Impact of Tax Reform on Treasury Functions and Foreign Currency Management

2018 U.S. Cross-Border Tax Conference

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Agenda

01 Overview of tax law changes affecting treasury functions
02 Interest expense limitations
03 Managing currency exposure with respect to PTI
04 Proposed section 954 987 and 988 regulations
05 Simplifying intercompany debt
06 Q&A
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# Today’s presenters

<table>
<thead>
<tr>
<th>Name</th>
<th>Title</th>
<th>Firm</th>
<th>Company Name</th>
<th>Email</th>
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<tbody>
<tr>
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<td>KPMG</td>
<td>LLP</td>
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Overview of tax law changes affecting treasury functions
### Functions typically performed by Treasury:

<table>
<thead>
<tr>
<th><strong>Cash Pooling</strong></th>
<th><strong>Intercompany Financing</strong></th>
<th><strong>Payments (internal &amp; external)</strong></th>
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<tbody>
<tr>
<td>Regional or global cash pools</td>
<td>In-house bank providing I/C financing through cash pool and/or I/C loans</td>
<td>Centralized internal and external payment activities to the ITC</td>
</tr>
<tr>
<td>• Increase visibility and control over cash</td>
<td>• Increase transparency</td>
<td>• Reduce transaction costs and optimizes interest result</td>
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<tr>
<td>• Enable centralized investments</td>
<td>• Facilitate loan administration, document, accounting</td>
<td>• Reduce banking systems</td>
</tr>
<tr>
<td></td>
<td>• Potential tax benefits</td>
<td>• Increase transparency, control and compliance</td>
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<thead>
<tr>
<th><strong>FX Risk Management</strong></th>
<th><strong>Investments</strong></th>
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<tr>
<td>Centralized global transactional FX exposure; back-to-back trades</td>
<td>Centralized short-/mid-term investments</td>
</tr>
<tr>
<td>• Allows netting of FX hedges</td>
<td>• Optimize return on global cash</td>
</tr>
<tr>
<td>• Reduce transaction volume and costs</td>
<td>• Improve transparency and control</td>
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</tbody>
</table>
Regional treasury centers common structure

- **U.S. Parent**
  - Non-U.S. OpCos
    - Non-U.S. Treasury Center
    - I/C Financing
    - I/C Hedges
  - U.S. OpCos
    - U.S. Treasury Center
    - I/C Financing
    - I/C Hedges
- **Bank/Exchange**
  - Financing
  - Hedges
- **I/C Hedges**
  - I/C Financing
### Key tax changes impacting treasury functions

<table>
<thead>
<tr>
<th>New opportunities</th>
<th>New challenges</th>
<th>Lingering challenges</th>
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</thead>
</table>
| **Significantly Reduced Corporate Rate (35% to 21%)**  
- The U.S. corporate tax rate was one of the highest in the OECD, which often created/enhanced incentives to increase deductions in – and avoid triggering income inclusions in – the U.S., relative to many other countries. The new rate is lower or on par with most other countries. | **New Limitations on Interest Deductions**  
- More difficult to maintain the benefit of an interest deduction in the U.S. and for U.S.-controlled subsidiaries (for U.S. tax purposes). | **Loans into the U.S. (from controlled foreign subsidiaries)**  
- Dividends from foreign operations may be exempt,  
- Section 956 still applies.  
- Opportunity for U.S. non-U.S. entities to participate in same cash pool? |
| **New Participation Exemption**  
- Foreign profits that are not currently taxable in the U.S. (e.g., new minimum tax) will generally be exempt from U.S. tax upon repatriation (as a dividend). | **Global Minimum Tax**  
- Global operations may be (essentially) charged a minimum tax on foreign profits.  
- Foreign-to-foreign intercompany loan interest may have a beneficial treatment,  
- Must be aware of the interaction of interest limitations. | **Other complexities persist**  
- Financial transactions rules  
- Withholding tax  
- Transfer pricing,  
- Character and timing mismatches under subpart F (partially addressed Proposed regulations directly address certain historical tax challenges for treasury centers). |
Key tax changes impacting treasury functions (con’t)

**BEAT Section 59A**
- Imposes additional tax
- Based on limiting deductibility of deductible payments to related foreign persons

**163(j) Limit on interest deduction**
- Related and unrelated party debt
- 30% of EBITDA (EBIT in 2026)

**Branch Income – 21%**
- Current inclusion
- Separate basket
- 10 year carryforward
- Cannot get FDII

**Sub F – 21%**
- Foreign base company income and 956
- Current inclusion at 21%
- General and passive baskets
- 10 year FTC carryforward

**Other Income – 21%**
- U.S. and Foreign source income that is not FDII or GILTI or eligible for DRDs

**FDII – 13.125%**
- Income from sale, leases, licenses, and dispositions of property to foreign person for foreign use
- Income from services to person outside the U.S./LFDII section 250(b) @ 13.125%

**Distributions**
- PTI
- Participation Exemption (section 245A)
- Subject to tax if hybrids of inverted companies

**GILTI – 10.5% (13.125%)**
- CFC income that is not exempt or sub F
- Current inclusion with 50% deduction
- 80% FTC haircut
- Separate basket
- No FTC carryforward

**Exempt Income – 0%**
- FOGEI
- 10% QBAI
- High Tax sub F income (elective)

**U.S.**

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Interest expense limitation

New Section 163(j)
Application to CFCs

Does new section 163(j) apply to CFCs?
— The proposed regulations under old section 163(j) limited its application to domestic corporations.
— Notice 2018-28 announced Treasury’s intent to revoke the proposed regulations
— Without an explicit carve out for CFCs, it appears that section 163(j) must be applied at the CFC level

For what purpose?
— Taxable income
— E&P?
— Interest expense allocation and apportionment among income categories
  (exempt, tested income, subpart F)
Tested income

All gross income of a CFC other than:
— Effectively connected income (ECI)
— Subpart F income
— Otherwise Subpart F income meeting high tax exception of section 954(b)(4)
— Dividends received from a related person
— Foreign oil and gas extraction income

Less deductions allocable to such gross income under rules similar to section 954(b)(5)

Must determine how much of section 163(j) limitation is allocable to the CFC’s tested income
— Do you calculate 163(j) first or do you allocate the expenses then calculate the 163(j) limitation?

No E&P limitation for tested income
What comes first – GILTI deduction or 163(j) limitation?

GILTI formula under section 951A
- Inclusion Amount = Net CFC Tested Income – Net Deemed Intangible Income Return
- Net Deemed Intangible Income Return = 10% of Qualified Business Asset Investment – Interest expense if attributable to interest income not taken into account in determining the USSH’s net CFC tested income
- QBAI = Adjusted tax basis of tangible assets
- Net CFC Tested Income = Tested Income – Tested Loss (on USSH basis)
- Tested Income = CFC gross income less ECI, Sub F, High-tax, related-party dividends, FOGEI, allocable deductions

GILTI deduction under section 250 = 50% x (GILTI inclusion + section 78 gross up attributable to GILTI inclusion)

The amount of the GILTI (+ FDII) deduction is limited to the USSH’s taxable income (determined without regard to the GILTI+FDII deduction)
Implications for funding

30% ATI threshold means that more interest expense will be deferred

Applies to third-party interest expense unlike old section 163(j)
— Unfavorable BEAT stacking rule: Any reduction of interest deduction under section 163(j) is first allocated to interest paid to third parties, and remaining reduction is allocated to related party interest payments

Applies on a consolidated basis … may be beneficial to domesticate funding entities to soak up interest expense with interest income

Does not apply to Domestic Corps for E&P purposes – no guidance on CFC

Appears to apply for purposes of computing “tested income”/”GILTI”
Interaction with GILTI

CFC-to-CFC loans may result in double GILTI inclusion

Accrual of full amount of interest income results in higher tested income

<table>
<thead>
<tr>
<th>163(j) calculation</th>
<th>$MM</th>
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</thead>
<tbody>
<tr>
<td>Interest Income</td>
<td>0</td>
</tr>
<tr>
<td>172 NOL</td>
<td>5</td>
</tr>
<tr>
<td>Depreciation</td>
<td>10</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>50</td>
</tr>
<tr>
<td>ATI (TI + Depreciation + NOL)</td>
<td>65</td>
</tr>
<tr>
<td>Deductible Amount (30%ATI+interest income)</td>
<td>19.5</td>
</tr>
<tr>
<td><strong>Disallowed Interest</strong></td>
<td>10.5</td>
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</table>

Disallowed interest expense increases tested income to the extent of $10.5MM
Managing currency exposure with respect to PTI

Section 163(j)
Previously taxed E&P (Section 986(c))

Foreign currency gain or loss recognized with respect to distributions of previously taxed E&P.
Gain or loss equal to difference in exchange rates between the times of the deemed and actual distribution.
Gain or loss is treated as ordinary from the same source as the associated income inclusion.
Previously taxed E&P (Section 986(c))

Sources of guidance on §986(c):

— Notice 88-71 (Pooling Approach)

— Proposed regulations issued in 2006
  - Default Rule: Foreign exchange gain/loss determined based on allocation rules (LIFO)
  - Dollar Pooling Basis: Proposed regulations permit taxpayers to pool PTI and determine foreign exchange gain/loss on an aggregate basis
Previously taxed E&P (Section 986(c))

Mandatory Repatriation PTI

— Notice 2018-07
— Proposed regulations issued in 2006
  - Proportionate reduction for 986(c) gain/loss related to inclusion under section 965(c).
  - Regulations to provide allocation rules for determining portion of distribution attributable to mandatory repatriation
  - Must keep mandatory repatriation PTI separate from other PTI
Does a distribution from EUR CFC to USD CFC result in realization and/or recognition of section 986(c) gain or loss?

3 possible approaches
1. FX realized but not recognized until distribution to USP
2. FX disappears upon distribution to USD CFC
3. Recognize FX
   - Analogize to changes in functional currency under section 985
   - Notice 88-71 – no layering of PTI for purposes of calculating section 986(c) gain or loss
   - Proposed regulations apply LIFO approach
Selected PTI issues: FX management of PTI

Timing of FX recognition under section 986(c) will not match timing of recognition of forward contract, which is governed by the mark-to-market regime of section 1256.

Accounting on currency forward – OCI v. P&L

To achieve matching and mitigate cash tax effect, could consider distributing €1000 note to USP and enter into forward to match the tenor of the note.

PTI = €1000
PTI basis = $1250
Value on distribution date = $1300
Proposed Section 954 987 and 988 regulations

Section 163(j)
Overview of proposed regulations affecting section 988 transactions

Expansion of Business Needs Exclusion (Subpart F/ Non-Subpart F)

- FX gains allocated to Subpart F and Non-Subpart F income based on the income generated by the underlying property
- Hedges of net investment in QBU may qualify as bona fide hedge

Timing of Foreign Currency Gains & Losses

- Extension of § 1.446–4 hedge timing rules to bona fide hedging transactions
- Election to mark-to market foreign currency gain or loss

Currency Hedges of Interest-Bearing Liabilities

- Acquisition of debt instrument to hedge interest-bearing liability may qualify as a bona fide hedging transaction
Example: business needs ‘cliff effect’

Section 988 property that produces Sub F / Non-Sub F income

**Facts**
- On 1/1/17, CFC2 (USD Functional) loans CFC1 20m euro with 5% interest when exchange rates are (€1 = $1).
- During 2017 CFC1 earns FPHCI of 200K and the remainder of its earnings are non-subpart F.
- On 12/31/17, when (€1 = $1.10), CFC1 pays €1m of interest and €20m of principal. CFC2 recognizes $2m of currency gain on the principal ($22m - $20m).

**Analysis**
- Under current law, none of the $2m would qualify for business needs exclusion to FPHCI because of the $200K of interest paid.
- Under the proposed regulations, since only 20% of the gain is interest that is FPHCI, 20% ($400K) of the gain would be treated as FPHCI income. The remaining $1.6m would qualify for the business needs exclusion.

Under look through rules, $200K is FPHCI to CFC2
Election to mark to mark Section 988 transactions

Proposed § 1.988–7 permits any taxpayer (U.S. Corp, CFC) to elect to use a mark-to-market method of accounting for section 988 gain or loss with respect to section 988 transactions (including 988 obligations).

Election takes into account only changes in the value of the section 988 transaction attributable to exchange rate fluctuations. Does not account for changes in market interest rates or the creditworthiness of the borrower.

Taxpayer may revoke the election any time. However, subsequent election cannot be made until the sixth taxable year following the year of revocation and cannot be revoked until the sixth taxable year following the year of such subsequent election.

Rules addresses mismatch for 475 dealers that are required to mark receivables but unable to mark payables and creates flexibility for all other taxpayers to follow book treatment.
Section 987 Regulations

After 30 years since enactment, on Dec 7, 2016, final regulations issued abandoning a P&L approach for a balance sheet method.

Less than 1 year later, Notice 2017-57 postpones until 2019.

Executive order 13789 issued stating that Treasury and IRS are reconsidering approach to section 987.

Until 2019, can apply any reasonable method (e.g., 1991, earnings only).

Prior to tax reform, section 987 gain or loss for QBUs of CFC’s in many cases had little to no impact on the U.S. taxable income determinations.

After tax reform, mandatory repatriation and GILTI make it necessary for a CFC to calculate Section 987 gain or loss in order to ensure proper taxation of U.S. shareholder.
Simplifying intercompany debt
Unwinding the “Spaghetti Bowl”

Repayment / refinancing
— Potential COD
— Section 988 gains or losses recognized
— FX losses could result in Tested Loss

Eliminate debt through non-taxable restructurings
— Consolidate borrowers and lenders, e.g., reorganization or section 304 transaction
— Liquidation

Consolidate funding through distributions and/or contributions

Must consider local tax implications
Rationalizing your intercompany loans – legal entity management tool

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Abbreviated structure – §988 loans ≥ $10MM
### Challenge/Opportunity Feasibility Study

<table>
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<th>As-is assessment</th>
<th>Modeling &amp; Analysis</th>
<th>Business case &amp; Roadmap</th>
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<tbody>
<tr>
<td><strong>Key activities</strong></td>
<td><strong>Key activities</strong></td>
<td><strong>Key activities</strong></td>
</tr>
<tr>
<td>- Review “as-is” treasury setup, processes, and technical architecture for relevant items</td>
<td>- Gather key data</td>
<td>- Develop detailed vision for the future state of treasury operations (target operating model)</td>
</tr>
<tr>
<td>- Consider pre-law-change treasury growth plans</td>
<td>- Perform scenario analysis (e.g., increase FDII, proactively trigger high-taxed subpart F, operating model changes, etc.)</td>
<td>- Specify roadmap to achieve functional and technical target</td>
</tr>
<tr>
<td>- Considering leading practice approaches</td>
<td>- Review and iterate key inputs/options/decisions</td>
<td>- Develop business case for the target setup, including tax considerations</td>
</tr>
<tr>
<td><strong>Key results</strong></td>
<td><strong>Key results</strong></td>
<td><strong>Key deliverables</strong></td>
</tr>
<tr>
<td>- Documentation of the current state, as relevant to near-term goals and law change impacts</td>
<td>- Detailed understanding of key challenges and opportunities</td>
<td>- Roadmap containing recommendations of the target operating model and detailed business case for change</td>
</tr>
</tbody>
</table>

### Possible approach

- **6-8 weeks**

### Project Management

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