Executive summary

On 2 November 2017, United States (US) House Republicans unveiled their comprehensive tax reform bill called the Tax Cuts and Jobs Act (the House Bill). The House Bill contains many provisions that would affect taxpayers in the retail and consumer products industry.

At the time of publication, the provisions of the House tax reform bill were in flux. Although changes have been made to some of the provisions, this Tax Alert covers the provisions as provided in the original House tax reform proposal.

Detailed discussion

Business tax reform

Immediate expensing of 100% of the cost of qualified property

Current law

Current law allows taxpayers to claim additional depreciation (i.e., bonus depreciation) under Section 168(k) in the year in which qualified property (described below) is placed in service through 2019 (with an additional year for qualified property with a longer production period, as well as certain aircraft). The bonus depreciation generally equals 50% of the cost of the property placed in service in 2017 and phases down to 40% in 2018 and 30% in 2019.
Qualified property is defined as tangible property with a recovery period of 20 years or less under the modified accelerated cost recovery system (MACRS), certain off-the-shelf computer software, water utility property or qualified improvement property. Certain trees, vines, and fruit-bearing plants also are eligible for additional depreciation when planted or grafted. To be eligible for bonus depreciation, the original use of the property must begin with the taxpayer.

Under current law, taxpayers have the option of making an annual election to not claim bonus depreciation with respect to qualified property under Section 168(k)(7). Alternatively, taxpayers may elect under Section 168(k)(4) to accelerate Alternative Minimum Tax (AMT) credits (as refundable credits) in lieu of claiming bonus depreciation with respect to qualified property. Such election comes with the added requirement to depreciate that qualified property using a straight-line recovery method.

Provision

The provision would allow taxpayers to immediately expense 100% of the cost of qualified property acquired and placed in service after 27 September 2017, and before 1 January 2023 (1 January 2024, for certain qualified property with a longer production period, as well as certain aircraft).

The provision also would expand the property eligible for immediate expensing by repealing the requirement that the original use of the property begin with the taxpayer; instead, property would generally be eligible for immediate expensing if it were the taxpayer's first use of that property. Qualified property would not include property used by a regulated public utility company or any property used in a real property trade or business (as defined in Section 469(c)(7)(C)).

Additionally, the provision would repeal Section 168(k)(4) (i.e., the election to accelerate AMT credits in lieu of claiming bonus depreciation) for tax years beginning after 31 December 2017. However, the provision would retain the annual election to not claim bonus depreciation with respect to qualified property under Section 168(k)(7).

Effective date

Generally, the provision would apply to property that is acquired and placed in service after 27 September 2017. Similar to prior bonus depreciation transition rules, property would not be treated as acquired after 27 September 2017, if a written binding contract for its acquisition was entered before 27 September 2017. The provision would apply to specified plants planted or grafted after 27 September 2017.

The provision would allow taxpayers to elect to apply Section 168, without regard to the amendments made by the provision (i.e., the current law), to a taxpayer’s first tax year ending after 27 September 2017. For taxpayers that instead choose to apply the provision to its first tax year ending after 27 September 2017, the provision would place limitations on the ability to carry back any losses attributable to the 100% expensing rules (by only allowing those taxpayers to carry back the portion of the loss that would have been generated under the current law).

Implications

Taxpayers in the retail and consumer products industry frequently incur significant capital expenditures. Therefore, they should consider the opportunities to immediately expense certain property, particularly if they acquire the property prior to the reduction in tax rate taking effect.

The reinstitution of 100% bonus depreciation or immediate expensing for property meeting the definition of “qualified property” under Section 168(k)(2) would provide retail and consumer products companies acquiring that property with an immediate cash-tax benefit. Further, as the ability to elect out of the provisions of Section 168(k) would still be available, retail and consumer products companies that are in a loss position and would not otherwise benefit from immediate expensing of the above-referenced property would have the flexibility to elect not to apply the provisions of Section 168(k) and, instead, utilize the depreciation provisions as set forth in Section 168.

Of particular note is the effective date of the immediate expensing provisions described previously as part of the legislative language; specifically, the expensing provisions would apply to property acquired and placed in service after 27 September 2017. Couple this with what would be the effective date of the 20% maximum corporate income tax rate, which is set to apply to tax years beginning after 31 December 2017, and taxpayers in the retail and consumer products industry, which already have one of the highest effective tax rates, would have a single, extremely limited opportunity to acquire qualified property before their 2018 tax year and benefit from expensing that property in the current tax year while a higher corporate tax rate is in play (the maximum corporate tax rate is currently 35%). Further, for the first time since Section 168(k) was enacted, used property would be qualified property and would be eligible for immediate expensing, provided the taxpayer itself had not previously used the property and/or the property is not acquired as
part of certain carryover basis or related-party acquisition transactions. This expansion on the concept of original use would be a substantial benefit to taxpayers and could affect how taxpayers value and structure future transactions (as taxpayers would be able to immediately expense a significant portion of the consideration paid for assets acquired in applicable asset acquisitions, as defined in Section 1060(c)).

Because the expensing provision would apply to qualified property acquired in a taxable acquisition such as Section 1060 transactions or deemed asset acquisitions (such as those under Section 338), capitalized costs incurred in these transactions would also be affected. In general, capitalized costs are added to the adjusted basis of acquired property, and, if added to the adjusted basis of qualified property, would be subject to the immediate expensing provisions. In Section 1060 transactions, specifically identifiable costs may be allocated to individual assets. To the extent there were specifically identifiable costs that were allocable to qualified property, they would also be subject to immediate expensing.

In addition, as the immediate expensing provisions would only apply to qualified property that is acquired and placed in service after 27 September 2017, taxpayers would again need to ascertain when property was not only placed in service, but also when it was purchased, with a particular focus on when a written binding contract (if any) was entered to acquire the property. This may significantly affect taxpayers that “acquire” property on or before 27 September 2017, but place it into service after 27 September 2017, as that property would not be subject to the immediate expensing provisions and would instead be subject to the current bonus depreciation percentages and corresponding phase downs (i.e., 50% bonus depreciation in 2017, phasing down to 40% in 2018, and 30% in 2019 generally).

Taxpayers in the retail and consumer products industry should evaluate their tax position and whether it makes sense to take advantage of the transition election to apply Section 168, without regard to the amendments made by the provision (i.e., the current law), to their first tax year ending after 27 September 2017, as such election would still allow them to claim 50% bonus depreciation on eligible property placed in service after 27 September 2017, and before the end of the tax year (as opposed to 0%). Even if these taxpayers have current-year losses, the transition election could still be beneficial if they are contemplating an election to accelerate AMT credits under Section 168(k)(4) on their 2017 return.

Finally, the provisions of Section 168(k)(4), which allow monetization of a portion of pre-2016 AMT credit carryforwards in lieu of claiming bonus depreciation, would be repealed for tax years beginning after 31 December 2017. Accordingly, the 2017 tax year would be the last year in which taxpayers could elect to apply Section 168(k)(4). The provision would, however, allow taxpayers to recover unused AMT credits through certain transition rules associated with AMT repeal. Such rules would allow taxpayers to recover any unused credits from 2019 through 2022 based on a specified formula. As such, taxpayers would need to evaluate whether it makes sense to attempt to recover AMT credits through a 2017 election under Section 168(k)(4) or simply wait until 2019 through 2022. The decision would largely depend on whether AMT credits recovered from 2019 through 2022 (under the AMT repeal transition rules) would be subject to a sequestration haircut, which is unclear under the House Bill.

Repeal of Section 199 domestic production activities deduction

Current law

Section 199 allows taxpayers to claim a deduction equal to 9% (6% for certain oil and gas activities) of the lesser of the taxpayer’s qualified production activities income or the taxpayer’s taxable income for the tax year. The deduction is limited to 50% of the W-2 wages paid by a taxpayer during the calendar year. Qualified production activities income is derived from certain production activities and services performed (i.e., construction, engineering or architecture) in the United States, and, for tax years beginning before 1 January 2017, in Puerto Rico.

Provision

The provision would repeal Section 199 for tax years beginning after 31 December 2017. For production activities performed in Puerto Rico, however, the provision would also extend Section 199 to tax years beginning before 1 January 2018.

Effective date

The repeal provision would be effective for tax years beginning after 31 December 2017.

Implications

As foreshadowed by the Unified Tax Reform Framework (Framework), the bill would eliminate Section 199 for tax years beginning after 31 December 2017. According to the Framework, Section 199 is no longer necessary because of the across-the-board rate reduction on all business income.
The Joint Committee on Taxation estimates that the elimination of Section 199 will increase tax revenues (relative to the baseline receipts projected for future years under present law) by US$195.2 billion during the 2018-2027 budget period (see JCX-46-17, 2 November 2017).

Section 199 has been a recent focus of increased Internal Revenue Service (IRS) examination activity, which has resulted in several cases pending in a variety of federal courts. Because the bill would eliminate Section 199 for tax years beginning after 31 December 2017, it is unclear how the IRS will examine and litigate Section 199 claims for tax years beginning before 2018. Because taxpayers can make amended return claims for Section 199 deductions, taxpayers with production or service activities that are within the scope of Section 199 may want to review the claims they have already made for additional opportunities or consider making an initial claim on an amended return for open tax years beginning before 1 January 2018.

Research and development incentives

Current law

Section 41: Under current law, Section 41 provides a credit for certain qualified research expenses paid or incurred by a taxpayer in carrying on its trade or business (the research credit). There are multiple research credit methods available. Section 41(a) (the regular credit) equals 20% of the excess of the qualified research expenses for the tax year over a computed base amount. Section 41(c)(5) (the alternative simplified credit) equals 14% of so much of the qualified research expenses for the tax year as exceeds 50% of the average qualified research expenses for the three preceding tax years.

Section 174: Under current law, Section 174 allows a taxpayer to treat research or experimental expenditures that it pays or incurs during the tax year in connection with its trade or business as deductible expenses, or to elect to capitalize and amortize these expenditures.

Provision

Section 41: The provision would retain the research credit under Section 41, but would modify the cost-of-living adjustment definition as part of the conforming amendments related to simplification of individual income tax rates, under Section 1005 of the bill.

Section 174: As part of the conforming amendments to the repeal of the AMT, Section 2001 of the bill, the provision would delete the cross-reference in Section 174(f) to Section 59(e).

Effective date

The provisions would be effective for tax years beginning after 31 December 2017.

Implications

Sections 41 and 174 remain unchanged other than conforming amendments related to the modification of the inflation adjustment and the repeal of the AMT, respectively. The fact that the bill does not remove or modify these sections is consistent with the Framework released in September, which stated that the research credit would be preserved because the incentive has proven to be effective in promoting policy goals important in the American economy. The Tax Cuts and Jobs Act Policy Highlights released by the House Ways and Means Committee asserts that preserving the credit under Section 41 “encourages our businesses and workers to develop cutting-edge ‘Made in America’ products and services.”

Interest expense deductions

Current law

Current law allows business interest as a deduction in the tax year in which the interest is paid or accrued, subject to limitation rules, as applicable. Section 163(j) limits a corporation's ability to deduct disqualified interest (i.e., interest paid or accrued to a related party when no federal income tax is imposed on the interest) paid or accrued in a tax year if: (1) the payor's debt-to-equity ratio exceeds 1.5 to 1.0 (safe harbor ratio); and (2) the payor's net interest expense exceeds 50% of its adjusted taxable income. In general, adjusted taxable income is the corporation's taxable income calculated without taking into account deductions for net interest expense, net operating losses (NOLs), domestic production activities under Section 199, depreciation, amortization and depletion. Disallowed interest amounts may be carried forward indefinitely and any excess limitation may be carried forward for three years.

Provision

The provision would limit the net interest expense deduction for every business, regardless of form, to 30% of adjusted taxable income. The provision would require the interest expense disallowance to be determined at the tax filer level. Adjustable taxable income for purposes of this provision would be a business's taxable income calculated without taking into account business interest expense, business interest income and NOLs, as well as depreciation, amortization and depletion.
The provision would allow businesses to carry forward interest amounts disallowed under the provision to the succeeding five tax years and those interest amounts would be attributable to the business.

The provision would include special rules to allow a pass-through entity’s owners to use the unused interest limitation for the tax year and to ensure that net income from pass-through entities would not be double-counted at the partner level. Retail and consumer products taxpayers often rely upon debt to fund seasonal inventory purchases in advance of the selling seasons, and to support ongoing cash flow needs in operations. These provisions may cause retail and consumer products companies to consider the need for more agile and tax efficient funding strategies.

The provision would exempt businesses with average gross receipts of $25 million or less from these rules. The provision also would not apply to certain regulated public utilities and real property trades or businesses; these businesses would be ineligible for full expensing.

Additionally, the provision would repeal Section 163(j).

Effective date
The provision would be effective for tax years beginning after 31 December 2017.

Implications
If enacted, this provision would significantly affect highly leveraged taxpayers in the retail and consumer products industry that consider the deduction of interest expense to be an important factor in their operating business decisions.

Modification to NOL deduction
Current law
Under current law, Section 172 allows taxpayers to carry back an NOL arising in a tax year for two years and carry forward the NOL for 20 years to offset taxable income. Generally, an NOL is the excess of the taxpayer’s business deductions over its gross income. Section 172 also provides special provisions modifying the carryback period for specific types of losses or losses arising in particular years. Included in these special provisions is Section 172(f), which allows a 10-year carryback of losses arising from specified liabilities. The AMT rules do not allow a taxpayer’s NOL deduction to reduce the taxpayer’s alternative minimum taxable income by more than 90%.

Provision
The provision, Section 3302 of the bill, would allow indefinite carry forward of NOLs arising in tax years beginning after 31 December 2017. The provision also would repeal all carrybacks for losses generated in tax years beginning after 31 December 2017, but would provide a special one-year carryback for small businesses and farms for certain casualty and disaster losses. The provision would define an eligible disaster loss in Section 172(b) as an NOL attributable to federally declared disasters. The provision would limit the amount of all NOLs that a taxpayer could use to offset taxable income to 90% of the taxpayer’s taxable income (computed without taking into account the NOL deduction) for tax years beginning after 31 December 2017. In addition, the provision would permit NOLs arising in tax years beginning after 2017 and carried forward to be increased by an interest factor to preserve the NOL value.

As part of the repeal of NOL carrybacks, the provision would repeal Section 172(f), the special rule allowing a 10-year carryback of specified liability losses.

Effective date
The indefinite carry forward and general repeal of carrybacks (including the repeal of Section 172(f)), and the special one-year carryback rule for casualty and disaster losses would be effective for losses arising in tax years beginning after 31 December 2017. The 90% limitation rule would be effective for tax years beginning after 31 December 2017. The annual increase of carry forward amounts would apply to amounts carried to tax years beginning after 31 December 2017.

Implications
In general. The Framework released in September did not specifically address changes to the NOL deduction, or the ability to carry an NOL forward or back to prior tax years.

The provision would reduce some of the incentives under current law to accelerate the utilization of NOLs. The 90% limitation on the utilization of NOL carryforwards would effectively impose a minimum tax for corporate taxpayers, even though the provision proposed to eliminate the corporate AMT (see Section 2001). This provision has the potential to significantly impact retail and consumer products companies that are currently generating NOLs. The elimination of the ability to carry back NOLs to prior years, other than in relation to small businesses and farms for certain casualty and disaster losses, would eliminate opportunities for immediate cash
refunds. By allowing for the indefinite carryforward of NOLs with interest, the proposal has the effect of confirming that the net present value of the NOL deduction remains constant over time.

The Joint Committee on Taxation estimates that the modification of Section 172 will increase tax revenues by $156 billion dollars during the 2018-2027 budget period (see JCX-46-17, 2 November 2017).

The effective date language for the 90% limitation for the use of NOLs implies that the limitation would not only apply to losses arising in tax years beginning after 31 December 2017, but to losses arising in tax years before 1 January 2018, and carried forward to tax years beginning after 31 December 2017.

**Specified liability losses.** Although the bill would preserve a majority of the NOL provisions under the Code, the repeal of Section 172(f) would significantly affect retail and consumer products companies that incur the types of liabilities eligible for the extended carryback benefit under Section 172(f). Taxpayers would not be able to rely on specified liability losses as a source of cash tax savings for eligible liabilities that generate losses in tax years beginning after 31 December 2017. Specified liability losses are limited deductible expenditures for certain liabilities. In the retail and consumer product industry, the relevant liabilities are product liability and workers’ compensation payments, and occasionally remediation of environmental contamination.

**Accounting for inventories**

**In general**

**Current law**

Current law requires businesses to use an inventory method if the production, purchase or sale of merchandise is a material income-producing factor to the business. Such businesses generally also must use an accrual method of accounting for tax purposes under the rules in Section 446. Under an exception, certain small businesses with inventory that have average gross receipts of not more than $1 million do not have to use an accrual method of accounting. Another exception also exempts businesses with inventories in certain industries (that are not otherwise prohibited from using the cash method) from having to use an accrual method of accounting if their annual gross receipts do not exceed $10 million. Businesses that meet one of the exceptions may account for inventory as materials and supplies that are not incidental.

**Provision**

The provision would add Section 471(c), which would exempt businesses with average gross receipts of $25 million or less from the requirement to maintain inventories. The provision would allow these businesses to: (1) treat inventories as non-incidental materials and supplies; or (2) follow the accounting method reflected on their applicable financial statements or books and records for the inventories. As they are not required to maintain inventories under Section 471, these entities would not be prohibited from using the cash method of accounting under the provision.

**Effective date**

This provision would be effective for tax years beginning after 31 December 2017.

**Implications**

Although the framework of Section 471 generally would not change, the new rules for small businesses would allow more retail and consumer products taxpayers to be exempt from accounting for inventories under Section 471, and thus allow those businesses to use the cash method of accounting (given the identical increase in the gross receipts test under Section 448). Additionally, these entities would be given the option of: (1) treating inventories as non-incidental materials and supplies; or (2) following their book treatment with respect to the inventory. If enacted, the option to follow the book method could be beneficial to taxpayers if their book treatment departs favorably from non-incidental material and supply treatment (i.e., the costs of some goods are deducted currently).

**Capitalization and inclusion of certain expenses in inventory costs**

**Current law**

The uniform capitalization (UNICAP) rules under Section 263A generally require a business to include certain direct and indirect costs associated with real or tangible personal property produced (either for sale or for use in the business (i.e., a self-constructed asset)) in the basis of that property. For real or personal property acquired for resale, the UNICAP rules require certain direct and indirect costs allocable to that property to be included in the basis of the inventory. A business with $10 million or less of average annual gross receipts, however, is not subject to the UNICAP rules for personal property acquired for resale.
Although business interest deductions could be limited (see prior discussion), taxpayers subject to the interest capitalization rules under Section 263A could nevertheless obtain an ancillary benefit with less interest available to be capitalized to designated property in production during the year. If this provision is enacted, these taxpayers will need to: (1) analyze and ensure they are taking into account the limitation in determining interest available to be capitalized to designated property, and (2) consider modeling different approaches to change capitalization. In addition, the Section 263A cost capitalization rules should be analyzed in conjunction with modeling for the potential excise tax on payments made by a US corporation to a related foreign corporation. Finally, any costs required to be capitalized to self-constructed assets under Section 263A may be eligible for the new 100% expensing provision as long as the costs are capitalized to qualified property under Section 168(k) (see prior discussion).

Employment tax reform

Work Opportunity Tax Credit (WOTC)

Current law
The WOTC was created to encourage employers to hire individuals facing significant barriers to employment – for example, veterans and the long-term unemployed – by offering a tax credit to employers that hire these individuals. In December 2015, the Protecting Americans from Tax Hikes Act of 2015 extended the WOTC to include individuals hired on or before 31 December 2019.

Provision
The provision would repeal the WOTC for wages paid or incurred to individuals who begin work after 2017.

Effective date
The provision would be effective after 2017.

Implications
In general. Consistent with the benefits of the other small-business tax provisions (e.g., more small businesses able to use the cash method of accounting), this provision clarifies that these businesses would not be subject to the rules under Section 263A. This provision is significant for two reasons: (1) the threshold increase from $10 million (generally) to $25 million would expand the pool of retail and consumer products taxpayers exempt from Section 263A; and (2) the provision would exempt small-business taxpayers from all requirements of Section 263A (inventory and self-constructed assets). Under the current rules, small taxpayers are only exempt from the rules as they relate to resellers and certain producers of inventory. Additionally, while Section 174 costs continue to be excluded from the Section 263A requirements, Section 263A would nevertheless be amended to remove its coordination with Section 59(e) (because this Section would be repealed under the bill).

LIFO inventory and Section 263A considerations. The rules for inventory valuation and identification remain largely unchanged. Therefore, all valuation methods would still be available (such as valuing at the lower of cost or market), along with all identification methods, such as the last in, first out method (LIFO method). Although the Senate bill could still include repeal of the LIFO method, the retention of the method in this bill should be considered a positive development. If the LIFO method ultimately is retained, taxpayers not currently using the LIFO method (such as certain foreign inbound companies or private companies) should analyze whether a LIFO method election makes sense for their 2017 tax year (i.e., assess whether the taxpayer experienced inflation with respect to its inventory in that year). The benefit obtained in 2017 with such an election would reverse in a lower-tax-rate landscape in 2018 or beyond, yielding a permanent tax benefit.
The proposed early repeal of the WOTC would not disqualify wages paid after 31 December 2017, to eligible employees hired on or before 31 December 2017, so employers should plan to track wages paid to eligible employees throughout the 2018 and possibly 2019 (for eligible long-term family assistance recipients) tax years in order to calculate the credit in future tax years.

**Compensation and benefits reform**

Two significant aspects of the compensation and benefits reform that will be of interest to retailers and consumer products taxpayers include the proposed changes to: (a) nonqualified deferred compensation (NQDC); and (b) excessive employee remuneration. The retail and consumer products industry often relies on these compensation vehicles to align management and shareholder objectives, and will need to thoughtfully consider their use.

**Nonqualified deferred compensation (NQDC)**

The provision effectively would eliminate tax deferral for most NQDC, including supplemental retirement plans, stock appreciation rights, and stock options under new Section 409B. Employees and other service providers would be subject to tax when they have completed all the services necessary to “vest” in the future compensation, even though these amounts continue to be subject to creditor risk and are not currently payable to them. Effectively, employees and service providers would be placed on an accrual method of accounting with respect to such amounts.

**Implications**

New Section 409B would be a radical change in the taxation of NQDC and likely would eliminate many types of plans that businesses currently use to incentivize their employees and management, because they would no longer be tax-efficient. In particular, supplemental defined benefit pensions would be particularly hard to maintain given the valuation issues that would arise at the time of vesting and deemed taxation. Placing a value on a future pension stream at the moment of vesting, based upon future events and future interest rates, may be difficult. Taxing the present value of such a benefit has proven extremely challenging under current-law Section 457(f) in the limited situations in which a tax-exempt employer provides such a plan.

Current taxation of options and appreciation rights is likely to be met with surprise by many businesses. Section 409B would effectively overturn the taxation of options that has been in effect since Section 83 was enacted in 1969. Current taxation of vested but unexercised options and appreciation rights would be particularly difficult for “start-ups” that utilize these arrangements when there may be limited cash in the business to otherwise incentivize employees.

If Section 409B were enacted without substantive changes, employers would need to significantly change their incentive compensation structure. They likely would utilize property transfers in lieu of NQDC when possible. Section 409B does not apply to any transfer of property that is taxable under Section 83. Thus, a transfer of restricted stock or a partnership interest (including a profits interest) would fall outside the ambit of Section 409B. Also, “short-term deferrals” that are designed to pay upon the completion of services would continue to be viable, as would tax-qualified plans (e.g., tax-qualified pensions and 401(k) plans), although the current-law compensation and benefit limits under those arrangements may be challenging to businesses looking for management incentive programs.

**Modification of limitation on excessive employee remuneration**

The provision would amend Section 162(m) to eliminate the exception for performance-based compensation, and to expand the definition of covered employees. Under the amendment, covered employees would specifically include the CFO, plus any individual who has previously been a covered employee, even after the individual no longer holds such position. Thus, once an individual is named as a covered employee, the limitation would apply to compensation paid to that individual at any point in the future, including after a separation from service.

**Effective date**

These expansions would be effective for tax years beginning after 31 December 2017.

**Implications**

The provision would significantly expand the $1 million deduction limitation for public companies and includes no transition relief. Thus, compensation paid under existing arrangements in excess of the limit, including outstanding stock options, would no longer be deductible in the future for any covered employees. Companies would need to monitor compensation payable after individuals are no longer covered employees, which may significantly affect the deduction related to supplemental retirement plans and other post-separation payments.
International tax reform

New excise tax on certain payments from a domestic corporation to a foreign affiliate

Current law

Under current law, a foreign corporation is generally subject to US taxation on a net basis on effectively connected income (ECI) under Section 882, or on a gross basis (30% statutory rate subject to reduction under a US tax treaty) on certain non-ECI income that is fixed or determinable annual or periodical (FDAP) under Section 881.

Provision

New Section 4491 would impose on each “specified amount” paid or incurred by a domestic corporation to a foreign corporation that is a member of the same international financial reporting group (IFRG) a tax equal to the highest rate of tax imposed under Section 11 for the tax year in which the specified amount is paid. This new “excise tax” would be imposed on the domestic corporation and would not be deductible for US federal tax purpose. For this purpose, a specified amount paid, incurred or received by a partnership that is a member of an IFRG would be treated as paid, incurred or received by its partners, and a specified amount paid, incurred or received by a foreign corporation in connection with a US trade or business (USTB) would be treated as paid, incurred or received by a domestic corporation.

A specified amount for this purpose means any amount that is, with respect to the payor, deductible or includible in cost of goods sold (COGS), inventory or the basis of a depreciable or amortizable asset for the payor. However, a specified amount does not include interest, amounts paid or incurred for the acquisition of certain commodities, FDAP payments subject to withholding tax under Section 881, or service fees not subject to a markup to the extent the payor elects the services cost method for Section 482 purposes. For FDAP amounts, however, the provision would only exclude the portion of such amount in proportion to the actual rate of tax imposed under Section 881(a) to 30%. Thus, for example, it would appear that, if $100 of a FDAP royalty payment were subject to a treaty-reduced withholding tax rate of 10% under Section 881(a), only 1/3 of that amount would be excluded from treatment as a specified amount.

An IFRG for this purpose is any group of entities, with respect to any specified amount, if the specified amount is paid or incurred during a reporting year of such group with respect to which it prepares consolidated financial statements (within the meaning of Section 163(n)(4)) and the average annual aggregate payment of specified amounts of such group for the three-reporting-year period ending with such reporting year exceeds $100 million.

Election to treat specified amounts as ECI

In lieu of the domestic corporation incurring an excise tax on a specified amount, the foreign corporation that receives the payment would be permitted to elect to take the specified amount into account as if it were engaged in a USTB and had a US permanent establishment (PE) during the tax year in which the amount was received, and as if such amount were ECI and attributable to the US PE (the ECI election). Once made, the ECI election could be revoked only with IRS consent. Importantly, for any underpayment, penalties, additions to tax or additional amounts, the provision would place joint and several liability on each domestic corporation that is a member of the IFRG.

If the ECI election were made, the foreign corporation would be allowed a deduction against the specified amount for a “deemed expenses” amount. The deemed expenses with respect to a specified amount received by the foreign corporation during a reporting year is the amount of expenses required so that the foreign corporation’s net income ratio (i.e., the ratio of the net income determined without regard to interest income, interest expense, and income taxes, divided by revenues) with respect to the specified amount equals the IFRG’s net income ratio with respect to the product line to which the specified amount relates. The amounts required to determine the net income ratio would be determined on the basis of the IFRG’s consolidated financial statements and the books and records of the IFRG members used to prepare those statements.

Any ECI amount resulting from the ECI election would be treated as such for all purposes of the Code. Thus, as explained in the Joint Committee on Taxation’s Explanation, it is subject to the branch profits tax and is not subject to the excise tax under Section 4371. For purposes of Section 245 and new Section 245A, however, these amounts would not be treated as ECI. Thus, a distribution of earnings attributable to the amounts described in this proposal would be eligible for the participation dividends received deduction under new Section 245A. No foreign tax credit or deduction would be allowed for any taxes (including withholding taxes) paid or accrued with respect to any amount to which this proposal applies.
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allowing a deduction against the required inclusion, based on the US shareholder's top marginal income tax rate in the inclusion year. The provision would allow a US shareholder to elect to pay the transition tax over eight years in eight equal installments. For a subchapter S corporation with a mandatory inclusion, however, the provision would permit each shareholder of the S corporation to elect to defer payment of its net tax liability with respect to the S corporation by reason of the mandatory inclusion until the tax year in which either of the following occurs first: the corporation ceases to be an S corporation; substantially all of the S corporation's assets are liquidated or sold; the S corporation ceases its business, ceases to exist, or any similar circumstance; or the shareholder transfers any share of stock in the S corporation.

Definition of accumulated post-1986 deferred foreign income
Accumulated post-1986 deferred foreign income of a specified foreign corporation means the earnings and profits (E&P) of the specified foreign corporation: (1) accumulated in tax years ending after 31 December 1986, and determined as of 2 November 2017, or 31 December 2017, whichever is greater, (2) without diminution by reason of any dividends distributed in its tax year that includes 2 November 2017, or 31 December 2017, as relevant, (3) reduced by any such E&P previously subject to US tax (as ECI or under subpart F of the Code), and (4) increased by certain qualified deficits of the specified foreign corporation. The US shareholder's mandatory inclusion would be determined by taking into account any E&P deficits of its specified foreign corporation, thus effectively requiring inclusion of the net positive amount of deferred foreign earnings. Prior proposals allowed an offset only for E&P deficits of specified foreign corporations owned directly or indirectly by the same US shareholder; however, the provision would permit a net E&P deficit attributable to one US shareholder to offset the net positive E&P of another US shareholder if both US shareholders were members of the same affiliated group.

Reduced transition tax on deferred foreign earnings
The provision would require a mandatory inclusion of the accumulated foreign earnings of a controlled foreign corporation (CFC) and other foreign corporations with a 10% domestic corporate shareholder (a 10/50 company), collectively referred to as specified foreign corporations, or “SFCs.” The mandatory inclusion would be implemented by increasing the subpart F income of the specified foreign corporation (treating a 10/50 company as a CFC solely for this purpose) in its last tax year beginning before 1 January 2018, by its “accumulated post-1986 deferred foreign income” determined as of 2 November 2017, or 31 December 2017, whichever amount is greater. Each US shareholder of a specified foreign corporation would be required to include in gross income its pro rata share of the additional subpart F income, even through only domestic corporations would benefit from the 100% deduction for dividends received from certain foreign subsidiaries under the new territorial tax system also included in the House Bill.

The mandatory inclusion would be subject to tax at reduced rates: 12% for earnings held in cash or other specified assets, and 5% for the remainder. The two rates are achieved by
that ended before 2 November 2017, and (3) at the end of the tax year preceding the last year of each specified foreign corporation that ended before 2 November 2017. So the cash positions of a CFC with a calendar tax year would be determined as of 2 November 2017; 31 December 2016; and 31 December 2015. If a specified foreign corporation did not exist as of the second or third measurement date, then such amount would be removed from the calculation.

In addition to cash, a specified foreign corporation’s cash position would include its net accounts receivable, the fair market value of actively traded personal property for which there is an established financial market; commercial paper; certificates of deposit; federal, state and foreign government securities; foreign currency; obligations with a term of less than a year, and any asset identified by the Treasury Department as economically equivalent to the specified assets. To prevent double counting, the provision provides rules to exclude certain accounts receivable, equity interest, and obligations with a term of less than one year, respectively, from other specified foreign corporations of the same US shareholder. Further, any block assets would also be excluded and the Treasury Department could disregard transactions with the principal purpose of reducing the aggregate cash position of a specified foreign corporation.

Use of tax attributes to reduce the transition tax

Any foreign income taxes deemed paid by the US shareholder under Section 960 would be reduced based on the same ratios applied to determine the allowable deduction against the mandatory inclusion. A gross-up under Section 78 would be required only for the reduced amount. The reduced amount could be claimed as a credit against the transition tax liability, subject to the normal limitations under Section 904. The bill also would not limit the use of a foreign tax credit carryforward, or any other attributes, of the US shareholder to offset the transition tax. Further, the bill would turn off recapture under Sections 904(f) and 907(c)(4), and extend the carryforward period for any foreign taxes deemed paid with respect to which it is a US shareholder in that tax year, over (2) any interest expense taken into account in determining the carryforward, or any other attributes, of the US shareholder’s foreign high return amount for that tax year. A US shareholder’s foreign high return amount is the excess, if any, of its “qualified business asset investment” of each CFC with respect to which it is a US shareholder in that tax year, over (2) any interest expense taken into account in determining the US shareholder’s net CFC tested income for that tax year.

Implications

This provision would affect retail and consumer products companies with significant amounts of post-1986 earnings permanently invested outside the United States. Unlike previous proposals, the House Bill provides a date certain (2 November 2017 or 31 December 2017) to determine the accumulated deferred foreign earnings that would be subject to the one-time transition tax. The House Bill does not specify, however, how that amount is to be “determined” on those dates, although any issues related to this determination would be limited to current E&P for the specified foreign corporation’s tax year in which the relevant date occurs. Nonetheless, US shareholders should begin considering E&P studies, at least for their most relevant specified corporations, gathering documentation for their foreign tax pool balances and determining their aggregate foreign cash position.

By increasing the subpart F income of a specified foreign corporation in the transition year, a US shareholder could be required to pay transition tax on foreign earnings accumulated before acquiring its ownership in the specified foreign corporation, including possibly E&P not included in “post-1986 undistributed earnings” for purposes of Section 902. The House Ways & Means staff appear to have rejected requests for these issues to be addressed.

New category of subpart F income: foreign high return amounts

The provision would add new Section 951A, which would require a US person that is a US shareholder of any CFC for any tax year to include in gross income 50% of its “foreign high return amount” determined for that tax year. A US shareholder’s foreign high return amount is the excess, if any, of the US shareholder’s “net CFC tested income” for that tax year over the excess, if any, of: (1) the US shareholder’s “applicable percentage” of its aggregate pro rata share of the “qualified business asset investment” of each CFC with respect to which it is a US shareholder in that tax year, over (2) any interest expense taken into account in determining the US shareholder’s net CFC tested income for that tax year. Effectively, the House Bill is identifying an amount of income earned by the US shareholder’s CFCs that it considers “excessive.”

A US shareholder’s net CFC tested income is the excess, if any, of its aggregate pro rata share of any tested income of each CFC over its aggregate pro rata share of any tested loss of each CFC. A CFC’s tested income is the excess, if any, of: (1) its gross income (other than ECI, subpart F gross income, amounts excluded from foreign personal holding company income under Section 954(c)(6) that do not reduce a US shareholder’s foreign high return amount, active insurance and financing income, amounts excluded from foreign base company income under Section 954(b)(4), commodities income (as defined), and related-party dividends), over (2) deductions (including...
taxes) properly allocable to such gross income under rules similar to those of Section 954(b)(5). Tested loss is the excess of: (1) properly allocated and apportioned deductions, over (2) gross income taken into account in determining tested income. So for any tax year a CFC would have either tested income or tested loss, but not both.

The applicable percentage for any tax year would equal the federal short-term rate (determined under Section 1274(d)) for the month in which or with which such tax year ends, plus seven percentage points. A CFC’s qualified business asset investment is the aggregate of its adjusted bases in tangible property that is: (1) used in a trade or business of the CFC, (2) of a type with respect to which a deduction is allowed under Section 168, and (3) used in the production of tested income or tested loss.

The provision would amend current Section 960 to treat a US corporation that includes a foreign high return amount in income as paying a portion of any foreign income taxes paid or accrued by its CFCs with respect to gross income taken into account in determining tested income or tested loss. Specifically, under new Section 960(d), the US corporation would be treated as paying foreign income taxes equal to 80% of “foreign high return percentage,” multiplied by the aggregate foreign income taxes paid or accrued by its CFCs that are properly attributable to gross income taken into account in determining tested income or tested loss (defined as “tested foreign income taxes”). For any tax year, the US corporation's foreign high return percentage would be the ratio of its foreign high return amount to its aggregate tested income. The provision would create a new Section 904(d) limitation category for foreign high return amounts but any foreign income taxes not claimed as a credit in a tax year could not be carried back or forward.

Effective date
New Section 951A would apply to tax years of foreign corporations beginning after 31 December 2017, and to tax years of US shareholders in which or within which such tax years of a foreign corporation end.

Implications
Although some form of anti-base erosion provision was expected as part of US tax reform, new Section 951A is more far-reaching than most anticipated. It would effectively establish a global minimum tax on foreign earnings of retail and consumer products companies. Because intangible property would not be treated as a qualified business asset investment, Section 951A will be particularly significant for retail and consumer products multinationals with considerable offshore intangible property, especially given the prevalence in the retail and consumer products industry to own brand names, licenses and trademarks/trade names in non-US locations. Further, because the House Bill would also repeal current Section 958(b)(4), which does not prevent stock owned by a foreign person to be attributed downward to a domestic subsidiary, the provision would also affect foreign-parented retail and consumer products groups with US subsidiaries that partially own non-US subsidiaries that would become CFCs because of the repeal.

Endnote
1. Currency references in this Alert are to US$.
2. For discussion of the additional limitation on deductibility of net interest expense in addition to this general limitation, see EY Global Tax Alert, US International tax provisions and implications of the Tax and Jobs Act, dated 6 November 2017.
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