utilisation, interest expense apportionment, supply chain restructuring, treaties and inbound investment.



ALEXANDRA MINKOVICH
Of Counsel
Washington, DC
+ 1 202 452 7015
Alexandra.Minkovich
@bakermckenzie.com

Alexandra focuses her practice on tax policy and tax controversy matters. Prior to the joining the Firm, she served as Associate Tax Legislative Counsel in the US Department of the Treasury, where her portfolio included a variety of domestic US tax matters. She currently advises clients on tax policy matters ranging from regulatory matters before the Treasury Department and the Internal Revenue Service to legislative matters before the US Congress. In addition, she has been involved in tax controversies at all stages, from audit and administrative appeals to litigation. She represents clients with respect to domestic tax issues with a particular focus on advising banks and financial institutions.

JOSHUA ODINTZ
Partner
Washington, DC
+ 1 202 835 6164
Joshua.Odintz
@bakermckenzie.com

Joshua has over 14 years of tax experience, having served in high-level government positions in the US Department of the Treasury and the Senate Finance Committee. He focuses on tax controversy and tax policy matters.
He advises clients on domestic and international tax controversy matters from audit and administrative appeals through litigation. He has handled cases involving transfer pricing, tax accounting, privilege and work product,
among others.

JAMES WILSON
Partner
New York
+ 1 212 626 4812
James.Wilson
@bakermckenzie.com

James is a member of the UK Corporate Tax Practice Group and handles international tax planning matters. He is currently based in the New York office. James practices in the area of, and advises on, all aspects of UK corporate and commercial tax. He concentrates on international tax planning issues with a particular focus on UK and European inbound planning for North American headquartered multinationals and multi-jurisdictional group reorganisations
and restructurings.

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