EVERSHEDS SUTHERLAND

Methods to the madness? Tax reform impacts on recognition of income and expense

TEI

Portland Chapter Meeting

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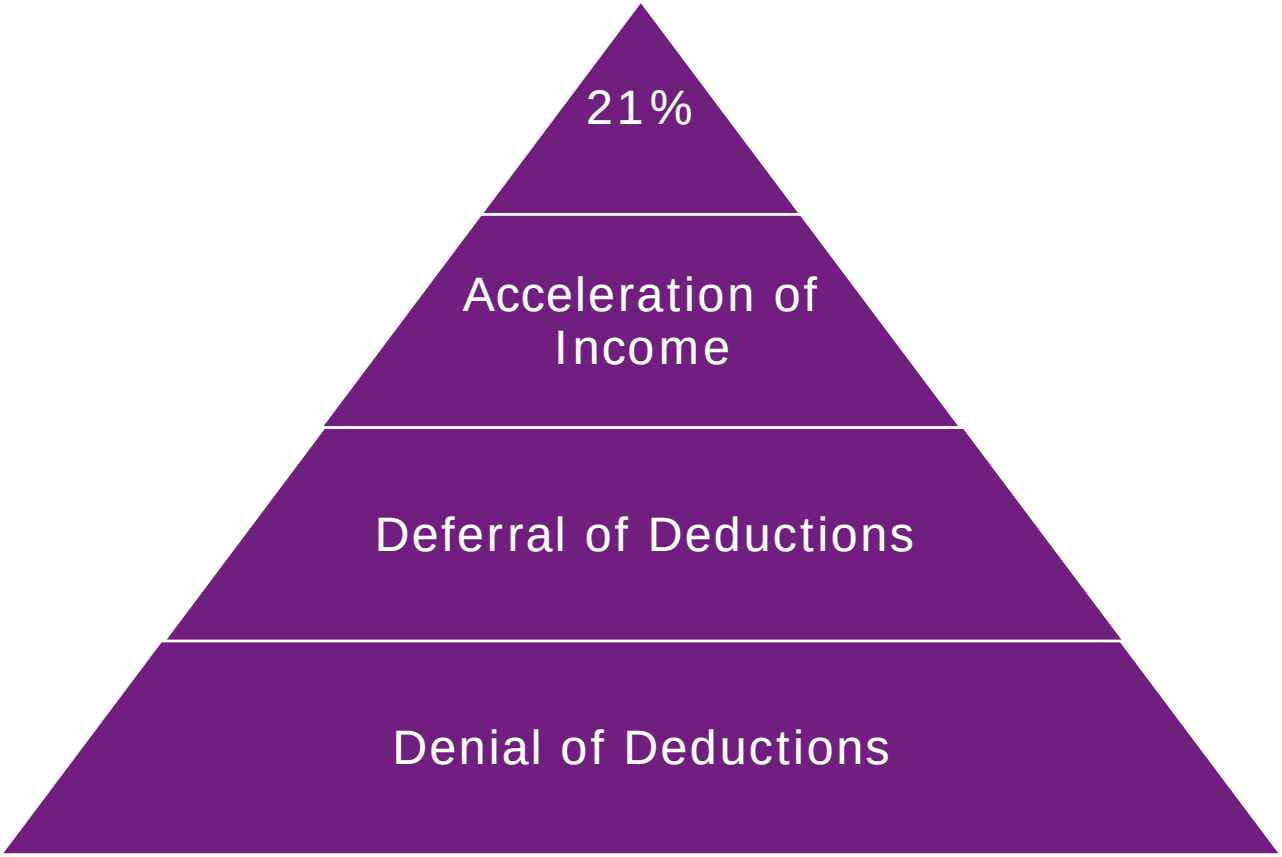
Agenda

- Acceleration: Section 451(b) and Section 118
- Deferral: Section 451(c) and Section 163(j)
- Denial: Section 267A and Section 59A (maybe?)

Overview

- Reducing the statutory rate means broadening the base:



Acceleration of Income: Sections 451(b)

Acceleration of income

Section 451(b) and the Proposed Regulations

Requires recognition of income *at the earlier of*:

- When the "**all events test**" is met for an item of income
- When the taxpayer takes the income into account on its "**applicable financial statement**"

Acceleration of income

Section 451(b) and the Proposed Regulations

- Applicable Financial Statement ("AFS") includes:
  - Certain financial statements that are certified as prepared in accordance with **generally accepted accounting principles**
  - A financial statement based on international financial reporting standards that is **filed by the taxpayer with a foreign governmental agency** similar to the SEC
  - A financial statement filed by the taxpayer with **any other regulatory or governmental body** specified by the Secretary

Acceleration of income

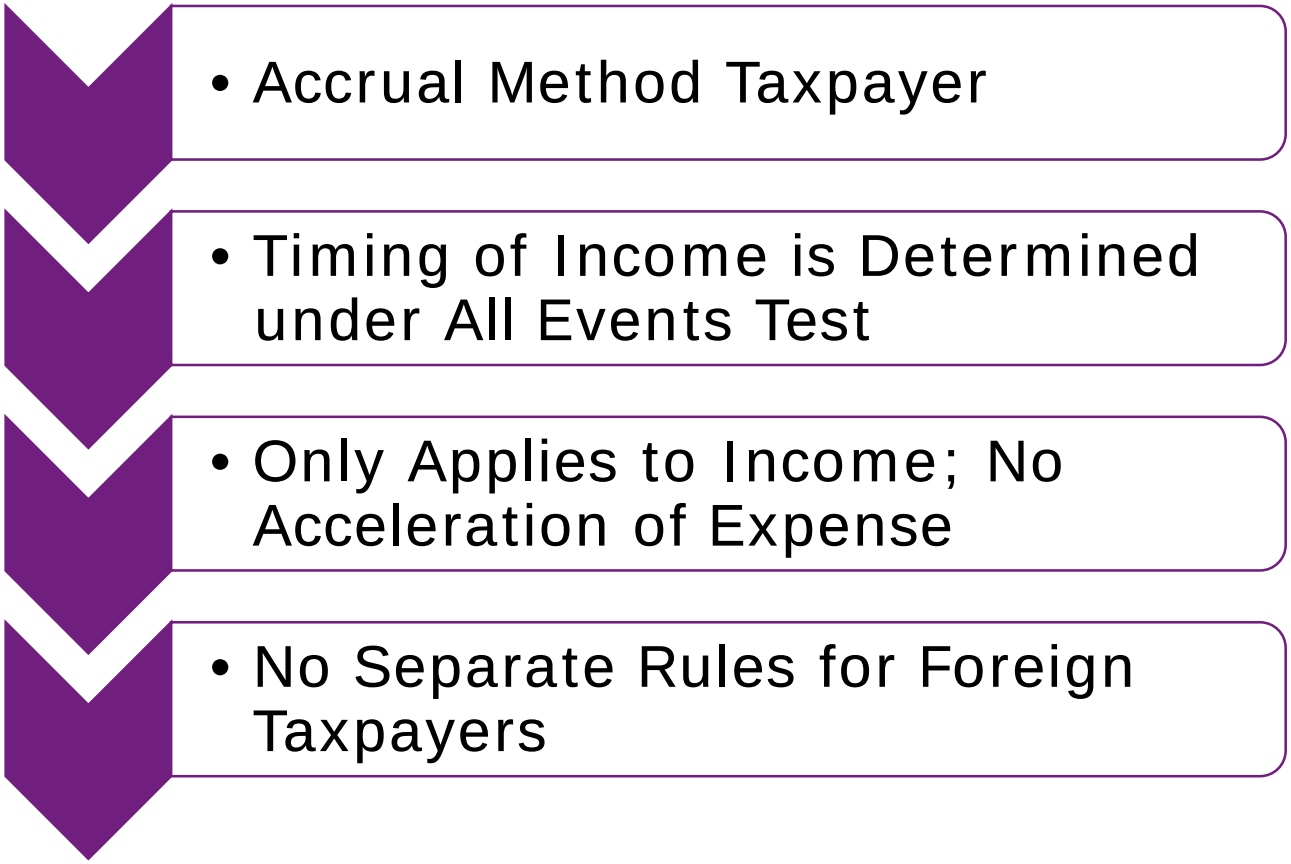
Section 451(b) and the Proposed Regulations

- The proposed regulations expand types of financial statements that qualify as AFS to include certain financial statements that had previously been treated as AFS under Rev. Proc. 2004-34
  - Including financial statements used for: credit purposes; reporting to shareholders, partners or other beneficiaries and any other substantial nontax purposes
- If a taxpayer's financial results are reported on an AFS for a group of entities, that AFS is treated as the AFS of the taxpayer
- ***A restatement of a taxpayer's financial statements that changes the timing of income constitutes a change in method of accounting***

Acceleration of income

Section 451(b) and the Proposed Regulations

- AFS Income Inclusion Rule



Acceleration of income

Section 451(b) and the Proposed Regulations

– Broad rule, but with limits:

Special Accounitng Methods	Characterization for US Tax Purposes
• Sections 460, 467, 475 • OID • Hedging Transactions • Intercompany Transactions	• Leasing transactions • Sale/Repurchase • Non-recognition transactions

Acceleration of income

Section 451(b) and the Proposed Regulations

- Increasing importance of "**transaction price**"
  - Generally defined as the gross amount of consideration to which a taxpayer expects to be entitled for AFS purposes in exchanges for goods, services, or other property.
- Exclusions from transaction price:

Collected on Behalf of Third-Parties

Contingent Consideration

Reductions for Amounts Subject to 461

Acceleration of income

Section 451(b) and the Proposed Regulations

- What amounts are **collected on behalf of third parties**?
  - Example: State income tax collection
  - Example: Amounts collected by platform provider in a marketplace transaction
- Similar considerations apply for purposes of section 59A BEAT, except with respect to expenses
  - Exclusion of COGS from definition of "base erosion payment" means greater significance to book treatment of expenses
- Increasing importance of how items are characterized for book purposes, which may be impacted by legal agreements

Acceleration of income

Section 451(b) and the Proposed Regulations

- What is **contingent consideration**?
  - Under proposed regulations, any amounts that are included in transaction price on an applicable financial statement are presumed to be non-contingent, unless the taxpayer can prove to the satisfaction of the IRS that it is contingent
  - An amount that is actually or constructively received, due and payable, or for which the taxpayer has an enforceable right is NOT contingent
- Proposed regulations focus on whether there is an equitable right to compensation in determining the existence of a contingency
- Examples of contingent consideration:
  - Bonuses that are contingent on performance, for the period during which the contingency remains
  - Warrants and options, that otherwise would be subject to open transaction treatment for U.S. tax purposes

Acceleration of income

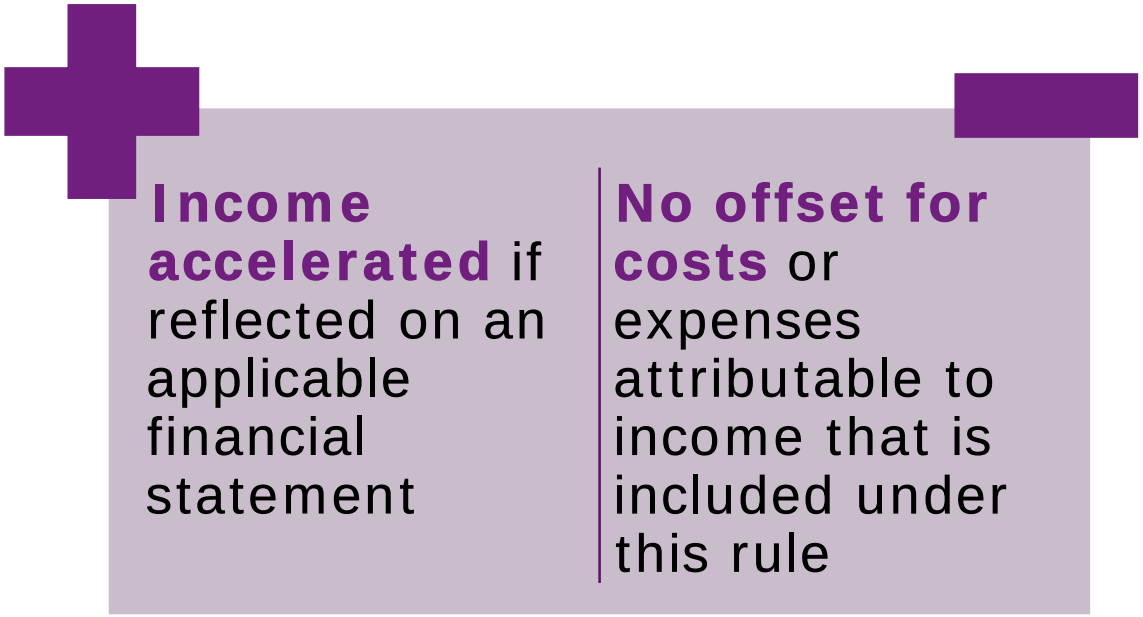
Section 451(b) and the Proposed Regulations

- Reductions for amounts subject to **section 461**?
- Interaction between sections 61 and 461 regarding variable consideration, and discrepancies between "applicable financial statement" and tax treatment is important
  - For applicable financial statement, variable consideration (discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties) may be considered in the transaction price
  - For Federal income tax purposes, variable consideration may be contingent on occurrence of future event, which could affect future income per section 61 or liabilities per section 461
- Proposed regulations provide that there is no reduction in transaction price for amounts subject to section 461
- Increasing importance to understanding book treatment in order to determine tax treatment

Acceleration of income

Section 451(b) and the Proposed Regulations

- No Cost Offset: Notwithstanding commentator requests, proposed regulations do not include a cost offset when income is included under the AFS income inclusion rule



- Preamble notes that nothing in the legislative history indicates an offset was contemplated, certainly promoted conformity

Acceleration of Income

Section 451(b) and the Proposed Regulations

- Special rules for **multi-year contracts**
- Proposed regulations require taxpayers to apply the all events test using a **cumulative approach**, rather than an annualized approach
  - For example, a taxpayer who provides engineering services entered into a contract in 2018 with a customer to provide services over four years. The taxpayer received $25 each year beginning in 2018 and reported revenue of $50, $0, $20, and $30 on its AFS for years 2018, 2019, 2020, and 2021, respectively. Under the proposed regulations, the taxpayer must include $50 in its income in 2018: $25 from its receipt of payment under the all-events test plus the remaining $25 that it recorded as revenue on its AFS in 2018 but did not recognize under the all-events test. In 2019, the taxpayer does not include any amount in its income because the taxpayer had already included the $25 it received in 2019 in its income in 2018 (this is an application of the cumulative approach noted above). In 2019 and 2020, the taxpayer includes $25 in income each year under the all-events test

Acceleration of income

Section 451(b) and the Proposed Regulations

- Special rules for contracts with **multiple performance obligations**:
  - The proposed regulations provide that if a contract has multiple performance obligations, the transaction price is allocated to each performance obligation in a manner similar to how the taxpayer accounts for the income in revenue in its AFS
  - "Performance obligation" is defined as a distinct contractual promise with a customer to transfer either a good or service (or a combination of both) or a series of goods
  - Consistent with the definition of "performance obligation" in International Accounting Standards Board's International Financial Reporting Standard (IFRS) 15

Acceleration of income

Section 451(b) and the Proposed Regulations

- Special rules for **certain debt instruments**
- Section 451(b) generally does not affect timing of OID; however, the proposed regulations also provide exceptions to this general rule for specified credit card fees
- Section 451(b) will apply before sections 1271 through 1275 to require inclusion of income consistent with a taxpayer's AFS with respect to the following fees:
  - A payment of additional interest or a similar charge with respect to unpaid amounts on a credit card (such as late fees)
  - Amounts charged to a credit card holder for cash advance transactions (such as credit card advance fees)
  - Amounts a credit/debit card issuer is entitled to upon purchase of goods or services by one of its cardholders (such as interchange fees)

Acceleration of income

Section 451(b) and the Proposed Regulations

- Rev. Proc. 2019-37 modifies Rev. Proc. 2018-31 to provide automatic method changes for:
  - Change in the treatment of an item of gross income as meeting the All Events Test no later than when such item is taken into account as revenue in its AFS under §451(b)(1)(A)
  - Change to allocate the transaction price to performance obligations under §451(b)(4), but is not adopting the new revenue recognition standards for financial accounting purposes
  - Change its method of accounting to comply with proposed Treas. Reg. §1.451-3
  - Change its method of accounting to comply with proposed Treas. Reg. §1.451-8(c)
- Available section 481(a) adjustment or on cut-off basis
- Audit protection is available, even if TP is under examination
- Ability to file concurrent method changes on same Form 3115

Acceleration of income: Section 118

Acceleration of income

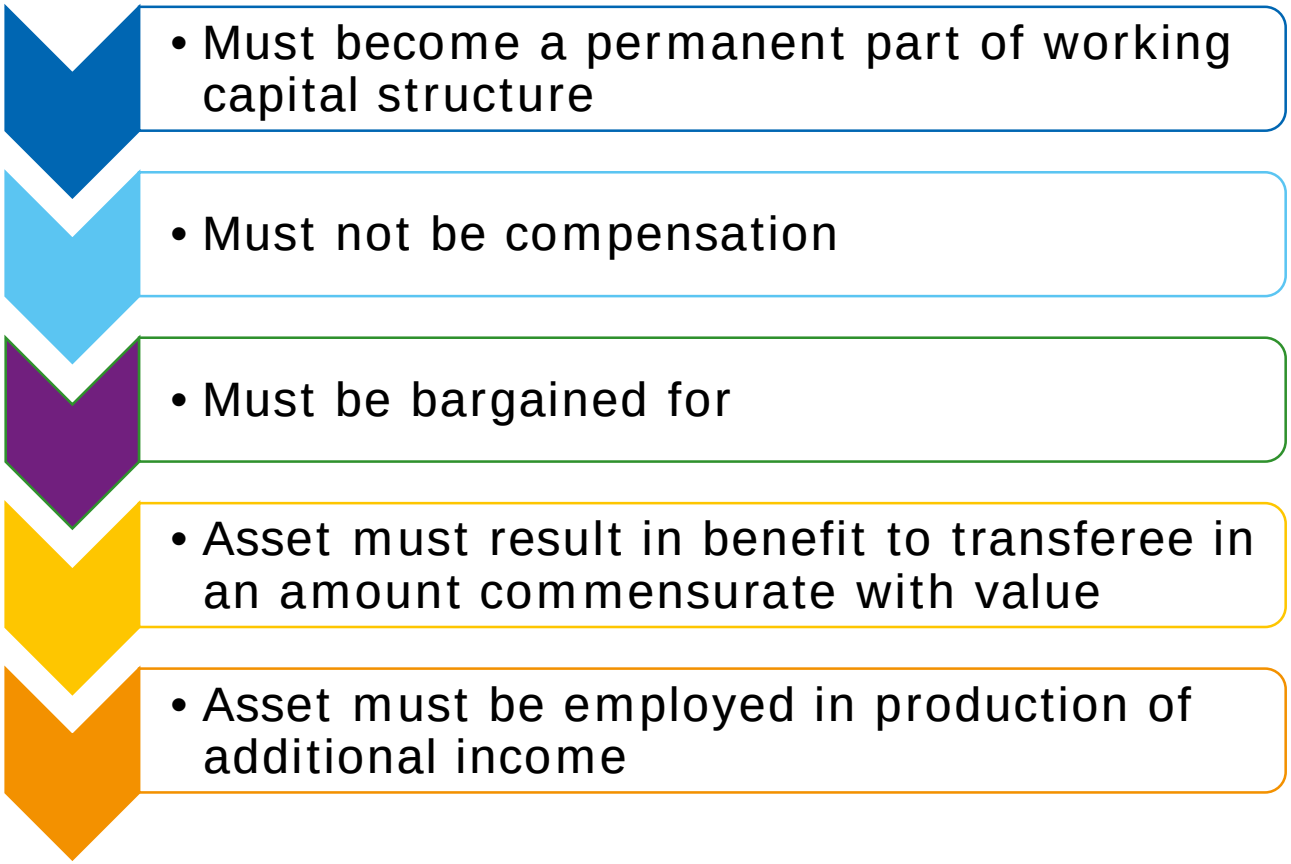
Section 118 and Non-Shareholder Contributions

- Section 118 generally provides that capital contributions are tax-free to the recipient
- Historically, taxpayers relied on section 118 to exclude certain non-shareholder capital contributions (e.g., government and civic organization grants) from income, applying the factors laid out by the Supreme Court in *US v. Chicago, Burlington & Quincy Railroad*
  - Taxpayers were required to reduce asset basis for any assets acquired in such a contribution, but current recognition of income was not required

Acceleration of income

Section 118 and Non-Shareholder Contributions

– *US v. Chicago, Burlington & Quincy Railroad* factors:



Acceleration of income

Section 118 and Non-Shareholder Contributions

- Following amendment, excludes contributions by a government or a civic association, except to the extent made as a shareholder
- Accelerates recognition of income for government grants and similar incentives
- Exceptions:
  - Does not apply to tax incentives, e.g., a municipal tax abatements versus a land grant
    - Important to take into account tax implications when structuring incentive agreements
  - Under grandfather rule, if provided pursuant to a master plan in place prior to enactment of current rules, then current rules do not apply

Deferral: Limitations of Section 451(c)

Deferral

Limitations of Section 451(c) and Proposed Regulations

- Essentially codified the Deferral Method provided under Rev. Proc. 2004-34
- Allows taxpayers to elect to defer the recognition of advance payments to the taxable year following the year of receipt to the extent such income is deferred for book purposes
  - Notice 2018-35 confirmed taxpayers could rely on Rev. Proc. 2004-34 until further guidance
  - On July 15, 2019, Treas. Reg. §1.451-5 (and its lengthier income deferral period) was officially repealed

Deferral

Limitations of Section 451(c) and Proposed Regulations

- Proposed regulations largely conform to Rev. Proc. 2004-34 for purposes of recognition of income from **advance payments**:
  - Adopts same acceleration rules for taxpayers that cease to exist or that participate in nonrecognition transactions
  - Allows continued used of the deferral method
  - A non-AFS taxpayer can defer income using an “earned” standard
- Use of the AFS (or non-AFS) deferral method under the proposed regulations is an adoption, or change in, method of accounting – requiring Form 3115
- Does not provide an accelerated cost offset

Deferral

Limitations of Section 451(c) and Proposed Regulations

- An **advance payment** is defined as:

Payment if full inclusion in year of receipt is permissible

Any portion of which is included in current and subsequent year for financial statement purposes

For goods or services designated by the IRS

Deferral

Limitations of Section 451(c) and Proposed Regulations

Included

- Services (and ancillary use of property)
- Sales of Goods
- Use of IP
- Sale, lease, license of software
- Subscriptions
- Memberships
- Gift cards

Deferral

Limitations of Section 451(c) and Proposed Regulations

Excluded

- Rent
- Insurance premiums
- Payments on financial instruments
- Payments in a tax year prior to the year immediately preceding contractual delivery date

Deferral: Section 163(j)

Deferral

Section 163(j)

- Section 163(j) was amended to limit net interest expense deduction to 30 percent of adjusted taxable income
  - Generally is EBITDA, until January 1, 2022
  - Exceptions for utilities and real estate businesses, as well as floor plan financing
  - Special rules apply to partnerships
- Disallowed interest expense carries forward and is treated as a business expense in the subsequent year
  - Although current cash tax cost may not have financial statement impact if projections indicate carried forward losses may be used

Deferral

Section 163(j)

- Largely mechanical rule, but proposed regulations address certain open questions:
  - Applies on a consolidated basis, and special rules for allocation of limitation between members of group—implications for state tax purposes
  - Broad definition of “interest expense” to include any item that includes “time value of money”
  - Applies to CFCs, although election to apply on a group basis—can have implications for GILTI calculation
- Final regulations are rumored to be forthcoming, but timing is uncertain

Denial: Section 267A

Denial

Section 267A and the Proposed Regulations

- ***Who*** is affected by § 267A?
  - Generally US persons, Controlled Foreign Corporations ("**CFC**") and a US branch, known under the proposed regulations as a "specified party"
- ***What*** is § 267A intended to do?
  - Introduced to target deduction/no inclusion ("**D/NI**") transactions between related parties (and certain "structured transactions") generally attributable to "hybrid transactions" and "hybrid entities" by eliminating the US deduction for "specified parties" with respect to interest and royalties in related party transactions

Denial

Section 267A and the Proposed Regulations

- ***Where*** did § 267A come from?
  - Legislative history indicates that § 267A came from a concern of the exploitation of different characterizations between US and non-US law
  - The legislative history also indicates that § 267A is meant to be "consistent" with many approaches taken in the Code, the OECD Base Erosion and Profits Shifting initiatives ("**BEPS**"), treaties and non-US law
- ***When*** does § 267A apply?
  - Although the general effective date for the proposed regulations is tax years after 2017 the following are applicable after December 20, 2018:
    - Disregarded payments
    - Deemed branch payments
    - Branch mismatch payments
    - Disqualified imported mismatch amounts
    - Structured payments
    - Structured arrangements

Denial

Section 267A and the Proposed Regulations

- ***Why and How*** does § 267A work?
  - As indicated above, § 267A polices US deductions by utilizing foreign law to determine whether there is an inclusion and, to some extent, whether there is hybridity—consistent with BEPS action 2
  - The proposed regulations also look to whether there is an inclusion that benefits from a preferred rate, no rate or certain tax credits and generally employs a 36-month period to test for an inclusion of income
  - There is also a principal purpose mechanism under the proposed regulations which technically does not require any hybridity in the transaction
  - Section 267A is interesting because it is a significant departure from the selectivity that taxpayers have enjoyed under the "check-the-box" rules and the general exclusivity of US tax rules to analyze transactions, as well as the extremely broad scope of the proposed regulations

Denial

Section 267A and the Proposed Regulations

- No deduction allowed for a ***disqualified related party amount*** paid or accrued pursuant to a ***hybrid transaction*** or with respect to a ***hybrid entity***
  - A ***disqualified related party amount*** is interest or royalties paid or accrued to a related party (as generally defined under Section 954(d)(3)) which is
    - not included in the non-US jurisdiction *or*
    - the related party is allowed a deduction in the non-US jurisdiction
  - A ***hybrid transaction*** is any transactions, agreements or instruments which is treated as interest or royalties in the US but not in the non-US jurisdiction (e.g., dividend or disregarded payment)
  - A ***hybrid entity*** is any entity which is
    - Treated as fiscally transparent in the US but not in the applicable non-US jurisdiction of residency or where subject to tax (i.e., a hybrid) *or*
    - Treated as fiscally transparent in the applicable non-US jurisdiction but not in the US (i.e., a reverse hybrid)
- Subpart F payments included by a CFC's "US shareholder" explicitly exempted from § 267A

Denial

Section 267A and the Proposed Regulations

- Broad grant of regulatory authority to address:
  - Conduit arrangements with hybridity
  - Branches and domestic entities
  - Certain “structured transactions”
  - Preferred rates for reducing the applicable non-US rate by 25% or more
  - Situations where the applicable payment is subject to a participation exemption or exclusion from tax or deduction in the applicable non-US jurisdiction
  - Determining tax residency where multiple non-US jurisdictions are at play
  - Exceptions from loss of deduction in cases where income is taxed under the laws of a non-US jurisdiction other than state of related party’s residence and other cases where it is determined that a risk of eroding the tax base does not apply
  - Recordkeeping and informational reporting
- Effective for tax years after 2017
- No limitation on persons and no exemption where full or partial withholding tax on payments is due

Denial

Section 267A and the Proposed Regulations

- Proposed regulations for § 267A released on December 20, 2018 that greatly expand scope of the statutory language and substantially alter the defined terms and language of the statute
  - Regulations promulgated in same packet that included proposed regulations under § 245A(e), § 1503(d) and § 7701
- The proposed regulations disallow a deduction for a ***specified payment*** with respect to a ***specified party*** to the extent such payment is:
  - A ***disqualified hybrid amount***
  - A ***disqualified imported mismatch amount*** or
  - A transaction where the ***principal purpose*** is to ***avoid*** the ***regulations*** under § 267A
- A ***specified payment*** is a payment of interest and royalties (or items deemed or presumed to be interest or royalties under the proposed regulations) and/or "structured payments"
- A ***specified party*** is a US person, CFC where there is a US shareholder owning 10% or more of vote or value and a US branch including a permanent establishment

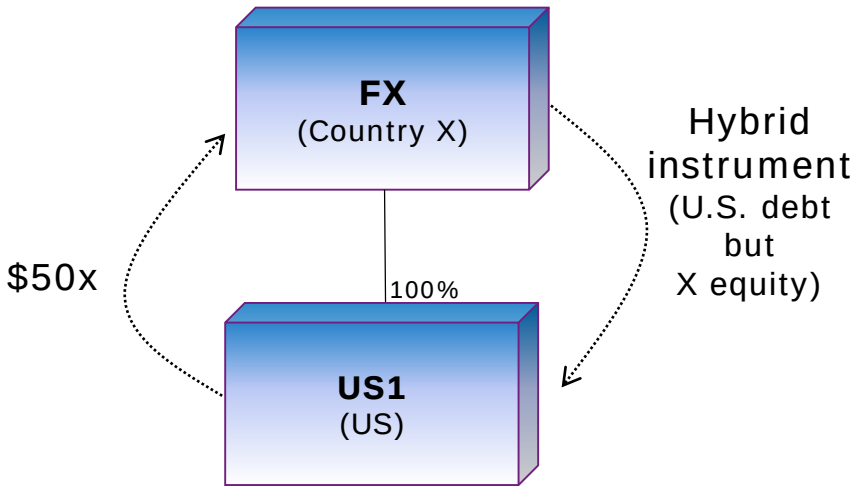
Denied

Section 267A and the Proposed Regulations

- **Withholding taxes ignored.** No exemption in circumstances where there is full (or even partial) US federal withholding tax
- **Staggered effective dates for the proposed regulations.** Although the general effective date for the proposed regulations is tax years after 2017, the following are applicable after December 20, 2018:
  - Disregarded payments
  - Deemed branch payments
  - Branch mismatch payments
  - Disqualified imported mismatch amounts
  - Structured payments
  - Structured arrangements
- **NI event not necessarily tied to hybridity.** Based upon the breadth of the proposed guidance, if an item is treated as interest in the U.S. but perhaps repayment of principal, it appears that § 267A may be implicated
- **Broad definition of specified payments could lead to unexpected disallowances.** Because of the definition of interest, royalties and structured payments, there is a greater chance of NI events where there is no tax avoidance purpose

Section 267A

Example #1, § 1.267A-6(c) – Classic Hybrid Instrument



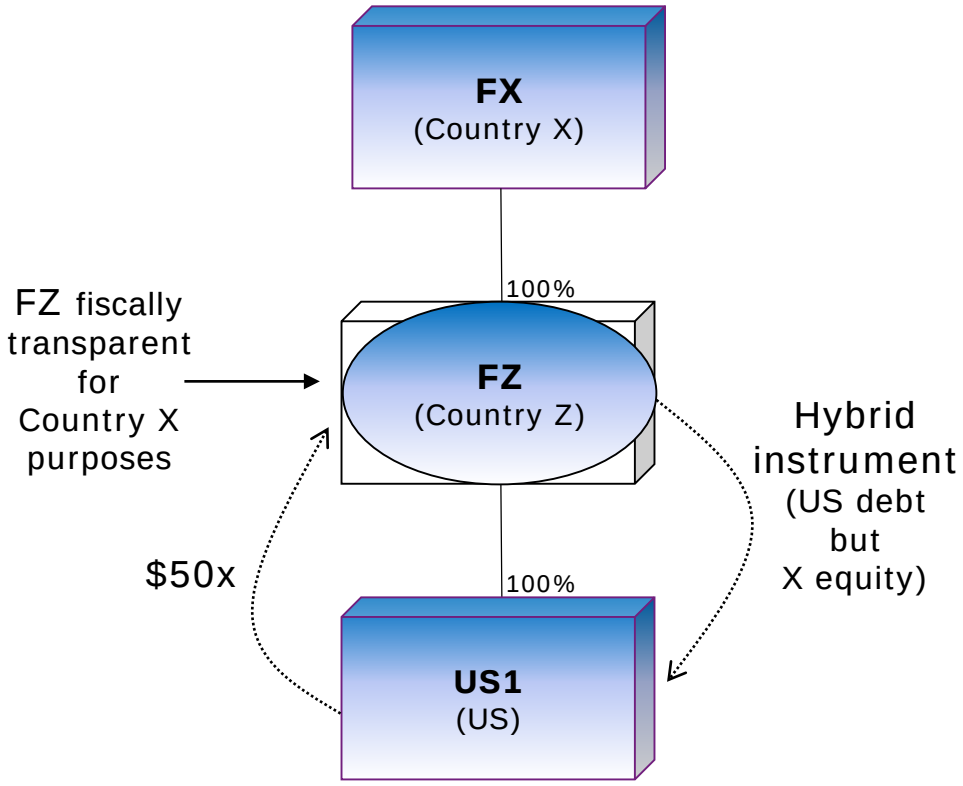
- Hybrid instrument treated as debt in the US but equity for Country X purposes
- The $50x is deductible as interest in the US and excluded from inclusion under Country X's the participation exemption
- US1 is a specified party (a US person), and the payment on the hybrid instrument is a specified payment to a related party
- The hybrid instrument is a disqualified hybrid amount (i.e., D/NI) and thus the deduction in the US is disallowed under Section 267A
- Result would be the same if Country X simply excluded the income or reduced or excluded the income under a dividends received deduction
- If there were a preferred rate, a calculation would determine the portion of the deduction disallowed
- If Country X was a pure territorial system (only taxes domestic source income) or did not have a corporate income tax, Section 267A would not disallow the deduction because Country X result not because of hybridity

Key

Corporation for all income tax purposes

Section 267A

Example #1, § 1.267A-6(c) – Variation of Prior Example



- Same facts although FZ is fiscally transparent for Country X purposes but fully taxes the $50x of income as interest in Country Z
- The $50x is deductible as interest in the US and remains excluded from inclusion under Country X's the participation exemption
- US1 is a specified party and the payment on the hybrid instrument is a specified payment to a related party
- Because Country X does not include the income the hybrid instrument remains a disqualified hybrid amount (i.e., D/NI) and thus the deduction in the US is disallowed under § 267A
- For § 267A purposes, both FX and FZ are aggregated together (i.e., each are a specified recipient) and if one does not include the income, § 267A denies the deduction

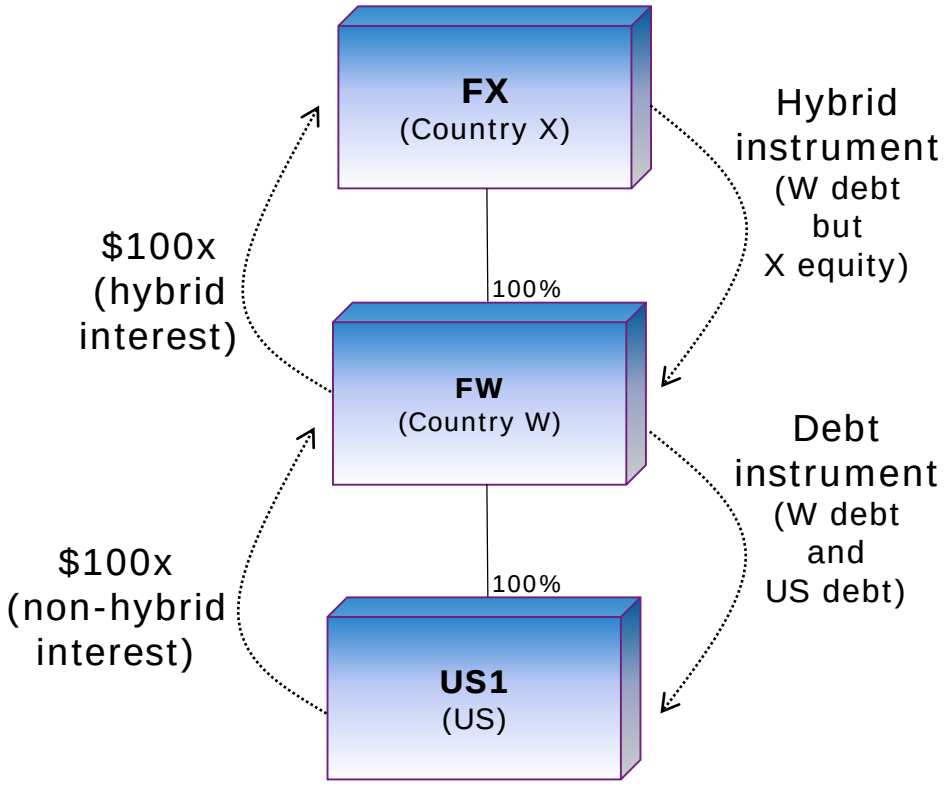
Key

Corporation for US federal income tax purposes

Disregarded entity for Country X income tax purposes

Section 267A

Example #8, Section 1.267A-6(c) – Disqualified Imported Mismatch



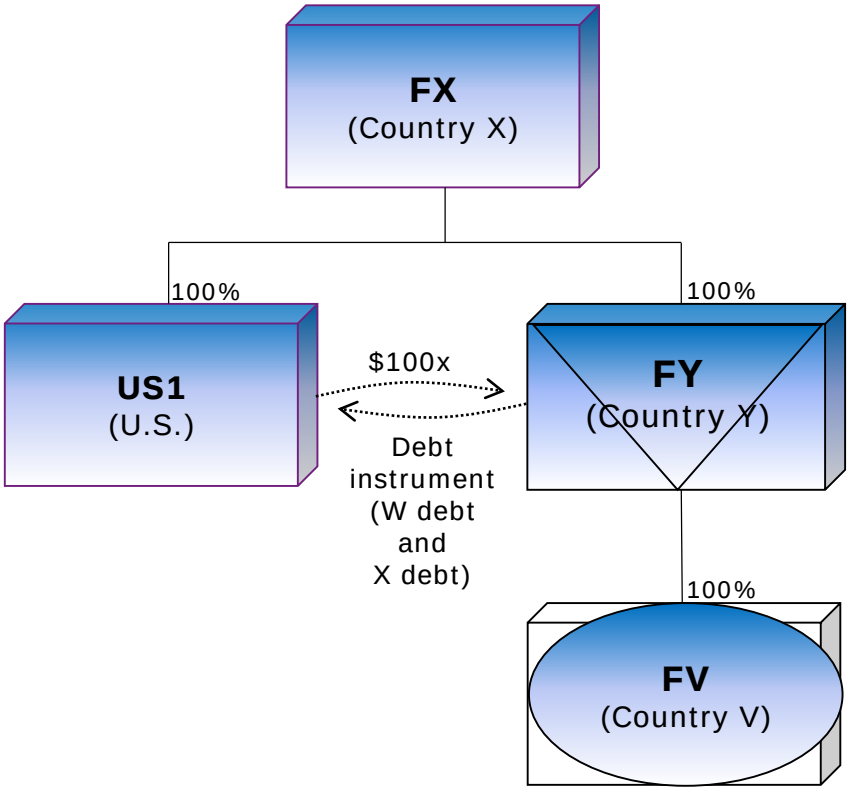
- Hybrid instrument treated as debt in Country W but equity for Country X purposes
- The $100x is deductible as interest in Country W and excluded from inclusion under Country X's participation exemption
- US source payment is an imported mismatch payment because of the hybrid instrument between FX and FW
- This is a disqualified imported mismatch amount because the $100x of income included by FW is offset by the deduction of $100x on the hybrid instrument
- US1's deduction is denied under Section 267A
- The result would be the same if the hybrid instrument was treated as debt in both countries, Country W accrues the deduction and Country X includes only when paid and there is no payment within 36 months of the end of the applicable tax year
- If Country W disallowed the deduction under hybrid rules, Section 267A is not applicable

Key

Corporation for all income tax purposes

Section 267A

Example #5, § 1.267A-6(c) – Reverse Hybrid



- Instrument treated as debt in the US and Country X
- FY is a reverse hybrid under the Section 267A rules because it is fiscally transparent in Country Y but not in Country X
- There is NI because FX is not deriving or including the $100x interest income
- Because the payment is made to a reverse hybrid and there is NI, Section 267A denies the deduction
- The result would be the same if the payment were made to FV
- If Country X has an anti-deferral regime that would require FX to include the full $100x (without offsets and deductions), Section 267A would no longer apply and the deduction would be allowed
- If FY had multiple owners, in addition to FX, and such multiple owners treated FY as fiscally transparent, it appears the disallowance under Section 267A would stand as there is one "specified recipient" that has NI

Key

Corporation for US federal income tax purposes

Fiscally transparent for Country Y income tax purposes but not Country X income tax purposes

Disregarded entity for Country X income tax purposes

Denied: Section 59A?

Denied

Section 59A and the Proposed Regulations?

- Section 59A “Base Erosion Anti-Abuse Tax” generally is a minimum tax that is imposed on an “applicable taxpayer” if:
  - The “base erosion percentage” (i.e., percentage of deductible payments made to related persons) is at least three percent of total deductible payments
- For taxpayers that otherwise are not in a tax-paying position, falling under the three percent threshold may be significant

Denied

Section 59A and the Proposed Regulations?

- Amounts included in COGS are not treated as base erosion payments
  - In the case of related parties, this may help to reduce the numerator
  - In the case of unrelated parties, excluding amounts from COGS, and treating them as deductions, will increase the denominator
- Treatment of items of expense as COGS or not COGS generally is a method of accounting, which requires consent to change
- In public comments, IRS has indicated it will be focused on efforts to avoid application of BEAT rules through characterization of payments

Denied

Section 59A and the Proposed Regulations?

- Proposed regulations are consistent with statutory framework
  - Provide helpful guidance as to application of “services cost method” exception—applies to the extent of the cost, so only the mark-up is a BEAT payment
  - Treatment of a payment as deductible is based on US federal income tax principles—no special rules for BEAT
- Rumored final and proposed regulations may permit taxpayers to self-disallow deductions in order to ensure that the three percent threshold is not met
  - Suggested that this could be applied during audit
  - May address treaty considerations related to application of BEAT

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