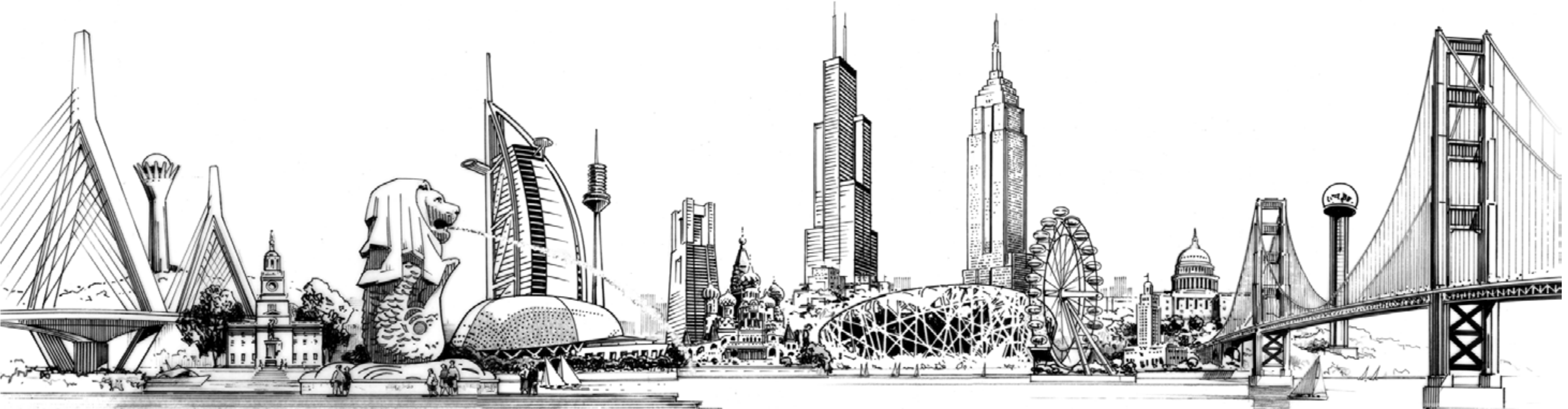
Morgan Lewis

HOW CORPORATE TAX REFORM WILL IMPACT THE TECH INDUSTRY

May 17, 2018



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TCJA ECONOMIC OVERVIEW

Economic – Overview

- Capital incentives are expected to cost $2.5 trillion over the next 10 years. Revenue raisers reduce the total expected cost to around $1.5 trillion. *Wasting $2.5 Trillion on No-Growth Capital,* Calvin H Johnson, https://www.taxnotes.com/tax-notes-today/tax-preference-items-and-incentives/wasting-25-trillion-no-growth-capital/2018/02/12/26txn?highlight=%22wasting%20%242.5%22

[Note that there was a perceived glut of capital evidenced by the low risk-free rates of return]

- After an initial expected surge, the growth rate is excepted to drop to 1.5% by 2021 (with a longer term rate of 1.7% between 2021 and 2027). *New CBO Forecast Sets the Stage for U.S. Tax Hikes*, Martin A. Sullivan, https://www.taxnotes.com/tax-notes-today/tax-policy/economic-analysis-new-cbo-forecast-sets-stage-us-tax-hikes/2018/04/16/27yx4?highlight=sullivan%20deficit

[Note that this growth rate is barely half of what was projected by the Administration]

REDUCTION IN CORPORATE TAX RATE

Corporate Rate Cut Overview

In General:

- Federal rate cut from 35% top marginal rate to flat 21% rate.
- Taxable years beginning after December 31, 2017.
- Permanent cut, unlike many other aspects of TCJA.

Implications:

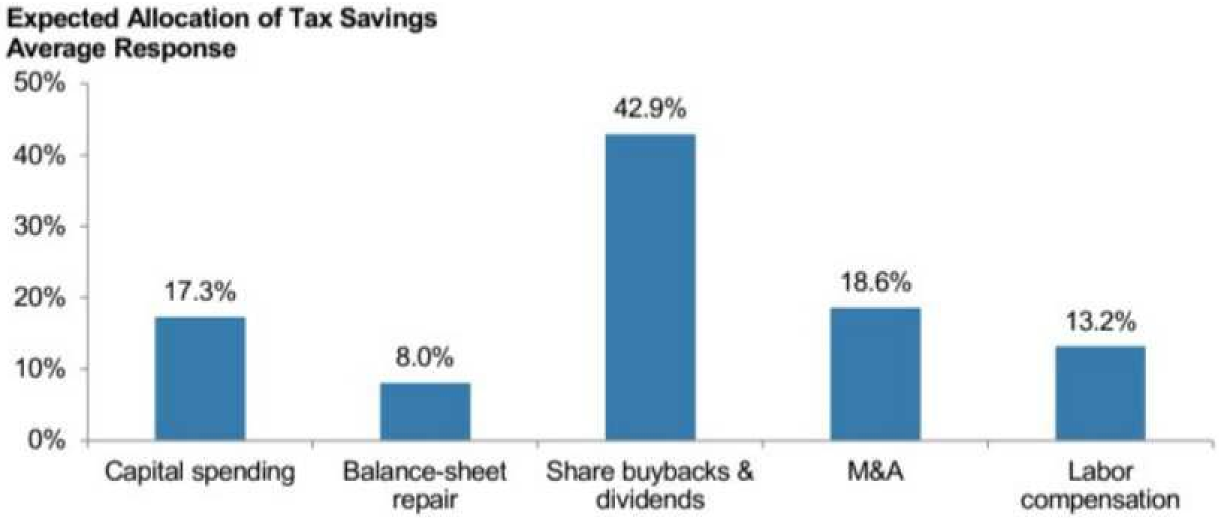
- Increases in corporate cash flows.
  - Wages.
  - Capital investments.
  - Debt repurchases.
  - Stock repurchases and dividends.
- Increased relative competitiveness of U.S.-based business operations.
- Choice of jurisdiction and inversion implications
- C-corps structures becoming more attractive

Corporate Rate Cut – Where Will it Go?

Possible Flows:

Source:
Morgan Stanley

Exhibit 4: On Average, How Are Companies Likely to Allocate Their Tax Savings?



THE NEW "PSEUDO TERRITORIAL" SYSTEM – PARTICIPATION EXEMPTION

Participation Exemption – New Section 245A

Domestic corporation that is a “U.S. shareholder” of a “specified 10% owned foreign corporation” is allowed a deduction in an amount equal to the “foreign-source portion” of any dividend received from the specified 10% owned foreign corporation

- **U.S. shareholder**
  - expanded section 951(b) definition: U.S. shareholder that owns by vote or value 10% of the stock of a foreign corporation, either directly, indirectly, or constructively, including attribution from foreign persons
- **Specified 10% owned foreign corporation**
  - foreign corporation to which any domestic corporation is a U.S. shareholder, except a passive foreign investment company (PFIC) that is not a CFC
- **Foreign-source portion of dividend**
  - portion of undistributed earnings of the foreign corporation that is neither attributable to ECI or dividends received (directly or through a wholly owned foreign corporation) from an 80% owned domestic corporation (determined without regard to whether the domestic corporation is a RIC or a REIT)
- **Effective date**: Distributions received after Dec. 31, 2017

Holding Period Requirement – New Sections 246(c)(1), (5)

- To claim section 245A DRD, must have "held" shares of the specified 10% owned foreign corporation for **more than 365 days during a 731 day** (beginning on the date which is one year before the date on which the shares become ex-dividend with respect to the dividend), and **in addition**,
  - specified 10% owned foreign corporation must have been a specified 10% owned foreign corporation at all times during that period, and
  - the taxpayer must have been a U.S. shareholder of the specified 10% owned foreign corporation at all times during that period
- Additionally, section 245A DRD is not allowed to the extent that the taxpayer is under an obligation (under a short sale or otherwise) to make related payments as to positions in substantially similar or related property

Other Special Rules

Denial of FTC

- No foreign tax credit under section 901 or deduction allowed for any foreign taxes paid or accrued (or treated as paid or accrued) as to any dividend for which the section 245A DRD is allowed
  - Thus, no indirect credit and no credit or deduction for foreign withholding taxes paid on dividend distribution

Hybrid Dividends Do Not Qualify

- A hybrid dividend is an amount received from a CFC:
  - for which the CFC received a deduction (or other tax benefit) with respect to any income, war profits, or excess profits taxes imposed by any foreign country or U.S. possession
  - As a back-up, an additional rule treats hybrid dividends received by one CFC from another CFC, if a domestic corporation is a U.S. shareholder with respect to both, as the first CFC's Subpart F income notwithstanding any exception (e.g., same-country dividend exception) and requires the US shareholder to include (without any offsetting Section 245A DRD) its pro rata share of such Subpart F income with respect to shares in the first CFC

PFIC Purging Dividends Do Not Qualify

- A PFIC dividend as a result of a purging election under section 1291(d)(2)(B) is not treated as dividend for section 245A purposes even though the PFIC is a CFC

Partnerships

- Regulatory authority ("Secretary shall prescribe such regulations") to defined dividends received to include dividends where a domestic corporation U.S. shareholder owns stock of a specified 10 percent owned foreign corporation through a partnership.

Other Special Rules (cont'd)

- **Section 1248/964(e) dividends**
  - Section 1248 dividend of a domestic corporation treated as dividend for section 245A purposes
  - Foreign-source portion of a section 964(e) dividend, where a CFC sells the stock of a lower-tier foreign corporation held for more than one year, also treated as dividend for section 245A purposes,
    - by classifying the foreign-source portion of such section 964(e) dividend as Subpart F income of the selling CFC and
    - treating a qualifying domestic U.S. shareholder reporting such Subpart F income as having received a section 245A dividend from the selling corporation equal to that portion
- **Effective date**: Sales or exchanges after December 31, 2017.

Repeal of Section 902

- Because a domestic corporation that is a U.S. shareholder now generally receives a section 245A DRD on dividends from specified 10% owned foreign corporations, section 902 was repealed

- **Effective date**: Dividends received after December 31, 2017.

Observations

- Section 245A DRD applies only to domestic corporations that received dividends from specified 10% owned foreign corporations
  - Thus, does not apply to
    - income earned by a domestic corporation through a foreign branch,
    - or income earned by individuals, whether U.S. or foreign
- Only applies if “dividend received”
  - Thus, subpart F inclusions and section 951A GILTI inclusions do not qualify even if dividends are distributed during the same year as the inclusion, as inclusions are not “dividends”
  - Accordingly, in practice section 245A DRD will likely be limited to returns on investments in tangible assets, at least for CFCs with low-tax earnings, as all other non-subpart F earnings will likely be included in income under section 951A under the GILTI provisions, as discussed below.

Observations (cont’d)

- What constitutes a “dividend” is not defined
  - Presumably section 367(b) inclusions and section 304 dividends will be treated as dividends for section 245A purposes
  - But holding period requirements may raise unique issues
- Partnerships – Unclear whether grant of regulatory authority to address partnerships should be treated as self-executing
  - the conference committee report supports current treatment (explaining that the “term ‘dividend received’ is intended to be interpreted broadly . . .” and illustrating that dividends on foreign stock owned through a partnership “would qualify for the participation DRD”)
- Repeal of section 902 can result in double taxation in various circumstances, *e.g.*,
  - Domestic corporate shareholder does not satisfy the holding period requirements
  - Dividends received by a domestic corporate shareholder from a PFIC that is not a CFC
- Repeal of section 902 also means that section 905(c) foreign tax credit redeterminations do not adjust the post-1986 foreign income tax pools of foreign corporations, but rather taxpayers will need to claimed additional taxes for the origin year to which the foreign taxes relate
  - If not filed timely, this can raise SOL issues.

SECTION 965 – DEEMED REPATRIATION OF FOREIGN CORPORATION EARNINGS & PROFITS

Section 965 – Overview

- As part of the transition to the participation exemption system of taxation, new Section 965 requires 10% "US shareholders" of CFCs and certain other foreign corporations to include a pro rata portion of existing untaxed foreign source E&P as subpart F income.

- Impact of Section 965 subpart F income inclusion lessened by (1) reduced effective tax rates imposed on this inclusion via deduction (15.5% effective rate for cash and cash equivalents and 8% effective rate for residual), and (2) an election to pay the tax liability on the associated income over an 8-year period.

- Significant unanswered issues remain under the statute as to general computation and possible planning matters that could impact a taxpayer's Section 965 inclusion. The government has already responded by publishing Notice 2018-7 on Dec. 29, 2017 and Notice 2018-13 on Jan 19, 2018 (the "Notices"), which express the government's intent to issue regulations addressing a variety of open, largely computational issues.

Section 965(a) – Subpart F Income Inclusion Amount of “DFICs”

Section 965(a) increases subpart F income of a “Deferred Foreign Income Corporation” or “DFIC” for its last taxable year beginning before 1/1/18 by its “Accumulated post-1986 Deferred Foreign Income” determined as of 11/2/17 or 12/31/17, whichever is greater.

- DFICs only include any “Specified Foreign Corporation” (“SFC”) – (1) any CFC, or (2) any other foreign corporation with respect to which one or more domestic corporations is a US shareholder and that is not a PFIC.

- “Accumulated post-1986 Deferred Foreign Income” or “ADFI” includes “Post-1986 E&P” or E&P accumulated in taxable years after 1986 other than (1) ECI, or (2) Section 959 PTI (if distributed), but only taking into account periods when the foreign corporation was a SFC.

  - ADFI not reduced for inclusion year distributions by the SFC other than for distributions made to another SFC.

- Per Notice 2018-13, deferred foreign income as of each measurement date must be compared in the functional currency of the SFC. If the functional currency has changed between dates, the currency as of 12/31 is used by translating E&P at the 11/2 spot rate.

Section 965(a) – Subpart F Income Inclusion Amount of “DFICs” (cont.)

The Notices express the government’s intent to issue regulations addressing:

- potential distortions to ADFI caused by payments between related SFCs during the interim period between the 11/2/17 and 12/31/17 (e.g., through double counting or double non-counting of E&P);
- distributions between SFCs during the inclusion year to the extent the distributor’s ADFI reduction from the distribution does not equal the distributee’s corresponding ADFI increase; and
- reductions of ADFI of a CFC with non-US shareholders attributable to E&P that, if distributed, would be PTI under Section 959 if such shareholders were US shareholders.
- alternative methods to calculate E&P for purposes of measuring 965 inclusion amounts.
- allocation of specified E&P deficits among US shareholders with multiple classes of stock.
- clarification on spot rates and currency for various 965-related determinations.

US Shareholder's Gross Income from Section 965 Inclusion

- US shareholder's gross income:
  - increased by pro rata share of the DFIC's Section 965 inclusion amount as if it was subpart F income (and treating the DFIC as a CFC for purposes of these rules); and
  - decreased by pro rata share of "Aggregate Foreign E&P Deficit" or post-1986 E&P deficits of SFCs determined as of 11/2/17.
- The statute permits netting among shareholders in an affiliated group where there are one or more US shareholders with a net E&P surplus and another with a net E&P deficit.
- The Notices describe that forthcoming regulations will (i) treat all of the members of a consolidated group that are US shareholders of one or more SFCs as a single US shareholder for purposes of calculating the consolidated group's gross income amount under Section 965, (ii) provide that with respect to SFCs with multiple classes of stock any specified E&P deficit is allocated first among the shareholders of common stock and in proportion to the value of common stock held by such shareholders, and (iii) confirm that hovering deficits are considered.

Coordinating Section 965 with PTI Rules

- For purposes of the Section 959 PTI rules, amounts taken into account as an E&P deficit reducing a US shareholder’s Section 965 inclusion treated as included in gross income under Section 951(a) with respect to such US shareholder.

- The Notices describe that regulations will describe a five-step method for determining subpart F inclusions under Section 951(a)(1)(A), the effect of distributions of PTI under Section 959, and Section 956 inclusions under Section 951(a)(1)(B):

1. a DFIC’s subpart F income and the US shareholder’s Section 951(a)(1)(A) inclusion are determined first, ignoring Section 965;
2. the Section 959 PTI treatment of pre-1/1/18 distributions from a DFIC to another SFC is determined;
3. the DFIC’s Section 965 inclusion amount and the US shareholder’s corresponding Section 951(a)(1)(A) amount are determined;
4. the treatment of all distributions other than those described in (2) is determined under Section 959; and
5. any Section 956 amount is determined for the DFIC and the US shareholder, and the US shareholder’s Section 951(a)(1)(B) inclusion is taken into account.

Coordinating Section 965 with PTI Rules (cont.)

- The Notices further (i) describe that regulations will provide a rule that reduces the Section 961(b)(2) gain (distributions of PTI in excess of basis) for inclusion year distributions from a DFIC to the US shareholder by reducing such gain by the Section 965 inclusion amount, and (ii) clarify that this gain reduction rule applies to distributions received from a DFIC through a chain of ownership.
  - Helpful for taxpayers wanting to pull out cash from SFCs prior to the end of the tax year of the Section 965 inclusion. Example:
    - 6/30 fiscal year US shareholder owns 100% the stock of 6/30 fiscal year CFC
    - US shareholder has $0 basis in CFC stock
    - CFC has $100 ADFI
    - CFC distributes $100 to US shareholder on 2/1/18

Section 965 Income Inclusion Year Timing Issues

- Because the Section 965(a) Subpart F income inclusion is based on a DFIC's last taxable year beginning before 1/1/18 (the "inclusion year"), a US shareholder may potentially recognize income under Section 965 during multiple tax years.
  - For example, if calendar year taxpayer U.S. Co is a US shareholder of a DFIC that has a calendar year tax year and another DFIC with a fiscal year tax year ending 11/30, Section 965 ADFI with respect to the first DFIC would be included on U.S. Co's 2017 return while ADFI with respect to the second DFIC would be included on U.S. Co's 2018 return.
- Having a US shareholder with DFICs with different inclusion years could lead to distortions (e.g., double counting of "foreign cash positions" as described in subsequent slides). The Notices recognize this and signals the government's intent to issue regulations addressing these issues.
- For fiscal year SFCs, income earned by the SFC after 12/31/2017 until end of its fiscal year is not taxed under Section 965 or under the GILTI provisions (discussed later in this presentation).

Section 965(h) – Election to Pay Section 965 Inclusion in Installments

- Election may be made (no later than the due date – without extension – of the return of the US shareholder reporting the Section 965 inclusion) to pay Section 965 liability in 8 yearly installments:
  - 8% of the total net tax liability for each of the first 5 installments;
  - 15% of the total net tax liability for the 6th installment;
  - 20% of the total net tax liability for the 7th installment; and
  - 25% of the total net tax liability for the 8th installment.
- Acceleration events for payment of remaining unpaid Section 965 tax liability:
  - there is a failure to pay timely any required installment;
  - there is a liquidation or sale of substantially all of the US shareholder's assets, including in a bankruptcy case;
  - the US shareholder ceases business; or
  - any similar circumstances.
- No acceleration if sale of substantially all the assets of a taxpayer to a buyer if the buyer enters into an agreement with the Secretary agreeing to satisfy all future installments.
- Special rule for S corporations permitting S corporation shareholders to elect to defer paying any Section 965 liability until a "triggering event": (1) the corporation ceases to be an S corporation; (2) a liquidation or sale of substantially all the assets of the S corporation (including in a title 11 or similar case), a cessation of business by the S corporation, the S corporation ceases to exist, or any similar circumstance; or (3) a transfer of any share of stock in the S corporation by the taxpayer (including by reason of death, or otherwise).

Participation Exemption Deduction

- The US shareholder's gross income inclusion under Section 965 attracts a deduction such that, before credits or NOL deductions, the amount of the Section 965 gross income inclusion (net of deficits), if taxed at the highest corporate tax rate for the year, would be subject to tax at the rate of:
  - 15.5%, up to the amount of the US shareholder's "aggregate foreign cash position", PLUS
  - 8%, for any gross income (net of deficits) in excess of the US shareholder's aggregate foreign cash position.
  - Effected through deduction mechanism working backwards

Aggregate Foreign Cash Position

- The aggregate foreign cash position of a US shareholder is the aggregate, over all SFCs, of the US shareholder's pro rata share of the SFCs' cash position.

- As with ADFI, the cash position is measured using different dates, and the aggregate foreign cash position taken into account is the larger of the US shareholder's pro-rata share of:
  - (i) The aggregate year-end "cash position" of each SFC for the last taxable year beginning before 1/1/2018; or
  - (ii) The average of:
    - (a) the aggregate year-end cash position of each SFC for the last taxable year beginning before 11/2/2017, and
    - (b) the aggregate year-end cash position of each SFC for the last taxable year preceding the one referenced in (a).

- Notice 2018-13:
  - Recognizes impracticability of asking taxpayers to determine post-86 E&P on measurement date that is not the last day of a month (e.g., 11/2/17) and states that forthcoming regs will provide an alternative method election to determine that amount as the sum of E&P as of 10/31/17 and the corporation's annualized E&P (defined as twice the average daily earnings for the tax year as of the close of 10/31).
  - Clarifies that regulations are forthcoming that will provide that the cash position of a SFC with respect to any cash measurement date must be expressed in USD.

Cash Position of a Specified Foreign Corporation

The cash position of a foreign corporation is made up of:

- Cash it holds
- Net accounts receivable [per Notice 2018-07, ignoring US shareholder's pro rata share of inter-SFC accounts; per Notice 2018-13, including receivables described in 1221(a)(4) and accounts payable described in 1221(a)(1) or (a)(8) or the receipt of services from vendors or suppliers]
- FMV of:
  - Property of a kind actively traded in an established financial market
  - Commercial paper, certificates of deposit, government securities
  - Foreign currency
  - Short-term (< 1 year) obligations [per Notice 2018-13, a loan that must be repaid on demand or within one year of demand of the lender is treated as a short-term obligation, regardless of the terms of the instrument]
  - [Per Notice 2018-07: Derivative financial instruments, except for *bona fide* hedges (under the Subpart F rules)]

Cash Position – Delegated Authority

- The statute explicitly authorizes the Secretary to:
  - Issue regulations to identify a class of assets as being equivalent to one of the enumerated assets;
  - Exclude net accounts receivable, actively traded personal property, or short term obligations if necessary to avoid double counting; and
  - Disregard transactions for which a principal purpose is to reduce the aggregate foreign cash position.
- This is in addition to the broad authority under Section 965(o) to prescribe regulations or other guidance "to prevent the avoidance of the purposes of this section, including through a reduction in earnings and profits, through changes in entity classification or accounting methods, or otherwise."

Pro-Rating the Indirect Foreign Tax Credit

- In the case of a CFC, Section 960 allows a deemed paid credit for Subpart F inclusions as if earnings in the amount of the Subpart F income were directly distributed by the CFC as a dividend to the US shareholder.

- Section 965(g) pro-rates the credit to take account of the 15.5% and 8% tax rates on the gross Section 965 inclusion by disallowing credits for:

  - 77.1% [=27%/35%] of the credit allocable to ADFI subject to 8% tax, and

  - 55.7% [=19.5%/35%] of the credit allocable to ADFI subject to 15.5% tax.

- The Section 78 gross-up is adjusted to take account of the reduced credit

  - The gross-up amount is essentially:
    Credit after Section 965(g) limitation x
    (35%)/(Highest Corporate Tax Rate in Inclusion Year)

Election Not to Apply NOL Deduction

- A taxpayer may elect to exclude the Section 965 inclusion (net of the participation exemption deduction, but grossed up by any Section 78 amount) from the calculation of current year NOL and not apply carryover NOLs in the inclusion year (up to the amount of the Section 965 inclusion).

- Election due by due date of tax return (with extensions).

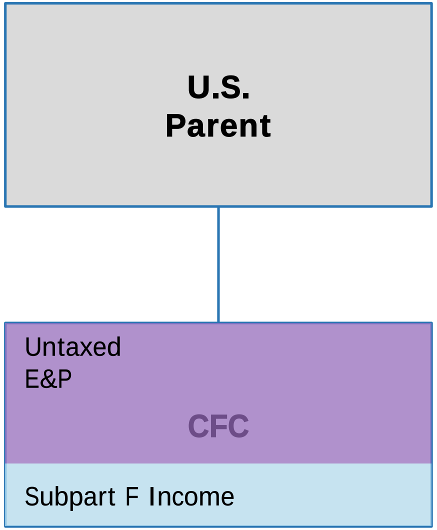
Special Rules

- If a US shareholder becomes an expatriated entity during the 10-year period beginning with the date of enactment of the TCJA, then in the year of expatriation, the US shareholder is subject to additional tax of 35% of the amount of the participation exemption deduction allowed (with no allowance of credits against the additional tax liability).
- A REIT that is a US shareholder of DFIC excludes the Section 965 inclusion in testing the limitation on types of income in Section 865(c)(2) and (3).
  - Elective 8-year spreading of the inclusion of the Section 965 in gross income for purposes of the REIT tax under Section 857.

TAXATION OF FOREIGN INTANGIBLE INCOME – GILTI & FDII

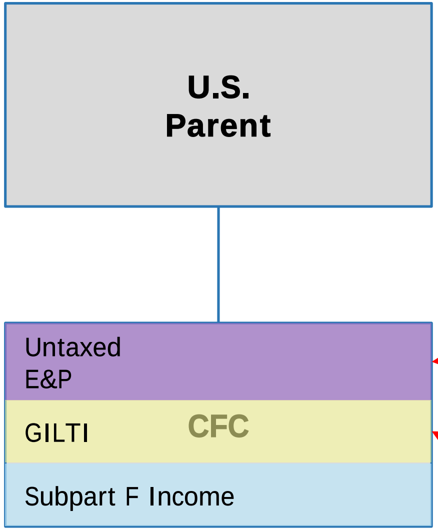
Historic Deferral System

- Current tax at US corporate rates – e.g. 35%
- FTC under §960



- U.S. tax deferred until repatriated (or deemed repatriated under §956)
- FTC under §902 when repatriated

New Deferral System



- Current tax at US corporate rate of 21%
- FTC under §960

- 100% DRD available for foreign source dividends - no U.S. tax (unless §956)
- No FTC

- New "minimum" foreign tax rate
- Current US taxation at 10.5% effective rate
- 80% FTC

GILTI – The Stick

- **<u>New Sections 951A and 250</u>**
  - Section 951A effectively imposes a minimum tax on “US shareholders” of CFCs to the extent of such CFCs’ global intangible low taxed income (“GILTI”).
  - Similar to the FDII provisions there is no requirement to actually trace or attribute the income to the exploitation of intangibles owned by the CFCs.
  - At a very high level the GILTI income is generally the income of the CFCs less a deemed return (10%) on tangible assets.
  - Section 250 contains a companion provision that provides for a 50% deduction for the amount of the GILTI inclusions (and Section 78 deemed dividend associated therewith) subject to certain limitations. The 50% deduction is reduced to 37.5% for taxable years beginning after December 31, 2025.

GILTI – The Stick

- **Section 951A - Formula**

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

- **Net CFC Tested Income** = aggregate of tested income of each CFC less aggregate tested losses of each CFC.
  - Tested Income = Gross income of the CFC (other than ECI, Subpart F income, Section 954(b)(4) high tax income, related person dividends, certain oil and gas income) less allocable deductions
  - Tested Loss = where allocable deductions exceed Tested Income of the CFC

- **QBAI** = Qualified Business Asset Investment or, generally, the average of the adjusted basis (using straight line) of specified depreciable tangible property determined as of the close of each quarter.

GILTI – The Stick

- **<u>Section 951A – Formula</u>**
- Tested Income – High Tax Exclusion
  - (III) any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4)
- Section 954(b)(4)
  - For purposes of subsection (a) and section 953, foreign base company income and insurance income shall not include any item of income received by a controlled foreign corporation if the taxpayer establishes to the satisfaction of the Secretary that such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of tax specified in section 11

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GILTI – The Stick

- **<u>Observations</u>**
  - When comparing the GILTI inclusions to FDII, Congress has apparently provided taxpayers with an incentive to locate investment offshore. This is because the deemed return on tangible property reduces the GILTI inclusion (thereby effectively reducing the amount of offshore income subject to US tax). Under the FDII rules, the deemed return on tangible property reduces the amount of income subject to lower tax rates on FDII.
  - Given that GILTI is an aggregate concept (in relation to the US Shareholder's CFCs), cross crediting is allowed. In other words, foreign tax credits a higher taxed CFC may be used to effectively lower the tax rate on GILTI income of lower tax CFCs.
  - If the US Shareholder is otherwise in a loss position, the amount of the Section 250 deduction is reduced.

GILTI – The Stick

- **Observations**
  - It is unclear the extent to which Subpart F conditions & restrictions mirror those imposed on GILTI.
  - Section 951A(f)(1)(A) says any GILTI inclusion under § 951A(a) is be treated in the same manner as an amount included as Subpart F income for purposes of applying Sections 959 and 961. This means, for example, that a distribution of GILTI is treated as distribution of PTI. There are some tricky issues that can arise under § 959 and § 961 with distributions of GILTI, especially given some of the uncertainties as to how the general Subpart F limitations and restrictions apply to GILTI (e.g., to what extent is distributed PTI Subpart F versus GILTI). Section 961 could also create some odd basis results for distributions.

GILTI – The Stick

- **Observations**
  - Because the GILTI determination is done on an aggregate CFC basis, but a tested loss is a CFC-by-CFC determination, the tested loss of one CFC can lower the overall GILTI inclusion which in effect allows the tested loss to be used to reduce tested income (GILTI income) of another CFC. However, the GILTI rules require the E&P of the CFC with the tested loss to be increased by the amount of the tested loss under Section 951A(c)(2)(B)(ii).
  - This could result in allowing for Subpart F inclusions where the CFC would otherwise be in a negative E&P position. Section 951A(c)(2)(B)(ii) prevents to dual use of such loss to both offsetting other CFC GILTI income and acting as a limit on Subpart F inclusions.

The FDII and GILTI Deductions of § 250

Overview

- New § 951A triggers a GILTI gross income inclusion for U.S. shareholders of certain foreign corporations $\Rightarrow$ GILTI inclusion nominally taxed at 21 percent (ignoring creditable foreign taxes)
- New § 250 provides two levels of tax relief for domestic corporate taxpayers:
  - a deduction based on the corporation's GILTI income inclusion; &
  - a deduction based on the corporation's "foreign derived intangible income"

The FDII and GILTI Deductions of § 250

Overview, cont.

- Section 250(a)(1) provides domestic corporate taxpayers with a deduction for the 8 taxable years beginning after 12/31/17 and before 1/1/26 equal to the following:
  - 37.5% x FDII, and
  - 50% x (§ 951A GILTI inclusion + § 78 gross-up attributable to GILTI)
- For taxable years beginning after 12/31/25 the § 250(a)(1) deduction percentages are reduced to:
  - FDII: 21.875%
  - GILTI: 37.5%
- Deduction limited to C-corps that are not RICs or REITs
- Deduction not in excess of current year income

The FDII and GILTI Deductions of § 250

<u>The Big Picture</u>: Under a 21% U.S. corporate tax rate, the effective tax rates on GILTI and FDII for taxable years beginning after 12/31/17 and before 1/1/26:

- GILTI:
  - 10.5% GILTI rate
  - Due to 80% limit on FTCs for GILTI per § 960(d), the minimum foreign tax rate at which no U.S. residual tax is owned is 13.125%
  - As foreign taxes on GILTI range between 0% and 13.125%, the total combined foreign and U.S. tax rates range between 10.5% and 13.125%
- FDII
  - 13.125%

The FDII and GILTI Deductions of § 250

The Big Picture: Under a 21% U.S. corporate tax rate, the effective tax rates on GILTI and FDII for taxable years beginning after 12/31/25:

- GILTI:
  - 13.125% GILTI rate
  - Due to 80% limit on FTCs for GILTI per § 960(d), the minimum foreign tax rate at which no U.S. residual tax will be owned is 16.406%
- FDII
  - 16.406%

FDII – the "Carrot"

FDII Mechanics

- FDII is an approximation of the domestic corporation's taxable income from exploiting intangible property outside the U.S.
- FDII formula:

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

FDII – the “Carrot”

<u>FDII Mechanics</u>

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- “Deduction Eligible Income” means the excess (if any) of the gross income of the corporation over the deductions properly allocable to such income, determined without regard (excluding) the following categories of income:
  - Subpart F inclusions;
  - GILTI inclusions;
  - Financial services income (as defined in § 904(d)(2)(D);
  - Dividends received from CFCs;
  - Any domestic oil and gas extraction income; and
  - Any foreign branch income

FDII – the "Carrot"

<u>FDII Mechanics</u>

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- "Foreign Derived Deduction Eligible Income" is defined as the taxpayer's Deduction Eligible Income derived in connection with:
  - Property sold by the taxpayer to any person who is not a U.S. person, provided the property is for "foreign use;" and
  - Services provided by the taxpayer to any person (or with respect to property) not located in the U.S.

FDII – the "Carrot"

Section 250 Mechanics

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

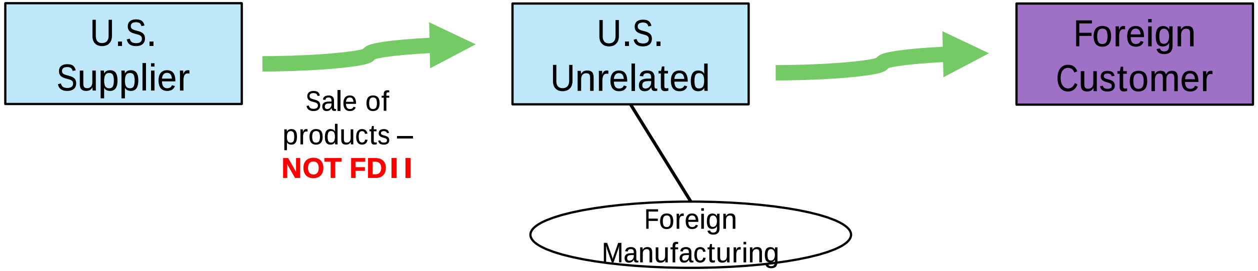
- Foreign use/foreign services must be established "to the satisfaction of the Secretary"
- "Foreign use" is defined as any use, consumption, or disposition that is not within the U.S.
- The terms "sold," "sells," and "sale" include any lease, license, exchange, or other disposition

FDII – the “Carrot”

Section 250 Mechanics

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- The sale of property to a U.S. unrelated party does not qualify as FDII, even if the property is ultimately subject to foreign use

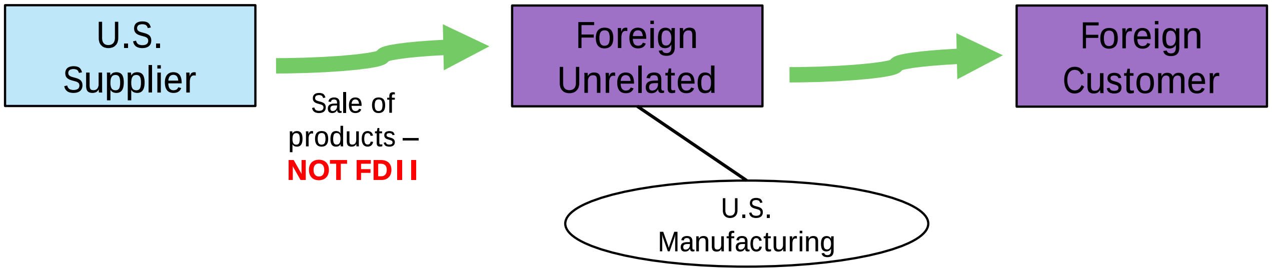


FDII – the “Carrot”

<u>Section 250 Mechanics</u>

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- The sale of property to a foreign unrelated party for further U.S. manufacturing or modification <u>does not qualify as FDII</u>, even if the property is ultimately subject to foreign use

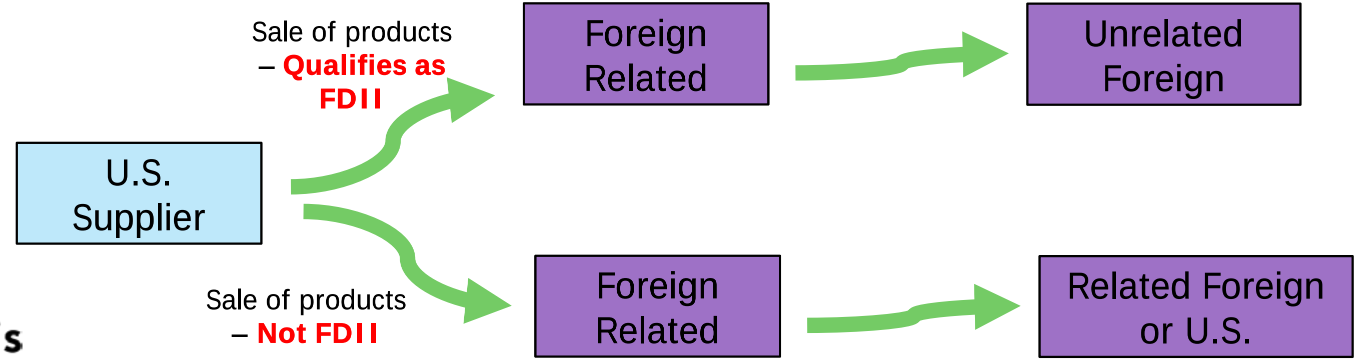


FDII – the “Carrot”

Section 250 Mechanics

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- The sale of property to a foreign related party will qualify as FDII, provided the property is sold to or used to provide services to an unrelated foreign party

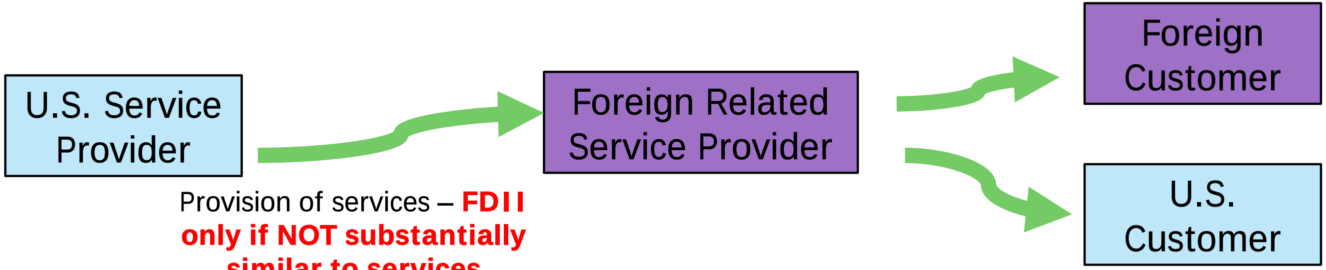


FDII – the "Carrot"

<u>Section 250 Mechanics</u>

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- The provision of services to a foreign related party <u>will not qualify as FDII</u>, <u>unless</u> the service is not substantially similar to services provided by such related party to U.S. persons



Provision of services – **FDII only if NOT substantially similar to services provided by Foreign Related to U.S. persons**

FDII – the "Carrot"

Section 250 Mechanics

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- "Deemed Intangible Income" is defined as the excess (if any) of a domestic corporation's deduction eligible income over its "deemed tangible income return"

  Deemed Intangible Income = Deduction Eligible Income – Deemed Tangible Income Return

- The "Deemed Tangible Income Return" is defined as an amount equal to 10% of the corporation's QBAI

  Deemed Intangible Income Return = Deduction Eligible Income – (10% x QBAI)

- In short, the Deemed Intangible Income calculation is equal to the corporation's Deduction Eligible Income less a fixed 10% return on the adjusted bases of the corporation's active trade or business assets

Will FDII Survive WTO Challenge?

- DISC and FSC revisited?
- On December 11, 2017 the Finance ministers from the five largest EU economies sent a joint letter to U.S. Treasury Secretary Mnuchin outlining concerns with respect to three proposed measures in the House and Senate bills – FDII was identified as problematic
- “The proposed incentive [FDII] would subsidize exports compared with the domestic consumption. It could therefore face challenges as an illegal export subsidy under WTO Subsidies and Countervailing Measures Agreement rules.”
- Asserts FDII is not compliant with BEPS consensus on accepted IP regimes

Structuring Considerations for Multinationals

- Existing IP structures – what to do?
  - How strong is your subpart F position?
  - Is your current structure defensible from a OECD DEMPE standpoint?
  - Does the exposure to shifting international tax rules warrant maintaining foreign structure or is FDII a better course of action?
  - Is moving IP back to the U.S. feasible/can it be done in a tax efficient manner?
  - Is FDII reliable? Future congressional changes and/or WTO challenge?

Structuring Considerations for Multinationals

- Acquired and newly created IP – where to locate?
  - Impact of revisions to §§ 367(d) and 482
  - Strength of subpart F position(s)
  - Is your international structure defensible from a DEMPE standpoint?
  - Changing foreign tax laws a concern?
- Foreign branch operations?
  - Subject to standard 21% corporate rate
  - Onshore operations and pursue FDII?
  - Offshore assets and navigate subpart F and GILTI

CHANGES TO SECTIONS 367, 482, AND 936(h)(3)(B)

Repeal of §367(a)(3) – Active Trade or Business Exception

- Section 367(a)(3) Active Trade or Business exception repealed
- Branch loss recapture rule moved to §91
- Effective Date: applicable to transfers made after December 31, 2017

Intangible Property Redefined in Section 936(h)(3)(B)

- The §936(h)(3)(B) definition of "intangible property" is amended as follows:
  - Inserting: "any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment)"
  - Inserting: "any other item the value or potential value of which is not attributable to tangible property or the service of any individual"
  - Deleting: "any similar item"
  - Deleting: flush language providing "which has substantial value independent of the services of any individual"
- Statutory "No Inference" statement
- Effective Date: Applicable to transfers in taxable years beginning after December 31, 2017

Addition of Section 367(d)(2) Valuation Guidance

- Addition of new §367(d)(2)(D), which provides that for purposes of determining the value of the transferred intangible(s), the Secretary <u>shall require</u>:
  - The valuation of any transfer of intangible property, including intangible property transferred with other property or services, on an aggregate basis, <u>or</u>
  - The valuation of the transferred property on the basis of the realistic alternatives to such transfer.
- Effective Date: Applicable to transfers in taxable years beginning after December 31, 2017

Valuation Changes to Section 482

- Added following language to section 482:
  - "For purposes of this section, the Secretary <u>shall</u> require the valuation of transfers of intangible property (including intangible property transferred with other property or services) on an <u>aggregate</u> basis or the valuation of such a transfer on the basis of the <u>realistic alternatives</u> to such a transfer, if the <u>Secretary determines</u> that such basis is the most reliable means of valuation of such transfers."
- Effective Date: Applicable to transfers in taxable years beginning after December 31, 2017

BASE EROSION TAX

Base Erosion Tax

- Base erosion anti-abuse tax ("BEAT," Code Section 59A) equal to the excess of (a) 10 percent (five percent in taxable year beginning in calendar year 2018) of modified taxable income ("MTI") over (b) regular tax liability
  - Add one percentage point for banks and securities dealers
- Regular tax liability not reduced by research credit and 80 percent of certain other credits
- Effective for payments paid or accrued in taxable years beginning after 2017

Base Erosion Tax (cont'd)

- For taxable years beginning after 2025, 12.5 instead of 10 percent, credits reduce regular tax liability

- BEAT impactful when deductions from/reductions in gross income taken into account in computing taxable income, but not MTI, exceed 52.38 percent (40.47 percent after 2025) of MTI

    - *Cf.* old law Section 163(j)

Base Erosion Tax (cont’d)

- Taxpayers to which BEAT applies are corporations (or corporate groups) that have at least $500m in gross receipts during the three years prior to current year and that have a “base erosion percentage” of at least three percent for the year
    - Cliff effects

- Base erosion percentage
  - Deductions/reductions taken into account in computing taxable income but not MTI divided by sum of (a) all deductions, (b) reductions for reinsurance premiums paid to a related foreign person, and (c) reductions in gross receipts from payments to a related corporation that inverted after November 9, 2017 and that is treated as a foreign corporation under Section 7874 (and its foreign affiliates).
    - Denominator excludes deductions for NOL carryover, participation exemption, GILTI/FDII

Base Erosion Tax (cont'd)

- Deductions/reductions taken into account in computing taxable income but not MTI
  - Deductions for a "base erosion payment," but only to the extent no withholding
    - "Amount paid or accrued by the taxpayer to foreign person that is a related party"
      - New Section 163(j) first disallows interest paid to unrelated persons
      - Foreign tax treatment irrelevant
      - Inclusion in Subpart F income irrelevant (*cf.* old Section 163(j) regulations)
      - Banks and insurance companies
  - Depreciation/amortization deductions with respect to property purchased by taxpayer from a related foreign person
  - Reductions in income for re-insurance premiums paid to related foreign person
  - Costs of goods sold paid to inverters

Base Erosion Tax (cont’d)

- Excludes deductions for “qualified derivative payments”
  - Taxpayer must mark to market derivative on last day of taxable year, treat gain/loss as ordinary, treat “all items of income, deduction, gain ,or loss” with respect to payment as ordinary
  - “Derivative” includes any contract the value of which/payment with respect to which determined by reference to “any rate, price, amount, index, formula or algorithm”
  - Exclusion does not apply to a payment that would be subject to BEAT if it weren’t made pursuant to a derivative, including interest, royalty, or services payment

Base Erosion Tax (cont’d)

- Excludes an amount paid or accrued for services if (a) services meet requirements for eligibility of the Section 482 services cost method (without regard to requirement that services not contribute significantly to fundamental risks of business success or failure) and (b) amount constitutes total services cost with no markup component
  - Portman/Hatch colloquy

Base Erosion Tax (cont'd)

- Related to unrelated
  - Third party borrowing/license (with parent guaranty) rather than back-to-back borrowing/licenses from foreign parent

    Cf. old Section 163(j)

- Reduce amount of deductible payments through netting
  - Cross-licenses?
  - Net amounts generally
    - *Cf.* Section 871(m)(5) ("the term 'payment' includes any gross amount which is used in computing any net amount which is transferred to or from the taxpayer")

Base Erosion Tax (cont’d)

- Reduce amount of deductible payment by avoiding deductible payments
  - Purchase finished product from foreign affiliate (perhaps acting as contract manufacturer for foreign affiliate –*but see* Section 956) rather than license intangibles owned by foreign affiliate and manufacture
  - Services fee paid to contract manufacturer?

Base Erosion Tax (cont’d)

- Regulations to “prevent the avoidance of the purposes” of the BEAT through:
  - “the use of unrelated persons, conduit transactions, or other intermediaries”
  - arrangements designed, “in whole or in part”
  - “to characterize payments otherwise subject to” the BEAT ”as payments not subject to” the BEAT
  - “to substitute payments not subject to” the BEAT for “payments otherwise subject to” the BEAT

M&A CONSIDERATIONS IN LIGHT OF TAX REFORM

Deal Structure – noncomprehensive list of considerations

- Deal valuations
  - Not atypical for a U.S. multinational to value a target acquisition by taking into account any tax inefficiencies that may result from the target's tax classification (ex. Double tax? Lack of basis step up?)
    - TCJA lessens the impact of this double tax, given the new 21% U.S. federal corporate tax rate for corporations in lieu of the prior highest graduated rate of 35%
    - Particularly notable with respect to target businesses that operate in corporate form and that would not otherwise be able to take advantage of the new 20% deduction that applies to certain pass-through business income were the businesses operated in qualifying pass-through form

Deal Structure – noncomprehensive list of considerations (cont'd)

- UP-C Structures
  - The benefits of an UP-C TRA, including any basis step-up, may not be as high in magnitude to either the public company or the TRA payment recipients as prior to the rate change
  - But, an UP-C transaction structure may allow the replacement of leverage with alternative financing structures to avoid the new Code Section 163(j) business interest deduction limitation (discussed in ensuing slides)
  - Also, as owners of a pass-through vehicle, the historic non-corporate owners of the UP-C operating partnership may be able to take advantage of the new 199A pass-through deduction for qualifying business income (although this deduction phases out, so this phase-out needs to be considered as well)

Use of leverage in deals – noncomprehensive list of considerations

- Historically common for years for buyers to use leverage in whole or in part to finance acquisitions
  - Availability of interest deductions (sometimes limited by earnings stripping limitations under former 163(j))
  - In cross-border deals, the repayment of principal is often an easy tax-free payment mechanism
- TCJA has created new limitations on these interest deductions under revised Code Section 163(j)
  - As revised, Code Section 163(j) imposes a new limitation on business interest deductions by capping them at 30% of adjusted taxable income
  - This new limitation will make the use of debt in target purchases less efficient from a tax perspective than pre-TCJA, and buyers may seek alternative financing structures such as preferred stock
  - There may still be non-U.S. reasons to consider leverage, such as tax-free repayment opportunities outside the U.S.

Negotiation over NOLs in deals – noncomprehensive list of considerations

- M&A transaction–related deductions, such as payments of transaction bonuses and investment banker fees, often give rise to NOLs, which could, pre-TCJA, be carried back to a prior tax year and provide the seller a refund
  - The TCJA limits the deductibility of NOLs arising in tax years beginning after December 31, 2017
  - Under the new law, NOLs arising in those years are capped at 80% of taxable income
  - What this means is that those transaction-related deductions can no longer give rise to an NOL carryback to a prior tax period to the M&A deal closing; instead, they can only be carried forward
  - Sellers: Consider asking for purchase price increases to offset the lack of refund claim, or seek not to bear certain transaction-related expenses in the first instance
  - Buyers:
    - May not see a benefit from these NOLs because the NOLs cannot be recovered until there is sufficient income generated after the closing of the acquisition to utilize the NOLs
    - Plus, the benefit is limited to 80% of taxable income
    - So, should these NOLs really be included in the deal economics?

Partnership M&A deals – noncomprehensive list of considerations

- When a buyer acquires a partnership interest, many tax issues can be implicated, including the disguised sale rule and basis step-up considerations
  - Many of these issues are left largely, if not entirely, unchanged by the TCJA but some important new rules are now in effect
- New rule 1: No more technical partnership terminations
  - Pre-TCJA, under the “technical termination” rule of Code Section 708(b)(1)(B), a partnership was considered to be terminated if there was a sale or exchange of 50% or more of the total interest in partnership capital and profits within any 12-month period
    - As a result of the technical termination, some of the tax attributes of the old partnership terminated
    - The partnership’s tax year closed
    - Most partnership-level elections generally ceased to apply
    - The partnership depreciation recovery periods restarted

Partnership M&A deals – noncomprehensive list of considerations (cont'd)

- Under the TCJA, the technical termination rule under Code Section 708(b)(1)(B) has been repealed for partnership tax years beginning after December 31, 2017
  - Favorable? No more inadvertent technical terminations – but not usually an M&A issue
  - In M&A deals involving a majority-interest purchase of a partnership because buyers now need to consider whether the partnership has undesirable tax elections in place that the buyers will be forced to step into as part of the purchase
  - Now need to negotiate how certain allocations will be undertaken to properly reflect the deal economics (for example, transaction bonuses are not specifically listed as an extraordinary item under the Code Section 706 regulations)

Partnership M&A deals – noncomprehensive list of considerations (cont'd)

- New rule 2: ECI withholding upon purchase of partnership interests
  - TCJA instituted a new 10% withholding regime on buyers that purchase interests in partnerships that generate income effectively connected with a U.S. trade or business (ECI) from foreign sellers under new Code Section 1446(f)
    - Applies to purchases of partnership interests occurring after December 31, 2017
    - Applies to minority, majority and 100% partnership interest purchases
    - IRS has released Notice 2018-8, 2018-7 I.R.B. 352 and Notice 2018-29, 2018-16 I.R.B. 495), which buyers and sellers should review prior to making any withholding determinations because these notices suspend the withholding obligation in some cases, as well as provide clarity on how to determine an amount to be withheld
  - Sellers:
    - Gross up? Unlikely - withholding obligation acts as a backstop to tax collection under a corresponding newly codified (per the TCJA) tax imposed on foreign sellers of partnership interests that generate ECI who otherwise have a filing obligation and can be entitled to a refund in appropriate circumstances
    - More likely – review rights over the withholding determination made by buyers in an effort to reduce overwithholding

Purchase Agreements - noncomprehensive list of considerations

- The usual rundown of representations and warranties in M&A purchase and sale agreements has not materially changed
  - Possible new tax representations and warranties? Ex., regarding any election made by a target to pay the new transition tax over an eight-year period, any transactions undertaken to avoid or reduce the transition tax, any transaction that might trigger the new anti-hybrid rules under Code Section 267A, any transaction that might trigger a BEAT issue and any transaction that might trigger a timing mismatch under new Code Section 451(b)
- Purchase price allocations are still necessary in asset (or deemed asset) sales and purchases
  - May be more contentious in light of the TCJA changes to the bonus depreciation regime under Code Section 168(k) - particularly true with respect to deals involving purchases of businesses with significant tangible depreciation property (such as manufacturing businesses) but much less relevant to deals involving significant IP, goodwill or other intangible asset purchases, which assets are not subject to bonus depreciation

Purchase Agreements - noncomprehensive list of considerations (cont'd)

- Pre-closing tax indemnities still relevant to private deals
  - May now need to cover potentially eight years of tax exposure triggered by the transition tax – practical or collectible?

THANK YOU

Biography

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Gregory Hartker focuses his practice on domestic and international corporate and partnership tax issues, as well as on investment fund structuring and representing investors in such funds. Gregory represents clients in both taxable and tax-deferred mergers and acquisitions, public and private issuances of debt instruments, and partnership and LLC structuring and operating issues. Additionally, his international tax background includes matters involving Subpart F, PFIC, foreign tax credits, withholding, treaty issues, cost sharing, and cross-border transfer pricing.

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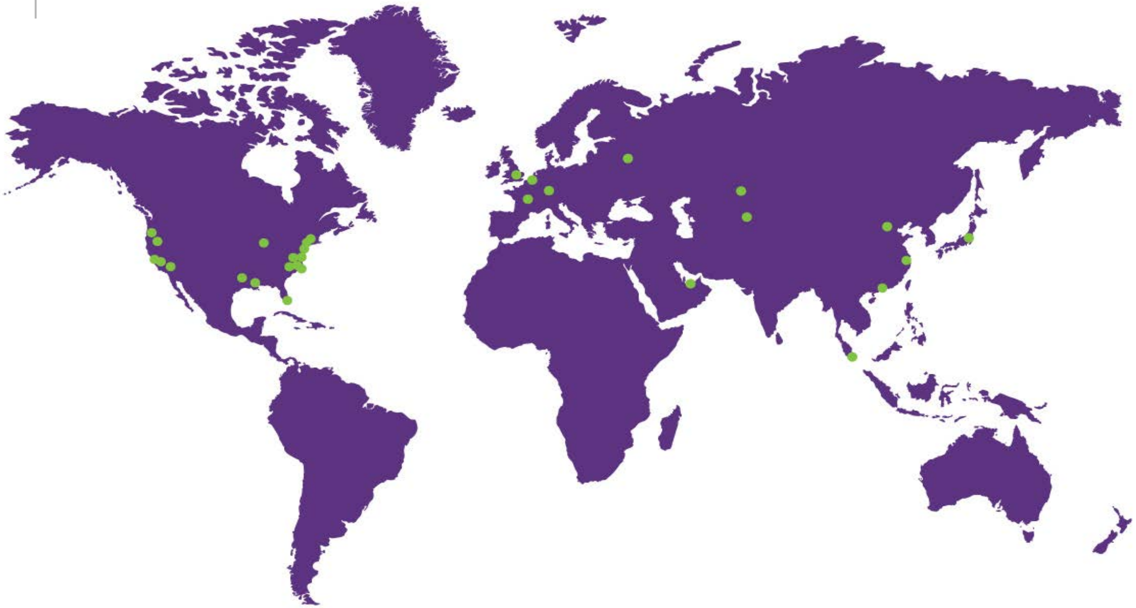

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