INBOUND ACQUISITION DUE DILIGENCE UNDER U.S. TAX REFORM

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The Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") introduced broad changes to the Internal Revenue Code ("Code"). Many significant changes apply to U.S. businesses. Some of the most notable are (i) the reduction of the corporate income tax rate to a flat 21%; (ii) the introduction of a 20% deduction for certain business income of pass-thru entities, such as limited liability companies, S-corporations, and sole proprietorships; and (iii) temporary 100% bonus depreciation for certain new and used business or income-producing property.

Some of the most fundamental changes to the taxation of businesses apply to cross-border operations or investments. While there are fewer new inbound provisions, the new outbound rules are plentiful, and for a foreign person acquiring a U.S. company with non-U.S. operations, all of the new tax provisions may come into play.

These include the following:

- A one-time tax (often called the "transition tax") on accumulated post-1986 deferred foreign earnings of specified foreign corporations ("S.F.C.'s"), including controlled foreign corporations ("C.F.C.'s"), deemed to be repatriated under Code §965 for tax year 2017
- A new regime that imposes a tax on global intangible low taxed income ("G.I.L.T.I."), which is current foreign earnings of a C.F.C. net of a nominal rate of return on tangible property, under Code §951A
- A "participation exemption" (known as the "D.R.D.") for foreign-source dividends from a specified 10%-owned foreign corporation or C.F.C. under Code §245A, with an exception for hybrid dividends[1]
- The elimination of the ability to claim indirect foreign tax credits with respect to most dividends from foreign subsidiaries and considerable limitations on indirect foreign tax credits attributable to G.I.L.T.I. (as a result of the participation exemption)
- A reduced corporate tax rate on income from foreign-use goods and services, referred to as foreign derived intangible income ("F.D.I.I."), under Code §250
- A significant expansion of the definition of C.F.C. – and, therefore, the reach of the C.F.C. rules – under Code §951 (broadening the definition of U.S. Shareholder to include value and eliminating the requirement that a foreign

[1] Technically, this new rule is a "dividend received deduction" rather than a "participation exemption" as commonly seen in the international tax context (*e.g.*, in the E.U. Parent-Subsidiary Directive and incorporating domestic laws of E.U. Member States). Notably, capital gains are not tax exempt under the new D.R.D. rule found in the T.C.J.A.

corporation must be controlled for 30 days before the C.F.C. rules apply) and Code §958(b) (in particular, relating to the downward attribution from foreign persons to related U.S. persons)

- Limitations on deducting interest from related and unrelated parties under Code §163(j)
- The disallowance of deductions for related party payments in hybrid transactions or with hybrid entities under Code §267A
- A new the base-erosion anti-abuse tax ("B.E.A.T."), a minimum tax on large corporations that make base-eroding payments to foreign related parties under Code §59A
- The interaction of the new rules with pre-T.C.J.A. provisions, in particular, the anti-deferral rules on certain C.F.C. income known as "Subpart F Income" and rules governing investments in U.S. property by a C.F.C.

Through the use of a hypothetical U.S. investment by a foreign investor, the following is a discussion on the U.S. Federal tax due diligence considerations. In order to cover the most significant changes to the Code under the T.C.J.A., the basic example is broad, allowing for modifications to provide for various scenarios that would trigger the various new rules.

As such, it is not meant to be an exhaustive list of all due diligence issues in an acquisition of a U.S. business by a foreign person. Not covered are investments into U.S. real estate, which are subject to a separate discussion in a future Insights edition. Further, it does not include state and local tax due diligence. Rather, it is an overview of the most significant new Federal income tax considerations of inbound acquisitions of cross-border businesses.

In addition, because of their importance to tax due diligence, we consider certain significant changes to provisions that apply primarily in the domestic context, such as the limitations to the use of net operating losses ("N.O.L.'s").

THE PROPOSED ACQUISITION

The hypothetical acquisition will consist of the following:

- A foreign investor seeks to make an inbound investment into the U.S. by purchasing a U.S. corporation (U.S. Co.).
- The investment includes a U.S. subsidiary (U.S. Sub.) as well as foreign subsidiaries, some of which qualify as C.F.C.'s. Others do not.
- U.S. Co. and U.S. Sub. are profitable.
- U.S. Co. and its subsidiaries each have a fiscal year that ends on June 30.
- The foreign investor wishes to close the acquisition before the end of 2018.
- The acquisition will be structured as a taxable stock acquisition in which the foreign parent (F.P. Co.) will acquire from the U.S. seller all of U.S. Co.'s shares.

NEW DUE DILIGENCE CONSIDERATIONS

Transition Tax

> ***Example 1:*** *For an illustration of this rule, assume that U.S. Co.'s C.F.C.'s (C.F.C. 1 and C.F.C. 2) are held via a holding company based in Luxembourg (Lux. HoldCo.). The C.F.C.'s have accumulated earnings that were not previously taxed in the U.S.*

The T.C.J.A. moves the U.S. toward a quasi-territorial tax system. Under the new law, U.S. corporations that receive foreign-source dividends from certain foreign subsidiaries are generally eligible for a 100% deduction with respect to such dividends under Code §245A. This 100% deduction applies to dividends distributed by qualifying foreign corporations to U.S. corporate shareholders after December 31, 2017. In effect, the 100% D.R.D. creates a participation exemption for dividends from certain foreign subsidiaries, as discussed below. While the transition tax also applies to U.S. individuals, the D.R.D. is limited to U.S. corporate shareholders of qualifying foreign subsidiaries.

As part of the transition to the new participation exemption regime, Code §965 imposes a one-time tax on accumulated post-1986 deferred foreign earnings of certain foreign corporations (*i.e.*, foreign earnings not previously subject to U.S. federal income tax), referred to as the "Code §965 income inclusion." This amount is the greater of such foreign earnings on one of two measuring dates.

The transition tax applies only to "specified foreign corporations" ("S.F.C.'s"), *i.e.*, C.F.C.'s or other foreign corporations in which a corporate U.S. Shareholder owns 10% or more. For this purpose, U.S. Shareholder generally means a U.S. person (individual and corporation) that owns 10% or more of the voting rights of the foreign corporation, or 10% or more of the voting rights or value for tax years of the foreign corporation beginning after 2017.

"U.S. corporations that receive foreign-source dividends from certain foreign subsidiaries are generally eligible for a 100% deduction."

The transition tax applies to the last tax year of the foreign corporation that began before 2018. With respect to the U.S. Shareholder, it applies to the tax year in which or with which the foreign corporation's tax year ends.

The transition tax rate is computed by applying a dividends received deduction under Code §965(c), which yields a tax rate of 15.5% on accumulated foreign earnings ("E&P") held in the form of cash or cash equivalents, and an 8% tax on all other earnings. A corporate U.S. Shareholder is entitled to a limited indirect foreign tax credit on foreign taxes paid or accrued with respect to the taxable portion of the Code §965 inclusion.

The transition tax liability, referred to as the "net tax liability," is eligible for deferral, through a special election, under which the taxpayer may pay the transition tax over eight tax years without interest or penalties.[2]

As part of its due diligence, the foreign investor should consider the following with respect to the transition tax:

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[2] Under a special rule for S-corporations, payment of the transition tax can be deferred upon election until a specified triggering event. C-corporations are not eligible for this deferral.

- Since U.S. Co., Lux. HoldCo., C.F.C. 1, and C.F.C. 2 are on a fiscal year that ends June 30, the transition tax will apply for the tax year that began on July 1, 2017, and ended on June 30, 2018. U.S. Co.'s fiscal year 2017 tax payments, including the transition tax liability, will be due by September 15, 2018. As a result, the foreign investor may own the U.S. Co. group at the time the transition tax liability is due and must understand the filing and payment requirements. Moreover, the foreign investor should review
    - U.S. Co.'s transition tax liability computations for accuracy, including
        - the determination of the Code §965 income inclusion,
        - the determination of the measuring date,
        - the computation of cash and cash equivalents, and
    - whether any anti-avoidance transactions were undertaken to reduce the transition tax liability.
- The foreign investor should determine whether an election to defer the transition tax liability is beneficial. Since the deferral is interest-free and without penalties, in most cases, the deferral election will be the best option. The tax representations and warranties of the purchase and sale agreement should include a provision requiring U.S. Co. to file a timely deferral election and make a timely payment for the first installment of the transition tax liability.
- The foreign investor should determine whether the estimated tax payments for the 2017 fiscal year take the transition tax liability into account. If they do not, interest and penalties may apply.
- The foreign investor should determine how the transition tax liability will impact the purchase price of the U.S. Co. group.
- The foreign investor should determine whether U.S. Co. will require an actual distribution from its foreign subsidiaries to pay the transition tax liability and, if so, how the distribution will affect the working capital and liquidity of C.F.C. 1 and C.F.C. 2. The E&P positions of C.F.C. 1 and C.F.C. 2 should be considered in this respect.

D.R.D.: Participation Exemption à l'U.S.A.

The following is based on Example 1 described in the previous section. C.F.C. 2 has U.S.-source income.[3]

As discussed above, the participation exemption (also referred to as the D.R.D.) for dividends under Code §245A, applies to foreign-source dividends received by a corporation[4] that is a U.S. Shareholder of an S.F.C. Foreign entities that are Passive Foreign Investment Companies ("P.F.I.C.'s"), described below, are excluded from

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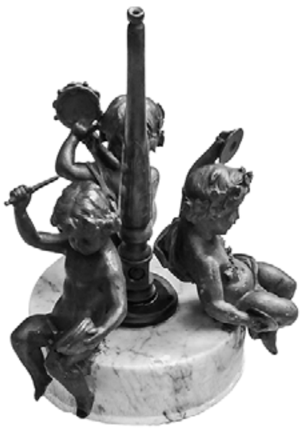
3 Typically, foreign entities will not operate in the U.S. without establishing a separate legal entity. An exception may apply in the banking area in order to comply with significantly increased bank capital requirements.

4 The D.R.D. does not apply to dividends received from a R.I.C. or R.E.I.T. Individuals and S-corporations are not eligible to elect into this provision.

the D.R.D.[5] The D.R.D. is subject to a holding period defined under this rule.[6] For this purpose, U.S. Shareholder means a U.S. corporation that owns 10% or more of the S.F.C.'s voting rights or value.

Foreign-source dividends are dividends attributable to foreign earnings of the S.F.C. If the S.F.C. also derives U.S.-source income, dividends must be pro rated. The U.S. portion may be eligible for a dividend received deduction under a pre-T.C.J.A. rule[7] that is similar to the new D.R.D. rule for foreign-source dividends. In the case of 100% ownership in the S.F.C., the domestic portion should qualify for a 100% deduction. As mentioned earlier, capital gains are not covered under the D.R.D. unless treated as dividends under certain circumstances.[8]



The D.R.D. does not apply to hybrid dividends from a C.F.C. A hybrid dividend is an amount received from a C.F.C. for which the specified 10%-owned foreign corporation received a deduction or other tax benefit with respect to income tax. An example of a hybrid dividend is a payment from a Luxembourg C.P.E.C.[9] Further, if a C.F.C. receives a hybrid dividend from another C.F.C., the hybrid dividend is treated as Subpart F Income for the C.F.C.'s common U.S. Shareholder. No foreign tax credit is allowed in this case.

Subpart F Income is readily moveable income of a C.F.C., including passive-type income such as dividends, interest, rents, or royalties as well as taxable investments in "U.S. property." Under Code §951, Subpart F Income is subject to current taxation on a *pro rata* basis at the U.S. Shareholder's ordinary tax rate, without the requirement of a cash or property distribution.

The indirect foreign taxes attributable to dividends eligible for the participation exemption are not creditable. Nonetheless, a corporate U.S. Shareholder may claim a credit for indirect foreign taxes attributable to Subpart F Income.

As part of its due diligence, the foreign investor should consider the following with respect to the D.R.D.:

- Whether U.S. Co.'s capital investment in Lux. HoldCo. is treated as debt for Luxembourg tax purposes for which Lux. HoldCo. receives an interest deduction in Luxembourg: If this is the case, dividends from Lux. HoldCo. will be treated as hybrid dividends included in U.S. Co.'s Subpart F Income for U.S. Federal income tax purposes. As a result, the Lux. HoldCo. dividends will be subject to U.S. corporate income tax at 21% under the T.C.J.A.

- Whether the dividends received by Lux. HoldCo. from C.F.C. 1 or C.F.C. 2 are hybrid dividends: If this is the case, U.S. Co. will have Subpart F Income with

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5 Code 245A(b)(2). Note that in the event a foreign entity is a C.F.C. and would also qualify as a P.F.I.C., the C.F.C. and Subpart F rules prevail (Code §1297(d)).

6 Code §§246(c)(1)(A) and (5). In broad terms, a one-year holding period applies within a 731-day period starting on the date 365 days before the ex-dividend date. The U.S. Shareholder must own the S.F.C. throughout the entire holding period.

7 Code §245.

8 Under Code §1248.

9 See "A New Opportunity for Nonresident Aliens – Ownership in an S-Corporation" *Insights* 5, no 2 (2018).

respect to the dividends received by Lux. HoldCo. The Subpart F Income will be subject to current taxation at the 21% corporate income rate with a foreign tax credit being denied.

- Whether C.F.C. 2 performs any trade or business activities in the U.S. that could create a U.S. branch or permanent establishment: In this outside the banking business rather unlikely event, the D.R.D. would not be available for earnings attributable to C.F.C. 2's U.S.-source income. However, up to 100% of the U.S.-source dividend could be eligible for the domestic D.R.D. if C.F.C. 2 is 100% owned.

- Whether the Lux. HoldCo. and C.F.C.'s structure is efficient under current legislation in light of the D.R.D. and, as discussed below, G.I.L.T.I. and F.D.I.I.: Short-term considerations may be outweighed by the long-term perspective under applicable domestic and foreign tax law.

Income Inclusion for G.I.L.T.I.

The rule is illustrated using Example 1.

The T.C.J.A. introduced new Code §951A, which applies to C.F.C.'s and, in the same manner as Subpart F, imposes current taxation on a U.S. Shareholder's *pro rata* share of the G.I.L.T.I. of its C.F.C.'s. Note that, contrary to the D.R.D., G.I.L.T.I. applies to both individuals (including sole proprietorships, partnerships, and S-corporations) and C-corporations that are U.S. Shareholders. The significant difference is that a 50% deduction, as described below, applies unequivocally only to C-corporations, whereas the I.R.S. position on whether individuals may elect into this deduction is currently unclear.

The tax generally is imposed at ordinary income tax rates (*e.g.*, 21% for corporate U.S. Shareholders). However, corporate U.S. Shareholders are eligible for a 50% deduction on G.I.L.T.I. under Code §250 (reduced to 37.5% for tax years beginning after 2025). The Code §250 deduction generally will reduce the effective tax rate on G.I.L.T.I. to 10.5% (13.125% for tax years beginning after 2025). Further, U.S. Shareholders that are corporations are allowed to claim indirect foreign tax credits for foreign taxes paid or accrued on G.I.L.T.I. However, only 80% of the foreign tax is creditable. To render tax calculations even more complex, foreign tax credits relating to G.I.L.T.I. are subject to a separate limitation "basket." Any excess foreign tax credits not used in the current year are lost, since they may not be carried back or carried forward.

The tax on the G.I.L.T.I. inclusion applies for tax years of a C.F.C. beginning after 2018 and for the tax year of the U.S. Shareholder with which or within which the C.F.C.'s tax year ends.

Despite its name, G.I.L.T.I. is not limited to income from intangible assets. In broad terms, G.I.L.T.I. is a C.F.C.'s gross income, with the exception of (i) Subpart F Income, (ii) Subpart F Income eligible for the high tax kick-out exception, and (iii) dividend income from related parties[10] reduced by attributable deductions.

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[10] As defined under Code §954(d)(3) (control requirement with a threshold set at more than 50% ownership by vote or value). Attribution rules similar to the ones under Code §958 apply.

From an inbound perspective, income derived by the C.F.C. that is effectively connected with a U.S. trade or business is also carved out unless it is exempted from U.S. taxation under an income tax treaty.[11]

In addition, G.I.L.T.I. is computed by netting 10% of the C.F.C.'s tax basis in its depreciable tangible property attributable to G.I.L.T.I. For this purpose, a routine return of 10% on the U.S. Shareholder's aggregate *pro rata* share of the bases in depreciable tangible property of all C.F.C.'s is assumed under this new rule.

With respect to subsequent dividends paid by the C.F.C. to its U.S. Shareholder, the net U.S. corporate tax paid on the G.I.L.T.I. inclusion is treated as previously taxed income ("P.T.I."). The character of the dividend remains, and foreign withholding tax levied in the C.F.C.'s country of residence is creditable.

As part of its due diligence, the foreign investor should consider the following with respect to G.I.L.T.I.:

- U.S. Co. may be subject to tax on G.I.L.T.I. from Lux. HoldCo., C.F.C. 1, and C.F.C. 2.
- The foreign investor should model U.S. Co.'s G.I.L.T.I. tax liability, taking into consideration certain factors:
  - The G.I.L.T.I. amounts with respect to C.F.C. 1 and C.F.C. 2 may be significant because as operating companies they may have low Subpart F Income.
  - Indirect foreign tax credits may not be significant if C.F.C. 1's and C.F.C. 2's taxable income is reduced by, *e.g.*, interest deductions. Further, rules that allocate and apportion expenses to foreign-source income, and thus reduce foreign-source income, may further reduce the indirect foreign tax credits since such credits may be claimed only against foreign-source income.
  - C.F.C. 1 or C.F.C. 2 may have low tax bases in their respective tangible property.
  - There may be an opportunity to increase U.S. Co.'s Subpart F Income through investments in U.S. property by its foreign subsidiaries under Code §956. That Code section creates a deemed dividend that is included in the U.S. Shareholder's Subpart F Income when the C.F.C. makes an investment in U.S. property. Thus, an investment in U.S. property under Code §956 includes acquiring tangible property located in the U.S., the right to use I.P. in the U.S., or the obligation of a U.S. person. Although Subpart F Income may be subject to tax at higher rates than G.I.L.T.I (*e.g.*, in the case of a U.S. Shareholder that is a corporation, 21% versus 10.5%), indirect foreign tax credits on Subpart F Income are not subject to the same limitations as indirect foreign tax credits on G.I.L.T.I. Further, as discussed above, the expense allocation and apportionment rules may increase the purported 10.5% tax rate on G.I.L.T.I.

"G.I.L.T.I. is computed by netting 10% of the C.F.C.'s tax basis in its depreciable tangible property attributable to G.I.L.T.I."

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[11] Code §951A(c)(2)(A)(i)(I) defining "tested income" with reference to Code §952(b).

- It may be prudent to move I.P. to U.S. Co. to reduce G.I.L.T.I.

<u>Export Subsidy for F.D.I.I.</u>

> ***Example 2:*** *Assume that U.S. Co. and U.S. Sub. earn all their income from selling products and providing services, manufactured and physically performed in the U.S., to persons located outside the U.S. for consumption outside the U.S. In addition to unrelated parties, customers include C.F.C. 1 and C.F.C. 2. The U.S. Co. group's net income from these activities amounts to $100.*

For tax years beginning after 2017, the F.D.I.I. of a U.S. corporation is eligible for a 37.5% deduction (reduced to 21.875% for tax years beginning after 2025). This new rule does not apply to income of foreign branches, and it does not apply to individuals who operate a business in the form of an L.L.C.

Thus, in the example, assuming the U.S. Co. group is eligible and F.D.I.I. is also $100, then the U.S. Co. group would have $62.50 in taxable income subject to U.S. corporate income tax at the 21% rate. U.S. Co. would pay $13.12 in U.S. corporate income tax and have $86.88 in E&P. As a result, the effective tax rate on F.D.I.I. is 13.125% (16.4% for tax years beginning after 2025).

In broad terms, F.D.I.I. generally is income from (i) property that is sold by a U.S. corporation to any foreign person for foreign use or (ii) services provided by a U.S. corporation provided to any person, or with respect to property, not located in the U.S. F.D.I.I. excludes Subpart F Income and G.I.L.T.I. Similar to G.I.LT.I., F.D.I.I. is computed by netting 10% of the domestic corporation's tax basis in depreciable tangible property attributable to F.D.I.I.

Conceptually, G.I.L.T.I. and F.D.I.I. operate "in concert." Whereas depreciable tangible assets held by a C.F.C. would decrease and thus lower a U.S. Shareholder's income for G.I.L.T.I. purposes, the opposite applies for F.D.I.I. purposes. The higher the average bases are in depreciable tangible property of the U.S. corporation, the less income remains for the F.D.I.I. deduction.[12]

Special rules exist for property or services provided to domestic intermediaries or related parties. In general, if a U.S. corporation sells property to an unrelated person for further manufacturing or modification in the U.S., it is not treated as sold for foreign use, even if the unrelated person subsequently uses the property for foreign use. A similar rule applies to services provided to an unrelated person in the U.S., even if the person uses the services to provide foreign use services. If property is sold to a foreign related party, the sale is not a foreign use sale unless the foreign affiliate sells the property to an unrelated foreign party and the property is intended for foreign use. Income from services provided to a foreign affiliate is not foreign use unless such services are not substantially similar to services provided by the related party to persons located in the U.S.

For the purpose of F.D.I.I., the terms "sold," "sell," and "sale" are broadly defined and include any lease, license, exchange, or other disposition.

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[12] Similar to G.I.L.T.I., the calculations are complex. In determining F.D.I.I. a "deemed tangible income" return equaling 10% of the average bases in depreciable tangible property is applied.

As part of its due diligence, the foreign investor should consider the following with respect to F.D.I.I.:

- The foreign investor should review the U.S. Co. group's system for tracking exports of products and services to determine whether improvements to the tracking system are required in order to properly capture F.D.I.I.
- For the purpose of modeling the effect of F.D.I.I., the foreign investor should review sales of products and services by U.S. Co. and U.S. Sub. to determine whether they constitute foreign use property or services. This includes sales to C.F.C. 1 and C.F.C. 2, which may meet the definition of foreign use. The more profitable the U.S. Co. group becomes due to its foreign use activities (*i.e.*, the higher its income from sales of products or services to foreign customers is over its tangible property), the higher the tax benefit (*i.e.*, lower effective tax rate).
- Unless re-invested, profits derived by U.S. Co. are subject to limitations under accumulation rules described below. Dividend distributions by U.S. Co. to its foreign shareholder are subject to 30% U.S. withholding tax that could be reduced under an applicable income tax treaty.

Interest Deductibility

> ***Example 3:*** *The foreign investor is planning to fund U.S. Co. in order to acquire a U.S. company. The loan will be granted at arm's length with a five-year term. U.S. Co. has obligations, vis-à-vis its current owner, that should be transferred to the foreign investor upon acquisition.*

Under Code §163(j) as amended by the T.C.J.A., the deductibility of net interest expense (*i.e.*, interest expense in excess of interest income) is limited to 30% of E.B.I.T.D.A. (earnings before interest, taxes, depreciation, and amortization) for tax years beginning before 2022, and 30% of E.B.I.T. thereafter. Under the revised rules, the limitation applies to business interest paid by U.S. debtors to related or unrelated parties.[13] The Code §163(j) limitation is not subject to a grandfathering rule. Accordingly, debt issued before the enactment of the T.C.J.A. falls under this new rule. The disallowed interest deductions may be carried forward indefinitely. However, carryovers of disallowed interest are treated as items of pre-change loss that are subject to the Code §382 limitation described below.[14] For coordinating rules with respect to interest payments that could also fall under the base erosion limitation rules see below.

If, in comparison, the foreign investor should choose to fund U.S. Co. by means of equity contribution, this limitation would not apply. While, on the one hand, repayments of capital are not tax deductible for the U.S. corporate payor, on the other hand, they are not subject to U.S. withholding tax.

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[13] "Business interest" means any interest paid or accrued on indebtedness properly allocable to a trade or business (Code §163(j)(5)). Because the investment interest limitation under Code §163(d) (investment interest) does not apply to corporations, Code §163(j) typically applies unless the trade or business is excluded from the definition (*e.g.*, certain real estate related obligations upon exercising an election).

[14] Code §382(d)(3) as amended by the T.C.J.A.

As part of its due diligence, the foreign investor should consider the following with respect to the Code §163(j) interest deduction limitation:

- The foreign investor should perform a review of U.S. Co.'s and U.S. Sub.'s debt obligations to determine the effect of any disallowed net interest expense on the U.S. Co. group's effective U.S. Federal corporate income tax rate.

- Implications under Code §382 for pre-acquisition debt should be analyzed.

- If it is determined that debt funding is feasible, the withholding tax position of the foreign debtor – in this case, the foreign investor – should be analyzed. While the 30% U.S. withholding tax may be lowered or even eliminated under an applicable income tax treaty, documentation (Form W-8)[15] and reporting obligations (Forms 1042-S and 1042) apply in order to benefit from treaty relief. The exemption for portfolio obligations[16] does not apply to 10% shareholders.[17]

- Before extending and/or entering into new loan agreements, arm's length interest rates should be determined. Depending on the facts, reference could be made to the Applicable Federal Rates ("A.F.R.") published monthly by the I.R.S. on its website. Alternatively, a transfer pricing study should be conducted.

Minimum Tax on Base-Eroding Payments

> ***Example 4:*** *The facts are as described in Example 3 with the exception that, based on forecasts, the U.S. Co. group is expected to generate average annual gross receipts in excess of $500 million in the very near future.*

Code §59A imposes a minimum tax (*i.e.*, a tax in addition to the taxpayer's regular income tax liability), referred to as the B.E.A.T., on large C-corporations (*i.e.*, corporate shareholders other than R.I.C.'s, R.E.I.T.'s and S-corporations) that make deductible payments (*e.g.*, interest and royalties) to related foreign persons. The B.E.A.T. is intended to apply to taxpayers that significantly reduce their U.S. tax liability through deductible payments to related foreign persons. In the case of foreign corporate payors, only gross receipts producing income effectively connected with a U.S. trade or business are taken into consideration.

In broad terms, the B.E.A.T. applies to a taxpayer that reduces its tax liability to an amount that is 10% of its modified taxable income. Modified taxable income is computed under the rules of Code §59A.

Because credits reduce the regular tax liability and potentially[18] increase B.E.A.T. liability, this new rule can be viewed as a modified alternative minimum tax ("A.M.T.").

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15 For foreign individuals this would be Form W-8BEN; foreign corporate beneficial owners would furnish Form W-8BEN-E.

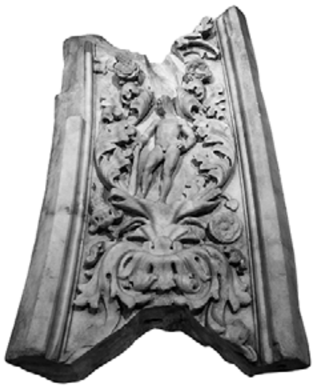
16 Code §871(h) for individuals and Code §881(c) for corporations.

17 As defined under Code §871(h)(3)(B)(i) for corporations. The term 10% shareholder is to be distinguished from the U.S. Shareholder definition under the Subpart F regime described in the foregoing.

18 These include R&D credits under Code §41 and 80% of other credits listed in Code §38 not exceeding a specified cap.

The following are examples of base erosion payments:

- Royalties
- Interest
- Payments for the acquisition of property giving rise to a depreciation or amortization
- Payments for services (except for services eligible for the Service Cost Method)



With respect to interest payments that would fall under this rule, note that the Code 163(j) limitation described above is applied first to unrelated party payments. As a result, adjusted taxable income is increased and more related party interest will be caught by the B.E.A.T. regime.

Certain payments to foreign affiliates are not considered base-eroding payments. Inter alia, these include the following:

- The cost of goods sold ("C.O.G.S."),
- Payments to the extent they are already subject to the 30% withholding tax under U.S. tax law
- Payments for certain intercompany services

Absent further guidance, it is currently not clear whether manufacturing royalties that are embedded in C.O.G.S. are excluded for purposes of the B.E.A.T. calculation.

The B.E.A.T. applies to corporations with average annual gross receipts of at least $500 million over a three-year period and with a "base erosion percentage" of at least 3% (2% in the case of financial institutions). The average annual gross receipts are measured on a worldwide group basis. Thus, for example, a foreign-parented group must aggregate the U.S. gross receipts of all of its controlled U.S. subsidiaries and U.S. branches, to determine whether the B.E.A.T. applies to any subsidiary. The base erosion percentage is the ratio of the base erosion tax benefits to total deductions (with some exceptions, including N.O.L. deductions).

As part of its due diligence, the foreign investor should consider the following with respect to the B.E.A.T.:

- In the fact pattern, the U.S. Co. group currently does not meet the gross receipts threshold for the B.E.A.T. However, since its gross receipts are expected to substantially increase in the near future, F.P. Co. is presented with the opportunity to structure intercompany transactions to avoid or reduce the effects of the B.E.A.T.
- F.P. Co. should determine which payments made by U.S. Co. and U.S. Sub. are potential base-eroding payments for B.E.A.T. purposes once the threshold is exceeded.

__**Deductibility of Hybrid Payments**__

> ***Example 5:*** *U.S. Co. made a loan to a foreign disregarded entity ("F.D.R.E.") wholly owned by U.S. Sub. F.D.R.E. is a hybrid entity (i.e., treated as a*

corporation for non-U.S. tax purposes but fiscally transparent from a U.S. tax perspective).

Code §267A disallows a deduction for certain related party amounts (i) paid or accrued in hybrid transactions or (ii) entered into with hybrid entities.

A related person for purposes of this rule is defined as (i) an individual, corporation, trust, or estate that controls, or is controlled by, the payor, or (ii) a corporation, partnership, trust, or estate that is controlled by the same person(s) that controls the payor.[19]

A related party amount is any interest or royalty paid or accrued to a related party to the extent that the amount is (i) not included in the income of the related person under the tax law of its country of tax residence, or (ii) the related party is allowed a deduction in that country. An exception applies to income that the U.S. Shareholder must include under the Subpart F regime of Code §951(a). A hybrid transaction involves a payment of interest or royalties from a U.S. person when the receipt of such payment is not taxable in the foreign country or the recipient is entitled to a deduction. A hybrid entity is (i) treated as transparent for U.S. Federal tax purposes but not for tax purposes in a foreign country or (ii) treated as transparent in the foreign country but not in the U.S. (referred to as a "reverse" hybrid entity).

Where payments involve certain foreign collective investment vehicles such as open-ended investment funds under German law, a mismatch of income and deductions could arise. The Code does not address these scenarios.

As part of its due diligence, the foreign investor should consider the following with respect to Code §267A:

- The interest expense generated by U.S. Sub. (via F.D.R.E.) is offset by U.S. Co.'s interest income, resulting in a "wash" from a U.S. tax perspective, assuming no other limitations apply (*e.g.*, dual-consolidated-loss limitations). It is unclear whether Code §267 disallows the deduction in this case. On the one hand, a deductible interest payment is made by a hybrid entity. On the other hand, the transaction does not appear to erode the U.S. tax base as intended to be addressed by this new rule.
- In analyzing the group structure, the foreign investor should confirm whether there are any entities that are treated as fiscally transparent in their countries of tax residence but not in the U.S. If a foreign subsidiary is determined to be a reverse hybrid, any payments of interest or royalties made to it by U.S. Co. or U.S. Sub may be disallowed.
- In its negotiations with the seller, the foreign investor should factor in this potential tax exposure.

Additional Changes Relevant in an M&A Context

A foreign investor should consider additional changes set forth by the T.C.J.A. with respect to future restructurings of the U.S. target:

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19 For corporations direct or indirect ownership of more than 50% by vote or value is required; for partnerships, trusts, and estates the threshold is direct or indirect ownership of more than 50% by value of the beneficial interest. Attribution rules under Code §958 apply.

- The definition of I.P. under Code §936(h)(3)(B) has been expanded to include goodwill, going concern value, workforce in place, and any other item the value or potential value of which is not attributable to tangible property or the services of an individual.[20] In addition, under the T.C.J.A. revised Code §936(h)(3)(B) no longer stipulates that I.P. must have substantial value independent of the services of an individual. Consequently, certain transfers of these assets by a U.S. person to a foreign corporation will be subject to outbound transfer rules for intangibles under Code §367(d) or transfer pricing rules under Code §482. Further, the law states that the Secretary shall have the authority to specify which method must be used to determine the value of intangible property with respect to outbound restructurings of U.S. operations as well as intercompany pricing allocations. This is accomplished through the amendment of Code §482 as well as granting authority under Code §367 to permit the use of aggregate basis valuation and the application of the realistic alternative principle.

- The active trade or business exception has been repealed for certain outbound non-recognition transfers by U.S. persons.[21] Thus, transfers of property used in an active trade or business will no longer qualify as a tax-free organization, reorganization, or liquidation.

- A U.S. corporation is required to recapture post-2017 branch losses when substantially all of a foreign branch's assets (as defined in Code §367(a)(3)(C)) are transferred to a 10%-owned foreign corporation. The recapture amount (*i.e.*, the transferred loss amount) is equal to the branch's previously deducted loss amount after 2017 (and before the transfer) reduced by any taxable income of the branch in subsequent years (but before the close of the transfer year) and any gain related to an overall foreign loss recapture amount.

Unintended C.F.C.'s

> ***Example 6:*** *The foreign investor, F.P. Co., holds a foreign subsidiary ("F. Sub.").*

The T.C.J.A. revised the constructive ownership rules of Code §958(b) to include downward attribution from a foreign person.

As a result, any stock owned by F.P. Co. will be attributed to U.S. Co. Since F.P. Co. wholly owns F. Sub., all of F. Sub.'s stock will be treated as owned by U.S. Co., and thus, F. Sub. will be a C.F.C.

Since U.S. Co. will not directly or indirectly own any F. Sub. stock (*i.e.*, it will not have actual direct or indirect ownership in F. Sub.), no U.S. Federal tax liability will arise under the Subpart F regime with respect to its constructive ownership of F. Sub. and F. Sub.'s status as a C.F.C.

Nonetheless, any post-acquisition restructuring should consider the C.F.C.-status of the foreign entities. For example, if F. Sub is a C.F.C. under the downward attribution

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[20] This provision overturns several recent Tax Court cases holding that assets such as workforce in place and goodwill are beyond the scope of the statutory definition of "intangible property."

[21] Code §367(a)(5).

rule, the group should not be restructured in such a manner that U.S. Co., directly or indirectly, owns F. Sub. stock because, in that case, U.S. Co. may have Subpart F Income or G.I.L.T.I. with respect to F. Sub.

Further, if F. Sub. is a C.F.C. under the downward attribution rule, the group should not be restructured in such a manner that F. Sub. makes or receives a hybrid dividend to or from another C.F.C. and both F. Sub. and the other C.F.C. have a common U.S. Shareholder. In that case, the common U.S. Shareholder will have Subpart F Income under Code §245A, as discussed above.

"P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution."

N.O.L.'s

The T.C.J.A. amended the rules on deducting N.O.L.'s for the following limitations and benefit. For losses arising in tax years beginning after 2017, a taxpayer may deduct an N.O.L. against 80% of its taxable income (determined without regard to the N.O.L. itself). Under prior law, N.O.L.'s could be deducted against 100% of a taxpayer's taxable income. For losses arising in tax years beginning after 2017, N.O.L.'s may be not be carried back but may be carried forward indefinitely. Under prior law, N.O.L.'s could be carried back two years and carried forward 20 years.

In our example, if U.S. Co. is a profitable company, the new limitations on N.O.L.'s may not be relevant.

However, with respect to pre-acquisition losses, U.S. Co. will be subject to limitations on deducting N.O.L.'s under Code §§269 and 382 as a result of the ownership change.

ONGOING CONSIDERATIONS

In addition to the items to be addressed regarding the T.C.J.A. changes, the following rules under pre-T.C.J.A. law are still relevant and should be taken into account:

P.F.I.C.'s

A P.F.I.C. is defined as any foreign corporation in which (i) 75% or more of its gross income for the taxable year consists of passive income or (ii) 50% or more of its assets consist of assets that produce, or are held for the production of, passive income (such as stocks, bonds or cash).[22]

A typical P.F.I.C. is an offshore investment company or mutual fund, although P.F.I.C. status can be a potential issue for any foreign corporation, especially if the corporation has large cash reserves or is in the services business outside the U.S.

A foreign company that is a C.F.C. and a P.F.I.C. will be subject to the C.F.C. and Subpart F rules. If the foreign company is not a C.F.C., P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution. An excess distribution is a current distribution that exceeds 125% of the average distributions over the prior three years. The excess distribution is deemed attributable to profits earned in an earlier year, as determined under a prescribed formula. In addition, gain on the sale of stock in a P.F.I.C. may be taxed at ordinary income rates and also be subject to an interest charge under the computations that apply to excess distributions.

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[22] Code §1298

Two elections are available for U.S. persons with P.F.I.C.'s.[23] In broad terms, as a result of an election, the U.S. person is taxed on a current basis. However, neither of these elections avoids taxation completely.

Anti-Accumulation Rules

U.S. tax law contains provisions that impose an additional corporate tax on earnings and profits that are accumulated beyond the reasonable needs of the business.[24] The tax is imposed at a rate of 20% of the unreasonable accumulation.

For the accumulated earnings tax[25] to apply, the earnings must be retained to avoid income tax with respect to its shareholders or the shareholders of any other corporation by permitting earnings and profits to accumulate instead of being distributed.[26] The fact that the earnings and profits of a corporation are permitted to accumulate "beyond the reasonable needs of the business" is determinative of the purpose to avoid the income tax with respect to shareholders unless the corporation proves otherwise by the preponderance of the evidence.[27] If a corporation is a holding or investment company, it is *prima facie* evidence of a tax avoidance purpose.[28]

Among others, the following grounds for an accumulation indicate that it is reasonable:

- To provide for a *bona fide* expansion of business or replacement of plant
- To acquire a business enterprise through purchasing stock or assets
- To provide necessary working capital for the business (*e.g.*, for the procurement of inventories)
- To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation
- To provide for the payment of reasonably anticipated product liability losses
- To provide for realistic business contingencies, including possible lawsuits[29]

Among others, the following facts indicate that an accumulation is unreasonable:

- Loans to shareholders or the expenditure of funds of the corporation for the personal benefit of the shareholders

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23 These are the mark-to-market election for marketable stock (*e.g.*, traded on a stock exchange) (Code §1296) and the Qualified Electing Fund election (Code §1293).

24 Code §531.

25 For tax years after 2012, the rate of tax is 20% of "accumulated taxable income," which is defined under Code §535 and is, in general, taxable income subject to certain adjustments. Prior to the change in law, the rate of tax was 15%.

26 Code §532; Treas. Reg. §1.532-1(a)(1).

27 Code §533; Treas. Reg. §1.533-1(a)(1).

28 Code §533(b); Treas. Reg. §1.533-1(a)(1).

29 Treas. Reg. §1.537-2(b). See *Knight Furniture Co. v. Commr.*, T.C. Memo 2001-19 (class action lawsuit pending).

- Loans having no reasonable relation to the conduct of the business made to relatives or friends of shareholders, or to other persons

- Loans to another corporation, the business of which is not that of the taxpayer, if the capital stock of such other corporation is owned, directly or indirectly, by the shareholder or shareholders of the taxpayer and such shareholder or shareholders are in control of both corporations

- Investments in properties or securities that are unrelated to the activities of the business of the taxpayer

- Retention of earnings and profits to provide against unrealistic hazards[30]

In light of the accumulated earnings tax exposure, it may be appropriate to have U.S. Co. make distributions to its shareholders from time to time to avoid the accumulated earnings tax. The Treasury has repeatedly emphasized its intent to revise this rule.

N.O.L.'s – Change of Ownership Rules Under Code §382 and §269

From a U.S. tax perspective, the use of N.O.L.'s may be

- limited where there is a substantial change of shareholders (*i.e.*, an increase of more than 50 percentage points by one or more shareholders owning, directly or indirectly, at least 5% of the loss company over the preceding three years)[31] or

- disallowed in the case of tax avoidance or evasion.[32]

Anti-Inversion Rules

The U.S. employs rules intended to prevent a domestic multinational company from undertaking a restructuring, merger, or acquisition that has the consequence of replacing the group's domestic parent company with a foreign parent company. This type of transaction is commonly referred to as an inversion.[33]

Anti-inversion rules have remained under the T.C.J.A. Final anti-inversion regulations were issued by the Treasury and the I.R.S. on July 11, 2018.[34]

FINAL POINTS

As demonstrated above, the changes to the Code's international provisions introduced by the T.C.J.A. are significant, particularly with respect to outbound

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30 Treas. Reg. §1.537-2(c).

31 Code §382.

32 Code §269.

33 Code §7874.

34 Final regulations were published in the Federal Register on July 12, 2018. With some modifications, these regulations finalize the temporary and proposed regulations released on April 8, 2016. The temporary regulation was invalidated in *Chamber of Commerce of the United States v. I.R.S.*, No. 1:16-CV-944–LY (W.D. Tex. Sept. 29, 2017), appeal docketed, No. 17-51063 (5th Cir. Dec. 1, 2017) for lack of prior notice and comment.

transactions. An inbound acquisition of a U.S.-parented multinational entity will encompass the new outbound considerations.

Many of the new regimes (*e.g.*, G.I.L.T.I., F.D.I.I., and B.E.A.T.) are computation-driven and have many variables. As a result, tax modeling in the acquisition process will become more significant and complex.

Additionally, O.E.C.D. countries are currently moving toward implementing the B.E.P.S. Action Plan. Already, the E.U. has issued two directives, A.T.A.D. 1 and A.T.A.D. 2, which implement certain B.E.P.S. actions in two phases. As a result, tax due diligence and modeling must include consideration of such recent and anticipated reforms.

In the light of changes under the T.C.J.A., foreign investors may want to avoid "buying-into" into new rules such as G.I.L.T.I., F.D.I.I., and B.E.A.T. by keeping the foreign group separate. One important consideration in this context is, however, the longevity of these new rules. Except for the lowered corporate income tax rate of 21%, most of the changes are subject to sunset. The chances of their survival are largely tied to the outcomes of the 2018 and 2020 elections. While proponents of the new rules stress the opportunity to spur investment, boost economic growth, and create jobs, these benefits come at a high price – namely, a significant increase in the nation's debt. The current administration's enthusiasm is not shared by everyone. A foreign investor must decide whether the incentives outweigh the pitfalls and, even more, on how much he or she is willing to rely on legislation that is subject to numerous open issues and an uncertain future.