Planning with the New FTC Baskets

2018 U.S. Cross-Border Tax Conference

May 15 – 17, 2018

kpmg.com
Agenda

01  Significant Tax Reform changes to FTC rules
    - New FTC baskets and FTC limitation
    - Deemed paid credits and “properly attributable to” standard
    - New Section 904(b)(5)
    - Other changes affecting FTC

02  Planning under the new FTC rules
    - Conversion of GILTI to subpart F income
    - Maximizing direct foreign source income
Notices

The following information is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
Today’s presenters

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Firm Name</th>
<th>Email</th>
<th>Telephone</th>
</tr>
</thead>
<tbody>
<tr>
<td>Steven Davis</td>
<td>Principal, International Tax</td>
<td>KPMG LLP</td>
<td><a href="mailto:smdavis@kpmg.com">smdavis@kpmg.com</a></td>
<td>212-872-2118</td>
</tr>
<tr>
<td>Seth Green</td>
<td>Principal in Charge of International Tax, WNT</td>
<td>KPMG LLP</td>
<td><a href="mailto:sethgreen@kpmg.com">sethgreen@kpmg.com</a></td>
<td>202-533-6002</td>
</tr>
<tr>
<td>Bob Wilkerson</td>
<td>Principal, WNT</td>
<td>KPMG LLP</td>
<td><a href="mailto:rwilkerson@kpmg.com">rwilkerson@kpmg.com</a></td>
<td>404-222-3639</td>
</tr>
</tbody>
</table>
Significant tax reform changes to FTC rules
New FTC baskets

Section 904(d) was amended to add two new FTC limitation baskets that only apply to U.S. persons; the four FTC limitation baskets are as follows:

— Amounts includible in income by U.S. shareholder under Section 951A (i.e., GILTI inclusions)
  - Basketing occurs at U.S. shareholder level upon inclusion, rather than at the CFC level
  - Excludes passive category income

— Foreign branch income
  - Defined as “business profits” of a U.S. person that are attributable to one or more QBUs (as defined in Section 989(a)); significant uncertainty as to the scope of the foreign branch basket
  - Excludes passive category income

— Passive category income
  - Generally income that would be FPHCI under Section 954(c)

— General category income
  - Residual basket, and includes financial services income earned by a person predominantly engaged in active banking, insurance, financing or similar business
The new GILTI basket is subject to additional limitations that may severely limit the ability to credit GILTI basket taxes:

— Section 960(d) allows an FTC for only 80% of relevant tested foreign income taxes
  - Section 78 gross up applies to 100% of taxes
— Section 904(c) FTC carryback (1 year) and carryforward (10 years) do not apply to GILTI basket taxes -- “use them or lose them” in current year
— Although some uncertainty exists (see next slide), the normal expense allocation rules of Section 864(e) appear to apply to the GILTI basket
  - The negative effects of expense allocation are magnified by the lack of an FTC carryover
— The normal Section 904(f)(5) separate limitation loss and U.S. loss offset rules apply
  - An SLL in another basket or a U.S. source loss can prevent the taxpayer from claiming FTCs with respect to GILTI; the unavailability of an FTC carryover means no credit will ever be allowed for the related GILTI basket taxes
  - Normal SLL/ODL recapture rules apply such that excess GILTI basket taxes in future years may offset recaptured GILTI basket income
— Basketing of Section 78 gross-up
Must expenses be allocated to the GILTI basket?

— The legislative history contains two statements that suggest that U.S. Shareholder expenses may not be allocable, or may be only partially allocable, to GILTI income:

- “Since only a portion (80 percent) of foreign tax credits are allowed to offset U.S. tax on GILTI, the minimum foreign tax rate, with respect to GILTI, at which no residual tax is owed by a domestic corporation is 13.125 percent.”

- “The Committee intends that the deduction allowed by new Code section 250 be treated as exempting the deducted income from tax. Thus, for example, the deduction for [GILTI] could give rise to an increase from a domestic corporate partner’s basis in a domestic partnership under section 705(a)(1)(B).”

— Section 864(e)(3) was not amended to treat CFC stock producing GILTI as an exempt asset

— Section 904(b)(4) indicates that expenses are required to be allocated to GILTI income

— Treasury and IRS continue to indicate publicly that they are considering possible expense allocation relief
GILTI basket FTC calculation

Section 960(d) deemed paid taxes with respect to GILTI inclusions:

— Deemed paid tax = 80% * (inclusion percentage x aggregate tested foreign income taxes)

— “Inclusion percentage” means, with respect to a domestic corporation, the ratio of such domestic corporation’s GILTI income inclusion for the taxable year to the aggregate of such corporation’s pro rata share of the positive tested income of each CFC as to which it is a U.S. shareholder for the taxable year

— Tested foreign income taxes means, with respect to any domestic corporation that is a U.S. shareholder of a CFC, the foreign income taxes paid or accrued by the CFC which are properly attributable to the tested income of such foreign corporation taken into account under Section 951A
  - Taxes of a CFC with tested losses are not taken into account
Example: Section 960(d) calculation

USP’s Section 951A inclusion:
- \( 160 = 180 \) (net CFC tested income) – 20 (QBAI return)
  - 80 attributable to CFC1 under Section 951A(f)
  - 80 attributable to CFC3

Section 960(d) deemed-paid credit:
- Inclusion percentage = 80% \((160 \text{ GILTI inclusion}) / 200\) (aggregate tested income amounts)
- Tested foreign income taxes: \(50\)
- Section 960(d) deemed-paid credit: \(32\) (80% * 80% * 50)
  - Section 960(d) does not specify which taxes are deemed paid, only the aggregate amount (but compare Section 951A(f)(2))
  - Apparently, 4 (20%) of CFC1’s foreign taxes are attributable to CFC1’s 20 of tested income that is not included under Section 951A and are potentially creditable under Section 960(a) if that 20 is included in income under Section 951(a)(1)(B)/956; similarly, 6 (20%) of CFC3’s foreign taxes are attributable to its 20 of tested income that is not included under Section 951A
- Section 78 gross-up: \(40\) (80% * 50)

*CFC1 has 200 of QBAI so its net deemed intangible return (NDTIR) is 20 (200 * 10%); no CFC has interest expense
Foreign branch basket

Foreign branch income is defined as business profits (other than passive category income) attributable to one or more qualified business units ("QBUs") in one or more foreign countries

— Section 989(a) defines a QBU as any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records
  - "Generally, a trade or business... is a specific unified group of activities that constitutes (or could constitute) an independent economic enterprise carried on for profit, the expenses related to which are deductible under section 162 or 212... To constitute a trade or business, a group of activities must ordinarily include every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit.” Treas. Reg. § 1.989(a)-1(c).

— The amount of business profits attributable to a QBU is to be determined under regulations, and the legislative history provides no meaningful discussion of what the regulations are intended to say

— The foreign branch basket is based on combined income of the taxpayer’s QBUs and is subject to normal FTC carryover rules of Section 904(c)
  - Query whether excess branch basket FTCs for 2018 can be carried back to 2017?
FTC basket transition issues

Pre-reform attributes such as FTC carryforwards, ODLs, OFLs and SLLs survive post-reform; transition issues must be considered

— Under the Code, such items appear to carry forward in their historical FTC limitation category (typically, general limitation basket)
— A question is whether Treasury/IRS will issue regulations that “reassign” such items based on the new basket regime
  - For example, might general limitation FTC carryforwards from 2017 be reassigned in part to GILTI and foreign branch baskets?
    — What methodology would be used to reassign items?
    — Taxes reassigned to GILTI basket would likely go there to die
    — Ability to recapture ODL as GILTI or foreign branch income could be beneficial for some taxpayers with excess credits in those baskets post-2017
— Can 2018 excess foreign branch taxes be carried back to 2017 (presumably as general limitation basket taxes)?
Repeal of Section 902

Consistent with the adoption of the Section 245A participation exemption, the Act repealed the Section 902 deemed-paid credit rules

— No deemed-paid foreign tax credit may be claimed with respect to a dividend received from a foreign corporation

— Section 245A(d) also disallows a credit (and deduction) for foreign taxes, such as withholding taxes, with respect to dividends qualifying for the Section 245A DRD

— Section 1293(f) continues to allow a deemed-paid credit under Section 960 for inclusions of a domestic corporation with respect to a PFIC to which the QEF election applies; prior law 10% ownership requirement applies
Amendments to Section 960

The Section 960 deemed-paid credit rules for subpart F inclusions were retained and significantly modified

— Deemed-paid credit allowed to corporate U.S. shareholders (no direct 10% ownership or qualified group requirement)
  - Section 960(a) credit allowed for taxes properly attributable to items of subpart F income and Section 956 inclusions
  - Section 960(d) credit allowed with respect to GILTI inclusions based on U.S. shareholder’s inclusion percentage multiplied by aggregate tested foreign income taxes
    — Tested foreign income taxes defined as foreign income taxes properly attributable to tested income taken into account under Section 951A
    — Credit only allowed for 80% of the taxes creditable under Section 960(d)
    — No credit for taxes of CFC with tested loss
— Prior law pooling rules repealed; credit is for taxes “properly attributable to” specified income
— Section 960(b) allows FTC for foreign taxes properly attributable to portion of a distribution that is PTI; applies through tiers of CFCs
— Section 960(c) provides “excess limitation account” rules that may increase a taxpayer’s FTC limitation in the year PTI distributions are received (but apparently not for GILTI PTI)
Section 960 taxes “properly attributable”

CFC with 11-30 US tax year and calendar foreign tax year

— Section 965 inclusion of 900 on 11-30-18 carries deemed paid credit (subject to section 965 haircut) based on post-1986 pools under pre-Reform section 960; pools include 12-31-17 foreign tax accrual

— Foreign tax of 25 accrues on 12-31-18, within CFC’s first U.S. tax year to which GILTI rules apply

— Assume all 100 of CFC’s tested income for US TYE 11-30-19 is includible as GILTI
  - Are taxes “properly attributable to” 100 of tested income included as GILTI the full 25 of taxes that accrue on 12-31-18 or only a portion (e.g., 2 if income earned ratably)?

— Assume all 100 of CFC’s tested income for U.S. TYE 11-30-20 is includible as GILTI
  - Are the 25 of taxes that accrue on 12-31-19 based on CFC’s foreign income for the 2019 calendar year “properly attributable to” the tested income included as GILTI on 11-30-20?

USP

CFC1

US TYE 11/30/18:
Acc E&P 11/30/18: 1000
- Sec 965 E&P: 900
- Untaxed E&P: 100
- For tax accrued 12-31-17: 25

US TYE 11/30/19
Current E&P/tested income: 100
Foreign tax accrued 12-31-18: 25
- GILTI Inclusion: 100
- Sec 960(d) credit: 80% * 25 or 2?

US TYE 11/30/20
Current E&P/tested income: 100
Foreign tax accrued 12-31-19: 25
- GILTI Inclusion: 100
- Sec 960(d) credit: 80% * 25?
Section 904(b)(4)* addresses the treatment of expenses allocated and apportioned to dividends qualifying for the Section 245A DRD (“Section 245A Dividends”)

— In the case of a corporate U.S. shareholder of a specified 10% owned foreign corporation, such shareholder’s foreign source income and entire taxable income shall be determined without regard to –
  - Section 245A Dividends
  - Any deduction (“Section 904(b)(4)(B) Deductions”) properly allocable or apportioned to:
    — Income (other than amounts includible under section 951(a)(1) or 951A(a)) with respect to stock of such specified 10-percent owned foreign corporation, or
    — Such stock to the extent income with respect to such stock is other than amounts includible under Section 951(a)(1) or 951A(a)

— Key Question: does “income with respect to such stock” mean only dividends actually paid? Current law stock characterization rules (Treas. Reg. § 1.861-12T(c)(3)) characterize CFC stock based on gross income or assets of CFC, not income earned currently by shareholder

* Enacted as Section 904(b)(5); renumbered in technical correction bill
New Section 904(b)(4)

FTC Limitation Pre-Reform:

\[
\frac{\text{FSI in Basket}}{\text{WW Taxable Income}} \times (\text{WW Taxable Income} \times \text{§ 11 rate})
\]

FTC Limitation with Section 904(b)(4):

\[
\frac{\text{FSI in Basket}^*}{\text{Adjusted WW Taxable Income}^{**}} \times (\text{WW Taxable Income} \times \text{§ 11 rate})
\]

* Determined without regard to Section 245A Dividends and Section 904(b)(4)(B) Deductions

** WW Taxable Income increased by Section 904(b)(4)(B) Deductions
### Expense allocation and Section 904(b)(4)

**Assume U.S. group owning a single CFC:**

<table>
<thead>
<tr>
<th><strong>U.S. Group Income</strong></th>
<th><strong>U.S. Group Assets</strong></th>
<th><strong>CFC GILTI</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. Source Gross Income</td>
<td>$550</td>
<td>U.S. Assets</td>
</tr>
<tr>
<td>GILTI</td>
<td>$100</td>
<td>CFC Stock</td>
</tr>
<tr>
<td>Section 250 Deduction</td>
<td>($50)</td>
<td>Tested Income</td>
</tr>
<tr>
<td>Interest Expense</td>
<td>($100)</td>
<td>Tangible Assets</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td><strong>$500</strong></td>
<td><strong>CFC NDTIR</strong> (10% of QBAI)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$5,000</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Section 864(e) Allocation / Apportionment**

Interest expense allocable to CFC stock: 2500/5000 x 100 = 50**

**Assume apportioned equally between tested income treated as GILTI and tested income treated as NDTIR**
Expense allocation and Section 904(b)(4), continued

US tax on net GILTI inclusion: 50 * 21% = 10.50

Interest apportioned to GILTI Basket:
50 * (100 / 200) = 25

Interest apportioned to “Section 245A Dividends”:*  
50 * (100 / 200) = 25

Net GILTI Basket Income: 100 – 50 - 25 = 25

US Pre-Credit Tax on GILTI basket income: 25 * 21% = 5.25

GILTI Basket Limitation:

\[
\frac{100 - 50 - 25}{500 + 25} = 5
\]

* Assumes Section 904(b)(4)(B) applies without regard to whether dividends are paid currently

** The $25 “add-back” represents the adjustment to the denominator for the Section 904(b)(4)(B) Deduction
Other changes affecting the FTC

The fair market value method for interest expense apportionment was repealed
— Section 864(e) continues to require interest expense to be apportioned under an asset method and on an affiliated group basis (regulations expand the definition of affiliated group)
— The tax book value or alternative tax book value method must be used in applying the asset method
— The Section 864(e)(3) tax-exempt asset rule was not amended to cross-reference Section 245A or Section 250
— The Section 864(f) worldwide expense allocation rules were not accelerated (still effective only for first taxable year beginning after December 31, 2020)

Section 863(b) was amended to repeal the prior law 50/50 sourcing rules for sales of manufactured inventory.
— Income from sales of inventory produced in whole or in part within the U.S. and sold outside the U.S. is U.S. source income
— Income from sales of inventory produced without the U.S. and sold within the U.S. is foreign source income
  - Beneficial rule for property manufactured outside the U.S. (e.g., Mexican maquiladora)
Other changes affecting the FTC

The ODL rules were amended to provide an election to increase the ODL recapture percentage for pre-2018 ODLs

— Election to recapture more than 50% (but not more than 100%) of an ODL arising in a year beginning before 2018
— Applicable to taxable years beginning after January 1, 2017 and before January 1, 2028

The FTC look-through rules of Section 904(d)(3) were not amended to refer to the GILTI basket or the foreign branch basket.

— The scope of the look-through rules in Treas. Reg. § 1.904-5 is unclear
— Because the GILTI basket is defined by reference to Section 951A inclusions, CFCs do not appear to have GILTI basket income
  - Accordingly, CFC income appears to be assigned to either the passive basket or the general basket at the CFC level, and interest and royalties paid by a CFC to which the look-through rules apply appear to be either passive or general basket income
  - IRS officials have indicated publicly that Treasury and IRS are considering regulations that would attribute interest and royalties paid by CFCs in part to the GILTI basket under look-through rules
Planning under the new FTC rules
Planning for general basket treatment

Due to the severe limitations on crediting of GILTI basket taxes, companies may consider planning to cause income of CFCs to fall outside of the GILTI regime and GILTI basket

— Although net GILTI income is generally taxed at a favorable 10.5% rate, the FTC limitations highlighted above may result in significant residual U.S. tax. Converting otherwise tested income to G/L subpart F income may allow U.S. companies to avoid the limitations of the GILTI basket

— Tested income does not include subpart F income or income that is excluded from subpart F income pursuant to the subpart F high-tax exception. Subpart F income that it is taxed at a rate of 18.9% (90% * 21%) will qualify for the subpart F high-tax exception
  - U.S. companies that otherwise generate low-taxed G/L FSI from, e.g., interest and royalties from CFCs or foreign source sales, may benefit from excess G/L credits attributable to high-tax (>21%) subpart F income inclusions
  - Companies with excess G/L credit carryforwards may also be able to credit such taxes against lower-taxed G/L subpart F income
  - Companies may also benefit from electing to apply the high-tax exception to subpart F income, resulting in untaxed CFC earnings that can be distributed as Section 245A Dividends

— MODELING IS CRITICAL!
Affirmative subpart F income planning
FBCSaI and in-country distributors

GILTI. If In-Country Distributor were a regarded entity, its income from sale of property purchased from CFC 1 would not be foreign base company sales income (“FBCSaI”) under the “same country of sales” exception

Subpart F

- In-Country Distributor files CTB election to be DRE of CFC 2, a holding company CFC incorporated in a different jurisdiction
  - CFC 2’s income from sales to customers in Country C (through In-Country Distributor DRE) would be FBCSaI
    - “Same country of sales” exception does not apply
    - Branch rule does not apply
  - CFC 1’s income from sales to In-Country Distributor would be excluded from FBCSaI as CFC 1 is the physical manufacturer (GILTI)

- Issues
  - Single holding company or multiple CFC holding companies?
FBCSaI and in-country services

GILTI. If CFC 3 were a buy-sell distributor, its income from sale of property purchased from CFC 2 would not be FBCSaI under “same country of sales” exception Subpart F

— Rather than selling products, CFC 3 provides sales services to CFC2, a related CFC in a different jurisdiction, which then sells the product directly to customers in Country C
  - CFC 2’s income from sales to customers in country C would be FBCSaI
  - CFC 1’s income from sales to CFC 2 would be excluded from FBCSaI as CFC 1 is the physical manufacturer (GILTI)
  - CFC 3’s service income would be excluded from foreign base company services income (“FBCSeI”) income under the in-country services exception (GILTI)

— Issues
  - Possible PE for Distributor CFC 2 as a result of activities undertaken on its behalf by CFC 3
  - Possible use of a Master Distributor to mitigate PE exposure
  - Multiple CFC holding companies may be preferable to segregate high-taxed income, or for treaty reasons
  - Customs implications (for example, first sale for export)
FBCSeI with subcontracting

GILTI. CFC 1’s income from performing services for a third party would not be FBCSeI

Subpart F
- CFC 1 subcontracts with CFC 2 for the performance of the service contract, and CFC 2 provides the services through employees located outside of its country of organization
  - CFC 2’s income from the subcontract would be FBCSeI
  - CFC 1’s income from third party would not be FBCSeI
- Potential for same result by CFC 2 guaranty of CFC 1’s performance of service under third-party contract?

Issues
- PE exposure
- Transfer pricing for services provided by CFC 2
FBCSeI and toll manufacturing

**Subpart F**
- Toll Manufacturer earns services income from performing out of country services
  - Toll Manufacturer’s income would be FBCSeI
  - Income derived by Principal from sales to Distributor would be FBCSaI
  - Income derived by Distributor CFC from sales to customers outside of its country of organization would be FBCSaI

- **Issues**
  - PE exposure
  - VAT issues
FSI planning – Section 862

Background:
— USP has general limitation basket FTC carryforwards or otherwise structures operations to generate excess general limitation FTCs.
— USP group is in the process of splitting production and sales into separate U.S. companies.
— Change in 863(b) results in need for additional FSI to use credits and enable high-tax inclusion planning

Transaction Steps:
— U.S. Production sells manufactured inventory to U.S. P’ship which is a partnership formed in the United States.
— U.S. P’ship sells purchased inventory to foreign customers.

U.S. Tax Considerations:
— The new rules of § 863 are not expected to apply to partnerships because of the exception provided in Treas. Reg. § 1.863-3(g).
— Instead, § 862(a)(6) is expected to apply to the income earned by U.S. P’ship and is expected to be treated as foreign source income (assuming title passes outside United States).
— FDII implications
— Substance in U.S. P’ship and transfer pricing
FSI planning – Section 863

**Background:**
- USP has FTC carryovers, or otherwise generates excess FTCs, in general limitation basket and possibly branch basket FTC limitation.
- USP has foreign manufacturing companies (e.g., Mexican maquiladora) that sell primarily to the U.S. for resale in the U.S. market.

**Transaction Steps:**
- CFC Manufacturing makes CTB election to be treated as a DRE (into the U.S. group).

**U.S. Tax Considerations:**
- Under amended § 863, inventory produced outside the United States and sold to U.S. customers should be foreign source income.
  - The foreign entity’s income now flows into the U.S. directly rather than becoming either 245A eligible or GILTI basket FSI when it was a CFC.
  - Treatment of CFC Manufacturer as a “foreign branch”; any 3rd party sales?
  - What are business profits properly attributable to foreign branch?
  - Branch vs general limitation analysis
Thank you
The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.