ABA Section of Taxation
Foreign Activities of US Taxpayers

Tax Reform: Outbound Case Study

SECTION OF TAXATION | 2019 MIDYEAR TAX MEETING
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HYATT NEW ORLEANS ◆ NEW ORLEANS, LA

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Basketing of Interest
CFC Look-Through Rule & GILTI

- CFC has substantial GILTI income and no passive or general basket income
- USCo loans money to CFC which pays interest to USCo
- USCo has excess FTCs in the GILTI basket

Results

- The interest reduces DITR, thus increasing GILTI inclusion
- The interest is also taxable at 21%
- Under Prop. Reg. §1.904-5(c)(2)(i), the interest is not subject to look-through under §904(d)(3)(C) unless it is allocable to passive income.
- Thus, the interest defaults to general basket, where it is of no use
CFC Look-Through Rule & GILTI

- Consider contributing the loan to F Holdco
- CFC pays interest to F Holdco

Results

- F Holdco has no subpart F income arising from interest due to the CFC look-through rule under §954(c)(6)
- Net wash on GILTI because there is no reduction of DTIR for interest paid to USCo, but F Holdco includes interest in tested income for GILTI purposes
- 21% tax on interest eliminated
Section 904(b)(4)
Section 904(b)(4)

For section 904 purposes only, section 904(b)(4) disallows deductions allocable to stock that does not give rise to sub F or GILTI inclusion:

“For purposes of subsection (a), in the case of a domestic corporation which is a United States shareholder with respect to a specified 10-percent owned foreign corporation, such shareholder's taxable income from sources without the United States (and entire taxable income) shall be determined without regard to-

(A) the foreign-source portion of any dividend received from such foreign corporation, and
(B) any deductions properly allocable or apportioned to—

(i) income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such specified 10-percent owned foreign corporation, or

(ii) such stock to the extent income with respect to such stock is other than amounts includible under section 951(a)(1) or 951A(a).”
Proposed Regulations §1.904(b)-3

Under proposed regulations, the section 904(b)(4) disallowance of deductions is applied prior to application of overall foreign loss (OFL) and overall domestic loss (ODL) recapture (see Prop. Reg. § 1.904(b)-3(d)).

- Includes deductions allocable to gross income in section 245A subgroup or allocable to or apportioned to stock of specified 10-percent owned foreign corporations in the section 245A subgroup. See Prop. Reg. § 1.904(b)-3(a)(1)

- Section 245A subgroup generally includes the value of stock that relates to non-sub F and non-GILTI foreign source income. See Prop. Reg. § 1.861-13(a).
Proposed Regulations §1.904(b)-3

Consequence of disallowance of deductions *solely* for section 904 purposes:

Results in potential OFL and ODL recapture beyond normal 50% limitation and even beyond taxable income.
Example

• Prior year ODL = 2000
• Assume significant carryover or current foreign taxes paid
• Current year US source income = 1100
• Current year foreign source income = (1000)
  – Current US taxable income = 100
  – Current US tax liability prior to ODL/OFL = 21 (i.e., 21% of 100)
• Minimum ODL recapture without sec. 904(b)(4) = 50% of 100 = 50
  – See Reg. § 1.904(g)-3 ordering rules
  – 50 of the net US source income is converted into foreign source income
  – Permits up to 10.5 of FTCs (21% of 50) to be used against US tax liability of 21
Under Section 904(b)(4) and Proposed Regulations ODL/OFL Ordering Rule

- Assume (500) is expense allocable to section 245A stock
- Foreign source loss for section 904 purposes is (500), not (1000)
- Net US source income after application of foreign source loss of (500) is 600, not 100
- Minimum ODL recapture is 50% of 600 = 300
- 300 of foreign source income creates FTC limitation of 63 (21% of 300)
- But actual US tax liability is 21, based on 100 of actual taxable income
- 200 of ODL recapture is wasted, creating FTC limitation that cannot be used
- Similar discontinuity and wasted recapture with respect to OFL, but wasted OFL recapture is generally taxpayer favorable by reducing OFL without loss of usable FTC limitation.
Affirmative Use of Subpart F
Affirmative Subpart F Planning for High-Taxed Income: Optionality

—Subpart F inclusions generally convert GILTI basket income to general basket
  • Excess FTCs can come up (with 10-yr carry-forward)
  • FTCs can be cross-credited against other general basket income and are otherwise subject to the 10-year section 904(c) carryforward

—OR, elect the high-tax exception to subpart F under section 954(b)(4):
  A path to true territoriality
  • Taxpayers may elect to exclude income from subpart F if the income is subject to a foreign tax rate of > 90% of the maximum U.S. tax rate (i.e., > 18.9%)
  • Income excluded under the subpart F high-tax exception is not subject to subpart F or GILTI (section 951A(c)(2)(A)(i)(III))
  • Eligible for participation exception under section 245A
    • Section 904(b)(4) applies to any allocable shareholder-level expenses
High-tax Exception to Subpart F: The Path to Territoriality

Income excluded from subpart F income under the subpart F high-tax exception is excluded from tested income for GILTI purposes

— Solves the GILTI “expense allocation” tax
— Particularly helpful when there are ODLs, OFLs, or SLLs, such that section 250 deduction may be limited and/or credits may be unavailable (all permanent effects)
— Can reduce BEAT by reducing FTCs
— Proposed regulations relating to section 956 and 960 change the stakes: Taxes appear gone

This sounds great! How do you qualify?

— Applies only to income that otherwise would be section 954(a) foreign base company income or section 953 insurance income
  - No exclusion from tested income for high-tax income that is not subpart F income
— Requires an affirmative election
  - The controlling US Shareholder makes the election for the CFC
  - Election made by filing a statement with an original or amended income tax return under §1.954-1(d)(5)
  - The election is binding on all US shareholders
High-Tax Rxception: Granularity of Calculation

- Under the proposed section 960 regulations, a CFC’s income and taxes for its current year are assigned to an “income group” within a section 904 category
  - The association of taxes with a particular group of subpart F income will directly determine whether that group qualifies for the high-tax exception
- Subpart F income is divided into separate groups for each category of foreign base company income identified under Reg. § 1.954-1(c)(1)(iii)
  - Foreign base company sales income and foreign base company services income are each a separate group
  - Groups would include income earned by separate QBUs of the CFC located in various foreign jurisdictions, effectively allowing averaging across QBUs but not across different categories of subpart F income
- Although the grouping rules have not changed, they have more significance going forward
  - In the past, grouping was of limited relevance for the high-tax exception of section 954(b)(4) because the determination was ultimately driven by the pooling regime of old section 902
Example – High-Tax Exception

Old law
— Qualification for high-tax exception if income taxed at >31.5% foreign tax rate
— Determined under pooling/basketing regime of old section 902
— Result: $220 may qualify for exception
  — (71/220 = 32.3%)

Proposed rules
— Qualification for high-tax exception if income taxed at >18.9% foreign tax rate
— Now driven by association of taxes with a particular group of subpart F income under section 960
— Result: only $200 may qualify for exception (no blending)
Converting From GILTI to Subpart F

Affirmative FBC Services Income: Performing services outside country of incorporation

Pre Tax-reform
- Service Provider was a regarded CFC, such that its service income was not FBC Services Income because performed by Country C CFC in Country C

Post Tax-reform
- Service Provider elects to be a DRE of a holding company CFC incorporated in a different jurisdiction (CFC 2), so that “same-country” exception for FBC Services would not apply
- Also consider performance guarantees and substantial assistance
Converting From GILTI to Subpart F

Affirmative FBC Sales Income: Convert same country LRD CFC to DE

Pre Tax-reform

- In-Country CFC Distributor’s income from sale of property purchased from CFC 1 was not foreign base company sales income ("FBCSaI") under the "same country of sales" exception

Post Tax-reform

- In-Country Distributor files CTB election to be DRE of CFC 2, a HoldCo incorporated in a different jurisdiction
- CFC 2’s income from Country C sales (through In-Country Distributor DRE) would be FBCSaI
  - "Same country of sales" exception would not apply. See Reg 1.954-3(b)(2)(ii)(f) (preventing affirmative use of branch rule)
- CFC 1’s income would be excluded from FBCSaI as CFC 1 is the physical manufacturer (GILTI)
Allocation of Interest to Tested Income
Allocation of Interest Expense to Tested Income

**Facts:**
- Leveraged HoldCo owns OpCo (assume same country and that there is some form of group relief/consolidation that allows the HoldCo interest expense to reduce the local tax liability of OpCo)
- HoldCo does not have gross tested income, and all of OpCo’s income is gross tested income
  - Debt payments are funded via distributions from OpCo to HoldCo

**Issue:**
- Is HoldCo's interest expense allocable to HoldCo's tested income for GILTI purposes?
  - Does not seem allocable under proposed §1.861-9(j) modified gross income method
    - In that case, HoldCo would not have a tested loss to offset OpCo’s tested income
  - Could be allocable under §1.861-9T(g) and proposed §1.861-9(g) asset method
    - In that case, Holdco would have a tested loss to offset OpCo’s tested income
  - Policy for asymmetrical result?
Branch v. Corporate Subsidiary
USP is a multi-national enterprise with numerous CFCs and operations around the world.

USP is a fiscal-year taxpayer.

USP has significant interest expense in the U.S.

CFC 3, a Country X Corporation, is subject to a corporate tax rate of 19%. Branch is located in Country X and is subject to a branch tax rate of 19%.

Country X requires CFC 3 to use the calendar year as its taxable year.

CFC 3 does not generate Subpart F income and has virtually no QBAI (therefore attracting GILTI exposure).

Both CFC 3 and Branch generate significant non-Sub F income (before application of GILTI).
<table>
<thead>
<tr>
<th>CFC</th>
<th>Branch</th>
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<tbody>
<tr>
<td><strong>Pre-Tax Reform:</strong></td>
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<tr>
<td>• Deferral Benefit</td>
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<td>• Issues with tax credits as income taxes would only accrue on Dec 31, so timing of tax credits was an issue.</td>
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<td>• FTCs from other entities could be used to offset marginal US tax on difference between 19% rate and 35% rate</td>
<td>• FTCs from other businesses could offset marginal rate difference between 19% and 35% rate</td>
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### CFC Tax Pre- & Post-Tax Reform

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<td>• No deferral benefit</td>
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<td>• Expense apportionment can result in GILTI b/c of no QBAI</td>
<td>• 901 Credit, but may be reduced because of expense apportionment</td>
</tr>
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<td>• Total tax = 19% PLUS GILTI (less partial credit w/r/t 19% Country X tax)</td>
<td>• FTCs from other businesses/activities conducted in branch form could offset marginal rate difference between 19% and 21% rate</td>
</tr>
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<td>• Issues with tax credits as income taxes would only accrue on Dec 31, so timing of tax credits remains an issue</td>
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Joint Venture Pre & Post-Tax Reform

Facts:

- USP is a multi-national enterprise with numerous CFCs and operations around the world.
- USP is a fiscal-year taxpayer.
- USP has significant interest expense in the U.S.
- Corp, a Country Y Corporation, is subject to a corporate tax rate of 4%. Partnership is located in Country Y and is not subject to any Country Y tax, but its operations are subject to a branch tax rate of 4%.
- Both Corp and P’ship generate significant amounts of income that would be FPHCl if they were subject to Subpart F, but have significant activities generating income from the active conduct of a widget business with unrelated parties—and therefore Corp is not a PFIC.
Joint Venture Pre & Post-Tax Reform

**Foreign Corp**

**Pre-Tax Reform:**
- Deferral Benefit for non-Sub F/956
- 901 & 902 Credits
- Issues with tax credits as income taxes would only accrue on Dec 31, so timing of tax credits was an issue
- Expense apportionment could increase effective tax rate above 35% as not all foreign taxes paid in Country Y would be creditable
- FTCs from other entities could be used to offset marginal US tax on difference between 4% rate and 35% rate

**Partnership**

**Pre-Tax Reform:**
- No Deferral Benefit
- 901 Credits
- 35% effective tax rate
- Issues with tax credits as income taxes would only accrue on Dec 31, so timing of tax credits was an issue
- Expense apportionment could increase effective tax rate above 35% as not all foreign taxes paid in Country Y would be creditable
### Joint Venture Pre & Post-Tax Reform

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<td>• No deferral benefit</td>
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<td>• Total tax = 4%</td>
<td>• Expense apportionment, but no FTCs to reduce.</td>
</tr>
<tr>
<td>• GILTI &amp; Subpart F do not Apply</td>
<td>• 901 Credit, but may be reduced because of expense apportionment</td>
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<tr>
<td>• Expense apportionment still exists, but does not affect result</td>
<td>• FTCs from other businesses/activities conducted in branch form could offset marginal rate difference between 4% and 21% rate</td>
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M&A Scenarios
U.S. Seller of CFC –
With §338(g) Election - Example

- Seller has zero basis in Target shares, which have $1,000 FMV
- Target inside basis is the same—zero basis, with $1,000 FMV
- Assume no E&P (no §1248)

- Seller effectively converts capital gains into GILTI taxable at 10.5%
  - Deemed sale of Target assets gives rise to GILTI of $1,000, taxed at 10.5% (after applying 50% deduction)
  - GILTI gives rise to immediate basis step-up in Target shares—thus no gain for §1248 to apply to
    - This can reduce §1248 dividend that might qualify for §245A DRD
  - Could contractually require foreign buyer to make §338(g) election
With §338(g) election, the situation changes drastically
  - Seller has GILTI income on the fictional sale of assets
    - 50% deduction under §250 not available to individual seller.
    - Seller gets basis for GILTI inclusion, which reduces gain the sale of the stock
    - Has the effect of converting capital gains into ordinary income taxable at 40.8%.
  - In most cases, US Individual will want to contractual protections to prevent buyer from making §338(g) election (regardless of whether buyer is US or foreign)
Section 78 & 245A
Interaction of §78 & §245A

- CFC has a June 30 fiscal year
- USCo has a §965 inclusion for CFC’s E&P on June 30, 2018
- The current interaction of old §78 and new §245A would apply the DRD to CFC’s inclusion on June 30, 2018.
- Prop. Reg. §1.78-1(c) turns off section 245A with respect to the §78 gross-up with respect to the last taxable year beginning before January 1, 2018 and ending in 2019. Valid?
- §4(II) of Technical Corrections would fix this