Analysis

US tax reform: recent changes and next steps

Speed read

US tax reform at the end of 2017 resulted in fundamental change. However, the reform did not stop there: since then, pages of proposed regulations have been issued (and in many cases finalised) and further proposed regulations have been released, along with some additional tax policy decisions where bipartisan agreement could be achieved. Key changes include proposed BEAT regulations, which set out procedures under which a taxpayer may elect to 'disavow' tax deductions; and extensive foreign tax credit regulations, which clarify the impact of and provide updates to previously proposed regulations, as well as introducing new proposed regulations. Further change is expected, regardless of who wins the US elections in November. UK practitioners would therefore be well advised to continue to consider future rule changes, in order to be best placed to advise groups with a US presence.

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For many years, the world of international tax was, for most countries, one in which major changes occurred regularly. Tax rates went up and down; new areas were added, such as controlled foreign company (CFC) rules; and incentives were introduced, such as dividend exemptions and the ability to sell shares tax free. However, one thing never seemed to change: the US tax system, which had remained broadly the same since 1986.

That seemingly unalterable position was swept away at the end of 2017, when Public Law 115-97, commonly known as the Tax Cuts and Jobs Act (TCJA), was enacted. The key corporate changes that were introduced by that Act included:

- a cut in the headline corporate tax rate from 35% to 21%;
- a new exemption system for foreign dividends;
- a one-off transition tax, levied on the undistributed earnings and profits of CFCs;
- the new base erosion and anti-abuse tax (BEAT), as an alternative method of calculating the tax liability of US companies;
- the introduction of global intangible low taxed income (GILTI) regime, under which more earnings of non-US subsidiaries could potentially be taxed in the US;
- tighter limits on the deductibility of business interest; and
- hybrid mismatch rules.

The business reaction

The extent and complexity of these changes, and the short transition to the new rules (many becoming effective within days of the law passing through Congress), presented businesses with a daunting task. Initial positivity over the headline rate reduction was tempered by the reality of the trade-offs, including various base erosion measures, limitations on deductions and lots of complexity.

Businesses are, though, now getting to grips with the law, having endured a testing inaugural compliance season preparing post-reform tax returns. As a result, the associated uncertainty is beginning to give way to a more forward-looking approach to assessing the risks and opportunities of the new international tax landscape.

However, the IRS and the US Treasury are continuing to formulate the long-term impact of the measures and consider how they should be implemented. Taxpayers therefore need to remain agile as additional regulations are released and the impact of recent regulations becomes clearer.

What has happened since the TCJA was passed?

In the period since the TCJA was passed, pages of proposed regulations have been issued (and in many cases finalised), whilst further proposed regulations have been released and some additional tax policy decisions have been made where there was bipartisan agreement. Some of the key changes are as follows:

BEAT

The complexity of the BEAT rules and the scale of their potential impact has typically caused significant tax friction for those affected. Many taxpayers therefore welcomed the proposed regulations released in December 2019, which set out procedures under which a taxpayer may elect to 'disavow' tax deductions (and are capable of retroactive application). A disavowed deduction will not be treated as a base erosion benefit under BEAT, and therefore could provide taxpayers with a straightforward mechanism to reduce their base erosion percentage below the safe harbour (generally 3% of total deductions for non-financial institutions).

The apparent ease with which deductions may be disavowed is likely to provide ample opportunity for some taxpayers to manage their BEAT position, but it means permanently foregoing the deduction not only for BEAT but for *all* federal tax purposes. This proposed regulation could therefore have a ripple effect through other tax provisions; for example, potentially altering a taxpayer's position under the dual consolidated loss rules.

The decision to disavow deductions is made annually and the amount may be increased on an amended return within three years of filing, or during the course of an IRS audit, which gives flexibility for taxpayers.

Foreign tax credits

Extensive foreign tax credit (FTC) regulations were released in December 2019, clarifying the impact of and providing updates to previously proposed regulations, as well as introducing new proposed regulations. The headline measures in the finalised regulations include a 'look-through' rule applying to payments where the FTC would otherwise be attributable to passive income, and clarification of the allocation and apportionment of interest expense under different methodologies.

The proposed regulations make sweeping and detailed changes. One of the most broadly applicable provisions is the introduction of comprehensive rules detailing the income against which FTCs should be allocated, and how that income should be characterised. Broadly, the income 'basket' should be determined by looking to the underlying payment giving rise to the FTC. These provisions cover the treatment of FTCs arising in multiple situations, and they will be important for groups considering their FTC profile. Recent indications are that these provisions could be expanded.

Other proposed regulations, which are expected to apply widely, include the requirement to allocate and apportion stewardship expenses to both dividends and inclusions, based on the relative value of the taxpayer's stock assets in the statutory and residual groupings. New rules also address the allocation and apportionment of research and experimentation expenditure.

The proposed rules on expense apportionment and foreign tax allocation may require taxpayers to revisit modelling exercises and reassess their FTC profile and the utilisation of credits.

Section 954(c)(6)

IRC section 954(c)(6) is, in theory, a temporary measure providing look-through treatment, which excludes from foreign personal holding company income certain passive income received from a CFC. The provision was due to expire on 31 December 2019.

Broadly, the exclusion applies where a payment is attributable to income of the related person which is not classed as Subpart F or effectively connected income. Since its enactment in 2005, this 'temporary' provision has been extended repeatedly (both prospectively and retroactively). As part of the Taxpayer Certainty and Disaster Tax Relief Act (passed in December 2019), s 954(c)(6) was re-extended once again, until 31 December 2020. This is a positive move for taxpayers, especially those that often move capital and funds across multiple CFCs. However, many are still concerned about the future of s 954(c)(6) and are considering whether to take pre-emptive steps to protect against its potential withdrawal.

Section 863(b) sourcing regulations

Proposed regulations have been released modifying the rules for determining the source of income from sales. These could affect the US tax treatment of inventory produced within the US and sold outside the US (or vice versa). The regulations require sourcing solely based on the location of production, removing the previously prescribed methods for determining the source of sales from partly within and partly without the US. The regulations propose that when allocating between foreign and US production activities, the US and non-US assets should be measured consistently; i.e. on a straight-line method over the same recovery period. This should broadly result in a simpler approach and removes inconsistencies in the sourcing rules deriving from differences, for example, in the depreciation methodology.

Foreign derived intangible income

An interesting feature of the TCJA was the introduction of the foreign derived intangible income (FDII) regime. FDII was intended to encourage companies to locate their intangible property (IP) in the US, in return for which foreign earnings in respect of that IP could be taxed at an effective rate of 13.125%.

There is limited data on whether many businesses have chosen to avail themselves of FDII. However, we are aware of some businesses questioning whether the regime will last. Specifically, is the beneficial tax rate outweighed by the risk of the regime being abolished, being ruled to be an invalid export subsidy by the WTO, or the rate being changed (by which point it would likely be impossible to transfer IP out of the US without triggering an exit charge)? As a result, the jury is out on whether or not FDII will be a significant driver of tax strategy.

What could the future hold?

So far, the passage of the TCJA has not shown signs of a new dawn in tax measures being enacted by Congress. Whilst Congress has discussed several potential measures since that time, none of great substance has made it into law. This is largely because the unusual circumstances of the TCJA (discussed below) are no longer in place.

However, 2020 is a US election year and therefore tax could become a subject of wider debate. Whilst it seems clear that Donald Trump will be the Republican presidential nominee, things are more uncertain on the Democratic side. At the time of writing, all the main candidates for the nomination have pledged to increase the rate of corporate tax, with proposals ranging from 25% to 35%, along with rolling back many other aspects of the TCJA. It goes without saying that such changes would radically alter the situation once again for businesses with US operations.

There are, however, practical challenges to tax legislation passing through Congress (which was the main cause of the stasis of the tax system between 1986 and 2017). This is because to become law, measures need to be passed by both the House of Representatives and the Senate, and then signed by the president. It is often the case (as it is now) that different parties are in control of these different facets of government. In addition, Senate rules mean that in most cases a measure can be filibustered, which can only be broken with the votes of at least 60 of the 100 senators. In practice, bipartisan support is therefore almost always needed. The TCJA was unusual in that it was tied to a specialised budget process that meant it could proceed through the Senate with only a simple majority of votes. Major revisions to the TCJA would likely need a similar environment (in which the same party controls both chambers of the legislature and the White House).

The impact of the TCJA may, however, be felt by a wider pool than just taxpayers subject to US tax law. The G20/OECD Inclusive Framework has recently been working to address the tax challenges arising from the digitalisation of the economy. This work is aimed at finding a 'unified approach' to address nexus and profit allocation challenges arising from digitalisation ('pillar one') and the development of a global anti-base erosion proposal ('pillar two'). Pillar two is aimed at enabling countries to tax profits which would otherwise be taxed at a rate below an agreed minimum, and these discussions bear more than a passing similarity to GILTI.

What should UK professionals do?

The fundamental changes introduced by the TCJA in 2017 meant that all UK practitioners with clients with US operations needed to spend time understanding the changes and their potential impact. The frequency with which regulations have been issued since that time and their wide-ranging impact means that no one can be complacent. ■

For related reading visit www.taxjournal.com

- US tax reform: the GILTI and FDII provisions (Mark Saunderson & Miles Humphrey, 26.7.18)
- US tax reform: examining the Tax Cuts and Jobs Act of 2017 (Donald L. Korb & Andrew Solomon, 11.1.18)