Practical financing considerations for US inbounds resulting from tax reform

August 27, 2019

In brief

The US tax reform legislation (the Act) enacted in late 2017 made important changes that affect financing of US operations of companies not headquartered in the United States. Among the most significant of these changes are the new Section 163(j) limitations on interest expense deductions and the new Section 267A anti-hybrid rules. Now that taxpayers and practitioners have had an opportunity to digest the impact of these changes, this is an excellent time to take a closer look at these provisions, especially with the IRS having published pertinent regulations and other guidance, with more expected in the near future.

The interest expense deduction limitations found in Section 163(j) apply to all taxpayers operating in the United States with respect to both related-party and third-party debt. Section 163(j) limits a taxpayer's US business interest expense deduction to the sum of the taxpayer's business interest income; 30% of the taxpayer's 'adjusted taxable income' (roughly equivalent to earnings before interest, tax, depreciation, and amortization, or EBITDA, through 2022 and to EBIT thereafter); and the taxpayer's floor plan financing interest for the tax year. ***Observation:*** These rules bring the US approach to interest deduction limitations more in line with the OECD approach.

Section 267A denies a 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' if (i) there is no income inclusion by the 'foreign' related party for 'foreign' purposes (based on country of residence), or (ii) the related party is allowed a deduction for 'foreign' purposes. Under proposed regulations that may be finalized with a retroactive effective date, certain other types of hybrid arrangements also may result in denied deductions. ***Observation:*** These rules generally are intended to be consistent with the BEPS anti-hybrid approach.

Non-US companies also need to analyze the possible impact of the new base erosion and anti-abuse tax (BEAT), as well as the regulations under Section 385, which authorizes the US Treasury to prescribe rules to determine whether an interest in a corporation is treated for purposes of the Code as stock or indebtedness (or as in part stock and in part indebtedness) by setting forth factors to be taken into account with respect to particular factual situations.

In detail

Interest expense deduction limitations: Section 163(j)

Under the Act, Section 163(j) limits US business interest expense deductions to the sum of business interest income, 30% of adjusted taxable income (ATI), and floor plan financing interest of the taxpayer for the tax year, effective for tax years beginning after 2017.

The Section 163(j) interest limitations 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. Section 163(j) applies regardless of whether the interest payment is to a foreign person or a US person, and regardless of whether such person is related or unrelated. ATI is roughly equivalent to EBITDA until January 1, 2022, when ATI roughly would be equivalent to EBIT. Disallowed business interest expense can be carried forward indefinitely.

On April 2, 2018, Treasury and the IRS released Notice 2018-28, which provided interim guidance with respect to Section 163(j); they then issued proposed regulations on November 23, 2018. The proposed regulations address the mechanics of determining the interest expense limitation and clarify their application to consolidated groups, RICs, REITs, partnerships, controlled foreign corporations (CFCs), and other foreign corporations. ***Observation:*** The proposed rules expand upon (and depart from) the statutory text by introducing a broad new definition of 'interest' for the purposes of Section 163(j) that includes certain interest equivalents and a wide range of other payments.

The proposed regulations also apply Section 163(j) to controlled foreign corporations (CFCs) and include complex additional rules that CFCs are permitted to follow in calculating their Section 163(j) limitations, as well as complex rules that apply to partnerships and to real estate businesses.

Observation: The statute is unclear on a number of points, such as with respect to disallowed interest expense carryforwards from prior-law Section 163(j). Some of these points, such as that related to disallowed carryforwards, are addressed in the proposed regulations. Pursuant to the proposed regulations, such disallowed interest expense carryforwards may be carried forward to the new Section 163(j) regime.

Prop. Reg. sec. 1.163(j)-8: Applicability to foreign persons with ECI

Section 163(j) applies to foreign persons with effectively connected income (ECI). Generally, when a foreign person engages in a trade or business in the United States, all income from sources within the United States connected with the conduct of that trade or business is considered to be ECI.

For foreign persons, adjusted taxable income, business interest expense, business interest income, and floor plan financing interest expense are limited to ECI items and expenses properly allocable to ECI. The limitation is modified for certain foreign partners that are nonresident alien individuals or non-CFC foreign corporations when a partnership is engaged in a US trade or business.

Taxpayers first must determine business interest expense allocable to ECI under Reg. sec. 1.882-5. Then they apply Section 163(j) to determine if a portion of such business interest expense is disallowed. Disallowance/carryforward does not have an impact on the determination of effectively connected E&P or US net equity for purposes of the Section 884 branch profits tax.

Observation: Because of the expanded definition of 'interest' and entities subject to the rule, taxpayers should reexamine the potential impact of Section 163(j) on their businesses.

Hybrid transactions and hybrid entities: Section 267A

Section 267A regarding hybrid entities and hybrid transactions, which was added by the Act, denies a 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' if (1) there is no income inclusion by the foreign related party for foreign purposes (based on country of residence) or (2) the related party is allowed a deduction for foreign purposes. Section 267A applies with respect to tax years that begin after December 31, 2017.

Proposed regulations with respect to Section 267A were issued on December 20, 2018. They provide certain clarifications with respect to the scope of Section 267A as applied to hybrid arrangements involving the payment of interest or royalties by certain branches, reverse hybrid entities, and other hybrid mismatch arrangements.

The proposed regulations address not only hybrid transactions and hybrid entities, but also provide rules that deny deductions with respect to certain payments involving branch structures, as well as rules dealing with situations in which an interest or royalty payment is not directly treated as a hybrid but the income is directly or indirectly offset by a deduction that itself gives rise to hybridity concerns.

Observation: As an example, Section 267A eliminates tax benefits for certain hybrid debt transactions that allow a US corporation a deduction for interest expense while the related foreign corporation typically does not have an income inclusion because the payment is viewed as a dividend (rather than interest income) and not taxed under a participation exemption regime. There are no grandfather or transition rules for structures currently in place, although certain provisions are proposed to apply only for tax years beginning after December 20, 2018.

The provision is consistent with the OECD's BEPS Action 2 (Hybrid Mismatch Arrangements) report on hybrid transactions. The direction in Section 267A to the Treasury Department to provide regulations or other guidance sets forth a detailed itemization of specific categories of guidance, which includes coverage of conduit transactions, structured transactions, and preferential tax regimes. Treasury also is directed to issue guidance on the application of the rules to branches (foreign and domestic) and domestic corporations, even if such branches or corporations do not meet the statutory definition of a hybrid entity.

The BEAT

The BEAT was enacted by the Act as Section 59A. It targets US tax-base erosion by imposing an additional corporate tax liability on corporations that, together with their affiliates, have average annual gross receipts for the three-year period ending with the preceding tax year of at least $500 million and that make certain 'base-eroding payments' to related foreign persons during the tax year that constitute 3% (2% for certain banks and securities dealers) or more of all their deductible expenses apart from certain exceptions.

The BEAT is imposed to the extent that 10% of the taxpayer's 'modified taxable income' — generally, US taxable income determined without regard to any base erosion tax benefits with respect to base erosion payments or the base erosion percentage of the NOL deduction — exceeds the taxpayer's regular tax liability net of certain tax credits. A base erosion payment generally is any amount paid or accrued by the taxpayer to a related foreign person with respect to which a deduction is allowable.

Observation: Thus, base erosion payments include interest payments to foreign entities even if the deduction for such payments may be limited by provisions such as Section 163(j) discussed above. However, the BEAT generally applies in a given year only to the extent that tax benefits for the payments are taken for that year for US federal income tax purposes.

Section 385 regulations

During 2016, Treasury and the IRS issued final and temporary regulations under Section 385 (under the authority noted above) addressing whether an interest in a related corporation is treated as stock or indebtedness, or as in part stock and in part indebtedness (the '385 Regulations'). The 385 Regulations appear intended to limit the effectiveness of certain types of tax planning by characterizing related-party financings as equity, even if they are in form ordinary debt instruments. The types of transactions targeted include debt arising through the distribution of notes or loans, primarily in the inbound context.

Observation: Application of the 385 Regulations is not limited to these types of transactions. The 385 Regulations instead would apply generally to characterize as equity broad categories of related-party debt transactions that routinely arise in the ordinary course of operations in both the domestic and international context. The 385 Regulations therefore could have a profound impact on a range of modern treasury management techniques, including cash pooling.

On October 4, 2017, Treasury issued a report recommending that the documentation requirements in the 385 Regulations be either revoked or revised but that the remaining regulations would be retained pending tax reform. An earlier Treasury Notice delayed the effective date of the documentation regulations for interests issued after January 1, 2019. On September 21, 2018, Treasury issued proposed regulations that would revoke the documentation requirements. ***Observation:*** The status of the remaining 385 Regulations should be monitored closely for developments.

The 385 Regulations generally apply to financial instruments issued after April 4, 2016, or instruments issued before that date that have undergone certain types of significant modifications. Instruments issued after April 4, 2016, but before January 19, 2017, are subject to certain transition rules.

The key operational rules in the 385 Regulations are the following:

- Reg. secs. 1.385-3 and 1.385-4 characterize as equity (1) notes distributed to a related shareholder, (2) notes issued to acquire equity of a related entity, and (3) notes distributed to a related entity as boot in an asset reorganization. The rules also generally would characterize as an equity investment loans to related entities within a 72-month period centered on the date of the loan

that (1) distribute dividends, (2) acquire equity in related entities, or (3) distribute boot in asset reorganizations.

- Reg. sec. 1.385-2 would provide a new contemporaneous documentation requirement for related-party debt. Taxpayers would be required to document both the commercial terms of the lending and an analysis of the creditworthiness of the borrower by the due date of the tax return for the year of the loan, with the new requirements applicable for instruments issued on or after January 1, 2019. Taxpayers also would be required to document events after the loan, such as payments of principal and interest and events of default and similar events within 120 days of such events. If these contemporaneous documentation requirements are not satisfied, the financing generally would be characterized as equity.

Observation: Companies and tax practitioners considering an acquisition of a US business entity by a foreign business entity, as well as certain inbound restructuring transactions, need to consider the full scope of the rules, and the possible adverse US consequences arising from their application. In the meantime, existing judicial principles still need to be followed, including documenting that there is adequate support for treatment of an instrument as debt or equity for US federal income tax purposes.

Observation: It is unclear at this time what the future holds for the Section 385 regulations. While preparations need to continue to achieve compliance, businesses also should stay focused on the potential for some or even dramatic changes affecting the application or even existence of the regulations.

The takeaway

The Act had a significant impact on the tax treatment of multinationals with non-US headquarters. While the reduction in the corporate tax rate brings advantages, this reduction must be balanced against the more restrictive earnings-stripping rules of revised Section 163(j), the application of the anti-hybrid rules under Section 267A, the possible impact of the new BEAT, and the Section 385 regulations.

These rules can lead to a denial or deferral of deductions in situations where no such denial or deferral would have occurred under prior law. Therefore, multinationals need to analyze the impact of these provisions and to monitor IRS guidance to determine whether final regulations will have significant differences from proposed regulations.

Let's talk

If you would like to discuss how these developments may affect your business, please contact:

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