International Tax Accounting Items

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Moderator
Ellen McElroy
Partner, Eversheds Sutherland (US) LLP

Panelists
Carol Conjura
Partner, KPMG

Jeff Mitchell
Branch Chief, International Tax Branch 2, Internal Revenue Service

Scott Rabinowitz
Counsel, Skadden, Arps, Slate, Meagher & Flom LLP

William Sutton
Senior Counsel, International Tax, U.S. Department of the Treasury
CFC Methods and Audit Protection
Methods of Accounting For CFCs

— CFCs are subject to general accounting method provisions under section 446
  • Used in the determination of the foreign corporation’s E&P
  • Generally, a CFC is not required to match methods of US shareholders

— Adopting a method of accounting
  • CFC required to adopt a method when its E&P becomes “significant” for controlling US shareholders:
    • Distribution from the CFC to its shareholders
    • Amounts includable by shareholders under section 951(a)
    • Exclusions from subpart F income of the CFC under section 952(c)
    • Event that makes the CFC subject to tax under section 882
  • Once adopted, may only be changed with an accounting method change
Methods of Accounting For CFCs

— Changing an Accounting Method
  • Change requested by controlling US shareholder(s)
  • Any change will revise an item of income or deduction
    • Depending on the item changed, the change may be automatic or non-automatic
  • Rev. Rul. 90-38
    • If no method has been adopted, an amended return may be proper
Audit Protection

- Rev. Proc. 2015-13 (Taxpayers Under Exam)
  - Taxpayers under exam my file method changes, but will not have back-year audit protection
    - Exceptions for issues not under consideration:
      - 3-Month Period
      - 120-Day Period
      - Negative section 481(a) adjustments
  - 150% Deemed Foreign Taxes Paid Restriction
    - No audit protection where any of the CFC’s domestic shareholders compute deemed paid taxes that exceed 150% of the average foreign taxes deemed paid over the prior three tax years
Section 965: Transition Tax
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Background

– Section 965 imposes a “transition tax” on unrepatriated foreign earnings and profits of a foreign corporation
  • Foreign corporations are treated similarly to domestic corporations (i.e., permissible methods, elections, and adopting or changing methods)

– Prior to the TCJA, CFCs largely indifferent with respect to their methods of accounting
  • May or may not have been using U.S. methods of accounting

– IRS guidance restricted a CFC’s ability to change methods of accounting if the change reduced transition tax liability
Section 965: Transition Tax

Methods Implications

- CFCs may have been required to retain incorrect methods of accounting
- Denial of audit protection under Rev. Proc. 2015-13
- Limitation on section 481 adjustments (both positive and negative)
- May still be able to adopt changes to correct errors
  - Changes may also be able to reduce E&P for purposes besides the transition tax (e.g., subpart F)
  - If the change is not a method and is made on a prospective basis, there is no audit protection for previously understated section 965 earnings
Section 951A: GILTI
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Background

- Section 951A requires a US shareholder to include a CFC’s global intangible low-taxed income (GILTI) in its gross income
  - A CFC’s GILTI is generally the CFC’s tested income less 10% of the CFC’s qualified business asset investment (QBAI)
    - QBAI is the aggregate adjusted bases in specified tangible property of the CFC
    - QBAI is also part of the foreign-derived intangible income (FDII) calculation under section 250
  - Bases must be calculated using the alternative depreciation system (ADS)

- GILTI is a new type of income
  - E&P methods may not cover all sources of tested income
  - Unclear whether method changes are required
Section 951A: GILTI
Methods Implications

- Lack of Records
  - CFC records may be insufficient to make accounting method changes

- Expense allocation

- Incorrect Bases
  - If bases are incorrect, is an accounting method change required prior to application of ADS?

- Tested income methods vs. E&P methods

- Use of simplifying conventions?
Section 59A: BEAT
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Background

– Section 59A imposes a minimum tax based on a taxpayer’s total base erosion payments
  • Base erosion payments are generally deductible payments paid or accrued to a foreign related party
  • Expenses included in cost of goods sold (COGS) are excluded from BEAT payments

– Methods considerations with respect to increasing COGS/reducing BEAT
  • UNICAP
  • Permissive capitalization
Section 59A: BEAT
Methods Implications

— Perpetual licensing of software and COGS
  • Considerations for cloud-based and downloadable software

— Capitalization of section 174 R&E expenses
  • Allocable to inventory/permissive capitalization?
  • Is section 174 treatment optional?

— Audit protect to change where costs were erroneously classified as COGS?

— Paid or Accrued
  • Limited to taxable transactions?

— Are costing changes considered changes in methods of accounting?
481(a) Adjustments
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- A section 481(a) adjustment is required to ensure that an accounting method change does not result in the omission or duplication of income
  - Rev. Rul. 2015-13, section 7.07:
    - Adjustment must take the same source and character as the taxpayer’s gross income that was offset by the expense

- 481(a) Adjustments and New International Provisions
  - Application of section 7.07 to new international provisions?
  - Adjustments for items incurred prior to TCJA effective dates?