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Report No. 1395
June 1, 2018

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Assistant Secretary (Tax Policy)
Department of the Treasury
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The Honorable David J. Kautter
Acting Commissioner
Internal Revenue Service
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The Honorable William M. Paul
Principal Deputy Chief Counsel and
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Internal Revenue Service
1111 Constitution Avenue, NW
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Re: *NYSBA Tax Section Letter Relating to the Section 385 Per Se Stock Rules*

Dear Messrs. Kautter and Paul:

This letter[1] of the New York State Bar Association Tax Section responds to (i) Notice 2017-38,[2] (ii) the Second Report to the President on Identifying and Reducing Tax Regulatory Burden, issued by Treasury[3] on October 2, 2017 (the "**Treasury Report**"), and (iii) the report entitled "Regulatory Reform Accomplishments Under President Trump's Executive

[1] The principal drafter of this letter was David H. Schnabel, with the assistance of Anne E. McGinnis and Rebecca A. Rosen. Helpful comments were received from William D. Alexander, Andy Braiterman, John T. Lutz, Deborah L. Paul, Yaron Reich, Richard Reinhold, Joel Scharfstein, Michael L. Schler, David R. Sicular, Eric B. Sloan, Eric Solomon, Karen G. Sowell, Dana Trier, Philip Wagman, Gordon E. Warnke, and Sara Zablotney. This letter reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] Notice 2017-38, 2017-30 I.R.B. 147.

[3] All references in this letter to "section" and "sections" are to the Internal Revenue Code of 1986, as amended (the "**Code**"), or to the regulations issued thereunder, unless otherwise indicated. References to the "**IRS**" are to the Internal Revenue Service, references to "**Treasury**" are to the United States Department of the Treasury, and references to "**Secretary**" are to the Secretary of the Treasury.

Orders," issued by Treasury on April 24, 2018 (the "**Treasury Follow-Up Report**"), each of which were issued (at least in part) in response to Executive Order 13789 (the "**Executive Order**").

Notice 2017-38 (i) identified Treas. Reg. Sections 1.385-3 and 1.385-3T (collectively, the "**Final Per Se Stock Rules**") and certain other Treasury regulations as imposing an "undue financial burden on United States taxpayers," adding "undue complexity to the Federal tax laws," or both, and (ii) requested comments on whether such regulations should be rescinded or modified (and, in the latter case, how the regulations should be modified in order to reduce burdens and complexity). The Treasury Report stated (in relation to the Final Per Se Stock Rules) that Treasury was actively working with Congress on fundamental tax reform and that tax reform was expected to obviate the need for the Final Per Se Stock Rules and make it possible for those rules to be revoked. The Treasury Report indicated that Treasury will either withdraw the Final Per Se Stock Rules or propose a "more streamlined and targeted set of regulations" based on the extent to which tax reform legislation effectively addresses the "general tax incentive for U.S. companies to engage in inversions" and the "distortions and base erosion caused by excessive earnings stripping." The Treasury Follow-Up Report stated (in relation to the Final Per Se Stock Rules) that Treasury and the IRS are currently studying the effect of tax reform legislation on the Final Per Se Stock Rules.

We believe that the Final Per Se Stock Rules should not be left outstanding in their current form and we urge Treasury to implement in the near term the plan set forth in the Treasury Report to either withdraw the Final Per Se Stock Rules or issue a more targeted and streamlined set of regulations. We see three basic options available to Treasury in doing so.

First, in light of the enactment of P.L. 115-97, commonly referred to as the Tax Cuts and Jobs Act (the "**TCJA**"),[4] Treasury could withdraw the Final Per Se Stock Rules and decline to reissue an alternative set of regulations. As described below, the TCJA effected substantial changes to the taxation of U.S. corporations (and the U.S. taxation of international operations in particular) and included a variety of provisions that specifically target the inversion and earnings stripping concerns noted in the Treasury Report.

Although it is possible that a withdrawal of the Final Per Se Stock Rules would lead to an incremental number of cross-border business combinations (that is, inversions), for the reasons discussed below, we expect that the withdrawal would lead to relatively few (if any) cross-border combinations that would not occur in any case if the Final Per Se Stock Rules were retained in their current form. Further, although a withdrawal of the Final Per Se Stock Rules presumably would lead to an incremental amount of earnings stripping beyond the amount that would occur if the rules were retained in their current form, it is unclear whether Congress envisioned Treasury continuing to use Section 385 to limit earnings stripping beyond the specific provisions included in the TCJA.

Second, in the event that Treasury determines that the TCJA provisions addressing inversions and/or earnings stripping are such that it is appropriate to issue a targeted and streamlined set of regulations under Section 385, Treasury could propose a revised set of

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[4] P.L. 115-97 is officially titled "an Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."

regulations under Section 385. We note that there are inherent limitations on the ability of Treasury to issue a targeted and streamlined set of regulations under Section 385 because Section 385 was originally designed to distinguish between debt and equity of a corporation and was not originally designed as an anti-inversion provision or an anti-earnings stripping provision. If requested by Treasury, we would be happy to submit a report making recommendations as to those revised regulations but, prior to issuing such a report, it would be helpful for us to understand (i) what tax policy objectives Treasury seeks to advance in issuing those revised regulations (*e.g.*, anti-inversion or anti-earnings stripping) and (ii) whether Treasury intends to (A) retain the basic approach taken by the Final Per Se Stock Rules (*i.e.*, focusing on transactions in which intercompany debt is created in a corporate distribution or in a transaction that might be treated as giving rise to a distribution) but reduce their burden and complexity or (B) develop an alternative framework.

Third, Treasury could suspend the Final Per Se Stock Rules. We raise this as a possibility in light of the enormous amount of Treasury guidance that must be issued under the TCJA and the scarce resources available at Treasury to develop and approve that guidance. We recommend that Treasury adopt this third alternative and suspend the Final Per Se Stock Rules if Treasury concludes that it will not be in a position in the near term to either withdraw the Final Per Se Stock Rules or issue a targeted and streamlined set of revised regulations.

I. Background

A. Proposed Regulations Under Section 385

On April 4, 2016, Treasury and the IRS issued proposed regulations under Section 385 (the "**Proposed Regulations**"). Very generally, the Proposed Regulations provided (among other things) that: (i) certain related party debt would be treated as debt for U.S. federal income tax purposes only if certain contemporaneous documentation rules were satisfied, (ii) certain related party debt would automatically be treated as stock for U.S. federal income tax purposes if it was issued in certain prescribed transactions or with a principal purpose of funding certain prescribed transactions (the "**Proposed Per Se Stock Rules**"), and (iii) the IRS was authorized to treat certain related party debt as in part debt and in part equity for U.S. federal income tax purposes (the "**Proposed Part-Stock Rules**").

B. Proposed Regulations Report

On June 29, 2016, the Tax Section submitted a 172-page report commenting on the Proposed Regulations (the "**Proposed Regulations Report**").[5] The Proposed Regulations Report made 61 recommendations relating to the Proposed Regulations, including a recommendation that the Proposed Per Se Stock Rules not be finalized and that the government put forward for public review and comment more targeted guidance to address the planning that is of concern to the government.

In discussing our concerns with the Proposed Per Se Stock Rules, the Proposed Regulations Report described why those concerns may be unavoidable if the government seeks to achieve its policy objectives through the issuance of regulations under Section 385

[5] The Proposed Regulations Report includes a detailed discussion of the Proposed Regulations.

(including that Section 385 appears to distinguish between debt and equity based on a variety of factors germane to that analysis rather than based on distinctions designed to achieve other tax policy goals). However, the Proposed Regulations Report also recognized the importance of the government's policy objectives in issuing the Proposed Regulations,[6] stated that many allow for the possibility that an appropriately targeted regulation could be issued under Section 385, and offered three alternative approaches the government could pursue in order to address the concerns that led to the issuance of the Proposed Per Se Stock Rules.[7]

C. Final and Temporary Regulations Under Section 385

On October 21, 2016, Treasury and the IRS issued final and temporary regulations under Section 385 (collectively, the "**Final Regulations**"). The Final Regulations largely followed the framework[8] of the Proposed Regulations but with a variety of significant changes.[9]

D. Executive Order 13789

On April 21, 2017, President Trump issued the Executive Order. The Executive Order directed the Secretary to review all significant tax regulations issued by Treasury on or after January 1, 2016, and to issue a report identifying those regulations that (i) impose an undue financial burden on United States taxpayers, (ii) add undue complexity to the Federal tax laws, or (iii) exceed statutory authority.

The Executive Order also directed the Secretary to prepare and submit a second report recommending specific actions to mitigate the burden imposed by the regulations that are identified in the initial report.

E. Notice 2017-38

On July 7, 2017, Treasury and the IRS issued Notice 2017-38. As noted above, Notice 2017-38 identified the Final Regulations (and seven other sets of Treasury regulations) as

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[6] The Proposed Regulations Report was written and submitted prior to the enactment of the TCJA and addressed the Proposed Regulations rather than the Final Regulations.

[7] The three alternatives were to (i) issue guidance under Section 385 that specifically targets debt issued as part of a particular type of tax planning identified as problematic (*e.g.*, an inversion or repatriation strategy), (ii) issue guidance under Section 385 that focuses on the debt/equity ratio of the issuer relative to the debt/equity ratio of the issuer's world-wide group, or (iii) continue with some elements of the Proposed Per Se Stock Rules but make changes that significantly reduce their reach and that better tailor the rules to curtailing the types of planning that motivated the government to issue the rules. The Proposed Regulations Report noted seven issues that would need to be resolved under the approach described in (ii) above and offered to assist the government in analyzing the issues and developing guidance. In addition, the Proposed Regulations Report offered four recommendations relating to the approach described in (iii) above. Notably, certain of the four recommendations were adopted in the Final Per Se Stock Rules.

[8] However, the Final Regulations eliminated the Proposed Part-Stock Rules.

[9] Perhaps most importantly, the Final Regulations excluded (at least on a temporary basis) debt issued by a non-U.S. corporation from the ambit of the Final Per Se Stock Rules.

meeting at least one of the first two criteria specified in the Executive Order—that is, either imposing an undue financial burden on U.S. taxpayers, adding undue complexity for the federal tax laws, or both.[10] In addition, Notice 2017-38 requested comments on whether such regulations should be rescinded or modified (and, in the latter case, how the regulations should be modified in order to reduce burdens and complexity). In considering the Final Regulations, Notice 2017-38 states that:

> [The Final Regulations] address the classification of related-party debt as debt or equity for federal tax purposes. The regulations are primarily comprised of (i) rules establishing minimum documentation requirements that ordinarily must be satisfied in order for purported debt among related parties to be treated as debt for federal tax purposes; and (ii) [Final Per Se Stock Rules] that treat as stock certain debt that is issued by a corporation to a controlling shareholder in a distribution or in another related-party transaction that achieves an economically similar result. Commenters to the [Final Documentation Rules] criticized the financial burdens of compliance, particularly with respect to more ordinary course transactions. Commenters also requested a longer delay in the effective date of the [Final Documentation Rules]. Commenters to the [Final Per Se Stock Rules] criticized the complexity associated with tracking multiple transactions through a group of companies and the increased tax burden imposed on inbound investments.

F. Prior Letter of the NYSBA Tax Section in Response to Notice 2017-38

On August 7, 2017, the Tax Section submitted a letter in response to the request for comments in Notice 2017-38. With respect to the Final Regulations, we referred to our Proposed Regulations Report and stated that:

> We have not commented on the Final and Temporary Regulations under Section 385. We are grateful for Treasury's and the Service's efforts in considering and responding to our and others' comments on the Proposed Regulations, and making revisions in the Final and Temporary Regulations. We believe, though, a number of our comments on the Proposed Regulations continue to be relevant and recommend further consideration of our earlier report.

G. Treasury Report

[10] This letter accepts without further discussion Treasury's conclusion that the Final Per Se Stock Rules satisfy at least one of the first two criteria set forth in the Executive Order. As noted below, although we submitted a detailed report relating to the Proposed Per Stock Rules (as defined below), we have not submitted a report specifically commenting on the Final Per Se Stock Rules. If requested by Treasury, we would be happy to submit such a report and include in it a discussion of whether the Final Per Stock Rules satisfy one or more of the criteria set forth in the Executive Order.

On October 2, 2017, Treasury issued the Treasury Report.[11] In discussing the Final Per Se Stock Rules,[12] the Treasury Report noted that:

> The [Final Per Se Stock Rules] address inversions and takeovers of U.S. corporations by limiting the ability of corporations to generate additional interest deductions without new investment in the United States. In recent years, earnings-stripping by foreign-parented multinational corporations, as well as corporate inversions whereby U.S. corporations become foreign corporations and engage in earnings stripping, frequently as a tax artifice, have put U.S. corporations at a competitive disadvantage compared to their foreign peers. Treasury is committed to the Administration's goals of leveling the playing field for U.S. businesses, so that they may compete freely and fairly in the global economy, and implementing tax rules that reduce the distortion of capital and ownership decisions through earnings stripping and similar practices.
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> Commenters have criticized the complexity and breadth of the [Final Per Se Stock Rules]. They criticized in particular the funding rule that addresses multiple-step transactions and the burdens of tracking multiple transactions among affiliated companies over long periods of time. Treasury understands that the [Final Per Se Stock Rules] are a blunt instrument for accomplishing their tax policy objectives, and continues to consider how the [Final Per Se Stock Rules] might be made more targeted and compliance with the regulations made less onerous. At the same time, Treasury continues to believe firmly in maintaining safeguards against earnings-stripping and diminishing incentives for inversions and foreign takeovers.
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> Treasury has consistently affirmed that legislative changes can most effectively address the distortions and base erosion caused by excessive earnings stripping, as well as the general tax incentives for U.S. companies to engage in inversions. Treasury is actively working with Congress on fundamental tax reform that should prevent base erosion and fix the structural deficiencies in the current U.S. tax system. Tax reform is expected to obviate the need for the [Final Per Se Stock Rules] and make it possible for these regulations to be revoked.

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[11] According to the Treasury Report, Treasury issued an interim report to President Trump on June 22, 2017 (the "**June Report**"), in which Treasury identified eight regulations that met one of the first two criteria specified in the Executive Order. As far as we know, the June Report is not publicly available.

[12] Shortly after issuing Notice 2017-38, Treasury and the IRS delayed the effective date of the documentation rules included in the Final Regulations (the "**Final Documentation Rules**") by one year (to debt instruments issued after January 1, 2019), noting that "Treasury and the IRS do not believe that taxpayers should have to expend time and resources designing and building systems to comply with rules that may be modified to alleviate undue burdens of compliance." Notice 2017-36, 2017-33 I.R.B. 208. The Treasury Report notes that Treasury and the IRS are considering a proposal to revoke the Final Documentation Rules as issued, and to replace the Final Documentation Rules with a new set of rules that would be "substantially simplified and streamlined in a manner that will lessen their burden on U.S. corporations, while requiring sufficient legal documentation and other information for tax administration purposes."

> In the meantime, after careful consideration, Treasury believes that proposing to revoke the existing [Final Per Se Stock Rules] before the enactment of fundamental tax reform, could make existing problems worse. If legislation does not entirely eliminate the need for the [Final Per Se Stock Rules], Treasury will reassess the [Final Per Se Stock Rules] and Treasury and the IRS may then propose more streamlined and targeted regulations.

H. The Tax Cuts and Jobs Act

On December 22, 2017, the TCJA was enacted into law. The TCJA is the first legislation to effect fundamental reform of the U.S. federal income tax system since 1986.

I. Treasury Follow-Up Report

On April 24, 2018, Treasury issued the Follow-Up Report, which states (in relation to the Final Per Se Stock Rules) that Treasury and the IRS are currently studying the effect of tax reform legislation on the Final Per Se Stock Rules.

II. Discussion

As noted above, the Treasury Report indicates that the determination of whether to withdraw the Final Per Se Stock Rules or to propose a more streamlined and targeted set of regulations will be based on the extent to which tax reform legislation effectively addresses (i) the "general tax incentive for U.S. companies to engage in inversions" and (ii) the "distortions and base erosion caused by excessive earnings stripping." As discussed below, the TCJA targets each of these concerns through a variety of substantial changes to the Code.

A. Provisions of the TCJA Addressing the General Tax Incentive for U.S. Companies to Engage in Inversions

1. Certain Tax Benefits that Commonly Motivated Inversions

A wide variety of factors impact the decision of a U.S. business to combine with another business and, in the context of a cross-border business combination, the determination as to where the parent company should be organized. These factors may include, for example, a desire to (i) expand into a larger global footprint, (ii) obtain access to a particular geographic market (or to complementary markets), (iii) expand into a more diverse (and more resilient) portfolio of products, (iv) achieve higher growth potential due to a more diverse product suite, (v) achieve a broader customer base, (vi) obtain access to complementary R&D activities, (vii) obtain operational and capital synergies driven by economies of scale, (viii) achieve an enhanced credit profile with increased earnings and cash flow, and (ix) obtain improved access to capital markets as a result of larger size.

In certain business combinations involving a U.S. corporation effected in the last 15 years or so, the potential ability to realize certain U.S. federal income tax benefits was a key factor in the decision to engage in the combination and to structure the combination so that the resulting parent company was organized outside of the United States. In order to illustrate these commonly sought-after potential U.S. tax benefits and the impact of various changes made by the TCJA, consider the following example:

A publicly traded U.S. corporation ("**US Corp**") conducts its U.S. operations directly and through one or more U.S. subsidiaries and conducts its non-U.S. operations through one or more non-U.S. corporate subsidiaries (the "**Non-US Subs**"). In a business combination (the "**Combination**"), all of the stock of US Corp is acquired by an unrelated publicly-traded non-U.S. corporation (the "**Non-US Parent**") in exchange for stock of Non-US Parent in a transaction that does not result in Non-US Parent being treated as a domestic corporation under Section 7874.

a) Accessing Trapped Cash

Under pre-TCJA law, (i) prior to the Combination, US Corp would generally recognize taxable income at the time the earnings of the Non-US Subs were repatriated to US Corp but (ii) following the Combination, it was often possible to engage in one or more transactions that would allow the Non-US Parent to access the earnings of the Non-US Subs without incurring U.S. tax. For transactions effected after September 22, 2014, this "inversion benefit" was generally available only if, after the Combination, the former owners of US Corp did not own 60% or more of Non-US Parent by reason of their ownership of the US Corp.[13]

Changes made by the TCJA generally obviate the need to engage in a Combination (or other inversion) in order to achieve this U.S. tax benefit.[14] This results from the enactment of (i) Section 965[15] (which generally taxes (at reduced rates by way of a deduction under Section 965(c)) all pre-TCJA untaxed accumulated E&P of the Non-US Subs and allows those earnings to be repatriated to US Corp without additional U.S. federal income tax), (ii) Section 245A[16] (which creates a new 100% dividends received deduction that effectively eliminates the U.S. federal income tax that would otherwise be payable by US Corp upon repatriation of future foreign earnings of the Non-US Subs) and (iii) 951A (which generally requires a United

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[13] Under Treas. Reg. Section 1.956-2T, if (as a result of the Combination) the former owners of US Corp owned 60% or more (but less than 80%) of Non-US Parent by reason of their ownership of the US Corp, for the 10-year period following the Combination, certain stock or obligations of a "related foreign person" that is not a CFC for U.S. federal income tax purposes (a "**Related Foreign Person**") held by the non-U.S. Subs would be deemed to be "United States property" for purposes of Section 956 (with certain limited exceptions). Similar rules would apply to a guarantee by the non-U.S. Subs of any debt of a Related Foreign Person and a pledge of the stock of the non-U.S. Subs to support any such debt.

[14] The changes made by the TCJA were intend intended to "eliminate the 'lock-out' effect under pre-TCJA law whereby U.S. businesses avoided bringing their foreign earnings back into the United States to avoid a U.S. residual tax on those earnings." Senate Explanation at 353.

[15] Section 965 requires a United States shareholder of a "deferred foreign income corporation" ("**DFIC**") to take into account its *pro rata* share of the greater of the DFIC's (i) accumulated post-1986 deferred foreign income determined as of November 2, 2017, or (ii) accumulated post-1986 deferred foreign income determined as of December 31, 2017, as additional subpart F income for the DFIC's last taxable year which begins before January 1, 2018. These amounts are generally includible at the tax rate then in effect, but a United States shareholder is entitled to a deduction under Section 965(c) that results in an effective tax rate of 15.5% on accumulated earnings and profits ("E&P") deemed to be held in cash and 8% on non-cash E&P.

[16] Specifically, Section 245A generally allows a U.S. corporate taxpayer to deduct 100% of the "foreign source" portion of any dividend that it receives from a foreign corporation in which it owns a 10% (or higher) interest, provided that certain holding period requirements are met.

States shareholder of one or more "controlled foreign corporations" ("**CFCs**") to include in income on a current basis the United States shareholder's share of the net "tested income" of the CFCs to the extent it exceeds a prescribed threshold).[17]

b) Eliminating Application of the CFC Rules

Under pre-TCJA law, (i) prior to the Combination, each of the Non-US Subs would be treated as a CFC and US Corp (as a United States shareholder of the Non-US Subs for U.S. federal income tax purposes) would be required to recognize income under the CFC rules in respect of the Non-US Subs, but (ii) following the Combination, it was often possible to engage in certain internal transactions that would cause the Non-US Subs to no longer be treated as CFCs and thereby cause the US Corp to no longer be required to recognize income under the CFC rules in respect of the Non-US Subs. For transactions effected after September 22, 2014, this "inversion benefit" was generally available only if, after the Combination, the former owners of US Corp did not own 60% or more of Non-US Parent by reason of their ownership of the US Corp.[18]

The TCJA's change to Section 958(b) relating to downward attribution is specifically designed to eliminate the ability of non-U.S. multinationals to engage in internal transactions that result in the Non-US Subs not being treated as CFCs.

c) Interest Earnings Stripping

Under pre-TCJA law, (i) prior to the Combination, it was generally not possible to use intercompany debt to reduce the U.S. tax of the US Corp, but (ii) following the Combination, it was often possible to reduce the U.S. tax of the US Corp with interest on intercompany debt between the US Corp (or another member of the same U.S. tax group) and the Non-US Parent (or a non-U.S. subsidiary of the Non-US Parent).

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[17] Tested income included in income under Section 951A generates "previously taxed income" ("PTI") under Section 959 and tax basis under Section 961, which generally allows for the repatriation of the tested income without additional U.S. tax.

[18] Under Treas. Reg. Section 1.7701(l)-4T, in the case of a 60%-80% Inversion (as defined below), for the 10-year period following the inversion, an acquisition by a Related Foreign Party of stock of a CFC of the US Corp is generally recharacterized as running from the Related Foreign Party to the CFC's Section 958(a) United States shareholders and then from the Section 958(a) United States shareholders to the CFC in a manner that eliminates the effect of the de-controlling transaction.

Under Treas. Reg. Section 1.367(b)-4T(e), the general income inclusion rule under Section 367(b) that applies to certain exchanges of the stock of a foreign corporation for stock of another foreign corporation if the exchange results in a loss of CFC status or Section 1248 shareholder status is expanded to apply to any exchange by a US Corp (or a CFC of the US Corp) of foreign corporate stock following an inversion transaction, even if the exchange does not result in a loss of CFC status or Section 1248 shareholder status. Similar to Treas. Reg. Section 1.7701(l)-4T, this rule applies only to transactions in the 10-year period following a Combination in which the former owners of the US Corp own 60% or more (but less than 80%) of Non-US-Parent by reason of their ownership of the US Corp, and certain exceptions (including a *de minimis* exception) apply. Both Treas. Reg. Section 1.7701(l)-4T and Treas. Reg. Section 1.367(b)-4T(e) apply only to transactions following Combinations effected after September 22, 2014.

The ability to create this debt in the Combination itself or in a wide variety of other transactions was eliminated by the Final Per Se Stock Rules. However, because the Final Per Se Stock Rules do not apply to all related-party debt, it would still be possible in certain instances to use intercompany debt to reduce the taxable income of US Corp following the Combination (*e.g.*, if the Non-US Parent loans money to the US Corp to fund an acquisition from an unrelated party and certain prescribed transactions were not effected within a prescribed period).

A variety of changes made by the TCJA significantly reduce the potential magnitude of this "inversion benefit" and in some cases may eliminate the benefit in its entirety. First, under Section 163(j), US Corp's deduction for net interest expense is capped at 30% of the US Corp's "adjusted taxable income" for the taxable year.[19] The cap under Section 163(j) combines third-party debt and intercompany debt.[20] Second, if US Corp and certain related parties collectively have at least $500 million in average annual revenue, US Corp may be subject to a new "base erosion and anti-abuse tax," which functions as an alternative minimum tax that reduces the benefit of deductible payments made by affected taxpayers to related foreign parties (the "**BEAT**"). Third, in a provision aimed at the use of so-called "hybrid instruments," new Section 267A generally denies a deduction for interest or royalties paid to a related party if the jurisdiction of the recipient does not treat the payment as a payment of interest or royalties.

2. <u>More General TCJA Changes to U.S. Corporate Taxation</u>

The TCJA also effected a number of more general and fundamental changes to the U.S. federal taxation of U.S. corporations. These changes were designed to allow U.S. companies to "compete on a more level playing field against foreign multinationals" and reduce the incentives that existed under prior law to invert.[21] Key aspects of the new system (in addition to those noted above) include:

a) 21% Corporate Tax Rate

The TCJA reduced the corporate tax rate from 35% to 21%, which is slightly below the Organisation for Economic Co-operation and Development ("**OECD**") average of 22.34%.[22]

b) Modified Territorial System

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[19] "Adjusted taxable income" generally means taxable income for the year determined without regard to (1) any income, gain, deduction or loss not properly allocable to a trade or business, (2) business interest income, (3) any net operating loss deduction under Section 172, (4) the deduction for "qualified business income" of a pass-through business under Section 199A, (5) for taxable years beginning before January 1, 2022, any deduction allowable for depreciation, amortization or depletion, and (6) other adjustments as provided by the Secretary.

[20] Special rules will apply to intercompany debt between members of an affiliated group that join in the filing of a consolidated U.S. federal income tax return.

[21] H.R. REP. NO. 115-409, at 370 (2017); Senate Explanation at 391.

[22] The OECD 2017 average corporate income tax rate increases to 24.18% when taking into account surtaxes, sub-central government income taxes and the deductibility of sub-central government income taxes against central government income taxes. *Available at* http://stats.oecd.org/index.aspx?DataSetCode=TABLE_II1.

The TCJA shifted the U.S. tax system from one that taxes worldwide earnings to a so-called modified territorial system. Under the new modified territorial system:

- New DRD. New Section 245A generally allows a 100% dividends received deduction on the foreign-source portion of dividends received by a U.S. corporate taxpayer from a "10-owned foreign corporation."

- New "GILTI" Regime. Under new Sections 250 and 951A, a United States shareholder of a CFC is generally (i) required to include in income its share of the CFC's active net income above a prescribed threshold, (ii) granted a deduction equal to 50% of the income so included,[23] and (iii) eligible (subject to limitations) to claim foreign tax credits equal to 80% of the foreign taxes paid by the CFC on such income.

- New FDII Rules. Also under the new Section 250, a U.S. corporate taxpayer is granted a deduction equal to 37.5% of the taxpayer's income above a prescribed threshold, if generated from the export of goods and services.

- New BEAT. New Section 59A imposes a new "base erosion and anti-abuse tax" on large U.S. corporate taxpayers that make above a prescribed threshold of deductible payments to related foreign parties in a taxable year. The BEAT functions to reduce the benefit of such deductible payments.

c) Expanded Expensing

The TCJA also added a number of new incentives for domestic taxpayers, including new Section 168(k), which permits immediate expensing of "qualified property" placed in service by the taxpayer prior to January 1, 2023 (with a phase-down in the five years thereafter).[24]

d) Intent of the Various Changes Made by the TCJA

The TCJA was designed (in part) to revise aspects of the U.S. federal income tax system that (i) made "foreign ownership of almost any asset or business more attractive than U.S. ownership," (ii) "unfairly favor[ed] foreign headquartered companies over U.S. headquartered companies, creating a tax-driven incentive for foreign takeovers of U.S. firms," and (iii) "created significant financial pressures for U.S.-headquartered companies to re-domicile abroad and shift income to low-tax jurisdictions.[25]

3. Additional TCJA Changes Specifically Targeting Inversions

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[23] This deduction applies only to U.S. corporate taxpayers, and is subject to certain limitations, including limitations in the event that the corporation otherwise has net operating losses available to offset taxable income.

[24] "Qualified property" generally includes tangible property with a recovery period of 20 years or less, computer software and certain other categories of depreciable property. Both property newly placed in service by the taxpayer and used property acquired from a party unrelated to the taxpayer are eligible for the deduction. Certain property with longer production periods is eligible for immediate expensing until January 1, 2024.

[25] Senate Explanation at 391.

Section 7874 generally distinguishes among inversion transactions based on the percentage of stock of the Non-US Parent held by the former owners of the US Corp after the transaction by reason of owning stock of the US Corp (the "**By Reason of Percentage**").

If the By Reason of Percentage is 80% or more, the Non-US Parent is generally treated as a domestic corporation for U.S. federal income tax purposes under the theory that the transaction "has little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes."[26] If the By Reason of Percentage is 60% or more but less than 80% (a "**60%-80% Inversion**"), the Non-US Parent is characterized as a "surrogate foreign corporation" and the US Corp is treated as an "expatriated entity." Although a surrogate foreign corporation is not treated as a domestic corporation, a variety of special rules apply with respect to the surrogate foreign corporation and its affiliates for the 10-year period following the transaction under the theory that the transaction "may have sufficient non-tax effect and purpose to be respected, but [the transaction] warrant[s] heightened scrutiny and other restrictions to ensure that the U.S. tax base is not eroded through related-party transactions."[27] If the By Reason of Percentage is less than 60%, no special rules apply, presumably under the theory that the transaction has sufficient non-tax effect and purpose to be respected and to not warrant heightened scrutiny or base erosion restrictions.

The TCJA made a number of changes that target 60%-80% Inversions. Specifically:

- <u>Recapture of the Section 965 Deduction</u>. Under new Section 965(l), if a United States shareholder is allowed a deduction under Section 965(c) and becomes an expatriated entity during the 10-year period following the enactment of the TCJA, the United States shareholder is subject to a 35% tax on the amount of such deduction.

- <u>Disqualification from QDI Treatment</u>. Under new Section 1(h)(11)(C)(iii), dividends paid by a surrogate foreign corporation that first becomes a surrogate foreign corporation after enactment of the TCJA are not eligible for qualified dividend income treatment.[28]

- <u>Expansion of the BEAT</u>. Although the BEAT generally applies only in respect of deductible payments made to related foreign parties and not to payments that reduce the initial calculation of gross income under Section 61 (such as the cost of goods sold), the BEAT applies more broadly in the case of a U.S. corporation that becomes an expatriated entity after November 9, 2017, and applies to both deductible payments to related foreign parties and payments that reduce gross income.

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[26] TAX TREATMENT OF EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS, COMM. REP. ¶ 78,741.099, LEGISLATIVE HISTORY OF THE AM. JOBS CREATION ACT OF 2004, P.L. 108-357 (2004).

[27] *Id.*

[28] Senate Explanation at 386.

- Increased Excise Tax on Stock Compensation. The TCJA increased the excise tax under Section 4985 from 15% to 20%.

4. Certain Observations

The Final Per Se Stock Rules were issued as part of a larger effort by Treasury and the IRS to stop what seemed like an increasing number of U.S. companies from engaging in inversion transactions. Although the Final Per Se Stock Rules were heavily criticized for a variety of reasons, they were justified (by many) by the interest of the United States in protecting its tax base and by a recognition of the fact that a legislative response to the increase in inversions was unlikely in the near term.

Since the issuance of the Final Per Se Stock Rules, Congress substantially reformed the U.S. federal income taxation of U.S. corporations and international operations through the enactment of the TCJA. As noted above, the TCJA (i) included provisions that target various U.S. tax benefits that commonly motivated U.S. companies to invert, (ii) effected substantial changes to the U.S. taxation of corporations that are designed to allow U.S. corporations to compete on a more level playing field against foreign multinationals, and (iii) added a number of provisions that effectively penalize a U.S. corporation that inverts in a 60%-80% Inversion.

We recognize that, if the Final Per Se Stock Rules are withdrawn, a U.S. corporation may (following a cross-border business combination) be able to achieve a U.S. earnings stripping benefit through the creation of intercompany debt in excess of the U.S. earnings stripping benefit that would be available if the Final Per Se Stock Rules were retained. Nevertheless, we expect that a withdrawal of the Final Per Se Stock Rules would lead to relatively few (if any) U.S. corporations deciding to engage in cross-border business combinations that would not have occurred in any case if the Final Per Se Stock Rules were retained.[29]

For example, in considering whether to engage in a particular cross-border business combination that would be treated as a 60%-80% Inversion, in light of the various changes made in the TCJA discussed above, the panoply of provisions specifically applicable to such an inversion and the various (non-tax) potential risks and benefits arising from the business combination, it seems unlikely that the incremental earnings stripping benefit that would be potentially available if the Final Per Se Stock Rules were withdrawn would regularly tip the scales in favor of going forward with the combination where a contrary decision would have been made if the Final Per Se Stock Rules were retained.

Further, in considering whether to engage in a particular cross-border business combination that would have a By Reason of Percentage that would be less than 60%, in light of the various changes made in the TCJA discussed above, the various (non-tax) potential risks and benefits arising from the business combination, and the fact that the shareholders of the

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[29] However, it is possible a withdrawal of the Final Per Se Stock Rules may increase the incentive (in the case of a cross-border business combination) to organize the parent company outside of the United States (*i.e.*, to allow the parties to use intercompany debt to reduce the taxable income of the U.S. corporation, to the extent permitted after the TCJA). However, this incentive will in each case need to be balanced with other (tax and non-tax) factors, particularly where the combined company will be subject to the special rules that apply to 60%-80% Inversions.

U.S. corporation would be relinquishing more than 40% of the stock of the parent company after the combination, it similarly seems unlikely that the incremental earnings stripping benefit that would be potentially available if the Final Per Se Stock Rules were withdrawn would regularly tip the scales in favor of going forward with the combination where a contrary decision would have been made if the Final Per Se Stock Rules were retained. Moreover, to the extent that the purpose of the Final Per Se Stock Rules is to curtail inversions, it is not clear to us whether the potential application of those rules to transactions in which the By Reason of Percentage is less than 60% should be a driving factor in the decision posed by the Treasury Report, given that Congress did not adjust the lines drawn by Section 7874 and that Congress specifically imposed a variety of penalties on inverted companies only where the By Reason of Percentage was 60% or more.

We also recognize that the changes made by the TCJA will not stop U.S. companies from engaging in business combinations, including cross-border business combinations, and that in some cross-border business combinations the parties will choose for the parent company to be organized outside of the United States. In many cases, this decision will have little or nothing to do with tax concerns.

In other cases, the modified nature of the U.S. territorial system may increase the incentive (in the case of a cross-border business combination) to organize the parent company outside of the United States (*e.g.*, to prevent the non-US company merger partner and its non-US subsidiaries from becoming subject to the U.S. tax system's modified territorial regime). However, this incentive will in each case need to be balanced with other (tax and non-tax) factors, particularly where the combined company would be subject to the special rules that apply to 60%-80% Inversions.

B. Provisions of the TCJA Addressing the Distortions and Base Erosion Caused by Excessive Earnings Stripping

1. Earnings Stripping and Base Erosion Provisions in the TCJA

As discussed above, the TCJA includes a variety of provisions addressing earnings stripping, including (i) the new limitations on the deductibility of net interest expense under Section 163(j), (ii) the BEAT under Section 59A, and (iii) the new hybrid instrument rules under Section 267A.[30]

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[30] The House and the Senate each considered adding another new provision (a new Section 163(n)) which would have limited the deductibility of interest by a domestic corporation that is part of a worldwide group to the extent that the domestic corporation bears an outsized percentage of the group's net interest expense. According to the House Report, the provision was intended to "prevent multinational companies from generating excessive interest deductions in the United States on debt that is issued to foreign affiliates or that is incurred to produce exempt foreign income." H.R. REP. NO. 115-409, at 397 (2017). In observing that U.S. subsidiaries of foreign-parented multinationals had an incentive to issue related-party debt to increase interest deductions allowed against U.S. taxable income under then-current law, the House Report noted that Sections 163(j), 267(a)(3), and 482 limit the deductibility of related-party interest payments in certain circumstances, the subpart F rules limit the U.S. tax benefits of issuing debt to a foreign subsidiary, and the Final Regulations limit the deductibility of related-party interest payments in certain cases by recharacterizing intercompany debt instruments as equity. The bicameral committee constituted to resolve the differences between the House and Senate's versions of the TCJA (the

2. Certain Observations

We recognize that, notwithstanding the various provisions in the TCJA targeting earnings stripping, a withdrawal of the Final Per Se Stock Rules will result in an incremental ability of non-U.S. multinationals to reduce the taxable income of their U.S. subsidiaries through the use of intercompany debt. However, we do not believe that this fact alone is a reason to retain the Final Per Se Stock Rules.

First, the Treasury Report is appropriately focused on "excessive" earnings stripping rather than "any" earnings stripping. Accordingly, the question is whether the use of Section 385 to further limit earnings stripping is necessary or appropriate to eliminate "excessive earnings stripping" in light of the other relevant limitations enacted by the TCJA. Given the specificity with which the TCJA addressed earnings stripping, it could be argued that the compromise reached by Congress in Section 163(j) (together with the BEAT and the new hybrid rules) define what Congress thought to be excessive earnings stripping and what Congress thought should be permitted.

However, it could also be argued that Congress did not intend for these provisions to be the exclusive means of limiting earnings stripping, and that Congress understood that Treasury might decide to issue a streamlined and targeted set of regulations under Section 385 that impose further limits on earnings stripping, depending upon the extent to which the TCJA addressed inversions and earnings stripping (*i.e.*, whether the TCJA "entirely eliminate[d]" the need for regulations under Section 385 to address "excess earnings stripping").[31] We note in this regard that the TCJA does not eliminate the ability of U.S. corporate taxpayers to reduce their U.S. federal income taxes through earnings stripping transactions. For example, (i) Section 163(j) generally allows a U.S. corporate taxpayer to deduct net interest expense (including interest expense on "internal" debt) to the extent the net interest expense does not exceed 30% of the taxpayer's "adjusted taxable income" for year, (ii) for taxable years beginning before January 1, 2022, adjusted taxable income for purposes of Section 163(j) is computed without regard to any deduction for depreciation, amortization or depletion, (iii) the BEAT does not apply to taxpayers that have average annual gross receipts below $500 million or base erosion payments below a prescribed threshold (and, even where the BEAT applies, it generally reduces but does not entirely eliminate the tax benefit of the payment), and (iv) Section 267A is limited to "hybrid transactions" (as defined for purposes of Section 267A).

It could further be argued that the Conference Committee's elimination of proposed Section 163(n) in the final legislation left room for Treasury to "fill a hole" with a streamlined and targeted set of regulations under Section 385 that further limited earnings stripping. However, it is notable that, at the same time that the Conference Committee eliminated proposed Section 163(n), the Conference Committee also adopted[32] and expanded[33] the BEAT

"**Conference Committee**") eliminated proposed Section 163(n) in its version of the legislation, and, accordingly, proposed Section 163(n) was not included in the final TCJA.

[31] See Treasury Report at pages 7-8.

[32] The final House bill prior to conference (as passed on November 16) did not include a BEAT provision but did include an excise tax on certain payments to members of the taxpayer's international financial reporting group. Although the excise tax generally applied to payments that were deductible, includible in the cost of goods sold,

that had been proposed by the Senate and expanded Section 163(j).[34] Accordingly, rather than leaving a "hole" that might be filled by a revised set of regulations under Section 385, the elimination of proposed Section 163(n) could be seen as part of a specific compromise reached by the House and the Senate as to the provisions that would limit earnings stripping going forward.

Second, there are inherent limitations on the ability of Treasury to issue a targeted and streamlined set of regulations under Section 385 because Section 385 was originally designed to distinguish between debt and equity of a corporation and was not originally designed as an anti-inversion provision or an anti-earnings stripping provision. As was noted in the Proposed Regulations Report, this fact likely explains the difficulty that Treasury and the IRS had in drafting the Final Per Se Stock Rules and the extent of the problems and criticism raised by the rules.[35] It also likely explains why the Treasury Report refers to the Final Per Se Stock Rules as a "blunt instrument" for accomplishing their tax policy objectives.

Thus, for example, in order to limit the deduction for interest on a debt instrument, the Final Per Se Stock Rules treat the instrument as equity for all purposes of the Code even if the instrument would clearly and unambiguously be treated as debt under traditional debt-equity principles. Similarly, even though the Final Per Se Stock Rules are being used to police earnings stripping, they may apply and treat a debt instrument as equity even if (i) all interest on the instrument would otherwise be deferred or disallowed under other provisions of the Code, (ii) all interest on the instrument would increase the BEAT payable by the issuer, or (iii) the underlying facts surrounding the debt instrument do not raise traditional earnings stripping concerns, such as where the issuer is not highly leveraged (in absolute terms or relative to the group as a whole) or where the interest on the debt instrument is currently taxable to the recipient. Finally, the application of the Final Per Se Stock Rules to a particular instrument is

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or could give rise to depreciation or amortization, the excise tax did not apply to payments of interest. However, as noted above, the BEAT adopted by the Conference Committee does apply to interest payments.

[33] The BEAT as enacted in the final TCJA was modeled after a similar provision in the final Senate bill prior to conference (as passed on December 2) but was expanded to apply to taxpayers with smaller base erosion payments. Under the final Senate bill prior to conference, a taxpayer would have been subject to the BEAT only if it had a base erosion percentage of 4% or more. The Conference Committee lowered this threshold to 3% (2% in the case of certain banks and securities dealers). (A taxpayer's "base erosion percentage" is generally the ratio of the taxpayer's "base erosion tax benefits" for the taxable year over the sum of the taxpayer's aggregate deductions plus certain non-deductible payments of the type included in the numerator).

[34] Under both the final House bill and the final Senate bill prior to conference, for all taxable years, ATI would have been increased by the taxpayer's deductions for depreciation, amortization, or depletion (*i.e.*, ATI was based on "EBITDA" for all taxable years). However, for taxable years beginning on or after January 1, 2022, the Conference Committee eliminated the increase on account of the taxpayer's deductions for depreciation, amortization, or depletion (so that for such years, ATI is based on "EBIT"). (Note that in the Senate's first publicly-released bill (both the initial Chairman's mark released on November 9 and the legislative text released on November 20), ATI was computed without any increase on account of deductions for depreciation, amortization, or depletion (that is, ATI would have been based on EBIT for all taxable years)).

[35] However, as noted above, the Proposed Regulations Report also recognized the importance of the government's policy objectives in issuing the Proposed Regulations,[35] stated that many allow for the possibility that an appropriately targeted regulation could be issued under Section 385 and offered three alternative approaches the government could pursue in order to address the concerns that led to the issuance of the Proposed Per Se Stock Rules.

based on the facts relating to the issuance of the instrument and the existence of certain transactions during a prescribed period and is not based on traditional earnings stripping considerations or on traditional debt-equity factors.

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We appreciate your consideration of our comments. If you have any questions or comments regarding this letter, please feel free to contact us and we will be glad to discuss.

Respectfully submitted,

Karen G. Sowell

Karen G. Sowell
Chair

Cc:

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Chairman
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