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USA

Law and Practice

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

1.1 Corporate Structures and Tax Treatment

The most commonly used business types in the United States of America (USA) include:

- sole proprietorships;
- partnerships;
- limited liability companies (LLCs); and
- corporations.

Unlike other jurisdictions, the type of business entity selected does not alone determine its US federal tax classifications.

Under the “check-the-box” regulations, domestic entities may be classified as corporations, partnerships or entities disregarded as separate from their owners (a “disregarded entity”). A business entity with two or more owners is classified either as a corporation or a partnership, and a business entity with only one owner is either classified as a corporation or as a disregarded entity. An entity is classified as a “per se corporation” if it is organised under a US federal statute or a US state statute that describes the entity as incorporated or as a corporation, body corporate or body politic. If an entity does not meet any of these requirements, it is an “eligible entity” and its classification is elective. Default classification rules determine initial classification, which can be changed by filing the appropriate forms with the Internal Revenue Service (IRS); by default, a domestic eligible entity is a partnership if it has two or more owners or is a disregarded entity if it has a single owner.

In addition, certain entities (such as corporations and LLCs) can qualify for, and elect to be taxed under, certain specialised tax regimes, such as those governing S corporations, regulated investment companies (RICs) or real estate investment trusts (REITs), provided various requirements are satisfied.

Generally, the LLC is the most commonly used entity type. LLCs are hybrid entities created under state law that are neither partnerships nor corporations. From a state law perspective, they offer their members protection from personal liability for the debts of the LLC’s business much like the liability protection that a corporation offers to its shareholders. From a federal tax standpoint, the IRS treats the LLC as an eligible entity under the “check-the-box” rules, meaning the LLC has flexibility to be classified as either a partnership, an association taxable as a corporation (including as an S corporation, RIC or REIT) or a disregarded entity depending on its business and ownership characteristics.

1.2 Transparent Entities

Partnerships and LLCs (that have elected to be taxed as partnerships) are the most commonly used “pass-through” entities in the USA across industries (including private equity and hedge funds). Unlike corporations (other than S corporations, RICs or REITs, discussed further below), partnerships are not viewed as “taxpaying” entities. Instead, the partners are, generally speaking, liable for the federal income tax on the income (or loss) derived by the partnership. While the determination of income (or loss) for the year is determined at the entity level (treating it as the computational entity), the income or loss is allocated to the partners pursuant to their respective distributive shares. Accordingly, partnerships provide owners significant flexibility (within parameters including that the allocations have “significant economic effect”) in how items

of income and loss are allocated among themselves for tax purposes.

Another method of eliminating "entity-level" tax is for an entity to qualify for, and elect to be taxed as, an S corporation, RIC or REIT. While these regimes vary, they share a common theme – corporate income of a qualifying entity is taxed only to the shareholders, and not to the corporation itself (similar to a partnership). Due to strict ownership requirements, S corporations are available only to US "individual" investors and generally involve closely held businesses. RICs and REITs, by contrast, can be significantly larger and attract different investor bases based on the types of assets owned by each such entity. For example, REITs are companies that own or finance income-producing real estate across a range of property sectors, while RICs are companies that derive their income primarily from passive investment sources (ie, dividends) and generally include mutual funds, closed-end investment companies and exchange-traded funds.

1.3 Determining Residence of Incorporated Businesses

There are four classes of "person" for US income tax purposes:

- individuals;
- corporations;
- partnerships; and
- trusts and estates.

Under US tax rules, as under most countries' tax systems, such persons are further classified as "resident" or "non-resident" based on a variety of tests.

For individuals, the US system treats both US citizens and resident alien individuals as income tax residents. "Resident" aliens are defined using two tests, as follows.

- First, lawful permanent residents (ie, US green card holders) are residents so long as they hold that status.
- Second, other individuals are considered residents if they are in the USA under a day-count test. Under the day-count test, a person is considered a resident if the total number of days such person is present in the USA in the current year, plus one-third of the days present in the prior year, plus one-sixth of the days present in the second prior year, equals or exceeds 183 days.

For corporations, the USA generally uses the place of incorporation rule for determining tax residence, under which a corporation is a "domestic corporation" if it is created or organised under the law of the USA, any US state or the District of Columbia. Note that a special set of rules, referred to as the "anti-inversion rules", may in limited circumstances cause a non-US corporation to be treated as a US tax resident.

Generally, partnerships are determined as domestic or foreign in the same manner as corporations – ie, based on the jurisdiction of formation. However, as partnerships are not subject to income tax (see **1.2 Transparent Entities**), their status as resident or non-resident is largely irrelevant for purposes of determining their taxation (although the jurisdiction of the entity could impact the tax treatment of the partners – eg, under a relevant income tax treaty). Trusts are classified as "domestic" or "foreign" according to whether they have a US trustee and are subject to US legal jurisdiction, and then are subject to tax as "US persons" or non-resident aliens according to such status. Although estates do not have a formal classification, they tend to

be categorised along principles similar to those used for trusts.

1.4 Tax Rates

The maximum US corporate income tax rate is currently 21%. In addition, US states and local governments may levy corporate income taxes on the same (or similar) tax base, but such taxes are generally deductible from the federal income tax base for corporations (subject to certain limitations). The average combined US federal, state and local corporate income tax rate is 25.89%.

However, the USA also recently enacted a new corporate minimum tax (effective from 1 January 2023) that generally imposes a 15% minimum tax on the financial statement income for US corporations (including consolidated groups; see **4.4 Transfer Pricing Issues**) with financial statement income of more than USD1 billion for three taxable years (or USD100 million in the case of a US corporation that is part of a non-US multinational group that has combined financial statement income of more than USD1 billion).

In contrast to corporations, the maximum income tax rate for individuals (including individuals invested in certain pass-through entities) is 37%. In addition, US states and local governments may levy additional taxes on the same (or similar) income incurred by such individuals, the rate of which fluctuates significantly between the various states and municipalities. Additionally, some US states and local governments may also levy an entity-level tax on the business entity notwithstanding its US federal tax classification.

2. Key General Features of the Tax Regime Applicable to Incorporated Businesses

2.1 Calculation for Taxable Profits

The US federal income tax is imposed on "taxable income", which is calculated as "gross income" reduced by deductions allowed under the Internal Revenue Code (the "Code"). Gross income is defined as "income from whatever source derived"; thus, the USA employs a global definition of income based on the accretion concept, where any accession to wealth (other than mere appreciation of asset value with nothing more) constitutes income unless the Code expressly excludes it.

Every taxpayer must figure taxable income for an annual accounting period called a "tax year". The calendar year is the most common tax year; however, other tax years can be selected (ie, fiscal year). Taxpayers must use a consistent accounting method, which is a set of rules for determining when to report income and expenses. The most commonly used accounting methods are the cash method (generally used by individuals and other small businesses) and the accrual method.

Under the cash method, a taxpayer reports income in the tax year it receives it, and deducts expenses in the tax year in which it pays them.

Under the accrual method, the taxpayer reports income in the tax year it earns it (regardless of when payment is received) and deducts expenses in the tax year incurred (regardless of when payment is made).

2.2 Special Incentives for Technology Investments

The Code includes a wide variety of credits that can help reduce, or fully satisfy, the income tax obligations (as well as payroll tax obligations) of taxpayers across a variety of industries, and that can even simply result in a net payment from the government to the taxpayer. These credits have many rules regarding who can claim them and the timing of when, in what order and how much of the credit(s) can be used (or carried forward or backward).

Notably, the R&D tax credit provides an incentive to invest in R&D (ie, performing activities related to the development, design or improvement of products, processes, formulas, technology or software) by allowing companies to claim credits for spending on certain qualified research expenditures (QREs). The R&D tax credit has four separate components:

- the regular credit (equal to 20% of QREs above a base amount);
- the alternative simplified credit (equal to 14% of QREs above half of the average of QREs over the prior three years);
- the energy research credit (equal to 20% of QREs); and
- the basic research credit (equal to 20% of QREs above a base amount).

In any year, taxpayers can take the energy research credit and the basic research credit, along with either the regular credit or the alternative simplified credit.

Additionally, the USA recently enacted a regime that offers domestic corporations a deduction for “foreign-derived intangible income” (FDII), which is an amount that exceeds a deemed return on tangible assets. However, rather than being a patent box, the deduction for FDII is designed to neutralise the effect of global intangible low-taxed income (GILTI) (see **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**) to incentivise US corporations to allocate intangible income to controlled foreign corporations (CFCs).

2.3 Other Special Incentives

In addition to the R&D tax credit (see **2.2 Special Incentives for Technology Investments**), there are several other credits that can provide tax benefits in the form of a dollar-for-dollar reduction to tax liability. For example, there are a variety of general business credits that can be claimed by a broad range of businesses ranging from hiring certain classes of employees (eg, the work opportunity and empowerment zone employment credits) to utilising certain resources in the manufacturing process (eg, the renewable electricity production credit). Moreover, in any year, a taxpayer can choose whether to take as a foreign tax credit (FTC) or as a deduction foreign income, war profits and excess profit taxes paid or accrued during the tax year to any foreign country or US possession. An FTC reduces US income tax liability dollar for dollar, while a deduction reduces the US income tax liability at the marginal rate of the taxpayer.

There generally are limited incentives related to inbound investment at the federal level, such as the portfolio interest exemption (PIE), bank deposit exceptions and trading safe harbours. Very generally, the PIE enables non-residents and foreign corporations to invest in certain obligations in the US without being subject to US income (or withholding) tax on the interest income (see **4.1 Withholding Taxes**). The bank deposit exception allows non-US investors to deposit funds in US banking institutions without

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being subject to US tax on the interest earned, provided that the investment meets the statutory definition of a "deposit" and the funds are held by persons carrying on a banking business, or certain other supervised institutions.

There also are statutory securities and commodities trading safe harbours that provide exceptions from being treated as engaged in a US trade or business for non-US persons trading in stocks, securities, or commodities through a resident broker or other agent. Additionally, interest income received on certain qualified private activity bonds is generally exempt from US federal income tax, which enables a business to issue the bonds at a lower interest rate.

The aforementioned incentives are not intended to represent an exhaustive list of all the benefits that are available; however, they do illustrate some of the core incentives utilised by businesses in a range of industry sectors.

2.4 Basic Rules on Loss Relief

Under the US tax system, a taxpayer with deductions exceeding gross income may have a net operating loss (NOL) that may be carried to and deducted in another year. The amount of an NOL is equal to the taxpayer's gross income minus deductions, computed with certain modifications. The modifications that must be made depend on whether the taxpayer is a corporate or non-corporate taxpayer. In addition, special rules apply when determining the NOLs of a group of corporations filing a US consolidated return, which require NOLs be computed on a consolidated basis (see **2.6 Basic Rules on Consolidated Tax Grouping**).

For NOLs arising in tax years that begin after 2020, there is no longer a carry-back period except a two-year carry back for certain NOLs attributable to farming losses and NOLs incurred by non-life insurance companies. The carry-forward period is unlimited for NOLs arising in post-2017 tax years; however, a 20-year carry-forward period applies to the NOLs of non-life insurance companies and pre-2018 NOLs.

In addition, post-2017 NOLs may only offset 80% of taxable income; however, this 80% limitation does not apply to non-life insurance companies. Apart from the 80% limitation, certain anti-loss trafficking rules may limit a company's NOL utilisation where there has been a sufficient change of ownership.

Individual taxpayers may offset capital gains with capital losses and, if such losses exceed the gains, ordinary income up to USD3,000 per year. Individuals may carry unused capital losses forward indefinitely. In contrast, corporate taxpayers may only offset capital gains with capital losses and may carry unused capital losses back three years and forward five years.

2.5 Imposed Limits on Deduction of Interest

In 2017, the USA passed legislation that limits the deductibility of business interest expense. Under these rules, a taxpayer's interest expense for any year is limited to the sum of:

- business interest income; plus
- 30% of adjusted taxable income (which, for 2022 and onwards, is generally equal to EBIT); plus
- floor plan financing.

Any interest disallowed can be carried forward indefinitely and deducted in subsequent years. While certain taxpayers are exempt from this limitation (eg, certain small taxpayers and real property businesses), it applies regardless of

whether related-party debt is involved, regardless of whether the debt is incurred by a sole proprietor, a corporation or a pass-through entity and regardless of whether the taxpayer is thinly capitalised. Other rules also exist that have the potential to limit or deny interest deductions (eg, interest on certain applicable high-yield debt instruments).

In addition to the foregoing rules, the USA has also introduced two "anti-hybrid" rules which, if applicable, generally deny US tax deductions in certain situations involving entities and payments of interest, royalties or dividends, if such entities or payments are treated differently under US and foreign tax laws and such different treatment results in double taxation. Furthermore, rules provided in tax regulations can recharacterise debt between related parties as a "stock or equity" instrument if such indebtedness is issued in certain related-party transactions (see **5.7 Constraints on Related-Party Borrowing**). These rules are designed specifically to target earnings-stripping transactions.

2.6 Basic Rules on Consolidated Tax Grouping

The Code and tax regulations (and several US states) allow a group of US corporations to file a consolidated federal income tax return, which effectively allows the profits of one group member to be offset by the losses of another group member.

The consolidated return rules, which are mostly in the tax regulations, are very detailed and complex. Very generally, certain US entities classified as corporations for US federal income tax purposes may elect to join in filing a consolidated return if they are members of an "affiliated group". An affiliated group is generally one or more chains of corporations connected through stock ownership with a common parent corporation, which must satisfy certain detailed stock-ownership rules with respect to the subsidiary corporations (generally requiring at least 80% ownership measured by voting power and value, but disregarding certain debt-like preferred stock). Sales, dividends and other intercompany transactions between group members are generally deferred until a transaction occurs with a non-member (or when a member leaves the group). Groups of corporations filing consolidated returns are subject to various special rules, such as:

- rules on intercompany transactions;
- loss disallowance rules;
- loss sharing rules;
- several liability among members of the group with respect to federal income taxes; and
- basis adjustments with respect to subsidiary member stock.

With respect to losses, a consolidated group is required to determine its NOL on a consolidated basis. For this purpose, the separate income and loss of each member is determined without taking into account any separate NOL deduction. Separate member income and losses are then aggregated and taken into account in determining the group's NOL for that year – meaning that the positive net income of some members is netted against the NOLs of other members to determine whether, on a net basis, the group has an NOL. In addition to certain general anti-loss trafficking rules (see **2.4 Basic Rules on Loss Relief**), certain loss disallowances apply only to consolidated groups.

2.7 Capital Gains Taxation

For corporate taxpayers, gains from the disposition of capital assets are subject to regularly applicable tax rates, and losses from the dispo-

sition of capital assets may only offset capital gains (see **2.4 Basic Rules on Loss Relief**).

The Code includes various non-recognition provisions under which a built-in gain may be deferred (or in the case of a tax-free subsidiary spin-off, eliminated) rather than recognised and included in taxable income in the specified transaction. For example, such provisions include like-kind exchanges of real property, involuntary conversion, and certain corporate reorganisations such as mergers, stock sales or liquidations. In addition, the 2017 tax reform introduced a regime under which taxpayers may defer or partially eliminate certain capital gains by investing in a "qualified opportunity fund" located in any of the "qualified opportunity zones" enumerated by the IRS.

2.8 Other Taxes Payable by an Incorporated Business

Various other transaction taxes may apply at the state and local levels. For example, most US states impose an ad valorem real property transfer tax. In addition, beginning on 1 January 2023, stock repurchases or redemptions of more than USD1 million by a US corporation (and in certain cases, a non-US corporation) that has stock traded on an established securities market will be subject to a 1% US federal excise tax.

2.9 Incorporated Businesses and Notable Taxes

Various other taxes may apply in addition to the taxes discussed elsewhere in this chapter, such as:

- the federal excise tax imposed on insurance and reinsurance premiums paid to non-US persons;
- the federal excise tax on certain stock repurchases or redemptions (see **2.8 Other Taxes Payable by an Incorporated Business**);
- social security; and
- Medicare tax and unemployment tax imposed on employers.

In addition, US states and local governments impose various other direct taxes (ie, franchises tax) and indirect taxes (ie, excise taxes, mortgage recording taxes, telecommunication taxes or insurance premium taxes) that may vary greatly between such US states.

3. Division of Tax Base Between Corporations and Non-corporate Businesses

3.1 Closely Held Local Businesses

As noted in **1.1 Corporate Structures and Tax Treatment**, the LLC (a hybrid-type entity) is the most commonly used entity type in the USA. This is because it not only affords liability protection for its members (similar to the protection that a corporation offers its shareholders) but also permits significant flexibility from a tax planning perspective. Specifically, an LLC, as an eligible entity, can generally elect to be classified for federal tax purposes as a corporation, a partnership, or a disregarded entity depending on its ownership. That said, by default LLCs are generally taxed like sole proprietorships or partnerships, meaning the owners are considered self-employed and generally are required to pay self-employment tax on all business profits.

Another popular form is the S corporation. As noted in **1.2 Transparent Entities**, S corporations are generally exempt from a federal income tax (meaning that any income is taxed only at the individual level) and, notably, provide cer-

tain self-employment tax benefits to their owners that are generally not available to other types of entities. Along with the tax advantages, S corporations enjoy the same protection from liability offered by corporation status. There are, however, a number of stipulations for operating as an S corporation that may disqualify or disincentivise a business seeking S corporation status. Perhaps the most important are the strict limits around shareholders, which are restricted largely to US individuals. Furthermore, unlike other types of pass-through entities (ie, partnerships), S corporations do not have flexibility when it comes to the allocation of income.

3.2 Individual Rates and Corporate Rates

Corporations in the USA are subject to what is referred to as the classic regime of corporate taxation. Specifically, corporations (other than certain types of corporations qualifying under special tax regimes – see **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**) are for the most part regarded as entirely separate legal entities and, as such, are subject to tax on their income, and shareholders are considered to receive income fully subject to tax when they receive distributions from corporations that are out of corporate earnings and profits (E&P). Thus, in the USA, corporate income is taxed twice, once at the entity level and again at the shareholder level when earnings are distributed and, as a result, such system generally prevents individuals from earning income at solely corporate rates.

As discussed in **1.1 Corporate Structures and Tax Treatment** and **1.2 Transparent Entities**, certain types of corporate entities (ie, S corporations, REITs and RICs) provide a mechanism of avoiding corporate-level tax where various requirements are satisfied.

3.3 Accumulating Earnings for Investment Purposes

The retention of profits may trigger additional tax liability, such as the accumulated earnings tax (AET) (ie, a 20% penalty tax) imposed on corporations formed or availed for the purpose of avoiding the income tax with respect to their shareholders, or the personal holding company (PHC) tax (ie, a 20% tax on undistributed PHC income) imposed on corporations that mainly derive passive-category income and the majority of which is owned by five or fewer individuals.

Notably, the PHC tax contrasts with the AET in several respects. First, if the requirements of the PHC tax are met, it applies automatically – there is no "intent" element that the government must establish. Second, if the PHC tax applies, the corporation must self-assess the tax by making certain filings with its annual tax return, which, if it fails to do, may subject it to additional penalties (ie, the AET is imposed by the IRS upon audit).

3.4 Sales of Shares by Individuals in Closely Held Corporations

For US individuals, gains from the disposition of capital assets (ie, shares) held for more than one year (ie, long-term capital gains) are subject to preferential capital gains tax rates, and losses from the disposition of capital assets may offset capital gains and, if they exceed such gains, ordinary income up to USD3,000 per year. Any unused capital losses can be carried forward indefinitely.

Distributions by a corporation to individual shareholders are taxed as "dividends" only to the extent they are paid out of the corporation's current or accumulated E&P. Dividends received from domestic and certain qualifying foreign corporations received by individual shareholders

("Qualified Dividends") may be taxed at a preferential tax rate or, if not Qualified Dividends, then at regular individual tax rates. If the corporation has no E&P (or if the distribution exceeds the corporation's E&P), the individual shareholder will be allowed to treat the distribution (or the excess, in the latter case) as a return of capital, to the extent of the shareholder's basis in the stock. Any distribution in excess of basis will be treated as gain from the sale of stock.

US-sourced dividend income generally constitutes fixed or determinable annual or periodic gains, profits and income (collectively referred to as FDAP) (see **4.1 Withholding Taxes**) and is subject to a 30% withholding tax if paid to a non-US tax resident, unless reduced by an applicable treaty. Gains from the sale of stock by a non-US tax resident are generally treated as giving rise to foreign-sourced income and, as such, are not subject to US tax.

3.5 Sales of Shares by Individuals in Publicly Traded Corporations

Individuals (both US residents and non-US residents) are generally subject to the same rules discussed in **3.4 Sales of Shares by Individuals in Closely Held Corporations** with respect to dividends from, and gain on, shares in publicly traded corporations.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

Non-US tax residents are generally taxed in the US on FDAP income (ie, interest, dividends and royalties), to the extent that such items of income are not effectively connected with the conduct of a US trade or business or attributable to a permanent establishment. Such FDAP income is subject to a 30% gross basis tax that is enforced by withholding at the source, unless such tax is reduced by exemption or an applicable income tax treaty.

Notably, the PIE generally exempts, from the otherwise applicable withholding tax previously discussed, interest paid on registered obligations held by non-US persons that own less than 10% of the voting power of the payer. The PIE is subject to various requirements and exceptions – for example, it is not available to:

- banks receiving interest on ordinary-course loans; and
- certain CFCs.

4.2 Primary Tax Treaty Countries

The USA currently has 58 income tax treaties in force covering 66 jurisdictions. While most US income tax treaties provide reduced rates for dividends (with reduced rates generally ranging from 10% to 25%) and for interest (with reduced rates generally ranging from 0% to 17.5%), foreign investors generally must satisfy certain ownership, income and other requirements before such beneficial rates can be obtained.

Furthermore, because most US income tax treaties include a limitation on benefits article as well as other anti-treaty shopping provisions (see **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**) foreign investors are somewhat limited as to which treaty country can be used to facilitate such investment (ie, as some amount of substance in such jurisdiction is generally required).

4.3 Use of Treaty Country Entities by Non-treaty Country Residents

Most US income tax treaties in force include a limitation on benefits article and, in addition,

those treaties may contain other anti-treaty shopping provisions. The 2016 US Model Income Tax Convention includes:

- the limitation on benefits article, which prevents residents of third-country jurisdictions from obtaining benefits under a treaty;
- a "triangular branch" provision, which limits treaty benefits for income attributable to a third-country permanent establishment if little or no tax is paid in the permanent establishment's jurisdiction;
- the "special tax regime" concept, which denies treaty benefits for items of income subject to a preferential tax regime; and
- a limitation that denies treaty benefits for certain payments made by expatriated entities.

Two of the most significant income tax treaties that do not include either a limitation on benefits article or a triangular branch provision are the treaties with Hungary and Poland. However, new treaties that include both such provisions are currently awaiting US Senate approval to replace these treaties.

4.4 Transfer Pricing Issues

Specifically, the Code authorises the IRS to adjust items of income, deductions, credits or allowances of commonly controlled taxpayers to prevent tax evasion. The applicable standard in examining intercompany transactions is that of a "taxpayer dealing at arm's length with an uncontrolled taxpayer" (ie, the arm's-length standard), which generally is met if the results of the transaction are consistent with the results that would have been realised if uncontrolled taxpayers had engaged in a comparable transaction under comparable circumstances. The US tax regulations include detailed rules regarding how such standards may be met.

If the IRS exercises its adjustment authority, the taxpayer bears the burden of proof to show that the arm's-length standard was met and, depending on the circumstances, may subject taxpayers to adverse penalties for non-compliance. Consequently, it is recommended that taxpayers routinely maintain robust, contemporaneous documentation to support their transfer pricing practices given that valuation misstatement penalties and reporting penalties may apply.

The aggressive transfer pricing regime of the USA has caused controversy with some of its trading partners, not all of whom have agreed with the USA's interpretation of this arm's-length standard. The tax regulations, together with a greater level of enforcement activity, have resulted in an increasing number of transfer pricing issues being considered through the competent authority process under the mutual agreement article of tax treaties concluded between the USA and most of its major trading partners.

4.5 Related-Party Limited Risk Distribution Arrangements

A typical limited risk distributor (LRD) agreement may provide for the LRD to earn a predictable, fixed margin and for all residual profit or loss to inure to the principal. While the LRD agreement may provide for the principal to bear most of the LRD's costs and risks in the ordinary course of business, tax authorities might challenge whether the agreement should be respected based on such agreement's compliance with the transfer pricing rules and regulations, especially in circumstances (eg, the impacts of COVID-19) where significant deviations from the arm's-length standard arise (see **4.4 Transfer Pricing Issues**).

4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards

Local transfer pricing rules and/or enforcement are generally consistent with OECD standards. That said, the OECD standards are generally less restrictive concerning market penetration strategies than the US regulations, which require a very extensive factual showing and documentation. Additionally, unlike the more restrictive US rules, OECD standards generally do not include specific rules for establishing (or benchmarking) an appropriate arm's-length range.

Moreover, the primary focus of the US regulations is on whether a taxpayer has reflected arm's-length results on its US income tax return, rather than focusing on the method and procedures used to set such prices. The OECD standards, by contrast, focus significantly less on results and more on whether the transfer prices were established using an arm's-length manner; this therefore places considerable emphasis on factors known by the taxpayer at the time the transfer prices were established.

Finally, while the OECD standards acknowledge that penalties may play a legitimate role in improving tax compliance in the transfer pricing areas, they do not provide for any such penalty regime. In contrast, the US system employs a detailed penalty regime that includes both transaction penalties and net adjustment penalties (that escalate depending on the severity of the transfer pricing deviations and/or tax return results).

4.7 International Transfer Pricing Disputes

The USA participates in the OECD International Compliance Assurance Program (the ICAP). Accordingly, the procedures the USA takes to handle any international transfer pricing disputes are generally consistent with those set forth in the ICAP. In addition, enhanced engagement programmes, such as advance pricing agreements (APAs), mutual agreement procedures (MAPs) and other avenues are available mechanisms in the USA for preventing and/or resolving transfer pricing disputes.

With respect to APAs, the USA was the first country to issue a formal, comprehensive set of procedures relating to the issue of binding APAs dealing with the application of the arm's-length standard to intercompany transfer prices. The effect of an APA is to guarantee that the IRS will regard the results of the transfer pricing method as satisfying the arm's-length standard if the taxpayer complies with the terms and conditions of the APA. In addition, when a taxpayer and the IRS enter into an APA, the US competent authority will, upon a request by the taxpayer, attempt to negotiate a bilateral APA with the competent authority of the treaty country that would be affected by the transfer pricing methodology. The IRS has encouraged taxpayers to seek such bilateral APAs through the US competent authority.

Furthermore, MAP arbitration is also available under most US tax treaties. Taxpayers should consult the MAP article under the applicable US tax treaty to determine whether it is an arbitration treaty and the extent to which mandatory arbitration applies under such treaty. Generally, US tax treaties contain a provision which would oblige the USA to make corresponding adjustments or to grant access to the MAP with respect to the economic double taxation that may otherwise result from a primary transfer pricing adjustment (ie, paragraph 2 of Article 9 of the OECD Model Tax Convention or the UN Model Double Taxation Convention is included in

the USA's tax treaties under the Advance Pricing Mutual Agreement Program).

While the provisions contained in these US tax treaties do not require the competent authorities to reach an agreement eliminating double taxation, such treaties do require that the competent authority make a good faith effort to reach such an agreement. Thus, there is no guarantee that competent authority assistance will result in the elimination of double taxation in every case; however, the vast majority of cases are concluded with an agreement that avoids double taxation.

5. Key Features of Taxation of Non-local Corporations

5.1 Compensating Adjustments When Transfer Pricing Claims Are Settled

Generally, compensating adjustments are allowed/made. A taxpayer may file a competent authority request with respect to a US federal court's final determination of its tax liability, but only for the purpose of seeking correlative relief from a foreign competent authority. Such final determinations include litigation settlements with the Office of Chief Counsel or the Department of Justice. If it accepts such a request, the US competent authority will seek correlative relief from the foreign competent authority only for the amount of such final determination and will not authorise competent authority repatriation.

5.2 Taxation Differences Between Local Branches and Local Subsidiaries of Non-local Corporations

Generally, local branches are not taxed differently. The imposition of corporate income tax on effectively connected income (ECI) is the equivalent of the tax that would be imposed if a US trade or business were incorporated as a US subsidiary of a foreign corporation, rather than an unincorporated operation. A US subsidiary of a foreign corporation would normally pay a 30% tax on dividends distributed to the foreign corporation (without an applicable tax treaty).

To achieve a similar tax result, the foreign corporation is made liable for a 30% tax computed on its dividend equivalent amount (DEA). This is referred to as a "branch profits tax" (BPT), although it is imposed on most income that is effectively connected to a trade or business, even if formally there is no established branch. Thus, the BPT substitutes for the taxation of the foreign corporation's shareholders while ensuring that US income is taxed twice, in accord with the US two-tier system for taxing corporate profits (see **3.2 Individual Rates and Corporate Rates**).

5.3 Capital Gains of Non-residents

Generally, capital gains from sales of stocks or bonds (ie, personal property) by non-US residents are exempt from US taxation and withholding (ie, as the residence of the seller generally determines whether such gain is foreign or US source). This rule, however, is supplanted to the extent the stock constitutes a "US real property interest" (USRPI), which includes an interest in stock of a "US real property holding corporation" (USRPHC). A USRPHC is generally a US corporation that holds US real property whose fair market value is at least 50% of the fair market value of all its real property and assets used in its trade or business. This regime is colloquially referred to as "FIRPTA" as it was enacted by the Foreign Investment in Real Property Tax Act.

If applicable, such tax is enforced by a withholding regime that generally requires buyers

to withhold 15% of the fair market value of the disposed USRPI. Sellers of corporate stock may generally provide a certification by the corporation upon sale that the corporation is not a USRPHC and thus avoid FIRPTA tax and withholding (although the IRS is not bound by the certification). Publicly traded corporations are subject to certain exceptions from both the substantive tax and withholding requirements.

5.4 Change of Control Provisions

There are, in general, no specific indirect transfer rules, nor any specific indirect change of control provisions that should be subject to local taxation.

5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates

To the extent goods or services are provided to related parties, transfer pricing principles apply (see **4.4 Transfer Pricing Issues**). Specifically, taxpayers are required to apply the arm's-length standard in establishing compensation amounts for the provision of intercompany goods and/or services. Accordingly, if one member of a group of related entities provides goods or services for the benefit of (or on behalf of) another group member without charge or at a non-arm's-length charge, the IRS can make appropriate reallocations to reflect an arm's-length charge for those goods or services. If the services benefit more than one group member, the IRS bases the allocation on the relative benefit intended for each group member when the services are performed.

These rules generally stipulate that taxpayers must apply one of six specified transfer pricing methods in evaluating the appropriateness of their intercompany services transactions. The six specified transfer pricing methods include three transactional approaches (ie, CUSPM, GSMM and CSPM), two profit-based approaches (ie, CPM and PSM), and a cost-based safe harbour (ie, SCM).

5.6 Deductions for Payments by Local Affiliates

Management fees between controlled taxpayers are subject to US transfer pricing principles (see **4.4 Transfer Pricing Issues** and **5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates**). As discussed previously, entities should be charging an arm's-length fee for the services they provide and, if this standard is not met, the situation can become exacerbated for tax purposes if the foreign subsidiaries are profitable in their home country while the US business is reflecting losses (meaning that the expenses in the USA are really supporting the foreign operations).

In such circumstances, the IRS has the power to reallocate income and deductions between such parties in order to reflect what it believes to be the true economic nature of the cross-border activity and, depending on the adjustments, a penalty can be imposed on an underpayment of taxes that results from improper management and administrative expenses incurred.

5.7 Constraints on Related-Party Borrowing

The Code and tax regulations contain rules that broadly impact on the tax treatment of certain related-party debt issued by US corporate borrowers to certain related parties (including non-local affiliates) (the "Debt Recast Rules"). The intention of these rules generally is to prevent erosion of the US tax base through placement of debt owed by a US corporation to a foreign affiliate and, if applicable, have the effect of recharacterising certain related-party debt as equity to eliminate US tax deductions on interest payments.

The Debt Recast Rules generally apply to debt issued in connection with certain enumerated transactions ("Specified Transactions"). Specified Transactions include:

- distributions within an expanded group;
- asset acquisitions from within the expanded group; and
- stock acquisitions within the expanded group.

In addition, the Debt Recast Rules also contain certain presumptions (such as related to the per se funding rule) that further expand the scope and applicability of the Debt Recast Rules. While the Debt Recast Rules are exceedingly complex, it should be noted that they contain many material exceptions that can mitigate or prevent the applicability of such rules in a broad range of cases.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

The USA taxes its citizens and residents (including domestic corporations) on their worldwide income directly earned from whatever source derived, which is generally taxed at a 21% rate (see **1.4 Tax Rates**). As described in later sections (see **6.3 Taxation on Dividends from Foreign Subsidiaries**), a special set of rules applies to income earned through a foreign subsidiary. That said, the USA generally permits an FTC (or deduction) against US income tax for taxes that are properly paid to other countries on income sourced to such other countries (see **2.3 Other Special Incentives**).

In addition, US taxpayers are generally permitted to utilise foreign losses to offset US-source income subject to certain recapture rules (see **6.2 Non-deductible Local Expenses**). The USA's "worldwide" system of taxation is in stark contrast to many foreign jurisdictions that impose a territorial tax regime, which generally excludes (or exempts) the profits earned by non-local companies.

6.2 Non-deductible Local Expenses

The USA generally taxes US persons on their worldwide income, including their foreign taxable income. If a taxpayer's losses (including deductions and expenses) from foreign sources exceed its foreign-source income, the excess, which is referred to as an overall foreign loss, can be used to reduce US-source income and, as such, the effective rate of tax on such income. In a subsequent year, however, the full allowance of an FTC may result in a double-tax benefit. To eliminate this benefit, foreign losses (claimed in a prior year) are recaptured by treating a portion of the foreign-source income in the later year as US-source income.

6.3 Taxation on Dividends From Foreign Subsidiaries

When a CFC makes a distribution to its US shareholder, the nature and character of that distribution must be determined. Specifically, whether the CFC has any earnings and profits (E&P) must be determined, as must the character of the E&P. If E&P exists, a distribution is generally sourced from the CFC in the following order:

- previously taxed E&P (PTEP) (ie, the E&P of a CFC attributable to income that has already been included in the gross income of a US shareholder);

- not previously taxed E&P (non-PTEP) (ie, the E&P of a CFC that has not been included in a US shareholder's gross income);
- return of capital; and
- capital gain.

Generally, PTEP distributions are excluded from a shareholder's gross income. However, a US shareholder must reduce its basis in its CFC stock by the amount of such PTEP distribution and, if a PTEP distribution exceeds stock basis, the excess results in capital gain. In contrast, non-PTEP distributions are included in a shareholder's gross income.

Notably, however, certain corporate shareholders may be eligible for a full dividends-received deduction (DRD) provided certain requirements are satisfied. The DRD, however, is not permitted for dividends received from tax-exempt organisations or for certain hybrid dividends (or if certain holding period requirements are not satisfied). A "return of capital" distribution is not a taxable event to the recipient US shareholder.

Finally, if a distribution exceeds the amount of non-PTEP and the US shareholder's basis in its CFC stock, any excess generally gives rise to a capital gain.

6.4 Use of Intangibles by Non-local Subsidiaries

The use of intangible property (including transfers or licences of such intangible property) are subject to US transfer pricing principles and other provisions of the Code (see **4.4 Transfer Pricing Issues** and **5.5 Formulas Used to Determine Income of Foreign-Owned Local Affiliates**), which require that arm's-length compensation and/or consideration be furnished. Regarding transfers or licences of intangible property, the income must be commensurate with the income attributable to the intangible. In this regard, the IRS has authority to mandate the method used to value transfers of intangible property (in the context of outbound transfers and intercompany pricing allocations) as well as to require that the valuation of such transfers be made on an aggregate basis (or on the basis of the realistic alternative principle if the IRS determines that such method constitutes the most reliable means of valuation of such transfers).

6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules

A foreign corporation is a CFC if US shareholders (ie, US resident persons that directly, indirectly or constructively own at least 10% of the vote or value of the foreign corporation) own stock that represents more than 50% of the vote or value in such corporation. In addition, application of certain attribution rules may deem, for example, sister companies to be constructive CFCs. The two major consequences of CFC classification are that its 10% US shareholders must include in income:

- their pro rata share of the CFC's "subpart F income" (generally passive-category income such as dividends, interest, royalties, capital gains or "foreign base company income"); and
- their GILTI, which is generally the excess of the shareholders' pro rata share of the CFC's gross income (reduced by certain items) over a 10% deemed return on the CFC's aggregate adjusted bases of depreciable tangible property used in the CFC's trade or business.

US corporations are generally taxed on GILTI at a preferential tax rate, and amounts taken into account in determining subpart F income are disregarded in calculating GILTI.

In addition, a foreign corporation with predominantly passive-category income or assets may be classified as a "passive foreign investment company" (PFIC), which may subject its owners to several onerous consequences, but which may generally be ameliorated by certain elections.

The US imposes worldwide taxation on US business entities, and a foreign branch is not considered an entity separate from its owner. As such, foreign branch income is deemed to be derived directly by its US corporate owner and is subject to corporate income tax on a net basis. Branch income is generally determined based on the income reflected in the foreign branch's separate books and records, and the US home office is allowed a foreign tax credit on taxes paid in the branch's jurisdiction (subject to certain limitations and "basketing" rules).

6.6 Rules Related to the Substance of Non-local Affiliates

There are various US judicially developed doctrines that are designed to look beyond the form of a transaction and disallow otherwise applicable tax benefits if the transaction violates the spirit of the law (see **7.1 Overarching Anti-avoidance Provisions**). Furthermore, the limitation on benefits and other anti-treaty shopping provisions contained in US tax treaties generally look at the "substance" of a non-local affiliate in such jurisdiction in determining whether the benefits afforded by such treaty may apply (see **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**).

6.7 Taxation on Gain on the Sale of Shares in Non-local Affiliates

A US corporation that is a US shareholder of a CFC will recognise a portion of any gain on the sale or exchange of stock in a CFC as a dividend, generally to the extent of the E&P in the CFC that are attributable to the stock sold or exchanged. In the case of the sale or exchange by a US corporation of stock in CFC held for one year or more, any amount received by the US corporation that is treated as a dividend may also qualify for exemption under the DRD rules (see **6.3 Taxation on Dividends From Foreign Subsidiaries**). Furthermore, if a CFC sells or exchanges stock of a lower-tier CFC, and any gain is treated as a dividend (similar to the rules noted above), then the foreign-source portion of that dividend will be treated as subpart F income of the selling CFC for which a US shareholder may be permitted a DRD.

7. Anti-avoidance

7.1 Overarching Anti-avoidance Provisions

There are various judicially developed doctrines that are comparable to a general anti-abuse rule, such as the "substance-over-form", "step transaction", "economic substance", "business purpose" and "sham transaction" doctrines. All these doctrines generally serve a similar purpose: to look beyond the form of a transaction and disallow otherwise applicable tax benefits if the transaction violates the spirit of the law. In addition, the economic substance doctrine was added to the Code and carries with it a 20% non-compliance penalty, which can be increased to 40% if the transaction is not properly disclosed.

8. Audit Cycles

8.1 Regular Routine Audit Cycle

The Code requires that the IRS assess, refund, credit and collect taxes within specific time limits, known as the statute of limitations. When

the statute of limitations expires, the IRS can no longer assess additional tax, allow a claim for refund by the taxpayer or take collection action. The determination of statute expiry differs for assessment, refund and collection.

The basic rule is that the IRS generally has three years after a return is filed to "assess" tax and begin any court proceeding, but numerous exceptions exist that provide more time for the IRS (ie, six years or longer). For example, the IRS gets six years to audit a return if a taxpayer omitted more than USD5,000 in income attributable to specified foreign financial assets and, notably, no time limits apply in situations where a taxpayer either failed to file, or fraudulently filed, tax returns. The filing of a tax return is generally the event that triggers the running of the statute of limitations on assessments. Once a tax assessment is made, the IRS generally has ten years to collect an assessed liability (subject to certain extensions).

9. BEPS

9.1 Recommended Changes

In 2017, the USA enacted legislation generally intended to be consistent with the recommendations in the two final reports under Action 2 of the BEPS project. This legislation, and the tax regulations issued thereunder, generally neutralise double non-taxation effects of:

- inbound dividends involving hybrid arrangements, by either denying a participation exemption or requiring domestic inclusion (depending on whether the hybrid dividend is received by a domestic corporation or a CFC); and
- outbound deductible interest or royalty payments that produce a deduction/no inclusion outcome due to hybridity by disallowing such deduction.

In addition, the USA enacted the BEAT, which targets base erosion by imposing additional tax on certain large US corporations that make deductible payments to foreign related parties. Such additional tax is designed as a 10% minimum tax (scheduled to increase to 12.5% in 2025) imposed on modified taxable income.

The USA also enacted a limitation on the deductibility of interest expense (which, very generally, is limited to 30% of EBIT) and country-by-country reporting consistent with the BEPS recommendations, and has the limitation on benefits article in most of its income tax treaties. Finally, it should be noted that the USA recently enacted a new 15% corporate minimum tax based on financial statement income (see **1.4 Tax Rates**).

9.2 Government Attitudes

While the USA generally agrees that the issues addressed by BEPS (both as related to Pillars One and Two) should be remedied (which, as discussed in this chapter, the USA has already take great strides toward implementing – see **9.1 Recommended Changes**), there is some disagreement on how this framework should be implemented. Specifically, the concerns are that:

- there are areas of international tax law that are (or should remain) the province of the USA and should be managed accordingly;
- the basic tenet of transfer pricing, the arm's-length standard, should remain a cornerstone of international tax law; and
- US international tax reform is urgently needed to complement BEPS actions so as to protect US interests from being adversely affected.

9.3 Profile of International Tax

Due to substantial activity by US multinationals and the overall strength of the US economy, international tax has a high public profile in the USA. This is evidenced by the USA's commitment to engage with the international community on the various BEPS Action Programs and, notably, through the US government's decision to enact legislation (and issue regulations) that is largely consistent with BEPS recommendations (see **9.1 Recommended Changes**).

9.4 Competitive Tax Policy Objective

The US government's main goal is to prevent other countries from taxing what it views as "its" tax base through the BEPS initiative (see **9.2 Government Attitudes**). In this respect, the USA is already balancing its competitive policy objectives against the pressures that BEPS will bring in its wake so as to ensure that US interests, and more specifically its tax base, are appropriately safeguarded. Accordingly, the USA is likely to continue to engage with the international community to help address tax avoidance, ensure coherence of international tax rules, and, ultimately, ensure a more transparent tax environment (see **9.3 Profile of International Tax**).

9.5 Features of the Competitive Tax System

While the US tax system provides many benefits for companies operating in its borders (as discussed throughout this chapter), a major drawback to the US system is its overall complexity. Specifically, the current tax law was not enacted all at once but is a result of numerous provisions added or subtracted in multiple tax bills. Often, Congress designs legislation under self-imposed constraints, such as short-term revenue goals or effects on the distribution of tax burdens among income groups. For example, the hybridity of the US international system may be seen as more vulnerable, given its complexity. Such complexity in itself can be viewed as a deterrent to cross-border investment. Another element of this complexity is the myriad of laws that separately apply at the state and local level, which may or may not conform to federal provisions.

9.6 Proposals for Dealing With Hybrid Instruments

The 2017 tax reform introduced two "anti-hybrid" rules which generally deny US tax deductions in certain situations involving entities and payments of interest, royalties or dividends, if such entities or payments are treated differently under US and foreign tax laws and such different treatment results in double taxation (see **2.5 Imposed Limits on Deduction of Interest**). The amendments made to the Code were a direct response to Action 2 of the OECD BEPS Project designed to address hybrid and branch mismatch arrangements.

9.7 Territorial Tax Regime

The USA does not have a territorial tax regime. That said, for tax years beginning on or after 1 January 2018, US international taxation has shifted to a more "hybrid" system that exempts some foreign-source income (foreign-source dividends and certain returns on foreign asset investments), but that currently taxes, at reduced rates, a much broader scope of previously deferred foreign profits (see **6.5 Taxation of Income of Non-local Subsidiaries Under Controlled Foreign Corporation-Type Rules**), while also enacting new provisions (and regulations) designed to curtail certain types of base erosion payments, such as:

- the BEAT (see **9.1 Recommended Changes**);
- anti-hybrid rules (see **2.5 Imposed Limits on Deduction of Interest**);

- limitations on interest deductibility (see again **2.5 Imposed Limits on Deduction of Interest**); and
- the Debt Recast Rules (see **5.7 Constraints on Related-Party Borrowing**).

9.8 Controlled Foreign Corporation Proposals

The USA does not have a territorial tax regime (see **9.7 Territorial Tax Regime**) and already has in place a CFC regime (see **6.5 Taxation of Income of Non-local Subsidiaries under Controlled Foreign Corporation-Type Rules**).

9.9 Anti-avoidance Rules

DTC limitation on benefit or anti-avoidance rules are not likely to have an impact. As discussed previously, most US income tax treaties already include a limitation on benefits article and, in addition, also contain various other anti-treaty shopping provisions (see **4.3 Use of Treaty Country Entities by Non-treaty Country Residents**).

9.10 Transfer Pricing Changes

The transfer pricing changes introduced by BEPS are generally consistent with the US transfer pricing rules and regulations; however, they do diverge in some respects (see **4.6 Comparing Local Transfer Pricing Rules and/or Enforcement and OECD Standards**). For intellectual property, it is worth noting that the BEPS proposals place significantly more emphasis on the "economic ownership" of intangible assets, which contrasts with the US position that focuses more on "legal ownership".

9.11 Transparency and Country-by-Country Reporting

The authors are not currently in favour of such provisions. Although the USA issued tax regulations requiring country-by-country reporting by US multinational enterprises, the information the government obtains is strictly confidential and used solely for tax purposes.

9.12 Taxation of Digital Economy Businesses

A number of countries have reached an agreement with the USA as to the treatment of their existing digital services taxes (DSTs), pending the implementation of Pillar One. This is known as the Unilateral Measures Compromise. This compromise, which was agreed upon by the USA and Austria, France, Italy, Spain, the United Kingdom, Turkey and India, covers the interim period between January 2022 and the earlier of either the date Pillar One formally takes effect or 31 December 2023.

Notably, under the compromise, these countries can keep their existing DSTs in place until the implementation of Pillar One; however, corporations (primarily US multinational corporations) that are subject to DSTs may receive a tax credit against future tax liabilities. In return for such compromise, the USA has agreed to terminate certain punitive trade actions against such countries and refrain from imposing certain additional trade actions.

9.13 Digital Taxation

The USA opposes unilateral action to tax digital presence (see also **9.12 Taxation of Digital Economy Businesses**).

9.14 Taxation of Offshore IP

Though such provisions have been introduced, much of the focus in the USA relates to "outbound" transfers of intellectual property. As discussed previously, the use of intangible property (including transfers or licences of such intangible property) are subject to US transfer pricing principles and other provisions of the Code, which

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generally require the arm's-length standard to be satisfied (see **6.4 Use of Intangibles by Non-local Subsidiaries**). Accordingly, in the USA the consideration paid for an intangible asset (or use of an intangible asset) will be evaluated consistent with the statutory requirement that the consideration be commensurate with the income derived from exploitation of the intangible.

For US transfer pricing purposes, the owner of legally protected intangibles is the legal owner. However, in the case of non-legally protected intangibles, the owner is the party with "practical control" over the intangible (ie, the party that possesses legal ownership under intellectual property law or that holds rights constituting an intangible pursuant to contractual terms (such as a licence). When the legal ownership standard is inconsistent with "economic substance," these rules may be dismissed and the substance of the overall arrangement is given effect.

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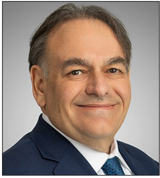

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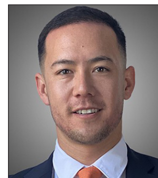

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Trends and Developments

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In late 2022, the United States Congress enacted two new significant tax provisions in connection with the Inflation Reduction Act of 2022 that each took effect as of 2023 – the 15% corporate alternative minimum tax (CAMT) and the 1% excise tax on corporate stock repurchases (the "Excise Tax"). Each of these is discussed in greater detail below.

The CAMT

The CAMT, which applies to tax years beginning after 31 December 2022, imposes a 15% minimum tax on the "applicable financial statement income" (ASFI) of an "applicable corporation" ("Applicable Corporation").

To be an Applicable Corporation, the corporation, together with every person treated as a single employer for US tax purposes with that corporation, must have aggregate average annual AFSI for the prior three taxable years in excess of USD1 billion. If the corporation is part of a foreign parented multinational group, then, for the corporation to be an Applicable Corporation, the overall group must meet the USD1 billion test and the corporation must have average AFSI for the prior three taxable years in excess of USD100 million. The starting point for determining AFSI is the net income or loss on the "applicable financial statement" (AFS), as defined in Section 451(b)(3) of the Internal Revenue Code of 1986 (the "Code"), of the corporation or, in the case of a group of entities (the "AFS Group"), the group's AFS. The net income or loss is then subject to a number of adjustments found in Section 56A of the Code to determine AFSI.

The IRS recently published guidance regarding the CAMT in Notice 2023-7, which, among other things, provided the following.

- Treatment of non-recognition transactions for calculating AFSI – the financial accounting treatment for purposes of the AFSI of a transaction that is subject to non-recognition treatment for US federal income tax purposes (eg, tax-free spin-offs under Section 355) should follow the US federal income tax treatment (ie, any financial accounting gain or loss resulting from the transaction is not taken into account for purposes of calculating AFSI of both the transferor and the acquirer). This may result in differences between financial accounting and AFSI that would need to be tracked.
- Treatment of recognition transactions for calculating AFSI – a recognition transaction is defined as any transfer, sale, contribution, distribution or other disposition of property treated for federal income tax purposes as resulting in gain or loss – essentially, anything that does not qualify as a non-recognition transaction. The recognition transaction rules are for most purposes a mirror image of the non-recognition transaction rules described above – ie, AFSI treatment follows US federal income tax treatment. Likewise, for purposes of this rule, each component transaction of an otherwise more comprehensive transaction must be examined separately for determining whether the transaction meets the definition of a recognition transaction.

- Impact of acquisitions on AFSI – if an acquirer acquires a corporation (or the assets of a corporation) or group of corporations (or the assets of the group), the acquirer will generally include the AFSI of such target corporation or group of corporations in its AFSI for purposes of applying the average AFSI tests. For purposes of determining who the acquirer is and who is the target in the transaction, Notice 2023-7 applies financial accounting standards and not tax rules.

If an acquirer acquires a corporation (or the assets of a corporation) or group of corporations (or the assets of a group of corporations) from another testing group, then the AFSI of the target group is allocated to the acquired corporation or corporation(s) (or the assets of such corporation or corporations) based on any reasonable allocation method selected by the target group. This AFSI is then combined with the acquirer's AFSI for purposes of applying the three-taxable-year period test. However, such allocation does not reduce the AFSI of the target group for purposes of the target group's test. Thus, the AFSI of the acquired corporation or group of corporations (or the assets of such corporation or corporations) is taken into account by both the acquiring and target groups for determining whether a taxpayer is an Applicable Corporation. Similar allocation rules apply when a corporation is distributed out of a testing group.

- Treatment of tax-consolidated groups – a consolidated group is treated as a single entity for purposes of computing AFSI for the group's status as an Applicable Corporation and for purposes of calculating AFSI for CAMT liability.
- Consequences of COD and emergence from bankruptcy – if cancellation of debt results in income on the AFS of an AFS Group, but the COD income is excluded for US federal income tax purposes, then financial accounting gain equal to the amount of excluded COD income is not taken into account for purposes of calculating the AFSI of the AFS Group for the taxable year in which the discharge of indebtedness occurs. Similar to the federal tax rules, the AFS Group's CAMT attributes must be reduced to the extent tax attributes are reduced under the relevant US federal income tax.

If emergence from bankruptcy results in gain or loss on the applicable financial statement of the AFS Group, such gain or loss is not taken into account for purposes of calculating AFSI of the group for the taxable year of the emergence from bankruptcy. In addition, any increase or decrease in the financial accounting basis of property (other than as a result of attribute reduction from excluded COD income as discussed above) is not taken into account for purposes of computing AFSI for any taxable year.

- Safe harbour method for determining applicable corporation status – taxpayers are allowed to make the determination of whether they are an Applicable Corporation without making certain adjustments to net income or loss on the taxpayer's AFS set forth in Section 56(A)(c) and (d) of the Code for calculating AFSI. However, under the safe harbour, the threshold average AFSI amount is lowered from USD1 billion to USD500 million, and from USD100 million to USD50 million, respectively.

The Excise Tax

The Inflation Reduction Act of 2022 enacted Section 4501 of the Code which imposes a 1% Excise Tax on the repurchase of corporate stock by a publicly traded US corporation (a "covered

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corporation") beginning after 31 December 2022. For purposes of the Excise Tax, the term "covered corporation" means any domestic corporation whose stock is traded on an established securities market (within the meaning of Section 7704(b)(1)). A covered corporation also includes any corporation that becomes a surrogate foreign corporation under Section 7874(a)(2)(B) after 20 September 2021.

Section 4501(c)(1) states that repurchases of stock of a covered corporation to which the Excise Tax may apply include the following two types of transactions:

- redemptions within the meaning of Section 317(b) with regard to the stock of a covered corporation (a "317(b) redemption"); and
- any transaction determined by the Secretary of the Treasury or their delegate to be economically similar to a 317(b) redemption.

The IRS recently published guidance regarding the Excise Tax in Notice 2023-2. Among other things, this notice provided the following guidance.

- Certain redemptions are not treated as repurchases of corporate stock for purposes of the Excise Tax – Section 4501 generally provides for the application of the Excise Tax to any Section 317(b) redemption. However, Notice 2023-2 provides an exclusive list of transactions that are not treated as repurchases (and therefore not subject to the Excise Tax) despite being treated as a Section 317(b) redemption. These include:
  (a) the receipt of proceeds with respect to transactions under Section 304(a)(1) (pursuant to which sales proceeds for the acquisition of stock of one corporation from another corporation where both buyer and target are under common control of the seller are treated as redemption proceeds from the acquirer); and
  (b) payments of cash by covered corporations in lieu of fractional shares in certain transactions that qualify under Section 368(a) or as a distribution to which Section 355 applies (or pursuant to the settlement of an option or similar financial instrument) where certain other conditions are satisfied.
- Transactions that are economically similar to a Section 317(b) redemption – Notice 2023-2 provides an exclusive list of repurchases that are treated as economically similar to a 317(b) redemption, which, subject to certain exceptions, are generally subject to the Excise Tax. These include:
  (a) for an acquisitive reorganisation, if the target corporation is a covered corporation, the exchange by the target corporation's shareholders of their target stock for reorganisation;
  (b) for a recapitalisation of a covered corporation that qualifies as a reorganisation under Section 368(a)(1)(E), the exchange by the corporation's shareholders of their stock;
  (c) for a reorganisation under Section 368(a)(1)(F) (an "F reorganisation") in which the target corporation is a covered corporation (or a covered surrogate foreign corporation), the exchange (deemed or actual) by the target corporation's shareholders of their stock;
  (d) for a split-off by a distributing corporation that is a covered corporation (or a covered surrogate foreign corporation), the exchange by the distributing corporation's shareholders of their distributing corporation stock for controlled corporation stock and, if applicable, other property (includ-

ing securities of the controlled corporation) or money; and
  (e) a complete liquidation of a covered corporation (or a covered surrogate foreign corporation) to which both Section 331 and Section 332 apply (provided however that the Section 331 distribution is a repurchase by a covered corporation and the Section 332 distribution is not).
- Certain repurchases of corporate stock treated as not economically similar to a 317(b) redemption for purposes of the Excise Tax – if a transaction is neither a Section 317(b) redemption nor economically similar to a Section 317(b) redemption, it will not be subject to the Excise Tax. Notice 2023-2 provides a non-exclusive list of transactions that are deemed not to be economically similar to a 317(b) redemption. These include complete liquidations to which either Section 331 or Section 332(a) (but not both) applies and that are not repurchases by the covered corporation (or the covered surrogate foreign corporation), and divisive transactions under Section 355 (that are not split-offs).
- Statutory exceptions – for purposes of computing the covered corporation's stock repurchase Excise Tax base, the fair market value of the stock repurchased by a covered corporation in a Qualifying Property Repurchase (defined below) is reduced to the extent that such repurchase is for property permitted by Sections 354 or 355 to be received without the recognition of gain or loss (the "Qualifying Property Exception"). Such repurchases include:
  (a) a repurchase by a target corporation as part of an acquisitive reorganisation;
  (b) a repurchase by a covered corporation (or a covered surrogate foreign corporation) as part of an E reorganisation;
  (c) a repurchase by a transferor corporation as part of an F reorganisation; and
  (d) a repurchase by a distributing corporation as part of a split-off (whether or not part of a D reorganisation) (each a "Qualifying Property Repurchase").
- The Qualifying Property Exception (as applicable) effectively negates in many circumstances the treatment of the transactions described above as purchases. Other exceptions include:
  (a) stock repurchases to facilitate contributions to employer-sponsored retirement plans;
  (b) repurchases by dealers in securities in the ordinary course of business;
  (c) repurchases by a RIC or REIT; and
  (d) repurchases treated as a dividend.
- Netting Rule – under the Netting Rule, the amount of stock repurchases subject to the Excise Tax with regard to a taxable year of a covered corporation is reduced by the aggregate fair market value of stock of the covered corporation (i) issued or provided to employees of the covered corporation or employees of certain related parties during the covered corporation's taxable year; and (ii) issued by the covered corporation to persons other than those described in clause (i) during the covered corporation's taxable year.

Notice 2023-2 provides an exclusive list of certain issuances that are disregarded for purposes of applying the Netting Rule. These issuances include, but are not limited to, distributions by a covered corporation of its own stock, stock issuances by a covered corporation to certain related parties, certain stock issuances to which the Qualifying Property Exception applies, deemed issuances pursuant to Section 304(a)(1), and issuances by a target corporation in transactions qualifying under Section 368(a)(2)(E).

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- Timing – generally, stock is treated as repurchased either at the time the ownership of the stock transfers to the covered corporation (or applicable acquirer) or, for purposes of an economically similar transaction, at the time the shareholders of the covered corporation (or covered surrogate foreign corporation) exchange their stock in the covered corporation (or covered surrogate foreign corporation).

The Year Ahead

Since the Inflation Reduction Act of 2022 was passed, taxpayers have had to navigate the complexities surrounding the CAMT and the Excise Tax, both from a compliance and ongoing operations standpoint. On 7 February 2023, in his State of the Union Address, US President Joe Biden called for an increase in the Excise Tax to 4%. If such increase were adopted, any Excise Tax liability would have heightened significance for covered corporations in their ongoing business operations and transactional tax planning. However, any such increase is unlikely at this juncture given it would need to be approved by the politically divided US Congress. Until further guidance or proposed regulations are issued, taxpayers can rely on Notices 2023-2 and 2023-7 to assist in their planning and compliance as they continue to adjust to the new legislation, which will continue to play a significant role in corporate tax law in the United States going forward.

USA TRENDS AND DEVELOPMENTS

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Weil Gotshal & Manges LLP was founded in 1931 and has provided legal services to the largest public companies, private equity firms and financial institutions for more than 90 years. Widely recognised by those covering the legal profession, Weil's lawyers regularly advise clients globally on their most complex litigation, corporate, restructuring, and tax and benefits matters. Weil has been a pioneer in establishing a geographic footprint that has allowed the firm to partner with clients wherever they do business. Weil's global tax department offers comprehensive knowledge of how the complex and continually evolving nature of tax law plays a crucial role in some of the most significant and high-profile domestic and cross-border transactions, restructurings and other commercial matters. The firm not only understands the nature of its clients' transactions, but also understands their businesses, and is a critical part of the team that works to accomplish each client's business goals.

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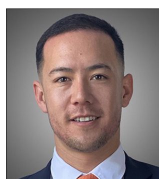

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