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TAX REFORM
A REVIEW OF THE TAX CUTS AND JOBS ACT AND RECENT GUIDANCE

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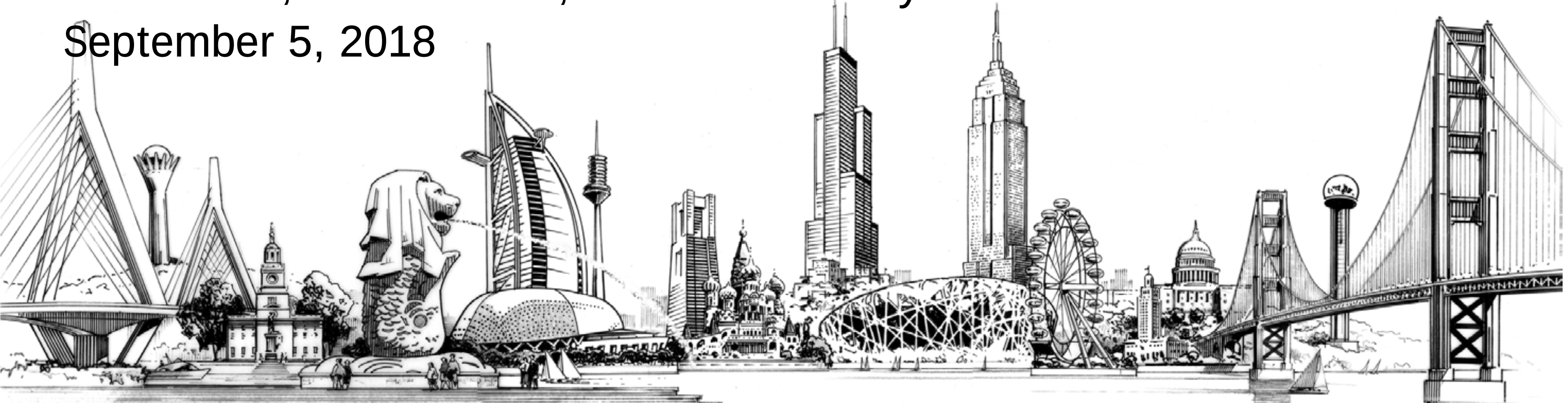
September 5, 2018



Overview

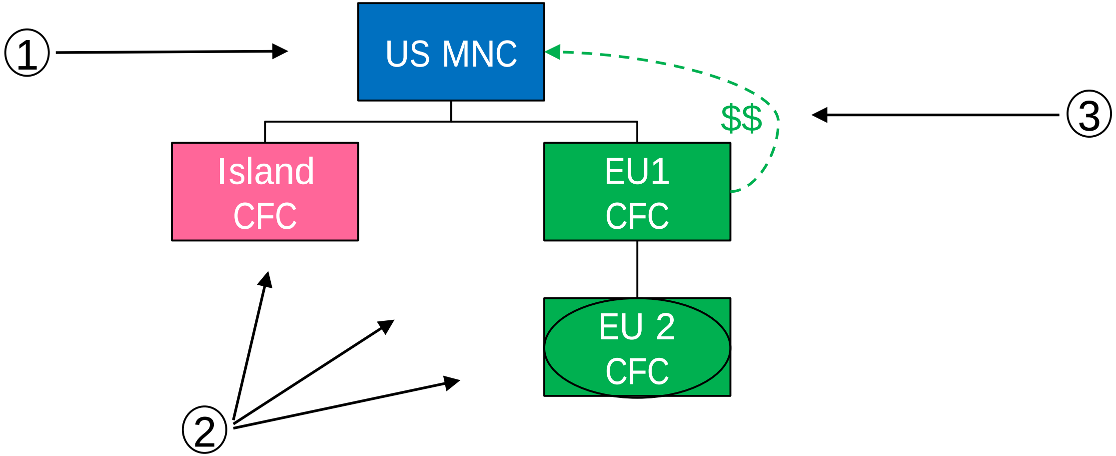
1. The Tax World As We Knew It
2. The Tax Cut and Jobs Act (“TCJA”)
   – Section 245A
   – Section 965 Transition Tax – Snapshot in Time
   – GILTI (and FDII)
   – BEAT
   – Section 199A
3. Post-TCJA Heartburn

The Tax World As We Knew It

Overview – Taxation on Worldwide Income (Pre-TJCA)

- **Highest Statutory Corporate Tax Rate –** 35%
- **Subpart F Regime –** U.S. shareholders of controlled foreign corporations were taxed on their respective pro-rata shares of certain foreign current year earnings such as foreign base company sales and services income. Once that "subpart F income" was taxed, it could be repatriated without further U.S. tax (known as previously taxed income or "PTI").
- **Foreign Tax Credits –** U.S. taxpayers received tax credits for foreign income taxes imposed on foreign source income, both direct tax credits (*i.e.*, credits on taxes on the income earned directly by the U.S. shareholder) and indirect credits (*i.e.*, taxes on income earned by foreign subsidiary of U.S. shareholder).
- **Transfer Pricing –** Transfer pricing is meant to mitigate the arbitrary shifting of income, gain, deductions and losses between related parties, from one taxing jurisdiction to another. The arm's length standard requires that related corporations act with each other in a manner consistent with unrelated parties, or at "arm's length."
- **Inversions and Outbound Transfers –** the Code expanded to address the influx of U.S. corporations that sought to migrate intellectual property ("outbound") to foreign subsidiaries and reincorporate the U.S. parent corporation to an overseas jurisdiction. Instances were in both situations, continued U.S. tax liabilities are imposed.

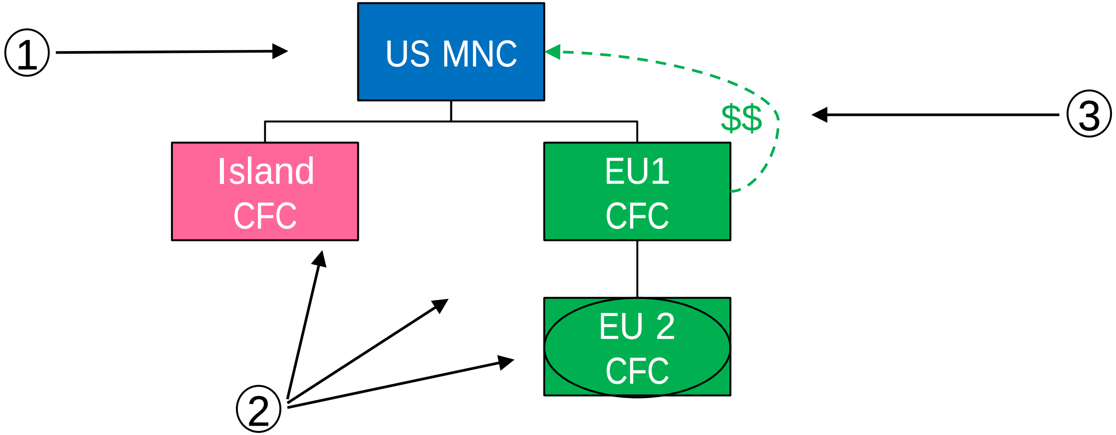
Overview – Taxation on Worldwide Income (Pre-TCJA)



1. US MNC taxed on its worldwide income at 35% statutory rate
2. CFCs not subject to U.S. federal tax unless fall under subpart F regime; repatriation of PTI without any additional U.S. tax
3. Repatriation of CFC income, otherwise not previously subject to U.S. federal tax, resulted in U.S. federal tax at 35%

TCJA – A Participation Exemption System And More…

Overview – U.S. Taxation (Post-TCJA)



1. US MNC taxed on its worldwide income at 21% statutory rate; however, certain export income is eligible for a reduced rate of 13.125% (FDII)
2. CFCs not subject to U.S. federal tax unless fall under the subpart F regime or the new GILTI regime
3. All previously deferred foreign earnings (earned prior to December 31, 2017) were subject to the one-time Repatriation Tax, but those earnings can be repatriated without additional U.S. federal tax

Overview – Foreign Dividend Received Deduction

The centerpiece of the new participation exemption system is section 245A (the “Foreign DRD”). In general, the Foreign DRD allows the tax-free repatriation of foreign earnings that are not otherwise subject to immediate U.S. tax (*e.g.*, subpart F or GILTI).

- **10 Percent –** the Foreign DRD is only available to those foreign corporations who have 10 percent or greater interest held by a U.S. shareholder (*cf.* Repatriation Tax 10-percent specified foreign corporation)
- **Foreign Source –** only the portion of the dividend from the 10-percent owned foreign corporation that are from undistributed foreign earnings (*e.g.*, not from U.S. source income such as ECI).
- **Hybrid Dividend –** the DRD is not available if a controlled foreign corporation is able to take a deduction or receive some other tax benefit in a foreign jurisdiction.
- **Foreign Tax Credits –** No tax credits (or deductions).
- **Compliments Existing U.S. Source Dividend Deduction –** section 245 provides for a dividend received deduction (ranging from 50-percent to 100-percent) from certain related foreign corporations for the U.S.-source portion of the dividend.

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Repatriation Tax – A "Snapshot"

Overview – Section 965 (“Repatriation Tax”)

The Repatriation Tax was needed because without it, as of January 1, 2018, the Foreign DRD was available, permitting the repatriation of non-U.S. taxed foreign earnings without any U.S. tax consequences. The solution – the Repatriation Tax – took a “snapshot” of that otherwise non-U.S. taxed foreign earnings pre-January 1, 2018 and taxed them one-time, at a reduced rate.

- **Expansive –** the takes into consideration deferred foreign income of not just controlled foreign corporations, but any foreign corporation that has a 10% or greater U.S. shareholder.
- **Anti-Deferral Regime –** the previously untaxed foreign income is taxed to the U.S. shareholder as a one-time increase to subpart F income.
- **Tax Rates –** 8% on foreign non-cash assets and 15.5% on foreign cash (and cash equivalents).
- **Foreign Tax Credits –** U.S. shareholder only receives FTCs proportional to amount of income taxed under section 965(a).
- **Tax Liability –** the U.S. shareholder may elect to make the payments over eight (non-equal) annual installments, without interest.

Overview – Proposed 965 Regulations

On August 1, 2018, the IRS published proposed regulations under section 965 (the "Proposed 965 Regulations"):

- Did not deviate from statutory language, though some changes from previously issued guidance (several Revenue Notices, a Revenue Procedure, an IRS FAQ, and an IRS Publication).
- Final regulations anticipated July 2019. If issued within 18mos of statute enactment (December 22, 2017), retroactivity is possible.
- IRS rejected most taxpayer comments and requests for "relief."
- Despite prior rejections, IRS seeks comments on the entirety of the Proposed 965 Regulations, and then also specifically calls out certain provisions *(e.g.*, cash position).
- Some noteworthy changes and open points.

Overview – Interesting Observations of Proposed 965 Regulations

Observations

- Aggregate Foreign Cash Position
  - Definition of "Account Payable"
  - Non-rebuttable presumption that demand feature causes an obligation to be a "short term obligation"
  - Certain payables between related parties disregarded but only by ownership lowest percentage
- Foreign Tax Credits
  - Multiple inclusion years results in multiple applicable percentages, which means permitted FTCs can vary
  - Section 78 "gross-up" may exceed permitted FTCs
  - No indirect FTCs for below third-tier specified foreign corporations
  - No indirect FTCs on DFIC E&P that was reduced by an allocation from an E&P deficit corporation
- Disregarded Transactions
- Consistent Basis Adjustments
- Revised Anti-Avoidance Rule

Overview – Section 965(h) Potential Enforcement Issue

Section 965(h) is a taxpayer-friendly election that permits the taxpayer to make payments of its section 965 tax liability, without interest, in eight annual installments.

- Issue – taxpayers make quarterly estimates, and have “overpaid” 2017 tax liability given section 965(h) election
- IRS Position
  - FAQ stated overpayments not refundable unless exceed all 2017 tax liability, including remaining deferred section 965 payments
  - On August 2, 2018 Office of Chief Counsel issued memorandum to LB&I providing its analysis as to why no refunds should be issued
- Requests for Taxpayer Guidance – argue that overpayments resulting from 2017 tax year estimated payments should not automatically be applied as credits towards future tax liability
  - Chamber of Commerce of the United States of America – Request taxpayer choice how to apply 2017 overpayments
  - Huntsman Corp – Request refund of 2017 overpayments

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Overview of FDII and GILTI

Overview – FDII and GILTI

- **Global Intangible Low-Taxed Income (“GILTI”) –** the aggregate Net Tested Income of all CFCs of a U.S. Shareholder, less a rate of return on the aggregate tax bases of the tangible assets used in the production of Tested Income held by those CFCs (10% of a corporation’s qualified business asset investment (“QBAI”))
- **Foreign Derived Intangible Income (“FDII”) –** in most cases, the Deemed Intangible Income of a U.S. corporation, less a rate of return on the tangible assets used by the corporation to generate such income (10% of QBAI)
- Deduction of 50% available for GILTI (10.5% eff. rate), and 37.5% for FDII (13.125% eff. rate) (until 2025).
- *Observations*
  - Increasing tangible assets held by CFCs (QBAI) effectively reduces the amount of income subject to GILTI or FDII taxation, as the case may be (assuming certain anti-abuse provisions do not apply)
  - In addition, the portion of non-U.S. income representing QBAI is treated differently under the two regimes:
    - GILTI – income not subject to current U.S. taxation (measured after taking into account subpart F); can be repatriated on a tax-free basis under (new) section 245A
    - FDII – income subject to U.S. corporate tax at 21%
  - Debt financed acquisitions of tangible assets could:
    - Maximize the amount of tangible assets acquired, thereby increasing QBAI
    - Reduced Tested Income through interest expense deductions (subject to certain interest expense limitations under section 163); however, QBAI is reduced to the extent corresponding interest income is not taken into account as Net CFC Tested Income)

U.S. vs. Non-U.S. Ownership of Intangibles

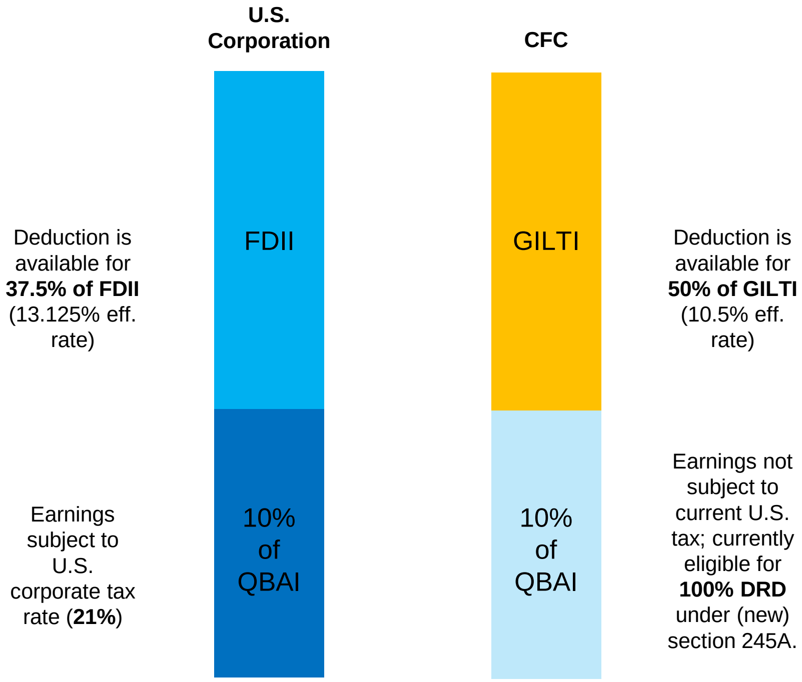
As noted, the calculation for both FDII and GILTI adopt the same tangible asset base – 10% of QBAI.

However, the treatment of income represented by that base differ under the two proposed regimes:

- FDII – subject to 21% corporation tax rate
- GILTI – not subject to U.S. tax; eligible for 100% DRD under section 245A

The taxation of GILTI and FDII also differs:

- FDII – 37.5% deduction available
- GILTI – 50% deduction available



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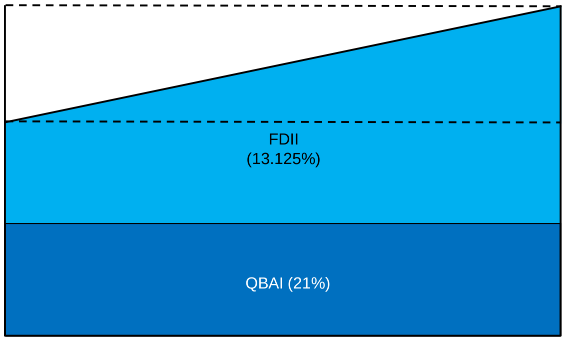
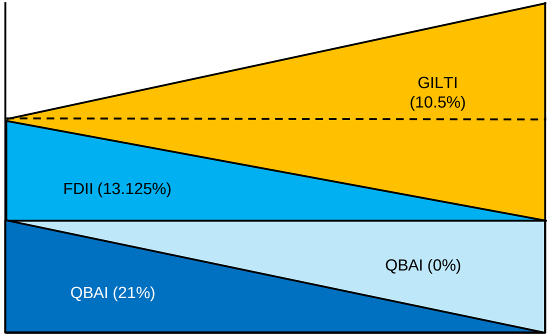
FDII and GILTI:
U.S. Tax Rate Comparison

Rate Comparison

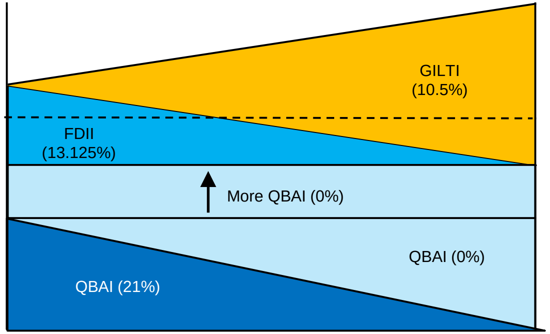
No Migration of Intangibles



Intangibles Migration – Base Case



Intangibles Migration – Supply Chain and Infrastructure Planning



- U.S. affiliate makes direct sales into non-U.S. markets to non-U.S. persons for foreign use
- FDII taxed at 13.125%; remaining earnings (representing QBAI) taxed at 21%

- U.S. affiliate transfers non-U.S. intangibles to CFC in exchange for (declining) payments for the outbound transfer of IP going forward, CFC makes direct sales into non-U.S. markets (foreign use)
- Payments for the outbound transfer of IP are taxed at 13.125% (FDII); remaining earnings (representing QBAI) taxed at 21%
- Overtime, GILTI replaces FDII and is taxed at lower 10% rate; CFC QBAI similarly replaces U.S. QBAI and is taxed at a lower rate (0%).

- Combining intangibles migration with broader supply chain and infrastructure planning could further reduce FDII and GILTI; earnings representing (increased) QBAI would be taxed at 0%

Note: Local foreign tax rate (and corresponding availability of U.S. foreign tax credits) may ultimately determine whether intangibles migration is beneficial from a tax standpoint

Intangibles Migration – Tax Impact Overview

- Payments for the outbound transfer of IP should qualify for FDII treatment
  - “Sales” income received from a foreign person (sales include licenses)
  - Property used outside the United States (foreign use)
- Payments in excess of 10% of U.S.-held QBAI taxed at 13.125%; remainder taxed at 21%
- Economically, U.S. transferor is effectively substituting PCT / 367(d) payments for direct sales income
  - Payments for the outbound transfer of IP should approximate direct sales income (commensurate with income)
  - **Thus, an intangibles migration has become a “nothing ventured, nothing lost” proposition**
  - In fact, after taking into account “ramp-up” expenses, overall FDII may actually be lower post-intangibles migration
  - **Local foreign tax rate may ultimately be the determining decision-making factor**

Intangibles Migration – Tax Impact Overview (cont.'d)

- Over time, GILTI will replace FDII and will be taxed at a lower 10% rate
  - In addition, earnings representing QBAI not subject to U.S. tax (0%) and can be repatriated tax-free under section 245A
- Supply chain and infrastructure restructuring could further optimize benefits of an intangibles migration
  - Third-party and internal "tooling" arrangements necessarily increase CFC QBAI (*e.g.*, hardware mfg., contract mfg.)
  - As a result, a greater portion of foreign earnings would be subject to 0% tax rate, rather than 21% rate
- If ultimately necessary, such a structure could be unwound on a tax-efficient basis
  - Previously-untaxed earnings can be distributed tax-free under section 245A, eliminating any all earnings and profits amount that would be taxable (under section 367(b))
  - Resulting inbound liquidation of intangibles company would not be subject to U.S. tax; although U.S. distributee would only receive carryover basis in distributed intangibles
  - Taxpayers should consider the impact of a foreign exit taxes as part of any potential exit strategy going forward once intangibles migrated

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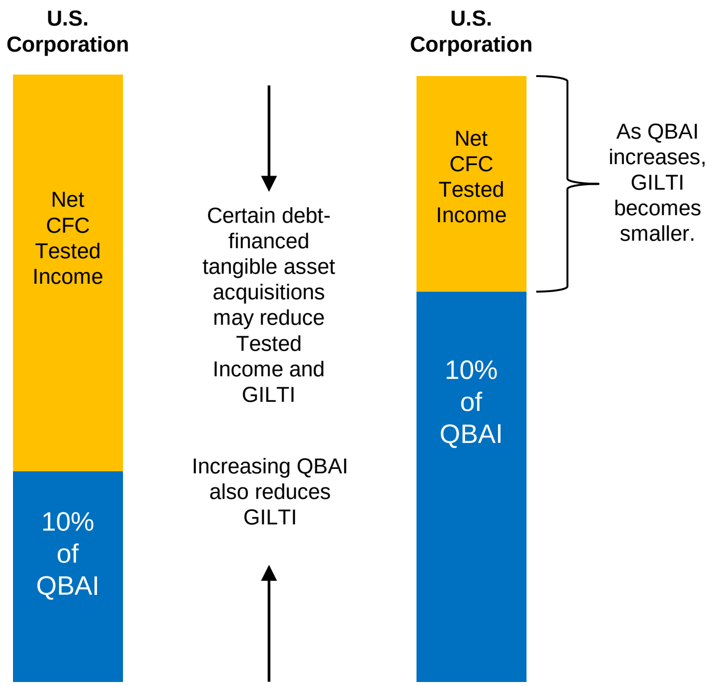
FDII and GILTI: Supply Chain and Infrastructure Planning

Managing GILTI and Optimizing QBAI

Increasing tangible assets held by CFCs (QBAI) effectively reduces the amount of income subject to GILTI taxation (assuming certain proposed anti-abuse provisions do not apply).

Debt financing can be used to:

- Maximize the amount of tangible assets held by a CFC, which in turn increases QBAI
- Reduce Tested Income through interest expense deductions (subject to certain interest expense limitations under section 163)
- However, QBAI reduced to the extent of corresponding interest income is not taken into account as Net Tested Income

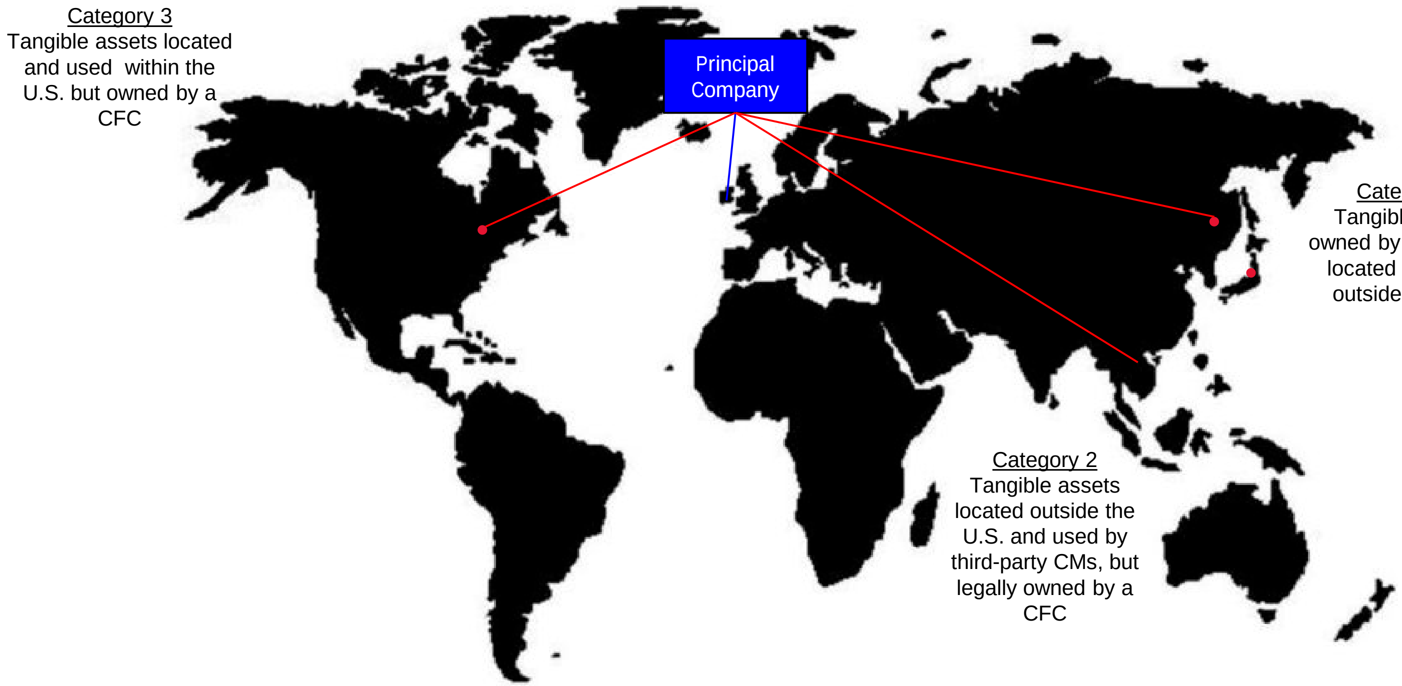


Optimizing QBAI

Potential sources of QBAI

1. Category 1 - Tangible assets located outside of the U.S., owned or held by CFCs and used to manufacture products
2. Category 2 - Tangible assets held and used by third-party contract manufacturers outside the U.S., but legally owned by a CFC
   – *Example:* Many technology companies that develop and sell hardware products (e.g., smartphones, tablets, computers, etc.) engage third-party contract manufacturers to manufacture their products. Often, and for a variety of non-tax reasons, the technology companies will purchase and own the equipment used to manufacture the products and make that equipment available to the manufacturers on a rent-free basis. This equipment arguably should be considered QBAI of the technology company. The same approach could be applied for most contract manufacturing arrangements even outside the technology sector (subject to potentially applicable anti-abuse rules).
3. Category 3 - Tangible assets located within the U.S. owned or held by CFCs and used to manufacture products
   – *Section 956* – The Senate bill initially repealed section 956, which would have made it potentially possible for CFCs to hold tangible property within the U.S. without creating a current taxable inclusion. The bill that was ultimately enacted left section 956 intact. Nevertheless, this planning approach may have continued viability, as section 245A would allow a CFC to distribute earnings to in effect “zero out” any section 956 inclusion.
   – *Subpart F / Foreign Personal Holding Company Income* – Rental income received by a CFC or equipment located and used in the U.S. could potentially create subpart F income for the CFC. Nevertheless, it may be possible for a CFC to make its assets available to U.S. manufacturers on a rent-free basis (perhaps in exchange for purchase price adjustments on finished goods); the third-party arrangements described above would arguably support such an approach.

Optimizing QBAI



QBAI Anti-Abuse Provisions

- Section 951A(d)(4) authorizes the Secretary to issue regulations to prevent the avoidance of the purpose of the “paragraph” establishing the QBAI rules, including guidance on the treatment of:
  - Property that is transferred or held temporarily (i.e., transitory transfers)
  - The transfer or holding of property where the avoidance of the purpose of section 951A is a “factor”
- In addition, general anti-abuse rules and provisions presumably continue to apply as well (e.g., section 7701(o), section 269, substance over form principles, etc.)
- *Observations*
  - The anti-abuse rule under section 951A(d)(4) is incredibly broad, applying if the avoidance of the purpose of the section is merely a “factor” in the transfer or possession or holding of property (i.e., an unusually low standard)
  - Arrangements and initiatives that pre-date section 951A (as published in the Senate bill) are likely on better footing vis-à-vis the anti-abuse rule
  - In addition, common / ordinary commercial arrangements and transactions, particularly those routinely entered into between unrelated parties, are also likely to fare better under the anti-abuse rule
    - Actual third-party arrangements may also provide useful comparables for purposes of establishing the transfer pricing for intercompany arrangements

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The Base Erosion Anti-Abuse Tax

Overview – Base Erosion Anti-Abuse Tax

The Base Erosion Anti-Abuse Tax (or “BEAT”) has been described as the new “minimum tax” because it is imposed on affected taxpayers regardless of any other tax imposed by the Code.

- **Base Erosion Minimum Tax Amount** – 10% (5% for tax years beginning in calendar year 2018) of modified taxable income in excess of an amount equal to the regular tax liability, reduced by any amount that allowed credits exceed section 38 credits
- **Application** – applies to certain taxpayers
  - Corporation (not REIT, RIC, or S-Corp)
  - Average annual gross receipts for last three taxable years at least $500mm
  - Base erosion percentage is 3% or greater
- **Base Erosion Payment** – any deductible payment made (accrued) by a U.S. taxpayer to a related foreign person with the limited exception for any deductible payment for services able to be charged out at “cost” (*i.e.*, COGS, etc.)

Overview – Base Erosion Anti-Abuse Tax (continued)

- Related Person –
  - 25% owner (vote or value) of taxpayer
  - Related person (sections 267(b) or 707(b)(1))
  - “Commonly controlled” under section 482 principles
- Base Erosion Percentage =

  Aggregate Base Erosion Benefits / (Aggregate Deductions + Base Erosion Benefits)
  - Sections 172 (NOLs), 245A, and 250 not taken into account
- Base Erosion Tax Benefit = Deduction from base erosion payment

Overview – Interesting BEAT Observations

Observations

- Unclear as to *how* SCM exception can be applied
- Broad definition of “related party”
- NOLs not taken into account
- Withholding exclusion (limited)
- Policy disconnect from practical application
- Potential for single transaction to result in BEAT outgoing and GILTI incoming

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Section 199A Deduction

Overview – Section 199A

The qualified business deduction under section 199A (the "Section 199A Deduction") was supposedly to go hand-in-hand with the drop in corporate tax rate to 21%, to ensure that tax rate on "business income" was reduced regardless of taxpayers' entity selection for earning that business income. In general, non-corporate taxpayers may take a deduction under section 199A to the extent of the lesser of 20 percent of taxable income or the amount of qualified business income earned from pass-through businesses (up to certain thresholds before adjustments are needed).

- **Applied at Partner or "S-Corp" Shareholder Level**
- **Qualified Business Income ("QBI")** – Qualified items of net amount of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer
- **Qualified Items** – Items effectively connected with the conduct of a U.S. trade or business subject to certain exclusions (*e.g.*, capital gain/loss)
- **Qualified Trade or Business** – Not a specified service business and not where the flow-three is performing personal services
- **Specified Services Trade or Business** – law, accounting, consulting, financial services, brokerage services, "skill or reputation businesses" (if a low-earner than will can be a qualified business)
- **Combined QBI** – For each qualified business the sum of (1) lesser of (A) 20 percent of taxpayer's QBI or (B) the greater of (i) 50 percent of the W-2 wages with respect to that trade or business or (ii) the sum of 25 percent of the trade or business' W-2 wages and 2.5% of the unadjusted basis immediately after the acquisition of qualified property, and (2) 20% of the aggregate amount of qualified REIT dividends and qualified publicly traded partnership income.

Overview – Proposed Section 199A Regs

- **Aggregation Rules** – In general, taxpayer able to aggregate trades or business if meet certain requirements (*e.g.*, 50% or more ownership, non-SSTBs)
- **SSTBs Defined** –
  - Proposed Section 199A Regulations provide more detailed descriptions of those services trades or businesses
  - **Reputation or Skill** – Endorsing of products or services; use of individual's image, likeness, name, signature, voice, trademark, or any other symbol; and/or appearing at an event, on radio, television, or another media format
- **Trade or Business** – section 162 trade or business, and also the licensing of IP if licensed to related party
- **Services or Property provided to an SSTB** – any trade or business that provides 80 percent or more of its property or services to an SSTB is itself an SSTB *if* there is 50 percent or more common control (anti-"Crack-and-Pack")

Overview – Section 199A

Observations

- Temporary (expires as of December 31, 2025)
- Not meant for athletes, actors and “reality” stars (all SSTBs)
- Firing and rehiring – once an employee likely still an employee
- *De minimis* versus incidental (10 percent & 5 percent thresholds versus > 5 percent threshold)
- Self-employed HNW individuals should consult estate planning counsel

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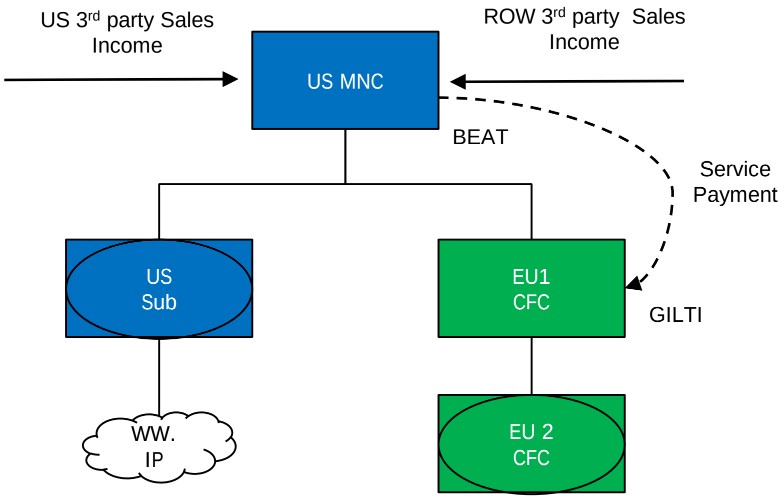
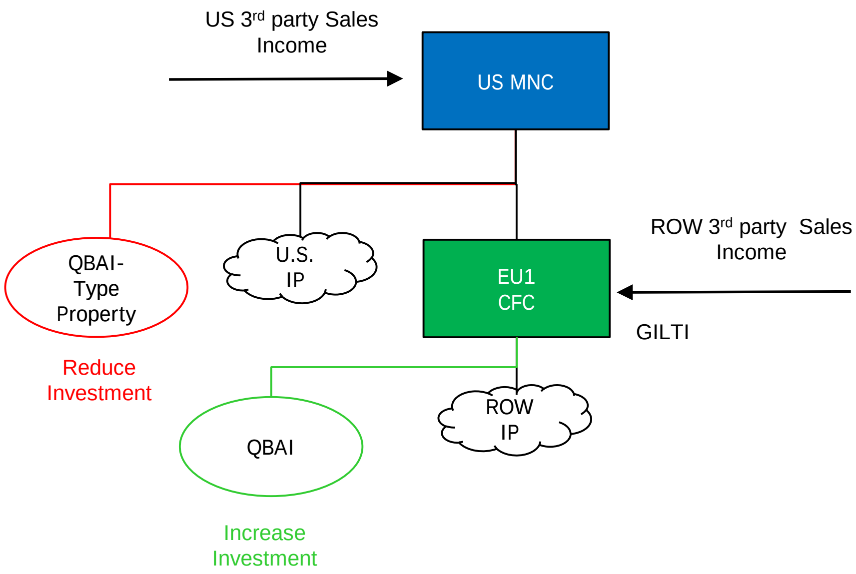
Post TCJA Heartburn

Post-TCJA Heartburn

U.S. "Onshore" Structure



IP Holding Company Structure



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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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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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