OSLER

The slow burn of U.S. tax reform

DECEMBER 18, 2018 8 MIN READ

Related Expertise

- International Tax
- Tax

Authors: Patrick Marley, Jennifer Lee, Paul Seraganian

From the moment of its enactment on December 22, 2017, the U.S. tax reform legislation commonly referred to as the "*Tax Cuts and Jobs Act*" (the "TCJA") signalled a seismic shift in U.S. tax policy. The TCJA promises to transform tax norms in a way that will make the U.S. more competitive and reshape cross-border planning and transactions. To date, few countries outside the United States have felt the effects of this change more forcefully than Canada has. Yet, in many ways, the real details of these reforms are only now coming into focus and their true impact has only begun to be felt. This summary provides an overview of key things that Canadians should be on the lookout for as major guidance begins to flow from the U.S. Treasury Department.

Regulations and guidance have been slow to emerge

Taxpayers (including Canadians with US businesses and investments) and their advisors have spent the last year parsing and unpacking the TCJA in order to assess its effects. In many areas, the prevailing view is that the new statute is unclear, ambiguous or technically flawed. These infirmities have impaired and/or delayed the ability of taxpayers to take decisive action in response to the new rules and, in many respects, have blunted the impact that the TCJA has had on taxpayer behaviour and transactional flows. While it is not altogether surprising that a tax reform package as ambitious and wide-reaching as the TCJA would suffer from some legislative imperfections (particularly given the compressed timetable under which it was produced), the prevalence of legislative "gaps" in the TCJA is formidable (and, correspondingly, the need for regulatory "support" is unprecedented). As 2018 has rolled on, the calls by taxpayers and tax practitioners for further guidance have grown immensely.

The Treasury Department has, by all accounts, been hard at work in developing much needed regulations to scaffold the new statute but their task is uniquely demanding. Moreover, the process for releasing tax regulations has been reshaped by the Trump administration, which now requires that certain tax regulations be reviewed by the White House office of management and budget (the OMB). Unofficial reports suggest that this 2nd layer of administrative review of regulations has significantly slowed down the pace of regulatory releases.

Despite these headwinds, the Treasury Department has begun releasing proposed regulations addressing several key areas of the tax reform, in particular: (i) guidance on "base erosion anti-abuse tax" or "BEAT" rules (providing much needed clarification on the application of these rules, including treatment of NOLs, the services cost method exception, treatment of ECI payments and the calculation of various key concepts); (ii) guidance on Section 199A (the deduction for certain business income earned through pass-through entities); (iii) preliminary instalments of guidance on the "global intangible low-taxed income" or "GILTI" rules (including very important guidance regarding the manner in which the foreign tax credit rules interact with GILTI rules); (iv) new Section 163(j) interest deductibility

rules (which, at over 400 pages, represent a significant escalation of complexity in this vital area for Canadian businesses), (v) the diminished role of Section 956 (which frequently operates to limit the credit support that foreign subsidiaries can provide for related U.S. borrowers), and (vi) rules illuminating the so-called territorial system transition tax. In addition, the Treasury has issued notices on a wide range of matters with cross-border significance, including (i) guidance regarding the recognition of "effectively connected income" on the disposition of certain partnership interests, (ii) the "transitional" tax applicable to accumulated earnings of non-U.S. subsidiaries of U.S. corporate partners, (iii) guidance addressing the ordering of previously taxed income, and (iv) guidance regarding the application of new Section 83(i) on certain compensatory arrangements issued by private corporations.

While this body of work is considerable, it represents just a small first instalment on the administrative work that is needed to build out the international provisions of tax reform so that there are sturdy, fully functioning foundations on which to base taxpayer decisions. After months of labour, the Treasury Department is now poised to release guidance that will form that foundation.

Significant further guidance is imminent

By early 2019, the Treasury is expected to release a welter of proposed regulations on some of the most consequential international tax provisions enacted in a generation. These advancements will begin to reveal the true "teeth" of the new rules and, in turn, will allow Canadians to realistically assess their impact on cross-border matters and to respond accordingly.

The following is a list of key guidance that Canadians should expect and key details they should be on the lookout for:

- **Anti-Hybrid Financing Rules (Section 267A)** – Section 267A, which shares some conceptual foundation with the OECD's anti-hybrid mismatch report, is designed to disallow interest deductions generated in connection with certain hybrid entity or hybrid instrument arrangements. The provision features an extraordinarily broad grant of authority to the Treasury Department to issue further regulations to address this multi-faceted issue. In general, aside from REPOs (which are clearly within scope of the new rule), many Canadian taxpayers with cross-border financing structures have been uncertain about whether these new rules actually affect those structures. As a result, many non-U.S. taxpayers have opted for a "wait-and-see" approach before taking action in this area. That "wait-and-see" period may soon be over. Canadians will be looking at how far the IRS goes in exercising its authority to issues broad-based regulations. This is an area where the rules may be rolled out in instalments, in which case taxpayers will want to pay particular attention to the preamble to these regulations in order to anticipate the direction that future instalments may take.
- **The "BEAT" (Section 59A — Base Erosion Anti-Abuse Tax)** – A central "bargain" of U.S. tax reform was the reduction in corporate tax rates from 35% to 21% in exchange for a broader U.S. corporate base. In order to secure this trade-off, there is added pressure from a policy perspective to "protect" the U.S. tax basis. The BEAT is a paradigm-shifting regime that provides this protection by effectively imposing a hard limit on the proportion

of the corporate tax base that can be stripped out of the U.S. to foreign affiliates. One unwelcome "surprise" is that the BEAT threatens to capture a much wider population of Canadian corporations than many had anticipated. The proposed regulations issued on December 13, 2018 provide much needed guidance on the application of the BEAT, including (i) clarifying that the base erosion percentage of NOLs is determined based on the year in which the loss arose and (ii) providing that the services cost method exception applies to the extent of the total services cost even if a mark-up is charged. Canadians should monitor the responses and commentaries to the proposed regulations that will be flowing in over the next two months for indications of any possible changes to the approaches taken in the proposed regulations and the finalization of these regulations.

- **Global Intangible Low-Taxed Income (GILTI – Section 951A)** – the GILTI rules are some of the most ground-breaking and complex rules contained in the TCJA. The true impact that these rules will ultimately have on Canadian corporations will depend significantly on how the Treasury Department chooses to shape the GILTI regime through regulation. In general, the GILTI rules treat U.S. corporations very differently from U.S. individuals and they have the potential to exert strong pressure on U.S. individual investors (including U.S. individuals investing through venture capital, private equity and other pooled funds) to hold foreign portfolio corporations under U.S. parent corporations. If these pressures are not mitigated or otherwise softened through regulations, they could have deleterious long-term effects on corporate Canada. For example, Canada's new and emerging companies searching for U.S. venture funding may find themselves being pressured by those funders to re-incorporate as U.S. corporations. The first instalments of Proposed GILTI regulations have already emerged but they do not yet meaningfully address these difficult issues. Additional instalments of guidance are anticipated in early 2019. Canadian taxpayers should be watching for: (i) whether the IRS takes meaningful steps to try to address the disparity in GILTI treatment between U.S. corporations and U.S. individuals; and (ii) rules addressing the manner in which foreign tax credits may be applied to offset GILTI tax liability.

These impending regulatory projects (as well as others) will shape Canadian-U.S. cross-border transactions for years to come – in ways that can be anticipated and in ways that can't. On top of this, there is now some prospect for a technical corrections bill in the lame-duck session of Congress (which ends in January 2019). A technical corrections bill would allow Congress to fix legislative "glitches" that can't be repaired by mere regulations. All of these converging forces mean that 2019 will be an especially consequential year for Canadian businesses, investors and policy makers with interests in cross-border transactions.