U.S. Tax Reform

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The Proposed Participation Exemption System

- The “Tax Cuts and Jobs Act” (H.R. 1, 115th Congress, 1st Sess.) (the “House Bill”) introduces a 100% deduction for “foreign-source portion” of dividends received by a domestic corporation that is a U.S. shareholder from a “specified 10% owned foreign corporation.”
  - A specified 10% owned foreign corporation is a foreign corporation of which 10% or more is owned by a U.S. corporate shareholder, other than a foreign corporation that is a PFIC but not a CFC.
  - The foreign-source portion of any dividend is generally the portion that is attributable to the specified 10% owned foreign corporation’s post-1986 undistributed foreign earnings (i.e., income that is not effectively connected with the conduct of a U.S. trade or business or that is not attributable to dividends received from a domestic corporation 80% of which is owned by the specified 10% owned foreign corporation). coneci3610 Tc 0 Tw (-)Tj 0.004 Tc -0.018 Tw -sour–

The Proposed Participation Exemption System (cont.)

- Applies participation exemption system to undistributed foreign earnings that are reinvested in U.S. property.
  - Repeals Section 956 with respect to U.S. corporate shareholders.
  - Section 956 would continue to apply with respect to noncorporate U.S. shareholders.
- Coordination with foreign tax credit rules (see slide below).
- Effective for dividends paid after December 31, 2017 (and, with respect to disallowance of foreign tax credits, taxable years ending after December 31, 2017).

The Proposed Participation Exemption System – Senate Bill

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Sale of Subsidiary Stock

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Impact on Foreign Branches

- Earnings of foreign branches of U.S. corporations are excluded from the proposed participation exemption system (*i.e.*, current tax system continues to apply).
- Section 901 foreign tax credits would continue to offset U.S. federal tax on earnings of U.S. corporations through foreign branches.
- If a domestic shareholder transfers substantially all of the assets of a foreign branch to a specified 10% owned foreign corporation (with respect to which the domestic corporation is a U.S. shareholder after such transfer), such U.S. corporate shareholder shall include in income for the taxable year of such transfer the "transferred loss amount" with respect to such transfer.
  - For transfers covered by Section 367(a)(3)(C), the transferred loss amount is excess of the post-effective date losses incurred by the foreign branch that were deducted by the U.S. corporate shareholder over the sum of the taxable foreign branch profit earned after the loss is incurred and the OFL arising out of the transfer of the branch assets.
  - For transfers not covered by Section 367(a)(3)(C), the transferred loss amount is further reduced (but not below zero) by any other gains recognized by the U.S. corporate shareholder on such transfer.
  - Amounts includible in income would be treated as U.S.-source income.
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Changes to Foreign Tax Credit Rules

- No foreign tax credit or deduction would be allowed for any foreign taxes (including foreign withholding taxes) paid or accrued with respect to any exempted dividends under the participation exemption system.
  - Consequently, the bill repeals Section 902 indirect foreign tax credits.
  - Impact on structure of foreign operations (*e.g.*, CFCs versus branches).
- Section 960 indirect foreign tax credits that are "properly attributable" to any subpart F income inclusions would be determined on a current-year basis and without regard to pools of foreign earnings retained offshore.
- For purposes of determining foreign tax credits, the source of income arising from the sale of inventory produced within the United States but sold outside the United States (or vice versa) would be apportioned solely on the basis of where production activities attributable to the inventory are located.
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Transition Tax - Overview

- The House Bill proposes to amend Section 965 to impose a one-time "transition tax" by creating a deemed inclusion of foreign corporations' deferred foreign earnings to such corporations' U.S. shareholders.
- Generally, the House Bill proposes to create a deemed repatriation from controlled foreign corporations and from any other foreign corporation that is at least 10% owned by a domestic corporation (excluding non-controlled passive foreign investment companies) (for purposes of this discussion, we refer to all such corporations as "**CFCs**") with undistributed foreign earnings which were not previously subject to U.S. taxation ("**deferred E&P**") to their 10% U.S. shareholders, by increasing such CFCs' subpart F income by the amount of its deferred E&P. The subpart F income is included in the last taxable year of the CFC which begins before January 1, 2018.
- A U.S. shareholder required to include deferred E&P in gross income is allowed a deduction, computed by reference to the portion of the deferred E&P attributable to cash or liquid assets. The deduction effectively results in a 7% tax being imposed on the non-cash portion of the deferred E&P, and a 14% tax being imposed on the cash portion of the deferred

Transition Tax - Deferred E&P – Definition

- Proposed Section 965 defines deferred E&P as post-1986 E&P, subject to certain exclusions and adjustments.
  - Post-1986 E&P of a CFC is determined as of November 2, 2017 or December 31, 2017, whichever is greater (the "**measurement date**"), without diminution by reason of dividends paid during such taxable year and increased by certain qualified deficits.
- The provision increases a CFC's subpart F income for the last taxable year beginning before January 1, 2018 by the deferred E&P determined as described above.
  - Consequently, for CFCs with a non-

Transition Tax - Measurement of Deferred E&P

- Under the proposal, a CFC's subpart F income would be increased in its last tax year which begins before January 1, 2018 by the CFC's deferred E&P as of the measurement date.
- Measurement date is either November 2, 2017 or December 31, 2017, whichever date results in a higher amount of deferred E&P.
  - Accordingly, CFCs with a one-

Transition Tax - Foreign Tax Credits

- Proposed Section 965 provides that credits under Section 901 are disallowed for the “applicable percentage” of any taxes paid or accrued (or treated as such) with respect to any amount subject to the transition tax.
  - Similarly, no deduction is allowed for any tax for which the credit is not allowable under these provisions.
- The Section 78 gross up does not apply to any tax for which the credit is not allowable under the statute.
- Any excess FTCs resulting from the inclusion are eligible for a special 20 year carryforward period, rather than the otherwise available 10-year period provided for by Section 904(c).
- Other FTCs available to the taxpayer (e.g., carryforwards from prior years) are available without reduction to offset the U.S. tax liability with respect to Section 965 inclusions.

Example 1

Facts

- U.S. Multinational (“Parent”) is a calendar year taxpayer. Parent owns CFC, which has a 12/31 taxable year.

Example 2

Facts

- Parent is a calendar year taxpayer. Parent owns CFC, which has an 11/30 taxable year.
- On 11/15/17, CFC pays a dividend of $100 with excess FTCs to Parent.
- CFC's E&P is static between the measurement dates.

Analysis

- The $100 dividend does not reduce CFC's deferred E&P as of 11/2/17.
- Parent has $100 of dividend income plus a Section 78 inclusion on 11/15/17, which brings back excess FTCs in the 2017 calendar year. These credits can either be used against other foreign source income or carried back or forward pursuant to Section 904(c).
- CFC's deferred E&P (including the $100 distributed) becomes subpart F income on 11/30/18, and is included in Parent's taxable income in 2018.
- Parent may be able to utilize the FTC carryforward from the 2017 dividend against its transition tax liability.

Example 3

Facts

- Parent is a calendar year taxpayer. Parent owns CFC 1, which owns CFC 2. Each of CFC 1 and CFC 2 has an 11/30 fiscal year.
- On 11/15/2017, CFC 2 pays a $100 dividend to CFC 1 out of cash on its balance sheet.
- CFC 1 excludes the dividend from subpart F income under Section 954(c)(6).
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Transition Tax - Deduction Against Subpart F Inclusion

- Under the House Bill, the transition tax would be imposed at a split rate of 5% and 12%.
- The split rate is implemented by allowing a U.S. Shareholder a deduction, determined by reference to the amount of the inclusion(s) of deferred E&P and the U.S. Shareholder's "aggregate foreign cash position" (described below).
- For example, for a calendar year U.S. Shareholder that owns CFCs with an 11/30 year end and therefore includes deferred E&P in 2018 (when the statutory corporate tax rate is 20%), the deduction is equal to 75% of the excess (if any) of the Section 951 inclusions over the aggregate foreign cash position, plus 40% of the lesser of (i) the Section 951 inclusions and (ii) the aggregate foreign cash position.

Transition Tax - Aggregate Foreign Cash Position

- Under the House Bill, the cash position of each CFC is the sum of the following assets held by the CFC—
  - cash and foreign currency
  - the excess of accounts receivable over accounts payable
  - the fair market value of the following assets:
    - actively traded personal property for which there is an established financial market
    - commercial paper, certificates of deposit, securities of the federal government and of any state or foreign government
    - any obligation with a term of less than one year
    - any asset that the Secretary identifies as being economically equivalent to any asset described above.
- A U.S. Shareholder's "aggregate foreign cash position" is the average of the sum of the shareholder's pro rata share of the cash position of each CFC with respect to which that shareholder is a U.S. shareholder on each of three dates: November 2, 2017 (the date of the House Bill's introduction), and the last day of the two most recent taxable years of such CFC ending before November 2, 2017.
- Prevention of double counting. The House Bill includes rules intended to avoid the double counting of the cash position of CFCs in a controlled group.

Transition Tax - Aggregate Foreign Cash Position (cont.)

- Blocked assets. A cash position is not taken into account if such position could not (as of the relevant measurement date) have been distributed to the U.S. Shareholder because of currency or other restrictions or limitations imposed under the laws of any foreign country. Cash that cannot be distributed for regulatory capital reasons (for example, in the case of banks and insurance companies) is not considered "blocked."
- Anti-abuse rule: In addition to the authority to identify other assets that are subject to the cash position determination by regulation, the proposal also authorizes the IRS to disregard transactions that it determines had the principal purpose of reducing the aggregate foreign cash position.

Transition Tax - Aggregate Foreign Cash Position Issues

- Reduce Cash Position by PTI. Under the House Bill, while deferred E&P is reduced by PTI, cash is effectively treated as allocable solely to non-PTI earnings. Arguably, the cash position should be reduced by PTI to the extent thereof, since PTI can generally be repatriated tax-free.
- Treatment of Accounts Receivable. Accounts receivable arising in the ordinary course of business are not excess funds and should generally be excluded from the computation of cash position.
- CFCs with Different Taxable Years. A U.S. shareholder measures its aggregate foreign cash position as a single sum across all CFCs. A U.S. shareholder with both 11/30 and calendar year CFCs would thus have to take foreign cash held by all of its CFCs (11/30 CFCs and calendar year CFCs) into account for purposes of determining the deduction in respect of its Section 965 inclusion for its calendar year CFCs in 2017, and would then have to take the exact same foreign cash into account again for purposes of determining the deduction in respect of its Section 965 inclusion for its 11/30 CFCs in 2018.

Transition Tax - Installment Payments

- Under the House Bill, a U.S. shareholder may elect to pay the net tax liability resulting from the inclusion of deferred E&P in 8 equal installments.
  - Installment payments are not subject to an interest charge.
- Pursuant to an "acceleration rule," if (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event.
- The taxpayer liable for the installment payments is the U.S. shareholder of the CFC, and not the common parent of its consolidated group.
  - Thus, liquidating the relevant U.S. shareholder would appear to generally accelerate the Section 965 tax liability, even though the U.S. consolidated group remains in existence and is entirely creditworthy.
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Transition Tax – Senate Modifications

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Calculation of Foreign High Return Amount

- Compute Tested Income on a CFC by CFC Basis
  - Tested Income: Excess of gross income (without regard to excluded amounts) over allocable deductions
    - Excluded Amounts:
      - ECI
      - Gross subpart F income
      - Income excluded from FPHCI under section 954(c)(6) (CFC look-thru rule), (h), or (i) (“AFE”)
      - High taxed income
      - Related party dividends
      - Gross income from disposition of actively traded commodities produced or extracted by the CFC (and identified hedges thereof)
  - Tested Loss: Excess of Allocable Deductions over relevant gross income
- Aggregate US shareholder’s pro rata shares of tested income and tested loss for all of its CFCs

Calculation of Foreign High Return Amount

- Step 2: Determine Applicable Percentage of US shareholder's Pro Rata Share of CFCs' aggregate Qualified Business Asset Investments
  - "Applicable Percentage": Short Term AFR + 7%
  - "Qualified Business Asset Investment": CFC's Adjusted Basis in tangible depreciable property used in a trade or business to produced tested income.
    - » Partnership Property: Partner takes into account its distributive share of partnership property using the partnership's basis in the property
    - » Determination of Adjusted Basis: Made without regard to any amendment to Code occurring after enactment of the TCJA
- Step 3: Identify interest expense incurred by CFCs and allocable to their gross Tested Income
- Step 4: Compute Foreign High Return Amount
  - US shareholder's Net CFC Tested Income minus Applicable Percentage of aggregate Qualified Business Asset Investment minus CFCs' interest expenses allocable to their gross tested income

Calculation of Foreign High Return Amount

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Analysis

- Foreign High Return Amount:
  - Net CFCs Tested Income = $87.5 + $190 = $277.5
  - Foreign High Return Amount = $277.5 – ($0 Asset Basis) = $277.5
- High Return Category Inclusion Pre-FTC calculation:
  - 50% of $277.5 = $138.75
- FTC Calculation:
    - » Foreign High Return Percentage = $277.5/$277.5 = 1
    - » Aggregate Taxes = $12.5 + $10 = $22.5
    - » Deemed Paid Credit = 80% * 1 * $22.5 = $18 5.19(*)-52ID 112 >>BET /Figure0.153 0.15010.349 sq /G
  - §78 Gross-Up
    - » §78 Gross-Up = 100% * 1 * $22.5 = $22.5
- Total High Return Category Inclusion:
  - Grossed-Up Foreign High 3J1(P)- T5.04 75.14iTm [(FTC)-1(5)17.5(=)1.8.455 0.396 0.349 scn /TT1 1 6o

GILTI—Part 1

- A US Shareholder must include in gross income its "global intangible low-taxed income" (GILTI) as if it were subpart F income.
- GILTI is generally gross income of a CFC (less ECI, sub F income, high taxed income, et al) over 10% of the CFC's basis in its tangible assets.
- An 80% deemed paid credit is available on GILTI inclusions; it is in a separate FTC basket, with no carryback or carryforward. Section 78 gross-up is based on 100% of foreign taxes attributable to GILTI.

GILTI—Part 2 and FDII

- Deduction equal to 37.5% of the lesser of (1) foreign-derived intangible income (FDII) plus GILTI, or (2) taxable income.
- To get to FDII, solve for X:
  - X/Deemed Intangible Income = Foreign-Derived Deduction Eligible Income/Deduction Eligible Income
    - » Deduction Eligible Income is gross income minus, inter alia, sub F income, GILTI, dividends from CFCs, foreign branch income
    - » Foreign Derived Deduction Eligible Income is deduction eligible income that is derived from export sales/services to foreigners.
    - » Deemed Intangible Income: Excess of Deduction Eligible Income over deemed intangible return (excess of 10% of tangible asset basis)
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Interest Deduction Limitations—new 163(j)

- Under a new § 163(j), interest deductions for a year would generally be limited to 30% of the taxpayer's adjusted taxable income plus any business interest income.
- Due to the repeal of § 956, this provision would have far greater relevance for outbound taxpayers
- Adjusted Taxable income is taxable income reduced by--
  - any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
  - any business interest or business interest income,
  - the amount of any net operating loss deduction under section 172, and
  - any deduction allowable for depreciation, amortization, or depletion,
- If a corporation had no adjusted taxable income (i.e., if it were in a loss position), it could only deduct business interest expense against business interest income
- Any disallowed interest deductions due to the 30% limitation could be carried forward for 5 years on a first-in, first-out basis.

Interest Deduction Limitations—new 163(j) (cont.)

- If a corporation had no adjusted taxable income (i.e., if it were in a loss position), it could only deduct business interest expense against business interest income.
- Any disallowed interest deductions due to the 30% limitation could be carried forward for 5 years on a first-in, first-out basis.

Interest Deduction Limitations—new 163(n)

- Under new § 163(n), a U.S. corporation’s interest deduction relative to the worldwide group’s interest deduction could be no greater than 110% of the U.S. corporation’s EBITDA relative to the worldwide group’s EBITDA.
- In other words, a U.S. corporation’s interest deductions would generally be restricted if it were more highly leveraged relative to the rest of the worldwide group.
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Excise Tax/ECI (cont.)

- It very well could be a violation of the business profits articles of all U.S. bilateral tax treaties and also a violation of the negotiated reductions in withholding rates set forth in many treaties.
- Further, it would provoke retaliatory measures by countries around the world.
- If countries did retaliate, the consequences would be severe: Either the additional foreign taxes would be creditable and cause a significant reduction in revenue, or not creditable and cause a significant increase in the tax burdens of U.S. corporations.
- A “specified amount” would mean any amount allowable as a deduction or includible in COGS, inventory, or the basis of a depreciable or amortizable asset, but excluding interest, amounts paid or incurred for certain securities and commodities, and amounts paid or incurred for services under the total services cost method with no markup under the § 482 regulations.
- Amounts subject to tax under § 881(a) would also be excluded in the same proportion as the tax rate imposed under that section (as reduced by any applicable treaties) bears to 30%.