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Hard Knock Life: The New Worldwide Territoriality and the Continuing Significance of the Foreign Tax Credit

November 7, 2018

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Agenda

- The Foreign Tax Credit: Background
- Impact of Source Rules
- Summary of Changes After Tax Reform
- Subpart F FTC Considerations
- GILTI Basket FTC Considerations
- Summary of the Summary
- Section 905(c) Adjustments

The Foreign Tax Credit:

Background

Purpose, History & Background

- Because U.S. taxpayers are subject to tax on their worldwide income, double taxation may occur on foreign source income
  - Notwithstanding move “toward territoriality” this remains the norm for U.S. taxpayers
- Purpose of the FTC is to provide unilateral relief from double taxation by crediting foreign tax paid or accrued against U.S. tax on foreign source income
  - Historically, an offset of $1 of foreign tax against $1 of U.S. tax was generally allowed, and this continues to be the case for most foreign taxes
  - New GILTI provision departs from direct dollar-for-dollar offset

Impact of Source Rules

Background on Source Rule

- FTCs can only offset U.S. tax on foreign source income
- The source of income and expenses is therefore critical to the FTC analysis
- Sections 861-865 set out various rules for sourcing income and expenses
- Examples:

Interest income generally sourced to location of payor

Sales of non-inventory property generally sourced to location of seller

Interest expense generally apportioned based on tax book value of taxpayer's assets

Income from services generally sourced to location provided

Income from rentals or royalties generally sourced based on location of property

Summary of Changes After TCJA

Summary of Changes After TCJA

What's New:

- Two new baskets – GILTI and foreign branch income (QBUs)
- Section 904(b)(4) pulls expenses allocable or apportioned to §245A stock/dividends out of §904 computation
- FMV apportionment of interest expense not allowed – tax bases of assets required
- FTCs for withholding taxes on CFC dividends often restricted
- No pooling of taxes (only current year relevant) and no §902
- New inventory manufacture/production source rule: if production in the US, 100% US source even if sales outside the US

New Inventory Source Rule – §863(b)

- Section 863(b) was changed by the TCJA to source 100% of income from the sale of inventory property produced by the taxpayer by the place of production/manufacture
  - Result is that if taxpayer manufactures the inventory property in the U.S., 100% of the sale proceeds will be treated as U.S. source even if the sale occurs outside the U.S.
  - Reverse is true: i.e., sale proceeds from the sale within the U.S. of inventory property the taxpayer manufactured outside the U.S. is 100% foreign source
- Prior rule generally sourced the sales proceeds 50% from the place of manufacture and 50% from the place of sale applying the title passage rule

Summary of Changes After TCJA

What's Unclear Under TCJA Changes:

- Does look-through apply to GILTI? If so, how?
- Allocation of expenses to the GILTI basket
- Characterization of CFC stock for expense apportionment and §904(b)(4) purposes where §245A applies
- How are "business profits" of a foreign branch determined?
- Interaction of Financial Services and the Foreign Branch Basket
- Interaction of Foreign Branch Basket and new production source rule
- Any FTCs ever allowed with respect to §956 inclusions?
- Transition Rules, e.g., carryover credits earned in pre-2018 years

Subpart F FTC Considerations

Foreign Tax Considerations

Section 960 – Modified Deemed Paid Credits

TCJA Changes

- Prior to TCJA, former §960(a) provided a deemed paid credit for taxes with respect to subpart F inclusions
  - The inclusion was treated as if it were a dividend so that foreign taxes were deemed paid under §902
- New §960(a) generally provides that, if foreign income is included in the gross income of a U.S. corporation under §951, the U.S. corporation is deemed to have paid so much of the CFC's current year foreign income taxes as are "properly attributable" to such item of income

Section 960 – "Properly Attributable"

- How to determine the amount of foreign taxes that are "properly attributable"?
  - Unlike pooling, the "properly attributable" standard is based on facts that tie the current year foreign taxes to the current year foreign income
  - The term "properly attributable" is not defined by statute
  - Questions raised by:
    - Timing differences with local tax laws or local tax year
    - Disregarded transactions
    - CFC taxes deferred under the §909 "splitter" rules
    - Section 956 inclusions

Section 960 – PTI Distributions

TCJA Changes

- New §960(b) allows deemed paid FTCs for foreign taxes "properly attributable" to PTI distributed through a chain to a US Shareholder from a CFC or to a CFC from another CFC and not already deemed paid
  - Similar to old §960(a)(3)
- New §960(c) increases foreign source income for purposes of the §904(a) limitation by the lesser of
  - The amount of foreign taxes paid or deemed paid with respect to distributed PTI
  - The unused balance of its "excess limitation account" carried forward from prior years
  - Similar to old §960(b)
  - Statute omits any reference to GILTI

Section 960 – PTI Distributions

TCJA Changes

- Proposed §965 regulations provide that only foreign taxes imposed on an upper-tier corporation on distributions of §965 PTI can be credited under old §960(a)(3)
  - No foreign taxes that were paid with respect to earnings treated as PTI as a result of deficit sharing under §965 and would have been deemed paid if the earnings had been included under §965 may be credited
  - Raises significant issue of statutory construction, similar to issue in pending *Ingersoll Rand* case
  - Proposed regulations reserve on treatment under new §960(b), but preamble says government expects to take a similar approach

GILTI Basket FTC Considerations

Foreign Tax Considerations

Foreign Tax Considerations

- Minimizing local tax on operations continues to be important, as it was in most cases prior to TCJA in light of deferral, because taxes imposed on GILTI are only creditable up to 80%

- Many taxpayers will also have excess GILTI basket FTCs, which have limited value

  - Because GILTI basket FTCs cannot be carried forward, if the FTCs are not used in the year paid or deemed paid, they have no value

- Acquisition structures should take impact of GILTI basket FTC posture into account (e.g., through financing structures or amortization of intangibles)

Excess GILTI Basket FTCs

General Considerations

- Many taxpayers will find themselves with excess FTCs in the GILTI basket in most years
  - Depends in part on expense allocation rules and whether §904 look-thru is extended to the GILTI basket
- Because FTCs in the GILTI basket cannot be carried back or forward, such excess FTCs are essentially a wasted tax attribute
  - Companies should seek to minimize their foreign taxes related to tested income
  - Should also think about planning opportunities to use any excess GILTI credits because they are a wasting attribute that cannot be carried forward
  - If in an excess limitation posture think about how to use it strategically

Value of Excess GILTI Basket FTCs in a Disposition

- The optimal result in a taxable disposition generally will be that the recognized gain is characterized as GILTI income so that the income is subject to the reduced GILTI rate rather than the full 21% corporate tax rate

- If there is little or no foreign tax on the disposition, which may often be the case,

  - and there are excess GILTI basket FTCs available to cover all or a portion of the gain generated on the disposition,

  - it may be possible to reduce or eliminate the U.S. tax cost of the disposition

Excess GILTI Basket FTC Considerations

Factors Potentially Increasing Value of Excess GILTI Basket FTCs	
Growth	Disproportionate growth in low-tax jurisdictions would reduce excess GILTI basket FTCs
Disposition in Future	A large foreign disposition could generate substantial GILTI without local taxes, providing an opportunity to utilize otherwise excess GILTI FTCs for that same taxable year
Audit Protection	Significant excess GILTI basket FTCs may reduce the incentive for the IRS to propose certain adjustments, including for example increasing royalties or similar flows if such flows are treated as GILTI, valuation issues, or challenging transactions that are intended to be non-taxable
Rate Increase	GILTI effective rate will increase to 16.4% in 2025, meaning the capacity to use GILTI basket FTCs will increase, and GILTI effective rate may also be increased through legislation
Expense Allocation	In addition to the potential for a change to the expense allocation rules, a significant taxable acquisition in the U.S. could reduce the expenses allocated to the GILTI basket, creating capacity to use additional GILTI basket FTCs

Maximizing Future GILTI Basket FTCs in an Acquisition

- A key consideration in planning and structuring an acquisition is the value to acquiror of generating net excess FTCs in the GILTI basket
  - The amount of GILTI basket net excess FTCs generated by a target post-acquisition depends primarily on:
    - the effective rate of the target and,
    - for a company with intangibles,
      - where those intangibles are held in the group
      - whether amortization is available for U.S. and local tax purposes on the intangibles and/or goodwill
      - whether §901(m) applies to any U.S. step-up on the intangibles and/or goodwill
  - In many cases, there will be GILTI basket net excess FTCs because of the low GILTI rate
- If Acquiror already has significant excess GILTI basket FTCs before taking into account any additional excess GILTI basket FTCs related to a target, the value of such incremental excess FTCs may be minimal, unless there is a disposition as discussed above or other change in circumstances

Summary of the Summary

INCLUSION MECHANISM COMPARISON

Order of Application	Step 1: Determine Subpart F income (CFC calculation)	Step 2: Determine GILTI (CFC) (Does not include Subpart F income but no exclusion for §956 amounts) (US SH level calculation)	Step 3: Determine any 956 amounts to be included under §956/951(a)(1)(B) to extent earnings not already taxed under GILTI	Step 4: Determine DRD (Corporations only) Qualifying Distributed Untaxed e&p
FTC Percentage Allowed	100%	80%	Unclear – 100% if any foreign taxes "properly attributable"	None (including withholding taxes)
FTC Basket (General, Passive, GILTI, Foreign Branch, Treaty)	General or passive	Separate GILTI basket except for passive (FPHCI)	Likely general or treaty (Passive and GILTI come first)	N/A
FTC Basket - Interest expense allocation	Applies	No express exclusion - Applies unless guidance says otherwise	Applies	Impact under §904(b)(4)
FTC carryover/ carrybacks	General rule applies - §904(c) (1 year back/10 forward)	None	General rule applies - §904(c) (1 year back/10 forward)	N/A
Timing	Current	Current	Upon U.S. investment, but proposed §956 regulations reduce inclusion to the extent §245A would apply	Never
Rate	21%	10.5% (or higher if §250 deduction is limited)	21%	0%

INCLUSION MECHANISM COMPARISON (CONTINUED)

Order of Application	Step 1: Determine Subpart F income (CFC calculation)	Step 2: Determine GILTI (CFC) (Does not include Subpart F income but no exclusion for §956 amounts) (US SH level calculation)	Step 3: Determine any 956 amounts to be included under §956/951(a)(1)(B) to extent earnings not already taxed under GILTI	Step 4: Determine DRD (Corporations only) Qualifying Distributed Untaxed e&p
Elective High Tax Exception (§954(b)(4)) for FBCI/Insurance Income	18.9% (.21 x .90) Not subpart F income if elected	If high tax election, not included as GILTI	e&p from high tax election	e&p from high tax election but no tax on dividends and no FTCs
No election and subject to subpart F	§78 gross-up applies under §960(a)	§78 gross-up (100%) added to GILTI inclusion (regulations expected to put in GILTI basket)	§78 gross-up applies under §960(a)	No DRD for §78 gross-up dividend
Effect of "loss CFC"	Chain deficit rule applies to reduce e&p if qualified deficit	Shared to offset tested income of other CFCs Wipes out FTC and QBAI of the loss CFC	No inclusion from CFC without net positive e&p	N/A

Section 905(c) Adjustments

Section 905(c) Background

- Section 905(c) provides rules for taking into account foreign tax redeterminations – when the amount of foreign tax ultimately paid differs from the FTCs accrued or the foreign tax is not paid within two years of the accrual

- Historically, required amended returns for changes to §901 “direct” FTCs, but foreign tax redeterminations with respect to CFCs were generally just taken into account in the §902 earnings and FTC pools in the year the redetermination occurred, not the year to which the tax was factually related

Changes to Section 905(c)

- Section 902 pooling repealed
- Section 905(c) adjustments to all foreign taxes will apparently require filing an amended return for the year with respect to which the adjustment is made
- What to do about closed years pre-2018?
  - TCJA effectively retroactively changes the rules for these years
  - Raises statute of limitations issues for CFC foreign tax audits related to years before 2008
- For ongoing lengthy foreign audits, file protective returns to keep statute of limitations open

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