International Tax Developments

Selected Outbound Aspects of Tax Reform

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AGENDA

There have been a number of important developments this past year with respect to the outbound aspects of the TCJA, including new guidance in the following areas:

1. **FDII**
2. **GILTI**
3. **PTI/PTEP**
4. **Section 245A**

This session will focus on key elements of this new guidance and seek to address open questions and issues based on our experiences so far

Foreign Derived Intangible Income – Section 250

Overview

- Treasury and the IRS issued proposed regulations under Section 250 on March 4, 2019 (REG-104464-18), providing computational, definitional, and ordering rules with respect to the deductions allowed for FDII and GILTI
- Prop. §1.250(a)-1 provides definitions and also rules for determining the amount of the deduction and section 250(a)(2) taxable income limitation;
- Prop. §1.250(b)-1 provides general FDII computational rules;
- Prop. §1.250(b)-2 provides QBAI rules for FDII purposes;
- Prop. §1.250(b)-3 provides general rules for the determination of gross foreign-derived deduction eligible income ("gross FDDEI"), a component of FDII;
- Prop. §1.250(b)-4 provides rules for determining gross FDDEI from sales of property;
- Prop. §1.250(b)-5 provides rules for determining gross FDDEI from the provision of a service; and
- Prop. §1.250(b)-6 provides rules relating to the sale of property or the provision of a service to a related party

Proposed Ordering Rules for Deductions

- As a result of the Proposed FDII Regulations and the Proposed Section 163(j) Regulations, a domestic corporation will determine its deductions under section 163(j), 172(a), and 250 pursuant to a Five Step Process:
  1. Computation of (a) tentative FDII amount and (b) "tentative section 250 deduction" taking into account all deductions but without regard to section 163(j) carryforwards or disallowances, section 172(a) NOL deduction, or section 250(a)(2) taxable income limitation;
  2. Computation of allowable business interest deduction, (a) taking into account tentative section 250 deduction (b) but without regard to NOL deduction;
  3. Computation of section 172(a) NOL deduction, (a) taking into account section 163(j) allowable business interest deduction, (b) taking into account section 172(a)(2) taxable income limitation, (c) but without regard to amount of section 250 deduction (including tentative section 250 deduction;

Proposed Ordering Rules for Deductions

4. Computation of FDII amount, taking into account section 163(j) allowable business interest deduction (see Step 2) and NOL deduction (see Step 3) and properly allocating deductions to gross DEI and gross FDDEI;
5. Computation of section 250 deduction after application of section 250(a)(2) taxable income limitation, taking into account section 163(j) allowable business interest deduction (see Step 2) and NOL deduction (see Step 3)

- ***Comments are requested on these proposed ordering rules***

FDII Computational Rules

- FDII = Deemed Intangible Income (DII) x Foreign-Derived Ratio;
- DII = Deduction Eligible Income (DEI) – Deemed Tangible Income Return (DTIR)
- Domestic corporation's DTIR = such corporation's QBAI x 0.10;
- Foreign-Derived Ratio = Foreign-derived deduction eligible income (FDDEI)/DEI
- DEI = excess of gross income without regard to certain excluded items ("Gross DEI") over the deductions properly allocable to Gross DEI;
- Gross DEI excludes: (1) any amount included in gross income under section 951(a), (2) GILTI, (3) financial services income, (4) dividends from CFCs, (5) domestic oil and gas extraction income, and (6) foreign branch income
- The computational rules include guidance on allocations and apportionment, treatment of costs of goods sold,

QBAI Rules for FDII Purposes

- Computational rules are similar, but not identical, to those used to compute QBAI for GILTI;
- A domestic corporation's QBAI for FDII is equal to its aggregate average adjusted bases in specified tangible property, which is defined as tangible property used in the production of gross DEI;
- *Domestic QBAI Anti-Abuse Rule*: The Regulations disregard certain transfers of specified tangible property by a domestic corporation to a related party where the corporation continues to use the property in production of gross DEI (two-year review period + "a principal purpose" test in analyzing transfer/lease arrangements, with a per se rule applying to transfers and leases occurring within the same 6-month period;

FDDEI

- The proposed regulations define “sale” to include a lease, license, exchange, or other disposition of property, including a transfer of property resulting in gain or an income inclusion under section 367;
- Proposed rules are set forth relating to determining foreign person status, foreign use, documentation and reliance, application of knowledge and reason to know limitations in reliance, combined sales/services transactions
- Many of these rules are tailored to either the provision of services or sales
- Special sales rules apply to “fungible mass” sales, sales of transportation property for foreign use, the foreign use of intangible property, and lump sum sales of intangibles;
- Special services rules distinguish between (a) services where the service provider and the recipient are in physical proximity when the service is performed (“proximate services”), (b) services with respect to tangible property (“property services”), (c) services to transport people or property (“transportation services”), and (d) all other services (“general services”)

FDDEI

- No special “domestic intermediary rules” (see section 250(b)(5)(B)) are set forth in the proposed regulations, because those rules are encompassed within the general rules relating to FDDEI sales and FDDEI services

Related Party Transactions

- While a sale of property or a provision of a service may qualify as a FDDEI transaction, regardless of whether the recipient of such service is a related party of the seller or services renderer, Prop. §1.250(b)-6 provides additional requirements that must be satisfied for the transaction to qualify as a FDDEI sale or FDDEI service;
- If a foreign related party resells purchased property (such as where the foreign related party is a distributor or a manufacturer of a product that incorporates the purchased property as a component), the sale to the foreign related party qualifies as a FDDEI sale only if an unrelated party transaction with respect to such sale occurs and the unrelated party transaction is a FDDEI sale

Related Party Transactions

- The rules applicable to related party sales apply only to determine whether sales of general property qualify as a FDDEI sale. In contrast, sales of intangible property, whether to a related or an unrelated party, are for a foreign use only to the extent that the intangible property generates revenue from exploitation outside the United States;
- Under a proposed “related party services rule,” the provision of a general service to a business recipient that is a related party qualifies as a FDDEI service only if the service is not substantially similar to a service provided by the related party to persons located within the United States. Detailed rules are provided for this determination;

Key Takeaways

- The Proposed Section 250 Regulations provide that “taxable income” under section for individuals making a section 962 election is reduced by the section 250 deduction that would be allowed to a domestic corporation for their GILTI and attributable the section 78 gross-up; closely held foreign corporations and private equity will take notice;
- It is proposed that foreign military sales or services to the US government under the Arms Export Control Act will be treated as a sale of property or provision of a service to a foreign person;
- The Proposed Section 250 Regulations provide that a domestic corporate partner of a partnership takes into account its distributive share of a partnership’s gross DEI, gross FDDEI, and deductions in order to calculate the partner’s FDII;
- Foreign use may be established for a portion of fungible mass property or intangible property, but not for general property;
- The foreign related party resale rule looks to the ultimate resale of the property, mirroring section 250(b)(5)(B)(i) for sales to domestic related parties

Applicability Date

- Proposed §§1.250(a)-1 through 1.250(b)-6, as well as the associated proposed information reporting provisions, are proposed to apply to taxable years ending on or after the date on which they are filed in the Federal Register;
- However, a "reasonable documentation maintained in the ordinary course of the taxpayer's business" transition rule is provided for taxable years beginning on or before the general Applicability Date, provided that such documentation meets the reliability requirements described in proposed §1.250(b)-3(d);
- Proposed §1.962-1(b)(1)(i)(B)(3), which allows individuals making an election under section 962 to take into account the section 250 deduction, is proposed to apply to taxable years of a foreign corporation ending on or after the general Applicability Date, and with respect to a U.S. person, for the taxable year in which or with which such taxable year of the foreign corporations ends;
- Taxpayers may rely on proposed §§1.250(a)-1 through 1.250(b)-6 and §1.962-1(b)(1)(i)(B)(3) for taxable years ending before the general Applicability Date

- **Application Issues/Open Questions**
  - Foreign use rules provide welcome relief, including acceptance of reasonable documention for pre-reg positions
  - Clarifies that services rule applies to non-US persons and to property held outside the United States (regardless of where owner resides)
  - Any tension between 50 percent test for transportation property and statutory language – "any" foreign use?
  - Residual concern by taxpayers about longevity which is limiting affirmative planning, e.g., ETI was repealed after 4 years.

Global Intangible Low-Taxed Income (“GILTI”) – Section 951A

Overview: Treasury and the IRS issued proposed regulations under section 951A on September 13, 2018 ("Proposed GILTI Regulations"). The proposals addressed multiple issues, with key sections of the guidance focusing on:

- Determinations of Pro Rata Share of various "CFC Tested Items" (i.e., Tested Income, Tested Loss, QBAI, Tested Interest Expense, and Tested Interest Income) and new pro rata rules for both subpart F and GILTI
- Computation of CFC Tested Items
- Prevention of Abuse
- Guidance on GILTI-Related Basis Adjustments
- Special Rules for Partnerships and Consolidated Groups

Pro Rata Share Determinations: While sections 951(a)(1)(A) and section 951A(a) ultimately operate differently, the Proposed GILTI Regulations, in accordance with section 951A(e), incorporate (and propose to amend) the pro rata share determination rules of section 951(a)(2) and §1.951-1(b) and (e), "with appropriate modifications." Accordingly, the Hypothetical Distribution construct is applied to both subpart F and GILTI

Pro Rata Share Anti-Abuse Rule: Prop. Treas. Reg. Sec. 1.951-1(e)(6) provides that any transaction or arrangement that is a part of a plan "a principal purpose" of which is the avoidance of Federal income taxation (including, but not limited to, avoidance through the reduction of a US Shareholder's pro rata share of the subpart F income or GILTI of a CFC) is "disregarded" in determining such US Shareholder's pro rata share of the subpart F income or GILTI of the corporation

Key Takeaways:

- Despite difference between the subpart F regime and the GILTI regime, section 951A(e)(1) and the Proposed GILTI Regulations adopt the pro rata determination rules of section 951(a)(2) and Treas. Reg. §1.951-1(b) and (e), and then apply necessary modifications

- Proposed Treas. Reg. §1.951-1(e) includes pro rata share determination rules – as well as an anti-abuse rule – applicable to both regimes

- Under the Proposed GILTI Regulations, pro rata share determinations with respect to CFC Tested Items for a "U.S. shareholder inclusion year" are made with respect to "section 958(a) stock" owned on the "CFC inclusion date"; these are all new terms meant to accommodate the purposes of the GILTI Regime

Application Issues/Open Questions:

- Consequences of the application of Prop. Treas. Reg. Sec. 1.951-1(e)(6), anti-abuse rule may be uncertain. For example, as a result of disregarding transactions might a US person be treated as a US Shareholder of a CFC on the last day of the taxable year in which the entity is a CFC even though such person owns no direct or indirect interest on such day? Might examples be forthcoming?

- Does the term “CFC inclusion date” and the associated rules create asymmetry between the GILTI and subpart F regimes? Commentators have suggested that this concept may create significant administrative and computational burdens

Computations of Tested CFC Items:

- As with the approach to the determination of pro rata share of CFC Test Items, the Proposed GILTI Regulations generally adopt the subpart F regime's computational rules, but then make modifications necessary to accommodate the GILTI regime

- Among the modifications are rules providing for coordination with section 952(c) and with the amended foreign tax credit rules

- The Proposed GILTI Regulations introduce the concept of "specified interest expense" for the purposes of applying section 951A(b)(2)(B) and determining Net Deemed Tangible Income Return. For the purposes of defining specified interest expense (an item that will reduce a US Shareholder's Net Deemed Tangible Income Return), expense associated with interest that is paid to a sister CFC and that is includible in the US Shareholder's net CFC Tested Income is excluded, but that same expense would not be excluded if the interest were directly paid to, and included in the income of, the US Shareholder

Application Issues/Open Questions:

- Might double taxation arise as a result of the application of the coordination rules with section 952 under Prop. Reg. Sections 1.951A-2(c)(4) and 1.951A-6(d)?

- Commentators have questioned the logic of this result and, while acknowledging potential statutory constraints, have suggested that Treasury and the Service may have sufficient authority to change this result in the final regulations

- How is the “predominately incurred in consideration of the time value of money” standard of Prop. Reg. Sec. 1.951A-4(b)(ii) to be applied to the determination of “interest expense”? How does it coordinate with other recent iterations of this rule (e.g., proposed regulations under sections 163(j) and 267A and temporary regulations under section 861), or with other US tax rules used to identify interest income and expense?

- Should Interest Expense and Interest Income of a Tested Loss CFC be used in the determination of “specified interest expense” if such CFC’s specified tangible property is not utilized for QBAI calculation purposes?

GILTI Anti-Abuse Rules

1. ***QBAI – Principal Purpose Temporary Transfers***

- If a CFC (i) acquired specified tangible property with a principal purpose of reducing the GILTI inclusion amount, and (ii) holds the property temporarily, the property is disregarded in determining the CFC's average adjusted basis in specified tangible property for purposes of determining the acquiring CFC's QBAI. Prop. Treas. Reg. Sec. 1.951A-3(h)(1)

- Property held for less than one year is irrebuttably deemed to be both temporarily held and acquired with a principal purpose of reducing the GILTI inclusion amount if the acquisition results in a reduction of the GILTI inclusion amount

GILTI Anti-Abuse Rules, cont'd

2. *Pre-GILTI Effective Date Transfers and QBAI Determinations*

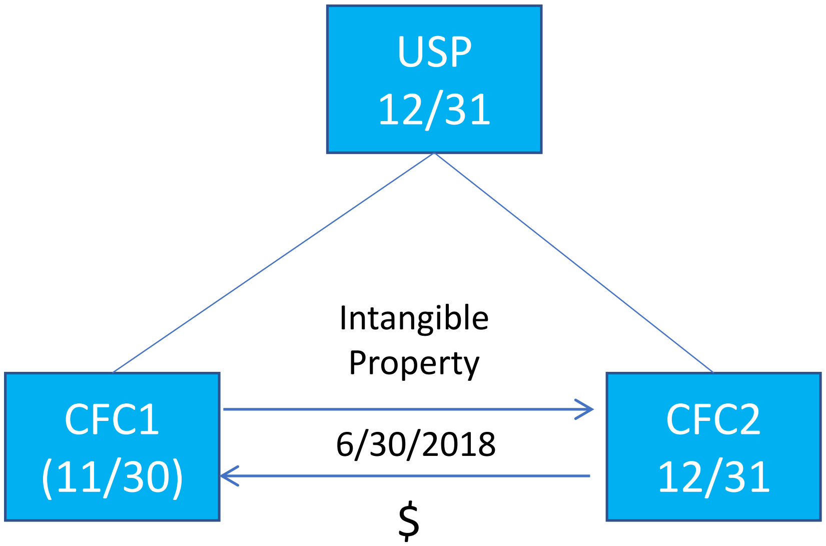
- In applying ADS under Section 168(g) to determine adjusted basis, any disqualified basis with respect to the specified tangible property is not taken into account. Prop. Treas. Reg. Sec. 1.951A-3(h)(2)
- "Disqualified basis" is the excess of the property's adjusted basis immediately after a "disqualified transfer" over the adjusted basis immediately before such transfer plus the "qualified gain amount"
  - The "qualified gain amount" is generally any taxable gain recognized by the CFC or US Shareholder on the disqualified transfer such as under subpart F
- A "disqualified transfer" is generally any transfer to a related person that takes place during the pre-GILTI effective date period starting on January 1, 2018 and that results in gain being recognized by the transferor with respect to the transferred specified tangible property.

GILTI Anti-Abuse Rules, cont'd

3. ***Pre-GILTI Effective Date Transfers and Tested Income/Loss Determinations***

   - Any deduction or loss attributable to disqualified basis of any "specified property" is disregarded for purposes of determining tested income or tested loss of a CFC. Prop. Treas. Reg. Sec. 1.951A-2(c)(5)

   - This rule applies more broadly than the prior rule because it applies to "specified property" instead of "specified tangible property," which covers both tangible and intangible property



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Application Issues/Open Questions:

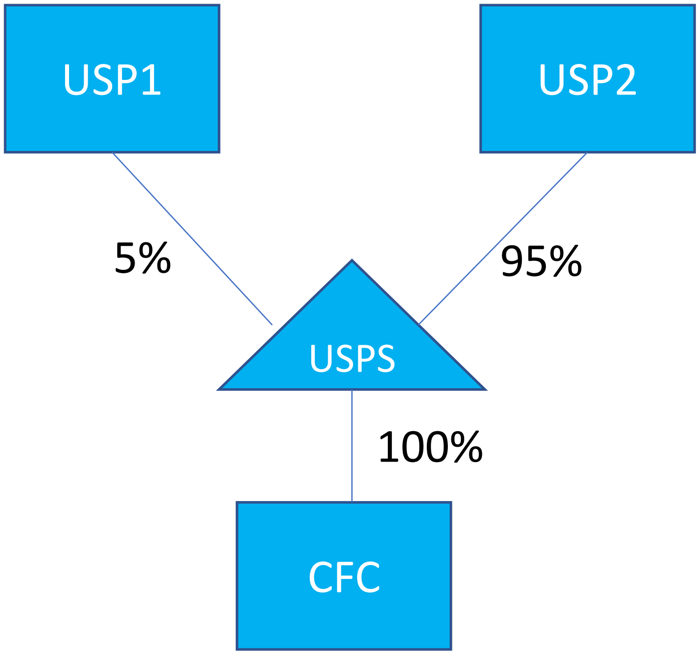
- Coordination of the "disqualified transfer" basis rules of Prop. Reg. Section 1.951A-3(h)(2) and the covered asset acquisition rules of section 901(m) to avoid a double penalty for taxpayers

- Commentators have voice concern that it is unclear how long an ownership period can be and still be "temporary" for purposes of Prop. Treas. Reg. Sec. 1.951A-3(h)(1)

Partnerships:

- Instead of using a pure entity or aggregate approach, the proposed regulations instead use a hybrid approach that treats a domestic partner as directly holding CFC stock held by a domestic partnership if the domestic partner is indirectly a US shareholder with respect to the CFC (an aggregate approach). Prop. Treas. Reg. Sec. 1.951A-5

- Partners that are not indirect US shareholders are not treated as directly holding the CFC stock (an entity approach)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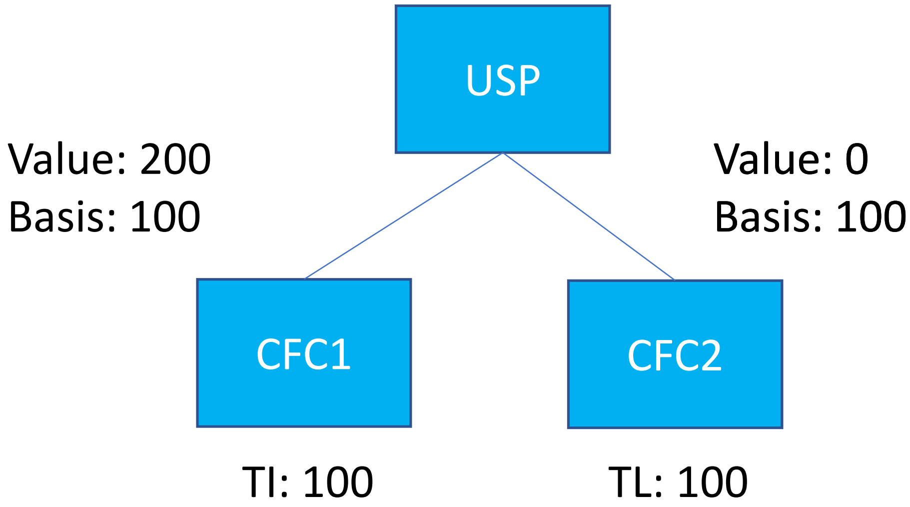
CFC

Application Issues/Open Questions:

- Commentators have voice concern that partners that are non-U.S. shareholder partners of one or more partnership CFCs (a) cannot offset their share of the partnership GILTI inclusion amount with unused Tested Losses or excess NDTIR from non-partnership CFCs and (b) will also lose the opportunity to use Tested Losses or NDTIR from partnership CFCs against Tested Income from non-partnership CFCs

- Will the need for each US Shareholder partnership to determine whether each of its partners is a US Shareholder partner or a non-US Shareholder partner for each partnership CFC present significant administrative and compliance burdens?

Adjustments to Basis for Net Used Tested Losses (Prop. Treas. Reg. Sec. 1.951A-6(e))



Cash Redeployment – Section 245A(e) and PTEP

- **Cash Redeployment, Generally**
  - Anticipate that US companies will be repatriating more of their foreign earnings post-tax reform
    - In 2018, it is estimated that US companies brought back half a trillion dollars
  - Two main factors
    - Section 245A
      - By enacting the participation exemption, Congress wanted to encourage US companies to bring back foreign earnings
    - PTI
      - Companies have significant amounts of Section 965 PTI that can be brought back without additional US tax
      - Going forward, companies will have a lot more PTI as a result of GILTI

Section 245A(e)

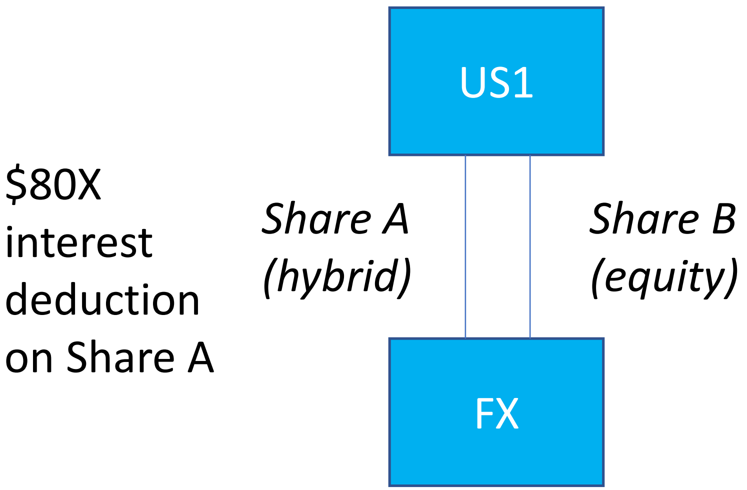
- **Overview**
  - Treasury and the IRS issued proposed regulations under Section 245A addressing hybrid dividends on December 20, 2018
    - Further guidance on Section 245A originally expected in April 2019
  - Amount of hybrid dividend to extent of sum of “hybrid deduction accounts” with respect to each share of stock of the CFC determined at the close of the CFC’s taxable year
    - Shareholder must maintain a hybrid deduction account with respect to each share which reflects the amount of hybrid deductions of the CFC allocated to the share
    - Intended to account for situations where dividend and hybrid deduction do not arise pursuant to the same payment and may occur in different taxable years

- **Key Takeaways**
  - "Hybrid deduction" is broadly defined
    - Deduction ***or other tax benefit*** such as an exemption, exclusion, or credit, to the extent equivalent to a deduction
    - The deduction or tax benefit is allowed to the CFC ***or a person related to the CFC***
  - The deduction or other tax benefit must be related or result from an amount paid, accrued, or distributed with respect to an instrument treated as stock for US tax purposes
    - Does not include an exemption provided to a CFC under its tax law for certain types of income (such as income attributable to a foreign branch) because there is no connection between the tax benefit and the instrument that is stock for US tax purposes

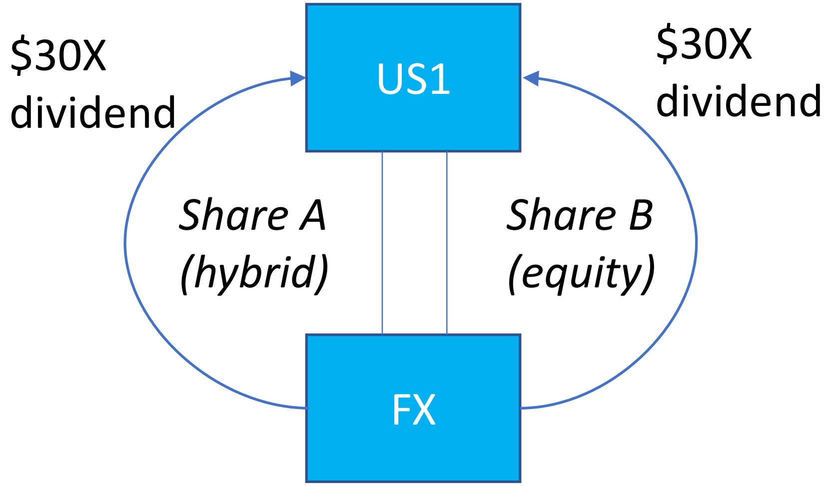
- **Key Takeaways, cont'd**
  - Clarified that distributions of PTI cannot constitute hybrid dividends, including in tiered CFC context
  - To the extent a Section 964(e) dividend would be a tiered hybrid dividend, Section 245A(e) applies first and no deduction is allowed under Section 964(e)(4)

- **Applicability Date**
  - Proposed regulations apply to distributions made after December 31, 2017

Year 1



Year 2



Result

- Entire $60X dividend is treated as hybrid dividend even though no hybrid deductions are allocated to Share B
- Regulations remove link between dividend and deduction so even distribution on non-hybrid instrument is tainted

- **Application Issues/Open Questions**
  - Planning in light of anti-avoidance rule, e.g., purposefully failing the holding period requirement
  - Commentators have called for delaying the effective date for hybrid deduction accounts to distributions occurring after December 31, 2018, instead of 2017
    - Taxpayers that made distributions in 2018 on non-hybrid instruments may have been unexpectedly subject to rules
    - No notice that account mechanism would apply until proposed regulations released
  - Treasury and IRS requested comments on whether hybrid deduction accounts should be reduced by PTI (or not be increased by deductions attributable to Subpart F or GILTI)

- **Application Issues/Open Questions, cont'd**
  - Definition of hybrid deduction could include a deduction attributable to group relief
    - Includes a notional interest deduction, contrary to OECD
  - With respect to tiered dividends, does not consider treatment of payment in foreign jurisdiction of recipient
    - Payment of interest may be fully includable in income of recipient so no net benefit from deduction
  - Includes tax benefits equivalent to a deduction, such as certain refunds to the shareholder of a CFC for taxes paid by the CFC
    - No hybrid deduction if shareholder either is a resident of CFC's country and includes the distribution in income or, if not a resident, is subject to WHT on the dividend
    - Earnings that fund the distribution must be included in income under the CFC's tax law under Section 267A principles

- **Application Issues/Open Questions, cont'd**
  - Further incentive to exit historic hybrid financing structures, e.g., CPECs, and instead switch to non-hybrid, but still low-rate financing structures
    - One recent Form 10-K filing of US multinational on impact of BEPS: "One impact for the Company is that the group's Dutch hybrid financing structure will no longer be effective as of January 1, 2019. The Company is in the process of establishing new treasury function in Switzerland but this change will give rise to an increase in our effective tax rate."

PTEP

- **Overview**
  - Proposed Regulations are still forthcoming but Treasury and the IRS issued Notice 2019-01 on December 14, 2018, which previewed proposed regulations
  - Important to update 2006 proposed regulations and provide additional guidance after tax reform given amount of PTI in the system
  - PTI now referred to as "PTEP" – previously taxed E&P

Under the new proposed regulations, the annual PTEP account must now be segregated into 16 groups to account for all of the new types of PTEP

Section 959(c)(1) PTEP	Section 959(c)(2) PTEP
Reclassified Section 965(a) PTEP	Section 965(a) PTEP
Reclassified Section 965(b) PTEP	Section 965(b) PTEP
Section 951(a)(1)(B) PTEP	Section 951A PTEP
Reclassified Section 951A PTEP	Section 245A(e)(2) PTEP
Reclassified Section 245A(e)(2)	Section 959(e) PTEP
Reclassified Section 959(e) PTEP	Section 964(e)(4) PTEP
Reclassified Section 964(e)(4) PTEP	Section 951(a)(1)(A) PTEP
Reclassified Section 951(a)(1)(A) PTEP	
Section 956A PTEP	

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- **Key Takeaways**
  - Distributions from any PTEP group reduce stock basis under Section 961(b) regardless of how the basis was created under Section 961(a), including due to an inclusion unrelated to the PTEP group being distributed
  - A distribution of PTEP only occurs to the extent it would otherwise have been a dividend under Section 316
  - Generally, a LIFO approach to PTI, but subject to a priority rule for Section 965 PTEP, and otherwise pro rata
  - A current year E&P deficit only reduces Section 959(c)(3) E&P without impacting the amount of Section 959(c)(1) PTEP or Section 959(c)(2) PTEP

- **Applicability Date**
  - Proposed regulations will apply to taxable years of US shareholders ending after December 14, 2018, but taxpayers may elect to apply the rules early

June 30 | **December 31**

Result

- Unclear whether mid-year distribution of non-Section 965 PTEP results in $20 gain at time of distribution under Section 961(b)(2) while basis only increased at the end of the year under Section 961(a)
- Inclusion of specific rules for Section 965 PTEP suggests that gain otherwise must be recognized

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- **Application Issues/Open Questions**
  - Compliance burden
    - Taxpayers have noted compliance burden with all of the new categories that will need to be tracked
      - But certain categories of PTEP will eventually go away, e.g., Section 965 PTEP, and some will be infrequent
    - Possible to simplify or have an elective exception/small business exception?
  - Issues currently addressed by 2006 proposed regulations
    - Treasury and IRS intend to withdraw 2006 proposed regulations
    - Presumably will carryover some of the rules to the new proposed regulations, while changing others

- **Application Issues/Open Questions, cont'd**
  - PTEP distributions between CFCs
    - Unclear whether Section 961(c) is self-executing, but taxpayers generally have taken the position that it is and made corresponding Section 961(a) and (b) adjustments
    - Any changes to position under Section 986(c)(2) that no exchange gain recognized on CFC-to-CFC PTEP distribution based on Notice 88-71?