TAX CUTS AND JOBS ACT ADOPT PROVISIONS TO PREVENT BASE EROSION

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INTRODUCTION

Following the lead of the O.E.C.D. and the European Commission ("E.C."), the Tax Cuts and Jobs Act ("T.C.J.A.") adopts several provisions designed to end certain tax planning opportunities. Provisions such as these are often described as attacks on base erosion and profit shifting. In bygone days, the targeted plans were known as innovative. Now, they are characterized as abusive.

In some instances, the T.C.J.A. closely follows counterpart provisions recommended by the O.E.C.D. and adopted by the E.C. In others, the provisions that are specific to U.S. tax law.

GLOBAL INTANGIBLE LOW-TAX INCOME

With the adoption of a dividends received deduction ("D.R.D."), the T.C.J.A. embraces a provision that prevents large U.S.-based groups from reducing U.S. tax through base eroding payments only to have these payments return to the U.S. in a tax-free manner under the D.R.D. The new Code §951A imposes a claw-back tax on U.S. corporations that make tax reducing payments to controlled foreign corporations ("C.F.C.'s"). The receipt of those payments leads the item to be included in the gross income of the C.F.C.'s "U.S. Shareholder," as defined under **Broadened Scope of Subpart F** below, as Global Intangible Low-Tax Income ("G.I.L.T.I."), to the extent a base amount is exceeded.[1] The base amount equals 10% of the taxpayer's Qualified Business Asset Investment. The inclusion is taxed at a special low rate of 10.5%, with a foreign tax credit allowed – albeit capped at 80% of the G.I.L.T.I. This ensures that a tax of at least 10.5% will be paid on the income, and if tax is imposed abroad, a global tax of 13.5% will generally be paid.

REVISION TO LIMITATIONS ON INTEREST EXPENSE DEDUCTIONS UNDER CODE §163(J)

Prior Law

Provisions designed to prevent "earnings stripping" were first adopted by the U.S. when Code §163(j) was adopted in 1989. Its goal was to prevent erosion of the U.S. tax base through excessive deductions for interest paid by a taxable corporation to a related party that was not fully taxed in the U.S. on the receipt of the income.

Under prior law, the provision disallowed a deduction for "disqualified interest" paid

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[1] The G.I.L.T.I. provision is discussed in greater detail in this edition of Insights in "A New Tax Regime for C.F.C.'s: Who Is G.I.L.T.I.?"

or accrued by a corporation in a taxable year if two threshold tests were satisfied. First, the payor's debt-to-equity ratio exceeded 1.5 to 1.0. Second, the payor's net interest expense exceeded 50% of its adjusted taxable income, generally, E.B.I.T.D.A. (earnings before interest, taxes, deprecation, and amortization) with certain adjustments for tax concepts.

Disqualified interest included, *inter alia*, interest paid or accrued to (i) related parties outside the U.S. that were not subject to full withholding tax and (ii) unrelated parties when the obligation was guaranteed or supported by a related party. Interest expense deductions disallowed under these rules could be carried forward indefinitely, and any excess limitation could be carried forward for three years.

T.C.J.A.

The T.C.J.A. expands the scope of Code §163(j) so that it is no longer a provision designed to prevent base erosion through payments to related parties. It is now a provision designed to limit the use of debt to fund the acquisition of business assets and the operation of a business in the U.S.

For taxable years beginning after 2017, the deduction for business interest is limited to the sum of

- business interest income,
- 30% of the adjusted taxable income of the taxpayer for the taxable year, and
- floor plan financing[2] interest on loans used to finance the acquisition of motor vehicles.

For taxable years beginning after December 31, 2017, and before January 1, 2022, adjusted taxable income is generally computed as under prior law.[3] Thereafter, adjusted taxable income is generally equivalent to E.B.I.T. At that point, depreciation, amortization, and depletion will no longer be added back to income for purposes of determining the base on which the 30% cap is computed.

The amount of any business interest not allowed as a deduction for any taxable year may be carried forward indefinitely, subject to certain restrictions applicable to partnerships.

Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Code is interest for purposes of the provision. Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year that is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment

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[2] "Floor plan financing" is a type of short-term loan used by retailers to purchase high-cost inventory such as automobiles. These loans are often secured by the inventory purchased as collateral.

[3] One of the adjustments under current law is the deduction under Code §199 for domestic production activities. This deduction is eliminated by the T.C.J.A. and is excluded from the adjustments.

income, within the meaning of Code 163(d).[4]

The limitation applies at the taxpayer level. Where a business is carried on through a partnership, including an L.L.C., the partners ignore their respective distributive shares of income, gain, deduction, or loss when calculating adjusted taxable income.[5] However, a partner of a partnership may deduct additional interest expense to the extent the partnership could have deducted more business interest. The additional interest that may be claimed by each partner is computed by a formula.

Certain businesses are not covered by revised Code §163(j). These include the following:

- Taxpayers with average annual gross receipts for a three-taxable-year period, ending with the prior taxable year, that do not exceed $25 million
- A taxpayer in the trade or business of performing services as an employee
- An electing real property trade or business
- An electing farming business
- A taxpayer in the trade or business of furnishing or selling (i) electrical energy, water, or sewage disposal services, (ii) gas or steam through a local distribution system, or (iii) transportation of gas or steam by pipeline, provided that in all such businesses the rates are subject to regulatory approval

HYBRID TRANSACTIONS AND ENTITIES

Prior Law

The use of hybrid entities and hybrid transactions has been a staple of U.S. tax planners for many years.

An example of a plan involving a hybrid entity includes royalty or interest payments between C.F.C. subsidiaries in different foreign countries where both subsidiaries make elections to be disregarded entities. If the recipient of the payment is based in a low-tax or no-tax country, the payment may be deductible for the payor, subject to little or no tax for the recipient. At the same time the payment may not be viewed to be Foreign Personal Holding Company Income because it is viewed for U.S. purposes to be an internal transaction within one C.F.C.[6]

An example of a hybrid transaction involves a U.S.-based group with a Luxembourg holding company that issues a contingent participating equity certificate to a group member. In Luxembourg, the payment is treated as interest and is not subject to

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[4] Interest expense incurred of a taxpayer other than a corporation on a borrowing to make an investment is deductible only to the extent of interest income.

[5] Similar treatment is applied to S-corporations and their shareholders.

[6] Even if the entities do not elect to be treated as disregarded entities for U.S. income tax purposes, the payments may avoid Foreign Personal Holding Company Income characterization by reason of Code §954(c)(6), which characterizes the income of the recipient by reference to the character of the payor's income that is reduced by the payment.

withholding tax. At the same time, the recipient of the payment takes the position that it may treat the payment as a dividend on which a D.R.D. is allowed under local law.[7]

T.C.J.A.

Two provisions in the T.C.J.A. limit the use of hybrid transactions and entities to reduce tax in a cross-border setting. One is Code §267A, which relates to deductions claimed for hybrid payments,[8] and the other is Code §245A, which relates to the new D.R.D. provision of U.S. tax law.[9]

Code §267A

A deduction is disallowed for any "disqualified related party amount" that is paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party amount is any interest or royalty paid or accrued to a related party to the extent that either of the following are true:

- There is no corresponding inclusion to the related party under the tax law of the country of which the related party is a resident for tax purposes or is subject to tax.
- The related party is allowed a deduction with respect to the amount under the tax law of that country.

"A hybrid dividend received by a U.S. shareholder from a C.F.C. does not qualify for the D.R.D. . . . A comparable provision applies in the international context."

A related party for these purposes is determined under the rules of Code §954(d)(3), which is applied to the payor as opposed to the C.F.C.

A hybrid transaction is any transaction, agreement, or instrument involving one or more payments that are treated as interest or royalties for Federal income tax purposes when comparable treatment is not provided to the recipient for purposes of the tax law in its country of residence (or in a country where the recipient is subject to tax).

A hybrid entity is any entity that meets either of the following conditions:

- It is treated as fiscally transparent for Federal income tax purposes but not for purposes of the tax law of the foreign country of residence (or in a country where it is subject to tax)
- It is treated as fiscally transparent, or is subject to tax, for purposes of the tax law of the foreign country of which the entity is resident for tax purposes but is not so treated for Federal income tax purposes.

Under an exception, a disqualified related party amount does not include any payment to the extent such payment is included in the gross income of a U.S. Shareholder under Code §951(a).

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[7] The opportunity for dividend treatment has been curtailed in recent years under the O.E.C.D.'s B.E.P.S. initiative, the multilateral tax convention, and various E.C. directives.

[8] Code §267A.

[9] Code §245A.

Code §245A

This section provides that a hybrid dividend received by a U.S. shareholder from a C.F.C. does not qualify for the D.R.D. A hybrid dividend means an amount received from a C.F.C. that would qualify for the deduction under Code §245A except that the C.F.C. distributing the dividend received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or possession of the U.S.

A comparable provision applies in the international context when a C.F.C. receives a hybrid dividend from any other C.F.C. and the same U.S. corporation is a U.S. Shareholder of both C.F.C.'s. Where those facts exist, the hybrid dividend is treated as Subpart F income, discussed below, notwithstanding any other provision of the Code. The U.S. Shareholder is taxed on the Subpart F income inclusion.

BROADENED SCOPE OF SUBPART F

Subpart F is applicable to C.F.C.'s and their U.S. Shareholders, as defined below. It is the principal anti-deferral regime of relevance to a U.S.-based multinational corporate group.

A C.F.C. generally is defined as any foreign corporation in which U.S. Shareholders own (directly, indirectly, or constructively) shares representing more than 50% of the corporation's voting power or value.

Under the Subpart F, U.S. Shareholders of a C.F.C. are taxed on their *pro rata* shares of certain C.F.C. income (referred to as Subpart F income). Subpart F income is included in the income of a U.S. Shareholder automatically. Thus, the taxable event does not require the receipt of a dividend from the C.F.C. Within certain limitations, dividends that are paid by a C.F.C. in the year of an inclusion in income, or a subsequent year, are deemed to come from previously taxed earnings of the C.F.C. This means that Subpart F income is taxed on a priority basis in relation to dividends, and consequently, is not taxed when received.

With exceptions, Subpart F income generally includes passive income – dividends, capital gains, interest, and royalties – and other income that is readily movable from one taxing jurisdiction to another. Examples are foreign base company sales income – generally arising from cross border trading activities involving a related supplier or customer based in a third country – and foreign base company services income – generally income from services performed in third countries for or on behalf of a related party.

Certain rules of attribution applied to treat shares owned by one person as if owned by another. In certain circumstances shares could be attributed from shareholders to a U.S. corporation, from one family member to another, and from trusts to beneficiaries. Also, shares could be attributed from corporations to shareholders, from partnerships to partners, and from partners to partnerships.

Prior Law

Under prior law, a U.S. Shareholder was a U.S. person that owned shares of the foreign corporation having 10% of the voting power. U.S. persons include U.S. citizens, U.S. residents, U.S. corporations, U.S. domestic trusts or estates, and U.S.

partnerships and L.L.C.'s.

Shares could not be attributed from a nonresident, noncitizen individual to a U.S. citizen or resident. Also, shares could not be attributed from a foreign corporation that is a shareholder to a U.S. corporation.

Congress became aware of a relatively simple method to decontrol a C.F.C. without imposing U.S. tax after a foreign corporation acquires a U.S.-based multinational group with foreign subsidiaries. Rather than sell the subsidiaries, the foreign parent of the U.S.-based group could invest in each of the C.F.C.'s and receive sufficient voting shares to own at least 50% of the voting power of the foreign subsidiaries. Those newly issued shares were not attributed to the U.S.-based group.

In addition, before Subpart F could apply to a C.F.C. and its U.S. Shareholders, a foreign corporation was required to be a C.F.C. for 30 days during the taxable year.

T.C.J.A.

Several changes are made to broaden the circumstances in which a U.S. person can be viewed to be a U.S. Shareholder and a foreign corporation can be a C.F.C.

Change in Definition of "U.S. Shareholder"

The T.C.J.A. revises the definition of U.S. Shareholder. A U.S. person can now be a U.S. Shareholder if it owns shares representing 10% of the voting power or 10% of the value of the foreign corporation.

Attribution from Foreign Corporations

Generally, attribution from a foreign parent of stock in a foreign corporation will occur only when a U.S. person actually owns shares in the foreign corporation.

To address the decontrol issue mentioned above, the law is now changed, so that the newly issued shares can be attributed to the U.S.-based group from the foreign parent. The Conference Committee report states that this change in law is intended to apply primarily to stop the use of decontrol plans. Hence, the focus on attribution when some stock is actually owned by the U.S. corporation.

Under the T.C.J.A., the *pro rata* share of a C.F.C.'s Subpart F income that may be taxed in the hands of a U.S. Shareholder continues to be determined based on direct or indirect ownership of the C.F.C., without application of the new downward attribution rule. In addition, the attribution rules remain unchanged for purposes of determining whether a Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, must be filed by a U.S. person.

Repeal of the 30-Day Rule

The T.C.J.A. repeals the 30-day requirement for a foreign corporation to be a C.F.C. in order for Subpart F to apply. Thus, if a foreign person owns all the shares of a foreign corporation, and a U.S. person acquires those shares within the 29-day period ending on the last day of the C.F.C.'s year, Subpart F applies to the U.S. acquirer for that for the days of ownership within the 29-day period. This prevents the foreign corporation from disposing of its assets without U.S. tax during the 29-day period without a potential tax imposed on the U.S. Shareholder.

CHANGES TO OUTBOUND TRANSFER RULES

Prior Law

Although a U.S. taxpayer generally was not permitted to transfer certain assets to a foreign corporation without recognizing gain,[10] an exception was provided for certain transfers of property for use in an active business conducted abroad.[11] Certain assets were not covered by this exception. These assets included (i) inventory, copyrights, or similar property; (ii) installment obligations, accounts receivable, or similar property; (iii) foreign currency or other property denominated in foreign currency; (iv) intangible property; and (v) property for which the transferor was the lessor at the time of transfer, unless the transferee is the lessee.[12] If the asset transfer was part of the incorporation of a foreign branch that generated losses, gain was required to be recognized in an amount equal to the previously recognized net loss.

"The I.R.S. unilaterally attempted to expand the list of intangible property under Code §936."

A separate rule applied to transfers of intangible property as part of a tax-free transaction.[13] Rather than mandating immediate gain recognition on the transfer, Code §367(d) provided that the transaction would be treated as a sale for contingent consideration based on productivity, use, or disposition of the transferred intangible property. For this purpose, intangible property was defined by reference to Code §936(h). One issue that arose was whether locally developed good will and workforce in place were items of intangible property covered by Code §367(d), as they are not among the listed items specified in Code §936(h).

This provision had many similarities with the buy-in provisions of the qualified cost sharing regulations issued under Code §482, under which related companies in various parts of the world could arrange to share intangible property development costs without the need for cross royalty payments if each participant agreed to bear its proper share of costs based on expected profits.

In recent years, the I.R.S. unilaterally attempted to expand the list of intangible property under Code §936 by asserting that foreign goodwill developed by a foreign branch and the value of a workforce in place were items of intangible property for which compensation would be required on transfer. This position was struck down by courts in *Veritas v. Commr.*[14] and *Amazon v. Commr.*,[15] cases involving qualified cost sharing arrangements. In *Amazon*, the I.R.S. also asserted that, where appropriate, related transfers of intangible property be valued in the aggregate if the value of the whole exceeded the sum of individual values. It also asserted that in determining whether a transaction conducted by related parties was arm's length, realistic alternatives to the chosen form of transaction had to be considered. Both arguments were rejected as inconsistent with the list of intangibles in Code §936. Although the issue was not presented before the court in *Amazon*, the decision implicitly invalidated Treas. Reg. §1.482-7(g)(2)(iv) regarding qualified cost sharing arrangements.

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[10] Code §367(a)(1).

[11] Code §3676(a)(2).

[12] Code §367(a)(3)(B).

[13] Code §367(d).

[14] 133 T.C. 297 (2009), nonacq., AOD 2010-005, 2010-49 I.R.B. (Dec. 6, 2010).

[15] 148 T.C. No. 8 (2017).

T.C.J.A.

The T.C.J.A. addresses the definitional and methodological issues that arose in the *Veritas* and *Amazon* cases in connection with the definition of intangible property and legislatively reverses the holdings by revising the law as follows:

- Workforce in place, both foreign and domestic goodwill, and going concern value are intangible property within the meaning of Code §936(h)(3)(B).
- Also included in covered intangible property is the residual category of "any similar item," the value of which is not attributable to tangible property or the services of an individual.
- Language at the end of Code §936(h)(3)(B) is removed, to make clear that the source or amount of value is not relevant in determining whether property that is one of the specified types of intangible property is within the scope of the definition.
- The I.R.S. is granted authority to specify the method to be used to determine the value of intangible property, both with respect to outbound restructurings of U.S. operations and to intercompany pricing allocations. This is done by amending Code §482 and granting regulatory authority to the I.R.S. in Code §367 regarding the use of aggregate basis valuation and the application of the realistic alternative principle.
- The use of the aggregate basis valuation method is required in the case of transfers of multiple intangibles in one or more related transactions if the I.R.S. determines that an aggregate basis achieves a more reliable result than an asset-by-asset approach.
- The use of the realistic alternative principle is codified when determining the transaction value to be used with respect to intangible property transactions. The realistic alternative principle is predicated on the notion that a taxpayer will only enter into a particular transaction if none of its realistic alternatives is economically preferable to the chosen transaction.
- Existing regulations under which the I.R.S. may determine an arm's-length price by reference to a transaction that is different from the transaction that was actually completed are ratified.

  Thus, for example, assume Corporation A is the owner of intangible property used to manufacture a widget, and Corporation B is a controlled foreign distributor. Corporation A can choose to manufacture the widget itself, or it can choose to license the intangible property to Corporation C, a related party in a low-tax jurisdiction, which uses the intangible property to manufacture the product for resale to Corporation B. In testing whether the value of the intangible asset transfer from Corporation A to Corporation B is arm's length, the I.R.S. may compare the actual results with those in a hypothetical fact pattern in which Corporation A chooses to manufacture the product itself.

DISPOSITION OF PARTNERSHIP INTERESTS

A partnership is generally treated as a pass-thru entity, and its items are realized

by the partners.[16] A partner is required to include in its income its share of the partnership items even if the item has not been distributed. The partner's basis in its partnership interest is increased and decreased by gains and losses, respectively. A transfer of a partnership interest does not trigger a basis adjustment unless a 754 election is made or there is a substantial built-in loss. Any adjustment made is to account for the difference between the transferee's proportionate share and basis in the interest.

Foreign persons that hold partnership interests are treated as engaged in a U.S. trade or business if the partnership is engaged in a U.S. trade or business because of its asset use or business activities.[17] Consideration received by the foreign person or corporation for its interest in a U.S. real property interest held by a partnership is treated as received in exchange for such property, making it effectively connected with the conduct of a U.S. trade or business.[18]

Prior Law

There have been conflicting rulings on the source of gain or loss from the sale or exchange of an interest in a foreign partnership engaged in U.S. trade or business.

Despite a contradictory revenue ruling, in *Grecian Magnesite Mining, Industrial & Shipping Co. v. Commr.*,[19] the court ruled that a foreign corporation's gain on the sale of a partnership interest of a partnership engaged in a U.S. trade or business wasn't U.S.-source income or effectively connected with a U.S. trade or business.

T.C.J.A.

The T.C.J.A. clarifies the confusion on whether gain or loss is effectively connected to certain interests by assuming a complete sale.

- The gain or loss from the sale or exchange of a partnership interest will be treated as effectively connected with a U.S. trade or business to the extent that the transferor would have effectively connected gain or loss had the partnership sold all of its assets on the date of the sale or exchange. Gain or loss is allocated to partnership interests in the same way as non-separately stated income and loss.
- In addition, the transferee is required to withhold 10% of the amount realized unless the transferor can certify it is not a nonresident alien or a foreign corporation. The partnership will deduct and withhold the amount that the transferee fails to.

CONCLUSION

Many European politicians have questioned whether the U.S. is compliant with the O.E.C.D.'s B.E.P.S. initiative. In light of the revisions to the international provisions of U.S. tax law that are discussed above, the answer appears to be, "Yes, but in

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[16] Code §702.

[17] Code §875.

[18] Code §897(a) and (g).

[19] 149 T.C. No. 3(2017).

an American way." Limitations have been placed on interest expense deductions, deductions for hybrid transactions have been eliminated in a deduction/no tax scenario, the scope of the C.F.C. laws has been broadened, and the transfer to foreign subsidiaries of profit-making opportunities can now be challenged through transfer pricing adjustments. Add to this CbC reporting for U.S.-based multinationals and F.A.T.C.A., and the U.S. appears to have followed the O.E.C.D. action plans in a stealth-like way.

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