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Not So Fast: 163(j), 245A, and Leverage in the Post-TCJA World

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ABSTRACT. The Tax Cuts and Jobs Act will require large multinational corporations to reevaluate the use of debt in their acquisition and corporate structures. Changes to the Tax Code brought about by the Act have reduced incentives to use debt in these contexts. These changes may require practitioners to identify new approaches to financing acquisitions and will necessitate reevaluation of current capital structures used by large multinational entities. This Essay examines these and other changes, and reflects on their likely effect on cross-border financing structures.

INTRODUCTION

On December 22, 2017, President Donald Trump signed into law H.R. 1,[1] colloquially known as the Tax Cuts and Jobs Act (TCJA). The TCJA makes several fundamental changes to the U.S. Internal Revenue Code (the "Code"). Some of these changes will likely have significant ramifications for the financing of cross-border mergers and acquisitions and for the capital structures of large, multinational companies with a U.S. presence. Historically, using U.S. debt to finance transactions and to support companies' ongoing operations was viewed as a tax-efficient approach for multinationals with a U.S. presence.[2] Under the TCJA, debt financing is now generally less favored by the Code, and so acquisition structures and capital structures will need to be rethought and remodeled to assess their relative tax efficiency going forward. Historically, one

1. Tax Cuts and Jobs Act, Pub. L. No. 115-97, 131 Stat. 2054 (2017).

2. *See, e.g.*, H.R. REP. NO. 115-409, at 247 (2017) ("The Committee believes that the general deductibility of interest payments on debt may result in companies undertaking more leverage than they would in the absence of the tax system.").

benefit of debt financing was that deductions could be taken for interest paid, subject to limitations on highly levered entities making payments to related parties not subject to U.S. tax or on debt guaranteed by such related parties.[3] After the TCJA, the limitations applicable to deductions for debt apply more broadly, which we expect to reduce tax benefits associated with using debt as a tool to finance acquisitions and in capital structures more generally.

Changes to § 163(j) of the Code may result in a partial disallowance of deductions for business interest in cases where a taxpayer incurs significant debt, regardless of whether the lender is a related person or subject to U.S. tax. Before the TCJA was enacted, disallowances under § 163(j) were generally aimed at reducing the use of related-party debt to engage in "earnings stripping." Post-TCJA, § 163(j) applies to a broader universe of debt, as it no longer looks to whether parties to the loan are related.[4] Additionally, the provision is no longer limited to highly levered entities, but instead applies to all entities with receipts in excess of $25 million.[5] The expanded scope of § 163(j) under the TCJA may significantly decrease the corporate appetite for relying on debt to finance future acquisition structures, including, notably, structures that did not raise any § 163(j) issues pre-TCJA. Given that § 163(j) does not allow grandfathering, both new acquisition structures and pre-existing corporate structures warrant analysis in light of the new legal landscape.

Multinational corporate groups have also historically favored debt over equity for repatriating cash from non-U.S. jurisdictions to the United States.[6] This was due in part to the effective income tax shield that interest expense could create, as well as the relative tax inefficiency of dividends paid to a U.S. corporate parent by non-U.S. subsidiaries. Accordingly, post-acquisition investment structures of groups with significant U.S. and non-U.S. components have typically included a mix of debt instruments and hybrid instruments[7] to create a more efficient repatriation environment. However, the TCJA's implementation of a quasi-territorial system of taxation (most notably in the form of a participation exemption for dividends between U.S. and non-U.S. entities codified in new § 245A of the Code[8]), combined with anti-abuse provisions fo-

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3. I.R.C. § 163(j) (2012).

4. Pre-TCJA, I.R.C. § 163(j)(3)(A) looked at whether the payment was made to a "related person." Post-TCJA, I.R.C. § 163(j) no longer contains this concept.

5. I.R.C. § 163(j)(3) (2018).

6. *See generally* Michael Faulkender & Jason Smith, *Taxes and Leverage at Multinational Corporations*, 122 J. FIN. ECON. 1, 1 (2016) (noting the pervasiveness of higher leverage ratios in respect of multinational corporations in high-tax jurisdictions such as the United States).

7. Hybrid instruments are treated as debt under one jurisdiction's tax regime and as equity under another jurisdiction's tax regime.

8. I.R.C. § 245A (2018).

cused on the use of hybrid instruments,[9] may lead multinational corporations to favor equity over debt and hybrid instruments in multinational financing structures. Determining the extent of that potential favorability will require us to remodel existing financing structures, as well as to rethink traditional post-acquisition financing structures for cross-border M&A transactions going forward.

In Part I of this Essay we discuss pre- and post-TCJA § 163(j) and the significant differences between the two versions of the provision. In Part II, we delve into the possible unintended consequences of the revisions to § 163(j), and outline possible approaches that multinational companies may use to mitigate the impacts of the TCJA's changes to § 163(j). Part III discusses, in broad strokes, the "worldwide" system of taxation that predominated U.S. international taxation regimes before the passage of the TCJA, while Part IV explains what changed because of the TCJA and the partial shift towards a "territorial" system of taxation. Part V then evaluates the potential effect of that shift on typical cross-border financing and acquisition structures.

I. SECTION 163(J): DISCOURAGING DEBT THROUGH LIMITING INTEREST DEDUCTIBILITY

U.S. federal income tax law generally provides that interest paid or accrued by a business is deductible from the business's taxable income, subject to certain limitations on the amount and structure of the debt. One such limitation is provided in § 163(j), which imposes restrictions on the magnitude of the permitted interest deduction in certain cases.[10] Although the overarching function of § 163(j) is consistent under the pre- and post-TCJA Code, the scope and operation of the two sections are radically different. The TCJA shifted the focus of § 163(j) from addressing cases where value is stripped, tax free, from the U.S. tax system, to cases where the legislature believes too much debt is being utilized in a capital structure.[11] These differences will affect the desirability of using debt to finance acquisitions and, given the absence of a grandfathering rule in the post-TCJA § 163(j), existing corporate structures. Considering these fundamental changes, tax lawyers and financial advisors will need to reexamine the viability of structures previously considered tax efficient.

Pre-TCJA § 163(j) barred certain corporations from taking a deduction for "disqualified interest," and, in determining whether interest should be treated as "disqualified interest," primarily focused on transactions resulting in the tax-

9. *Id.* § 267A.

10. *Id.* § 163(j).

11. *See, e.g.*, H.R. REP. NO. 115-409, at 247 (2017).

free removal of value from the U.S. tax system. The Code section targeted transactions in which Congress believed debt was used to inappropriately shift money (and thereby avoid paying tax) through interest payments either made by a U.S. taxable person to a related person outside the U.S. tax net, such as a foreign or tax-exempt person or on debt guaranteed by such related parties.

In particular, the section applied to corporations that (1) had "excess interest expense"[12] and (2) had a ratio of debt to equity at the close of the taxable year in excess of 1.5 to 1.[13] "Excess interest expense" was defined as the excess, if any, of the corporation's net interest expense over the sum of (1) 50% of the adjusted taxable income of the corporation plus (2) any excess limitation carryforward.[14] Three types of interest payments were "disqualified interest." "Disqualified interest" was not fully deductible if the corporate obligor had excess interest expense and was not within the debt-to-equity ratio safe harbor. The first category of "disqualified interest" was interest paid or accrued by the taxpayer, directly or indirectly, to a related person if no tax was imposed by the Code with respect to such interest.[15] The second was interest paid or accrued by the obligor with respect to any indebtedness to a person who was not a related person if (1) there was a "disqualified guarantee" of such indebtedness and (2) no gross basis tax was imposed by the Code with respect to such interest.[16] The last category was interest paid or accrued, directly or indirectly, by a taxable Real Estate Investment Trust ("REIT") subsidiary to its parent REIT.[17]

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12. I.R.C. § 163(j)(2)(A)(i) (2012).

13. *Id.* § 163(j)(2)(A)(ii).

14. *Id.* § 163(j)(2)(B). Section 163(j)(2)(B)(ii) defined excess limitation carryforward as follows:

> If a corporation has an excess limitation for any taxable year, the amount of such excess limitation shall be an excess limitation carryforward to the 1st succeeding taxable year and to the 2nd and 3rd succeeding taxable years to the extent not previously taken into account under this clause. The amount of such a carryforward taken into account for any such succeeding taxable year shall not exceed the excess interest expense for such succeeding taxable year (determined without regard to the carryforward from the taxable year of such excess limitation)." Section 163(j)(2)(B)(iii) defined excess limitation as "the excess (if any) of—
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> (I) 50 percent of the adjusted taxable income of the corporation, over
> (II) the corporation's net interest expense.

15. *Id.* § 163(j)(3)(A).

16. *Id.* § 163(j)(3)(B). A "disqualified guarantee" is any guarantee made by a related person if such related person is an organization exempt from taxation under the Code or a foreign person. This is subject to certain exceptions, including if the obligor owns a controlling interest in the guarantor, in which case a debt may be guaranteed without such guarantee being a disqualified guarantee. I.R.C. § 163(j)(6)(D) (2012).

17. *Id.* § 163(j)(3)(C).

If a deduction were subject to the limitation and therefore could not be taken in a given year, the deduction could be carried forward indefinitely until used.[18]

The TCJA expanded the scope of § 163(j). Section 163(j) now applies to all entities with gross receipts greater than $25 million,[19] not just to corporations with a debt-to-equity ratio in excess of 1.5 to 1.[20] Further, for years beginning after December 31, 2021, the taxable income base from which the limitation is calculated will not add back the deductions taken for depreciation, amortization, and depletion, thereby reducing the base on which the limitation is calculated and increasing the likelihood that interest deductions will be subject to the limitation.[21] A real property trade or business[22] may elect out of these limitations in exchange for extending the cost recovery period for its real estate assets.[23]

Under post-TCJA § 163(j), the allowable deduction for business interest is capped at the sum of the business interest income of the taxpayer for the taxable year, plus 30% of the adjusted taxable income of the taxpayer for the taxable year, plus the floor-plan financing interest[24] of the taxpayer for the taxable year. This limit applies regardless of whether the interest is paid to a related or unrelated person, and regardless of whether the recipient is otherwise subject to

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18. *Id.* § 163(j)(2)(B)(ii).

19. I.R.C. § 163(j)(3) (2018). Gross receipts are determined in accordance with the methodology set forth in I.R.C. § 448(c) (2018).

20. Pre-TCJA, I.R.C. § 163(j)(2)(A)(ii) looked at whether the payor had a debt-to-equity ratio in excess of 1.5 to 1. Post-TCJA, I.R.C. § 163(j) no longer contains this concept.

> In addition to corporations, I.R.C. § 163(j) (2018) also applies to partnerships. The application of these new rules to partnerships is complex, and is beyond the focus of this Essay. Further the erasure of the 1.5:1 debt-to-equity ratio means that post-TCJA I.R.C. § 163(j) (2018) applies to all entities, not just those that are highly levered. Because the new rules look at interest expense compared to adjusted taxable income, this change may present issues in the context of distressed entities which, even if not highly leveraged, may have low adjusted taxable income and thus be subject to the interest deduction limitation at a time when they most need relief from their tax burden.

21. I.R.C. § 163 (j)(8)(A)(v) (2018).

22. "Real property trade or business" is defined in I.R.C. § 469(c)(7)(C) (2018) as "any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business."

23. I.R.C. § 163 (j)(7)(A)(ii) (2018).

24. Floor plan financing interest is indebtedness relating to the acquisition of motor vehicles held for sale or lease and secured by such vehicles. I.R.C. § 163 (j)(9)(A) (2018). It thus is not relevant to the majority of the majority of multinationals evaluating these new rules.

U.S. federal income tax.[25] Similar to pre-TCJA § 163(j), disallowed interest deductions can be carried forward indefinitely.[26] Given that the limitation on interest deduction applies more broadly, § 163(j) may now significantly reduce incentives to use debt. Historically, U.S. commercial third-party debt not subject to a disqualified guarantee was not subject to the § 163(j) limitations on deductibility of interest. That is no longer the case. This change may encourage the use of non-U.S. debt or instruments that mimic debt but that are not subject to these limitations.[27]

A simple example can be used to highlight some of the differences between pre- and post-TCJA § 163(j). Consider the following example:

> Taxpayer A, a non-REIT corporation, is the debtor on a $100 loan from an unrelated lender. Interest accrues on the debt at 15% per annum. The debt is not guaranteed.
>
> A has an adjusted taxable income for the year of $30. A has no business interest income, no floor plan financing interest, and is not eligible to elect out of the post-TCJA § 163(j) regime.
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> A's equity, in the aggregate, is worth $100.

Under pre-TCJA § 163(j), Taxpayer A could deduct the full $15 of interest paid annually because A fell into the debt-to-equity ratio safe harbor and thus was not subject to the pre-TCJA § 163(j) limitation. Even if Taxpayer A's equity was much less valuable and A therefore did not fall into this safe harbor, A would not be subject to the limitation because the interest is not "disqualified interest." Under post-TCJA § 163(j), by contrast, Taxpayer A must calculate the applicable limitation, which here is equal to $9.[28] Taxpayer A can thus deduct only $9 of interest expense, and can indefinitely carryforward the remaining $6. As this example shows, the pre- and post-TCJA regimes produce different results for corporate obligors subject to U.S. federal income tax. Modeling will be necessary to determine the impact on real-world cases.

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25. Pre-TCJA, I.R.C. § 163(j)(3)(A) looked at whether the payment was made to a "related person" and whether such person was subject to U.S. federal income tax. Post-TCJA, I.R.C. § 163(j) no longer contains these concepts.

26. I.R.C. § 163 (j)(2) (2018).

27. Part II of this Essay discusses in greater depth possible tax planning opportunities arising from—and necessitated by—post-TCJA § 163(j).

28. Thirty percent of adjusted taxable income ($9), plus no business interest income ($0), plus no floor plan financing interest ($0).

One notable absence from the post-TCJA § 163(j) legislative history is a grant of authority for the Internal Revenue Service ("IRS") to promulgate regulations treating interest equivalents as interest for purposes of the § 163(j) limitations. The legislative history under pre-TCJA § 163(j) suggested that the IRS had discretion to increase net income expense for purposes of § 163(j)) to account for "expense items not denominated [as] interest but appropriately characterized as equivalent to interest expense."[29] The legislative history for post-TCJA § 163(j) provides no such guidance, leading to questions about whether the IRS can and will issue guidance on this point. The TCJA Conference Report states that "[a]ny amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the provision [§ 163(j)],"[30] and commentators have noted that this suggests congressional intent to apply post-TCJA § 163(j) more narrowly than pre-TCJA § 163(j) in the context of interest-like items.[31] Until regulations explicitly address the application of this limitation in the context of interest-like items, practitioners will continue to consider the viability of using synthetic instruments mimicking debt to avoid the interest deduction limitation.

II. A SET OF UNINTENDED CONSEQUENCES

Although Congress's aim may have been to reduce incentives for using significant debt in acquisition and capital structures, post-TCJA § 163(j) may instead incentivize large multinational corporations to seek out modified capital structures that are not subject to § 163(j), such as offshore debt or debt-like instruments. Debt and debt-like instruments continue to be a tax-favored form of financing in many non-U.S. jurisdictions, so multinational corporations may want to retain significant debt in their structures despite changes to the U.S. deduction rules.

One context in which planning opportunities will arise is in the financing of foreign acquisitions, as acquisitions typically have heavy capital requirements and the cross-border nature of these transactions may offer opportunities unavailable to purely domestic companies. In the following paragraphs we discuss some of the planning opportunities available to companies contemplating a cross-border acquisition.

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29. H.R. REP. NO. 101-386, at 567 (1989) (Conf. Rep.).

30. H.R. REP. NO. 115-466, at 386 (2017) (Conf. Rep.).

31. *See, e.g.*, *Report on Section 163(j)*, N.Y. ST. BAR ASS'N 11 (2018), https://www.nysba.org/Sections/Tax/Tax_Section_Reports/Tax_Section_Reports_2018/1393_Report.html [https://perma.cc/H3YX-YR53].

One such approach is to move borrowing offshore such that interest deductions are available in a non-U.S. jurisdiction. Another is to use instruments not subject to post-TCJA § 163(j) to avoid the limitations imposed by the section. We will discuss both of these approaches in greater detail in the following paragraphs.

Tax systems in many foreign jurisdictions also provide deductions for interest expense.[32] Multinational companies may either be able to borrow in non-U.S. jurisdictions or borrow in the United States and lend the proceeds to another member of their corporate group outside the United States in a process called "onlending." In either case, companies may be able to take an interest expense deduction in the foreign jurisdiction that could not be taken in the United States (due to the interest deduction limitation). In the context of onlending, the U.S. party will have sufficient interest income (from payments made to it by the non-U.S. borrower) to take a full interest deduction for interest paid on the original instrument, regardless of adjusted taxable income. Other aspects of the TCJA are also relevant to this approach. For example, the reduced U.S. corporate tax rate and new limitations on foreign tax credits may make it attractive to shift interest deductions offshore, where they may offset tax at a higher rate or reduce tax paid offshore that may not be eligible for a full foreign tax credit.

In addition to shifting deductions for interest expense offshore, a second approach for reducing tax burden is to use alternative financing structures. These structures could include issuing preferred stock or putting in place a securities loan under § 1058 of the Code.[33] In the latter case, a taxpayer would borrow low-volatility securities under a § 1058 securities loan, sell the securities and use the cash proceeds to finance the acquisition or ongoing corporate activities. The taxpayer would be obligated to make substitute payments equal to the interest on the securities. These payments are deductible but are not treated as "interest" under the Code and thus would not be subject to the post-TCJA § 163(j) limitation.[34] At the end of the loan period, the taxpayer would repurchase the securities on the open market and return them to the original owner.

The interest limitations introduced by post-TCJA § 163(j) will influence the extent to which debt is used in capital structures and, as discussed above, may provide an incentive to use alternative jurisdictions or approaches to fi-

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32. *See, e.g.*, Ruud A. de Mooij, *Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions*, INT'L MONETARY FUND (2011), https://www.imf.org/external/pubs/ft/sdn/2011/sdn1111.pdf [https://perma.cc/99KV-27E6] ("Tax systems typically favor corporate debt over equity, especially because interest payments are deductible for corporate income tax purposes while equity returns are not.").

33. I.R.C. § 1058 (2018).

34. *See id*.

nancing to avoid the limitation. However, in some cases, carrying excess debt may be appropriate from a business perspective, even if the interest deduction limitation kicks in. Consistent with pre-TCJA § 163(j), under post-TCJA § 163(j), disallowed interest deductions can be carried forward indefinitely. This means that a company anticipating strong growth in adjusted taxable income or a future reduction in interest expense may be comfortable incurring excess debt today on the basis that deductions carried forward will eventually be utilized. Further, in the context of certain foreign jurisdictions, repatriation of funds through interest payments may be preferred to dividend distributions if interest payments are treated more favorably than dividends under the relevant treaty.

As is true of many TCJA revisions, questions about the application of the revised § 163(j) remain unanswered. The IRS has already begun issuing guidance on many of the open issues that have arisen as companies and practitioners begin operating under the new rules.[35] Practitioners and industry groups have submitted extensive lists of items which they believe merit priority IRS action.[36] Comments made by IRS employees suggest that additional proposed rulemaking in this area will occur soon.[37]

In addition to IRS guidance, which will require ongoing revisions and review of structures, the post-TCJA § 163(j) builds in a change over time. For taxable years beginning before January 1, 2022, adjusted taxable income is computed without regard to deductions allowable for depreciation, amortization, or depletion.[38] For taxable years beginning after December 31, 2021, these items will be included in adjusted taxable income,[39] which will reduce the dollar value of the adjusted taxable income on which the 30% limit is calculated. In revising modeling and capital structures, multinational companies should account for this future change so that in addition to setting up a tax efficient

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35. Rev. Proc. 2018-18, 2018-16 I.R.B. 492.

36. For example, the American Bar Association Section of Taxation has flagged a number of items relating to the TCJA, including guidance on how a qualified taxpayer elects an exemption from § 163(j) and the impact of this election, guidance on how a taxpayer should apply interest expense limitations in the context of related and tiered parties, guidance on what qualifies as a "real property trade or business" for purposes of § 163(j), and guidance on how debt and interest should be allocated in contexts where there are both exempt and non-exempt businesses in the same corporate group. Section of Taxation, *Recommendations for 2018-2019 Priority Guidance Plan*, A.B.A. 3-5 (2018), https://www.americanbar.org/content/dam/aba/administrative/taxation/policy/052418recommendations.authcheckdam.pdf [https://perma.cc/2ZC8-RUBY].

37. Stephanie Cumings, *ABA Section of Taxation Meeting: Kautter Talks Timelines for TCJA Guidance Projects*, 159 TAX NOTES 1219 (2018).

38. I.R.C. § 163 (j)(8)(A)(v).

39. *Id.*

structure today, they can continue to utilize tax-efficient structuring in 2022 and beyond.

III. AMERICA THE OUTLIER – THE WORLDWIDE SYSTEM OF TAXATION

Before the enactment of the TCJA, U.S. persons, including domestic corporations, were generally taxable on their "worldwide income," regardless of such income's source.[40] Under the pre-TCJA regime, and subject to certain exceptions under applicable anti-deferral regimes,[41] the taxation of the earnings and profits (E&P) of a foreign corporate subsidiary in the hands of its domestic parent could generally be deferred until such earnings were actually distributed to the domestic parent. Thus, in many cases, U.S. taxpayers were able to benefit from keeping income trapped in offshore corporations to avoid current income inclusion. This was a particularly attractive proposition for domestic corporations with a multinational business, as income earned by a domestic corporation would have generally been subject to U.S. federal corporation taxation at a pre-TJCA rate of 35%. To the extent that effective deferral could be achieved, "stashing cash"[42] offshore was an attractive proposition for such domestic corporations.

As noted above, the ability to achieve deferral depended on a taxpayer's ability to navigate several complicated anti-deferral and anti-abuse regimes – most notably, the "subpart F" rules and the "passive foreign investment company" (PFIC) rules – which were enacted in the hopes of redirecting these stashed earnings back onshore. Generally speaking, U.S. shareholders[43] of certain "controlled foreign corporations" (CFCs) are required to pay current tax on their share of a CFC's subpart F income.[44] In addition, U.S. persons who

40. *Id.* § 61(a). The risk of double taxation under such a regime has gradually been reduced with the expansion of double-taxation treaties between sovereigns and the implementation and expansion of the complex foreign tax credit system under U.S. federal income tax law.

41. *See infra* Part IV.

42. Pre-TCJA, the top ten largest U.S. companies in the S&P 500 held an estimated combined total of $606.5 billion offshore, with Apple leading the way at $216 billion. *See* Robin Wigglesworth, *Where Will Corporate America's Overseas Cash Pile Go?*, FIN. TIMES (Dec. 5, 2016), https://www.ft.com/content/ee554c60-b6ed-11e6-961e-a1acd97f622d [https://perma.cc/Q85Y-HFFU].

43. A U.S. shareholder of a CFC is defined under pre-TCJA § 951(b) of the Code as "a United States person" who "owns directly or indirectly" or is considered to own "10 percent or more of the total combined voting power of all classes of stock entitled to vote of a foreign corporation." I.R.C. § 951(b) (2012).

44. Subpart F income generally includes dividends, interests, certain rents, and certain streams of income from related party transactions, as well as certain investments in U.S. property own shares of a PFIC—generally, a foreign corporation which (i) produces income 75% of which is considered "passive" income, and (ii) holds assets at least 50% of which are used in the production of passive income[45]—would be subject to a deemed tax and interest accrual regime.[46] In structuring cross-border transactions, practitioners have historically kept a close eye on these and other similar rules to ensure that a particular multinational structure would actually be able to deliver the desired level of deferral for relevant U.S. taxpayers.

IV. ENTER: THE QUASI-TERRITORIAL REGIME

The TCJA represents a dramatic shift from the worldwide system of taxation described above. As a replacement, the TCJA offers what is best described as a "quasi-territorial" regime, in which foreign earnings are taxed only in the foreign jurisdiction in which they are earned, subject to several exceptions. One such exception is the retention, and at times expansion, of the subpart F and PFIC regimes. Further, the TCJA has added a few extra arrows in the IRS's metaphorical anti-deferral quiver, including the Base Erosion Anti-Abuse Tax ("BEAT") and a tax on global intangible low-taxed income ("GILTI").[47]

A. Subpart F: The (Quasi-) Status Quo and an Aside on § 956

The post-TCJA subpart F regime leaves much of the pre-TCJA subpart F regime intact, save for two changes which operate to expand the universe of foreign corporations that qualify as CFCs. The first relates to one of the ownership thresholds under the CFC rules. Pre-TCJA, § 957 of the Code defined a CFC as a foreign corporation that was more than 50% owned (directly, indirectly, or constructively as determined under the CFC rules), by vote or by value, by "U.S. shareholders."[48] The post-TCJA language in § 957 is no different; however, the definition of "U.S. shareholder" under § 951(b) was amended by the TCJA in an important way. Post-TCJA, § 951(b) of the Code defines a U.S.

(including guarantees of certain credit obligations). I.R.C. § 952(a) (2018); *id.* § 954; *id.* §§ 956(a), 956(d).

45. *Id.* § 1297(a).

46. *See generally id.* § 1291. Certain elections are available that would instead require an owner of a PFIC to recognize income on a current basis. *See generally id.* §§ 1294, 1295.

47. The BEAT and GILTI regimes are complicated in their own right and are beyond the scope of this Essay. Both regimes were enacted to ensure that the offshore earnings of U.S. corporations and multinationals would be subject to at least a minimum level of tax on a worldwide basis. *See* Rebecca M. Kysar, *Critiquing (and Repairing) the New International Tax Regime*, 128 YALE L.J.F. 339 (2018). *See also* I.R.C §§ 59A (BEAT), 951A (GILTI).

48. I.R.C. § 957 (2012).

shareholder as, with respect to any foreign corporation, a United States person who owns, directly, indirectly, or constructively, 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, "or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation."[49] While this revision was likely intended to broaden the universe of corporations eligible for the participation exemption discussed further below, it represents a radical shift from the "vote only" CFC ownership rules that had prevailed for the last fifty years, creating more "U.S. shareholders" in the post-TCJA world.[50]

The second important change was a revision to the attribution rules under § 958(b) of the Code. Pre-TCJA § 958(b) included a restriction that prevented stock in a foreign corporation that was owned by a foreign person from being treated as constructively owned by a U.S. person.[51] This limited the scope of the so-called "downward attribution rules" under § 318 of the Code, from which the § 958(b) attribution rules take their cue.[52] As an example, assume a foreign parent corporation (FP), owned entirely by non-U.S. persons, owns 100% of the stock of two subsidiary corporations—one domestic subsidiary (DS) and one foreign subsidiary (FS). As a general matter, under § 318(a)(3)(C) of the Code (as modified by § 958(b)), "[i]f 50 percent or more of the value of the stock of a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by such person."[53] Applying the above rules to our hypothetical, given that the FP owns more than 50% of the DS, the DS would be treated as constructively owning the stock owned by the FP. This would mean that the DS constructively owns all the stock of the FS, which (absent any other nuances to the rules) would mean that the FS is a CFC under § 957 of the Code (even though it is not directly or indirectly owned by a U.S. shareholder). Pre-TCJA § 958(b)(4) prevented this result, as it would shut off the application of § 318(a)(3)(C) in this context.

However, the TCJA repealed § 958(b)(4) of the Code,[54] with the following implications in an expanded version of our hypothetical. Suppose our FP owns

49. *See* I.R.C. § 951(b) (2018) (emphasis added).

50. Pre-TCJA, it was possible to allocate voting rights among shareholders of certain entities to prevent certain 10%-value shareholders from inadvertently becoming U.S. shareholders for purposes of the CFC regime, as vote-only attribution under § 958(a) was determined "on the basis of all the facts and circumstances in each case." *See* Treas. Reg. § 1.958-1(c)(2) (2002).

51. I.R.C. § 958(b)(40) (2012).

52. I.R.C. § 318 (2018); I.R.C. § 958(b) (2012).

53. I.R.C. 318(a)(3(C) (2018).

54. *See* H.R.1, Pub. L. No. 115-97, § 14213, 131 Stat. 2054, 2217 (2017).

ten foreign corporate subsidiaries along with one domestic subsidiary. By the repeal of § 958(b)(4) and the operation of § 318(a)(3)(C)'s downward attribution rules (as modified by § 958(b)), each of the FP's foreign corporate subsidiaries would be treated as being 100% owned by the FP's one domestic subsidiary, thereby making each of them a CFC. Under our current hypothetical, this application of the attribution rules would generally not result in subpart F inclusions, because all of the FP's beneficial owners are non-U.S. persons. However, assume instead that one of the FP's beneficial owners is a U.S. person for U.S. federal income tax purposes, and that such person owns 12% of the vote and value of the FP. Under the pre-TJCA CFC regime, neither the FP nor its foreign subsidiaries were CFCs, so this U.S. beneficial owner did not have any subpart F income tax pickups. However, simply because of the repeal of § 958(b)(4), our U.S. beneficial owner becomes a U.S. shareholder of ten CFCs, which could create a host of new phantom income pickups for our U.S. beneficial owner.

Different versions of the above hypothetical have become live issues in the context of cross-border financings that were negotiated contemporaneously with the TCJA. Pre-TCJA, it was typical for security packages[55] that were agreed in connection with a cross-border financing to explicitly prohibit guarantees by CFCs of a U.S. borrower, as well as to limit the ability (and the obligation) of a U.S. borrower to pledge the stock of CFCs as collateral in order to prevent a U.S. borrower or certain of its U.S. subsidiaries from accumulating subpart F inclusions by way of the operation of § 956.[56] As a practical matter, based on the operation of the pre-TCJA rules (including, crucially, the absence of downward attribution pursuant to pre-TCJA § 958(b)(4)), "CFCs" were generally limited to foreign subsidiaries of either a U.S. borrower or of a borrower's U.S. subsidiaries. Lenders were thus generally comfortable specifically identifying certain subsidiaries that simply would not be part of the security package, assuming that the other subsidiaries represented sufficient value for purposes of the security package. Post-TCJA, however, the repeal of the downward attribution rules could cause every foreign subsidiary in a foreign-parented multinational group to be treated as a CFC. Lenders generally had not negotiated facilities for U.S. borrowers based on an assumption that they

55. Security packages are the set of contracts which described the collateral and guarantees to be provided by a borrower in respect of its debt obligations.

56. For the seminal treatment on this subject, see GARY FRIEDMAN, PLEDGES AND GUARANTEES IN LOAN AGREEMENTS (2017). Generally, § 956 of the Code provides that U.S. shareholders of CFCs are required to be taxed in respect of the earnings of a CFC to the extent those earnings are invested in U.S. property. Section 956(d) of the Code provides that a guarantee of a U.S. borrower's obligations by a CFC constitutes an investment in U.S. property for purposes of § 956 of the Code. Accordingly, security packages were historically limited in the ways described above.

would not get *any* credit support from the non-U.S. subsidiaries in the group. Accordingly, practitioners have sought to compromise by focusing on CFCs that have an identifiable U.S. shareholder that would actually have an income inclusion under § 956 if the typical restrictions were not applied. Such compromise therefore exposes any future U.S. shareholders of the foreign parent of these groups (for example, a U.S. corporation that purchases a significant amount of stock of our hypothetical foreign parent) to potential § 956 inclusions if this credit package remains in place. This can create problems for current owners of a foreign parent attempting to sell a portion of the parent to U.S. persons for U.S. federal income tax purposes.[57]

Going forward, the continued relevance of § 956 combined with the repeal of § 958(b)(4) may influence the decision of where a multinational structure's debt should be issued. Pre-TCJA, borrowing in the United States was more manageable from a § 956 perspective, and was often independently attractive in financing transactions from a withholding tax perspective.[58] Post-TCJA, borrowers and lenders alike may find the world to be much simpler if they agree to cause a non-U.S. corporation to issue the desired debt, despite the potential other benefits that a U.S. financing may provide.[59]

B. *Arriving at the Point: The § 245A Participation Exemption*

We can now discuss the counterweight to and, in some circumstances, the inspiration for the subpart F-related rule changes discussed above: the new "participation exemption"[60] under § 245A of the Code. Specifically, the exemption applies to the foreign-source dividend income of domestic corporations, and provides for a 100% deduction for the foreign-source portion of any divi-

57. Given that U.S. shareholders of the foreign parent may also be subject to GILTI, BEAT and/or non- § 956 subpart F inclusions, the analysis will often be more complicated than simply evaluating the foreign parent's § 956 exposure as exposure to GILTI or BEAT will cause a build-up of previously taxed income that could be used to offset any § 956 inclusions.

58. As a general matter, credit facilities that are syndicated to a wide group of lenders create a situation in which each lender can qualify for an exemption from U.S. withholding taxes on interest payments by virtue of the portfolio interest rules.

59. Section 956 of the Code may be less relevant going forward than we think given the fact that groups that are impacted by § 956 are likely to already have significant "previously taxed income" as a result of GILTI inclusions, which would reduce the amount actually subject to taxation under the § 956 regime.

60. Several European jurisdictions (for example, Luxembourg and Spain), which have historically applied a territorial tax regime, include similar exemptions under their own tax laws (see, for example, the Luxembourg participation exemption and the Spain participation exemption, as codified under Luxembourg and Spanish tax law, respectively).

dend paid by a "specified ten-percent owned foreign corporation" to a U.S. corporation which is a U.S. shareholder with respect to that foreign corporation.

To break that down a bit further, a "specified 10-percent owned foreign corporation" means any foreign corporation[61] that has any domestic corporation as a U.S. shareholder.§ [62] Thus, § 245A will apply to the foreign-source portion of any dividends paid to that domestic corporation or any other domestic corporations that are 10% shareholders of such foreign corporation.[63]

Determining the foreign-source portion of a dividend is decidedly more challenging. This portion is derived by multiplying the amount of the dividend in question by a fraction, the numerator of which is the "undistributed foreign earnings" of the specified 10%-owned foreign corporation and the denominator of which is the "total undistributed earnings" of such corporation.[64] "Undistributed earnings" is defined under § 245A(c)(2) as the amount of E&P of the specified 10%-owned foreign corporation at the close of the taxable year in which the dividend is distributed.[65] For these purposes, the E&P as of the close of the taxable year is *not* reduced by the amount of any dividends distributed during such taxable year.[66] Finally, "undistributed foreign earnings" is defined as the portion of undistributed earnings that is not attributable to either (i) income that is effectively connected with a trade or business within the United States or (ii) income derived from dividends received from certain domestic corporations.[67]

Clearly, this is a taxpayer-favorable development under the TCJA; however, the IRS does not let the taxpayer get off scot-free. Enter the § 965 transition tax, which imposes a one-time tax on a U.S. shareholder's pro-rata share of accumulated post-1986 E&P of a "deferred foreign income corporation" for taxable years beginning before January 1, 2018. A deferred foreign income corporation is any "specified foreign corporation" of a U.S. shareholder which has

61. Section 245A(b)(2) makes clear that a PFIC that is not a CFC cannot qualify as a specified 10%-owned corporation. I.R.C. § 245(b)(2) (2018). However, the repeal of § 958(b)(4) may limit the impact of this restriction, given that the expected result will be an increase in CFCs (which may swallow the exception under § 245(b)(2) of the Code).

62. "U.S. shareholder" is defined in § 951(b).

63. The "vote or value" revisions made to § 951(b) of the Code expand the potential universe of recipient domestic corporations and distributing foreign corporations to which § 245A applies.

64. I.R.C. § 245A(c)(1) (2018).

65. *Id.* § 245A(c)(2).

66. *Id.* § 245A(c)(2)(B).

67. *Id.* § 245A(c)(3).

accumulated post-1986 deferred foreign income greater than zero.[68] The rules are intended to subject U.S. shareholders to this transition tax at a rate of 15.5% on their share of cash and liquid assets of the deferred foreign income corporation, and 8% of all other earnings.[69] Accordingly, determining whether a corporation is a specified foreign corporation is crucial to properly complying with these rules. Given the repeal of § 958(b)(4), we live in a world where nearly everything is a CFC. The IRS has recently acknowledged that dilemma, and accordingly released Notice 2018-26, which addresses the difficulty in determining whether a foreign corporation is a specified foreign corporation under certain circumstances because of the complex attribution rules under § 958 of the Code, specifically focusing on the potentially absurd complexity introduced by partner-to-partnership downward attribution under § 318(a)(3)(A).[70]

V. THE IMPACT OF § 245A ON EXISTING AND FUTURE ACQUISITION STRUCTURES

Section 245A of the Code will become immediately relevant to the domestic corporate acquirer—both in terms of evaluating a target's existing intercompany repatriation arrangements and in structuring post-acquisition repatriation mechanics. Acquirers will need to evaluate newly-legislated U.S. and non-U.S. tradeoffs between the use of debt and equity instruments in multinational financing structures. Accordingly, we discuss U.S. considerations in isolation,

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68. A "specified foreign corporation" is any CFC or any foreign corporation that has one or more domestic corporations as a United States shareholder. *Id.* § 965(e)(1). PFICs that are not CFCs are excluded from the definition of specified foreign corporation; again, however, with the repeal of § 958(b)(4) of the Code, the reach of this limitation may be vastly diminished.

69. *See* H.R. REP. NO. 115-466, at 491 (2017). As a technical matter, the rules operate to provide for a deduction equal to the sum of (i) the "15.5 percent rate equivalent percentage" of the § 965 inclusion amount that is attributable to the aggregate foreign cash position, plus the "8 percent equivalent percentage" of the portion of the inclusion amount (if any) that exceeds the aggregate foreign cash position. I.R.C. § 965(c) (2018).

70. INTERNAL REVENUE SERV., NOTICE 2018-26, ADDITIONAL GUIDANCE UNDER SECTION 965; GUIDANCE UNDER SECTIONS 62, 962, AND 6081 IN CONNECTION WITH SECTION 965; AND PENALTY RELIEF UNDER SECTIONS 6654 AND 6655 IN CONNECTION WITH SECTION 965 AND REPEAL OF SECTION 958(B)(4) (2018), https://www.irs.gov/pub/irs-drop/n-18-26.pdf [https://perma.cc/Q498-QBEX]. Section 3.01 of the Notice provides that Treasury and the IRS "intend to issue regulations, pursuant to the grant of authority under section 965(o) [of the Code], providing that, *solely for purposes* of determining whether a foreign corporation is a specified foreign corporation within the meaning of section 965(e)(1)(B), stock owned, directly or indirectly, by or for a partner . . . will not be considered as being owned by a partnership under [the downward attribution rules] if such partner owns less than five percent of the interests in the partnership's capital and profits." *Id.* at 16-17 (emphasis added).

followed by non-U.S. considerations. We then reconcile the two for purposes of recommending inputs for modeling tax-efficient structures for domestic corporate acquirers.

A. U.S. Tax-Driven Strategies—Before and After § 245A

Before the TCJA, repatriating funds back to the United States, without incurring taxation, often involved substantial planning—especially in the context of acquisition structuring by corporate buyers. If a buyer could reasonably determine that it intended to take cash out of a multinational system as part its investment strategy, several strategies could be used to achieve that goal efficiently. One method was to push acquisition funding from the United States to non-U.S. jurisdictions in the form of downward intercompany lending—in other words, acquisition funding would be lent from a U.S. corporate acquiring entity (commonly referred to as a "bidco") to a non-U.S. subsidiary. This would allow cash to be repatriated in the form of interest payments from outside of the United States to the domestic corporate bidco. This strategy often relied on third-party borrowing occurring at the level of the domestic corporation, because this would allow interest income from the repatriation (which would otherwise be subject to a high rate of corporate taxation at the level of the domestic parent) to be offset by deductions in respect of payments of interest on the third-party borrowing. Larger distributions could be paid back to the United States as repayment of principal, sometimes in conjunction with the use of "leveraged recapitalizations" or other similar equity-release transactions, which would allow for a tax-free repatriation of those earnings.[71]

Because of § 245A, and the TCJA more generally, the modeling for such a strategy should be reevaluated. As an initial matter, it should be noted again that the corporate tax rate in the United States has been reduced to 21% of a domestic corporation's income. As a result, borrowing in the United States for purposes of creating a tax-shield may be less attractive relative to other high-income jurisdictions—which, accordingly, may limit the attractiveness of lending funds from a domestic corporate parent to a non-U.S. corporate subsidiary. In addition, dividends that qualify for the 100% exemption would allow a non-U.S. corporation to move foreign-source undistributed earnings into the United States without incurring any tax at all. Modeling will need to be done to determine, among other things, the impact of borrowing at the level of a U.S.

71. Planning for such transactions often involved acquisitions structures which would trap E&P below a certain level, so that leveraged recapitalizations could be accomplished at the level of an entity that was free of E&P. Such structuring would allow any equity distributions resulting from that transaction to be treated as a tax-free "return of capital" distribution, as opposed to a taxable dividend.

corporate parent, including expected deductibility of interest expenses,[72] and the portion of a foreign subsidiary's income that will constitute foreign-source undistributed earnings.[73]

B. Non-U.S. Tax-driven Strategies: Before and After § 245A

The choice between debt and equity in intercompany arrangements becomes significantly more complicated once typical non-U.S. tax concerns are layered on top of any U.S.-driven analysis. Either choice requires an analysis of any applicable withholding taxes that may apply at the local country level,[74] and the applicability of any treaty arrangements or other applicable exemptions to such withholding taxes. In addition, potential goals at the level of the non-U.S. subsidiary should be considered. These considerations include determining if there is potential income tax at the level of the non-U.S. subsidiary, and if there are ways for that tax to be eliminated by a chosen cash repatriation mechanism.

In typical acquisition structures of foreign targets, these goals often conflict with those of the U.S. tax practitioner. For example, consider the following pre-TCJA structure. A U.S. corporate parent desires to acquire a European Union target. Because of favorable E.U. treaty arrangements, the U.S. corporate parent's non-U.S. tax advisors suggest, as is typical, a Luxembourg corporate holding structure underneath the U.S. parent. The acquirer intends to repatriate cash. Cash repatriated to the level of Luxembourg may be subject to Luxembourg corporate taxation; as a result, the non-U.S. tax advisors wish to use an instrument that can generate deductible interest payments in Luxembourg, so they suggest a debt instrument. You, as the U.S. tax advisor, note that that there is no third-party debt at the level of your U.S. corporate parent, and are concerned about the potential drag of a 35% U.S. corporate income tax on any

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72. As discussed earlier in this Essay, post-TCJA § 163(j) of the Code may also make U.S. corporate borrowing significantly less attractive.

73. Some more straightforward examples exist. Another common mechanism was an upstream loan from a non-U.S. subsidiary to a U.S. corporate parent (a so-called "956 loan"). Under established regulatory guidance, such a loan would be treated as a deemed dividend under § 956 of the Code, resulting in an increase to a corporate parent's taxable subpart F inclusions. Given that actual dividends from a CFC are not taxable under § 245A, the switch from a debt arrangement to an equity arrangement is quite attractive post-TCJA.

74. This can be particularly problematic if, for example, the documentation underlying an intercompany loan were to include a "gross-up" provision requiring any payments to be increased such that the economic burden of withholding taxes is not actually borne by the recipient. Such provisions may be included to strengthen the argument that an arrangement should be respected as a loan for U.S. and/or non-U.S. purposes.

interest income received or deemed to be received from Luxembourg. As a result, you need an equity instrument.

Cross-border tax practitioners have historically offered an answer to this dilemma: the "preferred equity certificate" (PEC). These instruments, which in our hypothetical would be issued by our Luxembourg holding company to the domestic corporate parent, can achieve the dual-goal of debt treatment for Luxembourg tax purposes and equity treatment for U.S. tax purposes. The Luxembourg holding company would be entitled to its interest deduction, ideally on accrued yield on the PEC rather than an actual payment. The domestic corporate parent would not be currently taxable in the United States on any yield accruals, so it would generally[75] not recognize taxation until a dividend is actually paid on the PECs. Cash could be repatriated at exit by causing the issuer of the PECs to repay the PECs in connection with other corporate steps that could ultimately achieve a tax-free or tax-reduced repatriation of exit proceeds. This use of "hybrid instruments" has become commonplace in many foreign acquisition structures, and has been the target of scrutiny under the Organisation of Economic Co-operation and Development's "Base Erosion and Profit Shifting" initiatives.

This structure would initially seem to get a boost under the TCJA, as § 245A would provide an exemption to taxation on any dividends the corporate parent's CFCs (which would include our Luxembourg holding company), such that more complicated exit structures would not need to be used to achieve a tax-free repatriation. However, § 245A provides for a special exclusion from this general rule, which applies to "hybrid dividends." These are defined as amounts received from a CFC that would otherwise be allowed under § 245A and for which the CFC in question received a deduction or other tax benefit with respect to any income taxes (and certain other taxes) imposed by any foreign country.[76] Accordingly, any dividends ultimately paid on our hypothetical PEC would *not* be eligible for the § 245A exemption. As is the case with many issues we have discussed herein, the result is that in the post-TCJA world, the decision to use PECs or other hybrid structures will be a modeling exercise—trading off the value of accrued PEC yield in Luxembourg and the ability to make a deductible payment out of Luxembourg against the potential U.S. taxation of such payments and potential Luxembourg withholding taxes that may apply to a non-deductible (i.e., dividend) payment out of Luxembourg.

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75. There may be a concern that §§ 305-306 of the Code could operate to create a phantom income inclusion in respect of certain payments on these instruments, although there are currently no final regulations governing that issue.

76. I.R.C. § 245A(e)(1), (4) (2018).

CONCLUSION

The TCJA introduced some of the most fundamental changes to the U.S. taxation system since the reforms passed in 1986. Changes to § 163(j) of the Code—a set of rules and regulations that were originally designed to curb what legislators and the IRS viewed as potentially abusive use of debt in the context of related party transactions—now reflect what could fairly be described as a telegraphed preference on the part of legislators and the IRS for equity over debt in a business's capital structure. Indeed, the expanded scope of § 163(j) under the TCJA may significantly decrease the corporate appetite for relying on debt to finance future acquisition structures, including, notably, structures that did not raise any § 163(j) issues pre-TCJA. In addition, the TCJA moves the United States away from its historical worldwide system of taxation, in favor of what we have labeled a "quasi-territorial system" of taxation. The mechanisms by which the TCJA implements that shift likewise may cause a shift away from a preference for debt in multinational acquisition structures and repatriation systems.

It remains difficult to normatively evaluate the new post-TCJA world from a policy perspective. In other words, is it a good idea to dampen the worldwide preference for debt in capital structures? Is there a problematic preference for debt that needs fixing in the first place? It is likely too early to make that call given the potential number of unintended consequences that my result under the new law. However, in thinking normatively about these changes, we believe it is important to remember that the prior rules likely contributed significantly to any existing, pre-TCJA preferences for debt over equity. At the end of the day, then, the choice between debt and equity, leaving aside any corporate governance or other explicitly non-tax considerations, has often been the output of a series of modeling exercises, with the inputs including the potential tax benefits of equity versus debt in a business's capital structure. By changing the rules of the game, the IRS has effectively changed the inputs to that modeling exercise. It remains a complicated question whether, holistically, business entities carry excess debt relative to equity; but it is certainly the case that a new set of rules which, on their face, appear to favor equity over debt, may very well cause those modeling exercises to produce an output that suggests a shift in debt-equity preferences is in order. Time will tell exactly how large that shift will be.

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