TCJA and BEPS

Tax Cuts and Jobs Act: A Response to BEPS

Author: JESSICA SILBERING-MEYER

JESSICA SILBERING-MEYER, J.D., MBA, is a Managing Editor/Author with the Tax & Accounting business of Thomson Reuters, focusing on BEPS and international tax. She previously worked at several Big 4 firms in the international tax services field, specializing in hedge funds, private equity funds, and corporations.

The TCJA is a direct response to the OECD's BEPS project, with similar provisions on neutralizing hybrid mismatches, anti-deferral of CFC income, limitation on interest deductibility, and reduced tax on specified intangible income.

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The Tax Cuts and Jobs Act (P.L. 115-97, December 22, 2017) (TCJA) reduces the U.S. corporate tax rate from 35% to 21%; allows a 100% dividends-received deduction (DRD) for the foreign-source portion of dividends paid from 10%-owned foreign subsidiaries to U.S. corporations (e.g., participation exemption) **1** ; requires U.S. shareholders of controlled foreign corporations (CFCs) to include in gross income global intangible low-taxed income (GILTI) **2** ; and provides a minimum tax on base erosion payments (base erosion and anti-abuse tax) (BEAT). **3** In addition, new rules on foreign-derived intangible income (FDII) **4** encourage the development of intangibles in the U.S., with a reduced tax on a U.S. corporation's intangible income derived from foreign use. This article reviews these international tax provisions and compares them with the relevant Action items in the OECD BEPS project.

TCJA-Background

Prior to the TCJA, the U.S. had a worldwide tax system under which U.S. persons were generally taxed on all income derived in the U.S. and abroad. Under the Subpart F rules, U.S. shareholders of CFCs are required to include in income their pro rata share of the CFC's Subpart F income, whether or not distributed by the CFC.

Under the transition to the participation exemption, a CFC, with respect to its last tax year beginning before January 1, 2018, will increase its Subpart F income by the greater of accumulated post-1986 deferred foreign income determined either as of November 2, 2017, [5] or December 31, 2017. [6] A U.S. shareholder can deduct, for the tax year in which an amount is included in its gross income, 15.5% for cash and cash equivalents and 8% for other amounts. [7] No foreign tax credits (FTCs) are allowed for any taxes paid or accrued with respect to any amounts deducted under **Section 965** . [8]

Corporate Strategy

The TCJA will require companies to analyze various tax implications, especially in the M&A context. For example, when one company acquires another, the purchasing company will need to consider any outstanding obligations of the acquired company, including whether this company is a fiscal- or calendar-year taxpayer. In addition, all companies should consider potential foreign withholding taxes (WHT) on dividends transferred from a CFC to its U.S. shareholder.

Companies will need to determine how to use the additional cash repatriated from the foreign subsidiaries. Possibilities include a return to shareholders, repayment of debt, or investment in acquisitions or employee compensation/bonus. Investment in the U.S. should also increase following the tax reform. Companies should encourage their tax professionals to be involved in deal strategy from the beginning. Due diligence and structuring will continue to be important.

OECD BEPS Project

On October 5, 2015, the OECD presented the final package of BEPS measures. [9] The BEPS project assists countries in closing gaps in existing international rules that allow corporate profits to be shifted artificially to no- or low-tax jurisdictions, where little or no economic activity occurs. The final reports for the 15 BEPS Actions are:

- Action 1: Addressing the Tax Challenges of the Digital Economy.
- Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements.
- Action 3: Designing Effective Controlled Foreign Company Rules.
- Action 4: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments.
- Action 5: Countering Harmful Tax Practices More Effectively, Taking Into Account Transparency and Substance.

- Action 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances.
- Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status.
- Actions 8-10: Aligning Transfer Pricing Outcomes With Value Creation.
- Action 11: Measuring and Monitoring BEPS.
- Action 12: Mandatory Disclosure Rules.
- Action 13: Guidance on Transfer Pricing Documentation and Country-by-Country Reporting.
- Action 14: Making Dispute Resolution Mechanisms More Effective.
- Action 15: Developing a Multilateral Instrument to Modify Bilateral Tax Treaties

TCJA Response to BEPS

The TCJA includes international provisions that clearly correspond to their relevant counterparts in the BEPS project (i.e., hybrid mismatches, anti-deferral of CFC income, interest deductibility, and reduced tax on intangible income). In addition, Congress created a general base erosion provision through BEAT.

Hybrid mismatches.

Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double nontaxation. The BEPS Action 2 recommendations **10** aim to "neutralize hybrid mismatches" by prohibiting multiple deductions for a single expense, deductions without corresponding taxation, or multiple FTCs for one amount of foreign tax paid.

The TCJA includes new **Section 267A** , under which deductions are disallowed for interest or royalties paid to a related party when these payments are not included in income or the related party can take a deduction. In addition, the 100% DRD does not apply to dividends that a U.S. shareholder receives from a CFC if they are hybrid dividends (e.g., the CFC was allowed to take a deduction with respect to income tax imposed by a foreign country). **11** In effect, these provisions neutralize hybrid mismatches created from deduction/non-inclusion and double deductions.

CFCs.

The Action 3 final report **12** recognizes that groups can create nonresident affiliates to shift income, and that these affiliates may be established wholly or partly for tax reasons rather than for nontax business reasons. As a result, CFC and other anti-deferral rules permit jurisdictions to tax income of foreign subsidiaries when certain conditions are met.

The Revenue Act of 1962 reduced the tax deferral advantages of CFCs by refining the concept of a "controlled" foreign corporation and adding Subpart F to the Code. **13** The Subpart F inclusion rules

restrict a U.S. shareholder's ability to defer taxes on certain types of income by requiring the income to be included in the U.S. shareholder's current-year taxable income, regardless of the CFC's repatriation to the U.S.

Section 951(a) requires a U.S. shareholder of a CFC to include in gross income for the tax year its pro rata share of the CFC's Subpart F income for that year. Under the TCJA, new **Section 951A** requires U.S. shareholders of CFCs to include GILTI in their gross income for the tax year. GILTI is defined as the excess of the U.S. shareholder's net CFC tested income over its net deemed tangible income return (excess of 10% of the aggregate pro rata share of tangible assets of each CFC over interest expense). As a result, CFCs with little more than a 10% cost-plus return on tangible assets will incur a high tax under GILTI.

At a high level, to determine the GILTI inclusion, it is first necessary to determine the CFC's gross income less deductions. This amount is reduced further by 10% of the CFC's depreciable tangible business assets. The final amount is subject to potential tax at the U.S. shareholder level. However, the U.S. shareholder can deduct up to 50% [14] and take an 80% deemed-paid FTC for GILTI. [15]

GILTI will have a higher negative impact on individuals since only U.S. corporations are subject to the 50% deduction and 80% FTC. Therefore, it may be beneficial for these individuals to structure their foreign companies under a U.S. corporation. Further, companies should determine whether it makes sense to check the box on their CFCs, creating disregarded entities/branches. This will also have negative implications since income of these flow-through entities will be subject to current tax.

Interest deductibility.

Multinational groups may achieve favorable tax results by adjusting the amount of debt in a group entity. To address these risks, Action 4 [16] called for recommendations regarding best practices in the design of rules to prevent base erosion through interest expense. The recommended approach is based on a fixed ratio rule, which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of its earnings before interest, taxes, depreciation and amortization (EBITDA), with potential ratios between 10% and 30%. The approach can be supplemented by a worldwide group ratio rule, which allows an entity to exceed this limit in certain circumstances.

Interest deductibility is another aspect of U.S. tax reform. Under amended **Section 163(j)(1)** , deductions on business interest for the tax year cannot exceed the sum of business interest income; 30% of adjusted taxable income (cannot be less than zero); and the floor plan financing interest (see below). The amount of any business interest that cannot be deducted for a tax year is carried forward to the

following tax year. [17] Adjusted taxable income (ATI) is computed without regard to the following:

- Any item of income, gain, deduction, or loss that is not properly allocable to a trade or business.
- Any business interest or business interest income.
- Any net operating loss deduction under **Section 172** .
- Any deduction allowed under **Section 199A** .
- For tax years beginning before January 1, 2022, any deduction allowable for depreciation, amortization, or depletion. [18]

Floor plan financing interest is interest that is paid or accrued to finance the acquisition of motor vehicles held for sale or lease, and is secured by the acquired inventory. [19]

Companies should analyze how their transactions are financed (e.g., proportion of debt to equity) to maximize their interest deductions.

Preferential regimes and harmful tax practices.

The OECD's work on BEPS Action 5 [20] committed the Forum on Harmful Tax Practices (FHTP) to "[r]evamp the work on harmful tax practices with a priority on improving transparency, including compulsory spontaneous exchange on rulings related to preferential regimes, and on requiring substantial activity for any preferential regime. It will take a holistic approach to evaluate preferential tax regimes in the BEPS context. It will engage with non-OECD members on the basis of the existing framework and consider revisions or additions to the existing framework."

According to the BEPS Action 5 final report, [21] countries have agreed that the substantial activity requirement used to assess preferential regimes should be strengthened to realign the taxation of profits with the substantial activities that generate them. Consensus was reached on the "nexus approach," which was developed for IP regimes. The nexus approach allows a taxpayer to benefit from an IP regime only to the extent that the taxpayer itself incurred qualifying R&D expenditures that gave rise to the IP income.

In determining whether a preferential regime is potentially harmful, the OECD will consider the substantial activity factor under Action 5, along with four key factors below from the OECD's 1998 Report Harmful Tax Competition: An Emerging Global Issue: [22]

(1) The regime imposes no or low effective tax rates on income from geographically mobile financial and other service activities.
(2) The regime is ring-fenced from the domestic economy.
(3) The regime lacks transparency (i.e., the details of the regime or its application are not apparent, or there is inadequate regulatory supervision or financial disclosure).
(4) There is no effective exchange of information with respect to the regime.

FDII offers U.S. MNEs a reduced tax on intangible income derived from foreign use. As a result, this

provision resembles closely patent box and other incentive box regimes implemented in other

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countries. Under the TCJA, FDII includes property sold to a foreign person for foreign use, or services provided to a foreign person (or with respect to non-U.S. property). **23** U.S. taxpayers that license IP to foreign persons, and receive royalty income from these persons, would benefit from this provision. Under **Section 250** , a U.S. corporation can deduct 37.5% of FDII, with a resulting effective tax rate of 13.125%. For any tax year beginning after December 31, 2025, the deduction is reduced to 21.875%.

If a taxpayer sells property to another person (other than a related party) for additional manufacturing/modification in the U.S., the property will not be treated as sold for a foreign use even if the other person subsequently uses it for a foreign use. **24** If a taxpayer provides services to another person (other than a related party) located in the U.S., the services will not be treated as provided to a foreign person or with respect to non-U.S. property. **25**

The U.S. enacted FDII to encourage U.S. MNEs to locate their IP in the United States. While the U.S. is awaiting guidance from Treasury on FDII, it appears that this provision has broader implications than a simple patent box. FDII aims to put U.S. IP owners on a level playing field with their foreign counterparts, which currently receive similar tax benefits. Further, the location of IP in the U.S. leads to additional R&D and similar jobs in the U.S., further expanding economic growth and investment.

It remains to be seen whether the World Trade Organization (WTO) will consider the FDII to be a prohibitive export subsidy. If it does, other countries may be allowed to enact defensive measures in response (e.g., disallow deductions for royalty payments to the U.S.).

General base erosion tax.

With the addition of BEAT, the U.S. will impose a minimum tax on certain deductible payments to a related foreign person ("base erosion payment" **26**). This tax is in addition to any other tax imposed. **27** BEAT is a tax equal to the "base erosion minimum tax amount" for the tax year. The base erosion minimum tax amount is the excess of 10% (5% for tax years beginning in calendar year 2018) of the modified taxable income (determined without regard to base erosion tax benefits for base erosion payments, or the base erosion percentage of a net operating loss deduction) over the regular tax liability, reduced by applicable credits. **28** BEAT effectively adds back deductions for base erosion payments when calculating the potential tax liability.

This tax applies to taxpayers with average annual gross receipts for the three-year tax period ending with the preceding tax year of at least $500 million and a base erosion percentage for the tax year of 3% (2% for banks and securities dealers). **29** BEAT results in the disallowance of below-the-line (not included in cost of goods sold (COGS)) deductions on payments to foreign related parties. Taxpayers will need to determine which payments to foreign related parties are base erosion payments under

BEAT.

Under the TCJA, base erosion payments do not include any amounts that a taxpayer paid or accrued for services if (1) the services meet the requirements for eligibility for use of the services cost method under **Section 482** ; and (2) the amounts constitute the total services cost with no markup component. Treasury is considering additional guidance on this issue.

A taxpayer should determine first whether it is considered an "applicable taxpayer" under BEAT. If so, they will then need to model out potential BEAT liability. Due to the lack of current guidance, companies will need to make certain assumptions regarding the type of payments subject to BEAT, specifically whether any payments can be included in COGS and, therefore, excluded from the BEAT calculation.

Conclusion

The recently enacted (and long-awaited) U.S. tax reform is a clear response to the OECD's 2015 BEPS recommendations. The TCJA incorporates provisions that target hybrid mismatches, deferral of income, interest deductibility, and preferential regimes. With the addition of the CbC reporting final Regulations (**Reg. 1.6038-4**), the U.S. is well on its way to joining its global counterparts in combatting BEPS.

1 Section 245A .

2 Section 951A .

3 Section 59A .

4 Section 250 .

5 Section 965(a)(1) . H.R. 1, the Tax Cuts and Jobs Act, was released on November 2, 2017.

6 Section 965(a)(2) .

7 Section 965(c)(1) .

8 Section 965(g)(1) .

9 www.oecd.org/tax/beps/beps-actions.htm.

10

www.oecd.org/tax/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-97892642411138

11 Section 245A(e)(1) .

12
www.oecd.org/tax/designing-effective-controlled-foreign-company-rules-action-3-2015-final-report-9789264241152-en.h

13 See Redmiles and Wenrich, "A History of Controlled Foreign Corporations and the Foreign Tax Credit," www.irs.gov/pub/irs-soi/historycfcftc.pdf.

14 Section 250(a)(1)(B).

15 Section 960(d) .

16
www.oecd.org/tax/limiting-base-erosion-involving-interest-deductions-and-other-financial-payments-action-4-2015-final-

17 Section 163(j)(2) .

18 Section **163(j)(8)** .

19 Section 163(j)(9) .

20
www.oecd.org/tax/countering-harmful-tax-practices-more-effectively-taking-into-account-transparency-and-substance-a

21 *Id.*

22 *Harmful Tax Competition: An Emerging Global Issue*, OECD Publishing (Paris, 1998), http://dx.doi.org/10.1787/9789264162945-en.

23 Section 250(b)(4) .

24 Section 250(b)(5)(B)(i) .

25)Section 250(b)(5)(B)(ii).

26 Section 59A(d) .

27 Section 59A(a) .

28 Section 59A(b)(1) .

29 Section 59A(e) .

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