Panelists

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Agenda

- Background
  - Creation of PTI and Exempt Earnings
  - Basis Adjustments
  - Hybrid Deduction Accounts

- The Challenge – Repatriation
  - Basis Reductions and Potential Gain Recognition
  - Foreign Currency (FX) Gains and Losses
  - Foreign Tax Credit Considerations
  - Section 956 Considerations
Background
Multiple PTI Categories

- Proposed regulations include rules for identifying different groups of PTI
  - Annual PTI layer approach retained, based on the tax year of the original inclusion regardless of when the PTI is distributed through the ownership chain
  - Separate PTI categories are separately tracked within each foreign tax credit limitation, as required under Notice 88-71
  - PTI classified between different “PTEP Groups” to account for new statutory provisions
  - Less common PTI groups are also identified in Notice 2019-1, along with proposed ordering rule
Multiple PTI Categories

PTI is classified in the following groups for:
• Each FTC limitation
• Each taxable year

959(c)(1)
1. Section 965(a) PTI (reclassified from (c)(2))
2. Section 965(b) PTI (reclassified from (c)(2))
3. Section 956 inclusions
4. GILTI PTI (reclassified from (c)(2))
5. Section 245A(e)(2) (reclassified from (c)(2))
6. Section 959(e) PTI (reclassified from (c)(2))
7. Section 964(e)(4) PTI (reclassified from (c)(2))
8. Subpart F PTI (reclassified from (c)(2))
9. Section 956A inclusions

959(c)(2)
10. Section 965(a) PTI
11. Section 965(b) PTI
12. GILTI PTI
13. Section 245A(e)(2)
14. Section 959(e) PTI
15. Section 964(e)(4) PTI
16. Subpart F PTI
Sources of Non-PTI Earnings

- Section 245A exempt earnings
  - QBAI return
  - High-taxed subpart F income (on an elective basis)
  - Foreign oil and gas extraction income
  - Tested income that is offset by tested loss
  - “Deficit fill-in earnings” under section 965(b)(4)(B)
  - Potentially high-taxed GILTI (tested income)?

- Repatriated either as
  - a dividend eligible for section 245A DRD
  - taxable inclusion under section 951(a)(1)(B) (section 956 inclusion)
    - Proposed section 956 regulations would reduce a section 956 inclusion if earnings would qualify for a section 245A DRD (does not help individuals)
    - Proposed section 960 regulations provide that related foreign taxes are not deemed paid
Stock Basis Adjustments

- Section 961 authorizes regulations providing for basis adjustments in CFC stock (or other property through which CFC stock is owned) to prevent double taxation of subpart F income
  - Rules apply for section 965(a) and GILTI inclusions (which are treated as subpart F inclusions for this purpose)
  - No basis increase is provided for section 965(b) PTI, unless an election is made. Reg. § 1.965-2(f)(1)
- Section 961(a): U.S. shareholder increases basis in CFC stock (or other property, as applicable) by amount of its section 951(a) inclusions
- Section 961(b): U.S. shareholder decreases basis in CFC stock (or other property, as applicable) by amount of its PTI distributions
Stock gain recognized by a CFC generally results in subpart F income that is subject to full 21% taxation (subject to dividend treatment under section 964(e))

Section 961(c) provides that “under regulations,” “adjustments” similar to those under section 961(a) and (b) “shall” be made to the stock of lower-tier CFCs held by upper-tier CFCs, “but only for the purposes of determining the amount included under section 951” by the U.S. shareholder

Consider interaction of section 961(c) basis with section 961(a) basis when moving CFCs around

Can PTI distributions between CFCs trigger gain?

USP

USP has $0 basis in CFC1

CFC1

CFC1 has $0 basis in CFC2

$100x distribution

$100x 965(b) PTI
A section 245A DRD is not allowed for any “hybrid dividends,” and no credit is allowed for any foreign taxes paid or accrued with respect to the hybrid dividend.

Shareholders must establish “hybrid deduction accounts” (HDA) with respect to each CFC.

- An HDA reflects the amount of “hybrid deductions” of the CFC that are allocated to the share(s) of such CFC.
- An HDA will cause any dividend paid on any class of stock outstanding to constitute a hybrid dividend, even if the dividend is not paid on a hybrid instrument.

A hybrid deduction is generally a deduction or other tax benefit (such as an exemption, exclusion, or credit) for which:

- The deduction or other tax benefit is allowed to the CFC (or a person related to the CFC) under a relevant foreign tax law; and
- The deduction or other tax benefit relates to an amount paid with respect to an instrument issued by the CFC and treated as stock for US tax purposes.
Repatriation

- Ordering Rules and Potential Gain Recognition
- FX Gains and Losses
- Foreign Tax Credit Considerations
- Foreign Tax Credit Limitation
- Section 956 Considerations
Certain Key Considerations

- **Adjusted basis and possible gain** if the distribution exceeds basis
- **FX gains and losses** recognized under section 986(c)
- **Foreign tax credit issues:**
  - The **amount** of foreign tax credits that are related to the PTI under section 960(b)
    - Potential haircut of FTCs under the new TCJA regime
  - The **basket** that these foreign tax credits are allocated to
    - Taxes generally go into the same basket as the original subpart F income or GILTI
  - Sufficient **foreign tax credit limitation** to claim the credits
    - Most taxpayers will be capacity constrained in all of the baskets, especially GILTI, which will account for most of the PTI
    - Section 960(c) (former section 960(b)) may increase the FTC limitation for distributions of PTI
- **PTI ordering rules:** proposed ordering laid out in Notice 2019-1
Section 959(c) provides ordering rules for distributions of PTI and non-PTI
- Section 956 PTI on a LIFO basis
- Subpart F PTI on a LIFO basis
- Non-PTI E&P on a LIFO basis

TCJA created three new types of Subpart F PTI –
- Section 965(a) PTI
- Section 965(b) PTI
- PTI arising from a GILTI inclusion

Notice 2019-1
- Maintains general section 959(c) ordering (i.e., section 956 PTI, then Sub F PTI, then non-PTI E&P, each on a LIFO basis)
- However, any section 965(a) and 965(b) PTI is returned first (in that order), followed by distributions of all other PTI categories (including GILTI PTI) on a LIFO, pro rata basis
Can basis reduction for distributed PTI occur before increase in basis for current year subpart F income (or GILTI) inclusions?

- Treas. Reg. § 1.961-1(a)(1): basis increase under section 961(a) occurs “as of the last day in the taxable year of such corporation on which it is a controlled foreign corporation”

- Treas. Reg. § 1.961-2(a): basis decrease under section 961(b)(1) occurs “as of the time such person receives such excluded amount”

- Alternative interpretation is that all adjustments happen at year end and the basis reduction at the time of the PTI distribution is only intended to be relevant if there are intervening events between the distribution and the year end (e.g., if USP sold some of CFC stock)

Under 2006 proposed regulations, positive and negative adjustments generally occur at the same time, in conjunction with adjustments to a U.S. shareholders’ PTI account.
Future Solutions?

- Treas. Reg. §1.965-2(g) provides a limited gain reduction rule that allows section 961(b)(2) gain to be reduced to the extent of section 965(a) PTI (and if elected, section 965(b) PTI)
  - To the extent gain is reduced, basis is adjusted downward

- What about other types of PTI?
  - Modify section 961 regulations to clarify that for purposes of determining section 961(b)(2) gain, basis decreases in CFC stock under section 961(b) (and negative basis adjustments pursuant to Treas. Reg. §1.965-2(g)) do not occur prior to basis increases under section 961(a)
  - Alternatively, provide for a gain reduction rule similar to the one for section 965 PTI for all PTI
Repatriation

• Ordering Rules and Potential Gain Recognition
• FX Gains and Losses
• Foreign Tax Credit Considerations
• Foreign Tax Credit Limitation
• Section 956 Considerations
FX gain or loss: In General

- FX (foreign currency) gain or loss results from distribution of PTI
- Such gain or loss is attributable to FX rate movements between income inclusion date and distribution date
- Source of gain based on the original income inclusion
- Section 986(c)(2) authorizes regs on tiered distributions
- Section 986 was not amended by TCJA
- Treas. Reg. §1.986(c)-1 provides guidance on repatriation of section 965 PTI
FX gain or loss—Example

- CFC 1 has 100u of Subpart F in Year 1
- Average exchange rate for the taxable year of CFC 1 in Year 1 is 1u = $1. Thus USP has $100 subpart F inclusion
- Year 2, CFC distributes 100u to USP
- Spot exchange rate on the date of the distribution is 1u = $0.70
- USP has ordinary loss of $30 under Section 986(c) due to the movement between the income inclusion and the distribution date
- Ordinary loss is at USP level (not CFC 1 level)
FX Issues: Section 965 PTI

Key Points

- Section 965 E&P measurement date (Nov. or Dec. 2017) in CFC 1 functional currency
- Inclusion amount based on Spot Rate on Dec. 31, 2017
- Reduced by E&P deficit of CFC2 using same Spot Rate
- PTI increased by inclusion amount for section 965(a) amount
- PTI also increased by deficit offset amount for section 965(b) amount
- FX gain or loss recognized under section 986(c) on distribution of section 965(a) PTI
- FX gain or loss reduced by section 965(c) deduction
- FX gain or loss is not recognized on distribution of section 965(b) PTI
FX Issues—Impact of GILTI Deduction

- CFC 1 has 100u of Net Tested Income in Year 1
- Average exchange rate for the taxable year of CFC 1 in Year 1 is 1u = $1.50. USP has $150 of inclusion
- USP allowed $75 Section 250 deduction
- Year 2, CFC 1 distributes 100u when spot exchange rate is 1u = $2. USP receives $200 FMV
- Assume 25u of foreign tax was paid in year 1. Impact of gross up and impact of GILTI deduction on FX gain or loss?
- What is result on Distribution of 100U?
Repatriation

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Section 960(b): Foreign Taxes and PTI Distributions

- Section 960(b)(1) provides that a US corporation that receives a PTI distribution from a CFC in a taxable year that is excluded from its gross income under section 959(a) “shall be deemed to have paid so much of [the CFC’s] foreign income taxes as are properly attributable to such [excluded] portion.”

- Section 960(b)(2) tiers up foreign taxes paid on PTI distributions made through a chain of foreign corporations

- Limitations
  - Section 965(g) reduction applies to section 960(b) foreign taxes with respect to section 965 PTI
  - Section 965 regulations limit application of former section 960(a)(3) to foreign taxes paid on PTI distributions (and so does not apply to foreign taxes paid by the CFC with respect to which the PTI was created, even if paid on the E&P that becomes the PTI)
    - Proposed FTC regulations extend this limitation to section 960(b) taxes
  - Section 960(d) does not apply to foreign taxes deemed paid under section 960(b)
Section 960(b): Example

Anticipated Consequences:

- $20x of Country D taxes paid by DRE2 should be properly attributable to CFC2’s $180x of subpart F income (section 960(a))
- What about the $10x Country D withholding tax on Distribution 1?
  - Attributable to the subpart F income under section 960(a) if paid in the same year as the inclusion?
  - What if paid after CFC2 distributes the PTI from the subpart F income inclusion? Can the taxes be properly attributable to any amount?
- Country C withholding tax on Distribution 2: section 960(b)(2)
- Country B withholding tax on Distribution 3: Considered paid by CFC1 on the PTI distribution from CFC2? Timing difference?
- Country A withholding tax on Distribution 4: section 960 does not apply to foreign taxes directly paid by USP
- Distribution 4 triggers section 960(b)(1)
- Section 78 gross-up required for section 960(b)(1) deemed paid taxes??
Repatriation

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Section 960(c) – Limitation Carryforward

- Enacted to manage the timing issue created by subpart F inclusions, by increasing the section 904 FTC Limitation in the year the PTI is actually distributed
- Prop. Reg. § 1.960-4(a)(1) would extend the rules to GILTI
- Section 960(c) was amended in 1993 to apply on a basket-by-basket basis but the limitation can be shared,
  - Among CFCs, and
  - Among different tax years
- Operates as a carryback, and does not expire
  - Excess credits can only be carried forward 10 years, and back 1 year
  - Excess limitation is carried forward until used
CFC has $100x of general basket subpart F income in 2018, and pays $10x of foreign taxes

USP’s 2018 taxable income is $100x, and its general FTC limitation is $21x

USP establishes an $11x excess limitation account ("ELA")

CFC distributes $90x PTI in 2020; subject to $18x withholding tax (20% rate)

USP’s taxable income in 2020 is $0x, and so is its general FTC limitation (pre-960(c))

USP increase its general FTC limitation by the lesser of $18x withholding tax and its $11x ELA

\[ \text{USP} \rightarrow \text{CFC} \]
- $90x Dividend
- $18x W/H Taxes

\[ \text{USP} \rightarrow \text{CFC} \]
- $100x Sub F income
- $10x foreign taxes
2018: CFC2 has $100x tested income and $15x tested foreign taxes, leaving no capacity

2019: CFC1 has $100x tested income and no foreign taxes, thus creating capacity and an ELA

2020

- CFC2 distributes $100x PTI subject to 20% WHT
- USP can use its ELA created in 2019 to credit the WHT on the PTI distribution

If 2019 and 2020 events were reversed, and CFC2 distributed the PTI in 2019, and then CFC1 earned low-tax income in 2020, no credit would be allowed for the WHT because no ability to carryover taxes in the GILTI basket
Repatriation

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Section 956 Considerations

- Is section 956 still relevant?
  - Likelihood of a future section 956 inclusion is diminished
    - Inclusion of most foreign earnings on a current basis under GILTI
    - Proposed regulations reduce section 956 inclusions generally to the extent untaxed earnings would qualify for section 245A DRD
  - But still very relevant in certain contexts
    - Tracking and reporting of PTI categories is needed for proper ordering of PTI distributions
    - Hybrid deduction accounts
    - PTI balances in upper-tier CFCs
    - Consider impact of a potential GILTI high-taxed exception

- Treasury considerations
  - Revisiting exclusion of US entities from global cash pools?
  - Pressure from lenders on pledges of foreign stock?
QUESTIONS?

THANK YOU