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## WHITE PAPER

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### The U.S. Tax Cuts and Jobs Act: Fundamental Changes to Business Taxation

Signed into law December 22, 2017, the “Tax Cuts and Jobs Act” represents the most comprehensive reform to the U.S. federal tax code in a generation. The Act’s most notable provisions include significant reductions in both corporate and individual tax rates, the immediate expensing of 100 percent of the cost of certain business assets, a deduction for certain categories of pass-through income, and the creation of a partially territorial system that no longer taxes U.S. corporations on all of their worldwide income. Other changes involve limits on state and local tax deductibility, curbs on mortgage interest deductions, an increase in the estate tax exemption, and the effective repeal of the Affordable Care Act’s individual health insurance mandate.

This Jones Day *White Paper* explains, in general terms, the principal business, international, and individual tax reforms contained in the Act.

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On December 22, 2017, President Trump signed into law H.R. 1, the tax reform bill commonly referred to as the “Tax Cuts and Jobs Act” (“Act”). This sweeping legislation makes the most significant changes to the U.S. tax laws in a generation. In particular, the Act fundamentally alters the U.S. taxation of business income, including creating a partially territorial tax system, no longer taxing U.S. corporations on all of their worldwide income. In addition to lowering tax rates for both individuals and corporations, the Act will have a profound impact on taxpayer decisions regarding choice of entity, supply chain structuring, management incentives, and the location of intellectual property. Most of the Act’s provisions are immediately effective for the 2018 tax year. Many, however, are temporary and scheduled to sunset (or otherwise be modified or phased out) in future years. Also, many of the new provisions are complex, and the impact of many provisions in the Act may differ depending on each taxpayer’s situation. For these reasons, this *White Paper* describes, in general terms, the primary business, international, and individual tax reforms and changes contained in the Act. Each taxpayer will need to analyze the applicable provisions to determine their impact in its particular circumstances.

## BUSINESS TAX REFORMS

### Change to Corporate Tax Rate

The Act reduces the corporate income tax rate, set forth in section 11, from 35 percent to 21 percent, generally effective for taxable years beginning after December 31, 2017,<sup>1</sup> and eliminates all brackets and graduated rates applicable to corporate income under prior law. The Act also repeals the separate tax rate applicable to personal service corporations and eliminates the corporate alternative minimum tax (“AMT”).

*This lower corporate rate is the centerpiece of the tax reform plan and is intended to have significant beneficial effects on the U.S. economy. The new statutory rate is designed to be more competitive with the corporate tax rates of other countries and may incentivize more taxpayers to use U.S. corporations for many types of activities and investments.*

*Certain entities not taxed as corporations still retain some advantages over corporations notwithstanding the lower corporate rate, however. For example, as depicted in the chart below, certain business owners operating through partnerships and sole proprietorships and shareholders of real estate*

*investment trusts (“REITs”) would still be expected to have a lower cumulative U.S. federal tax burden on most income that is earned at the entity level and then distributed or allocated.*

	Corporation	Pass-through Entity
Entity-Level Tax	21%	0% <sup>2</sup>
Maximum Tax on Distribution / Allocation to Owner	23.8% <sup>3</sup>	29.6% <sup>4</sup>
Cumulative Tax Burden	-39.8%	29.6%

*If an investor does not plan to receive distributions during the life of an investment and instead pursues a “hold-and-sell” strategy, or if the pass-through deduction or REIT requirements cannot be met, holding an investment in corporate form may now be a more attractive structure than it previously had been.*

### Deduction for Pass-Through Income

Under new section 199A of the Internal Revenue Code (“Code”), the Act permits individuals (as well as certain trusts and estates) that own a business through a pass-through entity (e.g., a partnership, LLC treated as a partnership, or S corporation), or as a sole proprietorship (held directly or through a disregarded entity, such as a single member LLC that is disregarded), to take a deduction of up to 20 percent for their domestic qualified business income (“QBI”) earned directly or through such entity. In addition, taxpayers are generally allowed a 20 percent deduction for qualified REIT dividends, qualified publicly traded partnership income, and qualified cooperative dividends. The provision is applicable to taxable years beginning after December 31, 2017, and before January 1, 2026.

The amount of the deduction available to any particular taxpayer depends on the taxpayer’s taxable income and QBI, and it may also depend on characteristics of the relevant business. In general, QBI includes income effectively connected with a qualified trade or business in the United States, but it does not include investment-type income (e.g., dividends, interest, and capital gains), reasonable compensation for services, guaranteed payments, or certain payments made to a partner in a non-partner capacity. A qualified trade or business is any trade or business other than a specified service trade or business (“Specified Service Exception”). In general, a specified service trade or business includes any trade or business involving the performance of services in the fields of health, law, accounting,

consulting, financial services, brokerage services, actuarial science, athletics, or the performing arts, as well as any trade or business involving the performance of investing or investment management services, trading or dealing in securities, partnership interests, or commodities, or any trade or business where the principal asset is the reputation or skill of one or more employees.

The 20 percent deduction for QBI with respect to any qualified business is capped at an amount equal to the greater of: (i) 50 percent of the taxpayer's allocable share of the qualified business's W-2 wages; or (ii) the sum of 25 percent of the taxpayer's allocable share of the qualified business's W-2 wages paid with respect to such trade or business plus 2.5 percent of the taxpayer's allocable share of the qualified business's unadjusted bases of depreciable property, immediately after acquisition, of all depreciable property used in the qualifying trade or business ("Wage/Basis Cap"). This second limitation, however, does not apply to income from publicly-traded partnerships or to taxpayers whose taxable income does not exceed \$315,000 for taxpayers filing a joint return (or \$157,500 in other cases).

The Specified Service Exception and Wage/Basis Cap: (i) do not apply to taxpayers with taxable income of \$157,500 or less, or \$315,000 for joint filers ("threshold amount"); (ii) are phased in for taxpayers with taxable income between \$157,501 and \$207,500 (\$315,001 and \$415,000 for joint filers); and (iii) are fully applicable for taxpayers with taxable income in excess of \$207,500 (\$415,000 for joint filers).

*Many pass-through businesses are organized with multiple tiers and their wages are allocable to multiple lines of business. This can complicate the determination of the deduction with respect to each business. Taxpayers may desire to restructure their tiered-entity businesses and other arrangements (such as the allocation of wages among business lines). The Act's broad definition of the "Specified Service Exception," which includes "any trade or business where the principal asset is the reputation or skill of one or more of its employees," arguably sweeps into the exception any business with highly skilled employees or whose principal asset is the skill, reputation, or know-how of specific employees. Read in this way, the*

*Specified Service Exception is overbroad. Further guidance is needed to clarify the limits of this exception.*

*Alternatively, the provision allows taxpayers to look to W-2 wages and the business's unadjusted bases of depreciable property. This alternative approach is generally expected to benefit specific industries such as real estate and other businesses involving heavy capital investment and lighter payrolls.*

### **Limitation on Interest Expense Deductions**

Section 163(j), as amended by the Act, subjects all taxpayers to a new limitation, equal to 30 percent of adjusted taxable income, on the deductibility of its net business interest expense. The provision is effective for taxable years beginning after December 31, 2017, and has no "grandfather" provision for debt issued prior to the effective date. For purposes of this provision, "business interest" is any interest paid or accrued on debt properly allocable to a trade or business. Neither investment interest expense nor investment income is taken into account for purposes of this limitation.<sup>5</sup> Section 163(j) does not apply to taxpayers with average annual gross receipts of \$25 million or less, nor does it apply to the trade or business of performing services as an employee, certain energy production- and transportation-related businesses, and, provided the taxpayer so elects, certain real property and farming businesses. Further, certain interest expense incurred by automobile, boat, and farm machinery and equipment dealers is not subject to section 163(j)'s interest deduction limitation.

Subject to the exceptions discussed below, no deduction is allowed for net business interest expense in excess of 30 percent of a taxpayer's adjusted taxable income. For this purpose, "adjusted taxable income" is taxable income computed without regard to: (i) any items of income, gain, deduction, or loss not properly allocable to a section 163(j) trade or business; (ii) business interest expense and business interest income; (iii) net operating losses ("NOLs"); (iv) any newly enacted pass-through deduction for QBI under section 199A (primarily applicable to individuals and discussed above); and (v) solely for taxable years beginning prior to January 1, 2022, any deduction for depreciation, amortization, or depletion. Any disallowed amounts may be carried forward indefinitely, but such carryforwards will be limited in the event of a section 382 ownership change.

For partnerships, the limitation on deductibility of net business interest expense is determined at the partnership level based on the adjusted taxable income of the partnership. In applying the 30-percent limitation to business interest incurred at the partner level, the partner's adjusted taxable income will be determined without regard to items allocated to the partner by a partnership to avoid double counting. If, however, the 30-percent limitation applicable to a partnership exceeds the net business interest expense of the partnership, then the limitation of each partner will be increased by the partner's share of such excess. Similar principles apply to S corporation interest expense. Additionally, special rules apply to carryforwards of disallowed partnership interest.

*This new limitation on interest deductibility may result in an overall reduction in borrowing by businesses, particularly in conjunction with lower tax rates. This could narrow the cost gap between debt and equity. The most noticeable impact might be expected in private equity and leveraged buyout deals due to recent trends of higher leverage ratios, lower interest coverage ratios, and lower tax bills. There is also an increased likelihood that private equity acquisitions and leveraged buyouts will be structured with more preferred equity financing. With lower tax rates and limited interest deductibility in the United States, we expect U.S.-based multinational groups to borrow more at the foreign-subsidiary level; the limitation on deductibility applies to foreign taxpayers subject to U.S. tax, but generally has limited effect on foreign subsidiaries with wholly non-U.S. operations. The deductibility threshold will convert from EBITDA to EBIT in 2022, which may significantly increase interest disallowance.*

*We note that new section 163(j) does not treat all members of a consolidated group as a single taxpayer for purposes of calculating the interest deduction limitation. Interestingly, despite the absence of such a rule in the House and Senate proposals as well as the Act itself, the conference report provides that “[i]n the case of a group of affiliated corporations that file a consolidated return, the limitation applies at the consolidated tax return filing level.”<sup>6</sup> We understand that Treasury is aware of the issue and expect Treasury will provide relief via future guidance.*

### **Expanded Expensing**

The Act temporarily modifies section 168(k) to allow deduction of up to 100 percent of the cost of certain business assets

placed in service after September 27, 2017, by increasing the deduction available under the existing “bonus depreciation” regime. Like the existing regime, this 100-percent expensing applies only to “qualified property,” which generally includes certain tangible personal property with a recovery period of 20 years or less, certain computer software, and certain water utility property. The Act also adds certain qualifying film, television, and theater productions to the definition of “qualified property” and removes qualified improvement property (e.g., certain improvements to nonresidential buildings), which generally becomes subject to a 15-year recovery period, discussed below.<sup>7</sup> Notably absent from the definition of “qualified property” for bonus depreciation purposes (under both prior law and the Act) are most intangibles and real property.

Significantly, the Act includes in the definition of “qualified property” certain used property acquired and placed in service by the taxpayer, provided the buyer and seller are not related (generally using a 50 percent-related threshold for entities), the property is not acquired in a carryover basis transaction, and the buyer has not previously used the acquired property.

*This benefit may incentivize U.S. taxpayers to engage in asset sales and taxable stock sales subject to section 338 elections, eliminating some of the income tax friction between stock and asset sales. This change may be somewhat industry-specific, as “qualifying property” continues to be defined primarily as tangible personal property. Thus, transactions involving targets that do not hold a significant proportion of tangible personal property may be relatively unaffected (such as any transaction involving the acquisition of a target with value primarily derived from amortizable intangible property ineligible for expensing under modified section 168(k)). Further, in light of the repeal of section 1031 like-kind exchange treatment for assets other than real property, discussed below, we question whether otherwise eligible assets placed in service prior to September 28, 2017, may be swapped between unrelated parties to enable each party to use the expensing benefit.*

This increased expensing benefit is temporary under the Act. Generally, the percentage of basis for which a deduction may be taken declines by 20 percent each year after 2022 and reaches zero percent by 2027. Deductions for assets placed in service on or prior to September 27, 2017 that are subject to the old bonus depreciation regime are also phased out.

Like many of the other sunset provisions in the Act, however, it is not clear whether these phaseouts will be permitted to occur. Historically, Congress has repeatedly extended and revised the bonus depreciation regime. Deductions for assets acquired on or before September 27, 2017, but placed in service after such date are also partially limited.

The Act also increases the small business expense deduction available under section 179, which generally permits a taxpayer to expense fully up to approximately \$500,000 in qualifying property placed in service in a particular taxable year. Under prior law, this benefit is phased out if the taxpayer places qualifying property of more than about \$2 million in service in a single year. Under the Act, these limits are permanently increased to full expensing for \$1 million of qualifying property, with a phaseout starting at \$2.5 million of property placed in service.

### Depreciation Rules

For property placed in service after December 31, 2017, the Act eliminates the separate definitions of “qualified leasehold improvement,” “qualified restaurant improvement,” and “qualified retail improvement” property. The Act provides a general 15-year recovery period for such “qualified improvement property,” and a 20-year alternative depreciation system (“ADS”) recovery period.

For residential rental property placed in service after December 31, 2017, the Act provides that the ADS recovery period is shortened from 40 years to 30 years. The Act maintains the present law general modified accelerated cost recovery system (“MACRS”) recovery periods of 39 years and 27.5 years for non-residential and residential rental property, respectively.

Additionally, the Act requires that any trade or business involved in real property that elects to be excluded from certain limitations on the deductibility of interest must use the ADS periods for depreciating its real property.

### New NOL Limitations

The Act amends section 172 to limit a taxpayer’s deduction for NOLs in a particular taxable year to 80 percent of the taxpayer’s taxable income for that year. NOLs may now be carried forward indefinitely under the Act but generally cannot be carried back to prior taxable years.

The annual NOL usage limitation set forth in the amendment to section 172 applies to losses arising in taxable years beginning after December 31, 2017. The changes to carryforwards and carrybacks, however, apply to losses arising in taxable years ending after December 31, 2017.<sup>8</sup>

*For non-calendar year taxpayers, this start date may cause the new carryback and carryforward rules to apply to NOLs arising in the last fiscal year prior to the Act’s passage. For instance, if a taxpayer’s taxable year ends on March 31, 2018, the changes to the carryforward and carryback rules would apply to NOLs arising in the period from April 1, 2017, through March 31, 2018. NOL carryforwards from years prior to the Act’s effective dates appear to be subject to the law as in effect before the Act—a welcome change from the Senate proposal. Further, under the unchanged NOL ordering rules, pre-2018 NOLs (i.e., NOLs not subject to the 20 percent haircut) are applied prior to post-2017 NOLs.*

*The repeal of NOL carrybacks is an unexpected policy decision, as carrybacks have at times been cited as providing an economically beneficial countercyclical effect (i.e., when a company’s business declines, it can receive a benefit in the same taxable year by carrying back its NOL to claim a refund of previously paid taxes). These carryback-limitation rules do not apply to certain farming activities or to property and casualty insurance companies.*

The Act’s NOL usage limitation effectively retains and amplifies an aspect of the corporate AMT, which was repealed in the Act. Under the AMT, a corporation previously could not use NOLs against more than 90 percent of its alternative minimum taxable income for the year.

### Carried Interest

In general, a person receiving a partnership interest in exchange for services, often called a “carried interest” or “profits interest,” is treated as a partner on receipt of the interest and, when the partnership recognizes a capital gain (for instance, if it sells a capital asset), the carried interest holder recognizes its distributive share of the partnership’s capital gain. If the partnership holds a capital asset for more than one year before selling it, the gain from the sale generally is long-term capital gain, which flows through to the carried interest holder and is taxed at the

preferential long-term capital gains rate for individuals (generally a maximum federal rate of 23.8 percent).

The Act adds a new section 1061, which changes this treatment slightly by preventing a carried interest holder from receiving long-term capital gains from partnership sales of capital assets held for less than three years (or, potentially, from the interest holder's sale of the interest itself within three years of receipt). Two provisions appear intended to focus this rule on investment funds: (i) the new three-year requirement applies only to carried interests granted in certain investment-related businesses; and (ii) the Act calls for regulations to be issued exempting assets "not held for portfolio investment on behalf of third party investors." Several other exceptions can also apply, and the new provision contains a variety of technical rules and definitions. Importantly, the Act does not change the general U.S. federal income tax treatment of carried interests and in particular does not appear to alter the treatment of carried interests under section 83 or to cause the grant of a carried interest to be treated as compensation for services issued by the partnership to an individual acting in a non-partner capacity under the rules of section 707(a)(2)(A).

*This change, which applies to taxable years beginning after December 31, 2017, will have varying impacts on fund managers due to the business realities of the industries in which most carried interests are granted. Private equity fund managers will likely be less affected by this change because private equity funds routinely hold investments for longer than three years. Hedge funds managers whose funds invest in more liquid assets may have a harder time meeting the three-year-holding-period requirement. Generally, the change also does not apply to carried interests issued to executives and managers outside the investment fund industry.*

### Technical Terminations of Partnerships

Under pre-2018 section 707(b)(1)(B), an entity treated as a partnership for U.S. federal income tax purposes (including most limited liability companies with multiple members) was treated as "terminating" if 50 percent or more of the capital and profits interest in the partnership were sold or exchanged during any rolling 12-month period. If a technical termination resulted, the partnership was treated as contributing all of its assets to a new partnership, followed by the terminating partnership's liquidation. Such a termination had certain tax law effects, and in particular reset the depreciation schedule (the tax life but not

the adjusted tax basis) of the assets of the "terminated" entity. For instance, if a partnership owned a 10-year asset acquired for \$100, took annual \$10 depreciation deductions for five years, and then technically terminated due to one or more partners selling their partnership interests, the partnership would be required to depreciate the asset's remaining \$50 basis over a new 10-year period, yielding \$5 in annual deductions for 10 years (rather than \$10 in annual deductions for five years).

The Act eliminates the technical termination rule for partnership taxable years beginning after December 31, 2017.

*This change will generally benefit partnerships, including those engaged in M&A transactions—a frequent technical termination culprit—because depreciation schedules will not be extended by a partnership interest sale. There were, however, certain benefits to the treatment of a technical termination as creating a new entity in the hands of the buyer, including a closing of the partnership's taxable year as a result of the sale. Some of these benefits may still be achieved through use of an interim closing of the books method to determine partnership distributive shares under section 706, but this will not eliminate straddle periods for issues such as control of tax controversies. Many partnership agreements may contain transfer limitations to prevent "technical terminations." Taxpayers may also want to review their agreements and amend them to remove or modify these types of transfer limitations, which could now be more restrictive than necessary.*

### Additional Partnership Changes

**Statutory Override of *Grecian Magnesite* Decision.** The Act amends section 864(c) to provide that, on or after November 27, 2017, a foreign partner's sale or exchange of an interest in a partnership that is engaged in a U.S. trade or business generally will be subject to U.S. taxation to the extent that such partner would have effectively connected gain or loss if the partnership had sold all of its assets. This change generally codifies the "look-through" approach taken in Revenue Ruling 91-32 and overrides the Tax Court's recent decision in *Grecian Magnesite Mining v. Commissioner*, which held that such (non-FIRPTA) gain recognized by a foreign partner was exempt from U.S. tax.<sup>9</sup>

The Act adds a new withholding rule under section 1446, which imposes a new 10 percent withholding tax on amounts realized (which could exceed the consideration received) by foreign transferors of partnership interests subject to these

new rules, unless the transferee receives an appropriate certification that the transferor is a U.S. person. If the transferee fails to withhold the required amount, the partnership must withhold that amount, plus interest, from distributions to the transferee partner. The new withholding requirement applies to sales, exchanges, and dispositions of partnership interests made after December 31, 2017. On December 29, 2017, the IRS announced in Notice 2018-8 that it is temporarily suspending withholding on dispositions of some publicly traded partnership interests and intends to issue regulations or other guidance addressing these dispositions. The Act grants Treasury broad authority to issue regulations to enforce these new rules, including by providing for additional exceptions and reduced withholding in appropriate situations.

**Amended Definition of “Substantial Built-In Loss” for Partnership Interest Transfers.** In general, a partnership must make certain adjustments upon a transfer of an interest in the partnership in order to reduce or eliminate any difference between the new partner’s share of the partnership’s inside basis and the new partner’s outside basis. Under prior law, if a partnership did not make a section 754 election (many investment funds do not, for example), an inside basis adjustment generally occurred if the partnership had a “substantial built-in loss” after the transfer, which meant that the partnership’s aggregate inside basis had to exceed the aggregate fair market value of the partnership’s assets by at least \$250,000. The required adjustment seeks to prevent taxpayers from receiving a double tax benefit from depreciated partnership assets—such as if a partner sold a partnership interest at a significant loss without an inside basis adjustment, and then the partnership sold its depreciated assets at a significant loss and allocated the loss to its partners, including the new partner.

The Act amends section 743(d) to provide that, with respect to transfers of partnership interests occurring after December 31, 2017, a “substantial built-in loss” will also exist if the new partner would be allocated a loss of \$250,000 or more upon a hypothetical sale of all of the partnership’s assets (even if the partnership does not have an overall built-in loss in its assets). Such a situation could arise where built-in gain on a particular asset is allocated to one or more existing partners; the built-in gain would reduce the difference between the partnership’s aggregate inside basis and the aggregate fair market value

of its assets, but it would not reduce the amount of loss allocated to the new partner on a sale of the partnership’s assets. Taxpayers operating businesses in partnership form will now need to test for such a “substantial built-in loss” whenever a partnership interest (of any size) is transferred.

**Application of Section 704(d) Limitation to Partnership Charitable Contributions and Non-U.S. Tax Payments.** The Act also provides a technical amendment to section 704(d), which generally limits a partner’s deduction for its distributive share of partnership losses to the amount of the partner’s outside basis. Partnership charitable contributions and deductions for non-U.S. taxes paid or accrued were not considered in applying the section 704(d) limitation, and therefore a partner could deduct the full amount of its distributive share of such items even if the partner’s outside basis had been reduced to zero (though the allocation of any such charitable deduction or tax expense to a partner often reduces the partner’s outside basis if it exceeds zero). As the conference report accompanying the Act notes, the failure to consider such deductions in the calculation of the section 704(d) limitation can lead to situations in which a zero-basis partner receives its distributive share of a deduction without an outside basis reduction, while another partner with a positive outside basis receives a matching distributive share of the same deduction and, unlike the first partner, must reduce outside basis.

The Act addresses this issue by including partnership charitable deductions and non-U.S. taxes paid or accrued by a partnership in the calculation of the section 704(d) limitation for partnership taxable years beginning after December 31, 2017.

#### **New Restrictions on Capital Contributions**

In general, section 118 excludes capital contributions from the gross income of the recipient corporation. Under the Act, section 118 will no longer apply to contributions that are made: (i) in aid of construction or otherwise by a customer or potential customer; or (ii) by a government entity or civic group. This change generally applies to contributions made after December 22, 2017.

*This change appears to be aimed primarily at preventing taxpayers from treating a state or local tax incentive as a non-taxable capital contribution. Some taxpayers have treated*

such incentives as funds received directly (even if received in the form of an abatement) that were then used to pay state and local taxes. This approach permitted a taxpayer to deduct the full amount of state and local taxes “paid” (including the amount reduced through the incentive) while still excluding the incentive from income (with a matching reduction in asset basis pursuant to section 362(c)). The IRS released a coordinated issues paper on this topic in 2008, arguing that a taxpayer should instead treat a state or local tax incentive as a reduction in taxes and reduce its deduction for taxes paid by the amount of the incentive. In support of this position, under the Act, if a taxpayer treats a state or local tax incentive as a capital contribution, such amount would no longer be excluded from income under section 118.

### **Deduction Prohibited for Certain Government Settlements**

As a result of amendments to section 162(f) under the Act, subject to a key exception below, taxpayers will not be able to deduct amounts paid to any government pursuant to certain settlements and court orders. Effective as of December 22, 2017, this broad prohibition applies to “any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry ... into the potential violation of any law.” This change generally does not apply to existing binding orders or settlement agreements already in place. The Act provides an important exception to this new deduction limitation for payments made in restitution (including remediation of property) or payments made in order to come into compliance with law. To be deductible, such payments will have to be expressly identified in the relevant court order or settlement agreement as serving one of these specific purposes (in addition to satisfying the existing statutory requirements under section 162(f), as interpreted by the courts).

In general, an appropriate government official must report to the IRS the total amount of any payments made pursuant to a settlement or court order, along with the amount that constitutes restitution or that is paid to come into compliance with law. This reporting requirement gives the IRS significant influence over the tax treatment of any settlement payment, in essence inviting it to “sign off” on the deductibility of any such settlement (or court-ordered) payment.

### **Elimination of Most Section 1031 Exchanges**

The Act eliminates like-kind exchange treatment under section 1031 for all types of property other than real property. This new limitation generally applies to exchanges completed after December 31, 2017, although there is limited transition relief for property disposed of or received by the taxpayer on or before December 31, 2017.

*This change appears to significantly curtail the scope of section 1031, which, prior to the effective date of this change, applied to both tangible personal property and intangible property. In practice, however, the effect is somewhat ameliorated because the rules for determining whether property was of “like kind” were generally strict for property other than real property, particularly for intangible property.*

### **Adjustments to Dividends Received Deductions**

The domestic corporate dividends received deduction (“DRD”) under section 243 is also reduced. The goal was to reach approximately the same post-deduction rate under the new 21 percent corporate income tax rate as was provided under the prior 35 percent corporate rate. Thus, the 70 percent DRD is reduced to 50 percent (resulting in a 10.5 percent tax rate, as previously), and the 80 percent DRD is reduced to 65 percent (resulting in a tax rate of 7.35 percent, a slight increase from the former rate of 7 percent). The ownership percentages required to obtain these deductions have not changed—the 50 percent (formerly 70 percent) DRD is available for any dividend received by a U.S. corporation from another U.S. corporation, and the 65 percent (formerly 80 percent) DRD is available for a dividend received by a U.S. corporation from a 20 percent-owned U.S. corporation. The 100 percent DRD continues to be available for dividends within certain affiliated groups (generally connected through 80-percent ownership).

## **U.S. INTERNATIONAL TAX REFORMS**

### **Overview**

Much has been made about the Act transitioning the Code from a worldwide tax system to a territorial regime. In general, prior to the Act, U.S. shareholders of controlled foreign corporations (“CFCs”)<sup>10</sup> were subject to current inclusion of the pro rata portion of their CFCs’ passive-type (i.e., subpart F) income but were generally permitted to defer their CFCs’

active-type earnings until they were distributed back to the United States by the CFCs. Under the Act, however, the tables are somewhat turned—at least for corporate shareholders. Generally speaking, a CFC now will earn three basic categories of income: (i) subpart F income and earnings invested in U.S. property (subjecting their corporate U.S. shareholders to a 21 percent tax rate); (ii) routine returns of CFCs on tangible property (generally exempt from U.S. tax); and (iii) global intangible low-taxed income or “GILTI” (generally subjecting their corporate U.S. shareholders to a 10.5 percent tax rate). Further, the Act provides for a one-time transition tax, which subjects U.S. shareholders of certain foreign corporations with undistributed foreign earnings and profits (“E&P”) to current tax on that E&P at reduced rates. More details on these and other changes to the international tax provisions of the Code are discussed below.

### Transition Tax of Existing Foreign Earnings

In order to transition to the new hybrid-territorial system, the Act imposes a one-time transition tax under section 965 on U.S. shareholders of certain foreign corporations other than passive foreign investment companies (so-called deferred foreign income corporations) for post-1986 E&P (so-called accumulated post-1986 deferred foreign income).<sup>11</sup> Although the tax can be imposed on corporate and non-corporate shareholders, it only applies to U.S. persons with respect to foreign corporations: (i) in which they own at least 10 percent of the voting power (directly or through attribution); and (ii) which are either CFCs or have at least one U.S. corporation that owns 10 percent or more of their voting power (directly or through attribution); each, a so-called specified foreign corporation.

Accumulated post-1986 deferred foreign income determined as of either November 2, 2017, or December 31, 2017 (whichever is greater), is subject to this tax at a rate of 15.5 percent (to the extent of aggregate foreign cash positions, as determined below) or 8 percent otherwise. Foreign cash includes cash on hand, net accounts receivable, the fair market value of liquid assets including actively-traded stock, commercial paper, short-term notes, and any asset the IRS determines to be economically equivalent to these categories. The taxpayer’s “aggregate foreign cash position” for purposes of the tax is the greater of: (i) the amount of foreign-held cash at the close of the last taxable year of the corporation beginning before January 1, 2018; or (ii) the average of the foreign-held cash as

of the close of the last taxable year ending prior to November 2, 2017 and as of the close of the second-to-last taxable year ending prior to November 2, 2017. The tax itself is imposed on U.S. shareholders in their taxable year that includes the end of the last taxable year of the foreign corporation beginning before January 1, 2018.

The accumulated post-1986 deferred foreign income subject to the U.S. shareholder’s transition tax may generally be reduced by the foreign E&P deficit balances of specified foreign corporations held by the U.S. shareholder (so-called E&P deficit foreign corporations), subject to limitations. Unlike the testing dates for accumulated post-1986 deferred foreign income, deficits are measured only as of November 2, 2017—to prevent taxpayers from taking actions to increase deficits before year-end. Under the legislative text, it is not entirely clear what happens if a foreign corporation has a deficit as of November 2, 2017, but a positive E&P balance as of December 31, 2017 (or vice versa).

This may be clarified in guidance issued by Treasury, which has broad authority to issue regulations interpreting and implementing the transition tax. Rules are also provided allowing E&P deficit companies and E&P surplus companies to net their E&P for purposes of the tax even if the companies have different U.S. shareholders, provided that the U.S. shareholder having an aggregate foreign E&P deficit (so-called E&P net deficit shareholder) is in the same affiliated group as the U.S. shareholder having an aggregate E&P surplus (so-called E&P net surplus shareholder). Notice 2018-07, described below, provides a similar affiliation concept to account for intercompany debt in measuring cash positions.

Reduced foreign tax credits are available to offset the transition tax—22.9 percent of indirect foreign tax credits may be used against the tax with respect to the portion of the tax paid at a rate of 8 percent and 44.3 percent of indirect foreign tax credits may be used with respect to the portion of the tax paid at a rate of 15.5 percent.<sup>12</sup> The text of the Act does not prevent taxpayers from using foreign tax credit carryforwards against the transition tax without being subject to these limitations, and the committee reports confirm this.

A taxpayer may elect to pay the transition tax in eight installments. The method for making the election is left to Treasury

guidance (that has not been promulgated). The annual-installment election is favorable because the installments place a greater proportion of the tax in later years and have no interest component, thereby saving time value of money for taxpayers. Special rules allow owners of S corporations to defer payment of the tax until the occurrence of triggering events such as the cessation of S corporation status or the disposition of the owner's S corporation interest. Under the statute of limitations, the IRS has six years to assess a deficiency with respect to this tax.<sup>13</sup>

The Act provides Treasury with fairly broad regulatory authority to issue regulations preventing taxpayers from reducing their foreign E&P through, among other strategies, changing entity classification or accounting methods.

In the case of individual and other non-corporate U.S. shareholders, the effective tax rates on the cash and non-cash portions are 17.5 percent and 9 percent with respect to CFCs with calendar tax years.<sup>14</sup>

Treasury and the IRS released Notice 2018-7, probably the first of a series of notices addressing issues relating to this transition tax. The notice describes rules regarding the calculation of accumulated post-1986 deferred foreign income, including rules to prevent double counting where specified foreign corporations distribute E&P to other specified foreign corporations, rules to account for accumulated post-1986 deferred foreign income attributable to non-U.S. shareholders, and rules coordinating the transition tax with subpart F income earned and investments in U.S. property made in 2017. The notice also describes rules regarding the calculation of aggregate foreign cash, including rules to avoid double counting of cash positions in cases of related-party transactions and where specified foreign corporations have different inclusion years, rules treating certain derivative financial instruments as foreign cash (subject to an exception for certain bona fide hedging transactions), and a rule treating all members of a consolidated group as a single U.S. shareholder for purposes of calculating aggregate foreign cash, including members that have aggregate foreign E&P deficits.

*The rules for calculating the one-time transition tax on previously untaxed CFC E&P are complex in that the calculation is based on a full inclusion of the untaxed E&P, with a corresponding DRD that is adjusted based on the highest effective*

*tax rate applicable to the affected U.S. shareholder, which, under section 15, may be different from the general 35 percent tax rate for calendar year taxpayers if the taxpayer is a fiscal year taxpayer. Further, although the rules for related-party transactions may eliminate double-counting in the case of internal cash pools, it is not clear whether such applies in the case of synthetic cash pools. U.S. taxpayers should seek advice regarding their exposure to this one-time transition tax.*

### **Participation Exemption System with Respect to Certain Dividend Distributions**

As under prior law, a CFC generally will earn income that is fully taxed to the U.S. shareholder, partially taxed, or exempt from tax. Under the Act, however, to the extent that such earnings are exempt (i.e., not subpart F income, not GILTI, and not earnings invested in U.S. property), such earnings generally will be allowed to be both earned by the CFC and distributed to U.S. corporate shareholders without additional U.S. income tax.<sup>15</sup> Under newly enacted section 245A, a 100 percent deduction is available for dividends received by a U.S. corporate shareholder from a 10 percent-owned foreign corporation other than a passive foreign investment company (a so-called specified 10 percent-owned foreign corporation) and paid out of the foreign-source portion of such corporation's earnings—provided that the stock upon which such distribution was made has been held by such shareholder for at least 366 days.<sup>16</sup>

The portion of the dividend treated as made out of the foreign-source portion of the corporation's earnings is generally the portion of the foreign corporation's undistributed earnings that are not attributable to effectively connected income and certain U.S.-source dividends. No foreign tax credits may be taken with respect to amounts for which a deduction is taken under new section 245A. Exempt dividends will reduce the U.S. shareholder's basis in the CFC shares for purposes of determining loss on a disposition, but not for purposes of determining gain.

A separate rule applies for "hybrid dividends" received from a CFC—i.e. dividends for which a deduction or other tax benefit was allowed in a foreign jurisdiction or U.S. possession. Such amounts are generally treated as ineligible for the participation exemption under section 245A if received by the corporate U.S. shareholder, or as subpart F income to the U.S. shareholder if received by another CFC owned by the same corporate U.S. shareholder.

*The new hybrid dividend rule may pose a trap for the unwary, and U.S. corporations with multiple foreign subsidiaries should plan intercompany transactions carefully to avoid inadvertently paying hybrid dividends subject to current U.S. taxation.*

*Overall, by effectively eliminating the U.S. tax on foreign earnings repatriated from foreign subsidiaries, this provision aims to reduce the incentive for U.S. corporations to leave foreign earnings offshore. Interestingly, it does not apply to any non-corporate U.S. shareholders, who may now be incentivized to invest overseas through a U.S. corporation or a branch structure, or to leave foreign earnings offshore to obtain the benefits of deferral to the extent not subject to GILTI tax (discussed below). Note that individual and other non-corporate U.S. shareholders may be liable for the one-time transition tax, even though they cannot benefit from the participation regime (although they may still benefit from the lower repatriation rates on accumulated post-1986 deferred foreign income). Further, as discussed below, the Act does not repeal section 956. Thus, CFCs with earnings that would otherwise be eligible for the participation exemption should be mindful that loaning such earnings to a U.S. corporate shareholder may result in immediate taxation at a 21 percent rate, whereas distributing such earnings would be exempt from U.S. tax.*

### **Elimination of Deemed Paid Foreign Tax Credits**

The Act eliminates the deemed paid foreign tax credit under section 902, which generally treated a U.S. corporation as having paid a portion of the foreign taxes paid by its foreign subsidiary upon receipt of a dividend from such foreign subsidiary. This system also allowed foreign tax credits to be used against subpart F income, because subpart F inclusions were treated as deemed distributions bringing up foreign tax. The Act eliminates the deemed paid foreign tax credit as part of the move to the participation exemption system, which exempts certain foreign-to-U.S. dividends from tax (see above) and thus does not allow such dividends to bring any foreign tax credits with them. In place of the deemed paid foreign tax credit, the Act creates a rule under section 960 providing that if a U.S. corporation has an inclusion under subpart F due to income of a CFC, such U.S. corporation is deemed to have *directly* paid any foreign taxes paid by the CFC that are properly attributable to such income.

### **Taxation of Global Intangible Low-Taxed Income**

The Act adds new section 951A, which provides that any U.S. shareholder owning at least 10 percent of the total vote or

value of one or more CFCs must include in income annually its pro rata share of the CFCs' GILTI.<sup>17</sup> The tax on the GILTI inclusion effectively imposes a minimum level of U.S. tax on all foreign income of U.S. multinationals. Although the Act refers to "intangible income," the tax is formulaic and applies to any form of income in excess of a fixed return on certain tangible assets. The GILTI inclusion applies for taxable years of CFCs beginning after December 31, 2017.

With respect to any U.S. shareholder, the GILTI inclusion is calculated as the excess of the shareholder's net CFC tested income over the shareholder's "net deemed tangible income return." The net CFC tested income is the excess of the shareholder's pro-rata share of the tested income of its CFCs over the tested loss of its CFCs. The tested income or tested loss of a CFC is its net income or loss for the year (excluding subpart F income, income effectively connected with a U.S. trade or business, certain income excluded from subpart F income under the high-tax exception for subpart F income, and certain foreign oil and gas extraction income). The net deemed tangible income return of a CFC is the excess of 10 percent of its "qualified business asset investment" over its net interest expense for the year. "Qualified business asset investment" is defined for this purpose as the aggregate adjusted tax basis of the CFC's so-called specified tangible property, which is depreciable tangible assets used in the production of tested income (not tested loss), measured on a quarterly average basis.

The GILTI inclusion is generally taxed in the same manner as income that is currently taxed under subpart F of the Code, meaning that it is subject to ordinary income tax rates. However, the Act introduces new section 250 that provides U.S. corporate taxpayers with a deduction against taxable income equal to 50 percent of the taxpayer's GILTI—resulting in an effective tax rate of 10.5 percent on GILTI for corporate taxpayers.<sup>18</sup> The aggregate deduction under section 250 for GILTI, the section 78 gross-up for foreign taxes associated with GILTI, and FDII (described below) cannot exceed the U.S. corporation's taxable income determined without regard to those provisions. No similar deduction is provided for U.S. non-corporate taxpayers, who generally must pay tax on GILTI at a top rate of 37 percent. Corporate taxpayers are also permitted to use up to 80 percent of foreign tax credits against GILTI, but unused foreign tax credits do not carry forward or back for GILTI purposes, and credits are available only for foreign taxes of CFCs with net tested income.<sup>19</sup> The Act computes the section 78

gross-up by reference to 100 percent of the associated foreign taxes, rather than the 80 percent allowed as a credit. And the Act creates a separate basket for those taxes to prevent them from being credited against U.S. taxes on the U.S. shareholder's other income.

*The GILTI tax may not generate significant U.S. tax for corporate U.S. shareholders because it imposes tax at a rate of 10.5 percent while allowing 80 percent of foreign tax credits to be used. A U.S. shareholder should generally not have any GILTI tax liability with respect to income of a CFC that is taxed in the foreign jurisdiction at a rate of at least 13.125 percent; 80 percent of those foreign taxes would fully offset the U.S. shareholder's 10.5 percent GILTI tax. However, a U.S. shareholder may have expenses limiting its ability to fully use its foreign tax credits against GILTI. Thus, the GILTI tax may apply even with respect to CFCs that are subject to foreign taxes at rates greater than 13.125 percent. As of September 2017, 158 countries have corporate tax rates of at least 15 percent, compared to 44 countries that have rates under 15 percent.<sup>20</sup> As a result, the GILTI inclusion likely will be more costly to U.S. multinationals that historically have earned significant foreign income through jurisdictions with very low tax rates. It may also prove costly to U.S. individuals that hold CFCs directly or through pass-through entities.*

### **Deduction for Foreign-Derived Intangible Income**

The Act provides a deduction under new section 250 for U.S. corporations with respect to their "foreign-derived intangible income" ("FDII"). The deduction is equal to 37.5 percent of FDII for taxable years that begin after December 31, 2017, and on or before December 31, 2025, and 21.875 percent of FDII for taxable years beginning after such date. With the deduction, the corporate income tax rate on FDII is effectively 13.125 percent, increasing to 16.406 percent in seven years. The deduction is not available for S corporations or U.S. corporations that are RICs or REITs. The aggregate deduction under section 250 for FDII, GILTI, and the section 78 gross-up for foreign taxes associated with GILTI cannot exceed the U.S. corporation's taxable income determined without regard to those provisions.

A U.S. corporation's FDII equals its deemed intangible income multiplied by a fraction, the numerator of which is the corporation's foreign-derived deduction eligible income and the denominator of which is its deduction eligible income. First,

the "deduction eligible income" is calculated. It equals the corporation's net income with carveouts for subpart F income, GILTI, financial services income, dividends from related CFCs, domestic oil and gas extraction income, and non-passive foreign branch income,<sup>21</sup> and is reduced by allocable deductions including foreign taxes. Next, the "deemed intangible income" is calculated. It equals the corporation's deduction eligible income minus 10 percent of the corporation's qualified business asset investment (defined in the same way as for GILTI—i.e., the aggregated adjusted basis of the corporation's depreciable tangible assets used in a trade or business). Finally, the corporation's "foreign-derived deduction eligible income" is calculated. It equals the corporation's deduction eligible income derived in connection with (i) property sold or licensed to foreign persons or for foreign use, and (ii) services provided to persons, or with respect to property, not located in the United States. Sales to related parties (tested using a 50 percent ownership standard) generally are not counted as foreign-derived deduction eligible income, unless the taxpayer establishes that the property sold is ultimately destined for foreign use. Services performed for related parties are also not counted in the numerator of the FDII fraction, unless the taxpayer establishes that the service is not substantially similar to services provided by the recipient to persons located in the United States.

*The deduction for FDII appears to introduce something akin to the "patent box" regimes that have been adopted by a number of European nations. Unlike patent boxes, however, the FDII deduction is not narrowly targeted at income related to intangible activity. The European Commission reportedly wrote U.S. Treasury Secretary Steven Mnuchin before the Act was passed to say the measure appeared to be at odds with the World Trade Organization treaty, which governs taxation of cross-border trade, since it would give preferential tax treatment to IP that was originally created outside the United States and would be incompatible with the modified nexus approach as agreed in action 5 (harmful tax practices) of the G-20/OECD base erosion and profit-shifting project.<sup>22</sup>*

### **Base Erosion and Anti-Abuse Minimum Tax**

The Act imposes the Base Erosion and Anti-Abuse Tax ("BEAT"), a new, complex regime under section 59A focused on corporations with certain deductible payments made to related foreign parties. The BEAT is a minimum tax imposed in addition

to, not in lieu of, a U.S. corporation's regular tax liability. The tax—called the “base erosion minimum tax amount”—is the amount by which a statutory percentage of the U.S. taxpayer's “modified taxable income” exceeds its regular U.S. tax liability.

The BEAT rate is 5 percent in 2018, 10 percent in 2019 through 2025, and 12.5 percent thereafter (6 percent, 11 percent, and 13.5 percent respectively for certain banks and securities dealers).

For purposes of these rules, modified taxable income is taxable income calculated without regard to base erosion tax benefits (“BETBs”) or the base erosion percentage of the U.S. taxpayer's NOLs used in determining its regular tax liability for the year. BETBs include deductions for payments to foreign related parties and depreciation or amortization deductions for property purchased from foreign related parties. BETBs also include certain tax benefits from reinsurance payments to foreign related parties. A deductible payment may be a BETB even if the payment is also subpart F income to the foreign recipient's U.S. shareholder or effectively connected income of the foreign recipient.

BETBs do not include deductions for cost of goods sold, except in the case of certain inverted companies. Further, BETBs do not include deductions for related-party payments that are fully subject to withholding, such as outbound interest or royalty payments (with a proration mechanism for reduced or eliminated withholding under tax treaties). BETBs also do not include reimbursements for certain routine services made pursuant to the services cost method and payments with respect to certain derivative instruments.

The definition of “related” for BEAT purposes is quite broad, as the ownership threshold is generally only 25 percent (by vote or value), and the application of numerous attribution rules further expands the universe of potential related parties. In addition to the 25-percent ownership rules, the definition of “related” for BEAT purposes includes parties that are related within the meaning of section 482—further expanding the potential situations in which parties may be related for purposes of these rules. The definition of “related” under section 482 is based on facts and circumstances, and it has developed into a somewhat unpredictable standard under case law.

When determining a taxpayer's potential BEAT liability, such taxpayer's regular tax liability includes the reduction for all tax

credits other than R&D tax credits and a portion of certain section 38 business tax credits (i.e., low-income housing credits, renewable electricity production credits, and investment credits properly allocable to the energy credits). Including tax credits (other than these few specified credits) in the taxpayer's calculation of regular tax liability has the effect of essentially characterizing such credits as BETBs; both BETBs and such credits result in a greater likelihood that the taxpayer will be subject to the BEAT (or the taxpayer's BEAT liability will be increased). After 2025, regular tax liability for BEAT purposes will be reduced for all available tax credits, including R&D credits, which may further reduce regular tax liability for BEAT calculation purposes.

In general, the BEAT applies only to a C corporation (other than a RIC or a REIT) with average annual gross receipts for its worldwide controlled group on a three-year rolling basis of at least \$500 million and BETBs in a given year equal to at least three percent of the total deductions allowable for such year (two percent in the case of certain banks and securities dealers). The gross-receipt determination is made for foreign members by looking only to their income that is effectively connected with the conduct of a U.S. trade or business.

To enforce this new regime, the IRS is empowered to require reporting of information relating to deductible payments made to foreign related parties and any other information it deems necessary. Penalties will be imposed for failures to report as required.

*Like the now-moribund corporate AMT, the BEAT will effectively require many taxpayers to calculate their tax liability twice to determine their annual income tax liability. Further, the unfavorable treatment of several tax credits (and a haircut on others) in the BEAT calculation could result in BEAT liability for taxpayers without large BETBs. However, given the lower rate for the BEAT, the tax is unlikely to apply unless the taxpayer has limited net income combined with a large amount of BETBs or tax credits. The BEAT could apply to interest on foreign loans to related U.S. corporations to the extent not disallowed under section 163(j). Taxpayers will need to carefully reexamine their international structures and applicable tax credits to determine whether their outbound deductible payments trigger BEAT liability.*

*The European Commission reportedly wrote U.S. Treasury Secretary Steven Mnuchin before the Act was passed to say*

*the measure appeared to be discriminatory under the World Trade Organization treaty, since the BEAT would not apply to comparable related-party payments between domestic U.S. companies and would not allow the credit of foreign taxes paid, is not targeted to address the abuse, and could affect genuine commercial arrangements and give rise to double taxation.*<sup>23</sup>

### **Anti-Hybrid Rules**

The Act disallows deductions under new section 267A for disqualified related party amounts paid or accrued pursuant to a hybrid transaction or by or to a hybrid entity. A disqualified related party amount is any interest or royalty payment made to a related party (measured by 50 percent) if, under the relevant foreign tax law, either such amount is not included in the income of the recipient or the amount is allowed as a deduction to the recipient. A “hybrid transaction” is any transaction or agreement where payments that are treated as interest or royalties for U.S. tax purposes are not so treated for foreign tax purposes. A “hybrid entity” is any entity that is either treated as fiscally transparent for U.S. tax purposes but not foreign tax purposes or is treated as fiscally transparent for foreign tax purposes but not U.S. tax purposes. For purposes of these rules, the relevant foreign tax rules are the rules of the country in which the related foreign party is a resident for tax purposes or is subject to tax.

*Although these rules resemble the proposal of the Organisation for Economic Co-operation and Development’s Base Erosion and Profit Shifting project regarding hybrid transactions, their limitation to interest and royalty payments among related parties still permits a number of deductible payments to result in double deduction or deduction-no inclusion outcomes. Further, the effectiveness and applicability of the U.S. anti-hybrid regime remains unclear given the significant number of issues left unresolved, such as the treatment of conduit arrangements, three-country arrangements, and foreign tax preferences. That said, Treasury has been granted broad regulatory authority to promulgate rules to carry out the purposes of the anti-hybrid provision, including specific remedies to address: (i) treating a “tax preference” as an exclusion of income if it has the effect of reducing the foreign country’s generally applicable statutory rate by 25 percent or more; and (ii) treating a payment amount as not subject to tax in the foreign country if such amount is subject to a participation exemption-type system whereby the amount is entirely or substantially excluded from income in that foreign country.*

### **Valuation and Definition for Intangibles Transfers**

When determining whether intercompany transactions are conducted at arm’s length consistent with transfer pricing principles, the Act amends section 367(d)(2) to empower the IRS to require the valuation of transfers of intangible property on an aggregate basis and on the basis of the “realistic alternatives” to the transfer. In addition, the definition of “intangible property” in section 936(h)(3)(B), which is used for several key international provisions including section 367(d), is expanded to include goodwill, workforce in place, and any other non-tangible property—one of the biggest impacts of this change is discussed below. These changes apply only to transfers of intangible property made after 2017.

*These new rules are generally consistent with the IRS’s long-standing position on these issues, which was repeatedly, and successfully, challenged by taxpayers in court in recent years. The Act now expressly provides the IRS the authority for its litigating position with respect to post-2017 transfers.*

### **Outbound Transfers of Business Assets**

The Act eliminates the section 367 exception for outbound transfers of active businesses and amends existing statutory law to change the operation of section 367 for outbound transfers of goodwill and going-concern value. The Treasury Department applied a different approach to the treatment of goodwill in regulations issued in 2016. Under the Act, goodwill and going-concern value expressly constitute intangible property for purposes of the outbound transfer rules of section 367. Therefore, an otherwise tax-free U.S.-to-foreign transfer of goodwill and going-concern value will be treated as a U.S.-to-foreign license of such assets for deemed royalties commensurate with the value of such property pursuant to section 367(d).

### **Changes to Determinations of CFC Status**

As discussed above, the Act expands the attribution rules for determining whether a foreign corporation is a CFC. In determining whether an entity is a CFC, section 958 generally applies broad attribution rules adapted from section 318. Among these is a rule providing that if 50 percent or more of the value of the stock of a corporation is owned by any person, the corporation is treated as owning the stock owned by that person. This so-called “downward” attribution causes a corporate subsidiary to be treated as owning stock owned by its 50 percent-or-greater parent or shareholder. Prior to the Act,

section 958(b)(4) provided that downward attribution could not be applied to treat a U.S. person as owning stock owned by a foreign person—that is, downward attribution could not apply to treat a U.S. corporate subsidiary as owning stock held by a 50 percent-or-greater foreign shareholder. The Act eliminates section 958(b)(4), thereby allowing this type of foreign-to-U.S. downward attribution.

*This change appears to be primarily targeted at a particular type of planning transaction used by certain foreign multinationals. Consider a foreign company that acquires all the stock of a U.S. corporate target. The U.S. target has historical foreign subsidiaries that are CFCs. Using section 958(b)(4), the foreign parent was able to “de-CFC” the target’s foreign subsidiaries with little or no U.S. tax consequences by paying consideration directly to the foreign subsidiaries for the issuance of new foreign subsidiary stock with vote and value at least equal to the foreign subsidiary stock historically held by the U.S. corporate target. This caused the foreign parent to directly own at least 50 percent of the stock of each foreign subsidiary (with the U.S. corporate target owning the rest), with the result that the foreign parent’s newly acquired stock of the foreign subsidiaries could not be attributed to the U.S. corporate target under section 958(b)(4). Thus, none of the foreign subsidiaries was more than 50 percent owned by U.S. shareholders so none was a CFC. For most corporate multinationals not engaging in this type of planning, the removal of section 958(b)(4) will have little practical effect. It appears to have no effect on most U.S.-based multinationals and somewhat limited effect on most foreign-based multinationals. It may, however, affect targets acquired and held in private equity deals, based on the bespoke ownership structures sometimes used in those transactions.*

As described above, the definition of a “United States shareholder” for CFC purposes has also been amended. Prior to the effective date of this change, section 958(b)(4) defined a “United States shareholder” as a U.S. person that owned at least 10 percent of the voting power of a foreign corporation. The Act expands that definition to include any U.S. person that owns 10 percent or more of the vote or value of a foreign corporation. The definition of a “United States shareholder” is relevant because CFC status is tested only by looking to a foreign corporation’s U.S. shareholders, and only U.S. shareholders of CFCs are subject to taxation under subpart F.

Finally, the Act eliminates the statutory requirement that a foreign corporation be a CFC for 30 uninterrupted days in a single taxable year before its U.S. shareholders must include subpart F income. Under the Act, U.S. shareholders must pay tax on subpart F income if the foreign corporation is a CFC at any time during the year.

The first change above with respect to section 958(b)(4) applies starting in the last taxable year of a foreign corporation beginning before January 1, 2018, and thus could affect whether a U.S. shareholder of a foreign corporation is subject to the one-time transition tax. The latter two changes are effective only for taxable years of foreign corporations beginning after December 31, 2017, and thus have no effect on the one-time transition tax.

### **Other Changes to the Anti-Deferral Rules for U.S. Taxation of Offshore Earnings**

The Act introduces a number of other, less sweeping changes to the subpart F regime. Subpart F of the Code generally taxes certain types of passive and mobile income of CFCs when earned, rather than deferring taxation until the income is distributed to the U.S. taxpayer. The subpart F regime remains in place for U.S. taxpayers after the Act’s effective date (with some changes briefly described below and, as relevant, the changes to CFC status described above), notwithstanding the new participation exemption for certain domestic C corporations. And for non-corporate shareholders (and minority corporate shareholders) of foreign businesses, these rules remain in effect and are just as relevant as before the Act’s enactment.

- The Act eliminates the category of subpart F income for oil-related activities.
- The Act eliminates the subpart F income category for certain shipping-based income by repealing section 955.
- Although the House and Senate had proposed eliminating the current tax on certain investments in U.S. property by CFCs under section 956, the Act retains section 956 without any modifications. *This could create a seemingly incongruous result whereby a corporate U.S. shareholder of a CFC may be taxed if its CFC invests its earnings in U.S. property (or is so deemed), but the same shareholder would not be taxed if the CFC actually distributed its earnings to the shareholder, and the shareholder used those earnings to invest in the same U.S. property.*

## Repatriations of Intangible Property

Although the Senate proposal included a provision permitting multinationals to avoid recognizing gain for U.S. tax purposes on certain repatriations of intangible property held by CFCs in the years immediately following the proposal's effective date, this provision was not included in the Act.

*Taxpayers will need to review carefully their international structures given this lack of transition-period flexibility. Given the following factors, the economics of transferring intellectual property (back) into the United States may not be favorable in many situations: (i) the possibility of triggering U.S. tax, (ii) the imposition of exit taxes by many countries on outbound transfers of intellectual property, (iii) the ability to ensure that the effective tax rate on income earned on CFC-held intellectual property is no greater than the tax rate on such income if the intellectual property is held directly in the United States, (iv) the possibility that the FDII provision will be determined to be an impermissible export subsidy by the World Trade Organization, and (v) the possibility that future Congresses will raise the U.S. corporate tax rate.*

## Inventory Sourcing Rules

Prior to the Act's effective date, gains, profits, and income from sales of inventory produced in one jurisdiction and sold in another were sourced based on the locations of production and sale. The Act modifies section 863(b) so that, for taxable years beginning after December 31, 2017, such items are sourced solely based on the location of production activities, eliminating the taxpayer-favorable "title passage" aspect of these rules.

## Foreign Branch Losses

Coordinating with the participation exemption, the Act adds a new branch loss recapture rule. The new rule provides that if a U.S. corporation transfers a foreign branch to a foreign corporation from which dividends received are eligible for the participation exemption, the U.S. transferor must generally include in taxable income the net deductible losses incurred by the

foreign branch after December 31, 2017 (subject to certain limitations and exceptions).

*It appears that this recapture rule was added to prevent a U.S. corporation from deducting the losses of a growth-stage foreign branch, then transferring the foreign branch to a foreign subsidiary once it becomes profitable and claiming the participation exemption on receipt of the foreign branch's profits via distributions. This rule does not replace, but rather supplements, the existing branch loss recapture rules.*

## INDIVIDUAL TAX REFORMS

### Modification of Rates

For taxable years from 2018 through 2025, the Act retains seven tax brackets, but the rates have been lowered and the brackets adjusted. A top marginal rate of 37 percent applies to married individuals filing jointly with taxable income over \$600,000 and to single filer taxpayers with taxable income over \$500,000. This reflects a drop from the previous top rate of 39.6 percent, which had applied to taxable income over \$470,701 for jointly filed returns and to taxable income over \$418,401 for single filer taxpayers.

The Act also changes the method by which the tax rate brackets (and certain other tax provisions) are indexed for inflation. The method utilized prior to 2018 is known as "CPI-U," while the new method is commonly known as "chained CPI-U." In general, the chained CPI-U method measures a lower rate of inflation than the CPI-U method, which will result in slower growth of the various dollar thresholds. *The practical effect is that, over time, income will be taxed at higher rates than would have been the case with the CPI-U method.*

The updated rate tables for married individuals filing joint returns and single-filer returns are as follows for tax years beginning in 2018:

Married Individuals Filing Joint Returns and Surviving Spouses	
If taxable income is between:	The tax due is:
\$0 - \$19,050	10% of taxable income
\$19,050 - \$77,400	\$1,905, plus 12% of the excess over \$19,050
\$77,400 - \$165,000	\$8,907, plus 22% of the excess over \$77,400
\$165,000 - \$315,000	\$28,179, plus 24% of the excess over \$165,000
\$315,000 - \$400,000	\$64,179, plus 32% of the excess over \$315,000
\$400,000 - \$600,000	\$91,379, plus 35% of the excess over \$400,000
Over \$600,000	\$161,379, plus 37% of the excess over \$600,000

Single Filing Taxpayers	
If taxable income is between:	The tax due is:
\$0 - \$9,525	10% of taxable income
\$9,525 - \$38,700	\$952.50, plus 12% of the excess over \$9,525
\$38,700 - \$82,500	\$4,453.50, plus 22% of the excess over \$38,700
\$82,500 - \$157,500	\$14,089.50, plus 24% of the excess over \$82,500
\$157,500 - \$200,000	\$32,089.50, plus 32% of the excess over \$157,500
\$200,000 - \$500,000	\$45,689.50, plus 35% of the excess over \$200,000
Over \$500,000	\$150,689.50, plus 37% of the excess over \$500,000

### Alternative Minimum Tax

The Act retains the AMT system for individuals, with some modifications. The AMT generally requires individuals, estates, and trusts to calculate their tax liability twice—under the regular tax system and then under the AMT system, and pay the higher of the two amounts. Generally, a taxpayer’s AMT income is calculated by adding back various tax-preference items and deductions that were available under the regular tax system, but that are not available under the AMT, then subtracting the applicable exemption amount. The applicable exemption amount is based on the taxpayer’s filing status and income, as the exemption amount is phased out as a taxpayer’s income increases. The tax rate imposed on the resulting AMT income is generally 28 percent.

For taxable years from 2018 through 2025, the AMT exemption amount has been increased from \$84,500 to \$109,400 for married taxpayers filing jointly (from \$54,300 to \$70,300 for single-filer taxpayers). The threshold at which the exemption begins to phase out has also been increased. For married taxpayers filing jointly, the Act increases this amount from \$160,900 to \$1 million, while for single filer taxpayers the phase-out threshold has been raised from \$120,700 to \$500,000. Most of the exemption and phase-out amounts are indexed for inflation.

*The Act’s phase-out dollar thresholds are significantly higher than was the Senate proposal’s—a compromise position, given that the House proposal would have repealed the individual AMT entirely. After 2025, the increased exemptions and phase-out thresholds sunset, and the lower 2017 thresholds will again apply. Determining whether a particular taxpayer will be subject to the AMT under the Act, as under prior law, requires a complex, individualized analysis, as different provisions have countervailing effects on tax liability as determined under the regular tax system versus the AMT system. One of the key policy arguments for eliminating the AMT had been simplification, due to the complexity associated with calculating AMT, a goal that was not met.*

### Limitation on Deduction for State and Local Taxes

Under the Act, for taxable years from 2018 through 2025, the deduction for state and local real and personal property taxes, and state and local income taxes (or sales taxes in lieu of income taxes) not incurred in a trade or business is limited to \$10,000 for married taxpayers filing jointly and single-filer taxpayers, and \$5,000 for married taxpayers filing separately. Foreign real property taxes (other than those incurred in a trade or business) are not deductible.

The cap on the deduction for state and local taxes will result in a tax increase for many individual taxpayers, particularly taxpayers in states with relatively high state income or property taxes, such as California, New Jersey, and New York. This cap will also increase the number of taxpayers claiming the standard deduction. However, taxpayers subject to the AMT will not necessarily see a tax increase as a result of the limitation on state and local tax deductions, as the AMT does not permit (and has not historically permitted) a deduction for state and local taxes.

In response to the large number of taxpayers attempting to prepay property taxes for 2018 before the cap on state and local tax deductions took effect, the IRS issued an online “advisory” in late December 2017, taking the position that prepayments of anticipated real property taxes that had not been assessed prior to 2018 will not be deductible for the 2017 tax year.

#### **Limitation on Mortgage Interest Deduction**

The Act reduces the amount of interest on mortgage indebtedness that can be deducted. Previously, interest paid or accrued during the taxable year on acquisition indebtedness (indebtedness incurred in acquiring, constructing, or improving a principal residence, and one second home) was allowed as an itemized deduction. The maximum amount of such indebtedness with respect to which an interest deduction was permitted was \$1 million for taxpayers filing jointly (\$500,000 for single filer taxpayers). A deduction was also permitted for interest paid or incurred on home-equity indebtedness secured by a principal residence (and one second home) up to \$100,000 for married taxpayers filing jointly (and \$50,000 for single-filer taxpayers).

For loans incurred after December 15, 2017, the Act reduces the amount of acquisition indebtedness eligible for the itemized deduction from \$1 million to \$750,000 for married taxpayers filing jointly (and from \$500,000 to \$375,000 for single-filer taxpayers). These lower caps apply for taxable years from 2018 through 2025. Indebtedness incurred prior to, or after, this window would be unaffected. Indebtedness incurred during this seven-year window would again benefit from the higher \$1 million (or \$500,000) limitations beginning in 2026. Additionally, for taxable years from 2018 through 2025, the deduction for interest on home-equity indebtedness is suspended.

The practical implication of these limitations is an increase in the cost of homeownership for those who borrow to finance the purchase, construction, or improvement of a home, particularly in areas of the country with high real estate values.

#### **Increase in Standard Deduction**

The Act increases the standard deduction amounts to \$24,000 for married taxpayers filing jointly and \$12,000 for single filer taxpayers. This temporary increase applies for taxable years from 2018 through 2025.

As a practical matter, the increased standard deduction, coupled with the elimination and reduction of other deductions, is expected to reduce the number of taxpayers who elect to itemize deductions.

#### **Estate Tax**

The estate tax exemption has been doubled to \$11.2 million, from \$5.6 million. This temporary increase applies to taxable years from 2018 through 2025.

#### **Elimination of the Individual Health Insurance Mandate**

The Act effectively eliminates the individual mandate from the Affordable Care Act. The individual mandate is the legal requirement that every person have a minimum level of health insurance. The Act reduces the tax penalty for not having insurance (known as the individual responsibility payment) to zero. This change is effective with respect to health coverage status for months beginning after December 31, 2018.

*The Congressional Budget Office estimated that, with the repeal of the individual mandate, 13 million people would choose not to obtain health insurance. As a practical matter, the majority of people choosing not to obtain health insurance are expected to be those who are, and expect to continue to be, relatively healthy. As healthy policyholders leave the pool of insured persons, a greater proportion of the pool will be composed of sick people, which is expected to increase premiums for those still purchasing health insurance.*

#### **“First In, First-Out” Rule for Sales of Stock**

In general, a taxpayer owning multiple shares of a particular corporation may choose which shares to sell. For example, a taxpayer owning 10 shares of Corporation X stock, acquired at

different times, may choose to sell the share of Corporation X stock with the most tax basis and therefore recognize the least gain (or greatest loss), regardless of when such share was acquired. The Senate proposal had included a “first-in, first-out” rule that would have required an investor desiring to dispose of stock in any one corporation to dispose of its oldest shares first, which are often the ones with the least basis (and thus the greatest taxable gain or smallest loss). This provision did not survive in conference, however. *Such a rule likely would have incentivized investors to delay, or even avoid, selling certain stock.*

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For further information, please contact your principal Firm representative or the lawyers listed below. General email messages may be sent using our “Contact Us” form, which can be found at [www.jonesday.com/contactus/](http://www.jonesday.com/contactus/).

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## ENDNOTES

- 1 Fiscal year taxpayers not utilizing a calendar tax year will apply a blended tax rate as provided in section 15 of the Internal Revenue Code for the first taxable year ending after December 31, 2017. Unless otherwise specified, all "section" references in this *White Paper* are to the Internal Revenue Code.
- 2 In the case of REITs, this figure assumes that entity-level income is fully offset by the dividends paid deduction (as is usually the case).
- 3 This figure assumes that the corporation's dividends are treated as "qualified dividends" subject to taxation at the capital gains rate for individual recipients.
- 4 This figure assumes that the pass-through entity (or sole proprietorship) earns only qualified business income eligible for the full 20 percent deduction permitted under the Act and exempt from the 3.8 percent net investment income tax. In this highly simplified scenario, the partner or proprietor would be taxed at a maximum 37 percent rate with a 20 percent deduction on such business income. In the case of a REIT, this figure assumes that the REIT's dividends are "qualified REIT dividends" under the pass-through income rules.
- 5 In general, "investment interest" is interest expense allocable to property held for investment subject to certain exceptions. "Investment income" is generally net income (including certain gains) derived from property held for investment. The existing rules limiting deductions for investment interest expense applicable to non-corporate taxpayers under section 163(d) are not altered by the Act.
- 6 H. Rep. 115-466, Dec. 15, 2017, p. 386.
- 7 As discussed below, the Act's changes to other provisions of section 168 generally cause a 15-year recovery period to apply to qualified improvement property. A "recovery period of 20 years or less," however, would nevertheless appear to qualify such property for bonus depreciation under the terms of section 168(k)(2)(A). Presumably, Congress intended to remove qualified improvement property from the scope of the bonus depreciation rules, but this result is not clear from the statutory language.
- 8 The effective date rule in the final Act is different from the rule described in the conference report, which provided that the changes to carryforwards and carrybacks would apply to losses arising in taxable years *beginning* after December 31, 2017. H. Rep. 115-466, Dec. 15, 2017, pp. 393-94. We understand that the conference report language is what was intended, which needs to be clarified or corrected.
- 9 149 T.C. No. 3 (2017).
- 10 Under the law prior to the Act, a CFC was any foreign corporation that was more than 50 percent owned (by vote or value) by U.S. shareholders that each held at least 10 percent of the voting power of the foreign corporation. Under the Act, CFC testing counts not just shareholders owning at least 10 percent of the voting power but also those owning at least 10 percent of the value of the foreign corporation. However, this change is effective only for taxable years of foreign corporations beginning after December 31, 2017, and thus will not apply for purposes of the transition tax.
- 11 The post-1986 E&P generally means the E&P of the foreign corporation (computed in accordance with the rules of sections 964(a) and 986, and taking into account only those periods during which it was a CFC or had at least one 10-percent U.S. shareholder that was a domestic corporation) accumulated in taxable years beginning after December 31, 1986, and through November 2, 2017, or December 31, 2017, as relevant, and without diminution by reason of any dividends distributed in the last taxable year beginning before January 1, 2018.
- 12 If a U.S. shareholder's section 965 measurement date is November 2, 2017 (as opposed to December 31, 2017), the amount of foreign tax credits appears to be calculated based on the amount of the inclusion divided by the full year's E&P, not the E&P through November 2, 2017, under the language of section 902(a). This would dilute the credits as a result of E&P from November 2, 2017 to December 31, 2017.
- 13 The legislative text is not clear as to whether the six-year statute of limitations begins running with respect to the taxable year of the transition tax or each year for which an installment payment is made.
- 14 For fiscal tax year CFCs, the rates for individual and other non-corporate U.S. shareholders may be unclear.
- 15 The remaining previously taxed income may be distributed tax-free, subject to the rules in Section 959 and 961.
- 16 Specifically, the required holding period is at least 366 days during the 731-day period beginning on the date that is 365 days before the date on which the stock becomes ex-dividend with respect to the dividend.
- 17 As discussed above, the testing and relevancy of CFC status before the Act looked only to U.S. shareholders that each owned at least 10 percent of the voting power of a foreign corporation, but the Act changes this to ownership of 10 percent of the vote or value. This change applies in all taxable years for which the GILTI tax is effective.
- 18 The Act reduces the 50 percent deduction to 37.5 percent for taxable years beginning after December 31, 2025.
- 19 The Act permits non-corporate taxpayers to make an election under section 962 to be treated as a corporation and thus take advantage of foreign tax credits. It is not clear from the language of the Act whether making a section 962 election would allow an individual to claim the 50 percent deduction against GILTI, although there seems to be no logic supporting a denial of such deduction.
- 20 "[Corporate Income Tax Rates around the World, 2017](#)," The Tax Foundation, Sep. 7, 2017.
- 21 The Act also creates a separate foreign tax credit basket under section 904(d)(1)(B) for foreign branch income.
- 22 "EU Commission Mulls 'All Options' in Wake of Final U.S. Tax Bill," *Tax Notes*, Jan. 1, 2018, p. 60.
- 23 See footnote 22.

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