



Corporate Tax

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Introduction

Since December 22, 2017, corporate tax practitioners in the United States have been predominantly focused on the impact of legislation commonly known as the Tax Cuts and Jobs Act (the “Act”), which was signed into law on that date. In the ensuing months, the U.S. Treasury Department (“Treasury”) and the Internal Revenue Service (the “IRS”) have had the monumental task of issuing Treasury Regulations addressing the numerous provisions of the Act. In the meantime, prior to the release of regulatory guidance, corporations and practitioners alike have been grappling with how to implement the modifications to the Internal Revenue Code of 1986, as amended (the “Code”).

The Act was promulgated over 18 months ago, so our focus will be on the key regulatory guidance that has been released in the past year rather than on the provisions of the Act itself.

Deemed dividend inclusions under Section 956

Under Section 956,¹ a U.S. 10% shareholder of a controlled foreign corporation (“CFC”) that has made investments in certain U.S. property is deemed to have dividend income based on the U.S. 10% shareholder’s *pro rata* share of the CFC’s investment in U.S. property. Section 956 provides that investments in U.S. property include obligations of the U.S. 10% shareholder. Under applicable regulations,² an obligation includes a pledge by the U.S. 10% shareholder of more than 65% of the voting stock of the CFC as well as a guarantee of the debt of such U.S. 10% shareholder by the CFC.

One of the key features of the Act is Section 245A, which introduced a modified territorial tax system by including a participation exemption pursuant to which corporate U.S. 10% shareholders of certain foreign corporations, including CFCs, are entitled to a 100% dividends-received deduction for dividends distributed to the U.S. shareholder. Unexpectedly, however, the Act did not modify Section 956, meaning that corporate U.S. 10% shareholders of a CFC continued to be taxed on deemed dividend income, even though an actual dividend would have been eligible for a 100% deduction.

The IRS issued proposed regulations in November 2018³ (the “Proposed 956 Regulations”), which were finalised in May 2019⁴ (the “Final 956 Regulations”). These regulations are intended to reconcile Section 956 and the participation exemption. The Final 956 Regulations are effective as of July 22, 2019. Although taxpayers were entitled to rely on the Proposed 956 Regulations until finalised, in practice many taxpayers did not do so. The Final 956 Regulations provide that for corporate U.S. 10% shareholders of a CFC, the amount of income inclusion determined under Section 956 is reduced to the extent the shareholder would have been eligible for a dividends-received deduction under Section 245A

if the shareholder had actually received a dividend in the same amount. The Final Regulations also include changes to the ordering rules of previously taxed income under Section 959. The net effect of the Final Section 956 Regulations is that, in general, a corporate U.S. 10% shareholder should no longer face deemed dividend income consequences by pledging voting stock of its CFC or having its CFC guarantee the shareholder's obligations. The same is not true, however, for non-corporate U.S. 10% shareholders (e.g., partnerships) – because Section 245A does not apply to these shareholders, they must still contend with Section 956.

Transition tax

The implementation of the modified territorial system resulting from the introduction of the dividends received deduction under Section 245A required certain transition rules to rationalise the old and new taxing regimes, including a so-called “transition tax” on the previously untaxed earnings of certain foreign corporations. This result is accomplished under new Section 965 by increasing the Subpart F income of these foreign corporations for their last taxable year beginning before January 1, 2018 by the greater of the “accumulated post-1986 deferred foreign income” determined as of November 2, 2017 or December 31, 2017. The corporation's asset mix determines the applicable rate of tax – earnings held in the form of cash and cash equivalents are subject to tax at a higher 15.5% rate, as compared to an 8% rate on other earnings. In addition, under Section 965(h), a taxpayer can elect to make payments of the transition tax over eight annual instalments.

The IRS issued Proposed Regulations on August 9, 2018⁵ and Final Regulations effective February 5, 2019⁶ (the “Proposed Transition Tax Regulations” and the “Final Transition Tax Regulations”, respectively) addressing the calculation of the transition tax. The Final Regulations generally adopted the Proposed Regulations, with certain modifications. Anti-avoidance rules disregard transactions undertaken on or after November 2, 2017 with a principal purpose of changing the Section 965 inclusion amount of a U.S. 10% shareholder, the aggregate foreign cash position or the amount of foreign income taxes deemed paid by the U.S. 10% shareholder as a result of a Section 965 inclusion. Certain transactions, referred to as cash reduction transactions, E&P reduction transactions and *pro rata* share transactions, are rebuttably presumed to be undertaken with a principal purpose of having such effect.

Further, under the Final Regulations, any change in method of accounting for a corporation for a taxable year ending in 2017 or 2018 is generally disregarded for purposes of calculating Section 965 amounts if the method change would change the Section 965 inclusion amount of a U.S. 10% shareholder or the aggregate foreign cash position, or would change the amount of foreign income taxes deemed paid by the U.S. 10% shareholder, other than by reason of an increase in the Section 965(a) inclusion amount. This is true regardless of whether the accounting method change is made with the principal purpose of having such effect, and regardless of whether the method change was properly made. Check-the-box elections made on or after November 2, 2017 are disregarded under similar circumstances.

Global Intangible Low-Taxed Income (“GILTI”)

Under Section 951A, a U.S. 10% shareholder of a CFC is required to include in income its *pro rata* share of the GILTI of such CFC. At a high level, GILTI is the business income of a CFC less a 10% return on the CFC's tangible non-U.S. assets. For U.S. 10% shareholders that are corporations, a 50% deduction is available, which is reduced to 37.5% in tax years beginning after December 31, 2025, resulting in a tax rate of 10.5% or 13.125%. In addition,

corporate U.S. 10% shareholders (but not other U.S. 10% shareholders) may claim an indirect foreign tax credit for 80% of any foreign tax paid by the CFC that is allocable to GILTI. On June 14, 2019, the IRS released final⁷ and proposed⁸ regulations (“Final GILTI Regulations” and “Proposed GILTI Regulations”, respectively) which provide guidance related to the determination of a U.S. 10% shareholder’s *pro rata* share of GILTI. The details of the GILTI Regulations are beyond the scope of this chapter, but a few items are worth highlighting.

Section 951A(c)(2)(A)(i)(III) provides that gross income excluded from the foreign base company income and insurance income of a CFC by reason of Section 954(b)(4) (i.e., gross income that is excluded from subpart F income because it is subject to an effective foreign income tax rate of greater than 90% of the U.S. corporate income tax rate (currently 18.9%)) is also excluded from the GILTI calculations. Prior proposed regulations (the “Prior Proposed GILTI Regulations”) had limited the GILTI high-tax exclusion to income that otherwise would have been subpart F income.⁹ This exclusion was adopted by the Final GILTI Regulations and applies to taxable years of foreign corporations beginning after December 31, 2017.

In response to numerous comments, the Proposed Regulations broaden the high-tax exclusion from GILTI to provide that an election may be made to exclude any gross income subject to foreign income tax at an effective rate that is greater than 90% of the current maximum corporate rate, even if the income would not otherwise have been subpart F income. If the election is made with respect to a CFC, it applies to all income from that CFC and is binding on all U.S. shareholders of the CFC. In addition, if a U.S. 10% shareholder owns more than 50% of a CFC, the election applies to all CFCs that are more than 50% owned by such shareholder. Notwithstanding the “all or nothing” approach to the high-tax exclusion, the Proposed GILTI Regulations do not appear to require consistency between the high-tax election for GILTI and a similar election for subpart F income. The broader high-tax exclusion described in the Proposed GILTI Regulations is not effective until adopted as Final Regulations.

The Final GILTI Regulations provide that U.S. partnerships are not treated as owning stock of a foreign corporation for purposes of determining the GILTI inclusion – instead, the partners of the partnership are treated as owning the stock of the CFC on a *pro rata* basis, meaning that solely for purposes of calculating GILTI, the 10% U.S. shareholder status is determined at the partner level. The Proposed GILTI Regulations extend this to Subpart F/Section 951 and Section 956 inclusions on a prospective basis, although taxpayers may elect to rely on the provision in the Proposed GILTI Regulations for taxable years of foreign corporations beginning after December 31, 2017.

The Prior Proposed GILTI Regulations contained a very broad anti-abuse rule that would disregard transactions that are part of a plan a principal purpose of which is to avoid U.S. federal income tax for purposes of determining a U.S. shareholder’s *pro rata* share of subpart F income under Section 951 and determining the *pro rata* share of tested items of a CFC for purposes of determining GILTI. In response to comments regarding the breadth of this rule, the Final GILTI Regulations provide that the anti-abuse rule applies only to reallocate the amount of allocable earnings and profits that would be distributed in a hypothetical distribution with respect to any share of stock outstanding as of the date of the hypothetical distribution, as if such transactions had not occurred.

Foreign-Derived Intangible Income (“FDII”)

The counterpart to GILTI is provided by Section 250 – an incentive for domestic corporations (other than RICs, REITs and S corporations) to invest in U.S. operations by providing a deduction with respect to income from products sold for foreign use or services provided

by a domestic corporation to any person or with respect to property not located in the United States, less a 10% return on tangible assets.¹⁰ The deduction is 37.5% for tax years beginning before January 31, 2026 and 21.875% for tax years beginning after December 31, 2025, resulting in an effective tax rate of 13.125% and 16.406%, respectively.

Treasury and the IRS released proposed regulations regarding FDII on March 4, 2019¹¹ (the “Proposed FDII Regulations”). The Proposed FDII Regulations provide that domestic corporate partners of a partnership receive the benefit of the FDII deduction, which is computed and allowed solely at the corporate partner level. The Proposed FDII Regulations also provide a number of rules relevant to calculating FDII, including whether a sale of property or a provision of services is eligible for the deduction. “Sale” includes leases, licences and other dispositions of property, including a transfer that results in gain under Section 367. Generally, a sale of property other than intangible property is for foreign use if the customer is foreign and the property is not subject to domestic use for three years after sale, or is subject to further manufacture, assembly or processing outside the United States before domestic use. A sale of intangible property is for foreign use only if it is exploited outside the United States, based on the location of the end user.

The Proposed FDII Regulations divide services into four categories: (i) proximate services where the provider and the recipient are in physical proximity when the service is performed; (ii) services with respect to tangible property; (iii) transportation services; and (iv) other services. For purposes of determining whether a provision of services to a person or with respect to property not located within the United States, the relevant location is: (i) the location of the performance of proximate services; (ii) the location of the property services; (iii) the origin and destination of transportation services; and (iv) the location of the recipient of other services, respectively.

The Proposed FDII Regulations include extensive documentation requirements depending on the nature of the property sold or service rendered, as well as reliability requirements (i.e., that the seller or provider does not know or have reason to know that the documentation is unreliable), and the documentation is obtained no earlier than one year before the date of sale or service and no later than the due date (with extension) of the seller or provider’s income tax return for the taxable year in which income is included from the sale of property or provision of service. The Proposed FDII Regulations are proposed to apply to taxable years ending on or after March 4, 2019. However, for taxable years beginning on or before March 4, 2019, taxpayers may use any reasonable documentation maintained in the ordinary course of business for purposes of determining foreign use, provided the reliability requirements described above are satisfied.

Base Erosion and Anti-Abuse Tax (“BEAT”)

The BEAT is an additional tax that is designed to limit the ability of large U.S. corporations to reduce their corporate tax liability by making deductible payments to related non-U.S. entities (so-called base erosion payments), such as royalties, interest, and compensation for services. The BEAT is imposed only on corporations (other than regulated investment companies, real estate investment trusts and S corporations) that average \$500 million in gross receipts over the prior three-year period and have a base erosion percentage of 3% or more (2% if the corporation’s affiliated group includes a domestic bank or registered securities dealer).¹² The base erosion percentage is equal to the total base erosion tax benefits (generally reflecting the reduction in taxable income attributable to base erosion payments) for the taxable year divided by total deductions (with certain exceptions for deductions that

do not arise as a result of a payment by the taxpayer, such as the deduction for net operating losses (“NOLs”), the dividends-received deduction under Section 245A and the deductions for GILTI and FDII plus base erosion tax benefits not already included in total deductions. The BEAT is essentially a minimum tax equal to the excess of 10% of the taxpayer’s modified taxable income (for taxable years beginning in 2019, which increases to 12.5% beginning 2026) over its regular tax liability (with certain adjustments). Modified taxable income is determined like regular taxable income, but without reduction for base erosion tax benefits or a certain portion of the NOLs.

Treasury and the IRS released proposed regulations regarding the BEAT on December 13, 2018¹³ (“Proposed BEAT Regulations”). The Proposed BEAT Regulations provide guidance on many aspects of the BEAT, including which taxpayers are subject to BEAT, and how to calculate the base erosion percentage and modified taxable income. The Proposed BEAT Regulations also addressed the application of BEAT to banks and registered securities dealers, as well as to partnerships, insurance companies and consolidated groups. The Proposed BEAT Regulations were originally proposed to apply retroactively to taxable years beginning after December 31, 2017, but the preamble stated that provisions of the Proposed BEAT Regulations finalised after June 22, 2019 would apply to taxable years ending on or after the date the Proposed BEAT Regulations were filed in the Federal Register (December 17, 2018). Taxpayers are permitted to rely on the Proposed BEAT Regulations for taxable years beginning after December 31, 2017 provided that all related taxpayers consistently apply them.

Section 59A(d)(5) provides that base erosion payments do not include amounts paid for services that are eligible to be priced under the “services cost method” under Section 482 (generally, back office and administrative activities¹⁴). Prior to issuance of the Proposed BEAT Regulations, one area of interest to multinational companies was whether this exception applied to services eligible for the “cost of services plus method” under Section 482. The Proposed BEAT Regulations provide that service payments under a cost plus method are eligible for the exception as to the portion of the payments that represent the cost, so that only the mark-up constitutes a base erosion payment.

Deductions for business interest expense: Section 163(j)

Section 163(j) limits a taxpayer’s ability to deduct business interest to the sum of the taxpayer’s business interest income, 30% of its adjusted taxable income (EBITDA for taxable years beginning before January 1, 2022 and EBIT afterwards) and the floor plan financing interest for the year. Section 163(j) does not apply to a taxpayer (other than a tax shelter prohibited from using the cash method of accounting under Section 448(a)(3)) with average annual gross receipts for the prior three-year period of \$25 million or less. Any business interest expense that is disallowed under Section 163(j) may be carried forward indefinitely. Unlike prior law, Section 163(j) is no longer limited to corporations, highly leveraged companies or related party debt. The Proposed Regulations¹⁵ (the “Proposed 163(j) Regulations”) defined interest very broadly to include not only amounts treated as interest for tax purposes, but also amounts that are related to debt instruments or could be paid in *lieu* of interest, such as commitment fees, debt issuance costs, substitute interest payments and guaranteed payments paid by a partnership. In addition, the Proposed 163(j) Regulations contain an anti-avoidance rule that extends Section 163(j) to any deductible expense or loss “predominantly incurred” in consideration of the time value of money. The Proposed 163(j) Regulations also include complex rules governing how partnerships allocate Section 163(j) items to their partners. Finally, the Proposed 163(j) Regulations confirm that one Section

163(j) limitation applies to an affiliated group of corporations filing a consolidated return, and provide a default rule with respect to CFCs that Section 163(j) applies to determine the deductibility of their interest expense in the same manner as for domestic C corporations (on a CFC-by-CFC basis). An alternative method is provided by election to calculate the Section 163(j) limitation of 80% related CFCs on a group basis.

Case updates

*South Dakota vs. Wayfair, Inc.*¹⁶

On June 21, 2018, the U.S. Supreme Court ruled that a state can impose sales tax collection obligations on a seller without any physical presence in the taxing state, so long as the seller has sufficient connections with the state, so-called economic nexus. In so ruling, the Supreme Court overturned *Quill Corp. v. North Dakota*,¹⁷ a 1992 Supreme Court decision holding that the Commerce Clause prohibited states from taxing sellers that did not have any physical presence in the taxing state. The Supreme Court's decision in *Wayfair* permits states to impose sales tax collection and remittance obligations on remote sellers and online retailers that have substantial nexus with the state, i.e., when the seller "avails itself of the substantial privilege of carrying on business" in the state. Under the South Dakota law at issue in *Wayfair*, a seller that delivers more than \$100,000 of goods or services into the state or engages in 200 or more separate transactions for the delivery of goods and services into the state on an annual basis was required to collect and remit South Dakota sales tax. While the Supreme Court ruled that this requirement was sufficient to establish substantial nexus with South Dakota, it left open the possibility that the South Dakota law could be challenged as being unconstitutional on other grounds.

Since *Wayfair* was issued, over 30 states¹⁸ have introduced or begun enforcing legislation or regulations requiring sellers to collect sales tax even if they do not have physical presence in the state, including California. One issue not addressed by the Supreme Court in *Wayfair* is whether economic nexus applies for purposes of determining state income tax nexus in addition to sales tax nexus.

*Altera Corp. v. Commissioner*¹⁹

On June 7, 2019, the U.S. Court of Appeals for the Ninth Circuit, in a 2-to-1 opinion, ruled that Treasury Regulations involving transfer pricing promulgated in 2003 (the Regulations)²⁰ complied with the Administrative Procedure Act ("APA") and were entitled to deference under *Chevron*. The Regulations required related entities to share the costs of employee stock-based compensation in order for their cost-sharing arrangements to be classified as qualified cost-sharing arrangements under Section 482 and the relevant Treasury Regulations. The Ninth Circuit's decision in *Altera* reversed an earlier decision of the United States Tax Court, which had held that the Regulations were invalid in part because the Treasury Department did not satisfy a reasoned decision-making standard in promulgating them as required by the APA. The Ninth Circuit, including the late Judge Stephen Reinhardt, originally ruled in favour of the Commissioner on July 24, 2018, but that opinion was withdrawn on August 7, 2018 on procedural grounds to allow time for a reconstituted panel to confer on the case, with Judge Susan P. Graber replacing Judge Reinhardt.

Regulatory: tax-free spin-off guidance under Section 355

Section 355 sets forth a number of requirements for tax-free spin-offs of corporate subsidiaries, including an "active trade or business" requirement. On September 25, 2018,

the IRS released a statement announcing a study of the “active trade or business” test for entrepreneurial ventures whose activities consist of lengthy phases of research and development. In the statement, the IRS indicated that it would entertain requests for private letter rulings from such ventures regarding qualification for the active trade or business test. This announcement generated interest among pre-revenue technology companies that have not previously been able to rely on Section 355, including companies in fields with extended development stages, such as biotechnology and pharmaceuticals.

Following the issuance of the statement, the IRS suspended two revenue rulings, Rev. Ruls. 57-464 and 57-492.²¹ In these rulings, the IRS had ruled that business activities that produced negligible net income, or that produced income for less than five years, did not satisfy the active trade or business requirement. Further, on May 6, 2019, the IRS released a public request for information to “assist in identifying what types of entrepreneurial ventures should qualify as [active trades or businesses] absent a five-year track record of income collection” in order to facilitate the study of the ATB Test. The outcome of the IRS’s study on the “active trade or business” test could have favourable impact for emerging growth companies in highly regulated industries or operating in stealth mode, as such companies often do not generate revenue for several years while in development stages but may also have a desire to divide businesses for legitimate business purposes.

Tax treaties

The U.S. Senate recently ratified four tax treaty protocols amending tax treaties between the United States and Japan, Luxembourg, Spain and Switzerland, which date back to as early as 1990. Prior to these ratifications, the Senate had not approved any treaties or protocols since 2010.

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Endnotes

1. All Section references are to the Code.
2. Treas. Reg. Section 1.956-2(c).
3. 83 Fed. Reg. 55324 (Nov. 5, 2018).
4. 84 Fed. Reg. 23716 (May 23, 2019).
5. 83 Fed. Reg. 39514 (Aug. 9, 2018).
6. 84 Fed. Reg. 1838 (Feb. 5, 2019).
7. 84 Fed. Reg. 29288 (June 14, 2019).
8. 84 Fed. Reg. 29115 (June 14, 2019).
9. 83 Fed. Reg. 51072 (Oct. 10, 2018).
10. Section 250.
11. 84 Fed. Reg. 8188 (Mar. 6, 2019).
12. Section 59A.
13. 83 Fed. Reg. 65956.
14. Rev. Proc. 2007-13, 2007-1 C.B. 295.
15. 83 Fed. Reg. 67490 (Dec. 28, 2018).

16. No. 17-494, slip op. (June 21, 2018).
17. 504 U.S. 298 (1992).
18. See, e.g., Sales Tax Institute, *Economic Nexus State Guide*, <https://www.salestaxinstitute.com/resources/economic-nexus-state-guide> (as of July 3, 2019).
19. No. 16-70496, slip op. (Ninth Cir. June 7, 2019).
20. Treas. Reg. §§ 1.482-7A(d)(2), 1.482-7A(a)(3) (to the extent incorporating Treas. Reg. § 1.482-7A(d)(2)).
21. Rev. Rul. 2019-9, 2019-14 IRB 925.

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