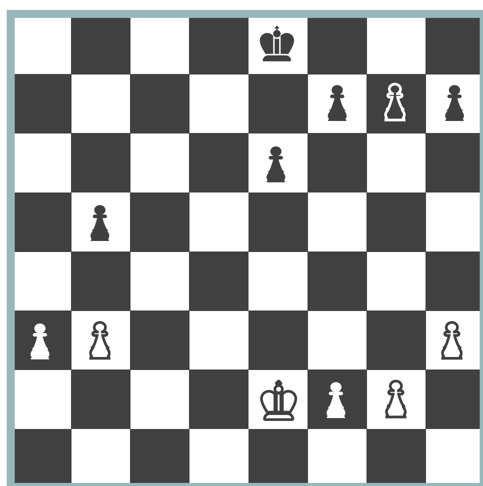
US Tax Reform from a Gamer's Perspective

By Kathrine A. Kimball, John S. MacArthur and Dale A. Spiegel, Jr.

As we shared in US Tax Reform as a Chess Puzzle (October 27, 2017), *the first of our article series on US Tax Reform,* tax directors are frequently in the same position as sportsmen or gamers – those who achieve the best results over time frequently are those who anticipate various potential moves of their opponents and put themselves in position to counter the most likely of them.

Sometimes the planning benefit may be incremental. In chess, a maxim could be "if you have no better move, gobble a pawn." In tennis, a player may rush to the net to reduce the spread of returns she must cover.



White wins by its skill in gobbling pawns.

On November 2, we received our first look at HR1, the Tax Cuts and Jobs Act. If passed as currently written, it eliminates one of the gambits posited in *Chess Puzzle*: Liquidity versus other E&P for purposes of 12% repatriation tax instead of 5% repatriation tax is determined by averaging over two prior year-ends and November 2, 2017 balance sheets.

Companies that reduced CFC cash before November 2 would have received some benefit; now reducing cash doesn't provide such a benefit. *If the determination date doesn't change as the bill moves through Congress (does it hurt to gamble that it may yet change?)!*

For today's practice, let's consider another example of potential advantage – moving CFC E&P between 2017 and 2018. How might an MNC accomplish that? Consider the situation below:

USP is a direct shareholder of CFC1 and CFC2. CFC1 manufactures in a tax-efficient location (perhaps Malaysia, with a 100% tax holiday currently in effect) and sells to CFC2 in a high-tax destination country in Europe. Neither CFC1 nor CFC2 have Subpart F income or investments in US property. USP has used arms-length pricing that maximizes the E&P accumulated in CFC1. Some of that is in the form of liquid assets, but

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for financial statement purposes USP considers CFC1's E&P permanently reinvested so it has not accrued 35% US tax on a potential remittance. All companies in the group have calendar year-ends for foreign as well as US tax purposes.

Under HR1, if CFC1 earns an incremental $10M of E&P in 2017, that E&P will be taxed in the US at the rate of either 12% (liquid E&P) or 5% (other E&P). USP may elect to spread the cash cost over 8 tax years. If CFC1 defers that $10M of E&P until 2018, it may be distributed to the US tax-free (100% dividends received deduction). The cash tax impact to USP of deferring the E&P should be $500K up to $1.2M; preferable to gobbling a pawn, if the cost of deferral is not exceedingly high. The NPV of the cash impact is reduced by the 8 year spread election, but still considered significant.

Absent contrary accounting guidance (and Aptis should not be considered as giving accounting guidance on this point), the earnings benefit to USP likely is the full $500K to $1.2M because deferred taxes are not normally discounted.

How might such a deferral be achieved? CFC1 manufactures and sells to CFC2. CFC1 creates E&P when its sales to CFC2 are consummated. If the intercompany agreements provide that the sale occurs when CFC1 ships, then the E&P is created at shipping. To delay E&P creation, CFC1 might delay shipping as year-end approaches (assuming that does not create a commercial problem). Alternatively, CFC1 and CFC2 might change their agreement so that CFC1 sells to CFC2 on a consignment basis such that the intercompany sale is consummated only at the time CFC2 delivers the goods to its local customers. One might worry about consignment inventory creating a PE for CFC1 in CFC2's country, and about whether a temporary change in terms might be attacked as abusive, but these are refinements for another discussion. Since the sale is on an intercompany basis, one would not expect these changes to affect USP's consolidated earnings for 2017 (again, Aptis is not giving accounting advice). These are details to be reviewed by USP and its advisors.

However, USP had best be quick about performing the review. Deferring $10M of profit by December 31, 2017 means deferring a much higher amount of sales - $100M of sales if CFC1 has a 10% gross profit percentage. This is two months' sales if CFC1 ships $50M per month or $600M per year to CFC2. Transformation to a company's supply chain requires time, resources and buy-in; a tax director that hesitates to serve as a catalyst for operational change in this scenario may miss out altogether.

End Game

Albeit a simplified example, one can see that even with a fast-track tax bill, there are planning opportunities. No one can accurately predict how USTR will play out, but in life as in sports, normally *the race goes to the swift.*

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Kathrine A. Kimball
Managing Principal and Founder

Aptis Global LLC
kkimball@aptisglobal.com

John S. MacArthur
Principal and Founding Member

Aptis Global LLC
jmacarthur@aptisglobal.com

Dale A. Spiegel, Jr.
Member, Aptis Senior Advisor Program

Aptis Global LLC
dspiegel@aptisglobal.com

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