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U.S. Tax Laws: A Review of 2018 and a Look Ahead to 2019

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Review of U.S. Tax Developments in 2018

U.S. taxpayers will remember 2018 as the year spent coming to terms with the tax reform legislation enacted at the end of 2017, known as the *Tax Cuts and Jobs Act* (TCJA). The TCJA included a surprisingly large number of new tax rules that have substantial consequences for U.S. and foreign individuals and multinational enterprises. It is not an exaggeration to say that tax reform in the United States changed the playing field in dramatic ways that arguably made the United States more “tax-competitive” than ever before. This tax competitiveness comes at the cost of new or expanded anti-base-erosion rules and overall heightened complexity, which characterizes most of the regulations and other interpretive guidance issued under the TCJA in 2018.

Among the more important changes introduced under the TCJA are the following: the maximum corporate income tax rate was reduced immediately (and on its face, permanently) to 21% (plus deductible state and city tax); temporary write-offs were provided for equipment purchases; and a wide variety of provisions were added to reduce opportunities for transferring assets offshore, deferring immediate taxation of offshore earnings, sheltering income through interest deductions and engaging in other worldwide tax-saving strategies. The new legislation increased incentives for U.S. production targeted to foreign markets¹ and reduced incentives for producing goods overseas.

While the U.S. initially appeared reluctant to embrace the OECD’s recommendations to address base erosion and profit shifting (BEPS), the TCJA actually includes a number of provisions that were advocated in the OECD’s BEPS Reports, including stronger anti-earnings-stripping rules and anti-hybrid rules, which mainly affect inbound investment, and a harsh minimum tax on large corporations making payments to related foreign parties. Tax reform also assured that non-U.S. investors would be subject to U.S. tax on the disposition of partnership interests that generate effectively connected income (ECI) and adopted rules that at least temporarily increased exclusions from U.S. gift and estate taxes for U.S. citizens and residents.²

Due to the vast scale of change in U.S. tax law, 2018 was expected to bring a flood of interpretative guidance from the IRS and Treasury Department. Many of those expectations were met when the IRS released Notices and Proposed Regulations in abundance, but mostly near the end of the year. Some of that guidance is described below.

A brief review of Tax Developments in 2018 precedes our outlook for 2019.

Federal Tax Legislation

While important technical corrections were expected to be made to the TCJA, they were not enacted in 2018. The Joint Committee on Taxation’s General Explanation of the TCJA, published in December of that year, includes reference to many areas in which technical corrections may be useful or necessary.

Federal Administrative Developments

A. Proposed Regulations Addressing Tax Reform

Proposed regulations were published in 2018 on a number of the more complex provisions in the TCJA, including rules about mandatory repatriation of accumulated offshore earnings, inclusions under the new “global intangible low-taxed income” (GILTI) regime, anti-earnings-stripping rules, the new corporate minimum tax known as the “base erosion anti-abuse tax” (BEAT), and anti-hybrid rules. Most

of these efforts have been impressive in size and some even include taxpayer-favourable approaches on a number of issues. In some areas, however, the IRS has indicated in the preambles to the proposed regulations that administrative burdens on taxpayers will be substantial, and that certain relief sought by taxpayers was inconsistent with the legislation as enacted (so no relief could be provided absent further legislation).

The following proposed regulations are among the most significant issued in 2018:

Earnings-Stripping Rules. The TCJA replaced a former provision of the Internal Revenue Code of 1986, as amended (Code), that limited only interest deductions on related party indebtedness with a broad new limitation on virtually all net business interest expense. Under the rewritten section 163(j), deductions for covered interest are limited to 30% of the taxpayer's adjusted taxable income, which generally is similar to a financial metric commonly known as EBITDA.³ Exceptions are available for certain utilities, real estate, energy and motor vehicle businesses.⁴ Complex, strict rules are applied to indebtedness owed by (and business conducted through) a partnership (the proposed regulations include a 10-step computational process and require tracking of a number of separate accounts for each partnership interest). The recently released proposed regulations would apply the new limitation widely to interest on financing transactions, implement Code rules to coordinate the new limitation with rules applicable under the BEAT and through partnerships, and provide allocation methods for businesses that may be only partially exempt. According to the proposed regulations, all interest of a C corporation is considered business interest (and thus potentially subject to the new limitation).

GILTI. The new GILTI rules severely limit tax deferral of income of controlled foreign corporations (CFCs). CFCs are foreign corporations that are owned over 50% by 10%-or-greater U.S. shareholders.⁵ Prior to tax reform, a U.S. shareholder was taxed only on its pro-rata share of so-called Subpart F income, which included passive and certain related party income. New section 951A expands immediate inclusion to nearly all of a CFC's other earnings, except for a fixed return on certain tangible foreign assets. Corporate shareholders are entitled to deduct 50% of their GILTI and may take a partial foreign tax credit, but no foreign tax credit carryover is available for GILTI. Accordingly, some multinationals will prefer to be taxed on Subpart F income instead. The proposed regulations provide details on how to compute GILTI. In addition, guidance is provided on how to apply GILTI in the context of partnerships.

BEAT. Regulations have been proposed under new section 59A that address ambiguities in the Code provision. Since the BEAT is essentially a new minimum tax on large corporations in groups with average annual gross receipts of at least \$500 million, the BEAT is expected to apply mainly to large U.S. subsidiaries of foreign multinationals and large U.S. multinationals. The BEAT applies if base erosion payments exceed a threshold amount computed in accordance with the proposed regulations. The BEAT applies only when it exceeds regular tax, but the foreign tax credit is not available.⁶ The proposed regulations provide guidance on (i) the application of the BEAT to foreign taxpayers that have income effectively connected with a trade or business in the United States; (ii) the application of the BEAT to combined groups and partnerships; and (iii) timing and coordination rules. For example, the proposed regulations would not subject deductions carried over from 2017 or earlier to the BEAT. In a twist, however, the proposed regulations provide that related party payments are excluded from the BEAT if the payment is included directly in the U.S. tax base, but not if the payment is taxable only to the U.S. shareholders of a CFC.

Section 956. Section 956 was designed to work with old Subpart F to accelerate inclusion of amounts in income of a U.S. shareholder of a CFC when otherwise-unrepatriated earnings were invested in certain U.S. assets. Surprisingly, the TCJA did not repeal section 956 when GILTI was enacted, bringing a near-end to the deferral regime. In a taxpayer-favourable action, the IRS proposed regulations providing an exception from section 956 for certain U.S. corporate shareholders of a CFC that would have qualified for the partial territorial exemption under section 245A if an actual dividend had been paid by the CFC.

Foreign Tax Credits. The TJCA affected several provisions of the Code that relate to foreign tax credits (FTCs). The IRS proposed regulations that clarify a number of these provisions, providing guidance on the allocation of expenses to the expanded number of FTC baskets, including the new foreign branch basket, and providing transition rules for carryovers and carrybacks to periods before 2018.

Anti-Hybrid Regulations. The IRS proposed phenomenally complex regulations that target hybrid structures, such as structures involving entities that are treated as a corporation in the United States or a foreign jurisdiction, and as a passthrough entity in the other jurisdiction. These proposed regulations target arrangements that have been used to produce double deductions or deductions for

payments that are not subject to tax in any jurisdiction. Tax practitioners expect these extremely broad proposed regulations to be controversial.

Section 965. As part of the transition to a partial territorial system of international taxation, the TCJA requires taxpayers to repatriate certain foreign earnings that had been deferred in offshore corporations. Related proposed regulations include guidance on how to calculate basis adjustments to reflect this mandatory repatriation; availability of an FTC for certain taxes paid with respect to the repatriated foreign earnings; details on the election to pay taxes under section 965 over eight years for most U.S. taxpayers; application of section 965 to consolidated groups; and an anti-avoidance rule. This Code provision includes a number of traps for non-corporate U.S. taxpayers of CFCs and other 10%-owned foreign corporations.

B. Other Tax Reform Guidance

Section 959. In Notice 2019-01, the IRS issued guidance on the taxation of the previously taxed earnings and profits (PTEP) of a CFC. The notice focused on the ordering of distributions out of multiple groups of PTEP and the tracking of PTEP required by the ordering rules.

Section 965. In addition to the proposed regulations described above, the IRS has issued multiple notices providing guidance on the details of how to calculate and report the amount that must be repatriated under section 965. Most of the rules described in these notices were incorporated into the proposed regulations.

Withholding on Sale of Interest in ECI-Generating Partnerships. The IRS released Notice 2018-29, which provides limited guidance on procedures relating to the newly enacted withholding tax on a foreign person's gain from the sale of an interest in a partnership that generates ECI. The Notice provides procedures for sellers to avoid withholding by delivering a certification from seller that the seller is not a foreign person; a certification that no net gain is realized in the sale; a certification by seller that less than 25% of the income allocated to seller from the partnership was ECI in the three taxable years before the sale; or a certification from the partnership that less than 25% of the gain realized on a hypothetical sale of the partnership's assets would be ECI.

C. Other Issues Under the TCJA

As noted above, the TCJA included a new deduction for FDII, which allows U.S. corporations to deduct a portion of their income from sales to foreign persons. This provision has resulted in a widespread controversy over whether the FDII deduction is a violation of the obligations of the United States under WTO rules. Although many tax practitioners predicted a WTO challenge to FDII (as well as to the BEAT), none has materialized yet.

D. Other Important 2018 Developments

Partnership-Level Audits. While not part of tax reform, a new regime for conducting partnership audits entered into force at the beginning of 2018. Now, the IRS can assess and collect unpaid taxes directly from a partnership instead of having to audit the partnership's partners. During 2018, the IRS released several packages of proposed and final regulations under the new regime, including finalized regulations relating to the eligibility criteria for a partnership to elect out of the new regime; proposed regulations on adjustments to a partnership's capital accounts to reflect partnership-level tax payments; final regulations on requirements for a person to become a "partnership representative" for the purposes of the new regime and on the scope of a partnership representative's authority; and final regulations on electing to apply the new partnership audit regime to tax years beginning after November 2, 2015, and before January 1, 2018.

Updates on Tax Cases

Wayfair. The U.S. Supreme Court released a historic decision on state income tax nexus in *South Dakota v. Wayfair Inc.* The *Wayfair* decision overturned the previously controlling precedent of *Quill Corp. v. North Dakota*, which required an out-of-state retailer to have a minimum physical presence in the state, such as a store or warehouse, in order to meet minimum contact permitting the state to collect sales tax. In *Wayfair*, however, the Supreme Court adopted a new "substantial virtual connection" standard that finds nexus where a retailer accesses a state's residents only online, but in that case the statute in question included a minimum number of customers and

sales revenues during the taxable period.⁷ Following *Wayfair*, a number of states have attempted to apply their sales taxes retroactively to prior periods and others have reduced the thresholds below those considered in the case.

Altera. The government had an unusual victory in a transfer-pricing case when the Ninth Circuit overturned the Tax Court in *Altera v Commissioner*, which invalidated a regulation requiring multinational companies to allocate stock-based compensation under cost-sharing agreements with foreign subsidiaries. The Ninth Circuit found that the regulation passed muster under the traditional test for the validity of regulations and was not “arbitrary and capricious.” In a surprise turn a month later, however, the Ninth Circuit withdrew its opinion, ostensibly because of the death of one of the original judges in the case.

Smith v Commissioner. Under Subpart F, a shareholder of a CFC may elect to be taxed like a corporation with respect to income inclusions, which has the benefit of allowing the shareholder access to the 21% corporation income tax rate and indirect FTCs. The election, however, causes the income inclusion to be taxed a second time, as if it were distributed out of a corporation. The Smith case considered whether that deemed dividend is a “qualified dividend” eligible to be taxed at capital gain rates. Unsurprisingly, the Tax Court held that the deemed dividend is ordinary income to the shareholder.

Updates on Tax Treaties

Senator Rand Paul has been blocking the Senate from ratifying updated tax treaties since 2010 in an effort to force repeal of FATCA, which many consider to be a violation of U.S. citizens’ constitutionally protected privacy rights. Currently, the stalled treaties include updated treaties with Chile, Hungary, Japan, Luxembourg, Poland, Spain and Switzerland. Senator Paul was re-elected in 2016 by his home state of Kentucky to serve another six-year term in the Senate, extending his expected tenure through 2022. Accordingly, there is no expectation that Senator Paul’s blockade against tax treaties will be lifted anytime soon.

State-Level Developments

Non-Conformity with the TCJA. Many states use federal taxable income as the starting point for their own tax calculations. Accordingly, a comprehensive tax reform package like the TCJA affects many states indirectly, without any action at all by the states. Nevertheless, many states have acted to adopt (or reject the application of) some or all of the new Code changes as applied for state income tax purposes. For example, some states have rejected the FDII regime, and most deny the eight-year spread for the mandatory income inclusion in 2017 of previously deferred offshore earnings under section 965.

Proposition 13 in California. Enacted in 1978, Proposition 13 imposes strict limitations on increases in property taxes in California, leading to billions of dollars in lost revenue as property tax receipts have lagged behind the real estate market. An initiative to repeal Proposition 13 with respect to commercial and industrial properties (but not with respect to residential properties) is under way in Sacramento and may be on the ballot as soon as 2020.

International Developments Impacting the U.S.

European State Aid Cases. Since 2016, the European Commission has been challenging tax rulings issued by various European states to private companies under Europe’s rules relating to state aid (a kind of anti-trust regime). The tax rulings at issue granted special tax exemptions to transfer-pricing rules for companies that establish headquarters in the ruling jurisdiction. When the European Commission succeeds in challenging these rulings, the company is required to pay the tax benefit back to the affected state. In 2018, Apple paid over €14 billion to the government of Ireland in one of the most prominent state aid cases, which is expected to be appealed. The European Commission continues to pursue companies such as McDonald’s in Luxembourg, which recently won its state aid case.

OECD Multilateral Instrument. The OECD has proposed a multilateral treaty (the Multilateral Instrument) intended to allow signatory states to adopt many of the recommendations of the OECD’s BEPS initiative without opening up the states’ existing tax treaty network to renegotiation. At the time of this writing, almost 90 countries have signed the Multilateral Instrument. The United States, however, has so far declined to sign the Multilateral Instrument.

U.S. Tax Development Outlook for 2019

The surest prediction for 2019 is that the IRS and the Treasury Department will continue to develop guidance relating to the TCJA. The regulatory packages proposed in 2018 include many gaps where the IRS reserved on important issues to be supplemented by practitioner guidance or further study by the IRS. In 2019, the IRS is expected to release regulations on FDI; regulations on the new exemption for dividends from foreign corporations attributable to foreign earnings; and further regulations on accounting for distributions of PTEP. Hearings on the proposed regulations issued in 2018, such as the proposed regulations on section 163(j), the BEAT and the anti-hybrid rules, are sure to be contentious. The IRS will continue to review regulations that have been flagged as unduly burdensome in response to Executive Order 13789, such as regulations under sections 367 and 385.

After legislation to end the spending cap, we predict the passage of technical corrections legislation (if the Republicans and Democrats in the House of Representatives can agree) that will fix a number of technical glitches in the TCJA, but we do not expect an extension of any tax benefits beyond the originally scheduled periods, due to their impact on the deficit.

Interest in tax reform continues in Congress. A "Tax Reform 2.0" bill was introduced during the summer which would have made certain changes from the TCJA permanent and introduced several taxpayer-favourable changes to U.S. retirement accounts and other tax-deferred savings accounts. Similarly, in December 2018, Republicans in the House of Representatives introduced a bill that would allow certain U.S. citizens residing abroad to exclude foreign-source income from taxation in the United States. It remains to be seen whether measures such as these gain much traction in the House of Representatives in the political climate resulting from the 2018 elections.

States are sure to press for retroactive application of *Wayfair* and to enact nexus statutes that reflect South Dakota's approach or reduce the required contacts even further. Some states may realize some windfall revenues from rejecting taxpayer-friendly aspects of the TCJA.

In the international context, anti-avoidance efforts should continue. Many countries have adopted the country-by-country reporting regime from BEPS action 13; in 2019 progress is expected with respect to the multilateral instrument, a multijurisdictional tax treaty that would allow participating countries to implement many of the BEPS recommendations without renegotiating their existing tax treaties. In a related development, the European Union Parliament has renewed the call to establish a common corporate tax base and common consolidated corporate tax base, which would simplify tax reporting for companies that do business across Europe.

In 2019, foreign countries may take measures in response to the enactment of the TCJA in the United States. Since the TCJA has generally increased the tax competitiveness of the United States for multinational corporations, other countries may try to make themselves even more attractive to international businesses. For instance, countries may reduce their corporate income tax rates or offer other incentives such as tax credits to attract businesses.

Finally, as this article went to press, a "temporary" government shut-down that caused significant delays with respect to hearings on proposed rules and progress on drafting regulations and other guidance had just ended. The shut-down lasted longer than any other shut-down in recent history. Another shut-down, however, may be looming if Congress and the President cannot find common ground on border security and immigration reform. No one can tell how long a new shut-down would last. Accordingly, it could still be a matter of weeks, months or even years before the United States sees additional clarification of the tax reform rules enacted under the TCJA.

[Read our Canadian Tax Review and Outlook.](#)

¹ As described further below, section 250 includes a deduction to corporations with respect to their foreign derived intangible income (FDII). The deduction is 37.5% of FDII from 2018 to 2025 and 21.875% thereafter. A challenge is expected at the WTO, claiming that this provision provides an illegal export subsidy. References to a "section" or "sections" are to sections of the Code.

² The TCJA increased the exclusion for U.S. citizens and residents to \$11.4 million (\$22.8 million for married couples) in 2019. Canadian and other non-U.S. residents are subject to U.S. gift and estate taxes only on their U.S.-situated property and are entitled to much more limited exclusions. Under the U.S.–Canada tax treaty, however, a Canadian resident can access the greater exclusions available to U.S. residents but the exemption is pro-rated over worldwide assets.

³ For taxable years beginning in 2022, the limitation is to be based on EBIT, which will result in much more limited deductions under the Code.

⁴ In addition, the IRS provided a special safe harbour in Revenue Procedure 2018-59 to allow P3 infrastructure projects to be treated as real estate businesses for the purposes of the new section 163(j).

⁵ Certain attribution rules apply to determine whether the shareholder requirements for CFCs are met. The TCJA vastly expanded the universe of CFCs by repealing a rule (known as “downward attribution”) that formerly prevented certain attribution of shares from a foreign shareholder. Legislative history suggests that the last described rule is overbroad as written, and technical corrections legislation introduced in 2019 would reduce the reach of that particular change in law.

⁶ The BEAT is levied on modified taxable income at a rate of 5% for 2018, 10% from 2019 until 2026 and 13.125% thereafter.

⁷ See [U.S. Supreme Court Decision Permits States to Tax Online Retailers Without Any In-State Physical Presence](#).

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