Tax News and Developments
North America Tax Practice Group

Newsletter
February 2018 | Volume XVIII, Issue 1

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Preface

Tax Reform in Congress Gives Way to Implementation, Additional Questions

Now that the dust has settled around the Tax Cuts and Jobs Act (the "TCJA"), taxpayers have shifted their focus to determining how the law affects them. This process includes modeling facts and considering options if modeling leads to negative results, but also involves identifying errors and ambiguities in the legislation and advocating in Washington for helpful guidance interpreting the TCJA.

The Joint Committee on Taxation ("JCT"), the Treasury Department, and the IRS are engaged in a similar exercise of scouring the legislation for ambiguities, determining where technical corrections are required and where guidance can be issued, and implementing the legislation.

JCT will issue a Blue Book, likely sometime this spring, that will provide a detailed explanation of the changes made by the TCJA. At the same time, JCT is preparing a list of items that could qualify as "technical corrections" (generally, technical corrections are corrections to obvious errors in the statute, the correction of which will implement Congress' clear intent) that it will share with members of the tax-writing committees. At this stage, it appears unlikely that there will be sufficient political will to enact tax technical corrections this year. However, it is always possible that individual technical correction provisions could be separated from a larger technical corrections bill and added to other items of legislation that have a significant chance of passage. Taxpayers who find that they need a technical correction should keep a close eye on opportunities to include the technical correction with non-tax pieces of "must-pass" legislation.

Treasury began issuing guidance on time-sensitive issues—such as the repatriation rules in Code Section 965 and withholding tables for employers—in December and has now turned its attention to less urgent, but equally important, provisions in the TCJA. On February 7, Treasury and the IRS released an updated version of the 2017-2018 Priority Guidance Plan, which included a new section titled, "Initial Implementation of Tax Cuts and Jobs Act (TCJA)". That section lists eighteen areas where Treasury intends to work on guidance in the coming year, including section 162(f) and new section 6050X (deductibility of fines and penalties and the related reporting requirements), section 163(j) (limitations on interest deductibility), section 199A (deduction for qualified business income), and section 965 "and other international sections of the TCJA." We understand that Treasury aims to issue proposed regulations on the TCJA's key provisions within 18 months of the date of enactment (under section

Upcoming Tax Events

[19th Annual Latin America Tax Conference]

Miami, FL
► February 26-27, 2018

[Tax Audit and Litigation in the US and UK]

Webinar
► March 14, 2018

[Supply Chain Risks & Rewards in Emerging Markets]

Washington, DC
► March 15, 2018

[TEI Partnership Tax Update - Including the Impact of Tax Reform]

Chicago, IL
► April 19, 2018

7805(b)(2), regulations that are issued within 18 months of the enactment of a statute may be applied retroactively to the date of enactment).

Taxpayers who have found ambiguities in the statute that affect them should not wait for Treasury and IRS to issue proposed regulations, but instead should adopt a proactive approach and reach out to Treasury to identify ambiguities and proposed solutions for Treasury to consider when issuing guidance. In addition, taxpayers should also consider prioritizing the list of items where they need guidance from Treasury, particularly where the priority is driven by non-tax needs (such as responding to questions from auditors, filing financial statements, or satisfying other, non-tax regulatory requirements) as Treasury may not be as sensitive to non-tax needs as taxpayers.

The next few years will be extraordinarily busy for Treasury, the IRS, and taxpayers alike as they develop an understanding of the law and guidance interpreting and implementing the law is issued. Taxpayers should take care to remain engaged with Treasury and IRS throughout the guidance process, and should be ready to reach out to Capitol Hill if legislative changes are required.

This issue of the newsletter features articles that tackle current developments (such as, *IRS Issues Repatriation Tax Guidance Under New Law (pg. 2)*), delve into substantive provisions in more detail than our previous articles and alerts (*Congress Reforms System to Make United States More Competitive Through Reduced Rates, Immediate Expensing, Shift to Territorial System, and the IP Carrot (and Stick) (pg.7)*), identify potential opportunities (*TCJA Raises New Opportunities and Traps for M&A Deals (pg. 30)*), and address potential reactions to US tax reform at both the state and international level (*EU Considers Impact of US Tax Reform (pg. 40)*). To view previous publications and client alerts regarding TCJA, please visit our dedicated tax reform website at *www.bakermckenzie.com/ustaxreform*.

By: Joshua Odintz and Alexandra Minkovich, Washington, DC

IRS Issues Repatriation Tax Guidance Under New Law

As part of the move to a "territorial" tax system, the Tax Cuts and Jobs Act (the "TCJA") introduced a mandatory deemed repatriation tax under new Code Section 965 (the "Transition Tax") on the earnings of foreign corporations that were not previously subject to US income tax. To date, Treasury and the IRS have published three sets of guidance related to the Transition Tax. Most recently, on February 13, 2018, Treasury and the IRS published Rev. Proc. 2018-17 modifying the procedures to change the accounting period of foreign corporations. Additionally, Treasury and the IRS issued Notice 2018-07 on December 29, 2018 and Notice 2018-13 on January 19, 2018 (collectively, the "Notices") to provide guidance on (1) determining accumulated post-1986 deferred foreign income, (2) the treatment of deficits, (3) determining the aggregate foreign cash position, (4) translating foreign currency, and (5) applying section 961.

Overview of the Transition Tax

Section 965 taxes a US shareholder's pro rata share of the untaxed earnings of specified foreign corporations (i.e., controlled foreign corporations ("CFCs") and foreign corporations with US shareholders) in a three-part analysis. First, under section 965(a), a deferred foreign income corporation ("DFIC") increases its "subpart F income" by its accumulated post-1986 deferred foreign income ("DFI") on November 2, 2017 or December 31, 2017, whichever amount is greater ("section 965(a) earnings amount"). A DFIC is a specified foreign corporation with DFI. DFI is the post-1986 earnings and profits ("E&P"), except to the extent those earnings are (i) attributable to income effectively connected with a US trade or business ("ECI") or (ii) previously taxed income ("PTI") under section 959. Second, under section 965(b), the US shareholder reduces (but not below zero) its inclusion under section 951(a)(1) by reason of section 965(a) to the extent of its pro rata share of deficits of any E&P deficit foreign corporation ("deficit foreign corporation"), resulting in an inclusion of the "section 965(a) inclusion amount." A deficit foreign corporation is a specified foreign corporation with a deficit in post-1986 E&P as of November 2, 2017. The deficit of a deficit foreign corporation is the "specified E&P deficit." The section 965(a) inclusion year for a DFIC is the DFIC's last taxable year that begins before January 1, 2018. Finally, under section 965(c), the US shareholder receives a deduction for the section 965(a) inclusion amount that results in 15.5 percent tax on DFI attributable to the US shareholder's aggregate foreign cash position and 8 percent on the remainder of the section 965(a) inclusion amount. For individual US shareholders, the rates for a calendar year DFIC are 17.5 percent to the extent DFI is attributable to the US shareholder's aggregate foreign cash position and 9.05 percent on the remainder of the section 965(a) inclusion amount.

The Transition Tax is generally due with the US shareholder's tax return for the taxable year in which the section 965(a) inclusion year ends. A US shareholder may elect an eight-year installment plan that results in payments of: (i) 8 percent of the liability for each of the first five years; (ii) 15 percent of the liability in the 6th year; (iii) 20 percent of the liability in the 7th year; and (iv) 25 percent of the liability in the 8th and final year. Further, for a US shareholder that is an S-Corporation, the individual shareholders of the S-Corporation may individually elect to defer the payment indefinitely until one of the following three triggering events occur: (i) the S-Corporation ceases to be an S-Corporation; (ii) the S-Corporation liquidates, sells substantially all of its assets, or ceases to do business; and (iii) the individual S-Corporation shareholder transfers a share of the S-Corporation stock (including by reason of death), unless the transferee agrees to accept the Transition Tax liability. Both of these elections should be available without incurring interest charges on the deferred payments.

Rev. Proc. 2018-17

In general, a taxpayer may change its annual accounting period if required by statute, regulation or if consented to by the Commissioner of the IRS. Rev. Proc. 2002-39 provides general procedures to obtain the Commissioner's approval to change an annual accounting period. Rev. Proc. 2006-45 provides procedures for certain corporations, including certain foreign corporations, to obtain automatic approval to change an annual accounting period.

Rev. Proc. 2018-17 limits a calendar-year specified foreign corporation (as defined under section 965) from changing its annual accounting period in a section 965(a) inclusion year. Specifically, a specified foreign corporation cannot change its annual accounting period under either Rev. Proc. 2006-45 or Rev. Proc. 2002-39 if the following three requirements are met: (i) the specified foreign corporation's taxable year ends December 31, (ii) the first effective year of the change would begin January 1, 2017, and end before December 31, 2017, and (iii) the specified foreign corporation has one or more US shareholders that would have a section 965 inclusion (without regard to the requested change) with respect to the specified foreign corporation or another specified foreign corporation. For a 52-53-week taxable year, the taxable year is deemed to begin on the first day of the calendar month closest to the first day of the taxable year, and is deemed to end on the last day of the calendar month closest to the last day of the taxable year.

The Notices

Determining DFI

Double-Counting / Double Non-Counting

Treasury and the IRS intend to issue regulations to avoid double-counting and double non-counting of DFI in the following situations.

- *Adjustments for amounts paid between specified foreign corporations between measurement dates:* For amounts paid or incurred between specified foreign corporations between measurement dates, adjustments will be made to eliminate double-counting or double non-counting, but the mechanics of such adjustments are not described.
- *Dividend reduction rule:* A dividend paid by a specified foreign corporation to another specified foreign corporation reduces the distributing specified foreign corporation's post-1986 E&P with respect to any measurement date that this dividend precedes to avoid double-counting post-1986 E&P in the section 965(a) earnings amount. In certain distributions, such as a distribution under section 312(a)(3) of loss property, the reduction to the distributing corporation's post-1986 E&P exceeds the increase to the distributee's post-1986 E&P. Thus, Treasury and the IRS intend to issue regulations providing that the reduction to distributing corporation's post-1986 E&P does not exceed the increase to distributee's post-1986 E&P because such reduction would not relieve double-counting.
- *CFCs with non-US shareholders:* As described above, DFI excludes ECI and PTI from post-1986 E&P. For a CFC that has shareholders that are not US shareholders on a measurement date, DFI of the CFC is reduced by amounts that would be excluded if these shareholders were US shareholders. Thus, any post-1986-E&P that would have been PTI in prior years if the shareholder was a US shareholder would also be excluded from DFI.

Section 959

Treasury and the IRS intend to issue regulations to clarify the interaction between sections 959 and 965 by taking into account lower tier distributions before determining the section 965(a) inclusion amount. Generally, section 959 provides the following steps to determine the treatment of dividends and section 951 inclusions (i.e., subpart F income and section 956 inclusions) for a CFC to avoid taxing income that was already subject to US income tax. First, a US shareholder determines any subpart F income and includes that amount in gross income. Second, the treatment of actual distributions is determined under section 959(c). PTI from the first step is available to be distributed in this second step. Third, the US shareholder determines any section 956 amounts and includes that amount in gross income to the extent that it exceeds subpart F PTI.

For a tax year with a section 965(a) inclusion amount, the section 959 rules are revised as follows. First, subpart F income is determined (without regard to section 965) as described above. Second, the treatment of distributions from the DFIC to another specified foreign corporation made before January 1, 2018, are determined under section 959. Third, the section 965(a) inclusion amount is determined and included in the US shareholder's gross income. Fourth, all other distributions other than those in the second step (i.e., distributions from a DFIC to a US shareholder and distributions made on or after January 1, 2018) are determined under section 959. Any PTI created from the first and third steps is available to be distributed in this fourth step. Fifth, the DFIC's section 956 amount is determined and included in the US shareholder's gross income to the extent that it exceeds subpart F PTI.

Alternative Method

Treasury and the IRS acknowledged the difficulty with calculating DFI on a day in the middle of the month (i.e., November 2, 2017), which is not a number easily ascertainable for most taxpayers. Treasury and the IRS intend to issue regulations providing an election to calculate DFI of a DFIC as of November 2, 2017 by determining DFI as of October 31, 2017 and prorating DFI for two days (the "Alternative Method"). Specifically, DFI as of November 2, 2017, is the sum of (i) post-1986 E&P as of October 31, 2017, and (ii) annualized E&P. Annualized E&P is two (the number of days after October 31, 2017) multiplied by the daily earnings amount. The daily earnings amount equals current E&P as of the close of October 31, 2017, divided by the number of days elapsed in such taxable year. For a calendar year taxpayer, the daily earnings amount equals current year E&P as of October 31, 2017, divided by 304 days. For a 52-53 week taxpayer, the alternative method may be used for both measurement dates, but the election must be made for both measurement dates.

Treatment of Deficits

Treasury and the IRS intend to issue regulations regarding the following issues related to the treatment of deficits.

- *DFIC status overrides deficit foreign corporation status*: If a specified foreign corporation qualifies as both a DFIC and a deficit foreign corporation, then the DFIC status controls. For example, if a specified foreign corporation had a specified E&P deficit as of November 2, 2017, but generated enough E&P in December that resulted in positive E&P as of December 31, 2017, the specified foreign corporation would be a DFIC and not a deficit foreign corporation.

- *Hovering deficits*: For purposes of determining post-1986 E&P of a specified foreign corporation, deficits include hovering deficits.

- *Multiple classes of stock*: For deficit foreign corporations with multiple classes of stock, Treasury and the IRS intend to issue regulations providing that the US shareholder's pro rata share is determined by allocating the specified E&P deficit first to shareholders of common stock in proportion to the value of the common stock.

Determining Aggregate Foreign Cash Position

For each US shareholder, the aggregate foreign cash position is the greater of (i) the aggregate of the US shareholder's pro rata share of the cash position of each specified foreign corporation of such US shareholder determined as of the close of the last taxable year beginning before January 1, 2018 ("current year cash position"), or (ii) the average of the aggregate cash position for the taxable year that ends before November 2, 2017, and the preceding year ("prior two year average cash position"). The cash position of a specified foreign corporation is the sum of (i) cash held, (ii) net accounts receivables, and (iii) the fair market value of: (a) personal property actively traded in an established financial market, (b) commercial paper, certificates of deposit, securities of any federal, state, or foreign government, (c) any foreign currency, (d) an obligation with a term shorter than one year ("short-term obligation"), and (e) any asset which the Secretary of Treasury identifies as economically equivalent to other assets in this list.

Double-Counting

To avoid double-counting of foreign cash, Treasury and the IRS intend to issue regulations to avoid double-counting in determining the aggregate foreign cash position in the following situations.

- *Multiple inclusion years*: For a US shareholder with multiple section 965(a) inclusion years, the aggregate foreign cash position in the first taxable year is the lesser of the US shareholder's aggregate foreign cash position or the aggregate section 965(a) inclusion amount taken into account in that taxable year. For any succeeding taxable year, the aggregate foreign cash position is reduced by the amount that was taken into account for the preceding year.
- *Cash measurement date after section 965(a) inclusion year*: If a specified foreign corporation has a cash measurement date after the section 965(a) inclusion year ends, the specified foreign corporation's cash position is treated as zero. If the specified foreign corporation's measurement of its cash position results in the current year cash position exceeding the prior two year average cash position, then the US shareholder must make appropriate adjustments to reflect the higher aggregate foreign cash position.
- *Intercompany payables and receivables*: Any receivable or payable of a specified foreign corporation from or to a related specified foreign corporation is disregarded to the extent of the common ownership of these specified foreign corporations by the US shareholder.

Definitions

Treasury and the IRS intend to issue regulations that provide clarity on the following definitions related to determining a specified foreign corporation's cash position.

- *Derivative financial instruments*: The catchall for assets economically equivalent to the other cash assets will include the fair market value of a derivative financial instrument held by the specified foreign corporation that is not a bona fide hedging transaction (but not below zero).
- *Accounts payables and receivables*: "Accounts receivable" means receivables described in section 1221(a)(4). "Accounts payables" means payables arising from the purchase of inventory under section

1221(a)(1), purchase of supplies under section 1221(a)(8), or the receipt of services from vendors or suppliers.

- *Demand obligations*: Demand obligations (i.e., a loan that must be repaid on demand of the lender, or paid within one year of demand), will be treated as a short-term obligation, regardless of the stated terms of the instrument.

Currency Translation Rules

Treasury and the IRS intend to issue regulations regarding the following to translate amounts from a taxpayer's functional currency to US dollars.

- *DFI:* DFI as of each measurement date must be compared in the functional currency of the specified foreign corporation. If the functional currency of a specified foreign corporation changes between the two measurement dates, the comparison must be made in the specified foreign corporation's functional currency as of December 31, 2017, with the E&P as of November 2, 2017, translated using the spot rate on November 2, 2017.
- *Section 965(a) inclusion amount:* For administrative convenience, the section 965(a) inclusion amount will be translated using the December 31, 2017, spot rate. Amounts necessary to determine the reduction under section 965(b) will also use the December 31, 2017, spot rate.
- *Foreign currency gain/loss*: Foreign currency gain or loss from distributions of PTI from section 965(a) inclusion amounts will be based on the exchange rate on December 31, 2017, and the date the PTI is actually distributed.
- *Cash position:* Cash position of a specified foreign corporation will be translated using the spot rate for the relevant measurement date.

Section 961

Currently, section 961(a) provides an increase in the stock basis of a CFC from a section 951(a) inclusion, and section 961(b)(1) provides a corresponding reduction in stock basis when PTI from such inclusion is distributed. If a distribution of PTI exceeds the basis in the shares, section 961(b)(2) treats such excess as gain from the sale or exchange of the shares. Under a mechanical application of this rule, a distribution of PTI from a section 951(a)(1) inclusion as a result of the application of section 965(a) could reduce basis under section 961(b)(1) before the basis related to such inclusion arises under section 961(a), thereby potentially triggering gain. However, Notice 2018-07 provided that gain recognized under section 961(b)(2) is reduced by the section 965(a) inclusion amount (but not below zero) for distributions from a DFIC to a US shareholder (the "gain-reduction rule"). Notice 2018-13 expanded the gain recognition rule to cover distributions from a DFIC through a chain of ownership under 958(a). Thus, the gain reduction rule applies to distributions from a DFIC to a US shareholder, as well as distributions to any other specified foreign corporations related to the DFIC under section 958(a). The gain reduction rule will apply similarly to reduce the amount of gain that would otherwise be recognized under section 961(c).

By: Steven Hadjilogiou, Miami and Michelle Ng, Palo Alto

Congress Reforms System to Make United States More Competitive Through Reduced Rates, Immediate Expensing, Shift to Territorial System, and the IP Carrot (and Stick)

One of the main goals of the Republican Congress was to make the United States a more competitive jurisdiction for business. The final bill intends to accomplish this goal by drastically reducing the corporate income tax rate, providing immediate expensing (on a temporary basis), and exempting certain foreign earnings from US federal taxation. These incentives were paired with base protecting measures that pare down some of the expected benefits. The new regime adds significant complexity to the Internal Revenue Code (the "Code"), as the new provisions are often layered on top of existing regimes. Multinational taxpayers must be mindful of the unintended consequences of this complexity as the ramifications of the Tax Cuts and Jobs Act (the "TCJA") continue to unfold.

Reduced Corporate Income Tax Rate

The clear and immediate benefits of the TCJA include the corporate rate reduction and immediate expensing. The United States now boasts a corporate income tax rate below the OECD average, decreasing from 35 percent to 21 percent. This rate is effective for taxable years beginning after December 31, 2017, but section 15 of the Code requires taxpayers with taxable years straddling the effective date of the statute to apply a blended rate in the transition year that is proportionate to the number of days before and after the effective date of the bill. For example, a fiscal year taxpayer with a taxable year ending on June 30, 2018, will have half of its taxable year under the 35 percent regime, and the other half under the 21 percent regime. As a result, the taxpayer will have a 28 percent blended rate for the transition tax year.

The change in the corporate rate triggers a one-time write down of the deferred tax assets and deferred tax liabilities recorded on the balance sheet of companies with deferred tax accounts. Though the SEC has encouraged companies to make all reasonable efforts to estimate the tax law's impacts in their fourth quarter financial statements, the SEC's deadline for reporting the full impact of the TCJA is December 22, 2018. SEC guidance issued shortly after passage of the TCJA states that the re-measurement of a deferred tax asset to reflect the impact of a change in tax rate or tax laws is not an impairment requiring taxpayers to file a Form 8-K immediate disclosure.

Immediate and Full Expensing on a Temporary Basis

The corporate income tax rate change is accompanied by a temporary modification to bonus depreciation under Code Section 168(k) to allow for full and immediate expensing for qualified property acquired and placed into service between September 27, 2017, and December 31, 2022. The 100 percent cost recovery allowance gradually decreases in the subsequent five-year period, by 20 percent each year:

Years (after/before)	§ 168(k) Bonus
September 27, 2017-January 1, 2023	100%
December 31, 2022-January 1, 2024	80%
December 31, 2023-January 1, 2025	60%
December 31, 2024-January 1, 2026	40%
December 31, 2025-January 1, 2027	20%

Property having longer production periods and aircraft specified under sections 168(k)(2)(B) and (C) are eligible for an extended phase-out of the 100 percent bonus depreciation allowance:

Years (after/before)	§ 168(k) Bonus
September 27, 2017-January 1, 2024	100%
December 31, 2023-January 1, 2025	80%
December 31, 2024-January 1, 2026	60%
December 31, 2025-January 1, 2027	40%
December 31, 2026-January 1, 2028	20%

The amendments also put into place transition rules for property acquired before, but placed into service after, September 28, 2017. These provisions allow such property 50 percent bonus depreciation if placed into service before January 1, 2018, with a decrease in 10 percentage points for each year thereafter that the property is placed into service. There are also extended phase-out periods for property with longer production periods.

Participation Exemption Regime

The United States addressed its status as an outlier in the international tax world by transitioning from a worldwide taxation system to a more territorial regime. In short, US-headquartered multinationals will be able to repatriate foreign earnings tax-free on a go-forward basis. This new territorial system takes the form of a participation exemption regime in which eligible dividends receive a 100 percent dividends received deduction ("DRD") pursuant to new section 245A of the Code.

For a dividend to qualify for the DRD, the dividend must be received from a "specified 10-percent owned foreign corporation" by a domestic corporation which qualifies as a "United States shareholder" of that specified 10-percent owned foreign corporation. A foreign corporation will qualify as a "specified 10-percent foreign corporation" if it has at least one US shareholder within the meaning of section 951(b). As amended by the TCJA, section 951(b) defines US shareholder as a United States person who owns directly or constructively pursuant to section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, *or* 10 percent or more of the total value of shares of all classes of stock of such foreign corporation. As a result, a foreign corporation can be a "specified 10-percent owned foreign corporation" without being a CFC, as having even one US shareholder with a 10 percent interest will meet this threshold. However, foreign corporations that fall within the definition of a passive foreign investment company ("PFIC") in section 1297 are excluded from the definition of "specified 10-percent foreign corporation."

The DRD only applies to the foreign-source portion of the dividend. This is determined based on the ratio between the specified 10-percent foreign corporation's undistributed foreign earnings and its total undistributed earnings. For this purpose, undistributed earnings means the earnings and profits of the specified 10-percent foreign corporation as of the close of that corporation's taxable year, unreduced by dividends distributed during that taxable year. Undistributed foreign earnings are undistributed earnings that are not attributable to: (i) effectively connected income ("ECI"); or (ii) any dividend received from a domestic corporation at least 80 percent of the stock of which is owned by the specified 10-percent foreign corporation.

The US shareholder taking the DRD is not entitled to claim a foreign tax credit ("FTC") under section 901 for taxes paid with respect to the dividend. The recipient also cannot take a section 164 deduction for foreign taxes paid or accrued with respect to the dividend. Thus, a US shareholder may not recover any foreign tax withheld on the dividend. Dividends receiving the DRD also are not treated as foreign source income for purposes of the section 904 FTC limitation.

The availability of the DRD is subject to a few other conditions. First, the exemption does not apply to "hybrid dividends," which are discussed later in this Newsletter. Second, the US shareholder must hold stock in the specified 10-percent foreign corporation for at least a year before the ex-dividend date and at least two years and a day in the case of distributions on preferred dividends.

The effective date of this provision is December 31, 2017, meaning that it applies without respect to when the taxpayer's next taxable year begins. This means that taxpayers satisfying the holding period requirement can benefit from this provision immediately.

FDII and GILTI: The IP Carrot and Stick

The transition to a participation exemption system was aimed primarily at the lock-out effect that US-headquartered multinational corporations have experienced as they structured their own forms of territorial systems over the years. While these taxpayers have successfully placed their foreign earnings outside the immediate US taxing jurisdiction, it was merely a deferral of earnings that would ultimately be subject to US tax. As a result, there has been a substantial build up of capital abroad due to the inevitable taxation of the deferred earnings. The new system alleviates this problem by allowing immediate repatriation within the parameters discussed above. However, Congress was not blind to the fact that territorial systems require base protection. As a result, Congress retained much of the existing subpart F regime, and actually added a whole new category of subpart F income—global intangible low-tax income ("GILTI"). The GILTI provision was paired with a deduction for certain preferred income, purporting to create an incentive for locating IP in the United States. For the reasons discussed below, this combination of a carrot and a stick is a very imprecise incentive regime that can produce unintended consequences.

Foreign Derived Intangible Income ("FDII"): The IP Carrot

The new section 250 enacted under the TCJA seeks to provide an additional incentive (the "IP Carrot") on top of reduced rates and the participation exemption to keep US multinationals' assets in the United States. Section 250 provides for a deduction against a domestic corporation's "foreign derived intangible income" ("FDII"). This stylization suggests that section 250 incentivizes intellectual property, but the calculation is a mere approximation of the assumed return on intangibles. The deduction operates more like an export incentive regime than a patent box, borrowing heavily from the 2014 Camp Proposal and incorporating concepts similar to the DISC, FSC, and ETI regimes.

Under section 250, corporations are allowed a 37.5 percent deduction against their FDII, which results in an effective tax rate of 13.125 percent on their FDII component of taxable income. Beginning in 2026, the deduction decreases to 21.875 percent, which results in an effective tax rate of 16.406 percent on FDII. The base FDII amount is calculated as follows:

$$FDII = Deemed\ Intangible\ Income \times \frac{Foreign\text{-}Derived\ Deduction\ Eligible\ Income}{Deduction\ Eligible\ Income}$$

FDII is determined with respect to a domestic corporation's "deemed intangible income," which is defined as the excess (if any) of the corporation's "deduction eligible income" over its "deemed tangible income return." Deduction eligible income is the corporation's gross income, less: (1) subpart F income; (2) GILTI; (3) financial services income as defined by section 904(d)(2)(D); (4) dividend income from a CFC; (5) domestic oil and gas extraction income; and (6) foreign branch income as defined by section 904(d)(2)(J). The corporation then reduces this adjusted gross income amount by any deductions properly allocable to such gross income. Neither the legislative text nor the Conference Committee's joint explanation sheds light on the parameters for the allocation of expenses to deduction eligible income.

The domestic corporation's "deemed tangible income return" equals 10 percent of the corporation's "qualified business asset investment" ("QBAI"). QBAI is defined as the aggregate of the corporation's adjusted bases in "specified tangible property" that is depreciable (as defined by section 167) and used in its trade or business. "Specified tangible property" means any tangible property used in the production of deduction eligible income. The domestic corporation's QBAI is calculated as the average of the adjusted bases of the tangible property at the close of each quarter of the taxpayer's taxable year, similar to the quarterly calculations under section 956.

Only a portion of the domestic corporation's deemed intangible income is eligible for the FDII deduction. The eligible portion is determined based on the ratio of the corporation's "foreign-derived deduction eligible income" to all of the corporation's deduction eligible income. Foreign-derived deduction eligible income is defined as deduction eligible income derived in connection with property sold by the taxpayer to any person who is not a United States person that the taxpayer "establishes to the satisfaction of the Secretary is for a foreign use." For this purpose, the terms "sold", "sells", and "sale" should be read as including any lease, license, exchange, or other disposition. This requirement will undoubtedly require new guidance, as it strays from the familiar sourcing rules and instead focuses on intended use. The FSC, DISC, and ETI regimes are potential sources of inspiration, with DISC specifically addressing foreign use. Income derived from services provided by the taxpayer to any person, or with respect to property, not located in the United States can also produce foreign-derived deduction eligible income. Taxpayers deriving such income must also establish, "to the satisfaction of the Secretary," the location of the recipient or property.

Sales to unrelated intermediaries will not qualify as sales for foreign use, even if there is a subsequent outbound sale, if the property is sold to the intermediary "for further manufacture or other modification within the United States". However, where the intermediary is a related person, the sale may qualify as for foreign use if a related party ultimately either: (1) on-sells the property; (2) uses the property in connection with property that is sold; or (3) uses the property for the provision of services; to an unrelated foreign person. In addition, services provided to foreign related parties will only be considered services provided to persons not located within the United States if the taxpayer can establish, to the satisfaction of the Secretary, that such service is not substantially similar to services provided by the foreign related person to a person located in the United States. Finally, services provided with respect to foreign property will not qualify if provided to an unrelated person located in the United States. For purposes of these provisions, "related person" is defined by a modified section 1504(a) that reduces the 80 percent threshold to 50 percent.

The FDII regime may be best explained with a simple example. Assume that a US corporation, ABC Corp., has gross income of $1,000 for its taxable year, $50 of which is excepted from "deduction eligible income." Further assume that there are $750 of deductions allocable to this gross income (other than to the excepted income), 40 percent of this income is derived in connection with sales to foreign persons, and ABC Corp. has $1,000 of QBAI. For the sake of simplicity, assume that the deductions are proportionately allocable to all deduction eligible income, including foreign-derived deduction eligible income, although the statute does not provide how to apportion these deductions. Under these facts, ABC Corp. has deduction eligible income of $200 ($1,000 - $50 - $750), $80 ($200 X 40%) of which is foreign-derived. ABC Corp.'s deemed tangible income return would be $100 ($1,000 X 10%), making its deemed intangible return $100 ($200 - $100). ABC Corp.'s FDII would then be $40, calculated as $100 multiplied by $80/$200. ABC. Corp would receive a deduction equal to 37.5 percent of this FDII, or $15, for its taxable year. ABC Corp. would then pay $5.25 of tax on this FDII (($40 - $15) X 21%).

The defined terms introduced in the FDII equation are highly dependent on the tangible, depreciable assets of the taxpayer, as well as the characterization of the taxpayer's foreign sales. The FDII calculation approximates the taxpayer's intangible income to be the excess of certain gross income over a deemed 10 percent return on its tangible assets, regardless of the use or value of the taxpayer's intangible assets. The resulting equation is mechanical in its application, giving taxpayers some control over their benefit or exposure going forward. Increasing either deemed intangible income or foreign-derived deduction eligible income will increase the FDII deduction benefit. However, taxpayers must be mindful of the anti-abuse provision with respect to QBAI in section 951A. In addition, as discussed below, the significant overlap between the FDII and GILTI calculations requires any affirmative planning to consider the impact on both provisions. Though in isolation FDII incentivizes export sales and services regardless of the location of assets used in the taxpayer's trade or business, the interaction with GILTI may alter that incentive.

The longevity of FDII may also be in question. FDII may be subject to a WTO challenge similar to those lodged against the United States with respect to the DISC, FSC, and ETI regimes because its benefits are restricted to domestic corporations. Trading partners and competitors may characterize this benefit as an impermissible export subsidy under WTO agreements. However, it typically takes three to five years to resolve a WTO dispute, meaning that FDII benefits should be viable at least for the immediate future.

Global Intangible Low Tax Income: The IP Stick

As a corollary to the deduction allowed for FDII, Congress enacted section 951A to tax the GILTI category of income (the "IP Stick"). In effect, section 951A taxes as a new category of subpart F income the excess of a taxpayer's pro rata share of its CFCs' net income (less ECI, subpart F income, and certain other amounts) over a deemed 10 percent return on its CFCs' net tangible assets. Because the GILTI and FDII rules both target intangible income earned outside the United States, the two sets of rules rely on similar concepts.

Taxpayers calculate GILTI at the US shareholder level and on an aggregate basis. Like FDII, GILTI is effective for taxable years beginning after December 31, 2017. For a given taxable year, a US shareholder's GILTI is equal to the excess (if any) of the shareholder's "net CFC tested income" over its "net deemed tangible income return," or:

$$GILTI = Net\ CFC\ Tested\ Income - Net\ Deemed\ Tangible\ Income\ Return$$

A US shareholder's "net CFC tested income" equals the aggregate of the shareholder's pro rata share of "tested income" over its pro rata share of "tested loss." "Tested income" is the excess of a CFC's gross income over deductions properly allocable to such gross income under rules similar to section 954(b)(5). For this purpose, a CFC's gross income is subject to several exclusions including ECI, subpart F income, income exempted from subpart F under the high-tax exception, dividends received from a related person, and foreign oil and gas extraction income. If a CFC's deductions exceed its gross income (subject to the exclusions discussed above), the CFC has a "tested loss," which is available to offset a US shareholder's aggregate tested income from other CFCs.

A US shareholder calculates its "net deemed tangible income return" similarly to the "deemed tangible income return" for FDII purposes. Specifically, "net deemed tangible income return" equals 10 percent of the aggregate of the US shareholder's pro rata share of QBAI of each CFC. However, unlike the deemed return for FDII purposes, a US shareholder must reduce this amount by any interest expense allocated to the tested income to the extent the corresponding interest income is not included in the shareholder's net CFC tested income. The definition of QBAI is the same as for FDII purposes, except that "specified tangible property" only includes property used in the production of "tested income," rather than "deduction eligible income."

A US shareholder includes its current year GILTI in income under rules similar to subpart F income. However, unlike subpart F income, FTCs associated with GILTI are subject to a 20 percent haircut and segregated into a separate FTC basket with no carryovers of excess FTCs allowed. Similar to the deduction allowed against FDII, section 250 provides the taxpayer a deduction equal to 50 percent of its GILTI (and the corresponding section 78 gross-up) for taxable years beginning before January 1, 2026. In effect, this subjects GILTI to a tax rate of 10.5 percent, which may be fully offset by FTCs to the extent the GILTI was taxed at a rate of at least 13.125 percent (which is higher than the 10.5 percent tax rate due to the FTC haircut in the GILTI basket). For US shareholders with effective foreign tax rates on their GILTI below the 13.125 percent break-even point, the worldwide effective tax rate after the application of the GILTI tax will fall somewhere between the 10.5 percent and 13.125 percent rates. Note, however, that FTCs that can offset the GILTI inclusion may be limited by operation of section 904 if a taxpayer is required to allocate expenses to the foreign source income in the GILTI basket. Congress did not provide expense allocation rules with respect to the new GILTI basket, but subsequent guidance requiring such allocations could modify a taxpayer's break-even point for offsetting the GILTI inclusion. For taxable years beginning after December 31, 2025, the GILTI deduction decreases to 37.5 percent, effectively increasing the US tax rate on GILTI to 13.125 percent and the break-even point for FTCs to 16.406 percent (the difference again being attributable to the FTC haircut). These break-even point rates are identical to the effective tax rates imposed on FDII for the same periods.

Let's revisit ABC Corp. to better explain the GILTI calculation. Assume that ABC Corp. has a wholly owned County A CFC, DEF Ltd. DEF Ltd. has gross income of $1,000 for its taxable year, $50 of which is treated as subpart F income. Further assume that there are $750 of deductions allocable (excluding taxes) to the non-subpart F gross income, Country A has a tax rate of 10 percent, DEF Ltd. has $900 of QBAI, and none of ABC Corp.'s expenses are allocated to its income in the GILTI basket. DEF Ltd. pays $20 of tax on its $200 of non-subpart F income in Country A. Under these facts, ABC Corp.'s net CFC tested income is $180 ($1,000 - $50 - $750 - $20), and ABC Corp.'s net deemed tangible income return is $90 ($900 X 10%). Therefore, ABC Corp. would have GILTI of $90 ($180 - $90). Only $8 of DEF Ltd.'s $10 of taxes attributable to GILTI would be available for a FTC ($90/$180 X $20 X 80%). DEF would then receive a GILTI deduction of $50 (($90 + $10 gross-up) X 50%). As a result, ABC Corp. would have a net US tax liability of $2.50 on its GILTI, calculated as follows:

GILTI Inclusion:	$ 90.00
§ 78 Gross-up:	$ 10.00
GILTI Deduction:	$ (50.00)
Taxable Income:	$ 50.00
Tax Rate:	21%
Tax on GILTI:	$ 10.50
FTC:	$ 8.00
Net US Tax:	$ 2.50

Taking into account the Country A taxes and this additional GILTI tax, ABC Corp.'s GILTI is effectively taxed at a 12.5 percent rate on a worldwide basis. If, however, DEF Ltd. had an effective tax rate of 13.125 percent or higher, ABC Corp. could have completely offset its GILTI liability with FTCs.

New section 951A raises a number of concerns and planning opportunities for taxpayers. Unlike the other subpart F rules, GILTI does not differentiate between active and passive returns on investment. Even if taxpayers are able to navigate the complex foreign personal holding company income, foreign base company sales income, and foreign base company services income rules, the taxpayer's otherwise deferred (i.e., unrepatriated) income may now be subject to immediate taxation even though, if repatriated, the income would generally have been eligible for a 100 percent DRD. Because subpart F income and income excluded from subpart F under the high-tax exception are not included in GILTI, taxpayers with CFCs in high-taxed jurisdictions may benefit from intentionally treating a portion of their income as subpart F income, which would enable taxpayers to avoid the 20 percent FTC haircut. For some, the combination of the FTC haircut and the reduced deduction for GILTI starting in 2026 may make the application of the GILTI provisions unpalatable. Taxpayers should carefully model out their future benefits under FDII and exposures under GILTI (in conjunction with the BEAT and other new rules) to determine whether a restructuring of their foreign operations is appropriate.

Congress reportedly intended the GILTI and FDII regimes to incentivize taxpayers to domesticate their IP and discourage US multinationals from moving operations offshore. Indeed, taxpayers should consider whether onshoring their IP makes sense in light of these and other new rules, like the BEAT. Some taxpayers, however, may instead want to consider moving tangible property overseas. By moving tangible property offshore and shifting the location of their QBAI, taxpayers may be able to increase their FDII deduction while simultaneously reducing their GILTI exposure. In the same vein, taxpayers may want to consider transactions that step-up their basis in tangible and intangible property offshore. These transactions can minimize a taxpayer's GILTI exposure in two ways: (i) increasing the US shareholder's net deemed tangible income return by increasing QBAI; and (ii) reducing the US shareholder's net CFC tested income by increasing amortization deductions. Taxpayers should watch for future guidance in this area because Congress granted Treasury broad authority to issue regulations to prevent avoidance of the QBAI provisions, including with respect to a transfer of property if avoiding the purpose of QBAI was a factor.

By: Matthew Jenner and Katie Rimpfel, Washington, DC

"Not GILTI" — Changes to Subpart F Under the New "Territorial" Regime Other Than the Addition of Section 951A

While most of the attention is being given to new Code Section 951A (a/k/a GILTI), the "Tax Cuts and Jobs Act" (the "TCJA") made significant modifications to other parts of subpart F. These modifications can generally be grouped into three categories. The first category consists of changes that expand the base of taxpayers that are subject to the subpart F regime. The second category includes adjustments to the types of earnings that constitute subpart F income. The third category includes changes to the indirect foreign tax credit rules. These changes are a part of a larger shift in the US system of international taxation away from a "deferral" regime and closer to a "territorial" regime. As a result, the role of subpart F within the Code and the importance of subpart F planning to taxpayers has changed.

TCJA Provisions that Broaden the Base of Taxpayers Subject to the Subpart F Regime

Before the TCJA, a US shareholder was defined as any US person that owns (directly, indirectly, or constructively) stock in a foreign corporation representing 10 percent or more of its voting power. A foreign corporation was a controlled foreign corporation ("CFC") if US shareholders, in the aggregate, owned (directly, indirectly, or constructively) stock in the foreign corporation representing more than 50 percent of its voting power or value. A US shareholder did not have an income inclusion with respect to a CFC's subpart F income unless the CFC maintained its status as a CFC for an uninterrupted period of 30 days or more during the relevant tax year. The TCJA modified these rules in three respects.

First, the TCJA expanded the definition of a US shareholder. Now, a US shareholder is any US person that owns stock in a corporation representing 10 percent or more of its voting power or value. Second, the TCJA eliminated the 30-day rule and US shareholders must include in gross income their pro rata shares of a CFC's subpart F income, regardless of whether the CFC maintains CFC status for 30 days. Both of these modifications are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of US shareholders that end with or within the tax year of a foreign corporation with respect to which these modifications are effective.

Third, the TCJA modified the "downstream" constructive stock ownership rules for purposes of identifying US shareholders. Under section 318, there are three "downstream" attribution rules. First, a partnership is considered to own any stock owned by its partners. Second, certain trusts are considered to own any stock owned by certain of their beneficiaries. Third, if a shareholder owns 50 percent or more in value of the stock in a corporation, the corporation is considered to own all stock owned by the shareholder. Historically, however, section 958(b)(4) carved out the "downstream" attribution rules for subpart F purposes such that stock owned by a foreign person could not be attributed downstream to a US person. The TCJA eliminated this limitation on "downstream" attribution, which radically broadens the number of foreign corporations that are classified as CFCs. For instance, if a foreign parent (with a shareholder base consisting solely of foreign persons) directly owns all the stock of each of a foreign corporation and a US corporation, the foreign corporation now would likely be a CFC and the US corporation would likely be its US shareholder. That said, the *amount* of a US shareholder's inclusion with respect to a CFC's subpart F income is still determined by reference to the US shareholder's direct and indirect ownership of the CFC. The constructive attribution rules, including the "downstream" attribution rules, are not taken into account when determining a US shareholder's inclusion. Therefore, in the hypothetical above, the US corporation would not have an inclusion with respect to the foreign corporation's income, notwithstanding the US corporation's status as a US shareholder of the foreign corporation. The US Treasury recently issued guidance in Notice 2018-13 that would exempt a US shareholder from having to file a Form 5471 with respect a CFC that had no direct or indirect US shareholders. The modification to the "downstream" attribution rules is effective for the last tax year of foreign corporations beginning before January 1, 2018, and for tax years of US shareholders that end with or within the tax year of a foreign corporation to which these modifications are effective (which for calendar year taxpayers is generally the 2017 taxable year).

TCJA Provisions that Modify the Types of Earnings that are Subpart F Income

In addition to expanding the base of taxpayers that can have a subpart F inclusion, the TCJA also modified the types of income that can be subpart F income. Before the TCJA, "foreign base company oil-related income" was a category of subpart F income. There were also rules under section 955 that caused a US shareholder to be taxed when it withdrew certain earnings that had previously been excluded from subpart F income from "qualified investment." The TCJA eliminated foreign base company oil-related income as a category of subpart F income and repealed section 955. Both of these changes are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of US shareholders that end with or within the tax year of a foreign corporation to which these modifications are effective.

TCJA Provisions that Modify the Indirect Foreign Tax Credit Rules

As part of broader changes to the foreign tax credit regime, the TCJA amended the deemed paid tax rules under section 960. Before the TCJA, a US shareholder was deemed to pay an amount of the CFC's foreign tax pool in proportion to the US shareholder's subpart F inclusion over the CFC's post-1986 undistributed earnings. Amendments to section 960 and the repeal of section 902 eliminated the concept of a CFC's foreign tax pool. Instead, a US shareholder is only deemed to have paid the foreign taxes that are attributable to the income that results in a subpart F inclusion. Additionally, given the separate basketing of foreign taxes attributable to GILTI inclusions and foreign branch income, subpart F inclusions may be one of the few avenues remaining for US shareholders to bring general basket foreign source income onto their US tax returns. There are a number of other conforming changes to section 960 throughout the TCJA. Taxpayers should carefully consider these new rules when determining their foreign tax position.

By: Ross Staine and Matthew Mauney, Houston

Provisions Targeting "Base Erosion": The BEAT and Other Deduction Limiting Rules

The BEAT

The recently enacted Tax Cuts and Jobs Act (the "TCJA") (P.L. 115-97) introduced a base erosion anti-abuse tax ("BEAT") in newly added Code Section 59A, which treats as "base eroding," and effectively imposes a minimum tax on, certain deductible payments made by US corporations to foreign affiliates beginning after December 31, 2017. Under the basic mechanics of new section 59A, certain deductible payments to foreign affiliates, such as royalties, rents, interest, management fees, and other high-margin service payments, are added back to taxable income, and the modified taxable income is subject to the BEAT.

Applicable Taxpayers

The BEAT applies to both US- and foreign- parented corporations (other than regulated investment companies, real estate investment trusts, or S corporations) with average annual gross receipts over the preceding 3 taxable years of at least $500 million and a “Base Erosion Percentage” of at least 3 percent for the taxable year (2 percent for banks and registered securities dealers).

The $500 million gross receipts threshold is calculated by aggregating the gross receipts of US and foreign corporations in the same controlled group, using a greater-than-50 percent control test. The gross receipts of a foreign corporation in the controlled group are included in the aggregation only if such foreign corporation has a US trade or business (“USTB”) and only to the extent that its gross receipts are taken into account in determining the amount of income that is effectively connected to that USTB.

The Base Erosion Percentage is generally determined by dividing the aggregate amount of the controlled group’s “Base Erosion Tax Benefits” by the aggregate amount of deductions allowable (including all “Base Erosion Payments”), reduced by any (i) net operating loss (“NOL”) carryforwards, (ii) dividends received deductions for dividends from controlled foreign corporations (“CFCs”), (iii) deductions for foreign-derived intangible income (“FDII”) and global intangible low tax income (“GILTI”), (iv) payments for low-margin services charged at cost, and (v) qualified derivative payments.

“Base Erosion Tax Benefits” include any deduction allowed with respect to Base Erosion Payments. Base Erosion Payment, in turn, generally refers to any payment made to foreign related parties for which a deduction is allowed for purposes of calculating US income tax liability. In particular, Base Erosion Tax Benefits include any amount attributable to depreciation or amortization on property that the corporation acquired from a foreign related party and also payments of reinsurance premiums to a foreign related party (although reinsurance premiums are not technically deductible payments for an insurance company, but instead reduce premium income). A related party here is defined as any (i) 25 percent owner of the taxpayer (by total voting power of all classes of stock entitled to vote or total value of all classes of stock, applying constructive ownership rules), (ii) related party within the meaning of section 267(b) or 707(b)(1), and (iii) other related person within the meaning of section 482. A foreign related party may, thus, be a subsidiary, a parent, or a sibling of the US corporation making the payment.

The Base Erosion Tax Benefit does not include:

- Payments that reduce gross receipts. As the Conference Committee Report suggests, payments that result in a reduction in gross receipts, rather than a deduction, such as cost of goods sold (“COGS”), do not constitute Base Erosion Tax Benefits. However, if a company which is treated as having inverted under section 7874 after November 9, 2017, is a member of the controlled group, payments that reduce gross receipts will not be excluded from Base Erosion Tax Benefits;

- Payments at cost for low-margin services. A carve-out is provided for any amount paid of accrued for services that meet the requirements to use the services cost method under section 482, without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure, if the amount paid or accrued constitutes the total services cost, with no markup component. As discussed further below, it may be permissible to bifurcate a charge for services eligible for the carve-out into cost and markup components, with only the markup component treated as a base erosion payment;

- “Qualified” derivative payments made in the ordinary course of a trade or business. However, the exception for qualified derivative payments does not apply if the payment would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty, or service payment; or

- Payments subject to withholding tax. If the US corporation withheld taxes under section 1441 or 1442 on a payment, such as interest on a loan, to a foreign related person at the full 30 percent statutory withholding rate, then that foreign payment is not treated as a Base Erosion Tax Benefit. But if the US corporation withheld taxes at a reduced rate, for example, under a tax treaty, then a prorated portion of the foreign payment reflecting the reduced withholding amount would constitute a Base Erosion Tax Benefit.

Calculation of Base Erosion Minimum Tax

The BEAT is imposed to the extent that 10 percent (5 percent in 2018) of the US corporation’s “Modified Taxable Income” exceeds the US corporation’s regular tax liability reduced (not below zero) by any excess of the tax credits allowed to the US Corporation under Chapter 1 of the Code over the sum of the Code Section 38 research credit and the lesser of: (i) 80 percent of section 38 low income housing credits, renewable energy production credits, and investment credits allocable to energy credits, or (ii) the Base Erosion Minimum Tax Amount calculated without regard to the section 38 credits receiving the 80 percent haircut. Modified Taxable Income consists of the US corporation’s regular taxable income, plus any Base Erosion Tax Benefit with respect to any Base Erosion Payment, and the Base Erosion Percentage of the corporation’s NOL carryforwards.

The BEAT regime employs a phased-in tax rate approach with the 10 percent rate increasing to 12.5 percent in 2026. The BEAT rate is one percentage point higher for banks and registered securities dealers. Beginning in 2026, the US corporation’s regular tax liability will be reduced (not below zero) by the aggregate amount of all tax credits allowed to the US Corporation under Chapter 1 of the Code, with no further exceptions for the section 38 credits discussed above.

Regulatory Authority to Prevent Abuses and Provide Guidance

Section 59A grants broad authority to Treasury to prescribe 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 BEAT as payments not subject to the BEAT or to substitute payments not subject to the BEAT for payments otherwise subject to the BEAT.

Treasury also is expected to issue regulations generally interpreting and implementing the provision. For example, a Treasury official recently signaled that Treasury may consider issuing guidance relating to the application of the BEAT to partnerships, on which new section 59A is silent. Taxpayers have also raised several other questions of statutory interpretation on which Treasury can reasonably be expected to issue guidance:

- Operation of the exception for payments at cost for low-margin services. If there is a mark-up charged for a service otherwise eligible for the exception, will the entire payment amount be included in determining the amount of the Base Erosion Tax Benefit? Or will there be a bifurcation between the cost and mark-up portions of the payment and only the markup component treated as a Base Erosion Payment? Although the statutory language and Conference Committee Report are unclear on this point, a Senate floor colloquy between Senator Portman and Senate Finance Chairman Hatch indicates support for the bifurcation option. Also, the fact that the exception includes payments that are not eligible to be charged at cost under the US transfer pricing regulations (i.e., services that "contribute significantly to fundamental risks of business success or failure") allows the logical inference that it must be permissible to bifurcate the charge and include only the markup component as a Base Erosion Payment.

- Treatment of back-to-back payments to unrelated parties. For payments to a foreign related-party that ultimately are remitted to unrelated parties, a conduit rule that excludes these payments from the BEAT can reasonably be contemplated. Where a related party is engaged in purchasing or contracting for the corporate group and is merely passing along the costs without any value add, such back-to-back payments could arise.

- Treatment of payments made in accordance with an advanced pricing agreement ("APA") or a resolution from a mutual agreement procedure ("MAP"). The possibility of a narrow carve-out for payments that are determined pursuant to an APA or a MAP resolution has been raised.

Risk of Double Taxation and Coordination with International Rules

As a final note on this provision, the BEAT poses significant risk of double taxation for many taxpayers and may face challenges concerning its misalignment with international tax and trade agreements. Deductible payments subject to the BEAT made by a US parent corporation to a controlled foreign subsidiary may also constitute Subpart F income to the US parent or give rise to GILTI. Further, the BEAT could be viewed as violative of the non-discrimination provision of US tax treaties because it only targets foreign related-party payments, rather than all related-party payments. Within the European Union, concerns regarding the BEAT's noncompliance with the World Trade Organization rules have been raised and continue to be examined.

Limitations on Interest Deductions

The Tax Cuts and Jobs Act also contains a complete reworking of the interest deduction limitation rules under section 163(j). The former rules that generally only applied to US corporations (and foreign- corporations engaged in a USTB) to disallow deductions on related-party debt to the extent that the corporation's debt-equity ratio exceeded 1.5 to 1 are eliminated. In their place, new section 163(j) has a significantly broader scope than the old section 163(j). Under the new provision, interest deduction limitation rules apply to limit deduction of business interest on debt with both related and unrelated lenders, and apply to individuals, partnerships and corporations. There are certain limited 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 an 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, new section 163(j) limits their business interest expense to an amount equal to 30 percent of adjusted taxable income ("ATI") plus business interest income. Subject to potential future adjustments dictated by Treasury, a taxpayer's ATI is its taxable income computed without regard to: (i) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business, or a distributive share of any such items from a partnership, (ii) any business interest or business interest income, (iii) the amount of any NOL deduction under section 172, or deduction allowed under section 199A; and (iv) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. Generally, ATI should approximately equal earnings before interest, taxes, depreciation and amortization (EBITDA). For taxable years beginning on or after January 1, 2022, ATI adds back a taxpayer's depreciation, amortization, and depletion (and so will be generally equivalent to EBIT).

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

In the case of partnerships, the new section 163(j) limitation is applied and calculated at the partnership level. To the extent the partnership does not utilize its limitation; any unused limitation is effectively passed through to the partners by increasing their ATI by the partner's distributive share of the partnership's excess taxable income. A partnership's excess taxable income is the amount which bears the same ratio to the partnership's ATI as the excess (if any) of 30 percent of the ATI of the partnership over the amount (if any) by which the business interest of the partnership (reduced by floor plan financing interest) exceeds the business interest income of the partnership bears to 30 percent of the ATI of the partnership (the mathematical equivalent being: ETI = ATI x (30% x ATI - net interest expense) / (30% x ATI)).

Similarly, any disallowed business interest expense of the partnership is allocated to each partner in the same manner as non-separately stated taxable income or loss of the partnership. A partner can only utilize the disallowed business interest expense carryover from a given partnership against the partner's share of such partnership's "excess taxable income" in later years. Additionally, a partner's share of disallowed business 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 enacted language of the Tax Cuts and Jobs Act dropped the additional interest expense limitation applicable to multinational corporations that was found in proposed section 163(n) of the House and Senate bills.

Hybrid Entity and Transaction Limitations on Deductible Payments

Another addition of the Tax Cuts and Jobs Act is new Code Section 267A, which aims to eliminate deductions for certain related party interest or royalty payments where the amount is paid pursuant to a hybrid transaction, or by (or to) a hybrid entity.

Section 267A introduces the new concept of a "disqualified related party amount," which is defined as "any interest or royalty paid or accrued to a related party" to the extent that, broadly, (i) such amount is not included in the income of such related party 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 must be paid from (or to) a "hybrid entity" or pursuant to a "hybrid transaction." A hybrid entity is an entity treated as transparent for US federal income 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 federal income tax purposes are not so treated for the purposes of the relevant foreign tax law.

To illustrate how this new provision might apply, assume that USCo pays interest to a related party who is tax resident in Country A. Under US federal income tax law, the instrument under which the interest is paid is treated as debt. Under the tax laws of Country A, however, the instrument is treated as stock, with the 'interest' treated as a dividend qualifying for exemption from tax in Country A. Such interest payment is a "disqualified related party amount" paid pursuant to a "hybrid transaction," and USCo's deduction is therefore denied under new section 267A.

For its definition of related party, new section 267A looks to section 954(d)(3), which encompasses (1) an individual, corporation, partnership, trust, or estate that controls, or is controlled by, the payor; or (2) a corporation, partnership, trust, or estate that is controlled by the same person (or persons) that controls the payor. For purposes of applying the foregoing, control is ownership of more than 50 percent of the total (i) vote for corporations, or (ii) value of the beneficial interests for partnerships, trusts or estates.

A statutory exception to the deduction denial 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.

As expected, the legislation leaves much to be fleshed out by regulations and authorizes Treasury to issue regulations covering a broad range of topics, including the treatment of conduit arrangements, and applying the new rules to specified nuanced circumstances, amongst others.

By: Christine Kim, Washington, DC and Daniel Hudson, Miami

Passthrough Tax Changes Under TCJA

20 Percent Deduction for Certain Passthroughs and Sole Proprietorships

Prior to the Tax Cuts and Jobs Act (the "TCJA"), items of income, gain, loss, deduction and credit of a partnership or S corporation generally passed through to the partner or shareholder without any deduction at the partner or shareholder level. Similarly, such items of a sole proprietor were reported on his or her Form 1040 without further deduction.

The TCJA adds new Code Section 199A. Under section 199A, individuals, trusts, and estates are generally allowed a deduction of 20 percent of their qualified business income from partnerships, S corporations and sole proprietorships, for taxable years beginning after December 31, 2017, and before January 1, 2026. For partnerships and S corporations, the deduction is taken at the partner or shareholder level. The deduction is also allowed for qualified REIT dividends and qualified cooperative dividends and qualified publicly traded partnership income. The deduction serves to reduce the tax paid on business-type income by certain non-corporate taxpayers closer to the 21 percent corporate rate.

The actual amount of the deduction for taxpayers with taxable income in excess of certain threshold amounts is subject to a number of limitations and exceptions. The deductible amount is the lesser of: (a) the taxpayer's "combined qualified business income amount" (defined below), or (b) 20 percent of the excess, if any, of (i) the taxpayer's taxable income for the taxable year over (ii) the sum of (1) the taxpayer's net capital gain and aggregate qualified cooperative dividends for the taxable year, plus (2) the lesser of (A) 20 percent of the taxpayer's qualified cooperative dividends or (B) taxable income (determined without regard to section 199A), reduced by capital gain, of the taxpayer for the tax year. The 20 percent deduction for passthroughs and sole proprietorships may not exceed the taxable income of the taxpayer (reduced by net capital gain) for the taxable year.

The deduction is available to individual taxpayers who take the standard deduction, as well as taxpayers who itemize deductions. It is not taken into account in computing adjusted gross income but is instead treated as a deduction that reduces taxable income.

Combined Qualified Business Income Amount

A taxpayer's "combined qualified business income amount" is equal to the sum of (a) the deductible amount determined for each "qualified trade or business" (defined below) of the taxpayer and (b) 20 percent of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income of the taxpayer for the taxable year.

A "qualified trade or business" means any trade or business other than (a) a specified service business (but see exception below) or (b) the trade or business of performing services as an employee.

A specified services trade or business is a trade or business, described in section 1202(e)(3)(A), that includes the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, and brokerage services and any trade or business the principal asset of which is the reputation or skill of one or more if its owners or employees, or any business that involves the performance of services that consist of investing and investment management, trading or dealing in securities, partnership interests, or commodities.

An exception from the specified services exclusion is provided where the taxpayer's income does not exceed the sum of the threshold amount of $157,000 (or $315,000 for joint returns) plus $50,000 (or $100,000 for joint returns). The exception to allow the 199A deduction for specified services is phased out beginning at the threshold levels of taxable income and is eliminated when taxable income exceeds the threshold amount by $50,000 (or $100,000 for joint returns).

Deductible Amount Determined for Each Qualified Trade or Business

The deductible amount for each qualified trade or business is the lesser of (a) 20 percent of the qualified business income for the qualified trade or business or, if applicable, (b) the wages limitation amount, discussed below.

Qualified business income is the net amount of qualified items of income, gain, deduction or loss which relate to any qualified trade or business of the taxpayer that is effectively connected with the conduct of a trade or business in the United

States under section 864(c) and which items are included or allowed in computing taxable income for the year.

If the net amount of such items is less than zero, the amount is treated as a loss for the qualified trade or business in the following taxable year. The following items are excluded from the determination of qualified business income: (a) short-term capital gain or loss, long-term capital gain or loss, dividend income and interest income, (b) reasonable compensation paid to the taxpayer by the qualified trade or business for services rendered to such trade or business, (c) any guaranteed payments under section 707(a) paid to a partner for services rendered with respect to the trade or business, (d) qualified REIT dividends, (e) qualified cooperative dividends, and (f) qualified publicly traded partnership income.

Wage and Capital Limitation

The 20 percent deduction for each qualified trade or business is subject to the wage and capital limitation where a taxpayer has taxable income over the threshold amounts of $157,500 (or $315,000 for joint returns). Note that the limitation does not apply if the taxpayer's income is below the threshold amounts.

To determine the applicable wage and capital limitation amount for each qualified trade or business, a taxpayer compares two amounts. First, the taxpayer determines the W-2 wages of the company. Second, the taxpayer determines the unadjusted basis of tangible property subject to depreciation and multiplies that amount by 2.5 percent and adds 25 percent of the W-2 wages. The taxpayer compares these two amounts and takes the greater amount as the wages limitation amount that is then used to determine the deductible amount for each qualified trade or business (as discussed above).

The Conference Report provides an example that illustrates the income threshold limitation. A taxpayer with income above the $157,500 (single return) or $315,000 (joint return) threshold conducts its widget-making business as a sole proprietorship. The business buys a widget-making machine for $100,000 and places it in service in 2020. The business has no employees in 2020. The wage and capital limitation in 2020 is the greater of (a) 50 percent of W-2 wages or $0, or (b) the sum of 25 percent of W-2 wages ($0) plus 2.5 percent percent of the unadjusted basis of the machine immediately after its acquisition, or $2,500 ($100,000 x .025). The taxpayer's deductible amount for its widget-making business is therefore limited to $2,500 for 2020.

W-2 wages generally means the amount of remuneration for services performed by an employee for his employer. The W-2 wages must be included in a timely filed return with the Social Security Administration.

The property that qualifies for the 2.5 percent calculation is tangible property subject to depreciation under section 167, (i) which is held by, and available for use in, the company at the close of the taxable year, (ii) is used at any point during the taxable year in the production of qualified income, and (iii) the depreciable period for which has not ended before the close of the taxable year. The depreciable period means the period beginning on the date the property was first placed in service by the taxpayer and ending on the later of (i) the date that is 10 years after such date, or (ii) the last day of the last full year in the applicable recovery period that would apply to the property under section 168.

Each Trade or Business

The 20 percent deduction is calculated for each of the taxpayer's qualifying companies. Thus, if the taxpayer has multiple qualifying businesses, the taxpayer determines the 20 percent deduction for each company and then combines the deductions for all the companies. Thus, the wage and capital limitations described above are done on a company by company basis.

The 20 Percent Deduction is Scheduled to Expire

Note that the 20 percent deduction is temporary. It is scheduled to expire at the end of 2025 and will not apply to taxable years beginning with 2026, unless extended by Congress.

***By: Michael Farrell,* Dallas and *Abrahm Smith,* Miami**

Transfer Tax/Code Section 482 Implications of TCJA Including Outbound Intellectual Property Transfers to Foreign Subsidiaries

Like many of the other changes to the international provisions of the Code enacted under the Tax Cuts and Jobs Act (the "TCJA"), the new outbound transfer and Code Section 482 rules have changed and increased the cost of transferring intangible property from the United States to foreign subsidiaries. As discussed further below, prior to the enactment of the TCJA, companies were able to transfer certain intangible property to foreign subsidiaries in a tax-free exchange under section 367(a)(3)(B), section 367(d), and section 482 based on the more limited definition of compensable "intangible property" under section 936(h)(3)(B). The new law under the TCJA has closed this opportunity, thereby significantly increasing the cost of transferring intangible property to foreign subsidiaries.

Prior Section 482/367(d) and 936 Language

Under section 367(a), transfers of property by a US transferor to a foreign related corporation in an otherwise non-recognition exchange will be treated as a taxable transaction. Prior to the enactment of the TCJA, former 367(a)(3)(A) provided an exception to this gain-recognition rule on the outbound transfer of property to be used in an active trade or business outside of the United States. Former section 367(a)(3)(B) excluded from this active-trade or business exception certain "intangible property" transferred in an outbound transaction. Such intangible property was instead subject to the gain-recognition rule under section 367(d), which required that gain be recognized on the outbound transfer of intangible property, as defined in section 936(h)(3)(B), as if the transferor had sold the intangible property in exchange for payments contingent on the property's productivity, use, or disposition. Similarly, outbound transfers, licenses, and sales of intangible property, as defined in section 936(h)(3)(B), to foreign controlled parties were subject to the section 482 transfer pricing principles, which required that payments be made in accordance with the arm's length standard and be "commensurate with the income" attributable to the intangible property.

Prior to the enactment of the TCJA, there was considerable controversy between taxpayers and the IRS generally related to what assets constituted compensable intangible property. Both former sections 367(d) and 482 were limited in scope regarding the type of intangible property that were considered “compensable.” Under former section 936(h)(3)(B), which defines compensable intangible property for purposes of section 367(d) and section 482, “intangible property” included intangible assets that had “substantial value independent of the services of any individual,” including the following: (1) patents, inventions, formulae, processes, designs, patterns, or know-how; (2) copyrights and literary, musical or artistic compositions; (3) trademarks, trade names, or brand names; (4) franchises, licenses, or contracts; (5) methods, programs, systems, procedures, campaigns, surveys, studies, forecasts, estimates, customer lists, or technical data; and (6) similar items. The definition of intangible property in the section 482 Regulations was identical to the list of intangibles codified in section 936(h)(3)(B), with the additional statement that for purposes of section 482, an item is considered “similar” to those listed if “it derives its value not from its physical attributes but from its intellectual content or other intangible properties.” Treas. Reg. § 1.482-4(b)(6).

The IRS regularly interpreted “other similar items” to include a broader set of intangibles than that recognized by taxpayers, including specifically goodwill, going concern value, and workforce in place (items missing from the list in the section 482 Regulations). Taxpayers, on the other hand, often took the position that these assets were not compensable intangibles under section 367(d), and could instead qualify for non-recognition treatment under section 367(a)(3)(A) for property to be used in an active trade or business. In the first place, the definition of intangibles in section 936(h)(3)(B) did not include goodwill, going concern value, and workforce in place. In addition, taxpayers took the position that these three intangibles did not fall within the catchall provision for any “similar item” because they were dissimilar to the more easily identified intangibles in the statute. In addition, the former regulations under section 367(d) expressly excluded foreign goodwill and going concern value from the application of section 367(d). Former Treas. Reg. § 1.367(d)-1T(b). The IRS inferred from this provision that while *foreign* goodwill and going concern value were excluded, *domestic* goodwill and going concern were necessarily compensable. Taxpayers often disagreed with this inference due in part to the difficulty of distinguishing between domestic and foreign goodwill and going concern value. This led to considerable controversy between the IRS and taxpayers, due in no small part to the fact that the value attributable to intangibles, and to these types of intangibles specifically, had increased significantly in recent years.

This controversy between the IRS and taxpayers led to two recent cases, in which the court ultimately sided with taxpayers to conclude that these items did not, in fact, fall within the definition of intangible property under former sections 936(h)(3)(B) and 482. In *VERITAS v. Commissioner*, 133 T.C. 297 (2009), the Tax Court held that goodwill, going concern, and workforce in place were not “intangible property” for purposes of section 936(h)(3)(B) and Treas. Reg. § 1.482-4(b) because it did not have substantial value independent of the services of any individual. Again, in *Amazon.com v. Commissioner*, 148 T.C. 8 (2017), the Tax Court held that the definition of intangible property under section 936(h)(3)(B) also excluded goodwill and going concern value as those assets were not a “similar item” to those codified by statute and did not have “substantial value independent of the services of an individual.” Not satisfied with these decisions, the IRS took its case to Congress to amend the statute to ensure that these intangibles would be subject to tax on an outbound controlled transfer.

Revisions to the Code Under TCJA

In the TCJA Congress implemented three revisions that directly affect the outbound transfer of intangible property, specifically: (1) expanding the definition of compensable intangible property under section 936(h)(3)(B) to include workforce in place, goodwill, and going concern value; (2) granting the IRS authority to issue regulations requiring valuation of intangible property on an aggregate basis, or the use of "realistic alternatives" principles; and (3) eliminating the exception for transfers of property used in the active conduct of a trade or business from tax-free treatment. TCJA 1 § 14222. Each of these changes was aimed at increasing the taxability of outbound transfers of intangible property to related parties and is discussed in further detail below.

Through the TCJA, Congress first explicitly expanded the definition of intangible property contained in section 936(h)(3)(B), and therefore subject to sections 367(d) and 482, to include workforce in place, goodwill, and going concern value. Thus, taxpayers can no longer transfer these types of intangibles tax-free in a non-recognition transaction, despite the Tax Court's rulings in *VERITAS* and *Amazon*. The new definition of intangible property retains the residual category of "any similar item" to those listed, the value of which is not attributable to tangible property or the services of an individual. Flush language from section 936(h)(3)(B) had formerly explained that any of the enumerated examples of intangible property had "substantial value independent of the services of any individual." That requirement was removed by the TCJA in order "to make clear 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." Cong. Reg. H10126. Congress thereby mooted any argument that workforce in place, goodwill, going concern, or other intangibles are not compensable based on the position that they do not have substantial value independent of the services of any individual. The TCJA also changed the definition of intangible property to include "any other item the value or potential value of which is not attributable to tangible property or the services of any individual." This provision serves as a "catch-all" to define as intangible property any property which the taxpayer cannot clearly identify as tangible property or services, and to bring such property within the gain-recognition rule of section 367(d).

In addition, Congress authorized the IRS to issue regulations requiring the use of two different methods in valuing outbound transfers of intangible property for purposes of section 367(d). The prior Treasury Regulations had provided that, if the transactions used by a taxpayer had economic substance, the form chosen by the taxpayers would be respected by the Treasury, and the transfers would be valued according to that form. Subsequent to the TCJA, two valuation methods – the "aggregate basis" method and the "realistic alternative" method – may now be required by the IRS "if the Secretary determines that such basis is the most reliable means of valuation of such transfers." Section 482.

Under the "aggregate basis" method, if the Secretary determines that aggregating the intangible property transferred by a taxpayer provides a more reliable means of valuing that transfer than on an asset-by-asset basis, then the

Secretary can require that the taxpayer value the transfer on an aggregate basis. According to Congress, the aggregate basis method is consistent with Tax Court decisions in cases outside of the section 482 context, and with the cost-sharing regulations. Cong. Reg. H10126.

In the alternative, the IRS may use the realistic alternative method—that a taxpayer would only enter into a transaction if none of the realistic alternatives to the transactions is economically preferable to the transaction under consideration. For instance, if a taxpayer enters into a licensed manufacturing relationship with a related party, that transaction may be compared to the taxpayer using its own intangible property to make the product itself. If making the product itself would be economically preferable, then the IRS may value the transaction as if the taxpayer had made the product itself, rather than enter into the licensing transaction. Com. Rept. ¶ 5117. Congress believed that these two alternative valuation methods were consistent with the addition of workforce in place, goodwill, and going concern value to the list of compensable intangibles in that they require a valuation of all the value that results from the interrelation of intangible assets that are transferred to a related party. *Id.*

Finally, Congress eliminated the exception for transfers of property used in the active conduct of a trade or business under former section 367(a)(3)(A). By eliminating this exception, all outbound transfers of tangible or intangible property are now subject to the gain recognition rules under section 367(a) or (d).

Impact of TCJA and Open Issues

As a result of the changes to the sections 367, 482, and 936(h)(3)(B) rules under the TCJA, companies can expect heightened scrutiny from the IRS around the valuation of intangibles and intangible property transactions, increased exit charges on future intangible property migrations, and other challenges relating to intangible property transactions as a result of the BEAT, FDII and GILTI rules (discussed elsewhere in this newsletter). The expansion of compensable intangible property in sections 367(d), 482 and 936 and provisions granting the IRS with the ability to apply the aggregate basis of valuation and the realistic alternatives principal make the calculus of transferring intangible property out of the United States very difficult and costly. In addition, companies must consider how and whether outbound transfers of intangibles will impact their GILTI and FDII calculations, which rely in part on the intangible asset basis in foreign companies. These new rules in the aggregate make outbound transfers of intangible property significantly more complex as well as potentially more costly.

In addition, the new rules raise many questions with respect to valuations and intangibles transfers. For instance, when are the aggregate basis method and the realistic alternative principle going to produce “more reliable results” than valuing on an asset-by-asset basis? Will this be addressed by regulation? Would additional steps be taken by regulation to expand the application of these valuation methods beyond the scope explicitly granted by Congress (i.e., when “most reliable”)? How do these rules impact cost sharing arrangements and will the IRS impute platform contribution transactions related to these new compensable intangibles? How should companies address workforce in place, goodwill, and going concern value in future transfer pricing documentation?

These, and other issues, should be considered as companies move forward in the new world of the TCJA.

By: Amanda Worcester Martin, Washington, DC and Daniel Wharton, Chicago

TCJA Raises New Opportunities and Traps for M&A Deals

It may take months, or even years depending on economic conditions, market trends, investor activism, etc, for the long-term impact of the Tax Cuts and Jobs Act (the "TCJA") on mergers and acquisitions, both foreign and domestic, to surface. In addition, the impact will likely vary widely depending on the factual circumstances of the seller, the buyer and the target in each acquisition. However, it is possible to identify certain provisions of the TCJA with particular relevance to merger and acquisition ("M&A") transactions and anticipate their potential impact on M&A trends.

Arguably, the most significant change of the TCJA likely to affect mergers and acquisitions may be the measures intended to reduce the US federal income tax burden of US multinational corporations. Among such measures are: 1) the reduction in the maximum statutory US federal income tax rate applicable to income derived by US corporations from 35 percent to 21 percent; 2) the 37.5 percent deduction for foreign-derived intangible income ("FDII") and the 50 percent deduction for global intangible low-taxed income ("GILTI") amount derived by US corporations under section 250 (effectively reducing the statutory US federal income tax rate significantly lower than 21 percent); and 3) the 100 percent deduction under section 245A for the foreign-source portion of any dividend received by a US corporation from a 10 percent-owned foreign corporation. In theory (and, in fact, if the general increase in US equity market prices are any indication), these statutory and effective reductions in US federal income tax rates should reduce the effective tax rates of US corporations, thereby increasing their value, and thus the acquisition price of their stock or assets, for potential acquirers. Of course, prior to the TCJA, many US corporations had already decreased their effective rate of US federal income tax by asserting for financial statement purposes that their low-taxed foreign earnings were permanently re-invested and thus not subject to current US federal income tax.

Even standing on its own, the 100 percent deduction under section 245A for the foreign source portion of any dividend received by a US corporation from a 10 percent-owned foreign corporation (when combined with the one-time deemed repatriation provision of section 965) could significantly impact the M&A market. Specifically, it should permit US corporations to freely repatriate overseas cash thereby providing them with ample consideration to fund future mergers and acquisitions of US or foreign targets. The use of overseas cash without a residual US federal income tax liability is a significant change. The historic residual tax (at a rate of 35 percent) was an extremely significant and an artificial impediment for US corporations in freely deploying the fruits of their considerable global growth for the last several decades. It remains to be seen whether US corporations deploy that overseas cash to fund mergers and acquisitions, US investment, employment and wages, share buybacks or dividends.

Another fundamental change in the TCJA that is bound to affect the structure of mergers and acquisitions, in addition to the capital structure of US corporations generally (including, especially, those owned and financed by foreign parent corporations), is the limitation on interest deductions by a taxpayer under section 163(j). Specifically, section 163(j), as amended by the TCJA, limits the deduction for business interest for any taxpayer for any taxable year to an amount equal to the sum for such taxable year of (i) the business interest income of the taxpayer and (ii) 30 percent of the adjusted taxable income of the taxpayer (as well as the floor plan financing interest of the taxpayer). Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Business interest income means the amount of interest income properly allocable to a trade or business. The term “adjusted taxable income” means the taxable income of the taxpayer computed without regard to: i) any item of income, gain, deduction, or loss not properly allocable to a trade or business; ii) any business interest or business interest income: iii) the amount of any net operating loss deduction under section 172; iv) the amount of any deduction allowed under section 199A; and v) in the case of taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion (as well as such other adjustments as provided by Treasury).

It is important to emphasize that, prior to the TCJA, section 163(j) only limited the deduction of interest paid to a related party (or interest on a debt guaranteed by a related party) by a taxpayer while, after the TCJA, the limitation applies to all interest paid by a taxpayer whether to a related party or not. In addition, prior to the TCJA, the limitation was based on 50 percent of adjusted taxable income while, after the TCJA, the limitation is based on 30 percent of adjusted taxable income. These fundamental changes could be incredibly impactful in terms of the consideration that might be paid by the acquirer to the seller in mergers and acquisitions. Specifically, the benefits of borrowing cash and issuing it to a target’s shareholders (in exchange for stock or assets) or issuing debt to those shareholders (in exchange for stock or assets) may be significantly reduced causing acquirers to consider using more stock as acquisition currency. Of course, the after-tax cost of issuing stock in the merger or acquisition may still be higher than debt and issuers will undoubtedly take this into account.

This limitation on the deduction of interest on debt under section 163(j) may not only impede a US corporation’s ability to issue debt in order to finance mergers and acquisitions, but also impede a foreign corporation’s ability to push down debt to a potential US target. And, of course, the reduction in the statutory rate of US federal income tax from 35 percent to 21 percent may provide less incentive to leverage a US target corporation in the first place. Therefore, it may be prudent for an acquirer to consider alternative structures for mergers and acquisitions that are financed through debt. For example, where a US corporation intends to acquire a foreign target or a foreign corporation intends to acquire a US target, perhaps it makes more sense to structure the financing in a way that generates interest deductions in a higher tax foreign jurisdiction and/or one that does not restrict the deduction of interest. A US corporation may be particularly incentivized in this regard because foreign source dividends paid to such corporation, while deductible under section 245A for US federal income tax purposes, do not carry with them any foreign tax credits and there is, therefore, a stronger incentive than ever to reduce such foreign taxes.

Another set of changes in the TCJA that are likely to affect mergers and acquisitions involving US corporations (or foreign corporations that have effectively connected income and losses) are the provisions affecting the use of net operating losses of such corporations under section 172. As amended by the TCJA, section 172(a) restricts the deduction for net operating loss carryovers and carrybacks for any taxable year to the lesser of: 1) the aggregate of such carryovers and carrybacks to such year; or 2) 80 percent of taxable income of the taxpayer computed for such year without regard to the deduction allowed under section 172. Further, the TCJA amends section 172(c) to eliminate the carryback of net operating losses and extend the carryforward of net operating losses from 20 years to indefinitely. These new provisions apply to net operating losses arising in taxable years beginning after December 31, 2017, and could, depending on the circumstances, affect the value placed on such losses by potential acquirers. For example, the 80 percent annual limitation on the use of net operating losses could suggest a lower value while the indefinite carryforward of net operating losses could suggest a higher value. In addition, eliminating the ability to carryback net operating losses suggests that, depending on the circumstances, a seller may not benefit from the allocation of transaction-related deductions to a pre-closing period. These new restrictions, when combined with the TCJA's reduction of the US corporate tax rate and elimination of certain deductions for stock-based compensation previously permitted under section 162(m), are likely to change the dynamics in deal negotiations on the allocation of deductions between the pre and post closing tax periods.

It is possible that other changes made by the TCJA might also impact the form of M&A transactions. For example, the immediate expensing under section 168(k) of 100 percent of the basis of many types of tangible property (and certain types of intangible property) acquired by a taxpayer, regardless of whether such property is new or not, placed in service by the taxpayer after September 27, 2017, and before January 1, 2023, could incentivize acquirers to push harder for asset deals (in whole or in part) rather than stock deals (at least where a section 338 election is not available). Furthermore, in the case of a taxable acquisition by a US corporation of the stock of a foreign corporation, there should be an even stronger incentive for the US corporation to make an election under section 338(g) to step up the basis of the assets of the foreign corporation. This is because a higher tangible asset basis in the hands of such foreign corporation as a result of such election should result, under section 951A, in a higher net deemed tangible income return and, therefore, a lesser amount of GILTI subject to US federal income tax in the hands of a US shareholder of such foreign corporation on a current basis. In addition, the limitations under section 901(m) on credits for foreign taxes paid by such foreign corporation may be less important to a US corporation in light of the 100 percent deduction it should receive for foreign-source dividends, and the disallowance of any attendant section 902 foreign tax credits, under section 245A.

We note that the TCJA contains several strong disincentives for US-parented multinationals to invert and become foreign-parented multinationals. For example, sections 965(a) and (b) creates a one-time deemed subpart F inclusion of the aggregate net post-1986 earnings and profits of the deferred foreign income corporations of a US shareholder. Section 965(c) allows a deduction from gross income to such US shareholder sufficient to create an effective US federal income tax rate of 15.5 percent on the portion of such aggregate net post-1986 earnings and profits that are represented by cash and an effective US federal income tax rate of 8 percent on the remainder of such aggregate net post-1986 earnings and profits. However, section 965(l) provides that, if such US shareholder becomes an expatriated entity (as defined in section 7874) at any time during the 10-year period beginning on the date of the enactment of the TCJA, then a US federal income tax is imposed equal to 35 percent of the amount of the deduction originally allowed under section 965(c) but against which no foreign tax (or other credits) may be taken. Thus, section 965(l) imposes a potentially significant penalty tax where a US-parented multinational become a foreign-parented multinational within such 10-year period.

Another provision included in the TCJA that should deter inversions is contained in section 59A which effectively imposes a base erosion and anti-abuse tax ("BEAT"). Section 59A imposes each year a tax equal to the excess of: A) 10 percent (5 percent in the case of taxable years beginning in calendar year 2018) of the modified taxable income of a taxpayer for the taxable year; over B) the regular tax liability of the taxpayer for the taxable year as reduced by certain tax credits. The modified taxable income of a taxpayer is the taxable income of the taxpayer determined without regard to certain base erosion payments. According to section 59A(d)(1), a base erosion payment generally includes any deductible amount paid or accrued by the taxpayer to a foreign person which is a related party of the taxpayer.

It seems clear from the statute (and accompanying legislative history) that a base erosion payment does not include a payment that constitutes costs of goods sold because such payments are a reduction in gross receipts, rather than a deduction, for US federal income tax purposes. However, section 59A(d)(4) provides that a base erosion payment includes any amount paid or accrued by the taxpayer, that constitutes a reduction in gross receipts, to a foreign surrogate corporation (as defined in section 7847 and which first becomes such after November 9, 2017) of an expatriated entity as well as any foreign person that is an affiliate of that foreign surrogate corporation. Thus, a payment of costs of goods sold to a foreign parent or foreign affiliate of an inverted US corporation would be considered a base erosion payment for purposes of section 59A and, in a typical situation involving the purchase and sale of inventory property, would result in a significant tax liability under section 59A.

In addition, section 4985 imposes an excise tax on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before a corporation's expatriation date. A disqualified individual would generally include officers, directors, and 10 percent owners of private and publicly-held corporations. The TCJA amends section 4985 to increase the excise tax from 15 percent to 20 percent for inversions that occur after the date of enactment of the TCJA.

It should be clear from the foregoing that Congress wanted to provide strong disincentives for US-parented multinationals to invert and become foreign-parented multinationals. Of course, certain of the TCJA's provisions provide incentives to remain a US corporation that did not exist prior to the TCJA, including the lower corporate income tax rate, the deduction for FDII and GILTI and the 100 percent deduction under section 245A for the foreign-source portion of dividends received by a US corporation from a 10 percent-owned foreign corporation. As a result, US multinationals are less likely to invert except perhaps in cases where they merge with a strategic partner of greater or roughly equal size.

Despite the decline in the headline corporate rate, tax-free reorganizations are likely to remain of interest to sellers, particularly to individual sellers who reside in high tax states and may no longer deduct all of their state income tax for US federal income tax purposes and may therefore prefer to defer realizing income until a period when they enjoy a lower combined federal and state tax burden. Perhaps Treasury also anticipates continued interest in the tax-free reorganizations provisions because they issued Revenue Procedure 2018-12 last month, which offers parties to tax-free reorganizations more flexibility to determine the measurement of the stock consideration to be issued in a reorganization.

The TCJA raises many new issues for buyers to scrutinize in the course of due diligence and potentially address in deal agreements. For example, prior to the TCJA, top corporate tax rates were similar to the top individual income tax rates. With significant discrepancies in these rates after the TCJA, parties to M&A transactions should revisit assumptions around effective tax rates for purposes of computing indemnities in agreements and for purposes of determining annual tax distributions. In addition, buyers must scrutinize a target's computation of section 965 liabilities and consider adding clauses to prohibit target from electing to recognize the section 965 tax over 8 years (as provided in the statute), for example, to avoid extending pre-closing statutes of limitation and prolonging uncertainty about pre-closing tax liabilities. Buyers must also scrutinize, particularly in the course of due diligence to anticipate post-acquisition integration steps, target structures to evaluate exposures to withholding taxes in the target group that are not creditable due to the repeal of the section 902 foreign tax credit regime. Going forward, the elimination of the section 902 foreign tax credit regime will likely create greater incentives for taxpayers to mitigate and eliminate withholding tax leakages that they may otherwise have tolerated. Taxpayers should also look for opportunities in post-acquisition integration planning to claim credits under section 901 and section 960 foreign tax credit regimes going forward.

The TCJA also heightens the importance of reviewing target structures for potential exposures with respect to payment flows, including payments potentially subject to the BEAT. Hybrid instruments within the target group will require greater focus from a US tax perspective as well. Perhaps most critically, the 100 percent deduction for foreign-source dividends under section 245A is not available for dividends that give rise to a deduction to the payor in the local jurisdiction (e.g., Luxembourg in the case of convertible preferred equity certificates). Thus, it will be important to consider post-acquisition restructuring, where necessary, to claim the section 245A deduction with respect to distributions out of target controlled foreign corporations that have hybrid instruments that qualify as equity for US federal income tax purposes.

Despite considering a repeal, Congress ultimately left section 956 in place. Although section 956 is likely to have less bite under the new regime, taxpayers must continue to evaluate its impact in their post acquisition integration plans. For example, when a US multinational acquires a foreign group with US subsidiaries, restructuring may be required to mitigate the impact of section 956 by extracting shares of US subsidiaries from the foreign target upon or after closing. Similarly, leaving US rights to intellectual property with a stepped up basis for US federal income tax purposes in a non-US target after an acquisition by a US multinational may create section 956 exposure to address in the integration.

In summary, the TCJA raises numerous new issues for dealmakers to consider and address from the due diligence, structuring, pricing, financing and documentation of a transaction all the way through the post-acquisition integration.

***By: Thomas May,* New York and *Kirsten Malm,* San Francisco**

State Corporate Income Tax Considerations of the Tax Cuts and Jobs Act

This article discusses the US state and local corporate income tax implications of the most significant aspects of the corporate income tax provisions of the Tax Cuts and Jobs Act (the "TCJA"), including interest deductibility, business expensing, and key international tax provisions such as the deemed repatriation, participation exemption, global intangible low-taxed income and the base erosion minimum tax.

In evaluating the impact of the TCJA on US state corporate income tax, the critical first step is understanding conformity to the Internal Revenue Code ("Code"). Many states use federal taxable income as computed under the Code as the starting point for computing state taxable income. However, state conformity to the Code for this purpose is achieved in different ways, including conforming to (1) the Code as of a fixed date, which may or may not be the most recent version of the Code ("static conformity"); or (2) the version of the Code that is currently in effect ("rolling conformity"). States may also conform to only specific Code sections ("selective conformity"), which may be either static or rolling.

As a general matter, rolling conformity states automatically incorporate the tax base changes made by the TCJA 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 of the TCJA.

It is also important to note that in several instances the TCJA made broad grants of authority to Treasury to issue guidance, and while states may conform to the Code itself, states may not conform to federal interpretations of the Code. Thus, to the extent that Treasury issues substantive guidance regarding any of the the TCJA provisions, an additional threshold question will exist as to whether such guidance applies in the states.

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 may be unlikely to reduce rates in the wake of state budget shortfalls. Thus, while corporations may enjoy a reduced tax rate of 21 percent at the federal level as a result of the TCJA, their state corporate tax rates are likely to hold steady in the near term.

Interest Deductibility

The TCJA limits (in new Code Section 163(j)) the deductibility of interest (i.e., interest expense is limited to 30 percent of adjusted taxable income as defined). This limitation applies to interest on debt with related and unrelated lenders. The TCJA also permits taxpayers to carry forward any disallowed interest expense indefinitely.

Rolling conformity states will likely conform to the TCJA's limitation 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. If taxpayers pay interest to both related and unrelated parties, ordering questions may arise for purposes of determining whether interest deducted federally is subject to addback for state tax purposes.

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?

Business Expensing

The TCJA revised Code Section 168(k), resulting in full and immediate expensing for certain property acquired and placed in service between September 27, 2017, and January 1, 2023 (the expensing amount is phased down beginning with property acquired and placed in service on or after January 1, 2023).

Since many states currently decouple from 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.

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.

Pennsylvania is one state that has weighed in on this issue. The Pennsylvania Department of Revenue has issued guidance, Pennsylvania Corporation Tax Bulletin 2017-02 (Dec. 22, 2017), concluding that Pennsylvania does not conform to section 168(k) and that the Pennsylvania tax statutes do not provide a cost recovery mechanism with respect to property that is fully depreciated under that provision. As a result, according to the Department, taxpayers cannot recover such cost until the property is sold or otherwise disposed. Not only is this position a departure from the Department's prior position in Pennsylvania Corporation Tax Bulletin 2011-01 (Feb. 24, 2011), in which the Department concluded that no adjustment is required to a taxpayer's Pennsylvania taxable income for full expensing under section 168(k), the use of an administrative bulletin to articulate this new position raises administrative procedure act concerns.

Transition Tax – Deemed Repatriation

The TCJA contains a one-time income inclusion in Code Section 965 for the amount of the undistributed, not previously taxed post-1986 foreign earnings and profits of certain US-owned businesses ("deemed repatriation income"). The TCJA also permits a deduction for a percentage of the deemed repatriation income to achieve a lower federal effective tax rate for this income.

For those states conforming to a prior version of the Code, this deemed repatriation income may never appear in state taxable income absent a legislative change. Even in those states with rolling conformity, many 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 Code (e.g., Code Sections 951 or 952) or may generally refer to income under Subpart F of the Code. Depending on the state's specific language in defining or referring to "Subpart F" income and the type of state conformity, questions may arise as to whether this deemed repatriation income (which is codified in section 965 and increases the income includible under section 951(a)) falls within the state's exclusion or deduction.

In states that do not permit a deduction for or otherwise exclude the deemed repatriation income from the state tax base as Subpart F income, the treatment of the deemed repatriation income as a dividend eligible for a dividends-received deduction or as non-apportionable nonbusiness income should be considered. Taxpayers should also review state corporate income tax conformity to the federal percentage deduction of the deemed repatriation income contained in section 965(c).

Issues may also arise when any cash is actually distributed by the foreign business. Depending on the state's conformity to the federal previously taxed income provisions, the cash distribution may be taxed at the state level unless a state-specific deduction applies (e.g., a dividends received deduction).

To the extent that any income is included in the state tax base (either as deemed repatriation 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 sales factor denominator (even though some states may try to exclude amounts from extraordinary or unusual transactions). The inclusion of such amounts in the sales factor numerator will depend on the state's specific sourcing rules (e.g., market-based sourcing or costs of performance sourcing).

The New York State Department of Taxation and Finance has already released a publication titled "Preliminary Report on the Federal Tax Cuts and Jobs Act" that articulates its position regarding the New York State tax treatment of various TCJA provisions, including New York's treatment of the deemed repatriation income and corresponding deduction. The Department's view is that the deemed repatriation income is excluded from the New York corporate income tax base as "other exempt income" and that the corresponding deduction flows through to the New York State tax base, meaning that taxpayers could get the benefit of an exclusion for the deemed repatriation income as well as the benefit of the federal deduction. The Department of Taxation and Finance has recommended that the legislature adopt an addback for the federal deduction in section 965(c) to avoid an "inappropriate windfall" for taxpayers. However, the Department's analysis does not seem to consider the treatment of any deemed repatriation income from foreign corporations that are not engaged in a unitary business with the taxpayer (since qualification as other exempt income generally depends on a unitary business relationship) and does not consider the potential treatment of such income as "investment income" (a second category of excludable income from the New York business income tax base).

International Tax Provisions

Participation Exemption System

In at least one important respect, the TCJA generally brings the US foreign tax system in line with international norms by providing a "participation exemption." Under the participation exemption in new Code Section 245A, eligible dividends a US corporation receives from an eligible foreign corporation qualify for 100 percent deduction. As a result, qualifying dividends are only subject to foreign tax and effectively are exempt from US tax.

As a general matter, most states permit deductions for dividends received from related corporations, either by adopting a state-specific dividends received deduction or by conforming to the federal dividends received deduction. Since the TCJA provides that certain dividends a US corporation receives from an eligible foreign corporation qualify for a 100 percent deduction, consideration should be given to whether states can conform to such a provision under US Constitutional principles requiring non-discrimination if a state does not provide a similar 100 percent deduction for dividends received from domestic corporations. As a solution, states may choose to modify the 100 percent deduction to align with the state's treatment of domestic dividends.

GILTI and FDII

The TCJA introduces a new category of income – global intangible low-taxed income ("GILTI"). The GILTI provisions are contained in new Code Section 951A, which is within Subpart F of the Internal Revenue Code.

As discussed above, some states permit a deduction or exclusion for Subpart F income. However, unlike the deemed repatriation income discussed above (which increases the amount of income includible under section 951(a)), GILTI is in an entirely new section of the Code (section 951A). Thus, questions may arise as to whether current state provisions addressing the treatment of Subpart F income will cover GILTI.

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 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?

The TCJA also includes a new Code section 250 that provides a special deduction for 37.5 percent of the foreign-derived intangible income ("FDII") of a domestic corporation and a 50 percent deduction for GILTI to achieve a lower federal effective tax rate for FDII and GILTI. The question of whether states will conform to these deductions generally hinges on the states' conformity to the Code (e.g., static, rolling, selective). Notwithstanding, given each state's unique conformity or state-specific modifications to taxable income, the new GILTI and FDII structure could produce winners and losers for state income tax purposes.

For example, in its "Preliminary Report on the Federal Tax Cuts and Jobs Act" the New York State Department of Taxation and Finance has stated that "[a]lthough this new GILTI income is treated similarly to Subpart F income, it is specifically not characterized as Subpart F income under the Code and therefore would not qualify as other exempt income." As a result, the GILTI income would be includible in the New York tax base as business income. The Department further concludes that the deductions provided for under section 250 would also flow through to New York and would not be subject to an add-back, so the result would be an inclusion of the "net" amount in the New York tax base. However, like the deemed repatriation income analysis, the Department fails to consider the potential treatment of GILTI as investment income.

BEAT

Under a new section of the Code (Section 59A), certain taxpayers would be required to pay a separate tax ("BEAT") equal to the base erosion minimum tax amount for the taxable year. Given that the BEAT 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.

Tackling the State Impact

As discussed above, the key to evaluating the impact of the TCJA on state corporate income taxes is evaluating state conformity to the Code, which may change as state legislatures start to consider the impact of the TCJA. Where there are areas of uncertainty with respect to conformity, state revenue authorities may interpret conformity provisions in such a way to generate the most additional tax. Given this, taxpayers should be prepared to carefully examine and support their filing positions.

By: Maria Eberle and Lindsay LaCava, New York

EU Considers Impact of US Tax Reform

EU officials are saying little about their next move following US tax reform. In a January 10, 2018 comment to the EUobserver, one EU Commission spokeswoman said it was "too early" to say what EU executives would do following the passage of the US Tax Cuts and Jobs Act of 2017 (the "TCJA"). "We have to analyze the law and this will take time," she said.

Although EU ministers are taking time to digest the TCJA before a formal response, several officials vocally opposed the TCJA while it sped through Congress and the Senate in December.

Warnings from EU Ministers Before Passage of Tax Reform

EU ministers sent two letters to US Treasury Secretary Steven Mnuchin expressing their disapproval of the then-pending bill.

On December 11, 2017, Italy's Pier Carlo Padoan, Germany's Peter Altmaier, France's Bruno Le Maire, the UK's Philip Hammond, and Spain's Cristóbal Montoro Romero issued a letter to US Treasury Secretary Mnuchin, warning that US tax reform may violate World Trade Organization ("WTO") obligations, treaty obligations, and international agreements under the OECD base erosion and profit shifting ("BEPS") plan. The ministers disapproved of three main points of the proposed tax reform bill: (1) the 20 percent excise tax on outbound payments, (2) the base erosion and anti abuse tax ("BEAT"), and (3) the global intangible low-taxed income regime ("GILTI") regime.

First, according to the letter, the 20 percent excise tax on payments to foreign affiliated companies would be discriminatory in a way that would contravene the WTO because only payments for foreign goods and services would be affected. The ministers argued that the excise tax would be inconsistent with tax treaties because it imposes a tax on the profits of non-US resident companies that do not have a US permanent establishment. The letter highlights concern that this tax would hamper trade and investment flows between the US and Europe.

Second, the EU ministers claimed that the BEAT is a poorly targeted attempt to curb base erosion that would impact genuine commercial arrangements involving payments to foreign companies. The letter says this would be "extremely harmful" for international banking and insurance businesses and "may harmfully distort international financial markets." The EU worried that the BEAT may result in US operations of foreign financial institutions being subject to greater than a 100 percent effective tax rate or double taxation. The ministers argued that foreign financial institutions are subject to strict regulatory restraints on borrowing in the US, which already limits artificial profit shifting and base erosion. In the ministers' view, the BEAT may constitute an unfair trade practice and may discourage non-US financial institutions from operating in the US.

Third, the letter argued that GILTI may be considered an illegal export subsidiary under WTO rules and Countervailing Measures Agreement rules, as it would subsidize exports compared with domestic consumption. The letter voiced concern that GILTI was incompatible with the generally accepted BEPS consensus and the modified nexus approach under BEPS.

The letter closed with the ministers expressing concern that the proposed bill may lead to distortions of the international tax consensus. “The OECD and the BEPS inclusive Framework are the relevant forums for working on the evolution of international tax principles on a multilateral basis,” the letter said. The ministers warned that consistency was “crucial for states and businesses.”

Following this initial letter, another letter was sent to Mnuchin just a day later, this time from the European Commission. The letter expressed a similar warning that the tax bill would hamper trade and lead to unfair trade practices or discrimination that are incompatible with international trade rules.

These letters hint at a possible challenge to the TCJA now that it passed, though the EU is taking time to consider ramifications for Europe before mounting a challenge.

Minor Market Impact

It may take time to see a market reaction as well. By December 29, 2017, the US Dollar dropped to a three-month low against the Euro, raising doubt about the TCJA's impact.

Viewing the US as Competition for Investment and Jobs

German economists are concerned about increased competition for investment and jobs in Germany due to the TCJA. The Director of the Federation of German Industries, Joachim Lang, said that tax reform would create “significant incentives to shift corporate operations and investments into the United States.”

In response, economists are urging Germany to pass its own tax reform to compete with the US. The Centre for European Economic Research (“ZEW”) and the University of Mannheim in Germany stated in a December 11, 2017, report that US tax reform “will challenge the current course of European and German tax policy.” If Germany does not adequately respond, “Germany could become one of the European losers in the new round of tax competition,” according to the ZEW report. Chief Economist at the German Engineering Federation, Ralph Wiechers, noted that “there is an opportunity for an intelligent reform of fiscal structures” in Germany. Lang added that tax reform is “all the more urgent” due to US tax reform.

The ZEW report warns that “US tax reform will not only intensify US-European tax competition but also intra-European competition.” In the coming days, other European states may similarly feel pressure to pass their own tax reform to keep jobs and investment at home.

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Positive European Corporate Outlook After Initial Write-Downs

There are mixed reactions to tax reform from the European corporate community, though the prevailing view is that the TCJA will have a positive impact in the long-run. For example, Royal Dutch Shell plc issued a statement expressing a favorable outlook on tax reform, largely due to the new reduced US corporate income tax rate. Credit Suisse similarly anticipates that the reform will have a positive impact on the US economy and Credit Suisse's activity levels in the US.

Others are concerned that the benefits of tax reform could be minimal. Barclays took a somewhat skeptical outlook in a December 27, 2017 statement. While the reduced corporate rate "is expected to positively impact Barclays' future US after tax earnings," Barclays worries that "the ultimate impact is subject to the effect of other complex provisions in the TCJA," namely the BEAT. Barclays commented that given the "uncertain practical and technical application" of the new provisions, it was impossible to know whether the BEAT would apply and if so, how it would impact Barclays.

While US tax reform may have a positive long-term impact, many companies have announced immediate one-time consequences of the TCJA. These consequences are largely in the form of one-time write-downs as a result of unusable tax credits. Credit Suisse announced an expected $2.3 billion write-down because of US tax reform, Shell announced a $2-$2.5 billion dollar charge to earnings, and Barclays expects a $1.34 billion write-down given the decreased value of its deferred tax assets. On the other hand, Daimler, the German company that makes Mercedes-Benz vehicles, says it expects a $2 billion earnings increase as a result of the TCJA.

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While the European community awaits formal action by EU officials, including possible challenges, the long-term impact of the TCJA on trade and European companies remains to be seen.

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