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Tax Reform Proposals Would Have Significant Consequences for Foreign Multinationals Doing Business Through Affiliates in the United States

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Both the House and the Senate tax reform proposals were designed to move the United States toward a territorial tax regime and both proposals contain base erosion protections intended to prevent otherwise taxable income from escaping to other jurisdictions. The impact of these protections can, however, significantly impact foreign-based multinational enterprises conducting business operations in the United States through a US corporate affiliate, causing income of the foreign entity to become subject to US taxation.

The current US tax overhaul is both highly charged and rapidly evolving. This alert is intended to focus on the potential impact the dueling proposals might have on foreign multinationals doing business in the United States through affiliates. The discussion below is high-level and does not discuss certain details and exclusions. Additionally, there are a number of issues, including different provisions of the proposals and an analysis of how the proposals would impact, or be impacted by, the broad network of bilateral income tax treaties to which the United States is a party, which are beyond the scope of this alert.

The House Proposal Would Impose an Excise Tax on Payments Made by US Corporations to Their Foreign Affiliates

Section 4303 of H.R. 1, the Tax Cuts and Jobs Act, as amended on November 9, 2017, would impose a 20% excise tax on amounts paid or incurred by US corporations to their foreign affiliates. The tax would apply to amounts that are normally deductible or includible in the cost of goods sold, in inventory, or in the basis of a depreciable or amortizable asset. The tax would be imposed on certain US corporations where the annual amounts total at least $100 million.

The excise tax can be avoided if the foreign affiliate elects to treat the amount paid or incurred as “effectively connected with the conduct of a trade or business within the United States” and attributable to a permanent

establishment in the US. By making the election, the amount in issue would avoid the excise tax but would, instead, be subject to US income taxation.

Section 4303 would allow the foreign corporation to take as a deduction "deemed expenses," which would be computed to be commensurate with the level of expenses (as a percentage of income) incurred by the multinational enterprise on the relevant product line in issue. While the original version of H.R. 1 did not allow for foreign tax credits to be used against the tax imposed on the elected effectively connected income, the current revision would allow such a credit, but would limit it to 80% of the taxes paid or accrued.

The Senate Proposal Would Also Seek to Tax Payments Made by US Corporations to Their Foreign Affiliates

The full Senate bill has yet to be publicly introduced, but the Senate Finance Committee released a detailed description of the bill on November 9, 2017. The description includes a proposal for a "base erosion minimum tax." Under this proposal, the minimum tax would be 10% of the US affiliate's "modified taxable income" ("MTI"). MTI would be calculated by excluding deductions for amounts paid or accrued to a foreign affiliate (similar to the House proposal described above). The minimum tax would be due to the extent it exceeded the regular income tax imposed.

The Finance Committee's minimum tax would be imposed upon a US corporation with average annual gross receipts in excess of $500 million and a "base erosion percentage" higher than 4%. A corporation's base erosion percentage would generally be calculated as the deductions attributable to the base erosion payments to foreign affiliates divided by the aggregate amount of deductions allowable to the corporation.

While Still Mere Proposals, the Inclusion of Base Erosion Protections Is Significant

Section 4303 has already been revised twice by the House Ways and Means Committee, and will likely be revised further. The actual language of the Senate proposal has yet to be released, and the content of the relevant provision could certainly change between now and the introduction of a bill. Nevertheless, the proposals indicate some level of legislative willingness to tax the income of a foreign corporation not engaged in a US trade or business.

Furthermore, the proposals have raised concerns that they are a scaled-back version of the controversial "border adjustable tax" (BAT) that was included in the original House GOP Tax Reform "Blueprint." The BAT, which eliminated deductions for imported goods and services used in US production processes, was criticized for several reasons, including that it constituted a *de facto* discriminatory tax on certain imports in violation of US international trade obligations under Article II:2 (charges "equivalent to an internal tax") or Article III (National Treatment) of the General Agreement on Tariffs and Trade (GATT). For this and other reasons, sponsors abandoned the BAT earlier this year.

However, Section 4303 and the corresponding Senate proposal have revived concerns that, although clearly different from the BAT in several important respects (e.g., it would only apply to affiliated party transactions), they effectively place companies with an international supply chain at a commercial disadvantage in the United States as compared to similar companies with exclusively domestic operations. The proposals can therefore be expected to raise concerns among certain disadvantaged countries or multinational corporations that they restrict routine cross-border transactions and thereby violate US commitments under international trade or tax agreements. Seen in this light, the proposals merit serious consideration by taxpayers at this time.

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