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What does US Tax reform mean for Ireland?

Feargal O'Rourke considers the changes enacted in the overhaul of the US tax system and what the implications of these provisions may be for Ireland.

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After a seemingly unlikely journey through the House of Representatives and the Senate, the proposed overhaul of the US tax system was finally signed into law on 22 December 2017 by President Trump.

Most commentators were initially predicting that it would be 2018 before any potential changes could be enacted, and even at that, questioned whether such changes would be significant. However, moving forward at unprecedented pace, and producing final tax legislation within a few weeks, against the odds Congress swept away years of inertia by introducing sweeping changes to the US tax system.

Given that the last major overhaul of the US tax system was more than 30 years ago, US tax reform is an extremely hot topic. The changes are being talked about, written about and deliberated on by individuals, companies, advisers, economists and governments, all hoping to decipher and get a deeper understanding as to what effect these provisions will have on their position.

Everyone is a stakeholder – even in Ireland – and is keen to get to grips with what US tax reform will actually mean in reality, whether it will result in wholesale changes in how companies operate and the taxes they pay and what the economic impact of this reform will be in the US and further afield.

While it is too soon to be able to answer these questions, what is clear is that the impact is not just confined to the US – it has far reaching global implications. Against this backdrop, it is now clear that US companies operating in Ireland and Irish companies operating in the US will be impacted regardless of the industry they operate in.

What are the key provisions of interest from an Irish perspective?

Tax reform was a cornerstone issue during the US presidential election, with President Trump declaring it as one of his key policy objectives. President Trump and the Republican Party have positioned this push for reform as an effort to make the US business environment more competitive, hoping this will encourage an influx of jobs and investment into the US, thereby driving economic growth. The provisions introduced have largely been framed against this overarching objective.

When considering the impact of US tax reform provisions on Ireland, it is necessary to think about two distinct communities, namely the foreign direct investment ("FDI") sector and the domestic sector. Depending on whether you are a US multinational with operations in Ireland, or conversely a domestic Irish company with operations in the US, different provisions will have different implications and a different weighting of importance.

The final legislation includes provisions that will positively and negatively move effective tax rates for companies. Which of these provisions is most relevant for a company is wholly dependent on its individual characteristics, structure and operating model. Not every US multinational group operating in Ireland or every Irish company operating in the US will be impacted in the same way. Taking all the provisions together and applying them to a company's specific facts and circumstances is the only way of knowing whether a company will be a winner or loser from these changes.

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(i) Corporate Tax rate reduction

Perhaps the most significant change is the reduction of the US corporate tax rate from 35% to 21%. While on the face of it, this should be a significant advantage to Irish companies operating in the US, stakeholders need to balance this change against other enacted provisions, for example the repeal of certain tax deductions that were previously available.

From an FDI perspective, while this is a substantial reduction in the US federal corporate tax rate, once US state taxes are taken into account, the Irish corporate tax rate of 12.5% should still be competitive in terms of a location for investment. Additionally, factors such as the need for US companies to internationalise so they can access markets easier, and the changing international tax environment driven by the BEPS project means that tax is often no longer the determining factor as to where companies locate operations. This is often driven by the availability of talent, the cost of doing business and access to markets, so in that sense Ireland as a location of choice for FDI remains competitive. What is clear however, is that the reduction of the corporate tax rate will make the US a more competitive location when considering potential investments, and this could put some pressure on Ireland's ability to encourage inward investment from the US in the future.

(ii) "International" provisions

The legislation includes provisions which aim to move the US towards a "territorial" system of sorts, with overseas subsidiaries now able to repatriate their profits without paying additional tax in the US (previously, repatriated profits were fully subject to US corporate tax).

This change is introduced in conjunction with a one-time mandatory tax (which applies at a rate of up to 15.5%) on overseas earnings of US subsidiaries, to be levied irrespective of whether the funds are repatriated to the US. Ultimately, this tax is likely to see a significant amount of cash being repatriated to the US, some of which could be currently held in Irish subsidiaries.

This repatriation of funds back to the US is not without precedent. The Homeland Investment Act ("HIA") in 2004 provided a onetime tax rate reduction on funds being repatriated back to the US. Around circa $300billion was repatriated at this time, and the results as later evidenced in economic analysis of the impact of the HIA, found they had an insignificant impact on employment and investment in R&D. What was relatively clear at that time was that this Act did not significantly impact Ireland's attractiveness as an investment location and the initial consensus would appear to be that the impact this time should be similar.

The legislation also has international provisions which seek to raise revenue by applying US tax on profits of overseas subsidiary companies that have only been subjected to a low level of tax in the foreign country. These provisions, known as "GILTI", seek to include the global intangible low-taxed income of overseas subsidiaries within the US taxable profits, initially at a rate of 10.5%. We would expect that these provisions could potentially make it more attractive for US multinationals to invest in the US as opposed to operating through overseas subsidiaries. This could particularly be the case when combined with certain other provisions that have been introduced which effectively provide for a reduced US tax rate on companies selling products and providing services to non-US customers.

(iii) Domestic "base broadening" provisions

As intimated above, a number of provisions have been introduced which seek to limit tax deductions available to US companies. These provisions will be of particular interest to Irish companies with operations in the US, as they could have a significant impact on the benefit available by virtue of the reduced corporation tax rate.

In particular, the limitation of interest deductions to 30% of the company's adjusted taxable income (defined similarly to EBITA) will also impact on how companies are funded and the typical approach to leverage. At this time when interest rates are historically low the impact of this may not be as significant as when the cost of capital begins to increase, but for certain inter-company financing with historically higher rates this could be significant.

In addition, provisions known as "BEAT" have been introduced which effectively seek to apply a minimum level of US tax where a US company is making significant payments to non-US related parties. In many cases, this could result in a significant increase in the US tax paid by such companies.

In summary and what next?

While the reform proposals outlined above will most certainly affect Irish companies with existing businesses in the US or vice-versa, a number of other potential impacts can also be expected.

In a wider sense, M&A activity may be driven by the repatriation of funds (albeit with changes to how it is generally financed or structured due to changes in the interest deductibility rules), changes to supply chain models and operational activity may be driven by provisions on capital expensing and or the international provisions.

It is important to note that the US tax reform journey doesn't end with the Act being signed into law. We expect the next steps to include the release of detailed guidance by the staff of the US Joint Committee on Taxation, which will contain explanations of the enacted law and attempt to combat uncertainties and unintended consequences arising.

It is also likely that the US Treasury department will consider the need for any additional regulations, to provide more colour to the law and enable a smoother transition. Given the unprecedented speed of the drafting and passing of the legislation it has been acknowledged that a number of technical corrections may be needed.

At this point, the majority of the new legislation has been effective for circa 2 months since 1 January 2018 so it's very early to reach conclusions, particularly given the scale of the change. The impact will only become clear in the months and years ahead as the practical considerations of the Act are worked through and strategically the C-Suites of companies begin to understand what reform actually means. But for most companies operating in or from the US, it will mean significant change.