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U.S. TAX REFORM AND ITS IMPACT ON SWISS COMPANIES

Tax planning more important for U.S. subsidiaries of Swiss corporations

In December 2017, the U.S. Congress passed the Tax Cuts and Jobs Act of 2017, consisting of the most significant changes in the way in which U.S. tax laws operate since 1986. The article addresses the key implications of the 2017 Tax Act in summary format, with an emphasis on how they affect Swiss companies that are parent companies of U.S. subsidiaries, or are subsidiaries of U.S. parent companies.

1. INTRODUCTION

In December 2017, the U.S. Congress passed the bill formerly known as *Tax Cuts and Jobs Act of 2017 (2017 Tax Act)* consisting of the most significant change in the way in which U.S. tax laws operate since 1986 [1]. More specifically, the 2017 Tax Act radically alters the taxation of a U.S. multinational's foreign operations, by shifting the balance towards a territorial form of taxation through the introduction of a dividends-received-deduction for dividends received from certain foreign participations. Conversely, in order to preserve the U.S. tax base, the 2017 Tax Act introduced a number of measures to prevent base erosion, including the base erosion minimum tax and an expansion of the rules that affect *controlled foreign corporations (CFCs)* [2].

In this article, the authors will address the key implications of the 2017 Tax Act in summary format, with an emphasis on how they affect Swiss companies that: (1) are parent companies of U.S. subsidiaries, or (2) are subsidiaries of U.S. parent companies.

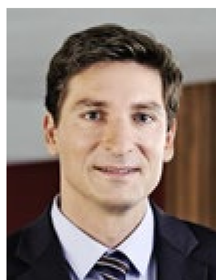
The analysis is not intended to be inclusive of all developments but aims to provide a flavor of the more significant changes.

2. CHANGES TO THE U.S. (DOMESTIC) [3] BUSINESS TAX RULES

2.1 Reduction of Corporate Tax Rate and Waiving of the Alternative Minimum Tax. Perhaps the most well-known change brought about by the 2017 Tax Act is the reduction of the corporate income tax rate from 35% to 21% [4]. The new reduced rate is effective immediately on January 1, 2018 for calendar year taxpayers. Non-calendar year taxpayers are subject to a blended rate for the taxable year that includes January 1, 2018. Prior to the 2017 Tax Act, U.S. corporations were subject to graduated tax rates of 15% to 35%, with that top rate applying to corporations with taxable income of over USD 10 million.

With this significant reduction in corporate tax rates, the United States is now more competitive as a corporate jurisdiction as compared to the tax rates imposed by other OECD countries. The value of most companies with U.S. operations or activity should also be increased, as the after-tax earnings receive an immediate boost. Additionally, the volume of M&A transactions should increase as well, as corporations will have access to more cash (repatriated, as outlined below) and such transactions would give rise to reduced tax leakage [5].

An additional significant change to the corporate tax regime is the elimination of the corporate *alternative minimum tax (AMT)* [6]. The AMT regime was essentially a parallel tax system that ran in conjunction with the normal corporate tax system, requiring corporations to calculate their tax burden under both systems and then pay the higher of the two. The elimination of corporate AMT should effectively lower the corporate tax burden and ease the complexity of record keeping and compliance. However, the *base erosion and anti-abuse*



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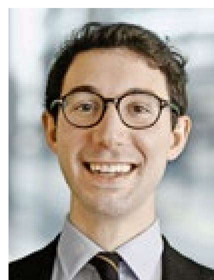

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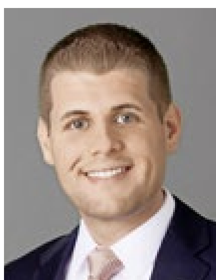
tax (BEAT) functions as a new alternative minimum tax for cross-border businesses.

2.2 Changes to Corporate Net Operating Loss Deduction. Prior to the 2017 Tax Act, corporations could carry net operating losses *(NOL)* [7] two years back and 20 years forward to offset taxable income in such prior or future years. In taxable years ending after December 31, 2017 corporations are no longer able to carry back NOLs, but may carry forward NOLs for an unlimited period [8]. However, the NOLs of property and casualty insurance companies can still be carried back two years and carried forward over a 20 year period to offset 100% of taxable income in such years [9]. For the sake of clarity, NOLs arising in taxable years ending on or before December 31, 2017, are still able to benefit from the old rules. This means every corporation with an NOL in 2017 or earlier should carefully plan accordingly.

Perhaps more significantly, NOLs arising in taxable years beginning after December 31, 2017 are subject to an annual limit of 80% on the amount of taxable income that such NOLs can offset. This limitation effectively results in a minimum tax of 4,2% (21% x [1–80%]). As a result of these new rules impacting NOLs, corporations should carefully consider the timing of income and deductions. For example, if a corporation anticipates losses in 2018–2019 and anticipates generating significant income in 2020, it might consider deferring deductions [10] to 2020 or accelerating income into the current year to mitigate the adverse timing impact of the 80% limitation rule on NOLs.

The changes to the NOL rules have numerous other implications. To the extent companies have existing NOLs, the reduced 21% corporate income tax rate significantly reduces their efficacy. Cyclical corporations with periods of significant income and loss generation will no longer be able to immediately monetize their tax losses by carrying them back to prior tax years to obtain refunds. Finally, from a financial account perspective, deferred tax assets associated with NOL carryforwards would require a write down under GAAP in light of changes in the corporate tax rates, the new unlimited carryforward period and the 80% ceiling.

2.3 Limitations on Interest Deductions. Prior to 2018, the gross amount of business interest expense was generally deductible in computing net taxable income. Some limitations did exist with respect to such deductions, such as the earnings stripping rule [11], which limited interest deductions on related party debt or debt guaranteed by certain related parties, if the debtor corporation was thinly capitalized [12]. The former earnings stripping rule was previously applicable only in the international context; i. e., the focal point was on interest expenses incurred by U. S. company borrowers to non-U. S. lender entities.



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Graph 1: **EXAMPLE OF CALCULATION OF ATI**

X Corp. a U. S. corporation, has gross receipts of USD 200 and incurs the following expenses:

- cost of goods sold = USD 110
- depreciation = USD 40
- interest expense = USD 40

Assume X Corp.'s taxable income for U. S. federal income tax purposes is USD 10.
To calculate the ATI, depreciation and interest expense must be added to the taxable income =
USD 10 + USD 40 + USD 40 = USD 90.
The interest limitation is equal to 30% of ATI =
USD 90 × 30% = USD 27
The disallowed interest is the interest expense that exceeds the interest limitation =
USD 40 – USD 27 = USD 13.

The 2017 Tax Act limits interest deductibility for businesses generally – whether treated as a corporation or partnership for U. S. federal income tax purposes – to 30% of *adjusted taxable income (ATI)* [13]. This limitation applies immediately for tax years beginning after December 31, 2017. For tax years beginning before January 1, 2022, ATI roughly approximates the EBITDA, meaning it is computed without regard to depreciation, amortization and depletion. Thereafter, ATI will be similar to EBIT, taking into account depreciation, amortization and depletion. ATI includes earnings regardless of whether they are earned in the United States or internationally and regardless of whether they are deriving from operational or from non-operational business activities, as long as such earnings are included in the borrower business's taxable income [14]. In many ways, this limitation is consistent with similar changes in law enacted recently in European jurisdictions, such as Germany and the UK, as a result of the OECD *Base Erosion and Profit Shifting (BEPS)* initiative. *Graph 1* pictures an example of calculation of ATI.

Businesses may carry forward any disallowed interest expense deductions for an unlimited period. Companies that generate NOLs (not taking into account business interest expense) may benefit from the fact that the 2017 Tax Act maintains NOLs as distinct tax attributes and disallowed net interest expense. Stated differently, a taxpayer may first reduce its taxable income by the amount of carried over disallowed interest, subject to the 30% limitation for the year, before taking into account the 80% taxable income ceiling applicable to the NOL carryover. However, to the extent a corporation with disallowed interest deductions is acquired, the carryover of such disallowed interest deductions is treated as a NOL and its use may be limited as a result of the new rules impacting the use of NOLs, as described above.

In the case of a corporation, it is unclear whether the consolidated group or each U.S. corporation is the taxpayer for purposes of the limitation. With respect to businesses taxed as a partnership for U.S. federal income tax purposes, the limitation on interest deductions is determined at the partnership level. The unused portion of the 30% limitation with respect to a partner is available to that partner. The 2017 Tax Act contains provisions that prevent double counting of income at the partner level. Similar rules apply to S corporations, which are another form of a pass-through entity.

"The new limitations on interest deductibility will be relevant to businesses relying primarily on interest deductions to reduce net taxable income and to businesses operating at a loss for extensive periods of time."

Notably, real property trades or businesses can elect out of the interest expense deduction limitation. However, upon such an election, such real property trades or businesses are required to use a slightly less favorable depreciation recovery period – one that lengthens the recovery period. Businesses with average gross receipts of USD 25 million or less per year over a three-year period are excepted from the interest expense deduction limitation. In addition, the interest expense deduction limitation does not apply to investment interest.

The new limitations on interest deductibility will be of most relevance to businesses relying primarily on interest deductions to reduce net taxable income and to businesses operating at a loss for extensive periods of time. As a result of both, decreased corporate income tax rates and the 30% limitation, U.S. borrower businesses may favor paying debt with lower interest rates and the prevalence of convertible debt with lower interest rates or preferred stock may increase.

2.4 Increased Expensing. Prior to the 2017 Tax Act, taxpayers were able to elect, subject to certain limitations, to deduct the cost of qualifying property [15], rather than to recover such costs through annual depreciation deductions. The maximum amount that a taxpayer could expend was USD 500 000 of the cost of qualifying property placed in service for the tax year (on a per-property basis). That USD 500 000 amount was reduced by the amount by which the cost of all qualifying property placed in service during that tax year exceeded USD 2 million.

The 2017 Tax Act now allows taxpayers to immediately expend 100% of the cost of qualified property – the definition of which has been expanded as further detailed below – that is placed in service after September 27, 2017 and before January 1, 2023. Certain property with longer production periods placed in service before January 1, 2024 is also eligible. Therefore, new qualified property, as well as *used* qualified property acquired by a taxpayer from an unrelated party, are eligible for immediate expensing. The bonus depreciation percentages will begin to phase down gradually after December 31, 2022 from 100% to zero beginning January 1, 2027.

Under the modified accelerated cost recovery system (i. e., MACRS) starting in 2018, qualified property is defined more broadly as tangible property with a recovery period of 20 years or less, certain off-the-shelf computer software, qualified film or television production, water utility property, qualified improvement property, or qualified live theatrical production. Certain trees, vines and fruit-bearing plants also are eligible for additional depreciation when planted or grafted.

While regulated public utilities are not eligible for immediate expensing, these businesses are not subject to the 2017 Tax Act's limitations on interest deductions discussed above. Moreover, real estate businesses are still eligible for immediate expensing. The type of entity – corporation versus pass-through – will impact the relative importance of the new immediate expensing rules. Further, the specific form of M&A transactions for U.S. federal income tax purposes (e. g., a stock sale versus a deemed asset sale) will change depending on the type of seller; a non-corporate seller taxed at a higher income tax rate (of up to 37%) will be more sensitive to gain on the sale of tangible property under the depreciation recapture rules, whereas a corporate seller is indifferent in light of the flat 21% tax rate. Also, while immediate expensing provides the benefit of lowering cash outlay for taxes upfront, depreciation is generally a timing issue (e. g., a longer recovery period). On the other hand, the limitations on interest deductions are generally permanent.

Due to the elimination of the carryback of NOLs for taxable years beginning after December 31, 2017 [16], and the availability of immediate expensing only after December 31, 2017, corporations will not be permitted to carryback any NOLs attributable to immediate expensing in 2018 to prior years. As noted above in Part B, Section 2, corporations that would otherwise be generating an NOL in their current taxable year may be better off on a post-tax basis by deferring capital expenditures and investments to the subsequent taxable year. Recall the 80% limitation with respect to NOLs. Alternatively, such a corporation could elect out of expensing with respect to one or more classes of property for the NOL year.

3. CHANGES TO THE INTERNATIONAL TAX RULES

3.1 Participation Exemption. The 2017 Tax Act introduces a participation exemption regime, whereby a U.S. corporation that owns 10% or more of a specified 10% foreign corporation can benefit from a 100% *dividends received deduction (DRD)* for the foreign source portion of dividends received from such foreign corporation [17]. The foreign source portion of a dividend is an amount which bears the same ratio to such dividend as (1) the undistributed foreign earnings of such foreign corporation bears to (2) the total undistributed earnings of such foreign corporation [18]. Undistributed earnings are determined at the year-end and without reference to any distributions made during the year [19]. Undistributed foreign earnings are the portion of the undistributed earnings which is attributable to neither: (i) income of the foreign cor-

Graph 2: **EXAMPLE OF CALCULATION OF DRD**

Y AG, a Swiss corporation, has undistributed earnings (calculated without reference to distributions made during the year) of USD 1 million, and the portion of undistributed earnings which is attributable to U. S. effectively connected income is USD 200 000. If Y AG distributes a dividend of USD 100 000 to its 10% U. S. shareholder, the foreign source portion of the dividend that is eligible for the DRD is:

foreign source portion of dividend =

$$\text{USD } 100\,000 \times \frac{\text{USD } 800\,000}{\text{USD } 1\,000\,000} = \text{USD } 80\,000$$

poration which is effectively connected with the conduct of a U. S. trade or business and subject to U. S. income tax, nor (ii) any dividend received (directly or through a wholly owned foreign corporation) from a domestic corporation of which at least 80% of the stock (by vote and value) is owned (directly or through that wholly owned foreign corporation) by the foreign corporation [20]. An example of a DRD calculation can be pictured in *graph 2*.

Basically, therefore, dividends that qualify under the foreign-source DRD will not be subject to taxation in the U. S. This constitutes a radical shift in framework, although its practical significance may be limited in the context of outbound U. S. investment through the introduction of the *global intangible low-taxed income (GILTI)* regime discussed below. Furthermore, the participation exemption regime can only be understood with reference to the mandatory repatriation regime (so that, collectively, they constitute the proverbial "carrot and stick").

In order to benefit from the new participation exemption regime, the U. S. corporation shareholder must have held the stock of the foreign corporation for more than 365 days during the 731-day period beginning 365 days before the ex-dividend date, and the payor must have qualified as a specified 10% foreign corporation at all times during the holding period [21]. The term "dividend received" is intended to be interpreted broadly, and includes a domestic corporation that indirectly owns stock of a foreign corporation through a foreign partnership, provided that the domestic corporation would qualify for the participation DRD with respect to dividends from the foreign corporation if the domestic corporation owned such stock directly [22].

No foreign tax credit or deduction is permitted for U. S. shareholders on dividends that benefit from the DRD [23]. Moreover, for purposes of computing the Code Section 904(a) foreign tax credit limitation, the foreign source portion of any dividend received for which the DRD is taken, and any deductions that are properly allocable or apportioned to that foreign-source portion, are disregarded [24]. Since foreign withholding taxes that are attributable to the foreign-source portion of a dividend that qualifies for the DRD are not creditable for U. S. federal income tax purposes, the possibility to structure outbound investment to benefit from a 0% withholding rate on dividends will assume significant importance. For example, the 5% residual Swiss withholding tax on the dividend distributed by a Swiss subsidiary to its U. S. parent company should not be creditable (insofar as it is attributable to the foreign-source portion of a dividend that qualifies for the DRD) and represents an effective cost of the structure [25]. Conversely, a UK subsidiary distributing dividends to a U. S. parent company bears a 0% withholding rate in analogous circumstances.

> *"The introduction of a participation exemption system is the most significant step towards the U. S. embracing a territorial tax system – similar to the Swiss tax system."*

A U. S. shareholder of a CFC cannot claim a DRD for a hybrid dividend, which is defined as a dividend for which a CFC making the distribution received a foreign income tax deduction or other tax benefit [26].

Gains from the sale of stock of certain foreign corporations that are recharacterized as dividends under Code Section 1248 are also eligible for the DRD, provided that the domestic corporation has held the stock in the foreign corporation for at least one year [27]. Upon receipt of a dividend that qualifies for the DRD, a U. S. shareholder must reduce its basis in the foreign corporation's stock for purpose of determining loss (but not gain) on a future disposition [28].

The 2017 Tax Act does not amend Code Section 956 and the "deemed dividend" rule which treats a CFC's investment in U. S. property as a taxable repatriation for its U. S. shareholders. This is in contrast to the proposals of the House of Representatives and Senate which would have denied the recognition of income when a CFC increases its investment in U. S. property [29]. Therefore, under the 2017 Tax Act, an actual distribution from a CFC to a U. S. corporate shareholder could potentially qualify for the DRD (even where followed by a purchase of U. S. property by the U. S. parent), while a CFC's increased investment in U. S. property is treated as a deemed dividend [30].

Foreign branch income derived by U. S. persons is ineligible for the participation exemption and is not otherwise exempted from U. S. taxation.

The participation exemption regime is effective with respect to distributions made after December 31, 2017 [31]. The introduction of a participation exemption system is the most significant step towards the U. S. embracing a territorial tax system – similar to the Swiss tax system.

3.2 Repatriation Tax in the Transition Period. The 2017 Tax Act introduces a one-time mandatory deemed repatriation tax on accumulated, untaxed earnings of certain *specified foreign corporations (SFS)* [32]. The rationale for imposing the deemed repatriation tax is to permit a transition to the

participation exemption regime for foreign dividends (discussed above). In fact, the repatriation tax creates a *tabula rasa,* it wipes out deferred offshore earnings and, therefore, legitimates the shift to a territorial tax system. Unlike the 2004 repatriation holiday, taxpayers are not required to move the earnings and profits to the U.S. to take advantage of the low rate.

> *"In fact, the repatriation tax creates a tabula rasa, it wipes out deferred offshore earnings and, therefore, legitimates the shift to a territorial tax system."*

Specifically, the repatriation tax provides that the *subpart F income* [33] of a SFC for its last tax year beginning before January 1, 2018, is increased by the greater of the corporation's accumulated post-1986 deferred foreign income determined as of November 2, 2017 *or* December 31, 2017 [34], reduced by deficits in earnings and profits of the SFC (including deficits from other SFCs) [35]. An SFC is a foreign corporation that is a CFC or a foreign corporation that has at least one domestic corporate U. S. shareholder [36]. A U. S. shareholder is a U. S. person who owns 10% or more of the voting power of the foreign corporation's stock [37].

Mechanically, a U. S. shareholder of a SFC includes in its gross income its pro rata share of the deferred income of the SFC that is subject to the repatriation tax. Such U. S. shareholder can benefit from a participation exception, with the result that the mandatory inclusion is taxable at a 15,5% rate

Graph 3: **EXAMPLE OF CALCULATION OF REPATRIATION TAX**

X Corporation, a U. S. C corporation, holds 20% of the stock of Y AG, a Swiss corporation, with USD 200 of post-1986 accumulated earnings and profits, consisting of USD 150 in cash and net accounts receivable and USD 50 in non-cash assets. If X Corp.'s share of earnings and profits deficits from "cash positions" in other SFCs as of November 2, 2017, was USD 50, these could be offset against the USD 150 in cash from Y AG. As a result, X Corp's accumulated post-1986 deferred foreign income equals USD 100 in cash (subject to a 15,5% rate = USD 15,5) and USD 50 in non-cash assets (subject to an 8% rate = USD 4). X Corp. can elect to pay the repatriation tax in 8-year installments in the following manner:

years 1–5	USD 1,56 (each year)
year 6	USD 2,93
year 7	USD 3,90
year 8	USD 4,88
total repatriation tax liability	USD 19,50

(to the extent that it is attributable to a shareholder's aggregate foreign "cash position") or at a 8% rate (to the extent that it is attributable to other assets) [38]. The "cash position" of a SFC is the sum of cash, net accounts receivable, personal property actively traded on a financial market, commercial paper, certificates of deposit, securities of the federal government and any state or foreign government, foreign currency, short-term obligations (of less than one year), and other assets that the Internal Revenue Service (IRS) may identify [39]. There is an exception to avoid double counting of cash positions (this would be the case, for example, where there is a deductible payment such as interest or royalties from one SFC to another SFC between measurement dates) [40].

An anti-abuse rule targets taxpayers that may have engaged in tax strategies to reduce the amount of deferred earnings, such as changing the entity classification, accounting method or taxable year [41].

Graph 4: **EXAMPLE OF CALCULATION OF GILTI**

X Corp., a U. S. C corporation, holds 100% of the stock of Y AG, a Swiss corporation, that is treated as a CFC for U. S. tax purposes.
→ QBAI = USD 1000
→ net CFC tested income = USD 1000

In order to determine GILTI:
→ net CFC tested income (USD 1000) – (10% QBAI [USD 100]) = USD 900

If we further assume that Y AG was subject to foreign taxes of USD 160,00, then the following results:
→ gross-up under Code Section 78 = USD 144,00
as calculated under the following formula:

$$\text{Section 78 gross-up} = \frac{\text{GILTI}}{\text{aggregate tested income}} \times \text{aggregate tested foreign taxes}$$

In essence, this provides that the gross-up is limited to the inclusion percentage of GILTI/aggregate tested income (in this case 90%).
→ GILTI + Code Section 78 gross-up = USD 1044,00
→ GILTI 50% deduction = USD 522,00
→ tentative U. S. federal income tax 21% = USD 109,62

The deemed-paid foreign tax credit follows the same formula as the Section 78 gross-up, with the addition of an 80% limitation =
→ 80% × 144,00 = USD 115,20

The tentative U. S. federal income tax of USD 109,62 can be fully offset with USD 115,20 of foreign tax credits (ignoring allocations). Excess GILTI foreign income tax credits cannot be carried back or carried forward.

A U. S. shareholder that is subject to the repatriation tax may elect to pay the tax in eight installments, with the first five installments equal to 8%, 15% due in the sixth year, 20% due in the seventh year and the remaining 25% due in the eighth and final year [42]. *Graph 3* pictures an example calculation of repatriation tax.

A U. S. corporate shareholder can claim a foreign tax credit to offset the repatriation tax, although 55,7% of the foreign tax credit is disallowed for repatriated earnings held as cash or cash equivalents, and 77,1% for other assets [43].

The repatriation tax permits S corporations to defer payment until the S corporation liquidates, ceases doing business or there is a transfer of the S corporation stock [44].

A U. S. shareholder that pursues a corporate inversion to become an expatriated entity before 2028 is liable to a 35% tax on the full deemed repatriated amount [45].

In short, the repatriation tax is necessary to wipe out deferred foreign earnings before the introduction of the participation exemption regime discussed above. Significantly, while the participation exemption regime is limited in availability to just U. S. C corporations, the repatriation tax applies to a broader spectrum of taxpayers (including partnerships or individuals) – and not just U. S. C corporations.

3.3 Modifications to the CFC rules. The 2017 Tax Act significantly expands the types of income that are subject to annual inclusion to a U. S. shareholder of a CFC irrespective of any distribution, through the introduction of the GILTI [46]. This new type of income, potentially subject to annual inclusions irrespective of distributions, targets a CFC's foreign income that is not deemed attributable to tangible depreciable assets.

A U. S. shareholder's inclusion for GILTI is calculated as a U. S. shareholder's aggregate income of all CFCs (excluding income effectively connected with a U. S. trade or business and subpart F income) – defined as "net CFC tested income" – less the excess of 10% of the CFCs' aggregate adjusted bases in depreciable tangible property (defined as *qualified business asset investment [QBAI]*) used in the trade or business over the net interest expense [47].

GILTI = net CFC tested income –
([10% × QBAI] – interest expense)

A U. S. corporation can benefit from a 50% deduction (reduced to 37,5% in 2026) with respect to GILTI income inclusions [48], and can be eligible for a foreign tax credit of up to 80% of the foreign taxes deemed paid [49]. A new foreign tax credit basket is introduced with respect to GILTI, so that foreign tax credits attributable to GILTI can only offset U. S. federal income tax on GILTI inclusions [50]. There is no carryback or carryforward with respect to excess foreign income tax credits attributable to GILTI inclusions [51]. In essence, this means that the effective tax rate on GILTI is 10,5%. Because of the partial foreign tax credit (80% limitation), the minimum foreign tax rate that is required to have no U. S. residual tax is 13,125%. Foreign taxes deemed to have been paid are treated as an increase in GILTI under Code Section 78 (determined by taking 100% of the inclusion percentage and aggregate tested foreign income taxes). An example of calculation of GILTI is pictured in *graph 4*.

The focus on depreciable tangible property under the computation of a CFC's GILTI inclusion creates incentives for CFCs to increase tangible assets which can be pursued by either (1) repatriation of intangible assets or (2) additional investment in tangible assets by CFCs (which, paradoxically, are presumably located in foreign jurisdictions).

"The BEAT essentially limits inter-company deductible payments which could otherwise strip earnings from the U. S. payor."

The focus on aggregation of a U. S. shareholder's CFC net tested income can be both beneficial (insofar as disparities in the tangible property between CFCs can be counterbalanced), but also limitative, insofar as intragroup transfers may have no net change on the equation.

In addition to the introduction of GILTI, the 2017 Tax Act significantly alters the definitional rules connected with CFCs. The definition of a U. S. shareholder is expanded to include U. S. persons who own 10% or more of the voting power *or total value* of a foreign corporation (opposed to prior law, which limited the determination to a 10% voting power threshold) [52]. The stock attribution rules are modified to allow attribution of stock of a foreign corporation to a domestic corporation from its foreign shareholder, to a domestic partnership from its foreign partner, or to a domestic trust or estate from its foreign grantor or beneficiary [53]. As such, foreign subsidiaries of a foreign parent company could now be treated as CFCs (because of the stock-attribution rules now operating downward through a common foreign parent) [54]. The requirement that a foreign corporation be a CFC for an uninterrupted 30-day period in a taxable year in order to trigger an income inclusion for the U. S. shareholder is repealed [55], so that a U. S. shareholder is subject to subpart F income inclusions if the foreign corporation was a CFC at any point during the taxable year. Finally, the foreign base company oil related income category (previously, another form of subpart F income inclusion) was also repealed [56].

When coupled with other base erosion preventive measures contained in the 2017 Tax Act (such as the base erosion minimum tax and the expanded definition of "intangibles" described below), there is now a strong tax incentive for U. S. corporations to have more tangible property outside of the U.S. to reduce or eliminate the bite of GILTI, especially for low margin manufacturers. Nevertheless, as the definition of "intangible" includes not only *intellectual property (IP)* assets that have a direct connection with research and development (R&D) activities but also design, copyrights and know-how, there are concerns among EU member states that the new law deviates from the OECD's agreed modified nexus approach [57].

3.4 Foreign-Derived Intangible Income Deduction. The 2017 Tax Act also provides for a 37,5% deduction for *foreign-derived intangible income (FDII;* reduced to 21,875% in 2026) [58]. In essence, FDII operates as an incentive for U.S. corporations to sell goods and provide services to foreign customers.

Foreign-derived intangible income is the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. In other words, FDII is deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived [59].

$$\text{FDII} = \text{deemed intangible income} \times \frac{\text{(foreign derived deduction eligible income)}}{\text{deduction eligible income}}$$

Deemed intangible income is the excess of deduction eligible income over its deemed tangible income return [60]. The deemed tangible income return is an amount equal to 10% of the corporation's qualified business asset investment.

$$\text{deemed intangible income} = \text{deduction eligible income} - (10 \times \text{QBAI})$$

Foreign-derived deductible eligible income is any deduction eligible income of the taxpayer that is derived in connection with property that is sold by the taxpayer to any non-U.S. person for foreign use; or services provided by the taxpayer to a non-U.S. person or with respect to non-U.S. property [61].

Deduction eligible income is equal to the gross income of the corporation minus income from CFCs and foreign branches, GILTI, financial services income and domestic oil and gas income [62].

$$\text{deduction eligible income} = \text{gross income} - \text{exceptions} - \text{allocable deductions}$$

In very simplified terms, the FDII deduction provides an effective tax rate of 13,125% for profits derived from sales into foreign markets for high-margin goods and services. This measure encourages U.S. corporations to engage in foreign exports (and therefore, keep production activities in the United States).

3.5 Measures to prevent base erosion. The 2017 Tax Act imposes a base erosion minimum tax, frequently referred to as the BEAT on a U.S. corporation's "modified taxable income" [63]. The BEAT essentially limits inter-company deductible payments which could otherwise strip earnings from the U.S. payor.

The base erosion minimum tax amount is the excess of 10% of the corporation's "modified taxable income" (the tax rate is reduced to 5% for 2018, and increased to 12,5% from 2026) over the tax otherwise imposed on the corporation, after reduction for credits, but adding back (i) 100% of the research credit of Code Section 41(a) and (ii) 80% of the lesser of (a) the low-income housing credit, the renewable electricity production credit, and certain investment credits allocable to the energy credit, or (b) the minimum tax amount (determined without regard to the addition of 80% of such credits) [64]. However, all other credits, including foreign tax credits, are not added back and have the effect of reducing ordinary income tax when compared to modified taxable income for purposes of the BEAT.

Graph 5: **EXAMPLE OF CALCULATION OF BEAT**

X Corporation, a U.S. C corporation, has taxable income from operations of USD 100. It then incurs the following payments in favor of foreign related parties:
- royalties for license of IP rights USD 50
- management fees USD 20
- interest expense USD 50

On these facts, modified taxable income = USD 220 (USD 100 + USD 50 + USD 20 + USD 50 = USD 220).

The tentative tax liability (ignoring BEAT) is USD 21 (USD 100 × 21%).

Because 10% of the modified taxable income > X Corporation's tentative tax liability, BEAT is due.

BEAT = 10% modified taxable income (USD 22) – regular tax liability (USD 21) = USD 1

Modified taxable income is a corporation's taxable income, increased by certain base erosion payments [65]. A base erosion payment includes deductible payments that the corporation makes to a foreign related party [66]. A "base erosion payment" does not include payments that are subject to tax under sections 871 or 881 and on which the full amount of tax has been withheld under sections 1441 and 1442 [67], as well as payments for services if the amount is based on the services cost method of Code Section 482 [68]. Significantly, base erosion payments should also not include any amount that constitutes "reductions in gross receipts", including payments for cost of goods sold [69].

"In very simplified terms, the FDII deduction provides an effective tax rate of 13,125% for profits derived from sales into foreign markets for high-margin goods and services."

The rationale for this provision is to target U.S. corporations that reduce their U.S. tax base by making large deductible payments to foreign related parties (in the form of deductible interest or royalties). As enacted in the 2017 Tax Act,

the BEAT largely follows the Senate's proposal rather than the House of Representatives' proposal for an excise tax [70]. Concerns have been raised that the BEAT would infringe World Trade Organization (WTO) obligations of the United States. In fact, U.S. treaty partners are concerned by the discriminatory nature of BEAT, insofar as it targets foreign related party payments (and not payments to all related parties).

> *"Switzerland would be well advised to reduce the residual Swiss withholding tax on dividends to zero as the two states proposed in 2009."*

The BEAT does not apply to regulated investment companies (RICs), real estate investment trusts (REITs) or S corporations [71]. Moreover, the minimum tax applies only to U.S. corporations that have average annual gross receipts of at least USD 500 million for the three preceding taxable years, and are making base erosion payments that represent 3% or more of all of its deductions, excluding NOL deductions, the new foreign DRD, and the foreign-derived intangible income and GILTI deductions (for members of an affiliated group that includes a bank or securities dealer, there is a 2% threshold) [72]. The BEAT is also imposed on the income of foreign corporations that is effectively connected with the conduct of a U.S. trade or business (provided the other qualifying thresholds are also satisfied) [73]. *Graph 5* pictures an example of calculation of BEAT.

From a transfer pricing perspective, the 2017 Tax Act modifies the definition of intangible property for purpose of Code Section 367(d) and 482, to include workforce in place, goodwill (both foreign and domestic), going concern value, and all other items of value not attributable to tangible property or services of an individual [74]. For outbound transfers, a significant change is the repeal of the active business exception of Code Section 367(a)(3) for outbound transfers of assets used in the active conduct of a trade or business outside of the United States, so that all outbound transfers of tangible or intangible assets should now be subject to gain recognition [75]. Furthermore, if a domestic corporation transfers substantially all of the assets of a foreign branch to a specified 10% owned foreign corporation with respect to which it is a U.S. shareholder after the transfer, the domestic corporation includes in gross income an amount equal to the transferred loss [76]. Furthermore, the 2017 Tax Act creates a new foreign tax credit basket for foreign taxes attributable to branches [77].

Another significant measure to contrast base erosion is the denial of a deduction for interest and royalty payments made to a related party in a hybrid transaction or by or to a hybrid entity, if there is no income inclusion in the foreign country (or by a U.S. shareholder as subpart F income) [78].

The 2017 Tax Act strengthens the policy of limiting inversions by denying qualified dividend income treatment to dividends that are received from corporations that invert after December 22, 2017 (with the result that these dividends cannot benefit from the preferential 20% available to non-corporate taxpayers) [79].

The 2017 Tax Act also alters the existing interest expense allocation regime under Code Section 864(e) by allocating worldwide interest expense among members of an affiliated group based on the members' adjusted tax bases in their assets, rather than the fair market value of such assets [80].

4. CONCLUSIONS

The 2017 Tax Act will have a significant impact on U.S. and international tax policy. Through the reduction in corporate income tax rates, the U.S. has suddenly transformed itself from a high-tax jurisdiction to a favorable tax jurisdiction for corporations, meaning that the emphasis on reducing non-U.S. income taxes for U.S. multinationals will acquire ever greater importance. The unilateral approach pursued by the U.S. in addressing base erosion and profit shifting has come under increasing criticism, as measures such as BEAT, FDII and GILTI are at odds with the multi-national cooperative approach to international tax policy that is generally pursued by the OECD through the BEPS initiative [81]. The 2017 Tax Act is also likely to generate regulatory arbitrage as foreign jurisdictions are under significant pressure to respond to the U.S. regime through changes in their own domestic tax legislation.

From a Swiss perspective, the foreign participation exemption regime and reduction in corporate tax rates may render the residual 5% Swiss withholding tax on dividends paid to a U.S. corporation a sunk cost of doing business through a Swiss subsidiary. Measures such as GILTI and FDII may also encourage U.S. multinationals to repatriate IP held with Swiss subsidiaries. Accordingly, Switzerland would be well advised to reduce the residual Swiss withholding tax on dividends to zero as the two states proposed in 2009.

On the other hand, for U.S. subsidiaries of Swiss corporations, tax planning will assume greater importance in order to avert the risk of a "reverse-lock-in" effect, with profits trapped at the U.S. subsidiary level and significant limitations on how these can be distributed to the Swiss parent company because of BEAT and the limitation on interest payments. ■

> *"The 2017 Tax Act is likely to generate regulatory arbitrage as foreign jurisdictions are under significant pressure to respond to the U.S. regime through changes yin their own domestic tax legislation."*

Notes: 1) In 1986, the U.S. Internal Revenue Code was significantly amended by the Tax Reform Act of 1986. Unless otherwise indicated, all references to Code Sections herein are to the Internal Revenue Code of 1986, as amended, including in particular by the 2017 Tax Act (the "Code"). **2)** A CFC generally is defined as any foreign corporation if U.S. persons own (directly, indirectly, or constructively) more than 50% of the corporation's stock (measured by vote or value) considering only those U.S. persons that are within the meaning of the term "U.S. shareholder" (which refers only to those U.S. persons who own at least 10% of the stock). Code Section 951. **3)** In this article, the reference to "domestic" refers to "U.S.", while the reference to "foreign" refers to "non-U.S.". **4)** Code Section 11(b). **5)** Amanda Athanasiou, U.S. Tax Reform Will Affect Global M&A, Experts Say, Tax Notes Worldwide Tax Daily, January 23, 2018. **6)** Code Section 55. **7)** Example: A corporation reports USD 25 000 losses from operations. It receives USD 100 000 in dividends from a 20%-owned corporation. Its taxable income is USD 75 000 before the deduction of dividends received. Non-operating losses cannot be carried back and forward. **8)** Code Section 382. **9)** Code Section 172. **10)** This means capital investments would be delayed until 2020 and the corporation would elect out of immediate expensing (see Part A, Section 4). **11)** Code Section 163(j) (pre-2017 Tax Act). **12)** A corporation is considered thinly capitalized when its debt-to-equity ratio exceeds 1,5 to 1. **13)** Code Section 163(j). **14)** Note that Subpart F income and GILTI, described in further detail below, would increase ATI, but the receipt of any dividends exempt under the new participation exemption would not increase ATI. **15)** See term below. **16)** See section A.2.2 above. **17)** Code Section 245A(a). A "specified 10% foreign corporation" is a foreign corporation to which a U.S. corporation is a 10% shareholder but does not include passive foreign investment companies (PFICs). Provided that there is a 10% U.S. shareholder, it is not necessary for the foreign corporation to be a CFC. Code Section 245A(b)(1), and (2). **18)** Code Section 245A(c). **19)** Code Section 245A(c)(2). **20)** Code Section 245A(c)(3). **21)** Code Section 246(c)(5). This holding period requirement is extended to two years in the case of preferred dividends. **22)** Joint Explanatory Statement of the Committee of Conference, page 470. **23)** Code Section 245A(d). Significantly, the indirect foreign tax credit of Code Section 902 has also been repealed. **24)** Code Section 904(b)(5). **25)** Swiss-U.S. Income Tax Treaty, Article 10, paragraph (2)(a). **26)** Code Section 245A(e). This corresponds with Art. 70 para. 2b of the Swiss Federal Direct Tax Act. **27)** Code Section 1248(j). Code Section 1248 functions to prevent U.S. shareholders from repatriating CFC earnings at capital gains rates instead of as dividends through the sale or disposition of CFC stock. In fact, Code Section 1248 provides that gain on a sale of CFC stock by a 10% U.S. shareholder who held the stock at any time during the 5-year period ending on the date of the disposition is recharacterized as dividend income to the extent of the untaxed earnings and profits attributable to that stock. The 2017 Tax Act provides that in the sale or exchange by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend under Code Section 1248 shall be treated as a dividend for purposes of the DRD. By way of example, assume that a U.S. corporate taxpayer, X Corp., that held 90% of a CFC's stock sold it for a gain of USD 1 000 000 on June 30, 2018. The CFC had accumulated earnings and profits of USD 300 000, and USD 300 000 in earnings and profits before any distribution in such year. On September 15, 2018, the CFC pays a dividend of USD 200 000 to the new shareholder (the purchaser of the shares). The CFC's USD 300 000 in earnings and profits for the year of sale are reduced by the USD 200 000 dividend. Of the remaining USD 100 0000, USD 49 863 (182/365 × USD 100 000) is attributable to that part of the year during which X Corp. was a shareholder in the CFC. Of the USD 49 863, USD 44 877 (0,90 × USD 49 863) is attributable to X Corp.'s former 90% interest. The USD 44 877 is then added to taxpayer's 90% share of the CFC's accumulated earnings and profits (0,90 × USD 300 000 = USD 270 000) to produce a total of USD 314 877 which is that part of X Corp.'s gain which must be reported as dividend income. X Corp could claim a DRD with respect to the foreign-source portion of such dividend, in accordance with the rules of Code Section 245A. **28)** Code Section 961(d). **29)** Joint Explanatory Statement of the Committee of Conference, page 472. **30)** Lee A. Sheppard, International Clawbacks and Minimum Taxes in Tax Reform, Tax Notes International, January 1, 2018, 9, 16. **31)** Code Section 245A(f). **32)** Code Section 965. **33)** Under the subpart F rules, the U.S. generally taxes the 10% U.S. shareholders of a CFC on their pro rata shares of certain income of the CFC, without regard to whether the income is distributed to the shareholders. In effect, the U.S. treats the 10% U.S. shareholders of a CFC as having received a current distribution of the corporation's subpart F income. Subpart F income generally includes passive income and other income that is readily movable from one taxing jurisdiction to another. Code Section 951. **34)** Code Section 965(a). The Internal Revenue Service (IRS) issued IRS Notice 2018-7 and Irs Notice 2018-13 in which it announced the intention to issue regulations to clarify the amounts to be included in gross income by a U.S. shareholder under the repatriation tax. A number of fact patterns were raised as controversial because of insufficient guidance under current law. As an example, the IRS outlined the following example: X Corp, a U.S. corporation, owns all of the stock of CFC 1, a foreign corporation, which owns all of the stock of CFC 2, also a foreign corporation. X Corp, CFC 1, and CFC 2 have calendar year taxable years. On November 2, 2017, each of CFC 1 and CFC 2 has post-1986 earnings and profits of 100u. Neither CFC [1] nor CFC 2 has previously taxed income or effectively connected income for any taxable year, and therefore each of CFC 1's and CFC 2's accumulated post-1986 deferred foreign income is equal to such corporation's post-1986 earnings and profits. On November 3, 2017, CFC 2 makes a deductible payment of 10u to CFC 1. The payment does not constitute subpart F income. CFC 1 and CFC 2 have no other items of income or deduction. Absent any adjustments, on December 31, 2017, CFC 1 has post-1986 earnings and profits of 110u (100u plus 10u income from the deductible payment), and CFC 2 has post-1986 earnings and profits of 90u (100u minus 10u deductible expense). The section 965(a) earnings amount with respect to CFC 1 would be 110u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 110u accumulated post-1986 deferred foreign income on December 31, 2017, and the section 965(a) earnings amount with respect to CFC 2 would be 100u, the greater of 100u accumulated post-1986 deferred foreign income on November 2, 2017, and 90u accumulated post-1986 deferred foreign income on December 31, 2017. Disregarding the intercompany deductible payment, CFC 1 and CFC 2 would have, in the aggregate, section 965(a) earnings amounts of 200u. However, taking the deductible payment into account, CFC 1 and CFC 2 would have, in the aggregate, section 965(a) earnings amounts of 210u, because the 10u of income from the deductible payment would increase the post-1986 earnings and profits of CFC 1 as of December 31, 2017, but the 10u of deductible expense would not decrease the post-1986 earnings and profits of CFC 2 as of November 2, 2017. In Irs Notice 2018-7, page 13, the IRS clarified that an adjustment should be made on these facts with the result that CFC 1 and CFC 2 would have, in the aggregate, section 965(a) earnings amounts of 200u. **35)** Code Section 965(b). For example, assume that a Swiss corporation has USD 100 of accumulated earnings and profits as of the relevant measuring date (November 2 or December 31, 2017), which consist of USD 120 general limitation earnings and profits and a USD 20 passive limitation deficit. In this case, the Swiss corporation's post-1986 earnings and profits would be USD 100, even if the USD 20 passive limitation deficit was a hovering deficit. Joint Explanatory Statement of the Committee of Conference, page 490. Irs Notice 2018-13, at 16. A hovering deficit is, in simplified terms, deficits in earnings and profits inherited from a transferor in a corporate reorganization that offset the transferee's post-acquisition earnings and profits. Treas. Reg. 1.367(b)-7(d)(2). **36)** Code Section 965(e). **37)** Code Section 951(a)(1). Significantly, the change in the definition of "U.S. shareholder" to include a shareholder that holds 10% of the vote or value is effective for tax years beginning after December 31, 2017 and should not apply to the repatriation tax. **38)** Code Section 965(c). **39)** Code Section 956(c)(3)(B). Cash or cash equivalents that cannot be distributed to a U.S. shareholder because of foreign law restrictions are not treated as cash. **40)** Code Section 965(c)(3)(D); Joint Explanatory Statement of the Committee of Conference, page 490. For individuals, the applicable rates are 17,5% for the "cash position" and 9,05% for non-cash assets. **41)** Code Section 965(c)(3)(F); Joint Explanatory Statement of the Committee of Conference, page 491. **42)** Code Section 956(h). **43)** Code Section 965(g). **44)** Code Section 965(i). **45)** Code Section 965(l). **46)** Code Section 951A. Joint Explanatory Statement of the Committee of Conference, page 517, clarifies how GILTI inclusions do not constitute subpart F income, although they are generally treated similarly to subpart F inclusions. **47)** Code Section 951A(b). **48)** Code Section 250(a)(1)(B). **49)** Code Section 960(d)(1). **50)** Code Section 904(d)(1)(A). **51)** Code Section 904(c). **52)** Code Section 951(b). **53)** Code Section 958(b). **54)** However, the change in the attribution rules will determine subpart F income inclusion for a U.S. shareholder only if the U.S. shareholder is a direct or indirect interest holder under Code Section 958(a). **55)** Tax Act of 2017, Section 14215. **56)** Tax Act of 2017, Section 14211. **57)** See generally, OECD/G20 Base Erosion and Profit Shifting Project, Action 5: Agreement on Modified Nexus Approach for IP Regimes. **58)** Code Section 250(a)(1). **59)** Code Section 250(b). **60)** Code Section 250(b)(2). **61)** Code Section 250(b)(4). **62)** Code Section 250(b)(3). **63)** Code Section 59A. **64)** Code Section 59A(b). **65)** Code Section 59A(c). **66)** Code Section 59A(d). **67)** Code Section 59A(c)(2)(B). **68)** Code Section 59A(d)(5). **69)** Joint Explanatory Statement of the Committee of Conference, page 532. **70)** Joint Explanatory Statement of the Committee of Conference, page 531. **71)** Code Section 59A(e)(1)(A). **72)** Code Section 59A(e)(1)(B), (C). **73)** Code Section 59A(e)(2)(A). **74)** Code Section 936(h)(3)(B)(iv). **75)** Tax Act of 2017 Section 14102; Code Section 367(d). **76)** Code Section 91(a). **77)** Code Section 904(d)(1)(B). **78)** Code Section 267A. **79)** Code Section 1(h)(11)(C)(iii)(II). **80)** Code Section 864(e)(2). **81)** See also, Mindy Herzfeld, Competition or Coordination: Responses to the Tax Cuts and Jobs Act, Tax Notes, January 16, 2018.