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December 20, 2017

The GOP tax bill, passed by both houses of Congress and awaiting the President's signature, is the most significant tax reform enacted since 1986. The measure, popularly known as the Tax Cuts and Jobs Act ("TCJA"), makes major changes to the taxation of individuals, modifying individual tax brackets and marginal tax rates, while limiting (or eliminating) deductions and exemptions. However, much of the meat of the new law is on the business side, where it fundamentally changes the taxation of corporations, pass-through entities and multinational groups. Given the speed of the legislative process, many technical issues and drafting errors remain unaddressed in the final legislation. Some glitches may be addressed in the "Bluebook" to be prepared by the staff of the Joint Committee on Taxation sometime in 2018. There also will be a great deal of pressure on Treasury and the IRS to issue guidance on the new rules, and key lawmakers have already signaled the need for a technical corrections bill in 2018.

This memorandum, one of a series on the TCJA, summarizes the new rate structures for individuals and corporations and the new capital expensing rules. It also provides an overview of (and links to) the other memoranda in this series.

### Taxation of Individuals

The TCJA temporarily lowers individual tax rates for taxable years beginning January 1, 2018 and ending December, 31, 2025. While the TCJA retains seven rate brackets, it lowers marginal rates and increases the bracket thresholds.

The top marginal rate is reduced from 39.6% to 37% in part to compensate for limitations on deductibility of state and local taxes. Married individuals filing jointly, for example, are subject to a 10% rate on their first \$19,050 of taxable income (instead of \$18,650) and to a top marginal rate of 37% instead of 39.6% on income exceeding \$600,000 instead of \$470,700. Except in the case of the top bracket, the changes reduce the "marriage penalty" and increase the "marriage bonus" for some married individuals because the joint filer brackets begin at twice the single individual brackets:

Married Individuals Filing Joint Returns and Surviving Spouses	
If taxable income is:	Then income tax equals:
Not over \$19,050	10% of the taxable income
Over \$19,050 but not over \$77,400	\$1,905 plus 12% of the excess over \$19,050
Over \$77,400 but not over \$165,000	\$8,907 plus 22% of the excess over \$77,400
Over \$165,000 but not over \$315,000	\$28,179 plus 24% of the excess over \$165,000
Over \$315,000 but not over \$400,000	\$64,179 plus 32% of the excess over \$315,000
Over \$400,000 but not over \$600,000	\$91,379 plus 35% of the excess over \$400,000
Over \$600,000	\$161,379 plus 37% of the excess over \$600,000

Single Individuals	
If taxable income is:	Then income tax equals:
Not over \$9,525	10% of the taxable income
Over \$9,525 but not over \$38,700	\$952.50 plus 12% of the excess over \$9,525
Over \$38,700 but not over \$82,500	\$4,453.50 plus 22% of the excess over \$38,700
Over \$82,500 but not over \$157,500	\$14,089.50 plus 24% of the excess over \$82,500
Over \$157,500 but not over \$200,000	\$32,089.50 plus 32% of the excess over \$157,500

Over \$200,000 but not over \$500,000	\$45,689.50 plus 35% of the excess over \$200,000
Over \$500,000	\$150,689.50 plus 37% of the excess over \$500,000

Other significant changes to the taxation of individuals include increases in the standard deduction from \$12,000 to \$24,000 for married individuals filing jointly (from \$6,350 to \$12,700 for individuals filing separately). The TCJA limits many popular itemized deductions, such as the state and local tax (“SALT”) deduction. As a partial offset, it allows property, sales or income taxes to be deducted up to a cap of \$10,000 for taxpayers who itemize. It disallows the deduction of mortgage interest on principal over \$750,000 for newly purchased homes, but retains the previous limit of \$1,000,000 for individuals who purchased a home or entered into a binding contract to purchase one before December 15, 2017, if certain conditions are met. It also retains the individual alternative minimum tax but with a higher exemption. Under the new law, more taxpayers are expected to claim the standard deduction, and some will end up paying more taxes despite the decrease in rates.

## Taxation of Businesses

For years, the nominal corporate tax rate of the United States, 35%, has been the highest of any member of the OECD, for which the average is 22.5%. The TCJA permanently reduces the U.S. rate from 35% to 21%, effective December 31, 2017, with a stated goal of attracting foreign investors, reducing the incentive for U.S. corporations to shift capital abroad, and creating more U.S.-based jobs.

**Headline Rate.** While the headline rate is a flat 21%, other changes will result in a higher or lower effective rate for most corporations. Under a new regime for international taxation, routine business profits of foreign subsidiaries can be distributed tax free to their corporate parents. However, some parts of the current worldwide system will be retained, and certain intangible foreign income (including income earned directly and income earned through foreign subsidiaries) will be included in the U.S. tax base, but taxed at a lower rate. In addition, the deduction of net interest expense will be limited; a base-erosion minimum tax may apply; numerous deductions, including some ordinary business expenses, will be disallowed; and other deductions will be accelerated or deferred.

**Capital Expenses.** For the next few years, corporations will be able to lower their effective tax rate through accelerated recovery of capital expenditures. An amended Section 168(k) will allow full expensing of the cost of “qualified property” placed in service within the next five years (six years for certain property with longer production periods). There is a 20% annual phase-down in the years after that. “Qualified property” generally includes computer software and tangible property with a recovery period of 20 years or less. The rules apply to property newly placed into service and to used property acquired from another unrelated taxpayer, if certain conditions are met, but not to property currently used by the taxpayer. For property placed into service in the first taxable year after September 27, 2017, taxpayers may elect to use a 50%-expensing rate in lieu of full expensing.

**Small Businesses.** The TCJA increases the dollar limitation on the amount of depreciable business assets that a small business taxpayer can elect to expense under Section 179 from \$500,000 to \$1,000,000. It also increases the threshold for qualifying businesses and expands the type of property for which the taxpayer may make the election.

**Research and Experimental Expenses.** Research and experimental expenditures (including software development expenses) are currently deductible in the taxable year they are incurred. Under the new law, amounts paid or accrued after 2021 must be capitalized and amortized ratably over a 5-year period. The amortization period is extended to 15 years in the case of certain expenditures attributable to foreign research. The 5- or 15-year amortization period continues to apply, and is not accelerated, even after the taxpayer sells, retires or abandons the property resulting from expenditures.

**Partnerships and Sole Proprietorships.** The TCJA provides a deduction equal to 20% of qualifying business income for partnerships and sole proprietorships engaged in a specified trade or business or

whose taxable income, before the deduction, is less than a threshold amount. Except in the case of income from publicly traded partnerships and REITS, the deduction is subject to limitations based on wages paid and basis of qualified property.

## **Overview of Other Memoranda**

We have written a number of other memoranda that discuss the changes to business taxation in greater detail. You can read each memorandum by clicking on the headings below.

**Changes to the Rules Governing Interest Expense and Net Operating Loss.** Existing Section 163(j), which currently limits the deductibility of interest paid to certain related parties, is amended to limit the deduction for net business interest expense, whether paid to a related party or not, to 30% of the taxable income, increased by deductions for business interest, non-business items, the 20% deduction for qualifying non-corporate business income, and (for taxable years beginning after January 1, 2022) depreciation and amortization. Base erosion provisions discussed below also limit interest deductibility. Together, these rules may cause multinational groups to issue more of their debt abroad. The TCJA also limits the use of a corporation's net operating losses for a given year to 80% of taxable income.

**Changes to the Rules Governing Taxable Year of Inclusion.** New timing rules will cause certain income to be reported for tax purposes when it is recognized for book purposes.

**The New “Not Quite Territorial” International Tax Regime.** The shift of the international tax regime to a modified territorial system may represent the most significant change from prior law. Multinational groups will be able to repatriate routine foreign earnings tax free due to a dividends-received deduction. The new regime also continues to include “subpart F income” in the U.S. tax base (with a narrowed exception for active insurance businesses) and includes a new direct tax, initially at an effective 10.5% rate, on a global intangible low-tax income (“GILTI”) earned by foreign subsidiaries and a reduced tax, initially at a 13.125% effective rate, on foreign derived intangible income (“FDII”) earned directly by U.S. taxpayers. These provisions aim to level the playing field with jurisdictions that have tax rates on intangible income as low as 12.5% (e.g., Ireland). The TCJA also includes a new base erosion and anti-abuse tax (“BEAT”) that imposes a minimum tax to limit a corporation's ability to reduce its normal U.S. taxes through payments to related foreign parties. Notably, this rule does not apply to purchases of goods from foreign related parties. The TCJA modifies these rules for inverted companies and includes a lower trigger and higher rate for banks and securities dealers. The TCJA also includes a new rule denying a deduction for any interest or royalty paid to a related party that is effectively not taxed on receipt of the payment.

**Transition Tax / Deemed Repatriation.** A transition tax requires a deemed repatriation of accumulated foreign earnings of specified foreign corporations and provides for a partial dividends-received deduction so that offshore earnings invested in cash or cash equivalents are taxed at an effective 15.5% rate and earnings in excess of the cash position are taxed at an effective 8% rate. The effective rate is increased for any company that inverts in the next 10 years. The regime allows for the netting of positive earnings of one specified corporation against deficits of others. The transition tax may be paid in back-loaded installments over eight years. It also contains rules intended to minimize double counting and to account for fiscal year foreign corporations, but does so inadequately. Members of Congress and representatives of the IRS have suggested that these issues will be addressed in regulations, and possibly in a technical corrections bill.

**Impact on Businesses Owned by U.S. Individuals.** The TCJA provides for a 20% pass-through deduction for non-corporate business entities and sole proprietorships engaged in a specified business or whose income, before the deduction, is less than a threshold amount (\$315,000 in the case of joint filers), but it subjects them to the limitations on interest deductibility. These and other changes will affect decisions on whether to run a business through a partnership, C corporation, S corporation or sole proprietorship.

**Effect of the TCJA on Private Investment Funds.** The final memo in our series addresses the effect of the TCJA from the perspective of the private equity industry, including the effect of the changes to partnership taxation, changes to interest deductibility, changes to the rules related to carried interest, and a modification to the UBTI rules precluding the aggregation of income and losses from different active businesses.

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# Changes to the Rules Governing Interest Expense and Net Operating Loss

December 20, 2017

## Changes to the Interest Expense Rules of Section 163(j)

New Section 163(j) generally provides that a taxpayer's net "business interest" expense deduction (its business interest expense minus its business interest income<sup>1</sup>) for a taxable year cannot exceed 30% of its adjusted taxable income, or "ATI."<sup>2</sup> We will refer to 30% of a taxpayer's ATI for a given year as its "net interest limitation," or "NIL." For this purpose, business interest expense ("BIE") means interest paid or accrued on indebtedness properly allocable to a trade or business. It does not include investment interest (as defined in Section 163(d)), which appears to be intended to be applicable only to non-corporate entities.<sup>3</sup> A trade or business does not include (1) performing services as an employee; (2) an electing real property trade or business;<sup>4</sup> (3) an electing farming business; or (4) certain public regulated utilities.

ATI means taxable income for the year determined without regard to (1) any income, gain, deduction or loss not properly allocable to a trade or business, (2) business interest income or BIE, (3) any net operating loss deduction under Section 172, (4) the deduction for "qualified business income" in new Section 199A,<sup>5</sup> (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion, and (6) other adjustments as provided by the Secretary of the Treasury. The legislative history indicates that all members of a consolidated group are treated as a single taxpayer. The Section provides that amounts disallowed will be carried forward (indefinitely) and treated as interest in succeeding taxable years. A disallowed business interest carryforward is carried over in certain corporate acquisitions under Section 381 and is included in the term "pre-change loss" for purposes of Section 382.

The Section provides no specific grant of regulatory authority (unlike existing Section 163(j), which includes several), and leaves a number of questions unanswered, including whether and how to allocate disallowed interest to particular instruments (for example, when a member leaves a consolidated group – assuming all members of the group are indeed treated as one taxpayer) or how the Section might apply to foreign entities' U.S. operations.

### Application to partnerships and S corporations

In the case of a partnership, the limitation is determined at the partnership level, and any business interest deduction is taken into account in determining the partnership's non-separately stated taxable income or loss for a given taxable year of the partnership. Accordingly, each partner's ATI (*i.e.*, for

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<sup>1</sup> Certain "floor plan financing interest" expense is also excluded.

<sup>2</sup> Certain small businesses, generally those with average annual gross receipts for the prior three years of \$25,000,000 or less, are exempt from this limitation.

<sup>3</sup> The Report of the Committee on Ways and Means House of Representatives on H.R. 1 (the "House Report") makes this explicit.

<sup>4</sup> This is defined as a trade or business described in Section 469(c)(7)(C) (any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business) that makes an (irrevocable) election at such time and in such manner as prescribed by the Secretary of the Treasury. Generally, an electing real property trade or business must use an alternate, and longer, method of depreciation under Section 168(g)(1)(F).

<sup>5</sup> Section 199A generally permits a deduction for certain passthrough business income.

purposes of computing its own Section 163(j) limitation) is determined without regard to its share of the partnership's income, gain, deduction or loss, but is increased by its allocable share of the partnership's "excess taxable income" ("ETI"), which is generally the percentage (if positive) of the partnership's ATI equal to the percentage of the partnership's NIL that exceeds its BIE. A partnership's disallowed BIE is not carried forward by the partnership but is treated as "excess business interest" ("EBI") allocated to its partners, and treated as paid or accrued by the partner to whom allocated in the next succeeding year in which the partner is allocated ETI from the partnership, and only to the extent of that ETI, and then carried forward to succeeding years accordingly. Moreover, a partner may not use ETI allocated to it from a partnership to increase its NIL with respect to BIE paid or accrued outside that partnership until all of the partner's EBI allocated to the partner from that partnership (in all years) has been treated as paid or accrued.<sup>6</sup>

### **Basis adjustments**

The rules provide that each partner decreases its outside basis (in its partnership interest) by the amount of the partnership's EBI allocated to it. If a partner disposes of a partnership interest in either a taxable or a non-recognition transaction, then immediately before disposition, the partner's adjusted basis in its partnership interest is increased by the amount of EBI previously allocated to but not yet deducted by it. In the case of a taxable transaction this has the effect of accelerating the deduction but also of converting it from an ordinary deduction to a capital loss (to the extent the basis increase is not allocated to "hot assets" of the kind described in Section 751). The rules do not specify how the basis increase is to be allocated among the partnership's assets, nor do they make clear whether or how the basis adjustment mechanism applies in the case of a partial disposition of a partnership interest. They do specify that no deduction is allowed to either the transferor or the transferee for any EBI resulting in a basis increase.

Similar rules (other than the rules relating to EBI carryforwards) apply to S corporations and their shareholders.

### **Changes to the Net Operating Loss ("NOL") Rules of Section 172**

An NOL generally means the amount by which a taxpayer's business deductions exceed its gross income for a taxable year. Under current law, an NOL generally can be carried back to the two taxable years preceding the year of the loss and then forward to the twenty taxable years following the year of the loss. The TCJA generally repeals the NOL carryback but permits an indefinite carryforward. However, the amount of an NOL carryover that is deductible in any taxable year is limited to 80% of that year's taxable income.

The provision repeals the special rule for "corporate equity reduction transactions," as well as a three-year carryback for certain individual casualty and theft losses and certain small business and farming losses.

The TCJA exempts property and casualty insurance companies from this new regime, so that they continue to be permitted to carry their NOLs back for two years and then forward for twenty years, with no limitation on the amount of income in any year that may be offset by an NOL carryback or carryforward.

The 80% limitation and the insurance exception therefrom are effective for losses arising in taxable years beginning after December 31, 2017. The remainder of these rules are effective for losses arising in taxable years ending after December 31, 2017.

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<sup>6</sup> For this and other reasons, on a "consolidated" basis, a partner's overall effective NIL may be less than 30% of its overall ATI.

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## Changes to the Rules Governing Taxable Year of Inclusion

December 20, 2017

### Revisions to the Application of the “All Events” Test

Income generally is includible in gross income of an accrual-method taxpayer when the “all events” test is met, *i.e.*, when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. Under the TCJA, a new Section 451(b) will be added to provide that the “all events” test is treated as being met no later than when the item is taken into account as revenue by the taxpayer in a financial statement, as defined. Because Section 451(b) is limited to items of gross income that are subject to the “all events” test, the new rules in Section 451(b) would not apply to non-recognition provisions, like Sections 351 and 721, or to gain on the sale of assets under Section 1001. However, although it is arguable that income on a debt instrument subject to the original issue discount (“OID”) rules is not subject to the all events test, because the OID rules prescribe when income is taken into account (regardless of the taxpayer’s method of accounting), it is clear that Section 451(b) applies to income on a debt instrument subject to the OID rules. New regulations likely are necessary to demonstrate the interaction of Section 451(b) and the OID and other debt-related rules (*i.e.*, how OID should accrue if a portion of the interest income on a note is taken into account earlier than it would be taken into account under the OID rules).

The expanded “all events” test in Section 451(b) provides rules only for gross income inclusion and not for loss inclusion. This could at least in theory produce distorted results, if there is a circumstance in which income to which the Section applies and that is reflected in a financial statement can be offset in the current or subsequent tax year by another item.

Section 451(b) provides a list of financial statements that qualify for purposes of the Section. If a taxpayer has no financial statement on the list, Section 451(b) does not apply to it.

The new rules provide that if financial results are reported on a relevant financial statement for a group of entities, that statement shall be treated as the applicable financial statement of each taxpayer in the group for purposes of Section 451(b).

Section 451(b) excludes from its scope items of gross income earned in connection with a mortgage servicing contract. Section 451(b) also excludes from its scope items subject to a “special method of accounting,” other than one in Sections 1271 through 1288, relating to debt instruments (unless the item is a mortgage servicing contract). The term “special method of accounting” is not defined. It seems clear that overall accounting methods, such as those provided for in the mark-to-market rules applicable to securities dealers and other electing dealers and traders in Section 475, or the rules governing hedging transactions entered into in the ordinary course of a taxpayer’s trade or business, would fall within the “special method of accounting” exception.

### Codification of an Exception to the “All Events” Test for Certain Advance Payments

Section 451(c) codifies an exception from the application of the all events test for certain types of advance payments (described below) received by accrual-method taxpayers. An accrual-method taxpayer that receives an advance payment during the taxable year may elect to include for that taxable year the portion taken into account as revenue in an applicable financial statement and include the remaining portion in the following taxable year. The election is effective for the relevant taxable year and all subsequent taxable years, unless the taxpayer receives the Secretary’s consent to revoke the election. If a taxpayer does not make an election under Section 451(c), an advance payment must be taken into account under the general rules in Section 451(b).

Under current law, in certain instances advance payments are excluded from the all events test to allow tax deferral to mirror financial accounting deferral. For example, Treasury regulations allow for deferral with respect to advance payments for goods, and other guidance allows for deferral with respect to advance payments for a broader set of items.<sup>1</sup> The advance payment rule in Section 451(c) differs from both the rule in Section 451(b) and the Treasury regulations that currently allow for deferral with respect to certain advance payments. Unlike Section 451(b), Section 451(c) allows for deferral beyond the year of receipt of payment other than with respect to amounts taken into account for financial statement purposes. However, in contrast to current law, which allows for deferral with respect to advance payments for goods to the time at which the advance payments are included in gross receipts for purposes of the taxpayer's reports to shareholders, partners, beneficiaries, and other proprietors, or for credit purposes, Section 451(c) only allows for deferral for one year. Thus, while the advance payment provision codifies the availability of deferral, it may be less generous in certain respects than what was previously available.

An "advance payment" is defined as any payment which meets all of the following criteria:

- The full inclusion of the payment in the taxpayer's gross income for the taxable year of receipt is a permissible method of accounting under Section 451 (determined without regard to Section 451(c));
- A portion of the payment is included in revenue by the taxpayer for a subsequent taxable year in one of the financial statements listed in Section 451(c);
- The payment is for goods, services or such other items as may be identified by the Secretary;
- The payment is not on the list of excluded types of payments in Section 451(c).<sup>2</sup>

Computing income under Section 451(c) is treated as a method of accounting.

### **Coordination with Section 481**

In the case of any change in method of accounting for the taxpayer's first taxable year beginning after December 31, 2017 that either (x) is required by the amendments made to Section 451 or (y) was previously prohibited and is permitted after the amendments, the change is treated as initiated by the taxpayer and as made with the consent of the Secretary of the Treasury. Furthermore, the period for taking into account any Section 481 adjustments with respect to income from a debt instrument with OID is six years.

### **Effective Date**

The amendments to Section 451 are effective for taxable years beginning after December 31, 2017, except that, for debt instruments with OID, the effective date is delayed until the first taxable year beginning after December 31, 2018.

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<sup>1</sup> See, e.g., Rev. Proc. 2004-34, which allows for deferral for advance payments for services, sales of goods other than a sale for which the taxpayer used the deferral method outlined in the Treasury regulations, use of intellectual property, use or occupancy of property if ancillary to the provision of services, sale, lease, or license of computer software, guaranty or warranty contracts ancillary to the provision of services, sale of goods, use of intellectual property, use or occupancy of property, or sale, lease, or license of software, certain subscriptions, certain memberships in organizations, and "eligible gift card sales".

<sup>2</sup> Certain payments are excluded from Section 451(c), including rent, insurance premiums, payments with respect to financial instruments, certain payments under warranty or guarantee contracts, payments received by foreign persons that are not income effectively connected with a U.S. trade or business, certain payments in property in connection with the performance of services and any other payment identified by the Secretary.

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# The New “Not Quite Territorial” International Tax Regime

December 20, 2017

## Background

The TCJA adopts a new international tax regime that shifts the United States from a world-wide system of taxation to a quasi-territorial one.

Briefly, the new rules:

- Establish a 100% deduction for corporate recipients of foreign-source dividends (the “participation exemption”)
- Retain subpart F (including Section 956<sup>1</sup>), with modifications
- Limit certain tax benefits deemed inappropriate in the context of the a quasi-territorial regime that operates by way of participation exemption
- Repeal an exception to gain recognition under Section 367 with respect to transfers of property used in the active conduct of a trade or business to a foreign corporation in certain nonrecognition transactions
- Impose, at a reduced tax rate and on a current basis, a minimum tax on foreign earnings deemed to be received by corporations from intangibles (“GILTI”)
- Impose, on a current basis, tax at ordinary individual income tax rates on certain non-corporate U.S. shareholders’ share of a controlled foreign corporation’s GILTI
- Allow a deduction for income earned directly by corporate U.S. taxpayers from selling property or providing services outside the United States (“FDII”)
- Expand the definition of intangible property for purposes of Section 367(d) and Section 482 and expand the Internal Revenue Service’s authority to challenge transfer pricing using aggregation and “realistic alternatives” theories
- Provide new anti-hybrid rules denying deductions for certain interest and royalties paid to foreign related persons
- Implement a new base erosion alternative minimum tax (“BEAT”)

## The Participation Exemption

The TCJA’s shift from a world-wide system to a quasi-territorial system is anchored by the creation of a dividends-received deduction or “participation exemption”. The deduction is paired with several new limitations on certain tax benefits deemed inconsistent with the new regime.

## Foreign-Source DRD

Under new Section 245A, a U.S. corporation generally may deduct the amount of the “foreign-source portion” of any dividend it receives from a foreign corporation (other than a “passive foreign investment

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<sup>1</sup> All “Section” references herein are to the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise described.

company” as defined in Section 1297) in which it owns a 10% interest (the “Foreign-Source DRD”). Simplifying:

- the “foreign-source portion” of any such dividend is determined by reference to the ratio of the foreign corporation’s “undistributed foreign earnings” to its total undistributed earnings at the close of its taxable year; and
- a foreign corporation’s “undistributed foreign earnings” are defined as its undistributed earnings that are not attributable to (i) income effectively connected with the conduct of a U.S. trade or business or (ii) dividends from U.S. corporations in which the foreign corporation owns at least 80% of the stock (by voting power and value).<sup>2</sup>

The deduction is available only to U.S. “C corporations” other than regulated investment companies and real estate investment trusts (“Eligible C Corporations”). The Eligible C Corporation must own 10% or more of the vote or value of the corporation’s stock (*i.e.*, such corporation must be a 10% U.S. Shareholder) and satisfy a holding period requirement with respect to the foreign corporation of at least 366 days during the 731-day period around the ex-dividend date. Under an amendment to Section 1248, upon the sale or exchange of stock of a foreign corporation, an amount treated as a dividend for that purpose is eligible for the Foreign-Source DRD if the domestic corporation held the stock of the foreign corporation for at least one year.

#### **Limitations on Certain Tax Benefits**

The TCJA includes a number of rules intended to prevent taxpayers from obtaining a “double” tax benefit (*i.e.*, a reduction of taxes beyond that available from the participation exemption) when combined with the Foreign-Source DRD.

- No foreign tax credit or deduction will be allowed for any foreign taxes, including withholding taxes, paid (or any entity-level foreign taxes that are deemed paid) with respect to a dividend for which a Foreign-Source DRD is allowed.
- The Foreign-Source DRD will not apply to any “hybrid dividend” – that is, a dividend with respect to which a controlled foreign corporation (as defined in Section 957(a), also referred to as a “CFC”) received a deduction or other tax benefit from a foreign country.
  - In addition, if a CFC with respect to which a U.S. corporation is a 10% U.S. Shareholder receives a “hybrid dividend” from another CFC with respect to which such U.S. corporation is also a 10% U.S. Shareholder, the U.S. corporation will be required to include its pro rata share of the “hybrid dividend” as subpart F income. No foreign tax credit or deduction will be allowed for any foreign taxes paid (or deemed paid) with respect to a “hybrid dividend” or a subpart F income inclusion attributable to a “hybrid dividend.”
- Because a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable, new Section 91 generally requires a domestic corporation to recapture the U.S. tax benefits of any such losses immediately upon the incorporation of a foreign branch. Specifically, if a domestic corporation transfers substantially all of the assets of a foreign branch to a specified 10%-owned foreign corporation, the domestic corporation includes in gross income an amount equal to the losses incurred by the

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<sup>2</sup> As under prior law, a U.S. corporation that owns at least 10% of the stock of a foreign corporation (by vote *and* value) may claim a dividends-received deduction equal to a specified percentage of the “U.S.-source portion” of any dividend it receives from the foreign corporation. Generally, the “U.S.-source portion” is post-1986 undistributed earnings of the foreign corporation that do not constitute “undistributed foreign earnings”, as defined above.

branch after December 31, 2017 (net of certain taxable income of the branch and gain recognized as a result of the transfer).

- A corporate 10% U.S. Shareholder could also benefit twice as a result of a foreign-source dividend if it takes advantage of the participation exemption and subsequently sells the stock of the relevant foreign corporation at a loss (because the distribution reduced the value of the foreign corporation). In order to prevent this result, the TCJA amends Section 961 to provide that, for the purpose of determining a loss, a corporate 10% U.S. Shareholder's adjusted basis in the stock of such foreign corporation is generally reduced by the amount of any Foreign-Source DRD allowable with respect to such stock.

### **Regulatory Authority to Carry Out the Purposes of the Section**

The TCJA directs the Secretary to prescribe regulations necessary or appropriate to carry out the provisions of Section 245A, including addressing the treatment of 10% U.S. shareholders owning stock through a partnership. The conference report prepared by the committee of conference ("Conference Report") specifically contemplates that a "dividend received" will include a dividend paid to a partnership in which a domestic corporation is a partner. Given the specificity of the language in the Conference Report and the direction to the Secretary to issue regulations, we believe that domestic corporate partners in partnerships receiving otherwise eligible dividends would likely be able to claim the exemption prior to the promulgation of any such regulations.

### **Quasi-Territorial System**

As noted above, the approach of the TCJA is not a full territorial system. 10% U.S. Shareholders of a CFC are required to include in income each year, as ordinary income, their shares of certain types of the CFC's income under subpart F, as well as the earnings that the CFC invests, or is treated as investing, in "United States property" under Section 956, regardless of whether the CFC makes any distributions. The Foreign-Source DRD does not apply to these inclusions, even if the CFC distributes an amount equal to the inclusions during the same taxable year, with the result that 10% U.S. Shareholders will be subject to U.S. taxation on such foreign source income. As described below, the TCJA makes a number of additional changes to the subpart F rules that will increase the situations in which a foreign corporation is treated as a CFC and will increase the universe of taxpayers who are treated as 10% U.S. Shareholders subject to the tax consequences of the CFC regime. Finally, the Section 954(c)(6) "look-through" rule will sunset in 2019, absent an extension.<sup>3</sup>

It is not at all clear why Congress chose to retain Section 956 and there is no guiding principle in the legislative history. One could reasonably infer that Congress decided that Section 956 was necessary to backstop the residual elements of the worldwide tax system, e.g., the holding period and anti-hybrid requirements of Section 245A or the expanded tax base arising upon the sunset of Section 954(c)(6) although the scope of Section 956 after the TCJA is broader than these limited circumstances. This development may be of particular note to the financing markets – we expect that market participants may evaluate differently the impact of conventional pledge limitations designed to avoid the application of the Section 956 rules.

The sunset of the Section 954(c)(6) look-through rule may have a significant impact on tax planning in light of the Foreign-Source DRD. The look-through rule has significant utility in structuring business operations and permitting flexibility in the deployment of active foreign earnings within U.S.-based multinational groups.

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<sup>3</sup> The "look-through rule" was originally enacted in 2009 as a temporary three-year measure and has been extended several times.

Without the look-through rule, subpart F income may include active business earnings that are redeployed from a subsidiary that earned the income in one country to a subsidiary in another country for purposes of expanding in the other country or making an acquisition, even though these earnings would not otherwise be considered “passive” in nature.<sup>4</sup> Moreover, if such a tax is triggered, it appears that corporate 10% U.S. Shareholders will not be entitled to a foreign tax credit for foreign taxes paid with respect to such active earnings at least absent an affirmative invocation of Section 956. It may therefore be beneficial for a U.S. parent corporation to own only a single tier of CFCs (e.g., by “checking open” any lower tier subsidiaries).

Accordingly, the regime preserves significant components of (and in some ways expands) the world-wide system of taxation.

## **FDII**

In order to minimize incentives to move and hold intangible assets outside the United States, new Section 250 allows a deduction for Eligible C Corporations that reduces the effective U.S. tax rate on foreign-derived income treated as attributable to intellectual property and other intangible assets.

### **Determination of FDII**

“Foreign-derived intangible income” (“FDII”) is generally the portion of the U.S. corporation’s net income (other than GILTI and certain other income) that exceeds a deemed rate of return of the U.S. corporation’s tangible depreciable business assets and is attributable to certain sales of property to foreign persons or to the provision of certain services to any person, or with respect to any property, located outside the United States.

Specifically, the calculation of FDII includes the following three steps:

- **Step 1 – Calculate the Deduction Eligible Income (“DEI”):** DEI is generally (i) the gross income of the corporation without regard to (A) the subpart F income of the corporation; (B) the GILTI of the corporation; (C) any dividend received from 10%-owned CFCs; (D) domestic oil and gas income; and (E) foreign branch income over (ii) the deduction (including taxes) properly allocated to such income.
- **Step 2 – Calculate the Deemed Intangible Income (“DII”):** DII is the DEI minus 10% of the tax basis of the corporation’s qualified business asset investment (“QBAI”). QBAI is the quarterly average tax bases in depreciable tangible property used in the corporation’s trade or business to produce the relevant income or loss. For purposes of this calculation, the taxpayer is generally required to use straight-line depreciation (in lieu of accelerated depreciation), thus requiring cost recovery over a longer period of time.
- **Step 3 – Calculate the FDII:** DEI is considered “foreign-derived” DEI if it is derived in connection with (i) property sold to a non-U.S. person for a foreign use or (ii) services provided to any person (or with respect to property) outside of the United States.
  - “Foreign use” means any use, consumption, or disposition that is not within the United States. Sales of property to another person for further manufacture or other modification within the United States are not treated as sold for a foreign use even if the other person subsequently uses such property for a foreign use, subject to exceptions with respect to

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<sup>4</sup> Footnote 1486 of the Conference Report suggests that a participation exemption may be available for a CFC that receives a dividend from a lower tier foreign subsidiary, but the operation and scope of that footnote is unclear.

related parties and for property that the taxpayer establishes to the satisfaction of the Internal Revenue Service is for a foreign use. Property sold to a related person is not treated as sold for a foreign use unless certain conditions are met and the taxpayer establishes to the satisfaction of the Internal Revenue Service that such property is for a foreign use.

- Services provided to another person (except certain related parties) located within the United States are not generally treated as provided outside of the United States, even if the other person uses the services in order to provide further services outside the United States. If services are provided to a related party who is not located in the United States, the services are not treated as provided outside of the United States unless the taxpayer establishes to the satisfaction of the Secretary that such service is not substantially similar to services provided by such related party to persons located within the United States.

Simplifying, FDII can be expressed as the following formula:

$$\text{FDII} = \text{DII} * [\text{Foreign-Derived DEI/DEI}]$$

While a formula-driven approach to determining FDII is more administrable than a facts and circumstances approach, it is by no means clear that 10% of the adjusted basis of fixed assets is a universally appropriate deemed rate of return on tangible assets. Treating the residual amount as a return on intangible assets also eliminates any other factors (e.g., risk) associated with returns on investment that might otherwise be appropriate to consider.

### **Deduction Amount**

- For taxable years 2018-2025, Eligible C Corporations are allowed a deduction equal to 37.5% of FDII. At the new 21% corporate tax rate, this results in an effective tax rate of 13.125% on FDII.
- For taxable years after 2025, the deduction is reduced to 21.875% of FDII. Assuming a 21% corporate tax rate, this will result in an effective tax rate of 16.406% on FDII.
- The amount of the FDII deduction is subject to a limitation if the sum of such Eligible C Corporation's FDII and GILTI exceeds its taxable income (determined without such deductions) (see discussion below at "GILTI Deduction" and Example 3 of the Appendix).

### **GILTI**

New Section 951A will, in effect, impose a foreign minimum tax on 10% U.S. Shareholders of CFCs to the extent the CFCs are treated as having "global intangible low-taxed income" ("GILTI"). The calculation of GILTI is based on a formula, described below, that exempts from inclusion a deemed return on tangible assets and deems the residual income to be intangible income that is subject to current U.S. tax. In addition, similar to the FDII regime described above, new Section 250 provides a deduction that reduces the effective U.S. tax rate on GILTI for 10% U.S. Shareholders that are Eligible C Corporations. The regime operates in this manner without regard to whether the income in question is, in fact, from the exploitation of intangible assets.

### **Calculating GILTI**

Under the TCJA, each 10% U.S. Shareholder of a CFC, whether such shareholder is an individual or an entity, is required to include currently in its income its GILTI in the applicable tax year.

The calculation of GILTI follows three basic steps and is calculated in the aggregate for a U.S. person with respect to the CFCs for which it is a 10% U.S. Shareholder (a "relevant CFC"):

- Step 1 – Calculating Net Tested Income: "Net tested income" (or loss) of a U.S. person is generally the aggregate net income (or loss) of each of its relevant CFCs other than (i) income that is effectively connected with a U.S. trade or business, (ii) subpart F income, (iii) income that

is subject to an effective foreign income tax rate greater than 90% of the maximum U.S. corporate income tax rate, (iv) dividends received from related persons and (v) certain foreign oil and gas income.

- **Step 2 – Calculating the Net Deemed Tangible Income Return:** A U.S. person's "net deemed tangible income return" is generally an amount equal to 10% of the tax basis of the QBAI of each relevant CFC minus the net amount of interest expense taken into account in determining the net tested income. The QBAI of a CFC is calculated similarly to QBAI for FDII purposes, including the requirement to use the straight-line depreciation method.
- **Step 3 – Calculating GILTI:** GILTI is the excess (if any) of the U.S. person's aggregate net tested income over aggregate net deemed tangible income return, or:

$$\text{GILTI} = \text{Net Tested Income} - \text{Net Deemed Tangible Income Return}$$

The observation above regarding the formula-driven approach to FDII applies equally to the determination of GILTI. This approach is potentially overbroad, as it will affect U.S.-based groups that have any offshore intangible assets, without regard to how the intangibles were developed. Reliance on U.S. tax basis as the metric for determining QBAI also threatens to impose significant compliance burdens on foreign corporations.

### **GILTI Deduction**

The TCJA provides a deduction equal to a percentage of GILTI that reduces the effective rate imposed on such income. However, the deduction is available only to Eligible C Corporations, while GILTI is required to be included by all 10% U.S. Shareholders.

For taxable years 2018-2025, a deduction is allowed equal to 50% of GILTI plus any deemed dividend under Section 78 to the extent attributable to GILTI (see Examples 1 and 3 in the Appendix for additional detail regarding the interaction of Section 78 and the GILTI regime). At the new 21% corporate tax rate, this results in an effective tax rate of 10.5% on GILTI (without taking into account foreign taxes). Taking into account foreign tax credits (see discussion below), at foreign tax rates of 13.125% or higher, Eligible C Corporations will owe no residual tax with respect to their GILTI. For taxable years after 2025, the deduction is reduced to 37.5% of GILTI (plus any related Section 78 amount). At the new 21% corporate tax rate, this results in an effective tax rate of 13.125% on GILTI.

The amount of the GILTI deduction is subject to a limitation if the sum of such Eligible C Corporation's GILTI and FDII exceeds its taxable income (see Example 3 in the Appendix for additional details regarding the application of this limitation). The practical effect of this limitation is to (1) ensure that GILTI and FDII deductions are not used to offset other income of the Eligible C Corporation and (2) impose a higher tax rate with respect to any GILTI and FDII that, in the aggregate, exceed other taxable income.<sup>5</sup>

### **Foreign Tax Credit**

10% U.S. Shareholders that are Eligible C Corporations will be entitled to a tax credit for 80% of the foreign taxes paid by their CFCs attributable to the GILTI amount (the "GILTI Tax Credit").

The foreign taxes paid by CFCs attributable to the GILTI amount are calculated by multiplying the 10% U.S. Shareholder's "inclusion percentage" by the foreign income taxes paid by such CFCs that are

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<sup>5</sup> Section 250A provides a deduction calculated with respect to GILTI and the Section 78 deemed dividend that is attributable to GILTI taken into account for purposes of the deduction. The statute does not specify what portion of the Section 78 deemed dividend is attributable to GILTI for this purpose in a fact pattern in which the limitation applies. Example 3 of the Appendix illustrates one possible method of attribution.

attributable to tested income. The “inclusion percentage” is the ratio of such 10% U.S. Shareholder’s GILTI amount divided by the relevant aggregate amount of tested income. GILTI Tax Credits are segregated into a separate foreign tax credit basket with no carryforward or carryback available for any excess credits.

As a formula, the GILTI Tax Credit can be expressed as:

$$\text{Deemed-Paid Credits} = 80\% (\text{GILTI/Aggregate Tested Income}) * \text{Aggregate Tested Foreign Income Tax}$$

Because the calculation of the GILTI Tax Credit is done by first aggregating all foreign income taxes attributable to tested income, foreign taxes paid by one CFC with respect to its tested income may be available to offset GILTI inclusions from another CFC. However, taxes with respect to any income excluded from “tested income” (including subpart F income and, if applicable, “high-tax” income of a CFC excluded from subpart F income by election of the taxpayer) are not eligible for cross-crediting. In certain circumstances, these rules may interact to subject 10% U.S. Shareholders that are Eligible C Corporations to U.S. tax, even where the effective worldwide rate exceeds the highest applicable U.S. rate.

### **Regulatory Authority to Address Abuse**

The TCJA provides regulatory authority to prevent the avoidance of the purposes of the GILTI rules. The Conference Report provides that “[t]he conferees intend that non-economic transactions intended to affect tax attributes of CFCs and their [10% U.S. Shareholders] (including amounts of tested income and tested loss, tested foreign income taxes, net deemed tangible income return, and QBAI) to minimize tax under this provision be disregarded.” In furtherance of this principle, the conferees expect Treasury regulations to address transactions intended to increase a CFC’s QBAI that occur after earnings and profits are measured for purposes of the deemed repatriation rules of new Section 951A and the application of this Section.

### **Interaction with the FDII Regime**

The TCJA applies a “carrot and stick” approach to reducing incentives to shift income abroad through the use of intangibles. The stick takes the form of the current taxation of GILTI and the expansion of certain elements of the worldwide system of taxation discussed above. The carrot takes the form of a lower rate on deemed intangible income implemented through the FDII and GILTI deductions. Together, the carrot and stick are intended to reduce distortions caused by differences in tax rates between the U.S. and other jurisdictions.

However, it is not at all clear that the FDII and GILTI regimes will achieve their intended results. While income deemed attributable to intangible assets held abroad will be taxed at an effective rate as low as 10.5% without regard to where the intangible assets are exploited, income deemed attributable to intangible assets held domestically will benefit from an effective 13.125% tax rate only when the intangible assets are exploited abroad (*i.e.*, income from the exploitation of domestically-held intangible assets in the United States is subject to the regular corporate rate). It may therefore continue to be advantageous to hold intangible assets in (and relocate such assets to) foreign low-tax jurisdictions.

*Examples.* Illustrative examples as to the application of the GILTI and FDII regimes can be found in Appendix I.

### **Subpart F Changes**

The TCJA has made a number of changes to the subpart F rules, including changes that expand the scope of the CFC regime.

### **Modification of Attribution Rules**

Beginning in 2017, the TCJA expands the constructive ownership rules for purposes of determining 10% U.S. Shareholders, whether a corporation is a CFC and whether parties satisfy certain relatedness tests. Specifically, the TCJA treats stock that is owned by a foreign person as attributable to a U.S. entity that is owned by the foreign person (so-called “downward attribution”).

As a result, stock owned by a foreign person may generally be attributed to (i) a U.S. corporation 10% of the value of the stock of which is owned, directly or indirectly by the foreign person, (ii) a U.S. partnership in which the foreign person is a partner and (iii) certain U.S. trusts if the foreign person is a beneficiary or, in certain circumstances, a grantor or a substantial owner.

This change is intended to render de-controlling transactions (e.g., transactions designed to cause a foreign subsidiary to cease to be a CFC by taking advantage of the downward attribution exception) ineffective as a means of avoiding U.S. tax under subpart F. This change is expected to have a significant impact on inverted groups, potentially causing minority U.S. owners of foreign subsidiaries in the group to be treated as 10% U.S. Shareholders of CFCs as a result of downward attribution of stock in the foreign subsidiaries that is owned by other foreign members of the group to domestic shareholders.

Importantly, however, many non-inverted groups may also be affected by this change. For example, under the TCJA, a foreign subsidiary of a foreign parent that also owns a U.S. subsidiary could be treated as a CFC as a result of downward attribution to the U.S. subsidiary, even if the foreign subsidiary was never directly or indirectly controlled by domestic shareholders. In that case, a U.S. group member that directly or indirectly owns an interest in a foreign subsidiary could be subject to current U.S. tax on the subpart F income of the foreign subsidiary.

### **Change to Definition of 10% U.S. Shareholder**

In general, a non-U.S. corporation will be a CFC if more than 50% of its stock (based on value or voting power) is owned, directly or under applicable constructive ownership rules, by 10% U.S. Shareholders. Prior to the enactment of the TCJA, a 10% U.S. Shareholder was defined as a U.S. person that owns, directly or under applicable constructive ownership rules, at least 10% of the voting power of the non-U.S. corporation's stock. Beginning in 2018, the TCJA expands this definition to include any U.S. person that owns, directly or under applicable constructive ownership rules, at least 10% of the voting power *or value* of the non-U.S. corporation's stock.

As a result of this change, voting power “cutbacks” or similar arrangements designed to prevent CFC status for foreign corporations with one or more U.S. owners of significant value in the corporation, which are common among foreign reinsurers, will no longer be effective. In addition, foreign corporations with multiple classes of stock may be at greater risk of becoming CFCs due to value fluctuations during the year, particular when the “any time” rule described in the next section is taken into account. Finally, for minority U.S. owners of 10% of the value of a foreign corporation that are becoming 10% U.S. Shareholders for the first time as a result of the TCJA, obtaining information necessary to calculate their subpart F inclusions may be difficult or impossible if they have little or no voting control over the foreign corporation.

### **Other Changes**

- Prior to the enactment of the TCJA, the consequences of the CFC regime applied to 10% U.S. Shareholders of a foreign corporation for any taxable year only if the foreign corporation had been a CFC for an uninterrupted period of 30 days or more during any taxable year. Under the TCJA, beginning in 2018, these consequences will apply if the foreign corporation has been a CFC at any time during a taxable year.

- The TCJA makes several other changes to the subpart F regime, including eliminating the foreign base company oil related income category of subpart F income effective for tax years after 2017.<sup>6</sup>

### Active Insurance Exception to PFIC Rules

The TCJA provides, for the first time, specific rules for interpreting the exception from “passive income” in the passive foreign investment company (“PFIC”) rules for income derived in the active conduct of an insurance business. Beginning in 2018, to qualify for the exception, income must be derived in the active conduct of an insurance business by a foreign corporation with “applicable insurance liabilities” representing more than 25% of its total assets.<sup>7</sup> The calculation is made by reference to the company’s financial statements prepared on the basis of (i) GAAP, (ii) IFRS or (iii) a statement filed with an applicable insurance regulatory body, if neither (i) nor (ii) is available. The TCJA provides regulatory authority for relief if the relevant percentage is at least 10% and certain conditions are met.

The TCJA includes loss and loss adjustment expenses and certain reserves (other than deficiency, contingency or unearned premium reserves) as applicable insurance liabilities. The Conference Report indicates that loss reserves for property and casualty and annuity contracts are also included, although such reserves are not explicitly mentioned in the TCJA.

This change to the PFIC rules, combined with the expansion of the definition of 10% U.S. Shareholders, seems likely to cause many more U.S. persons to recognize income currently with respect to foreign reinsurance companies.<sup>8</sup>

### Election to Accelerate Use of Overall Domestic Losses

The TCJA permits taxpayers with “overall domestic losses” (“ODLs”) to accelerate the rate at which such losses may be used to re-source U.S. source income, for tax years after 2017 and before 2028.

- If a taxpayer sustains an ODL (*i.e.*, a net-domestic loss in a taxable year that is used to offset foreign source income in that year or in a preceding taxable year), a specified amount of the taxpayer’s U.S. source income for each succeeding taxable year is treated as foreign source income until the amount of U.S. source income that is re-sourced is equal to the amount of the ODL. This may allow the taxpayer to utilize more foreign tax credits.
- In general, the amount of the taxpayer’s U.S. source income that is resourced for each succeeding year is limited to the lesser of (i) the amount of the loss (to the extent that not used to re-source income under this provision in prior years) and (ii) 50% of the taxpayer’s U.S. source income for the applicable taxable year.

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<sup>6</sup> Foreign base company oil related income is, very generally, income derived outside the United States from certain processing, transportation and sale activities with respect to minerals extracted from oil or gas wells. Although such income will not be subpart F income, it may be subject to U.S. tax under the new GILTI regime discussed above.

<sup>7</sup> The TCJA’s shift to a quantitative approach for determining whether a foreign company is subject to the exception is similar to recent legislative proposals—in particular, a 2015 proposal by Senator Ron Wyden. This objective approach differs from proposed Treasury Regulations released in 2015, which would have adopted a more subjective analysis and would generally have required the business to be conducted by the corporation’s officers and employees.

<sup>8</sup> Because the income of many foreign reinsurers consists primarily of subpart F income, and because a foreign corporation is a CFC with respect to subpart F insurance income based on a lower percentage ownership (25%) by 10% U.S. Shareholders than applies in general, the organizational documents of many such reinsurers limit the voting percentage that is exercisable by a U.S. person to less than 10% in order to prevent the corporation from becoming a CFC. These limitations will no longer be effective in preventing 10% U.S. Shareholder status for U.S. persons owning (by attribution or constructively) 10% by value of the company. See “Subpart F Changes” above.

Taxpayers with pre-2018 unused ODLs are now permitted to substitute for 50% a percentage greater than 50% (but not greater than 100%), accelerating the rate at which such ODLs can be used to re-source U.S. source income.

### **Sections 367(d) and 482**

The definition of an “intangible asset” for purposes of both Sections 367(d) and 482 is revised to include goodwill, going concern value, workforce in place, and any other item of value or potential value that is not attributable to tangible property or the services of any individual, clarifying for years after TJCA as to the assets potentially subject to tax in many outbound transactions. In addition, the TCJA directs the Internal Revenue Service to require the valuation of transfers of intangible property on an aggregate basis with other property or services transferred or on the basis of the “realistic alternatives” to such a transfer if the Internal Revenue Service determines that such basis is the most reliable means of valuation of such property. This would allow the Internal Revenue Service to pursue transfer pricing theories that it has previously unsuccessfully asserted in litigation.

### **Transfers of Property from the United States to a Foreign Corporation**

As part of the transition to a quasi-territorial system, beginning in 2018, the TCJA eliminates from Section 367(a) the exception for transfers of certain property by a U.S. person to a foreign corporation for use in the active conduct of a foreign trade or business. Section 367(a) generally prevents built-in gain from escaping the U.S. tax jurisdiction in situations where a U.S. person transfers property to a non-U.S. corporation in what would otherwise qualify as a nontaxable exchange. Prior to the TCJA, there was an exception to gain recognition for property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States. Were this exception not eliminated, it would be possible to permanently avoid the imposition of U.S. tax on gains realized with respect to certain property transferred from the United States to a foreign corporation.

### **Base Erosion and Anti-Abuse Tax (BEAT)**

New Section 59A imposes a base erosion<sup>9</sup> tax that will be imposed in relation to deductible payments made by certain corporations to their non-U.S. affiliates in taxable years beginning after December 31, 2017. The stated goal of this tax is to address base erosion that results from U.S. and foreign companies serving the U.S. market through foreign affiliates located in low- or zero-tax jurisdictions, rather than through U.S. affiliates, although it has potentially broader consequences and can function almost as a “backdoor” alternative minimum tax in some cases.

#### **Determination of Base Erosion Tax Liability**

The base erosion tax applies to large corporate taxpayers (“applicable taxpayers”) that make “base erosion payments.” “Applicable taxpayers” are U.S. and non-U.S. corporations (other than regulated investment companies, real estate investment trusts and S corporations) with average annual gross receipts of at least \$500 million for the prior three-year period that have a “base erosion percentage” (as defined below) of at least 3%, or 2% for financial group members. An applicable taxpayer must pay a tax equal to the “base erosion minimum tax amount” for the taxable year, which is generally equal to the excess of 10% of the modified taxable income of the taxpayer for the taxable year over an amount equal to that taxpayer’s regular tax liability for the taxable year, reduced by certain credits.

Specifically, the calculation of the base erosion tax includes the following 3 steps:

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<sup>9</sup> The TCJA names this tax the “Base-Erosion and Anti-Abuse Tax,” and it has been abbreviated colloquially as “BEAT.” The following discussion will use the phrase “base erosion tax” to refer to this new tax.

- Step 1 – Calculate “modified taxable income”: An applicable taxpayer’s modified taxable income is equal to its taxable income calculated without regard to any “base erosion tax benefits” (as described in detail below) or the “base erosion percentage” of any net operating loss carrybacks or carryforwards.
    - Base erosion tax benefits are determined by reference to “base erosion payments.” “Base erosion payment” means:
      - (i) any amount (including interest) paid or accrued by a taxpayer to a related foreign person and with respect to which a deduction is allowable;
      - (ii) any amount paid or accrued by the taxpayer to a related foreign person in connection with the acquisition by the taxpayer from such person of depreciable or amortizable property;
      - (iii) certain reinsurance premiums paid to a related party;<sup>10</sup> and
      - (iv) certain payments to expatriated entities that are “surrogate foreign corporations” or their related foreign persons. Base erosion payments do not include “qualified derivative payments” (as discussed below) or payments with respect to certain services.
- Notably, base erosion payments also do not include payments for cost of goods sold (except for payments to surrogate foreign corporations described in (iv) above), although this could change subject to the regulatory authority for anti-avoidance regulations. Taxpayers may seek to restructure their arrangements in light of this distinction by, for example, having a U.S. entity purchase goods from a foreign affiliate that owns intellectual property in lieu of paying the foreign affiliate a royalty for the use of the intellectual property and using the intellectual property to produce the item domestically.
- “Base erosion tax benefits” are, generally, deductions or certain other tax benefits arising from base erosion payments. The fact that the foreign related party treats the payment as generating effectively connected income to it, or as subpart F income to its 10% U.S. Shareholders, does not prevent a payment from being a base erosion payment.
  - For purposes of determining whether payments are base erosion payments (as well as for the Treasury’s regulation authority, as discussed below), a related party includes a person owning, directly or pursuant to constructive ownership rules, at least 25% of the voting power or value of the relevant corporation’s stock, any person related to such corporation or such 25% owner pursuant to Section 267(b) or 707(b)(1) and, more generally, any person treated as a related to such corporation for purposes of the statutory rules on transfer pricing.
- Step 2 – Calculate “regular tax liability” and apply certain tax credits: An applicable taxpayer’s regular tax liability is its general income tax liability for a taxable year determined pursuant to Section 26(b) of the Code. An applicable taxpayer’s regular tax liability is then reduced by certain income tax credits.

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<sup>10</sup> The addition to the definition of base erosion payment of reinsurance premiums will affect foreign reinsurance groups offering reinsurance through a U.S. operating company that cedes a significant portion of that risk to a foreign affiliate.

- For taxable years beginning after December 31, 2017 but before January 1, 2026, an applicable taxpayer's regular tax liability is reduced by the excess of its allowable income tax credits over its allowable research credits and a portion of certain of its general business credits.<sup>11</sup>
- For taxable years beginning on or after January 1, 2026, an applicable taxpayer's regular tax liability is reduced by all allowable income tax credits. For corporations that claim research tax credits as well as the specified general business credits, this change will increase their potential base erosion tax liability.
- **Step 3 – Calculate the “base erosion minimum tax amount”:** The base erosion minimum tax amount is equal to the excess of (i) the product of the applicable base erosion tax rate and an applicable taxpayer's modified taxable income, over (ii) the applicable taxpayer's regular tax liability (reduced by certain credits as described in Step 2). Credits cannot be applied against the base erosion minimum tax amount.
  - For taxable years beginning in 2018, the base erosion tax will be imposed at a rate of 5%.
  - For taxable years beginning after December 31, 2018 but before January 1, 2026, the base erosion tax will be imposed at a rate of 10%.
  - For taxable years beginning after January 1, 2026, the base erosion tax will be imposed at a rate of 12.5%.
  - The base erosion tax will be imposed on banks (as defined in Section 581) and registered securities dealers, as well as their affiliates, at a rate that is 1% higher than the applicable rate for other taxpayers.

#### **Aggregation Rule for Determining Whether a Corporation is an “Applicable Taxpayer”**

Generally, all persons who are members of a controlled group of corporations within the meaning of Section 1563(a) are treated as one person for purposes of aggregating gross receipts when determining whether a corporation has sufficient gross receipts for the base erosion tax to apply (a \$500 million annual average over the previous three years).

In general, in the case of a foreign person whose gross receipts are taken into account when determining whether a corporation has sufficient gross receipts under this rule, only gross receipts of that foreign person which are effectively connected with the conduct of a trade or business within the United States are considered.

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<sup>11</sup> The specific general business credits taken into account for this calculation are the low-income housing credit (Section 42(a)), the renewable electricity production credit (Section 45(a)) and the investment credit (Section 46), but only to the extent properly allocable to the energy credit determined under section 48.

Other than the research credit, these credits were not in the Senate version of the bill and were added in after significant commentary stating the concern that the base erosion tax would eliminate the benefits of affected renewable energy credits for many taxpayers, including with respect to existing renewable energy projects, and thereby significantly reduce the sources of funding for these projects going forward.

## Base Erosion Percentage

A corporation's "base erosion percentage" is relevant to determining whether the corporation is subject to the base erosion tax at all. It is also relevant for determining the degree to which net operating losses are added into the "modified taxable income" to which the base erosion tax applies.

The base erosion percentage is generally determined for any taxable year by dividing the deductions taken by the applicable taxpayer with respect to its "base erosion payments" by the overall amount of deductions taken by the corporation (including deductions taken with respect to "base erosion payments," but excluding net operating loss carrybacks and carryforwards, deductions for dividends attributable to foreign earnings, deductions in connection with GILTI and FDII, deductions for payments for certain services and deductions for "qualified derivative payments" (as discussed below)).

The statutory language requires computation of the base erosion percentage based on the Section 1563(a) controlled group described above. Read literally, it is possible to interpret this aggregation rule as effectively netting out base erosion payments between members of the same controlled group, as the rule treats the group as a single taxpayer for purposes of calculating the base erosion percentage. We think this rule is better understood to mean that the base erosion payments of entities in a controlled group are calculated by computing the base erosion payments for each entity as if the entity were a standalone entity and then aggregating them.

## Exception for Qualified Derivative Payments

"Qualified derivative payments" are carved out of the definition of base erosion payment. This provision is vital to multinational financial groups, as they frequently use intercompany swaps and other derivatives to transfer risk between group members that enter into customer-facing transactions and other group members that provide centralized hedges of the relevant risk. A "qualified derivative payment" is defined in such a way that it will, generally, apply to derivatives subject to the mark-to-market regime applicable to dealers under Section 475. However, the term does not include an embedded payment or item in a derivative that is specifically categorized as something else under the tax rules (*i.e.*, interest, royalties or service payments).<sup>12</sup> Furthermore, a payment will only be treated as a qualified derivative payment if the taxpayer reports information required to be reported under regulations to be prescribed by the Secretary.

While the exception for qualified derivative payments has been reported as a significant concession to the financial services industry, it should be noted that banks and securities dealers and their affiliates will face a higher base erosion tax rate than other applicable taxpayers (as discussed above). Moreover, by treating interest payments made by financial group members to their related parties, including those arising from ordinary-course transactions such as repurchase agreements and posted collateral, as well as debt instruments required by regulators (*e.g.*, "TLAC" instruments), as base erosion payments, the exception is less generous than might have been hoped by these groups. For foreign banking groups, which often operate in the United States through branches, the fact that the rule applies to foreign

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<sup>12</sup> Section 59A(h)(3)(A) provides that a payment will not be treated as a qualified derivative payment if it "would be treated as a base erosion payment if it were not made pursuant to a derivative, including any interest, royalty or service payment." Read broadly, this exception could be interpreted to swallow the entire carveout for qualified derivative payments. We think a better reading of Section 59(h)(3)(A) is that it applies a similar concept as (h)(3)(B) (which provides that in the case of a contract which has derivative and non-derivative components, payments properly allocable to the non-derivative component are not qualified dividend payments) to contracts that do not clearly have non-derivative components, but may still effectively provide for payments such as interest, royalties or service payments which would not properly be considered part of the derivative contract.

taxpayers with effectively connected income, but does not appear to exempt payments by U.S. or non-U.S. group members to foreign related parties who treat such payments as effectively connected, is particularly significant.

“Derivative” is defined broadly for purposes of Section 59A as any contract (including any option, forward contract, futures contract, short position, swap, or similar contract) the value of which, or any payment or other transfer with respect to which, is (directly or indirectly) determined by reference to one or more of the following: any share of stock in a corporation, any evidence of indebtedness, any actively traded commodity, any currency, or any rate, price, amount, index, formula or algorithm. Insurance, annuity and endowment contracts issued by an insurance company are not derivatives for purposes of Section 59A. The definition of derivative is loosely similar to the types of derivatives that are “securities” or “commodities” for purposes of Section 475.<sup>13</sup>

### **Regulatory Authority, Information Reporting & Penalties**

The TCJA provides the Secretary with authority to issue regulations in connection with the implementation and application of the base erosion tax. The TCJA also amends Section 6038A(b) to allow the Secretary to prescribe regulations requiring corporations to report (i) the names, principal places of business and jurisdictions of organization or residency of related foreign parties with which the corporations transact during the taxable year, (ii) the nature of the relationships between the corporations and related foreign parties and (iii) information with respect to transactions between the corporations and related foreign parties. Failure to furnish this information will result in a \$25,000 penalty.

### **Other Observations**

- The operation of the base erosion tax can produce perverse, and perhaps unintended, results in respect of tax credits that would otherwise apply against the regular tax liability. Notably, credits reflecting earlier payments by a taxpayer (e.g., the Section 33 credit for amounts withheld under Section 1446 for effectively connected income of a partner, or the Section 37 credit for overpayments of tax) would appear to reduce regular tax liability under the above calculation, and would thus increase the base erosion minimum tax amount. This is surprising as credits resulting from earlier overpayments effectively reflect a pre-payment of a tax liability, rather than a reduction in tax liability calculated without regard to credits.
- More generally, there is a potentially significant cliff effect with respect to credits, including foreign tax credits and the GILTI tax credit, for taxpayers potentially subject to the base erosion tax. Because credits reduce regular tax liability, and therefore increase potential base erosion tax liability, a taxpayer subject to the base erosion tax will effectively lose a percentage of its credits – other than the R&D credit and certain general business credits, at least until 2026 – equal to the applicable base erosion tax rate. This operates as a sort of backdoor alternative minimum tax, albeit one targeted at corporations making base erosion payments. Relatedly, a corporation subject to the base erosion tax potentially loses the benefit of a portion of its net operating losses along with its base erosion tax benefits, even though the two may not be connected.

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<sup>13</sup> The definition even more closely resembles that found in the Modernization of Derivatives Act, proposed by Senator Ron Wyden in 2017. The main differences between the Section 59A definition and the corresponding definition in Section 475 are (1) the inclusion of the reference to a price, amount, index, formula or algorithm as a potential reference item for a derivative and (2) the exclusion of derivatives with respect to a publicly traded partnership or trust (although they could arguably be included under the broad category of derivatives with respect to a “price” or “amount”).

- Because the base erosion tax applies to interest payments to related parties, groups will need to consider its effect on intragroup financing structures involving foreign finance entities or treasury centers.
- Because the base erosion tax applies only to payments to related parties, it may in some cases make sense for taxpayers involved in a vertically integrated business to disaffiliate. However, Treasury has broad authority to write regulations that would apply to conduits, intermediaries and even “unrelated persons” to prevent avoidance of the base erosion tax.
- Base erosion tax benefits do not include deductions for any payments subject to U.S. withholding tax (taking into account any reductions to the rate of such taxes pursuant to an applicable tax treaty) and actually deducted and withheld. However, there is no corresponding exclusion for reinsurance payments with respect to which an excise tax is imposed pursuant to Section 4371, even though the Section 4371 excise tax is, in effect, a substitute for withholding tax on payments to foreign insurance companies.

### **Anti-Hybrid Rules for Certain Related Party Amounts**

In order to target perceived exploitation of legal differences across jurisdictions to escape taxation, new Section 267A denies a deduction for any “disqualified related party amount” paid or accrued pursuant to a “hybrid transaction” or by, or to, a “hybrid entity.” Generally, a disqualified related party amount includes any interest or royalty paid or accrued to a related party if:

- there is no corresponding inclusion to the related party under the tax law of its country, or
- the related party is allowed a deduction with respect to the payment under the tax law of its country.

A hybrid transaction is any transaction, agreement or instrument one or more payments with respect to which are treated as interest or royalties for U.S. tax purposes and which are not so treated under the tax law of the recipient. A hybrid entity includes any entity which is treated as fiscally transparent for U.S. tax purposes but not so treated for purposes of the tax law of the foreign entity, or *vice versa*.

Section 267A does not apply to any payment to the extent it is included in the gross income of a 10% U.S. Shareholder. “Related party” is defined by reference to the rules under Section 954(d)(3).

The TCJA grants broad authority to the Secretary to promulgate regulations or other guidance to carry out the objectives of Section 267A (including by providing anti-avoidance rules, for instance, in conduit situations). The rule, which is similar to recommendations set forth in the OECD’s Base Erosion and Profit Shifting (BEPS) Project, applies to taxable years beginning after December 31, 2017 – the TCJA does not provide grandfathering provisions or other transition rules for arrangements that are currently in place.

### **Inversion Related Changes**

In addition to the recapture provision for expatriated entities discussed in the [Transition Tax / Deemed Repatriation memorandum](#), the TCJA includes several other changes intended to further deter inversions that are effective beginning in 2017.

- Section 1(h)(11)(C) is amended so that dividends paid by inverted corporations that are surrogate foreign corporations are taxed at ordinary rates rather than capital gains rates potentially available under prior law.
- Stock compensation received by insiders in inverted companies will be taxed at a rate of 20%, rather than 15% under prior law.

## Appendix I – Examples

### Example 1 – Basic Calculation of GILTI and GILTI Deduction

- Facts. U.S. corporation (USCo) owns 100% of the stock of a foreign corporation (CFC) and no stock of any other foreign corporation. CFC has \$900 of tested income, no interest expense and paid \$100 of foreign taxes that are properly attributable to its tested income. USCo has \$1000 of net taxable income determined without regard to the GILTI and FDII deductions, none of which is FDII. CFC also owns a factory, which it uses to produce its tested income, and which has an average adjusted U.S. tax basis of \$4500 (taking into account the straight-line depreciation method).
- GILTI. USCo's GILTI is \$450, calculated as CFC's tested income (\$900) less \$450, which represents a deemed 10% return on its tangible assets (*i.e.*, the factory with a \$4500 U.S. tax basis).
- GILTI Tax Credit. USCo's "inclusion percentage" with respect to CFC's foreign taxes is 50% ( $\$450/\$900$ ). Accordingly, the foreign tax deemed paid by USCo attributable to GILTI is \$40 ( $80\% \times 50\% \times \$100$ ). Under modified Section 78, the taxes deemed paid by USCo (without regard to the 80% limitation) are treated as a dividend received by USCo (but not for purposes of the participation exemption under Section 245A).
- GILTI Deduction. Because USCo's GILTI of \$450 is less than USCo's taxable income determined without regard to the deduction of \$1000, USCo can deduct 50% of its \$450 GILTI (plus the \$50 Section 78 deemed dividend), resulting in net taxable income from GILTI of \$250 ( $\$500 \times 50\%$ ).
- Effective Tax Rates. Applying a 21% U.S. corporate tax rate, the U.S. tax liability with respect to GILTI plus Section 78 deemed dividend is \$52.50 ( $\$250 \times 21\%$ ) less foreign tax credits of \$40, or \$12.50. USCo's effective U.S. tax rate with respect to its GILTI is approximately 2.5% ( $\$12.50/\$500$ ); USCo's world-wide effective tax rate with respect to its GILTI plus Section 78 deemed dividend is 12.5% ( $(\$12.50 + \$50)/\$500$ ).

### Example 2 – Calculation of FDII

- Facts. Assume the same facts as Example 1, but all of USCo's \$1000 of net taxable income other than GILTI and the Section 78 deemed dividend is treated as DEI and \$200 of that \$1000 is attributable to the sale of property to non-U.S. persons for foreign use. USCo owns a factory with an average adjusted basis of \$2500 (taking into account the straight-line depreciation method).
- FDII. USCo's DII is \$750, calculated as USCo's DEI (\$1000) less \$250, which represents a deemed 10% return on its depreciable tangible assets (*i.e.*, the factory with a \$2500 U.S. tax basis). The foreign-derived portion of USCo's DEI is \$200 out of \$1000 total DEI, or 20%. Accordingly, USCo's FDII is \$150 ( $20\% \times \$750$ ).
- FDII Deduction. USCo's FDII (\$150) plus GILTI (\$450) equals \$600, which does not exceed USCo's taxable income (determined without regard to the deductions in respect of FDII and GILTI) of \$1500. Accordingly, USCo is permitted to deduct 37.5% of its \$150 FDII (\$56.25), resulting in an inclusion of \$93.75.
- Effective Tax Rate. Assuming a 21% U.S. corporate tax rate (and no relevant foreign taxes), USCo's effective tax rate with respect to its \$150 of FDII is 13.125% (calculated as the 21% rate \*  $\$93.75$  included income, over \$150 of FDII).

### Example 3 – Limitation on FDII and GILTI deduction

- Facts. Assume the same facts as Example 2, but USCo has a loss of \$1200 not allocable to DEI.

- FDII and GILTI. USCo's \$1200 loss does not impact the calculation of USCo's GILTI or FDII. Accordingly, USCo's GILTI is \$450 (as calculated in Example 1), the Section 78 deemed dividend is \$50 and USCo's FDII is \$150 (as calculated in Example 2).
- Deduction Limitation. USCo's taxable income (determined without regard to the deductions in respect of FDII and GILTI) is \$300 (\$450 GILTI + \$50 Section 78 deemed dividend + \$150 FDII + \$850 remaining DEI less the \$1200 loss). Because USCo's FDII (\$150) plus GILTI (\$450) equals \$600, which exceeds \$300, USCo's deductions for GILTI and FDII will be limited as follows:
  - First, the excess of \$600 over \$300 is determined (\$300).
  - For purposes of calculating the deduction, FDII is reduced by an amount equal to the excess (\$300) times the percentage equal to  $\text{FDII}/(\text{FDII} + \text{GILTI})$ , or 25% ( $\$150/\$600$ ). Thus, FDII is reduced by \$75 ( $\$300 \times 25\%$ ) to \$75 (\$150 less \$75).
  - For purposes of calculating the deduction, the remainder of the excess (\$300 less \$75, or \$225) reduces GILTI to \$225 (\$450 less \$225).
- FDII and GILTI Deductions. USCo is permitted to deduct:
  - 37.5% of its adjusted FDII of \$75 (\$28.125), resulting in an inclusion of \$121.875 (\$150 less \$28.125), and
  - 50% of its adjusted GILTI of \$225 plus the amount of the Section 78 deemed dividend attributable to the adjusted GILTI amount.
    - The TCJA does not specify what portion of the Section 78 deemed dividend is attributable to the adjusted GILTI amount. One possible method is to calculate USCo's "inclusion percentage" as the adjusted GILTI amount of \$225 over \$900 of tested income (25%), resulting in a deemed dividend attributable to the adjusted GILTI amount of \$25 ( $25\% \times \$100$  foreign taxes paid).
    - In that case, the deduction would equal 50% of \$250 (adjusted GILTI of \$225 + \$25 deemed dividend), or \$125, resulting in a total inclusion of \$375 (\$500 less \$125).
- Effective Tax Rate.
  - USCo's U.S. tax liability with respect to FDII is approximately \$25.59 ( $\$121.875 \times 21\%$ ), representing an effective tax rate of approximately 17.0625% ( $\$25.59/\$150$ ).
  - USCo's U.S. tax liability with respect to GILTI, including the Section 78 deemed dividend, is approximately \$78.75 ( $\$375 \times 21\%$ ), less a GILTI Tax Credit of \$40 (as calculated in Example 1), or \$38.75. USCo's effective U.S. tax rate with respect to its GILTI and Section 78 deemed dividend is approximately 7.75% ( $\$38.75/\$500$ ); USCo's world-wide effective tax rate with respect to its GILTI and Section 78 deemed dividend is 17.75% ( $(\$38.75 + \$50)/\$500$ ).

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If you have any questions regarding the matters covered in this publication, please contact your regular Davis Polk contact.

## Transition Tax / Deemed Repatriation

December 20, 2017

Section 965 of the TCJA provides for a one-time “transition tax” on untaxed accumulated earnings and profits (“E&P”) of certain non-U.S. corporations. The TCJA splits E&P between cash and non-cash amounts with cash amounts taxed at a 15.5% effective rate and non-cash amounts taxed at an 8% effective rate.

The transition tax builds off of the mechanics of “subpart F” of the Code, which provides for current taxation of certain types of income of foreign corporations to certain of their U.S. shareholders. As described in more detail below, under the transition tax an applicable foreign corporation’s E&P is treated as subpart F income (subject to adjustments for the U.S. shareholder’s allocable share of the E&P deficits of applicable foreign corporations), and a U.S. shareholder is allowed a deduction in respect of this income in an amount calibrated to provide for the desired cash and non-cash effective tax rates. A U.S. shareholder is generally allowed to claim foreign tax credits, reduced in proportion to the reduction in effective tax rates, against the transition tax.

### Transition Tax Mechanics

#### Framework

Under the TCJA, a 10% U.S. shareholder of a “specified foreign corporation,” generally defined as a controlled foreign corporation or a foreign corporation with respect to which one or more domestic corporations is a 10% U.S. shareholder (each an “SFC”), is required to include in its gross income, as subpart F income, its *pro rata* share of the SFC’s previously untaxed post-1986 accumulated E&P (“deferred E&P”), determined as of November 2, 2017 or December 31, 2017 (whichever date on which there is more deferred E&P). The 10% U.S. shareholder is required to include this amount in its taxable year with or in which ends the last taxable year of the SFC beginning before January 1, 2018. A 10% U.S. shareholder is entitled to a corresponding deduction (i) in respect of the amount included in gross income attributable to its *pro rata* share of the aggregate cash position of its SFCs, of the percentage of such amount that would result in such amount being subject to a 15.5% effective rate and (ii) in respect of any remaining amount included in gross income, of the percentage of such amount that would result in such amount being subject to an 8% effective rate. The deferred E&P of an SFC is determined on a net basis, taking into account any E&P deficits without regard to the limitation category of the deficit or whether the deficit is a “hovering” deficit.

For this purpose, a 10% U.S. shareholder is a U.S. person (domestic individuals and partnerships included) that owns or is considered as owning<sup>1</sup> 10% or more of the total combined voting power of all classes of voting stock of a foreign corporation. A U.S. shareholder’s “*pro rata* share” of any amount with

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<sup>1</sup> In determining whether a U.S. person is a 10% U.S. shareholder for purposes of the transition tax, the TCJA treats stock that is owned by a foreign person as attributable to a U.S. entity that is owned by the foreign person (so-called “downward attribution”). As a result, stock owned by a foreign person may generally be attributed to (i) a U.S. corporation 10% of the value of the stock of which is owned, directly or indirectly by the foreign person, (ii) a U.S. partnership in which the foreign person is a partner and (iii) certain U.S. trusts if the foreign person is a beneficiary or, in certain circumstances, a grantor or a substantial owner.

respect to the transition tax is determined under the principles of Section 951(a)(2) as if such amount were subpart F income.

### **E&P Deficit Netting Permitted**

The TCJA permits a 10% U.S. shareholder to reduce the aggregate deferred E&P of its SFCs with deferred E&P (each a “deferred E&P SFC”) by the aggregate foreign E&P deficits of SFCs with E&P deficits (each an “E&P deficit SFC”). The E&P deficit of each E&P deficit SFC of a 10% U.S. shareholder is aggregated, and then the total deficit is allocated among the deferred E&P SFCs of the 10% U.S. shareholder in proportion to each deferred E&P SFC’s share of the total deferred E&P the 10% U.S. shareholder would otherwise include in income, so as to reduce the subpart F inclusion in respect of each such deferred E&P SFC. Importantly, the TCJA also permits netting of E&P deficits and surpluses among 10% U.S. shareholders that are members of the same affiliated group.

The amount of a deferred E&P SFC’s deferred E&P that is offset by an allocated deficit is still treated as “previously taxed income” of the deferred E&P SFC for purposes of distributions made in taxable years beginning with the deferred E&P SFC’s last taxable year beginning before January 1, 2018. Correspondingly, the E&P of an E&P deficit SFC with respect to a 10% U.S. shareholder is increased by the amount that offsets deferred E&P in respect of the deferred E&P SFCs of the 10% U.S. shareholder.

### **Determination of “Cash Position”**

The “cash position” of an SFC equals the sum of its:

- cash;
- net accounts receivable; and
- the fair market value of actively traded personal property (e.g., publicly traded stock), commercial paper, certificates of deposit, federal, state and foreign government securities, foreign currency, obligations with a term of less than one year and any asset identified by the IRS as economically equivalent to any such asset.

In determining an SFC’s cash position, a special rule prevents double counting with respect to net accounts receivable, actively traded personal property and obligations with a term of less than one year, if it can be demonstrated that such amounts would otherwise be included in income by a 10% U.S. shareholder with respect to two SFCs.

With respect to any 10% U.S. shareholder, the aggregate foreign cash position equals the greater of the 10% U.S. shareholder’s *pro rata* share of (i) the cash position of each of its SFCs as of the last day of the taxable year of the inclusion or (ii) the average of the cash positions of each of its SFCs determined on the last day of each of the last two taxable years of each such SFC ending before November 2, 2017. The aggregate foreign cash position also includes the cash position of any non-corporate non-U.S. entity if an interest in such entity is held by an SFC of a 10% U.S. shareholder and such entity would be an SFC of such shareholder if it were a corporation.

### **Foreign Tax Credits**

The foreign tax credit provisions are generally applied after taking into account the reduced effective tax rates applicable to cash and non-cash deferred E&P. Specifically, a portion of the foreign tax credits that would otherwise be available to a 10% U.S. shareholder that is a domestic corporation in respect of the amount included in gross income is disallowed in an amount of 55.7% for the cash portion of the inclusion and 77.1% for the non-cash portion. Moreover, no deduction is allowed in respect of any foreign tax for which a foreign tax credit is not allowable. Similarly, Section 78—which, generally, requires that taxes of a CFC deemed paid by a 10% U.S. shareholder be treated as a dividend to the U.S. shareholder in the

amount of the taxes deemed paid—applies only to the portion of the taxes treated as paid by the 10% U.S. shareholder in respect of the amount included in gross income.

### **Installment Payments Permitted**

A 10% U.S. shareholder may elect to pay its net transition tax liability (after reduction for foreign tax credits) in 8 annual installments, starting with the taxable year of the inclusion. The TCJA sets each of the first 5 installments at 8% of the net liability, the 6th installment at 15%, the 7th installment at 20% and the final installment at 25%. Under certain circumstances, such as a liquidation or sale of substantially all the assets of a taxpayer or an addition to tax for failure to timely pay an installment, the full amount of any remaining payments will become due immediately. If a taxpayer elects the installment method and a deficiency is assessed with respect to its net transition tax liability (other than for negligence, intentional disregard of rules and regulations or fraud with intent to evade tax), the deficiency is prorated across the installments.

### **Election for NOLs**

A 10% U.S. shareholder may elect not to use its net operating loss carryforwards and carrybacks to offset the subpart F inclusion required under Section 965 and the deemed dividends resulting from the application of Section 78 in the manner set forth above.

### **Special Rules for REITs**

Certain types of 10% U.S. shareholders are subject to special rules. For real estate investment trusts (each a “REIT”), the subpart F income required to be included for purposes of the transition tax does not count as gross income solely for purposes of the REIT income tests. In addition, for purposes of computing its REIT taxable income, a REIT may elect to include such income in the calculation of its REIT taxable income ratably over the 8 years starting with the taxable year in which the income would otherwise be required to be included in gross income, in the same percentages in which the transition tax is required to be paid in the case of an installment payment election. The inclusion in gross income is also subject to acceleration under circumstances similar to those under the installment payment method.

### **Special Rules for S Corporations**

Like REITs, the rules that apply to an S corporation that is a 10% U.S. shareholder differ in some respects from those that apply to other U.S. shareholders. For instance, a shareholder of such an S corporation may elect to defer payment of the transition tax indefinitely until the occurrence of a triggering event with respect to the shareholder. Triggering events include the S corporation ceasing to be an S corporation, the S corporation liquidating or selling substantially all of its assets, ceasing business, ceasing to exist, or any similar circumstance, or a transfer of stock in the S corporation by the shareholder (in which case a partial transfer of stock is a triggering event for a portion of the tax liability).

### **Anti-Inversion Provisions**

Any 10% U.S. shareholder which becomes an “expatriated entity” (as defined under Section 7874) during the 10-year period after enactment of the TCJA is subject to an additional tax equal to 35% of the amount of the deduction allowed in respect of the transition tax. No foreign tax credits may be used to offset this additional tax.

### **Observations**

Unsurprisingly, there are a number of ambiguities in Section 965 that raise an even greater number of questions. We anticipate that many, if not most, of these questions will be addressed in regulations or other guidance to be issued or resolved in a technical tax corrections bill enacted in 2018. Here are just a few of these questions:

- **Double Counting.** Literally applied, Section 965(a) could result in the double counting of E&P, in determining the total amount included as subpart F income by a 10% U.S. shareholder, and cash, in determining the portion of such E&P subject to tax at the higher rate.
  - **E&P.** As described above, the amount of a 10% U.S. shareholder's inclusion with respect to an SFC is based on the accumulated post-1986 E&P of the SFC at November 2, 2017 and December 31, 2017, whichever is greater. Distributions and other payments between SFCs with different measurement dates may result in the double counting of E&P. The final language of the TCJA cured E&P double counting in many circumstances where a lower-tier SFC makes a distribution to an upper-tier SFC. However, the final language does not address the treatment of deductible payments between SFCs, which can similarly result in double counting of E&P, although the Conference Committee Joint Explanatory Statement (the "Joint Explanatory Statement") states that Treasury may provide guidance on this issue. Among other possibilities, double counting of E&P could result from:
    - dividends from an SFC with a November 30 taxable year and a November 2, 2017 measurement date to a U.S. shareholder between the measurement date and the SFC's taxable year ending November 30, 2017; and
    - dividends from an SFC with a November 30 taxable year and a November 2, 2017 measurement date to an SFC with a December 31, 2017 measurement date (regardless of whether the upper-tier SFC has a November 30 or December 31 taxable year) between November 2, 2017 and November 30, 2017.
  - **Cash**
    - The aggregate foreign cash position of a 10% U.S. shareholder's SFCs is measured for each SFC as the greater of the cash position as of the close of its last taxable year beginning before January 1, 2018 and the average aggregate cash position as of the close of the two prior taxable years. Therefore, if an SFC with a December 31 taxable year end were to make a cash distribution between January 1, 2018 and November 30, 2018 to an SFC with a November 30 taxable year end, the same cash would be included twice, once for each SFC.
- **Actively Traded Stock.** The cash position of an SFC is defined to include, among other amounts, the fair market value of actively traded personal property, apparently including publicly traded stock of another SFC (a "Public SFC"). Treating an SFC's interest in a Public SFC as part of its cash position would have the odd result of treating the same interest as cash for purposes of determining the U.S. shareholder's "aggregate foreign cash position" and as an interest in an SFC for purposes of determining the U.S. shareholder's *pro rata* share of the Public SFC's deferred E&P and cash. Moreover, because SFC status requires a 10% ownership interest in a corporation, this situation will typically arise only where an SFC owns an interest in a Public SFC of a size that typically would be difficult to sell efficiently (and may carry transfer restrictions), *i.e.*, it would not normally be considered liquid. Our view is that the actively traded personal property element of the cash definition should not include such illiquid investments, and we thus would view the promulgation of a rule to this effect as an appropriate use of the broad grant of regulatory authority provided by Section 965(o).
- **Section 961 Considerations.** For a November 30 taxable year SFC, the subpart F income required to be included under Section 965 is included in the gross income of the relevant 10% U.S. shareholder for its taxable year that includes November 30, 2018. While the E&P that gives rise to such inclusion will constitute "previously taxed income" when distributed and will accordingly not result in an income inclusion pursuant to Section 959, under the applicable Section 961 regulations the increase in the basis of the stock of the SFC occurs "as of the last day" of the SFC's year. As a result, if the SFC seeks to distribute the E&P associated with such

subpart F income before November 30, 2018, and if a 10% U.S. shareholder does not have pre-existing tax basis in the stock of the SFC that exceeds the amount to be distributed, there is the potential for gain recognition under Section 961(b). The Joint Explanatory Statement states that basis adjustments to stock of SFCs may be needed, and that Treasury is empowered to promulgate regulations to provide for such adjustments, so we are cautiously optimistic that this issue will be addressed.

- **SFC History.** E&P that is counted for purposes of the transition tax is limited to E&P accumulated when the relevant foreign corporation was an SFC. As drafted, however, the TCJA would attribute to a 10% U.S. shareholder that owns SFC shares as of the relevant testing date its entire *pro rata* share of the post-1986 E&P accumulated while the SFC was an SFC, without regard to the length of time for which the 10% U.S. shareholder has owned the SFC shares. For example, assume that a U.S. corporation purchases on November 28, 2017 10% of the shares of a December 31 taxable year SFC with 100x of accumulated post-1986 E&P on the acquisition date. Even if the SFC generates no further E&P in the remaining days of its 2017 taxable year, the U.S. corporation (now 10% U.S. shareholder) will have a subpart F inclusion of 10x under Section 965.
- **Installment Election for Partnerships.** In the case of a partnership that is a U.S. shareholder, the statute fails to specify whether the partnership or the partners of the partnership make the election to pay the transition tax over 8 years.
- **Anti-Abuse Regulations.** Section 965 and related sections of the TCJA and the Joint Explanatory Statement call for regulations to prevent abuse in several areas, including:
  - **Cash reduction strategies.** “If the Secretary determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account under this subsection, such transaction shall be disregarded for purposes of this subsection.”
  - **E&P reduction strategies.** “The conferees are also aware that certain taxpayers may have engaged in tax strategies designed to reduce the amount of post-1986 earnings and profits in order to decrease the amount of the inclusion required under this provision. Such tax strategies may include a change in entity classification, accounting method, and taxable year, or intragroup transactions such as distributions or liquidations. The conferees expect the Secretary to prescribe rules to adjust the amount of post-1986 earnings and profits in such cases in order to prevent the avoidance of the purposes of this section.”

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If you have any questions regarding the matters covered in this publication, please contact your regular Davis Polk contact.

## Impact on Businesses Owned by U.S. Individuals

December 20, 2017

The TCJA makes significant changes to the taxation of U.S. and non-U.S. businesses owned (in whole or significant part) by U.S. individuals. For example, under the TCJA:

- Changes in Tax Rates. The top corporate tax rate is reduced from 35% to 21%, while the top individual tax rate is reduced from 39.6% to 37.0%. Because the corporate tax rate will now be significantly lower than the individual tax rate, holding a business in corporate form may in certain cases be more attractive than under current law. Nevertheless, we expect that individuals (on the whole) will continue to hold their U.S. businesses in pass-through form, particularly where the new pass-through deduction (discussed below) is available.
- New Pass-Through Deduction. A new deduction is established that will reduce the effective tax rate for non-corporate taxpayers on (i) “qualified income” from certain types of businesses owned in pass-through form (a sole proprietorship, partnership, or S corporation), (ii) certain dividend income received from a REIT or cooperative and (iii) qualified income from an MLP (the “Pass-Through Deduction”).
- New Loss Limitation Rule. A new limitation is imposed on the ability of individuals to use losses from businesses to offset certain types of non-business income, with excess losses generally carried over to the following year.
- New Limit on Interest Deductibility. A new limitation is imposed on the deduction for business interest.
- Changes to Taxation of 10% Owners of Non-U.S. Corporations. Significant changes are made to the tax rules governing U.S. owners of non-U.S. corporations which may dramatically increase the amount of “phantom income” (that is, taxable income realized without a corresponding cash payment) recognized by an individual who owns 10% or more of a non-U.S. corporation (a “U.S. Shareholder”) if certain conditions exist.
  - A “transition tax” is imposed in certain cases on U.S. owners of non-U.S. corporations. For individuals, the impact of the transition tax can be substantially mitigated if the stock of the non-U.S. corporation is transferred to an S corporation before January 1, 2018.
  - Beginning in 2018, each “U.S. Shareholder” of a “controlled foreign corporation” (“CFC”) will be deemed to have income each year equal to its share of the active income of the CFC for the year (to the extent such income exceeds a prescribed threshold). Although corporate U.S. Shareholders are granted certain deductions and credits that mitigate the tax impact of this income inclusion, these deductions and credits are not available to individual U.S. Shareholders (including for this purpose S corporations).

Each of these provisions is discussed below.

## Changes in Tax Rates

### In General

For individuals, the top marginal tax rate on ordinary income is reduced from 39.6% to 37%. The maximum tax rate on qualified dividends and capital gains remains at 20%. For corporations, the top tax rate is reduced from 35% to 21%.

### Observations and Opportunities in Light of Rate Changes

#### Should a Business Owned by an Individual be Held Through a Corporation or Pass-Through?

A variety of factors affect the decision by an individual to hold a domestic business as a corporation or a partnership (or other flow-through entity) including (i) the fact that the income of a corporation is taxed twice (once at the corporate level and then again upon a distribution by the corporation or a sale of the stock of the corporation), (ii) the relative tax rates imposed on various types of income received by corporations and individuals, (iii) the fact that it is generally not possible to remove appreciated assets from a corporation without triggering tax on those assets, (iv) the tax consequences resulting from a sale of the business, (v) the application of employment-related taxes and the so-called Medicare tax under Section 1411, and (vi) the possibility of future changes in law (including tax rates).

Prior to the reduction in tax rates effected by the TCJA, the effective federal income tax rate on a business held by an individual was (i) 48%<sup>1</sup> if the business was held in corporate form and (ii) 39.6% if it was held in pass-through form (an 8.4% difference).<sup>2</sup>

Under the new tax rates prescribed by the TCJA, the effective tax rate will be (i) 36.8%<sup>3</sup> if the business is held in corporation form, (ii) and 29.6%<sup>4</sup> if it is held in pass-through form and the new Pass-Through Deduction is fully available (a 7.2% difference), and (iii) 37% if it is held in pass-through form and the new Pass-Through Deduction is not available (a 0.2% difference).

Our expectation is that (on the whole) these changes in rates will not fundamentally change an individual's calculus in deciding whether to hold a business as a corporation or a partnership (or other flow-through entity).

#### Limitation on the SALT Deductions by Individuals

In general, if a business is operated in flow-through form, the owners of the business must pay income taxes in each state in which the business operates based on an apportionment of the income of the business. Although the TCJA caps an individual's deduction for state and local income and property taxes at \$10,000 per year,<sup>5</sup> it does not limit the deduction claimed by a corporation for these taxes. This differing treatment of state and local taxes may (in certain cases) become an additional factor in deciding whether to hold a business in corporate form or as a pass-through, particularly where the business operates in a high tax state and the individual would otherwise be taxable only in a low-tax state.

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<sup>1</sup> The 48% is computed as  $35\% + (20\% * (100\% - 35\%))$ . The 48% rate is in some respect overstated in that it ignores the fact that the second level of tax (on the shareholder) is not due until the shareholder receives a distribution or sells his or her stock.

<sup>2</sup> Except as noted, the tax rates described herein do not include employment-related taxes or the so-called Medicare tax under Section 1411.

<sup>3</sup> The 36.8% is computed as  $21\% + (20\% * (100\% - 21\%))$ . The 36.8% rate is in some respect overstated in that it ignores the fact that the second level of tax (on the shareholder) is not due until the shareholder receives a distribution or sells his or her stock.

<sup>4</sup> The 29.6% is computed as  $37\% * (100\% - 20\%)$ .

<sup>5</sup> The \$10,000 limit does not apply with respect to state and local real or personal property taxes paid or accrued in carrying on a trade or business.

## The Pass-Through Deduction

The TCJA adds new Section 199A,<sup>6</sup> which establishes a deduction for individuals<sup>7</sup> who receive (i) qualified income from a qualified trade or business held in flow-through form (whether a partnership, S corporation or sole proprietorship), (ii) certain types of dividend income from a REIT or cooperative or (iii) qualified income from an MLP (or other “publicly traded partnership”).

### 20% Deduction for Qualified Income from a Qualified Trade or Business

Under Section 199A, an individual who owns a “qualified trade or business” (a “QTB”) in flow-through form will generally be entitled to a deduction equal to 20% of the individual’s “qualified business income” with respect to the QTB. However, the amount of the deduction with respect to a QTB is generally<sup>8</sup> capped at an amount computed based on the individual’s share of the “W-2 wages” and unadjusted basis in “qualified property” with respect to the QTB (discussed below).

### Qualified Trade or Business

A qualified trade or business means any trade or business other than a “specified trade or business” (and other than the business of performing services as an employee). A specified trade or business generally refers to (i) a variety of traditional service businesses specified in the Code<sup>9</sup> and (ii) any trade or business which involves the performance of services that consist of (x) investing and investment management or (y) trading or dealing in securities, partnership interests or commodities.

As discussed below, however, the exclusion for a “specified trade or business” does not apply to an individual whose taxable income is below certain prescribed limits.

### U.S. Qualified Business Income

Qualified business income is generally defined to mean the net amount of qualified items of income, gain, deduction and loss with respect to the QTB. An item of income, gain, deduction or loss is generally considered a “qualified item” only if the item:

- Limited to U.S. Income. Is effectively connected with the conduct of a trade or business within the United States (within the meaning of Section 864(c)).
- Not Passive-Type Income. Is not (among other things): (i) capital gain or capital loss (whether long-term or short-term), (ii) dividend (or similar) income, (iii) interest income (other than interest income properly allocable to a trade or business), (iv) an item relating to certain transactions in commodities, foreign currencies or notional principal contracts, or (v) a deduction or loss properly allocable to the foregoing.
- Not Compensation to the Taxpayer. Is not compensation income paid to the taxpayer by the QTB.<sup>10</sup>

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<sup>6</sup> All “Section” references herein are to the Internal Revenue Code of 1986, as amended (the “Code”) unless otherwise described.

<sup>7</sup> The deduction is also available for trusts and estates.

<sup>8</sup> However, if the individual’s taxable income is below a prescribed threshold, the cap based on W-2 wages and qualified property does not apply. See “Individuals with Taxable Income Below Certain Levels” below.

<sup>9</sup> The traditional service businesses are (i) a trade or business involving the performance of services in the fields of health, law, accounting, actuarial services, performing arts, consulting, athletics, financial services, or brokerages services and (ii) any trade or business where the principal asset is the reputation or skill of one or more of its employees or owners.

<sup>10</sup> For this purpose, compensation includes (i) reasonable compensation paid to the individual by a QTB of the taxpayer for services rendered with respect to the QTB, (ii) any guaranteed payment for services paid to a partner for services rendered with respect to the QTB, and (iii) to the extent provided in regulations, any payment described in Section 707(a) to a partner for services rendered with respect to the QTB.

## **Qualified Business Loss**

If an individual's share of the net amount of qualified items of income, gain, deduction and loss with respect to one QTB is less than zero (a "QTB Loss"), the QTB Loss will (in general) reduce the amount of the Section 199A deduction otherwise available to the individual in respect of a different (and profitable) QTB. Further, if an individual's net share of qualified items from all QTBs is less than zero for a taxable year, that amount is treated as a loss from a QTB in the next taxable year.<sup>11</sup>

It is not clear what happens if (for example) there is an overall QTB loss (which Section 199A deems to be a loss from a QTB in the next taxable year) but that loss is actually used in the current taxable year to offset (i) business income from a specified business or (ii) non-qualified items from a qualified business.<sup>12</sup>

## **Cap Based on Share of W-2 Wages and Qualified Property**

The deduction available to an individual with respect to a QTB is generally capped at the greater of (i) 50% of the individual's share of the "W-2 wages" from the QTB and (ii) the sum of 25% of such W-2 wages and 2.5% of the unadjusted basis of the QTB's "qualified property."

For this purpose, W-2 wages are limited to amounts that are (i) remuneration for certain services (including non-cash compensation) performed by an employee for his or her employer and (ii) properly included in a return filed with the Social Security Administration on or before the 60th day after the due date (including extensions) for such tax return.<sup>13</sup>

Qualified property is certain depreciable tangible property that is held by (and available for use in) a QTB at the close of the taxable year and is used in the production of qualified business income.

As discussed below, however, the cap based on an individual's share of the W-2 wages and qualified property does not apply to an individual whose taxable income is below certain prescribed limits.

## **Application to Partnerships and S Corporations**

In the case of a partnership or S corporation, Section 199A is applied at the partner (or shareholder) level. Each partner (or shareholder) takes into account its allocable share of the partnership's (or S corporation's) (i) qualified items of income, gain, deduction and loss, (ii) W-2 wages and (iii) unadjusted basis immediately after acquisition of qualified property. (The allocation of W-2 wages is determined in the same manner as the allocation of wage expenses, and the allocation of unadjusted basis immediately after acquisition of qualified property is determined in the same manner as the allocation of depreciation.)

## **Individuals With Taxable Income Below Certain Levels.**

Certain of the generally applicable limitations under Section 199A do not apply to individuals whose taxable income is below certain specified thresholds, and the limitations phase in above those thresholds.

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<sup>11</sup> The Conference Report includes an example that demonstrates the QTB Loss rule. In the example, H and W file a joint tax return on which they report taxable income of \$200,000 prior to application of the Pass-Through Deduction. Each of H and W (separately) owns a qualified trade or business. H's QTB income for the year is \$150,000 whereas W has a QTB loss for the year of \$40,000. In addition, H and W have a carryover QTB Loss of \$50,000 from a prior year. First, the Pass-Through Deduction with respect to H's \$150,000 of QTB income is determined to be \$34,500 (23% of \$150,000). W's QTB Loss reduces the Pass-Through Deduction by \$9,200 (23% of \$40,000). And finally H and W's carryover QTB Loss reduces their Pass-Through Deduction by an additional \$11,500. Ultimately, H and W are entitled to a Pass-Through Deduction of \$13,800 for the year. Note that in the final TCJA, the Pass-Through Deduction was reduced from 23% to 20% of QTB income, but the example nevertheless illustrates the mechanics of the QTB Loss rule.

<sup>12</sup> As discussed at "New Loss Limitation Rule in Section 461(l)" below, the use of QTB losses in this manner seems to be permitted under Section 461(l).

<sup>13</sup> W-2 wages also exclude (among other things) (i) amounts paid for certain services rendered outside of the U.S. and (ii) certain amounts which are not taxable to the employee.

- Exclusion of Specified Service Businesses. The specified business exclusion does not apply to an individual whose taxable income is less than a certain threshold amount (\$157,500 or, in the case of a joint return, \$315,000). If taxable income exceeds the threshold amount by no more than \$50,000 (\$100,000 in the case of joint return), the specified business limitation is phased in on a proportionate basis.
- Wage and Qualified Property Cap. Similarly, the W-2 wage limit and qualified property cap do not apply to an individual whose taxable income is no more than the above threshold amounts. The limits are phased in proportionately and become fully applicable when taxable income exceeds the threshold by \$50,000 (\$100,000 in the case of a joint return).

### **Deduction for Qualified REIT Dividends**

Section 199A also permits an individual to claim a deduction equal to 20% of the individual's "qualified REIT dividends." A qualified REIT dividend is defined to mean any dividend from a REIT which (i) is not a capital gain dividend (as defined in Section 857(b)(3)) and (ii) is not qualified dividend income (as defined in Section 1(h)(11)). In essence, this means the deduction is available with respect to any dividend derived from a REIT to which ordinary income tax rates apply.<sup>14</sup>

### **Deduction for Qualified PTP Income**

Section 199A similarly permits an individual to claim a deduction equal to 20% of the individual's "qualified publicly traded partnership income." Qualified publicly traded partnership income is defined to mean the sum of (i) the net amount of qualified items from a publicly traded partnership that is not treated as a corporation under Section 7704 and (ii) any gain recognized upon a disposition of the interest in such a partnership to the extent such gain is treated as ordinary income under Section 751(a).

### **Overall Cap**

An individual's total deduction under Section 199A for any taxable year is generally capped at an amount equal to 20% of the excess (if any) of (i) the individual's taxable income for the year over (ii) any net capital gain (as defined in Section 1(h)) for the year.

### **Scope of Deduction**

Section 199A(f)(3) provides that the deduction under Section 199A applies only for purposes of Chapter 1 of the Code. Since self-employment taxes are imposed under Chapter 2 of the Code and the Section 1411 Medicare tax is imposed under Chapter 2A of the Code, it would appear that the Section 199A deduction is not taken into account in determining those types of taxes.<sup>15</sup>

### **Observations and Opportunities under Section 199A**

#### **Incentive for Employees to be Taxed as Partners**

Section 199A creates an incentive to structure the arrangement between a partnership and a service provider as a partnership arrangement, in which the service provider receives a profits interest in the partnership, rather than as an employment arrangement. Qualified income properly allocated to a service partner under Section 704(b) of the Code may be eligible for the Section 199A deduction but compensation income paid to an employee is not eligible for the deduction. However, there are real factual and legal limitations in structuring arrangements in this manner. First, there is no reason to do so

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<sup>14</sup> Section 857(c) makes clear that capital gain dividends, qualified dividend income, and ordinary dividend income comprise a complete universe of the types of REIT dividend income.

<sup>15</sup> By contrast, Section 1411(c) provides that for purposes of Chapter 2A, net investment income is reduced by the deductions allowed by "this subtitle" (which includes Section 199A) which are properly allocated to gross income or net gain included in net investment income.

(from a Section 199A perspective) in the case of a highly compensated individual who works for a specified business because the pass-through deduction will remain unavailable. In many other cases, there will be a difficult balance between (i) the desire of the individual for some assurance about his or her compensation and (ii) the rule in Section 199A that expressly denies a Section 199A deduction for amounts treated either as a “guaranteed payment”<sup>16</sup> or (to the extent provided in regulations) as paid to a person in a non-partner capacity.<sup>17</sup>

### **W-2 Wage and Qualified Property Cap Not Applicable to REIT or PTP Income**

The W-2 wage and qualified property cap does not apply to the 20% deduction for (i) qualified REIT dividends or (ii) qualified publicly traded partnership income. This creates an incentive to operate a business as a REIT or publicly traded partnership if (i) the business would be eligible for treatment as a REIT or a PTP and (ii) the W-2 wage limitation or qualified property cap would otherwise limit the Section 199A deduction if the business operated as a regular flow-through entity. This could arise, for example, in the case of some real estate and energy-related businesses.

### **Mortgage Interest Passed Through by REIT as Qualified Dividends**

The 20% deduction under Section 199A in respect of qualified REIT dividends is seemingly available even if the underlying income received by the REIT would not have been qualified income from a qualified business. For example, certain mortgage interest received by a REIT can be passed through as qualified dividends eligible for the Section 199A deduction even if the deduction would not be available if the interest were received by a partnership unless the interest was effectively connected with a U.S. trade or business and treated as properly allocable to that business.

### **Businesses that Include a Specified Business**

It is not clear how Section 199A operates if (i) a trade or business that would otherwise constitute a qualified business also provides an ancillary service that meets the definition of a specified business or (ii) a partnership engages in two businesses and only one of the businesses is treated as a QTB.

### **Benefit in Using Employees vs. Independent Contractors**

If the W-2 Wage and qualified property cap would otherwise limit the Section 199A deduction for a QTB, there may be an incentive for the QTB to restructure independent contractor relationships as employment relationships.

### **Section 751(a) and PTPs**

The Section 199A deduction is expressly available in the case of ordinary income arising under Section 751(a) in the case of a sale of a PTP but the statute is silent on whether this treatment is also available in the case of a sale of an interest in a partnership that is not a PTP.

## **New Loss Limitation Rule in Section 461(l)**

### **Summary of the Rule**

Under new Section 461(l), the “excess business loss” of an individual<sup>18</sup> for any taxable year is disallowed and treated as a net operating loss carryover to the following taxable year under Section 172.

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<sup>16</sup> Guaranteed payments are generally payments to a partner for services or the use of capital if the payments are determined without regard to the income of the partnership. They are treated for tax purposes as if made to a person who is not a partner.

<sup>17</sup> See proposed Treasury Regulations sections 1.707-1, 1.707-2, 1.707-9, 80 Fed.Reg. 43652 (July 23, 2015) (addressing disguised payments for services by a partner to a partnership).

<sup>18</sup> Like Section 199A, the provision applies to taxpayers “other than a corporation,” with special rules provided in the case of partnerships and S corporations. Unlike Section 199A, however, there is no express provision addressing trusts and estates.

An “excess business loss” means the excess of the aggregate deductions attributable to the taxpayer’s trades or businesses over the sum of the aggregate gross income or gain of such taxpayer attributable to such trades or businesses, but only to the extent such net loss exceeds \$250,000 (\$500,000 in the case of a joint return).

The limitation is applied at the partner or shareholder level in the case of partnerships or S corporations. It applies after application of the passive loss rules.

### **Observations**

- The items of business income, gain and deduction taken into account under Section 461(l) are not limited to (i) those attributable to a “qualified trade or business” under Section 199A or (ii) qualified items under Section 199A.
- The normal limitations applicable to net operating losses under Section 172, including the new rule that limits NOL carryforwards to 80% of taxable income,<sup>19</sup> presumably apply to an excess business loss that Section 461(l) treats as an NOL under Section 172.

### **New Limitation on the Deduction for Business Interest**

The TCJA rewrites Section 163(j) to create a new limitation on the deduction of business interest, applicable both to individual business owners and to corporations. Under revised Section 163(j), a taxpayer’s deduction for business interest expense for a taxable year cannot exceed the sum of (i) the taxpayer’s business interest income and (ii) 30% of the taxpayer’s “adjusted taxable income.”

For this purpose, adjusted taxable income generally means taxable income computed without regard to (i) items of income gain, deduction, or loss not properly allocable to a trade or business, (ii) any business interest expense, (iii) any net operation loss deduction, (iv) any deduction under Section 199A, and (v) prior to taxable years beginning in 2022, any deduction for depreciation, amortization, or depletion. Interest expense that exceeds this limit is not deductible in the current taxable year but may be carried forward to subsequent years.

Unlike Section 199A and 461(l), in the case of interest paid by a partnership or (S corporation), the new Section 163(j) limitations are applied at the partnership (or S corporation) level rather than at the partner level. As a result, the location of debt in a pass-through structure may impact the extent to which the interest on the debt is currently deductible.

Real estate businesses are permitted to elect out of these rules, but certain other tax costs are imposed for doing so.

See [Changes to the Rules Governing Interest Expense and Net Operating Loss](#) for a full discussion of the new Section 163(j) rules and their application in the partnership context.

### **International Businesses Held by Individuals**

The TCJA makes significant changes to the manner in which U.S. corporate and individual taxpayers are taxed on income from international operations.<sup>20</sup> Although Congress sought to maintain some equilibrium between the treatment of corporations and individuals in the domestic context through the enactment of the Section 199A pass-through deduction, the changes made in the TCJA will exacerbate differences in treatment between corporations and individuals in the foreign context.

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<sup>19</sup> Changes to Section 172 under the TCJA generally provide that net operating losses may no longer be carried back to prior years and that they may now be carried forward indefinitely, but may be used in any taxable year to offset no more than 80% of the taxpayer’s taxable income, determined without regard to the net operating loss deduction.

<sup>20</sup> See [The New “Not Quite Territorial” International Tax Regime](#) and [Transition Tax / Deemed Repatriation](#) for more information.

## The Transition Tax<sup>21</sup>

As part of the transition to the new international tax rules, new Section 965 provides for a one-time tax in certain cases where a U.S. taxpayer (i) owns (or is treated as owning) 10% or more of the stock of a non-U.S. corporation or (ii) owns an interest (of any size) in a domestic partnership (or S corporation) which owns (or is treated as owning) 10% or more of the stock of a non-U.S. corporation.

More specifically, Section 965 requires that each “U.S. Shareholder”<sup>22</sup> of a “specified foreign corporation”<sup>23</sup> (an “SFC”) include in income the U.S. Shareholder’s pro rata share of the SFC’s “post-1986 earnings & profits” that have not been subjected to U.S. tax. In order to reduce the effective tax rate on this income, Section 965 also creates a partially offsetting deduction (as discussed at “Tax Mechanics and Rates” below).

### When Imposed: Relevant Ownership Dates

In cases where a SFC has the calendar year as its taxable year, the tax under Section 965 generally applies to the U.S. Shareholders who own the SFC’s stock on December 31, 2017 and (in the case of an individual) the tax will generally be imposed for the 2017 taxable year. In other cases (*i.e.*, where the SFC’s taxable year is not the calendar year), the tax is imposed on U.S. Shareholders who own stock in the SFC on the last day of the SFC’s last taxable year that begins before January 1, 2018 and (in the case of an individual) the tax will be imposed for the 2018 taxable year.

The tax is generally based on the U.S. Shareholder’s pro rata share of the non-U.S. corporation’s accumulated earnings and profits, determined as of November 2, 2017 or December 31, 2017 (whichever is greater) (the “applicable E&P”).

### Tax Mechanic and Rates

The mechanism for imposing the tax is (i) to require each U.S. Shareholder of a SFC to include in income the shareholder’s pro rata share of the SFC’s applicable E&P and (ii) to grant the U.S. Shareholder a deduction for a portion of the amount required to be included in income. The amount of the deduction is designed to result in corporate taxpayers being subject to a 15.5% tax rate on the portion of the SFC’s applicable E&P viewed as invested in cash (the “Cash E&P”) and an 8% tax rate on the balance of its applicable E&P (the “Residual E&P”).

Accordingly, for amounts included for 2017 (when the corporate tax rate is 35%), the deduction in respect of the Cash E&P is equal to 55.71% of the Cash E&P and the deduction in respect of Residual E&P is

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<sup>21</sup> These rules are described in greater detail in [Transition Tax / Deemed Repatriation](#).

<sup>22</sup> A U.S. person (whether an individual, partnership, S corporation or C corporation) is generally treated as a U.S. Shareholder if the person owns (or is treated as owning) 10% of the stock of the non-U.S. corporation (a “U.S. Shareholder”). The TCJA expands the definition of “U.S. Shareholder” (effective for taxable years of non-U.S. corporations beginning in 2018) to be a vote or value test rather than a test based solely on voting power.

<sup>23</sup> A non-U.S. corporation is generally treated as a specified foreign corporation if (i) the non-U.S. corporation is treated as a “controlled foreign corporation” (a “CFC”) (which generally requires that the U.S. Shareholders of the non-U.S. corporation collectively own more than 50% of the stock of the non-U.S. corporation) or (ii) the non-U.S. corporation is not a CFC but there exists a “domestic corporation” that is treated as a U.S. Shareholder of the non-U.S. corporation. However, a specified corporation does not include a “PFIC” with respect to the U.S. Shareholder that is not a CFC.

Beginning in 2017 and for purposes of determining whether a U.S. person is a 10% U.S. shareholder, the TCJA treats stock that is owned by a foreign person as attributable to a U.S. entity that is owned by the foreign person (so-called “downward attribution”). This will cause many non-U.S. corporations to become CFCs or SFCs in 2017 and (somewhat unexpectedly) potentially subject their U.S. Shareholders to the traditional CFC rules for 2017, the transition tax in 2017 and the expanded CFC rules for 2018 and future years.

77.14% of the Residual E&P. For amounts included in 2018 (when the corporate tax rate is 21%), and not subject to proration, the deduction percentages are 26.19% and 61.90% respectively.<sup>24</sup>

Although the above deduction percentages are calculated based on the rates applicable to corporations, they are also used in determining the Section 965 deduction available to individuals. Since the tax rate applicable to individuals is higher than the tax rate applicable to corporations, the percentages will result in individuals being subject to somewhat higher rates of tax under Section 965 than corporations. Specifically, the tax rate for individual U.S. Shareholders subject to this tax in 2017 will be approximately 17.5% on the Cash E&P and approximately 9% on the Residual E&P. However, for individual U.S. Shareholders subject to this tax in 2018, the rates will be approximately 27.3% and 14%, respectively.<sup>25</sup>

### **Installment Payments and Special Deferral Rules for S Corporations**

Section 965 permits a U.S. Shareholder of a SFC to pay the net tax liability under Section 965 in eight annual installments, with increasing portions of the liability due in the later years.<sup>26</sup> Due dates for installments may be accelerated in certain circumstances.<sup>27</sup>

Under a special rule, in the case of an S corporation that is a U.S. Shareholder of a SFC, each shareholder of the S corporation may elect to defer payment of the shareholder's net tax liability until the shareholder's taxable year which includes a "triggering event." Triggering events occur if the S corporation ceases to be an S corporation, liquidates or sells substantially all of its assets (including in bankruptcy proceedings), ceases to conduct business, or ceases to exist. A proportionate triggering event also occurs if and to the extent that the shareholder transfers any share of its stock in the S corporation, including by reason of death, unless the transferee agrees with the IRS that it will assume the liability for the tax upon the occurrence of a future triggering event.

Effectively, a shareholder of an S corporation—unlike a C corporation or an individual owning its interest in a specified foreign corporation either directly or through a partnership—would seem to be permitted to defer its share of the deemed repatriation tax indefinitely. Individuals who are expected to be taxable in respect of a SFC under Section 965 may wish to transfer their stock of the SFC to an S corporation prior to 2018.

The application of the rules permitting deferment of the Section 965 tax are not entirely clear where the U.S. shareholder of the SFC is U.S. partnership that is owned by a U.S. individual, S corporation or C corporation.

### **Future Distributions and Section 1411**

A U.S. Shareholder that includes income in respect of a SFC under Section 965 will generally be able to distribute cash from the SFC without incurring an additional tax liability under Chapter 1 of the Code. However, an individual U.S. Shareholder will be subject to the 3.8% net investment tax under Section

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<sup>24</sup> The Conference Report specifies that the highest corporate tax rate is used in the deduction calculation, even where the U.S. Shareholder is an individual.

<sup>25</sup> The markedly higher rates for individuals in 2018 is attributable to the increase in the rate differential between individuals and corporations in 2018. The Conference Report notes the availability of the election under Section 962 for individuals to be entitled to the corporate rate of taxation with respect to 951 inclusion. However, there are significant drawbacks to making the Section 962 election.

<sup>26</sup> The election allows the taxpayer to pay 8% of the liability in each of the first 5 years, 15% in the 6<sup>th</sup> year, 20% in the 7<sup>th</sup> year and 25% in the 8<sup>th</sup> year.

<sup>27</sup> For example, installments become immediately due if timely payment of any previous installment is not made, if the taxpayer liquidates or ceases to conduct business, or if the taxpayer sells substantially all of its assets, unless the buyer enters into an agreement with the IRS to assume liability for the remaining installments.

1411 on such a cash distribution unless the individual elected to be taxed under Section 1411 based on the corporation's subpart F income under Treasury regulation Section 1.1441-4(g).<sup>28</sup>

### **International Considerations Going Forward**

Historically, U.S. individuals, like U.S. corporations, generally preferred to hold non-U.S. businesses through non-U.S. corporations. U.S. owners of non-U.S. corporations generally were not subject to current tax on active business income earned at the foreign corporation level. Those foreign earnings were not subject to U.S. tax until distributed ("repatriated"), an event that was often within the taxpayer's control and often delayed for a considerable period of time. The main exception arose in the case of "subpart F income" which, prior to the TCJA, generally consisted of passive investment income and other narrow income categories.<sup>29</sup>

The TCJA significantly expands the current taxation of foreign corporate earnings<sup>30</sup> to generally require that U.S. Shareholders include in current income all earnings, including active business earnings, in excess of an assumed ten percent return on tangible assets. This is described as a tax on "global intangible low-taxed income" (or "GILTI"). The GILTI tax eliminates a substantial portion of the benefits of deferral from conducting foreign business operations through non-U.S. corporations.

For U.S. Shareholders that are C corporations, the GILTI blow is mitigated with the benefits of several deductions and credits. These include:

- A deduction for 50% of the amount included in income under the GILTI tax (the "GILTI deduction");<sup>31</sup>
- Tax credits for 80% of the foreign taxes paid by the foreign corporation attributable to the GILTI inclusion (the "Deemed Paid Credit");<sup>32</sup> and
- A dividends-received deduction for the foreign-source portion of dividends received from the foreign corporation (the "Participation Exemption DRD").<sup>33</sup>

None of these deductions or credits are made available to individuals—they apply only to U.S. C corporations.<sup>34</sup>

### **Observations**

If a business uses only a modest amount of tangible property and the business is held by a CFC, a substantial portion of the income of the business will (under the GILTI rules) effectively flow up as ordinary income to the U.S. Shareholders of the CFC even if the CFC does not make any cash

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<sup>28</sup> However, an individual U.S. Shareholder may be able to access the cash without triggering Section 1411 by having the SFC make a loan to the individual shareholder.

<sup>29</sup> The subpart F income inclusion was generally limited to the non-U.S. corporation's earnings and profits for that year.

<sup>30</sup> The Act also expands the scope of subpart F by (1) expanding the definition of a "U.S. Shareholder" to include owners of 10% of value, as well as voting power; (2) expanding the scope of the attribution rules to permit attribution from non-U.S. entities to their U.S. owners, and (3) imposing tax on subpart F income even if the non-U.S. corporation has not been a CFC for an uninterrupted period of 30 days during the taxable year.

<sup>31</sup> See new Section 250.

<sup>32</sup> See new Section 960.

<sup>33</sup> See new Section 245A.

<sup>34</sup> The deductions under new Sections 245A and 250, and the indirect foreign tax credits under new Section 960(d) (relating to GILTI), are available to "domestic corporations." The Conference Report specifies that these benefits are available only to C corporations that are not RICs or REITs. The Report notes that under Section 1373(b), an S corporation's taxable income is calculated in the same manner as an individual's, such that deductions allowed only to corporations are not available to shareholders of S corporations.

distributions. Since an individual U.S. Shareholder of such a CFC is not entitled to the related deductions and credits available to corporate U.S. Shareholders (as described above), the CFC may generate substantial amounts of phantom income to an individual U.S. Shareholder. Moreover, while lenders to a partnership are accustomed to permitting tax distributions to the partners of the partnership, this is far less common in the CFC context (both because it has traditionally not been an issue and because, unlike a partnership, the CFC itself may be subject to corporate taxes in its home jurisdiction).

Although the phantom income issue would also arise if such a non-U.S. business were held by an entity treated for U.S. tax purposes as a partnership (rather than a CFC), holding the business through an entity treated as a partnership would allow for certain benefits. First, the partners (including individuals) would generally receive a tax credit for any non-U.S. taxes paid by the business. Second, any capital gain recognized by the business would flow through as capital gain to the partner. Third, subject to the passive activity rules and the new rules limiting the use of business losses against non-business income, an individual may be able to use losses from an unrelated business to offset income from the partnership. Fourth, a basis step-up for U.S. federal income tax purposes could be delivered to a future U.S. buyer of the business (which may ameliorate the impact of the GILTI tax on the buyer).

Alternatively, it may be desirable to hold such business through a CFC but for an individual U.S. shareholder to hold the stock of the CFC through a U.S. C corporation. The U.S. C corporation would generally be able to claim the related deductions and credits noted above. However, the interposition of a U.S. C corporation may significantly increase the taxes payable upon a sale of the business (though this depends on how the sale is structured).

Finally, it may be desirable to hold such business through a CFC but for an individual U.S. shareholder to make an election under Section 962.<sup>35</sup> However, we expect that in most cases the costs and downsides of such an election will outweigh any benefits.

A summary of the relative tradeoffs is set forth below.

U.S. Entity/Foreign Entity	Impact
<b>Individual/CFC</b>	<p>Tax Rate<sup>36</sup>: 37%<sup>37</sup></p> <p>Current Inclusion: subpart F and including GILTI</p> <p>No deduction for GILTI or FDII</p> <p>No deemed foreign tax credit for foreign taxes attributable to GILTI</p> <p>Foreign Tax Credits: Unavailable<sup>38</sup></p> <p>Inbound Distributions: Participation Exemption Unavailable</p>

<sup>35</sup> Section 962 generally applies a second level of taxation to the electing taxpayer, the effect of which is to treat the taxpayer as if he or she holds his or her investment through a domestic corporation. While the tax rate applied in the initial inclusion through Section 962 and 951 would be smaller as a result of the election (and potentially offset by foreign tax credits), earnings subsequently distributed in excess of taxes already paid would again be subject to U.S. taxation.

<sup>36</sup> The tax rates used in this chart do not include Medicare tax.

<sup>37</sup> The Pass-Through Deduction is available only for income effectively connected with the conduct of a trade or business in the United States.

<sup>38</sup> Section 901 allows only foreign tax credits for taxes paid by the taxpayers themselves. Section 960 provides an exception for corporate U.S. Shareholders of CFCs.

	Sale: Sale of CFC does not result in step-up in basis of assets <sup>39</sup>
<b>Individual/Pass-Through</b>	<p>Tax Rate: 37% on ordinary income; 20% on capital gain</p> <p>Current Inclusion: Income earned abroad subject directly to U.S. tax, but inclusion is incremental only to the extent it exceeds income that would have been included under the subpart F regime, including GILTI</p> <p>Foreign Tax Credits: Available</p> <p>Inbound Distributions: n/a</p> <p>Sale: Sale of foreign assets will result in step-up of basis</p>
<b>Corporation/CFC</b>	<p>Tax Rate: <i>Corporate</i>—21%; <i>Individual</i>—20%</p> <p>Current Inclusion: subpart F and GILTI</p> <p>Deduction available for GILTI and FDII</p> <p>Deemed foreign tax credit for foreign taxes attributable to GILTI</p> <p>Foreign Tax Credits: Available</p> <p>Inbound Distributions: Participation Exemption Available</p> <p>Sale: Tax consequences depend on structure of sale</p>

## Miscellaneous Partnership Tax Changes

The TCJA includes several changes to the general rules of partnership taxation.

- The TCJA provides rules under which partners that hold profits interests in certain businesses transferred to them in connection with the performance of substantial services are entitled to the benefit of long-term capital gain treatment only with respect to assets the partnership has held for at least three years (as compared to the one-year holding period generally required for long-term capital gain treatment). The new rules apply only to businesses involved in raising capital or investing in securities, commodities, real estate and certain financial assets.<sup>40</sup>
- The outside basis limitation on a partner's distributive share of partnership losses must now be reduced by the partner's distributive share of the basis of property contributed by the partnership as a charitable contribution and by the partner's distributive share of foreign taxes paid by the partnership.
- The technical termination rule (which under prior law treated a partnership as terminating if 50% or more of interests in the partnership's capital and profits were sold or exchanged within twelve months) is repealed.
- The definition of "substantial built-in loss" for purposes of Section 743 is expanded to include losses in excess of \$250,000 that would be allocated to a transferee of a partnership interest if all of the partnerships assets were sold, even if the partnership does not have an overall built-in loss.

<sup>39</sup> A step-up in basis could benefit a U.S. buyer for GILTI purposes.

<sup>40</sup> For more detail on these new rules, see [Effect of the TCJA on Private Investment Funds](#).

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If you have any questions regarding the matters covered in this publication, please contact your regular Davis Polk contact.

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## Effect of the TCJA on Private Investment Funds

December 20, 2017

The TCJA is likely to have a significant effect on private funds, with consequences for portfolio companies, investors and investment professionals. This memorandum discusses the treatment of “carried interest” under the TCJA and provides a brief overview of a number of other provisions of the TCJA that may affect private funds, including changes in tax rates, the repeal of the allowance of “miscellaneous itemized deductions” and the deduction for state and local income taxes, new rules affecting the taxation of pass-through business income, new rules affecting U.S. tax-exempt and non-U.S. investors, and the TCJA’s overhaul of the international tax regime.<sup>1</sup>

### Carried Interest

Typically, the general partner of a private fund or a separate entity owned by the fund’s investment professionals (such entity, the “Carry Entity”) holds an equity interest in the fund that entitles the Carry Entity to a share of the fund’s profits that is larger than the Carry Entity’s percentage interest in the capital invested in the fund. This “carried interest”<sup>2</sup> gives the Carry Entity a percentage (e.g., 20%) of the profits that would have been allocated to the fund’s other investors if all fund profits had been allocated *pro rata* according to capital contributions. The fund vehicle that issues the carried interest is an entity treated as a partnership for U.S. federal income tax purposes. A partnership is not subject to entity-level tax, but instead allocates its items of income, gain, loss and deduction to its partners, who include their shares of those items in determining their own tax liability. Under current law, a carried interest is treated in the same manner as any other partnership interest, with the result that the character of the income and gains recognized by the issuing fund vehicle (e.g., as long-term capital gain, short-term capital gain or ordinary income) flows through to the Carry Entity. The Carry Entity, in turn, is typically itself a partnership for tax purposes, so that the character of the underlying fund income flows through to the individuals who hold interests in the Carry Entity.

Over the last several years, various bills have been introduced in Congress that, if enacted, would have treated all carried interest allocated by an investment partnership as ordinary income derived from the provision of services by the Carry Entity and its members. While the TCJA contains a provision that modifies the treatment of carried interest, it does not take this approach. Instead, it retains the general treatment of carried interest under current law, but imposes a three-year holding period for the determination of whether capital gain derived by the fund is long-term or short-term. The principal features of the carried interest provision are outlined below.

- **Three-year holding period.** Individuals are subject to U.S. federal income tax on net capital gain (that is, the excess of net long-term capital gain over net short-term capital loss) at rates that are substantially lower than the rates applicable to ordinary income and

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<sup>1</sup> Unless otherwise noted, this memorandum assumes that the private fund investment vehicles described herein are entities that are treated as partnerships for U.S. federal income tax purposes.

<sup>2</sup> In hedge funds, this profits interest is generally called an “incentive allocation” or “performance allocation,” rather than a “carried interest.”

short-term capital gains (under the TCJA, a maximum rate of 20% vs. a maximum rate of 37%).<sup>3</sup> In general, gain from the sale or other disposition of a capital asset is treated as long-term capital gain if the owner has held the asset for more than one year as of the date of disposition and as short-term capital gain if the owner has held the asset for a shorter period. The TCJA changes this rule for carried interest allocations. Under the TCJA, gain allocated in respect of carried interest will qualify as long-term capital gain only if the fund has held the relevant investment for more than **three** years at the time of the disposition. If the fund has held the investment for a shorter period of time, the gain will be treated as short-term capital gain.

- **Sale of carried interest.** The three-year holding period requirement also apparently applies to gain derived from the sale or other disposition of a partnership interest attributable to carried interest (called an “applicable partnership interest”). The taxpayer will be required to have held the “applicable partnership interest” for more than three years in order for gain on the disposition to qualify as long-term capital gain.
- **Qualified dividend income unaffected.** “Qualified dividend income” (generally, dividends from U.S. corporations and certain non-U.S. corporations) is subject to U.S. federal income tax at the rates applicable to net capital gain (*i.e.*, 20%, plus the 3.8% tax on net investment income, in the case of an individual). The TCJA does not modify the treatment of carried interest allocations of qualified dividend income, and therefore these allocations will continue to qualify for the 23.8% rate.
- **Limited to “applicable partnership interests.”** For purposes of imposing the special three-year holding period requirement, the TCJA defines a carried interest as an “applicable partnership interest” – specifically, the three-year holding period requirement applies only to capital gain derived with respect to an “applicable partnership interest.”<sup>4</sup> An “applicable partnership interest” is a partnership interest that is transferred to, or held by, a taxpayer in connection with the performance of substantial services by the taxpayer (or by a person related to the taxpayer) in an “applicable trade or business.” The TCJA provides no guidance as to what will constitute “substantial services.”
  - An “applicable trade or business” is generally defined to mean (i) raising and returning capital and (ii) either investment or development activities with respect to “specified assets.”
  - “Specified assets” are (i) securities, commodities, real estate held for rental or investment and cash or cash equivalents and (ii) options or derivative contracts with respect to, and interests in partnerships relating to, any of these assets.
- **No effect on capital interests.** An “applicable partnership interest” does not include a partnership interest that provides the taxpayer with a right to share in partnership capital commensurate with either (i) capital contributions made by the taxpayer or (ii) amounts that were included as compensation income by the taxpayer at the time of grant or vesting of the relevant partnership interest (in either case, a “capital interest”). As a result, the new three-year holding period rule will not apply to any capital interest.

<sup>3</sup> These are the U.S. federal income tax rates. Net capital gain is generally also subject to the 3.8% tax on net investment income. Any ordinary income that constitutes net earnings from self-employment will be subject to the hospital insurance tax (that is, the Medicare tax), generally at the rate of 3.8%.

<sup>4</sup> An “applicable partnership interest” does not include any partnership interest directly or indirectly held by a corporation.

- For this purpose, the amount of capital contributed by a taxpayer in respect of a partnership interest is determined at the time of the taxpayer's receipt of the partnership interest. In private funds other than hedge funds, it is typical for investors to make capital commitments that are drawn down as capital contributions over a number of years. While it is not entirely clear how the TCJA's definition of a capital interest would apply in this situation, it seems likely that the requirement was not intended to preclude capital interest treatment, but instead that the Carry Entity (and each of its members) will be treated as receiving a separate capital interest each time the Carry Entity (and the relevant member) makes a capital contribution.
  - The timing requirement may be aimed at arrangements in which a portion of the management fee otherwise payable by the fund is replaced with a special profits interest held by the Carry Entity, providing for a targeted amount of allocations equal to the management fee reduction, and the capital contributions that the Carry Entity would otherwise have made to the fund are reduced by the amount of allocations to be made in respect of this special profits interest. Under the TCJA, any such special profits interest would be treated as an "applicable partnership interest," rather than as a capital interest.
- **Section 83(b) Elections.** In general, a person who receives property in connection with the performance of services must include in income, as compensation income, an amount equal to the excess of the fair market value of the property over the amount, if any, that the person paid for the property, with the inclusion occurring on the date of grant if the person's rights to the property are fully vested on grant or on the vesting date if the person's rights to the property are subject to vesting conditions. Section 83(b) of the Internal Revenue Code of 1986, as amended (the "Code") allows a person who receives unvested property in connection with the performance of services to elect to ignore the vesting conditions and to recognize the compensation income, if any, as of the grant date. Under guidance issued by the IRS (the "Profits Interest Guidance"), these rules do not apply to a partnership profits interest that is issued to a person in respect of services the person provides to or for the benefit of the partnership in a partner capacity (as opposed to another capacity, such as an employee of a related entity).
  - The IRS has explicitly stated that Section 83(b) elections are not required in the case of the issuance of a partnership profits interest that is subject to the Profits Interest Guidance. It is typical, however, for individuals who hold interests in a Carry Entity also to be employees of a related entity (generally, a management company that provides services to the fund), and as a result, there may be some uncertainty as to whether the IRS would view the individuals' services as being provided in their capacities as partners of the Carry Entity, rather than in their capacities as employees. It is therefore common for an individual to make a "protective" Section 83(b) election in connection with the receipt of an interest in a Carry Entity.
  - While an earlier version of the tax bill provided that Section 83 (and thus a Section 83(b) election) would not apply to a grant of an "applicable partnership interest," the TCJA contains no such provision. Indeed, the TCJA specifically contemplates the possibility that a taxpayer will make a Section 83(b) election in respect of an "applicable partnership interest" by stating that the three-year holding period rule applies notwithstanding any Section 83(b) election.

- The TCJA does not limit the definition of “applicable partnership interest” to the provision of substantial services “in a partner capacity.” Thus, if an individual receives an interest in a Carry Entity in connection with services that he or she performs as an employee of another entity, the three-year holding period requirement will apply except in respect of the portion of the interest that is treated as a capital interest, as described above.
- **Exclusions for certain service providers.** The three-year holding period requirement will not apply to a partnership interest held by a person who is employed by an entity other than the issuing partnership if (i) such other entity conducts a trade or business other than an “applicable trade or business,” as defined above, and (ii) the person to whom the partnership interest is issued provides services only to that other entity. Although not entirely clear, this provision may be intended to clarify that the three-year holding period requirement does not apply to executives of a portfolio company who hold profits interests in a holding vehicle for the portfolio company (sometimes referred to as a “top hat” vehicle).
- **Related party transfers.** Although not entirely clear, a special rule appears to treat a direct or indirect transfer of a carried interest to certain specified persons as a taxable sale of the carried interest, even if the transfer would otherwise be entitled to non-recognition under another provision of the Code. The specified persons are (i) any family member or (ii) any person who performed services in the current year or the preceding three years in any “applicable trade or business” in or for which the taxpayer performed a service.

## Changes in Tax Rates

The TCJA revises the tax rates for both corporations and individuals.

- **Corporate Tax.** The TCJA dramatically reduces the highest corporate rate from 35% to 21%. This rate reduction has no “sunset” provision and is effective for taxable years beginning after December 31, 2017. The TCJA also repeals the corporate alternative minimum tax (the “AMT”), unlike a version of the Senate tax bill, which would have retained the corporate AMT. Given the lower corporate tax rate, the amount of the dividends-received deduction (which a corporation may claim in respect of dividends received from U.S. corporations and the “U.S.-source portion” of dividends received from certain foreign corporations) has been reduced.
- **Individual Tax.** The tax brackets for individuals have been modified, with the highest marginal individual rate reduced from 39.6% to 37%. The reduced rates are temporary – they will be effective for 2018 through 2025. Although the corporate AMT has been repealed, the TCJA retains the individual AMT, but increases the relevant exemption amount and the threshold amount of “alternative minimum taxable income” after which the exemption is phased out.

The TCJA also significantly increases the standard deduction available to individuals.

## Restrictions on Deductions for Individuals

For 2018 through 2025, the years in which the reduced marginal tax rates apply to individuals and other non-corporate taxpayers, the TCJA imposes certain significant restrictions on the deductions that an individual or other non-corporate taxpayer may claim, thereby increasing the base on which the income tax will be imposed.

**Disallowance of “Miscellaneous Itemized Deductions.”** The TCJA disallows all miscellaneous itemized deductions for 2018 through 2025. For non-corporate taxpayers,

investment-related expenses (called “Section 212 expenses”) are miscellaneous itemized deductions. These expenses generally include an investor’s share of the expenses of a private equity fund or other private fund that is not an active trader in securities or other assets, including the investor’s share of the management fee paid by the fund. If such a private fund enters into a swap (*i.e.*, an interest rate swap), a non-corporate investor’s share of payments made on the swap will be disallowed miscellaneous itemized deductions and will therefore not be netted against the investor’s share of the payments made on the swap.

Disallowed miscellaneous itemized deductions may not be capitalized, with the result that the investor will not receive any tax benefit in respect of such expenses. Under current law, a non-corporate taxpayer’s ability to deduct miscellaneous itemized deductions is subject to significant limitations. In particular, miscellaneous itemized deductions are allowable for any taxable year only to the extent that they exceed 2% of the taxpayer’s adjusted gross income for that year (a limitation known as the “2% floor”). After 2026, these limitations will again be applicable.

Expenses incurred in connection with trading activities by funds that are active traders in securities or other assets are treated as business expenses, rather than miscellaneous itemized deductions, and as a consequence the new disallowance will not apply to these expenses. In addition, an investor’s share of the expenses of a portfolio company that is engaged in a trade or business and is treated as a partnership for U.S. federal income tax purposes (an “operating partnership”) will generally constitute business expenses, rather than miscellaneous itemized deductions. An investor’s share of interest paid or accrued by a private fund will not constitute a miscellaneous itemized deduction, but is subject to separate limitations on deductibility, including primarily the pre-existing limitation on the deductibility of “investment interest,” under which a non-corporate taxpayer’s deduction for “investment interest” is limited to the amount of the taxpayer’s “net investment income.”<sup>5</sup>

**Disallowance of Deduction for Excess Business Losses.** For 2018 through 2025, a non-corporate taxpayer will not be entitled to deduct an “excess business loss.” An “excess business loss” is the amount, if any, by which (i) the taxpayer’s aggregate deductions attributable to trades or businesses exceed (ii) the taxpayer’s aggregate gross income or gain attributable to trades or businesses plus an amount equal, in 2018, to \$250,000 (or \$500,000 in the case of a joint return) and indexed for inflation in subsequent taxable years. Any disallowed excess business loss will be treated as a net operating loss carryover.<sup>6</sup>

In the case of a partnership, this limitation applies at the partner level by taking into account each partner’s share of the partnership’s items of income, gain, loss and deduction. The same approach applies to shareholders of S corporations.

The “passive activity rules,” which pre-date the TCJA, limit the ability of taxpayers other than widely held corporations to deduct losses from a “passive activity,” generally defined as an activity that involves the conduct of a trade or business in which the taxpayer does not materially participate. The passive activity rules limit the ability of investors in private funds, as well as members of a Carry Entity, to deduct their shares of the losses and deductions of operating

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<sup>5</sup> For this purpose, “net investment income” does not include long-term capital gains or qualified dividend income unless the taxpayer elects to be subject to tax on such income at the rates applicable to ordinary income.

<sup>6</sup> The TCJA has also revised the rules applicable to net operating losses: it eliminates the two-year carryback, provides an indefinite (as opposed to a 20-year) carryover and limits the amount of a net operating loss carryover that may be used in any taxable year to 80% of taxable income, as computed without regard to the net operating loss deduction.

partnerships in which the fund invests. The new excess business loss limitation will apply after application of the passive activity rules.<sup>7</sup>

This limitation will also apply in situations in which the passive activity loss rules do not apply. In particular, trading in actively traded personal property is not treated as a “passive activity,” and therefore an investor’s share of the income, gains, losses and deductions derived by a fund from trading in actively traded securities or other assets is not subject to the passive activity rules. The new limitation on excess business losses will apply to investors in active trading funds. In addition, this limitation will apply in situations in which the taxpayer materially participates in the relevant business and in which the passive activity rules therefore do not apply. For example, it will apply to fund managers who hold interests in a management company that is treated as a partnership for tax purposes and to managers of an operating partnership who hold equity interests in the operating partnership.

**Limitation on Deduction for State and Local Taxes.** For an individual taxpayer, the TCJA limits to \$10,000 (or \$5,000 in the case of a married individual filing a separate return) in any taxable year the deduction for the aggregate amount of:

- state and local income taxes; and
- state and local property taxes, other than taxes paid or accrued in carrying on a trade or business or an investment activity.

These rules will apply for 2018 through 2025. Corporations, unlike individuals, have retained the deduction for state and local income taxes.

The rules will apply not only to state and local income taxes paid directly by an individual, including in respect of the individual’s share of the income of a partnership, but also to an individual’s share of any state and local taxes paid by a partnership. As a consequence, individual investors in private equity funds and individual members of any Carry Entity will not be able to deduct state and local income taxes imposed with respect to their shares of income derived from an operating partnership, regardless of whether those taxes are payable by the individuals or by the relevant portfolio company. In addition, individuals who are members of “management company” partnerships operating in New York City will not be able to deduct state and local income taxes imposed with respect to the management company’s income, including their shares of any New York City unincorporated business tax paid by the management company.

### **Special Deduction for Pass-Through Business Income**

The TCJA establishes a new deduction for business income derived by individuals from partnerships and other pass-through arrangements (a “pass-through deduction”). For this purpose, pass-through arrangements include sole proprietorships, S corporations and entities that are treated as partnerships for U.S. federal income tax purposes, including limited liability companies that are treated as partnerships. This deduction will be available for 2018 through 2025.<sup>8</sup>

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<sup>7</sup> In general, U.S. persons other than widely held corporations may deduct their losses from “passive activities” only to the extent of their income from “passive activities.” Disallowed passive activity loss deductions in respect of any passive activity may be carried forward to future years as passive activity losses and, subject to the new limitation on excess business losses, are allowed in full when the taxpayer disposes of its entire interest in the relevant passive activity, provided that the acquirer is unrelated to the taxpayer.

<sup>8</sup> In addition to the deduction in respect of qualified dividend income, qualified REIT income and qualified PTP income described below, an individual may claim a deduction equal to the lesser of (i) 20% of his or her “qualified cooperative (....continued)

- **Deduction for “Qualified Business Income.”** An individual may deduct an amount equal to 20% of the “qualified business income” he or she derives from each “qualified trade or business” in which he or she is engaged, either directly or through ownership of an interest in an entity that is treated as a partnership, subject to the wage cap and the taxable income cap described below.
  - In general, a “qualified trade or business” means any trade or business other than (i) a specified service trade or business, as discussed below, or (ii) the performance of services as an employee.
  - “Qualified business income” generally includes the net income derived from the relevant trade or business, but does not include (i) capital gain or loss, dividends, investment interest and certain other types of investment income, (ii) any compensation paid to the individual for services rendered with respect to the “qualified trade or business,” whether paid as salary, as a “guaranteed payment” by a partnership or otherwise or (iii) any qualified REIT dividends or qualified publicly traded partnership (“PTP”) income, which give rise to a separate pass-through deduction, as described below. Net loss of a trade or business is carried over for purposes of determining the amount of an individual’s “qualified business income” for subsequent taxable years.
- **Deduction for REIT Dividends and PTP Income.** Subject to the taxable income cap described below, an individual may also deduct 20% of (i) any dividends he or she receives from real estate investment trusts (“REITs”), other than any portion of any REIT dividend that constitutes a capital gain dividend or qualified dividend income<sup>9</sup> (“qualified REIT dividends”) and (ii) his or her share of the “qualified business income” of any PTPs, as well as the ordinary income that he or she recognizes on a disposition of an interest in a PTP in respect of certain non-capital assets of the PTP<sup>10</sup> (“qualified PTP income”). The pass-through deduction will generally be available for income derived from a PTP that is engaged in a natural resources business, such as an oil and gas business, but generally will not be available for income derived from an investment management PTP because the income derived directly by such a PTP will generally constitute investment income, rather than “qualified business income.”
- **Taxable Income Cap.** The amount deductible by an individual in respect of qualified business income, qualified REIT income and qualified PTP income for any taxable year may not exceed 20% of the individual’s taxable income, reduced by his or her net capital gain, for such taxable year.
- **Wage Cap.** In general, an individual’s deductible amount in respect of any “qualified trade or business” is capped at the greater of (i) 50% of the individual’s share of the W-2 wages paid to employees in connection with the qualified trade or business and (ii) the sum of 25% of such W-2 wages and 2.5% of the individual’s share of the tax basis,

(continued...)

dividends” and (ii) his or her taxable income, reduced by net capital gain. This memorandum does not address qualified cooperative dividends.

<sup>9</sup> An individual is subject to U.S. federal income tax at a maximum marginal rate of 20% in respect of both REIT capital gain dividends and qualified dividend income.

<sup>10</sup> Under Section 751 of the Code, a person who disposes of an interest in a partnership may recognize ordinary income or loss to the extent that the sale proceeds are treated as attributable to certain unrealized receivables and inventory held by the partnership.

immediately after acquisition, of certain tangible depreciable property used in the qualified trade or business. This cap does not apply to an individual whose taxable income is no more than a certain threshold amount (\$157,500 or, in the case of a joint return, \$315,000) and is phased in on a sliding scale for individuals whose taxable income is between this threshold amount and a higher specified amount (\$207,500 or, in the case of a joint return, \$415,000). The wage cap also does not apply to qualified REIT income or qualified PTP income.

- **Service Businesses Excluded.** The pass-through deduction will not be available in respect of income derived from a “specified service trade or business,” generally defined as a trade or business involving the performance of services in which the reputation or skill of one or more individuals is the principal asset. These categories of business include investment management and investing, trading or dealing in securities, partnership interests or commodities.<sup>11</sup> As a consequence, the special 20% deduction generally will not be available with respect to an individual’s share of income derived from a partnership that sponsors and manages investment funds, regardless of whether the individual is actively engaged in the fund management business or is a passive investor. Similar to the wage cap, however, this exclusion does not apply to an individual whose taxable income is less than a certain threshold amount (\$157,500 or, in the case of a joint return, \$315,000) and is phased in on a sliding scale for individuals whose taxable income is between the threshold amount and a higher specified amount (\$207,500 or, in the case of a joint return, \$415,000).

Fund investors who are individuals will generally be entitled to claim the pass-through deduction in respect of their shares of any “qualified business income” generated by an operating partnership in which the fund invests, as well as their shares of any qualified REIT dividends and qualified PTP income derived by the fund. Although it is not entirely clear how the pass-through deduction rules will apply to individuals who are members of a Carry Entity, it would appear that these individuals may claim deductions for their shares of such “qualified business income,” qualified REIT dividends and qualified PTP income, including the portion of any such income that is allocated to the Carry Entity as carried interest.

### **Tax-Exempt Investors in Funds**

Certain provisions of the TCJA will affect investors that are organizations generally exempt from U.S. federal income tax, including the provisions described below.

**Excise Tax on Net Investment Income.** The TCJA imposes a 1.4% excise tax on the “net investment income” of a private institution of higher education if (i) the institution has at least 500 tuition-paying students more than 50% of whom are located in the United States and (ii) the aggregate value of its assets (other than assets used directly in carrying out its educational purpose) is at least \$500,000 per student. “Net investment income” is defined by reference to rules similar to those applicable to private foundations, which are subject to an excise tax on net investment income under current law, and would generally include income (net of certain expenses) from interest, dividends, rent, payments with respect to securities loans, royalties and capital gains. This tax would generally apply to such an institution’s share of the income of an investment fund.

**UBTI Separately Computed for Each Trade or Business.** In general, tax-exempt organizations are subject to U.S. federal income taxation with respect to any unrelated business taxable income

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<sup>11</sup> However, engineering and architecture are exempted from the “specified service trade or business” category.

(“UBTI”) they derive. UBTI is generally defined as income derived from any trade or business that is not substantially related to the purpose constituting the basis for the organization’s exemption from tax. Most types of investment income are excluded from UBTI, but investment income that would otherwise be excluded will constitute UBTI to the extent it constitutes “debt-financed income” (that is, to the extent that it is derived from property in respect of which “acquisition indebtedness” is outstanding).

A tax-exempt investor’s share of all or most of the income of an operating partnership will constitute UBTI. While some tax-exempt organizations elect to participate in operating partnership investments through investment vehicles that are treated as corporations for U.S. federal income tax purposes (“blockers”), other tax-exempt entities do not elect to participate in these investments through blockers, in large part because, under current law, they can offset net UBTI with net losses derived from UBTI-generating investments.

Under the TCJA, a tax-exempt organization will be required to calculate UBTI separately with respect to each trade or business in which it has an interest. Thus, a tax-exempt organization will not be entitled to use a net operating loss from one trade or business to offset UBTI from another trade or business: the net operating loss will be available only to offset net income generated by the same trade or business in subsequent years. However, the use of a net operating loss arising in a taxable year beginning before January 1, 2018 will be grandfathered. Any such loss may be carried over to subsequent years and used to offset UBTI from a different trade or business. It is not entirely clear how the new limitation applies to debt-financed income, but presumably, a tax-exempt organization would compute its UBTI separately in respect of all of its debt-financed income that consists of income that would otherwise have been excluded from UBTI.

As a result of this “no netting” provision, an increased number of tax-exempt investors may elect to invest in operating partnerships through blockers. Tax-exempt investors may also be less likely to invest in funds that are likely to make a significant number of investments in operating partnerships and more likely to request contractual limitations on the portion of the investors’ commitments that a fund may invest in operating partnerships. In situations in which tax-exempt investors have unblocked interests in a fund with operating partnership investments, the investors will need the fund to provide information that separates the net income or net loss generated by each such operating partnership.

**State and Local Governments.** State and local governments, including pension plans for state and local employees, do not pay U.S. federal income tax on UBTI. An early version of the tax legislation that was introduced in the House would have subjected state and local governments to tax on UBTI. The TCJA contains no such provision.

## **Non-U.S. Investors in Funds**

**Effectively Connected Income on Sale of Partnership Interest.** In general, under pre-TCJA law, the sale by a non-U.S. individual or corporation of an interest in an entity that is treated as a partnership for U.S. federal income tax purposes is not subject to U.S. federal income or withholding tax. However, the Code provides that if a partnership holds one or more “U.S. real property interests” (“USRPIs”) and a non-U.S. person disposes of an interest in the partnership, the portion of the sales proceeds attributable to the USRPIs will be treated as a disposition of the USRPIs, and any gain from this deemed disposition will constitute “effectively connected income” (“ECI”). The non-U.S. person is required to file a U.S. federal income tax return reporting any ECI and is required to pay U.S. federal income tax on a net income basis, at the rates applicable to U.S. persons (either the individual or the corporate rates, as the case may be), in respect of the ECI. In addition, if the non-U.S. person is a corporation, it will be subject to a U.S. branch profits tax at a flat rate of 30% on its “dividend equivalent amount” attributable to certain ECI (very

generally, the after-tax amount of certain ECI that is not treated as reinvested in a U.S. trade or business).

In a 1991 ruling, the IRS extended this rule to cover other ECI-generating assets. The ruling adopted the position that gain derived by a non-U.S. person from the sale or other disposition of an interest in a partnership constitutes ECI to the extent that the gain is attributable to partnership assets, *other than USRPIs*, the sale of which by the partnership would have given rise to gain that is treated as ECI (*i.e.*, assets used in a U.S. trade or business conducted by the partnership). In 2017, the U.S. Tax Court rejected the IRS's position, holding that such gain is not subject to U.S. tax.

The TCJA codifies the 1991 IRS ruling, effective for dispositions of partnership interests on or after November 27, 2017. The new rule applies to dispositions of interests in PTPs (sometimes referred to as "master limited partnerships" or "MLPs"), as well as to dispositions of interests in private partnership.

The TCJA also provides that a non-U.S. person will recognize gain on the disposition of an interest in a partnership even if the disposition is within the ambit of a non-recognition provision of the Code (*e.g.*, a contribution of a partnership interest to another partnership that would not otherwise be a recognition event). The TCJA gives Treasury regulatory authority to prescribe circumstances in which certain non-recognition provisions will apply to defer the recognition of gain under the new provision.<sup>12</sup>

**Withholding Tax on Sale of Partnership Interests.** The TCJA generally requires a buyer of a partnership interest to withhold 10% of the gross purchase price on the sale of the interest unless the seller can establish that it is a U.S. person or that no portion of the seller's gain is attributable to ECI-generating assets. While not explicitly provided in the legislation, the withholding tax would likely also apply to a redemption of a partnership interest. If the buyer fails to withhold, the partnership is liable for the withholding tax, plus interest. Although the substantive tax is applicable to gain realized on dispositions of partnership interests on or after November 27, 2017, as described above, the withholding tax requirement is effective only for dispositions after December 31, 2017.<sup>13</sup>

As a consequence of these new rules, a private fund with a non-U.S. partner that wishes to transfer its interest will need to provide the non-U.S. partner with information regarding the non-U.S. partner's share of the partnership's ECI-generating assets. In general, it would be prudent for the fund to require the transferor and transferee to inform the fund of the sale price and to provide the fund with a copy of the relevant withholding certificate and proof of payment of the withholding tax, if applicable. Because the fund will have ultimate liability for the withholding taxes, private investment funds should consider amending their organizational documents and transfer documents to ensure that the fund is indemnified by the transferor and transferee for any withholding tax imposed under this new provision.

### **Limitations on Deduction for Business Interest**

The TCJA limits the deductibility of "business interest," defined as any interest expense properly allocable to a trade or business. Business interest includes any interest paid or accrued by a

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<sup>12</sup> Treasury has exceptions for non-recognition events in the case of certain transfers of USRPIs by non-U.S. persons. Although these rules would not apply to the portion of any gain that is not attributable to USRPIs, they may serve as a template for eventual exceptions in the case of such non-USRPI gain.

<sup>13</sup> The legislative history states that Treasury may provide guidance permitting a broker to withhold 10% of the sale proceeds as an agent of the transferee (for example, on the sale by a non-U.S. person of units in a PTP).

corporation. This limitation may affect portfolio companies in which funds invest, blocker entities formed by funds and investors in funds.

The deduction for business interest for any taxable year is limited to the sum of (i) the taxpayer's "business interest income," (ii) the taxpayer's "floor plan financing interest"<sup>14</sup> and (iii) 30% of the taxpayer's "adjusted taxable income" ("ATI") for the taxable year. In general, a taxpayer's ATI is its taxable income computed without regard to (i) items not properly allocable to a trade or business, (ii) business interest income or business interest expenses, (iii) any net operating loss deduction, (iv) any pass-through deduction, as discussed above and (v) for taxable years beginning before January 1, 2022, any deduction for depreciation, amortization or depletion. "Business interest income" is any interest income properly allocable to a trade or business.

Any business interest that is not deductible as a consequence of this limitation may be carried forward indefinitely. Following a change of control of a corporation, the corporation's carryforward of unused business interest expenses would be subject to limitation under Section 382 of the Code, which limits the use of a corporation's net operating losses and other tax assets following a change of control.

Existing debt will not be grandfathered. The limitation on the deductibility of business interest will not apply, however, to interest attributable to an electing real property trade or business<sup>15</sup> or to certain other narrowly defined businesses.

In the case of a partnership, the limitation on the deductibility of business interest will apply at the partnership level, by reference to the partnership's ATI and business interest income. After application of the limitation, any partnership deduction for business interest will decrease the net income, or increase the net loss, allocated by the partnership to its partners.

- For purposes of determining the deductibility of business interest paid or accrued directly by a partner, the partner's ATI will be determined without regard to the partner's share of any items of income, gain, deduction or loss of the partnership.
- If a partnership has excess capacity for business interest deductions, each partner's ATI will be increased by its share of the partnership's "excess ATI" (that is, its share of the partnership's ATI that corresponds to such excess capacity).
- A partnership may not carry forward any of its business interest that it is not permitted to deduct. Instead, the excess business interest will be allocated to the partners and may be deducted by the partners to the extent, and only to the extent, of their shares of excess ATI, if any. The allocation of excess business interest to a partner results in certain adjustments to the basis of the partner's interest in the relevant partnership.

If a taxpayer holds an interest in more than one partnership, the limitation is calculated separately for each partnership. As a result of the application of the limitation at the partnership level, a partner's overall deduction for business interest, including the partner's share of the partnership's business interest expenses, may be less than the overall deduction would have been if the

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<sup>14</sup> "Floor plan financing interest" means interest paid or accrued on indebtedness used to finance the acquisition of certain motor vehicles held for sale or lease and secured by the inventory so acquired.

<sup>15</sup> Specifically, it will not apply to any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business that elects not to have the limitation apply. A real property trade or business that makes such an election will be required to recover the cost of certain of its property over a longer period of time (and thus will have lower annual cost recovery deductions) than a real property trade or business that does not make such an election.

limitation applied at the partner level. Rules similar to the rules for partnerships will apply with respect to S corporations and their shareholders.

The limitation on the deductibility of business interest will affect portfolio companies that are treated as corporations for tax purposes and investors in operating partnerships. Moreover, it will significantly reduce the impact of debt incurred by a blocker entity. A blocker generally has no income other than its share of the income of the operating partnership(s) for which it serves as an investment vehicle. As a result of the partner-level calculation described above, the blocker will have no ATI other than ATI that is attributable to its share of any excess ATI of the operating partnership. In the absence of any excess ATI, a leveraged blocker would not receive a current tax benefit for any interest paid or accrued on its debt. However, if gain from the sale of an interest in an operating partnership is treated as ATI (a point that is not clear), the blocker could use its carryforward of business interest expense to offset its share of any gain from the sale of the blocker.

In general, this limitation will not affect a non-corporate partner's share of interest paid or accrued on fund-level indebtedness because that interest would generally be considered investment interest, rather than business interest. Instead, the non-corporate partner's share of this interest would be subject to the pre-existing limitations on the deductibility of investment interest. It is not clear whether the interest in any fund-level borrowing that is incurred to finance the fund's investment in an operating partnership would be treated as business interest.

### **Certain Provisions Affecting Portfolio Companies**

Some of the provisions of the TCJA that may have a significant effect on portfolio companies are described below.

**Full Expensing for Certain Business Assets.** Under current law, a taxpayer is allowed a first-year depreciation deduction equal to 50% of the adjusted basis (generally, the cost) of certain depreciable property it acquired and placed in service before January 1, 2021 ("bonus depreciation"). This deduction is allowed only if the taxpayer was the first user of the property. The TCJA extends the application of the first-year deduction to property placed in service before January 1, 2027. Moreover, for property placed in service after September 27, 2017 and before January 1, 2023, the deduction will be equal to 100% of the adjusted basis of the relevant property. The percentage ratchets down for property placed in service during subsequent years: 80% for 2023; 60% for 2024; 40% for 2025; and 20% for 2026.<sup>16</sup> Each of these dates is extended one year in the case of certain property with a longer production period.

The TCJA also removed the requirement that the taxpayer be the first user of the property, thus permitting a taxpayer to claim the deduction for used property that it acquires. Certain restrictions on the deduction in respect of used property, including the requirement that the property be acquired from an unrelated party, are intended to prevent abuse of this provision.

**Net Operating Loss Deduction.** Under current law, a taxpayer is permitted to carry a net operating loss back for two years and forward for twenty (20) years and could use a net operating loss carryback or carryover to offset all of its taxable income (determined without regard to the net operating loss deduction) for a taxable year. The TCJA eliminates the two-year carryback and provides that a net operating loss may be carried forward indefinitely. In addition, it limits the amount of a net operating loss carryover that may be used in any taxable year to 80% of the taxpayer's taxable income, determined without regard to the net operating loss deduction.

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<sup>16</sup> Special rules apply to property acquired before, and placed in service on or after, September 28, 2017.

However, these changes in the rules relating to net operating losses do not apply to insurance companies.

### Certain International Provisions

Provisions of the TCJA that change the international tax rules may affect both portfolio companies and fund investors, including members of a Carry Entity. As noted below, these provisions are in several respects more favorable for corporations than for non-corporate taxpayers.

**Controlled Foreign Corporations.** Certain significant U.S. shareholders of a “controlled foreign corporation” (a “CFC”) are required to include in income each year, as ordinary income, their shares of certain types of the CFC’s income (“subpart F income”), as well as the earnings that the CFC invests, or is treated as investing, in “United States property,” regardless of whether the CFC makes any distributions. In addition, all or a portion of any gain recognized by such a shareholder on the sale or other disposition of stock in a CFC may be treated as dividend income. The TCJA has made a number of changes that will increase the situations in which a foreign corporation is treated as a CFC and will increase the universe of U.S. shareholders who are subject to the tax consequence of the CFC regime.

- In general, a non-U.S. corporation will be a CFC if more than 50% of its stock (based on value or voting power) is owned, directly or under applicable constructive ownership rules, by U.S. persons each of which owns a specified percentage of the CFC’s stock (each such U.S. person, a “10% U.S. Shareholder”).<sup>17</sup> Under current law, a 10% U.S. Shareholder is defined as a U.S. person that owns, directly or under applicable constructive ownership rules, at least 10% of the voting power of the non-U.S. corporation’s stock. The TCJA expands this definition to include any U.S. person that owns, directly or under applicable constructive ownership rules, at least 10% of the voting power **or value** of the non-U.S. corporation’s stock.
- The TCJA also expands the constructive ownership rules that are applied for determining whether a U.S. person is a 10% U.S. Shareholder of a foreign corporation. Under prior law, certain ownership attribution rules did not apply so as to treat a U.S. person as owning stock that is owned by a non-U.S. person. This limitation has been repealed.
- Under current law, the consequences of the CFC regime apply to 10% U.S. Shareholders of a foreign corporation for any taxable year only if the foreign corporation has been a CFC for an uninterrupted period of 30 days or more during any taxable year. Under the TCJA, these consequences will apply if the foreign corporation has been a CFC at any time during a taxable year.

In certain situations, these changes may render ineffective prior planning that was intended to prevent a foreign corporation from being treated as a CFC or investors from being treated as 10% U.S. Shareholders. In general, however, the structures commonly used by private equity funds for investments in non-U.S. corporations, which are intended to prevent fund investors from being treated as 10% U.S. Shareholders, should not be affected by these changes.

**PFIC Rules Regarding the Active Conduct of Insurance Business.** A U.S. person may be subject to certain adverse U.S. federal income tax consequences as a result of holding an equity interest in a PFIC. In general, a non-U.S. corporation will be treated as a PFIC for a taxable year if either (i) 75% or more of its gross income for such taxable year is passive income or (ii) 50% or more of its assets in such year (determined on the basis of average quarterly asset values)

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<sup>17</sup> Different ownership thresholds apply with respect to an investment in a non-U.S. corporation that is engaged in an insurance business.

produce, or are held for the production of, passive income. Under a statutory exception, income derived from an active insurance business is not treated as passive income for purposes of the PFIC rules. Some fund sponsors have offered for investment shares of foreign reinsurance companies that contract with the sponsor (or an affiliate of the sponsor) to manage the investment of the reinsurance company's reserves, and these reinsurance companies generally take the position that they are not PFICs.

Under the TCJA, income derived by a foreign insurance or reinsurance company will qualify for the exemption under the PFIC rules only if (i) the foreign corporation would be subject to tax under the provisions of the Code relating to insurance companies if it were a U.S. corporation and (ii) the foreign corporation's "applicable insurance liabilities" constitute at least 25% of its total assets (any such corporation, a "qualifying insurance corporation").<sup>18</sup> The second requirement is more objective (and, for certain foreign corporations, may be more restrictive) than the statutory language prior to the enactment of the TCJA, which required that the foreign corporation be "primarily engaged in an insurance business." The new rule is mitigated to some extent by an exception under which a shareholder of a foreign corporation that would be a qualifying insurance corporation but for its failure to meet the "applicable insurance liabilities" test may elect to treat the foreign corporation as a qualifying insurance corporation if the foreign corporation's "applicable insurance liabilities" constitute at least 10% of its total assets and, under regulations and based on the applicable facts and circumstances, (i) the foreign corporation is predominantly engaged in an insurance business and (ii) the failure to satisfy the "applicable insurance liabilities" test is due solely to run-off-related or rating-related circumstances involving its insurance business.<sup>19</sup>

**Dividends-Received Deduction for Distributions from Foreign Subsidiaries.** The TCJA introduces a modified "territorial" system of corporate income taxation under which certain income earned by certain foreign subsidiaries of U.S. corporations is not subject to tax when it is repatriated to the United States. The approach of the TCJA is not a full territorial system, however. The dividends-received deduction that gives effect to the system does not apply to a 10% U.S. Shareholder's inclusions of subpart F income of a CFC or inclusions of earnings that the CFC invests in "United States property," even if the CFC distributes an amount equal to those inclusions during the same taxable year.

As noted above, the modified territorial system is implemented by means of a dividends-received, or "participation," deduction. Specifically, a U.S. corporation generally may deduct the amount of the "foreign-source portion" of any dividend it receives from a foreign corporation in which it is a 10% U.S. Shareholder, regardless of whether the corporation is a CFC, provided that it satisfies a one-year holding period requirement with respect to the stock of the foreign corporation (the "Foreign-Source DRD"). Very generally:

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<sup>18</sup> For this purpose, "applicable insurance liabilities" generally means, with respect to any life or property and casualty insurance business, loss and loss adjustment expenses and, subject to certain limitations, reserves (other than deficiency, contingency or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing for mortality or morbidity risks. The determination of the percentage that a non-U.S. corporation's "applicable insurance liabilities" constitute of its total assets is made in accordance with its financial statements that are (i) prepared in accordance with GAAP, (ii) prepared in accordance with IFRS or (iii) required to be filed with the applicable insurance regulatory body, in that order of priority.

<sup>19</sup> Treasury regulations proposed prior to the enactment of the TCJA would, if finalized in their current form, require that a foreign insurance or reinsurance company act through its own officers and employees (rather than officers and employees of related companies) in order to be treated as engaged in the active conduct of an insurance business for purposes of the exception in the PFIC rules. These proposed regulations would also exclude from the exception any investment income that is not required to support or is not substantially related to insurance or annuity contracts issued or reinsured by the foreign corporation.

- the “foreign-source portion” of any such dividend is determined by reference to the ratio of the foreign corporation’s “undistributed foreign earnings” to its total undistributed earnings at the close of its taxable year; and
- a foreign corporation’s “undistributed foreign earnings” are defined as its undistributed earnings that are not attributable to (i) ECI (that is, income effectively connected with the conduct of a trade or business in the United States) or (ii) dividends from U.S. corporations in which the foreign corporation owns at least 80% of the stock (by voting power and value).<sup>20</sup>

The Foreign-Source DRD will not apply to any dividend received from a foreign corporation that is a “passive foreign investment company” (a “PFIC”) that is not a CFC. Several rules are aimed at preventing the duplication of tax benefits.<sup>21</sup>

**Transition Tax in Respect of Deferred Foreign Income.** In connection with the introduction of the Foreign-Source DRD, the TCJA provides for a one-time transition tax. Very generally, a U.S. person that owns, directly or under applicable constructive ownership rules, at least 10% of the voting power of the stock of a “specified foreign corporation” (that is, a 10% U.S. Shareholder, as defined under pre-TCJA law, of the specified foreign corporation, referred to in this section as a “Specified 10% U.S. Shareholder”) must include in income its *pro rata* share of the foreign corporation’s undistributed post-1986 earnings and profits (“E&P”), except for any portion of such E&P that has previously been subject to U.S. federal income tax.<sup>22</sup> The Specified 10% U.S. Shareholder will have the income inclusion for its taxable year that ends with, or includes, the end of the specified foreign corporation’s last taxable year beginning before January 1, 2018. A “specified foreign corporation” is (i) a CFC or (ii) any foreign corporation with respect to which one or more U.S. corporations is a Specified 10% U.S. Shareholder. Even though the Foreign-Source DRD is available only to corporations, the inclusion requirement applies to all Specified 10% U.S. Shareholders of a specified foreign corporation, including individuals.

If any of the specified foreign corporations in which a U.S. person is a Specified 10% U.S. Shareholder have post-1986 E&P deficits, the aggregate amount otherwise includible by the Specified 10% U.S. Shareholder will be reduced (but not below zero) by the aggregate amount of the Specified 10% U.S. Shareholder’s *pro rata* share of these post-1986 E&P deficits. This calculation will occur on a netted basis among U.S. members of an affiliated group of corporations (with affiliation determined by ownership of at least 80% of voting power and value).

<sup>20</sup> As under prior law, a U.S. corporation that owns at least 10% of the stock of a foreign corporation (by vote and value) may claim a dividends-received deduction equal to a specified percentage of the “U.S.-source portion” of any dividend it receives from the foreign corporation. Generally, the “U.S.-source portion” is the post-1986 undistributed earnings of the foreign corporation that do not constitute “undistributed foreign earnings, as defined above.”

<sup>21</sup> No foreign tax credit or deduction will be allowed for any foreign taxes, including withholding taxes, paid (or any entity-level foreign taxes that are deemed paid) by the Specified 10% U.S. Shareholder with respect to a dividend for which a Foreign-Source DRD is allowed. The Foreign-Source DRD will not apply to any “hybrid dividend” – that is, a dividend with respect to which the CFC received a deduction or other tax benefit, with respect to income or certain other taxes, from any foreign country or U.S. possession. In addition, if a CFC with respect to which a U.S. corporation is a Specified 10% U.S. Shareholder receives a “hybrid dividend” from another CFC with respect to which such U.S. corporation is also a Specified 10% U.S. Shareholder, the U.S. corporation will be required to include its *pro rata* share of the “hybrid dividend” in income as subpart F income under the CFC rules. No foreign tax credit or deduction will be allowed for any foreign taxes paid (or deemed paid) with respect to a “hybrid dividend” or a subpart F income inclusion attributable to a “hybrid dividend.” Solely for purposes of determining any loss on a U.S. corporation’s disposition of the stock of a foreign corporation, the U.S. corporation’s tax basis in such stock will generally be reduced (but not below zero) by the amount of any Foreign-Source DRD allowable to the U.S. corporation with respect to such stock.

<sup>22</sup> The amount of untaxed accumulated post-1986 E&P is determined as of November 2, 2017 or December 31, 2017, whichever date results in a larger amount.

A Specified 10% U.S. Shareholder will be allowed to claim a deduction equal to a portion of the amount included in income under the transition rule. For a corporate Specified 10% U.S. Shareholder, this deduction results in (i) a 15.5% tax on the portion of the inclusion that is attributable to cash and other liquid assets and (ii) an 8% tax rate on the remainder of the inclusion.<sup>23</sup> Because the amount of the deduction is defined in a manner that results in the relevant tax rates by reference to the regular rate of corporate income tax, the tax rates on the income inclusions will be significantly larger for non-corporate Specified 10% U.S. Shareholders.

A Specified 10% U.S. Shareholder may elect to pay the tax resulting from this inclusion in installments over eight years, with the installments increasing in size after the fifth year. There is no provision under which this election is made separately by each partner of a U.S. partnership that is a Specified 10% U.S. Shareholder of a “specified foreign corporation.” Therefore, in the absence of further guidance, the election would be made by the U.S. partnership.

If an S corporation has an income inclusion under this transition rule, each shareholder of the S corporation may elect to defer payment of such shareholder’s resulting tax liability until the occurrence of a “triggering event.” A “triggering event” which is the earliest to occur of (i) the corporation’s ceasing to be an S corporation, (ii) a liquidation or sale of substantially all of the assets of the S corporation and (iii) a transfer of any stock of the S corporation by such shareholder (including by reason of death), unless the transferee enters into an agreement with the Internal Revenue Service (the “IRS”) under which it assumes liability for the deferred tax.<sup>24</sup> If a shareholder elects to defer the income inclusion, the S corporation will be jointly and severally liable for the payment of the deferred tax. Upon the occurrence of a “triggering event” (other than a liquidation, or sale of substantially all of the assets, of the S corporation), the shareholder may elect to pay the resulting tax in installments over eight years, as described above.<sup>25</sup> No similar election is available to a partnership that has an income inclusion under the transition rule.

A U.S. partnership that is a fund vehicle may be a Specified 10% U.S. Shareholder in a specified foreign corporation. If so, all taxable U.S. investors in that partnership will be subject to their shares of the transition tax, without regard to their indirect percentage interests in the foreign corporation. The fund manager might consider converting the partnership into a non-U.S. partnership before the last day of the specified foreign corporation’s last taxable year that begins before January 1, 2018, which is the date as of which the Specified 10% U.S. Shareholders subject to the inclusion will be determined. If that is not feasible, investors in the partnership, including members of the relevant Carry Entity, might wish to consider forming S corporations before that date to hold their partnership interests (or their interests in the Carry Entity, as the case may be). It is typical, however, for private funds to structure investments in foreign corporations in a manner intended to prevent any taxable U.S. person from being a Specified 10% U.S. Shareholder.

**Global Intangible Low-Taxed Income and Foreign Derived Intangible Income.** The TCJA creates a special reduced tax regime on certain foreign-derived income that is treated as attributable to intellectual property and other intangible assets. The regime has two principal features.

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<sup>23</sup> No foreign tax credit or deduction will be allowed for an applicable percentage, reflecting the relevant deduction calculations, of any foreign taxes paid (or deemed paid) with respect to any amount for which the deduction is allowed.

<sup>24</sup> A transfer of fewer than all of such shareholder’s S corporation shares is a triggering event with respect to only the portion of the deferred tax liability that is properly attributed to the transferred shares.

<sup>25</sup> Upon a liquidation (or sale of substantially all of the assets) of the S corporation, a shareholder may make this election only with the consent of the IRS.

- First, a 10% U.S. Shareholder of a CFC (whether or not such 10% U.S. Shareholder is a corporation) is required to include its share of the CFC's "global intangible low-taxed income" ("GILTI") in income each year, with the result that deferral of U.S. taxation of this income is eliminated. Very generally, GILTI is the portion of the CFC's net income (determined without regard to ECI, gross income included by the 10% U.S. Shareholder as subpart F income and certain other types of income) that exceeds an amount equal to (i) a routine rate of return on the CFC's tangible depreciable business assets minus (ii) the amount of the interest expense taken into account in determining the CFC's net income for this purpose (other than interest expense attributable to certain intercompany interest payments).
- Second, a U.S. corporation is entitled to deductions generally equal to (i) 50% of its GILTI inclusion and the Deemed GILTI Dividend, as defined below, and (ii) 37.5% of its "foreign-derived intangible income" ("FDII"). FDII is generally the portion of the U.S. corporation's net income (other than GILTI and certain other income<sup>26</sup>) that exceeds a routine rate of return of the U.S. corporation's tangible depreciable business assets and is attributable to certain sales of property to foreign persons or to the provision of certain services to any person, or with respect to any property, located outside the United States.

Subject to certain limitations, a U.S. corporation that has a GILTI inclusion in respect of a CFC will be entitled to a "deemed paid" foreign tax credit equal to 80% of the foreign income taxes paid by a CFC that are treated as attributable to the CFC income corresponding to the GILTI inclusion. As is the case with any "deemed paid" taxes of a CFC for which a U.S. corporation claims a foreign tax credit, the amount of the creditable foreign taxes will be treated as a dividend distributed by the CFC to the U.S. corporation (a "Deemed GILTI Dividend").

The effect of these provisions is different for corporations and non-corporate taxpayers. Specifically, while any 10% U.S. Shareholder of a CFC, including an individual, is required to include GILTI in income, the deduction for GILTI and FDII is available only to corporations.

**Base Erosion and Anti-Abuse Tax.** In order to prevent erosion of the tax base subject to U.S. federal income tax, the TCJA imposes an excise tax on certain deductible amounts paid by large U.S. corporations to related foreign persons. The TCJA directs Treasury to issue regulations intended to prevent avoidance of this excise tax, including avoidance by means of the use of conduit transactions and intermediaries.

A U.S. corporation will be subject to this tax for any taxable year only if (i) the average annual gross receipts of the affiliated group of corporations to which it belongs (with affiliation generally determined by reference to more than 50% of vote and value) for the three-year period ending with the preceding taxable year are at least \$500 million and (ii) at least 3%<sup>27</sup> of the aggregate deductions and certain other tax benefits of such affiliated group for such taxable year (with certain exclusions) consist of certain deductions and other tax benefits attributable to certain payments made by the corporation to foreign related parties ("base erosion tax benefits").<sup>28</sup> For this purpose, a related party includes a person owning, directly or pursuant to constructive ownership rules, at least 25% of the voting power or value of the relevant corporation's stock, any person related to such corporation or to such 25% owner pursuant to certain pre-existing

<sup>26</sup> Other excluded income includes subpart F income, dividends received from CFCs in respect of which the U.S. corporation is a 10% U.S. Shareholder, business profits of the U.S. corporation's foreign branches, certain financial services income and domestic oil and gas extraction income.

<sup>27</sup> The threshold is 2% for a member of an affiliated group of corporations that includes a bank or a registered securities dealer (with affiliation determined by ownership of at least 80% of voting power and value).

statutory related-party rules and, more generally, any person treated as a related to such corporation for purposes of the statutory rules on transfer pricing.

The excise tax payable by such a corporation for any taxable year is an amount equal to the excess, if any, of (i) a specified percentage of the corporation's taxable income, computed without regard to any base erosion tax benefits or the portion of its net operating loss that is treated as attributable to base erosion tax benefits over (ii) the corporation's regular income tax liability for the taxable year, reduced (but not below zero) by the credits allowed against such liability, other than certain specified credits (e.g., the research credit). The specified percentage is 5% for taxable years beginning in 2018; 10% for taxable years beginning after December 31, 2018 and before January 1, 2026; and 12.5% for subsequent taxable years. In addition, for taxable years beginning on or after January 1, 2016, the corporation's regular income tax liability will be reduced by all allowable credits for purposes of determining the amount of the excise tax it owes.<sup>29</sup>

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<sup>28</sup> Regulated investment companies, REITs and S corporations are not subject to this tax.

<sup>29</sup> In the case of a member of an affiliated group of corporations that includes a bank or a registered securities dealer, each of these percentages is increased by one percentage point (i.e., to 6%, 11% and 13.5%).

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If you have any questions regarding the matters covered in this publication, please contact your regular Davis Polk contact.