Getting Credit – Generating and Using Foreign Tax Credits After the TCJA (Breakout E)

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Topics

- New GILTI Basket
- New Foreign Branch Income Basket
- Affirmative Planning
- Other FTC Considerations
- Foreign Tax Audits
- Election under Section 962
- Section 901(m) Post-Reform

New GILTI Basket

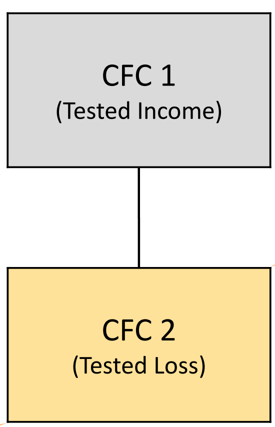
Statutory Overview

- **Section 960(d)**
  - A domestic corporation that includes GILTI in gross income will be deemed to have paid foreign income taxes equal to 80% of the product of (i) the Inclusion Percentage *multiplied by* (ii) the aggregate Tested Foreign Income Taxes of all CFCs
    - Inclusion Percentage: ratio of (i) GILTI over (ii) the aggregate tested income of all CFCs
    - Tested Foreign Income Taxes: foreign income taxes paid or accrued by a CFC that are properly attributable to the tested income of such CFC

- **Section 904(d)(1)(A)**
  - GILTI is treated as a separate basket for purposes of section 904
    - Section 78 Gross-up for GILTI: "It is anticipated that the proposed regulations relating to foreign tax credits will provide rules for assigning the section 78 gross-up attributable to foreign taxes deemed paid under section 960(d) to the separate category described in section 904(d)(1)(A)." (REG-104390-18, page 3)

- **Section 904(c)**
  - No carrybacks / carryforwards of any excess foreign tax credits in the GILTI separate basket

Practical Considerations – Tested Losses



- **Consider check-the-box election for CFC 2**

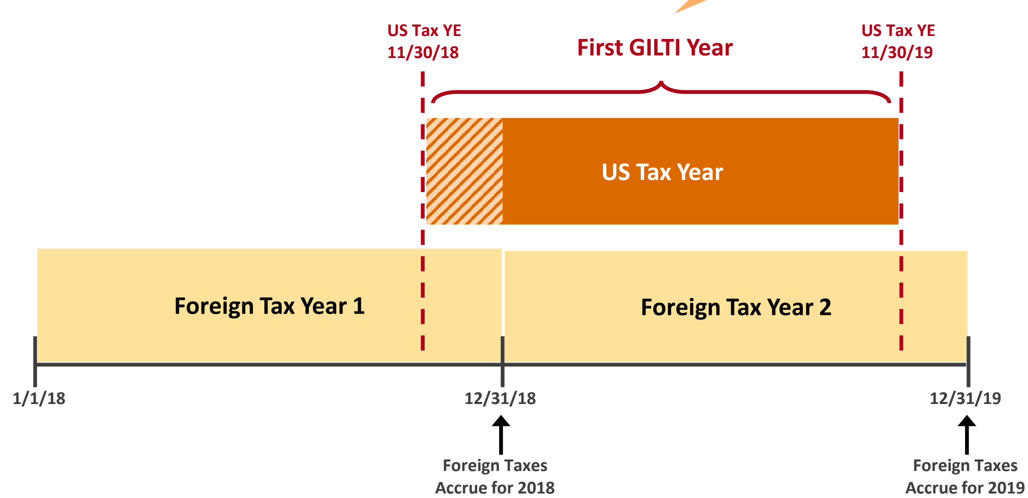
- **Tested Foreign Income Taxes** are limited to foreign income taxes paid or accrued by a CFC that are properly attributable to its tested income, and thus do not include any foreign income taxes paid or accrued by a CFC with a tested loss (Section 960(d)(3); Conference Explanation, page 518)
- **Inclusion Percentage** denominator is the aggregate tested income of all CFCs (*i.e.*, not reduced by the tested loss of any CFC) (Sections 960(d)(2)(B); 951A(c)(1)(A))

Practical Considerations – Tested Losses

	Separate CFCs			Check-the-Box Election	
	CFC 1 (2.5% Tax Rate)	CFC 2 (15% Tax Rate)	USP	CFC 1	USP
Local Country Pre-Tax Income	1000	500		1500	
Tested Income (Tested Loss)	975	(390)		585	
Net CFC Tested Income			585		585
QBAI		1170		1170	
Net Deemed Tangible Income Return			~~117~~		117
GILTI			**585**		**468**
Tested Foreign Income Taxes	25	~~75~~		100	
Inclusion Percentage			60%		80%
Section 78 Deemed Dividend			15		80
80% FTC			**12**		**64**

Practical Considerations – Varying Tax Years

- **Tested Foreign Income Taxes** are foreign income taxes paid or accrued by a CFC that are "properly attributable to" its tested income (Section 960(d)(3); *See also* Section 960(a); Treas. Reg. § 1.904-6(a); Conference Explanation, page 501)
- Foreign income taxes do not accrue until the end of the foreign tax year (*See* Rev. Rul. 61-93)



Practical Considerations – Expense Apportionment

		Without Expenses	With Expenses
Pre-Tax	Pre-Tax Income	100,000	100,000
GILTI	Net CFC Tested Income	86,875	86,875
	QBAI	0	0
	Net Deemed Tangible Income Return	0	0
	GILTI	86,875	86,875
Section 78 Deemed Dividend	Tested Foreign Income Taxes	13,125	13,125
	Inclusion Percentage	100%	100%
	Section 78 Deemed Dividend	13,125	13,125
Section 250 Deduction	Total Gross Income Inclusion	100,000	100,000
	Section 250 Deduction	(50,000)	(50,000)
	Taxable Income	50,000	50,000
80% FTC & US Tax	US Tax Before FTC	10,500	10,500
	80% FTC	(10,500)	(8,400)
	Residual US Tax	--	**2,100**
Section 904 FTC Limitation	Total Gross Income Inclusion	100,000	100,000
	Section 250 Deduction	(50,000)	(50,000)
	Allocated / Apportioned Expenses	0	**(10,000)**
	Net Income in GILTI Separate Basket	50,000	40,000
	FTC Limitation	**10,500**	**8,400**

New Foreign Branch Income Basket

Foreign Branch Income Issues – Overview

- New section 904(d)(2)(J) defines foreign branch income:

  In general. The term "foreign branch income" means the business profits of such United States person which are attributable to 1 or more qualified business units (as defined in section 989(a)) [("QBUs")] in 1 or more foreign countries. For purposes of the preceding sentence, the amount of business profits attributable to a qualified business unit shall be determined under rules established by the Secretary.

  Exception. Such term shall not include any income which is passive category income.
- The definition raises 4 key questions:
  - What are business profits?
  - What is a QBU?
  - When is a QBU in a foreign country?
  - What business profits are attributable to a QBU?
- Transition rules for carryback/carryforward of excess foreign taxes?
  - Treasury provided transition rules when the FTC limitation went from 9 separate baskets in 2006 to 2 in 2007. If Treasury adopts a similar methodology for TCJA, generally branch income would have been general income before TJCA and therefore carrybacks would go to the general basket.

Foreign Branch Income Issues – Business Profits

- Business profits is not a widely used term for U.S. federal income tax purposes, but is widely used in the treaty context
- Like PEs, many QBUs are disregarded entities or branches that are not treated as entities separate from their owners
- The use of the term "business profits" suggests a portion of a U.S. person's net income that is allocable to a specific set of activities

Foreign Branch Income Issues – QBU

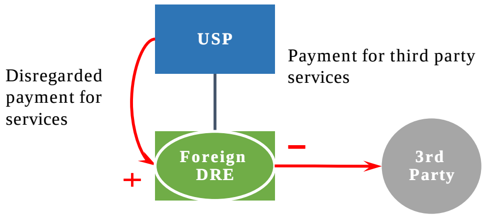
- A QBU is any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained
- The final regulations under section 989(a) describe two types of QBUs:
  - Entities: A corporation is a QBU. A partnership,* trust, or estate is a QBU of its partners or beneficiaries.
  - Activities: The activities of an entity or individual qualify as a QBU if both—
    - The activities constitute a trade or business,
      - Trade or business: “a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit”
    - A separate set of books and records is maintained with respect to the activities:
      - Books and records include: balance sheet, income statement, journals, etc.

*New final section 989(a) regulations set to become effective in 2019 create an exception to QBU status for certain partnerships.

Foreign Branch Income Issues – Determination of Profits

- Statute does not define “attributable to” – Consider several possible approaches:
  - Section 987/DCL books and records: Items are attributable to a QBU to the extent they are reflected on the QBU’s separate set of books and records.
  - PE: In the treaty context under an Authorized OECD Approach, the business profits attributable to a permanent establishment are the profits it would have earned if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions.
  - ECI/DCL branch: Income is attributable to a U.S. trade or business or foreign branch separate unit under the section 864 regulations.
    - One key question: was the QBU a material factor in the realization of the income?
- What about expenses of a foreign branch that are subject to “special allocation and apportionment” regimes (e.g., R&E, Interest, Charitable Deductions, etc.)?
- What about “special” expenses of a US parent (e.g., is R&E or Interest expense allocated to branch limitation income)?

Foreign Branch Income Issues – Attribution of Profits

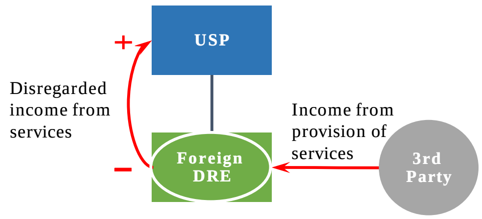


Scenario:

- USP provides services to third parties utilizing the services of a foreign DRE and pays DRE an arm's length price for services
- DRE contracts with a third employees for the performance of the services.
- Assume DRE is a QBU

Considerations

- What income and deduction are attributable to DRE?
- Should DRE be attributed a portion of the income earned by USP?
- Consider the source of the income



Scenario:

- DRE purchases services from USP at an arm's length price
- DRE sells services to an unrelated third party at a mark up
- Assume DRE is a QBU
- Assume sale to foreign party for foreign use

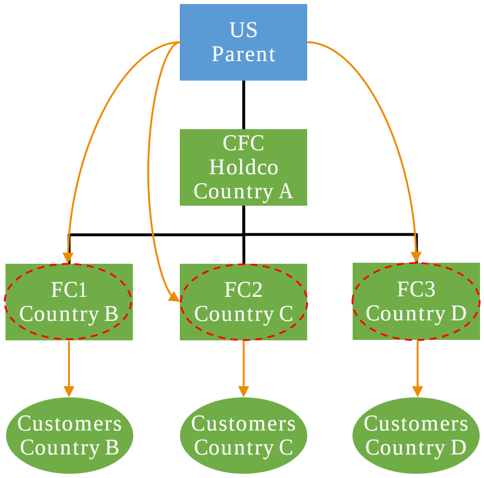
Considerations

- What income and deduction are attributable to DRE?
- Is income paid to DRE foreign branch income and, therefore, not DEI for purposes of FDII? See section 250(b)(3)(A)(i)

Affirmative Planning

High Taxed CFCs and Subpart F

Subpart F Income and GILTI Management



- US Parent manufactures finished goods, some of which are sold abroad through related foreign corporations
- US Parent has historically managed its subpart F inclusions through the use of local distributors
- US Parent expects a significant GILTI inclusion related to its foreign operations, and due to Section 861 expense allocation and apportionment, anticipates residual US tax to be due annually on such GILTI inclusion
- To the extent high-taxed (> 21% ETR), consider having FC1, FC2, and FC3 make CTB elections. As a result, US Parent expects CFC Holdco to generate subpart F income by application of section 954(d)

Analysis

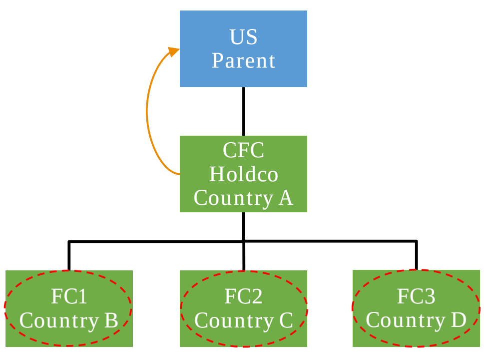
- Subpart F income, including subpart F income for which the high tax exception under section 954(b)(4) is elected, is excluded from tested income for purposes of GILTI, minimizing US Parent's GILTI inclusion

Considerations

- Highly dependent on facts and circumstances, especially as it relates to US Parent's legal entity and supply chain structure
- Generally desirable if subpart F income is considered to be "high-taxed" (i.e., local tax rate of FC1, FC2, and FC3 is comparable to (or higher than) the US tax rate)
- Impact of high tax exception under section 954(b)(4)

High Taxed CFCs and Section 956

Section 956 and High-Taxed CFCs.



- CFC Holdco has, from its first subpart F year, earned income for which it made a high-tax exception election under section 954(b)(4)
- In 2020, CFC Holdco makes a loan to US parent such that US Parent includes an amount in income under section 956

Analysis

- Section 956 was not repealed by the TCJA, and section 960, as applicable to tax years of domestic corporations beginning after December 31, 2017, provides that US parent may choose to claim a credit, subject to the limitation under section 904, a foreign tax credit for those foreign taxes that are attributable to the section 956 inclusion.
- TJCA repealed former section 960(c), which had the potential to reduce, or eliminate, foreign tax credits deemed paid from indirectly held CFCs, in the case of a section 956 inclusion.

Considerations

- What does it mean for taxes to be "attributable to" a section 956 inclusion.
- What if US Parent has a section 956 inclusion attributable to earnings of CFC Holdco that were earned in a pre-TJCA year?

Foreign Tax Credits

US Tax on GILTI = 21% x (GILTI and **related §78 gross-up** - §250 Deduction) - **FTCs**

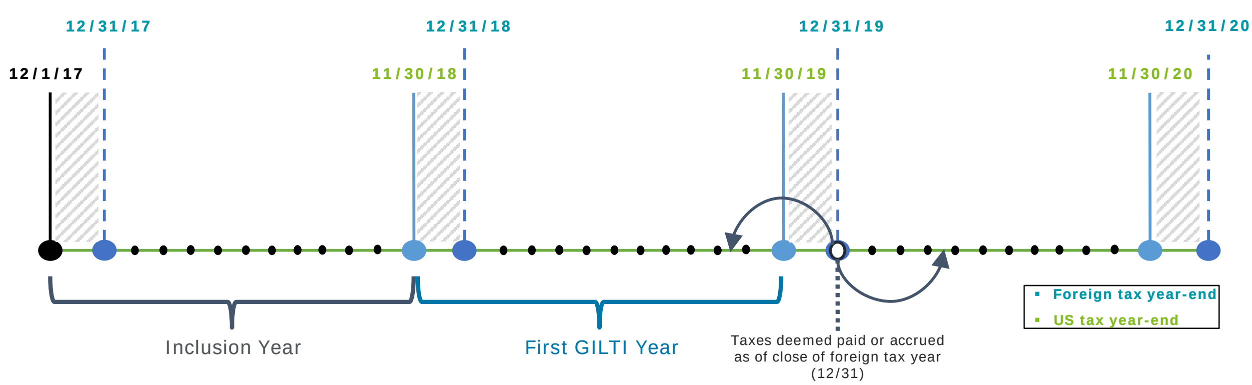
- Deemed Taxes Paid (§960(d)) = **80%** x Aggregate **Tested Foreign Income Taxes** paid or accrued by CFCs x **Inclusion Percentage**
  - **80%:** Credits are capped at 80% of foreign taxes (except for PTI and 901 withholding taxes)
  - **Tested Foreign Income Taxes**: Foreign income taxes paid or accrued by a CFC which are properly attributable to the tested income of such CFC.
    - Foreign income taxes of a tested loss CFC are not included
- **Inclusion Percentage**: $\dfrac{\text{US shareholder's GILTI}}{\text{US shareholder's aggregate pro rata share of CFC tested income}}$

- §78 gross-up = 100% of deemed taxes paid (instead of 80%)
- Separate section 904 FTC basket for GILTI
- Excess credits cannot be carried forward or back to other taxable years

Foreign Tax Credits: Properly Attributable to Tested Income

SCENARIO: A US shareholder with a calendar year end owns a CFC with an 11/30 US tax year end

- New § 960(d)(1) states that, with respect to a GILTI inclusion, "a domestic corporation shall be deemed to have paid foreign income taxes equal to **80 percent** of the product of such domestic corporation's inclusion percentage, multiplied by the aggregate **tested foreign income taxes** paid or accrued by controlled foreign corporations."
- New § 960(d)(3) defines tested foreign income taxes, with respect to a domestic corporation which is a US shareholder of a CFC, "the foreign income taxes **paid or accrued** by such foreign corporation which are **properly attributable to the tested income** of such foreign corporation **taken into account** by such domestic corporation under § 951A."
- What portion of taxes paid or accrued by a CFC at 12/31/19 are "properly attributable" to the CFC's tested income for the year ending 11/30/19? Consider application of rules similar to Treas. reg. 1.904-6.

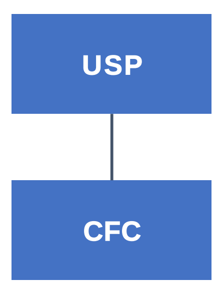


Other FTC Considerations

Simple illustration, GILTI with expense allocation

Assumptions

- Taxable year 2018
- CFC gross income of $140 (non-sub F)
- CFC local tax of $40
- CFC has no qualified business asset investment ("QBAI")
- CFC gross income equals pre-tax book income for the group
- USP has $70 of deductions that are allocated and apportioned to the GILTI basket



Question

- What is USP's residual U.S. tax on its GILTI?

Illustration

GILTI Calculation	Taxable income	FSI GILTI basket
Net CFC tested income ($140 – 40)	$ 100.0	
Net deemed tangible income return (10% of QBAI)	0.0	
Global intangible low-taxed income (GILTI)	100.0	
§78 gross-up	40.0	
GILTI inclusion + §78 gross-up	140.0	
§250 deduction (50%)	(70.0)	
Taxable income	70.0	$ 70.0
Deductions allocated/ apportioned to the GILTI basket		(70.0)
Net foreign-source income in the GILTI basket		$ 0.0
US statutory rate (21%)	$ 14.7	0.0
Allowable foreign tax credits	$ 0.0	
Residual US tax on GILTI	$ 14.7	
Excess FTCs permanently disallowed (80% x 100% x $40 = $32)	$ 32.0	

Note: For simplicity, this example assumes the §78 gross-up is in the GILTI basket. This issue will be discussed in later slides.

Rate reconciliation and key takeaways

Rate reconciliation:		
Pre-tax book income	$ 100.0	
Tax expense @ statutory rate	$ 29.4	21.0%
Foreign rate differential [$40 – ($140.0 x 21%)]	10.6	7.6%
Residual US tax on GILTI *	14.7	10.5%
Total tax expense	$ 54.7	39.1%

Key takeaways

- Any expense allocated and apportioned to GILTI basket has the potential to increase the US tax
- In this example, even though the CFC's ETR is > 13.125%, every $1 of expense allocated and apportioned to the GILTI basket resulted in an additional US tax of $0.21 ($70.0 x 21% = $14.7 residual GILTI tax in the example)

Note: * Example simplified to combine impact of GILTI inclusion and § 250 deduction

ODLs, OFLs, and SLLS

Just because a domestic corporation has room in its GILTI "basket" FTC limitation doesn't necessarily mean it can claim a GILTI FTC

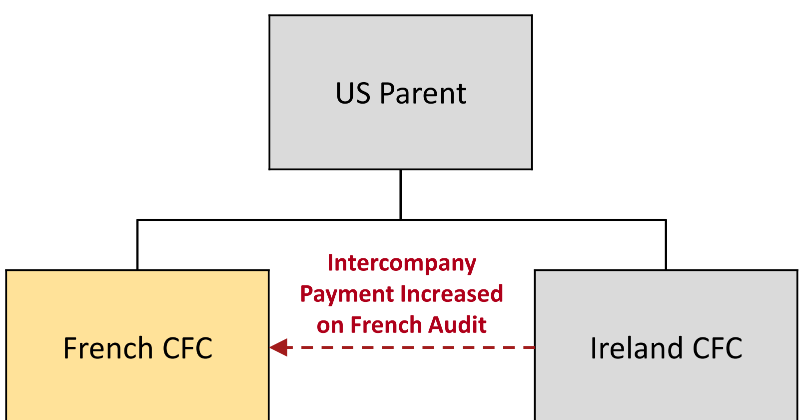
- Separate limitation losses (SLL)
  - USCo has a general and branch limitation losses and GILTI limitation income
- Overall domestic losses (ODL)
  - USCo has US source losses, and GILTI limitation Income.

Foreign Tax Audits

Foreign Tax Redeterminations

- **Section 905(c)**
  - Prior to TCJA, section 905(c)(2)(B)provided as follows:
    - Any such taxes if subsequently paid – (i) shall be taken into account
      - (I) in the case of taxes deemed paid under <u>section 902 or section 960</u>, for the <u>taxable year in which paid</u> (and no redetermination shall be made under this section by reason of such payment), and
      - (II) in any other case, for the taxable year to which such taxes relate…
  - TCJA amended section 905(c)(2)(B) to provide as follows:
    - Any such taxes if subsequently paid – (i) shall be taken into account for the <u>taxable year to which such taxes relate</u>…

Practical Considerations – E&P and Cash Balances



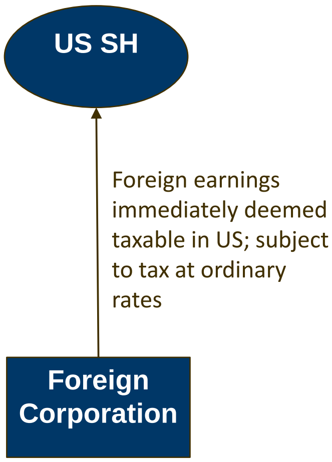
- **E&P:** Consider whether the E&P of French CFC should be increased and the E&P of Ireland CFC should be reduced (*See* Treas. Reg. § 1.482-1(a)(3) (taxpayer-initiated primary adjustments); Treas. Reg. § 1.482-1(g)(2) (correlative allocations)).
- **Cash Balances:** Consider (i) deemed distributions / contributions that may arise under Treas. Reg. § 1.482-1(g)(3) vs. (ii) establishing an account receivable at French CFC under Rev. Proc. 99-32. Also consider the foreign tax treatment of any cash payments.

Election under Section 962

IRC Section 962 Elections

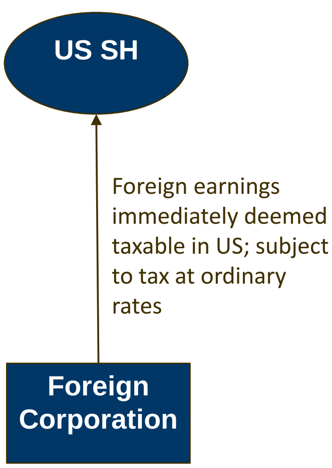
- Originally enacted with Subpart F.
- Allows noncorporate investors in foreign corporations to elect the same treatment they would have had if they had made the investment through a domestic corporation (i.e., it makes indirect foreign tax credits available to the noncorporate investor).
- Section 962 elections may be made by individuals (including a trust or an estate) who are US shareholders in a foreign corporation, either directly, or indirectly through pass-through entities.
- The election is made by including a statement with the tax return providing information required by Treas. Regs. §1.962-2(b).
- Effect of election: applies all to subpart F income, GILTI and 956 inclusions from all foreign corporations for the taxable year.

Tax Impact of Income Inclusion without 962 Election



	Qualified FC	Nonqualified FC
Income Inclusion	75	75
Section 78 Gross Up	0	0
Taxable Income	75	75
US Tax Rate	37.0%	37%
US Pre-FTC Tax	27.75	27.75
FTC	0	0
US Tax Due	27.75	27.75
Cash Distribution	75	75
Less US Tax Paid on Inclusion	0	0
Less Amount Treated as PTI	75	75
Taxable Distribution	0	0
US Tax Rate	23.80%	37.00%
US Tax on Cash Distribution	-	-
Total US Tax Paid	27.75	27.75

Tax Impact of Income Inclusion with 962 Election



	Qualified FC	Nonqualified FC	GILTI QFC	GILTI NQFC
Income Inclusion	75	75	75	75
Section 78 Gross Up	25	25	25	25
Taxable Income	100	100	100	100
US Tax Rate	21.0%	21%	21%	21%
US Pre-FTC Tax	21	21	21	21
FTC	21	21	20	20
US Tax Due	0	0	1	1
Cash Distribution	75	75	75	75
Less US Tax Paid on Inclusion	0	0	1	1
Less Amount Treated as PTI	0	0	0	0
Taxable Distribution	75	75	74	74
US Tax Rate	23.80%	37.00%	23.80%	37.00%
US Tax on Cash Distribution	17.85	27.75	17.61	27.38
Total US Tax Paid	17.85	27.75	18.61	28.38

IRC Section 962 Elections

- Pros
  - Flexibility to choose to make election or not each year
  - Access to 21% corporate tax rate on subpart F, GILTI and 956 inclusions without need to create C corporation
  - Indirect foreign tax credit available to offset 21% tax; GILTI FTC limited to 80%
  - Possible indefinite deferral of cash tax if money not brought to US
- Cons
  - Administrative burden to file election annually to utilize FTC carryovers
  - Possible increase to effective tax rate when money brought to US
  - No GILTI deduction available
  - No FDII deduction available
  - Qualified dividend treatment only available to cash distributions from qualified foreign corporations

Section 901(m) Post-Reform

A new Look at 901(m) and 338(g) After Tax Reform

Before Tax Reform:

- 338(g) elections historically provided taxpayers the ability to treat stock purchases of foreign target stock as asset purchases with the following benefits:
  - Stepped up basis in assets and new depreciation life
  - Elimination of target's historic tax attributes, such as E&P (no need to recompute history)
  - Hyped effective tax rate for foreign tax credits (US E&P lower than foreign taxable income due to extra depreciation/amortization)
  - Reducing subpart F income inclusions and taxable dividend distributions by target due to lower E&P.
- 901(m) created disincentives to 338(g) elections by disallowing the "hyped" foreign tax credit.

A new Look at 901(m) and 338(g) After Tax Reform

After Tax Reform:

- The new 100% dividends received deduction of Section 245A and the elimination of indirect foreign tax credits under Section 902 may favor keeping the E&P history of the foreign target in tact in order to minimize exposure to 301(c)(3) capital gain distributions.
- New Section 1248(j) provides that gains recharacterized as dividends under 1248(a) on the sale of CFC stock. Such recharacterized dividend amounts are eligible for the 245A dividends received deduction. Tax free dividends are more attractive than taxable capital gains.
- Similarly, if a top tier CFC sells a lower tier CFC, gain recharacterized as dividends may increase E&P while avoiding the creation of subpart F income due to the lookthrough rules of 954(c)(6).