The Impact of U.S. Tax Reform on Latvian Companies

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Agenda

- Overview of Latvian Taxation
- Overview of Legal Structures to Enter U.S. Market
- U.S. Tax Issues for Latvian Companies, including U.S. Tax Incentives
- State Income and Sales Tax Issues
- Conclusion

Investing in the US – the Latvian taxation

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Janis Taukacs, partner

Riga

11 June 2020

The new CIT system

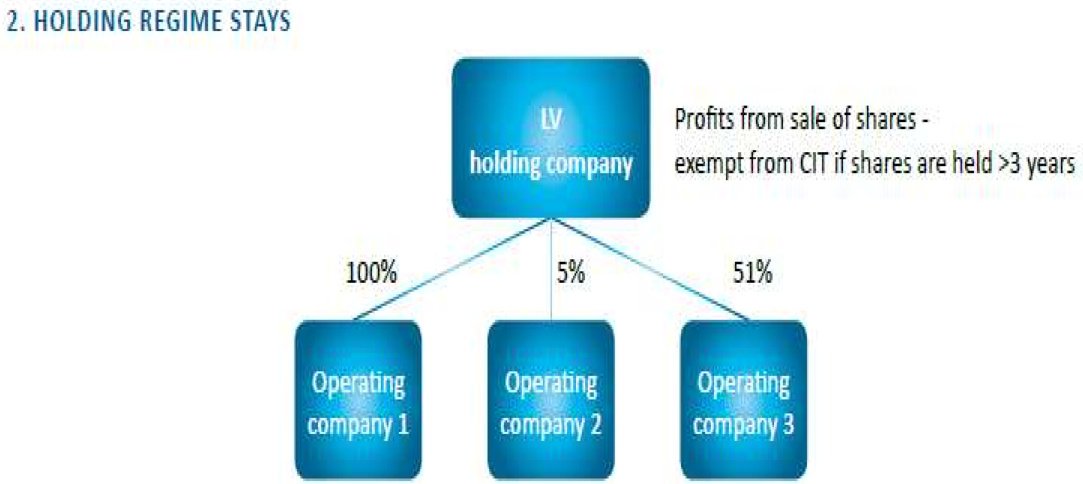
1. 0% CIT FOR REINVESTED PROFITS

In the new corporate income tax (CIT) system, Latvian company profits are only taxed on distribution of dividends. The taxable moment is the day when dividends are calculated, e.g.:

2018	EUR
Current year profit/loss	-500 000
Dividends distributed	0
CIT 20/80	0
2019	
Current year profit/loss	1 000 000
Dividends distributed	0
CIT 20/80	0
2020	
Current year profit/loss	2 000 000
Dividends distributed	300 000
CIT 20/80	75 000

- Interim dividends are also allowed in Latvia, so earlier distribution may be arranged.
- No withholding tax on dividends paid out by Latvian company (CIT – is not WHT).

Holding regime

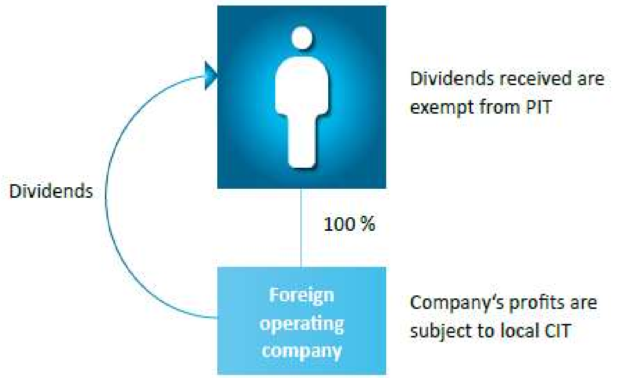


- Capital gains exemption on sale of shares - notwithstanding share of participation.
- Foreign source dividends in & out are exempt from CIT.

0% to the US profits

3. NO PIT PAYABLE ON DIVIDENDS RECEIVED

In the new corporate income tax (CIT) system, Latvian company profits are only taxed on distribution of dividends. The taxable moment is the day when dividends are calculated, e.g.:



For Latvian tax residents dividends received are exempt from personal income tax in Latvia if:

- the company is registered in EU/EEA, or
- for the rest of the world - the company has paid CIT on profits distributed.

Estonia

Lithuania

Belarus

Latvia

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Current Structures for Entering the U.S. Market

- Agent, distributor, other third party
  - Written agreements
    - *Similar issues, considerations in the U.S.*
    - *Notes*
      - Be clear about responsibility for product problems, other liability issues
      - Termination – no general obligation to make termination goodwill or similar payments, but be clear in the agreement regarding termination rights

Current Structures for Entering the U.S. Market

- Direct presence
  - Branch
  - Generally not (almost never) recommended
    - *Tax issues*
    - *Liability/asset exposure*

Current Structures for Entering the U.S. Market

- Corporation (Inc. or Corp.)
  - Most common
    - *Establishment is convenient and straight forward*
    - *Limited liability*
    - *No audited financial statement requirement for private companies*
    - *Financial results for private companies are confidential*
    - *Ownership generally confidential*
    - *Importance of proper capitalization and maintenance*
  - Corporation subject to U.S. federal, state and local income (and possibly other) taxes
    - *Benefits under Income Tax Treaty with the U.S. may be available*

Current Structures for Entering the U.S. Market

- Limited Liability Company (LLC)
  - Similar liability protection to a corporation
  - Less common for non-U.S. owners
  - Tax treatment
    - *LLC, in general, is treated the same for tax purposes as a branch, so the non-U.S. owner files tax returns and pays U.S. federal, state and local taxes*
    - *Treaty benefits may not be available*

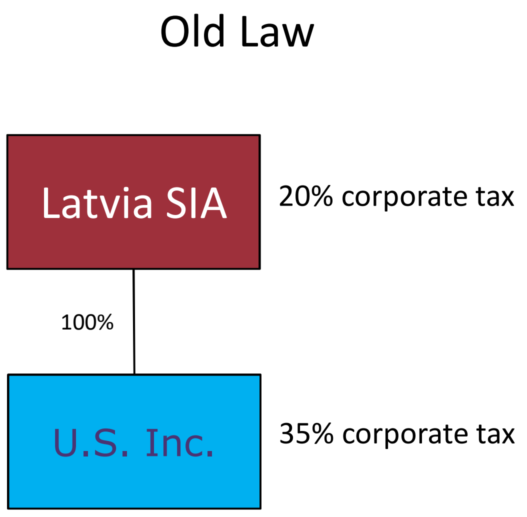
Tax Cuts and Jobs Act (TCJA) – Transformative Changes

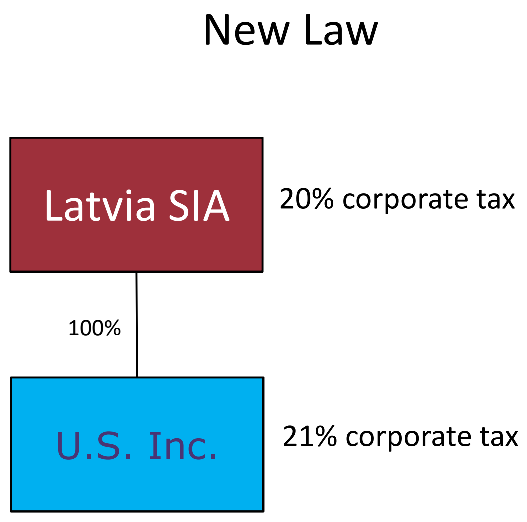
- The TCJA signed into law in December 2017 enacted the most comprehensive overhaul of the Internal Revenue Code in 30 years.
  - Moves the U.S. from a worldwide to a quasi-territorial tax system consistent with U.S. trading partners. As a one-time cost of moving to a quasi-territorial system, imposes a transition tax on 30 years of accumulated foreign earnings.
  - Enacts new foreign source tax provisions intended to raise money to offset tax cuts and tilt the playing field to favor domestic commerce over foreign commerce (e.g., GILTI, BEAT, FDII).
  - Over 10 years provides for $6 trillion of tax cuts offset by $4.5 trillion of tax increases.
  - Made other significant changes include 100% expensing, interest deduction limitations, special pass through entity deduction, limitation on state and local tax deductions and general base broadening.

Overview of Major Changes

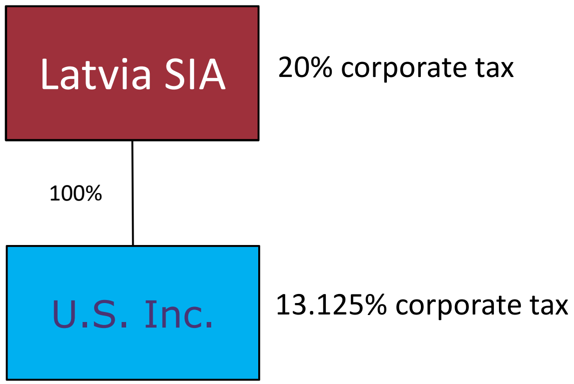
- The U.S. federal corporate tax rate has been reduced to 21%.
- The U.S. joins the rest of the world with a participation exemption.
- Deemed paid credits are no longer available, except for Subpart F and GILTI.
- Interest deductions are limited to 30% of EBITDA.
- An anti-hybrid rule has been introduced.
- There is a new minimum tax related to cross-border payments called Base Erosion Anti-Abuse Tax or BEAT.
- A special deduction is available for sales and services provided outside the U.S., called FDII.

Reduction in U.S. Corporate Tax Rate





Foreign Derived Intangible Income (“FDII”)



- To the extent that the U.S. corporation sells to customers outside the U.S., a deduction is available for 37.5% of the gross income related to the sale.
- As a result, the U.S. corporate tax rate is reduced to 13.125%.

Overview of FDII

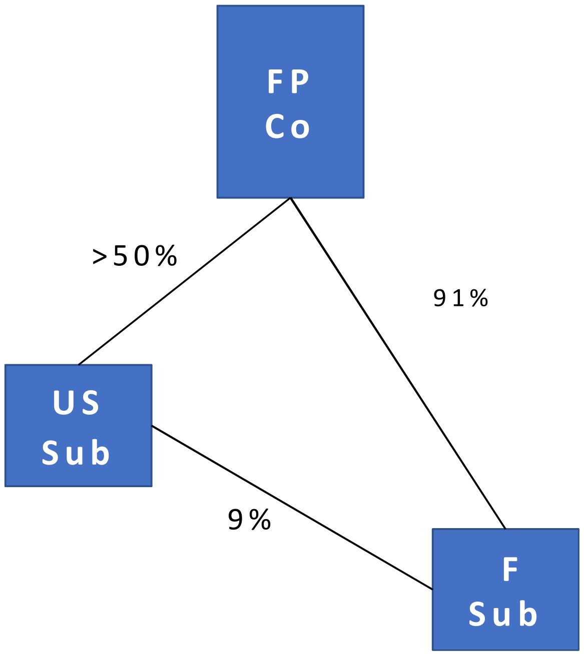
- Foreign-Derived Deduction Eligible Income = Deduction Eligible Income derived in connection with
  - property sold, leased or licensed to any foreign person; or
  - foreign services that are provided to any foreign person or with respect to foreign property, in each case if "established to the satisfaction of the Secretary"
- Effective Tax Rate on Foreign Derived Intangible Income ("FDII")
  - 13.125% 2018-2025
  - 16.406% After 2025

“Downward Attribution” Repeal

- To determine whether a U.S. person is a U.S. shareholder and whether a foreign corporation is a CFC direct, indirect and constructive ownership rules applied.
  - U.S. Shareholder: 2017: 10% or more of Vote; in 2018, 10% of Vote or Value.
  - CFC: More than 50% of Vote or Value.
- Stock owned by an NRA not considered as owned by a U.S. citizen or resident alien individual.
- TCJA repealed Section 958(b)(4), which prevented constructive attribution from (1) a foreign partner to a U.S. partnership, (2) a foreign beneficiary to a U.S. trust (irrevocable or “grantor”), and (3) a foreign corporation to a U.S. corporation.

Downward Attribution—Example

Expanded Taxation



- **Old Rule**: No "downward" attribution of FP Co's 91% ownership in F Sub to US Sub; therefore, F Sub not a CFC.
- **Under TCJA**: US Sub *constructively* owns FP Co's 91% interest in F Sub, making it a CFC.
- **Result**:
  - US Sub subject to Transition Tax, Subpart F and GILTI.
  - Taxation implicated because of US Sub's 9% direct ownership.
  - For taxation, need direct or indirect ownership for taxation under Transition Tax, Subpart F and presumably GILTI.
  - If only constructive ownership, should not be taxation.

Net Interest Expense: Section 163(j)

- Net US business interest expense limited to 30% of adjusted taxable income (“ATI”)
- ATI similar to EBITDA for taxable years beginning before January 1, 2022 (EBIT thereafter)
  - For corporations, EBITDA is generally taxable income computed without regard to NOLs, interest income, amortization/depreciation, and “with such other adjustments as provided by the Secretary”
- For TY beginning after January 1, 2022, ATI is EBIT, so no add-back for amortization/depreciation
  - Differs from BEPS/International approach, which generally provides a safe harbor for domestic groups that are no more leveraged than the worldwide group

Net Interest Expense: Section 163(j)

- Disallowed interest can be carried forward indefinitely but no carryforward of excess limitation
- Carryforwards subject to sections 381 and 382
- Effective for tax years beginning after December 31, 2017 -- No grandfathering — Applies to all debt (related and third-party obligations)
- Applies to corporate and non-corporate entities (e.g., partnerships); real estate industry generally can elect out
- Application of Section 163(j) to partnerships— determined at partnership level
- Section 163(j) disallowance applied first to unrelated party debt for purposes of applying section 59A (BEAT)

Net Interest Expense: Section 163(j)

- $25 million gross receipts exemption
- Carryover of disallowed interest under old Section 163(j) may survive
- U.S. consolidated group treated as single entity for computations? Awaiting guidance
- Section 163(j) disallowance applied first to unrelated party debt for purposes of applying section 59A (BEAT)

Overview of the BEAT (Section 59A)

- Additional minimum tax imposed on U.S. companies having certain deductible 'base erosion payments' made to related foreign companies
- Tax years beginning in 2018 at a **5% rate**
- Tax years in 2019- 2025 at a **10% rate**
- Tax years beginning after 12/31/2025, **12.5% rate**
- Slightly higher rates for certain financials
- Minimum tax liability:
  - **Excess of 10% (or other rate) of the U.S. company's "modified taxable income" ("MTI") over its** regular U.S. tax liability reduced by certain allowable credits (but not R&D and certain other credits)

BEAT - Triggers

- Applicable Taxpayer
  - Corporation other than RIC, REIT, or S Corp
  - Average annual gross receipts (over 3 year period) > $500 million
  - Base erosion percentage of at least 3% (2% for certain financials)
  - Aggregation rules apply
- Base Eroding Payment
  - Certain Deductible payments
  - To related foreign person
- BEAT tax liability([10%] of MTI) exceeds regular tax liability (without the benefit of certain credits)

Applicable Taxpayer – Base Erosion Percentage

- To be an applicable taxpayer, must have a BEPct of at least 3% (2% for certain financials)
- BEPct = $\frac{\text{Base Erosion Tax Benefit (BETB)}}{\text{all deductions (excluding 172 , 245A, or 250)}}$
- BETB = deductions attributable to base eroding payments
- Applied annually

BEAT Calculation

Base Erosion Tax Benefits ÷ All annual deductions other than 172 NOL, 245A participation exemption = Base Erosion % >3% (2% for banks/broker-dealers)

Taxable Income + Base Erosion Tax Benefits + Base Erosion % of NOL Deduction = Modified Taxable Income

Modified Taxable Income × 10% − R&D Credits − 80% Sec. 38 Credits = BEAT

BEAT > Regular U.S. tax liability = Potential addition to regular tax liability

State Partial Conformity with TCJA

- Impact of the TCJA on Corporations:
  - A federal tax cut of about 10%
  - A state tax increase of about 12%
    - *COST/EY study "The Impact of Federal Tax Reform on State Corporate Income Taxes" (based on 2018 update and pre-federal tax reform (FTR) linage to IRC).*
- This outcome is <u>inadvertent and arbitrary</u>: If states simply conform to the TCJA, either automatically or by updating the conformity date, and do nothing more they will link to federal corporate base-broadening measures, but not to federal tax rate reduction.

State Income Tax Rules for Remote Sellers

- If your Latvian company has inbound sales into the U.S., you and your U.S. subsidiaries (if any) may have different state sales tax responsibilities resulting from the Supreme Court's 2018 decision in *South Dakota v. Wayfair*.
- *Wayfair* overturns the requirement from the court's 1992 ruling in *Quill Corp. v. North Dakota*, which held that sellers must have a physical presence in a state before that state can require you to collect sales tax.
- Because many Latvian companies selling into the United States have had no physical presence in the U.S., they have not previously been subject to a state sales tax collection obligation.

State Income Tax Rules for Remote Sellers

- But under *Wayfair* — and because of the economic nexus requirements that many U.S. states have implemented in response to the ruling — your company needn't have an actual physical presence before a state can make you collect sales tax on the goods and services you sell.
- These new rules are similar to the new EU Value Added Tax (VAT) system which is intended to simplify VAT obligations for cross-border sales of goods and services to final consumers that will come into force in 2021.

50 U.S. States, 50 Different State Tax Laws

- Each U.S. state has its own set of laws and determines whether to impose a sales tax (45 of our 50 states do) and what products and services are taxable.
- For Latvian companies selling to customers in the U.S., the *Wayfair* decision is merely another example of the fact that DTAs between the U.S. and Latvia (and other countries) do not cover or protect against many aspects of U.S. tax law; in particular, the array of tax laws enacted and applied by the individual states and local jurisdictions within the states.
- In general, all sales of tangible personal property are taxable unless a specific exemption applies.
- The taxability of services and digital goods varies widely, with some states taxing a very narrow set of services, and others taxing them broadly.
- In most states, the tax is imposed on the ultimate purchaser of the taxable good or service, but the seller has the responsibility to collect and remit the tax to the state.

Latvian Companies Should Evaluate Operations in Light of *Wayfair*

- In the past, Latvian companies selling inside the United States without any physical presence in the states did not have a reason to understand or implement sales tax collection regimes.
- In light of *Wayfair*, however, it is important to evaluate your U.S. operations in light of this change.
- There are many issues to consider:
  - Whether your business exceeds a particular state's economic nexus threshold
  - Whether the product or service you sell is taxable in the given state
  - Whether an exemption applies
  - Whether a U.S. state would have the ability to legally enforce a sales tax assessment against a business with no connection to the United States (though this issue has not been tested by the courts)

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