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Law and Practice

Contributed by:
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Weil, Gotshal & Manges LLP

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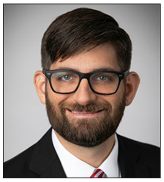

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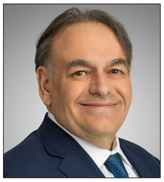

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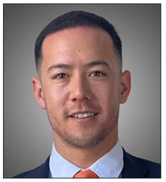

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1. Types of Business Entities, Their Residence and Basic Tax Treatment

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 on 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). Therefore, a corporation operating in the US could face a combined tax rate in excess of 21%. On average, corporations have paid a combined US federal, state and local corporate income tax rate of approximately 26%.

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%. Furthermore, 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 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 of 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 are generally 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 USA 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 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 to 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 if 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.

Regarding 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 disposition 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, telecommunications 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 certain 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; 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 – failure to do so 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 that 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 who 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.

Special withholding rules also apply in the cases of:

- dispositions of US real property interests; and
- partnerships (with foreign partners) having effectively connected income.

Dispositions of US real property interests are generally subject to the FIRPTA withholding rules, which generally require the transferee to withhold 15% on the total amount realised by the foreign person on such disposition (see **5.3 Capital Gains of Non-residents**). Partnerships (foreign or domestic) having income effectively connected with a US trade or business (or income treated as effectively connected) generally must pay a withholding tax on the effectively connected taxable income that is allocable to its foreign partners. The tax rate for such withholding varies depending on whether the foreign partner is a corporation or an individual. Currently, the withholding tax rate for effectively connected income allocable to non-corporate foreign partners is 37%, and is 21% for corporate foreign partners.

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. Of note, on 19 December 2023, the United States Department of the Treasury announced the entry into force of the tax treaty between the USA and Chile. The USA-Chile treaty is only the second comprehensive bilateral tax treaty that the USA has with a South American country (the other country being Venezuela). In addition, the USA-Hungary income tax treaty was terminated, effective on 8 January 2023. However, in accordance with Article 26 (Termination) of the convention, the treaty ceased to have effect with respect to tax withheld at source on amounts paid or credited on or after 1 January 2024. For other taxes, the treaty ceased to have effect with respect to taxable periods beginning on or after 1 January 2024.

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, taxpayers may be subjected 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 USA's aggressive transfer pricing regime 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 Programme (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 and 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 accordance 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, they 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 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, certain entities subject to specialised tax regimes, 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).

Certain special rules apply for outbound transfers of intangible property (eg, intellectual property) by a US person to a foreign corporation in certain specified transactions. Generally, under these rules, when a US person transfers intangible property to a foreign corporation in an otherwise tax-free exchange under US tax law, the US transferor is treated as having sold the intangible property in exchange for annual royalty payments over the useful life of the intangible property (or a lump sum payment in the case of a disposition of the intangible property following the initial outbound transfer). The US transferor treats such annual inclusion and lump sum as ordinary income and royalties for purposes of determining source and the foreign tax credit limitation category.

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 (currently ranging from 10.5% to 13.125%, but expected to increase to a range of 13.125% to 16.406% starting in 2026), 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 USA 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), 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

The OECD BEPS project has been continuously evolving to develop an agreement on a two pillar approach to help address tax avoidance, ensure coherence of international tax rules, and a more transparent tax landscape. Pillar One, which applies to large multinationals, will reallocate certain amounts of taxable income to certain impacted jurisdictions, resulting in a change in effective tax rate and cash tax obligations, as well as impacting on transfer pricing arrangements. Pillar Two, in contrast, aims to ensure that income is taxed at an appropriate rate and has several mechanisms to ensure tax is paid.

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 owing 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**).

The USA is still working on finalising tax regulations under the various tax provisions enacted in 2017, many of which are consistent with the BEPS recommendations. More recent legislative proposals (generally modifying the provisions introduced in 2017 and/or aligning with the minimum tax and undertaxed profits rules under Pillar Two of BEPS) have not been adopted. It is worth noting that, in the context of Pillar Two's implementation guidance, the USA has been largely successful in getting favourable treatment from the OECD for GILTI and transferrable energy credits, but is seeing more difficulty in gaining relief for the non-refundable research and development tax credit. This development sets the stage for subsequent rounds of negotiations between the USA and OECD as to whether Pillar Two taxes are creditable against US tax.

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 taken great strides towards 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.

Currently, implementation of Pillar Two in the US remains stalled. Passage of law to align the US international tax regime with Pillar Two appears unlikely in the short term, though this could change based on upcoming elections and developments at the international level. The implementation of Pillar Two taxes abroad could have a significant impact on US companies, though transition relief will blunt the impact in the near term. The level of urgency for legislative efforts will ultimately come down to how potential double taxation affects US companies, and what impact compliance with the international agreement has on the overall US corporate tax base.

9.3 Profile of International Tax

Owing 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 engaging with the international community on the various BEPS Action Programmes 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. These include the following:

- 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 a CFC regime in place (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 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, 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 to 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, and 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 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.

Trends and Developments

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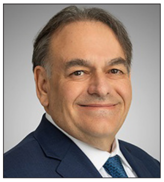

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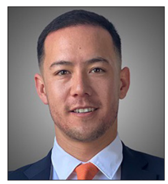

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In 2023, the Treasury Department (the "Treasury") and the Internal Revenue Service (IRS) issued proposed regulations under Section 367(b) and Section 367(d) of the Internal Revenue Code (the "Code"). Each such set of proposed regulations is described in further detail below.

Proposed Rules Aimed at Triangular Reorganisations and Inbound Non-recognition Transactions – Section 367(b)

The Treasury and the IRS issued long-awaited proposed regulations under Section 367(b) providing guidance on the use of property to acquire parent stock or securities in connection with certain cross-border triangular reorganisations, colloquially referred to as "Killer B" transactions (the "Proposed 367(b) Regulations"). These Killer B transactions generally had the effect of allowing a foreign subsidiary ("foreign acquirer") to effectuate a tax-efficient repatriation of cash or other property to its corporate shareholder ("parent") via the use of such cash or property to acquire parent stock, which is then used by the foreign acquirer to acquire another corporate entity ("foreign acquired corporation") in a triangular reorganisation.

The Proposed 367(b) Regulations modify regulations previously announced and largely adopt the rules described in Notice 2014-32 (the "2014 Notice") and Notice 2016-73 (the "2016 Notice"). The 2014 Notice contained rules to address aspects of these Killer B transactions which the Treasury identified as exploiting certain aspects of final regulations published on 19 May 2011 under Section 367(b) (the "2011 Final Regulations"). The 2016 Notice contained additional guidance for addressing subsequent variations of the Killer B transactions that arose after the 2014 Notice, which the Treasury identified as exploiting the 2011 Final Regulations (as modified by the rules announced in the 2014 Notice); and the Treasury announced that additional regulations would be issued under Section 367.

The Proposed 367(b) Regulations generally adopt the rules set forth in the 2014 and 2016 Notices, with modifications.

Explanation of Proposed Regulations

Generally, the modifications to the 2014 and 2016 Notices include but were not limited to:

- narrowing the potential scope of the excess asset basis rules (described below);
- providing clarity on the definition of "specified earnings" that are included in the all earnings and profits (E&P) amount upon an inbound transaction;
- modifying the priority rules to take into account the extent to which a distribution would give rise to an inclusion under Section 951A(a) that would be subject to US tax (even though it is unlikely that a distribution from the subsidiary to the parent corporation would give rise to a Section 951A(a) inclusion); and
- certain other adjustments.

Excess asset basis and specified earnings

Certain variations of the Killer B transactions that arose following Notice 2014-32 involved a triangular reorganisation where the parent was a foreign entity followed by a subsequent inbounding of a parent (which had the effect of bringing the foreign acquirer's cash, but not E&P, into the USA). To address these, Notice 2016-73 proposed a number of rules (the "excess asset basis" rules) which would have the result of including a foreign acquirer's earnings in the all E&P amount that is potentially subject to tax upon the inbounding of a foreign parent. The Proposed 367(b) Regulations would provide that an exchanging shareholder of the foreign acquired

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corporation – ie, a foreign parent – computes its amount of all E&P after accounting for the effects of a deemed distribution from the foreign subsidiaries of the foreign acquired corporation to the foreign acquired corporation. The deemed distribution, which occurs immediately before the inbound non-recognition transaction, would be equal to the amount of "specified earnings" – this would be defined under the Proposed 367(b) Regulations as the lesser of:

- the aggregate E&P of foreign subsidiaries of the foreign acquired corporation (with no exclusion for those E&P characterised as previously taxed E&P or PTEP); and
- the excess asset basis of the foreign acquired corporation.

Priority rule

The Proposed 367(b) Regulations adopt the guidance set forth in the 2016 Notice by modifying the priority rule under Treasury Regulations Section 1.367(b)-10(a)(2)(iii), such that it will continue to apply only when the target is a domestic corporation. The Proposed 367(b) Regulations also modify the priority rules to take into account the extent to which a distribution would give rise to an inclusion under Section 951A(a) that would be subject to US tax.

Other applications

In addition to the above, the Proposed 367(b) Regulations would (among other things) have the following effects.

- Modify the definition of "foreign subsidiary" to be based on the ownership rules in Section 1248(c)(2)(B).
- Apply to the exchange of a foreign target corporation's stock that occurs in connection with an applicable triangular reorganisation, in requiring all shareholders of the target corporation to:
  (a) include in income as a deemed dividend the Section 1248 amount regarding the target stock exchanged; and
  (b) after taking into account the increase in basis resulting from the deemed dividend, recognise all realised gain regarding the stock that would not otherwise be recognised.

Reporting and applicability dates

The Proposed 367(b) Regulations would also modify the reporting requirements under Treasury Regulations Section 1.367(b)-1(c), to require corporations that acquire stock or securities of the parent corporation in a transaction described in the Final Regulations to disclose such acquisitions by attaching a Section 367(b) notice (within the meaning of Treasury Regulations Section 1.367(b)-1(c)) to the corporation's tax return (or Form 5471, as applicable) for the year in which the stock or securities of the parent corporation are acquired.

With respect to those rules described in the 2014 Notice, the Proposed 367(b) Regulations would generally be applicable to transactions completed on or after 25 April 2014, subject to limited exceptions. For those rules described in the 2016 Notice, the Proposed 367(b) Regulations would generally be applicable to transactions completed on or after 2 December 2016.

Proposed Rules on the Repatriation of Intangible Property – Section 367(d)

Section 367(d) of the Code provides rules for outbound transfers of intangible property (eg, intellectual property) by a US person (a "US transferor") to a foreign corporation. Under these rules, when a US transferor transfers intangible property to a foreign corporation in an otherwise tax-free exchange, the US transferor is treated as having sold the intangible property in exchange for annual royalty payments (an "annual inclusion") over the useful life of the intangible property (or a lump sum payment in the case of a disposition of the intangible property following the initial outbound transfer). The US transferor treats the annual inclusion and lump sum as ordinary income and royalties for purposes of determining source and the foreign tax credit limitation category.

Notably, the existing Final 367(d) Regulations provide rules addressing a subsequent transfer of the intangible property; the tax consequences of such transfer depend on whether the transferee is related or unrelated (within the meaning of Sections 267 and 707, with some modifications) to the US transferor. If the new transferee is unrelated, the US transferor is required to recognise gain (but not loss) equal to the fair market value of the intangible property (determined as of the date of the subsequent disposition), minus the US transferor's basis in the intangible property (determined as of the date of the initial transfer). If the new transferee is related, the same annual inclusion payment method applicable to the initial transfer will continue to apply, with the new transferee substituting as the initial foreign transferee corporation, even if the new transferee is a US person. Thus, subsequent transfers of the intangible property to related US persons potentially result in a double inclusion of income. The Treasury and the IRS believe that continuing to apply Section 367(d) in such cases would give rise to excessive US taxation and disincentivise taxpayers from repatriating that property.

To address this concern, on 2 May 2023, the IRS and the Treasury released a new set of proposed regulations (the "Proposed 367(d) Regulations"), which, in certain cases, would terminate the continued application of certain provisions of the existing Final 367 Regulations arising from a previous transfer of intangible property to a foreign corporation when the intangible property is transferred to certain US persons (such transfer of the intangible property back onshore is referred to below as a "repatriation" of such property). A brief discussion of the core changes made by the Proposed 367(d) Regulations follows.

General repatriation consequences

The Proposed 367(d) Regulations generally terminate the application of Section 367(d) to a prior transfer of intangible property if the transferee foreign corporation repatriates the intangible property to a "qualified domestic person" and if certain reporting requirements are satisfied. If the repatriation and reporting requirements are satisfied, the Proposed 367(d) Regulations require the US transferor to include in gross income a partial annual inclusion attributable to the part of its taxable year in which the transferee foreign corporation held the intangible property, after which the intangible property is no longer subject to Section 367(d) (thus, the annual inclusion stream terminates).

Gain recognition rule

The Proposed 367(d) Regulations also require the US transferor to recognise gain (the amount of which may be zero in certain cases) as a result of the repatriation. The manner in which the repatriation occurs will determine whether the US transferor must recognise gain in connection with the repatriation transaction, with corresponding adjustments made by the transferee foreign corporation.

Specifically, the gain recognition rule focuses on whether the intangible property is transferred basis property by reason of the repatriation, without regard to the application of Section 367(d) and the existing Final 367 Regulations. If the intangible property is transferred basis property, the amount of gain the US transferor will recognise pursuant to the gain recognition rule is the amount of gain the transferee foreign corporation would recognise, if any, upon the repatriation under general subchapter C rules if its adjusted basis in the intangible property were equal to the US transferor's former adjusted basis in the property. However, if the intangible property is not transferred basis property by reason of the repatriation, the amount of gain a US transferor will recognise pursuant to the gain recognition rule is the excess, if any, of the fair market value of the intangible property on the date of the repatriation over the US transferor's former adjusted basis in the property.

Required adjustments related to certain recognised gain

In order to prevent excessive E&P and gross income regarding the transferee foreign corporation, the Proposed 367(d) Regulations provide certain adjustments to the transferee foreign corporation's E&P and gross income that arise by reason of any gain the US transferor recognises under the gain recognition rule or the existing Final 367 Regulations. Pursuant to these adjustments, the transferee foreign corporation reduces (but not below zero) the portion of its E&P and gross income arising from the transaction, to take into account the gain recognised by the US transferor.

Required adjustments related to the annual inclusion

The Proposed 367(d) Regulations clarify the existing Final 367 Regulations by confirming that the deemed payment is treated as an allowable deduction, which can be allocated and apportioned under Treasury Regulations Sections 1.882- 4(b)(1), 1.954-1(c), and 1.960-1(c) and (d) (as appropriate), potentially to any class (or classes) of gross income (as appropriate) rather than solely to gross income subject to subpart F in all circumstances.

Section 904(d) foreign branch income rule

Section 904 and the regulations promulgated thereunder (the "Section 904 Regulations") provide, in relevant part, that the principles of Section 367(d) apply for determining gross income that is attributable to a foreign branch that must be adjusted under the Section 904 Regulations. In general, the Section 904 Regulations adjust the attribution of gross income when disregarded payments are made between a foreign branch and a foreign branch owner, or between foreign branches. Disregarded remittances or contributions, however, do not result in the reattribution of gross income.

Accordingly, when a disregarded transaction with a foreign branch may be structured as either a remittance or contribution on the one hand, or as a sale, exchange or licence on the other hand, the amount of gross income attributed to a foreign branch could be manipulated. If there are multiple transfers of an item of intangible property over time, each transfer must be separately evaluated and could result in differing amounts of deemed annual payments depending on any interim changes in the value of the intangible property between successive transfers.

The Proposed 367(d) Regulations provide that each successive transfer to which the Section 904 Regulations apply should be considered independently from any other transfers. Therefore, the subsequent transfer rules in the existing final regulations under Section 367(d), including the rule for repatriations provided in these Proposed 367(d) Regulations, do not apply in the context of determining gross income attributable to the foreign branch income category, and each successive transfer is separately subject to the provisions of the Section 904 Regulations and will not terminate or otherwise impact on their application to a prior transfer described in that paragraph.

Other modifications and reporting

The Proposed 367(d) Regulations eliminate Treasury Regulations Section 1.951A-2(c)(2)(ii), which provides that deductions taken into account in determining a CFC's tested income and tested loss under Section 951A include the amount of a deemed payment under Section 367(d)(2)(A). This rule is no longer necessary because the Proposed 367(d) Regulations provide that such deemed payments are treated as allowable deductions in accordance with, in relevant part, Treasury Regulations Section 1.951A-2(c)(3).