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International Tax Regulations: The Road Ahead – Key Practitioner Concerns and Government Responses

It has now been over 15 months since the passage of the Tax Cuts and Jobs Act (TCJA). In that time, the IRS and Treasury have released numerous sets of proposed regulations, and some final regulations, to implement the changes made by the TCJA. Practitioners have now had time to digest these new rules and regulations, finding many aspects in need of improvement along the way. Here are just a few of the concerns that have been voiced by practitioners in recent weeks, along with responses from employees of the IRS and Treasury.

Foreign-Derived Intangible Income (FDII)

To encourage domestic corporations to develop intangibles in the U.S., the TCJA provides for a deduction of up to 37.5% of a domestic corporation's FDII for tax years beginning after December 31, 2017, and before January 1, 2026. The FDII deduction aims to create parity for domestic corporations that earn intangible income directly, rather than through controlled foreign corporations (CFCs).

On March 5, 2019, the IRS and Treasury released proposed regulations on the Section 250 deduction for FDII and global intangible low-taxed income (GILTI). The proposed regulations contain rules for computing the deduction, particularly its FDII-related components, and applying the taxable income limitation. Unfortunately, some "clarifications" in the proposed regulations present substantial complexity and have little statutory basis. In recent weeks, employees of the IRS and Treasury have addressed several concerns about FDII ambiguities in these proposed regulations.

Practitioners have voiced concerns about how sales are treated when determining if a transaction is foreign. Under the proposed regulations, a sale of intangible property is for foreign use only to the extent it generates revenue from exploitation outside the U.S. To determine whether intangible property used in development, manufacture, sale, or distribution is exploited outside the U.S., the proposed regulations look to the location of the end-users licensing the intangible property or purchasing products. A senior counsel with the IRS Office of Associate Chief Counsel (International) acknowledged that the IRS will need to provide additional clarity and examples to assist taxpayers to determine the end user. The IRS is currently seeking comments on "where to draw the line" in making this determination. Relatedly, an attorney-advisor with the Treasury Office of the International Tax Counsel also acknowledged that the final regulations will need to clarify the difference between back-office IP and a patent being exploited.

Practitioners have also raised concerns over the detailed rules in the proposed regulations about how taxpayers will document that their sales of property or provisions of services are for foreign use and to a foreign person in order to be eligible for the deduction. The fear among many practitioners is that these rules could require companies to change their business practices. An attorney-advisor with the Treasury Office of the International Tax Counsel recently stated that he suspects the documentation rules will have some simplification, presumptions, or safe harbors once finalized, and also stated that it is not the government's intention to disrupt taxpayers' businesses with these documentation rules.

Global Intangible Low-Taxed Income (GILTI)

The TCJA introduced new Section 951A, which requires U.S. shareholders of CFCs to include their share of GILTI in current income, similar to other Subpart F inclusions. The tax on GILTI, a remnant of the pre-TCJA Code's worldwide tax system, was intended to preserve the U.S. tax base in the wake of the TCJA's move to a participation exemption regime. But to keep U.S. corporations competitive, the law lowered the effective tax rate on GILTI via the GILTI deduction. Section 250 allows for a deduction of up to 50% of GILTI (including the Section 78 gross-up attributable to GILTI) for tax years beginning after December 31, 2017, and before January 1, 2026.

On September 13, 2018, the government issued proposed regulations under Section 951A. These proposed regulations included antiabuse and antiavoidance rules that many practitioners have found confusing. To the relief of many practitioners and taxpayers, an attorney-advisor with the Treasury Office of the International Tax Counsel recently stated that officials recognize that taxpayers have valid concerns over the scope and clarity of the proposed GILTI regulations' antiabuse and antiavoidance rules.

Specifically, the government has received many comments on a proposed rule that would disregard transactions entered into with a principal purpose of reducing a U.S. shareholder's pro rata share of a CFC. An attorney-advisor with the Treasury Office of the International Tax Counsel recently stated: "People are concerned we're basically saying if you sold the stock 10 years ago and you had a bad purpose at the time, somehow we're going to treat you as still having a pro rata share of the CFC that you disposed of. And that's not the intention." Instead he believes the government will clarify the scope of this rule so that it only applies to transactions that were carried out to change the economic rights of a class of stock to avoid Subpart F and GILTI.

The government has also received numerous taxpayer comments about the broad scope of the proposed antiavoidance rule for transfers of tangible property, which would disregard transfers of specified tangible property to a CFC made to reduce the GILTI inclusion by increasing deemed tangible income. An attorney-advisor with the Treasury Office of the International Tax Counsel recently stated that the intention of this rule is to target a specific potential avoidance technique, and so the final regulations will reflect that narrower scope.

Base Erosion and Antiabuse Tax (BEAT)

As its name suggests, the BEAT of new Section 59A introduced by the TCJA is meant to combat base erosion. It applies to corporate taxpayers (other than REITs, RICs, and S corporations) with annual gross receipts over $500 million and whose base erosion percentage is 3% or higher. Generally, the BEAT operates as a minimum tax (5% for 2018, 10% for 2019 through 2025, and 12.5% for years after 2025) on related-party payments. The BEAT is calculated on the excess of modified taxable income over a taxpayer's regular tax liability, reduced by some types of credits.

The BEAT took some heat from practitioners at the March 25, 2019 IRS hearing on the Section 59A proposed regulations. Several provisions in the proposed regulations were criticized as being contrary to statutory language or intent.

Under the proposed regulations, Section 15 (which provides that if a tax change is effective on a day other than the first day of the taxpayer's taxable year, a straddle computation must be made to reflect the fact that different tax rates apply to the taxpayer's income for that year) applies to fiscal-year taxpayers, resulting in a blended BEAT rate between 5% and 10% for their taxable year that begins in calendar-year 2018. Taxpayers and practitioners have taken issue with this blended rate, and at the hearing the argument was made that the application of Section 15 in this situation is contrary to the words of that statute, which states that it only applies to changes in tax rates effective on a particular date. Since Section 59A does not reference tax years beginning or ending after a specific date, an argument can be made that Section 15 should not apply. Additionally, some have argued that Congress enacted the initial 5% rate to create a transition year, and the application of a blended rate is contrary to that intent.

At the hearing, the argument was also made that the regulations should exempt payments that result in Subpart F and GILTI inclusions from the definition of base erosion. While a carve-out has been created for effectively connected income, a similar carve-out has not been made for a CFC's Subpart F or GILTI income recognized by a U.S. shareholder. Some practitioners assert that this is unwarranted because payments resulting in Subpart F or GILTI are already taxed under Sections 951 and 951A.

Under the proposed regulations, payments or accruals that could be considered base erosion payments are defined broadly and cover noncash payments that are nonrecognition transactions. At the hearing, the argument was made that including the acquisition of depreciable assets from a related foreign party under Section 351 and a Section 332 liquidation in the definition of base erosion payments is contrary to whole point of the BEAT. The BEAT was designed to encourage U.S. companies to bring their worldwide attributes into the U.S., and it does not seem logical to penalize taxpayers that engage in the very activities that the BEAT was designed to encourage.

Unfortunately, the four-person panel of IRS and Treasury officials was unresponsive to the criticisms voiced at the hearing, making it difficult to predict whether any of the issues raised at the hearing will be addressed in the final regulations.

The Road Ahead

The IRS and Treasury should be commended for timely issuing significant proposed regulations packages concerning the key international tax provisions of the TCJA. However, it is hoped that they will take practitioner concerns to heart and will work together toward the implementation of a user-friendly set of rules governing the new international tax world we live in.

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