# Proposed revisions to US tax code would significantly impact inbound companies

*November 28, 2017*

## In brief

On November 17, 2016 the House of Representatives passed the Tax Cuts and Jobs Act (the House bill). The House vote came a day after the Senate Finance Committee (SFC) approved a Senate version of tax reform legislation (the SFC bill). On November 20, 2017, the text of the SFC bill was released. Prior to the release of the SFC bill, the Joint Committee on Taxation (JCT) had released a description of the SFC bill. The full Senate is expected to consider the SFC bill during the week of November 27, 2017. Both the House bill and the SFC bill (collectively the 'Proposed Legislation') if enacted, would represent the largest overhaul of the US tax code (the Code) since the Tax Reform Act of 1986. The Proposed Legislation would lower corporate and individual tax rates, reform US international tax rules, and simplify the Code.

For a detailed explanation of the international provisions of the House bill and SFC bill, please see House passes tax reform bill with international tax provisions.

For an overview of the other provisions of the House bill and SFC bill, please see Finance Committee approves tax reform bill and House passes tax reform bill.

## In detail

### New corporate rates

The Proposed Legislation would eliminate the current graduated corporate tax rate structure and corporate income generally would be taxed at 20 percent. Under the House bill, the rate would be effective for tax years beginning after 2017. The effective date under the SFC bill is tax years beginning after 2018.

**Observation**: Many of the provisions in the SFC bill would apply to tax years beginning after December 31, 2017. However, the lower corporate tax rate would not apply until tax years beginning after December 31, 2018. Thus, foreign corporations with US operations may be denied certain deductions under the provisions of the SFC bill for the 2018 tax year while the US corporate tax rate remains at 35 percent. With the reduction in the US federal corporate tax rate, taxpayers' state income tax burden would be of greater significance to the computation of the overall effective tax rate.

### Interest expense deduction limitation

#### *Section 163(j)*

Under current Section 163(j), a US corporation's net interest expense deduction for certain interest paid or accrued to a foreign related party (where US tax is reduced by a treaty) or paid or accrued to an unrelated party and subject to a guarantee from a foreign related party is limited to 50 percent of the US corporation's adjusted taxable income (roughly EBITDA). The

current law includes a safe harbor such that the limitation does not apply if a taxpayer's debt to equity ratio is 1.5 to 1 or less. Disallowed deductions can be carried forward indefinitely and a taxpayer's excess limitation (the excess, if any, of 50 percent of the adjusted taxable income of the taxpayer over net interest expense) can be carried forward for three years.

If enacted, the Proposed Legislation would repeal and replace current Section 163(j) with a new Section 163(j). New Section 163(j) would limit US net business interest expense deductions to 30 percent of adjusted taxable income (ATI). The new Section 163(j) interest limitation would broadly apply to the 'business interest' of any taxpayer (regardless of form) and regardless of whether the taxpayer is part of an 'inbound' group or an 'outbound' group. That is, unlike current Section 163(j), new Section 163(j) is not limited to inbound companies and would apply regardless of whether the interest payment is to a foreign person or a US person. ATI under the House bill is roughly equivalent to EBITDA (similar to current Section 163(j)) while ATI under the SFC bill does not include an addback for depreciation or amortization deductions and is roughly equivalent to EBIT. As a result, the SFC bill would be more limiting than the House bill version of new Section 163(j).

Additionally, the interest limitation imposed under the House version of new Section 163(j) takes into account floor plan financing interest (generally indebtedness incurred used to finance the acquisition of motor vehicles for sale to retail customers). Thus, under the House bill, a taxpayer's interest deduction for business interest cannot exceed the sum of: business interest income, 30 percent of ATI, plus floor plan financing interest for the taxable year.

The Proposed Legislation would not apply to regulated public utilities, the real estate industry (by election under the SFC bill), the trade or business of performing services as an employee, electric cooperatives (under the SFC bill), any farming business (by election under the SFC bill), and to certain small taxpayers. Special rules would apply to partnerships to address the computation of the limitation at the partnership level and the ability for unused excess limitation, if any, to be passed up to the partners of the partnership.

The JCT descriptions of both the House bill and the SFC bill indicate that the limitation on net interest deductions applies at the taxpayer level (a US parent in the case of a US consolidated group). It's unclear whether two US consolidated groups may be combined (i.e., the super-affiliation rules in the proposed regulations to current Section 163(j)).

Any amount of disallowed business interest under the House bill could only be carried forward for five years but could be carried forward indefinitely under the SFC bill. Neither the House bill nor the SFC bill have an excess limitation carryforward.

Both proposals would be effective for tax years beginning after 2017.

***Observation:*** The new Section 163(j) limitation generally would operate as a broad limitation on interest deductibility for any US company (and a foreign corporation with a US trade or business) that incurs indebtedness. Inbound companies should consider the impact of their US subsidiaries only being able to deduct business interest expense equal to the sum of their business interest income plus 30 percent of their ATI in contrast to the current 50 percent limitation.

Further, new Section 163(j) would apply to all US indebtedness, not just related party indebtedness. Notably, since new Section 163(j) only applies to 'business interest' and 'business income' corporations would need to consider whether their interest expense and interest income is incurred in connection with a US trade or business. Specifically, inbound companies with US corporations that act as 'treasury centers' that typically earn 'net interest income' should consider whether the activities in the treasury center are sufficient to create a US trade or business such that they may continue to deduct their interest expense against interest income under new Section 163(j). There are no transition or grandfathering rules in the Proposed Legislation. Accordingly, any indebtedness already in place would be subject to the new limitation. It is currently unclear whether disallowed interest carryforwards or excess limitation carryforwards under current Section 163(j) could continue to be carried forward or would be eliminated.

The creation of a new carryover attribute for disallowed interest causes complexity for state income tax purposes since states may (1) not adopt the five-year carryover period, (2) apportion the carryover, and/or (3) impose Section 381 and Section 382 limitations.

### *New interest limitation (new Section 163(n))*

The Proposed Legislation introduces a new interest limitation that would apply concurrently with new Section 163(j). Under the House bill, new Section 163(n) would limit US net interest expense deductions for taxpayers that are part of an international financial reporting group (IFRG) by calculating a US person's share of the group's earnings

(EBITDA), and effectively limiting the US person's interest deduction to 110 percent of that percentage of the group's total interest expense. Any disallowed interest could only be carried forward for five years.

An IFRG is generally a global group of entities that prepares consolidated financial statements with respect to the year and that had average annual gross receipts exceeding $100 million over a 3-year period.

The SFC bill would limit US net interest expense for taxpayers that are part of a worldwide affiliated group to the extent US debt exceeds 110 percent of the debt the US group would have had if the US leverage was based on the worldwide debt to equity ratio. In other words, unlike the House Bill, the focus of the SFC bill is on the relative leverage ratio rather than limiting the deduction by reference to worldwide net interest expense that is further limited by comparing the US group's EBITDA to the worldwide group's EBITDA. A worldwide affiliated group is generally a group of US and foreign corporations that are connected in a chain of more than 50 percent ownership. Under the SFC bill, any interest not currently deductible could be carried forward indefinitely.

Both provisions would be effective for taxable years ending after December 31, 2017.

**Observations**: New Section 163(n) would apply what is essentially a proportionate worldwide leverage test to determine a limitation on the amount of net interest expense that may be deducted for US federal income tax purposes. Inbound companies should consider the impact of both new Section 163(j) and new Section 163(n) on their financing structure. New Section 163(n) looks at the financing structure of the entire worldwide group. Thus, to the extent inbound companies do not have significant foreign leverage, the US net interest deduction would be limited. Additionally, the SFC bill is drafted much broader than the House bill in that it applies to an affiliated global group that only requires 50 percent affiliation. Thus, a foreign corporation with a 51 percent investment in two different US corporations could cause the two US groups to be affiliated, which could potentially impact each US group's limitation under new Section 163(n). However, the House bill requires consolidated financial statements in order for two chains of US corporations to be subject to new Section 163(n). Further, similar to new Section 163(j), the interest limitation would apply regardless of whether the payment is made to a US person or foreign person and regardless of whether the payment is made to a related or unrelated person.

Under the House bill and the JCT explanation of the SFC bill, a corporation must compute its interest expense limitation under both new Section 163(j) and new Section 163(n) in order to determine the amount by which it is limited. The provision that disallows a greater amount of interest expense is the provision that would apply (i.e., the harsher result of the two provisions is the interest deduction that is denied and carried forward). Notwithstanding the JCT description of the SFC bill, the statutory text of the SFC bill does not provide for coordination between the two provisions and instead provides the Secretary of the Treasury the authority to issue regulations for the coordination of the limitation imposed by new Section 163(j). Other countries have provisions similar to new Section 163(j) (interest limitations based on fixed percentage of earnings such as 30 percent of EBITDA) and new Section 163(n) (interest limitations based on the domestic corporation's relative leverage compared to the worldwide group). However, the provisions are inconsistent with international trends, in that other countries, the OECD standards (i.e., BEPS Action 4 (Limiting Base Erosion Involving Interest Deduction and Other Financial Payments), and the EU Anti-Tax Avoidance Directive (providing for an optional worldwide leverage test) generally allow taxpayers to deduct interest above the fixed percentage limit, in cases where the domestic company is not overleveraged compared to the worldwide group. It is not clear why the provisions adopt an approach that applies the 'harsher of' the two calculations.

Conformity to new Sections 163(j) and 163(n) could provide states an opportunity to restrict deductibility of interest expense. State taxpayers may need to determine how each limitation applies on a separate-entity basis. Taxpayers should consider the interaction of these limitations with existing state intercompany interest addback provisions and potential Section 385 recharacterization.

The application of these new limitations to partnerships and S corporations raises various state tax considerations, such as state conformity to flow-through treatment and different state rules for corporate-owned versus individual-owned partnerships.

***Excise tax / Base erosion tax***

### Excise tax

The House bill would introduce a new excise tax for certain deductible payments paid or incurred by a US corporation to a foreign corporation that is a member of the same IFRG. Similar to the definition of an IFRG for purposes of new Section 163(n), an IFRG is generally a global group of entities that prepares consolidated financial statements with respect to the year and had an average annual

aggregate amount of specified payments exceeding $100 million over a three-year period. The excise tax is a tax on the gross amount of the deductible payment equal to the highest rate in effect under Section 11 (i.e., 20 percent under the House bill). The excise tax is not creditable or deductible by the US corporation.

Deductible payments that would be subject to the excise tax generally include amounts that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset with respect to the US corporation. Deductible payments generally do not include payments of interest, costs of acquiring certain securities or commodities, certain services if such amount is at cost with no markup, and payments where US withholding tax is imposed. However, if a treaty reduces the full rate of US withholding tax (e.g., 30-percent rate), the excise tax is applied proportionately to the amount not taxed. For example, if a US corporation paid a royalty to its foreign parent and the royalty was subject to a 10 percent withholding tax under a treaty (instead of a full 30 percent withholding tax under US domestic law), 2/3 of the royalty would be subject to the excise tax because only 1/3 of the payment was subject to the full 30 percent rate of tax.

Notably, the excise tax would not apply if the amount is treated as effectively connected to the foreign corporation's US trade or business (ECI) or attributable to a US permanent establishment, or an election is made under new Section 882(g) to treat the income as ECI with a US trade or business and attributable to a US permanent establishment. If an election is made to treat the income as ECI, the foreign corporation would be subject to US federal income tax on a net basis as opposed to a 20 percent tax on the gross payment. For purposes of determining the amount that is subject to US federal income tax, only deemed expenses can be taken into account. Deemed expenses with respect to a specified amount are generally determined by treating the foreign corporation as if it had the same net income ratio of the foreign members of the IFRG for the year with respect to the product line to which the specified amount relates. The net income ratio is used to determine the foreign profit margin of the IFRG with respect to the product line and then applies the same profit margin against the specified amount to determine what the remaining net ECI amount should be. Net income ratio is essentially foreign net income with certain adjustments (essentially foreign EBIT) divided by foreign revenues, taking into account adjustments for certain related party payments. The amounts are determined using consolidated financial statements and books and records of the members of the IFRG. If an election is made, the foreign corporation could claim a foreign tax credit for 80 percent of foreign taxes paid or accrued.

The House proposal would be effective for amounts paid or incurred after December 31, 2018.

**Observations:** If enacted, the excise tax would represent a new and sweeping US tax on certain deductible payments made to a related foreign party. The excise tax would apply to payments made by domestic corporations, regardless of shareholder ownership, as long as the US corporation and the foreign payee are part of the same IFRG. The new tax is expected to have a significant adverse effect on multinational groups, particularly companies that import parts or manufactured products or that rely on services from affiliates outside the United States, have intellectual property held by a foreign affiliate, or have principal structures based outside the United States.

If an election is made to treat the income as ECI, such amount also would be subject to the branch profits tax. The branch profits tax is a 30 percent US federal income tax imposed on the after-tax earnings of the foreign corporation that are connected with a US trade or business, subject to certain adjustments. The 30 percent branch profits tax may be reduced by an applicable income tax treaty. All multinational groups will need to model the impact of this new tax to determine the overall US tax impact of the foreign corporate member making the ECI election versus the US corporate member being subject to the 20 percent gross basis excise tax. However, we would expect most multinational groups to have overall less US tax liability by having the foreign corporate member receiving the payment make the ECI election. Foreign corporations that are engaged in a US trade or business through a US branch also would be subject to this new excise tax unless the income is treated as ECI to the recipient foreign corporation or the recipient foreign corporation makes an ECI election under new Section 882(g).

As a general matter, states do not automatically conform to federal excise taxes. To the extent states have enacted comparable federal excise taxes, such state levies operate independently and are often measured on completely different bases than their federal counterparts.

In the absence of enabling legislation, state tax burdens for corporations would not generally be impacted by a federal excise tax. However, were a taxpayer to make the ECI election, the related foreign corporation would be deemed to have federal taxable income under Section 882. Notably,

Section 882 is a section to which many state statutes either incorporate, conform, or otherwise adopt, but that adoption is inconsistent and the application among the states in the context of the ECI election leads to a number of issues, including where an electing foreign corporation would have nexus and what happens in states that don't allow foreign entities to be included in a combined group. Since many states don't follow federal treaty protections, a foreign entity protected from US federal income tax may not have the same protection from state taxation.

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

Instead of adopting an excise tax similar to the House bill, the SFC bill would target base erosion by imposing an additional corporate liability on taxpayers with annual gross receipts in excess of $500 million and that make certain base eroding payments to related foreign persons for the taxable year of four percent or more of all their deductible expenses (other than the NOL deduction, the new dividend received deduction for foreign source dividends, and the new deduction for foreign derived intangible income and global intangible low-taxed income). For this purpose, affiliated groups are treated as a single taxpayer. However, for purposes of computing the amount of gross receipts, gross receipts of foreign corporations are included if the foreign corporation has ECI. The BEAT is imposed if 10 percent of the modified taxable income (generally taxable income adding back any base eroding tax benefit) exceeds the taxpayer's regular tax liability reduced by the excess of allowable credits over the research and development credit. For purposes of computing modified taxable income, any base eroding tax benefit attributable to a base eroding payment that has been withheld upon is not taken into account, except that if the rate of tax was reduced (e.g., by treaty) then the exclusion will apply only in proportion to the reduction.

A base eroding payment generally is any amount paid or accrued by the taxpayer to a related foreign person that is either deductible or to acquire property subject to depreciation or amortization. Additionally, a base eroding payment includes certain payments to expatriated entities that reduce the gross receipts of the taxpayer. Unlike the House Bill, base eroding payments do not include cost of goods sold unless the payment is made to a foreign corporation that became a surrogate foreign corporation after November 9, 2017 or a foreign person related to the surrogate foreign corporation (generally a foreign corporation that acquired or acquires a US corporation and the US corporation's former shareholders own at least 60 percent but less than 80 percent of the vote or value of the foreign acquiring corporation and the foreign acquiring corporation does not meet the substantial business activities test). Base eroding payments include interest expense deductions. However, if the taxpayer is subject to new Sections 163(j) or (n) for the taxable year, the reduction in the amount of interest for which a deduction is allowed is treated as allocable first to interest paid or accrued to persons who are not related parties with respect to the taxpayer and then to such related parties. Similar to the House bill, base eroding payments do not include payments for certain services if such amounts are at cost with no markup.

The provision would be effective for amounts paid or accrued after December 31, 2017. The BEAT would increase to 12.5 percent and would allow all credits to be applied in determining the US corporation's regular tax liability in 2026 to the extent certain revenue thresholds are not satisfied by 2026.

**Observations:** The BEAT essentially ensures that US corporations (and foreign corporations engaged in a US trade or business) pay a 10 percent minimum tax to the extent they are making significant base eroding payments (applied after Sections 163(j) and 163(n)). Thus, where a US corporation is not overly eroding its US tax base, no BEAT would be due. For example, if a US corporation had taxable income of $200 and a royalty payment of $50, its modified taxable income (MTI) would be $250. To determine whether any BEAT is due, the taxpayer must determine whether 10 percent of its MTI (here $25) exceeds its regular tax liability ($200 x 20% or 35% (for 2018)). Because $25 does not exceed $40 or $70, there is no BEAT. Alternatively, if the US corporation had $300 of royalty payments, the BEAT would be $10 in 2019 and no BEAT would be due in 2018 (10% of MTI =$50 and regular tax liability is $40 in 2019).

Unlike the House bill, there is no election to treat the income as ECI and thus there is no branch profits exposure in connection with the BEAT. In line with current US tax policy, this is one of several provisions that apply harsher tax consequences for US corporations that have moved offshore. Surrogate foreign corporations are generally subject to the 'inversion regime' whereby US tax attributes are limited for ten years. However, this provision would apply regardless of whether the US expatriated entity (the former US parent) is within the ten year inversion regime window. Since this provision would apply to payments starting January 1, 2018 but the lower corporate tax rate does not start until January 1, 2019, there could be a one year delay in which US corporations would have a BEAT since US

corporations would have a higher tax liability for 2018 and the BEAT is in part based on the US corporation's regular tax liability.

***Stock attribution***

The Proposed Legislation would modify the attribution rules for purposes of determining whether a US person is considered a 'US shareholder' in connection with determining whether a foreign corporation is a controlled foreign corporation (CFC). Under current law, stock owned in a foreign corporation by a foreign parent cannot be attributed to the foreign parent's US subsidiary (i.e., downward attribution). This exception prevents the foreign subsidiaries of foreign-parented groups that are not held under US entities from being treated as CFCs.

The Proposed Legislation would repeal the exception so that the foreign subsidiaries (but not the foreign parent) of foreign-parented groups with at least one controlled US subsidiary or an interest in at least one US partnership would generally be treated as CFCs, even if the foreign subsidiaries are not held, directly or indirectly, under a US entity.

These changes would be effective for tax years of foreign corporations beginning on or after December 31, 2017 under the House Bill. The SFC bill would make these changes effective for the last taxable year of a foreign corporation beginning before January 1, 2018, and for the taxable years of a US shareholder with or within which such taxable years end.

The SFC bill would also modify the definition of a US shareholder under subpart F to include any US person who owns 10 percent or more of the total value of shares of all classes of stock in a foreign corporation. Under current law, the definition of a US shareholder is only based on vote. Thus, if enacted, a US shareholder would include any US person who owns 10 percent or more of the vote or value of a foreign corporation. The SFC bill would make these changes effective for the last taxable year of a foreign corporation beginning before January 1, 2018 and for the taxable years of a US shareholder with or within which such taxable years end.

***Observation:*** This modification would treat significantly more foreign corporations as CFCs, with severe collateral consequences and would impact any 'de-controlled' structure where a US entity continues to own an interest in a former CFC. Notably, in the SFC bill, a US entity that owns less than 10 percent of the voting interest but at least 10 percent of the value in a foreign corporation (a structure that may have been used to mitigate CFC status) would be treated as a US shareholder. Under the SFC bill both of these changes would be made retroactive to the last year of the CFC that begins before 2018. As a result, foreign corporations may be treated as CFCs and US persons may be treated as US shareholders in 2017 even if they are not CFCs or US shareholders under current law.

Additionally, although foreign subsidiaries of foreign-parented groups that hold any US entities would generally be treated as CFCs, subpart F (the regime that requires current inclusion of certain types of income) would only impose additional US tax on such subsidiaries' earnings to the extent their stock is held, directly or indirectly, by a US shareholder. Accordingly, if a US corporation does not own any stock in a foreign corporation directly or indirectly, it would not have any subpart F income inclusion but would be subject to additional reporting requirements. This compliance burden would be administratively difficult, particularly for large foreign multinational corporations whose US subsidiaries operate independently from the foreign group and do not have access to the type of information that would be required on a Form 5471 (information return of CFCs).

Foreign multinational companies in a de-controlled structure not only need to take into account future income inclusions under subpart F but their US subsidiary would be subject to the 'toll charge' described below. Additional changes to subpart F can be found in the ITS insight referenced in the introduction.

***Toll charge***

In connection with shifting to a participation regime, the Proposed Legislation would require US shareholders that have an interest in a foreign corporation to include in income their pro rata share of the undistributed, non-previously-taxed post 1986 foreign earnings of the corporation determined as of certain measurement dates. The mechanism for the inclusion is subpart F. Thus, this provision, when combined with the new stock attribution rule causes US subsidiaries of foreign parented groups to be subject to the toll charge to the extent the US subsidiary owns a 10 percent interest in the voting stock of the foreign subsidiary. Taxpayers in de-controlled structures where the US corporation maintains an ownership interest in the foreign subsidiary would need to calculate the untaxed earnings and profits of their foreign subsidiaries in order to determine the impact of the toll charge. Under the SFC bill, a 10 percent rate would apply to earnings and profits (E&P) relating to cash or cash equivalent assets and a five percent rate would apply to illiquid assets. Under the House bill, a 14 percent rate would apply to earnings held in liquid assets and a seven percent rate would apply to illiquid assets.

The effective date for the House Bill is taxable years beginning after December 31, 2017. The SFC bill would make these changes effective for the last taxable year of a foreign corporation beginning before January 1, 2018, and for the taxable years of a US shareholder with or within such taxable years end.

Apart from federal tax reform, many states provide some level of deduction or elimination of subpart F income, domestic dividends, and foreign dividends, but these deductions and eliminations vary significantly from state to state and often result in significant departures from federal treatment and amount. The impact of repatriation in states will depend on existing state rules, but also on conformity or subsequent adoption of Section 965 (the toll charge mechanism). Moreover, the impact to a company's state income tax position may be affected to a greater degree by subsequent, actual distributions of earnings subjected to the federal toll charge, particularly in states that do not conform to the Section 965 toll charge mechanism

### *Hybrid transactions and hybrid entities*

The SFC bill would deny a US deduction for interest and royalty payments paid or accrued by a US corporation to a related foreign party pursuant to a hybrid transaction or made by, or to, a hybrid entity to the extent that there is no income inclusion by the foreign related party under the tax laws of their country or the related party is allowed a deduction with respect to such amount under the tax laws of their country. The proposal would also grant the Secretary of the Treasury the regulatory authority that may be necessary or appropriate to carry out the purposes of the proposal.

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

**Observations:** If enacted, this proposal would eliminate, for example, current tax benefits for certain hybrid debt transactions that typically allow a US corporation a deduction (subject to any applicable interest limitations) while the related foreign corporation typically does not have an income inclusion because the payment is viewed as a dividend and subject to low or no tax under a participation regime. There are no grandfather or transition rules for structures currently in place. Accordingly, foreign corporations may wish to consider the impact on existing hybrid structures and potential alternative structures. The proposal is consistent with the BEPS Action 2 (Hybrids Mismatch Arrangements) report on hybrid transactions.

### *Domestic International Sales Corporations*

The SFC bill would repeal the special rules for DISCs and IC-DISCS and terminates any corporate election to be treated as a DISC that is in effect for the corporation's last taxable year beginning in 2018 and is effective for the corporation's immediately succeeding taxable year and all subsequent taxable years.

### *Sale of partnership interest*

The SFC bill would create new Section 864(c)(8) and treat gain from the sale or exchange of a partnership interest as ECI to the extent the foreign partner would have had ECI had the partnership sold all of its assets in a taxable sale at fair market value and allocated the gain or loss to the foreign partner in the same manner as non-separately stated income and loss (i.e., generally the partner's distributive share). The SFC bill would apply to a foreign partner that *directly or indirectly* owns an interest in a partnership that is engaged in a US trade or business. If the partnership holds any US real property interests (USRPIs) at the time of the sale or exchange, the amount that is treated as ECI under the provision is reduced by the amount treated as ECI by reason of Section 897 (rules related to dispositions of USRPIs). The term sale or exchange includes any transaction where gain or loss is realized from the sale or exchange of such interest. A new provision would be added to Section 1446 (which generally requires a partnership to withhold tax on effectively connected taxable income allocable to a foreign partner) to require the transferee of a partnership interest to withhold 10 percent of the amount realized on the acquisition of a partnership interest if any portion of the gain is treated as ECI under the new provision unless the transferor certifies that it is not a foreign person. At the request of the transferor or transferee, the Secretary of the Treasury may prescribe a reduced amount of withholding tax if the Secretary determines that the reduced amount will not jeopardize the collection of tax on the amount of gain treated as ECI under Section 864(c)(8). If the transferee fails to withhold, the partnership is required to withhold from the transferee partner an amount equal to the amount the transferee was required to withhold.

The provision would be effective for sales and exchanges after November 27, 2017.

**Observation**: The provision would codify a revenue ruling issued by the IRS in 1991 and overrule the recently issued *Grecian Magnesite* case, which held that gain on the sale of a partnership interest is treated as the sale of a capital asset and generally not ECI (subject to exceptions for certain types of assets and certain types of sales). The provision applies

to both domestic and foreign partnerships as long as the partnership is engaged in a US trade or business. By referring to 'direct or indirect' ownership, the provision could apply to tiers of partnerships to the extent one partnership in the chain is engaged in a US trade or business. In a tiered partnership structure, it's unclear how and whether Section 1446 would apply to create a Section 1446 withholding tax liability on the selling partnership, in addition to the 10 percent withholding tax imposed on the transferee partner. Additional complexity could arise if the upper tier partnership has other items of effectively connected gain and loss, which would typically be netted for Section 1446 purposes. Although the transferee only has to withhold when there is gain on the disposition of the partnership interest that would be treated as ECI, the amount of withholding is still based on the amount realized, as opposed to the gain recognized, which could cause over withholding.

Similar to FIRPTA withholding, there appears to be a possibility for reduced withholding when the withholding tax exceeds the tax liability as long as the reduced withholding does not impact the amount of tax ultimately collected. It remains to be seen whether a form similar to Form 8288-B (reduced FIRPTA withholding) will be created by the IRS. Although the amount treated as ECI is reduced by the amount treated as ECI under the FIRPTA provisions, because the withholding tax is based on the amount realized, it seems that this could create a FIRPTA withholding tax when no withholding tax would otherwise be due under FIRPTA (to the extent the partnership had both US trade or business assets and USRPIs). FIRPTA withholding only applies if 50 percent or more of the gross value of the partnership's assets are USRPIs and 90 percent or more of the gross value are USRPIs plus cash and cash equivalents. Moreover, since the provision applies to any transaction in which gain or loss is realized, it would appear to override nonrecognition transactions. Because the gain is treated as ECI, foreign corporations may have branch profits tax exposure in addition to US tax filing obligations.

***Denial of qualified dividend rate***

Under the SFC bill, US individual shareholders of foreign corporations would not be eligible for the lower qualified dividend rate (generally referred to as qualified dividend income) if the dividend is from a surrogate foreign corporation. The proposal would be effective for dividend payments paid after December 31, 2017.

***Transportation income***

Unlike the House bill, which contains no modifications to the taxation of transportation income, the SFC bill would introduce a new category of taxable ECI described as passenger cruise gross income. Passenger cruise gross income includes all income derived from the operation of a commercial vessel from a covered voyage (i.e., a cruise on which passengers embark and/or disembark a vessel in the United States). The income subject to this new provision broadly includes both the cruise revenue itself as well as incidental amounts received with respect to on- or off-board activities, and services or sales provided during the voyage, such as gambling revenue. Effectively connected passenger cruise gross income is limited to only the portion of income derived from a voyage that occurs in US territorial waters, based on a time-spent ratio, with any part of a day in US territorial waters treated entirely as one US day. Under the proposal, if passenger cruise gross income is effectively connected with a US trade or business, such income would be subject to US net taxation, as well as branch profits tax.

The SFC bill would also modify current rules related to gross income derived from the international operation of aircraft. Under the SFC bill, new limitations would apply to the reciprocal exemption under current Section 883(a)(2) if (i) the foreign corporation operating the aircraft is headquartered in a foreign country whose residents are not entitled to a reduction in or exemption from tax under Sections 881 or 882, (ii) that foreign country has fewer than two arrivals and departures per week, from major passenger airline carriers headquartered in the United States, and (iii) the foreign corporation earns more than $1 billion of gross operating revenue annually.

Both transportation income modifications would be effective for taxable years beginning after 2017.

***Observation:*** The description of the passenger cruise proposal seems to encourage cruise lines to start and end cruises outside of the United States. Such operational changes by cruise lines could have a detrimental effect on tourism industries in US locations where they currently have a significant presence, particularly Florida, Alaska, and Texas, including potentially shifting jobs to non-US jurisdictions.

The aircraft provision appears to be targeted at supporting the ongoing government subsidy dispute between major US carriers and certain Middle Eastern carriers, which may potentially lead to future complaints being filed with the World Trade Organization. The legislative text differs from the JCT description that indicated it would apply to non-treaty country residents, which, as currently worded, is not the result. Additionally, the legislative text fails to define certain new terms, which may lead to

uncertainty in the application of the rule.

## *Let's talk*

For a deeper discussion of how this might affect your business, please contact:

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