THE NATIONAL LAW REVIEW

US Tax Reform Measures Affecting Foreign Multinationals

Friday, January 12, 2018

Summary

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In Depth

On December 22, 2017, President Trump signed broad tax reform legislation into law that, among other things, reduced the corporate income tax rate to 21 percent and reformed the US international tax system (the Final US Tax Legislation). This article focuses on key aspects of the Final US Tax Legislation that will impact foreign (non-US) multinational entities (FMNEs) with US inbound investments and operations.

Base Erosion and Anti-Abuse Tax

The Final US Tax Legislation added section 59A which imposes a Base Erosion and Anti-Abuse Tax (the BEAT) as a minimum tax on certain US corporations, and foreign corporations with US branches, that take US tax deductions giving rise to "base erosion tax benefits."

- **Applicable Taxpayers**. The BEAT is imposed on any corporation (US or non-US) that (1) has average annual gross receipts over a three year look-back period of at least $500 million and (2) has a "base erosion percentage" of 3 percent or higher. In general, the "base erosion percentage" is the percentage of the taxpayer's overall deductions for the taxable year consisting of base erosion tax benefits. For non-US corporations, gross receipts only include those used to determine income that is effectively connected to a US trade or business. Special rules apply to banks and registered securities dealers.
- **Base Erosion Tax Benefits**. A "base erosion tax benefit" generally includes (1) base erosion payments and (2) depreciation and amortization deductions in respect of property acquired from foreign related parties. "Base erosion payments" are generally amounts paid or accrued by a US corporation (or by a foreign corporation's US branch) to foreign related parties for which a deduction is allowable, including most royalties, rents, service fees, interest and payments made under a cost sharing agreement. For purposes of these rules, foreign related parties include any 25 percent owner of the taxpayer (by vote or value) and any person who is related to the taxpayer under the section 482 transfer pricing rules.
    - An exception applies in the case of certain service fees if the services in question meet the eligibility requirements for use of the services cost method under the US transfer pricing regulations (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure) and the amount constitutes the total services cost with no markup component.
    - Any base erosion tax benefit attributable to any base erosion payment that has been subjected to the US 30 percent withholding tax imposed on certain types of fixed, determinable, annual or periodical income (such as US source interest and royalties) is disregarded in making BEAT computations. If the 30 percent rate is reduced by reason of an applicable tax convention with the

    - United States, the amount disregarded is proportionally reduced.
    - Payments that reduce gross receipts (*e.g.*, cost of goods sold) as opposed to being deductible from taxable income do not give rise to a base erosion tax benefit *unless* the recipient foreign affiliate is an expatriated entity or an affiliate of an expatriated entity.
- **Calculation of BEAT**. Generally, the BEAT equals the excess of (1) 10 percent (5 percent for tax year 2018, and 12.5 percent for tax years after 2025) of the taxpayer's taxable income, calculated without regard to any "base erosion tax benefit" or net operating loss deduction attributable to any base erosion payment over (2) the taxpayer's regular tax liability reduced by allowable tax credits. For this purpose, for tax years 2018 to 2025, allowable tax credits will be reduced by the research credit and 80 percent of the low income housing credit, renewable electricity production credit and the energy investment credit.

Potential Impact of BEAT on FMNEs. As a rough rule of thumb, the BEAT generally only will be imposed on a US corporation or a US branch of a foreign corporation if the taxpayer's base erosion tax benefits reduce its US taxable income by more than approximately 52 percent or if approximately 52 percent of the taxpayer's US tax is offset by applicable tax credits, or a combination of the two.

The BEAT will likely have a disproportionate effect on FMNEs that have US affiliates (or US branches) that are funded with foreign related party debt or that make royalty payments to foreign related parties and do not have sufficient amounts of non-base erosion payment deductions (such as payroll expenses) to fall below the threshold base erosion percentage and thereby avoid application of the rules. The commonplace practice of deploying affiliates to intermediate payments of interest and royalties within the FMNE group (*e.g.*, the use of related-party "Fincos" and "LicenseCos") will need to be re-examined, perhaps in favor of direct third-party arrangements.

The BEAT also may significantly impact US subsidiaries of expatriated entities. As discussed above, while under the general rules cost of goods sold incurred in connection with purchases from foreign related parties are not treated as base erosion payments for purposes of the BEAT, if such payments are made to a "surrogate foreign corporation" that is related to the taxpayer (but only if such person first acquired that status after November 9, 2017), or is a foreign person which is a member of the same expanded affiliated group as the surrogate foreign corporation, the reduction in gross receipts of the taxpayer to reflect such costs of goods sold will be treated as a base erosion payment and factored into the calculation of the BEAT.

New Limit on Interest Expense Deductions

In a substantial rewriting and broadening of the US "earnings stripping" rules of section 163(j), the Final US Tax Legislation generally limits a US taxpayer's deduction for net business interest expense to 30 percent of the taxpayer's adjusted taxable income for the taxable year.

- "Adjusted taxable income" means the taxable income of the taxpayer computed without regard to items not properly allocable to a trade or business, any business interest or business interest income, any pass-through deduction, any net operating loss deduction and, solely in the case of taxable years beginning before January 1, 2022, any deduction for depreciation amortization or depletion. Thus, the test shifts from essentially an "EBITDA" test to an "EBIT" test commencing with 2022.
- The amount of any business interest not allowed as a deduction for any taxable year can be carried forward in succeeding taxable years indefinitely.

Potential Impact on FMNEs. Similar to the BEAT, this provision could greatly affect FMNEs that have capitalized their US operations with debt and deduct significant amounts of interest from their US taxable income. US subsidiaries of FMNEs may find that they are unable to deduct all of their interest in computing their US taxable income. As a result, FMNEs may want to evaluate whether their capital plan can tolerate third-party debt at the US subsidiary level. Of course, if the FMNE has public debt, covenants may restrict third-party debt at the subsidiary level. Consequently, migrating to a capital structure that uses third-party debt at that level may require negotiation with lenders.

Changes to Subpart F Stock Attribution Rules

The Final US Tax Legislation also modifies the constructive stock attribution rules used to determine whether a foreign corporation is treated as a controlled foreign corporation (CFC) for US tax purposes. A foreign corporation will be a CFC if it is more than 50 percent owned (directly, indirectly or constructively) by US persons that are US shareholders. Prior to the enactment of the Final US Tax Legislation, under section 958(b)(4), a US person would not be attributed stock owned by a foreign person. So, for example, a US subsidiary of a foreign parent would not be treated as constructively owning the stock of foreign subsidiaries owned by the foreign parent. The new legislation repealed section 958(b)(4) in response to concerns that some US shareholders were avoiding subpart F inclusion of a CFC by decontrolling a CFC through the transfer of more than 50 percent of the

CFC's stock to a foreign parent. As a result, effective for fiscal year 2017 (this rule is retroactive not just prospective), stock of a foreign corporation owned by a foreign shareholder of a US corporation will be attributed to a US subsidiary of that foreign shareholder for purposes of determining whether such foreign corporation is a CFC. *This will significantly increase the number of CFCs of FMNEs.*

- To the extent that the US shareholder does not directly or indirectly own any stock in the foreign corporations whose stock is attributed to it through its foreign parent (for example) for purposes of the CFC rules, the repeal of Section 958(b)(4) will not cause the US shareholder to have Subpart F income (as Subpart F income is only required to be included by US shareholders who directly or indirectly, not just constructively, own stock in the CFC). Importantly, however, US shareholders of CFCs are required to annually file a Form 5471 (Information Return of US Persons with Respect to Certain Foreign Corporations) for each of their CFCs. Failure to file such a return may result in significant penalties (*viz.*, $10,000 per failure to file). *Therefore, this change to the CFC attribution rules will result in an increased compliance burden to FMNEs.*
- The legislative history indicates that a foreign corporation should not be treated as a CFC with respect to a particular US shareholder as a result of attribution of ownership to a US person that is unrelated to such US shareholder (*e.g.*, stock attributed to the US subsidiary of a foreign joint venture partner unrelated to the US shareholder in question). It is not clear, however, that the statutory language fully effectuated this intent. IRS guidance or technical corrections legislation may be necessary to ensure that the statute does not overreach with respect to common joint venture structures that do not involve any CFC decontrol planning.

Gain on Disposition of Interests in Partnership with US Business

Under general US partnership tax rules, the disposition of a partnership interest by a partner is treated as the sale of a single capital asset based on an entity treatment of the partnership. In Revenue Ruling 91-32, however, the IRS stated that the sale of an interest in a partnership by a foreign person should be treated on a "look-through" or "aggregate basis" as though the sale by the foreign partner of its share of the partnership's assets, with the result that any gain realized on the sale of the partnership interest, to the extent attributable to assets of the partnership used in a US trade or business, should be treated as effectively connected income and subject to US taxation accordingly. A recent US Tax Court case rejected this ruling and held that the sale of a partnership interest by a foreign person generally should be treated as the sale of a capital asset under general partnership tax rules and therefore should give rise to foreign source income not subject to US tax. *See Grecian Magnesite Mining v. Commissioner*, 149 TC No. 3 (July 13, 2017). The Final US Tax Legislation overrides the recent US Tax Court decision and codifies the position of the IRS set forth in Rev. Rul. 91-32, providing that gain on the sale of a partnership interest will be treated as effectively connected income to the extent that a sale of the assets of the partnership would generate such effectively connected income.

Additionally, the transferee of a partnership interest is required to withhold 10 percent of the amount realized on the sale or exchange unless the transferor provides an affidavit of non-foreign status. If the transferee fails to withhold, the partnership is required to deduct and withhold from distributions to the transferee. These withholding tax rules are much like those that already exist for sales of real property interests under the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) rules.

Potential Impact on FMNEs. FMNEs that currently hold an interest in a partnership that is engaged in a US trade or business should be aware that gain realized upon a sale of such partnership interest could constitute income effectively connected with a US trade or business that is subject to US tax. Additionally, a FMNE that purchases an interest in a partnership that conducts a US trade or business will be obligated to withhold 10 percent of the purchase price unless the seller can provide proof of non-foreign status. In addition, if the FMNE fails to withhold when it has the obligation to do so, the partnership will be required to withhold an amount equal to the withholding tax from the FMNE's future distributions from the partnership.

Anti-Hybrid Rules

The Final US Tax Legislation adds a new section 267A to the Internal Revenue Code, which disallows deductions for interest and royalties paid or accrued to a related party pursuant to a "hybrid transaction" or by, or to, a "hybrid entity." This rule bears certain parallels to the Organisation for Economic Co-operation and Development (OECD) proposals in BEPS Action 2 regarding hybrid instruments and hybrid entities.

- This provision applies to interest and royalty payments where:
    - The payment is either (1) made pursuant to a hybrid transaction or (2) made to a hybrid entity; and
    - The payment is either not included in the income of the foreign related party or is deductible from the taxable income of the related party in such related party's tax jurisdiction as a result of the hybrid nature of the payment or related-party entity.

- A hybrid transaction is any transaction, series of transactions, agreement or instrument under which a payment treated as a payment of interest or royalties for US tax purposes is not so treated for relevant foreign tax purposes. A hybrid entity is an entity that is fiscally transparent in one jurisdiction but not in the other.
- The new rule does not apply to payments that are included in the income of a US shareholder pursuant to subpart F.

Potential Impact on FMNEs. This new rule could limit the deductibility of interest or royalty payments made to or from related parties if one of the related parties is a hybrid entity or if there is a mismatch in the characterization and tax treatment of the payment in the United States and the relevant foreign jurisdiction. FMNEs will need to be aware of the local characterization of royalty and interest payments made among related parties, and this may not always be easily ascertainable.

Conclusion

The Final US Tax Legislation applies to both US and non-US multinationals with cross-border operations. Several of the provisions could increase an FMNE’s US tax liability through disallowance of, or material limitations with respect to, deductions for payments by the FMNE’s US affiliates to its non-US affiliates, or by subjecting transactions to US tax that might not have been subject to US tax prior to tax reform. Still, other provisions will increase the FMNE’s compliance and administrative burden. FMNEs should thoroughly review their US operations, paying particular attention to cross-border payments to non-US related parties. The cost of doing business in the United States for these FMNEs may increase and it may be the right time to consider restructuring opportunities.