International Bar Association

Recent developments in international taxation - United States

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Introduction

The United States has focused on three key areas in developing international tax law in the past year, principally focusing on implementation of the 2017 tax reform provisions, as well as introducing guidance in other key areas, including transfer pricing and the digital economy. In addition, the US has relied on the tax system for a material portion of its Covid-19 related financial support, passing multiple rounds of legislation that utilise the tax system to provide individual and corporate tax relief, as well as temporary liquidity. The Internal Revenue Service (IRS) has also evolved its enforcement methodology and priorities, introducing 'campaign'-based enforcement initiatives focused on a variety of issues, many involving international and cross-border issues.

Implementation of the tax reform's international provisions and other internationally focused regulations

Over the last year, the Treasury Department and IRS have released final and proposed regulations relating to several provisions of the US tax reform Tax Cuts and Jobs Act (TCJA). They have also issued other internationally focused regulations promulgated under Internal Revenue Code (the 'Code') sections in place prior to the TCJA.

Anti-abuse rules

Foreign Derived Intangible Income (FDII) and Global Intangible Low Tax Income (GILTI) deduction

FDII and GILTI were enacted as part of the TCJA and are intended to reduce the role tax considerations play in a US corporation's decision to locate operations and assets abroad through a controlled foreign corporation (CFC). Final regulations were issued addressing the computation of the deduction for both FDII and GILTI under Section 250, a TCJA provision that is part of the regime to neutralise tax considerations US corporations may take into account in locating their income from intangibles.

GILTI and Subpart F high-tax exception

Final regulations established the high-tax exception for GILTI that excludes income subject to an effective foreign tax rate tied to 90 per cent of the maximum tax rate under Section 11 of the Code (currently 18.9 per cent). Proposed regulations conform the subpart F high-tax exception to this more restrictive GILTI exception.

Dividend Received Deduction under Section 245A

Section 245A was passed as part of the TCJA and provides a corporate US shareholder a 100 per cent dividends received deduction (DRD) with respect to the foreign source portion of a dividend received from a specified ten per cent owned foreign corporation (SFC) provided certain requirements are met. The 'CFC look-through' rule under Section 954(c)(6) excludes from foreign personal holding company income dividends, interest, rents, and royalties received or accrued by one CFC from a related CFC to the extent attributable or properly allocable to non-Subpart-F income of the payer (the 'section 954(c)(6) exception'). The final regulations limit the amount eligible for the DRD and the section 954(c)(6) exception to 50 per cent of certain amounts attributable to extraordinary dispositions (eg, non-ordinary course assets sales between related parties).

Hybrid Deduction Rules under Section 245A

Section 245A(e) is intended to prevent double non-taxation of income of a hybrid dividend or tiered hybrid dividend by denying them the Section 245A DRD or requiring an inclusion that gives rise to a dividend that is a tax deduction abroad under Section 951(a)(1)(A). The regulations implement this regime and an anti-avoidance rule.

Anti-Hybrid Provisions under Section 267A

Section 267A generally disallows deductions for certain related party payments involving hybrid entities or pursuant to hybrid transactions. It is an anti-hybrid mechanism for the IRS to attack certain base-eroding payments. The finalised regulations generally disallow deductions for interest and royalty payments that involve a deduction/no inclusion (D/NI) outcome (ie, where the issuer can take a tax deduction without an inclusion by another party), but only to the extent such D/NI outcome is caused by the use of a hybrid or branch arrangement. They also contain an anti-avoidance rule that applies if there is a D/NI outcome resulting from a hybrid arrangement with a principal purpose of avoiding application of Section 267A.

Base Erosion and Anti-Abuse Tax (BEAT)

The BEAT was enacted as part of the TCJA as a minimum tax on related party payments that applies to corporations with annual gross receipts exceeding $500m and whose base erosion (base erosion tax benefits over deductions) percentage is three per cent or more. Final regulations released in December 2019 provide rules for determining the amount of modified taxable income (computed in part by reference to a taxpayer’s base erosion tax benefits and base erosion percentage of any net operating loss deduction) and rules for computing the base erosion minimum tax amount. Final regulations released in September 2020 allow taxpayers to waive a deduction using specific procedures so that the deduction would not be treated as a base erosion tax benefit. This could potentially help taxpayers on the bubble of triggering the BEAT to mitigate its potential cliff effect, where, theoretically, a single dollar of base erosion tax benefit could create significant BEAT tax liability.

Proposed Anti-Conduit Regulations

The anti-conduit regulations (Treas. Reg. § 1.881-3) permit the IRS to disregard intermediate entities in financing transactions when the intermediate entity is acting as a conduit entity with a principal purpose of avoiding withholding tax on fixed or determinable annual or periodical (FDAP) payments. Currently proposed regulations would expand the existing rules to allow the IRS to also recharacterise and disregard intermediate entities when a taxpayer uses hybrid instruments (instruments that are treated as debt for foreign tax purposes but equity for US tax purposes). The proposed rules also apply to certain equity arrangements and where the foreign issuer has a permanent establishment and receives a deduction from that country.

Abusive transfers to foreign partners

Final regulations made certain partnership contributions taxable to combat an abuse whereby partnerships were used to shift income or gain to related foreign partners that do not pay US tax. The regulations generally foreclose the non-recognition treatment for partnership contributions of property with built-in gain under section 721(a) in specific scenarios: if a US transferor contributes certain built-in gain property to a partnership and 1. a related foreign person with respect to the US transferor is a direct or indirect partner in the partnership; and 2. the US transferor and related persons together own more than 80 per cent of the interests in the partnership's capital, profits, deductions, or losses.

Foreign tax credit

FOREIGN TAX CREDIT UNDER THE TCJA

The IRS released final and proposed regulations for determining the foreign tax credit under the TCJA in December 2019. In September 2020, the IRS finalised the regulations released in proposed form in December 2019 and issued another set of proposed regulations regarding the foreign tax credit. The final regulations provide rules regarding allocation and apportionment of certain items, describe the interaction of certain provisions, and include several definitions. The September 2020 proposed regulations provide guidance on several aspects of foreign tax credit, including expense allocation, foreign tax liability, deductions for life insurance companies, and the definition of foreign branch category and financial services income.

COVERED ASSET ACQUISITIONS

Finalised regulations provide rules for computing the disqualified portion of foreign income taxes under Section 901(m) that is not taken into account for purposes of calculating the foreign income tax credit. The regulations apply to covered asset acquisitions (ie, transactions that generally are treated as asset acquisitions for US income tax purposes but that are either treated as stock acquisitions or disregarded for foreign income tax purposes).

Attribution

DOWNWARD ATTRIBUTION RULES

Final regulations issued in November 2019 restrict the scope of downward attribution of stock in controlled foreign corporations. Separately, in September 2020, final regulations related to the TCJA's repeal of Section 958(b)(4)'s downward attribution rules were issued. The regulations modify a number of US tax provisions and provide that CFC status will be determined without applying the downward attribution rules to attribute ownership of stock from a foreign person to a domestic person. Finally, in September 2020, the IRS issued additional proposed regulations with respect to the repeal of Section 958(b)(4) that modify the ownership attribution rules to disregard the downward attribution to treat a US person as owning stock that is owned by a foreign person in certain circumstances.

PASSIVE FOREIGN INVESTMENT COMPANY (PFIC) OWNERSHIP DETERMINATION

Regulations issued in July 2019 and finalised in December 2020 provide guidance on PFIC rules. At a high level, the proposed regulations address the attribution of PFIC stock to US shareholders, the determination of a foreign corporation's PFIC status, and the application of the PFIC insurance exception.

Transfer Pricing

In June 2019, the US Court of Appeals for the Ninth Circuit reissued its decision in *Altera v Commissioner* 926 F.3d 1061 (9th Cir. 2019), after an earlier opinion was withdrawn because a judge on the panel passed away before the opinion's release. The second opinion followed the outcome of the initial one and reversed the Tax Court's decision to invalidate Treasury regulations requiring related parties to allocate stock-based compensation costs when entering into cost-sharing agreements to develop intangible assets. Both the full Ninth Circuit (in November 2019) and the US Supreme Court (in June 2020) declined to review the *Altera* decision. As a result, *Altera* remains good law in the Ninth Circuit and will be followed by the IRS nationwide.

Following the Ninth Circuit's 2019 decision, the IRS lifted a moratorium on examinations of taxpayers that did not include stock-based compensation costs as intangible development costs. In the summer of 2020, the IRS confirmed that audits of such taxpayers are underway, meaning that companies that took positions whereby they excluded stock-based compensation from cost-sharing arrangements could come under scrutiny.

In November 2020, the US Tax Court upheld the IRS' primary transfer pricing adjustments in *The Coca-Cola Co. v Commissioner* 155 T.C. No. 10 (2020). The dispute primarily concerned the reliability of the transfer pricing method used in pricing Coca-Cola's license of trademarks, product formulas, and other intangibles to its affiliated foreign supply points. The Tax Court held that the historic method that the IRS and Taxpayer had agreed to in a closing agreement that bound for years prior to those in dispute, violated the arm's length standard. The Tax Court rejected the residual profit method and applied the comparable profit method.

Digital tax developments

The US has taken a vocal position in the worldwide digital tax discussions. Domestic digital services taxes (DSTs) like those enacted or proposed in many nations will be imposed on large technology companies, most of which are based in the US (eg, Google, Amazon and Facebook). As a result, the US Trade Representative ('USTR') has opened investigations into digital taxes that Austria, Brazil, the Czech Republic, the European Union, France, India, Indonesia, Italy, Spain, Turkey and the United Kingdom have either adopted or imposed. The investigations consider whether the digital taxes are 'unreasonable or discriminatory and burden or restrict US commerce' under Section 301 of the Trade Act.

The USTR completed its investigation of France's DST in July 2020, concluding that it is unreasonable or discriminatory and burdens or restricts US commerce. As a result, the US announced that it would impose a 25 per cent tariff on French handbags, cosmetics and soaps beginning on 6 January 2021. However, on 7 January 2021 the USTR suspended the tariffs on French goods pending its investigation of other nations' similar DSTs. In January 2021, the USTR also announced that it found that the DSTs adopted in Austria, India, Italy, Spain, Turkey and the United Kingdom discriminated against US companies; the USTR declined to take further specific actions in connection with those findings.

In June 2020, the US Treasury Secretary sent a letter to European finance ministers seeking to pause Organisation for Economic Co-Operation Development (OECD) discussions regarding taxation of the digital economy in light of the Covid-19 pandemic. The letter expressed support for the reform of the international tax system, but levied objections to adopting measures focusing solely on digital businesses, including domestic DSTs. The letter explained that the US felt the parties to the discussion were at an impasse on an agreement with respect to Pillar 1 that would apply on a broad basis and would not place financial burdens predominantly on the interests of a single country or industry. Notwithstanding the US' position as stated in the letter, the OECD confirmed later that month that the US had not walked away from the negotiations.

Covid-19-related relief

The IRS issued guidance and enacted a variety of relief measures to minimise tax burdens arising from individuals working in geographic locations where they would otherwise not work as a result of travel restrictions and disruptions caused by the worldwide Covid-19 pandemic.

US residency

If an individual intended to leave the US between 1 February 2020 and 1 April 2020 but was unable to due to Covid-19 travel restrictions, the individual may exclude 60 consecutive calendar days from calculations for the substantial presence test – a manner for determining whether an individual is a resident alien for US tax purposes. Further, the days in which the individual was unable to leave the US due to emergency travel restrictions would not be counted for purposes of eligibility for tax treaty benefits relating to income from employment or performance of personal services in the US.

US citizens or residents living abroad

The IRS waived the time requirements for being considered a 'qualified individual' under Section 911(d)(1), which allows non-US residents to exclude foreign income and housing costs from gross income in certain circumstances for certain periods in late 2019 through to July 2020.

US trade or business or permanent establishment

The activities of individuals who were 'temporarily present' in the US and performing services in the US for up to 60 consecutive calendar days between 1 February 2020 and 1 April 2020 would not factor into the assessment of whether a non-resident foreign corporation, or partnership was engaging in a US trade or business or had a permanent establishment, so long as those activities would not have been performed in the US but for the Covid-19 pandemic. Further, during that same period, income earned by the individual would not be subject to the 30 per cent gross basis tax since there would be no US trade or business or business conducted through a permanent establishment.

Foreign branch

A US business may exclude up to 60 days of employees' temporary activities abroad for purposes of determining whether such business has a foreign branch separate unit under Section 1503(d) or must make a foreign branch filing.

Enforcement initiatives

Offshore enforcement continues to be an IRS priority. The agency relies on the Foreign Account Tax Compliance Act (FATCA), other inter-governmental cooperation, information provided in voluntary disclosure and tax filings, and whistleblowers.

In addition to the *Altera*-related examinations described above, the IRS has put in place a number of internationally focused enforcement initiatives over the last year:

TCJA transition tax audit campaign

In November 2019, the IRS announced a campaign to examine 2017 and 2018 tax returns for compliance with the TCJA's transition tax under Section 965. The transition tax requires US shareholders to pay a one-time transition tax on untaxed foreign earnings of certain foreign corporations as if these earnings had been repatriated to the US. In the summer of 2020, the IRS announced its intention to begin enforcing the Section 965 repatriation tax in October 2020 through soft letters and audits.

High income non-filer

This campaign focuses on high income US citizens and resident aliens who are subject to tax on their worldwide income, but who have not filed tax returns.

Expatriation of individuals

This campaign focuses on persons who expatriated on or after 17 June 2008 who may not have met certain filing requirements.

Post Offshore Voluntary Disclosure Program (OVDP) compliance

This campaign addresses noncompliance related to OVDP by taxpayers' failure to remain compliant with their foreign income and asset reporting requirements. The OVDP closed in September 2018 and was replaced with the current voluntary disclosure programme, which includes, but is not limited to, offshore financial reporting issues.

The US is also a participant in the Joint Chiefs of Global Tax Enforcement (known as the J5) along with Australia, Canada, the Netherlands and the UK. In January 2020, the J5 countries participated in a globally coordinated day of action to investigate suspected offshore tax evasion believed to be facilitated by a financial institution in Central America. Likewise, in November 2019, members of the J5 participated in an event known as 'The Challenge' focusing on tax evasion relating to cryptocurrency. The Challenge brought together experts from each country to optimise data from a variety of open and investigative sources so each country could develop leads, trends and methodologies to be used in current and future investigations.

Reporting form updates

The IRS has released new draft forms Schedule K-2 (Form 1065) 'Partner's Distributive Share Items—International' and Schedule K-3 (Form 1065) 'Partner's Share of Income, Deductions, Credits, etc.—International' that will apply to the 2021 tax year. The new forms are intended to streamline the partnership tax reporting compliance process. The new forms replace certain portions of existing Form 1065, Schedule K where international tax information is reported.

Tax treaty updates

In July 2019, the US Senate approved treaty protocols with Switzerland, Spain, Japan and Luxembourg. The protocols modernised the underlying treaties and aligned them with current US treaty policy. They were the first updates to US income tax treaties in nearly a decade, and their approval had been delayed for several years in the Senate Foreign Relations Committee as a result of a senator's objections relating to concerns regarding the privacy of taxpayers' information. Each of the four protocols entered into force between 30 August 2019 and 27 November 2019. Double tax treaties with Hungary (signed 4 February 2010 and submitted to Senate 17 May 2012), Chile (signed 4 February 2010 and submitted to Senate 17 May 2012), and Poland (signed 13 February 2013 and submitted to Senate 20 May 2014) remain pending before the US Senate Foreign Relations Committee.