Client Alert
December 20, 2017

The Tax Cuts and Jobs Act: Congress Passes A Major Tax Bill For First Time in Thirty Years

Introduction

On December 15, 2017, the conferees working on reconciling the differences between the House and Senate versions of the Tax Cuts and Jobs Act held a signing ceremony and released *legislative text* and a *Joint Explanatory Statement*. This client alert describes the contents of the legislation (the "Conference Agreement" or "bill") and provides some preliminary observations.

At the time of writing, both the House and Senate had passed the bill with only Republican votes. The bill will be sent to the president's desk for signature, although a signing ceremony has not been scheduled yet.

In addition to passing the tax bill, Congress must pass a continuing resolution to fund the government beyond December 22. At the time this client alert was drafted, we expected the continuing resolution to fund the government through mid-January or February. It is possible that the continuing resolution may contain tax provisions. In particular, the continuing resolution would serve as a useful vehicle to delay some of the tax provisions in the Affordable Care Act, such as the medical device excise tax and the health insurance providers fee.

Many commenters have observed that the tax bill was quickly drafted and has not been fully vetted by stakeholders, which means that the bill may contain drafting errors that lead to unintended consequences. Some taxpayers have expressed concern that some of the provisions may be unworkable as currently drafted. In response, Republican leadership has announced plans to introduce a technical corrections bill in early 2018 to address any errors. However, taxpayers should be aware that passing a technical corrections bill will be legislatively difficult. Reconciliation is not a viable option for a technical corrections bill, which means that 60 votes will be required to pass the bill in the Senate. If Republicans cannot persuade their Democratic counterparts to support a technical corrections bill, that will increase the pressure on Treasury to issue regulations that address any errors and uncertainties in an administrable fashion. The situation here is similar to the situation faced by Democrats after the Affordable Care Act was passed—because Democrats did not control 60 seats in the Senate and Republicans were unwilling to vote for a technical corrections bill, drafting errors remain uncorrected. While it is too early to tell whether Democrats will withhold their votes, Republicans have done nothing to incentivize them to participate in the technical corrections process.

The Joint Committee on Taxation (JCT) is preparing a bluebook describing the legislation, although it will not be released until after the legislation is signed. Although JCT documents are not technically legislative history, they have historically been viewed as an accurate reflection of Congress' views at the time legislation was passed. As a result, JCT documents are often consulted during the guidance process and may influence Treasury and the IRS' views about legislative intent.

Domestic Business Provisions

One of the most beneficial provisions in the Conference Agreement is the reduction of the corporate income tax rate from 35 percent to 21 percent for taxable years beginning after December 31, 2017. It is worth noting that fiscal year taxpayers will get a partial benefit of the reduced rate for a fiscal year that began in 2017 pursuant to Section 15 of the Internal Revenue Code. Moreover, the corporate alternative minimum tax, which was retained in the Senate bill, is repealed in the Conference Agreement.

Another pro-taxpayer provision is current expensing. Mid to large size businesses can immediately expense property acquired and placed in service between September 27, 2017 and December 31, 2022. Current expensing phases out after that date. The current expensing rules apply to property that qualified for bonus depreciation, as well as qualified film, television and live theatrical performances. Current expensing applies to new and used property.

To pay for the reduced corporate income tax rate ad, the Conference Agreement would reduce or repeal deductions and credits. Specifically, the Conference Agreement would:

- Repeal the domestic production deduction (Section 199) for taxable years beginning after 12/31/2017;
- Reduce the orphan drug credit from 50 percent to 25 percent of qualifying expenses;
- Eliminate like kind exchanges (except for real property);
- Repeal expensing and require 5-year amortization for most research and experimental expenditures paid or incurred in taxable years beginning after December 31, 2021;
- Deny deduction for settlements subject to nondisclosure agreements paid in connection with sexual harassment or sexual abuse, effective for amounts paid or incurred after the date of enactment;
- Require accrual method taxpayers subject to the all events test to recognize income no later than the taxable year in which the income is included as revenue on an applicable financial statement.
- Permit deferral for advance payments for goods, services, and other specified items in Rev. Proc. 2004-34 until the end of the tax year following receipt of the payment if inclusion for financial statement purposes is also deferred.

Some credits would have been repealed in the House bill, but ultimately remain in effect. Such credits include the work opportunity tax credit and the new markets tax credit. It is also worth noting that some other provisions were not considered in the House, Senate or conference, such as the last in, first out method of inventory. Such provisions could be addressed in future legislation.

The Conference Agreement would also make important changes to the net operating loss (NOL) rules. NOL carrybacks would be eliminated, and carryforwards would be limited to 80% of taxable income for losses in taxable years beginning after December 31, 2017 (it is worth noting that there is a conflict regarding the effective date in the report and statutory language). Congress would likely revisit the carryback rules in the event the U.S. economy has a recession, as NOL carrybacks provide an opportunity for a quick refund to support ailing companies.

Business Deductions With Respect to Sole Proprietorships and Pass-through Entities

The Conference Agreement largely followed the Senate bill and provides that a non-corporate taxpayer (partnership, S corporation, trusts and estates, and sole proprietorship) is entitled to a potential deduction on newly defined "qualified business income" such that a full deduction effectively reduces the maximum marginal tax rate from 37% to 29.6%. Mechanically, such non-corporate taxpayers may generally deduct in any taxable the lesser of (A) 20 percent of the taxpayer's combined qualified business income or (B) the greater of (x) 50 percent of the W-2 wages paid with respect to the qualified trade or business, and (y) the sum of 25 percent of the W-2 wages with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property (property currently being used and depreciated as part of a qualified business).

For this purpose, qualified business income includes income (with certain exclusions) generated from a qualifying US trade or business. The W-2 wage base includes all wages, including withholding amounts and amounts an employee elects to defer. A qualifying trade or business is any trade or business other than (1) a newly defined "specified service trade or business", and (2) the trade or business of performing services as an employee. A specified trade or business is expressly defined to include: health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of 1 or more of its employees. Additionally, a specified trade or business also includes the performance of services that consist of investing and investment management, trading, or dealing in securities, partnership interests, or commodities.

The new rules also contain income thresholds, phase-in limitations, and rules intended to prevent guaranteed payments, reasonable compensation, and payments paid to partners in non-partner capacities from qualifying for the 20 percent deduction. A special rule also allows a deduction of 20% of qualified REIT and publicly traded partnership income. Finally, for partnerships and S corporations, the deduction is applied at the partner or shareholder level.

Note that the Conference Agreement materially expanded the benefit of this deduction beyond what was in the original Senate bill by allowing an alternative to the original 50% of W-2 wages limitation to benefit capital-intensive businesses. The Conference Agreement also excepted engineering and architectural services from the list of specified services that are denied the deduction. If enacted, the provisions are effective for taxable years beginning after December 31, 2017 and ending before January 1, 2026.

Non-Passive Loss Limitations for Non-Corporate Taxpayers

The Conference Agreement provides a new loss limitation applicable to non-corporate taxpayers—the limitation applies at the shareholder or partner level in S corporations and partnership, respectively.

Specifically, a taxpayer's excess aggregate trade or business losses are disallowed for the current taxable year and not usable against other non-business income, such as stock dividends. This limitation is applied after the Section 469 passive loss limitations and is applied at the partner or S corporation shareholder level. Excess business losses are the aggregate net business losses of a taxpayer *plus* a threshold amount of $250,000 for a single person and $500,000 for a joint return.

Excess business losses disallowed in the current taxable year are treated as net operating losses ("NOLs") in subsequent taxable years with indefinite carryover subject to the new limitation of NOLs to 80% of taxable income for taxable years beginning after December 31, 2017.

This provision is scored as a significant revenue raiser, creating a concern as to a broader scope than may first appear. If enacted, the rules apply for taxable years beginning after December 31, 2017.

Partnerships with Income Effectively Connected with a US Trade or Business

In Revenue Ruling 91-32, the IRS took the position that a non-US partner's share of gain from the sale of a partnership interest would be treated as income effectively connected with a US trade or business ("ECI") to the extent the seller would have been allocated ECI if the partnership sold its assets. In 2017, the Tax Court disagreed with the IRS and held that a non-US partner's gain on the disposition of its partnership interest (to the extent the gain is not attributable to US real property interests) is not ECI.

The Conference Agreement codifies Revenue Ruling 91-32. Additionally, a new withholding rule is enacted that requires the transferee of the partnership interest to withhold ten percent of the amount realized on the sale or exchange of a partnership interest absent certification that the transferor is exempt from withholding. Congress intends for "transfer" to apply to a broad range of transactions, including many tax free transfers in which taxpayers continue to retain indirect interests in the partnership interest. As a backup enforcement mechanism, failure to withhold imposes an obligation on the partnership to deduct and withhold from distributions to the transferee partner those amounts that should have been withheld by the transferee, plus interest. Congress authorized regulations which could potentially reduce over-withholding such as when partnerships own both ECI and non-ECI property.

If enacted, the codification of Revenue Ruling 91-32 applies to all partnership interests sold or exchanged on or after November 27, 2017. If enacted, the withholding provisions apply for taxable years beginning after December 31, 2017.

Repeal of Partnership Technical Terminations

Under current rules, an entity classified as a partnership undergoes a technical termination if 50% or more of the capital and profits of the partnership are sold or transferred within a 12-month period. This results in a short tax year, a termination of all existing partnership-level elections, and a resetting of the underlying Section 168 depreciation lives. The concept of technical terminations has been viewed as outdated for decades.

If enacted, the Conference Agreement eliminates technical terminations effective for taxable years beginning after December 31, 2017.

New 3-Year Holding Period for Carried interest

After many prior attempts to tax service partner "carried interest" as compensation income, the Conference Agreement reached a compromise that retained the capital nature of the income but requires a 3-year holding period to obtain the benefits of long-term capital gain rates. Specifically, this rule applies to taxpayers receiving partnership interests in connection with the performance of substantial services in any applicable trade or business consisting of: (1) raising or returning capital, and either (2) investing in (or disposing of) specified assets (or identifying specified assets for investing or disposition), or (3) developing specified assets. Specified assets generally means securities, commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to such securities, commodities, real estate, cash or cash equivalents, as well as an interest in a partnership to the extent of the partnership's proportionate interest in the foregoing.

Holders of partnership interests that transfer their interests to related parties prior to three years in certain instances will trigger immediate gain taxed as short term capital gain.

If enacted, this provision is effective for taxable years beginning after December 31, 2017.

Partnership Substantial Built-in Loss

The Conference Agreement expands the instances in which a partnership is required to make an inside basis adjustment under Section 743. Under current law, a partnership is required to make a Section 743(b) adjustment only if the partnership has an aggregate net built-in loss in its property exceeding $250,000. The Conference Agreement expands on this requirement by providing that if the purchaser of a partnership interest would be allocated $250,000 or more in built-in partnership losses with respect to its purchased interest, determined immediately after the purchase, then the partnership is required to make a Section 743(b) adjustment that would eliminate such built-in loss.

If enacted, this provision is applicable for taxable years beginning after December 31, 2017.

Partner-level loss limitations

The Conference Agreement expands the Section 704(d) basis limitation language to clearly apply the limitation to deductions for partnership charitable contributions and foreign tax expense. Consistent with Rev. Rul. 96-11, the basis limitation does not apply to the extent of a partner's distributive share of the excess of fair market value over basis of an in-kind charitable contribution entitled to a deduction based on value and not tax basis.

If enacted, this provision is applicable for taxable years beginning after December 31, 2017.

Interest Deductibility

Like the House and Senate bills, the Conference Agreement contains a new Section 163(j) interest expense limitation. The new Section 163(j) has a significantly broader scope than the current Section 163(j). Under the new provision, the limitation would apply to interest on debt with related and unrelated lenders, and to individuals, partnerships and corporations. There are exceptions under the new provision for taxpayers with average annual gross receipts of $25 million or less and certain real property, farm, and utility businesses. There is also a new exemption for auto dealers and lessors that allows them to fully deduct otherwise deductible interest on debt used to acquire motor vehicles.

For most taxpayers, their business interest expense is limited to an amount equal to 30 percent of adjusted taxable income ("ATI") plus business interest income. For taxable years beginning before January 1, 2022, a taxpayer's ATI is generally determined in same manner as it is under the current rules, with the addition of an adjustment for the new deduction under Section 199A available to certain pass-through entities. Generally, ATI should be equal to earnings before interest, taxes, depreciation and amortization (EBITDA). For taxable years beginning on or after January 1, 2022, ATI includes a taxpayer's depreciation, amortization, and depletion (generally, this is a taxpayer's EBIT). Taxpayers should consider the timing of their depreciation, amortization and depletion deductions, including the proposal to increase bonus depreciation to 100% discussed elsewhere in this alert.

Interest that is disallowed under new Section 163(j) is added to the business interest expense for the succeeding year. This carryforward is indefinite. The disallowed interest expense carryover can also be carried over in certain corporate acquisitions, subject to the limitations under Section 382. A taxpayer with excess interest expense under the current Section 163(j) rules may not be able to utilize that carryover for purposes of calculating the Section 163(j) limitation under the new rules.

For partnerships, the Section 163(j) limitation is calculated at the partnership level, while the disallowed interest expense is carried over at the partner level. A partner can only utilize the disallowed interest expense carryover from a given partnership against the partner's share of the partnership's "excess taxable income" in later years. Additionally, a partner's share of disallowed interest expense reduces the partner's tax basis in her partnership interest. If a partner is not able to utilize the disallowed interest expense before the partner disposes of her interest in the partnership, these basis reductions are added back. Apart from the basis adjustment provision, similar rules apply to S corporations and their shareholders.

The Conference Agreement drops the additional interest expense limitation applicable to multinational corporations that was found in proposed Section 163(n) of the House and Senate bills.

Impact of Tax Reform on Banks and Other Financial Institutions

There are a number of provisions of the conference bill which impact banks and other financial institutions either directly, by impacting the tax they have to pay, or indirectly, by affecting the instruments they may underwrite or facilitate the issuance of.

Interest Deductibility Limitations

Financial institutions, like all companies that are heavily leveraged, will be significantly impacted by the limit on interest deductibility. The House and Senate versions of the bill contained two significant new interest limitations. The first modified Section 163(j) of the Code and imposed an absolute limit on interest deductibility. The second created a new Section 163(n) which ensured that the U.S. group was not more heavily indebted than the rest of the worldwide group. The bill that emerged from the Conference Committee only included the former limitation and omitted the latter.

Specifically, Section 13301 of the Conference Agreement revises Section 163(j) of the Code so that interest deductions are limited to the sum of three amounts: (i) net interest income; (ii) 30% of adjusted taxable income; and (iii) the taxpayer's floor plan financing interest.

For taxable years beginning before January 1, 2022, the adjusted taxable income is the taxpayer's earnings before interest, taxes, depreciation, and amortization ("EBITDA"). After that point, adjusted taxable income is a more stringent EBIT base.

The provision for floor plan financing is directed primarily to retailers who sell motor vehicles. It is common for these taxpayers to borrow funds secured by their inventory. These taxpayers may deduct interest on loans secured by their inventory. Had the bill not included an exception for such financing, it would have significantly altered the manner in which motor vehicle retailers finance the acquisition and sale of their products.

Municipal Bonds

The House bill would have repealed the federal tax exemption for interest on private activity bonds - the proceeds of which are used by entities other than the government. The House bill also eliminated the federal tax exemption for advance refunding bonds - new bonds that are issued to repay an original private activity bond but are issued more than ninety days before the original bond matures. The House bill also repealed the provisions that allowed issuers to issue bonds that entitled the holder to certain federal tax credits in lieu of interest. The House bill also prevented bonds issued for the purpose of financing a professional sports stadiums from qualifying as a private activity bond that would qualify for tax-exempt interest under Section 103 of the Code.

The Conference Report rejected the House's attempted repeal of the private activity bond provisions. Thus municipalities can continue to issue private activity bonds. Moreover, the proceeds can still be used to fund a professional sports stadium. Despite the foregoing, the Conference Agreement followed the House's approach with respect to advance refunding bonds and bonds that generated tax credits.

Deductibility of FDIC Premiums

To prevent runs on banks, the Federal Deposit Insurance Corporation ("FDIC") insures the deposit of depositors at banks up to a certain amount. Banks have to pay premiums to the FDIC for this insurance. The tax bill includes a new Section 162(r) which denies a tax deduction for the premium. The deduction denial only applies to large banks with assets in excess of $10 billion. Once that asset threshold is satisfied, the denial is phased in until the bank's assets reach $50 billion, at which point the deduction is fully denied.

Denial of Operations Loss Deduction

Life insurance companies are entitled to carryback and forward operating loss deductions in lieu of the net operating loss deduction permitted other types of corporations. Given the changes to the Section 172 net operating loss deduction provisions, the tax bill repeals the special rule for operating losses applicable to life insurance companies. Instead, life insurance companies will simply have to follow the net operating loss rules, like other companies, including the limit on the amount of taxable income that a net operating loss may offset.

Small Life Insurance Company Deduction

Current law allows small life insurance companies with assets less than $500 million a deduction up to $1.8 million. The bill repeals the small life insurance company deduction.

Income Adjustments to Life Insurance Companies Due to Changes in the Method for Computing Reserves

Although most taxpayers, when they undergo a change in accounting method, have to recognize the corresponding adjustment to their income ratably over a four year period, life insurance companies are generally entitled to recognize the income adjustment ratably over ten years. The bill shortens the ten year period to four.

Change to PFIC Insurance Company Exception

The Conference Agreement amends the insurance company exception to passive foreign investment company (PFIC) treatment. The PFIC rules (specifically, Section 1297(b)(2)(B)) currently provide that income (including investment income) earned in the "active conduct" of an insurance business by a non-US company that would qualify for taxation as an insurance company if it were domestic, will not be treated as passive income for PFIC purposes. However, there are no bright-line rules in the Code or regulations for determining when income is earned in the active conduct of an insurance business. This has led to concerns in Congress that some companies that are primarily focused on investment rather than insurance (so-called "hedge fund" reinsurance companies) are avoiding PFIC treatment by claiming that their income meets the active conduct test under Section 1297(b)(2)(B). The Conference Agreement amends Section 1297(b)(2)(B) to provide that, to meet the active conduct test, an insurance company's insurance liabilities must constitute more than 25 percent of its total assets as reported on the company's applicable financial statement. The bill also includes an electable "facts and circumstances" test for insurance companies that have at least a 10% insurance liabilities to assets ratio, if the company's failure to meet the 25% test is due solely to specified circumstances involving such insurance business (for example, if the insurance company is in runoff). This proposal mirrors legislation introduced by Senator Wyden (D-OR) in previous legislative sessions.

Application of BEAT to Financial Services Industry

The Base Erosion and Anti-Abuse Tax (BEAT) will potentially significantly increase the tax liability of large multinationals in the financial services industry. This Alert describes the BEAT rules in detail below, but very generally, the BEAT subjects U.S. corporations with gross receipts in excess of $500 million to an alternative minimum tax (at a 5% rate in 2018, increasing to 10% in 2019 and 12.5% in 2026) by recalculating tax liability after disallowing deductions for payments to non-U.S. related parties. Most types of related party cross-border payments commonly made by banks, insurance companies, and other financial institutions would be non-deductible payments under the BEAT. For example, new language in the Conference Agreement makes clear that cross-border payments of insurance and reinsurance premiums to related parties would not be deductible under the BEAT. There is, however, an exception for payments made in the ordinary course of a trade or business that constitute a "qualified derivative payment". The BEAT tax rate is one percentage point higher for banks and registered securities dealers than for other categories of U.S. corporations. Financial institutions should review the BEAT provisions carefully to determine how the tax applies to them.

Various Other Changes

The Conference Agreement contains other changes that we do not elaborate on here. The bill changes the computation of life insurance reserves. The bill modifies certain rules relating to computing dividends received deduction and insurance companies. The bill also changes the amortization period for certain policy acquisition expenses.

State Corporate Income Tax Considerations of Business Tax Reform

From a U.S. state and local corporate income tax perspective, the federal corporate tax reform provisions present several interesting issues.

The key to evaluating how federal tax reform will impact state corporate income tax is conformity. Many states use federal taxable income as computed under the Internal Revenue Code (IRC) as the starting point for computing state taxable income. However, state conformity to the IRC for this purpose is achieved in different ways, including (1) conforming to the IRC as of a fixed date, which may or may not be the most recent version of the IRC ("static conformity"); (2) conforming to the IRC that is currently in effect ("rolling conformity"); or (3) conforming to only specific IRC sections ("selective conformity"), which may be either static or rolling.

As a general matter, rolling conformity states will automatically incorporate the tax base changes found in the tax bill and must pass legislation to specifically decouple from those provisions (unless a state-specific modification already exists). In contrast, in static conformity states, legislation will be required to explicitly conform to the new provisions in the tax bill.

While these different types of conformity are likely to create variances among a taxpayer's state income tax bases, states do not conform to federal tax rates and are unlikely to reduce rates in the wake of state budget shortfalls. Thus, while corporations may enjoy a reduced tax rate of 21% at the federal level, their state corporate tax rates are likely to hold steady (if not increase) in the near term.

1. Interest Deductibility

Rolling conformity states will likely conform to the bill's limitations on interest expense deductions due to conformity to the federal tax base. However, since a number of states already disallow deductions for interest paid to related parties, the more significant state impact is likely for interest paid to unrelated lenders.

Taxpayers will also need to carefully consider how the interest limitation should be calculated in both separate and combined reporting states as the composition of the tax return group may differ from the federal group. Additionally, consideration should be given to how states will conform to the carry forward of disallowed interest expense. For example, will such amounts be carried forward and applied on a pre- or post-apportionment basis?

2. Business Expensing

Since many states currently decouple from IRC Section 168(k), it is likely that those states will similarly decouple from the full expensing provisions. Nevertheless, in most states, decoupling from full immediate expensing is likely to be a timing difference as most states allow some form of depreciation, requiring taxpayers to maintain separate federal and state depreciation schedules.

An additional consequence of states decoupling from full and immediate expensing may result at the time an asset is sold. For example, if an asset is sold before it is fully depreciated for state tax purposes, questions may arise regarding state conformity to federal basis for purposes of calculating any gain or loss on the sale of the asset for state tax purposes.

3. Transition Tax

Many states exclude or allow a deduction from the state tax base for Subpart F income. However, in excluding or deducting Subpart F income, states may refer to specific provisions of the IRC (e.g., Sections 951 or 952) or may generally refer to income under Subpart F of the IRC. Depending on the state's specific language, questions may arise as to whether this deemed repatriation income (which is codified in Section 965 of the IRC) falls within the state's exclusion or deduction. In states that do not include Subpart F income in the tax base, issues may arise when the cash is actually distributed. Depending on the state‘s conformity to the federal previously taxed income provisions, the distribution may be taxed at the state-level unless a state-specific deduction applies (e.g., a dividends received deduction).

For states that do not permit a deduction for or otherwise exclude Subpart F income from the state tax base, additional questions arise regarding the treatment of any Subpart F income as a dividend eligible for a dividends-received deduction or as non-apportionable nonbusiness income.

To the extent that any income is included in the state tax base (either as Subpart F income or later as a cash distribution) taxpayers should consider the impact on state tax apportionment. As a general rule, factor representation should be required (i.e., if an item of income is includable in the state tax base the receipts associated with that item of income should be included in the state apportionment factor). Thus, any income resulting from the [transition] tax provisions should be included in the apportionment factor denominator (even though some states may try to statutorily exclude amounts as extraordinary or unusual transactions). The inclusion of such amounts in the apportionment numerator will depend on the state's specific sourcing rules (e.g. market-based sourcing or costs of performance sourcing).

4. International Tax Provisions

Participation Exemption System

As a general matter, most states permit deductions for dividends received from related corporations. However, since the bill provides that certain dividends a US corporation receives from an eligible foreign corporation qualify for a 100% deduction, consideration should be given to whether states can conform to such a provision under U.S. Constitutional principles requiring non-discrimination if a state does not provide a similar 100% deduction for dividends received from domestic corporations. As a solution, states may choose to modify the 100% deduction to align with the state's treatment of domestic dividends.

GILTI and FDII

As discussed above, some states permit a deduction or exclusion for Subpart F income. However, unlike the deemed repatriation income discussed above, GILTI is found in an entirely new section of the IRC (Section 951A). Thus, the question of whether current state provisions addressing the treatment of Subpart F income will cover GILTI may be less clear.

Like the deemed repatriation income, if GILTI is included in the calculation of the state income tax base, consideration should be given to whether other arguments exist to exclude GILTI from the tax base (e.g., as nonbusiness income) and to how GILTI income should be reflected in state apportionment factors. Consideration should also be given to the interplay of these new federal provisions with the current state income tax modifications for intercompany intangibles. Many states require taxpayers to add back to the computation of state taxable income intangible expenses paid or incurred to a related member. In light of the new GILTI provisions, if a taxpayer pays an intangible expense to a CFC and is required to add back that expense to its state taxable income, would the new category of Subpart F income for GILTI satisfy state subject to tax exceptions to addback and, if not, would the result be tantamount to double taxation?

As discussed above, new IRC Section 250 provides a special deduction for 37.5% of the foreign-derived intangible income ("FDII") of a domestic corporation and a 50% deduction for GILTI. The question of whether states will conform to these provisions generally hinges on the states' conformity to the IRC (e.g., static, rolling, selective). Notwithstanding, given each state's unique conformity or state-specific modifications to taxable income, the new GILTI/FDII structure could produce winners and losers for state income tax purposes.

BEAT

Under a new section of the IRC (Section 59A), certain taxpayers are required to pay a separate tax equal to the base erosion minimum tax amount for the taxable year. Given that this is a separate tax and does not impact the calculation of federal taxable income, states would not likely conform to the BEAT absent specific legislation. Additionally, to the extent that the BEAT is viewed as imposing a tax on foreign commerce (as opposed to domestic commerce), states would have a difficult time enacting a similar tax that would pass constitutional muster as states are not permitted to discriminate against foreign commerce.

5. Future Guidance

The tax bill contains numerous additional provisions that may impact state corporate income taxes. As discussed above, in examining the impact of any of these provisions on state corporate income taxes, taxpayers must first evaluate state conformity to the IRC. In terms of conformity, it is also important to note that in several instances the tax bill contains broad grants of authority to Treasury to issue guidance, and while states may conform to the IRC itself, states may not conform to federal interpretations of the IRC. Thus, if and when Treasury issues substantive guidance regarding any of the provisions in the tax bill, an additional threshold question will exist as to whether such guidance applies in the states.

Considerations for High-Net Worth Individuals

The conference bill includes several provisions that are relevant to high net worth individuals. The most significant changes for high net worth individuals include: (i) the increased estate and gift tax exclusion, (ii) outbound issues for individuals, (iii) changes to the taxation of business organizations, and (iv) changes to individual income tax and deduction items.

1. Increased Estate and Gift Tax Exclusion

The bill provides immediate relief from the estate tax, gift tax, and generation-skipping transfer tax ("GST") by doubling the exclusion to $11.2 million beginning in 2018. By doubling the exclusion, married couples who use portability or credit shelter trusts can shield up to $22.4 million (as indexed for inflation) from estate, gift, and GST tax.

The bill does not eliminate the estate and generation-skipping transfer tax and does not change the current rules that adjust the basis of property acquired from a decedent. The bill does not change the current estate and gift tax rules for non-resident aliens. Under the current rules, non-resident aliens have a $60,000 exclusion from estate and no exemption from gift tax.

Under current law, the exclusion is $5.49 million in 2017. The current exclusion levels (as indexed for inflation) will apply beginning in 2026 because the increased exclusion under the bill would sunset in 2025. Due to the scheduled sunset in 2025, taxpayers should consider planning that will utilize what may be a temporarily doubled gift and estate tax exclusion. Such planning may include exclusion gifts in trust to one's spouse and children, leveraged gifts through life insurance trusts, or sales to grantor trusts seeded with a sufficient up-front gift to the trust. Taxpayers should review their current wills and trusts to confirm that they take full advantage of the new transfer tax regime and reconcile differences between state estate tax and federal estate tax rules.

2. Outbound Issues for Individuals

Controlled Foreign Corporation Provisions

The bill eliminates the requirement that a U.S. shareholder must control a non-U.S. corporation for an uninterrupted 30-day period before Subpart F inclusions apply (the so-called "30 day rule"). This change is relevant for U.S. individuals that receive gratuitous transfers of foreign stock, such as individuals who inherit shares from non-U.S. family members. A popular technique that will no longer be as effective as it was in the past is to liquidate an inherited foreign corporation within 30 days of the decedent's death. This technique prevented the foreign corporation from being treated as a CFC in the hands of the U.S. individual's receipt of a bequest from a decedent. In light of the new provision, it may be advisable to consider elections to convert the foreign corporation to a flow-through entity effective prior to the decedent's death.

Further, the bill eliminates Section 958(b)(4), which prevents downward attribution of stock from certain non-U.S. partnerships, estates, trusts, and corporations to U.S. persons for purposes of determining whether the CFC and U.S. shareholder tests are satisfied. This repeal may result in unintended tax and reporting consequences. For example, by eliminating this provision, a domestic corporation owned by a non-U.S. individual shareholder could be considered to own the shares of non-U.S. corporations owned by the non-U.S. individual shareholder. This could result in the non-U.S. corporations being constructively owned CFCs of the domestic corporation in certain circumstances. The domestic corporation may have a reporting obligation, or an income inclusion if it owns actual shares in the foreign corporation.

The bill expands the definition of "United States shareholder" to include any U.S. person who owns 10 percent or more of the total vote or *value* of all shares of all classes of stock of a foreign corporation. Under current law, the definition of United States shareholder required a U.S. shareholder to hold 10% or more of the voting power of the CFC. Therefore, individuals that own non-voting shares in a foreign corporation that were not previously considered United States shareholders, should determine if their non-voting shares will cause them to become United States shareholders and also cause the entity to become a CFC.

The GILTI regime may cause income of a CFC that is not otherwise caught by the existing Subpart F rules to be includable in the gross income of its U.S. shareholders. This regime will affect almost all U.S. individuals that own CFCs, unless the CFC has incurred significant investment in tangible assets. This regime would apply to U.S. shareholders of foreign IP-rich CFCs, service provider CFCs, and CFCs with low-basis assets, and which otherwise would not cause Subpart F inclusions for its U.S. shareholders. If a U.S. C corporation owns the CFC, the GILTI inclusion will be subject to a reduced effective U.S. tax rate of 10.5% plus the C corporation can offset the U.S. tax liability with a tax credit equal to 80% of the foreign tax paid by the CFC. However, if a U.S. individual owns the CFC directly or through a pass-through entity, then the GILTI inclusion will be subject to ordinary U.S. federal tax rates of up to 37%. Furthermore, the individual will not be able to apply a tax credit against the income for taxes paid by the CFC. Therefore, the CFC will be subject to tax in the foreign country plus the individual will be subject to an immediate 37% tax on GILTI income. Furthermore, dividend withholding by the CFC's country of incorporation will likely not be able to be offset by foreign tax credits. That said, the GILTI regime should not apply if the CFC's foreign income is subject to foreign tax at a rate of 13.125% or more for C corporation shareholders and 18.9% or more for non-C corporation shareholders. When applicable, the U.S. individual should consider restructuring his or her interest in the CFC. The GILTI regime is discussed in more detail in the section below "Global Intangible Low-Taxed Income".

Participation Exemption for Foreign Source Dividends

The bill's provision that exempts 100% of foreign source dividends paid by a specified 10-percent owned non-U.S. corporation would apply only to U.S. C corporation shareholders of non-U.S. corporations. When a U.S. individual shareholder receives a dividend from a non-U.S. corporation, the dividend is includable in the shareholder's gross income. U.S. individual shareholders of CFCs cannot claim indirect tax credits for non-U.S. taxes paid by the CFC.

There are several options to improve the tax position of U.S. individual shareholders holding non-U.S. investments, such as forming a U.S. corporation to own the shares of a non-U.S. corporation. This can be especially beneficial to U.S. individual shareholders that own non-U.S. corporations in jurisdictions that do not have a treaty with the United States. An alternative is for the shareholder to make an election under Section 962(b) to treat the CFC as if it were owned by a domestic C corporation. The 100% foreign source dividends exemption will not apply to dividends from passive foreign investment companies ("PFICs") even if the U.S. shareholder is a corporation.

Forced Repatriation

The bill's forced repatriation rule applies to U.S. individuals who own CFCs, or non-U.S. corporations that have at least one 10-percent U.S. shareholder that is a U.S. domestic corporation. It does not apply to individuals who own non-CFC PFICs. In simple terms, the tax applies as a Subpart F inclusion on all of the CFC's pre-effective date foreign earnings at a rate of approximately 8% for non-cash earnings and profits and 15.5% for earnings and profits held in cash. Individuals will not be afforded the benefit of foreign tax credits for any foreign tax imposed on the CFC's earnings. That said, individuals may be afforded a partial tax credit for any foreign withholding tax imposed on the distribution of any of the foreign corporation's earnings that was subject to the forced repatriation tax. Furthermore, the new provision will allow for an 8-year deferral on payment of the tax owed, meaning the majority of payments will be owed in the later part of the 8-year period. Finally, if the CFC was owned by an S corporation, there is an indefinite deferral of the tax that may apply until one of the following triggering events is met. The first type of triggering event is a change in the status of the corporation as an S corporation. The second category includes liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy. The third type of triggering event is a transfer of shares of stock in the S corporation by the electing taxpayer, whether by sale, death or otherwise, unless the transferee of the stock agrees with the Secretary to be liable for net tax liability in the same manner as the transferor.

3. Changes to the Taxation of Business Organizations

Changes to Corporate and Pass-Through Income Tax Rates

By reducing the headline corporate tax rate to 21%, the bill will increase the attractiveness of using U.S. corporations in planning for individuals. Taxpayers must carefully balance the pros and cons of conducting business in corporate or pass-through form under the bill's various provisions. For example, taxpayers will need to consider the headline rate but also the reduced dividends received deduction as part of planning using corporations.

QBI Deduction for Pass-Through Entities

Taxpayers are allowed a new deduction of 20% with respect to domestic "qualified business income" (QBI) from a pass-through entity (partnership, S corporation, or sole proprietorship), for tax years beginning after December 31, 2017, and before January 1, 2026. Certain limitations apply to the QBI deduction for specified service businesses. The QBI deduction could reduce the effective tax rate for income earned through pass-through entities to 29.6%.

QBI includes all domestic business income other than certain types of investment income. The deduction is limited to a percentage of the pass-through entity's wages paid that are subject to wage withholding, elective deferrals, and deferred compensation. Thus, if the pass-through entity does not pay such items, the taxpayer is not eligible for the QBI deduction. There may be a significant advantage for pass-through entities where the QBI deduction is available. Trusts and estates are eligible for the QBI deduction as owners of qualifying pass-through entities.

Look-Thru on Sale of Partnership Interest

The bill provides that a non-U.S. partner's gain or loss on the sale of a partnership interest in a partnership that is engaged in a U.S. trade or business will be treated as income that is effectively connected with a U.S. trade or business. This rule codifies the IRS position in Revenue Ruling 91-32 and overrides the Tax Court's decision in *Grecian Magnesite*.

4. Changes to Individual Income Tax and Deductions

Individual Income Tax Rates and AMT

The bill reduces the maximum tax rate for individuals to 37%. The maximum 37% rate applies in 2018 to married individuals filing joint returns with income over $600,000 and single individuals with income over $500,000. Under current law, the maximum income tax rate for individuals is 39.6%.

The bill maintains the alternative minimum tax for individuals but increases the exemption amount and the threshold amount after which the exemption is phased-out for tax years 2018 through 2025. For tax year 2018, the exemption amounts and phase-out thresholds would be $109,400 and $1,000,000 for joint filers and $70,300 and $500,000 for single filers, respectively.

Impact on Deductions

The bill roughly doubles the standard deduction while suspending personal exemptions and miscellaneous itemized deductions for tax years after December 31, 2017 and before January 1, 2026. The bill also modifies or suspends several deductions, including deductions for alimony, personal casualty losses, net operating losses, medical expenses, and mortgage interest, among others.

Current law provides that contributions of cash and ordinary income property to public charities are eligible for deductions up to 50% of the taxpayer's adjusted gross income (not counting any net operating loss carrybacks). The bill would increase the ceiling to 60% for contributions made after December 31, 2017 and before January 1, 2026.

Another significant change is the limitation on the deduction for state and local taxes. Currently taxpayers who itemize may deduct the full amount of property, income, or sales taxes paid at the state and local level from their federal taxable income. Under the bill, taxpayers may only deduct up to $10,000 ($5,000 in the case of a married individual filing a separate return) of state or local property, income or sales taxes. This limitation will have an adverse impact on high net worth individuals who reside, operate, or own property in high-tax states, such as New York, New Jersey, Connecticut, California, and Illinois. For purposes of the limitation on deducting state and local taxes, state and local income taxes are treated as paid on the last day of the taxable year for which the tax is imposed. This limits the ability of taxpayers to prepay future year state and local income taxes before the end of 2017.

The bill reduces the mortgage interest deduction limitation amount from $1,000,000 of acquisition debt acquired after December 15, 2017, to $750,000 ($375,000 for married taxpayers filing separately). The reduction is applicable for taxable years after December 31, 2017 and before January 1, 2026, after which the limitation amounts would revert to current law and existing loans are grandfathered. For tax years 2018 through 2025, the bill eliminates interest deductions on home equity mortgages.

International Provisions

The bill makes fundamental and sweeping changes to the U.S. taxation of international businesses. The overarching purposes of this new international tax regime include making U.S. multinationals more competitive with companies based in other countries, removing impediments to the repatriation of profits to the United States, reducing opportunities to shift income offshore to low-tax jurisdictions, incentivizing exports of products and services from the United States, and preventing erosion of the U.S. tax base by foreign companies.

The cornerstone of this new system is a lower rate of corporate income tax and the move to a territorial system, which eliminates the tax on dividends to the U.S. shareholder, and thereby removes the principal disincentive to repatriate profits to the United States. In transitioning to this new system, existing offshore earnings are immediately included in income and taxed at a reduced rate. To prevent the use of the territorial regime to earn income in low-tax countries that can then be repatriated free of U.S. tax, offshore profits in excess of a deemed return on tangible assets earned offshore are taxed at a reduced rate in a manner similar to Subpart F income so as to ensure that all income of the multinational enterprise is subject to some level of income taxation. To encourage the export of products and services by U.S. corporations, the income from such transactions (again, in excess of a deemed return on tangible assets) earned from such transactions are taxed at a reduced rate of tax. Finally, a new form of alternative minimum tax reduces the opportunity to erode the U.S. tax base by denying much of the tax benefit of otherwise deductible payments to foreign corporations. While these changes have reduced the incentives for U.S.

companies to migrate intangible property offshore, U.S. multinationals may still find reason to enter into, or remain in existing, principal company structures.

1. Participation Exemption System

In at least one important respect, the bill generally brings the US foreign tax system in line with international norms by providing a "participation exemption." Under the participation exemption in new Section 245A, eligible dividends a US corporation receives from an eligible foreign corporation qualify for a deduction equal to the amount of the dividend. As a result, qualifying dividends are only subject to foreign tax and effectively are exempt from US tax.

To qualify for the dividends received deduction, the US corporation must be a US shareholder under Section 951(b) in the foreign corporation. As long as there is at least one US shareholder, the foreign corporation does not need to be a CFC. The bill also amends the definition of the term US shareholder in Section 951(b) for taxable years of foreign corporations beginning after December 31, 2017, so that a US corporation is a US shareholder if it owns 10% of the foreign corporation by vote or value.

The deduction is limited to the foreign portion of the dividend. The foreign portion of the dividend is determined by multiplying the amount of the dividend by the ratio of the foreign corporation's undistributed foreign earnings over its total undistributed earnings. Undistributed earnings are determined as of year-end and without taking into account any distributions during the year.

If a dividend qualifies for the deduction, the US shareholder cannot claim a Section 901 foreign tax credit or a Section 162 deduction for any foreign tax that is paid or accrued with respect to the dividend. Thus, if a dividend is subject to a foreign withholding tax, that tax represents a true cost to the US shareholder, as the US shareholder cannot credit that tax against any other US taxes. In addition, qualifying dividends do not create limitation under Section 904 for purposes of using other Section 901 credits.

The participation exemption does not apply to "hybrid dividends." Hybrid dividends are dividends with respect to which a CFC making the distribution is entitled to a deduction (or some "other tax benefit") for local tax purposes. If a CFC receives a hybrid dividend from another CFC, the hybrid dividend is Subpart F income. Tightening the noose on hybrids, the bill also provides that the US shareholder cannot claim a Section 901 foreign tax credit or a Section 162 deduction for any foreign tax that is paid or accrued with respect to a hybrid dividend.

Like other dividends received deductions ("DRD"), the participation deduction is subject to a holding period requirement. In this case, the bill requires the US shareholder to hold the stock for at least a year before the ex-dividend date and at least two years and a day in the case of preferred dividends. This holding period is substantially longer than the typical 45 or 90 days in Section 246(c).

Dividends from PFICs do not qualify for the deduction and if a PFIC makes a purging election so that it ceases to be subject to the PFIC rules, the purging dividend also does not qualify for the deduction. Similarly, US corporations with RIC and REIT status do not qualify for the deduction.

Turning to the effective date for the participation exemption, the bill is effective with respect to dividends made after December 31, 2017. Thus, starting January 1, 2018, taxpayers that satisfy the requirements described above may distribute cash or other property to the US tax free, regardless of whether their tax years begin on that date.

2. Foreign Derived Intangible Income (FDII)

New Section 250 provides a special deduction for a domestic corporation's FDII. In summary, the provision provides a lower rate of tax on a portion of profits derived from sales into foreign markets. In the language of the Conference Report, a domestic corporation's FDII is the portion of its income "that is derived from serving foreign markets," in excess of a deemed return on tangible assets (the "deemed tangible income return"). The Conference Agreement largely adopted the Senate amendment. Broadly speaking, a domestic corporation is allowed a deduction under new Section 250 in an amount equal to 37.5 percent of its FDII, resulting in an effective tax rate on FDII of 13.125%. The deductible percentage of FDII declines to 21.875% in tax years beginning 2026 and beyond, resulting in an effective tax rate on FDII of 16.406%. (Section 250 also allows a deduction of 50 percent of the corporation's GILTI (discussed below).)

To determine the FDII of any domestic corporation, one first must determine its so-called "deemed intangible income". Deemed intangible income, roughly speaking, is net income after certain adjustments, which is then reduced by the applicable deemed tangible income return. In the FDII context, the deemed tangible income return is equal to 10 percent of a corporation's qualified business asset investment ("QBAI"), as defined by reference to new Section 951A(d) (with that provision applied to domestic corporations instead of CFCs). QBAI, roughly speaking, is the aggregate adjusted basis in depreciable tangible property owned and used by the domestic corporation in its trade or business. QBAI is measured on a quarterly averaging basis, similar the manner in which investments in U.S. property are calculated under Section 956.

Next, one must calculate the "deduction eligible income," and the "foreign derived deduction eligible income" of the domestic corporation to determine the foreign-derived ratio. The FDII calculation can be expressed as follows:

$$FDII = deemed\ intangible\ income\ X\ \frac{(A)\ the\ foreign\text{–}derived\ deduction\ eligible\ income}{(B)\ the\ deduction\ eligible\ income.}$$

"Deduction eligible income" is the excess of the domestic corporation's gross income (without regard to inclusions under Sections 951 or 951A, or dividends from CFCs) over deductions allocable to this income (applying rules similar to Section 954(b)(5)). "Foreign derived deduction eligible income" is deduction eligible income derived in connection with (A) property sold, leased, licensed or exchanged by the taxpayer to any person who is not a United States person for a foreign use, or (B) services provided by the taxpayer to any person, or with respect to property, not located within the United States. The bill places a limit on the amount of FDII if the sum of FDII and GILTI exceeds the domestic corporation's taxable income.

Sales to intermediaries trigger a set of special rules. Essentially, a sale of products or services to an unrelated US intermediary will not qualify as foreign-derived deduction eligible income even if that intermediary on-sells to a foreign person for a foreign use, while sales to related domestic intermediaries can qualify as foreign derived deduction eligible income if the property is ultimately sold for foreign use.

While Section 250 itself does not contain an anti-abuse rule (it merely authorizes the Secretary to prescribe regulations or other guidance as may be appropriate "to carry out this provision"), the cross-reference to the QBAI definition implicates the grant of authority in Section 951A(d)(4) (discussed further below).

A couple of observations are in order. First, the reference to "deemed" intangible income is somewhat misleading, as the mechanics of the rule confirm that there is no requirement for any of the "deemed intangible income" to be, in fact, derived from the exploitation of intangibles. Second, as a planning matter, we note that the key components of the formula - specifically, those over which the taxpayer might be able to exercise some degree of control - are "deemed intangible income" and "foreign derived deduction eligible income". Broadly speaking, any increase in such amounts will result in an increase in the deduction under Section 250. Deemed intangible income is gross income (with some adjustments) less 10 percent of the corporation's QBAI. Consequently a reduction in a domestic corporation's QBAI will tend to increase deemed intangible income and, accordingly, FDII. Foreign derived deduction eligible income essentially means income derived from exports of property (including leases or licenses) or export of services, such that an increase in the income from such exports will tend to increase the "foreign-derived" ratio, and, accordingly, FDII. Planning in this area will involve striking the right balance among several factors, including the effect on FDII and GILTI of QBAI located inside or outside the US, the different foreign tax rates arising depending on whether the major productive assets are located inside and outside the US, and other factors.

3. Global Intangible Low-Taxed Income (GILTI)

In addition to the new FDII regime, the Senate bill introduced what is, in effect, a new category of Subpart F income – global intangible low-taxed income ("GILTI"). The Conference bill largely adopted the Senate proposal, but included new additional guidance addressing the treatment of assets and property held through partnerships.

The GILTI rules target the same type of income as the FDII rules discussed above - namely, income derived from outside the United States. Thus, as one might expect, the framework for the two sets of rules share certain similarities. In broad strokes, GILTI taxes the aggregate, net income of all of a U.S. Shareholder's CFCs income not otherwise captured under the Subpart F and ECI provisions of the Code ("Net CFC Tested Income"), less a return on the tangible assets held by those CFCs used for the production of tested income in a trade or business ("deemed tangible income return").

Net CFC Tested Income and deemed tangible income return are each determined on an aggregate basis.

Net CFC Tested Income is the aggregate tested income of each CFC of the U.S. Shareholder, less properly allocable deductions (as determined under Section 954(b)(5)), over the aggregate tested losses of the shareholder's CFCs. Tested income is the gross income of a CFC, without regard to ECI, Subpart F income, foreign base company and insurance income, related party dividends, and certain oil and gas income, less allocable deductions. Conceptually and substantively, tested income and deduction eligible income (under the FDII rules) represent similar, though not entirely identical, pools of earnings. Once determined on an overall basis, Net CFC Tested Income is allocated to each U.S. Shareholder in the same manner Subpart F income is allocated under Section 951(a)(2).

The deemed tangible income return for each U.S. Shareholder is determined in a similar manner. As a threshold matter, the GILTI rules define deemed tangible income return almost identically to the definition used in the FDII context - namely, an amount equal to ten percent of the aggregate QBAI of a U.S. Shareholder's CFCs. QBAI, in the GILTI context, is the average aggregate basis of tangible assets held by a U.S. Shareholder's CFCs that are used in a trade or business. The Conference bill includes a new provision which allows a CFC to treat as QBAI its distributive share of tangible assets held by a partnership in which it is a partner. Like Net CFC Tested Income, QBAI is allocated to each U.S. Shareholder in the same manner as Subpart F income.

GILTI, the difference between the U.S. Shareholder's pro rata share of Net CFC Tested Income and ten percent of its pro rata share of QBAI, must be included in gross income; however, a U.S. Shareholder is also entitled to a deduction equal to 50 percent of the GILTI amount, resulting in an effective tax rate on GILTI of 10.5%. The deductible percentage of GILTI declines to 37.5% in tax years beginning 2026 and beyond, resulting in an effective tax rate on FDII of 13.125%. To determine foreign tax credit consequences, GILTI is allocated back to a U.S. Shareholder's CFCs in proportion to the extent to which their earnings contributed to the GILTI amount. As discussed in greater detail below, this allocation of GILTI is treated the same as Subpart F PTI, which can be used to offset other Subpart F income or inclusions under Section 956.

Several observations are in order. First, as alluded to above, the GILTI rules create a surprising and unexpected incentive for U.S. multinationals to increase the amount of tangible assets held by their CFCs, which in most circumstances will presumably be situated outside the United States. Assuming a more or less steady amount of overall income potentially subject to Section 951A (and deductible under Section 250), increasing QBAI held by CFCs may be one of the most effective ways to manage or reduce GILTI. Apparently aware of this dynamic, the Senate amendment included, and the Conference bill adopted, an unusually broad anti-abuse provision which provides that the Secretary "shall issue" regulations as appropriate to prevent the avoidance of the purposes of the

QBAI provision, and explicitly allows the Secretary to prescribe guidance for the treatment of (i) transitory transfers of assets and (ii) circumstances where the avoidance of purpose of the rules is "a factor" in the transfer or holding of property. This rule applies in the FDII context as well and, thus, could provide a basis for challenging planning approaches historically used in the Section 956 context to reduce QBAI at quarter-end measuring dates, and in turn reduce deemed tangible income return.

Second, the "aggregate" approach that the GILTI rules adopt for purposes of calculating Net CFC Tested Income and QBAI is quite helpful in some respects, but also potentially restrictive in other respects. Determining tested income and QBAI on an aggregate basis allows tangible assets held by one CFC to reduce GILTI attributable to tested income earned by a separate and different CFC. This is generally a helpful feature of the rules, as it eliminates the need to restructure existing supply chains to align tangible asset ownership with revenue and income recognition. At the same time, however, the aggregate approach may also limit the extent to which intercompany transactions can be used to effectively manage Net CFC Tested Income, as reduction in tested income for one CFC will very often create tested income for the counterparty, resulting in no net change.

Third, whether intentional or unintentional, the Conference committee's decision to forego repealing Section 956 for corporate U.S. Shareholders narrows a potential approach for managing QBAI and GILTI. Neither the Senate nor Conference bills explicitly require that QBAI be located outside of the United States. Thus, tangible assets of a CFC located in the United States may qualify as QBAI. The principal limitation to increasing QBAI through U.S. tangible asset ownership, under current law, would be Section 956. That is, ownership of assets located in the United States would in most cases give rise to a current taxable charge. The Senate bill, however, initially eliminated the application of Section 956 with respect to corporations. Thus, the only remaining limitation to such planning would be the potential risk of creating a U.S. trade or business or permanent establishment. However, in some cases, it may have been possible to manage this exposure by housing the assets in a separate CFC (earning only a routine return). Because QBAI is calculated on an aggregate basis, these tangible assets would create QBAI that would apply against income earned by other CFCs. Assuming one could navigate the anti-abuse provisions described above, in some circumstances, the benefit of additional QBAI might outweigh the U.S. tax cost of U.S. trade or business or permanent establishment. The elimination of the repeal of Section 956 for corporate shareholders would makes this planning approach more costly. As discussed below, however, the ability to distribute foreign source earnings under Section 245A may provide an opportunity manage any potential Section 956 exposure.

Finally, as policy matter, it is not clear that the statute will ultimately achieve its ostensible purpose of encouraging U.S. multinationals to locate (or re-locate) property in the United States. Simply put, the FDII deduction mechanics incentivizes domestic corporations to minimize the amount of tangible property (whether located in the United States or outside the United States) on their balance sheets, whereas the mechanics of the GILTI regime incentivizes groups to maximize the amount of tangible property owned by CFCs, which in most cases will presumably be outside of the United States. These rather obvious incentives are surprising and somewhat troubling in light of the bill's policy goal to increase US investment and employment. One can question the longevity of these rules if a significant number of taxpayers make decisions to increase foreign, not US, investment in tangible assets. Further to that point about stability, questions have been raised whether a tax reduction on export profits such as the one arising through FDII violates the United States' international trade obligations and could be vulnerable to challenge from the World Trade Organization (WTO), or otherwise.

FDII could revive the decades old tax policy dispute between the United States and the European Union (EU). The WTO’s Subsidy and Countervailing Measures Agreement, s.3.1, classifies as a prohibited subsidy tax reductions "contingent ... upon on export performance." A WTO panel would likely find that FDII, which will yield a lower tax rate for income from exports than income from domestic sales, to constitute a prohibited subsidy. The WTO provides for expedited litigation procedures for prohibited subsidies. While normal WTO litigation can take several years, it is possible for a prohibited subsidy case to reach conclusion in about a year. The European Commission and finance ministers of a number of European Union member states have already lodged their concerns with the Trump administration and Congress. If the EU (and others) were to decide to challenge FDII, they could initiate proceedings immediately after the President's signing of the tax bill. After adjudication, the EU (and others) could receive authorization to impose retaliatory tariffs in the amount of the benefit of FDII. Typically, retaliatory tariffs are targeted at politically influential exporters in order to maximize the motivation to replace the condemned provisions. Thus, if FDII is challenged and deemed a prohibited subsidy, the next Congress may find it necessary to revisit FDII.

4. Foreign Tax Credits

Under current law, earnings of foreign corporate subsidiaries of a US-resident shareholder are subject to US federal income taxation when distributed as a dividend to the US shareholder. To avoid double-taxation of those earnings, Section 902 deems a US corporate shareholder that meets certain ownership requirements to have borne the foreign income taxes imposed on the earnings of the foreign corporation that are distributed to it. Similarly, Section 960 provides that the US shareholder is deemed under Section 902 to have borne its pro rata share of the foreign income taxes imposed on the Subpart F income of its CFC, as if the income inclusion under Section 951 were an actual dividend to the US shareholder. The foreign taxes deemed paid by the US shareholder is the total pool of post-1986 undistributed foreign income taxes of the CFC times the amount of the dividend (or Section 951 inclusion) divided by the total pool of post-1986 undistributed earnings and profits of the CFC. The US shareholder can claim foreign tax credits under Section 901 for the foreign income taxes it actually pays or accrues, or is deemed to pay or accrue under Section 902, but effectively limited under Section 904 to the US income tax imposed on its foreign-source taxable income. The limitation under Section 904 is applied separately to passive and general "basket" income.

Under the territorial taxation regime of new Section 245A, earnings of foreign subsidiaries of a US corporation are no longer subject to US income taxation when distributed as a dividend to the US-resident shareholder. Consequently, the deemed-paid credit of Section 902 is no longer required to prevent double-taxation of these earnings, and has therefore been repealed in its entirety in Section 14301 of the bill. In contrast to the treatment of actual dividends under new Section 245A, Subpart F income inclusions under Section 951 are still subject to full income taxation in the US. Because Section 902 is repealed, Section 960 will be amended to deem the US shareholder to have borne its pro rata share of the foreign income taxes imposed on the Subpart F income of its CFC without relying on Section 902. The US shareholder is also deemed to bear any additional foreign income taxes imposed on an actual distribution of earnings described in Section 959 as having been previously taxed under Section 951. Under the new territorial regime, the CFC no longer tracks a pool of earnings and taxes. Instead, the deemed-paid taxes under Section 960 are those that are allocated to the Subpart F income of the CFC, under rules similar to those that currently govern the allocation of taxes to the separate foreign tax credit baskets. Conforming amendments have been made to other sections of the Code, including the Section 78 gross-up, to reflect the repeal of Section 902 and the amendments to Section 960.

To prevent taxpayers from utilizing foreign tax credits from Subpart F inclusions against GILTI income or active business income earned through foreign branches, these other two categories of income are now segregated for foreign tax credit purposes into separate foreign tax credit baskets. Foreign branch income is business profits of a US person that is attributable to QBUs in foreign countries, but does not include any passive basket income.

Because foreign tax credits under Section 901 are limited under Section 904 to the US taxes deemed to be imposed on the foreign-source income of the US taxpayer, generating foreign-source income is important to full utilization of foreign tax credits. In this regard, the Bill makes a significant change to the sourcing rule under Section 863(b)(2) for sales of inventory property produced in the US and sold outside the US (or produced outside the US and sold within the US). Under current law, this provision typically results in the income being sourced 50% to the location of the production activities and 50% to the location of title passage. Section 14303 of the Conference Agreement provides that this income shall be sourced "solely on the basis of the production activities with respect to the property." Therefore, income from the production of inventory property in the United States for sale outside of the United States will now be treated as 100% US-source income, even if title to the property passes outside of the United States. On other the hand, the traditional title passage sourcing rules for goods purchased and resold remain unchanged. It remains to be seen what impact, if any, the combination of these rules has on in-house domestic manufacturing.

5. Base erosion

The Conference Agreement adopted in large part the Senate's Base Erosion and Anti-Abuse Tax (the BEAT), an alternative to the House excise tax proposal. Under the BEAT, an applicable taxpayer is required to pay a tax equal to the base erosion minimum tax amount for the taxable year. The BEAT applies to corporations (other than regulated investment companies, real estate investment trusts, or S corporations) with average annual gross receipts for a 3-taxable-year period of at least $500 million and a "base erosion percentage" for the taxable year of at least 3% (2% for banks and registered securities dealers).

The Conference report also reinforces Congress's intent to pursue payments to expatriated companies. Specifically, whereas payments paid or accrued to a related foreign person that reduce gross receipts do not constitute base erosion payments, payments paid or accrued to a related surrogate corporation (or an affiliate that is part of the expanded group) are considered base erosion payments even if they reduce gross receipts. For this purpose, the provision only targets surrogate corporations formed after November 9, 2017.

Finally, as is the case with other provisions in the Act, the BEAT provides that the Secretary "shall issue" regulations or other guidance necessary to prevent the avoidance of the purpose of the statute including through the use of unrelated persons, conduit transactions, or other intermediaries, or transactions or arrangements designed in whole or in part to characterize payments otherwise subject to the provision as payments not subject to the provision or to substitute payments not subject to the section for payments otherwise subject to the provision. For this purpose the use of the word "shall" implies an expectation of Congress for Treasury to issue regulations to address the issue, rather than simply delegating an authority to issue regulations, if desired.

The Base Erosion Minimum Tax

The base erosion minimum tax is the excess of 10%* of the taxpayer's "modified taxable income" over the taxpayer's "regular tax liability" (defined in Section 26(b)) reduced (not below zero) by the excess (if any) of credits allowed against such regular tax liability over the sum of (a) the Section 38 credit (properly allocable to the Section 41(a) research credit plus (b) the portion of the applicable Section 38 credits (not in excess of 80% of lesser of amount of such credits or the base erosion minimum tax amount). The Conference Agreement provides that "applicable Section 38 credits" include credits under Section 42(a), Section 45(a), Section 46 (to the extent properly allocable to the energy credit under Section 48).

* As mentioned, the 10% tax rate is reduced to 5% for taxable years beginning in calendar 2018. Finally, the tax rate will increase to 12.5% for taxable years after 2025 and for purposes of the calculation of the regular tax liability, the taxpayer will be able to reduce the amount by the aggregate credits rather than just the excess amount. Note, the rate is one percentage point higher for banks (as defined under Section 581) and registered securities dealers under Section 15(a) of the SEC Act of 1934.

Relevant Definitions

Modified Taxable Income: Taxable income of the taxpayer computed under chapter 1, without regard to any base erosion tax benefit with respect to any base erosion payment or the base erosion percentage of any net operating loss deduction allowed under Section 172.

Base Erosion Tax Benefit. There was a slight amendment to the definition of the base erosion tax benefit to address reductions in the gross amount of premiums and other consideration with respect to insurance and annuity contracts. The remainder of the language in the final report remained the same.

A base erosion tax benefit includes any deduction allowed with respect to a base erosion payment. This includes deductions for depreciation (or amortization in lieu of depreciation) for property acquired with such payment, and in the case of base erosion payments paid or accrued to surrogate entities, any reduction in gross receipts with respect to such payment in computing gross income.

Note: The provision retained the exclusion of payments on which tax is imposed by Sections 871 or 881 *and* with respect to which tax had been deducted and withheld under Section 1441 or 1442 from the computation of modified taxable income and the base erosion percentage. Therefore, to the extent withholding tax is reduced or eliminated by an applicable treaty such exclusion should either be prorated or excluded from modified taxable income. The excluded amount under the withholding tax provision is reduced by rules similar to Section 163(j)(5)(B) as in effect before the enactment of the bill.

Base erosion payment: A base erosion payment is defined as any amount paid or accrued to a foreign related person for which a deduction is allowable, including amounts paid in connection with an acquisition of property subject to the allowance for depreciation (or amortization in lieu of depreciation). Premiums or other consideration paid or accrued for any reinsurance payments constitute base erosion payments. Finally, base erosion payments include any amount paid or accrued to a related surrogate foreign corporation as defined under Section 7874(a)(2)(B) (if such corporation first became a surrogate foreign corporation after November 9, 2017) or to a foreign person which is a member of the same expanded affiliated group as the surrogate foreign corporation that payment results in a reduction of gross receipts. On the other hand, payments for services are excluded if such services generally qualify for the services cost method under Section 482 (and such amount constitutes total services without the markup component). Similarly, there is a special exception for payments made in the ordinary course of a trade or business that constitute a "qualified derivative payment."

Importantly, whether a payment qualifies for the services cost method under Section 482 is determined for this purpose without regard to the requirement that the services do not contribute significantly to fundamental risks of the business. In other words, payments for services that constitute the group's core business can still potentially qualify for this exception so long as they are charged out at cost. The requirements for this exception are that (i) the services are low margin, meaning that the median comparable markup on the service must be less than or equal to 7%, and (ii) the services must not be on the list of excluded services such as manufacturing, R&D and reselling. Consider for example a group that is in the business of background checks and other security and support services. If the group outsources much of the work to a subsidiary in India, the payments for the services the foreign affiliate performs in India can still potentially qualify for this exception. With respect to BEAT planning, provided the requirements for services cost method are satisfied, the US taxpayer can elect to pay the related foreign party at cost and thereby remove the payments from the scope of the BEAT. A taxpayer that elects this solution to the BEAT may be required to make an affirmative transfer pricing adjustment in the foreign country to satisfy local transfer pricing requirements. Taxpayers in this situation should also confirm that the local jurisdiction will not impose withholding on a deemed dividend for any amounts that might have been due under local transfer rules, but that are not, in fact, paid.

The determination of what constitutes a base erosion payment "with respect to which a deduction is allowable" is not entirely clear. The Senate report provided that "base erosion payments do not include payments for cost of goods sold (which is not a deduction but rather a reduction to income)." In contrast, the Conference report provides that "base erosion payments do not include any amount that constitutes reductions in gross receipts including payments for costs of goods sold." The language in the Conference report implies that there may be other allowable reductions in gross receipts in addition to cost of goods sold that may be excluded from the definition of a base erosion payment.

Base Erosion Percentage. The percentage is determined by dividing the aggregate amount of base erosion tax benefits by the sum of aggregate base erosion payment deductions and base erosion tax benefits described in the base erosion tax benefit provision, excluding any (i) deductions under Sections 172, 245A, 250, (ii), deduction for amounts paid or accrued for services which meet the services cost method under Section 482, and (iii) deduction for qualified derivative payments not treated as base erosion payments.

For purposes of this section, a foreign person has the meaning given in Section 6038A(c)(3). Related parties include any 25% owner of the taxpayer (by total voting power of all classes of stock entitled to vote or total value of all classes of stock), any related party within the meaning of Section 267(b) or 707(b)(1) and any other related person within the meaning of Section 482. For these purposes, Section 318 constructive ownership of stock apply to the related party rules except that 10% is substituted for 50% in Section 318(a)(2)(C), and the rules do not cause a U.S. person to own stock owned by a person who is not a United States person.

Finally, taxpayers should note the reporting requirements that require descriptions of all transactions with related parties, descriptions of the nature of the related party relationships, and information regarding the base erosion payments. A failure of to file also carries with it a higher penalty of $25,000 rather than the regular $10,000 penalty for failure to furnish information in the taxable year.

Effective Date: The BEAT will apply to base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

The BEAT presents a significant risk of double taxation with respect to deductible payments made to foreign affiliates of a U.S. corporate group. Such a payment could give rise to Subpart F income in the hands of a CFC. Even if it does not, the payment could nevertheless give rise to GILTI. In either event, the payment is included in the regular and modified taxable income of the U.S. shareholder, but the shareholder may not get a deduction for the payment for purposes of computing the BEAT. In effect, the U.S. taxes this amount twice. Because these payments are taxable in the United States, they do not erode the U.S. tax base, and should have been excluded from the definition of base eroding payments. Committee staff have noted that the bill contains many technical errors, and are open to receiving suggestions for technical corrections. This is an example of a presumably unexpected result which warrants correction.

6. Other

The bill modifies the attribution rule of Section 958(b) to allow attribution under Section 318(a)(3) of stock of a foreign corporation to a domestic corporation from its foreign shareholder, to a domestic partnership from its foreign partner, or to a domestic trust or estate from its foreign grantor or beneficiary, for purposes of determining whether the foreign corporation is a CFC or whether a US person is a US shareholder of such CFC. This means that certain foreign subsidiaries of a foreign parent company that have not previously been considered CFCs could now be treated as CFCs. Even if such a foreign corporation is treated as a CFC, the Subpart F income of such CFC will only be includible in the income of a US shareholder of such CFC to the extent of the US shareholder's direct or indirect interest in the CFC under Section 958(a).

The bill also expands the circumstances under which a US person will be treated as a US shareholder of a CFC, and when a US shareholder will have income inclusions from a CFC. The definition of US shareholder is expanded to include any US person who owns 10 percent or more of the total vote or value of shares of all classes of stock of a CFC. This means that a US person with more than 10 percent of the stock of a CFC by value can no longer avoid US shareholder status by holding less than 10 percent of the voting stock of such CFC. The bill also eliminates the requirement in Section 951(a)(1) that a foreign corporation must be a CFC for an uninterrupted period of 30 days in the taxable year in order for the US shareholders of the CFC have Subpart F income inclusions. A US shareholder will now have inclusions under Section 951(a)(1) if the foreign corporation is a CFC "at any time" during the taxable year.

Both the House bill and the Senate amendment proposed to repeal Section 956, but this was not adopted in the Conference Agreement. This is somewhat curious, since it was thought to be unnecessary after the shift to a territorial system. Practically speaking, the failure to repeal Section 956 seems likely to have minimal significance moving forward. Under Section 959, an inclusion of a Section 956 amount is excluded from income to the extent of earnings previously taxed under Subpart F. Section 951A(f)(1)(A) provides that an inclusion of GILTI is treated the same as an inclusion under Section 951(a)(1)(A) for purposes of applying Section 959. So a GILTI inclusion creates Subpart F PTI, and therefore Section 956 should not trigger an additional income inclusion unless the amount of the potential Section 956 inclusion exceeds the total Subpart F PTI of the CFC, including the amount of PTI arising from the GILTI inclusion for the year. If the net deemed tangible income return for the CFC is distributed annually, then it would appear that there should never be any income inclusions under Section 956.

Both the House bill and the Senate amendment proposed to make permanent the Subpart F look-through rule of Section 954(c)(6) , but this was not adopted in the Conference Agreement. This provision will expire for taxable years beginning on or after January 1, 2020. If not extended or made permanent before it expires, then dividends, interest, rents, and royalties from related CFCs will likely result in Subpart F income unless some other exception applies.

7. Transfers of Intangible Property

To encourage taxpayers to repatriate intangible property to the United States, the Senate amendment proposed to treat distributions of intangible personal property from a CFC to its US shareholder as taking place at the adjusted basis of the property, thereby avoiding any gain or loss on the distribution. This provision was not included in the Conference Agreement. Therefore, repatriations of intangible property to the US could potentially give rise to significant US tax costs under Subpart F or GILTI if foreign personal holding company income or Section 311(b) gain is triggered on the distribution.

With respect to transfers of intangible property from the US, the Conference Agreement fully accepted the Senate proposal addressing definitional terms relevant for purposes of Section 367(d) and 482, both of which use the statutory definition of intangible property in Section 936(h)(3)(B). The explanation references the controversies in cases like *Veritas v. Commissioner* and *Amazon v. Commissioner* that addressed whether goodwill, going concern value and workforce in place fell within the current law definition of intangible property. The Conference Agreement replaces the phrase "any similar item" in Section 936(h)(3)(B)(vi) with "any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment." The bill also added a new item (vii) to include any other item "the value or potential value of which is not attributable to tangible property or the services of any individual." Finally the flush language of Section 936(h)(3)(B) was removed to provide that the source or amount of value is not relevant to whether property that is one of the specified types of intangible property is within the scope of the definition.

The Conference Agreement makes parallel amendments to the regulatory authority granted in Section 367(d) and to Section 482 to authorize the Secretary to "require" that the valuation of transfers of intangible property on an aggregate basis or on the application of the realistic alternative approach if the Secretary determines that such basis is the most reliable means of valuing such transfers.

The amendments apply to transfers in taxable years beginning after December 31, 2017.

In a seemingly unrelated amendment, the Section 367(a)(3) exception for outbound transfers of assets used in the active conduct of a trade or business outside of the United States has been repealed. Therefore, all outbound transfers of tangible or intangible assets should now be subject to gain recognition under either Section 367(a) or (d). The exception in Section 367(a)(2) for transfers of stock or securities of a foreign corporation "to the extent provided in regulations" was not repealed.

Transfer Pricing Implications of Tax Reform

With the lower US corporate income tax rate of 21%, combined with the Foreign-Derived Intangible Income ("FDII") rules, which allow companies to deduct 37.5% (i.e., an effective tax rate of 13.125 percent through 2025 and 16.406 percent after 2025) of "excess" income derived from exports of property and services, regardless of whether the FDII profit relates to intangibles or not, it is expected that US multinationals will look closely at opportunities to move high-margin businesses back to the US and possibly to expand US exports of products and services. However, for certain low-margin and/or asset-intensive businesses, an analysis of the final provisions could indicate opportunities to perhaps expand manufacturing offshore. For instance, companies with manufacturing operations and not high margins, there may be limited to no impact from the Global Intangible Low-Taxed Income ("GILTI") provision due to the 10% deemed return on tangible assets, thereby making it more viable to expand non-US manufacturing. Regardless of the potential direction of impact, it is reasonable to expect an uptick in non-US driven transfer pricing disputes related to these intercompany transactions. Specifically, companies can expect further scrutiny around the valuation of intangibles, potential exit charges, and other challenges driven by the BEPS guidance.

As the proposed Section 966 was dropped from the conference bill, which essentially would have allowed a tax-free repatriation of existing offshore intangible property, many companies may choose to leave intangible property offshore. A portion of this offshore income could be construed as GILTI and subject to US tax. This bifurcation of economic ownership of the intangible property, people functions performed to develop, enhance, maintain, protect, and exploit the intangible property, and the claim to the residual/excess income could result in increased risk of double taxation, with limited to no competent authority relief. Further, the EU has already raised concerns that FDII and other incentives included in the US tax reform subsidize exports and are susceptible to challenge as an illegal export subsidy under WTO rules. These types of challenges could also carry over to the application of tax treaties and the availability of competent authority relief on certain intercompany transactions. It is recommended that taxpayers consider both the transfer pricing opportunities stemming from tax reform, but also to conduct a well-informed risk assessment to appropriately gauge the benefits and potential costs of making drastic changes to intercompany transaction flows and pricing.

The final provisions also include two items that are intended to limit low tax intangible income offshore and a measure to curb potential base erosion payments. The GILTI rules impose a minimum tax on a US multinational's foreign earnings that exceed an amount equal to a prescribed rate of return on the foreign company's tangible qualified business assets. The BEAT is an alternative minimum tax designed to curtail excessive earnings stripping through payments to foreign affiliates. The GILTI rules will require a close review of the tangible assets used as part of foreign operations and potentially opportunities to get a step up in basis on these assets. Ultimately, companies will need to model the impact of these items as part of any decision to migrate intangibles back to the US, review of the company's existing supply chain, and analysis of the company's global tax footprint before and after tax reform.

The final provisions also limit interest deductibility to 30% of EBITDA for the first five years and then 30% of EBIT after January 1, 2022. This change will require companies to both review existing intercompany loans and potentially limit the use of debt in the future. This change could trigger restructuring of intercompany financing arrangements and the need to analyze the arm's-length price on such loans.

Finally, the final provisions grant the IRS broad latitude to apply principles that have been heavily scrutinized and criticized. The codification of Sections 367(d), 482, and 936 to expand the definition of compensable intangible property to include workforce and going concern value and provisions granting the IRS the ability to apply the aggregate basis of valuation and the realistic alternatives principle make the calculus of moving intangible property out of the US very difficult and costly.

Hybrid Provisions

The bill contains a new Section 267A, the effect of which is to eliminate deductions for certain interest or royalty payments made to related parties, where the amount is paid to a "hybrid entity" or pursuant to a "hybrid transaction".

The new section introduces the concept of a "disqualified related party amount". This means any interest or royalty that is paid or accrued to a related party to the extent that, broadly, (i) the amount is not included in income under the foreign tax law of the jurisdiction in which the related party is resident or subject to tax, or (ii) that jurisdiction allows the related party a deduction for the amount of the interest or royalty.

For a deduction to be denied, the disqualified related party amount has to be paid to a "hybrid entity" or pursuant to a "hybrid transaction". A hybrid entity is an entity treated as transparent for US tax purposes but not for purposes of the relevant foreign tax law, or vice versa. The term "hybrid transaction" encompasses a broad range of transactions or agreements under which payments that are treated as interest or royalties for US tax purposes are not so treated for the purposes of the relevant foreign tax law.

Example: USco pays interest to a related party resident for tax purposes in Country A. Under US tax law, the instrument under which the interest is paid is treated as a debt instrument. Under the laws of Country A, however, the instrument is treated as stock, with the interest treated as a dividend qualifying for exemption from tax. The payment is a "disqualified related party amount" paid pursuant to a "hybrid transaction", and USco's deduction is therefore denied under Section 267A.

An exception applies to the extent that the amount paid or accrued to the related party is included in income of a US shareholder under the Subpart F rules.

The new provision is a very limited version of the much broader anti-hybrid provisions recommended by the OECD under BEPS Action 2. In particular, the rules only apply to interest and royalty payments, and only to outbound payments. There is no equivalent provision that subjects hybrid income paid by a foreign related party to tax in the US where that income would otherwise escape

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US tax. Moreover, the definitions of "hybrid entity" and "hybrid transaction" are relatively narrow, so that the new Code Section would not seem to apply, for example, to permanent establishment hybrid mismatches.

As expected, the bill leaves much to be fleshed out by regulations, authorising the Treasury to issue regulations covering a broad range of topics, including:

- How the rules will deal with conduit arrangements
- Applying the rules to domestic entities and branches
- Applying the rules to certain "structured transactions"
- Applying the rules where the recipient benefits from a "tax preference" that reduces the prevailing statutory tax rate in the foreign jurisdiction by 25% or more
- Applying the rules to foreign participation exemption systems that only apply a partial exemption
- How the concept of "tax residence" will be determined
- Providing exceptions for:
  - Cases in which the foreign related party is subject to tax on the income in a jurisdiction other than its jurisdiction of residence (e.g. has a foreign PE to which the income is attributable)
  - Other cases in which base erosion risk is limited.

Treaty Considerations

The bill's base erosion anti-abuse tax (BEAT) raises a potential conflict with US tax treaties. It prescribes a modified taxable income base which prohibits deductions for certain related party payments made to foreign persons only. The Nondiscrimination article of US treaties typically includes a provision which guarantees that interest, royalties, and other payments made by a US resident to a resident of the treaty partner will be deductible under the same conditions as if paid to a US resident. Under the treaties, an exception to that prohibition against restrictions on deductions applies for provisions that are designed to enforce the arm's length principle, but the BEAT does not fit within that exception because its restriction applies without regard to whether the related party payments comply with the arm's length principle. The BEAT therefore raises the possibility that US treaty partners may consider reactions to this apparent breach of US treaty obligations.

Conclusion

Although many taxpayers are focused on immediate needs, such as what actions should be taken by year-end, it is important not to lose sight of additional legislative and regulatory events. Passing a significant tax bill is often only the first step in a prolonged process.

Although Congressional leadership intends to pursue a technical corrections bill, taxpayers should not count on the passage of a technical corrections bill to correct any errors in the Tax Cuts and Jobs Act. Instead, taxpayers should focus their energy on understanding the new provisions and determine how to comply with them in a timely fashion. Moreover, taxpayers should not be shy about contacting Treasury to alert Treasury to challenges and ambiguities that they have identified in the bill. Because many of the provisions in the tax bill are effective for tax years beginning after December 31, 2017, Treasury will need to quickly issue guidance on a variety of topics. Taxpayers can provide valuable insight from the beginning of that process, helping to smooth the implementation of the tax bill for all parties involved.

Clients who are interested in engaging with the Hill during the technical corrections process, the Joint Committee on Taxation during the Bluebook process, or Treasury and IRS about issuing guidance implementing the Tax Cuts and Jobs Act should contact Baker McKenzie's tax policy team for further discussions.

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