2018 Outlook
Tax and Accounting

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In Practice / *Page S-5*

Federal Tax / *Page S-10*

State Tax / *Page S-21*

International Tax / *Page S-26*

Accounting / *Page S-36*

BNA Insights / *Page S-15, S-30, S-32*

IN PRACTICE

CORPORATE TAXES Five things corporate tax directors are worrying about in 2018 .... S-7

TAX POLICY What's next after tax reform: Bloomberg Tax roundtable S-5

FEDERAL TAX

EMPLOYMENT TAXES Withholding a head-scratcher for some as IRS guidance rolls out S-13

TAX ENFORCEMENT IRS may face legal challenges on tax law regulations S-12

TAX POLICY Tax writers eye tax law corrections, IRS reshuffle in 2018 .... S-10

TAX REGULATIONS Tax overhaul 'crying out' for IRS guidance in 2018, attorneys say S-11

STATE TAX

TAX POLICY Federal law prompts states to weigh own tax policy overhauls S-22

States scramble to measure, mitigate impact of federal tax law S-21

INTERNATIONAL TAX

AUSTRALIA U.S. tax reform to vex Australia in year ahead S-28

CHINA U.S. tax cut may lead to more open China S-27

EUROPEAN UNION U.S. reform clouds EU's 2018 tax agenda S-26

ACCOUNTING

MULTINATIONAL CORPORATIONS Foreign companies' U.S. operations confront tax overhaul S-37

TAX PRACTICE Five areas where new tax law affects accounting S-36

BNA INSIGHTS

CFCs Tax reform: Taxation of income of controlled foreign corporations S-15

FOREIGN CORPORATIONS U.S. Tax Cuts and Jobs Act—potential impact on India S-32

MULTINATIONAL CORPORATIONS U.S. tax reform: What U.K. multinationals need to know S-30

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In Practice

Tax Policy

What's Next After Tax Reform: Bloomberg Tax Roundtable

Bloomberg Tax spoke with tax practitioners about their expectations for corporations, states, and foreign countries now that the U.S. has passed a tax cut package.

The new tax act (Pub. L. No. 115-97) made sweeping changes to the tax code, and has created as many opportunities for corporations to plan as it has questions about its effects. We asked Bloomberg Tax advisory board members to share their insights into what to expect during the next year—and beyond.

The practitioners were: Lisa M. Starczewski, a shareholder at Buchanan Ingersoll & Rooney PC in Philadelphia; William Alexander, of counsel at Skadden, Arps, Slate, Meagher & Flom LLP in Washington; John L. Harrington, a partner at Dentons in Washington; Richard S. Franklin, a member at Franklin Karibjanian & Law PLLC in Washington; and Joe Huddleston, executive director of the national indirect tax group at Ernst & Young LLP.

The reporters were Laura Davison, Colleen Murphy, and Sony Kassam.

Here's a wrap-up of the discussion. The questions and responses have been edited for length and clarity. For a complete transcript, see http://src.bna.com/vG3. A podcast is available at http://src.bna.com/vKv.

Federal Tax

Davison: How can we expect estate tax planning strategies to change between now and when the doubled exemption amount expires in 2026?

Franklin: The act leaves the entire estate, gift, and GST system in place, which made it easy for this Congress to make the change. But it also makes it easy for, you know, future legislation to unwind these changes or simply leave them as they currently are, and they will sunset in 2026. . . .

So, this provision is great for the uber-wealthy. It's going to make it much more complicated planning-wise for families who are not able to immediately use the exclusion. And in some sense, if they can't do it it's a use it or lose it system. In 2026 it sunsets. So, for those families that can't use it prior to that time, you know, it will be in effect illusory and somewhat confusing because it makes the planning options more complicated.

Davison: What planning opportunities exist with the new law? What planning can happen now and what needs to wait until the IRS issues guidance?

Starczewski: I think everyone knows this, but I think it's very important just to think about it for a minute. We have this massive new tax act. . . .

We have all been digesting, reading, thinking, analyzing. We've had two and a half weeks. We've had prior versions, but there are significant differences between those versions and what we ended up with in some instances. And so, the point is it's new. It's very new.

And secondly, it came to us in a relatively unique way—a fast, unique way. We didn't get the benefit of hearings and debates and learning with respect to the intent behind these provisions, the way in which they're intended to be applied. . . .

Everyone wants to talk about choice of entity as, you know, a planning opportunity. We get calls from clients on choice of entity literally every day. I personally don't believe and I haven't talked to many people who believe that we're going to see this wholesale, you know, conversion to C corporations. . . .

But there is no question that for people starting new businesses, choice of entity got a little bit more complicated, a little bit different than the items we focused on before. . . .

So for me, you know, I think it's very important to understand that under the Tax Act there's no quick and easy answer to what should we change. You know, if this and this are true, do we do this? It's more like a matrix. There are a lot of factors.

Alexander: What I think they're mostly focused on right now is if they have a multinational business, how to structure that. Their worldwide business, is it configured the right way? And I think that's really where a lot of their attention is going to be. . . .

In terms of the attractiveness of, you know, subchapter C, well, the rates are lower, but again, you know, there are a lot of things that have changed. . . . People will be sitting down in front of a spreadsheet and saying, is this good for me? One of the things people have to be mindful of is the fact that it is a lot easier to get into subchapter C than to get out.

Starczewski: I think with respect to the pass-through deduction there's a lot of planning that can happen there. There are going to be ways I think to plan into the deduction and out of the wage and qualified property cap. Maybe there can be some restructuring, for instance, of independent contractor relationships into employment relationships. . . . All of this planning is very fact- and circumstance-specific. . . . We may see different conclusions than we've seen under current rules in specific circumstances. . . . Real estate businesses are highly impacted, I think, across the board by a lot of these provisions. I think for that type of business the business interest limitation may be incredibly impactful. There is going to need to be analysis and modeling about whether a business should elect out of that limitation, because that needs to be compared, that scenario, with the increased depreciation periods, the loss of bonus depreciation for qualified improvement property.

International Tax

Murphy: On the international side, we've talked a lot about planning today, and certainly one group that's been paying really close attention as this bill has devel-

oped and as it was passed is multinational companies. So, what should companies with cross-border operations consider as they're crafting a long-term tax strategy?

Harrington: I think the company needs to decide, you know, whether it needs to change its structure. And that could be fundamental changes, like where the parent company is located—whether it's the United States or somewhere else. It's also going to mean re-evaluating or revisiting more minor issues, such as whether an entity should remain disregarded or a controlled foreign corporation—a CFC—or whether it should convert. . . .

Also, you have—you can have assets such as intellectual property that are held in, you know, in a particular holding company—or used in a certain way. . . . Then you have to move into the more —call it ''transactional issues,'' in terms of looking at what you're doing now.

Is there a more favorable way to do it or is it—or what you're doing now is unfavorable; you need to re-visit it?

Murphy: European Union members have been pretty vocal about some concerns that they have, particularly the base erosion and anti-abuse tax provision, the BEAT. The EU has warned about a World Trade Organization challenge over some provisions. What do you think is the likelihood of such a case? What would the impact of that be?

Harrington: Whether to bring a WTO challenge is ultimately a political decision. . . . A country could have a very strong case and think, for political reasons, they don't want to bring a dispute. They can also defer bringing a dispute. They can also have a relatively weak case and decide, for domestic consumption or something else, it's worth bringing the case. . . .

Since the Ways and Means Committee, the Finance Committee have jurisdiction over trade as well as taxes, presumably they did take a close look at this. . . . The track record of the United States on this isn't good. Each time, we seem to think we've found some way to create an incentive for exports, following the rules for consumption taxes without actually having a value-added tax, or sales tax.

But each time that European countries have brought that under GATT [General Agreement on Tariffs or Trade] or under WTO, the U.S. has lost that.

Murphy: Some countries, like China and Australia, have been concerned that the reforms in the U.S. could hurt their own competitiveness, and there's been talk about countries making their own reforms in response. Is there a risk some of that could clash with what the OECD is trying to do around base erosion and profit shifting?

Harrington: A lot of these international provisions really were generated, you know, through Congress, which wasn't really part of the BEPS process. . . . I think, in that sort of sense, you know, there's not the same buy-in to BEPS that would have occurred. And also, BEPS, I think, is just reaching its natural progression, where countries now are starting to implement BEPS, often taking unilateral actions. It's—the same forces that kind of led to BEPS are leading to the unilateral actions. So, I think, to a certain extent, this is just kind of returning to the norm.

State Tax

Davison: Is it safe to assume that many states won't follow the full expensing provision, just as they decoupled from bonus depreciation?

Huddleston: Somewhere close to 30 of the 50 states have substantially missed their revenue projections over the last couple of years. That's causing real problems. So, when you add to that what's happening at the federal level, the likelihood that states would not decouple is very small. . . .

Largely, states where they would see a revenue reduction, they clearly are going to decouple, much as they did with bonus depreciation before, but at the expensing level and in depreciation. States will decouple if they have to. . . .

I find it very unlikely that states, in their current economic situation, are going to ride any kind of a bus that results in reduction in revenue for them.

Davison: Does the idea of replacing income taxes with payroll taxes or creating a charitable group to fund public services sound like viable ways around the SALT [state and local tax] deduction limit?

Huddleston: Keep in mind, there's a real distinction here between individual citizens of the state—who are going to see a direct impact on themselves, particularly in those high tax states that we all know around the country—whether it's California, New York, Connecticut. The individual citizens are going to see an impact.

The state governments, on the other hand, may not see anything but a marginal impact as a result of that. So, there's the real question, as between the two—do the citizens and the state demand some kind of action? Because if you're talking about state revenues as a result of this cap, the alteration is going to be marginal.

Transfer Pricing

Kassam: Now that we have a lower corporate income tax rate of 21 percent, do you think U.S. companies will consider moving their operations and their intangibles back to the U.S.? How do you think the new foreign-derived income rules factor into that?

Harrington: There can be tax costs to moving operations. If you're in a foreign country, there can be an exit tax. . . . When you pre-move something into the U.S., sort of like if you're a corporation, it's easy to get in, it's hard to get out. . . . If you move intangible property in the U.S. you've got to be pretty sure that you're not going to move it back out. . . .

If you do this to benefit from the foreign-derived intangible income, it also raises the question about how long . . . you feel that those rules are going to continue to stay there. It's supposed to become less favorable over time. . . . If there's changes to the act to raise revenue or for political reasons, this is the one that might be taken into account. So, even if it's available now . . . you don't know how long it would be available, at least in its present form.

Kassam: Since there's so much of a focus on intangibles and where it's placed, how likely is it that U.S. companies will face more audits by foreign tax administrations?

Harrington: Companies are particularly concerned about it as country-by-country reporting comes online. . . . Also, you have to be concerned about potential double or multiple taxation because the U.S. rules for outbound transfer intangible have been tightened as well. . . .

Because it's intangible, you don't know where it's located, and that's created opportunities for companies, because they've often been able to tell a foreign government, ''Our intangible properties are located here or

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somewhere else and are low taxed.'' . . . The flip side of that is it's hard to prove it's not there, either.

Final Thoughts

Kassam: What aspects of the new tax law do you think have the most staying power? And what aspects do you think would need to be revised because of unintended consequences?

Starczewski: I do think that we are going to have consequences we didn't expect. Even just something as simple as business losses and the fact that they are so limited now out of pass-throughs.

Alexander: I wouldn't be surprised if six to 12 months into the next major recession we have loss carrybacks again. . . . Until then it's going to be a little bit rough for struggling businesses. . . . Loss carryback is cash in hand. It's not just a tax asset, and their competitors are going to have an extra, if they're profitable, an extra 14 cents on the dollar. So, their situation may be rough in the short-run, but if things get really rough for the country as a whole, I wouldn't be surprised to see that return.

Harrington: From a political standpoint, they have to take into account the fact this was passed with only Republican votes, and so if the Democrats take one or both houses then you would expect there to be changes over the types of things they've criticized in the bill. . . .

From a practical standpoint, . . . the more novel and the more complicated the provision, the more likely it's going to have unintended consequences and need to be tweaked. . . . In the international area, I see the GILTI and the foreign-derived income—intangible income and the deemed repatriation provision as being areas that probably fall in that category.

Franklin: Historically the modern estate tax has been around for 101 years and it's been gone for one year. . . .

And we look at first world countries. The United States, by some metrics, is the most unequal country for income and wealth inequality. So, just looking at the landscape, to me, says the gift, estate and GST tax system will endure. . . . Repeal is alluring, but I think it's ephemeral and it's imprudent if your idea is you want to preserve family wealth to rely on the vagaries of our government about keeping or not keeping the federal estate tax. . . .

Even the carryover basis there will be lots of games that people play with increasing the basis of assets, which not only will affect the federal system, but the states as well.

Huddleston: One thing that I believe will endure is that the relative significance of state and local taxes is increased, both for the individual and for the corporations, and the scattershot approach that the states have always used will continue to be a huge problem for both corporate and individual planning. Some of the unintended consequences could well reach into the area of both corporate and individual migration.

Do businesses, do individuals stay in the states they're in? Or if there are dramatic shifts in the relative tax burden, do they begin to find other places to have their headquarters or to live?

By Sony Kassam, Colleen Murphy, and Laura Davison

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Corporate Taxes

Five Things Corporate Tax Directors Are Worrying About in 2018

The tax directors of large U.S. companies face a mind-boggling job in 2018 if they aim to answer the boss' question: What tax issues should our company be worried about?

Last month's U.S. tax overhaul compressed three decades of tax law evolution. Thus, corporate tax directors will have to scramble to digest the ramifications for their companies and answer a multitude of questions from financial officers.

In 2018, the harried tax director will be addressing these five key issues: a tsunami of potential technical corrections; the treatment of mixed companies; finding a home for the lifeblood of multinational companies—their invaluable intangible assets; the dismaying prospect of more competent authority disputes; and complying with their state-and-local tax obligations.

Corrections Ahead Tax executives can expect a wave of technical corrections to the new tax law (Pub. L. No. 115-97). The question remains, however, just how soon they'll get them.

''We're—at least during my lifetime—in uncharted territory right now. This tax bill is massive and was rushed through with so little oversight that the likelihood that mistakes were made is significant.''

Don Leatherman
University of Tennessee

''With the '86 act, it took up to a couple of years to get technicals done,'' said Lisa M. Zarlenga, a partner at Steptoe & Johnson LLP and co-chair of the law firm's tax group. ''Hopefully, the more significant and pressing questions the IRS will answer by that time.''

Many of the new rules were effective at the start of this year, so most companies won't have to worry about filing changes in 2019, Zarlenga said. But for measures like the provision allowing temporary full expensing, which was effective Sept. 27, 2017, and the mandatory repatriation tax, which requires companies with offshore cash to calculate their income on two dates, Nov. 2 and Dec. 31 of last year, she said, guidance, clarifications, and technical fixes may be more urgent.

Likely delays, she added, could hamper corporate accounting teams working to revamp their computer systems to comply with new rules that took effect Jan. 1, 2018—and late last year.

Analysts agree that the haste with which congressional Republicans produced the law ensured that they'd leave confusion and mistakes in their wake. Still, some

said that tax executives shouldn't hold their breath, as both opposition from Democrats and the sheer number of technical corrections needed could slow the process.

"We're—at least during my lifetime—in uncharted territory right now," Don Leatherman, a professor at the University of Tennessee, told Bloomberg Tax. "This tax bill is massive and was rushed through with so little oversight that the likelihood that mistakes were made is significant."

Worse, he pointed out, the Internal Revenue Service, tasked with administering the law, remains hobbled by budget and staffing shortages, and may not have the resources "to deal with the many, many issues that arise from the tax act."

Treatment of Mixed Companies One area of the new law where tax executives may need or want to watch for guidance from the IRS and Treasury Department is the tax treatment of conglomerates with subsidiaries that have to follow a different set of rules than their parent companies.

The new tax act limits the deduction of interest expenses to 30 percent of income—and then, in four years, a smaller measure of income—and the law allows temporary full expensing for both exempt companies in the real estate trade and publicly regulated utilities. But what about a non-real estate firm that owns a real estate investment trust, or an energy company that recently acquired an entity that owns a regulated utility? It's a question that should leave tax executives scratching their heads until they're provided further guidance, analysts agree.

"If you've got a mixed business, how do you divide that up and allocate the interest between the two buckets?" said Ray Beeman, co-leader of the Washington Council Ernst & Young practice of Ernst & Young LLP, who focuses on tax and budget policy. He cited as an example the regulated electric power giant Dominion Energy's merger with non-regulated SCANA Corp., which itself owns a variety of regulated utilities. "The bill uses the term 'properly allocable' to determine how much of the interest you would attribute to the utility business and wouldn't be subject to the limitation, but it doesn't tell you how to do that."

That problem could become more widespread as companies seek to reorganize to seize the benefits of more generous tax treatment of, say, real estate investment trusts, not unlike the way the private prisons corporation GEO Group restructured as a REIT several years ago.

"Larger groups may start setting up REITs and then shift all real estate that's owned by the group to the REIT and then lard the REITs with debt," Leatherman said. "So there are games that will be played, because of the disparate ways that interest is treated."

Finding a Home for Intangible Assets Facing changes in the U.S. tax code and shifts in global taxation in a post-base erosion and profit shifting (BEPS) world, multinationals face a decision on where to put the intellectual property they had stored in low-tax offshore structures.

"Tax reform came at an interesting time," said Tom Zollo, international tax principal at KPMG in Washington. "We're coming to a fork in the road, where companies are looking at these structures saying, 'The jig is up. We won't get zero tax income offshore so we have to think about where we put the IP.' "

The tax code aims to encourage multinationals to repatriate intellectual property and other intangible assets through a tax on global intangible low-taxed income (GILTI), and a deduction for foreign-derived intangible income. These provisions redefine "intangible": Where the tax code used to define intangible property through a list of specific types of assets, including intellectual property like patents, the new definition encompasses anything not strictly considered a tangible asset. That is because the provisions assign a standard 10 percent return on tangible assets at a tax threshold above which anti-deferral measures take effect.

"If you move intangible property in the U.S. you've got to be pretty sure that you're not going to move it back out. That was true before, it's even more true now."

JOHN HARRINGTON
DENTONS

Outside U.S. tax reform, the global tax environment for multinationals is also changing, as the Organization for Economic Cooperation and Development's project on BEPS takes hold. Started by the OECD in 2012, the BEPS effort takes aim at the practice of companies moving profits between foreign entities to avoid taxation. As a result, it's becoming increasingly more difficult for companies to achieve the very low global effective tax rates of recent years.

Furthermore, the loopholes multinationals relied on may not be open much longer. Ireland closed its "Double Irish" loophole in 2015—although any company already using it can continue to do so until 2020—and the Netherlands may end the hybrid Dutch CV structure, Zollo said. Leaving these assets overseas could also expose a company to audits by foreign tax authorities empowered by the expanded U.S. definition of intangibles.

Bringing the assets back to the U.S. runs its own set of risks. First, there are the potential costs of moving intellectual property, such as IP exit taxes imposed by some countries, including Ireland. The U.S. may also represent an uncertain choice. Companies must contend with the risk that any provision of the new tax code could change as the IRS issues guidance, or that pieces of the bill could be overturned entirely if the Democrats retake either Congress or the White House. Large multinationals with offshore structures in no-tax jurisdictions like Bermuda or the Cayman Islands are well-placed, Zollo said, because "the consequences are nil"—they will not pay tax on the property they move out.

Facing these factors, multinationals can either keep their intangible property overseas, bring it back, or take a middle option of a wind-down, where offshore patents are allowed to "wither on the vine," or stay where they are for the rest of their useful life, while all new patents are registered in the U.S.

Once a company brings IP assets to the U.S., it is much harder to move them back offshore, said John

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Harrington, a partner at Dentons tax practice in Washington, because they would then be subject to deemed royalty taxes.

"If you move intangible property in the U.S. you've got to be pretty sure that you're not going to move it back out," said Harrington, who chairs the Bloomberg Tax International Advisory Board. "That was true before, it's even more true now."

More Disputes and Audits The expanded definition of intangibles may strengthen the IRS's hand against companies in disputes and lead to more audits of U.S. multinationals by both the IRS and foreign tax authorities.

"I think the proponents of these broader changes would argue, it's so broad now they pick up anything, therefore there will be less," Harrington said. "It doesn't make those disputes go away. I think changing and broadening the definition will lead to more disputes."

For example, companies and the IRS previously would argue whether workforce in place—the value of having a group of employees already trained—is an intangible asset, with companies arguing against counting that value. Under the new rules, workforce in place is clearly an intangible asset. But that may just mean that disputes will now arise over how, rather than whether, to value it.

"Now it's really more about the allocation of values, versus whether it's an intangible subject to tax," Harrington said.

Intangibles are just one of several factors contributing to a rise in recent years in the number of foreign tax authority audits.

"Over the past few years there has been the same set of forces that led to the whole BEPS project, also leading to increased audits by FTAs," Harrington said, pointing to two reasons: the digitizing of the economy, which allows companies to separate income and economic activity from their physical assets, and more aggressive tax planning by multinationals.

"I think a lot of tax authorities are trying to understand why you can earn income from consumers but pay no tax," he said. "It became a political issue: Why aren't companies paying tax? And that led to increased scrutiny of multinational companies."

Conforming or Decoupling Businesses will find state and local taxes a bit more complicated, particularly those operating in multiple states, as some states conform to some federal changes and reject others.

States could opt not to follow the new full-expensing provision for machinery, adopt the limit on the net interest deduction, make tweaks to their treatment of pass-through entities, and devise ways to skirt the new limit on the deductibility of taxes paid to state and local governments that could involve payroll taxes.

Given that most businesses organize as a partnership, S corporation, sole proprietorship, or other pass-through entity, a new 20 percent deduction for these entities could make compliance in a handful of states more cumbersome for many businesses.

The deduction will be taken from the taxable income of individual owners of pass-through businesses rather than their adjusted gross income. Most states look to adjusted gross income as the starting point for their income tax, so the vast majority of states won't take any action on this provision, Steve Wlodychak, a principal with Ernst & Young LLP's Indirect (State and Local) Tax Practice, told Bloomberg Tax.

However, six states—Colorado, Idaho, North Dakota, Oregon, South Carolina, and Vermont—use taxable income, so they will have to determine whether they should conform.

A bit more troublesome for businesses may be a limit on the deduction they take on net interest expenses. The deduction will be capped at 30 percent of a business's "adjusted taxable income," although amounts above that could be carried forward, tax practitioners tell Bloomberg Tax. Many states, especially separate-return reporting states, as well as those with combined and consolidated reporting, "do not follow the federal consolidated group rules," Wlodychak said.

A bit more troublesome for businesses may be a limit on the deduction they take on net interest expenses.

Combined or consolidated reporting is a regime in which a group of wholly or majority-owned companies and other entities are treated as a single entity for tax purposes.

For members of a federal consolidated group, the new deduction limit applies at the tax-filer level, Wlodychak said. States will have to "come up with rules to properly allocate the federal interest limitation among different members filing returns in the state," he said.

A somewhat related provision that allows immediate full expensing of machinery purchases isn't popular with states.

Signing the tax bill Dec. 22, President Donald Trump said companies will go "wild" about being able to immediately write off the full cost of equipment purchases for a number of years. States, however, would see a revenue loss and may not conform to the provision, Joseph Bishop-Henchman, executive vice president of the Tax Foundation, told Bloomberg Tax.

Many states have already decoupled from Internal Revenue Code Section 168(k)'s 50 percent bonus depreciation, which is being replaced by full expensing, because linking to that provision also would have cost them money. States that already decoupled from Section 168(k) wouldn't have to do anything to remain disconnected to full expensing.

By Lydia O'Neal, Isabel Gottlieb, and Che Odom

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Federal Tax

Tax Policy

Tax Writers Eye Tax Law Corrections, IRS Reshuffle in 2018

Congressional tax writers say they aren't done yet with tax reform and will turn to issues such as overhauling the IRS, updating taxation of education and retirement benefits in the coming year, and correcting mistakes in the new tax law.

House Ways and Means Committee Chairman Kevin Brady (R-Texas) has said that his committee will continue to make changes to the tax code, though not on the scale it did in 2017. Lawmakers are setting long-term goals following the passage of the tax bill, but efforts to meet shorter-term priorities, such as extending expired tax breaks and delaying some taxes funding the Affordable Care Act, are already underway.

''The agenda is—we're not going to wait 31 years to modernize the tax code again,'' Rep. Erik Paulsen (R-Minn.) said. ''This is going to be an ongoing effort to making sure we are constantly looking at reforms that need to be made, whether they are for startups or entrepreneurs or small businesses or large employers.''

The committee will flesh out how to address technical corrections to the tax bill and member priorities in the first half of the year, Paulsen said. Ways and Means Republicans will hold a retreat in the coming weeks to plan out their agenda.

On the Senate side, the agenda is still taking shape. ''We are looking at everything including major IRS overhaul,'' Senate Finance Committee Chairman Orrin G. Hatch (R-Utah) said.

Hatch and Brady have indicated that technical corrections to the tax legislation signed into law last year will be necessary. How expansive those will be and how quickly they can pass is still uncertain, and largely will depend on whether Republicans can persuade Democrats to vote for legislation fixing a law that none in the minority supported. Aspects of the international provisions in the code, as well as tweaks to how to tax pass-through entities, could be prime candidates for technical corrections because they are two of the largest paradigm shifts in the law.

''If technical corrections is an effort by Republicans to try to cover up the mistakes they made,'' Democrats need to figure out how to respond to that, Rep. Sander M. Levin (D-Mich.) told Bloomberg Tax. ''We Democrats want to sit down and think through how we should approach a bill that we very much oppose.''

Tax Reform Leftovers Brady also is looking at ways to tinker with retirement and education savings, but has yet to lay out a detailed plan. He previously said he would like to streamline the retirement account offerings to make it less complex. Brady now says he will announce a direction after the House GOP retreat Jan. 31-Feb. 2.

Another priority is restructuring the IRS—a goal that was left out of the tax reform bill because it didn't comply with Senate budget reconciliation rules.

Rep. Vern Buchanan (R-Fla.), who chairs the Ways and Means Tax Policy Subcommittee, said he is working with Oversight Subcommittee Chairman Lynn Jenkins (R-Kan.) to introduce legislation by April that would overhaul the IRS.

''We need to get that done, and on a bipartisan basis,'' he said.

Senate Republicans are receptive to the idea of overhauling the IRS, an agency that the GOP says has been inefficient and mired in scandal tied to allegations of targeting conservative tax-exempt groups. House Republicans have proposed in their 2016 tax blueprint to separate the IRS into three units—one that works with individuals, another that works with businesses, and a ''small claims'' court. The goal is to make the IRS more customer-service focused, Republicans say.

''The agenda is—we're not going to wait 31 years to modernize the tax code again.''

Rep. Erik Paulsen (R-Minn.)

''If the House has a proposal that makes the IRS work more efficiently and effectively and more responsibly to the American people, obviously we're interested in it,'' said Sen. John Thune (R-S.D.), the third-ranking Republican in the Senate.

Democrats, however, are skeptical this will be a bipartisan process. It could pass the House without any support from the minority, but would need at least nine Democrats in the Senate to back the plan. A restructuring would come as the IRS is implementing the new tax law, but Republicans say an overhaul wouldn't disrupt the rollout of tax reform.

''There needs to be hearings on everything, full throttle discussion of all these changes,'' Ways and Means ranking member Richard E. Neal (D-Mass.) said. ''If we're going into this for more beating up on the IRS, I don't know how that moves the discussion.''

Competing Priorities Tax issues—after dominating the lawmakers' and committee staff time—could also take a back seat as other areas in the committee's jurisdiction, such as trade, Medicare, and Medicaid, become GOP legislative priorities.

Working with President Donald Trump and trading partners on the North American Free Trade Agreement is a priority, said Rep. Dave Reichert (R-Wash.), chairman of the Ways and Means Trade Subcommittee.

''We put so much of our resources into tax for the last several months, now we're stepping back and looking to see if there are things that we could do that would be

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positive for other programs,'' Rep. David Schweikert (R-Ariz.) said. ''There's never a shortage of work.''

Say Farewell 2018 marks the last year that several members of the House and Senate tax-writing committees will be in Congress. Hatch will retire when his term concludes this year and at least seven Ways and Means members are also slated to leave Congress at the end of the year.

Reps. Jenkins, Reichert, Levin, and Sam Johnson (R-Texas) will retire at the end of their terms. Reps. Kristi Noem (R-S.D.) and Diane Black (R-Tenn.) are running for governor in their respective states. Rep. James B. Renacci (R-Ohio) is running for the Senate. Rep. Pat Tiberi (R-Ohio) left Congress in January, after announcing his retirement from Congress in 2017, to lead the Ohio Business Roundtable.

By Laura Davison, Kaustuv Basu, and Allyson Versprille

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Tax Regulations

Tax Overhaul 'Crying Out' For IRS Guidance in 2018, Attorneys Say

Implementing the new tax law will dominate the guidance landscape for 2018, practitioners said.

It's likely to be an all-hands-on-deck effort for the Internal Revenue Service, they told Bloomberg Tax, with the agency striving to issue as much guidance as quickly as possible on the first major tax overhaul since 1986.

How that effort will play out against the backdrop of the administration's effort to pare down hundreds of tax regulations is unclear. The process was set in motion by President Donald Trump in 2017 with executive orders that are still in place.

Attorneys said they expect tax reform guidance to take precedence over everything else. Former IRS commissioner Lawrence Gibbs, now with Miller & Chevalier Chartered in Washington, called it ''job one.''

Triage Mode The situation is critical, said Mark Mazur, Treasury Department assistant secretary for tax policy under President Barack Obama. ''There are a thousand things that are crying out for guidance,'' he said. ''The IRS is probably multiplying time sensitivity versus importance. We'll see where things fall out.''

Congress passed sweeping changes to the tax code that need attention, affecting individuals and businesses in the U.S. and abroad. Eric Solomon, a former Treasury assistant secretary for tax policy in the George W. Bush administration, said the government now has those provisions in ''triage,'' with many requiring expedited efforts because they have immediate effective dates and have a significant impact.

''Treasury and the IRS have a great task before them,'' said Solomon, who now co-chairs the National Tax Department at Ernst & Young LLP.

One question is how the IRS will handle an international provision requiring multinationals to bring home pre-2018 earnings and profits and pay a one-time ''deemed repatriation'' tax.

Although the agency put out initial guidance on repatriation in late December, practitioners across the board have said more is needed.

Base Erosion Provisions Other provisions designed to stop revenue from U.S. multinationals from draining out of U.S. coffers also need guidance, according to Gregory Kidder, a tax partner with Steptoe & Johnson LLP in Washington, and Kimberly S. Blanchard, a tax partner with Weil, Gotshal & Manges LLP in New York.

Both Kidder and Blanchard said there are questions about the base erosion and anti-abuse tax (BEAT) and a minimum tax on global intangible income.

Other areas where taxpayers need help include a new structure for withholding taxes, new rules governing pass-through entities, and provisions limiting the interest deductions that businesses are allowed to take, which affects their ability to finance their operations through debt.

Withholding Sensitive Gibbs, who led the IRS during implementation of the 1986 tax law changes, said he thinks withholding is going to be a particularly sensitive issue where guidance is badly needed—and one that could create political issues for the government.

''If taxpayers are expecting a refund and they're frustrated, you could run into problems,'' he said. ''If the IRS isn't careful, the government could be criticized. You've got a middle class that's been promised bigger take-home pay.''

Mazur, now director of the Urban-Brookings Tax Policy Center, said he thinks pass-throughs are going to be a big issue, in addition to ''a whole new multinational structure.''

With the 2017 tax filing season opening Jan. 29, ''Treasury and IRS are going to have to go through some kind of ruthless prioritization,'' Mazur said.

IRS Wary of Formal Regulations? Even as efforts on new tax guidance are expected to quickly go forward, practitioners said it's likely the IRS will be wary of issuing formal regulations. This is because the IRS will have to keep tabs on the parallel track of Treasury's ongoing review of tax regulations, which could influence the agency's decision-making.

The president froze regulations across all federal agencies on his first day in office in January 2017. Soon after, he called for a government-wide review of the cost and burden of federal regulations and said agencies must delete two troublesome regulations for each new one issued.

That two-for-one directive would likely make the IRS think twice about issuing formal regulations when it isn't clear whether the new rules might be subject to that order, attorneys said.

''It's always been unclear how that would apply,'' said John Harrington, a Dentons tax partner in Washington and a former Treasury international tax counsel. ''Can you put everything into one package and call it a

regulation? How do you even count it?'' said Harrington, who chairs the Bloomberg Tax U.S. International Advisory Board.

Regulatory Review Derailment No one knows whether guidance implementing new tax law provisions will derail the ongoing Treasury and IRS review of existing regulations, in response to the 2017 executive orders.

Trump in April specifically ordered a review of 2016 tax regulations. In October, Treasury Secretary Steven Mnuchin recommended action on eight controversial regulations, including temporary rules taxing spinoffs involving regulated investment companies and real estate investment trusts (T.D. 9770).

Treasury also said it would wait to see what Congress did on reforming the tax code before deciding what to do about widely criticized rules to prevent companies from ''stripping'' earnings out of the U.S. through loans to subsidiaries (T.D. 9790).

''There are a thousand things that are crying out for guidance. The IRS is probably multiplying time sensitivity versus importance. We'll see where things fall out.''

MARK MAZUR
URBAN-BROOKINGS TAX POLICY CENTER

In releasing the October report, Mnuchin said the IRS had already identified more than 200 regulations to repeal or change.

Solomon said in an email that he doesn't expect the government to ''forsake the initiative to examine preexisting guidance and withdraw or modify it as appropriate.''

Treasury didn't respond to a request for comment.

Gary Wilcox, a tax controversy and transfer pricing partner with Mayer Brown LLP in Washington, said the eight recommendations—now on the IRS 2017-2018 Priority Guidance Plan—could be slated for work in 2017, but implementing the tax overhaul will still be at the top of the IRS's list.

''The government needs to be as flexible and fluid as possible,'' said Wilcox, who served as an IRS attorney. ''They cannot let the perfect be the enemy of the good. Their attitude has to be 'let's get something out there, let folks comment on it, and if it's wrong, we'll fix it.' ''

Flexibility Needed Another challenge that could confront issuance of regulations is the Administrative Procedure Act.

Companies are watching the U.S. Chamber of Commerce's lawsuit challenging the IRS's anti-inversion regulations, which asserted the agency didn't meet the APA's notice-and-comment procedures. The Chamber won in the U.S. District Court for the Western District of Texas. On Nov. 27, 2017, the IRS filed an appeal with the U.S. Court of Appeals for the Fifth Circuit.

Companies will be looking at new tax regulations for the slightest infraction of the APA, tax attorneys said.

The potential hurdles to traditional regulations mean the IRS will ''probably be forced to use almost every means they can to get guidance out,'' Harrington said.

IRS officials and tax practitioners have said notices are almost certain to be a big part of the effort to provide guidance.

However, Blanchard of Weil, Gotshal & Manges said: ''My take is that people at the IRS chief counsel's office are probably acting as if they are not deterred from issuing guidance by the president's executive order.''

BY ALISON BENNETT

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Tax Enforcement

IRS May Face Legal Challenges On Tax Law Regulations

The IRS may face legal challenges as it issues regulations to implement the new tax law, according to tax practitioners and law professors.

Budgetary constraints and staff shortages may increase chances of the agency running afoul of the Administrative Procedure Act (APA), they said. The APA defines the rulemaking process for administrative agencies and police agencies for improper behavior. Usually, an agency must give notice and have a comment period as part of the process. Noncompliance with the rulemaking process can trigger lawsuits.

''Taxpayers will scrutinize Treasury's adherence to the APA and be ready to pounce on any missteps. This includes whether the Treasury engages in reasoned decisionmaking in making the policy choices embedded in the regs,'' said Robert J. Kovacev, a partner at Steptoe & Johnson LLP in Washington, who previously was a senior litigation counsel in the Department of Justice Tax Division.

Practitioners told Bloomberg Tax that the Internal Revenue Service's current funding and staffing issues make it susceptible to errors, and that taxpayers will be eager to challenge regulations stemming from the 2017 tax law (Pub. L. No. 115-97) as a result.

''The IRS and Treasury will need to issue a lot of guidance under the legislation and their resources are already stretched very thin,'' said Patrick Smith, a partner at Ivins, Phillips & Barker Chartered in Washington. ''That combination of circumstances provides fertile ground for the agencies not being able to devote the necessary resources to every issue, and that in turn increases the risk of noncompliance with APA requirements.''

Matter of Timing ''Certainly it could be the case that states or individuals, when they see regulations issued by the IRS under the new tax bill, may bring a regulatory challenge,'' said Andy Grewal, a professor at the University of Iowa College of Law. ''But the question then becomes, can you fight the IRS in court outside of a deficiency suit?''

Kristin Hickman, distinguished McKnight University professor and Harlan Albert Rogers professor of law at the University of Minnesota Law School in Minneapolis, said that taxpayers ordinarily challenge Treasury Department regulations or IRS guidance when the agency denies a refund or issues a deficiency notice

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based on interpretations in the regulations or guidance documents.

The U.S. Chamber of Commerce didn't wait for a deficiency notice to take its dispute involving the agency's anti-inversion regulations to court. The Chamber challenged Treasury Regulations Section 1.7874-8T (T.D. 9761, REG-135734-14, issued in April 2016), which was implemented to inhibit corporate inversions, including the Allergan-Pfizer merger. When the IRS didn't allow for a notice-and-comment period as required by the APA, the Chamber challenged the regulations on their face.

The Chamber won its suit against the IRS. The U.S. District Court for the Western District of Texas ruled that the IRS unlawfully issued the regulations, and determined the Tax Anti-Injunction Act (TAIA) didn't preclude pre-enforcement judicial review of IRS regulations.

''The huge job they have ahead of them to interpret this legislation is going to be even more burdensome because of the consciousness that they have to be more careful and more diligent in explaining their decisions.''

PATRICK SMITH
IVINS, PHILLIPS & BARKER CHARTERED

The agency on Nov. 27, 2017, filed a notice stating its intent to appeal the decision to the U.S. Court of Appeals for the Fifth Circuit.

''I think there's a strong likelihood that a taxpayer who feels aggrieved by a regulation issued by Treasury will mount a legal challenge upfront rather than wait for the deficiency process to go all the way,'' Kovacev said. ''For every other agency, that's how it works. Plaintiffs don't have to wait five years for the administrative process, they can just go to court.''

Why Is Tax Different? Johnson said ''if you're challenging IRS actions based on the APA you still have to deal with justiciability issues such as finality, ripeness, and exhaustion of remedies, plus you have to deal with Section 7421,'' the TAIA.

The TAIA says ''no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed.''

The IRS tends to favor a broad interpretation of ''restraining,'' while taxpayers seeking to challenge an IRS action argue for a narrow interpretation.

Johnson said that pre-enforcement challenges, as opposed to the traditional method of waiting for deficiency notice, ''will be a very important theme or dimension of tax litigation going forward.''

Some pre-enforcement challenges, such as the one brought by the Chamber of Commerce, have been successful, while others haven't, Johnson said. In *Fla. Bankers Assoc. v. United States*, the majority of a U.S. Court of Appeals for the District of Columbia Circuit panel found banks couldn't challenge, prior to enforcement, a regulation requiring them to report to the IRS deposit interest paid to nonresident aliens.

The pre-enforcement challenge under the APA provides a significant advantage for taxpayers because a resolution can be reached faster, Smith said at a Jan. 10 D.C. Bar panel on APA regulatory challenges.

Hickman said that parties challenging the new law may have difficulty establishing standing because no taxpayer injury has materialized yet.

To avoid APA challenges to regulations implementing the new law, the IRS can issue guidance in the form of notices ''that provide their interpretation of the statute and they don't need to go through the same process for those,'' Kovacev said. Further, ''interpretive regulations aren't legally binding for taxpayers,'' he said.

Treading Lightly In the aftermath of the *U.S. Chamber* case, Smith said the IRS will need to ''explain why they are doing what they are doing and responding to comments'' when it issues tax regulations.

The agency also needs to be sure that its regulations are in line with the tax law changes. ''If an agency promulgates regulations that are consistent with a statute, you can't use the APA,'' said Steve R. Johnson, a tax law professor at Florida State University College of Law.

Johnson said that a suit also could be brought under Section 706 of the APA, which sets the standard for courts evaluating challenges to agency actions. Taxpayers might file a challenge saying the IRS's guidance on the tax law provisions are ''arbitrary and capricious,'' he said, meaning that the agency made a decision that was inconsistent with the evidence before it. ''Take the courts at their word that that is an uphill fight.''

The IRS could argue that disputed regulations are merely interpretive rules, but that position wouldn't be legally sound, Hickman said.

With or without the immediate threat of an APA lawsuit, the IRS is likely aware that issuing regulations that aren't APA-compliant can put those rules in legal jeopardy.

''The huge job they have ahead of them to interpret this legislation is going to be even more burdensome because of the consciousness that they have to be more careful and more diligent in explaining their decisions,'' Smith said.

The IRS didn't respond to a request for comment.

BY MATTHEW BEDDINGFIELD AND CAROLINA VARGAS

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Employment Taxes

Withholding a Head-Scratcher For Some as IRS Guidance Rolls Out

It's a head-spinning start to 2018 for employers, payroll companies, and possibly confused workers.

The new tax law not only cut taxes and changed tax brackets, but it made such big changes to exemptions

and deductions that fundamental pieces of the employment tax system are being overhauled—bit by bit.

And the Trump administration's drive to deliver the cuts immediately means the changes aren't coming at the same time.

By 2019, major adjustments to the withholding process may be finished, and more accurate ways to withhold on employee pay will be in place. In the meantime, companies and workers are left to determine whether paycheck withholding will be too much, too little, or just right.

This isn't the first time late-year tax law changes have set up complications for withholding, but the magnitude of the changes is notable.

Top tax-writing Democrats in Congress have expressed alarm about the potential for people to have too little withheld this year, leaving them with unexpected tax bills next year. Peter Isberg, president of the National Payroll Reporting Consortium, agreed there is some potential for that.

Still, amid confusion about the moving parts, some people may not have to worry. ''It may be that some can ignore the changes and it will all turn out OK,'' Isberg said.

Phase-In The impact of the new law (Pub. L. No. 115-97) is meant to show up in paychecks no later than Feb. 15, the Internal Revenue Service said Jan. 11 when it issued its first piece of guidance (Notice 1036) for employers: new withholding tables.

The tables reflect the new law's much higher standard deduction and adjusted tax rates, but they keep the personal-exemption-based withholding allowances set last year for 2018—even though the law eliminated personal exemptions.

There may be mismatches, then, between the allowances employees have registered for 2018 and the withholding that will be suitable for them under the new system.

Isberg, who is also vice president for government relations for payroll services company ADP LLC, said Jan. 16 he hadn't expected the IRS's instruction that employers should rely on existing W-4 forms, where employees list personal exemptions. It was surprising, but at least it makes the initial process easier than requiring employees to file new W-4s, he said.

In the next phase of the rollout, Isberg expects the agency to update its online tax calculator and issue a revised W-4 but not require employees to file new ones. Instead, he expects the IRS to ''strongly encourage employees to review their status.''

In Notice 1036, the IRS said that by the end of February it would have the calculator ready, along with information to help people determine whether to adjust withholding to account for repeal of the exemptions, the higher child tax credit, and more.

Correct Estimates The existing W-4 is ''so focused on personal exemptions'' as a base for withholding allowances, Isberg said, that he wondered ''how do we come up with an estimate'' that's close to correct?

Using the withholding allowance amounts wasn't perfect, either, he said, but people knew how to make adjustments to avoid over- or underwithholding.

The IRS has gone out of its way to avoid a W-4 refiling requirement this year, Isberg said. The American Payroll Association didn't get the one-year transition period it asked lawmakers for in December, but at least the ''worst-case scenario of, early on, requiring everyone to file a new W-4″ was averted, Isberg said.

This isn't the first time late-year tax law changes have set up complications for withholding, but the magnitude of the changes is notable.

As for later phases, he said the service provider industry has a long history of recommending that the IRS institute a six-month delay in implementing withholding processes that involve new database fields, reporting, or recordkeeping requirements.

It isn't a small thing for some 150 million to 160 million workers to refile W-4s in a short time frame, he said. While it isn't ''as big a deal as it would be in print,'' because of automated systems, still ''a lot of preparation is needed.''

States, Too States with income tax withholding policies that use the federal personal exemption may have to change their withholding methods.

The 21 states that allow the use of the federal Form W-4 may need to change their policies, if not in 2018 then probably by 2019.

Nine states require the use of Form W-4.

Many states use up to three additional elements of the federal tax code, including federal Form W-4, in the withholding process, a recent Bloomberg Tax analysis showed. Even if a state has its own W-4, sometimes the federal values for personal exemptions and the standard deduction are related.

Missouri, for example, recently released interim 2018 withholding tables but said they would be revised after release of the federal tables. Colorado, North Dakota, Oregon, and Vermont also announced they were waiting for a cue from the federal government before updating their withholding methods.

By Michael Baer and Kathy Larsen

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BNA Insights

CFCs

Lowell D. Yoder, David G. Noren, and Elizabeth R. Chao of McDermott Will & Emery LLP discuss the significant expansion of Subpart F by the recently enacted tax reform legislation and provide an overview of the taxation of income derived by controlled foreign corporations owned by U.S. corporations under the new law. The authors say that many long-standing planning issues remain under the new law, including most Subpart F and Section 956 considerations. In addition, taxpayers will need to contend with significant complexity, unanswered questions, and traps for the unwary under the new ''global intangible low-taxed income'' (GILTI) and ''base erosion and anti-abuse tax'' (BEAT) regimes.

Tax Reform: Taxation of Income of Controlled Foreign Corporations

BY LOWELL D. YODER, DAVID G. NOREN, AND ELIZABETH R. CHAO

Subpart F requires U.S. shareholders of a controlled foreign corporation (CFC) to include in their gross incomes each year their pro rata shares of the CFC's Subpart F income and investments in U.S. property. The recently enacted tax reform legislation, Pub. L. No. 115-97 (12/22/2017) (Tax Act), significantly expanded the application of Subpart F, including by adding a new inclusion rule for non-routine CFC income, termed ''global intangible low-taxed income'' (GILTI). The Tax Act also subjects historic CFC earnings to immediate taxation at reduced tax rates under a transition tax, but going forward provides a 100% deduction for the foreign source portion of dividends received from a CFC. This article provides an overview of the taxation of income derived by CFCs owned by U.S. corporations under the Tax Act.

Definition of U.S. Shareholder and CFC

Subpart F applies to a foreign corporation that is owned more than 50% (by vote or value) by U.S. shareholders. A U.S. shareholder had been defined as a U.S. person that owns 10% or more of the *voting* stock of a foreign corporation. The Tax Act expanded the definition of U.S. shareholder to also include U.S. persons that own 10% or more of the *value* of the stock of the foreign corporation. For example, a U.S. person that owns stock in a foreign corporation with 6% of the votes and 15% of the value would be a U.S. shareholder under the new definition.

Lowell D. Yoder is a partner and Elizabeth R. Chao is an associate with McDermott Will & Emery LLP in Chicago, and David G. Noren is a partner with McDermott Will & Emery LLP in Washington, D.C. Yoder is a member of the Bloomberg Tax U.S. International Advisory Board.

For purposes of the above ownership tests, stock owned directly, indirectly, and constructively is taken into account. Under prior law, stock in a foreign corporation owned by a foreign person was not treated as constructively owned by a U.S. person; the Tax Act removed this limitation. For example, a U.S. subsidiary of a foreign based multinational will be considered as owning stock in a foreign subsidiary of the foreign parent, not just prospectively but also retroactively for the last taxable year of foreign corporations beginning before Jan. 1, 2018.

The new rules expand the range of foreign corporations that are classified as CFCs and the U.S. owners that are classified as U.S. shareholders. However, the amount of a CFC's income that is included in the income of a U.S. shareholder is limited by that U.S. shareholder's ownership interest directly and indirectly through another foreign corporation. For example, while the foreign subsidiary of the foreign parent in the above example would be a CFC, no portion of its Subpart F inclusions would be subject to taxation under Subpart F. Nevertheless, the U.S. shareholder would have to comply with all the CFC reporting requirements with respect to the foreign parent's foreign subsidiary.

One potentially unintended result of the expanded ownership rules is that foreign joint venture corporations that are minority-owned by U.S. persons arguably might become CFCs, even though the legislative history suggests that this is not the intent of the provision. For example, assume a foreign joint venture corporation is owned 30% by a U.S. corporation and 70% by an unre-

lated foreign publicly traded company. The foreign owner also has a U.S. subsidiary, which under the modified constructive ownership rules would be considered as owning its 70% interest in the foreign joint venture. This structure does not involve any CFC de-control planning, and yet it appears possible as a technical matter that the foreign joint venture might be a CFC. The legislative history specifically disclaims any intent to treat a foreign corporation as a CFC with respect to a U.S. shareholder (such as the 30% owner in this example) as a result of attribution of ownership to a U.S. person that is unrelated to such U.S. shareholder, but it is not clear that the statutory language fully effectuates that intent. Guidance and/or technical corrections legislation on this point would be useful.

Subpart F Income Inclusions

Subpart F income is defined generally as including insurance income and foreign base company income. Foreign base company income includes foreign personal holding company income (e.g., dividends, interest, rents, royalties), foreign base company sales income, and foreign base company services income. The definitions of these categories of Subpart F income were not changed. The foreign base company income category for oil related income, however, was removed.

Congress has extended the look-through exception several times in the past, and it appears likely that the exception will be extended again.

An important temporary exception for foreign personal holding company income is provided under tax code Section 954(c)(6) for dividends, interest, rents and royalties received by one CFC from a related CFC. The application of this look-through exception expands with the expansion of the definition of foreign corporations that are classified as CFCs. While the House bill and the Senate bill would have made Section 954(c)(6) permanent, that proposal ultimately was not adopted, presumably due to revenue considerations as opposed to any policy concern. Thus the exception remains scheduled to expire for taxable years beginning on or after Jan. 1, 2020. Congress has extended the look-through exception several times in the past, and it appears likely that the exception will be extended again. As discussed below, the exception is no longer necessary for dividends received from CFCs, because they should be excluded from Subpart F income under the dividends received deduction provided in Section 245A.

If the look-through exception is not extended in the future, interest may qualify for the more limited exception that applies to amounts received from a related foreign corporation organized in the same country as the recipient. Rents and royalties may qualify for the exception that applies to amounts received from a related foreign corporation for the use of property in the recipient's country of organization. Alternatively, the two companies may be organized in a disregarded entity structure that causes such payments to be disregarded for U.S. tax purposes.

The full inclusion rule, high tax exception, and *de minimis* rule were not modified. The computation of the high tax exception, however, is affected by two other changes. First, lowering the corporate tax rate from 35% to 21% reduces the threshold for high taxed income from 30.5% to 18.9%. Second, the foreign taxes associated with an item of income will be determined no longer on the basis of post-1986 pools of earnings and taxes (because those rules were repealed), but rather on the basis of actual taxes attributed to the income. As discussed below, Section 960 deemed-paid foreign tax credits are available for the foreign taxes associated with Subpart F inclusions, and a novel foreign tax credit approach applies with respect to GILTI inclusions.

Under prior law, Subpart F income earned by a CFC was not subject to U.S. taxation if the foreign corporation was not a CFC for an uninterrupted period of at least 30 days. For example, if a CFC was formed during the last month of its taxable year, any Subpart F income earned during that short year would not be taxable under Subpart F. This rule was repealed.

Amounts included in the income of U.S. corporate shareholders are entitled to deemed paid tax credits under Section 960. The Tax Act eliminated the post-1986 pool rules for earnings and taxes. Thus, apparently taxes are traced on a current-year basis to the Subpart F income that is included. Treasury is expected to issue regulations describing how such taxes should be traced. The general and passive foreign tax credit baskets continue to be relevant, though new baskets were created for non-passive GILTI (discussed below) and foreign branch income. As under current law, any excess taxes (except taxes attributable to non-passive GILTI) may be carried back one year, and forward ten years. The Section 78 gross-up continues to apply to deemed paid tax credits under Section 960.

As under prior law, the amount of Subpart F income included in the gross income of a U.S. shareholder becomes previously taxed income. In addition, the basis the U.S. shareholder has in the first-tier CFC is correspondingly increased.

The New GILTI Inclusion and GILTI and FDII Deductions

After a CFC calculates its Subpart F income, it must then apply the GILTI inclusion rules provided in new Section 951A. Such amount is included in the income of the U.S. shareholders in the same manner as Subpart F income inclusions, but is then reduced by certain deductions.

In general, the new GILTI provision is designed to impose a minimum residual U.S. tax on above-routine CFC earnings, with the exempt routine return being defined generally as a 10% return on the CFC's tangible property (''qualified business asset investment,'' or ''QBAI''). This tax is reduced by a special deduction and a partial foreign tax credit, as described below.

While Subpart F income is determined on a separate CFC basis, GILTI is determined on an aggregate basis at the U.S. shareholder level. The relevant amounts for each CFC in which a U.S. corporation is a U.S. shareholder are attributed to the U.S. shareholder for purposes of the GILTI calculation. Thus, although the general approach is to aggregate CFCs for GILTI purposes,

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this aggregation apparently applies separately for each U.S. shareholder chain in a structure in which multiple (even consolidated) U.S. shareholders own CFCs, such that there may be multiple GILTI groups under a single U.S. consolidated group (contrary to the consolidation approach that was taken under Notice 2018-7 for purposes of the transition tax).

> The formula for GILTI calculated at the shareholder level is:
>
> GILTI = Net Tested Income – [(10% of QBAI) – interest expense].

To arrive at a U.S. shareholder's Net Tested Income, the aggregate amount of its pro rata share of Tested Income from each CFC is reduced by the aggregate amount of its pro rata share of Tested Loss from each CFC. The Tested Income of a CFC is the excess of its gross income over deductions (including taxes) properly allocable to such income. The Tested Loss of a CFC is the excess of allocable deductions over gross income. For purposes of determining Tested Income and Tested Loss, gross income does not include the amount of Subpart F income, income which would have been Subpart F income if the high-tax exception had not been elected, income taxed as effectively connected with a U.S. trade or business, and dividends received from a related person.

In calculating GILTI, the Net Tested Income is reduced by 10% of QBAI less interest expense. QBAI means the average of the aggregate of a CFC's adjusted bases, determined as the close of each quarter, in specified tangible property used in a trade or business, of a kind subject to depreciation under Section 167. Only tangible property used in the production of Tested Income is taken into account (and QBAI of a CFC with a tested loss is not taken into account). This amount is reduced by interest expense taken into account in calculating the U.S. shareholder's Tested Income to the extent the corresponding interest income is not taken into account in determining such shareholder's Net Tested Income.

There is no high tax exception or *de minimis* rule. Thus, income that is high taxed but is not Subpart F income (and is not excluded from Subpart F by the high tax exception) would be included in GILTI.

New Section 250 provides a deduction of 50% of GILTI and 37.5% of foreign derived intangible income (FDII) (these deductions are scheduled to decrease in 2026). FDII is the corporation's deemed intangible income multiplied by the ratio of its foreign-derived deduction eligible income to its total deduction eligible income. Deemed intangible income is deduction eligible income over a deemed tangible income return (similar to QBAI). Deduction eligible income is gross income (not including any inclusions for Subpart F income or Section 956 investments in U.S. property, GILTI inclusions, dividends from CFCs, or foreign branch income) over deductions (including taxes). Deduction eligible income is foreign derived if it is derived in connection with property sold by the corporation to a foreign person for foreign use; services provided by the corporation to foreign persons; and services provided by the taxpayer with respect to property not located in the United States. Sales to related foreign parties can generate eligible income if the taxpayer can establish that the foreign affiliate ultimately sells the property to an unrelated party for foreign use. Royalty and rental income also can qualify as deduction eligible income if the licensed or leased property is used in connection with the provision of goods or services to foreign customers.

The effect of the 50% GILTI deduction is that GILTI is effectively taxed at a 10.5% rate (which tax, as discussed below, the legislative history indicates would generally be reduced to zero with foreign tax credits if subject to foreign tax at a rate of at least 13.125%). The effect of the 37.5% FDII deduction is that income derived from providing sales, services or rights to foreign persons is effectively taxed at 13.125%. The taxation of GILTI and the low tax rate on FDII are intended to encourage U.S. taxpayers to own their intangible property in the United States.

New Section 250 provides a deduction of 50% of GILTI and 37.5% of foreign derived intangible income (FDII)—these deductions are scheduled to decrease in 2026.

A foreign tax credit is permitted for 80% of the foreign taxes associated with GILTI (the inclusion is increased under Section 78 by 100% of the taxes). A separate basket is provided for non-passive GILTI taxes, and any excess credits may not be carried forward or back (i.e., the computation is carried out on a purely annual basis). It appears that the U.S. tax consequences are calculated by treating all non-passive GILTI the same. This allows for cross-crediting between non-passive GILTI that is subject to tax at different rates, but taxes associated with non-passive GILTI may not be used to offset income in other baskets. Because non-passive GILTI is in a separate basket, a U.S. shareholder that has built up overall foreign losses in its general basket under prior law will not be prevented from using foreign tax credits in the GILTI basket to reduce U.S. tax on its GILTI income going forward.

For example, assume a CFC has $900 of GILTI and the income was subject to $100 of foreign tax. The CFC's U.S. shareholder would be subject to a 21% U.S. tax on $500 [$1,000 ($900 GILTI plus $100 gross-up) – 0.5*($1000)], which would be $105. The U.S. shareholder would receive a foreign tax credit of $80 [80% of $100 foreign taxes], and have a net GILTI tax liability of $25.

If instead GILTI were $850 and the income were subject to $150 of foreign tax, U.S. tax would be imposed on $500 [$1,000 ($850 GILTI plus $150 gross-up) – 0.5*($1000)], which would be $105. The U.S. shareholder would receive a foreign tax credit of $105 [80% of $150 foreign taxes is $120, but GILTI inclusion cannot be reduced below zero] and have a net U.S. tax liability of $0 (the excess credits of $15 would disappear). Thus, as emphasized in the legislative history, foreign income subject to a tax rate of 13.125% generally should not be subject to incremental U.S. taxation (80% of 13.125% is 10.5%, the rate of U.S. tax that applies after taking into account the 50% GILTI deduction).

As noted above, the Section 904 foreign tax credit limitation applies to foreign taxes associated with GILTI. To the extent that expenses are allocated to the

GILTI inclusion, some portion of the foreign tax credits may be disallowed, which indirectly results in U.S. taxation. In addition, the treatment of the GILTI deduction for purposes of determining the Section 904 limitation is not expressly addressed. Depending on how expense allocation and the GILTI deduction are addressed, it is possible that the GILTI rules could result in the imposition of significant residual U.S. tax even in situations in which the overall foreign effective tax rate is well above 13.125%, contrary to the clearly expressed legislative intent. Further guidance on these issues (and potentially technical corrections) should be a high priority.

As with Subpart F income inclusions, the amount of GILTI included in the income of a U.S. shareholder (before the 50% deduction) becomes previously taxed income. In addition, the basis the U.S. shareholder has in the first-tier CFC is correspondingly increased.

Dividends Received from CFCs (and Taxation of Historic Earnings)

Under prior law dividends received by a U.S. shareholder from a CFC generally were included in income. The amount subject to taxation was reduced by the CFC's previously taxed income. Such previously taxed income included amounts for current year and prior year Subpart F income inclusions and for prior year inclusions as investments in U.S. property.

The taxable portion of the distribution was accompanied by deemed paid foreign taxes which could be claimed as a credit against U.S. taxes. The foreign taxes were computed on a post-1986 pool basis and determined separately for the passive and general limitation baskets.

The legislation retains the special foreign tax credit rules that provide credits for taxes imposed on distributions of previously taxed income and for which a credit hasn't already been provided.

Distributions of previously taxed income continue to be excluded from income (such amounts are not treated as dividends). Previously taxed income includes income included in the U.S. shareholder's gross income as Subpart F income, GILTI and investments in U.S. property, and income subject to the transition tax under Section 965. The basis in the CFC stock that was increased for such inclusions must be reduced for distributions of previously taxed income, and as under prior law, the amount of a distribution in excess of basis would be subject to tax as capital gain (except to the extent the gain would be recharacterized as a dividend under Section 1248 taking into account earnings of lower-tier CFCs).

The tax legislation retains the special foreign tax credit rules that provide credits for taxes that are imposed on distributions of previously taxed income and for which a credit has not already been provided. These rules should apply to withholding taxes imposed on distributions to CFCs of previously taxed income, including amounts that have been subject to tax under the Section 965 transition tax or as GILTI. Withholding taxes imposed on distributions of previously taxed income from CFCs to U.S. corporations should continue to be creditable under Section 901.

Under new Section 245A, the foreign source portion of distributions received by a U.S. shareholder from a CFC out of earnings that were not previously taxed are entitled to a 100% dividends received deduction. These would include earnings that were not subject to tax under the Section 965 transition tax and earnings that were excluded from Subpart F and GILTI (e.g., routine return that does not exceed 10% of QBAI). This deduction is also available for dividends received by one CFC from another CFC. No foreign tax credits are permitted to accompany such distributions, and any foreign taxes associated with such earnings are not creditable, including withholding taxes.

To transition to the dividend exemption system, all post-1986 earnings of a CFC are subject to taxation under a Section 965 transition tax. Such earnings and profits of a CFC became taxable at either a 15.5% rate (for earnings treated as being held in the form of cash or cash equivalents) or 8% rate (for the balance) and are treated as a current Subpart F income inclusion. The 15.5% and 8% rates are achieved by including all untaxed CFC earnings in a U.S. shareholder's income and providing a deduction equal to the amount that, at the U.S. shareholder's U.S. tax rate, would yield a rate of 15.5% or 8%, as applicable, on those earnings (this cumbersome formulation being necessary due to the fact that the transition inclusion may occur in taxable years in which the general corporate rate is 35%, 21%, or a blended rate under Section 15).

Foreign tax credits can be used to offset the transition tax, but foreign taxes associated with the earnings subject to the tax are haircut: 55.7% of foreign taxes on cash earnings and 77.1% of foreign taxes on non-cash earnings are disallowed. The haircut disallows the portion of foreign tax credits associated with the earnings that, at the 35% pre-reform corporate tax rate, would be deducted in order to reach the 15.5% and 8% transition tax rates (55.7% is 1-(15.5%/35%), and 77.1% is 1-(8%/35%)). Foreign tax credit carryforwards associated with CFC earnings that have already been included in the U.S. shareholder's gross income can be fully used. Other than the haircut described above, the pre-Tax Act foreign tax credit rules apply to the transition tax. Earnings subject to the Section 965 transition tax become previously taxed income and the U.S. shareholder's basis in the CFC stock is correspondingly increased.

In practice, the Section 245A dividend received deduction may have limited application in many cases. Because of the addition of the Section 965 transition tax and GILTI, and the retention of the Subpart F regime, a large portion of CFC earnings will be subject to current U.S. tax, even if not distributed. As a result, Section 245A may primarily apply to distributions of returns on tangible assets.

Investments in U.S. Property

In addition to Subpart F income and GILTI, a U.S. shareholder must also include in gross income its pro rata share of a CFC's investments in U.S. property. The amount is equal to the average of the amounts of U.S. property held (directly or indirectly) by the CFC as of the close of each quarter, but limited to the amount of

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the CFC's earnings and profits. This amount is reduced by the amount of the CFC's earnings and profits that were previously taxed as Subpart F income or investments in U.S. property.

U.S. property is defined to include tangible property located in the United States, stock or obligations of related U.S. persons, and certain intangible property held for use in the United States (subject to a number of exceptions). In addition, a CFC is considered as holding an obligation of a U.S. person if the CFC is a guarantor or pledgor of the obligation.

While both the House and Senate bills would have repealed this inclusion rule for corporate U.S. shareholders, the Tax Act ultimately retained it. Therefore, after applying the Subpart F income provisions and GILTI, and taking into account any current year distributions, Section 956 is applied.

Section 960(a) provides a basis for credits with respect to any item of income includible under Section 951(a)(1), which seems to include Section 956 inclusions (which are includible under Section 951(a)(1)(B)). However, a provision limiting the foreign tax credits for Section 956 inclusions may have been unintentionally repealed. Section 960(c) had provided that the amount of foreign tax credits with respect to a Section 956 inclusion could not exceed the amount of foreign tax credits if the same amount of cash had been distributed to the U.S. shareholder. This provision was removed in the House and Senate bills along with the removal of Section 956. When the conference agreement added back Section 956, perhaps as a last-minute decision, it did not add back Section 960(c).

It is likely that Section 956 will have a more limited scope of application in the future. For some companies the GILTI inclusions will create a significant amount of previously taxed income, which would reduce any Section 956 amount. A CFC may also have a significant amount of previously taxed income as a result of the earnings that were taxable under new Section 965. Section 956 investments would not give rise to an inclusion to the extent of a CFC's previously taxed income.

Furthermore, because dividends received from CFCs qualify for a 100% dividends received deduction, and a Section 956 inclusion would be subject to U.S. tax, it may be more advantageous to taxpayers to distribute non-previously taxed earnings rather than make an investment in U.S. property, especially when no dividend withholding tax is imposed. Unfortunately, because Section 956 has been retained, it will continue to limit a taxpayer's ability to use CFC assets to support third party loans to U.S. related persons.

Sale of a CFC

The Tax Act did not change the general treatment of the taxation of gain when the stock of a CFC is sold. The gain recognized by a U.S. shareholder on the sale of stock in a CFC would generally be subject to taxation. In addition, the gain recognized by a CFC on the sale of stock in a lower-tier CFC generally would be Subpart F income.

Section 1248 recharacterizes all or a portion of any gain on the sale of stock by a U.S. shareholder in a CFC as dividend income to the extent of the earnings and profits attributed to the selling shareholder. Such amount should qualify for the 100% dividends received deduction provided by Section 245A. Unlike current rules, no deemed paid foreign tax credits would accompany such dividend. The balance of any gain would be subject to the 21% corporate tax rate.

In addition, Section 964 provides a similar rule when a CFC sells stock in a lower-tier CFC, recharacterizing a portion of the gain as dividend income. Under current law, the dividend portion of the gain generally would not be subject to U.S. taxation under the look-through rule of Section 954(c)(6). Such dividend portion of the gain should also be excluded from Subpart F income pursuant to Section 245A.

New Section 59A imposes a base erosion and anti-abuse tax (BEAT), which effectively imposes a minimum tax on income of large U.S. corporations making a certain level of deductible payments to foreign related parties.

The Tax Act did not repeal the regulations that permit a taxpayer to change the classification of a foreign eligible entity. Accordingly, a CFC may elect to disregard a lower-tier CFC prior to its sale and treat the transaction as a sale of the CFC's assets, thus generally qualifying the gain for the exception to Subpart F that applies to gain on the sale of assets used in a trade or business. Nevertheless, such gain would be taken into account for purposes of applying the GILTI rules, and if no foreign tax is imposed, the GILTI inclusion generally would be subject to a 10.5% U.S. tax rate.

The BEAT and CFCs

New Section 59A imposes a base erosion and anti-abuse tax (commonly called the ''BEAT''), which effectively imposes a minimum tax on income of large U.S. corporations making a certain level of deductible payments to foreign related parties. The amount of the tax is the amount by which 10% of modified taxable income (5% for 2018) exceeds the regular tax liability over credits (other than certain specified credits, namely research and development credits).

The payments that are excluded as a deduction in calculating modified taxable income are deductible amounts paid to related foreign persons. Such amounts also include amortization and depreciation deductions with respect to property acquired from a related foreign person. The BEAT does not apply unless these amounts exceed 3% of the taxpayer's total deductions (not including net operating loss deductions, deductions for GILTI or FDII, and the Section 245A 100% dividends received deduction).

A related foreign person can include a CFC. The deductible amounts that are added back when calculating modified taxable income include amounts paid to a CFC that are Subpart F income or GILTI that is included in the U.S. corporation's income.

These add-backs do not include payments for services that are eligible for the application of the services cost method under the Section 482 regulations (without regard to the requirement under those regulations that

the services not contribute significantly to the fundamental risks of business success or failure), to the extent that the amount in question constitutes total services costs, with no mark-up component. Based on the statute and legislative history (including a floor colloquy between Senators Hatch and Portman), in many cases it may be possible to bifurcate service fees into cost and mark-up components, with the BEAT applying only to the mark-up component.

When calculating modified taxable income, the 50% deduction for GILTI inclusions, the 37.5% deduction for FDII, and the 100% dividends received deduction for the foreign-source portion of dividends received from a CFC are not added back to income. In addition, previously taxed income received is not included in modified taxable income.

As discussed above, U.S. tax on the Subpart F income or GILTI inclusions can be reduced by foreign tax credits accompanying such amounts. Such credits are not backed out for purposes of calculating the BEAT (unlike research and development credits, which are backed out for taxable years beginning before 2026), and thus may be considered as effectively disallowed to the extent of any BEAT.

For example, consider a U.S. corporation that has $1000 of gross income (including $250 of Subpart F income of its CFCs), $200 payments to third parties, $300 rental payments to a related CFC ($250 of which is Subpart F income of the related CFC), $30 of amortization with respect to intangible property purchased from a foreign related party, $15 of research and development credits, and $50 foreign tax credits. The U.S. corporation's taxable income is $470 [$1000-$200-$300-$30]. Its regular pre-credit U.S. tax liability is $98.7 [$470*21%]. After taking into account $65 credits ($15 research and development credits and $50 foreign tax credits), the U.S. corporation would have to pay tax of $33.7. The BEAT applies because the taxpayer's base erosion payments ($330) exceed 3% of its total deductions ($530). Modified taxable income is $800 [$470 + $300 + $30], and 10% of that is $80. The BEAT is $31.3 [$80 – ($98.7 regular tax liability – ($65 all credits – $15 R&D credits))]. The U.S. shareholder would have a $33.7 regular tax liability plus a $31.3 of BEAT, for total U.S. taxes of $65. Note that Subpart F income is included in calculating modified taxable income even though the rental payment giving rise to the Subpart F income is backed out in calculating modified taxable income, and that a portion of the foreign tax credits are effectively denied as a credit (and there is no carryover of such credits). Notwithstanding the loss of some foreign tax credits, the full Section 78 gross-up is apparently includible in modified taxable income and thus taxable for BEAT purposes.

Concluding Remarks

Most of the existing Subpart F rules have been retained, and new rules have been added that significantly expand the application of Subpart F. The definitions of U.S. shareholder and CFC have been expanded such that minority-owned foreign joint ventures can become CFCs. In addition, a new Subpart F inclusion rule—GILTI—was added, which will have broad application.

Distributions from CFCs now are essentially excluded from income, whether as previously taxed income or under the new 100% dividends received deduction.

Planning to minimize Subpart F income remains important despite GILTI, because only 50% of GILTI is included in taxable income of the U.S. shareholders, and there is an exclusion for 10% of the adjusted basis of tangible assets. Subpart F income can also increase the likelihood of the BEAT applying because 100% of such amounts is included in taxable income. On the other hand, taxpayers with existing operations in high-tax jurisdictions may consider electing the high-tax exception for income that would be Subpart F but for the high-tax exception, because the high-tax exception causes amounts to be excluded from both Subpart F and GILTI (there is no similar exception for high-taxed GILTI), although in certain situations the high-tax exception might not be elected, in order to permit the taxes to be claimed as a credit against lower-taxed Subpart F income.

Distributions from CFCs now are essentially excluded from income, whether as previously taxed income or under the new 100% dividends received deduction. Nevertheless, investments in U.S. property can trigger a Subpart F inclusion to the extent the investment exceeds a CFC's previously taxed income, and therefore generally it will continue to be desirable to monitor such investments.

The sale of a CFC is treated more favorably because any portion of the gain reclassified as a dividend is not subject to taxation. On the other hand, because of the GILTI tax, gain recognized by a CFC on the sale of a disregarded entity would potentially be subject to current U.S. tax, even if the gain is not Subpart F income.

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State Tax

Tax Policy

States Scramble to Measure, Mitigate Impact of Federal Tax Law

Taxpayers operating in multiple states may find the next few years challenging as states examine the implications of the new federal tax law for their revenue and tax administration, including, most pressingly, whether and how to conform to all the changes.

Bloomberg Tax recently asked four state and local tax thought leaders about aspects of the federal tax law that President Donald Trump signed Dec. 22, 2017, that may present the greatest complications for states and taxpayers.

Decoupling or Conforming Joe Huddleston, an executive director in Ernst & Young LLP's National Indirect Tax group in Washington, said states will have to ''determine quickly whether to conform or decouple'' from the new Internal Revenue Code requirements as they determine the potential impact on revenue.

Scott Austin, a principal at PwC in Philadelphia, said ''how states choose to conform to or decouple from federal tax reform provisions will create complexity and controversy through 2018.'' The provisions certain to be scrutinized by state lawmakers include:

- mandatory deemed repatriation,
- a new measure taxing global intangible low-taxed income (GILTI),
- a new deduction for foreign-derived intangible income (FDII),
- a new base erosion minimum tax (BEMT),
- interest expense limitations, and
- full expensing of certain purchases.

''States will be faced with significant policy decisions,'' Austin said. ''States could potentially receive increased tax revenues due to the application of deemed repatriated income, GILTI income, and interest limitations.''

Corporate taxpayers may pressure state lawmakers to decouple from certain provisions of the 2017 tax law (Pub. L. No. 115-97) to avoid increased state liabilities, he said.

The new law contains ''dramatic changes'' in both personal income and corporate income taxes. Deciding ''how to'' and ''whether to'' adjust individual income tax to federal changes such as the standard deduction, personal exemptions, and itemized deductions ''and assessing the distributional effects of all the federal changes will generate a tremendous amount of debate in state legislatures,'' said Harley Duncan, managing director of the state and local tax group in KPMG LLP's Washington National Tax practice.

State policymakers may need to re-evaluate their IRC conformity philosophy, said Valerie Dickerson, a partner at Deloitte Tax LLP who leads the firm's Washington National Tax-Multistate practice. Automatic conformity to ''minor tweaks'' to the code ''is one thing,'' she said. ''However, when automatic conformity pulls through fundamental shifts in how the federal government treats foreign income, that is quite another animal.''

States might even consider non-income taxes, such as a gross receipts tax, to buffer against fluctuations in the federal code and maintain a stable revenue base, Dickerson said. That is ''always a risky political venture,'' but it ''may well be taken up by some legislatures and policymakers, depending on how budgets look when the tax reform dust settles,'' she said.

Multistate Issues High-tax states, such as New York and New Jersey, may be among those that attempt to enact changes to address what they perceive as unfair treatment to their residents by the new federal tax law, Austin said.

> **This is ''an incredible time for engagement'' on how to administer a ''newly revamped federal tax regime in the state context.''**
>
> Valerie Dickerson
> Deloitte Tax LLP

In his State of the State address Jan. 3, New York Gov. Andrew Cuomo (D) said the new federal law promotes ''double taxation,'' and violates the principles of equal protection. Cuomo said he would challenge the tax law in court as unconstitutional.

''Gov. Cuomo also said he would look to modify New York's tax code, perhaps through the payroll tax,'' Austin said. ''Similarly, California legislation may be introduced allowing citizens to make a donation to the state in lieu of income taxes.''

In particular, Cuomo and other state lawmakers from predominantly Democratic states including New Jersey, Illinois, and California are incensed about the law's new cap on the deductibility of state and local taxes on federal returns. The law allows taxpayers who itemize to deduct their state sales, individual income, and property taxes up to $10,000 beginning this year. The deduction previously was unlimited.

Lawmakers in those states have already floated proposed end-runs of the tax law, including through converted charitable gifts or an employer-based payroll tax system.

Policy Challenges The focus on the federal tax law will push other prominent state tax issues such as combined reporting and transitioning to market-based sourcing to ''the back burner,'' Duncan said.

States will focus particularly on how the federal income tax changes pose substantial fiscal and policy

challenges to states and raise compliance issues of ''considerable magnitude,'' he said.

''The limitation on the federal deduction for state and local tax along with increased federal deficits raises fiscal challenges for states to deal with next year and in the longer run,'' Duncan said.

State lawmakers will need ''quality, clear analysis'' of the impacts from the federal changes, but that may be difficult to accomplish in the ''short time available between now and the legislatures convening,'' he said.

Dickerson called this ''an incredible time for engagement'' on state-level discussions regarding how to administer a ''newly revamped federal tax regime in the state context.''

Dickerson said she has been predicting a convergence in the technical issues between multistate and international tax for some time. The convergence ''can no longer be ignored,'' she said.

''Exhibit A in this regard is the uncertainty around the state tax treatment of foreign income,'' she said. ''The potential magnitude of deemed repatriation on the state tax level underscores the significance of conducting a detailed state by state analysis of tax base, apportionment and filing group options.''

Debate over what comprises the sales factor for purposes of apportioning income, which already receives attention in many states, may become ''a stronger trend as these worlds converge,'' Dickerson said.

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Tax Policy

Federal Law Prompts States To Weigh Own Tax Policy Overhauls

California. Maryland. New Jersey. New York. Pennsylvania. These states are joining number of others in proposing policy changes to bypass federal tax law changes that eliminate many deductions and alter the way businesses are treated.

New York may move away from taxing the income of wage earners in favor of payroll taxes. California might allow taxpayers to make certain charitable contributions and take the full amount as a credit against their state tax liability.

Maryland could restore personal exemptions on state tax returns, and a Pennsylvania lawmaker aims to reverse a state revenue official's position on the expensing of large equipment purchases.

In general, states want to prevent taxpayers from paying more as a result of federal base broadening, but some of their ideas for doing so carry a host of potential problems, tax experts told Bloomberg Tax.

At the same time, states want to protect revenue for public services.

''Right now, states are inevitably evaluating the budgetary impact of federal tax reform and will soon be making decisions based on the expected revenue loss or gain,'' said Valerie Dickerson, a partner at Deloitte Tax LLP who leads the firm's Washington National Tax-Multistate practice.

Payroll Taxes Acting on a request from Gov. Andrew Cuomo (D), the New York Department of Taxation and Finance on Jan. 17 released a report laying out possible options the state might take to bring relief to state taxpayers who may lose money to a new limit on the federal deductibility of state and local taxes.

The limit is part of the new federal tax act (Pub. L. No. 115-97) signed by President Donald Trump on Dec. 22. Taxpayers who itemize deductions on the federal return can deduct state sales, individual income, and property taxes up to $10,000 beginning this year. The deduction previously was unlimited.

Several states, including New York, California, and New Jersey, have begun to explore how to do an end run of new tax law provisions through converted charitable gifts or an employer-based payroll tax system.

Several states, including New York, California, and New Jersey, have begun to explore how to do an end run of new tax law provisions through converted charitable gifts or an employer-based payroll tax system. Cuomo has been among the most outspoken critics of the new tax law and even suggested he will sue over the deduction cap.

Among the options suggested by New York tax officials is a progressive employer compensation expense tax—or payroll tax—coupled with elimination of the personal income tax on wages. Another option also calls for a payroll tax plus wage credits to employees.

''Superficially, it sounds great,'' Christopher Doyle, a partner and state and local tax practice leader at Hodgson Russ LLP, said of replacing income tax with payroll tax.

Instead of withholding and remitting tax to the state on behalf of the worker, the burden simply shifts to the employer, which becomes the taxpayer, Doyle said.

Likely Unpopular The change from a tax on wage earners to employers may mean workers would actually be paid lower salaries to cover the employers' new tax bill, though actual employee take-home pay would remain the same, Doyle said.

''I imagine it will not go over well, even if you educate people,'' he said.

In the simplest terms (and using rough numbers), an employer-side payroll tax would work like this: an employee who previously earned a salary of $100,000 per year, but netted about $80,000 after the employer deducted taxes on their behalf, would now earn a salary of $80,000 with the employer just paying the $20,000 in taxes they otherwise would have deducted from the employee. The net effect to the employee would be the same, but the employee wouldn't be subject to the new state-and-local taxes deduction cap. And because employer payroll taxes are still deductible in full, the company wouldn't be affected by the new tax law.

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However, the problem may not end there. Lower salaries may mean lower contributions to individual retirement accounts, 401(k) retirement plans, and Social Security, Doyle said. Pensions, which are often calculated based on earnings in an individual's last years of employment, also could be slightly reduced, he added.

In addition, businesses could find calculating tax payments for nonresident employees difficult to do until the end of the year, he said.

Charitable Contributions Cuomo, in his proposed budget for fiscal year 2019, called for creating two charitable funds through which New Yorkers could pay for the state's education and health care needs. The contributions, which would be federally deductible, would be eligible for a state tax credit.

In the same vein, California may decide to allow residents to make a donation to the state to satisfy their income tax liabilities and claim the charitable contribution as a credit to reduce their federal tax bill. New Jersey and Maryland lawmakers are considering similar plans.

However, Treasury Secretary Steven Mnuchin, during a Jan. 12 talk in Washington, threatened to target tax audits at residents of states that allow deductions for charitable donations to state charities that provide funding for public services.

States might not adopt such a system if they're not sure it will hold up to Internal Revenue Service scrutiny, said Jared Walczak, a senior policy analyst at the Tax Foundation.

''The IRS operates on the concept of substance over form,'' he said. ''What a state or local government calls it or how they frame it matters much less than what it actually is.''

The charitable donation approach has its fans. Eight law professors wrote a paper posted Jan. 11 on the Social Science Research Network, a website that shares academic papers, arguing that states may expand their use of charitable tax credits in this manner.

Given that charitable donations are fully deductible, while state and local taxes are now capped at the $10,00 threshold, ''it may be possible for states to provide their residents a means of preserving the effects of a state/local tax deduction, at least in part, by granting a charitable tax credit for federally deductible gifts, including gifts to the state or one of its political subdivisions,'' the paper said.

Taxable Income Defined Minnesota is widely expected to zero in on a facet of its tax code that is shared by only a few states: the state uses taxable income as a baseline for calculating state income taxes.

Therefore, the state could modify its law in response to federal adjustments to the definition of federal taxable income.

The federal taxable-income changes are likely to reduce the amount Minnesota taxpayers send to the federal government and boost the amount paid to the state.

Minnesota's legislative session doesn't begin until Feb. 20, but most tax policy groups believe lawmakers will pursue revenue-neutral reforms that avoid a revenue windfall for the state. The Minnesota Center for Fiscal Excellence has said lawmakers will likely remedy the tax imbalance by using adjusted gross income as a base for calculating state income taxes.

Federal Tax Deduction Another state issue stemming from the tax law is expected to play out in Iowa. During the Condition of the State address Jan. 9, Gov. Kim Reynolds (R) said she is preparing a tax overhaul that would end federal tax deductibility and provide tax relief to middle-class taxpayers and small businesses.

Unless addressed, federal deductibility would essentially raise state income taxes on most Iowans, she said.

Reynolds didn't offer a specific framework for revamping the state tax code after erasing federal deductibility, but pointed to a strategy that significantly reduces rates, modernizes the tax code, and provides other forms of relief for middle-class families, farmers, and small businesses.

Attacking Property Taxes While New York, Maryland, California, and New Jersey look for creative ways to mitigate the cap on the federal SALT deduction, Illinois Gov. Bruce Rauner (R) is using it as an opportunity to curb escalating local property taxes, as well as a recent income tax increase engineered by Democrats.

Eliminating the federal deduction for taxes paid to state and local governments would hurt states that give more to the federal government than they get back in federal spending.

NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT

In a series of Twitter posts and a talk radio interview Jan. 3, Rauner said he would devote much of the year to restructuring the state's tax system. The new federal limit on the SALT deduction could be ''punishing'' for Illinois taxpayers, adding urgency to his demands for reform.

Though Rauner is Republican, Illinois is one of the predominantly Democrat-leaning states where lawmakers have been most outspoken about the 2017 tax law and opposing the new deduction cap. Though estimates of the revenue impact from the new tax law are still preliminary and inconsistent, many reports have said the deduction cap will hit high-tax states like California, Illinois, New Jersey, and New York the most.

Specifically, the Nelson A. Rockefeller Institute of Government said in an Oct. 5 report that eliminating the federal deduction for taxes paid to state and local governments would hurt states that give more to the federal government than they get back in federal spending.

Connecticut taxpayers would be hardest hit, the report said, followed by those in New Jersey, New York, Massachusetts, Illinois, and California.

Reactions by State So far, states have reacted to the federal tax changes in widely differing ways. And many not at all. Almost all state officials, however, have said they are looking for ways to lower the tax burden of residents who might otherwise have to make higher payments merely because the state conforms to parts of the federal code.

A general rundown of state responses follows, including whether the state has a system of rolling conformity to the Internal Revenue Code and the definition of taxable income. ''Rolling'' means states automatically con-

forms to the latest version of the IRC and definition of federal taxable income; ''static'' IRC conformity means states calculate state taxable income as of a certain date; and ''none'' identifies states with no defined IRC conformity system, meaning that they take a selective approach to federal conformity.

■ **Alabama** (rolling) — Could allow more taxpayers to take the minimum standard deduction on state income taxes

■ **Alaska** (no income taxes) — Not much talk of taking action in response to federal changes

■ **Arizona** (static) — Impact of federal changes are, as in most states, under review by state revenue officials, but no talk yet of responding with specific legislation

■ **Arkansas** (none) — Regulators considering lower utility rates after federal changes lead to tax savings for utilities

■ **California** (static) — Could allow taxpayers to make charitable contributions, then take the full amount as a credit against state tax liability

■ **Colorado** (rolling) — Governor said ''there's not much'' state can do to mitigate effects of cap on state and local deduction

■ **Connecticut** (rolling) — No legislation offered, but some talking of replacing income tax with payroll tax, finding ways to mitigate cap on state and local deductions

■ **District of Columbia** (rolling) — Council member proposed measure calling for report on how D.C. might decouple from federal tax law

■ **Delaware** (rolling) — No serious talk of a legislative response to federal changes

■ **Florida** (static; no income taxes) — Regulators asked to adjust power-utility rates

■ **Georgia** (static) — No serious talk of a legislative response to federal changes

■ **Hawaii** (static) — No serious talk of a legislative response to federal changes

■ **Idaho** (static) — Senate bill lowering rates may be introduced as a result of increased revenue expected from conformity to federal code

■ **Illinois** (rolling) — Governor plans to use limit on state-local tax deduction as a political tool to push for lower property rates

■ **Indiana** (static) — Various tax bills already introduced this session, but none address federal changes

■ **Iowa** (static) — Lawmakers may look to lower rates as a result of increased revenue resulting from conformity to federal changes

■ **Kansas** (rolling) — No serious talk of a legislative response to federal changes

■ **Kentucky** (static) — No serious talk of a legislative response to federal changes

■ **Louisiana** (rolling) — No serious talk of a legislative response to federal changes

■ **Maine** (static) — Regulators looking to lower utility rates as a result of increased revenue from federal changes

■ **Maryland** (rolling) — May allow taxpayers to receive a tax credit for donations made to state-run charity to benefit public schools, may restore personal exemptions on state tax returns

■ **Massachusetts** (static) — Officials discussing a way to mitigate higher tax burdens on individuals, but no legislation has been proposed

■ **Michigan** (static) — GOP leaders to reduce income taxes while conforming to federal code, proposing to increase state personal income tax deduction to $4,800 by 2021

■ **Minnesota** (static) — Expected to redefine federal taxable income, possibly adopt adjusted gross income as baseline

■ **Mississippi** (none) — No serious talk of a legislative response to federal changes

■ **Missouri** (rolling) — Legislation already introduced would decouple the Missouri standard deduction from the federal standard deduction, but bill's sponsor may scrap that provision

■ **Montana** (rolling) — No serious talk of a legislative response to federal changes and legislature not in session this year

■ **Nebraska** (rolling) — Sen. Jim Smith (R) plans a bill to address the personal income-tax side to prevent the state from ''receiving a windfall''

■ **Nevada** (no income taxes) — Regulators considering rate decreases for utility industry customers

■ **New Hampshire** (static; no tax on earned income, but interest and dividends are taxed) — No serious talk of a legislative response to federal changes

■ **New Jersey** (none) — New governor working on plan to convert property taxes into charitable gifts

■ **New Mexico** (rolling) — No serious talk of legislative response to federal changes

■ **New York** (rolling) — Officials considering charitable contribution alternative, replacing income tax with employer levy

■ **North Carolina** (static) — Regulators considering lower rates for utility companies' customers; companies should see more revenue from tax changes

■ **North Dakota** (rolling) — Revenue officials saying federal changes to have a negligible impact on state revenue from federal changes

■ **Ohio** (static) — No legislation yet offered

■ **Oklahoma** (rolling) — Regulators considering lower utility rates after federal changes

■ **Oregon** (static) — Lawmakers considering ways to maintain revenue for local services, but no details as of yet

■ **Pennsylvania** (none) — Lawmaker considering bill to address full expensing after state revenue officials require businesses to add back any deduction

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■ **Rhode Island** (rolling) — No legislation yet offered

■ **South Carolina** (static) — State may look at ways to address deduction for pass-through entities

■ **South Dakota** (no income taxes) — No serious talk of a legislative response to federal changes

■ **Tennessee** (rolling; no tax on earned income, but interest and dividends are taxed) — No serious talk of a legislative response to federal changes

■ **Texas** (static; no income taxes) — Not expected to respond in a significant way

■ **Utah** (rolling) — No talk of taking action to mitigate impacts of federal changes

■ **Vermont** (static) — May give tax relief to group of taxpayers impacted by federal changes

■ **Virginia** (static) — Regulators considering lower utility rates after companies benefit from federal changes

■ **Washington** (no income taxes) — No legislation proposed

■ **West Virginia** (static) — No significant response expected

■ **Wisconsin** (static) — No significant response expected

■ **Wyoming** (no income taxes) — No significant response expected

By Che Odom

With assistance from Tripp Baltz in Denver, Michael J. Bologna in Chicago, Christopher Brown in St. Louis, Leslie A. Pappas in Philadelphia, and Gerald B. Silverman in New York.

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International Tax

European Union

U.S. Reform Clouds EU's 2018 Tax Agenda

European Union finance ministers face critical tax issues in 2018, including how to tax profits from large internet companies, but the cloud hanging over all EU tax deliberations will be the new U.S. tax law and how the bloc should respond.

Already the European Commission has threatened a full frontal legal assault at the World Trade Organization over allegations that elements of the U.S. law amount to illegal export subsidies because of deductions for foreign-derived intangible income. In a statement issued after the U.S. Congress passed the legislation in December, the EU executive body said ''all options are on the table.''

The commission has gone silent since the statement. A spokeswoman told Bloomberg Tax in a Jan. 8 statement it was still studying the U.S. tax law in order to determine its next move. Incoming EU presidency holder Bulgaria told Bloomberg Tax in a Jan. 9 statement it has no plans to put the issue on the agenda when EU finance ministers meet Jan. 23 for the first time in 2018.

No Idle Threat But the EU's threats should be taken seriously, according to Howard Liebman, a Brussels-based tax partner with Jones Day and president of the American Chamber of Commerce in Belgium.

''In view of the fact that the European Commission has brought WTO cases against the U.S. any number of times, including with regard to tax issues and has not backed down on state aid cases even in the face of tough U.S. Lobbying, I would not be surprised if the EU brings a complaint after careful analysis,'' Liebman told Bloomberg Tax in an email. ''Perhaps as early as the fall.''

The EU did win the right to impose billions of dollars of tariffs on U.S. goods after the WTO ruled in the early 1990s that the U.S. Foreign Sales Corporation legislation provided illegal export subsidies to U.S. multinationals. The EU never imposed the tariffs after the U.S. Congress changed the law.

EU finance ministers must also wrestle with how to craft EU legislation after enactment of the U.S. tax law, which cut the corporate rate to 21 percent from 35 percent and gives incentives for U.S. multinationals to repatriate overseas profits. For countries such as Ireland and the Netherlands, where hundreds of U.S. multinationals have set up European headquarters in order to take advantage of low rates or convenient corporate profit regimes, the concerns are especially acute.

''Changes in the U.S. tax system could have an impact on Ireland given the large volume of U.S. investment,'' the Irish Ministry of Finance told Bloomberg Tax in a Jan. 10 email.

Noting the nation's 12.5 percent corporate tax rate, the Irish government also noted that ''Ireland's access to the European market is, and will remain, a key factor in attracting foreign direct investment from the U.S.'' but added that it ''will remain alert and responsive to any changes in the U.S. or global tax environment.''

EU Corporate Rate Reductions? It isn't clear yet if the U.S. rate reduction will trigger EU member nations to follow suit. Tomasso Faccio, a lecturer of tax law at the U.K.'s University of Nottingham, told Bloomberg Tax ''there is a risk this will happen but the fiscal constraints of the EU fiscal compact may reduce the room for maneuver for many countries as taxes will have to be found elsewhere.''

''EU member states should take the U.S. tax reform as an incentive to make sure that EU profits of U.S. companies are effectively taxed in the EU.''

EDOARDO TRAVERSA
CATHOLIC UNIVERSITY OF LOUVAIN

The European Fiscal Compact, agreed in 2012 at the behest of Germany in the wake of the EU 2010 sovereign debt crisis, calls on EU member nations to have balanced budget laws, preferably at the constitutional level.

Digital Taxation Dilemma The U.S. tax reform is also expected to affect upcoming EU digital taxation legislation due in March, including a possible turnover tax aimed at internet companies such as Google Inc., Facebook Inc. and Amazon.com Inc. While Ireland has led some countries in opposing the tax, Edoardo Traversa, a company tax law professor at the Catholic University of Louvain in Belgium, said the U.S. tax reform will be an important argument to move ahead with the plan.

''The EU member states should take the U.S. tax reform as an incentive to make sure that EU profits of U.S. companies are effectively taxed in the EU,'' Traversa told Bloomberg Tax in a Jan. 9 email.

EU member states led by France, Italy, Germany and Spain are meanwhile pushing for an agreement in the Organization for Economic Cooperation and Development (OECD) on digital taxation, which is an evolving issue that remains unresolved. Joachim Englisch, a professor of tax law at the University of Muenster in Germany, told Bloomberg Tax the U.S. tax reform has undermined the EU's hopes for an interim report due in April from the OECD.

''The time for a coherent, internationally coordinated solution has passed,'' Englisch said in an email. ''The OECD has lost the race. The U.S. reform has contributed to this. Incentives to attract intangible income and

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special levies to tax it if regular nexus (based on the OECD model) is avoided is spreading globally and the U.S. reform certainly sets another bad example.''

While the EU and others have welcomed the U.S. tax reform measures designed to counter the base erosion and anti-abuse tax (BEAT), the way it is structured has triggered howls of protest. The European Commission said in December the measure is discriminatory. Englisch agreed and said it will violate bilateral tax treaties the U.S. has with major EU countries, as well as undermine the OECD Model Tax Convention.

The BEAT imposes a 10 percent tax on large corporations that make ''base-eroding payments'' to their foreign affiliates.

''The BEAT is more a problem with large trading partners rather than for future treaties with countries that have not signed up yet,'' Englisch said. He added that not ''to honor existing treaties sets a bad example that is liable to be followed by U.S. trading partners.''

Foreign Bank Protest European banks, including Deutsche Bank Group, BNP Paribas S.A., and Barclays PLC, warned against the BEAT measures before the U.S. Congress passed the law. The banks, represented by the Institute for International Bankers (IIB), reiterated the criticism in Jan. 8 comments to Bloomberg Tax.

''We strongly object to the final bill's treatment of cross-border payments between U.S. and foreign affiliates of internationally headquartered banks, which runs counter to the pro-growth aims of the legislation by impeding their ability to make loans to U.S. companies as well as many infrastructure and other growth generation projects,'' IIB Chief Executive Officer Sally Miller told Bloomberg Tax in an Jan. 8 email statement. ''Because the BEAT is imposed on gross payments, it could more than offset any savings that result from the corporate tax rate being lowered to 21 percent.''

Miller also said the IIB hopes that by working with the U.S. tax-writing committees and the Department of Treasury it will be able to ''remediate the inevitable adverse consequences of the BEAT provision in a possible corrections bill next year.''

By Joe Kirwin

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China

U.S. Tax Cut May Lead to More Open China

China is re-evaluating its business environment to halt an exodus of foreign capital and companies after the U.S. slashed its corporate tax rate.

The new U.S. tax law lowers the corporate rate to 21 percent from 35 percent in an effort to draw U.S. companies back home and compete internationally.

The move sparked concern over currency depreciation and job losses in China, which responded with tax breaks for foreign firms reinvesting profits in the country, and an expansion of tax breaks for Chinese companies repatriating profits back to China. As a result, foreign firms will be temporarily exempt from withholding taxes on profits made from Chinese investments if they meet a list of conditions. And more complex company structures, including a wider range of overseas Chinese companies, will now qualify for the tax break.

Additional tax breaks and a more open business environment may follow, experts say, as Beijing looks for ways to counter the new U.S. tax policy.

The American cut threatens to create ''a vacuum attracting capital from all over the world to the U.S.,'' Wang Huiyao, a counselor to the State Council, China's chief legislative body, told Bloomberg Tax.

''A lot of foreign companies maybe would rather invest in the U.S. than come to China,'' he said.

The Threats The corporate tax cut brings potentially serious consequences, including a rapid impact on China's currency, Patrick Yip, a China tax partner at Deloitte in Hong Kong, told Bloomberg Tax, with the possibility that U.S. companies might take advantage of the tax cut to repatriate profits, leading to a rise in inflation in China and an expanding U.S.-China trade imbalance as exports become cheaper.

The American tax cut threatens to create ''a vacuum attracting capital from all over the world to the U.S.''

Wang Huiyao
State Council

Companies are already asking how they can qualify for China's new tax break on repatriated profits, Yip said.

The second threat to Beijing is that American companies move to the U.S. to take advantage of the lower tax regime.

There is also concern about a possible drop in high-tech investment, Zhu Ning, a professor of finance at the Shanghai Advanced Institute of Finance, told Bloomberg Tax, because it is often an ''entrepreneurial activity which does not require too much fixed asset investment,'' and therefore is easy to relocate.

Following Suit The U.S. tax cut may reinvigorate discussion of other reforms, according to Xu Hongcai, a nonresident senior fellow at the Center for China and Globalization.

Many reforms have been ''delayed or abandoned'' because of inefficiency, he said at a Dec. 7 seminar on the U.S. tax cuts organized by the Center for China and Globalization, a think tank connected to the Chinese government.

These may include opening the door wider to foreign firms and creating a better economic environment, Huo Jianguo, president of the Chinese Academy of International Trade and Economic Cooperation, said at the same event.

''If we create a better environment for foreign capital, we can keep it in China and it will not go back to the U.S. or somewhere else,'' he said.

Yip added, ''To compensate for this tax rate discrepancy and potentially stronger capital outflows to the U.S., China will try to be more user friendly in terms of attracting foreign direct investment; becoming more open, more receptive to foreign investment in the more

restrictive industry sectors. So I think that could be a catalyst to some positive change.''

Louis Kujis, chief Asia economist at Oxford Economics in Hong Kong, told Bloomberg Tax the U.S. tax cut was already ''affecting the discussions around taxation in China,'' and ''will strengthen the position of the business people and others who advocate lower corporate taxation.''

Chinese authorities may take more punitive measures to prevent Chinese capital going overseas, alongside making changes meant to attract and retain foreign companies, practitioners said.

They are likely to ''be more vigilant'' with regard to capital controls and outbound merger and acquisitions, as a means to stem capital outflow, Yip said.

Ultimately the tax change will act as a ''reminder to China that the world is highly competitive,'' said Kenneth Jarrett, president of the American Chamber of Commerce in Shanghai.

''It's possible that China may respond with better incentives for U.S. companies or look to open some parts of the economy that have been restricted to foreign investors,'' he said.

By John Butcher

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Australia

U.S. Tax Reform to Vex Australia in Year Ahead

Australia's corporate tax system will present major challenges for the government as it deals with the impact of the U.S. lowering its corporate rate to 21 percent.

Already this year, Federal Treasurer Scott Morrison and Revenue Minister Kelly O'Dwyer have renewed their efforts to garner support for Australia's Enterprise Tax Plan, the main feature of which is reduction of the standard corporate tax rate to 25 percent from 30 percent.

The U.S. cut is viewed as a serious threat to the Australian economy and is catalyzing those who say Australia should follow suit. Some countries, including China and Australia, have argued the U.S. action could hurt their competitiveness.

Support for Rate Reduction Legislation to enact the Enterprise Tax Plan was initially blocked by Parliament's upper house last year, but the government revealed its intention Jan. 11 to reintroduce the bill as soon as Parliament resumes in early February.

In the interim, major business groups in Australia have been pushing for the government to introduce its Enterprise Tax Plan as soon as possible.

For example, the Minerals Council of Australia—the top body representing Australian mining companies—said in its pre-2018-19 budget submission last month that now that the U.S. has slashed its corporate rate, Parliament should pass the government's ''much more modest'' Enterprise Tax Plan ''as a matter of urgency.''

The Australian Chamber of Commerce and Industry gave similar support to the Enterprise Tax Plan in its pre-budget submission, and said cutting the corporate rate to 25 percent ''will encourage larger businesses to undertake more investment—to grow and, employ more people.''

Marcus Leonard, national head of tax at BDO Australia, warned in a Dec. 4 news release that U.S. multinational companies with operations in Australia could be convinced by the U.S. tax changes to take those operations back to the U.S. unless Australia acts.

Big Hurdles Despite the high level of business support, the government is facing challenges on two fronts.

First, it's far from certain that the Enterprise Tax Plan bill will be passed. The ruling Liberal/National coalition's control of the lower house in Parliament—the House of Representatives—is a tenuous one-seat majority and, as the government experienced with its first attempt to get the bill passed, it doesn't control the upper house, the Senate. Thus, the government's warning about the impact of the new U.S. tax law is geared to convince non-aligned senators.

The immediacy of the U.S. rate cut calls into question the ''importance and relevance of Australia's relatively paltry'' proposed 5 percent reduction.

Bob Deutsch
Tax Institute in Sydney

Chris Bowen, shadow treasurer of the main opposition Labor Party, repeated Jan. 11 in a doorstop interview both his party's commitment to vote against the bill and his often-stated assertion that the proposed cut would cost the budget A$65 billion ($51 billion) in lost revenue over a 10-year period.

With the resumption of parliamentary debate on the Enterprise Tax Plan now looming, Bowen also said in the interview that ''we are more than happy to take this fight up to the Liberals right up until the next election,'' which must be held no later than in November 2019, but which some reports suggest could be called by the government as soon as late this year.

The second challenge facing the government is that even if it did pass the tax plan, some question if a corporate rate of 25 percent would be a sufficient response to the threat to foreign investment into Australia.

Unlike the new U.S. tax act (Pub. L. No. 115-97), which reduces the corporate tax from a top rate of 35 percent to a flat 21 percent for tax years beginning after 2017, Australia's new 25 percent rate would be phased in over five years instead of implemented immediately.

Bob Deutsch, senior tax counsel with the Tax Institute in Sydney, told Bloomberg Tax in an email Jan. 8 that the immediacy of the U.S. rate reduction calls into question the ''importance and relevance of Australia's relatively paltry'' proposed phasing in of a 5 percent reduction.

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''From an Australian perspective, there is without doubt a need to remain competitive in the context of our tax rates. While it is true that the headline tax rate is not all that matters, it is important, particularly on a psychological level,'' Deutsch said.

Rate Comparison 'Not Fair' Deutsch, however, noted that ''many have pointed out that a comparison of rates is also not fair because Australia, somewhat unusually, adopts an imputation system of corporate taxation. He said this differs fundamentally from the U.S. system, ''which clings rigidly to what amounts to more or less a classical system of company taxation.''

The imputation system, where tax paid by companies can be passed onto resident shareholders as tax credits attached to dividends, isn't available to foreign investors. But the ultimate benefit of those credits depends on shareholders' individual marginal rates of tax.

Thus it is difficult to generalize about how a 5-point reduction in Australia's company tax rate, to 25 percent, would have an impact on a global basis in relation to all shareholders, Deutsch said.

In the Jan. 11 interview, Bowen did make a generalization when discussing how Australia has a dividend imputation system and the U.S. doesn't. He said ''a domestic investor gets their corporate tax back, in effect. So, if you want to compare the tax systems, sure, but let's do it on an apples-for-apples basis, as our tax systems are very different.''

Deutsch observed, however, that the immediate benefit of a lower company tax rate would be more funds available to companies for further activities.

Push for Broader Tax Reform There have been more calls for Australia to embark on its own, broader tax reform process given the concerns over the effectiveness of the tax plan and the odds of its passage.

In its pre-budget submission, BDO said the Enterprise Tax Plan was only part of the answer, and the government ''should consider what other similar measures are available'' in addition to the proposal's base-broadening and protective measures such as the Multinational Anti-Avoidance Law, Deferred Profits Tax, and goods and services tax newly levied on non-resident suppliers.

The Australian Institute of Company Directors said in its pre-budget submission that it considers ''the best approach to adjusting the tax mix to be a comprehensive reform model, rather than piecemeal prioritisation of corporate tax over all others.''

Should the government fail to achieve its desired reduction in the standard company tax rate, all eyes will be cast on its response in May when it delivers its 2018-19 budget.

By then, the specter of the longer-term impact of the U.S. tax reforms on the Australian economy may be clearer.

By Peter Hill

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BNA Insights

Multinational Corporations

Unsurprisingly, despite a reduction in the headline rate of U.S. corporate income tax, the broad implications of the U.S. Tax Cuts and Jobs Act 2017 (''TCJA'') isn't good news for U.K. businesses. Indeed, while the TCJA was billed as increasing simplicity, the scale of complexity in many respects is nothing short of rather ugly.

U.S. Tax Reform: What U.K. Multinationals Need to Know

BY BERNHARD GILBEY

The lower rate of corporate income tax (''CIT''), 21 percent, is clearly good news for a group with subsidiary operations in the U.S. If a U.S. subsidiary's profit is now subject to tax at 21 percent rather than 35 percent and because most dividends received by U.K. companies from their U.S. subsidiaries benefit from an exemption from any further tax you would expect the group's effective rate of tax as a result of TCJA to reduce. At a simple level, this ought to boost the earnings per share of a U.K. parented group with meaningful operations in the U.S. One twist, that has already been shown to affect several non-U.S. companies, is the impact that the lower rate of CIT has on the value of deferred tax assets. If carried forward losses have been valued based on saving tax at 35 percent, the value of those deferred tax assets will reduce if they will only save tax at 21 percent. There are a number of U.K. banks that have already noted the one-off accounting charge that arises out of the reduced value of their carried forward losses. The corollary to this is also true, in that deferred tax liabilities will also be reduced because of the reduced CIT rate. Perhaps an aside at this juncture, but U.K. companies should be aware that losses (''NOLs'') arising after December 31, 2017, will be restricted. Only 80 percent of NOLs arising after that date can be used to reduce taxable profits each year in the future.

Of course, steps taken in the past to mitigate the amount of U.S. profit subject to tax at 35 percent mean that in most cases the benefit of the reduction in the headline rate of CIT will be less than first appears. For example, it was historically common for U.S. subsidiaries to carry high levels of debt, the interest on which was tax deductible. The interest deduction reduced profits taxable in the U.S. at 35 percent and the interest receipt would be taxable (if at all) in the hands of a group company in a jurisdiction with a much lower corporate income tax rate.

Bernhard Gilbey is a partner at Squire Patton Boggs, U.K.

Interest Deductions

The TCJA includes a restriction on the amount of deductible interest expense on payments from a U.S. borrower to an affiliated lender. The restriction limits the interest deduction to 30 percent of EBITDA (which will become 30 percent of EBIT from 2022 onwards). The new provisions will ***not*** apply to groups with average annual gross receipts (measured over a three-year period) of $25 million or less. Although any unrelieved interest expense can be carried forward indefinitely, there is no grandfathering for existing debt. U.K. parented groups should look at the current level of debt in their U.S. subsidiaries to assess the impact of these new provisions and assess whether existing intra-group debt arrangements should be adjusted. These new rules replace what were known as the earnings stripping rules that previously limited related-party interest deductions for U.S. companies, albeit the restrictions under the TCJA are expected to have a bigger impact than those earnings stripping rules did.

Of course, avid followers of the OECD's Base Erosion Profit Shifting (''BEPS'') proposals and how they have been implemented, in particular across the EU, will be quite familiar with limiting interest deductions. The TCJA provisions have many similarities with the way that the BEPS proposals have been implemented, with the limits being applied as a percentage of EBITDA (at least until 2022), the rate limit being at 30 percent of the interest and a de minimis level below which the restrictions do not apply.

Anti-Hybrid Rules

In another nod to the BEPS proposals, the TCJA also includes provisions to deny tax deductions for U.S. companies on interest and royalty payments that are not subject to tax in the recipient country. These anti-hybrid rules (which result either from the recipient entity not being seen as a taxable entity or the type of payment not being subject to tax on receipt) again echo changes that have been implemented across the EU to prevent tax avoidance by multinational groups that arbitrage different tax systems around the world.

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Groups with average annual gross receipts of at least $500 million making certain ''base erosion payments'' of at least 3 percent of all deductions by U.S. companies to affiliated companies outside the U.S. may become subject to BEAT—the Base Erosion Anti-avoidance Tax. The BEAT imposes a minimum tax on U.S. companies that make those outbound deductible payments by adding back those payments to taxable income in order to ensure an effective U.S. rate of at least 5 percent in 2018, then 10 percent from 2019 through to 2025, and finally 12.5 percent for 2026 onward. There are, however, important exceptions to the BEAT, including the ''cost of goods sold'' and some service payments. Great care will have to be taken on future transactions to make sure that the BEAT consequences of outbound deductible payments from the U.S. for services, intercompany interest, or royalties are taken into account. U.K. parented groups should assess the implications of BEAT on their U.S. tax bill. They should not be surprised to find that BEAT reverses some of the net effect of the reduced rate of corporate income tax to 21 percent.

So far, the impact of the TCJA has been looked at in the context of a U.K. parented group with U.S. operations. That raises the question whether the TCJA has implications for U.K. subsidiaries of U.S. parented groups. Two related measures are designed to have an impact on the appetite U.S. groups might have to invest in the U.K. (or anywhere else outside the U.S.). First, there will be a one-time deemed repatriation of profits earned by non-U.S. subsidiaries of U.S. companies that were not yet repatriated to the U.S. by December 31, 2017. Tax will be levied at 15.5 percent on those unrepatriated earnings held in cash and at 8 percent on unrepatriated earnings held in assets. Although the tax is payable over eight years this may likely cause U.S. multinationals to bring back those existing offshore profits or otherwise deploy them around the world now that they are freed up from concerns of U.S. taxation. Second, the introduction of a participation exemption in the U.S. allowing future overseas earnings to be paid to the U.S. generally, without further tax payable in the U.S. will encourage U.S. parented groups to bring future profits back to the U.S. and carry out their investments there. Now that there is no tax ''penalty'' for bringing their overseas earnings back the U.S. government hopes to encourage U.S. multinationals to invest in development at home rather than abroad. For U.K. subsidiaries of U.S. parents looking to thrive in a post-BREXIT era, the effect of these two provisions is unlikely to be helpful!

Additionally, specified research or experimental expenditure is now to be capitalised and then amortised over five years. However, if the research is carried on outside the U.S. the amortization period is extended threefold to 15 years. In other words, if you are a U.S. company spending money on this kind of specified research, you will look to spend it in the U.S. It is unclear what impact this would have on outsourcing the research to the U.K. but it will be a feature in the decision as to where to undertake the research.

Global Intangible Low-Taxed Income

One feature of the TCJA that should not, at least from a high level consideration, affect U.K. subsidiaries of U.S. parented groups is the new Global Intangible Low-Taxed Income (''GILTI''). This set of provisions results in U.S. current tax charges, by treating as an income inclusion in the U.S. certain high-return income that has been subject to low taxation in the jurisdiction in which the income arises. Although the mechanics of calculating if, and to what extent, income is taxable as GILTI are complex, estimates of the impact suggest that if the corporate tax rate in the jurisdiction in which the income arises is at least 13.5 percent (i.e. 3.5 percent lower than the lowest rate planned for U.K. corporate tax), the GILTI provisions should not result in the new charge applying. If, for example, you are an Irish subsidiary of a U.S. parent (paying tax at 12.5 percent) you may be more worried. At the same time the GILTI inclusion is a ''stick'' intended to discourage inappropriately high-return income in low-tax offshore income (typically intangible income, though not limited to that), the TCJA provides a ''carrot'' for offshore exploitation of U.S. IP via the ''foreign derived intangible income'' deduction that provides a lower U.S. tax rate on such income.

Conclusion

Although the TCJA has been brought into law there are a considerable number of unclear aspects and the inevitable need to correct and tidy up such an extensive rewrite of the U.S. tax code. This will take time and, depending on what needs to be tidied-up, could be very difficult to implement given the legislative process. If changes require a 60-vote support in the Senate and if, as one might expect, there is little sympathy from Democrats for helping the Republicans correct errors that arose out of the manner and speed at which the law was enacted, the discomfort of the TCJA could be felt for some time to come.

BNA Insights

Foreign Corporations

As the U.S. prepares to implement its 2017 Tax Act, Indian multinational companies with operations there need to take stock and plan for the repercussions—and attractive opportunities—ahead.

U.S. Tax Cuts and Jobs Act—Potential Impact on India

BY ASIM CHOUDHURY AND ROHAN PODDAR

Corporate Taxes

After much back and forth, the most notable change is the permanent reduction in corporate income tax rate from 35 percent to 21 percent. This is especially a very aggressive move which could potentially benefit the manufacturing sector encouraging greater investments and the creation of jobs. However, several reports and data suggest otherwise. American tech giants have spent their bulging cash in paying out greater dividends and stock buybacks rather than to create more jobs. Therefore, the automatic assumption that there could be an overnight increase in jobs after the corporate tax cuts turn into law might be misleading.

India is an engineering hub and produces millions of engineers every year who go on to work in these tech corporations. It might turn out to be a setback for these individuals who are looking forward to a manifold increase in work opportunities in the U.S. However, there are several Indian corporations who are looking forward to building a more substantial and trusted presence, for example, the likes of Mahindra Corporation who wishes to increase their American footprint in the automobile sector. Nonetheless, this cut remains an attractive opportunity, for more and more Indian corporations wishing to travel westward subject to clearance of regulatory hurdles.

Alternative Inflation Adjustment—A Shift of Methods

The U.S. government has changed the measure of inflation on which rate of taxes are calculated from the existing Consumer Price Index (''CPI-U'') method to another method called the Chained Consumer Price Index (''C-CPI-U''). As the Senate and House puts it, it appears to be a newer way to calculate the cost of living adjustments to inflationary or deflationary pressures. The C-CPI-U takes into account ''substitution bias'' by recognizing that consumers tend to shift their purchasing habits as the relative prices of commodities change. A possible argument for this change is that it is a more accurate and a better indicator than the standard CPI-U.

The repercussions of this standard would be felt across the board as it can have a significant impact on the cost of living adjustments even at the time of exit. The Tax Policy Center reports that:

> using chained CPI may result in a more accurate inflation adjustment, but it would also raise taxes for many since those indexed provisions of the Tax Code would be less generous over time than under today's methodology. And that means people would pay higher income taxes than under current law. It would especially hit low and moderate-income households that rely on the EITC and standard deduction, but it would affect all taxpayers in some way. And unlike proposals to repeal, say, itemized deductions, people might not notice this hidden tax increase for years to come.

Setback for Alimony Payers—No More Deduction

Following the U.S. Supreme Court judgment, in the case of *Gould v. Gould [245 U.S. 151 (1917)]*, the final version of the tax plan released by the Republicans, eliminates the tax deduction for alimony payments. The new rule would be effective for any divorce or separation instrument executed after December 31, 2018. This rule would not impact those who are already paying alimony. Moreover, there are several consequential implications especially for the lower- and middle-income groups who may eventually take the hit. Alimony agreements have been drafted keeping in mind the available tax deduction. Post this amendment, the clauses would have to be reworked and arrangements worked out for adequate child support.

Estate Tax—Here to Stay

There is no doubt that fewer Americans would now have to pay estate taxes, but nonetheless it stays on. Initially, there were conjectures and speculations from several corners on the complete removal of the estate

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taxes from the books, but the Republicans have taken a call in the negative. The law in its present form raises the exemption threshold of estate and gift taxes to $10 million from the existing $5 million per person and indexes the new exemption level for inflation after 2011. This is certainly a huge sigh of relief for wealthy families as the exemption provided now doubles.

Bonanza on the Personal Tax Front—Nonresident Indians to Benefit

As the Trump administration brings about some sweeping changes to the U.S. tax code after a long gap, the impact on individuals is consequentially significant. An estimated 4 million nonresident Indians (''NRIs'') live in the U.S. and the rationalization of the income tax slab thresholds and lowering of income tax rates could see tax residents pay lower taxes. This liberalization of personal taxes is a win-win situation for the NRIs who are tax residents of the U.S. Almost every tax resident would witness a decrease in their tax brackets and would be paying lesser taxes.

We are already aware that the new law would index the tax brackets and other provisions by the C-CPI-U measure of inflation. There is an increase of the standard deduction to $12,000 for single filers, $18,000 for heads of household, and $24,000 for joint filers in 2018 (as compared to $6,500, $ 9,550, and $13,000, respectively, under current law). However, there are two things to bear in mind:

(a) it eliminates all forms of personal exemption; and

(b) a substantial chunk of these changes is temporary and would expire on December 31, 2025, barring C-CPI-U, which is set to remain.

Tax-Free Dividends from Certain Foreign Subsidiaries—No More Offshore Tax

The final bill provides a 100 percent deduction for the foreign sourced portion of dividends received from ''specified 10 percent owned foreign corporations by domestic corporations'' that are U.S. shareholders within the meaning of Section 951(b) (thereby implying that passive foreign investment company that is not a Controlled Foreign Company (''CFC'') will be excluded. In the conference agreement, the term dividend received has been stated to be interpreted broadly and consistently with the meaning of the phrases ''amount received as dividends'' and ''dividends received'' under Sections 243 and 245, respectively. It may be noted that no foreign tax credits will be allowed in relation to the dividend received. Further a holding period requirement has been provided i.e., the U.S. parent should be holding the foreign corporation for not less than 365 days before the date the share becomes ex-dividend with respect to the dividend. One may also note that the deduction is not available to hybrid dividends which are essentially amounts received from a CFC. The said hybrid dividend should have also received a deduction or other tax benefit from taxes imposed by a foreign country.

From an Indian tax impact perspective, it could lead to creation of intermediary vehicles and if proper justification and transfer pricing models are drawn up or juxtaposed, then the offshore profits by the U.S. parent can be efficiently structured. This could also lead to substantial capital.

Special Rules Relating to Sales or Transfer Involving Foreign Subsidiaries

Firstly, only for the purposes of determining whether there is a loss if any deduction of dividend is taken under the new Section 245A, then the cost would be reduced to that extent, i.e., let U.S. say that the cost of the share is $200 and the amount of dividend is $160, then in future if the shares are sold at $190, then the loss of $10 would not be recognized as the cost for determining the loss at $40 ($200–$160).

Secondly, sale by a CFC of a lower tier CFC will now be included and treated as subpart F income and deduction under Section 245A will be allowable to the U.S. shareholder with respect to the subpart F income included in gross income. It may be noted that the same will be treated as a part of subpart F income to the extent of undistributed Earnings and Profits (''E&P'') of the lower tier CFC. This could potentially change the way election are done by both the buyer and seller under the IRC code and could further see effective sales strategies of businesses held in India.

Thirdly, there would be an inclusion of transfer loss amount in case of foreign branches. Traditionally the losses of a foreign branch are allowed are deductions in the hands of the U.S. parent. However, when the branch assets are substantially transferred to a foreign corporation when the branch turns profit making, then there is no method of taxing the foreign company. This leads to a potential tax loss as the loss has been claimed in the U.S. tax returns the final bill has provided for a recapture of the transferred loss in the gross income of the U.S. parent if the foreign branch is transferred substantially to a specified 10 percent owned foreign corporation.

One Time Tax on Deemed Dividend Repatriation Accumulated Post 1986

As a one-time and changeover measure, the U.S. proposes to impose tax on deemed repatriation of foreign profits. The Bill's tax rate on the deemed repatriation of currently deferred foreign profits is 15.5 percent for liquid assets and 8 percent for other assets. An option has been provided to taxpayers to pay this tax in installments over an eight-year period. Therefore, the companies can still shield a portion of their foreign profits for an additional eight years. The deferred earnings of the U.S. shareholders are to be reduced by the shareholders' share of deficits as of November 2, 2017, from a specified foreign corporation that is not a deferred foreign income corporation (a specified foreign corporation that does not have deferred income) and also the pro-rata share of deficits of a U.S. shareholder in an affiliated group. But what remains is a critical indicator for all U.S. businesses based out of India as the proposed deemed profit repatriation tax could see a capital

restructuring of Indian entities and Dividend Distribution Tax in India.

GILTI v. FDII—the U.S. Patent Box

The Bill introduces a global intangible low-taxed income (''GILTI'') in relation to CFCs which basically assumes that there would be a 10 percent return of the tangible assets of the CFCs and anything more than that is an income from intangibles. This is similar to the U.K. patent box, however the rules are wider as it not tied to a specific patent and it arbitrarily assumes that tangible assets should yield 10 percent in profit. The GILTI is taxed on a formulae basis of the ''net tested income of the CFCs.''

The calculation of the net CFC tested income exceeds over the 10 percent of the CFCs' aggregate qualified business asset investment (''QBAI''). QBAI is the CFCs' aggregate quarterly average basis in tangible depreciable business property. GILTI is also to be reduced by a standard deduction of 50 percent for taxable years beginning after December 31, 2017, and before January 1, 2026. Thus, with the effective tax rate of 21 percent the effective tax rate on GILTI will be 10.50 percent for the aforementioned taxable years. The U.S. shareholder can claim up to 80 percent of the foreign tax credits paid.

Foreign Derived Intangible Income (''FDII''), as opposed to GILTI, is a tax on the U.S. resident on a deemed intangible income. Even in FDII it has been assumed and deemed that any return over and above 10 percent of the tangible assets is an intangible income. However, in FDII the starting point of computing Deemed Intangible Income is deduction eligible income which allows reduction of allocable deductions.

To not double count the same intangible income of a CFC, GILTI income is to be excluded. A standard deduction of 37.5 percent is available only to C corporations, for taxable years beginning after December 31, 2017, and before January 1, 2026, thus, bringing the effective tax rate to 13.125 percent. Special rules have been made for property or services provided to domestic intermediaries and related party transactions.

On a combined reading of GILTI and FDII, there is now less incentive for offshore holding of Intellectual Property. However, from an India tax perspective, GILTI provisions are from a both U.S. inbound and outbound structures as now CFCs will attract GILTI provisions. Also, for Indian MNCs, there are incentives for moving intellectual property to offshore U.S. subsidiaries, where the effective tax rate on intellectual properties is now substantially low (obviously the special rules in relation to related party and transfer pricing rules have to be taken into account). The Senate Bill also provided for a tax exempt transfer of intellectual property from CFCs to an U.S. parent which has been omitted in the Conference Agreement, thus, the incentive of moving Intellectual Property to the U.S. may have other tax implications.

Broader CFC Inclusion Rules

The Bill has repealed the ''downward attribution rules'' which prevented stock owned by a foreign shareholder from being attributed downward to a domestic subsidiary. For foreign parented groups, the current-law rule could prevent CFC status for any foreign subsidiaries which was jointly owned by the foreign parent corporation and the U.S. subsidiary. However with the repeal the downward attribution rules, the CFC rules are expanded which in turn would impact the GILTI provisions, application of subpart F and the mandatory deemed repatriation of dividend rules. For Indian MNCs, the said provision has to be worked out early as it would impact the entire group tax outgo. It is also important to note that the 30-day rule, that is, income of CFC is included only if the shares are held for a consecutive 30 days during the tax year is also eliminated. This will affect the group holdings (if any) of an Indian MNC to a great extent and a proper due diligence of the impact by Indian MNCs will have to be conducted.

Expanded Definition of U.S. Shareholder

Under the present law the requirement of a specified 10 percent owned foreign corporations by domestic corporations required that the U.S. shareholder should be holding 10 percent of the voting stock. However, now the definition is being amended to include 10 percent of all classes of stock. This expansion of the definition of U.S. shareholder will have an impact on the mandatory deemed repatriation of dividend rules and subpart F income. This would also have impact on all outbound investments made by U.S. residents and Indian investments to a great extent may be also affected.

BEATing the Offshoring Business

The Bill introduces a Base Erosion and Anti-Abuse Tax (''BEAT'') which is in the nature of an Alternate Minimum Tax (''AMT'') for U.S. corporate taxpayers with annual gross receipts in excess of $500 million on certain deductible payments made to foreign related parties to the extent such payment exceed 3 percent (as opposed to 4 percent in the Senate Amendments) or more of the U.S. corporate taxpayers deductible expenses. The tax is imposed to the extent that the 10 percent of modified taxable income (roughly taxable income along with deductible related foreign party payments) exceeds the corporation's regular tax.

This will impact India's outsourcing business and contract manufacturing business and could potentially put a spanner in the churning wheels of Make in India initiative. However an important thing to remember is that BEAT only applies to deductions and not to reductions in gross income. For example payment for cost of goods is not treated as a deduction but as a reduction. That being the case there could be potential renegotiation of contracts in the manufacturing sector from a job work contract to a principal-principal contract subject to transfer pricing documentation.

Limitation on Interest Deduction

The U.S. taxpayers have now an overall limit of their interest deduction for any taxable year and the same is 30 percent of Earnings before Interest, Tax depreciation and amortization expenses till Financial Year 2021 (Earnings before Interest and Tax to be taken into account after Financial Year 2022). The threshold for the section to be triggered is that the taxpayer should meet annual gross for the last three taxable years at $25 million. Since Section 199 has been repealed there is no de-

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duction in relation to Section 199 available. There is a carryforward of the interest deduction unlimitedly. This is an important provision as many Indian Pharma Companies and New Companies that are set up in the U.S. and are highly leveraged. Further there has to be reconciliation with allocation of interest under Section 884 (Branch Profit Tax), the impact of which has to be also assessed in view of the new provisions.

Accelerated Expensing

This section under the U.S. tax code is somewhat akin to the investment allowances that we have for new businesses in India. The new law significantly expands bonus depreciation to allow full expensing of the cost of ''qualified property'' acquired and placed in service after September 27, 2017, and before January 1, 2023. The bonus depreciation is now available for both new and used property. A changeover rule provides that a taxpayer may elect to apply a 50 percent allowance instead of the full 100 percent allowance during its first taxable year ending after September 27, 2017. It must be noted that this law now allows a 100 percent first-year deduction for the adjusted basis for ''qualified property'' which is acquired and placed in service after September 27, 2017, and before January 1, 2023. There is phase-down of the 50 percent allowance for property acquired before September 28, 2017, and placed in service after December 31, 2017, and for 2020 no bonus depreciation will be available.

This could hit the Indian pharma and other research-based companies operating out of the U.S. This would be applicable for property placed in service from tax years starting post after December 31, 2017. The phase-out threshold amount is increased to $2.5 million and for tax years beginning 2018, these amounts would be indexed for inflation. As reported by the U.S. think tank Heritage Foundation, ''limiting expensing to new equipment exacerbates the relative tax disadvantage faced by longer-lived capital investments and undermines the potential economic growth promised by tax reform. Congress must follow up in future legislation to make full expensing permanent and available to all investments.''

The purpose of Section 179 was to provide small businesses a deduction in the current year the full purchase price of financed or leased equipment. The current law broadens the expensing limit for small businesses by raising the cap on eligible investment from $500,000 to $1 million. However, businesses would no longer be able expense their research and development costs.

The aforesaid coupled with interest disallowance has to be seen for new businesses and as to how to structure capital for starting or expanding business in the U.S.

Disclaimer: The Authors are Indian Lawyers and this article should not be construed as advice on U.S. Tax Laws. This article is only a possible impact analysis of the U.S. Tax Reforms which may arise on Indian non-residents and Indian businesses. Every transaction which has a consequential tax impact involving U.S. and an Indian Entity, the same has to be studied from both the U.S. as well as the Indian Laws perspective. The U.S. tax implication will have to be necessarily examined by U.S. tax lawyers and the aforesaid article may be only be treated as indicative and academic.

Accounting

Tax Practice

Five Areas Where New Tax Law Affects Accounting

Companies need to prepare for the financial reporting effects of the new tax law by establishing a good accounting plan to find answers to questions as they arise, accountants and analysts told Bloomberg Tax.

Here are five developing areas that warrant close monitoring:

1. Repatriation Tax

Multinational companies, now subject to a one-time repatriation tax—also called a transition tax—on post-1986 accumulated foreign earnings under the 2017 tax law (Pub. L. No. 115-97), might find calculating the liability they expect to pay complex, accountants said. That complexity comes from having to determine the amount of the liability at two different tax rates: a 15.5 percent rate for cash or cash equivalents and an 8 percent rate for illiquid assets.

In determining the cash amount, cash is measured at three different dates. Companies wouldn't discount the liability recorded, even though it may be paid over an eight-year period on an interest-free basis.

The repatriation tax on foreign earnings will be especially important to companies in the technology, health care, and pharmaceutical sectors, and other large multinationals with significant offshore cash balances and international operations, said Rick Lane, senior vice president at Moody's Investors Service Inc. in New York. ''Of course they will be repatriating significant amounts of their offshore money,'' he said.

2. Remeasuring Deferred Tax Items

Because of the reduction of the corporate tax rate to 21 percent from 35 percent, companies must remeasure their deferred tax assets and liabilities at the new rate.

Calendar-year companies will remeasure their deferred tax items to 21 percent in their fourth quarter of 2017. Fiscal-year companies have a blended tax rate in their year of enactment. For example, a June 30 fiscal year-end company has a blended tax rate that goes back to its fiscal year beginning July 1, 2017, and ending June 30, 2018. Therefore, a company may have to schedule the reversal of its temporary differences for two years to remeasure its deferred tax items.

Depending on whether a company is in an overall deferred tax asset position or a deferred tax liability position, the effect of adjusting its deferred tax items to the new statutory rate will result in either a tax expense or a tax benefit, recorded in its income tax expense in the period of enactment.

''One item of caution I have for companies,'' Joan Schumaker, a partner at Ernst & Young LLP in New York, said, ''is that even though the Dec. 22 enactment date may be very close to their year-end date, they need to make sure that they're determining their temporary differences as of the enactment date, rather than just using the balances at their year-end date and remeasuring those year-end balances to the new tax rate in continuing operations.''

The adjustment companies make for the rate change could create amounts that are stranded in accumulated other comprehensive income. Companies will be allowed a one-time reclassification to retained earnings of those stranded amounts, the U.S. Financial Accounting Standards Board said Jan. 10.

3. Putting SAB 118 Into Practice

The Securities and Exchange Commission issued Staff Accounting Bulletin 118 on Dec. 22 to provide greater clarity to investors and preparers about the financial reporting impacts of the new tax law. It has succeeded, in part, analysts and investors said.

The guidance allows financial report preparers to provide estimates of the tax law's effects and adjust them quarterly until they can complete the full accounting of the effects. The full accounting must be completed by Dec. 22, 2018, the SEC said.

But SAB 118 also has ''driven some confusion'' for investors as companies determine and book shifting provisional estimates over the next year of deferred tax assets and deferred tax liabilities, Todd Castagno, an equity analyst at Morgan Stanley & Co. in New York, said Jan. 11.

''Investors should note they may not receive full tax reform information perhaps expected in the next earnings release or 10-K/Q filing,'' Castagno and other Morgan Stanley analysts wrote in a Jan. 2 client note. ''The mix of evolving tax and accounting requirements will likely create volatility in key financial statement line items and metrics as certain effects will be booked before others and provisional amounts will require adjustment.''

Global law firm White & Case LLP advised companies in a Jan. 11 note to ''carefully consider the impact that future tax rates and any impairments could have on contractual provisions, such as debt maintenance covenants and executive compensation targets, and update disclosure as necessary.''

4. What to Disclose

SAB 118 also provides guidelines for what companies need to disclose for calendar year-end statements ending Dec. 31, or fiscal-year filers with the period that includes Dec. 22, the date the tax legislation was signed. If a company has a September year-end, it would file its disclosures in the first quarter ended Dec. 31, 2017.

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''When reviewing disclosure costs and redundancies, SEC 118 is an exception. It's designed for short-term application in a transition time,'' said Rick Day, a partner and national director of accounting at RSM US LLP in Davenport, Iowa. ''In essence, it affords companies a one-time extension to ensure time for accurate financial impact assessment, meaning it won't be repeated and therefore isn't overly burdensome for companies to apply.''

Filers would have to include a paragraph in their tax footnote that explains the impact of the tax law changes on their rates. The disclosures should provide clarity as to where a company is in its analysis.

''Even if companies have a fairly precise estimate, many may choose to apply the estimate disclosure for added cover in case unexpected impacts arise as they file their tax returns and refine the numbers,'' said Al Cappelloni, a partner at RSM in Boston. ''You see that now in the business combination area, which provides a similar measurement time period window.''

Other disclosures should provide accounting estimates on the effects of the tax rule, why the estimate is being made, or if the number is too complex to be estimated.

5. Reporting Burden

The whole idea behind SAB 118 was to reduce the reporting burden. Several analysts and accounting firms in notes to clients called it the SEC staff's ''Christmas present'' to the profession.

But it can have effects that will ripple throughout the financial statement, including additional information in the management discussion and analysis (MD&A) section, an area where many companies might not have focused.

Jeffrey Hochman of Willkie Farr and Gallagher LLP, a New York-based law firm whose clients include financial services companies, said in a Dec. 29 report that in preparing MD&As, ''companies must evaluate and discuss the impact of the Tax Cuts Act, to the extent material, with respect to the just completed fiscal year as well as its impact on future periods as a 'known trend.' ''

The MD&A and other reporting burdens will ''vary widely by company,'' Hochman said Jan. 12. He said there is ''clearly a requirement to not only disclose and analyze historical results,'' but also to disclose in MD&A ''known trends and to make them reflective of future results.''

A company that might have a future tax liability should describe it in the MD&A qualitatively, if not quantitatively, Hochman said.

Still, SAB 118 has made financial reporting under the law easier. It ''is another instance of the SEC staff coming out with helpful guidance in light of new developments and providing flexibility, and making disclosures good as well as flexible,'' Hochman said.

By Denise Lugo and Steven Marcy

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Multinational Corporations

Foreign Companies' U.S. Operations Confront Tax Overhaul

An array of overseas businesses with U.S. operations will see profound effects—including to near-term accounting—from the new U.S. tax law, U.K.-based analysts told Bloomberg Tax.

The law ''really impacts companies in all sectors, and most will benefit if they have material operations'' in America, said Craig Hillier, Ernst & Young LLP international tax services leader in London.

Other U.K. analysts agreed, and for individual businesses and industry sectors, ''the devil will be in the details'' in assessing how they will be affected, said Melissa Geiger, head of international tax at KPMG LLP in London.

BP Plc, Bayerische Motoren Werke AG (BMW), Daimler AG, and Royal Dutch Shell Plc have already determined that the tax act (Pub. L. No. 115-97), which came into force on Jan. 1, will have near-term effects for their tax accounting.

The U.S. tax law marks ''a fantastic opportunity'' for overseas companies to restructure their business operations to benefit from the overhaul's provisions.

Nicola Pardy
Grant Thornton International Ltd.

Along with overhauling the tax code for U.S. companies, the law includes provisions affecting overseas companies that do business in America, such as:

- slashing the top corporate tax rate to 21 percent from 35 percent;
- implementing a new base erosion and anti-abuse tax (BEAT) that aims to prevent companies from artificially shifting U.S.-generated profits to lower-tax jurisdictions; and
- restricting interest expenses.

Most Will Benefit Most foreign companies with a U.S. footprint stand to benefit from the reduced corporate tax rate, analysts said. Other measures in the new law will have differing impacts on companies.

Although the law contains provisions specific to certain business sectors, such as energy and insurance companies, Hillier said in a Dec. 21 assessment that he and other analysts concurred that an overseas company's structure and operations in the U.S. will have the greatest effects on its bottom line.

BP said Jan. 2 that it would take a one-off, noncash charge of about $1.5 billion to its group income statement from the law's requirement that companies recog-

nize the impacts of changes on deferred tax assets (DTAs) and deferred tax liabilities (DTLs) in their first reporting period after the law's enactment.

Several oil and gas and automobile multinationals operating in the U.S. have highlighted these effects.

Anglo-Dutch company Royal Dutch Shell Plc said Dec. 27 that based on its third-quarter 2017 results, it would have incurred an estimated charge to earnings of $2 billion to $2.5 billion, ''primarily driven by a remeasurement of its deferred tax position to reflect the lower corporate income tax rate.''

Shell hasn't finished assessing the impact of this noncash adjustment.

Auto Boost? In the automobile industry, German companies BMW and Daimler AG said they expect near-term benefits.

BMW anticipates a boost to group net profit in 2017 from remeasuring deferred taxes of 950 million to 1.55 billion euros ($1.16 billion to $1.9 billion), though the Munich-based company said Dec. 22 that the exact amount can't be determined until it prepares its 2017 group financial statements.

Daimler, headquartered in Stuttgart, said the same day that re-evaluation of its net deferred tax liabilities would increase group net income by about 1.7 billion euros ($2.1 billion).

While some companies have already gauged the new law's short-run impact, others are holding off until issuing their first financial statements in 2018.

''What we can say at this time is limited by the fact that we are in the closed period (between the end of the 2017 trading year and the announcement of our 2017 financial results),'' U.K.-based insurer Prudential Plc said in a Jan. 11 email, adding that it ''can't comment on the new tax laws and their effects at this stage.''

New Opportunities Analysts urged overseas companies doing business in the U.S. to thoroughly assess their ventures and determine whether the tax overhaul offers new business openings.

''It's not yet clear who the winners and losers are,'' Geiger said. U.K. companies with American operations ''will be impacted differently depending on the complexity of their international supply chain and how the U.S. fits into those operations.''

Non-U.S. companies with large operations in America that primarily import finished or nearly finished goods into the U.S. for onward sale stand to gain from the reduced corporate tax rates, Geiger said. ''The flip side of this is that the services sector or those with more complex supply chains, including those in digital or technology, could be more adversely impacted.''

Intercompany Charges Hillier said U.K. companies operating in America with large intercompany charges could feel the pinch from BEAT and restrictions on interest expenses.

Foreign companies must understand the impact of reduced U.S. corporate rates and the new law's provisions to protect America's tax base, such as restrictions on interest deductions, Nicola Pardy, associate director for global tax services at Grant Thornton International Ltd. in London, said in an email.

Grant Thornton is advising its clients to review their internal charging structures in light of BEAT, Pardy said.

Most companies should carefully examine the capital structure of their U.S. operations and determine if they need to make changes, Geiger said. ''Those that are highly leveraged into the U.S., such as infrastructure or other capital intensive businesses, will be most impacted,'' she said.

Organizational Structure Geiger, Hillier, and Pardy agreed that, along with potential tax pitfalls, the new law offers foreign companies the chance to consider substantially revamping their corporate setups and activities to secure long-run benefits.

Overseas companies should review their organizational structures, Pardy said, because the new law marks ''a fantastic opportunity'' for them to restructure their business operations to benefit from the overhaul's provisions.

''There may be ways to simplify or change the supply chain and operating model if the consequences are severe, but such changes may be disruptive in the short term and so need to be approached with care,'' Geiger said.

The new law's impact will extend beyond tax policy, Pardy said, and could influence such tasks as hedging.

''Businesses may be more likely to move operations to the U.S. and so may their customers,'' Pardy said, and it is ''crucial for businesses to plan and think about how this affects their supply chain and logistics operations.''

By David R. Jones

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