U.S. TAX REFORM TWO YEARS DOWN THE LINE

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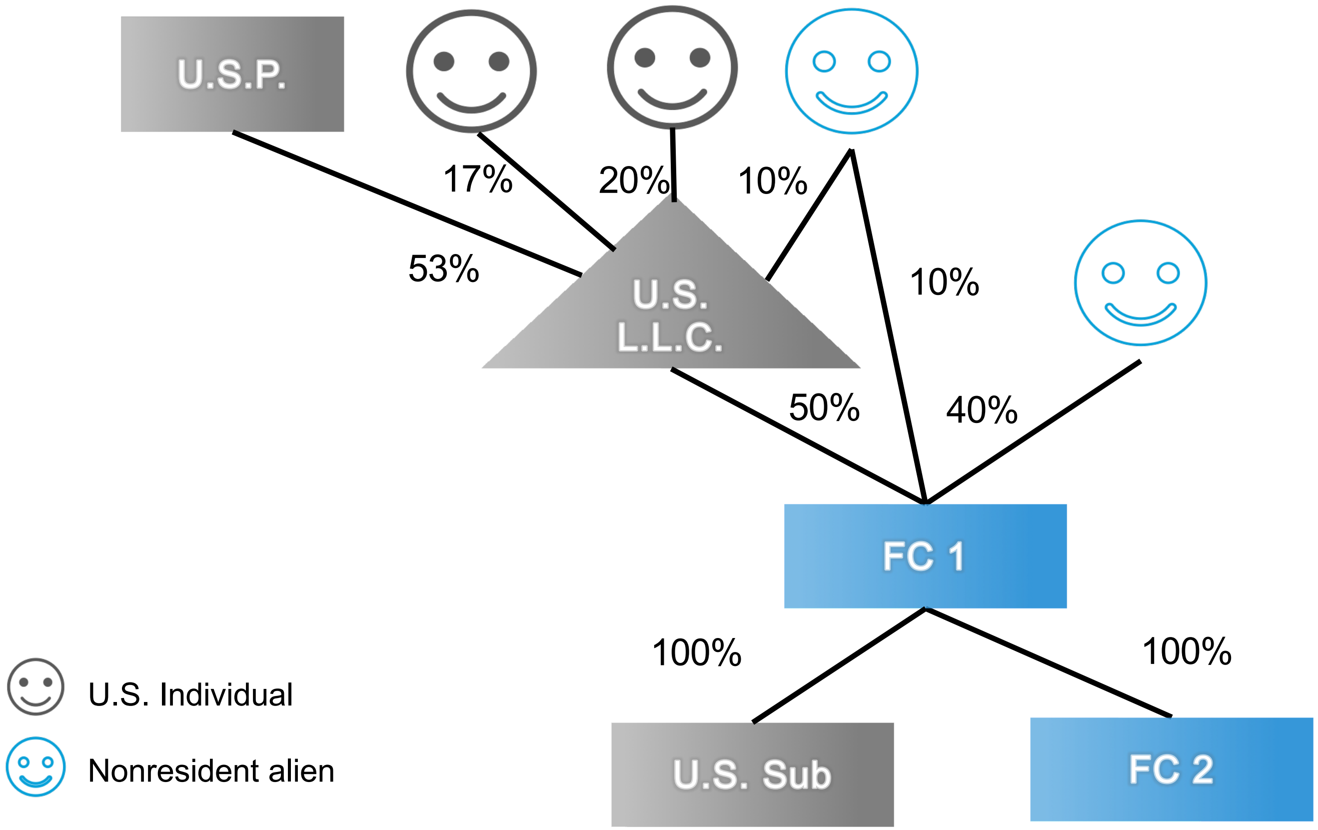
INTRODUCTION

Topics Covered

- Subpart F -- Expansion of C.F.C. ownership rules and its effect of foreign and domestic shareholders
- Elimination of 30-day rule for C.F.C. status and its effect on cross-border families
- G.I.L.T.I. rules for C.F.C.'s, including the high-tax exception
- Code §962 relief for U.S. individuals owning C.F.C.'s
- D.R.D. for foreign dividends and anti-hybrid

SUBPART F – EXPANSION OF C.F.C. OWNERSHIP RULES

Case Study


U.S.P.
17%
20%
10%
53%
U.S. L.L.C.
10%
50%
40%
FC 1
100%
100%
U.S. Sub
FC 2
U.S. Individual
Nonresident alien

Controlled Foreign Corporation

- More than 50% ownership by U.S. Shareholders
  - By vote or value (Always)
- U.S. Shareholder = U.S. person owning 10% or more
  - By vote (always) or value (new)
  - Direct and indirect ownership through foreign entities (§958(a) ownership)
  - Constructive ownership (Code §958(b) ownership)

Code §958(a) Ownership

- Direct ownership
- Indirect ownership through foreign entities in proportion to ownership
- Stock ownership flows through a chain of foreign entities until it is attributed to an individual (U.S. or foreign) or a domestic entity
- Final regulation under G.I.L.T.I. treat a domestic partnership as a foreign partnership for determining §958(a) ownership for income inclusion and as an entity for purposes of determining U.S. Shareholders and C.F.C. status; Proposed regulations to neutralize treatment for Subpart F purposes

Code §958(b) Ownership

- Constructive ownership:
  - From U.S. family members (spouse + lineal; not siblings; not from foreign family member)
  - From corporations in proportion to ownership, once 10% of value is owned
  - From partnerships in proportion to ownership, with no threshold
  - Special rule for chains of ownership:
    - Once a corporation or a partnership own more than 50% of the vote in a lower tier foreign corporation – directly or indirectly – it is deemed to own *all* of the vote in that lower-tier foreign corporation
  - Downward attribution

Downward Attribution; Change

- A partnership is treated as owning all of the shares owned by its partners. No threshold applies
- A corporation is treated as owning all of the shares owned by a shareholder who owns 50% or more of the stock of the corporation
- A trust is treated as owning all of the shares owned by its beneficiaries, unless a beneficiary's interest is a remote contingent interest
- Code §958(b)(4) provided that downward attribution to entities would not apply to attribute ownership from a foreign person to a U.S. person; Repealed in Reform

Effect of Change

- More C.F.C.'s; More U.S. persons subject to filing; More U.S. persons subject to income inclusion
- Income inclusion only with respect to shares owned under Code §958(a)
- U.S. reporting obligations could also apply to constructive owners (§958(b))

Relief from Filing re Foreign Controlled C.F.C.'s

- Relief is available for U.S. Shareholders of "foreign controlled C.F.C.'s" (C.F.C. that would not be a C.F.C. if it wasn't for downward attribution from foreign person)
- Category 1 and Category 5 filers are exempt from filing if:
  - No U.S. shareholder (including the filer) owns interest under Code §958(a) or
  - The filer is an Unrelated Constructive 958(b) U.S. Shareholder
- Category 1, 4 or 5 filers are exempt from filing if:
  - Does not own a direct or indirect interest in the C.F.C.
  - Required to file only because of constructive ownership from nonresident alien

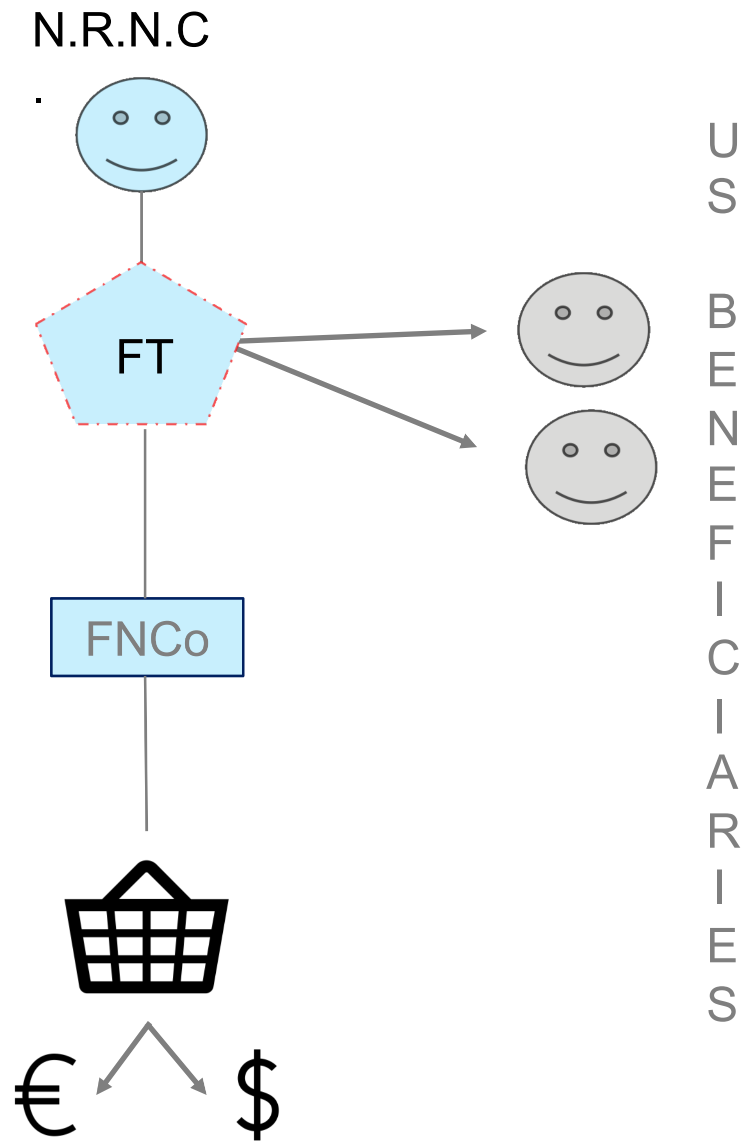
Additional Reporting Relief

- Rev Proc 2019-40 Safe Harbor: a determination that a C.F.C. status does not exist will be accepted if:
  - the U.S. person does not have actual knowledge or statements received that the entity is a C.F.C.
  - There is no reliable publicly available information sufficient to determine that the entity is a C.F.C., and
  - If the U.S. person directly owns an interest in a foreign entity, the U.S. person must engage in further due diligence with the foreign entity in which it owns the interest to determine if it may be a C.F.C., if it owns directly or indirectly (§958(a)) stock in another foreign corporation, or in a domestic entity
- When information is not readily available, an unrelated §958(a) U.S Shareholder may use alternative information in determining income inclusion and other amounts reported on Form 5471 (subject to priority list), provided that the C.F.C. has no related Code §958(a) U.S. shareholder
- Penalty relief for failure to file a under the safe harbor and for accuracy related penalties for amounts based on alternative information

ELIMINATION OF 30-DAY RULE – EFFECT ON CROSS-BORDER FAMILIES

Facts

- N.R.N.C. establishes a revocable trust outside the U.S. The beneficiaries are her U.S.-resident children
- Trust owns one asset: all the shares of FNCo, a non-U.S. corporation
- FNCo owns a portfolio of publicly traded shares issued by non-U.S. and U.S. entities

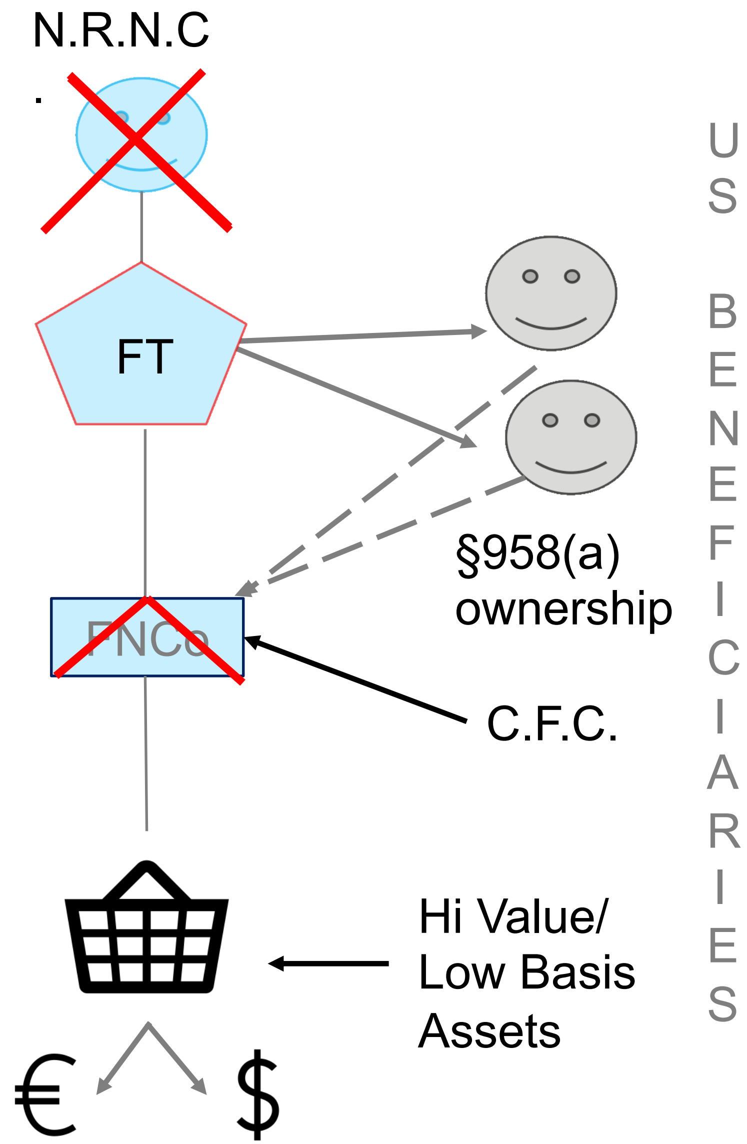


Pre-T.C.J.A. Tax Plan

- During lifetime of N.R.N.C., distributions to U.S. beneficiaries must be reported to I.R.S. but are free of U.S. income tax
- At death, no U.S. estate tax.
- Because trust was revocable during the life of N.R.N.C. settlor, Trust takes a FMV basis in FNCo shares at death of N.R.N.C.
- Tax rules for non-grantor trust begin to apply because trust becomes irrevocable at death of N.R.N.C.
- FNCo is NOT given a step-up at death in the basis of its portfolio
- U.S. beneficiaries are deemed to own FNCo

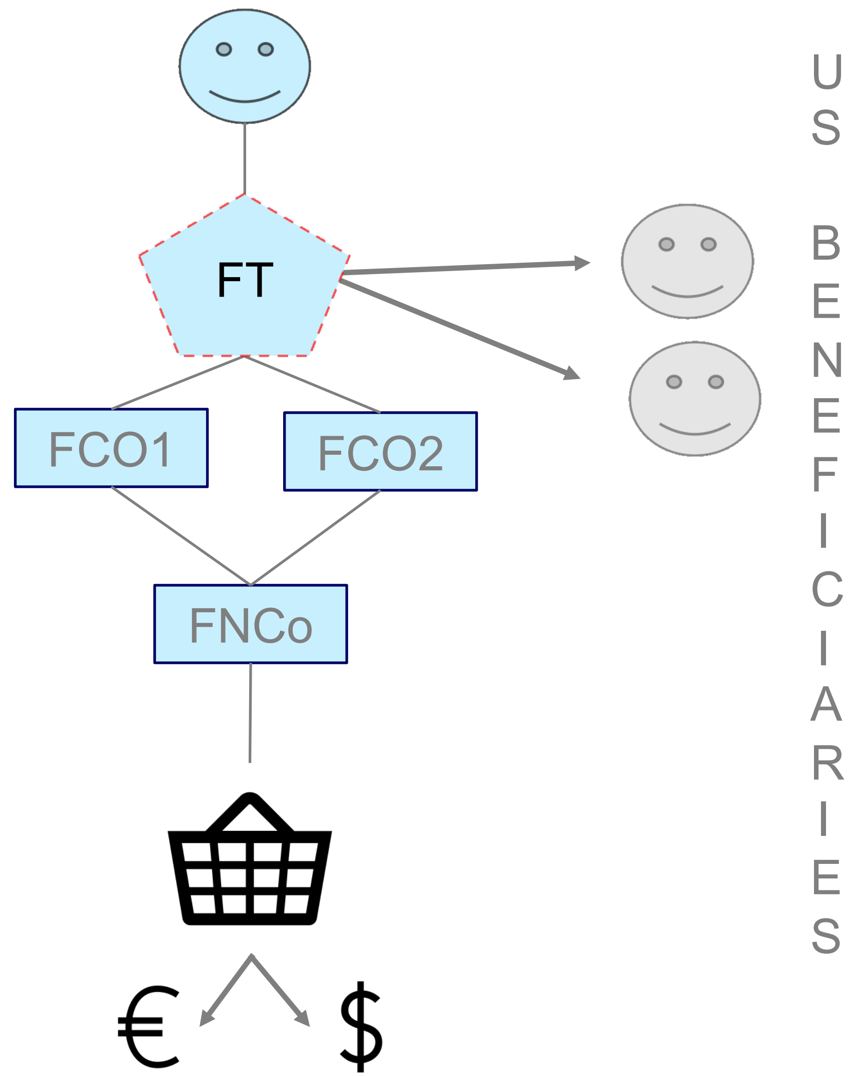
At death of N.R.N.C.

- The goal is to provide a step-up in the investment portfolio of FNCo without tax imposed on Trust or U.S. beneficiaries under Subpart F
- Prior to the T.C.J.A., Subpart F applied to FNCo only if C.F.C. status exceeds 30 days in the year
- FNCo elects to be treated as disregarded entity effective within 30-day period
- Election results in deemed taxable liquidation which yields step-up in basis which is tax-free for FNCo and for U.S. beneficiaries of FT



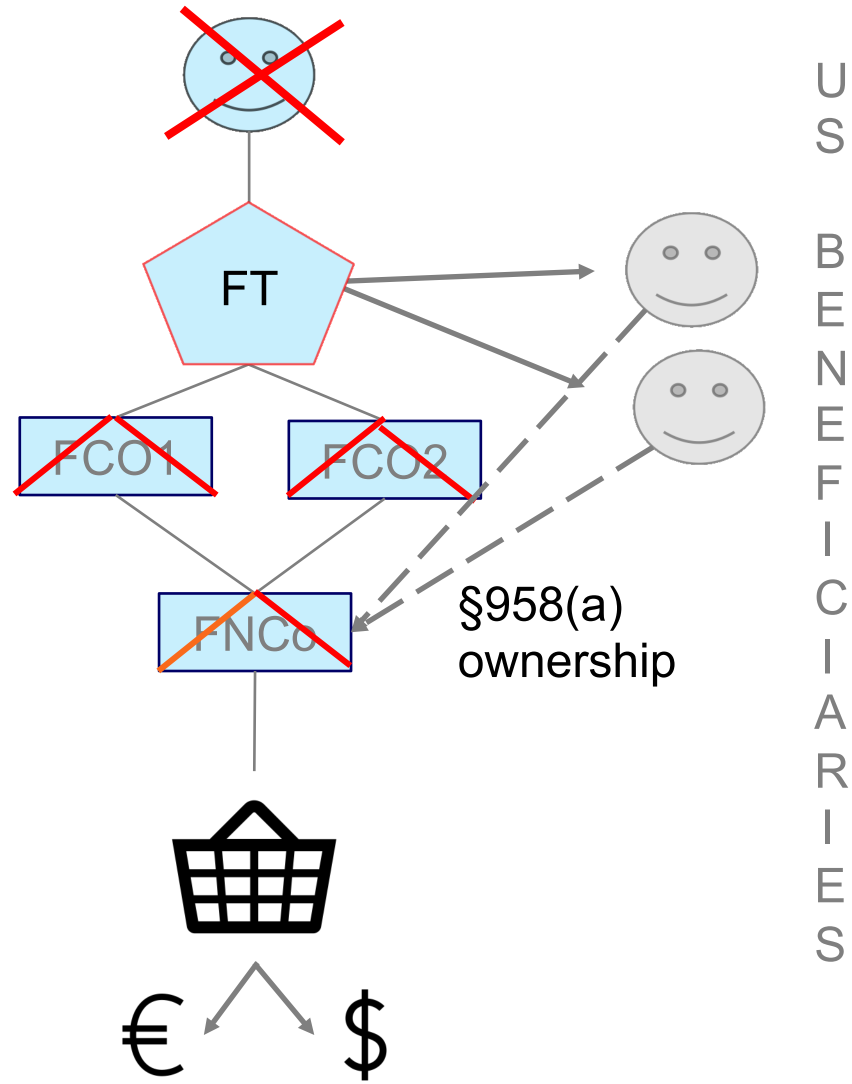
Post T.C.J.A. Tax Plan

- T.C.J.A. eliminates 30-day rule for application of Subpart F to a C.F.C.
- Old prior plan no longer provide tax-free step-up in basis
- Two alternatives for consideration:
  - FNCo rotates its portfolio several times each year
  - A revised structure calling for:
    - Two top-tier FCO's owned by FT;
    - The FCO's own FNCo in ownership split in the range of 50-50 to 79/21
    - Good business reasons for the structure, such as separate FCO's for each U.S. beneficiary in order to allow for separate investment policies with ringfenced protection in the event of losses



At death of N.R.N.C.

- FT takes a FMV basis in each of FCO1 and FCO2 because trust is revocable
- Effective not later than the day prior to the date of death of N.R.N.C., FNCo elects to be treated as disregarded entity
- FNCo is treated as if it were liquidated for U.S. income tax purposes
- The deemed liquidation is tax-free because it occurs prior to the date of death and is not a “parent-subsidiary” liquidation
- FCO1 and FCO2 are given a F.M.V. basis in the respective portions of the portfolio each receives
- Liquidation gains are not taxed under Subpart F because N.R.N.C. is alive on the effective date
- Effective shortly after the date of death, FCO1 and FCO2 are each liquidated; because FT took a FMV basis in the shares of each company, virtually no tax is due on the deemed liquidations
- FNCO1 and FNCO2 are C.F.C.’s and are deemed to sell portfolio at FMV; however the cost basis in the portfolio was stepped shortly before the effective date of the deemed liquidation



G.I.L.T.I. RULES FOR C.F.C.'S, INCLUDING THE HIGH-TAX EXCEPTION

Global Intangible Low-Tax Income

- Applies only to U.S. Shareholders of C.F.C.'s
- Taxes foreign earnings that are not otherwise caught under U.S. taxation
- Allows 10% (arbitrary) return on qualified business asset investment ("Q.B.A.I.")
- Q.B.A.I. = the C.F.C.'s average aggregate adjusted basis as of the close of each quarter of a taxable year in Q.B.A.
- Q.B.A. = depreciable (under S.L. method) tangible property used in a trade or business to produce tested income as of the end of each quarter

G.I.L.T.I. Tested Income

- Tested Income is the starting point for G.I.L.T.I. inclusion.
- Includes all gross income except:
  - E.C.I.
  - Subpart F Income
  - Income that escapes Subpart F character under high tax (18.9%) exception
  - Foreign oil and gas income
  - Dividend from related persons

G.I.L.T.I. Inclusion

Net Tested Income - Net D.T.I.R.

- D.T.I.R. (Deemed Tangible Income Return) = 10% of the Q.B.A.I.
- Net D.T.I.R. = D.T.I.R. - Specified Interest Expense
- Specified Interest Expense = Tested interest expense minus tested interest income

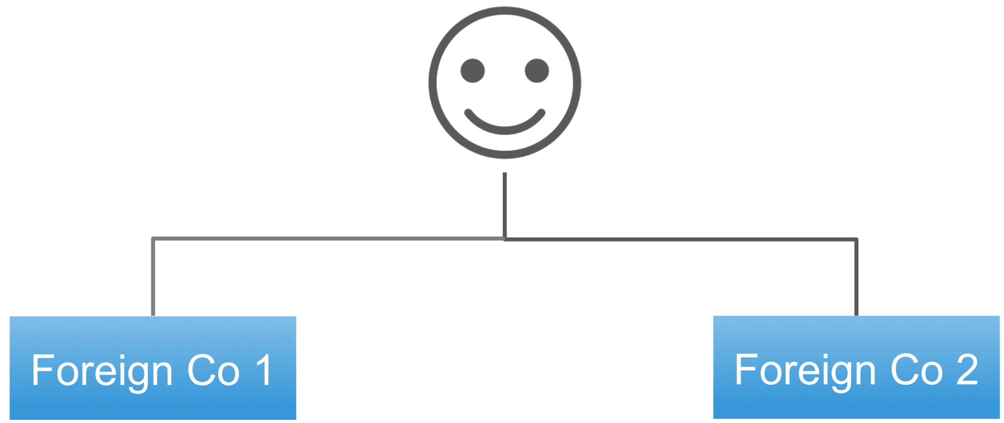
G.I.L.T.I. Inclusion – Cont’d

- Tested interest expense and tested interest income is a C.F.C. level determination
- Specified Interest Expense is a U.S. Shareholder level determination based on the pro rata share
- To calculate the G.I.L.T.I. inclusion, a U.S. Shareholder aggregates the pro rata share of D.T.I.R. of tested income C.F.C.’s and reduces the Specified Interest Expense
- The net D.T.I.R. is reduced from the aggregate net tested income

Limitations on D.T.I.R.

- Q.B.A.I. return is not available for C.F.C.'s with tested loss (Reg. §1.951A-3(b))
- If a C.F.C. with tested loss has interest expense taken into account in calculating the net loss, the interest expense ends up reducing the available D.T.I.R. of a tested income C.F.C.
- To mitigate the result, the final regulations reduce the amount of the interest expense of a tested loss C.F.C. by the disallowed D.T.I.R. (Reg. §1.951A-4(b)(1))
- More of the D.T.I.R. will be available to reduce Tested Income

Limitation of D.T.I.R. - Illustration



Foreign Co 1

$150 Tested Interest Income

$400 Other Tested Income

$150 Tested Interest expense

$400 Net Tested Income

$2000 Q.B.A.I.

Potential D.T.I.R. $200

Foreign Co 2

$149 Gross Tested Income

$150 Interest Expense

(-1) Tested Loss

$1000 Q.B.A.I.

Potential D.T.I.R. $100

G.I.L.T.I. Inclusion - Illustration

- C.F.C. determination:
  - Tested interest expense from Foreign Co 1 = $150
  - Tested interest income from Foreign Co 1 = $150
  - Tested interest expense from Foreign Co 2 = $50 ($150 - $100)
  - Tested interest income from Foreign Co 2 = $0
- U.S. Shareholder determination:
  - Total interest income $150
  - Total interest expense $200
  - Specified Interest Expense = $50 ($200 - $150)
  - Net D.T.I.R. = $200 - $50 = $150
- G.I.L.T.I. Inclusion = $399 - 150 = $249

High Tax Exclusion from G.I.L.T.I.

- Code §954(b)(4) excludes from subpart F income any item of income received by a C.F.C. that is taxed at an effective rate greater than 18.9% (90% of the 21% corporate tax rate).
- Code §951A(c)(2)(A)(i)(III) excludes from G.I.L.T.I. tested income any gross income excluded from Subpart F by reason of Code §954(b)(4)
- Proposed regulations (Proposed Reg. §1.951A-2(c)(6)) clarifies that the high tax exception of Code §954(b)(4) would apply for G.I.L.T.I. purposes provided that
  - An election is made and
  - The taxable rate condition is met
- The proposed rules applies to a C.F.C.'s taxable years beginning on or after publication of the final regulations
- Reliance on the proposed rule is not permitted

High Tax Exclusion from G.I.L.T.I.- Cont'd

- To determine whether the taxable rate condition is met, a qualified business unit (Q.B.U.) approach is applied
  - Any trade or business with separate books and records is considered a Q.B.U.
  - One Q.B.U. may be eligible while another, within the same C.F.C., isn't
- The election is made by the controlling U.S. Shareholder (those that in the aggregate own more than 50%) and is binding on all U.S. Shareholders of the C.F.C.
- All-or-nothing election. Must be made for all income of C.F.C.'s (or Q.B.U.'s) under common control and that are considered high-taxed

High Tax Exclusion from G.I.L.T.I.- Cont'd

- The election applies indefinitely
- The election may be revoked at any time on an original or amended return
  - Once the election is revoked, a new election cannot be made for 60 months
  - Subsequent election is generally irrevocable
- If the high tax exclusion applies:
  - F.T.C. from the high-taxed C.F.C. isn't available
  - Q.B.A.I. from the high-taxed C.F.C. isn't included in the D.T.I.R. calculation

Deduction for G.I.L.T.I.

- New Code §250 provides a deduction for G.I.L.T.I. inclusion
- Available to domestic corporations other than a R.I.C., R.E.I.T., or S-corporation
- Does not apply to individuals (But Code §962 can help)
- The deduction applies to the G.I.L.T.I. amount plus the deemed dividend under Code § 78
- The deduction is 50% until 2025
  - Provides a 10.5% rate on G.I.L.T.I.
- Beginning in 2026 the deduction is 37.5%
  - Provides a 13.125% rate on G.I.L.T.I.
- Foreign taxes paid on G.I.L.T.I. by the C.F.C. are subject to 80% limitation
- Excess F.T.C. attributable to G.I.L.T.I. not allowed for carryover

CODE §962 RELIEF FOR U.S. INDIVIDUALS OWNING C.F.C.'S

Hypothetical Investment by U.S. Corp

- Subpart F and G.I.L.T.I. provisions applies equally to U.S. individuals and U.S. corporations
- Two major differences exist between the tax treatment of U.S. corporations and U.S. individuals under Subpart F
  - Disparity in tax rates
    - Individuals are taxed at rates up to 37% plus 3.8% N.I.I.T.
    - Corporation are taxed at a flat 21%
  - Indirect foreign tax credits
    - Corporations may claim a foreign tax credit for income taxes paid by a C.F.C. at the time the operations of the C.F.C. generate Subpart F Income
    - Individuals are not entitled to claim a foreign tax credit for foreign income taxes paid by a C.F.C.

Disparities of Treatment

U.S. CO

U.S. PERSON

50%

50%

C.F.C.

FACTS

• C.F.C. taxable income	$100
• C.F.C. income tax	15
• Net income after tax	$ 85

- All income is Subpart F Income
- No dividends are paid

Disparities of Treatment

U.S. Co Tax

Share of Subpart F Income	$42.50
Share of foreign income taxes	7.50
Subpart F Income + Gross Up	$50.00
Tentative Tax (at 21%)	10.50
Less F.T.C.	(7.50)
Net U.S. tax paid	$2.50
Total taxes paid on share of pre-tax income	$10.00

U.S. Individual Tax*

Share of Subpart F Income	$42.50
U.S. income tax (at 37%)	$15.75
U.S. N.I.I.T. (at 3.8%)	1.62
Total U.S. tax	$17.37
Total taxes paid on share of pre-tax income	$24.87

* See below for tax when actual dividend is paid

Code § 962

- Code §962 generally allows an individual who is a U.S. Shareholder to be treated as a domestic C-corporation for the purpose of computing tax on Subpart F Income
  - The amount will equal the tax imposed under Code §11 (relating to corporations), rather than under Code §1 (relating to individuals), and
  - The individual may obtain an indirect foreign tax credit for the shareholder's foreign taxes paid or accrued by the C.F.C. with respect to the Subpart F Income allocable to the individual

Code § 962

- When an actual dividend is paid by the C.F.C., it is treated as a dividend from a foreign corporation
  - The tax rate on the actual dividend is capped at either 20% or 37%, depending on whether the dividend is a qualified dividend
  - It is P.T.I. to the extent of the U.S. tax previously paid, which in the example is $2.50

Actual dividend received	$42.50
Less: P.T.I.	(2.50)
Net dividend income	$40.00
Tax on Qualified Dividend (@20%)	$ 8.00
U.S. income tax paid previously	2.50
Total U.S. income tax	$10.50

D.R.D. FOR FOREIGN DIVIDENDS AND ANTI-HYBRID

DIVIDENDS RECEIVED DEDUCTION

Territorial System

Question to Ponder

- Is the D.R.D. for foreign dividends . . .

- Is the D.R.D. for foreign dividends . . .

Dividends Received Deduction

- Code §245A provides for a 100% dividends received deduction for the foreign-source portion of a dividend paid by a "specified 10%-owned foreign corporation"
  - Applies to a foreign corporation having10% U.S. Shareholder that is a U.S. domestic corporation
  - 10% of vote or value is same as "U.S. Shareholder" definition for Subpart F purposes
  - Ownership requirement may be met directly, indirectly, or constructively
  - 1-year holding period
  - Only a C-corporation may claim the benefit – no R.I.C.'s or R.E.I.T.'s
  - Foreign-source portion of a dividend is calculated as a formula: dividend x (foreign source E&P ÷ total E&P)
    - E&P computations are made as of the close of the taxable year and are not reduced by dividends during the taxable year
  - The undistributed foreign earnings are earnings that are not attributable to
    - income connected to a U.S. trade or business a
    - Dividends from U.S. corporations in which the foreign corporation owns at least 80% of the outstanding shares (D.R.D. under Code §245 may be available)

Dividends That are Not Eligible for the D.R.D.

- When are foreign dividends not eligible for the D.R.D.?
  - When the foreign dividend is distributed by a P.F.I.C., unless the P.F.I.C. is a C.F.C
  - When the foreign corporation is a C.F.C. and generates earnings taxed to a U.S. Shareholder under Subpart F
  - When the foreign corporation is a C.F.C. and generates earnings taxed to a U.S. Shareholder G.I.L.T.I.
  - When the dividend is a hybrid dividend
  - When the distribution is treated as a capital gain, typically when the amount received exceeds the paying company's E&P and the basis of the shareholder in the shares of the foreign corporation
  - Does not apply to capital gains, except for the portion of the gain that is treated as a dividend under Code §1248

When does the D.R.D. apply?

- When are foreign dividends eligible for the D.R.D.?
  - When the foreign corporation is not a C.F.C.
  - When the foreign corporation is a C.F.C., but the high tax income rule applies and “washes” the character of certain items of Subpart F Income to
  - When the foreign corporation is a C.F.C. and
    - Its earnings are not subject to tax under Subpart F for its U.S. Shareholder,
    - Its earnings are subject to tax in the hands of its U.S. Shareholder under G.I.L.T.I., and
    - The income is Qualified Business Asset Income under G.I.L.T.I. – a 10% return on investment in depreciable tangible assets
  - When the foreign corporation is a C.F.C. and
    - Its earnings are not subject to tax under Subpart F for its U.S. Shareholder,
    - Its earnings are subject to tax in the hands of its U.S. Shareholder under G.I.L.T.I., but
    - Losses from a C.F.C. that is an affiliate of the foreign corporation recognizes losses that reduce the tested income that would otherwise be taxed under G.I.L.T.I.

Basis, P.T.I., Withholding Taxes, and U.S. Property

- What happens when the foreign corporation paying a dividend is a C.F.C. that has income that was previously taxed in the hands of its U.S. Shareholder by reason of Subpart F or the G.I.L.T.I. provisions?
  - In general, the distribution is deemed to be paid out of a pool of P.T.I. E&P.
  - Such dividends are not taxed a second time
  - The regulations require that a U.S. corporation must track 16 different pools of E&P of each foreign corporation in which the 10% ownership threshold is met order to identify the potential source of distributions
- For any portion subject to the D.R.D., direct or indirect foreign tax credits are generally not allowed
  - Withholding taxes imposed on distributions of P.T.I. from a C.F.C. should continue to be creditable under Code §901
  - Foreign income tax disallowed for credit may not be deducted
- If the D.R.D. would apply to a C.F.C., no Code §956 inclusion for an "investment in U.S. Property" is applicable

Anti-Abuse Rules

- What anti-abuse rules apply to prevent a taxpayer from abusing the D.R.D.?
  - In order to prevent a D.R.D. from becoming a financial product generating capital losses that offset capital gains, Code §961(d) requires the U.S. Shareholder to make a downward adjustment to basis for dividends qualifying for the D.R.D.
    - This adjustment is made only for purposes of computing a subsequent capital loss on the shares of the foreign corporation
  - To prevent fiscal year taxpayers from taking advantage of a disjuncture between the G.I.L.T.I. rules and the D.R.D. in calendar year 2018 a rule applicable to an extraordinary disposition is adopted
    - It applies to an intragroup sale of assets in the fiscal year beginning in 2017 after the transition tax has been computed and before the G.I.L.T.I. rules are first applicable to the fiscal year group
    - The sale is structured so that it does not generate Foreign Personal Holding Company income taxed under Subpart F
    - Because G.I.L.T.I. is no effective in the gap period, the sale is not tested income taxed under G.I.L.T.I. in the hands of its 10% U.S. Shareholder
    - The purchasing C.F.C. steps up its basis in depreciable property increasing the tax-free Q.B.A.I.
    - The selling C.F.C. pays a dividend that would benefit from the D.R.D

Extraordinary Reduction Limitation

- The extraordinary reduction rules disallow the D.R.D. for the "extraordinary reduction amount" when a rule designed to tax foreign income under Subpart F only once when the C.F.C. is sold to another U.S. Shareholder during the year
  - Any dividends paid by the selling U.S. Shareholder during the year of the sale can be used by the purchaser to reduce its Subpart F income in the balance of the year
  - With the adoption of the D.R.D., the rule can result in double no-taxation
    - Reduction in Subpart F income by the purchaser, D.R.D. treatment for dividends.
    - The regulations eliminate the double no-taxation by eliminating the D.R.D.
    - The extraordinary reduction limitation applies to all post-2017 distributions

Conclusion

CODE §§245A & 267A

Hybrid Transactions

Hybrid Dividends – Code §§245A(d) & (e)

- Hybrid Dividends paid to U.S. shareholder
  - No Code §245A deduction allowed
  - Do not carry F.T.C.'s
- C.F.C.-to-C.F.C. Hybrid Dividends
  - Treated as Subpart F Income – cannot be reduced by other expenses or the Code §952(c) limitations
  - Do not carry F.T.C.'s
- Hybrid Dividend
  - Dividend from a C.F.C. that otherwise would generate a Code §245A deduction
  - For which the payor C.F.C. received a deduction (or other tax benefit) with respect to any foreign income tax
    - What is an example of an "other tax benefit"?

Other Hybrid Transactions – Code §267A

- Disallowance of deductions for certain related-party interest and royalty expense payments by U.S. taxpayers and C.F.C.'s
- No deduction allowed for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity
- Disqualified related-party amount = interest or royalties paid or accrued to related party if
  - Such amount is not included in the income of the related party under the tax law of its country of tax residence, or
  - Such related party is allowed a deduction with respect to such amount under its local country tax law
- A hybrid transaction is any transaction, instrument, or agreement for which one or more payments is treated as interest or royalties for U.S. tax purposes but not so treated for purposes of the tax law of the recipient's country of residence
- A hybrid entity is an entity treated as fiscally transparent in one jurisdiction but not the other, where one of the jurisdictions is the U.S.

Code §267A

- Broad regulatory authority to expand the scope of Code §267A to
  - Deny deductions for conduit arrangements that involve a hybrid transaction or hybrid entity
  - Apply the provision to foreign branches
  - Apply the provision to "certain structured transactions"
  - Treat as an exclusion a tax preference that has the effect of reducing the headline rate by 25% or more
  - Deny all or a portion of a deduction claimed for interest or royalties paid that are subject to certain preferential tax regimes or a participation exemption
  - Determine the tax residence of a foreign entity
  - Identify exceptions to the general rule

Important Notice

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