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Editor
Tim Sanders

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PREFACE

In January 2021, the 11th edition identified and described two material global tax trends that emerged in 2020: the response of economies to the covid-19 pandemic and the taxation of the digital economy. These two trends evolved through 2021 and can be expected to occupy centre stage in 2022 and beyond.

In 2020 and 2021, governments sought to bolster economies hit by the pandemic through a series of measures ranging from furlough schemes, postponing tax deadlines and deferring tax payments to relaxing residence rules. In 2021 and into 2022, governments will face the difficult balancing act of continuing to support their economies and encourage growth on the one hand, while needing to raise money from damaged economies to pay for such support and reduce the size of large deficits on the other, without such tax raising stifling any recovery. Precisely how each jurisdiction will deal with this balance remains uncertain and is a key area to observe in 2022. At this stage it appears that, while we may see some limited tax rises, more rigorous tax enforcement is likely to play a material role.

On 1 July 2021, a statement was made by the G20 Finance Ministers that on 8 October 2021 resulted in the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS 2) that contains details of how Pillars 1 and 2, which seek to address the issues raised by the digital economy, will be applied in practice. Pillar 1 deals with the reallocation of certain profits from very large multinational enterprises to market jurisdictions, while Pillar 2 deals with a global minimum tax. Among significant points to note is that under Pillar 1 it is intended that a new multilateral convention will be drafted and available for signature in 2022 that will remove unilateral digital services taxes and similar measures. Some jurisdictions that have applied a unilateral solution, notably the United Kingdom, Austria, France, Italy and Spain, have committed to transition from existing digital services taxes to the new multilateral approach solution. Under Pillar 2, the minimum tax rate is set at 15 per cent rather than the previously proposed rate of 'at least 15 per cent'. This has already had an impact, with Ireland announcing an increase in its minimum corporate rate to 15 per cent. While a remarkable amount of progress has been made in a short time, there are still important technical issues to be addressed quickly if the timetable, which proposes implementation in 2023, is to be adhered to. However, there is sufficient detail in the proposals for businesses likely to be affected to consider starting the process of reviewing their internal procedures and processes to ensure they can be compliant.

It is hoped that this volume will prove to be a useful guide to the tax rules in the jurisdictions where clients conduct their businesses. Each chapter aims to provide topical and current insights from leading experts on the tax issues and opportunities in their respective jurisdictions. While specific tax advice is always essential, it is also necessary to have a broad understanding of the nature of the potential issues and advantages.

The views expressed in this book are those of the authors and not of their firms, the editor or the publishers. Every endeavour has been made to ensure that what you read is the latest intelligence.

Tim Sanders
London
January 2022

Chapter 32

UNITED STATES

Moshe Spinowitz, Robert C Stevenson and Leonard I Greenberg[1]

I INTRODUCTION

Foreign persons investing in the United States have great flexibility in determining the form and taxation of their investments. However, foreign investors should note that an investment in the United States may be subject to administrative, filing and tax requirements at the state and federal levels. At the federal level, US tax can be imposed on a 'net' basis on US business income (using available deductions, etc.) and on a 'gross' withholding basis on investment income.

II COMMON FORMS OF BUSINESS ORGANISATION AND THEIR TAX TREATMENT

Foreign persons have several options with respect to the organisational form through which they conduct business in the United States (e.g., corporation formed under state law, general or limited partnership, or limited liability company). A foreign person can conduct business in the United States through either a US entity or foreign entity. However, from a tax perspective, regardless of the form chosen, the vehicle used generally will be considered either a corporation taxed at the entity level, with additional potential tax to the entity's owner when funds are distributed; or a flow-through entity (e.g., partnerships) not subject to an entity-level tax, but with tax imposed directly at the owner (partner) level. Flow-through entities can also include entities treated as 'branches' for US tax purposes. The United States has far-reaching entity classification rules, the 'check-the-box' rules, which provide the ability in many cases to elect entity status as a corporation, partnership, etc.[2]

i Corporate

As a matter of corporate law, non-US investors may choose to invest in the United States either through a 'regular' corporation (a body corporate for state law purposes), or through a limited liability company or other entity, such as a partnership. For US federal income tax purposes, a regular corporation is subject to US tax at the corporate level. A special class of corporation that provides for 'flow-through' treatment (no entity-level tax) to investors, the

1 Moshe Spinowitz is a partner, and Robert C Stevenson and Leonard I Greenberg are associates at Skadden, Arps, Slate, Meagher & Flom LLP. Unless otherwise indicated, all 'Section' references in this chapter are to the Internal Revenue Code of 1986, as amended (the Code), or to the Treasury Department regulations promulgated thereunder (the Treasury Regulations).

2 Treasury Regulation, Section 301.7701-3.

'S' corporation, is not available to non-US investors. With respect to other forms, such as limited liability companies, US tax rules generally permit the entity to elect to be taxed as a corporation or a flow-through entity. Other special types of investment entities, such as real estate investment trusts, generally have the status of a regular corporation and are subject to tax at the corporate level to the extent their earnings are not distributed.

Inbound businesses are often operated through a regular domestic corporation, or an entity formed in the United States that has elected to be taxed as a corporation. Operating through a domestic corporation offers a relatively simplified filing regime, in which the corporation files its tax return on Internal Revenue Service (IRS) Form 1120, just like a domestic-owned corporation. If a single non-US investor owns 25 per cent of the voting power or value of the domestic corporation, certain additional filing requirements apply. In general, however, many investors prefer the relative anonymity and simplicity that this filing regime provides, as opposed to the filing requirements that apply if a US trade or business is conducted directly through a branch or flow-through entity. Operations through a domestic corporation also insulate a foreign corporate investor from the complex 'branch profits' tax (discussed below) applicable to non-corporate forms of business. In addition, only domestic corporations are eligible for certain deductions, such as a deduction for a portion of the corporation's foreign-derived intangible income (FDII). There can, however, be US withholding on dividend distributions by the corporation. Further, whether operating through a domestic corporation or a branch or flow-through entity, certain inbound businesses are subject to a minimum tax on deductible payments to, and depreciation and amortisation of property purchased from, foreign related parties under the Base Erosion and Anti-Abuse Tax (BEAT) discussed in more detail below.

ii Non-corporate

A non-US person wishing to invest in or operate a business in the United States may choose to do so through a pass-through entity (i.e., an entity not taxed at the entity level) that flows through the results of its operations to its owners. Generally, an entity with a single owner can be treated as 'disregarded' as separate from its owner (that is, treated as a branch or division of its owner) or as a corporation, and an entity with multiple owners can be treated as a partnership or as a corporation. The Treasury Regulations set forth general default classifications of single owner and multiple owner entities, with additional rules that generally permit the entity to adopt or change its classification, subject to certain limitations.[3]

Non-US partners that engage in a US trade or business through an entity treated as a partnership are treated as if they engage in a US trade or business directly, and generally are subject to US tax on their share of partnership income (regardless of whether distributed) at the same rates applicable to US partners. Generally, the partnership is obliged to withhold and pay over tax on the non-US partner's distributive share of net business income at the maximum tax rate applicable to such person, and the non-US partner must file a tax return in the United States reporting such income and claiming credit for such withheld tax.[4] Gain on the sale of an interest in a partnership that conducts a US trade or business is also subject

3 ibid.

4 Section 1446.

to US tax and the proceeds from such sale can be subject to US withholding.[5] This is one of the few areas where a US withholding tax is imposed on US business income (as opposed to US investment income, as discussed below).

Certain industries, such as the banking industry, typically operate directly in the United States through a branch. The United States taxes the branch on all income that is effectively connected with its US trade or business, and, in certain cases, applies special rules in computing the tax base.[6] Transfers of 'dividend equivalent amounts' from the US branch back to the non-US home office trigger a 30 per cent branch profits tax, which may be reduced by treaty.[7] The policy of the branch profits tax is to establish 'branch–subsidiary parity'. The notion is that the United States should tax outbound remittances equally, whether they emanate from a US branch (including a partnership's US operations) or a US corporation. Private equity investments will often be made through a pass-through entity such as a partnership, with non-US investors owning their partnership investment through a foreign or US corporate 'blocker' to avoid these complex rules.

In choosing between different forms of investment, non-US investors should also take into account whether the entity is likely to retain a significant portion of its earnings and whether the business might qualify for the deduction for qualified pass-through business income under Section 199A. Because of the disparity between corporate and individual income tax rates, these considerations in addition to those listed above may make one form of investment more advantageous than the other.

III DIRECT TAXATION OF BUSINESSES

i Tax on profits

Determination of taxable profit

The United States imposes tax on 'taxable income', which is defined as 'gross income' less allowable deductions.[8] Gross income is defined as gross revenues (receipts) less cost of goods sold. Allowable deductions include those for expenses that are ordinary and necessary to the conduct of the trade or business, such as salary and rental expenses of the business.[9] Other expenses that may be deducted, subject to certain limitations, include interest expense, depreciation and amortisation, state and local income taxes and real estate taxes, and certain losses and bad debts.[10] A non-US person engaged in business in the United States is generally entitled to the same wide range of deductions as a US person, with a notable exception for the deduction for FDII.

Among the expenses that are non-deductible are most capital expenditures, certain excessive employee remuneration, 'golden parachute payments' made to executives in connection with a corporate change in control, expenses related to the production of

5 Sections 864(c)(8) and 1446(f).
6 Section 882.
7 Section 884.
8 Sections 11 and 63.
9 Section 162.
10 Sections 163 to 198.

tax-exempt income and certain federal taxes.[11] In addition, the interest expense deduction to which certain businesses would otherwise be entitled is subject to limitations (discussed further below).

Taxable income is not based on accounting profits, but instead on the method required by the Code and applicable Treasury Regulations. US corporations with assets above a certain threshold are required to reconcile their book and tax income on a separate schedule attached to their tax return.

Generally, taxpayers must compute their taxable income using the method of accounting that the taxpayer uses to compute book income.[12] These methods could include the cash receipts method, the accrual method or any other permitted method. However, corporations and partnerships with a corporate partner with average annual gross receipts exceeding US$26 million generally may not use the cash receipts method.[13] If the US IRS successfully determines that the taxpayer's method does not 'clearly reflect' its actual income, it may require the taxpayer to use another method. Once a taxpayer adopts a method of accounting, it generally must obtain the consent of the IRS to change its method.

US citizens and residents are taxed on worldwide income, while US corporations are taxed on a modified territorial basis. Previous law allowed deferral for US shareholders for certain active income earned abroad by a non-US corporation until distributed as a dividend to such shareholder. The Tax Cuts and Jobs Act (TCJA), signed into law on 22 December 2017, moved away from this system of taxation by establishing a participation exemption for US corporate shareholders on certain foreign income, a one-time 'transition tax' on certain past accumulated foreign earnings, and a current inclusion in income for such shareholders with regard to certain global intangible low-taxed income (GILTI) of such non-US corporations. GILTI is generally defined as all income of a non-US corporation that is in excess of a fixed return on such corporation's tangible assets. Although the United States generally grants a 'credit' for certain non-US income taxes incurred by US taxpayers (foreign tax credit), no such credit is allowed for any taxes paid with respect to income that qualifies for the participation exemption.[14]

Non-US taxpayers are generally taxed only on income that is effectively connected with a US trade or business (which generally includes US-source income and very limited types of foreign-source income) (ECI), and on US-source income that is passive income, such as interest, dividends, rents and royalties. Non-US persons also may generally claim a foreign tax credit for non-US income taxes paid on income that is considered effectively connected with a US trade or business (other than taxes paid to their country of residence).[15]

Capital and income

In general, for US corporate taxpayers there is no difference in the rate of tax applied to ordinary business income as opposed to capital gains. As discussed below, non-US persons generally are not subject to US tax on capital gains (the main exceptions being gains related to certain US real property, including gains realised on an interest in certain domestic

11 Sections 263, 162(m), 280G, 265, 275.
12 Section 446.
13 Section 448; Revenue Procedure 2019-44.
14 Sections 27, 901 and 245A(d).
15 Section 906.

corporations that hold US real property, and gains realised in connection with a US trade or business, including gains realised on an interest in a partnership conducting a US trade or business).

Losses

A US net operating loss (NOL) generally cannot be carried back but can generally be carried forward indefinitely (with special rules for insurance companies and for farming losses), subject to a limitation that the NOL used in a particular subsequent year cannot exceed 80 per cent of taxable income for that year.[16] The deduction of losses is limited following certain types of ownership changes.[17] An ownership change is generally deemed to occur if there is a change in the stock ownership of a corporation aggregating to more than 50 percentage points over a three-year period. In such a case, the amount of 'pre-change' NOLs that may be deducted in each future year is generally limited to an amount of income each year equal to the value of the target corporation immediately before the ownership change multiplied by the long-term tax-exempt rate of interest published by the IRS for the month of the ownership change.

A capital loss can only offset capital gains.[18] Excess capital losses may be carried back three years and forward five years.[19] Because of the shorter carry-forward period for capital losses, taxpayers may seek to accelerate a capital gain to ensure that the capital loss does not expire unused.

Non-US corporations conducting a trade or business in the United States through a branch or other fiscally transparent entity must file an appropriate and timely tax return in the United States reporting any credits, deductions or losses to preserve their ability to use any credits, deductions or losses in future years.[20]

Rates

Under previous law, corporations were subject to graduated rates and an alternative minimum tax (AMT) to the extent that tax exceeded the regular corporate tax.[21] The TCJA reduced the federal corporate rate and repealed the AMT such that, for tax years beginning after 2017, the corporate tax rate is a flat 21 per cent rate.[22]

The TCJA also introduced the BEAT, a minimum tax imposed in addition to any other income tax. The BEAT imposes a tax equal to the excess of 10 per cent of the taxpayer's 'modified taxable income', less the taxpayer's regular tax liability and certain specified tax credits (but without reduction for any foreign tax credit). Modified taxable income is taxable income computed without regard to base erosion tax benefits (i.e., deductions for payments to related foreign parties or depreciation or amortisation deductions on property purchased from related foreign parties). The BEAT only applies to (1) corporations, other than regulated investment companies, real estate investment trusts, or S corporations; (2) with annual gross receipts of at least US$500 million for the three-tax year period ending with the preceding

16 Section 172.
17 Section 382.
18 Section 1211.
19 Section 1212.
20 Section 882(c). A similar rule also applies to non-corporate persons, Section 874(a).
21 Section 55(e) repealed by the TCJA.
22 Section 11 as amended by the TCJA.

tax year; and (3) a base erosion percentage of 2–3 per cent. With certain limited exceptions, tax credits, including foreign tax credits, cannot be used to reduce the minimum tax due pursuant to the BEAT regime.

The rate of US withholding tax for outbound payments of US-source passive 'investment' income such as dividends, interest, rents and royalties is generally 30 per cent. This rate may be subject to reduction or elimination pursuant to an income tax treaty between the United States and the recipient's country of residence. If withholding does not properly occur, the foreign recipient of the payment must file a US tax return and pay the appropriate tax, or else the payor of the income may be liable for the tax. Similarly, as discussed above, branch profits tax, if applicable, is also imposed at a rate of 30 per cent and may be subject to reduction or elimination by treaty.

Administration

A US corporation must generally file its income tax return on or before the 15th day of the fourth month following the end of its taxable year, although an automatic six-month extension is available and typically taken.[23] As a result, a calendar year corporation usually files its returns by the following 15 October. A foreign corporation required to file a US income tax return with respect to its conduct of, for example, a US trade or business is required to file its income tax return on or before the 15th day of the sixth month following the end of its taxable year, although an automatic six-month extension is available.[24] The tax owed for the year must be paid on or before the due date of the tax return (without extensions). Further, corporations must make estimated tax payments on a quarterly basis during the year, generally in an amount each equal to 25 per cent of the required annual payment.[25] Special provisions apply to corporations with assets of US$1 billion or more. The total quarterly payments must equal at least the lesser of (1) 100 per cent of the tax shown on the final return for the current year or (2) 100 per cent of the tax shown on the final return for the immediately preceding taxable year. Penalties apply if the estimated tax payments are less than these safe harbour amounts. For corporations with taxable income of at least US$1 million during any of the three preceding taxable years, the required annual payment must equal 100 per cent of the current year's tax liability; that is, the preceding year's safe harbour in point (2) above cannot be used.

The most significant taxing authority for non-US taxpayers is the IRS, a division of the US Treasury Department.[26] States and local jurisdictions, such as counties and cities, may impose additional taxes.

In general, there is no regular audit cycle. Special audit regimes may apply. For example, certain eligible taxpayers may be part of the compliance assurance process (CAP), which allows compliant taxpayers to resolve certain issues on an expedited basis, with the taxpayer and the IRS agreeing to the treatment of items by the time the tax return is filed, or shortly thereafter. The IRS expanded the CAP programme in 2011 to include pre-CAP (readying taxpayers to enter the CAP programme) and post-CAP (a maintenance stage for taxpayers with a low-compliance risk and low controversy rate) stages of the process. Certain large

23 Sections 6072(a) and 6081.
24 Sections 6072(c) and 6081.
25 Section 6655.
26 Section 7803.

corporations may also be under continuous audit. Although no specific length of time is used for audit cycles, US corporations, for example, are typically audited for two to four taxable years at any one time.

Before a transaction is undertaken, taxpayers may seek private letter rulings from the IRS when there is uncertainty regarding the treatment of a transaction or an item of income. Each year, the IRS publishes a revenue procedure that details the steps to be taken in requesting a private letter ruling; the revenue procedure also describes those areas in which the IRS normally will not issue a private letter ruling. This general guidance is set forth in the first revenue procedure for the year.[27] In addition, the seventh revenue procedure of each year[28] discusses certain international issues regarding which the IRS will not, or ordinarily will not, issue a private letter ruling. Other forms of administrative filings for rulings are available. Among the most noteworthy are the 'pre-filing agreement' with the IRS and an advance pricing agreement (APA) for transfer pricing issues with the 'advance pricing and mutual agreement' programme, which was formed from the recent combination of the APA Office and certain functions of the US competent authority.

If a taxpayer wishes to challenge a published IRS position on the treatment of an item, the taxpayer can minimise penalties (in the event that it ultimately fails in its challenge) by disclosing on its tax return that it is taking a position contrary to IRS guidance.[29] If the IRS specifically challenges a taxpayer's position on a tax return, the taxpayer generally has the opportunity to make an administrative appeal of the IRS determination. If the taxpayer does not succeed in its appeal, it may either file a petition in Tax Court (which does not require the taxpayer to pay the asserted deficiency in advance), or it may pay the asserted deficiency and file a suit for refund in either a US federal district court or with the US Court of Federal Claims.

In addition, in certain cases where the IRS has proposed adjustments that result in a taxpayer being subject to double taxation or that should appropriately give rise to a correlative adjustment for a related person in a foreign country, the taxpayer may invoke the mutual agreement procedure of an applicable US tax treaty to attempt to resolve the issue.

Tax grouping

An affiliated group of US corporations may elect to file a consolidated income tax return.[30] Non-US corporations generally are not 'includible corporations' in an affiliated group (with exceptions for certain Canadian and Mexican corporations), and therefore are not included in the consolidated group.[31] The stock ownership requirements for an affiliated group are that the common parent must directly own at least 80 per cent of the stock (by vote and value) of at least one subsidiary in the group, and each other subsidiary in the group must be at least 80 per cent directly owned (by vote and value) by one or more of the other members of the group. An election made by the common parent to file a consolidated return applies to all corporations for which the ownership requirements are met. The common parent files the US tax return for the consolidated group.[32]

27 For example, Revenue Procedure 2021-1.
28 For example, Revenue Procedure 2021-7.
29 Treasury Regulation, Sections 1.6662-3 and -4; IRS Forms 8275 and 8275-R.
30 Section 1501.
31 Sections 1504(b) and 1504(d).
32 Treasury Regulation, Section 1.1502-77.

Under the theory that a consolidated group is a unified entity, assets, losses, dividends and interest can generally move within a group without current tax cost.[33] The consolidated group rules focus, however, on an item of income's location, and therefore intercompany transactions will ultimately trigger tax when the item is no longer capable of being reflected in the consolidated group. Income and losses of a group member generally give rise to adjustments to tax basis in the stock of that member held by other members.[34]

In general, a consolidated group determines its income tax liability by computing the separate taxable income of each member as if it were filing a separate return but excluding income and deductions that are determined on a group basis, and computing income and deductions on a group basis, such as the NOL deduction.[35] Credits, determined on a group basis, may be available to offset the consolidated income tax liability. Each member of the group is jointly and severally liable for the total tax liability of the entire group.[36]

Losses incurred by a corporation while it is a member of the group are available to offset another member's income. Losses incurred before a corporation joins a consolidated group are subject to 'separate return limitation year' rules, generally permitting use of such losses only to the extent of the corporation's contribution to the consolidated group's positive net income. Special limitations also apply to 'dual consolidated losses', generally defined as an NOL of a domestic corporation (or component thereof) that may also be used to reduce tax in a foreign country.[37] Thus, for example, a US corporation tax resident in the United Kingdom generally cannot offset its NOL against another member's income unless it elects to use the loss only in the United States. If such an election is made, the loss could be used in the United Kingdom after five years, provided that UK law permits the loss to be claimed.

ii Other relevant taxes

The United States does not impose value added tax (VAT) or sales tax at the federal level, although many states, counties and cities do impose a sales tax on the sale of goods. The United States also does not impose stamp duty, capital duties, registration taxes or net wealth taxes. US employers have payroll tax obligations, including paying obligations for US social security and Medicare taxes and withholding from employee wages.[38] The United States has considered a federal VAT (or similar tax) from time to time, either as an additional tax or as a replacement for income tax. So far, however, no such tax has been enacted.

33 Treasury Regulation, Section 1.1502-13.
34 Treasury Regulation, Section 1.1502-32.
35 Treasury Regulation, Section 1.1502-11.
36 Treasury Regulation, Section 1.1502-6.
37 Section 1503(d).
38 Sections 3102, 3111 and 3301.

IV TAX RESIDENCE AND FISCAL DOMICILE

i Corporate residence

The United States does not generally employ the concept of corporate 'residency' based on the seat of management. Instead, how a corporation is taxed is generally based on its place of incorporation, and not where it is managed or controlled. In some circumstances, a non-US corporation can elect to be treated as a US corporation,[39] or in some cases generally designed to prevent a perceived abuse, a foreign corporation may be deemed to be a US corporation.[40]

In recent years, certain members of Congress have periodically proposed legislation that would define a corporation's residency for US tax purposes based on where it is managed and controlled. This legislation, if ever enacted, would represent a significant change in the US tax treatment of both US and non-US corporations. In addition, Treasury Regulations have significantly expanded the scope of existing anti-abuse provisions, which potentially cause non-US-incorporated entities to be treated as US corporations for tax purposes, in particular when such non-US-incorporated entities have engaged in cross-border business combination transactions with US corporations.

ii Branch or permanent establishment

If a non-US person conducts sufficient activities in the United States, it will be 'engaged in a US trade or business', and income that is 'effectively connected' with such business generally is subject to net basis tax.[41] The threshold of activities needed to constitute a US trade or business is not precisely defined, but factors derived from case law include whether there are 'regular and continuous' activities within the United States, including through employees or agents. To secure greater tax parity between a US subsidiary and a US branch, a 30 per cent 'branch profits' tax may apply when the US branch makes distributions (or is deemed to make distributions) to its home office.[42] This is the same rate of US withholding tax that applies to dividend distributions by US corporations.[43] Just as US tax treaties may reduce withholding tax on corporate distributions, so do they provide for a common, reduced rate of tax that applies to branch remittances. Some US treaties even provide for the complete elimination of branch profits tax. The United States no longer imposes a 'secondary' withholding tax on dividends paid by a non-US corporation.

If the non-US entity is a resident of a jurisdiction with which the United States has an income tax treaty, and such entity is eligible for benefits under such treaty, the entity will generally become subject to tax on its 'business profits' that are attributable to a US permanent establishment (PE) maintained by the non-US entity. The PE standard generally requires a non-US entity to have a greater nexus with the United States than is required to be considered 'engaged in a US trade or business'. The relevant treaty and domestic law provide rules regarding the definition of a PE and, if a PE exists, the amount of income and expenses that are attributable to that PE and subject to US tax. The rules for attributing income and capital to a PE are generally based on Organisation for Economic Co-operation and Development (OECD) standards and may result in differing amounts of income and

39 See, e.g., Sections 953(d), 897(i) and 1504(d).
40 See, e.g., Sections 269B and 7874.
41 See, e.g., Section 882.
42 Section 884.
43 See, e.g., Section 881.

deduction than under the US rules that apply in determining the non-US entity's effectively connected income. US tax treaties generally require a non-US entity to consistently apply either the PE rules or the US effectively connected rules in determining its income subject to US tax.

V TAX INCENTIVES, SPECIAL REGIMES AND RELIEF THAT MAY ENCOURAGE INWARD INVESTMENT

i Holding company regimes

Prior to the passage of the TCJA, potential double taxation with respect to non-US income paid to a US person or US branch of a non-US corporation was generally addressed through the US foreign tax credit regime and the relief from double taxation articles of US tax treaties. Recently, however, to encourage US corporations to repatriate earnings, the United States enacted a provision under the TCJA that exempts certain foreign earnings from taxation. This 'participation exemption' system allows certain US corporations a 100 per cent dividends received deduction (DRD) for the 'foreign-source portion' of dividends received from a 'specified 10 per cent owned foreign corporation'.[44] Because, as at the time of writing, the IRS has yet to issue Treasury Regulations or publish guidance under the directive of Section 245A(g), it is uncertain how, or whether, the DRD would apply to a domestic corporation that indirectly owns shares in a foreign corporation through its interest in a partnership. The GILTI regime, discussed further below, significantly reduces the otherwise expansive scope of the DRD by making a significant portion of a non-US subsidiary's earnings subject to current US taxation at a reduced rate.

Importantly, unlike some other countries, the United States does not generally impose any tax on the sale of capital assets (such as stock) by non-US persons. One key exception to the general rule relates to the sale of certain 'US real property interests' (USRPI),[45] which may require the purchaser to withhold 15 per cent of the consideration paid for the property.[46] USRPIs may include an interest in real property located in the United States as well as stock of a US corporation that is a 'US real property holding corporation', which generally occurs if the fair market value of USRPIs held by such corporation exceeds 50 per cent of the fair market value of its total assets.[47] No withholding is required if the non-US person transfers stock in a non-US corporation that holds the USRPI. Other important exceptions relate to deferred payments for property or services, and the sale of assets that are used (or within the prior 10 years were used) in a US trade or business (e.g., depreciable assets).[48] Generally, the US taxation of such income or gain from such payments or sales is determined based on the facts existing when the property or service was provided, without regard to whether the non-US entity is engaged in a US trade or business in the taxable year the income or gain is received. The United States does not impose a withholding tax on 'portfolio interest', discussed further below.

44 Section 245A(a) and (c).

45 Section 897.

46 Section 1445.

47 Section 897(c)(2).

48 Section 864(c)(6) and (c)(7).

ii IP regimes

Research and development (R&D) expenses paid or incurred in tax years before 2022 may be deducted in the year incurred or amortised over five years.[49] Beginning in 2022, R&D expenses must be capitalised and amortised over five (or 15) years.[50] The United States also provides a 20 per cent R&D credit for expenses that exceed a base amount determined by reference to a percentage of the taxpayer's average annual gross receipts for the preceding four taxable years.[51]

iii FDII

The TCJA adopted a regime that generally allows a domestic corporation to deduct 37.5 per cent of its FDII for tax years beginning after 2017, decreased to 21.875 per cent of FDII for tax years beginning after 2025.[52] Very generally, a domestic corporation's FDII is equal to the excess of income earned selling certain goods and services or licensing or leasing property to non-US persons for use outside the United States over the corporation's deemed return on investments in tangible assets.

iv General

Certain tax credits (particularly for renewable energy) and accelerated depreciation deductions can reduce the tax cost of running a US business.[53] The TCJA made extensive changes to the depreciation (and expensing) rules, including changes to Section 168(k) that provide a 100 per cent first-year depreciation deduction for certain 'qualified property'. Additionally, states and local jurisdictions may have investment incentives.

The relatively extensive advance pricing and mutual agreement programme (discussed further above), which can include 'bilateral' agreements with other taxing jurisdictions, may help minimise tax controversy for an inbound investor. Investors also benefit from the fact that the United States does not generally impose any tax on the sale of capital assets by non-US persons, unless the asset is a 'US real property interest'.[54]

VI WITHHOLDING AND TAXATION OF NON-LOCAL SOURCE INCOME STREAMS

i Withholding on outward-bound payments (domestic law)

A US person must generally withhold 30 per cent of the gross amount of certain US 'investment' income paid to non-US persons, such as dividends, interest and royalties, and certain dividend equivalent amounts.[55] This statutory rate, however, can be reduced by an applicable bilateral treaty. Many US bilateral treaties reduce the withholding tax rates on interest or royalties to zero, but as discussed in detail above, for certain taxpayers, the

49 Section 174 repealed by the TCJA.
50 Section 174(a) as amended by the TCJA.
51 Sections 38 and 41 as amended by the TCJA.
52 Section 250.
53 Sections 48 and 168 as amended by the TCJA.
54 Section 897.
55 Sections 871(m), 1441 and 1442. Further, amounts paid by US corporations or non-corporate US residents for guarantees issued after 27 September 2010 are treated as US-source payments subject to withholding. Section 861(a)(9).

BEAT functionally disallows deductions with regard to deductible payments to related foreign persons above a minimum percentage.[56] A recent treaty trend has been to reduce the withholding tax on certain dividend distributions to zero if certain ownership and holding period requirements are met. In certain cases, the US tax rules treat certain payments or distributions by foreign persons (e.g., a foreign partnership) as US-source income subject to withholding.[57]

ii Domestic law exclusions or exemptions from withholding on outward-bound payments

A portfolio interest exception applies to eliminate US withholding tax on certain interest payments to non-US corporations and individuals.[58] This exception is fairly broad and operates as a matter of domestic US tax law, regardless of the application of any bilateral treaty. The interest recipient must establish its ability to claim the exception by providing documentation to the payor. The exception does not apply to:

a interest paid to a 10 per cent shareholder of the payor and certain other related persons;
b interest paid to a controlled foreign corporation (CFC) that is a related person;
c payments to certain foreign banks;
d payments on non-registered instruments (i.e., bearer bonds); and
e contingent interest (i.e., dependent on metrics related to sales, profits, etc.).

Outside of the treaty context, or unless the recipient is a non-US sovereign, the United States does not have exemptions from withholding on outbound dividend or royalty payments. Certain income of non-US sovereigns is exempt from US federal income tax, including income received from investments in the United States of stocks and bonds or other US securities, and income from financial investments held in the execution of governmental, financial or monetary policy.[59] The exemption does not apply to income derived from a commercial activity, any income received by or from a controlled commercial entity, or income from the disposition of an interest in such entity.[60]

iii Double tax treaties

The United States has approximately 60 income tax treaties covering 68 countries. The treaty network is most extensive in Europe, is expanding in Asia, and is limited in South America and Africa. Generally, these income tax treaties reduce the US withholding tax on dividends, interest and royalty payments to residents of a treaty country, provided that the beneficial owner is a resident of the treaty country and meets the anti-treaty shopping provision (i.e., the limitation on benefits (LOB) provision) of the applicable treaty. The current negotiating position of the United States is reflected in its 2016 model income tax convention, which contains certain significant changes from the prior 2006 model income tax convention. The changes generally deny treaty benefits on payments by expatriated entities (generally, US companies that have engaged in an 'inversion' transaction), where income is subject to a

56 Section 59A.
57 Sections 861(a)(1)(B).
58 Sections 871(h) and 881(c).
59 Section 892(a)(1).
60 Section 892(a)(2).

special tax regime in the country of receipt and where a country reduces its tax rates below a certain threshold. The United States typically uses its own US model treaty rather than, for example, the OECD model, as the starting point for negotiations.

With respect to dividends, the US position is generally to provide for a maximum of 5 per cent withholding if the shareholder holds 10 per cent or more of the US resident corporation, and 15 per cent in all other cases. In an increasing number of US treaties, the United States has agreed to forgo withholding on dividends if the shareholder holds 80 per cent or more of the US tax-resident corporation. This elimination of US dividend withholding tax typically requires updated LOB and exchange of information provisions.

With respect to interest and royalty payments, the general US position is to eliminate withholding.

The table in the Appendix to this chapter summarises the withholding rates applicable to dividend, interest and royalty payments under the double taxation treaties concluded by the United States.

iv Taxation on receipt

The United States permits US corporations to credit foreign income taxes (or taxes imposed in lieu of a foreign income tax) against the US tax liability on non-US dividends and other income flows.[61] In general, many non-US withholding taxes are creditable in the United States provided that certain requirements (such as a minimum holding period) are met. Under prior law, if a US corporation owned at least 10 per cent of the total voting power of a foreign corporation's stock, the US corporation could claim a 'deemed paid' credit for foreign taxes that the foreign corporation actually paid on its income, once the US corporation received a dividend (or was deemed to receive a distribution under the US anti-deferral regime) from the foreign corporation.[62] If a US corporation claimed a deemed paid credit, it also had to increase its income in the year the dividend was received by the amount of the foreign taxes deemed paid, whether or not the US corporation, after application of various limitation provisions, was able to use the credit to reduce its US tax liability.[63]

The TCJA repealed the deemed-paid credit with respect to dividends received by a US corporation that owns 10 per cent of the total voting power of a foreign corporation's stock. Instead, earnings of foreign corporations can generally be repatriated free of tax under the participation exemption system of taxation discussed above and subject to the GILTI regime discussed below. The deemed-paid credit regime generally remains in place, albeit with significant limitations, for the portion of a foreign corporation's foreign income taxes that are properly attributable to the subpart F income or GILTI of that corporation.[64]

v Foreign Account Tax Compliance Act

The Foreign Account Tax Compliance Act (FATCA) is a complex reporting regime intended to encourage US persons to report ownership of offshore accounts; however, the provisions affect, inter alia, non-US entities and financial institutions receiving payments from US

61 Sections 27 and 901.
62 Sections 902 repealed by the TCJA and 960 before amendment by the TCJA.
63 Section 78.
64 Section 960 as amended by the TCJA.

sources, directly or indirectly. Under FATCA, withholding at a rate of 30 per cent would apply to certain payments to (or through) certain financial institutions (including investment funds), unless such institution:

a enters into, and complies with, an agreement with the IRS to report, on an annual basis, information with respect to interests in, and accounts maintained by, the institution that are owned by certain US persons or by certain non-US entities that are wholly or partially owned by US persons and to withhold on certain payments;

b if required under an intergovernmental agreement between the United States and an applicable foreign country, reports such information to its local tax authority, which will exchange such information with the US authorities; or

c otherwise qualifies for an exemption.

Similarly, certain amounts payable to a non-financial non-US entity generally will be subject to withholding at a rate of 30 per cent, unless such entity certifies that it does not have any 'substantial United States owners', provides certain information regarding the entity's 'substantial United States owners' or otherwise qualifies for an exemption. The Treasury Department has entered into agreements for the implementation of FATCA with the competent authorities of other countries, including Canada, France, Germany, Italy, Japan, Spain, Switzerland and the United Kingdom, among others, and such agreements modify certain of these provisions.

VII TAXATION OF FUNDING STRUCTURES

Entities may be funded with capital contributions or with debt funding, but there must be some member with an equity interest in the entity. The US tax rules generally permit a deduction for interest payments made on indebtedness,[65] but do not permit a deduction (or deem a deduction) on capital contributed to an entity in exchange for equity. Regardless of the entity's form, contributions of cash or property when forming an entity are generally tax-free for the contributor and the receiving entity.

i Characterisation of funding as debt or equity

The characterisation of an instrument as debt or equity for US federal income tax purposes generally depends on all the surrounding facts and circumstances. Because the Code does not contain a single defined set of standards for purposes of distinguishing between debt and equity, taxpayers generally rely on case law and certain published pronouncements of the IRS to guide them in making general debt–equity determinations. Courts and the IRS have articulated certain factors that are relevant in determining whether an investment, analysed in terms of its economic characteristics, constitutes risk capital largely subject to the performance of the issuer's business (thus making the investment more like equity) or, alternatively, exhibits the characteristics of a bona fide loan that is expected, or may be compelled, to be repaid in full (thus making the instrument more like debt).

In an effort to discourage 'earnings stripping' out of the United States, the US Treasury Department and the IRS have issued final and temporary Treasury Regulations under Section 385. The Treasury Regulations materially impact the treatment of certain related-party debt

65 Section 163.

issued by issuers that are domestic corporations (including disregarded entities and certain partnerships owned by domestic corporations).[66] These new Treasury Regulations generally operate to convert certain instruments that are otherwise classified as indebtedness for US federal income tax purposes into equity (and thus convert interest and principal payments on such debt as distributions on equity). The new Treasury Regulations generally apply to convert into equity debt instruments issued by domestic corporations (including disregarded entities and certain partnerships owned by domestic corporations) to certain related parties (such as a non-US parent corporation or a non-US finance entity that is directly or indirectly owned by the same parent corporation that owns the domestic issuer) if:

a such instruments are issued in certain prohibited transactions, such as a distribution of the instrument to a related party; or

b if the issuer of such instrument engages in certain prohibited transactions, such as a distribution of property to a related person that is funded by or occurs within three years before or after the issuance of such instrument.

ii Thin capitalisation

Under the 'business interest deduction limitation' passed as part of the TCJA, the interest deduction to which certain taxpayers would otherwise be entitled (after application of other statutory limitations) is generally limited to the sum of: (1) 30 per cent of the taxpayer's 'adjusted taxable income' (roughly equivalent to earnings before interest, taxes, depreciation and amortisation for tax years beginning before 1 January 2022, and roughly equivalent to earnings before interest and taxes for tax years beginning after 31 December 2021); and (2) any interest includible in the taxpayer's income for the taxable year.[67] If a taxpayer has interest disallowed for a tax year as a result of this provision, such interest may be carried over to the following tax years indefinitely, subject to restrictions applicable to certain partnerships;[68] any excess limitation, however, is not able to be carried forward. In 2018, 2019 and 2020, the IRS issued several packages of proposed and final Treasury Regulations under the TCJA, including proposed Treasury Regulations addressing the business interest deduction limitation and final and proposed Treasury Regulations regarding the BEAT regime.

iii Deduction of finance costs

Interest deductions may be limited if the interest is:

a paid with respect to certain acquisition indebtedness that is subordinated and convertible into equity, and the issuer's debt-to-equity ratio exceeds two-to-one, or projected earnings do not exceed three times the interest on the acquisition debt;[69]

b paid on certain high-yield obligations;[70]

c payable either in cash or equity of the issuer (or a related party);[71]

66 See Treasury Regulation, Sections 1.385-1, 1.385-3 and 1.385-4.

67 Section 163(j) as amended by the TCJA.

68 Section 163(j)(2) and (j)(4)(B)(i)(I).

69 Section 279.

70 Section 163(e)(5).

71 Section 163(l).

d paid or accrued by or to a hybrid entity or pursuant to a hybrid instrument;[72] or
e related to tax-exempt income (e.g., debt incurred to acquire tax-exempt securities).[73]

Finance costs may generally be deducted by a US debtor, although certain rules may require that these costs be capitalised if related to inventory property or deducted over the term of the financing.

iv Restrictions on payments

The ability to pay dividends is governed by state, not US federal, law. Many states, such as Delaware, do not impose burdensome restrictions on the ability to pay dividends. In general, a corporation needs either 'surplus' or net profits from the fiscal year in which the dividend is paid (in the latter case, provided that capital represented by outstanding stock of classes having a preference upon the distribution of assets is not impaired).[74] However, the definitions of 'dividend' for state law and US federal income tax law are not coterminous. For example, a distribution could constitute a dividend under state law because it is paid out of 'surplus', while it may not constitute a taxable dividend for US federal income tax purposes because the corporation has no 'earnings and profits' (a tax concept that roughly corresponds with taxable income, subject to adjustments).[75]

v Return of capital

Distributions are treated first as taxable 'dividends' to the extent the distributing corporation has 'earnings and profits'; distributions beyond this amount are tax-free 'return of capital' distributions; any distribution amounts greater than a taxpayer's capital are treated as capital gain (generally not taxable for a non-US person).[76]

VIII ACQUISITION STRUCTURES, RESTRUCTURING AND EXIT CHARGES

i Acquisition

Taxable acquisitions of US corporations are frequently structured as cash mergers, whereby a non-US acquiring corporation funds a transitory US merger subsidiary with equity and debt, after which the merger subsidiary merges with and into the US target corporation, with the latter surviving. The acquisition debt resides with the US target corporation after the transaction, providing a means to reduce the US tax base.

Generally, there is no US withholding tax when a non-US corporation acquires a US corporation. However, if the US corporation fails (or is unable) to certify to the acquirer that it is not a 'US real property holding corporation', then the acquirer generally would be obliged to withhold 15 per cent of the consideration paid to any non-US sellers.[77]

72 Section 267A.
73 Section 265.
74 8 Del C, Section 170.
75 Sections 312 and 316.
76 Section 301(c).
77 Section 1445.

ii Reorganisation

The United States has very flexible rules that permit merging and demerging (or 'spinning off') corporations on a tax-free basis.[78] Mergers, stock combinations or asset acquisitions generally can be implemented on a tax-free basis within the United States. If a non-US entity acquires the stock or assets of a US corporation, there are several requirements that must be satisfied to avoid adverse US tax consequences. These rules are focused on preventing an 'inversion', whereby a US corporation moves to a non-US jurisdiction with substantial continuity of its existing shareholder base, and, somewhat related, the loss of US taxing jurisdiction over corporate assets. If a transaction violates anti-inversion rules, the US shareholders or the US target could be subject to tax or, in certain cases, the non-US acquiring corporation could actually be treated as a US corporation for all US federal income tax purposes.[79] Generally, foreign-to-foreign reorganisations do not give rise to US tax, except in certain cases where there is significant (i.e., controlling) US ownership of the acquired or target foreign corporation before but not after the transaction.[80]

iii Exit

Under prior law, relocating outside the United States was an issue of great interest to many US taxpayers, given the relatively high US corporate tax rates and broad tax base. Although less attractive after the TCJA's reduction of US corporate income tax rates, a US corporation may nevertheless wish to exit the United States. To do so, either its stock or assets must be transferred to a non-US corporation. Two different sets of rules limit a US corporation's ability to 'invert' to a non-US jurisdiction.

The Section 367 rules tax US shareholders on gain in stock of a US corporation that is transferred to a foreign corporation, unless several requirements are met. These requirements include that the foreign acquiring corporation be at least as valuable as the US target corporation and conduct an active foreign trade or business. Further, a US parent corporation generally will recognise gain on assets that it transfers to a foreign acquiring corporation even if the transaction otherwise qualifies as a non-taxable asset reorganisation. For this reason, it generally is necessary to transfer the stock, rather than assets, of a US corporation that wishes to exit the United States.

The Section 7874 rules apply at the entity level, and can treat a foreign acquiring corporation as a US corporation for all US federal income tax purposes if:

a the foreign acquiring corporation acquires substantially all the assets (either directly or through a stock acquisition) of the US target corporation (or substantially all the properties constituting a trade or business of a US partnership);

b at least 80 per cent of the stock of the foreign acquiring corporation is owned by former shareholders of the US target corporation (or US partnership) by reason of having owned the US target; and

c the foreign acquiring corporation's expanded affiliated group lacks 'substantial business activities' in the jurisdiction in which the foreign parent corporation is incorporated. Treasury Regulations require that at least 25 per cent of a foreign acquiring corporation's

78 Sections 368 and 355.

79 Section 367(a); Section 7874(b); Treasury Regulation, Section 1.367(a)-3(c).

80 Treasury Regulation, Section 1.367(b)-4.

expanded affiliated group's employees, assets and income be located or derived from the relevant foreign jurisdiction for there to be substantial business activities in that foreign jurisdiction.[81]

Alternatively, if the above requirements are satisfied but the ownership continuity is at least 60 per cent (but less than 80 per cent), then the foreign acquiring corporation is respected as a foreign corporation; however, the US target will not be able to use any tax attributes (such as losses or foreign tax credits) against any gain that the US target corporation recognises (or royalty income it receives from affiliates) by reason of property transfers during the 10 years that follow the inversion. Under the TCJA's recapture provision, a corporation that undergoes such a 60 per cent inversion during the 10 years after 22 December 2017 may also have to increase its tax by an amount equal to the difference between 35 per cent and the actual rate of tax paid on its foreign earnings that were subject to the one-time transition tax under the TCJA.[82] Such corporations are also subject to more onerous rules under the BEAT regime and dividends paid by such corporations are not eligible for the reduced rate of taxation otherwise applicable to 'qualified dividend income'.[83] In addition, Treasury Regulations generally make it more difficult to satisfy the above-mentioned ownership thresholds and recent law changes make it more difficult for such corporations to efficiently integrate their non-US operations.[84]

A special excise tax may also apply to certain stock compensation of insiders or large shareholders of a US corporation that inverts to a foreign jurisdiction.[85]

A non-US person's disposition of assets used in a US trade or business will be subject to US tax;[86] however, a disposition of stock in a US or foreign corporation conducting a US business will generally not give rise to US tax unless, in the case of stock of a US corporation, the corporation is considered a US real property holding corporation.[87]

Entities operating in partnership form are generally able to relocate their business to a foreign partnership without US tax.

IX ANTI-AVOIDANCE AND OTHER RELEVANT LEGISLATION

i General anti-avoidance

Anti-avoidance doctrines developed through common law (i.e., court decisions) include the 'step transaction' doctrine, the 'business purpose' requirement (imposed on reorganisations and spin-offs) and the 'economic substance' doctrine. In 2010, Congress codified the common law 'economic substance' doctrine with substantial penalties for transactions subject to the provision (discussed further below).[88] Anti-deferral rules discussed immediately below

81 Treasury Regulation, Section 1.7874-3. Treasury Regulations also require that the foreign parent's tax residence be located in the relevant foreign jurisdiction.
82 Section 965(l)(1) as amended by the TCJA.
83 Section 59A(d)(4); Section 1(h)(11)(C)(iii)(II).
84 Section 958(b)(4) repealed by the TCJA; Treasury Regulation, Section 1.7874-5 et seq.
85 Section 4985.
86 Sections 871(b), 882 and 864(c)(7).
87 Sections 897 and 1445.
88 Section 7701(o).

are generally aimed at income received in low-tax jurisdictions. The United States also seeks to police treaty shopping in low-tax jurisdictions by negotiating for a strict 'limitation on benefits' in its treaties.

ii Controlled foreign corporations

The US CFC regime is expansive and imposes current US tax on subpart F income,[89] an umbrella term that comprises:

a passive income (foreign personal holding company income);[90]

b income earned in a jurisdiction resulting from related-party transactions where there may be little activity and value added in the foreign jurisdiction where the CFC is created or organised (sales and service income);[91]

c certain insurance income;[92] and

d certain other types of income.[93]

With respect to foreign personal holding company income, a key exception is the 'same country exception' whereby certain payments of dividends, interest and royalties between corporations in the same jurisdiction do not give rise to current tax in the United States.[94] A further exception is available for 'qualified banking or financing income'.[95] An additional temporary exception is provided for payments received from related CFCs that are not attributable to subpart F income.[96]

A foreign corporation generally is a CFC if more than 50 per cent of the vote or value of the foreign corporation is owned by 'United States shareholders',[97] which are defined as US persons owning at least 10 per cent of the total vote or value of all classes of stock of the foreign corporation.[98] The US has an extensive constructive ownership attribution regime. Under this regime, a shareholder that does not directly hold a 10 per cent interest may still be classified as a United States shareholder if the shareholder is attributed stock of other shareholders and, as a result, that shareholder indirectly holds a 10 per cent interest. Another anti-deferral regime applies, without regard to the level of US ownership, to a foreign corporation classified as a passive foreign investment company (PFIC).[99] A foreign corporation is classified as a PFIC with respect to any US shareholder if at least 75 per cent of its gross income is passive income or if at least 50 per cent of its assets are passive assets.

89 Section 952.
90 Section 954(c).
91 Section 954(d) and (e).
92 Section 953.
93 Section 952(a)(3), (4) and (5).
94 Section 954(c)(3).
95 Section 954(h).
96 Section 954(c)(6).
97 Section 957.
98 Section 951(b) as amended.
99 Sections 1291 to 1298.

iii Transfer pricing

The US transfer pricing regime is based upon the familiar tax principle that transactions between commonly controlled entities must be priced at arm's length. There is no precise definition of what constitutes common control. Penalties of up to 40 per cent may apply if a taxpayer's price deviates significantly from the ultimately determined arm's-length price.[100] Taxpayers can avoid penalties by preparing contemporaneous documentation of a reasonable choice of method to determine the appropriate price. Treasury Regulations also provide detailed descriptions of methods, and the taxpayer is required to use the 'best method' to determine the appropriate price. For sales of tangible property, these methods include:

a the comparable uncontrolled price method;
b the resale price method;
c the cost-plus method;
d the comparable profits method;
e the profit-split method; and
f unspecified methods.[101]

For transfers of intangible property, a fundamental principle is that the income received must be 'commensurate with the income attributable to the intangible'. The methods include:

a the comparable uncontrolled transaction method;
b the comparable profits method;
c the profit-split method; and
d unspecified methods.[102]

Guidance has also been provided regarding transfer pricing of controlled services transactions. The methods include:

a the services cost method;
b the comparable uncontrolled services price method;
c the gross services margin method;
d the cost of services plus method;
e the comparable profits method;
f the profit-split method; and
g unspecified methods.[103]

A very significant element of the transfer pricing Treasury Regulations pertains to 'cost sharing', where parties develop and own IP based on their share of cost and risk.[104] The major benefit of a qualified cost sharing agreement is that the IRS is limited to adjusting the 'inputs' or allocated costs of the IP development, and cannot adjust the potentially much larger 'outputs' (i.e., income) attributable to the cost-shared IP.

As discussed in further detail below, many taxpayers find it advantageous to enter into an APA with the IRS, which generally precludes the IRS from challenging the relevant transfer pricing for a specified period contained in the agreement.

100 Section 6662(e) and (h).
101 Treasury Regulation, Section 1.482-3.
102 Treasury Regulation, Section 1.482-4.
103 Treasury Regulation, Section 1.482-9.
104 Treasury Regulation, Section 1.482-7.

iv GILTI

A US shareholder of a CFC must include in gross income its share of each of its CFCs' GILTI using mechanics similar to subpart F income inclusions. GILTI is the excess of 'net CFC tested income' over the shareholder's 'net deemed tangible income return'. Net deemed tangible income return is generally equal to 10 per cent of a CFC's basis in tangible depreciable property. Broadly, net CFC tested income is equal to gross income, excluding ECI, subpart F income, foreign oil and gas extraction income, certain related-party dividends, and non-economic transactions intended to affect tax attributes of US shareholders and their CFCs, less any allocable deductions and foreign taxes.[105] A US shareholder of one or more CFCs may elect on behalf of its CFC group to exclude 'high-taxed' income (generally, income subject to foreign tax at a rate greater than 90 per cent of the then-effective maximum US corporate tax rate) from GILTI and subpart F income.[106] A US corporation is allowed to claim foreign tax credits for foreign income taxes paid with respect to GILTI, but such credits are limited to 80 per cent of foreign income taxes paid and cannot be carried forward or back, or used to offset any other income.[107] In addition, while both corporate and non-corporate US shareholders must include their GILTI in income, generally only domestic corporations are entitled to a 50 per cent deduction on the included GILTI (effectively cutting the applicable tax rate on GILTI in half for domestic corporations).[108]

v Tax clearances and rulings

Taxpayers may seek private letter rulings when there is uncertainty regarding the treatment of a transaction or an item of income. Each year the IRS publishes a revenue procedure that details the steps to be taken in requesting a private letter ruling; the revenue procedure also describes those areas in which the IRS normally will not issue a private letter ruling. Tax clearances are not required for the acquisition of a US business.

The IRS will also enter into APAs with taxpayers to ensure that transfer pricing is not challenged. A taxpayer may also be able to enter into a pre-filing agreement, which ensures that the IRS will not challenge how a taxpayer reports certain positions on its return for a specified number of years. US tax treaties generally contain a provision that allows for a 'competent authority agreement', which grants the benefit of a treaty article the terms of which are not otherwise technically satisfied.

X YEAR IN REVIEW

The TCJA, which was signed into law in late December 2017, introduced the most dramatic changes in US federal income taxation in the past three decades. In addition to the massive overhaul of the US outbound taxation regime, the TCJA made several significant changes relevant to inbound investors, such as the BEAT and expanded interest expense limitations. As a result of the changes, the clear focus of both tax administrators and taxpayers in 2021 has continued to be on interpreting the provisions of this new tax regime. Numerous questions have been raised as to the proper interpretation of, and as to technical errors in, the TCJA,

105 Section 951A.

106 Sections 954(b)(4) and 951A(c)(2)(A)(i)(III); Treasury Regulation, Section 1.951A-2(c)(1)(iii), -2(c)(7).

107 Section 904(c).

108 Section 250. The deduction for GILTI is scheduled to decrease to 37.5 per cent, and thus the effective tax rate on GILTI is expected to increase to 13.125 per cent, for tax years beginning after 31 December 2025.

and the Treasury and the IRS have been working diligently to release guidance, particularly in those areas most critical to taxpayers. At the time of writing, certain proposed and final Treasury Regulations have been released with regard to the new provisions under the TCJA, with more expected.

Additionally, the Coronavirus Aid, Relief and Economic Security Act (the CARES Act), which was signed into law in March 2020, introduced additional changes to US federal income tax rules in response to the covid-19 pandemic, some of which directly affect provisions that were introduced in the TCJA. The tax provisions of the CARES Act generally seek to alleviate certain tax burdens on businesses by allowing the deferral of certain employer payroll tax payments, providing for limited carry-backs of NOLs and tax refunds resulting therefrom, and increasing the business interest deduction limitation of Section 163(j). The Treasury and the IRS have prioritised certain guidance intended to implement the provisions of the CARES Act to quickly provide relief to taxpayers.

XI OUTLOOK AND CONCLUSIONS

The Treasury and the IRS have continued to focus on drafting and finalising guidance relating to the TCJA, and several packages of proposed and final Treasury Regulations have been issued, with additional final Treasury Regulations expected in the coming year. In addition, at the time of this writing, Congress is considering significant tax reform legislation, some of which seeks to modify provisions of the TCJA and the Treasury Regulations thereunder. The proposed legislation, if enacted, is expected to, among other things:

a limit the deduction of interest by certain domestic corporations that are members of an international financial reporting group;
b reduce the deductions for FDII and GILTI;
c impose country-by-country application of GILTI and provide for the carryover of country-specific net CFC tested losses;
d increase the amount of deemed paid tax credits a taxpayer may claim with respect to GILTI;
e restrict the participation exemption to dividends from corporations that are CFCs;
f modify the tax rates and computational rules applicable to the BEAT;
g limit the portfolio interest exemption in the case of 10 per cent shareholders of the payor;
h delay the effectiveness of the requirement to amortise research and experimental expenditures;
i provide for increased information reporting; and
j increase funding for tax enforcement.

At the time of writing, the prospects for this legislation are uncertain, and its proposed provisions are subject to change in all respects. Inevitably, any changes to US tax law will require implementation and interpretation by regulations and guidance from the Treasury Department and the IRS, which could significantly affect the operation of any such law changes. Further, there can be no certainty as to what additional tax legislation, if any, Congress may pass in the coming year.

Appendix I: Domestic and treaty rates for dividend, interest and royalty payments

	Dividends			
	Individuals, corporations	**Qualifying corporation***	**Interest**	**Royalties**
Domestic rates	%	%	%	%
Companies	30	30	0/30	30
Individuals	30	N/A	0/30	30
Treaty rates	%	%	%	%
Armenia†	–	–	–	0
Australia	15	0‡/5	10	5
Austria	15	5	0	0/10
Azerbaijan†	–	–	–	0
Bangladesh	15	10	10	10
Barbados	15	5	5	5
Belarus†	–	–	–	0
Belgium	15	0‡/5	0	0
Bulgaria	10	5	5	5
Canada	15	5	0	0/10
China	10	10	10	7/10
Cyprus	15	5	10	0
Czech Republic	15	5	0	0/10
Denmark	15	0‡/5	0	0
Egypt	15	5	15	15/30
Estonia	15	5	10	5/10
Finland	15	0‡/5	0	0
France	15	5/‡0	0	0
Georgia†	–	–	–	0
Germany	15	0‡/5	0	0
Greece	–	–	0/30	0/30
Hungary	15	5	0	0
Iceland	15	5	0	0/5
India	25	15	15	10/15
Indonesia	15	10	10	10
Ireland	15	5	0	0
Israel	25	12.5	17.5	10/15
Italy	15	5	10	0/5/8
Jamaica	15	10	12.5	10
Japan	10	0‡/5	0	0
Kazakhstan	15	5	10	10
Kyrgyzstan†	–	–	–	0
Latvia	15	5	10	5/10
Lithuania	15	5	10	5/10
Luxembourg	15	5	0	0
Malta	15	5	10	10
Mexico	10	0‡/5	15	10
Moldova†	–	–	–	0
Morocco	15	10	15	10

	Dividends		Interest	Royalties
	Individuals, corporations	Qualifying corporation*		
Domestic rates	%	%	%	%
Netherlands	15	0‡/5	0	0
New Zealand	15	0‡/5	10	5
Norway	15	15	0	0
Pakistan	–	15	–	0
Philippines	25	20	15	15
Poland	15	5	0	10
Portugal	15	5	10	10
Romania	10	10	10	10/15
Russia	10	5	0	0
Slovakia	15	5	0	0/10
Slovenia	15	5	5	5
South Africa	15	5	0	0
South Korea	15	10	12	10/15
Spain	15	0‡/5	0	0
Sri Lanka	15	15	10	5/10
Sweden	15	0‡/5	0	0
Switzerland	15	5	0	0
Tajikistan†	–	–	–	0
Thailand	15	10	15	5/8/15
Trinidad and Tobago	–	–	–	15
Tunisia	20	14	15	10/15
Turkey	20	15	15	5/10
Turkmenistan†	–	–	–	0
Ukraine	15	5	0	10
United Kingdom	15	0‡/5	0	0
Uzbekistan†	–	–	–	0
Venezuela	15	5	10	5/10

* Generally, the lower non-zero rate applies if the corporate shareholder owns at least 10 per cent of the voting stock of the US corporation. The text of the treaty should be consulted.
† The treaty concluded between the United States and the former USSR.
‡ The zero per cent rate generally applies if the corporate shareholder owns 80 per cent or more of the voting stock of the US corporation for a 12-month period and qualifies under certain provisions of the limitation on benefits article of the treaty. The text of the treaty should be consulted.

Appendix 1

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