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Tax Reform – A Review of the Tax Cuts and Jobs Act and Recent Guidance *Part II*

The GILTI Proposed Regulations

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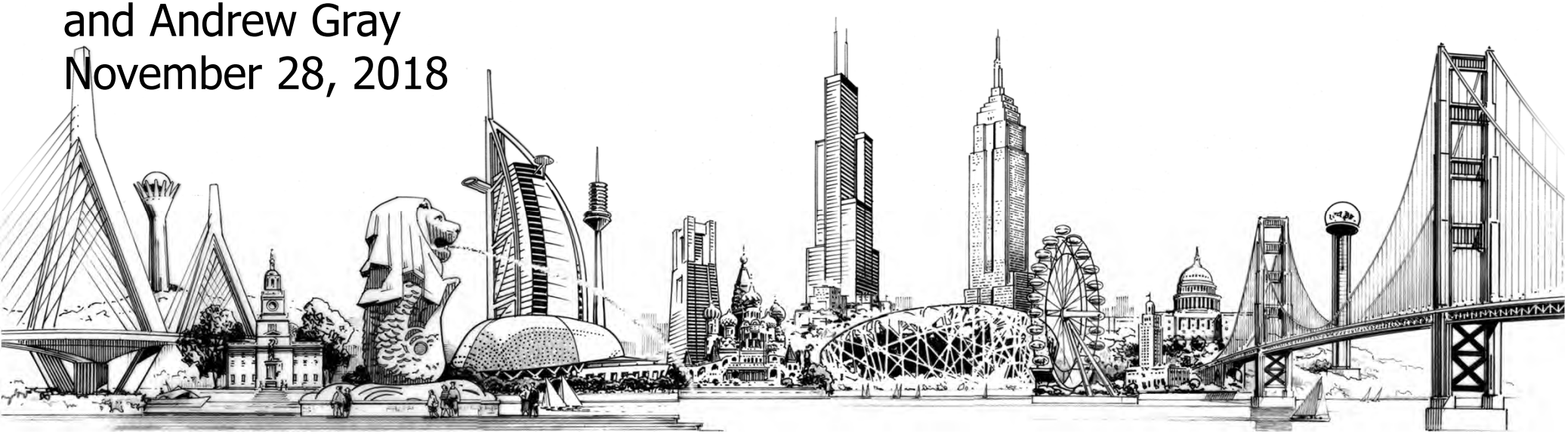


Agenda

I. Introduction
   A. Before the TCJA – Overview of Subpart F
   B. Overview of the Proposed Regulations
II. Key developments and guidance
   A. Pro rata share
   B. Anti-abuse rules
   C. Partnership application
   D. Consolidated return rules
III. Comments requested

Subpart F Regime

- Before TCJA, Subpart F was the primary anti-deferral regime in U.S. federal income tax laws for certain types of moveable income earned overseas
  - The Subpart F regime requires a U.S. shareholder to pay tax currently on its pro rata share of certain types of income earned by their foreign subsidiaries that qualify as controlled foreign corporations ("CFC")
- Key Definitions
  - U.S. Shareholder – U.S. person who owns 10% or more of the total vote or value of a CFC
    - A U.S. person includes U.S. citizens and residents, domestic partnerships, domestic corporations, and any estate or trust that is not considered to be foreign under §7701(a)(31)
  - CFC – a foreign corporation that on any day of the taxable year is owned in amount of 50% or more by U.S. Shareholders

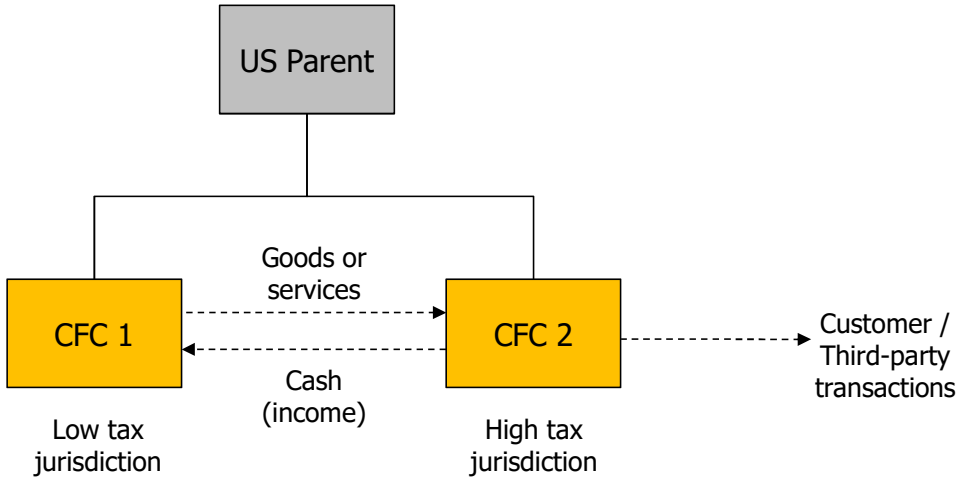
Subpart F Regime (continued)

- Applies generally to dividends, interest, rents and royalties earned by CFCs
  - Types of Subpart F income:
    - Foreign Base Company Income ("FBCI")
      - **Foreign Personal Holding Company Income ("FPHCI")** – Generally consists of passive income such as interest, dividends, annuities, net gains from sales of property that do not generate active income, net commodities gains, net foreign currency gains, certain rents and royalties, and income from personal service contracts.
      - **Foreign Base Company Sales Income ("FBCSI")** - Income attributable to related-party purchases and sales of personal property made through a CFC if the country of the CFC's incorporation is neither the origin nor the destination of the goods and the CFC itself has not "manufactured" these goods
      - **Foreign Base Company Services Income ("FBCSI")** - Income from services performed by a CFC for or on behalf of a related party where the services are performed outside the country of the CFC's incorporation.

Subpart F Regime (continued) -

Related-party transactions

- Historically, U.S. multinationals could maximize the benefits of deferral by increasing the amount of income earned in low-taxed jurisdictions
- Often, this was accomplished through intercompany transactions involving sales of goods or the provisions of services from low-taxed CFCs to high-taxed CFCs
- The Subpart F rules impose current U.S. taxation on some, but not all, of these intercompany transactions (effectively limiting the benefits of deferral)
- The GILTI rules target foreign earnings that historically were not subject to Subpart F taxation



Section 951A Overview

- Global Low-Taxed Intangible Income (GILTI)

GILTI = Net CFC Tested Income – [(10% QBAI) – Specified Interest Expense]

- Summary
  - The GILTI rules require 10% domestic shareholders (US Shareholders) of a CFC to include in gross income annually the US Shareholders' pro rata share of GILTI for the year.
  - GILTI is the sum of the US Shareholder's pro rata shares of the Tested Income of each of its CFCs *less* (i) the sum of the pro rata shares of the Tested Losses of each of its CFCs and (ii) its net deemed tangible income return (NDTIR).
    - NDTIR is 10% of a US Shareholder's pro rata share of the qualified business asset investment (QBAI) of each of its Test Income CFCs, less specified interest expense.

Section 951A Overview (continued)

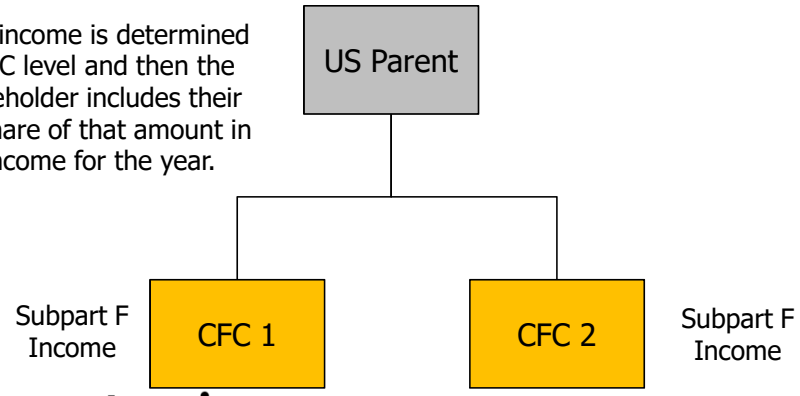
- Income taken into account
- The CFC's gross income determined without regard to:
  - Effectively connected income under section 952(b)
  - Subpart F income of the CFC
  - Gross income of the CFC excluded from foreign base company income (determined under section 954) and insurance income (determined under section 953) by reason of the high tax exception under section 954(b)(4)
  - Any dividend received from a related person (as defined in section 954(d)(3)), and
  - Any foreign oil and gas extraction income (determined under section 907(c)(1)), over
- The deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5)

Section 951A Overview (continued)

- In addition to Subpart F, the Code now includes another anti-deferral regime - GILTI
- Similar to Subpart F income, but with two key differences:
  - (1) Calculated at the U.S. Shareholder level, not CFC
  - (2) For corporations, taxed at a lower 10.5% rate (sec. 250)
    - The Preamble states the reduced rate was implemented so that "GILTI would not harm the competitive position of U.S. corporations relative to their foreign peers"

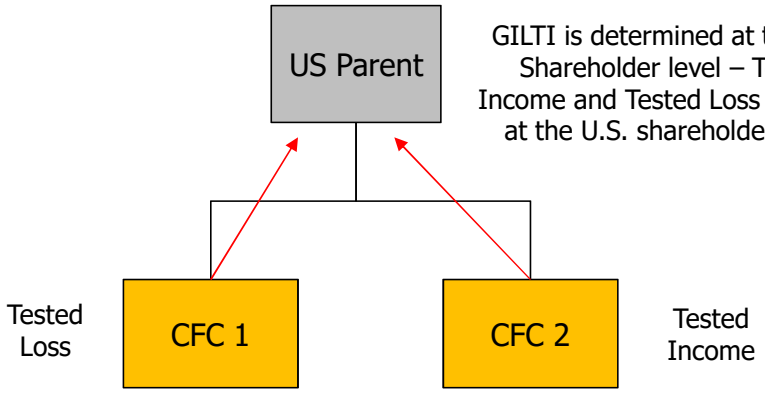
Subpart F Income

Subpart F income is determined at the CFC level and then the U.S. shareholder includes their pro rata share of that amount in gross income for the year.



GILTI Income

GILTI is determined at the U.S. Shareholder level – Tested Income and Tested Loss is netted at the U.S. shareholder level.



Section 951A – Effective Dates

- A "CFC inclusion year" refers to the relevant taxable year of the CFC beginning after December 31, 2017 (the effective date of section 951A for a foreign corporation that is a CFC)
  - Section 951A and the proposed regulations also apply to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end
- Potential "gap period"
  - For calendar year CFCs and U.S. shareholders, GILTI applied on Jan. 1, 2018.
  - For CFCs with Nov. 30 year ends, GILTI will not go into effect until their taxable years beginning Dec. 1, 2018.
    - Calendar year U.S. shareholders with Nov. 30 CFCs therefore would not have a GILTI inclusion with respect to those CFCs until 2019.

Proposed GILTI Regulations

- Issued on September 13, 2018
  - Published on October 10, 2018
- Part of a series of guidance on GILTI
  - Addresses a number of computational issues
  - Introduces guidance on
    - Anti-abuse rules
    - Partnerships and partners
    - Consolidated groups
    - Basis adjustments
- Proposed regulations are clear that further Notices and regulations are expected

Proposed GILTI Regulations (continued)

- **<u>Proposed Regulations do NOT cover:</u>**
  - Section 250 deduction calculations
  - Foreign tax credit guidance
  - Expense apportionment / allocation
  - Section 78 gross-up
  - Ordering rules
    - Section 163(j)
    - Section 245A

Proposed GILTI Regulations (continued)

- What is covered in the proposed regulations:

Section 1.951A-1	General provisions and definitions
Section 1.951A-2	Tested Income and Tested Loss
Section 1.951A-3	QBAI (Includes anti-abuse rules for transfers of property)
Section 1.951A-4	Tested interest expense and tested interest income
Section 1.951A-5	Domestic partnerships and their partners
Section 1.951A-6	Treatment of the GILTI inclusion amount
	Adjustments to E&P and basis related to tested loss CFCs
	Consolidated returns

General Guidance – Tested Income and Loss

- Partial-year CFCs – only portion of earnings accrued while a CFC taken into account
- Deductible expenses – generally those deductible for a domestic corporation
- Allocation – deductions (including taxes) properly allocable to such gross income under rules similar to the rules of section 954(b)(5)
- Section 952(c) – E&P limitation
- Foreign currency conversion
- No carryforward of Tested Loss

General Guidance – QBAI

- QBAI
  - No additional guidance on "used in the production of"
  - Dual-use property allocated between GILTI and non-GILTI uses
    - Directly identifiable – allocation based on Tested Income from property
    - Not directly identifiable – allocation based on CFC Tested Income

- Specified interest expense
  - Broadest definition of interest income and interest expense possible
  - Rejected a strict "tracing" approach
  - Special provisions for "Qualified CFCs," which include (i) active financing CFCs (Section 954(h)(2)) and (ii) qualifying insurance companies (Section 953(e)(3))

Pro Rata Share – Prop. Reg. §1.951A-1

- Unlike Subpart F, the pro rata share of GILTI items – e.g., tested loss, tested income, QBAI and specified interest expense – are allocated to the US Shareholder
  - US Shareholder then determines GILTI by aggregating those GILTI items
- Pro rata share rules for GILTI based on existing regulations under Treas. Reg. §1.951-1
  - Pro rata share based no only on distribution rights, but also take into account all relevant facts and circumstances.
- Proposed Regulations introduce new "anti-abuse" rule
  - Transactions or arrangements that avoid U.S. federal income taxation
  - "a" principal purpose test
- Treasury and the IRS have requested comments on the proposed approaches for determining a U.S. shareholder's pro rata share of a CFC's QBAI and tested loss

Anti-Abuse Rules

- Temporarily held property
  - "a" principal purpose test
  - Holding / possession for less than 12 months per se considered "temporarily" held

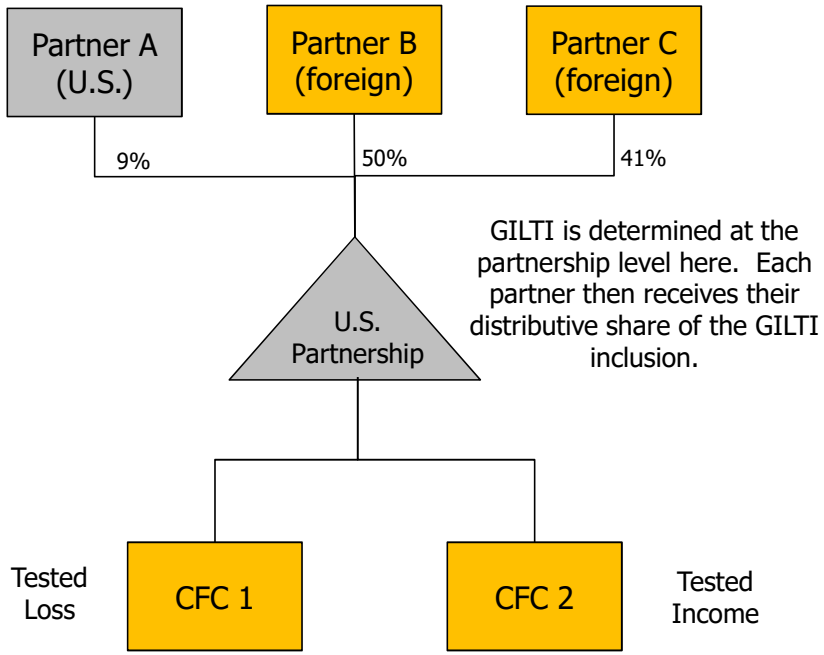
- Disqualified period (fiscal year taxpayers)
  - In broad strokes, applies to "step-up" transactions that increase either:
    - QBAI, or
    - Tested Income and Tested Loss
  - Disallowance largely follows "untaxed" portion of basis step-up
  - Applies to tangible and intangible property
  - Status at time of transfer as Tested Income CFC or Tested Loss CFC irrelevant

Partnership Rules

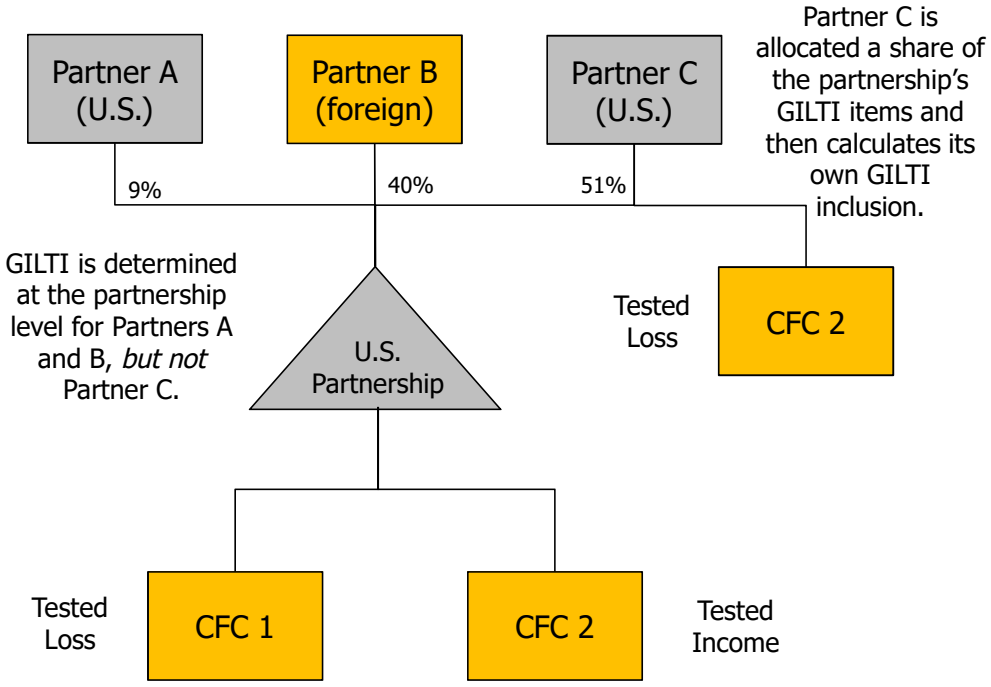
- Proposed Regulations adopt "hybrid" approach
  - **Entity approach**: A partner that is not a US Shareholder of with respect to CFCs held by a domestic partnership is allocated a distributive share of the partnership's GILTI inclusion
    - See Section 702; Treas. Reg. §1.702-1(a)(8)(ii))
  - **Aggregate approach**: Partners that are themselves US Shareholders of CFCs held by a domestic partnership ("US Shareholder Partner") are allocated GILTI items of the CFCs (e.g., Tested Income, Tested Loss, QBAI, etc.)
    - A US Shareholder Partner then determines its GILTI inclusion based on:
      - GILTI items allocated from the domestic partnership
      - GILTI items relating to direct / indirect ownership of CFCs
    - Allows for increased netting of GILTI items

Partnership Rules (continued)

Entity Approach - US Shareholder Partnership



Entity/Aggregate Approach - US Shareholder Partner



Consolidated Groups

- New Prop. Reg. §1.1502-51 added
  - Adopts a **single-entity approach** to determining GILTI inclusions for U.S. consolidated groups
- The GILTI inclusion of a U.S. consolidated group member is equal to the excess of the member's net CFC tested income over the member's net DTIR
  - **GILTI Allocation Ratio:** For this purpose, pro rata shares of tested loss, QBAI, tested interest expense, and tested interest income of each member are aggregated and then a portion of each aggregate amount is allocated to each US shareholder member based on the proportion of such member's pro rata share of tested income to total tested income of the group for the year (see Prop. Reg. §1.1502-51(e))
- Provides special rules for making basis adjustments required under Prop. Reg. §1.951A-6(e) to CFC stock held by a member to take into account the determination of members' GILTI inclusions on a consolidated basis. Prop. Reg. §1.1502-51(c).

Comments Requested

- Treasury and the Service have requested a number of comments in the Proposed Regulations, including (but not limited to):
  - **Deductions ordinarily only available to domestic corporations.** Whether the Proposed Regulations should allow a CFC a deduction, or require a CFC to take into account income, that is expressly limited to domestic corporations under the Code (e.g., whether a CFC may be entitled to a dividends received deduction under Section 245A, even though that section by its terms applies only to dividends received by a domestic corporation).
  - **Characterization of GILTI inclusions.** Whether there are other circumstances or arrangements in which the characterization of a GILTI inclusion amount is relevant and, if so, whether the inclusion should be treated in the same manner as a Section 951(a)(1)(A) inclusion or in some other manner (e.g., as a dividend).
  - **Specified tangible property held by a partnership.** Comments generally on the treatment of specified tangible property held through a partnership, including the proposed rules addressing property that does not produce directly identifiable income.
  - **Treatment of domestic partnerships and their partners.** Whether other approaches to the treatment of domestic partnerships and their partners should be considered (i.e., other than a pure entity, pure aggregate, or hybrid approaches described in the preamble) that would more appropriately harmonize the provisions of the GILTI regime (particularly with regard to administrative and compliance burdens for both taxpayers and the IRS).
  - **Aggregate approach - attribute adjustments.** Comments generally on adjustments required by reason of computing a GILTI inclusion amount (in whole or in part) under an aggregate approach (i.e., at the partner level) (e.g., adjustments affecting a partner's basis in a partnership interest or its Section 704(b) capital account, a partnership's basis in CFC stock under Section 961, and a CFC's previously taxed earnings and profits with respect to the partner or partnership under Section 959.
  - **Dispositions of CFC stock.** With regard to dispositions of CFC stock, whether (i) the definition of "disposition" should be modified; and (ii) additional adjustments to stock basis or E&P should be made to account for a used Tested Loss or offset Tested Income. And, in both cases, whether the same rules should apply to corporate and non-corporate US Shareholders, given that non-corporate US Shareholders are not eligible for the deduction under Section 245A.

Comments Requested (continued)

- Treasury and the Service have requested a number of comments in the Proposed Regulations, including (but not limited to):
  - **Consolidated return investment adjustments.** Comments generally on the coordination between (i) Prop. Treas. Reg. §1.951A-6(e) and 1.1502-51(c); and (ii) the investment adjustment rules in Treas. Reg. §1.1502-32. In this regard, the preamble specifically requests comments on
    - whether the amount of the adjustments to the basis of member stock should be limited to the amount of the adjustments to the basis of the stock of a CFC under the rules of proposed Treas. Reg. §1.951A-6(e);
    - whether the adjustments to the basis of member stock should all be made on a current basis, made to the extent of the basis adjustments provided in Prop. Reg. §1.951A-6(e) on a current basis with any remaining adjustments being made at the time of a disposition of stock of a CFC or of a member, or made only at the time of a disposition of the stock of a CFC or of a member; and
    - whether rules should provide that a deduction under Section 245A should not be treated as tax-exempt income to the extent that the underlying dividend is attributable to offset Tested Income for which basis adjustments have already been made.
  - **Deemed dispositions of CFC stock.** Whether there are any circumstances in which there should be a deemed disposition of the stock of a CFC owned by a member, such that the rules of proposed Treas. Reg. §1.951A-6(e) would apply, including, but not limited to, a deconsolidation or taxable disposition of the stock of a member that owns (directly or indirectly) the stock of a CFC to either a person outside of the consolidated group or to another member, and a transfer of the stock of a member in an intercompany transaction that is a non-recognition transaction.
  - **Consolidated return.** Whether there are other transactions that should be described in the definition of transferred shares in proposed Treas. Reg. §1.1502-32(b)(3)(ii)(F)(1), such as a deemed disposition pursuant to Treas. Reg. §1.1502-19(c)(1)(iii)(B).
  - **Duplication of gain or loss.** Whether any other adjustments are necessary to prevent the duplication of gain or loss resulting from a member's ownership of a CFC, including situations where a member owning a CFC joins another consolidated group.
  - **Additional rulemaking.** Whether additional rules under Treas. Reg. §1.1502-33 or any other regulations issued under Section 1502 are necessary.
  - **Small entities**. Comments generally on the impact of the Proposed Regulations on small entities.

Biography

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Michael Liu advises multinational corporations with domestic and international tax planning. His clients span a variety of industries, including those in the high technology, semiconductor, software, pharmaceuticals, and biotechnology sectors. Before joining Morgan Lewis, he was a partner in the tax practice of another global law firm, based in Palo Alto. Michael is admitted in California only, and his practice is supervised by Illinois Bar members.

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Nelson Yates assists taxpayers both with federal income tax controversy matters as well as tax planning. Nelson's primary areas of experience include transfer pricing and international tax. Prior to joining Morgan Lewis, he was an associate at another international law firm where he advised clients on transfer pricing disputes. Nelson also spent three years focused on international tax planning at a Big 4 accounting firm. He holds an LL.M. in taxation from Northwestern University Pritzker School of Law, where he graduated with honors.

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Kensington Wolgamott advises clients on domestic and international tax planning, working with clients across a variety of industries. Her practice focuses on advising multinational companies on both their overall international structure and particular transactions from a tax planning perspective. She assists clients with intellectual property migrations, subpart F planning, tax-efficient cash repatriation strategies, post-acquisition integration and implementation, and a variety of other tax planning solutions. Prior to joining Morgan Lewis, Kensi served as an associate at another international law firm.

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Serving as the leader of Morgan Lewis's semiconductor practice, Andrew J. Gray IV concentrates his practice on intellectual property (IP) litigation and prosecution and on strategic IP counseling. Andrew advises both established companies and startups on computer and Internet law issues, financing and transactional matters that involve technology firms, and the sale and licensing of technology. He represents clients in patent, trademark, copyright, and trade secret cases before state and federal trial and appellate courts throughout the United States, and before the US International Trade Commission.

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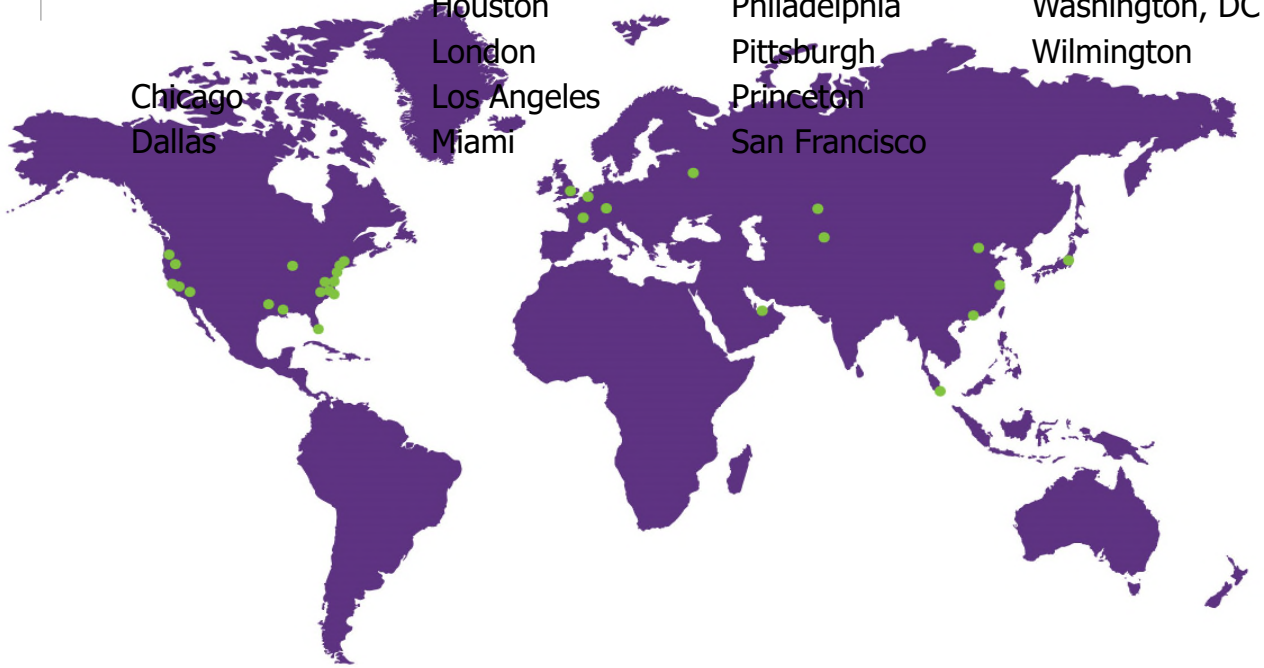

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