INTERNATIONAL TAX PLANNING UNDER THE TCJA: How It All Fits Together

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GILTI and Section 163(j)
Basic Rules Applicable to CFCs

- Basic GILTI Rules
  - U.S. Shareholder includes in income as GILTI the excess of “net CFC tested income” (“tested income”) over “net deemed tangible income return” (“NDTIR”).
  - NDTIR is generally 10% of qualified business asset investment (“QBAI”) minus interest expense taken into account in computing tested income (“specified interest”).
  - GILTI inclusion is computed at shareholder level, and losses from one CFC can generally offset income from another CFC the stock of which is owned by the U.S. shareholder.
  - Domestic corporations benefit from Section 250 deduction of 50% of GILTI.
- Basic Section 163(j) Rules
  - Business interest deductions limited to 30% of adjusted taxable income (“ATI”), generally taxable income without regard to business interest income and deductions, and prior to 2022, depreciation and amortization, plus amount of business interest income.
  - Interest deductions exceeding the limit (“EBI”) carry over.
  - Complex rules apply to partnerships, including rules limiting double counting.

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GILTI and Section 163(j)
Basic Rules Applicable to CFCs (cont.)

- Application of Section 163(j) to CFCs Generally
  - Pursuant to comprehensive proposed Section 163(j) regulations, Treasury and the IRS apply Section 163(j) to CFCs; thus Section 163(j) applies in determining GILTI inclusions.
  - Subject to certain very specific exceptions, ATI is defined based on general U.S. rules under the principles of Treas. Reg. 1.952-2.
  - One exception is that under the general rule a dividend from one CFC to another is not taken into account in ATI; this exception is based on double counting considerations.
  - In addition, under a limited CFC group election, excess taxable income ("ETI") of a CFC may tier up to a CFC owning stock in such CFC.

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GILTI and Section 163(j)
The Basic Tax Stakes

- It is easy to see that in some basic simple cases application of Section 163(j) will increase the net inclusion of the U.S. shareholder because the net tested income of the CFC will be greater.
- As an example assume a CFC wholly owned by USP that has no QBAI. Assume that USP has 150 of ATI and tested income; annual interest expense of 60; and net tested income of 90 (150-60) if Section 163(j) does not apply. If Section 163(j) limits the interest deduction to 30% of 150, or 45, the net tested income will be 105 (150-45). The GILTI inclusion is 15 greater, although there is a 15 EBI carryover.
- However, there are a number of cases in which application of Section 163(j) does not really affect the U.S. shareholder, and in some cases it is advantageous because for example, EBI carries forward.

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GILTI and Section 163(j) The Effect of QBAI

- One case in which the stakes of application of Section 163(j) are changed is the case in which there is QBAI that is relatively significant in relation to debt so there is positive NDTIR.
- The basic point is that NDTIR is reduced by allowed interest (specified interest). Thus, as long as interest expense does not exceed 10% x QBAI, an increase in net tested income from the interest disallowance is accompanied dollar for dollar by more NDTIR.
- Depending on the facts, it is also possible that the presence of foreign tax credits will result in the application of Section 163(j) having little or no negative impact (or being beneficial, because EBI is carried forward whereas unused foreign tax credits in the GILTI basket do not).

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GILTI and Section 163(j) The Effect of QBAI (cont.)

- Assume again that a CFC is wholly-owned by USP, with 60 of annual interest expense. Assume ATI of 150, 110 of tested income before interest deductions and 1,000 of QBAI.
  - If Section 163(j) does not apply, the GILTI inclusion is tested income of (110-60) – NDTIR of (100-60) = 10.
  - If Section 163(j) applies to limit the interest deductions to 45, the GILTI inclusion is (110-45) – (100-45) = 10.
  - Note there is a carry over of the 15 of EBI. Depending on future events, the application of Section 163(j) can thus actually be good for the taxpayer.
  - In general, this phenomenon will be present so long as specified interest does not exceed 10% x QBAI.

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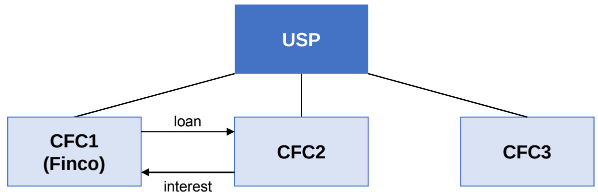
GILTI and Section 163(j)
Application of GILTI Rules to Inter-CFC Debt



- Under Section 951A(b)(2)(B), the interest paid by CFC1 to CFC2 is generally not treated as specified interest that reduces NDTIR if the interest income attributable to the interest expense is taken into account by USP in calculating its tested income.
- The proposed GILTI regulations treat inclusions in tested income of interest received from third parties as attributable to such interest expense. Prop. Reg. 1.951A-1(c)(3)(iii).
- As a conceptual matter, why should interest on a loan from USP to a CFC not get the same treatment?

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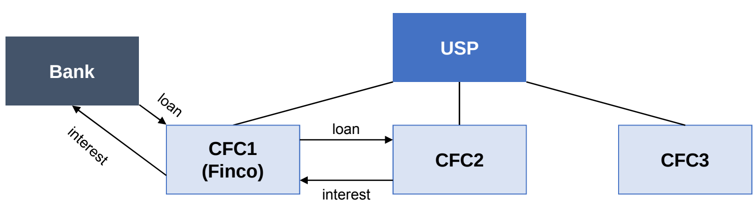
GILTI and Section 163(j)
Application of Section 163(j) to Inter-CFC Debt



- In crafting the Section 163(j) regulations, the government also had to deal with inter-CFC debt. The problem is that if Section 163(j) applied, for example, to interest on CFC2's loan from CFC1, but USP had a full inclusion of interest income through CFC1 there would be a distortive result.
- Moreover, merely ignoring the inter-CFC debt would not work because CFC1 needs business interest income to support its loan from Bank under Section 163(j).

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GILTI and Section 163(j)
Application of Section 163(j) to Inter-CFC Debt (cont.)

- The proposed Section 163(j) regulations permit a limited "group CFC" election to solve these problems. The election is available to 80% commonly controlled groups. Prop. Reg. 1.163(j)-7(b)(3) and -7(b)(5).
- Note similar problem with loan from USP to CFC. Another approach to this issue would perhaps be justified which presents issues similar to those addressed by look through rules or self-charged interest rules.

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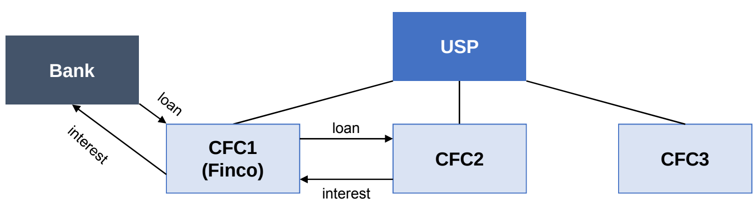
GILTI and Section 163(j)
Operation of Group Election to Inter-CFC Debt



- Assume CFC1 borrows from Bank and lends the same amount to CFC2 at the same interest rate. Assume CFC1 has 100 of business interest deductions and 100 of business interest income; and CFC2 has 100 of business interest deductions.
- The group has 100 of net business interest deductions. CFC2 has the only net business interest deductions so all of net business interest deduction is allocable to CFC2. Section 163(j) will be applied to that 100 based on the ATI of CFC2 alone.

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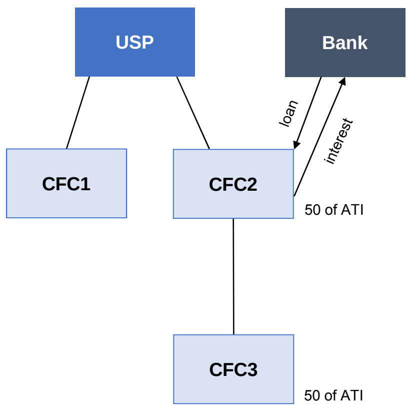
GILTI and Section 163(j)
Operation of Group Election to Inter-CFC Debt (cont.)

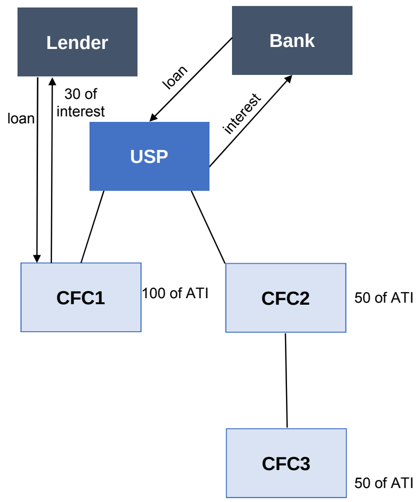
- Note this result would change if CFC3 had net business interest income. If CFC3 had 100 of such business interest income, for example, Section 163(j) would not apply because the group would not have net business interest deductions.
- But the ATI of CFC3 is not available with respect to CFC2's net deductions.
- Note, however, that net business interest income of CFC3 would lessen the aggregate net business interest deductions of the group so that less ATI of CFC2 is necessary to avoid Section 163(j) disallowance.
- A constraint on use of net business interest income of a member is a rule segregating financial services subgroups. Prop. Reg. 1.163(j)-7(f)(1)(ii).

GILTI and Section 163(j)
Application of Group Election Rules to ETI of CFCs Owning CFCs



- Assume CFC2 has a loan from Bank, with 30 of annual interest; CFC2, taken alone, has 50 of ATI; CFC3, which is a wholly owned subsidiary of CFC2, has 50 of ATI and no debt.
- Under the CFC group election rules, 50 of CFC3's ATI would tier up to CFC2 so it would have 100 of ATI.
- In this "vertical" configuration, CFC2 can thus use the ATI of CFC3.
- Note that for ATI of CFC2, all the ATI counts even if part of it is not taxable to USP because, for example, of QBAI in CFC1 or CFC3.

GILTI and Section 163(j)
Effect of CFC Income on USP ATI



- The proposed Section 163(j) regulations also deal with the effect of the CFC income on USP's ATI.
- In this example, there is debt at USP level, but there is ATI at CFC level.
- In absence of combined CFC group election, there is no effect on USP's ATI, even though in absence of regulations the net GILTI inclusion (after taking into account the Section 250 deduction) would increase ATI.
- If a CFC group election is made, ETI of CFCs tiers up to USP, but only ATI subject to U.S. tax after taking into account effect of QBAI etc. In this case, there potentially would be ETI from CFC2 and CFC3, but not CFC1.
- Moreover, there is overall limit based on GILTI inclusion net of GILTI deduction, which we will discuss in a later slide.

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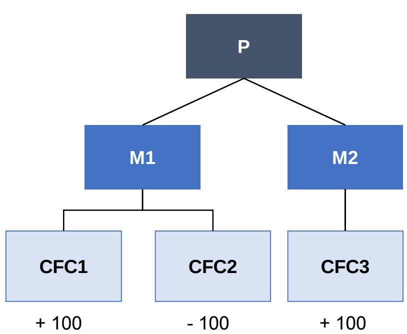
GILTI and Section 163(j)
Location of CFCs Within a Consolidated Group



- Example:
  - Consolidated parent P owns member M1, which owns 100% of two CFCs. CFC1 has 100 of tested income, CFC2 has 100 of tested loss.
  - Member M2 owns 100% of CFC3, which has 100 of tested income.
  - The overall GILTI inclusion of the group would be 100 if it was a single corporation.
  - Under the regulations, the tested loss of CFC2 is allocated in proportion to the tested income allocated to M1 and M2, i.e., 50 to M1 and 50 to M2.
  - As a result, M1 and M2 each has net tested income of 50 and a GILTI inclusion of 50.

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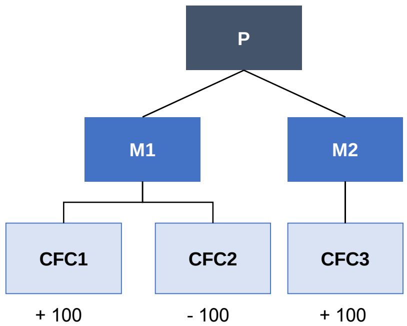
GILTI and Section 163(j)
Location of CFCs Within a Consolidated Group



- This is a noneconomic result, since M1 has no overall economic income from its CFCs, and M2 has overall economic income of 100. The noneconomic result tiers up to P's basis in the stock of M1 and M2.
- The Preamble to the Proposed Regulations indicates that this rule is designed to prevent the location of CFCs within the group from affecting the overall GILTI inclusion of the group. This would prevent both tax planning and traps for the unwary based on the location of CFCs within the group.

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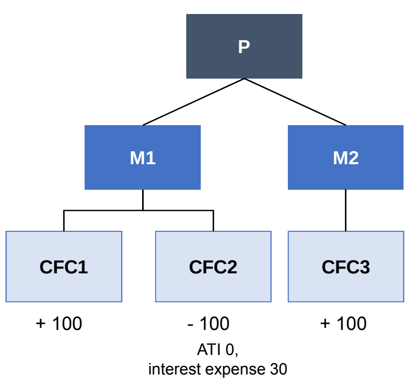
GILTI and Section 163(j)
Location of CFCs Within a Consolidated Group



- However, the Section 163(j) regulations are inconsistent with this goal. The location of CFCs within a group can greatly affect the ability of CFCs to use interest deductions.
- E.g., suppose that in addition to the above facts, CFC2 has ATI of 0 and interest expense of 30, and a group election is made.
- Under the stated structure, none of the interest will be deductible because CFC2 cannot access any ATI of CFC1 or CFC3.
- If M1 contributes CFC1 to CFC2, and CFC1 has ATI of 100, then CFC2 can utilize that ATI, and CFC2 can deduct the 30 of interest expense. The same would be true if CFC3 had ATI of 100 and was contributed to CFC2.
- This would NOT be true if CFC2 became a subsidiary of CFC1 or CFC3, since there is only "upstream" attribution of ATI.
- As a result, the uneconomic allocation of GILTI inclusions to M1 and M2 may be less justifiable because they do not in fact result in the location of CFCs within a group being irrelevant.
- However, the only alternative would be to treat all commonly owned CFCs as a "CFC consolidated group", which would raise innumerable complexities of its own.

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Section 163(j) and Section 250

- Section 250(a)(1) provides for a deduction to a U.S. shareholder of a CFC equal to 50% of a GILTI inclusion.
- Section 250(a)(2) provides that if the GILTI inclusion is greater than taxable income, the deduction is limited to 50% of taxable income.
  - For example, if there is a GILTI inclusion of 100 and a separate operating loss of 40, the tentative taxable income is 60 and the Section 250 deduction is 30. Final taxable income is 60 minus 30, or 30.
- Since both Section 250(a)(2) and Section 163(j) limit deductions on the basis of taxable income, an ordering rule is necessary.
- Under Prop. Reg. 1.163(j)-1(b)(37)(ii), Section 250 applies before Section 163(j).
- However, under the same proposed regulation, taxable income for Section 163(j) purposes is determined by taking into account the Section 250(a)(1) deduction without regard to Section 250(a)(2) (referred to herein as the "**unlimited Section 250 deduction**").
- The following slides consider the significance of these rules.

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Section 163(j) and Section 250

- Consider a U.S. shareholder with:
  - GILTI inclusion 100
  - Unrelated operating loss 40
  - Section 250(a)(1) deduction of 50.
  - Section 250(a)(2) limit on Section 250 deduction equal to 50% of 60 tentative taxable income, or 30.
  - "Regular" taxable income is 100 GILTI inclusion minus 40 operating loss minus 30 Section 250 deduction, or 30.
  - Taxable income for Section 163(j) purposes of 100 GILTI inclusion minus 40 operating loss minus 50 unlimited Section 250 deduction, or 10.
- Suppose no group election is made.
  - Under Prop. Reg. 1.163(j)-7(d)(1)(i), in determining ATI of the U.S. shareholder, taxable income (as defined above) is reduced by the excess of the GILTI inclusion over the unlimited Section 250 deduction.
  - The result is (x) taxable income of 10 reduced by (y) the excess of 100 over 50, or 50. The result is 10 minus 50, or negative 40. This is the same as the operating loss of the shareholder.
  - **The regulations have the effect of "backing out" the GILTI inclusion and the Section 250 deduction allowed to the shareholder from the CFC.**

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Section 163(j) and Section 250

- Consider the same facts as in the preceding slide:
  - GILTI inclusion 100
  - Unrelated operating loss 40
  - Section 250(a)(1) deduction of 50.
  - Section 250(a)(2) limit on Section 250 deduction equal to 50% of 60 tentative taxable income, or 30.
  - "Regular" taxable income is 100 GILTI inclusion minus 40 operating loss minus 30 Section 250 deduction, or 30.
  - Taxable income for Section 163(j) purposes of 100 GILTI inclusion minus 40 operating loss minus 50 unlimited Section 250 deduction, or 10.
- Now suppose a group election is made.
  - Under Prop. Reg. 1.163(j)-7(d)(2)(i), in determining ATI of the U.S. shareholder, taxable income is first adjusted under -7(d)(1)(i) as if no group election is made. This results in taxable income of (40), as on the preceding slide.
  - Taxable income is then increased by certain income inclusions from CFCs, but not in excess of the "CFC group inclusions".

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Section 163(j) and Section 250

  - Those inclusions are (x) the GILTI inclusions subtracted from taxable income under Prop. Reg. 1.163(j)-7(d)(1)(i), reduced by (y) the portion of the Section 250(a)(1) deduction taken into account under -7(d)(1)(i) that is allowable by reason of the GILTI inclusions.
  - In the example, the increase in (x) is 100. It appears that the reduction in (y) is 30, the deduction actually *allowed* under Section 250.
  - If this is correct, there is a net increase in taxable income of 70.
  - When this is added to taxable income of (40), the result is positive taxable income of 30.
  - **This is the regular taxable income of the shareholder taking into account all GILTI items, including the actual Section 250 deduction.**
- On different fact patterns involving multiple CFCs, it will not always be true that the group election puts the shareholder in the same position as if all GILTI items of the CFCs were taken into account directly.
- However, even in such cases, it does not appear that the results of the group election would be different if the actual Section 250 deduction was taken into account.

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Section 163(j) and Section 250

- If these results are correct, what is the significance of the rule in the regulations that Section 163(j) applies by taking account of Section 250 without regard to Section 250(a)(2)?
  - If a group election is not made, the net effect of the regulation is to exclude all GILTI items from the taxable income of the U.S. shareholder. The same result could easily be achieved if Section 250(a)(2) was taken into account.
  - If a group election is made, the regulation appears to reach the same result as if Section 250(a)(2) was into account.

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GILTI and Subpart F

- Before TCJA:
  - Year 1: CFC has 100 of Subpart F income, 100 of operating loss, and 0 E&P.
  - Year 2: CFC has 100 of operating income and E&P.
  - Under Section 952(c)(1)(A), Subpart F income for the year is limited to E&P for the year, so there is no Subpart F income in year 1.
  - Under Section 952(c)(2), if the (c)(1)(A) limit applies to reduce Subpart F income for a year, then E&P in a future year in excess of Subpart F income in the future year is recharacterized as Subpart F income to such extent. So there is 100 of Subpart F income in year 2.

	Year 1	Year 2
Subpart F Income	100	0
Operating Income (Loss)	(100)	100
E&P	0	100
Subpart F Inclusion	0	100

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GILTI and Subpart F

- After TCJA: If Tested Loss in Year 1
  - Assume same facts, with the operating loss in year 1 being a tested loss and the operating income in year 2 being tested income.
  - Under new Section 951A(c)(2)(B)(ii), tested losses do not reduce E&P for Subpart F purposes. As a result, there is 100 of Subpart F income in year 1.
  - In year 2:
    - Section 952(c)(2) does not apply since the Subpart F income was reported in year 1.
    - There is 100 of tested income. The 100 of tested loss in year 1 cannot carry forward to offset that tested income unless future regulations allow loss carryforwards in a CFC.

	Year 1	Year 2
Subpart F Income	100	
Tested Income	(100)	100
E&P	100	n/a
Subpart F Inclusion	100	

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GILTI and Subpart F

- After TCJA: If Non-tested Loss in year 1
  - Assume same facts, but the operating loss in year 1 is not a tested loss or Subpart F loss (e.g., it is an oil and gas loss).
  - In year 1:
    - There is no Subpart F income. Section 951A(c)(2)(B)(ii) only increases E&P by the amount of tested losses, and so the E&P limitation of Section 952(c)(1)(A) applies.
    - The Subpart F-type income is not converted into tested income.
      - Section 951A(c)(2)(A)(i)(II) excludes from tested income any gross income taken into account in determining Subpart F income.
      - In order to give continuing substance to Section 952(c)(2), the 100 of Subpart F-type income should be treated as taken into account in determining future Subpart F income.
      - The proposed regulations confirm this result.

	Year 1	Year 2
Subpart F Income	100	
Non-Tested Income	(100)	
Tested Income	0	100
E&P	0	100
Subpart F Inclusion	0	100
Tested Income Inclusion	0	100

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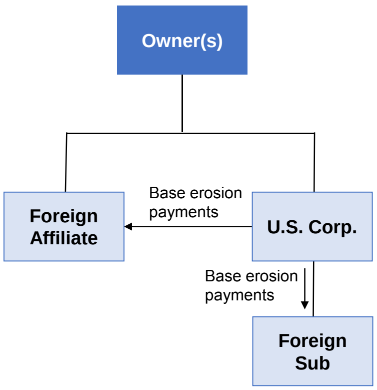
GILTI and Subpart F

- In year 2:
  - Section 952(c)(2) by its terms applies, since the 100 of E&P in year 2 exceeds the Subpart F income in year 2. As a result, the 100 of E&P is converted into year 2 Subpart F income.
  - But there is also 100 of tested income in year 2. If that is taxed as tested income, 100 of tested income in year 2 will give rise to a 200 income inclusion in year 2.
  - The proposed regulations provide for this result.
    - On its face, this looks like double taxation of the 100 of tested income.
    - The NYSBA GILTI report supports this result.
    - Since there is no income inclusion in year 1, failure to tax 200 in year 2 is the equivalent of allowing a deduction for the 100 of nondeductible expense in year 1.
    - Section 952(c)(2) was designed to defer taxation of Subpart F income, not to eliminate taxation entirely.
    - Under Section 952(c)(2), the Subpart F inclusion in year 2 is based on E&P in year 2. E&P can arise independently of tested income, so the triggers for the Subpart F income and tested income in year 2 are different.

	Year 1	Year 2
Subpart F Income	100	
Non-Tested Income	(100)	
Tested Income	0	100
E&P	0	100
Subpart F Inclusion	0	100
Tested Income Inclusion	0	100

BEAT

BEAT - Review



- Under Section 59A, a U.S. corporation that has average annual gross receipts ≥ $500 million, and makes “base erosion payments” (BEPs) ≥ 3% of its total annual deductions, generally must pay at least a minimum amount of U.S. tax.
  - A BEP means, generally, a deductible payment by the corporation to a foreign affiliate (including a CFC).
  - The minimum tax = 10% of the amount of the corporation’s taxable income, computed without taking into account the benefit of any BEPS. The rate increases from 10% to 12.5% after 2025.
  - Foreign tax credits cannot be used to reduce BEAT liability.
- Proposed regulations released on December 13, 2018.

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BEAT – Conduit Principles

- Section 59A(i) authorizes “such regulations as may be necessary or appropriate to carry out the provisions of this section,” including rules to “prevent avoidance of the purposes of this section, including through…the use of unrelated persons, conduit transactions, or other intermediaries.”
- The proposed regulations address conduit-type issues in a number of contexts. Some of the decisions that have been made in the proposed regulations of whether/when to “look through” an intermediate entity are addressed in the following slides.

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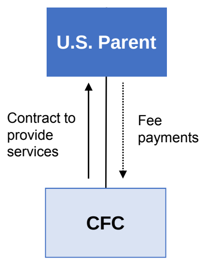
Interaction with CFC Rules



- Suppose U.S. Parent pays a fee to a CFC, for services performed by the CFC.
- The CFC's fee income may result in Subpart F income or GILTI for U.S. Parent.
- The proposed BEAT regulations provide no exception from the definition of a BEP, for an amount that is paid to a CFC and included by a U.S. shareholder under Sections 951 or 951A.
  - Cf. Prop. Reg. 1.59A-3(b)(2)(v), generally treating an amount received by a REIT/RIC as a BEP, to the extent the REIT/RIC is owned by a foreign related party.
- Thus, U.S. Parent computes its "modified taxable income" on which BEAT is imposed by including any Subpart F income/GILTI attributable to the CFC's fee income, with no deduction (generally) for U.S. Parent's fee payment (which generally would be a BEP).

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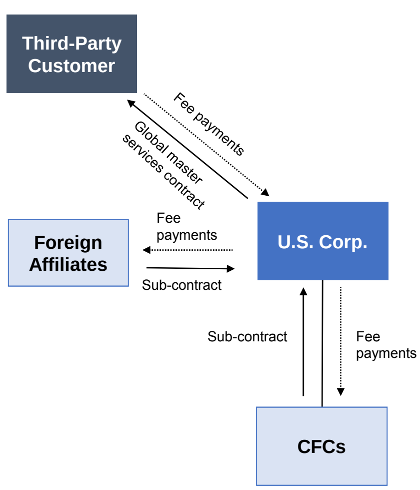
Intermediary Issues



- Suppose U.S. Corp. enters into a master agreement with a third-party Customer to provide services globally. U.S. Corp. sub-contracts with its CFCs, as well as other Foreign Affiliates that are not CFCs, to provide the services to Customer locally in foreign countries.
- U.S. Parent acts essentially as an intermediary here.
- The proposed regulations do not exclude payments by U.S. Parent to the CFCs and other Foreign Affiliates from being BEPs, in situations like this one.
- If it would be difficult to design such an exclusion, then an exclusion for payments to CFCs that result in GILTI or Subpart F income would have the effect of at least partially addressing this issue.

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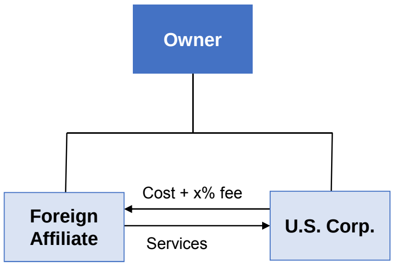
Services Cost Method



- Proposed regulations confirm that, if U.S. Corp. pays a fee in excess of the cost of the services provided by Foreign Affiliate, and the requirements of the services cost method under Section 482 are met, then only the portion of the fee in excess of cost is a BEP. Prop. Reg. 1.59A-3(b)(3)(i).
  - Preamble: the statute is "ambiguous," but the above approach is "the most logical interpretation."
- No disaggregation/look-through, if U.S. Corp. pays Foreign Affiliate for a non-covered service, and that service includes/depends upon other affiliates' provision to Foreign Affiliate of related, covered services that are eligible for the services cost method.

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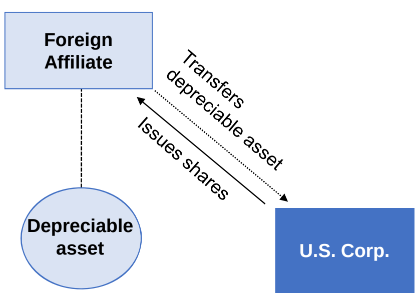
Payment in Kind



- A BEP includes a payment to a foreign affiliate to acquire depreciable or amortizable property.
- The U.S. corporation's depreciation/amortization deductions with respect to the acquired property are "base erosion tax benefits" which are disregarded, for purposes of computing the U.S. corporation's modified taxable income subject to BEAT.
- Under Prop. Reg. 1.59A-3(b)(2)(i), a BEP includes a payment in any form, including cash, property, stock, or the assumption of a liability.
- Is it appropriate to treat U.S. Corp.'s issuance of its stock to Foreign Affiliate as a BEP?
  - Should the result here be the same, as if Foreign Affiliate had paid cash to subscribe for U.S. Corp. stock, and U.S. Corp. then had bought the asset with the cash?

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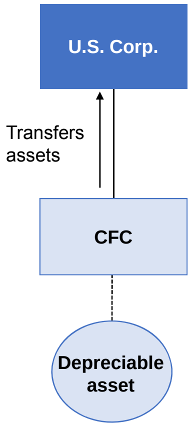
Payment in Kind (cont.)



- If CFC transfers a depreciable asset to U.S. Corp. in an inbound Section 381 transaction, should that affect the analysis of whether there is a payment?
- Should it matter whether the amount of CFC's E&P that has been subjected to U.S. income tax (either at, or before, the time of the Section 381 transaction), equals or exceeds CFC's tax basis in its assets?

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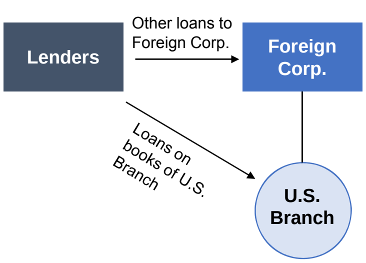
Interest Expense of U.S. Branches



- If Foreign Corp.'s interest expense on U.S.-connected liabilities exceeds its interest expense on U.S.-booked liabilities (as determined under Treas. Reg. 1.882-5), then the excess interest expense is treated as payable to foreign related parties, in the same ratio as
  - Liabilities owed by Foreign Corp. to foreign related parties, bear to
  - All of Foreign Corp.'s liabilities (other than U.S.-booked liabilities). Prop. Reg. 1.59A-3(b)(4)(i).
- The proposed regulations thus do not treat the excess interest as deemed paid by U.S. Branch to Foreign Corp. (cf. Section 884(f)(1)(B)), but rather as an allocation to U.S. Branch of the interest paid by Foreign Corp. to its lenders.

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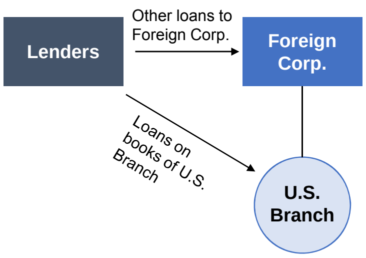
Interest Expense of U.S. Branches



- Section 59A(c)(2)(B) provides an exception from the definition of base erosion payment (BEP), for amounts subject to U.S. withholding tax under Section 1441/1442.
- That statutory exception has not been extended by the proposed regulations to include Section 881/884(f)(1)(B) tax paid by a foreign corporation on its excess interest expense attributable to a U.S. branch. See Prop. Reg. 1.59A-3(c)(2).
  - This tax is technically not a withholding tax, although it is economically similar to one, and thus it is not within the literal language of the statutory exception.

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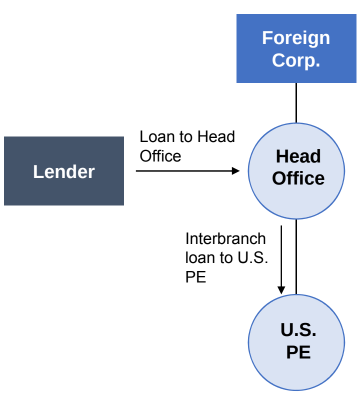
U.S. Permanent Establishment



- If Foreign Corp. is entitled to the benefit of a U.S. tax treaty under which Foreign Corp. computes its business profits attributable to a U.S. PE by reference to the "assets used, risks assumed, and functions performed" by the U.S. PE, then BEAT applies to a payment made by the U.S. PE to a foreign branch of Foreign Corp. Prop. Reg. 1.59A-3(b)(4)(v).
- The quoted wording tracks the 2016 U.S. Model Treaty, and approximates the wording of the 2006 U.S. Model Treaty. (Most current U.S. treaties predate these two Model Treaties, and use different wording in concerning business profits.)
- The approach taken here differs from that taken in the rules for excess interest (previous slides).

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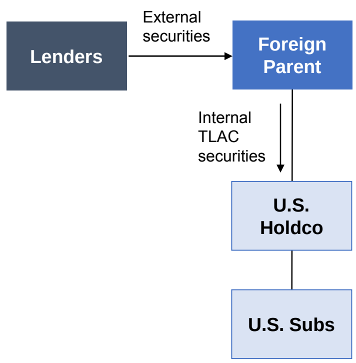
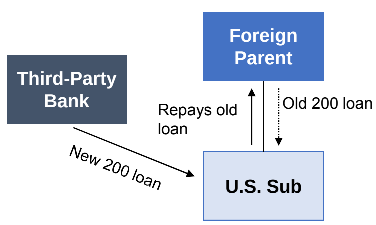
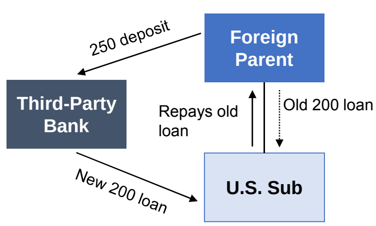
Bank Regulatory Requirements



- Interest on TLAC securities issued by a U.S. corporation to a foreign parent to satisfy Federal Reserve requirements is not a BEP. Prop. Reg. 1.59A-3(b)(3)(v).
  - Not “avoidance,” if mandatory requirement to issue external debt at the parent level rather than at the subsidiary level.
  - Preamble seeks comments on whether to provide an exemption for payments on loss absorbing securities that are issued to satisfy corresponding foreign banking requirements.

BEAT Antiabuse Rule





- If a taxpayer pays an amount to an intermediary that would have been a BEP if paid to a foreign related party, and the intermediary makes “corresponding payments” to the foreign related party “as part of a transaction (or series of transactions), plan or arrangement that has as a principal purpose avoiding a base erosion payment (or reducing the amount of a base erosion payment),” then the intermediary is disregarded, or the amount paid or accrued to the intermediary is treated as a BEP. Prop. Reg. 1.59A-9(b)(1).
- **Example – Non-Abusive**: U.S. Sub borrows 200 from Third-Party Bank and repays a loan from Foreign Parent that had similar terms.
- **Example – Abusive**: Same facts, except Foreign Parent deposits 250 with Bank, with a principal purpose of avoiding a BEP, and the interest rate paid by Bank is within 1 percentage point of the interest received by Bank. The transaction is treated as a direct 200 loan by Foreign Parent to U.S. Sub (cf. Rev. Rul. 87-89).
- See Prop. Reg. 1.59A-9(c) Examples 3 & 4.

Interaction with Section 163(j)

- The determination of whether business interest expense is a BEP is made in the year the interest is treated as paid or accrued under normal tax accounting principles, disregarding any Section 163(j) limit on deductibility (the “vintage year”). See Prop. Reg. 1.59A-3(c)(4)(i).
- Stacking rule: Interest for which a deduction is allowed under Section 163(j) in the vintage year consists of –
  - First, pro rata, interest paid to (1) foreign related parties and (2) U.S. related parties;
  - And then, interest paid to unrelated parties. Prop. Reg. 1.59A-3(c)(4)(ii).

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Interaction with Section 163(j) (cont.)

- If any interest is disallowed under Section 163(j) in the vintage year and carried forward, then the same stacking rule is used in order to apply BEAT to the carried-forward interest, when the interest becomes deductible under Section 163(j) in a future year.
  - For example: In 2019, U.S. Corp. has ATI of 100 and pays 100 of interest – 60 to unrelated parties, 20 to foreign related parties, and 20 to U.S. related parties.
  - Under Section 163(j), U.S. Corp. is allowed to deduct 30 of interest in 2019. For purposes of BEAT, this consists of 15 of foreign related-party interest and 15 of U.S. related-party interest.
  - U.S. Corp. has a 70 carryforward of disallowed interest under Section 163(j). If U.S. Corp. becomes entitled to deduct (say) 50 of this carried-forward interest in 2020, then under the proposed regulations, 5 of the 50 will be treated as paid to foreign related parties in 2020.
  - It is irrelevant whether, in 2020, foreign related-party lenders continue to own debt of U.S. Corp.

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NOL Carryovers

- NOL deduction computed in the same manner for purposes of BEAT, as for the regular income tax.
  - No separate attribute to track like an AMT NOL.
- Proposed regulations provide that the base erosion percentage (generally, in a given year, the ratio of the taxpayer's BEPs to all of its tax deductions for that year) is determined in the year when the NOL arose. Prop. Reg. 1.59A-4(b)(2)(ii).
  - Where a taxpayer is a member of a group that is aggregated for purposes of determining whether Section 59A applies (i.e., whether the gross revenue and base erosion percentage tests are met), the base erosion percentage applied to an NOL of the taxpayer is the one that is computed for the group – the percentage is not separately computed for each taxpayer in the group. See Prop. Reg. 1.59A-2(e)(3).
- Base erosion percentage is zero, for carryforwards from pre-effective date periods. Prop. Reg. 1.59A-4(b)(2)(ii).

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FDII

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FDII

- Under Section 250, a U.S. corporation can deduct a portion of its "foreign-derived intangible income" (FDII).
  - Deduction is 37.5% for years beginning after December 31, 2017 (yielding effective tax rate of 13.125%) and 21.875% for years beginning after December 31, 2025 (yielding effective tax rate of 16.406%).

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FDII

- FDII = $[\text{DEI} - (10\% \times \text{QBAI})] \times \frac{\text{Foreign-Derived DEI}}{\text{DEI}}$
- DEI = Deduction eligible income = gross income (less exclusions) over properly allocable deductions.
  - Exclusions from DEI include GILTI, Subpart F, CFC dividends, and foreign branch income.
- QBAI = adjusted basis in depreciable tangible property used in a trade or business to produce DEI.
  - Determined in the same manner as under GILTI.

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FDII

- Foreign-Derived DEI comes from:
  - Sales of property to non-U.S. persons for a foreign use; and
  - Provision of services to any person, or with respect to any property, not located within the United States.
- Property sold to a related foreign party will not be for foreign use unless eventually sold (or used in connection with property that is sold or the provision of services) to an unrelated foreign person for a foreign use.
- Services provided to a related foreign party will not be foreign-derived unless the related foreign party does not perform substantially similar services for persons within the U.S.

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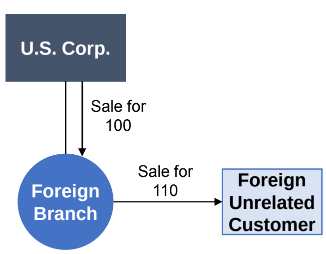
FDII and Branch Transactions



- Foreign branch income is not DEI and therefore cannot be FDII.
- How should a sale of property (or provision of services) by a U.S. taxpayer to its foreign branch be treated?
  - Approach One: Disregard Branch/Owner Transactions – All sale gain is foreign branch income – no FDII.
    - See e.g. Treas. Reg. 1.987-2(c)(2)(iii).
  - Approach Two: Regard Branch/Owner Transactions – Sale gain on 100 FDII-eligible.

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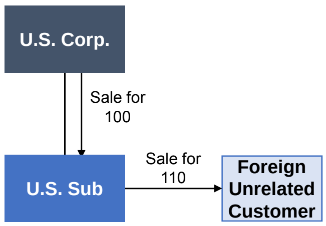
FDII and Consolidated Groups



- Property sold, and services provided, to a U.S. person are per se not FDII-eligible.
- How should an intermediate sale of property within a consolidated group be treated?
  - Approach One: Single Entity Treatment – intercompany sale gain reattributed as foreign-derived.
    - See Treas. Reg. 1.1502-13(c)(7)(ii), Ex. 14.
  - Approach Two: Separate Entity Treatment – only U.S. Sub's sale gain treated as foreign-derived.

FDII and Interplay with GILTI

- GILTI reduces incentive to generate foreign-derived revenues offshore by imposing a minimum rate of current U.S. tax on income derived through CFCs.
- FDII reduces incentive to generate foreign-derived revenues offshore by reducing the U.S. tax rate on income derived directly.
- FDII rate slightly higher than GILTI rate, but only 80% FTC available for GILTI.
- Both GILTI and FDII encourage locating tangible property outside the U.S. – U.S. QBAI reduces FDII, foreign QBAI reduces GILTI.

PTI and Basis Adjustments

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Basic Framework

- Under Section 959(a), a U.S. shareholder generally recognizes no gain or loss when a CFC distributes “previously taxed income” (PTI) to the U.S. shareholder.
  - Statutory ordering rule: Distributions are considered to come ***first***, from PTI attributable to Section 956 inclusions (Section 959(c)(1)); ***second***, from PTI attributable to Subpart F income (Section 959(c)(2)); and ***last***, from E&P not previously subject to shareholder-level taxation (Section 959(c)(3)).
- Under Section 961(a), a U.S. shareholder increases its basis in the stock of a CFC by amounts included in the U.S. shareholder’s income under Section 951; and under Section 961(b) the U.S. shareholder’s basis in the stock is reduced when PTI is distributed to it.
  - Section 961(c) provides that under regulations, similar adjustments shall be made to the stock of a lower-tier CFC, but only for the purposes of determining amounts included under Section 951 in the gross income of the U.S. shareholder.
- Regulations were proposed in 2006 under these sections, never finalized.

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Impact of TCJA

- After the TCJA, the variety of types of income a CFC can have, and corresponding types of E&P, has proliferated.
  - Section 959(c)(1):
    - Section 956 inclusions
  - Section 959(c)(2):
    - GILTI allocated to the CFC under Section 951A(f)(2)
    - Section 965(a) income, and Section 965(b) income
    - Subpart F income
    - Section 1248 gain, and Section 964(e) gain
  - Section 959(c)(3):
    - NDTIR
    - High-taxed income under Section 954(b)(4)
    - Income from periods before the corporation was a CFC
- Notice 2019-1, published on December 17, 2018, identifies 16 categories of E&P described in Sections 959(c)(1) and (c)(2) (listed on a later slide).

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Why Does It Matter?

- Distributions by a CFC out of different types of E&P can have divergent impacts on:
  - **Foreign tax credits**. Withholding taxes (and foreign income taxes at intermediate levels, in the case of a distribution up through a chain of CFCs) generally should be fully creditable on a distribution of PTI (Section 960(b)), and not creditable at all on a distribution of E&P that is not PTI (Section 245A(d)).
  - **Stock basis**. Distributions to a U.S. shareholder of PTI attributable to inclusions by that U.S. shareholder, should result in a basis reduction under Section 961(b). Other distributions out of E&P by a CFC generally don't result in a basis reduction (except in cases where Section 1059 applies).
    - Distributions of E&P through a chain of CFCs can create additional issues, depending on the type of E&P distributed.
  - **FX gain/loss**. Depending on the type and vintage of E&P to which a distribution is traced, a U.S. shareholder's gain/loss under Section 986(c) may vary. For distributions of Section 965(b) E&P or E&P that is not PTI, there is no gain/loss under Section 986(c).

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Notice 2019-1

- Builds on system of shareholder accounts in 2006 proposed regulations
- Each U.S. shareholder has a separate account for each of the 16 types of previously taxed E&P (“PTEP”) described in Sections 959(c)(1) and (c)(2) that are identified in the Notice, arising in each taxable year of the CFC.
  - Section 959(c)(2) (7 categories): PTEP attributable to income described in Sections 951A, 965(a), 965(b), 245A(e)(2), 1248, 964(e) and (to the extent not covered by the preceding provisions) 951(a)(1)(A);
  - Section 959(c)(1) (9 categories): PTEP attributable to income in any of the preceding 7 categories under Section 959(c)(2), before being reclassified to Section 959(c)(1); PTEP that results from income inclusions under Section 951(a)(1)(B); and PTEP attributable to income inclusions under former Section 956A.
- Ordering rule – distributions come from:
  - First, Section 965(a) PTEP;
  - Then, Section 965(b) PTEP;
  - Then, on a LIFO basis, the E&P accounts for each taxable year of the CFC, pro rata from each category of E&P that arose in that year.

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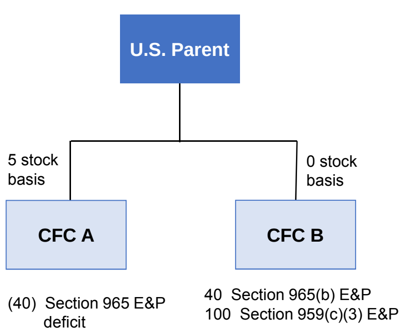
Interaction of Sections 245A, 961 and 965



- Suppose it is desired to have CFC B distribute 30 to U.S. Parent. Under Notice 2019-1, the distribution is treated as made out of CFC B’s Section 965(b) PTI.
- It appears that under Section 965(b)(4)(A), U.S. Parent may not be entitled to a Section 961(a) increase in its basis in the stock of CFC B on account of the Section 965(b) PTI; but, a distribution of that PTI would result in application of Section 961(b) – causing 30 of gain for U.S. Parent.
- Does Section 1248 apply to that gain? If so, then does Section 245A apply?
- Note that, if U.S. Parent had not owned CFC A, U.S. Parent would have been taxed under Section 965 at a maximum effective rate of 15.5% on CFC B’s 40 of Section 965 E&P, with no additional tax imposed on the 30 distribution.
- A basis reattribution election under Prop. Reg. 1.965-2(g) mitigates, but does not eliminate, these issues.
- U.S. Parent cannot access CFC B’s 100 of non-taxed E&P, without first addressing these issues.

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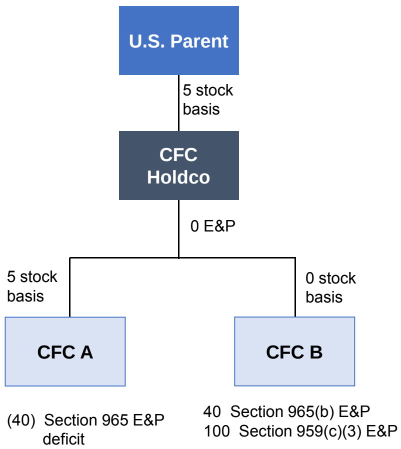
Interaction of Sections 245A, 961 and 965



- Same facts as on the previous slide, except that U.S. Parent owns CFCs A and B through CFC Holdco, which has no E&P.
- If CFC B distributes 30 to CFC Holdco, then will CFC Holdco recognize gain? Is gain recognition an "adjustment" to "the basis of stock" of CFC B, per Section 961(c)?
- Does it make more sense for any gain recognition to occur when CFC Holdco makes its distribution to U.S. Parent (assuming that it makes sense for gain recognition to occur at any level in the structure)?

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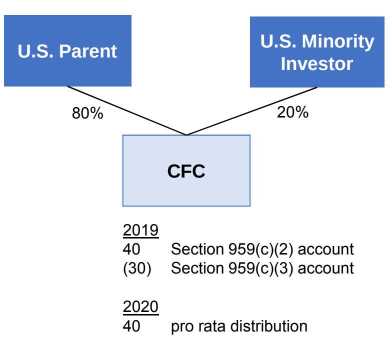
Interaction of Sections 951A and 961



- Notice 2019-1 states:
  - A CFC's Section 959(c)(1) and 959(c)(2) accounts cannot be negative.
  - A CFC's current E&P must equal the sum of the adjustments to its Section 959(c)(1), (c)(2) and (c)(3) accounts for a taxable year.
- The Notice recognizes that the GILTI attributed to a CFC under Section 951A(f)(2) may exceed the CFC's current E&P for the taxable year. In such a case, the CFC's Section 959(c)(2) account will be positive, and its Section 959(c)(3) account must be negative.
- Suppose that:
  - In 2019, CFC is solely owned by U.S. Parent and has 40 of tested income, plus a 30 expense not deductible against tested income, resulting in current E&P of 10.
  - In 2020, U.S. Minority Investor subscribes for a 20% stake in CFC. Later that year, CFC distributes 40, pro rata.
- U.S. Parent treats the 32 distribution to it as PTI and applies Sections 959 and 961.
- What are the consequences to U.S. Minority Investor and CFC of the 8 distribution to U.S. Minority Investor?

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Partnership Issues

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CFCs and Attribution

- Under Section 318(a)(3)(A), stock owned by a partner in a partnership is attributed to the partnership (regardless of partner's percentage ownership).
- Prior to TCJA, Section 958(b)(4) turned off "downward attribution" from non-U.S. persons for CFC testing purposes.
- Repeal of Section 958(b)(4) dramatically increases the number of CFCs worldwide and affects minority shareholders.

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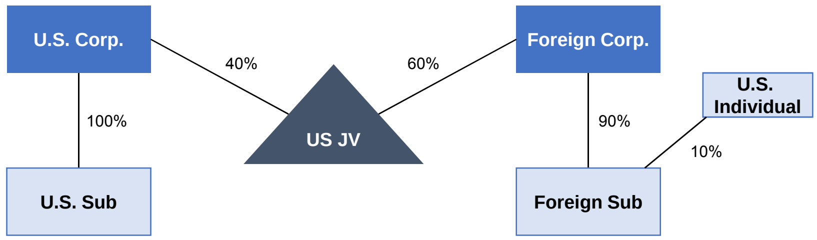
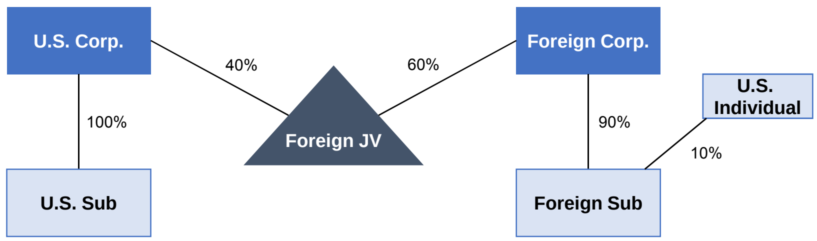
CFCs and Attribution



- 90% of Foreign Sub is attributed to US JV under Section 958. Foreign Sub is a CFC.
- U.S. Individual is a 10% U.S. shareholder subject to GILTI, Subpart F, etc. (and may have been subject to Section 965 inclusion).

CFCs and Attribution



- 90% of Foreign Sub is attributed to Foreign JV – so far so good.
- 100% of U.S. Sub is attributed to Foreign JV, and 90% of Foreign Sub is further attributed to U.S. Sub – Foreign Sub is a CFC.
- Query whether this result (or the prior example's result) is appropriate.

GILTI and Partnerships

- For CFC (including GILTI) purposes, a domestic partnership is a U.S. person that can be a 10% U.S. shareholder of a CFC.
  - The deduction for GILTI under Section 250 is only available to domestic corporations (not partnerships).
- The GILTI inclusion is determined by a 10% U.S. shareholder of a CFC by (i) netting tested income and tested loss and (ii) aggregating 10% of QBAI of all CFCs of which the taxpayer is a 10% U.S. shareholder.
- How should these rules apply to a domestic corporation that owns an interest in a CFC through a partnership?

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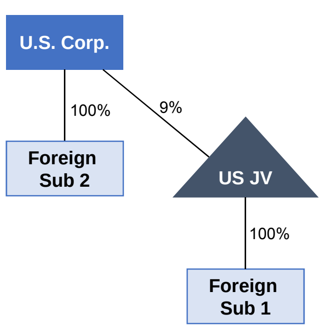
GILTI and Partnerships



- Possible Approaches:
  - Pure aggregate – effectively disregard US JV as U.S. person – all partners determine need for and amount of GILTI inclusion at partner level based on pro rata share of Foreign Sub 1's tested items.
  - Pure entity – inclusion determined solely at US JV level without regard to partner status or outside CFC tested items.
  - Hybrid 1 – US JV regarded in determining CFC status and need for inclusion, but all CFC tested items flow up to partners to determine inclusion amount at partner level taking into account outside CFC tested items.

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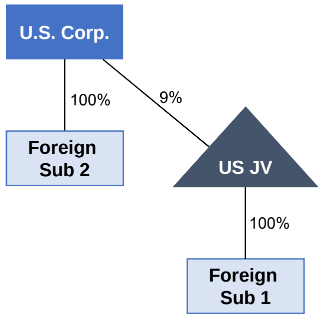
GILTI and Partnerships



- Possible Approaches:
  - Hybrid 2 – US JV regarded in determining CFC status and need for inclusion; CFC tested items flow up to 10% U.S. shareholder partners, who can net outside CFC tested items; other partners get distributive share of partnership-level inclusion. (Prop. Reg. 1.951A-5).
  - Applying proposed regs to example, U.S. Corp. has 9% distributive share of US JV's GILTI inclusion for Foreign Sub 1, unaffected by Foreign Sub 2's tested items.
    - Question: Can (or should) U.S. Corp. get a Section 250 deduction on the US JV GILTI inclusion?

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FDII and Partnerships

- Can income earned through partnerships qualify as FDII?
  - Statute refers to sales and services by the "taxpayer" and FDII deduction only applies to domestic corporations.
  - Conference Report suggests that a domestic corporation can get a Section 250 deduction for partnership income.
- Should domicile of partnership matter?
  - E.g., a foreign partnership that conducts all business in the U.S. – appropriate to view as domestic?
- Given difference in statutory operation of FDII compared to GILTI, pure aggregate principles seem more appropriate.

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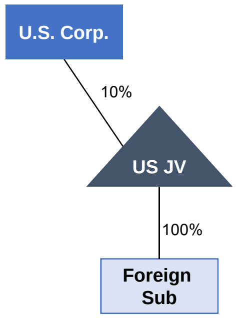
Section 245A



- Section 245A allows a 100% DRD for 10% U.S. corporate shareholders of foreign corporations.
- Do "dividends received" include indirectly through a partnership?
  - Conference Report notes that the DRD should apply if the partner could have qualified had it owned the stock directly.
- Open issues:
  - How to determine 10% ownership at partner level under Section 958(a) principles, especially when partnership has non pro rata allocations.
  - Testing holding period – at partnership level, partner level, or both?

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