U.S. Tax Reform

33rd Annual TEI-SJSU – High Tech Tax Institute

November 14, 2017

David Forst, Partner – Fenwick & West LLP

Nathan Giesselman, Partner – Skadden, Arps, Slate, Meagher & Flom LLP

Sajeev Sidher, Managing Director – Deloitte

The Proposed Participation Exemption System

- The "Tax Cuts and Jobs Act" (H.R. 1, 115th Congress, 1st Sess.) (the "House Bill") introduces a 100% deduction for "foreign-source portion" of dividends received by a domestic corporation that is a U.S. shareholder from a "specified 10% owned foreign corporation."
  - A specified 10% owned foreign corporation is a foreign corporation of which 10% or more is owned by a U.S. corporate shareholder, other than a foreign corporation that is a PFIC but not a CFC.
  - The foreign-source portion of any dividend is generally the portion that is attributable to the specified 10% owned foreign corporation's post-1986 undistributed foreign earnings (i.e., income that is not effectively connected with the conduct of a U.S. trade or business or that is not attributable to dividends received from a domestic corporation 80% of which is owned by the specified 10% owned foreign corporation).
- 6-month holding period requirement:
  - Foreign corporation must be a specified 10% owned foreign corporation for at least 181 days during the 361-day period that begins 180 days before payment of the dividend.
  - Domestic corporation must be a U.S. shareholder with respect to the specified 10% owned foreign corporation for at least 181 days during the 361-day period that begins 180 days before payment of the dividend.

The Proposed Participation Exemption System (cont.)

- Applies participation exemption system to undistributed foreign earnings that are reinvested in U.S. property.
  - Repeals Section 956 with respect to U.S. corporate shareholders.
  - Section 956 would continue to apply with respect to noncorporate U.S. shareholders.
- Coordination with foreign tax credit rules (see slide below).
- Effective for dividends paid after December 31, 2017 (and, with respect to disallowance of foreign tax credits, taxable years ending after December 31, 2017).

The Proposed Participation Exemption System – Senate Bill

- Generally tracks House approach, with a few modifications:
  - No exemption for “hybrid dividends”
    - » Those where a deduction is allowed, i.e. payments on CPECs
  - Extends holding period requirement to 366 out of 731 days
  - Effective for taxable years of foreign corporations beginning after 12/31/17 - - no exemption for 11/30 CFCs until 12/1/18 as a result.

Sale of Subsidiary Stock

- In general, capital gains recognized from the sale of foreign subsidiary stock would not qualify under the proposed participation exemption system.
  - Sections 355 and 368 would continue to be relevant.
  - Consider check-and-sell transactions for lower-tier CFCs.
- For purposes of determining loss on the sale or exchange of stock of a specified 10% owned foreign corporation by a U.S. corporate shareholder in a taxable year, the basis of the U.S. corporate shareholder in such stock would be reduced by the amount of any exempt dividends received by the U.S. corporate shareholder in such taxable year or a prior taxable year.
  - Not applicable to determination of gain on the sale or exchange of subsidiary stock.
  - Basis cannot be reduced below zero.
  - Under House bill, effective for dividend payments after December 31, 2017; under Senate bill, only for taxable years beginning after December 31, 2017.
- House proposal does not modify Section 1248 or Section 964(e) and is silent on the application of the proposed participation exemption system to gain recognized pursuant to sale of CFC stock and dividend-equivalent Section 304 transactions.
  - Senate extends exemption approach to 964(e) sales and clarifies application of Section 1248

Impact on Foreign Branches

- Earnings of foreign branches of U.S. corporations are excluded from the proposed participation exemption system (*i.e.*, current tax system continues to apply).
- Section 901 foreign tax credits would continue to offset U.S. federal tax on earnings of U.S. corporations through foreign branches.
- If a domestic shareholder transfers substantially all of the assets of a foreign branch to a specified 10% owned foreign corporation (with respect to which the domestic corporation is a U.S. shareholder after such transfer), such U.S. corporate shareholder shall include in income for the taxable year of such transfer the “transferred loss amount” with respect to such transfer.
  - For transfers covered by Section 367(a)(3)(C), the transferred loss amount is excess of the post-effective date losses incurred by the foreign branch that were deducted by the U.S. corporate shareholder over the sum of the taxable foreign branch profit earned after the loss is incurred and the OFL arising out of the transfer of the branch assets.
  - For transfers not covered by Section 367(a)(3)(C), the transferred loss amount is further reduced (but not below zero) by any other gains recognized by the U.S. corporate shareholder on such transfer.
  - Amounts includible in income would be treated as U.S.-source income.
  - Effective for transfers after December 31, 2017.

Changes to Foreign Tax Credit Rules

- No foreign tax credit or deduction would be allowed for any foreign taxes (including foreign withholding taxes) paid or accrued with respect to any exempted dividends under the participation exemption system.
  - Consequently, the bill repeals Section 902 indirect foreign tax credits.
  - Impact on structure of foreign operations (*e.g.*, CFCs versus branches).
- Section 960 indirect foreign tax credits that are "properly attributable" to any subpart F income inclusions would be determined on a current-year basis and without regard to pools of foreign earnings retained offshore.
- For purposes of determining foreign tax credits, the source of income arising from the sale of inventory produced within the United States but sold outside the United States (or vice versa) would be apportioned solely on the basis of where production activities attributable to the inventory are located.
- Effective for taxable years beginning after December 31, 2017.
- Senate bill also requires foreign branch income to be allocated to a separate basket

Transition Tax - Overview

- The House Bill proposes to amend Section 965 to impose a one-time "transition tax" by creating a deemed inclusion of foreign corporations' deferred foreign earnings to such corporations' U.S. shareholders.
- Generally, the House Bill proposes to create a deemed repatriation from controlled foreign corporations and from any other foreign corporation that is at least 10% owned by a domestic corporation (excluding non-controlled passive foreign investment companies) (for purposes of this discussion, we refer to all such corporations as "**CFCs**") with undistributed foreign earnings which were not previously subject to U.S. taxation ("**deferred E&P**") to their 10% U.S. shareholders, by increasing such CFCs' subpart F income by the amount of its deferred E&P. The subpart F income is included in the last taxable year of the CFC which begins before January 1, 2018.
- A U.S. shareholder required to include deferred E&P in gross income is allowed a deduction, computed by reference to the portion of the deferred E&P attributable to cash or liquid assets. The deduction effectively results in a 7% tax being imposed on the non-cash portion of the deferred E&P, and a 14% tax being imposed on the cash portion of the deferred E&P.
- Under the House Bill, taxpayers are permitted to claim foreign tax credits ("**FTC**") subject to a reduction, which is based in part on relative amounts of earnings that are represented by cash versus non-cash assets.
- The resulting tax may be paid by the U.S. shareholder in 8 equal annual installments, without an interest charge being imposed.

Transition Tax - Deferred E&P – Definition

- Proposed Section 965 defines deferred E&P as post-1986 E&P, subject to certain exclusions and adjustments.
  - Post-1986 E&P of a CFC is determined as of November 2, 2017 or December 31, 2017, whichever is greater (the "**measurement date**"), without diminution by reason of dividends paid during such taxable year and increased by certain qualified deficits.
- The provision increases a CFC's subpart F income for the last taxable year beginning before January 1, 2018 by the deferred E&P determined as described above.
  - Consequently, for CFCs with a non-calendar taxable year, e.g., November 30, the inclusion will occur in 2018, allowing for up to nearly a year's deferral of the tax.
- Deferred E&P excludes earnings attributable to effectively connected income and earnings that would be treated as previously taxed income ("**PTI**") under Section 959 if distributed.
- Regulations or other guidance may provide for additional reductions to deferred E&P in the case of CFCs with non-U.S. shareholders (for example, by treating such shareholders as though they were U.S. shareholders for purposes of determining PTI).

Transition Tax - Measurement of Deferred E&P

- Under the proposal, a CFC's subpart F income would be increased in its last tax year which begins before January 1, 2018 by the CFC's deferred E&P as of the measurement date.
- Measurement date is either November 2, 2017 or December 31, 2017, whichever date results in a higher amount of deferred E&P.
  - Accordingly, CFCs with a one-month deferral tax year under Section 898(c)(2) could have a one-month stub period.
  - Query how readily taxpayers will be able to determine their deferred E&P as of November 2, which is neither a month nor year end.
- <u>"Add-Back" of Dividends</u>. Deferred E&P is determined without diminution "by reason of" dividends distributed during the foreign corporation's taxable year ending on or including the measurement date.
  - The add-back rule could interfere with taxpayer planning to repatriate high-taxed foreign earnings in the period leading up to the measurement date and appears to result in double taxation in certain instances.
- The JCT Explanation notes that the Service may promulgate Regulations "that are appropriate to implement the intent of the revised Section 965 and the use of the date of introduction as one of the measurement dates in order to establish a floor for determining the post-1986 deferred foreign earnings and profits."
  - For example, guidance may address the extent to which retroactive effective dates for "check-the-box" elections filed after November 2, 2017 will be permitted.

Transition Tax - Foreign Tax Credits

- Proposed Section 965 provides that credits under Section 901 are disallowed for the "applicable percentage" of any taxes paid or accrued (or treated as such) with respect to any amount subject to the transition tax.
  - Similarly, no deduction is allowed for any tax for which the credit is not allowable under these provisions.
- The Section 78 gross up does not apply to any tax for which the credit is not allowable under the statute.
- Any excess FTCs resulting from the inclusion are eligible for a special 20 year carryforward period, rather than the otherwise available 10-year period provided for by Section 904(c).
- Other FTCs available to the taxpayer (e.g., carryforwards from prior years) are available without reduction to offset the U.S. tax liability with respect to Section 965 inclusions.

Example 1

Facts

- U.S. Multinational ("Parent") is a calendar year taxpayer. Parent owns CFC, which has a 12/31 taxable year.
- On 11/15/17, CFC pays a dividend of $100 with excess FTCs to Parent.
- CFC's E&P is static between the measurement dates.

Analysis

- The $100 dividend does not reduce CFC's deferred E&P as of either measurement date (11/2/17 or 12/31/17).
- Pursuant to Section 965, Parent has a subpart F inclusion that includes the $100 on 12/31/17.
- Assuming that the $100 is represented by cash, Parent incurs a $14 transition tax liability on the deferred E&P represented by the $100 dividend.
- The indirect FTCs are subject to haircut pursuant to Section 965(g).
- The $100 distribution on 11/15/17 is treated as PTI, and not subject to taxation in the hands of Parent.

Example 2

Facts

- Parent is a calendar year taxpayer. Parent owns CFC, which has an 11/30 taxable year.
- On 11/15/17, CFC pays a dividend of $100 with excess FTCs to Parent.
- CFC's E&P is static between the measurement dates.

Analysis

- The $100 dividend does not reduce CFC's deferred E&P as of 11/2/17.
- Parent has $100 of dividend income plus a Section 78 inclusion on 11/15/17, which brings back excess FTCs in the 2017 calendar year. These credits can either be used against other foreign source income or carried back or forward pursuant to Section 904(c).
- CFC's deferred E&P (including the $100 distributed) becomes subpart F income on 11/30/18, and is included in Parent's taxable income in 2018.
- Parent may be able to utilize the FTC carryforward from the 2017 dividend against its transition tax liability.

Example 3

Facts

- Parent is a calendar year taxpayer. Parent owns CFC 1, which owns CFC 2. Each of CFC 1 and CFC 2 has an 11/30 fiscal year.
- On 11/15/2017, CFC 2 pays a $100 dividend to CFC 1 out of cash on its balance sheet.
- CFC 1 excludes the dividend from subpart F income under Section 954(c)(6).
- CFC 1 and CFC 2 otherwise have static E&P between the measurement dates.

Analysis

- As in Example 2, the $100 is included in CFC 2's deferred E&P for purposes of calculating the transition tax on 11/30/18.
- Parent incurs a $14 transition tax liability.
- Query whether the $100 dividend is also included in CFC 1's deferred E&P for purposes of the transition tax?

Transition Tax - Netting of Positive E&P and Deficits

- A taxpayer that is a U.S. shareholder in respect of one or more CFCs with deferred E&P and one or more CFCs with deficits in post-1986 E&P (“deficit CFC”) is entitled to an offset to its subpart F inclusions in respect of deferred E&P.
- Specifically, the taxpayer first aggregates its pro rata share of post-1986 deficits of all deficit CFCs with respect to which it is a U.S. shareholder, and then allocates this amount proportionately among its Section 965 inclusions as an offset.
- The House Bill also permits intragroup netting among U.S. shareholders in a consolidated group. Thus, if one member of the group owns CFCs with net positive deferred E&P, and an affiliate owns CFCs with a net deficit, the affiliate’s deficit may be used to reduce the first member’s Section 965 inclusions.

Transition Tax - Deduction Against Subpart F Inclusion

- Under the House Bill, the transition tax would be imposed at a split rate of 5% and 12%.
- The split rate is implemented by allowing a U.S. Shareholder a deduction, determined by reference to the amount of the inclusion(s) of deferred E&P and the U.S. Shareholder’s “aggregate foreign cash position” (described below).
- For example, for a calendar year U.S. Shareholder that owns CFCs with an 11/30 year end and therefore includes deferred E&P in 2018 (when the statutory corporate tax rate is 20%), the deduction is equal to 75% of the excess (if any) of the Section 951 inclusions over the aggregate foreign cash position, plus 40% of the lesser of (i) the Section 951 inclusions and (ii) the aggregate foreign cash position.

Transition Tax - Aggregate Foreign Cash Position

- Under the House Bill, the cash position of each CFC is the sum of the following assets held by the CFC—
  - cash and foreign currency
  - the excess of accounts receivable over accounts payable
  - the fair market value of the following assets:
    - » actively traded personal property for which there is an established financial market
    - » commercial paper, certificates of deposit, securities of the federal government and of any state or foreign government
    - » any obligation with a term of less than one year
    - » any asset that the Secretary identifies as being economically equivalent to any asset described above.
- A U.S. Shareholder's "aggregate foreign cash position" is the average of the sum of the shareholder's pro rata share of the cash position of each CFC with respect to which that shareholder is a U.S. shareholder on each of three dates: November 2, 2017 (the date of the House Bill's introduction), and the last day of the two most recent taxable years of such CFC ending before November 2, 2017.
- Prevention of double counting. The House Bill includes rules intended to avoid the double counting of the cash position of CFCs in a controlled group.

Transition Tax - Aggregate Foreign Cash Position (cont.)

- Blocked assets. A cash position is not taken into account if such position could not (as of the relevant measurement date) have been distributed to the U.S. Shareholder because of currency or other restrictions or limitations imposed under the laws of any foreign country. Cash that cannot be distributed for regulatory capital reasons (for example, in the case of banks and insurance companies) is not considered "blocked."
- Anti-abuse rule: In addition to the authority to identify other assets that are subject to the cash position determination by regulation, the proposal also authorizes the IRS to disregard transactions that it determines had the principal purpose of reducing the aggregate foreign cash position.

Transition Tax - Aggregate Foreign Cash Position Issues

- Reduce Cash Position by PTI. Under the House Bill, while deferred E&P is reduced by PTI, cash is effectively treated as allocable solely to non-PTI earnings. Arguably, the cash position should be reduced by PTI to the extent thereof, since PTI can generally be repatriated tax-free.
- Treatment of Accounts Receivable. Accounts receivable arising in the ordinary course of business are not excess funds and should generally be excluded from the computation of cash position.
- CFCs with Different Taxable Years. A U.S. shareholder measures its aggregate foreign cash position as a single sum across all CFCs. A U.S. shareholder with both 11/30 and calendar year CFCs would thus have to take foreign cash held by all of its CFCs (11/30 CFCs and calendar year CFCs) into account for purposes of determining the deduction in respect of its Section 965 inclusion for its calendar year CFCs in 2017, and would then have to take the exact same foreign cash into account again for purposes of determining the deduction in respect of its Section 965 inclusion for its 11/30 CFCs in 2018.

Transition Tax - Installment Payments

- Under the House Bill, a U.S. shareholder may elect to pay the net tax liability resulting from the inclusion of deferred E&P in 8 equal installments.
  - Installment payments are not subject to an interest charge.
- Pursuant to an "acceleration rule," if (1) there is a failure to pay timely any required installment, (2) there is a liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case), (3) the U.S. shareholder ceases business, or (4) another similar circumstance arises, the unpaid portion of all remaining installments is due on the date of the event.
- The taxpayer liable for the installment payments is the U.S. shareholder of the CFC, and not the common parent of its consolidated group.
  - Thus, liquidating the relevant U.S. shareholder would appear to generally accelerate the Section 965 tax liability, even though the U.S. consolidated group remains in existence and is entirely creditworthy.
  - A Section 338(h)(10) election in connection with a sale of the stock of a U.S. shareholder that has installment payments remaining would also seem to trigger the acceleration rule, while a sale of such stock without the election would not.

Transition Tax - Considerations for REITs, RICs, and PTPs

- For a real estate investment trusts (“REITs”), subpart F income is not qualifying income under the 75% income test, and could cause an inadvertent termination and a 100% penalty tax on the subpart F income to maintain REIT status.
- For both REITs and regulated investment companies (“RICs”), Section 965 inclusions of deferred E&P could pose challenges for the distribution requirement.
- For publicly traded partnerships (“PTPs”), subpart F inclusions would flow through to the PTPs’ individual unitholders, who would not be entitled to the benefit of Section 902 credits. It is unclear how the deduction intended to result in effective tax rates of 5% and 12% is to be computed (if at all) in this situation.

Transition Tax – Senate Modifications

- E&P measured as of December 9, 2017, or “other applicable measurement date”
- 10% rate for cash and 5% for other E&P
- Special full 35% rate if U.S. corporation becomes an expatriated entity within 10 years; no FTCs
- Cash position calculated as of last day of the taxable year of the inclusion, or the average of the last day of two preceding taxable years immediately before measurement date, whichever is larger. Acknowledged need for rules to prevent double counting.

New Category of Undeferred Income: High Return Category

- In General: Each person who is a US Shareholder of any CFC for any taxable year shall include in gross income for such taxable year 50% of such shareholder's "foreign high return amount" for such taxable year.
- Foreign High Return Amount:
- "Net CFC Tested Income" over
- "Applicable Percentage" of aggregate of shareholder's pro rata share of "Qualified Business Asset Investment" for each CFC less interest expense taken into account in computing net CFC tested income.
- High return category appears to require both separate CFC calculations and global CFC calculations

* *Ultimate Impact: To the extent foreign income taxes on tested income are imposed at an average global effective rate of 12.5% or greater, and assuming timing rules for US and foreign tax purposes are the same, no additional US income tax need result*

Calculation of Foreign High Return Amount

- <u>Compute Tested Income on a CFC by CFC Basis</u>
  - Tested Income: Excess of gross income (without regard to excluded amounts) over allocable deductions
    - Excluded Amounts:
      - ECI
      - Gross subpart F income
      - Income excluded from FPHCI under section 954(c)(6) (CFC look-thru rule), (h), or (i) ("AFE")
      - High taxed income
      - Related party dividends
      - Gross income from disposition of actively traded commodities produced or extracted by the CFC (and identified hedges thereof)
  - Tested Loss: Excess of Allocable Deductions over relevant gross income
- <u>Aggregate US shareholder's pro rata shares of tested income and tested loss for all of its CFCs</u>

Calculation of Foreign High Return Amount

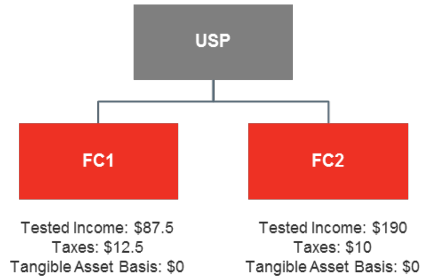
- Step 2: Determine Applicable Percentage of US shareholder's Pro Rata Share of CFCs' aggregate Qualified Business Asset Investments
  - "Applicable Percentage": Short Term AFR + 7%
  - "Qualified Business Asset Investment": CFC's Adjusted Basis in tangible depreciable property used in a trade or business to produced tested income.
    - » Partnership Property: Partner takes into account its distributive share of partnership property using the partnership's basis in the property
    - » Determination of Adjusted Basis: Made without regard to any amendment to Code occurring after enactment of the TCJA
- Step 3: Identify interest expense incurred by CFCs and allocable to their gross Tested Income
- Step 4: Compute Foreign High Return Amount
  - US shareholder's Net CFC Tested Income minus Applicable Percentage of aggregate Qualified Business Asset Investment minus CFCs' interest expenses allocable to their gross tested income

Calculation of Foreign High Return Amount

- Step 5: Determine Inclusion and Coordination with subpart F
  - § 951A inclusion
    - » 50% of Foreign High Return Amount
  - Allocate Foreign High Return Amount among CFCs for subpart F purposes
    - » If CFC has "tested loss": No inclusion allocated to CFC
    - » If CFC has positive tested income, allocate to CFC:
      - > *FHRA x CFC's tested income ÷ "net CFC tested income*"
- Step 6: Compute foreign taxes of a CFC deemed paid with section 951A inclusion
  - "Foreign High Return Percentage" × Aggregate foreign taxes paid by CFCs on gross tested income × 80%
  - Foreign High Return Percentage = FHRA ÷ aggregate of tested incomes of all CFCs with positive tested incomes
  - Apply § 904(d)(1) treating the Foreign High Return Amount as a separate "basket"
  - No carryover of excess credit in the basket
  - § 78 gross-up calculated substituting "100%" for "80%"

Analysis

- Foreign High Return Amount:
  - Net CFCs Tested Income = $87.5 + $190 = $277.5
  - Foreign High Return Amount = $277.5 – ($0 Asset Basis) = $277.5
- High Return Category Inclusion Pre-FTC calculation:
  - 50% of $277.5 = $138.75
- FTC Calculation:
    - » Foreign High Return Percentage = $277.5/$277.5 = 1
    - » Aggregate Taxes = $12.5 + $10 = $22.5
    - » Deemed Paid Credit = 80% * 1 * $22.5 = $18
  - §78 Gross-Up
    - » §78 Gross-Up = 100% * 1 * $22.5 = $22.5
- Total High Return Category Inclusion:
  - Grossed-Up Foreign High Return Amount = $277.5 + $22.5 = $300
  - Total High Return Category Inclusion = 50% of $300 = $150
- Residual U.S. Tax:
  - $150 * 20% = $30
  - Less FTC   = $18
  - Residual Tax = $12



******Total Global ETR: $34.5/$300 = 11.5%*

Key Take-Away

- Identify highly profitable subsidiaries and begin to calculate FHRA inclusion.
  - Consider additional foreign planning if inclusion remains subject to residual U.S. tax
- Consider Pre - 11/30/2018 Basis Step Up Transactions For 11/30 Year End CFCs
  - Although E&P could be picked up in transition tax (e.g. if E&P created during 11/30/2017 – 12/31/2017), this may be at a lower rate than the future FHRA.
- In addition, E&P created from 1/1/2018 – 11/30/2018 may not be subject to any residual US tax, provided current subpart F rules are managed.

GILTI—Part 1

- A US Shareholder must include in gross income its "global intangible low-taxed income" (GILTI) as if it were subpart F income.
- GILTI is generally gross income of a CFC (less ECI, sub F income, high taxed income, et al) over 10% of the CFC's basis in its tangible assets.
- An 80% deemed paid credit is available on GILTI inclusions; it is in a separate FTC basket, with no carryback or carryforward. Section 78 gross-up is based on 100% of foreign taxes attributable to GILTI.

GILTI—Part 2 and FDII

- Deduction equal to 37.5% of the lesser of (1) foreign-derived intangible income (FDII) plus GILTI, or (2) taxable income.
- To get to FDII, solve for X:
  - X/Deemed Intangible Income = Foreign-Derived Deduction Eligible Income/Deduction Eligible Income
    - » Deduction Eligible Income is gross income minus, inter alia, sub F income, GILTI, dividends from CFCs, foreign branch income
    - » Foreign Derived Deduction Eligible Income is deduction eligible income that is derived from export sales/services to foreigners.
    - » Deemed Intangible Income: Excess of Deduction Eligible Income over deemed intangible return (excess of 10% of tangible asset basis)
- Therefore, both GILTI (excess foreign IP income) and FDII (excess US IP income on export transactions) are subject to 12.5% rate.
- U.S. IP returns on domestic sales are still subject to 20% rate.

Interest Deduction Limitations—new 163(j)

- Under a new § 163(j), interest deductions for a year would generally be limited to 30% of the taxpayer's adjusted taxable income plus any business interest income.
- Due to the repeal of § 956, this provision would have far greater relevance for outbound taxpayers
- Adjusted Taxable income is taxable income reduced by--
  - any item of income, gain, deduction, or loss which is not properly allocable to a trade or business,
  - any business interest or business interest income,
  - the amount of any net operating loss deduction under section 172, and
  - any deduction allowable for depreciation, amortization, or depletion,
- If a corporation had no adjusted taxable income (i.e., if it were in a loss position), it could only deduct business interest expense against business interest income
- Any disallowed interest deductions due to the 30% limitation could be carried forward for 5 years on a first-in, first-out basis.

Interest Deduction Limitations—new 163(j) (cont.)

- If a corporation had no adjusted taxable income (i.e., if it were in a loss position), it could only deduct business interest expense against business interest income.
- Any disallowed interest deductions due to the 30% limitation could be carried forward for 5 years on a first-in, first-out basis.

Interest Deduction Limitations—new 163(n)

- Under new § 163(n), a U.S. corporation's interest deduction relative to the worldwide group's interest deduction could be no greater than 110% of the U.S. corporation's EBITDA relative to the worldwide group's EBITDA.
- In other words, a U.S. corporation's interest deductions would generally be restricted if it were more highly leveraged relative to the rest of the worldwide group.
- The EBITDA of U.S. corporations includes the EBITDA of any disregarded entities but generally does not include any distributions received from foreign subsidiaries.
- The taxpayer can only claim the lower amount of the allowed deduction under § 163(j) and 163(n),

Excise Tax/ECI (cont.)

- New § 4491 would impose a 20% excise tax on "specified amounts" paid or incurred by a domestic corporation to a related foreign corporation if the worldwide group's 3-year average of such amounts exceeded $100 million. Alternatively, the foreign corporation could elect to treat the amount minus deductions as ECI.
- This provision would effectively subject the earnings of a foreign subsidiary which sells or otherwise provides value to the U.S. market to the 20% U.S. corporate rate, though under the Brady amendment of November 6th, some credits for foreign taxes paid would be allowed if the ECI election were made.
- The provision also would have a major adverse impact on many foreign-parented companies with U.S. subsidiaries. It is not unlike the "border adjustability tax," or "BAT," called for by the 2016 House Blueprint. Lobbying to kill this provision has already begun.
- The provision upends the international consensus that has lasted for nearly a century that business profits cannot be taxed by a source country if the person who earns the income does not conduct business in the source country ("excise tax" designation notwithstanding).

Excise Tax/ECI (cont.)

- It very well could be a violation of the business profits articles of all U.S. bilateral tax treaties and also a violation of the negotiated reductions in withholding rates set forth in many treaties.
- Further, it would provoke retaliatory measures by countries around the world.
- If countries did retaliate, the consequences would be severe: Either the additional foreign taxes would be creditable and cause a significant reduction in revenue, or not creditable and cause a significant increase in the tax burdens of U.S. corporations.
- A “specified amount” would mean any amount allowable as a deduction or includible in COGS, inventory, or the basis of a depreciable or amortizable asset, but excluding interest, amounts paid or incurred for certain securities and commodities, and amounts paid or incurred for services under the total services cost method with no markup under the § 482 regulations.
- Amounts subject to tax under § 881(a) would also be excluded in the same proportion as the tax rate imposed under that section (as reduced by any applicable treaties) bears to 30%.

Excise Tax/ECI (cont.)

- The excise tax would not apply, however, if the related foreign corporation elected to be treated as engaged in a U.S. trade or business and to treat the specified amount as ECI under new Code Section 882(g).
- If such an election were made, the domestic corporation would not be allowed a deduction for the specified amount. Instead, the foreign corporation would be allowed a deduction against its (elected) ECI equal to the “deemed expenses” with respect to the specified amount.
- The deemed expenses would be determined based on certain financial ratios of the worldwide group.
- The § 884 branch profits tax would also apply to the amounts treated as ECI.
- Specified amounts paid, incurred, or received by a partnership would be treated as having been paid, incurred, or received, by the partners in proportion to their distributive shares of income to which the amounts relate.
- Specified amounts paid, incurred, or received by a foreign corporation in connection with the conduct of a U.S. trade or business (other than the trade or business deemed conducted pursuant to the election) would be treated as paid, incurred, or received by a domestic corporation.

Excise Tax/ECI (cont.)

- Foreign tax credits under Code Section 901 would be disallowed with respect to specified amounts received by a foreign corporation. Under special “shadow” foreign tax credit rules, however, credits would be available to offset net ECI from specified amounts at a maximum rate of 50% of the worldwide group’s effective foreign tax rate or 20%, whichever is less.
- New Code Section 6038E would impose reporting requirements with respect to specified amounts.