LEAD THE VALUE

# Impact of U.S. Tax Reform on Japanese Corporations

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# 1. Purpose of Tax Reform

U.S. Congress passed the tax reform bill "Tax Cuts and Jobs Act." Through tax reform, the current administration aims to create jobs and grow the economy by improving the competitiveness of U.S. Businesses.

## Purpose of Tax Reform

- **Cut** tax rate
- **Simplification** / **equalization** of tax system
- Introduce policies that promote U.S. investment
- Shift to a **territorial taxation system** from the current worldwide taxation system(*)

→

- Improve the U.S. **competitive** environment as **advantageous** to **business** and **investment**

→

- **Job creation** in the U.S.
- **Economic growth** in the U.S.

(*)Worldwide taxation system: U.S. corporates must pay corporate income tax on all taxable income regardless of where it is earned. Territorial taxation system: U.S. corporates pay corporate income tax only on U.S. income. Many developed countries already have a territorial taxation system.

(Source) SMBC

# 2. Summary of Tax Reform Bill “Tax Cuts and Jobs Act”

“Tax Cuts and Jobs Act” consists of provisions to cut the corporate tax rate to 21%, expand the taxable base by limiting deductions for interest expense, and prevent tax avoidance.

## Summary of Tax Reform Bill “Tax Cuts and Jobs Act” (For Businesses)

| Concept | Main Item | Current Law | Tax Cut and Jobs Act |
|---|---|---|---|
| Cut tax rate | Business tax rate | Graduated tax rate up to 35% | Across the board **21% (From 2018)** |
| Simplification/ equalization of tax system (tax base expansion) | Tax deductibility of interest payment | No limitation as a general rule | Net interest expense exceeding **30%** of adjusted taxable income (*) is **not deductible** (Exception: regulated utilities, real estate)<br>(*)Adjusted taxable income: EBITDA for 2018-21, EBIT for 2022 and after |
| | Tax credits | Tax credits for Manufacturers, etc. | No tax credit as a general rule (Exception: R&D expenses for orphan drugs and renewable energy) |
| | Net operating loss | 20 yr. carryforward<br>2 yr. carryback<br>No limitation | Carryforward **indefinitely**, Carryback is not permitted,<br>Limit deduction to **80%** of taxable income |
| Promoting U.S. investment | Bonus depreciation | Allow bonus depreciation with conditions | Allow 100% first-year depreciation for new and used properties placed in service after Sep 27, 2017 through 2022 (The 100% allowance is phased-down after 2022) |
| Shift to a territorial taxation from a worldwide taxation system (to prevent tax avoidance) | Dividends from group companies outside U.S.(*) | Included in Taxable Income | **No** tax<br>(*)Foreign subsidiaries at least 10% owned by U.S. corporations |
| | Retained income from group companies outside U.S.(*) | **No** tax | **Of the accumulated earnings of group companies outside the U.S.,** tax **15.5%** on cash equivalents and **8%** on other assets<br>(Possible to split tax payments over 8 years)<br>(*)Foreign subsidiaries at least 10% owned by U.S. corporations |
| | Payments to group companies outside U.S. (*) | **No** tax | **10%** tax under certain conditions (5% in 2018)<br>(*)See Page 7. |

(Source) U.S. House of Representative, U.S. Senate





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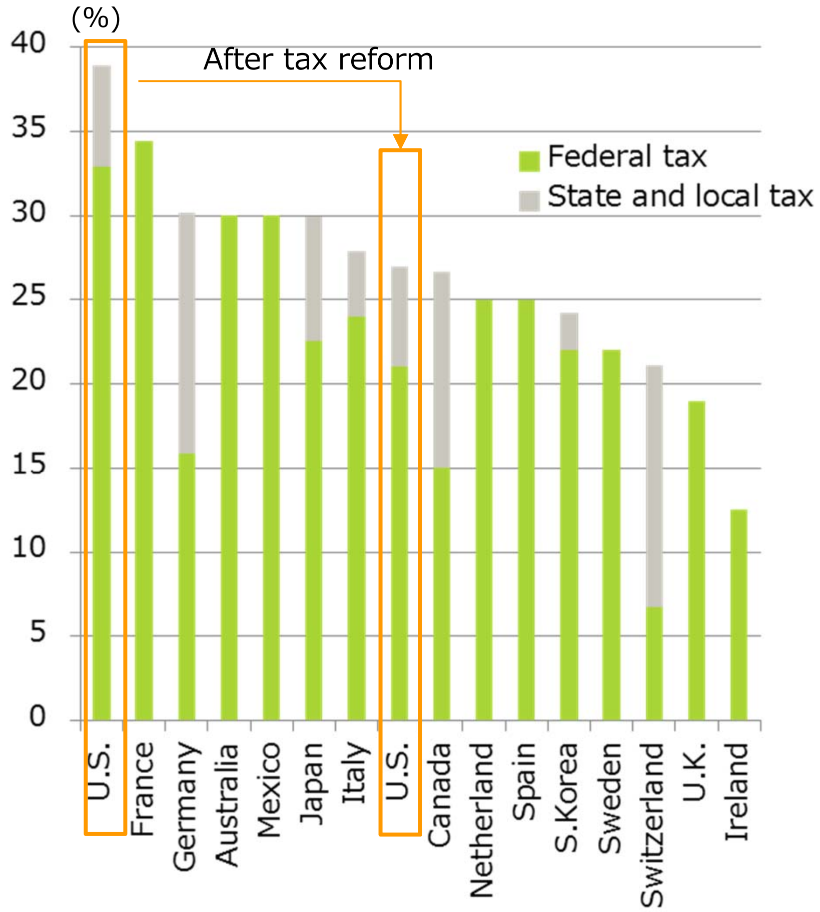
# 3. Impact on Japanese Corporations ~ Corporate Tax Rate Cut

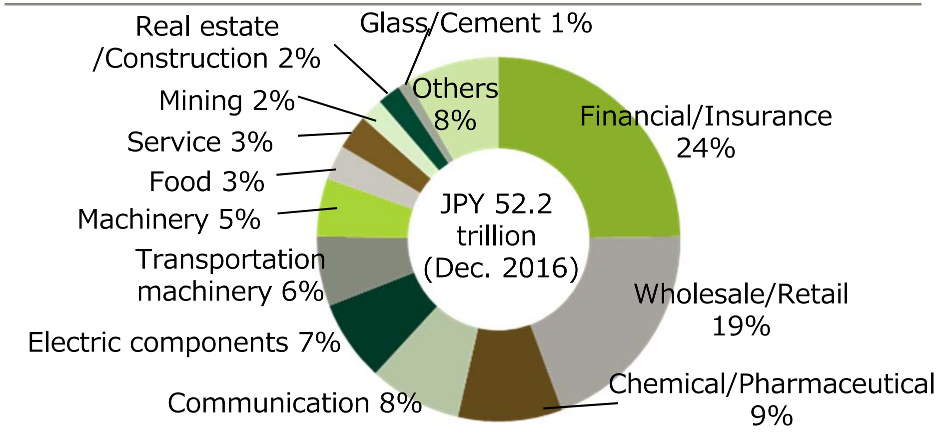
Japanese U.S. subsidiaries are expected to save on tax expenses from a cut in the corporate tax rate. Meanwhile, a lower tax rate would require a reversal of deferred tax assets.

## Effective Corporate Tax Rate by Major Countries



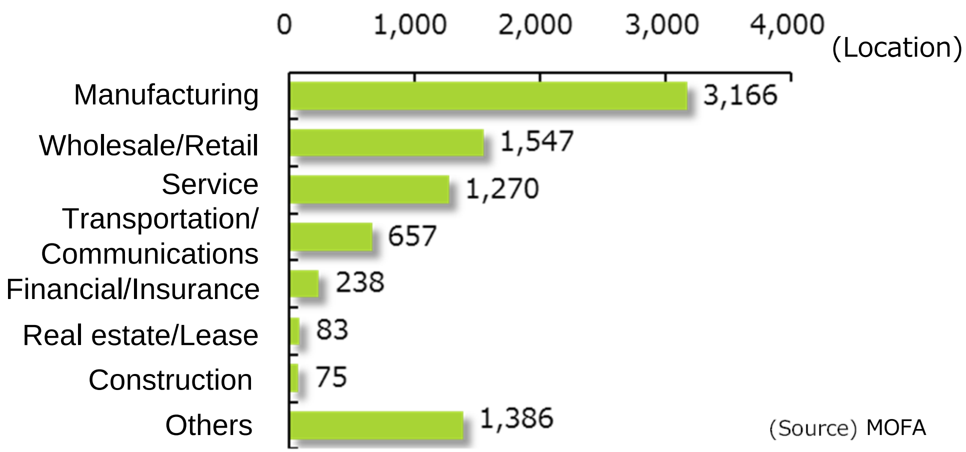

(Source) OECD, 2017, Statutory corporate income tax rate

## Japanese Direct Investment in the U.S. (Dec. 2016)




(Source) Bank of Japan, Ministry of Finance

## Number of Japanese Businesses in the U.S. (Oct. 2016)




(Source) MOFA





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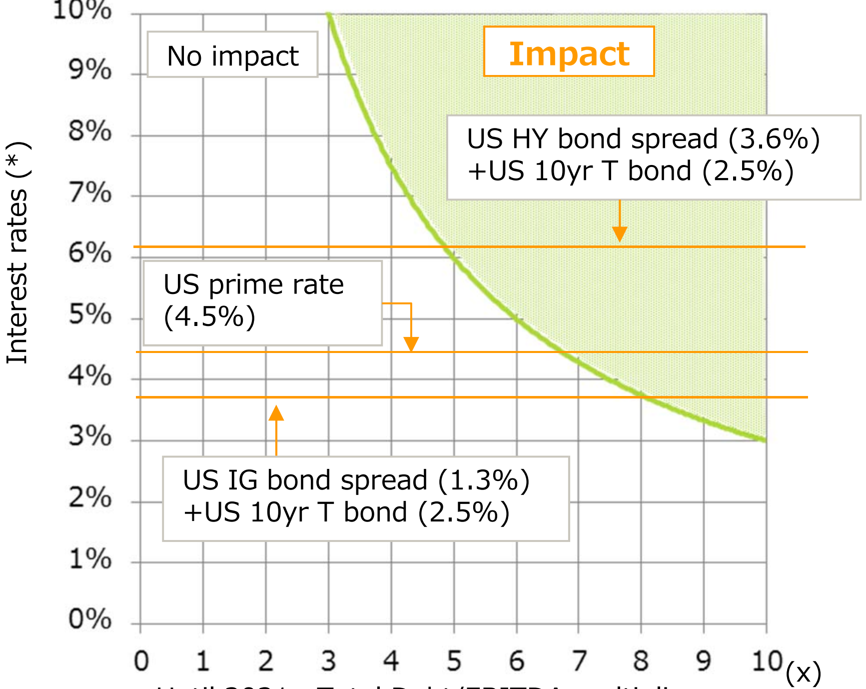
# 3. Impact on Japanese Corporations ~ Limitation on Deduction for Net Interest Expense

Japanese companies could reconsider their funding strategies for M&As in the U.S. or recapitalize U.S. subsidiaries with high debt profile considering interest rate outlook.

## Estimated Number of Companies Being Impacted

In theory, **the companies located in the upper right corner above the green line** may not be able to deduct a portion of net interest expense.

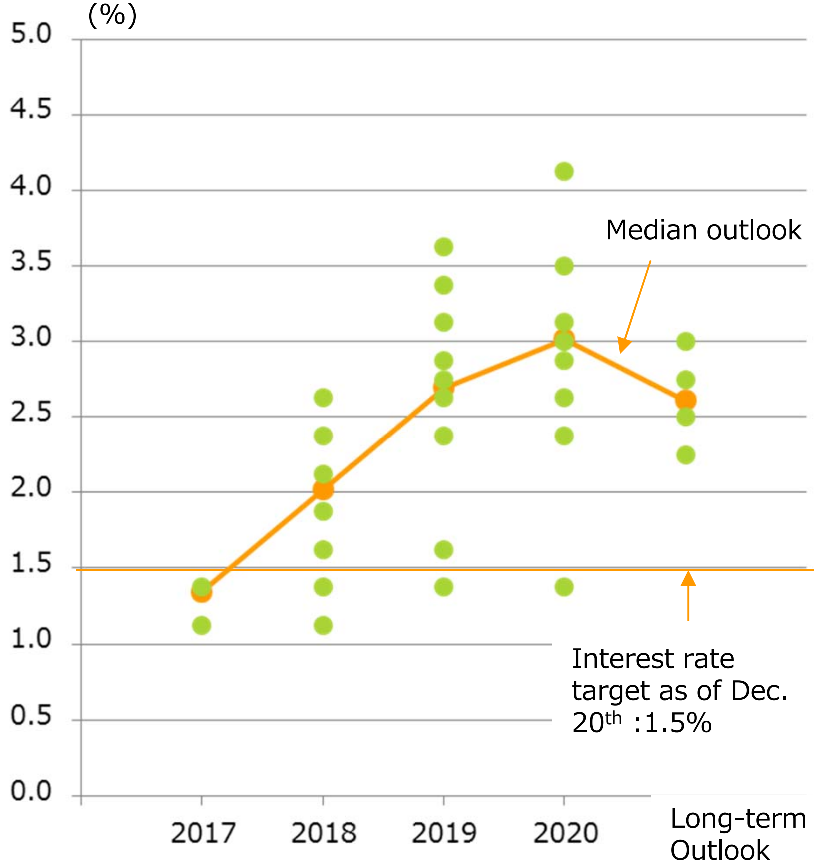



Until 2021 : Total Debt/EBITDA multiplier
Until 2022 : Total Debt/EBIT multiplier

(*)Interest rate is as of Dec. 20th, 2017.
In practice, net interest expense is calculated, thus the result will not be as above if there is interest income.

(Source) Federal Reserve Bank

## U.S. Policy Interest Rate Outlook(*)




(*)Distribution of interest rate policy outlook by FOMC members.

(Source) Federal Reserve Bank

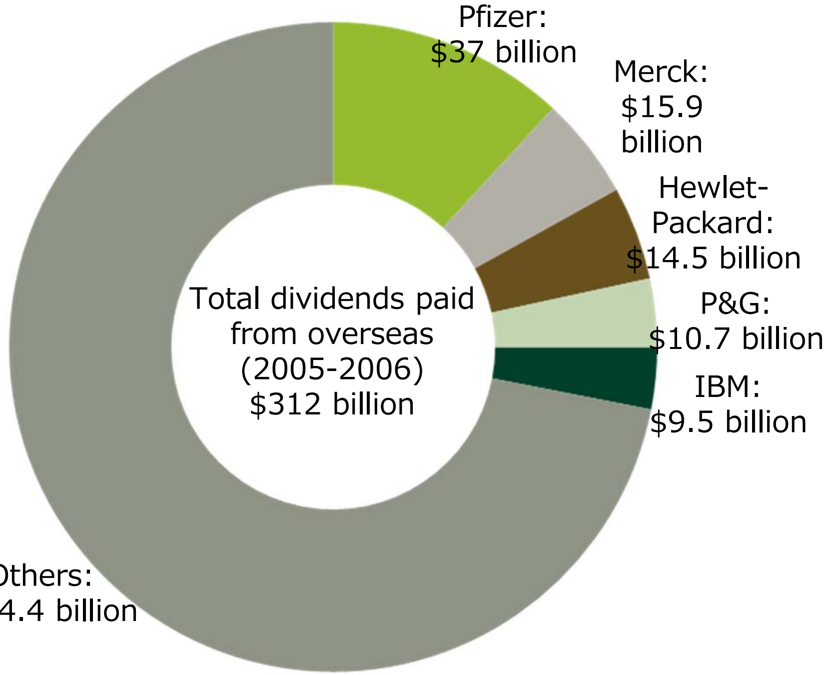
# 3. Impact on Japanese Corporations ~ Tax cut on dividends from companies outside the U.S.

U.S. corporations would repatriate cash to the U.S. from overseas as is the case with "repatriation tax holiday" implemented in 2004. Some Japanese U.S. subsidiaries would also bring cash back from group companies outside the U.S.

(*)temporary tax deduction for corporations to bring back cash held by foreign group companies.

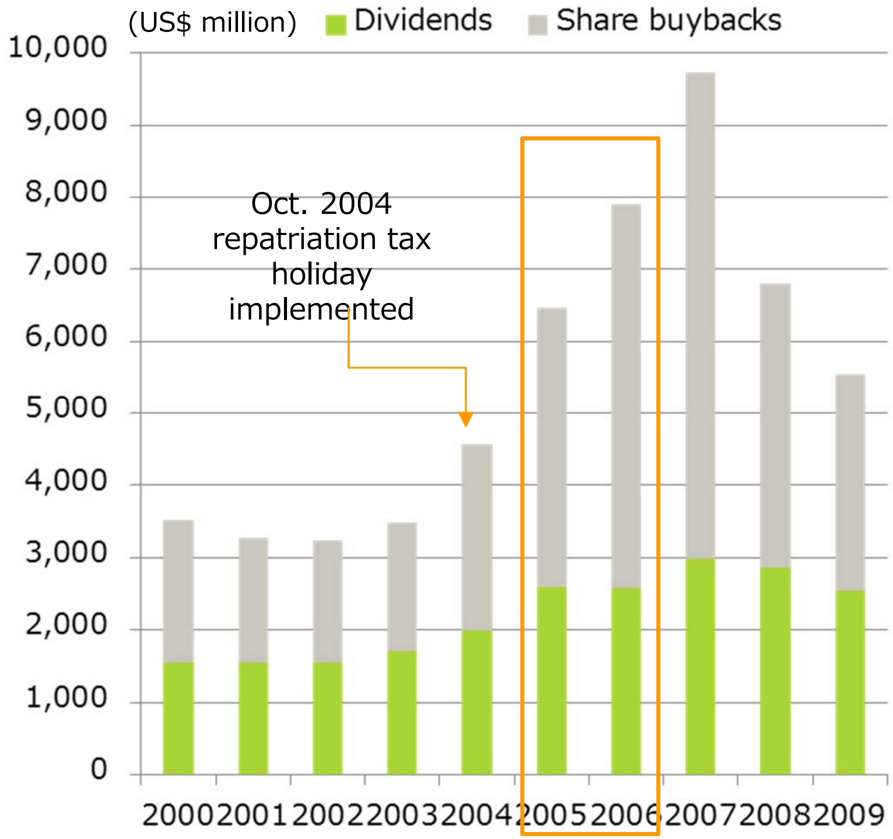
## Dividends Paid After 2004 Repatriation Tax Holiday

The U.S. governmental agency the Congressional Research Service found that **91%** of the $312 billion in dividends received by U.S. corporations from overseas group companies in 2005-2006 were used for **share buybacks.**




(Source) Congressional Research Service

## Shareholder Returns by S&P 500 Corporations




(Source) S&P





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# 3. Impact on Japanese Corporations ~Tax on payments to foreign group companies

Japanese U.S. subsidiaries paying with high tax deductible expenses to their group companies outside the U.S. would lose some benefit due to the implementation of the Base Erosion and Anti-Abuse Tax(BEAT).

## Base Erosion and Anti-Abuse Tax (BEAT)

①Applicable taxpayers : at least US$500 million annual gross sales(*1) and payments to foreign group companies(*2) of 3% or more of total expenses

(*1)Total gross sales of related companies owned more than 50% (*2)any 25% owner of the taxpayer and any person who is related to the taxpayer

②Calculate tax liabilities and BEAT

Tax liabilities = Taxable income × 21%

**BEAT** = ( Taxable income + Tax credits (such as renewable energy credits) + **Payments to foreign group companies** ) × 10%

- Exceptions :COGS, expenses taxed at source
- **Service costs** such as **royalties, patent fees, technical fees** and **interest expenses** are included

- 5% in 2018
- 12.5% after 2026

③Pay whichever is bigger

**Many Japanese U.S. subsidiaries are expected to follow this provision**. In theory, however, companies whose payments to foreign group companies are **1.1 times** as much as taxable income are taxed BEAT. This provision leads tax increases for companies who makes payments to foreign companies that are 2.5 times as much as taxable income. As a result, Japanese corporations could reorganize their corporate structure, functions and business conditions among group companies.

This provision could **cut tax credit benefits for renewable energy companies** depending on their taxable income and tax credit, which could **reduce investments on renewable energy**. In theory, in cases where tax credits are more than 1.1 times as much as taxable income, companies would not be benefit from tax credits.

(Source) U.S. House of Representative, U.S. Senate

# 3. Impacts on Japanese Corporations ~Reform on individual taxes

Individual tax reform is expected to be positive for consumer spending as most households' disposable income should increase. Meanwhile, repealing the individual mandate could slow healthcare expenditures. Limitation on deductions would benefit people living in "red states" such as the Mid-West and the South.

## Major Changes to Individual Taxes

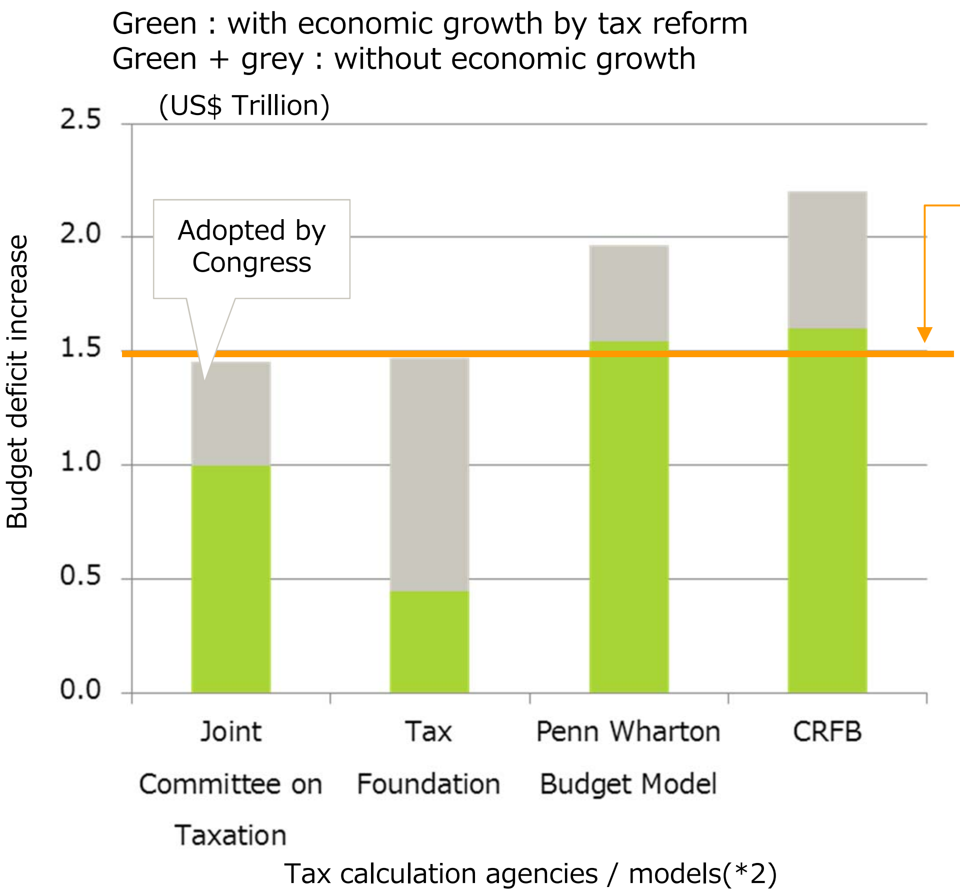
| Main Item | Current Law | Tax Cuts and Jobs Act | Impact on Japanese Corporations |
|---|---|---|---|
| Individual income tax brackets | 7 brackets<br>(10～39.6%) | **7** brackets<br>(10～**37**%)<br>(**Sunset** at the end of 2025) | • **Positive for retail and service sector**; consumer spending is expected to grow<br>• Some changes could be **neutral or negative for real estate related sectors** such as homebuilders.<br>• This reform is expected to **benefit more people living in the Mid-West and the South** where real estate prices are relatively low and where there are many Republicans.<br>• Most tax cut provisions sunset at the end of 2025. |
| Standard deduction | US$6,500~13,000 | US$12,000~24,000<br>(**Sunset** at the end of 2025) | |
| Child and family tax credits | US$1,000 for the first 2 children | US$2,000<br>(**Sunset** at the end of 2025) | |
| State and local tax deduction | No limitation | **Limit to US$ 10,000** | |
| Mortgage interest deduction | Limit to US$1,000,000 in mortgage debt | Limit to US$**750,000 in mortgage debt** | |
| Individual mandate for healthcare insurance | Impose a penalty to those who forgo health insurance | **No** mandate | • **Negative for healthcare sector**; healthcare expenditures are expected to slow down due to higher insurance costs and an increase in the uninsured. |

(Source) U.S. House of Representative, U.S. Senate

# 4. Considerations After Tax Reform

In case budget deficit could not stay within the target of $1.5 trillion, tax increase and spending cut would be expected. In addition, it is necessary to monitor how implementation would be ruled.

U.S. Budget Deficit(10-year cumulative post tax cut)




In case budget deficit could not meet the target of **$1.5 trillion for 10 year**, which was set by budget resolution,

- **Tax increases** and **spending cuts** (*1) could be expected.
- It could be **challenging to increase spending** for infrastructure investments and others.

(*1)As budget deficit significantly increased after "Bush tax cuts in 2001 and 2003, the Obama administration raised the tax rate for wealthy people and cut spending.
(*2)Penn Wharton Budget Model is calculated by the University of Pennsylvania Wharton School.
CRFB stands for Committee for a Responsible Federal Budget.

(Source) U.S. House of Representative, U.S. Senate, Committee for a Responsible Federal Budget