Morgan Lewis

TAX REFORM : THE DEVIL'S IN THE DETAILS

PART II OF OUR TAX REFORM DISCUSSION

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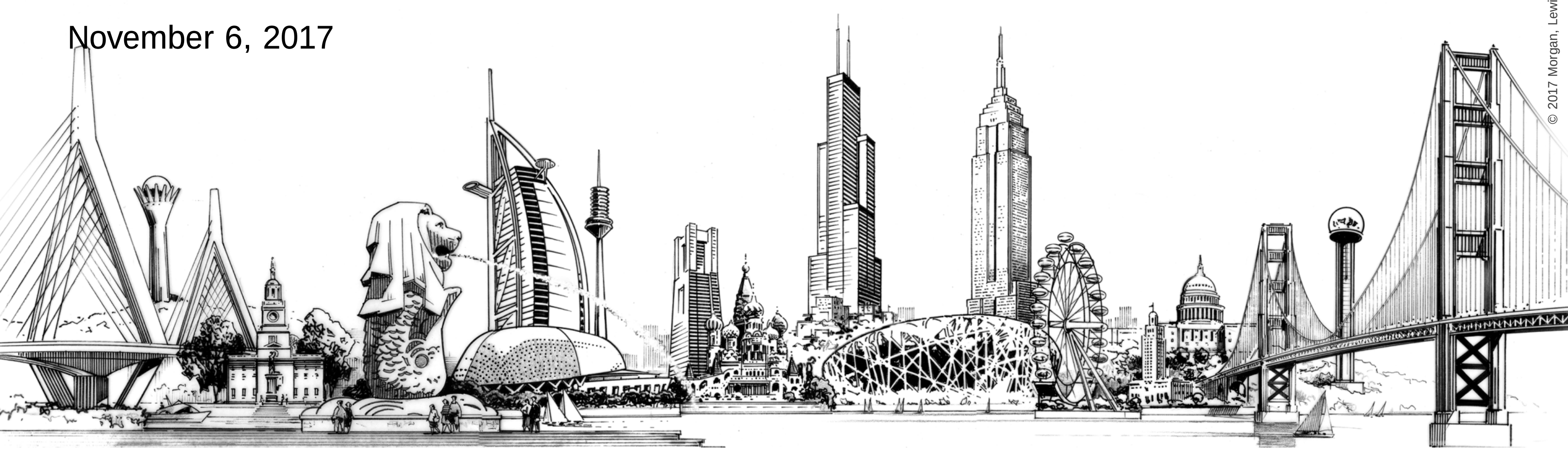

Overview: Business Tax Reform

- Reduces the corporate income tax rate from 35% to 20%.

- Limits the corporate alternative minimum tax.

- Taxes pass-through business income at a maximum rate of 25%, subject to anti-abuse rules.

- Allows for capital investment, except for structures, to be fully and immediately deductible for five years, and increases the Section 179 expensing limit from $500,000 to $5 million, with an increased phase-out threshold.

- Eliminates the deductibility of net interest expense on future loans to 30% of earnings before interest, taxes, depreciation, and amortization for all businesses with gross receipts of $25 million or more.

- Restricts the deduction of net operating losses to 90% of net taxable income and allows net operating losses to be carried forward indefinitely, increased by a factor reflecting inflation and the real return to capital. Eliminates net operating loss carrybacks.

- Eliminates the domestic production activities deduction (section 199), and other business deductions and credits.

- Creates a territorial tax system, exempting from U.S. tax 100% of dividends from foreign subsidiaries.
- Enacts a deemed repatriation of currently deferred foreign profits, at a rate of 12% for cash and cash-equivalent profits and 5 percent of all other profits.

Overview: Individuals

- Consolidates the current seven tax brackets into four, with rates of 12%, 25%, 35%, and 39.6%.
- Increases the standard deduction from $6,350 to $12,200 for singles, from $12,700 to $24,400 for married couples filing jointly, and from $9,350 to $18,300 for heads of household.
- Eliminates the personal exemption. Creates a $300 personal credit, along with a $300 nonchild dependent personal credit, in place for five years.
- Increases the child tax credit to $1,600, with $1,000 of the tax credit initially refundable. The refundable portion is indexed to inflation until the full $1,600 is refundable. The phase-out threshold for the child tax credit is also increased: for married households, it rises from $110,000 to $230,000.
- Retains the mortgage interest deduction, but with a cap of $500,000 of principal on newly purchased homes.
- Retains charitable contribution deductions and the deduction for state and local property taxes, the latter of which would be capped at $10,000; eliminates the remainder of the state and local tax deduction along with other itemized deductions.
- Eliminates the individual alternative minimum tax.
- Indexes tax brackets and other components using the chained CPI measure of inflation.
- Eliminates the federal estate taxes.

Business Tax Issues

- Tax rates
- Cost recovery
- Small business
- Business-related exclusions, deductions, etc.
- Business credits
- Energy credits
- Compensation

Tax Rates

New Rate:	• Flat 20 percent rate. • No brackets. • Repeals corporate AMT. • Personal service corporations taxed at 25 percent. • For taxpayers subject to the normalization method of accounting (e.g., regulated public utilities), the proposal provides for the normalization of excess deferred tax reserves resulting from the reduction of corporate income tax rates (with respect to prior depreciation or recovery allowances taken on assets placed in service before the date of enactment).
Effective Date:	• Taxable years beginning after December 31, 2017.

Cost Recovery – Extension of Bonus Depreciation and Temporary 100% Expensing

In General:	• The 50-percent first-year bonus depreciation deduction is increased to 100 percent for property acquired and placed in service after September 27, 2017, and before January 1, 2023. • Applies to: (1) property to which MACRS applies with an applicable recovery period of 20 years or less; or (2) computer software other than computer software covered by section 197.
Used Property:	• Removes the requirement that the original use of qualified property must commence with the taxpayer. • Thus, applies to purchases of used as well as new items.
Exceptions:	• Excludes any property used in a real property trade or business, i.e., any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. • Excludes any property used in the trade or business of certain regulated public utilities.

Small Business Reforms

Expansion of Section 179 Expensing:	• Small business expensing limitation under section 179 would be increased from $500,000 to $5 million and the phase-out amount would be increased from $2 million to $20 million. • Would apply to taxable years beginning after December 31, 2017.
Accounting Methods:	• Cash Method of Accounting – The $5 million threshold for corporations and partnerships with a corporate partner would be increased to $25 million and the requirement that such businesses satisfy the requirement for all prior years would be repealed. The increased $25 million threshold would be extended to farm corporations and farm partnerships with a corporate partner, as well as family farm corporations. • Inventories – Businesses with average gross receipts of $25 million or less would be permitted to use the cash method of accounting even if the business has inventories. • Long-term Contracts – The $10 million average gross receipts exception to the percentage-of-completion method would be increased to $25 million.
Exception from Limitation on Deduction of Business Interest:	• Businesses with average gross receipts of $25 million or less would be exempt from the interest limitation rules described in later.

Business Deductions

Limitations on Interest Deductions

In General:	• In the case of any taxpayer for any taxable year, the deduction for business interest is limited to the sum of (1) business interest income plus (2) 30 percent of the adjusted taxable income of the taxpayer for the taxable year. • The amount of any interest not allowed as a deduction for any taxable year may be carried forward for up to five years beyond the year in which the business interest was paid or accrued, treating business interest as allowed as a deduction on a first-in, first-out basis. • Business interest means any interest paid or accrued on indebtedness properly allocable to a trade or business. Any amount treated as interest for purposes of the Internal Revenue Code is interest for purposes of the proposal. • Business interest income means the amount of interest includible in the gross income of the taxpayer for the taxable year which is properly allocable to a trade or business. Business interest does not include investment interest, and business interest income does not include investment income, within the meaning of section 163(d). • By including business interest income in the limitation, the rule operates to limit the deduction for net interest expense to 30 percent of adjusted taxable income. That is, a deduction for business interest is permitted to the full extent of business interest income. To the extent that business interest exceeds business interest income, the deduction for the net interest expense is limited to 30 percent of adjusted taxable income. • Adjusted taxable income means the taxable income of the taxpayer computed without regard to: (1) any item of income, gain, deduction, or loss which is not properly allocable to a trade or business; (2) any business interest or business interest income; (3) the amount of any NOL deduction; and (4) any deduction allowable for depreciation, amortization, or depletion. • Repeals current section 163(j).

Limitations on Interest Deductions, *continued*

Application to Pass-Through Entities:	• In the case of any partnership, the limitation is applied at the partnership level. • Any deduction for business interest is taken into account in determining the non-separately stated taxable income or loss of the partnership. • To prevent double counting, special rules are provided for the determination of the adjusted taxable income of each partner of the partnership. • Similar rules apply with respect to any S corporation and its shareholders
Exceptions:	• Does not apply to any taxpayer if the taxpayer's average annual gross receipts for the three-taxable-year period ending with the prior taxable year does not exceed $25 million. • Does not apply any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. • The limitation does not apply to certain regulated public utilities (specifically, the trade or business of the furnishing or sale of (1) electrical energy, water, or sewage disposal services, (2) gas or steam through a local distribution system, or (3) transportation of gas or steam by pipeline, if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof is not treated as a trade or business for purposes of the limitation.
Effective Date:	• Applies to taxable years beginning after December 31, 2017.

Modifications of NOL Deductions

In General:	• Limits NOL deduction to 90 percent of taxable income (determined without regard to the deduction). • Carryovers to other years are adjusted to take account of this limitation, and may be carried forward indefinitely. • NOL carryovers attributable to losses arising in taxable years beginning after December 31, 2017, are increased annually by an inflation adjustment. • Repeals the two-year carryback and the special carryback provisions, but provides a one-year carryback in the case of certain disaster losses incurred in the trade or business of farming, or by certain small businesses (a corporation, partnership, or sole proprietorship whose average annual gross receipts for the three-taxable-year period ending with such taxable year does not exceed $5,000,000).
Effective Date:	• The proposal allowing indefinite carryovers and modifying carrybacks generally applies to losses arising in taxable years beginning after December 31, 2017. • The proposal limiting the NOL deduction applies to taxable years beginning after December 31, 2017. • The annual increase in carryover amounts applies to taxable years beginning after December 31, 2017.

Limitations on Like-Kind Exchanges

In General:	• Would limit section 1031 to real property that is not held primarily for sale. • Excludes depreciable, intangible, or non-depreciable personal property.
Effective Date:	• Applies to exchanges completed after December 31, 2017.

Limitations on Contributions to Capital

In General:	• Repeals section 118 under which, generally, a corporation's gross income does not include contributions of capital to the corporation. • Provides that a contribution to capital, other than a contribution of money or property made in exchange for stock of a corporation or any interest in an entity, is included in gross income of a taxpayer. • For example, a contribution of municipal land by a municipality that is not in exchange for stock (or for a partnership interest or other interest) of equivalent value is considered a contribution to capital that is includable in gross income. • By contrast, a municipal tax abatement for locating a business in a particular municipality is not considered a contribution to capital.
Effective Date:	• Applies to contributions made, and transactions entered into, after the date of enactment.

Self-Created Property and Patents

Self-Created Property:	• Amends section 1221(a)(3) to exclude a patent, invention, model or design (whether or not patented), a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) from the definition of a “capital asset.” • Thus, gains or losses from the sale or exchange of a patent, invention, model or design (whether or not patented), or a secret formula or process which is held either by the taxpayer who created the property or a taxpayer with a substituted or transferred basis from the taxpayer who created the property (or for whom the property was created) will not receive capital gain treatment. • Applies to dispositions after December 31, 2017.
Patents:	• Repeals section 1235. • Thus, the holder of a patented invention may not transfer his or her rights to the patent and treat amounts received as proceeds from the sale of a capital asset. • Intended that the determination of whether a transfer is a sale or exchange of a capital asset that produces capital gain, or a transaction that produces ordinary income, will be determined under generally applicable principles. • Applies to dispositions after December 31, 2017.

Business and Energy Tax Credits

Business Credits Repealed:	• Credit for clinical testing expenses for certain drugs for rare diseases or conditions. • Employer-provided child care credit. • Rehabilitation credit. • Work opportunity tax credit. • Deduction for unused business credits. • New markets tax credit. • Expenditures to provide access to disabled individuals.
Energy Credits:	• Modifies credit for electricity produced from certain renewable resources. • Modified energy investment tax credit. • Repeals enhanced oil recovery credit. • Repeals credit for producing oil and gas from marginal wells. • Modified credit for production from advanced nuclear power facilities.

Compensation

Nonqualified Deferred Compensation

In General:	• Under new section 409B, any compensation deferred under a nonqualified deferred compensation plan is includible in the gross income of the service provider when there is no substantial risk of forfeiture of the service provider’s rights to such compensation. • The rights of a service provider to compensation are treated as subject to a substantial risk of forfeiture only if the rights are conditioned on the future performance of substantial services by any individual. • A condition related to a purpose of the compensation other than the future performance of substantial services (such as a condition based on achieving a specified performance goal or a condition intended in whole or in part to defer taxation) does not create a substantial risk of forfeiture, regardless of whether the possibility of forfeiture is substantial. • In addition, a covenant not to compete does not create a substantial risk of forfeiture. • Generally would apply to equity awards, including stock options and SARs, but transfers of property under section 83 (other than stock options) would remain exempt.
Effective Date:	• Generally applies to amounts attributable to services performed after December 31, 2017. • In the case of any deferred compensation amount to which the proposal does not otherwise apply solely by reason of the fact that the amount is attributable to services performed before January 1, 2018, to the extent such amount is not includible in gross income in a taxable year beginning before 2026, such amount is includible in income in the later of (1) the last taxable year before 2026, or (2) the taxable year in which there is no substantial risk of forfeiture of the rights to such compensation (determined in the same manner as determined under the proposal). • Earnings on deferred amounts attributable to services performed before January 1, 2018, are subject to the proposal only to the extent that the amounts to which the earnings are attributable are subject to the proposal.

Excessive Remuneration

In General:	• No exceptions for performance compensation. • Thus no exceptions for stock options/ SARs. • No exception for the top 5 officers who leave before year end. • No exception for CFOs, current or who leave before year end. • No exception for payments made after the officer leaves. • No exception for payments to officers who were officers (i.e. covered employees) of the company or of any predecessor company for any taxable year beginning after 2016. • No exception even if payments are made to former spouses or beneficiaries after the covered employees die. • No ability to defer payment to shrink payments below $1 million per person (because of deferred compensation limits in prior slide).
Effective Date:	• Applies to taxable years beginning after December 31, 2017.

International Tax Issues

- Switch to participation exemption system
- Related and other changes to FTC rules
- Treatment of excess FTCs
- NOLs, OFLs, ODLs, and FOG losses
- Changes to Subpart F
- Denial of interest deductions for US corporations in an international financial reporting group
- Tax on amounts paid to foreign affiliates
- Transition tax (new Section 965)
- Transition rules

Switch to Participation Exemption System

- **Participation Exemption.** New Section 245A would provide for a 100 percent DRD for foreign source portion of dividends received by domestic corporation from a 10-percent owned foreign corporation, provided six-month holding period satisfied.
  - Foreign source portion - portion of dividends from post-1986 or pre-1987 earnings of the foreign corporation that are not attributable to ECI or dividends from an 80 percent-owned domestic corporation.
  - Dividends from 10/50 companies eligible
  - Foreign branches of a domestic company not eligible (not treated as foreign corporations).
    - Thus foreign income generated by a foreign branch income would not qualify for exclusion from the taxable income of a domestic corporation.
  - Partnerships not addressed - *Cf*. Rev. Rul. 71-141.
  - Effective for distributions made after 2017

Switch to Participation Exemption System

- **Repeal of Section 956 for corporate shareholders**. Effective for taxable years of foreign corporations beginning after December 31, 2017.
  - Note discrepancy with participation exemption effective date.
  - No need for Section 956 when earnings can be repatriated free of U.S. tax.

Switch to Participation Exemption System

- **Gains or Losses on Sale of Stock in Foreign Corporation**
  - Gain from the sale of stock treated as a dividend (Sections 304, 1248) would presumably be eligible.
    - Gain in excess of Section 1248 dividend subject to tax
  - Solely for purposes of computing a loss on disposition, basis in stock of a 10-percent owned foreign corporation is reduced by the amount of any DRD allowed to the 10 percent US corporate shareholder.
  - Effective for distributions made after 2017
    - Loss in excess of reduced basis, however, is allowed
  - Appears, therefore, to allow deductions for the basis in worthless stock, as reduced by amount of DRD with respect to the stock.

Switch to Participation Exemption System

- **Branch Losses Transferred to 10-Percent Owned Foreign Corporation**
  - Domestic corporation that transfers a foreign branch's assets to a 10-percent owned foreign corporation must include as U.S. source income losses incurred after 2017 and before the transfer that are not otherwise recaptured under Sections 904(f)(3) (recapture of overall foreign losses) or 367(a)(3)(C) (recapture of foreign branch losses on transfer of a foreign trade or business to a foreign corporation) and not previously offset by income or currently by gain recognized in the transaction
  - Newly treats recapture amount under 367(a)(3)(C) as U.S. source income
  - Applies to transfers after 2017

Related Changes to FTC Rules

- **No FTC with respect to Dividends Eligible for Participation Exemption**
  - Section 902 repealed.
    - Thus, no deemed paid credits on dividends received by a domestic corporation owning at least 10 percent of the voting stock of a foreign corporation
  - No FTC or deduction for withholding tax imposed on dividend distribution.
  - Dividend eligible for DRD and (expenses allocable thereto) not included in foreign tax credit limitation

Other Changes to FTC Rules

- **Section 960 Deemed Paid Credit**
  - Taxes associated with Subpart F inclusion still deemed paid under Section 960.
  - But domestic corporation deemed to pay only foreign corporation's foreign income taxes "properly attributable" to item of income included.
    - Since all post-1986 earnings will be taxed under transition rule (discussed below), "properly attributable" would presumably look only to tax on items that would be associated with current earnings included under Subpart F.
      - Not clear whether "properly attributable" concept would be applied a basket or item of income basis, but rule implies on an "item" basis even within a basket.
      - Applicable to taxable years beginning after 2017
- **Section 904 Categories**
  - New separate basket for "foreign high return amount" (discussed below)
    - Effective for taxable years of foreign corporations beginning after 2017 and to taxable years of U.S. shareholders in which or with which such taxable years end.
  - Effective for taxable years beginning after 2017, sales of inventory sourced solely on basis of location of production.

Changes to FTC Rules (Cont'd)

- **Other FTC Provisions**
  - Section 960 deemed paid credit for any taxes paid by a CFC retained, no matter how many tiers down.
  - Section 904(h) (recharacterization of Subpart F inclusions, PFIC inclusions, interest, and dividends as U.S. source) retained.
  - Section 907 retained.
  - Section 909 (FTC splitter rule) retained.
  - Section 901(m) (denial of credit with respect to tax on foreign income not subject to US tax by reason of a covered asset acquisition) retained.
  - FTC allowed for taxes imposed on distribution of PTI.

Treatment of Excess FTCs

- FTC carry forwards from pre-effective dates survive and could be utilized in accordance with new FTC limitations
- If Congress follows precedent from 1986 Act, pre-effective date taxes on overall basket income would be post-effective date overall basket taxes except if taxpayer wanted to and could show that, if the new definition of “high return” income (see below) applied to pre-effective date years, the taxes would have been high return taxes, in which case such taxes would be high return basket taxes post-effective date.
  - Since proposal does not amend section 907, pre-effective date excess 907 taxes would become post-effective date 907 taxes and presumably would be associated with same section 904(d) basket as above for purpose of applying section 907 on a section 904(d) basket basis.

NOLs, OFLs, ODLs, and FOG Losses

- Proposal does not alter any of these rules, except that the transition tax does not trigger OFL recapture or FOG loss recapture on transition inclusion
- So assumption is that, without regard to other changes in the law,
  - Pre-effective date NOLs will offset post-effective date taxable income to the same extent as they would have had the taxable income been generated pre-effective date
  - Same rule for the recharacterization of
    - post-effective date foreign source as US source income to the extent of pre-effective date OFLs,
    - post-effective date US source as foreign source income to the extent of pre-effective date ODLs
    - post-effective date FOGI as non-FOGI foreign source income to the extent of pre-effective date FOG losses
  - Appropriate given the reduction in the corporate rate? Does it matter whether the pre-effective date attribute is a benefit (e.g., ODL, NOL) or detriment (e.g., OFL, FOG loss)?

Changes to Subpart F: The Foreign High Return Amount Rules (New Section 951A)

- Every U.S. person (not just corporations) who is a U.S. shareholder of any CFC for any taxable year of such shareholder must include in income 50 percent of such shareholder's "foreign high return amount"
- U.S. person treated as a U.S. shareholder of a CFC for the shareholder's taxable year if (a) the CFC's taxable year ends in or with the U.S. shareholder's taxable year or (b) such person owns (under Section 958(a)) stock in the CFC on the last day of the taxable year in which the foreign corporation is a CFC.
- **Foreign High Return Amount ("*FHRA*")**
  - U.S. shareholder's "net CFC tested income" ("NCTI") for the shareholder's taxable year
  - minus the "applicable percentage" for such shareholder's taxable year of the shareholder's pro rata share of the "qualified business asset investment" in each CFC with respect to which the shareholder is a U.S. shareholder for the CFC's taxable year ending in or with the shareholder's taxable year
  - minus interest expense taken into account in determining the shareholder's NCTI for the year.

Changes to Subpart F: The Foreign High Return Amount Rules

- **Net CFC tested income" ("NCTI")**
  - Aggregate of the shareholder's pro rata share of the "tested income" of each CFC with respect to which the shareholder is a U.S. shareholder for the CFC's year ending in or with the shareholder's year, ***minus***
  - Aggregate of such shareholder's pro rata share of the "tested loss" of each such CFC
  - With respect to a CFC, "tested income" is its gross income determined without regard to (i) effectively connected income, (ii) amounts included in Subpart F income, (iii) any amount excluded from foreign personal holding company income ("FPHCI") by reason of the CFC look-through rule (but only to the extent that the payment does not reduce the payor's FHRA), (iv) amounts excluded from FPHCI under the financing and insurance exceptions, (v) amounts excluded from foreign base company income or insurance income under the high-tax exception, (vi) dividends excluded from FPHCI under the same-country exception, and (vii) any "commodities gross income" ***minus*** deductions (including taxes) properly allocable to such gross under Section 954(b)(5)
    - "Commodities gross income" is gross income from the disposition of commodities (as described in Sections 475(e)(2)(A) or 475(e)(2)(D)) produced or extracted by the corporation
  - "Tested loss" is the excess (if any) of the CFC's allocable deductions over gross income used in determining "tested income"

Changes to Subpart F: The Foreign High Return Amount Rules

- **Qualified Business Asset Investment**
  - CFC's adjusted bases in "specified tangible property"
    - (i) used in a trade or business of the corporation and
    - (ii) of a type with respect to which a deduction is allowable under section 168.
  - "Specified tangible property" includes only tangible property to the extent used in the production of tested income or tested loss.
  - A CFC that is a partner in a partnership must take into account its distributive share of the aggregate of the partnership's adjusted bases in tangible property described above
    - Distributive share the same as the CFC's distributive share of income or loss with respect to the property
  - Adjusted basis in property "shall be determined without regard to any provision of this title (or any other provision of law) which is enacted after the date of the enactment" of the FHRA rules.

Changes to Subpart F: The Foreign High Return Amount Rules

- **Applicable Percentage**
  - With respect to the U.S. shareholder's taxable year, the federal short-term rate for the month in which or with which such taxable year ends plus seven percent.
- **Foreign Tax Credit Provisions**
  - Credit allowed only for foreign income taxes "properly attributable to" gross income used in determining "tested income"
  - Taxes deemed paid for 80 percent of such taxes X [FHRA/aggregate of the shareholder's pro rata shares of positive "tested income" of CFCs taken into account in determining "net CFC tested income"]
    - Note that this appears to allow deemed credits for taxes with respect to the 50 percent of the FHRA that isn't included in the shareholder's gross income.
  - Amount of included FHRA included in a separate foreign tax credit limitation basket
  - No carryover of taxes deemed paid with respect to FHRA
  - Section 78 gross-up for 100 percent (not just 80) percent of taxes X the fraction set out above
- **Effective Date** – Taxable years of foreign corporations beginning after 2017 and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Additional Changes to Subpart F

- Inclusion based on withdrawal of previously excluded Subpart F income from qualified investment in shipping operations repealed.
- Inclusion of foreign base company oil related income repealed.
- Subpart F de minimis exception indexed for inflation
- Look-through exception from FPHCI made permanent.
- For purposes of determining whether a US person that is an entity (corporation, partnership, trust) is a U.S. shareholder in a foreign corporation and whether the foreign corporation is a CFC, stock in the foreign corporation owned by a foreign person that owns an interest in the entity may be attributed to the entity.
- Elimination of 30-day rule
- Rules effective for taxable years of foreign corporations beginning after 2017 and taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

Denial of Interest Deductions for U.S. Corporations in an International Financial Reporting Group

- New Section 163(m) limits deductibility of interest expense of U.S. corporation that is a member of an “international financial reporting group” (“IFRG”) for a taxable year to the sum of corporation’s interest income for the taxable year and the “allowable percentage” of 110 percent of the corporation’s net interest expense for the year.
- An IFRG is, with respect to any “reporting year,” any group of entities which includes (i) at least one foreign corporation engaged in a U.S. trade or business or at least one domestic and one foreign corporation, (ii) prepares consolidated financial statements for such year, and (iii) reports in such statements average annual gross receipts for the three-year reporting period ending with the reporting year of more than $100m.

Denial of Interest Deductions for U.S. Corporations in an International Financial Reporting Group

- The "allowable percentage" is the ratio of (a) the corporation's "allocable share" of the IFRG's "reported net interest expense" for the reporting year which ends in or with the corporation's taxable year and (b) the corporation's "reported net interest expense" for the reporting year.
- "Reported net interest expense"
  - Of the IFRG, the net interest expense reported on the group's consolidated financial statements
  - Of the corporation, the net interest expense of the corporation reported in the IFRG's books and records used in preparing the group's consolidated financial statements.
- "Allocable share" is the group's reported net interest expense times [the corporation's EBITDA/the group's EBITDA].
- Amount of interest not allowed as a deduction may be carried forward, but not past the fifth year after the year not allowed.
- Effective for taxable years beginning after 2017.

Tax on Amounts Paid to Foreign Affiliates

- 20 percent excise tax imposed on a domestic corporation's "specified amounts" paid or incurred to a foreign corporation that is a member of the same IFRG
- "Specified amount" means any amount which is, with respect to the payor, allowable as a deduction or includible in COGS, inventory, or the basis of depreciable or amortizable asset except (i) interest, (ii) any amount paid or incurred for the acquisition of a commodity, and (iii) any amount to the extent (taking statutory and treaty exemptions/reductions into account) subject to the 30 percent tax under Section 881(a).
- An IFRG means any group of entities, with respect to any specified amount, if such amount is paid during a reporting year of the group with respect to which the group prepares consolidated financial statements and the average annual aggregate specified amounts for the three-year period ending with the reporting year exceeds $100m.
- No deduction for the excise tax
- Tax does not apply to so much of a specified amount that is ECI or that is treated as such under an election provided by the bill
- Payments paid, incurred, or received by a partnership which is an IFRG member treated as paid, incurred, or received by its partners.
- Payments from a foreign corporation's US branch to the head office subject to the tax.

Tax on Amounts Paid to Foreign Affiliates

- Any specified amount that the foreign corporation elects to be treated as ECI not eligible for treaty benefit
- Actual expenses may not reduce any specified amount elected to be treated as ECI
  - Instead, a deduction allowed with respect to the specified amount received by the foreign corporation during a reporting year in an amount such that the corporation's ratio for the year of its (a) net income without regard to interest and taxes for the product line to which the specified payment relates divided by (b) its revenues from the product line equals the IFRG's corresponding ratio for such year.
- Amount not treated as ECI for purposes of the DRD, including new Section 245A
- No credit for foreign taxes on amounts treated as ECI under this provision.
- Amounts treated as ECI subject to branch profits tax

Transition Tax (New Section 965)

- **Inclusion of Deferred Foreign Earnings**
  - 10 percent U.S. shareholder (not just corporations) required to include as Subpart F income such shareholder’s pro rata share of undistributed, accumulated post-1986 foreign earnings (“deferred foreign income”) of CFCs and 10/50 companies (treated as CFCs for this purpose).
    - Must include the greater of the amounts “determined as of” November 2 or December 31, 2017
    - Pre-1987 foreign earnings not included.
    - ECI that is subject to U.S. tax not included.
      - Remains subject to normal section 245 DRD regime.
    - PTI not included.
  - The CFC’s Subpart F income increased by the deferred foreign income for its last taxable year beginning before 2018.
  - Pro rata share determined under “principles of section 951(a)(2).”
- **Treatment of E&P Deficits**
  - Income inclusion reduced by 10-percent U.S. shareholder’s pro rata share of foreign E&P deficit in one or more CFCs by allocating deficit to foreign corporations in which shareholder has a pro rata share of deferred foreign income based on the pro rata share of each such foreign corporation.

Transition Tax -- Reduced Rate

- **Bifurcated Deduction to Produce Lower Effective Tax Rate**
  - 10 percent U.S. shareholder allowed a deduction in such amount that produces a five percent tax rate on the amount included in excess of the shareholder's "aggregate foreign cash position" and a 12 percent tax rate on the aggregate foreign cash position.
  - The shareholder's aggregate foreign cash position is equal to the average of the shareholder's pro rata shares of the cash position of each CFC as of November 2, 2017, as of the close of the CFC's last taxable year ending before that date, and as of the close of the taxable year preceding such last taxable year.
  - Cash position not taken into account if it could not (as of the dates above) have been distributed by the CFC to U.S. shareholders because of currency or other restrictions imposed under the laws of a foreign country.
  - IRS given authority to promulgate anti-abuse rules to make it difficult to invest liquid assets into illiquid asset to obtain lower rate
  - ➢ No rules restrict the ability to use other current year deductions or NOL carryovers to reduce the nondeductible portion of the inclusion.
  - ➢ Contrast with former section 965(e)(2).

Transition Rules – FTC, Installment Payments, PTI

- **FTC allowed for only such portion of foreign taxes equal to percentage that the five or 12 percent tax rate bears to 35 percent.**
  – No deduction for denied foreign taxes
  – No gross-up
  – Carryover period extended to 20 years.
- **Elective 8-Year installment payment schedule**
  – Equal payments
  – No interest charge
- **On distribution, earnings treated as PTI**

Transition Tax – Claiming FTC on Nondeductible portion of Inclusion

- All of current foreign tax credit rules, including section 904 limitation and ODL rules, apply
  - Except OFL and foreign oil and gas loss recapture rules turned off for amounts included under transition tax
- Section 907 otherwise applies
- Normal section 861 allocation and apportionment rules apply
  - Based on prior section 965 guidance (Notice 2005-64), stock in a foreign corporation not treated as tax exempt asset even though deduction allowed under new section 965
- FTCs not limited to foreign taxes "attributable to" the nondeductible portion of inclusion; apply normal section 960 rules
  - Contrast with prior section 965(e)
- Thus, excess section 907 credits or excess section 904 credits on other foreign source income in the same section 904(d) basket allowed to offset U.S. tax on portion of inclusion that is not deductible.

THANK YOU

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Biography

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Bill McKee's practice encompasses all areas of federal taxation, with special emphasis on partnership taxation. Bill served as tax legislative counsel at the US Treasury Department from 1981 to 1983. He is a member of the American Law Institute, the American College of Tax Counsel, and the National Institute for Tax Professionals.

In addition to authoring numerous articles, Bill co-authored the treatise Federal Taxation of Partnerships and Partners (Warren, Gorham & Lamont, 4th edition, 2007) as well as Structuring and Drafting Partnership Agreements: Including LLC Agreements (Warren, Gorham & Lamont, 3rd edition, 2003). He also frequently speaks on partnership taxation at seminars across the United States.

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Josh's practice encompasses a broad range of corporate tax issues involving corporations, partnerships, and their owners and investors. He is widely recognized for his work on mergers and acquisitions, distributions, financings, restructurings, and corporations filing consolidated returns.

Josh advises both public and private clients on a number of sophisticated acquisition and disposition structures, including tax-free mergers, tender offers, going-private transactions, and cross-border joint ventures. He represents public corporations in large spin-offs and split-offs, including spin-offs attendant to mergers, joint ventures, private equity investments, and cash-rich split-offs. He also represents taxpayers before the Internal Revenue Service on audits, appeals, and obtaining IRS private letter rulings on transactions. Josh additionally represents clients before the Treasury Department and Congress on matters involving proposed legislation and regulations.

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With more than 30 years of experience, Peter Daub concentrates his practice in the areas of international and domestic tax planning for US- and foreign-based multinationals, financial institutions, and financial intermediaries. Domestically, he helps US-based multinational clients in deferral and repatriation structures and foreign tax credit planning and provides tax advice on financial and currency transactions. For foreign-based multinationals, Peter's principal areas of concentration include the structuring of US operations, withholding tax minimization, and enhancement of US tax treaty benefits. He has counseled a wide range of clients on withholding, including on Foreign Account Tax Compliance Act issues. Peter's clients include multinational institutions in virtually all major industries, including technology, consumer products, aerospace, telecommunications, banking, finance, insurance, defense, and energy.

Peter previously served as associate international tax counsel at the US Department of the Treasury, where he had principal responsibility for the development and subsequent implementation of some of the most important international tax provisions in the Tax Reform Act of 1986, including those related to the foreign tax credit and Subpart F.

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Alex Reid advises tax-exempt organizations in planning, structuring, and transactional matters. He also represents taxpayers under audit, and helps organizations improve their governance and enhance their tax compliance. Alex counsels taxpayers seeking administrative guidance from the Internal Revenue Service (IRS) and US Department of the Treasury, as well as on legislative matters with the US Congress. His tax-exempt clients include charities, foundations, colleges and universities, museums, and other nonprofit organizations.

Before joining Morgan Lewis, Alex served as legislation counsel for the Joint Committee on Taxation of the US Congress, where he advised members of Congress and staff regarding tax policy. He also drafted legislation, hearing publications, and technical explanations of tax legislation.

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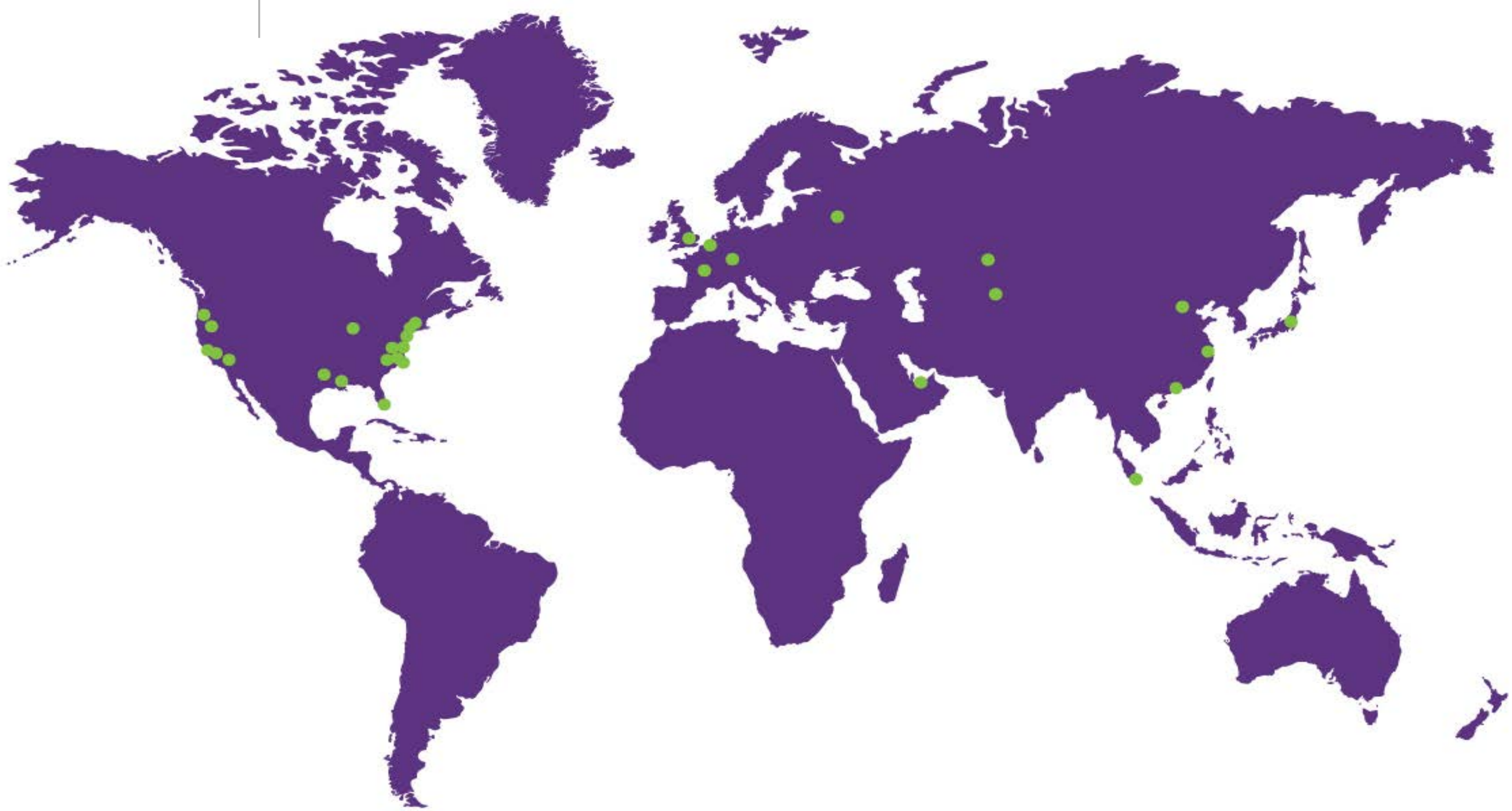

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