Leading the way?

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Craig Hillier and *Adam Becker* provide an overview of recent developments in US tax reform

Key Points

What is the issue?

The most significant US federal tax reform since 1986, commonly referred to as the ‘Tax Cuts and Jobs Act’ (TCJA), turned 18 months on 22 June 2019.

What does it mean to me?

That 18-month milestone has special significance for US federal rule-making procedures as a safe harbour by when a regulation can be issued and applied retroactively to the date of enactment of the statute to which the regulation relates.

What can I take away?

In many respects, the US's tax system has inched closer to its peers' (and vice versa). However the TCJA has also introduced new approaches to the global tax policy debate. This may well advance the long sought-after harmony of global tax principles, but if the US sets the example that harmony may come at the cost of increased complexity.

The most significant US federal tax reform since 1986, commonly referred to as the 'Tax Cuts and Jobs Act' (TCJA), turned 18 months on 22 June this year. That 18-month milestone has special significance for US federal rule-making procedures as a safe harbour by when a regulation can be issued and applied retroactively to the date of enactment of the statute to which the regulation relates (see Section 7805(b)(2). Regulations issued after 18 months may still have retroactive effect, subject to meeting more nuanced requirements under Section 7805(b)(1)). Due to the breadth of the TCJA's changes, it has been a herculean task for the US Treasury Department ('Treasury') to provide regulatory guidance, although so far it has issued more than a dozen proposed regulations and two final regulations: on the Section 965 transition tax and on the Section 199A deduction for qualified business income.

The TCJA was not cultivated in a bubble. It's been over three years since the G20 and OECD countries released the 15 'Base Erosion and Profit Shifting' (BEPS) reports, which sparked a shift in international tax cooperation and led many countries to kick-start their own reform efforts. While the TCJA modernised some US tax rules to reflect BEPS developments and other global trends, through the BEPS Project the G20/OECD has also adopted elements of the US international tax system. Even now, the feedback loop is expected to continue, with the BEPS Inclusive Framework (the expanded group of 129 countries which has adopted the BEPS project) possibly considering both a base erosion tax perhaps similar to the US Section 59A's 'base erosion and anti-abuse tax' (BEAT) and a minimum tax which

may mirror Section 951A's 'global intangible low-taxed income' (GILTI) provisions.

US tax rules adapting to existing global trends as a result of the TCJA

New 21% corporate federal rate and Section 245A

Through the TCJA, the US Congress fulfilled two longstanding goals of tax reform advocates: first, reducing the headline corporate tax rate to 21%, thereby making the US more competitive for foreign and domestic investment; and, second, moving the US international tax system closer to a territorial system by replacing the foreign tax credit system with a system that allows US corporations a deduction (DRD) for certain dividends received from their foreign subsidiaries.

The US corporate rate reduction follows the trend among developed countries to reduce their headline rates while also expanding their tax bases. The UK has been at the forefront, having gradually reduced its rate over the past decade from 28% to 19%. The US, by reducing its federal rate from 35% to 21%, has now leap-frogged to one of the more competitive tax rates in the OECD.

The new DRD also aligned the US with global standards. After the UK and Japan implemented participation exemption systems in the late 2000s, the US remained one of the few OECD countries using a credit system to mitigate economic double taxation. This resulted in over a trillion dollars held offshore due to the high residual tax cost of repatriating low-taxed earnings to the US. Post-TCJA, Section 245A now allows a 100% DRD for dividends from 10% or more owned foreign subsidiaries (however, as discussed below, as a result of the GILTI provisions, the Section 245A DRD may only apply to a small portion of a foreign subsidiary's income).

These two changes alone have prompted many multinationals to consider the US as a location for capital, intellectual property and direct investment. In comparison, pre-TCJA tax rules often created an incentive for US multinationals to invest abroad (and keep profits there) and for foreign multinationals to minimise their US-based operations. Now post-TCJA, multinationals are adapting to a more multifaceted – and sometimes counter-intuitive – US tax system. Modelling out the impact of the new rules to guide investment decisions has become essential given the complexity of the still evolving provisions.

Section 163(j) and Section 267A

The TCJA also brought in changes that adopted specific BEPS Action item principles. Specifically, the US revised its Section 163(j) limitation on interest expense deductibility and enacted Sections 245A(e) and 267A to target certain hybrid mismatch arrangements.

New Section 163(j) initially conforms to BEPS Action 4 by limiting interest expense deductibility based broadly around a '30% of EBITDA' rule. However, starting from 2022, Section 163(j) will become more onerous than the Action 4 standard when the EBITDA base is replaced with an EBIT base (i.e., the 30% will apply without adding back depreciation or amortisation expense).

Unlike BEPS Action 4, Section 163(j) does not provide a 'group-ratio' exception, whereby the worldwide group's interest expense-to-EBITDA ratio could be substituted for the general 30% of EBITDA limit. Also, the proposed Section 163(j) regulations – released 26 November 2018 – deviate further from BEPS Action 4 by specifically applying the 30% standard outward, such that Section 163(j) would apply to any CFC's business interest expense similarly as for a domestic corporation. Notably, the proposed regulations also reserve on how Section 163(j) interacts with potentially overlapping rules – including Section 267A (on hybrid arrangements), Section 482 (transfer pricing) and Section 59A (Base Erosion and Anti-abuse Tax, or 'BEAT') – that could each impact a taxpayer's interest expense deductibility. This creates a complex fabric of rules that adds significant compliance considerations for multinationals.

The TCJA's other BEPS Project-style reform exists in Sections 245A(e) and 267A, targeting hybrid mismatch arrangements. In particular, Section 267A broadly adheres to BEPS Action 2 by denying deductions in connection with certain arrangements that produce deduction/no-inclusion (D/NI) or double deduction (D/D) outcomes. However, rather than adopting BEPS Action 2 wholesale, the US Congress provided Treasury significant authority to issue regulations to expand (or narrow) application of the statutory provisions.

Treasury issued proposed regulations under Sections 245A(e) and 267A on 20 December 2018. Like BEPS Action 2, the proposed Section 267A regulations identify specific categories of D/NI or D/D arrangements that produce a 'hybrid disqualified amount' or a 'hybrid imported mismatch amount.' Additionally, the proposed regulations would require a causal connection between the hybridity and the D/NI outcome, such that a deduction would not be denied if the 'no-inclusion' is a general

feature of a foreign country's tax laws. However, the proposed regulations would also bring into scope 'structured arrangements' and a broad principal purpose test, which together may threaten interest or royalty deductions even where no foreign related party is involved. Finally, proposed regulations under Section 245A(e) would adopt the BEPS Action 2 'defensive rule' to have taxpayers identify and track deductions attributable to hybrid dividends in a 'hybrid deduction account.' Taxpayers would be denied the Section 245A DRD to the extent of the balance of a hybrid deduction account of the foreign subsidiary from which the eligible dividend is received.

Where US tax rules have set global trends

CFC rules and US LoB

US tax policy has also influenced OECD developments, including both the 2015 BEPS Action Reports and now the most recent OECD working group considering nexus for digital taxes, as well as a base erosion and a global minimum tax.

Slowly but surely, countries are implementing CFC regimes to dis-incentivise arrangements that might artificially shift profits to low-tax jurisdictions or outside of a multinational's primary locations of activity. Particularly, BEPS Action 3 initiated dialogue on the need for effective CFC rules, and the Anti-Tax Avoidance Directive (ATAD) more formally compelled EU member states to adopt CFC regimes. In the US, the 'Subpart F' regime was enacted in 1962, with its basic framework largely identical today (notwithstanding the overlay of GILTI, discussed below). While both BEPS Action 3 and ATAD give deference to countries to set their own CFC standards and scope, there is little doubt that Subpart F principles will serve as a guide when countries draft their own CFC rules and consider minimum tax proposals that may be enforced through a CFC regime.

BEPS Action 6 on preventing treaty abuse highlights another example of US influence. Per Action 6 minimum standards, many countries have adopted in their treaties – particularly via the Multilateral Instrument – either a principal purpose test (PPT) or a Limitation on Benefits (LoB) clause. The US first negotiated treaties with LoB clauses in the 1980s as a means of combatting treaty shopping, and some form of the LoB has appeared in every US treaty since. Both LoB clauses and PPT clauses require an in-depth analysis of legal ownership, substance and operational activity to claim treaty benefits.

BEAT as a potential new standard

Through the TCJA, the US has again seized the early-adopter role. Most significantly for foreign (non-US) multinationals, Section 59A introduced the BEAT, fulfilling promises of congressional Republicans and the Trump administration to level the playing field for US multinationals versus foreign multinationals. While Section 59A applies to both US and foreign multinationals, US subsidiaries (or branches) of foreign multinationals generally make a greater volume of deductible payments to their headquarter territories and foreign affiliates, thus becoming more negatively impacted by BEAT.

Section 59A operates generally by increasing taxable income by any ‘base erosion tax benefits’ allowed to the taxpayer for a tax year and multiplying that ‘modified taxable income’ by the BEAT rate for the year (generally, 5% in the first year, then 10%, and eventually increasing to 12.5%) (The rate is 1% higher for groups that include a bank or registered securities dealer). Generally, ‘base erosion tax benefits’ arise when a US taxpayer (meaning a US corporation or US branch of a foreign corporation) makes any ‘base erosion payment’ to a foreign related person for which a deduction is available or in connection with which depreciable or amortisable property is acquired. The term ‘applicable taxpayer’ excludes any taxpayer whose gross receipts are less than $500 million or whose ‘base erosion percentage’ (i.e., base erosion tax benefits over all deductions and base erosion tax benefits) is less than 3% (a 2% threshold applies to groups that include a bank or registered securities dealer), both computed on an aggregate group basis.

The proposed BEAT regulations released on 13 December 2018, address many questions left open by the BEAT statute. For starters, the proposed regulations provide that a ‘base erosion payment’ cannot be offset by a matching inbound payment (i.e., no netting). In addition, the proposed regulations clarify that a ‘base erosion payment’ includes payments with non-cash consideration, such as transactions where a US corporation or US branch acquires property subject to depreciation or amortization from its foreign affiliate in a tax-free contribution or reorganisation, even where the property is received with historical tax basis. Finally, in a helpful provision for taxpayers, the proposed regulations clarified that for certain qualifying services using the services cost method (generally lower value services), the cost component does not constitute a ‘base erosion payment,’ even if the taxpayer pays a mark-up.

GILTI as a potential new global standard

The TCJA also created two complementary new rules out of whole cloth: the foreign-derived intangible income (FDII) regime and the GILTI. The FDII and GILTI regimes constitute a 'carrot-and-stick' approach to encourage multinationals to develop (or maintain) valuable intangibles in the US and export goods and services, while also imposing a minimum tax on the income of their foreign subsidiaries.

Both FDII and GILTI rely on the concept of 'qualified business asset investment' (QBAI), or basically the adjusted basis of tangible property, and specify a 'routine' 10% return on such tangible property. Thus, under Section 250's FDII rules, any return over 10% earned by a US taxpayer is generally eligible for a 37.5% deduction (the FDII deduction under Section 250 will decrease to 21.875% for taxable years beginning after 31 December 2025), provided that the income is foreign-derived – resulting in an effective tax on this qualifying income of 13.125%. By contrast, under Section 951A's GILTI rules, any return over 10% earned by a CFC of a US taxpayer is potentially subject to current US taxation at the US parent level but with a 50% deduction for this income provided by Section 250 – resulting in an effective tax of 10.5% on GILTI income (the GILTI deduction under Section 250 will decrease to 37.5% for taxable years beginning after 31 December 2025). Section 951A marks a significant development in international tax by eliminating deferral and creating almost a true 'worldwide' tax system for GILTI (a US shareholder (of a CFC) calculates its GILTI inclusion amount by aggregating its pro rata share of 'tested income' from each CFC with its pro rata share of 'tested loss' from each CFC, then subtracting 10% of QBAI as aggregated across all CFCs with tested income. That 10% of QBAI is therefore exempt from current taxation at the US shareholder level and also can be repatriated to the US as a dividend eligible for the Section 245A DRD).

Proposed GILTI regulations were released 13 September 2018, and proposed FDII regulations were released 4 March 2019 (final GILTI regulations are expected by June 22, 2019 (proposed anti-abuse rules make the 18-month safe harbour in section 7805(b)(2) especially important). However, final FDII regulations are not expected by 22 June 2019). Given that both GILTI and FDII are sui generis rules, the proposed regulations for each focused primarily on defining new concepts (such as QBAI), as well as setting computational ground rules. The proposed GILTI regulations also provide broad anti-abuse rules intended to identify transactions that a US multinational may undertake to artificially increase QBAI and thereby reduce its

GILTI inclusion amount. The proposed FDII regulations focus on computational issues and establishing guidelines and documentation requirements for taxpayers to avail themselves of the FDII deduction.

Final thoughts

The past 18 months have been a whirlwind of US tax reform with both Treasury and taxpayers needing to adapt to a vastly new, and ever-changing, US federal tax system. In many respects, the US's tax system has inched closer to its peers' (and vice versa). However, as seen with BEAT, GILTI and FDII, the TCJA has also introduced into the global tax policy debate new approaches to taxing multinationals' income that may underwrite a new global BEPS accord. This may well advance the long sought-after harmony of global tax principles, but if the US sets the example that harmony may come at the cost of increased complexity.

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