PRAGER
DREIFUSS

Tax Newsletter / February 2018

Reform of the U.S. Tax Regime – The Swiss Perspective

1. Introduction

On December 22, 2017, U.S. President Donald Trump signed the Tax Cuts and Jobs Act ("TCJA") into law, which took effect January 1, 2018 and is considered by many as the most sweeping overhaul of the U.S. tax system in over three decades. The TCJA not only makes major changes to the taxation of individuals but – more significantly – modifies the system of taxation for corporations and multinational groups. While proponents claim that the reform puts America first and boosts job creation and economic growth, critics fear that the new tax regime cuts taxes for the rich and will increase the federal debt by billions of dollars annually.

The new 185-page act will clearly affect almost every individual and business in the U.S., but it is very likely that the TCJA will have substantial effects outside the U.S.

This PD tax newsletter – prepared in collaboration with Galia Antebi, Partner at Ruchelman PLLC (New York) – analyzes some of the highlights of the TCJA's international provisions relating to U.S. individuals residing in Switzerland as well as non-U.S. headquartered corporate groups with local (U.S.) operations.

Prager Dreifuss AG is one of Switzerland's leading law firms for business law. We offer advice in the areas in which we can provide outstanding quality. We thus strive to find integrated, innovative solutions for our clients that are adapted to legal and economic realities. Our attention is equally focused on legal issues as on controlling business risks.

Dr. Roland Böhi
Partner, Head of Tax
roland.boehi@prager-dreifuss.com

Danielle Wenger
Partner
danielle.wenger@prager-dreifuss.com

Dr. Stefan A. Wandel
Trainee Lawyer
stefan.wandel@prager-dreifuss.com

2. Overview of TCJA Key International Provisions

2.1. *Taxation of Corporations*

2.1.1. *Reduced corporate tax rate*

One of the core elements of the TCJA is the introduction of a new flat corporate income tax at a rate of 21% (down from a maximum rate of 35%; the highest rate among OECD members), which will be applicable on a permanent basis as from 2018. This means that the effective combined total tax burden for companies in the U.S. will range from 21% to approx. 30%, taking into account additional taxes levied at individual state level (note that additional income taxes may also be levied at local level e.g. in New York City).

2.1.2. *Dividend exemption*

Another significant change compared to prior law is the establishment of a so-called (modified) territorial tax system (similar to the Swiss system). Subject to certain holding period requirements, this would allow a dividend received deduction for 100% of the foreign-source portion of dividends received from a foreign corporation in which the U.S. corporate shareholder recipient owns 10% or more of the vote or value (under the expanded definition for a U.S. shareholder as amended by the TCJA) . To transition to the new territorial system, the TCJA contains a deemed repatriation provision, under which U.S. shareholders (as more broadly defined under the TCJA) must include in income their pro rata share of undistributed, non-previously taxed earnings and profits from certain foreign corporations (generally corporations treated as "controlled foreign corporations" and any non-U.S. corporation that has one or more U.S. corporate shareholder owning 10% or more of the vote or value). Unlike the dividend received deduction, which is available only to corporate shareholders, the deemed repatriation inclusion applies to all U.S. shareholders, including individuals. The Code provides for a special deduction that brings the effective tax rate for corporate shareholders down to 15.5% with respect to the "cash portion" and 8% with respect to the "non-cash" portion. This mandatory inclusion applies for earnings and profits accumulated as of the last tax year of the foreign corporation beginning before January 1, 2018. This means that U.S. shareholders may have additional income inclusion in their 2017 income. This burden is somewhat mitigated by the ability to elect to pay the tax over 8 years with no interest.

2.1.3. *New tax on global intangible low-taxed income*

Going forward, with respect to income generated in tax years beginning on or after January 1, 2018, the TCJA will generally require a U.S. shareholder to pay an immediate U.S. income tax on a big part of the profits of its non-US subsidiaries, which would not otherwise be subject to U.S. tax as income effectively connected with a U.S. trade or business or as subpart F income. This inclusion would apply regardless of whether or when the profits are repatriated to the U.S. This special regime applies to global intangible low-taxed income ("GILTI") earned by non-U.S. corporations, which are "controlled foreign corporations". Despite its name, the income that is picked up in this provision has nothing to do with intangible property and generally speaking is any income generated by the corporation to the extent total gross income of the CFC exceeds a hypothetical return generated from the use of the corporation's tangible assets (generally referred to as property, plant and equipment, or PP&E). The hypothetical return is an amount equal to 10% of the adjusted basis of the corporation's PP&E. Corporate shareholders in the U.S. are allowed a deduction equal to 50% of GILTI for 2018 through 2025, which would be decreased to 37.5% beginning in 2026. As a result, the effective tax rate on GILTI for U.S. corporations would be 10.5% prior to 2026 increasing to 13.1% afterwards. Individuals who are U.S. shareholders of a CFC

as defined may elect to be treated as corporations for these purposes. The U.S. tax on the GILTI inclusion may be reduced by a partial foreign tax credit that is capped at 80% of the GILTI tax otherwise due.

2.1.4. New deduction for foreign derived intangible income

On the beneficial side, U.S. corporate shareholders of a CFC may be entitled to claim a deduction for foreign derived intangible income ("FDII"). This is the portion of profits from supplying goods or services to customers in foreign markets, provided those items are held by the customer for sale, use, or consumption in a market outside the U.S. As with GILTI, the amount of the deduction has nothing to do with intangible property as such and generally speaking is any income generated by the corporation to the extent total gross income of the U.S. corporation exceeds a hypothetical return generated from the use of its PP&E. The hypothetical return is an amount equal to 10% of the adjusted basis of the corporation’s PP&E.

2.1.5. New base erosion and anti-abuse tax

Under the TCJA, a new base erosion and anti-abuse tax ("BEAT") will be introduced. BEAT imposes a minimum tax on the U.S. corporation to limit a corporation's ability to reduce its normal U.S. taxes through otherwise deductible payments to related foreign parties (normally located in low-/zero-tax jurisdictions). Payments accounted for in the determination of the BEAT are deductible payments made to a foreign affiliate, including payments such as royalties and management fees, but excluding certain payments, including purchases that generally are taken into account as cost of goods sold. The tax would be applicable to certain enterprises with average annual gross receipts in the preceding three years of at least USD 500 million and whose base erosion percentage (the ratio that the tax benefits derived by “base erosion payments” bear to the total deductions claimed by the corporation) is 3% or more. The BEAT is imposed as a minimum tax equal to the excess of 10% of modified taxable income over the tax computed under the regular rules. In 2018, the BEAT is imposed at 5%; after 2025, at 12.5%.

2.1.6. Stricter interest deductibility rules

Subject to some exceptions, prior law stated that interest paid or accrued by a business generally is fully deductible. Under the TCJA, affected corporate and non-corporate businesses generally cannot deduct interest expenses in excess of 30% of “adjusted taxable income” (whether paid to a related party or not) starting with the 2018 tax year. This provision converts what had been an earnings stripping provision for interest paid to related parties to a ceiling on the net business interest paid to all creditors. For purposes of the ceiling, adjusted taxable income is similar to the concept of EBITDA (earnings before interest, tax, depreciation and amortization). For taxable years beginning on or after January 1, 2022, the definition of “adjusted taxable income” will be modified to reflect EBIT (earnings before interest and tax).

2.1.7. Stricter loss carryforward rules

The TCJA restricts the use of net operating losses ("NOLs") by taxpayers. An NOL generally means the amount by which a taxpayer's business deductions exceed its gross income for a taxable year. Effective for losses arising in tax years beginning after December 31, 2017, the TCJA generally repeals the current carryback provisions (i.e. the two taxable years preceding the year of loss) but allows NOLs to be carried forward indefinitely. However, the amount of NOL deduction will be limited to 80% (from 100%) of the taxpayer's taxable income.

2.1.8. Attractive expensing rules

The TCJA generally provides for full (100%) expensing of the cost of qualified property placed in service after September 27, 2017 and before January 1, 2023 (essentially tangible property and certain computer software). This

expensing regime would go further than current law bonus depreciation by applying to both new and used property. The 100% bonus depreciation rule would apply through 2022, and then would pro rata wind down over the succeeding five years.

2.2. *Taxation of Individuals*

2.2.1. *Reduced income tax rates*

A cornerstone of the new tax regime at the level of individual taxation is the reduction of tax rates for taxable years beginning January 1, 2018. The TCJA will retain seven rate brackets but will change the thresholds for the brackets and reduce the rate for the top bracket to 37%. The new brackets take effect at 10%, 12%, 22%, 24%, 32%, 35% and 37% of taxable income. The top rate is applicable to single filers with taxable income over USD 500'000 and married taxpayers filing jointly with taxable income over USD 600'000. The lowest tax rate is applicable to for taxable income of up to USD 9'525 for a single filer and up to USD 19'050 for married taxpayers filing jointly.

The TCJA suspends personal exemptions but increases the child credit and roughly doubles the standard deduction amounts to USD 12'000 for singles and separate filers, USD 18'000 for heads of households, and USD 24'000 for married filing jointly. The TCJA also contains provisions that reduce mortgage interest deduction. It disallows taxpayers to deduct interest on mortgage debt exceeding USD 750'000 (down from USD 1'000'000). Loans entered into before December 15, 2017 are grandfathered). Furthermore, deductions for interest on home equity indebtedness are no longer permitted under the TCJA. The TCJA eliminated the state and local tax ("SALT") deduction, with the exception that taxpayers who itemize their deductions (and do not claim the standard deduction) may elect to deduct up to USD 10'000 of SALT for property, sales or income taxes. The TCJA generally suspends the deduction for moving expenses and the exclusion from gross income for reimbursement of qualified moving expenses. For the deemed repatriation inclusion that also applies to U.S. shareholders, including individuals, please refer to para. 2.1.2 above.

2.2.2. *Limitation until December 31, 2025*

Many of the provisions applicable to individuals are scheduled to sunset on December 31, 2025. This is required under U.S.-budget reconciliation rules, which do not allow any bill to add to the federal deficit for more than 10 years. It is possible however, – and indeed likely as previous experience shows – that political resolve and common popularity of tax cuts may lead legislators to prolong the tax cut measures permanently. Unless otherwise stated, the below changes to the taxation of individuals apply for tax years 2018-2025.

2.2.3. *More attractive federal estate and gift tax*

The TCJA doubled the federal estate and gift tax unified credit applicable to U.S. residents (generally speaking, U.S. citizens and those who are treated as domiciled in the U.S.) so that including inflation adjustments, for 2018 this amount is set at almost USD 11.2 million for a single taxpayer and almost USD 22.4 million for a married couple. The exemption amount applicable to non-U.S. residents remains at USD 60,000.

3. TCJA implications for Swiss-based groups with U.S. activities

In general, foreign companies that are active in the U.S. will profit from the significant reduction in corporate tax rates. As from 2018, Swiss groups with operations and affiliates in the U.S. will only have to pay a flat federal tax of 21% on their profits (plus state tax). In return for the reduction in tax rates, various deductions will be restricted (or entirely abolished). Depending on the applicable accounting standards, the lower U.S. corporate tax rates may require a

downward adjustment of deferred tax credits on U.S. NOLs but will also decrease the deferred tax for those claiming accelerated depreciation for income taxes and other provisions where deductions are claimed for tax purposes on an accelerated basis in relation to financial accounting purposes.

Swiss groups in capital-intensive industries may also benefit from an expedited expensing regime for investments in U.S. assets. However, the limitation of interest deduction and the restricted use of NOLs indicate a closer examination of Swiss groups' U.S. financing schedules. Swiss groups may want to analyze to what extent intra-group loan financing granted for tax reasons could be replaced by an increase in equity financing. However, benefits for debt financing have been reduced in all jurisdictions following the BEPS action plan of the OECD.

In the unusual circumstance of a Swiss group of companies that uses a U.S. subsidiary as a holding company for other members outside the U.S., the TCJA's new rules concerning mandatory repatriation for non-distributed profits and earnings to that U.S. subsidiary may adversely or positively affect cash flow from those non-U.S. subsidiaries. This will become relevant if non-distributed profits are held in a U.S.-based subsidiary. As a result, those profits kept abroad will become subject to a one-time transition tax, of 10.5% payable over 8 years and back-loaded. During this 8-year period, all cash subject to the tax can be brought into the U.S. without further tax. The ripple effect of mandatory repatriation could also affect a foreign group's financing structures and decisions about where and how to invest surplus cash.

In addition, the new BEAT rules will certainly also have an impact on large Swiss groups and, in particular, intra-group transactions. While BEAT does not subject the costs of goods to the tax, it may still be worthwhile for Swiss multinational groups with substantial U.S. affiliates to scrutinize all segments of their internal value chains.

4. TCJA implications for Swiss-based U.S. citizens

The new and lowered effective tax rates for individuals will primarily be beneficial to those with U.S.-sourced income. However, the restructuring of the individual tax rates may impact upon employer tax reimbursement costs.

As a consequence of the reduced mortgage interest deduction, which is only available at the taxpayer's primary residence and the eliminated deduction of home equity indebtedness, U.S. citizens abroad with properties in the U.S. and the host country will likely be faced with reduced deductible interest and higher tax costs. Additionally, these taxpayers may no longer deduct their foreign property taxes, subject to the USD 10'000 cap.

Due to the elimination of the deduction for moving expenses and the repeal of reimbursements for qualified moving expenses, untaxable moving expenses that were not taxable before will now be taxable. Whereas companies will likely see increased tax costs because of the gross-up for these reimbursements, individuals may also expect elevated costs as the tax base in the U.S. may be higher than in prior years.

Lastly, U.S. citizens living in Switzerland will benefit from the increased lifetime exclusion amount so that fewer individuals will be subject to estate tax in the U.S.

5. Outlook

Securing the adoption of the TCJA by both chambers of Congress constitutes the biggest legislative success of the Trump presidency so far, which entails profound implications for Swiss multinational corporate groups but also for foreign-based U.S. citizens by amending tax rates, tax bases as well as intra-corporate transactions. On this side of the Atlantic, however,

concerns have been raised that some of the international tax provisions in the TCJA could contravene the U.S.'s double taxation treaties and risk a distortive effect on international trade.

Despite the fact that Switzerland already has a very beneficial tax environment, the reform may spur another round of international tax competition since it will make U.S. companies more competitive towards their international peers and the country more attractive to foreign investment. Further tax developments, especially at OECD and EU level, will also contribute to a reshuffling of cards in the area of international taxation. For Switzerland this implies that the current regulatory momentum should be maintained. In this context, the implementation of the corporate tax reform (Swiss Tax Reform Proposal 2017) might turn out to be a sound basis to improve the fiscal and legal environment in this country.

As with any substantial (tax) reform legislation, there are many outstanding issues and questions about actual implementation and effects, which will have to be resolved going forward as part of practical application. In the meantime, please contact us if you have any questions or would like to discuss how you might be affected. As one door closes, another door opens.

Prager Dreifuss AG
www.prager-dreifuss.com

Mühlebachstrasse 6
CH-8008 Zürich
Tel: +41 44 254 55 55
Fax: +41 44 254 55 99

Schweizerhof-Passage 7
CH-3001 Bern
Tel: +41 31 327 54 54, Fax:
+41 31 327 54 99

Avenue Louise 235,
B-1000 Bruxelles
Tel: +32 2 537 09 49, Fax:
+32 2 537 21 16