

# 2018 McDermott Tax Symposium

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Panel I: A Holistic View of Business Tax Reform –  
The Major Changes and Their Impact

APRIL 24 | CHICAGO

**David Noren**, Moderator | Washington, DC  
**Andrew Liazos** | Boston  
**Jane May** | Chicago  
**Patrick McCurry** | Chicago  
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# Agenda

- Overview
- Corporate / general business tax provisions
- Partnership/pass-through provisions
- Employee benefits provisions
- SALT implications
- Controversy implications
- Tax policy process going forward

# Overview – A Holistic View of Business Tax Reform

- Overarching design of the legislation
  - Pro-competitive orientation
  - Balanced, aggressive approach to income shifting and abuse
  - Not simplification
  - Political urgency / speed
  - Revenue compromises
- Complex new interactions across various substantive areas
- Unintended consequences big and small
- Still a work in progress—enactment was only the first chapter....

# Corporate / general business tax changes

- Impact of corporate rate reduction, AMT repeal (but a new AMT in form of BEAT!), and NOL limitations on business planning
  - Blended rates for non-calendar taxpayers under section 15, Notice 2018-38
- Impact of cost recovery provisions on investment
  - Temporary expensing
  - Capitalization of R&D expenditures, with delayed effective date (TYBA 12/31/21)
- Expanded interest limitation under section 163(j)
  - Recent IRS guidance (Notice 2018-28)
  - Interaction issues
- Responding to replacement of section 199 with combination of general rate cut, FDII, etc.

# Partnership/Pass-Through Provisions

- Section 199A – Qualified Business Income Deduction
- International Tax Aspects – Winners and Losers
- Other Significant Topics Impacting Pass-Through Entities

# Section 199A – Qualified Business Income Deduction

- Rate reduction delivered in the form of a deduction
- Deduction generally equal to 20% of “qualified business income” through 2025, with some limitations. Includes REIT dividends and PTP income.
- Limited to the greater of (1) 50% of the taxpayer’s share of W-2 wages, or (2) 25% of the taxpayer’s share of W-2 wages and 2.5% of the taxpayer’s share of the unadjusted basis of qualified property
- Specified personal services businesses not eligible, except for taxpayers with taxable income <\$157,500/\$315,000 (deduction phased out over next \$50k/\$100k)
- Personal services businesses include, among others, legal, finance, consulting, accounting, healthcare or any business where the principal asset is the reputation or skill of its employees or owners.

# Section 199A – Qualified Business Income Deduction

- Ripe for future controversy due to lack of clarity on key points in the statute
  - Aggregation/disaggregation
  - Reasonable compensation determinations
  - Scope of disqualified services businesses
- Impact on choice-of-entity decisions (check-the-box planning, revocations of S elections, etc.)
- Creative planning available but some strategies carry significant uncertainty

# International Tax Aspects – Winners

- Winner – S Corp shareholders with respect to transition tax – section 965(i)
  - Can elect to indefinitely defer payment of transition tax until “triggering event” (e.g., transfer of stock (including a result of death) and a sale of the S corporation)
  - Eight-year deferral still available upon a triggering event
  - Retroactive check-the-box planning
- Winner – Pass-through entities avoid the BEAT



# International Tax Aspects – Losers

- Loser – Pass-through entities with respect to GILTI
  - No deduction for GILTI amount and GILTI subject to 37% rate
  - Generally cannot claim foreign tax credits paid or accrued by CFC on GILTI
  - C Corp planning solution but consider all knock-on consequences
  - Consider QSub drop-down planning
  - Consider use of branches and/or checked foreign entities
- Loser – Pass-through entities get no deduction for FDII

# Other Significant Topics Impacting Pass-Through Entities

- Carried interest provision – section 1061
  - Requires three-year holding period for long-term capital gain treatment
  - Applies to sales of carried interests and gain allocations with respect to carried interests
  - Strategies developing to mitigate the impact but difficult to predict effectiveness
  - Regulations could be broad or narrow regarding “with respect to” qualifier

# Other Significant Topics Impacting Pass-Through Entities, Cont'd

- Elimination of section 708(b)(1)(B) (so-called “technical terminations”)
- Excess business loss limitation – section 461(l)
  - Business loss in excess of \$500,000 disallowed (can no longer offset portfolio or other income)
  - Appears to be a one-year deferral because disallowed loss becomes part of NOL
- *Grecian Magnesite* repeal – section 864(c)(8)
  - Sale of a foreign partner’s interest in a US partnership is ECI

# Employee Benefits Provisions – Highlights

- Tighter pay deduction rules at public companies for top management
- Changes impact most incentive pay and deferral programs
- Uncertainties as to transition rule require monitoring and planning
- Expect renewed focus on ways to defer pay to maximize deductions
- Don't forget state tax law considerations
- Expect restructuring of fringe benefit programs

# Section 162(m) - \$1 Million Deduction Limit

## Prior Law

- No deduction limit for “performance-based compensation”
- Compensation paid to CFO not subject to \$1 million limit
- Applies only to other current NEOs employed at fiscal year end
  - CEO and three other most highly compensated executive officers
- Most deferred compensation avoided this deduction limit
- Only covers corporations with publicly traded equity securities

# Section 162(m) - \$1 Million Deduction Limit

## Key Changes under Tax Cuts and Jobs Act

- Eliminates performance-based compensation exception
- Expands who are covered employees
  - Includes CFO
  - Once a covered employee, always a covered employee
- No easy workaround for deferred compensation
- Includes certain private companies
- Effective for tax years beginning after 2017

# Section 162(m) - \$1 Million Deduction Limit Transition Rule

- Applies to “written binding contracts” as of 11/02/17
  - Impact of “negative discretion” provisions
  - Impact of employer authority to amend contract
- Loss of relief if there’s a “material modification”
- Scope of transition rule remains uncertain
- Guidance expected from Treasury later this year

# Section 162(m) - \$1 Million Deduction Limit Impact on Arrangements Going Forward

- Changes to incentive programs structures
  - ISS / institutional shareholder concerns
  - State tax considerations
- Less prevalence of NQSOs? More prevalence of ISO?
- Increase in salaries
- Maximizing use of annual deduction limit through deferred compensation



# Section 162(m) - \$1 Million Deduction Limit Planning

- Identify plans and agreements that may benefit from transition rule
- Avoid unintentional loss of grandfathering relief
  - Adjusting performance awards; amending plans when seeking more shares
- Update proxy disclosures
- Have committee consider loss of deductions when approving pay
- Don't change committee charters just yet
- Update award agreements for post 2017 grants

# State and Local Taxation

## CEO Pay Ratio

- Wide range of reported CEO pay ratio under SEC rules
- Several states have proposed additional taxes related to CEO pay
- Most would impose surtax based on the ratio
- State/local pay ratio calculations would likely differ from SEC rules

# SALT Implications of Federal Tax Reform

- Broader base with no state rate reductions: windfall for the states?
- Divergent state starting points regarding conformity to federal
- Existing state provisions may limit effect of federal conformity
- International provisions may raise constitutional issues
- State legislative responses underway
  - Conformity
  - Selective decoupling

# Controversy Implications of Tax Reform

- IRS Observations
  - Resource constraints are a major driver
  - Actively managing inventory in a number of ways
  - Current areas of focus
- Impacts of Tax Reform
  - New paradigms
  - Interpreting the new law
    - Compliance
    - Deference to guidance

# Controversy Implications, Cont'd

- Transfer pricing
  - BEAT
  - Aggregate theory of valuation
  - Evolving role of APAs

# Tax Policy Process Going Forward— Technical Corrections Legislation

- Criteria for a proper technical correction
- Normal technical corrections process
- Obstacles to technical corrections legislation in current political environment
- Role of JCT Bluebook
- Potential for non-“technical” legislative changes
  - No “must pass” vehicles for awhile, after March budget deal
  - Some chance of tax reform tweaks in FAA reauthorization bill in the fall?
  - “Phase 2” tax bill primarily politics/messaging, but worth watching
- Impact of 2018 midterm elections?

# Tax Policy Process Going Forward— Treasury/IRS Guidance

- Notices for urgent matters
- Otherwise preference for proposed regulations
- Impact of April 11 MOA framework for OMB/OIRA review
- Treasury approach to authority questions
- Interaction with technical corrections and other Hill activity

# Tax Policy Process Going Forward— Tax Reform Sustainability Issues

- Political context (Ds want to revisit the legislation; need +24 in House and +2 in Senate to gain control)
- Temporary provisions => lots of new “extenders” (2022, 2023, and especially in 2026)
- Budget impact => historically high deficits relative to GDP assuming full extension of currently temporary policies
- Reactions of trading partners, WTO



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Panel II: Integrated Planning for GILTI, FDII,  
the BEAT and Repatriation

**Lowell Yoder**, Moderator | Chicago  
**Britt Haxton** | Washington, DC  
**Jay Singer** | Washington, DC  
**Elizabeth Chao** | Chicago

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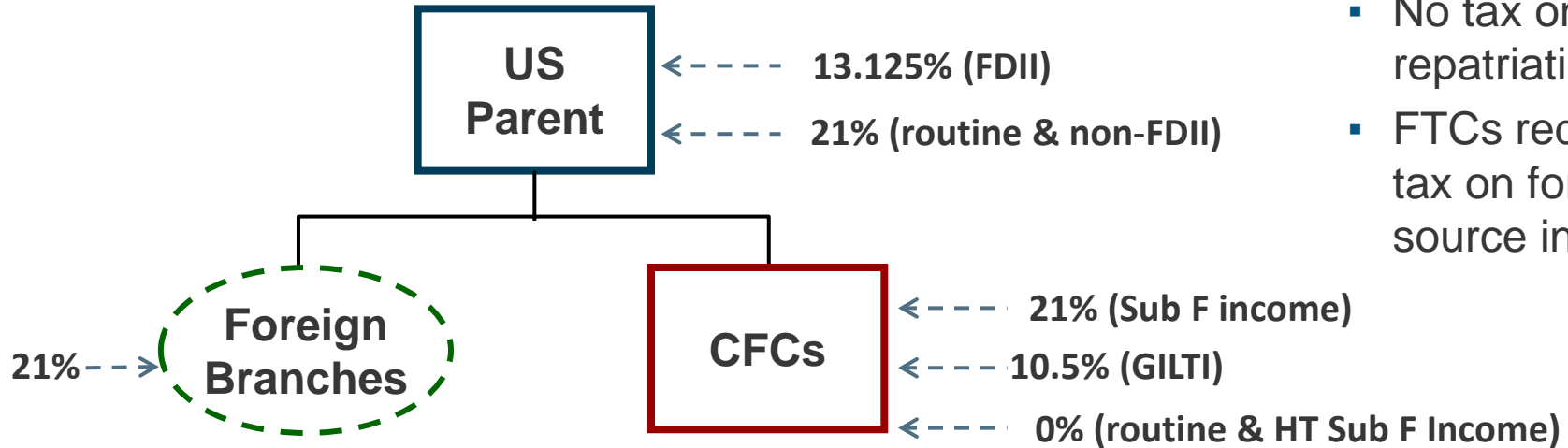
# Overview: Taxation of Foreign Business Income

- General worldwide taxation (but lower rates)
- Foreign tax credits are important (but more limited)
- Reduced benefits for deductions related to foreign income
  - Less FDII & GILTI
  - Decrease foreign tax credits
  - Increase BEAT

# Tax Rates on Foreign Income

## Comments

- No tax on repatriation
- FTCs reduce US tax on foreign source income



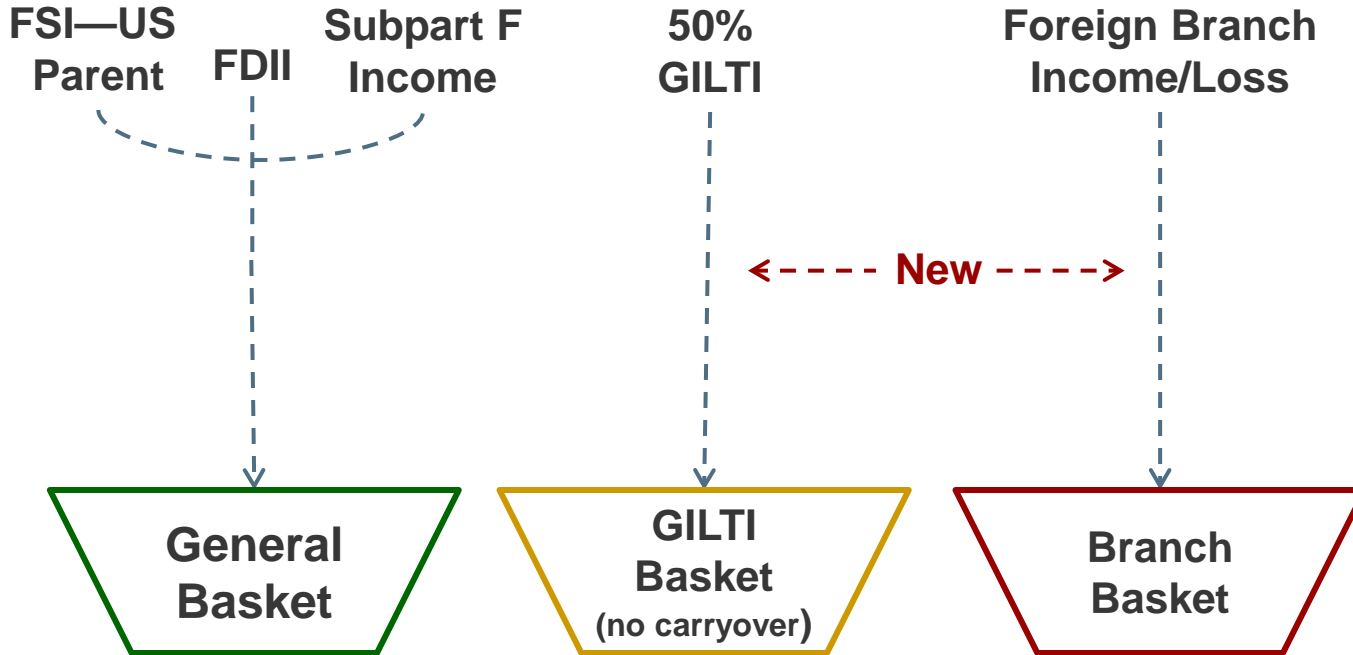
# Foreign Tax Credits

- Rules for creditability of foreign taxes unchanged
- CFCs: Annually determine foreign taxes “attributable” to Subpart F inclusions; some taxes left behind & some lost
- Tighter FTC limitations
  - 21% rate (vs. 35%)
  - Two new limitation categories
- No FTCs for BEAT

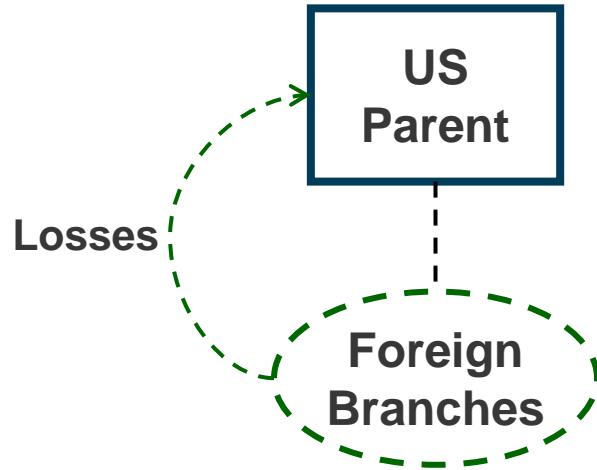
# FTC Limitation Categories

## Comments

- Separate FTC computations
- Seek to maximize taxes in general basket
- Seek to reduce foreign income taxes



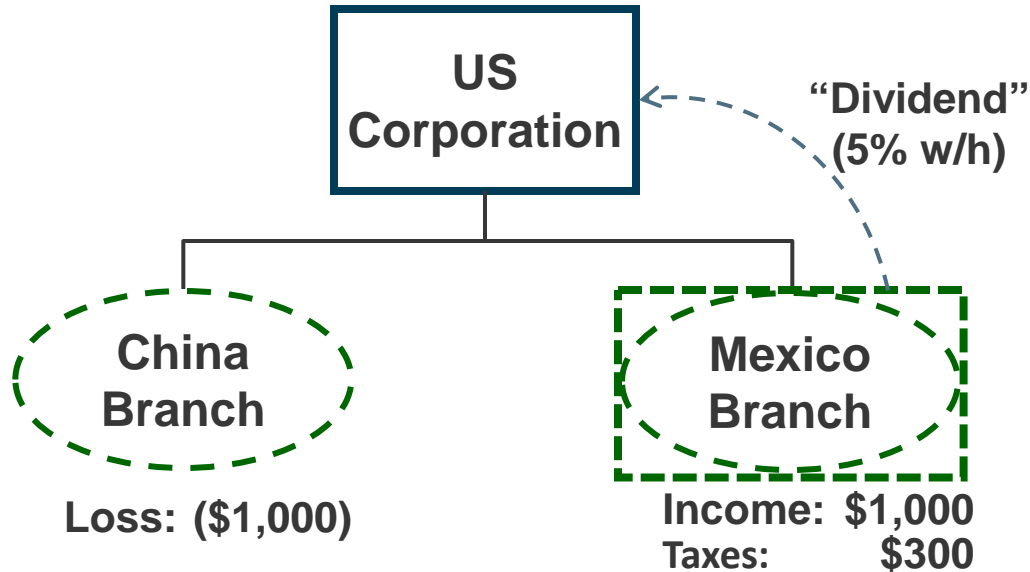
# Foreign Branch Losses



## Comments

- Reduce US taxable income (21%)
- Consider DCL loss limitation rules
- Consider § 987 branch remittance gain/loss rules (basket?)
- Losses reduce FSI in other FTC categories (spill over)

# High-Taxed Foreign Branch



## Comments

- Mexican branch income subject to 21% rate (no FDII)
- No current FTC for \$300 of Mexican taxes
- Is 5% w/h tax in branch basket or general basket?

# Foreign Branch Planning

- Move functions/property to the US (e.g., IP)
  - Consider § 987
  - Consider foreign tax costs
- Incorporate foreign branch
  - All gain subject to tax (expanded § 367) & loss recapture
  - Goodwill/GCV/WIP subject to § 367(d)
- Elect to disregard low-taxed first-tier CFCs (lose 10.5% GILTI rate and taxed on routine amount)



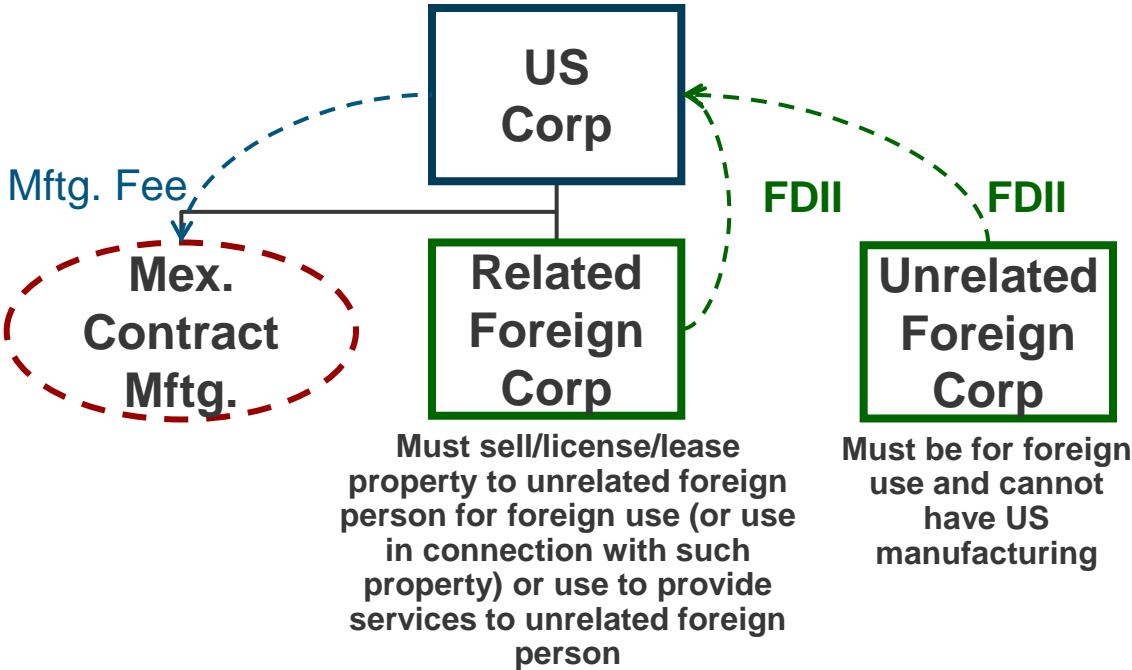
# Foreign Derived Intangible Income

- 37.5% FDII Deduction → 13.125% rate

$$\text{FDII} = \text{Deemed Intangible Income} \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}$$

- Deduction Eligible Income is gross income minus sub F income, GILTI, dividends from CFCs, and foreign branch income, minus allocable deductions (including taxes)
- Deemed Intangible Income is Deduction Eligible Income minus 10% of depreciable tangible property giving rise to Deduction Eligible Income

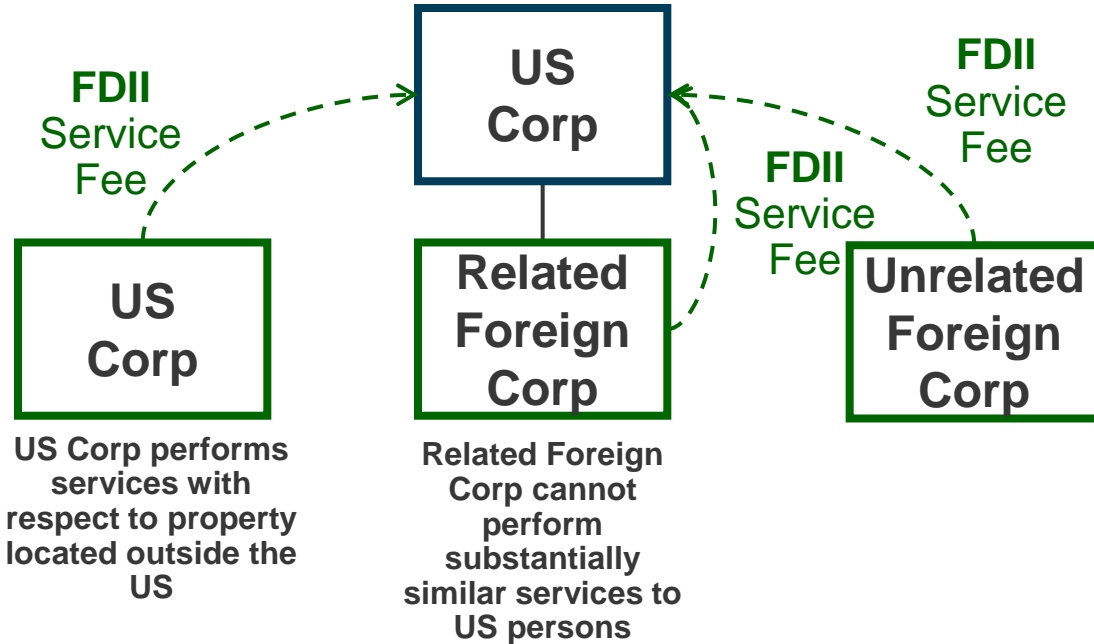
# Qualifying Sales, Leases & Licenses



## Comments

- Foreign use requirement: must be for “use, consumption, or disposition” outside the US
- No FDII if unrelated foreign corp. manufactures in US
- Related foreign corp. must sell, license, or use to provide services or sell property to unrelated foreign corp.
- No requirement to manufacture in the US

# Qualifying Services



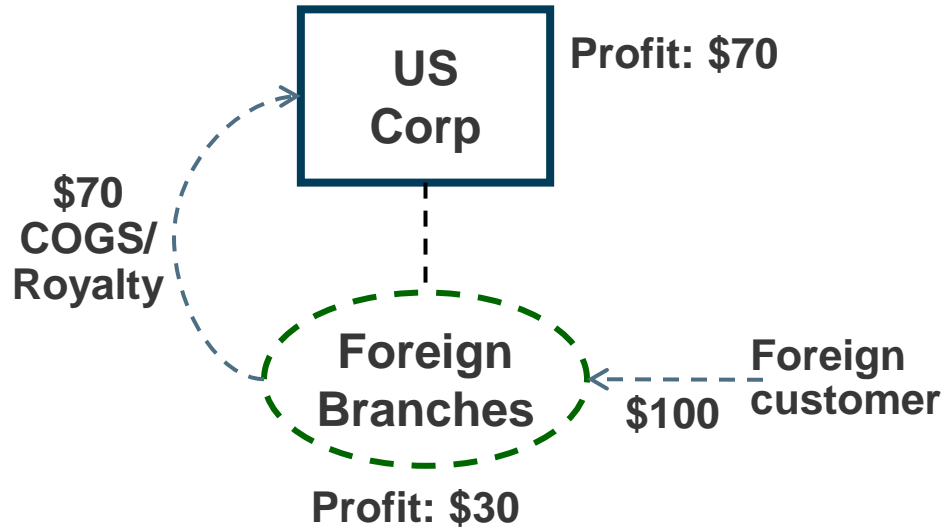
## Comments

- Qualifying services must be (1) for persons located outside the US or (2) with respect to property located outside the US
  - Service payments from a related foreign corporation not FDII if related foreign corp performs substantially similar services to persons located in the US
  - Consider meaning of “located”
- No requirement to perform services in the US
  - But services performed outside the US likely in a foreign branch

# FDII Foreign Tax Credits

- FTCs allowed for foreign-source FDII
  - FDII sales income US source if US manufacturing (863(b)(3))
    - If no US manufacturing, foreign source if title passes outside US
  - FDII royalty income generally foreign source because for foreign use
  - FDII services income generally US source because services performed outside US may be foreign branch income
- No haircut on FTCs
- General basket
- Subject to the 904 limitation

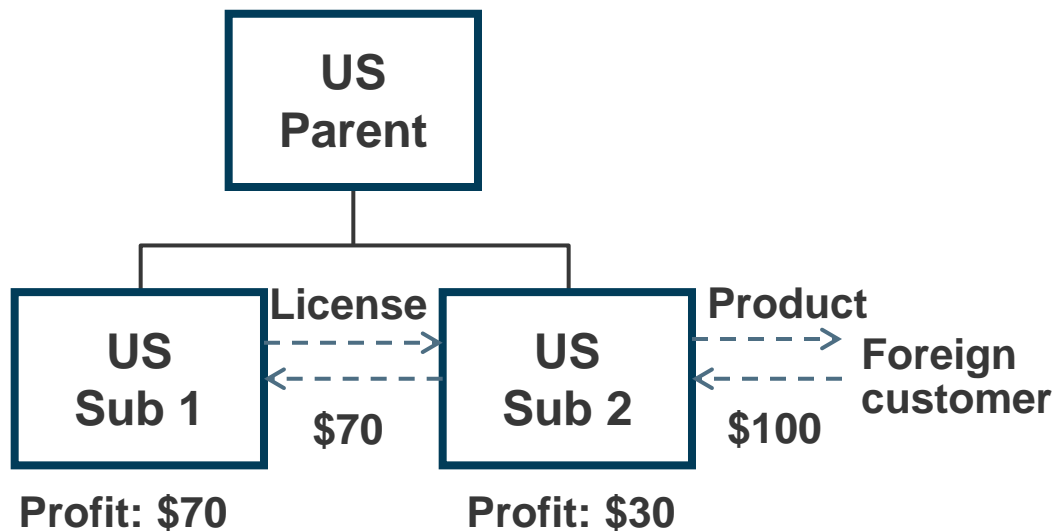
# FDII & Foreign Branch Income



## Comments

- FDII does not include foreign branch income
- Foreign branch determined under 989 QBU rules
- Income attributable to foreign branch determined under future regulations
  - Consider PE rules, ECI attribution rules

# FDII & Consolidated Groups



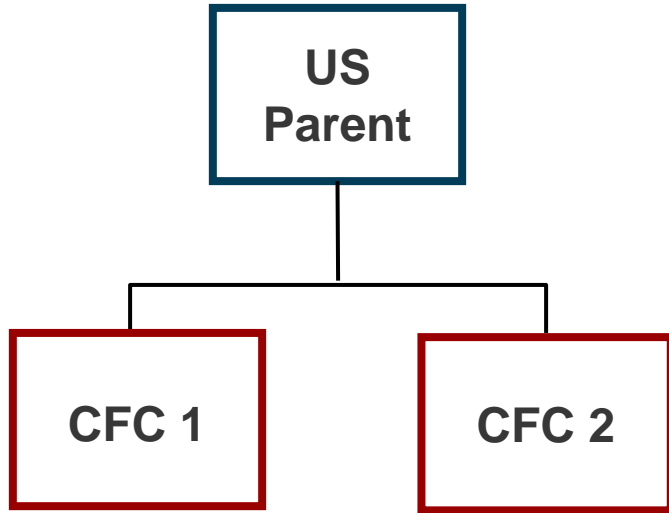
## Comments

- \$70 royalty reduces US Sub 2's FDII, but is it FDII to US Sub 1?
  - Consider whether \$100 should be FDII under consolidated return regulations
- Consider converting to LLCs

# Global Intangible Low Taxed Income (“GILTI”)

- Minimum tax regime that taxes US shareholders on CFC earnings in excess of a deemed base level return
  - US shareholder by US shareholder
- Calculation:
  - Net CFC Tested Income – Net Deemed Tangible Income Return
  - 50% Deduction
    - Limited to taxable income
  - 80% FTCs
    - Expense allocation?

# GILTI: CFC by CFC Aspects

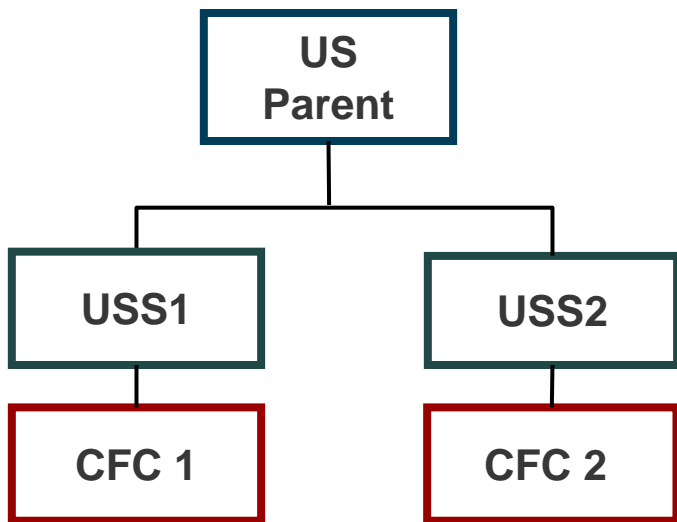


- Tested losses offset tested income
- Foreign taxes of tested loss CFCs are left behind
- QBAI of tested loss CFCs is left behind
- Reorganization of CFC 1 with CFC 2?
- Inbound liquidation of CFC 1 and CFC 2?
- Business purpose?

Tested Income = \$100	Tested Loss = \$50
Foreign Taxes = \$10	Foreign Taxes = \$20
QBAI = \$0	QBAI = \$100



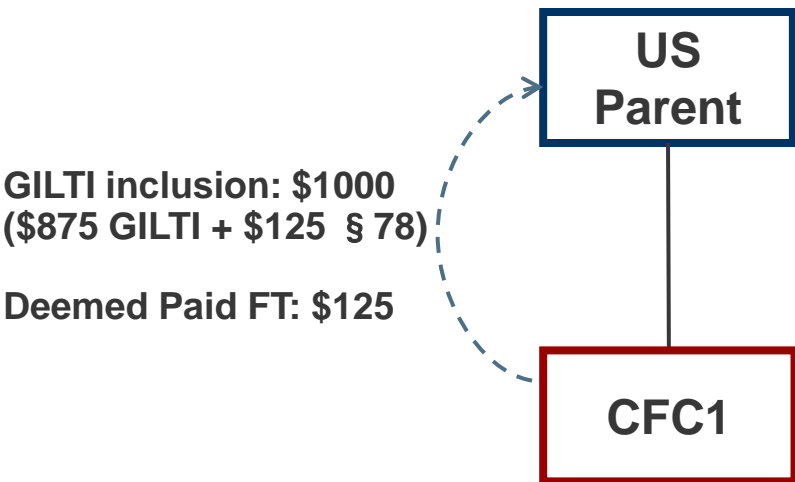
# GILTI: US Shareholder by US Shareholder Aspects



Tested Income = \$100	Tested Income = \$50
Foreign Taxes = \$10	Foreign Taxes = \$20
QBAI = \$0	QBAI = \$100

- GILTI is calculated US SH by US SH
- Tested loss chains
- FTC considerations
- Aggregation of members of a consolidated group?
- Reorganization solution?
- State law conversion solution?
- Business purpose?

# GILTI FTC Limitation



	w/o 904 Limit	w/ 904 Limit*
Inclusion	\$1000	\$1000
50% deduction	<u>(\$500)</u>	<u>(\$500)</u>
Taxable income	\$500	\$500
US Tax (21%)	\$105	\$105
FTC (80% FT)	\$100	\$0 <sup>^</sup>
Residual US Tax	\$5	\$105
	_____	_____
Overall Tax	\$130	\$230
ETR	13%	23%

\* Assume \$500 Interest Expense Allocated to GILTI

<sup>^</sup> § 904 limitation = 21%\*(\$500-\$500) = \$0

# GILTI FTCs—Expense Allocation Methods

- Expenses generally allocated based on gross income in each grouping
- R&D expenses are allocated based on product category and then apportioned based on either the sales method or the gross income method
- Interest Expense
  - Apportioned according to basis in assets (no FMV method)
  - CFC stock—Add to basis amount of CFC's E&P (including PTI)
  - CFC stock is characterized according to the income the CFC's assets generate
- A change in the allocation method is not a change in a method of accounting; however, IRS consent is required in certain situations

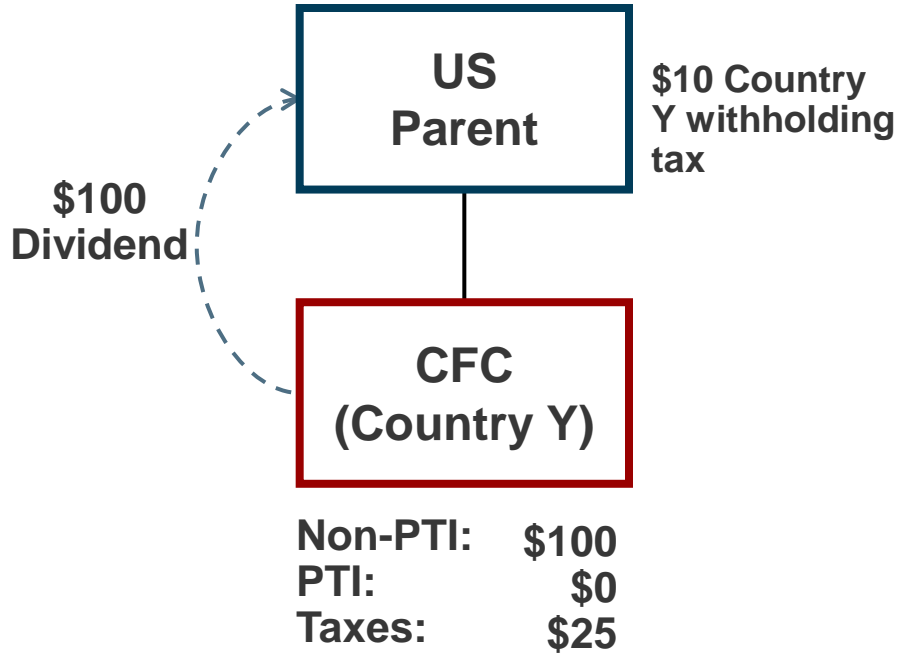
# GILTI FTCs—Expense Allocation Questions

- Interest Expense Allocated to GILTI
  - Section 904(b)(5) considerations
  - Treas. Reg. § 1.861-8T(d) exempt asset considerations
- R&D Expense Allocated to GILTI
  - Does sales method result in no allocation to GILTI?

# GILTI FTCs—Basket

- It will generally be desirable to maximize income in the GILTI basket to have higher § 904 limitation
- Is § 78 gross up associated with GILTI in the GILTI basket? If not GILTI basket, how about the related FTs and GILTI deduction?
- Royalties and interest paid by CFCs to US shareholder are treated as income in the basket to the extent allocable to income of the CFC in that category under § 904(d)(3) look-through rule
  - Do royalties and interest go into the GILTI basket or general basket?

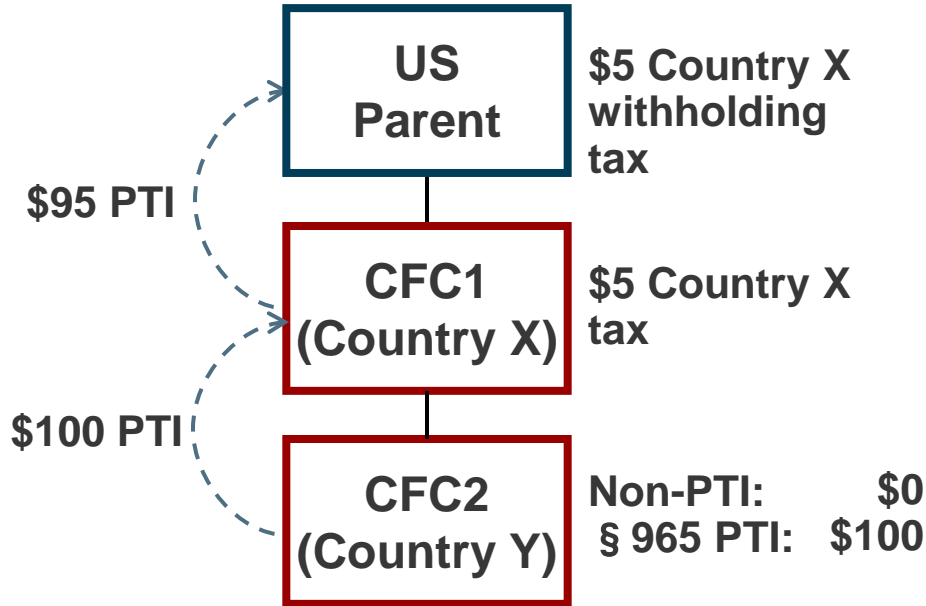
# Repatriation: 100% DRD



## Comments

- US Parent entitled to 100% DRD
- No FTCs:
  - \$25 tax on earnings
  - \$10 withholding tax
- Do foregone FTCs carryforward?
- Consider section 956 loan?
- Results of hybrid dividend
  - No DRD
  - No FTC

# Repatriation: PTI



## Comments

- \$5 Country X income tax creditable under § 960(b)
- \$5 Country X withholding tax creditable under § 901
- Application of § 965(g) haircut?
- Consider CFC1 GILTI PTI and \$5 tax paid with respect to dividend income
  - GILTI 20% haircut?

# Base Erosion Anti-Abuse Tax (“BEAT”)

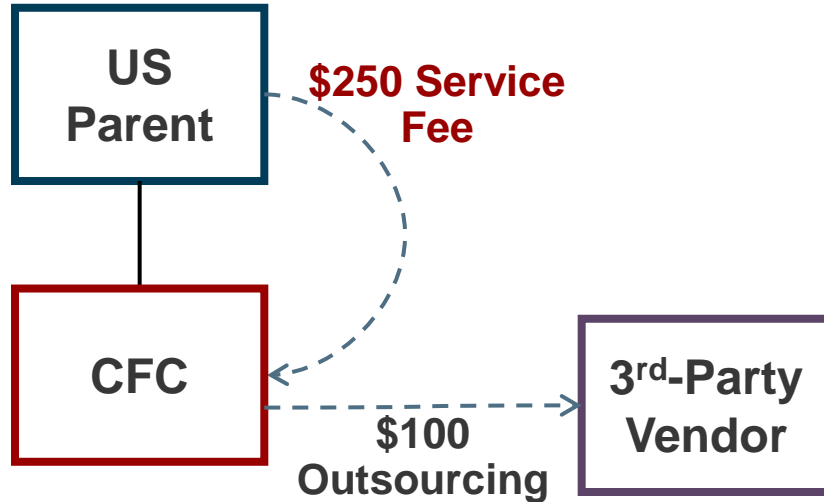
- Calculation:
  - 10% of modified taxable income less regular tax liability (increased for certain tax credits, but not FTCs)
  - Modified taxable income:
    - Regular taxable income adjusted by adding back current year deductions involving payments to related foreign persons (“base erosion payments”)
- Exception: Base erosion payments < 3% total deductions



# Base Erosion Payments

- Interests, rents, royalties
- Payments for services (exception for certain no-markup service payments)
- Excludes COGS and payments to foreign branches
- Cost sharing payments? PCT?
- Reimbursements made to a foreign related party?

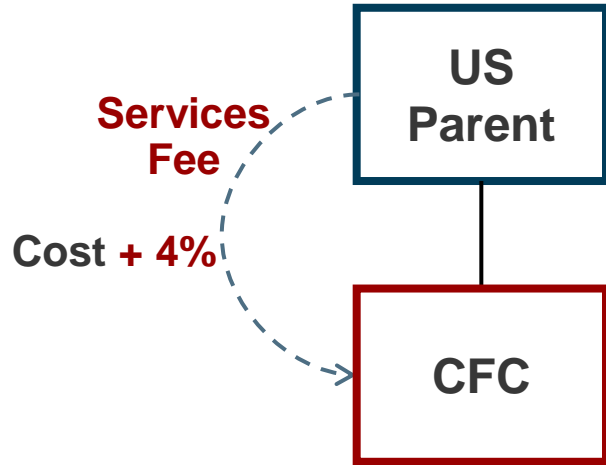
# Base Erosion Payment Planning



## Comments

- No look-through for outsourced services
- Consider restructuring contracts
- What if CFC is receiving payment as an agent of US Parent?
- Treasury's anti-abuse authority

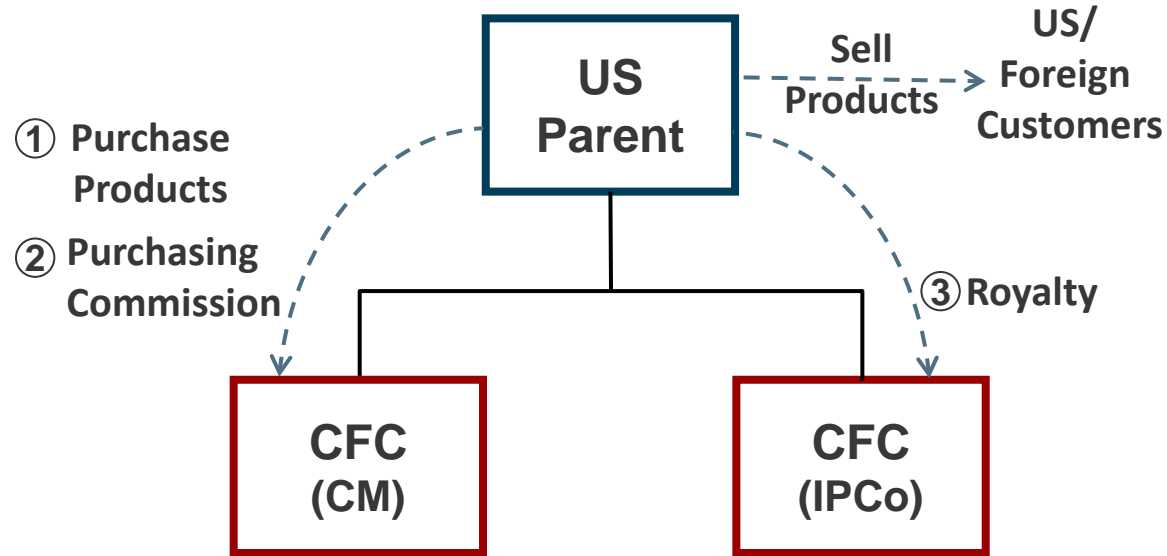
# Base Erosion Payment Planning



## Comments

- If payment is eligible for SCM and “such amount constitutes the total services cost with no markup component,” the payment is not BEP § 59A(d)(5)
- Cost component excludible?
- Bifurcate into two payments (one for cost, one for the markup)?
- Statutory text and conference report language inconsistent

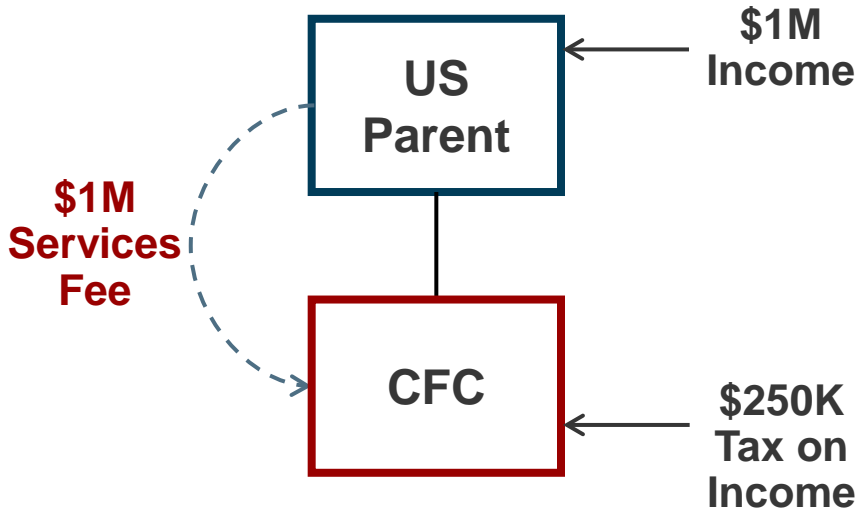
# Foreign Manufacturing



## Comments

- COGS not BEP
- Purchasing Commission?
- Royalties?
- Capitalization under § 263A?

# Subpart F & BEAT



## Comments

- MTI includes Subpart F income and 50% of GILTI
- US Parent has \$0 domestic income and \$1M taxable income from subpart F income inclusion ( § 78 gross-up)
- FTCs eliminate US tax on subpart F inclusion (\$0 regular tax)
- BEAT: no deduction for \$1M fees and no FTCs, so \$200K BEAT (excess FTCs carryover)
- If income were GILTI, \$150K BEAT (GILTI FTCs lost)

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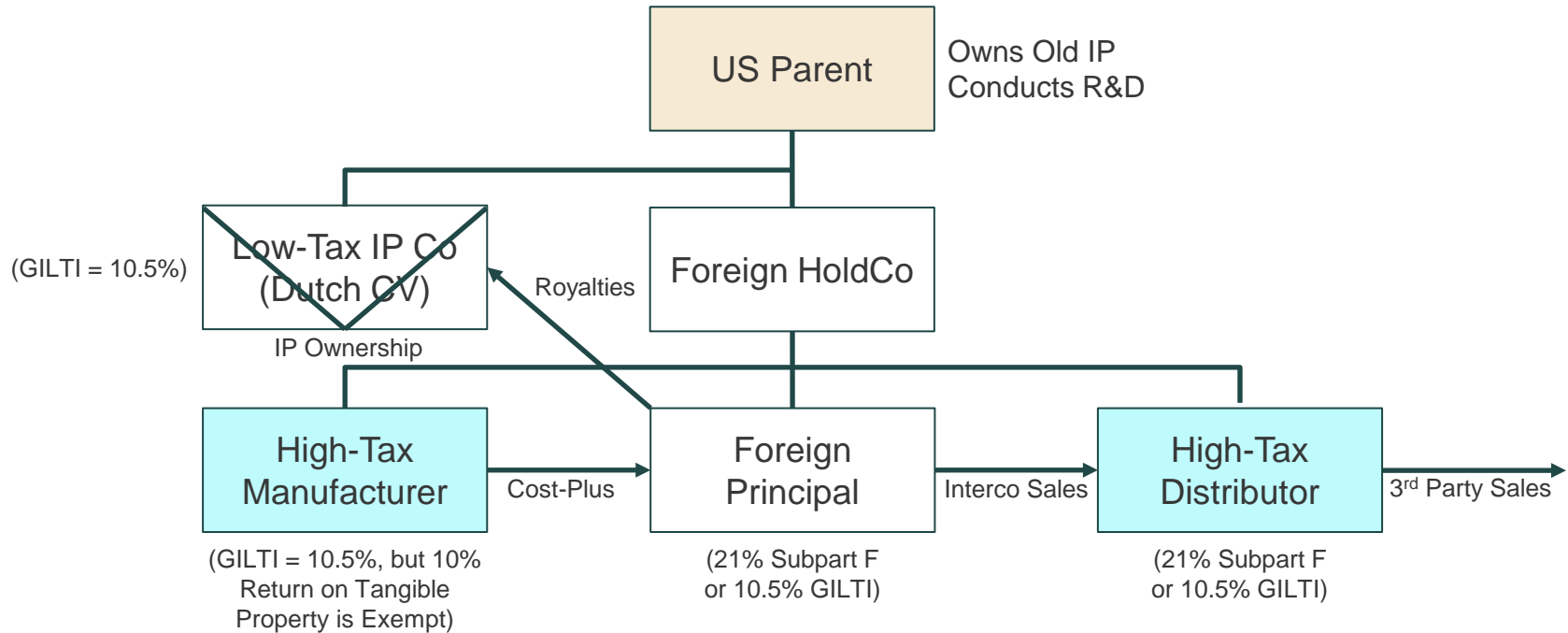
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Breakout Session I: IP and Supply Chain Planning  
Post Tax-Reform

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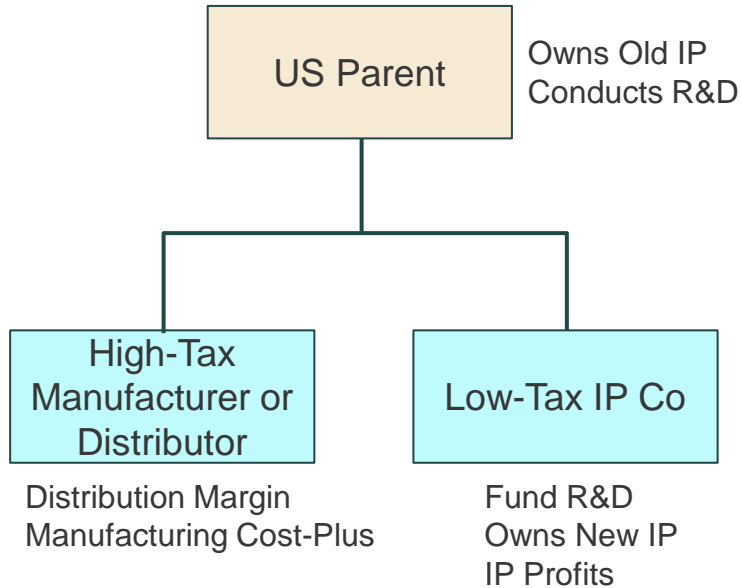
**Barry Quirke**, Moderator | Chicago  
**Justin Jesse** | Washington, DC  
**Enrica Ma** | Washington, DC  
**David Noren** | Washington, DC

# Overview – Classic Supply Chain Structure



\* 16.406% after 2025

# Historic IP Planning Structure



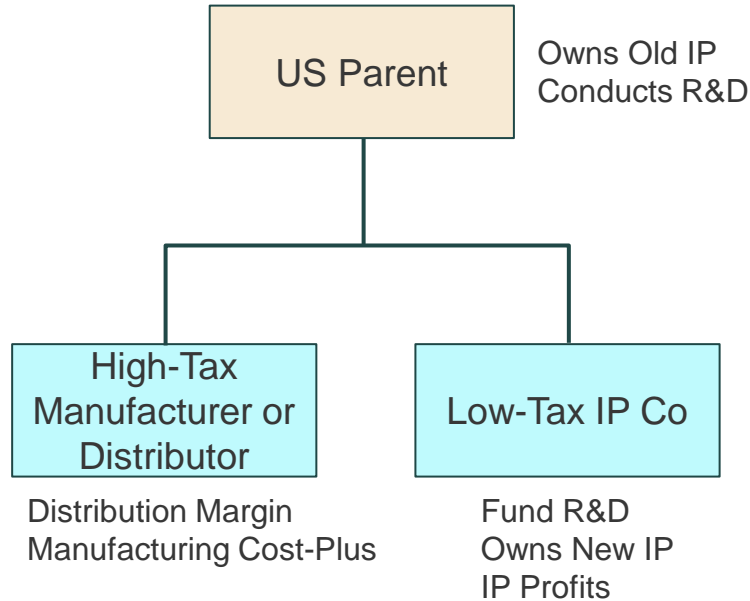
- Overview
  - Concentrate IP economic rights in low-tax jurisdictions
  - Earn a large share of IP profits in low-tax jurisdictions
  - Maintain limited substance in low-tax jurisdictions
  - Allow for US tax deferral and avoid double taxation
  - Minimize PE/ECI and withholding taxes
  - Support US and non-US transfer pricing position
- How to address recent changes to relevant tax laws?



# Recent Changes to Tax Laws Affecting IP

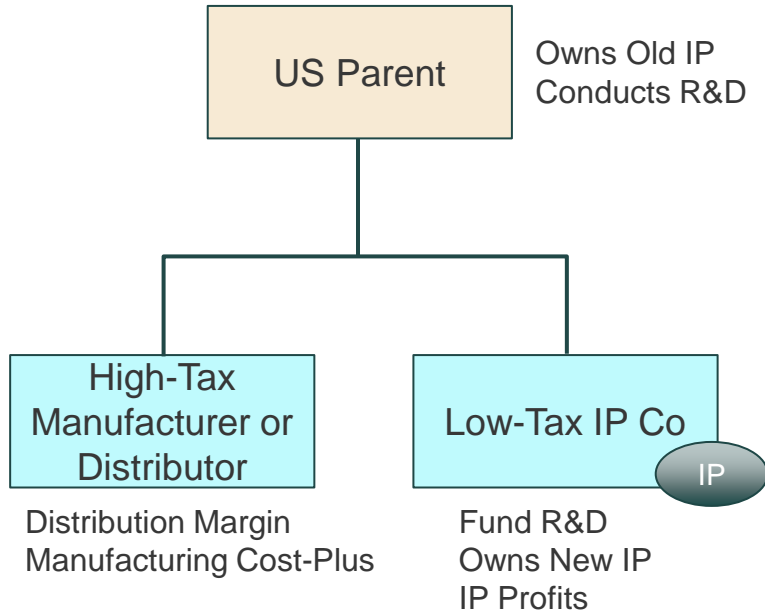
- Select US developments under 2017 TCJA
  - Amendment to § 936(h)(3)(B) and § 367(d)
  - New § 59A – Base Erosion Anti-Abuse Tax (BEAT)
  - New § 245A – 100% DRD and § 245A(e) hybrid dividends
  - New § 267A – Hybrid transaction/hybrid entity deduction disallowance – interest and royalties
  - New § 250 – Foreign derived intangible income (FDII) and global intangible low-taxed income (GILTI) deduction
  - New § 951A – GILTI gross income inclusion
- Select non-US developments
  - EU-wide CFC rules, anti-hybrid mismatches
  - OECD transfer pricing guidelines on DEMPE
  - BEPS Action 10 – Revised guidance on profit split discussion draft

# IP Planning in the New Environment



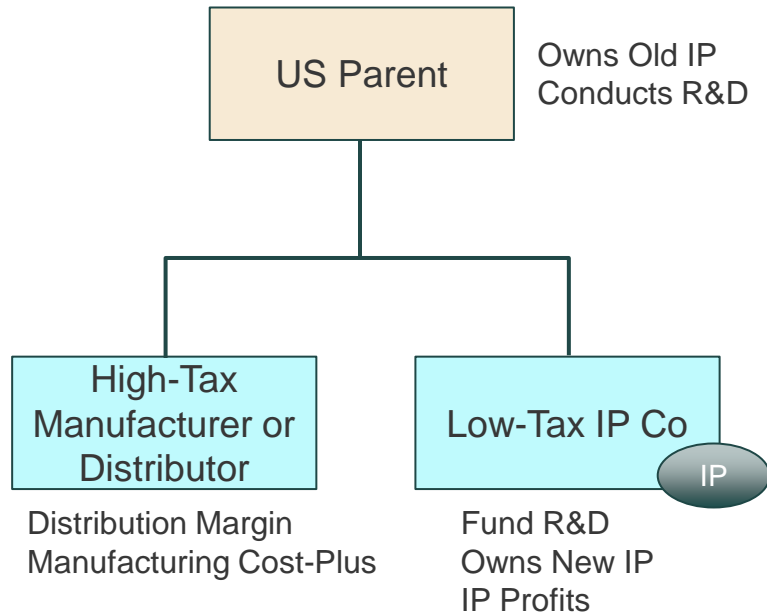
- Options
  - Option 1. Outbounding IP
  - Option 2. Remain status quo
  - Option 3. Migrate IP to other foreign jurisdictions
  - Option 4. Onshore IP to US
  - Option 5. Acquired IP
- Types of IP
  - Future IP
  - Existing IP post-commercialization
  - Existing IP pre-commercialization
- Modeling
  - After-tax NPV of taxable income under the alternative structure vs the existing structure
  - Consider impact of recent changes to tax law quantitatively and qualitatively

# Outbounding IP



- Section 367(d) deemed royalty (including GW/GCV value)
  - Prior Law – 35% vs 0%
  - Current Law – 21% (or 13.125% FDII) vs 10.5% GILTI
- Foreign source income planning with excess FTCs
- Tax attribute planning strategy

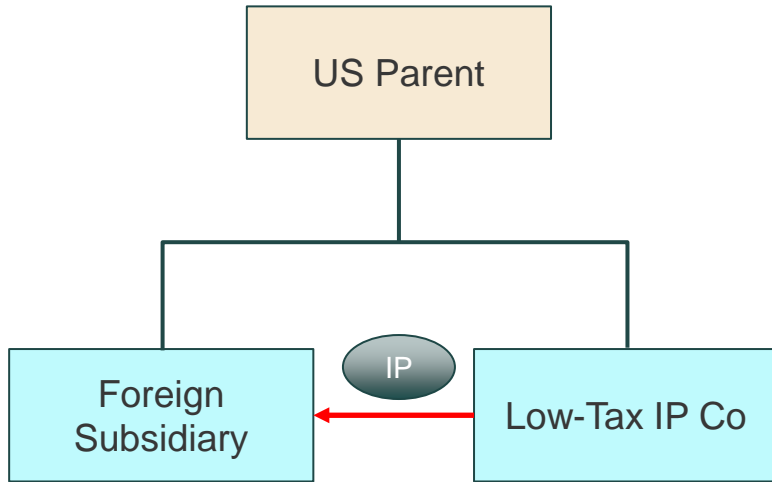
# Remaining Status Quo



## ■ Considerations

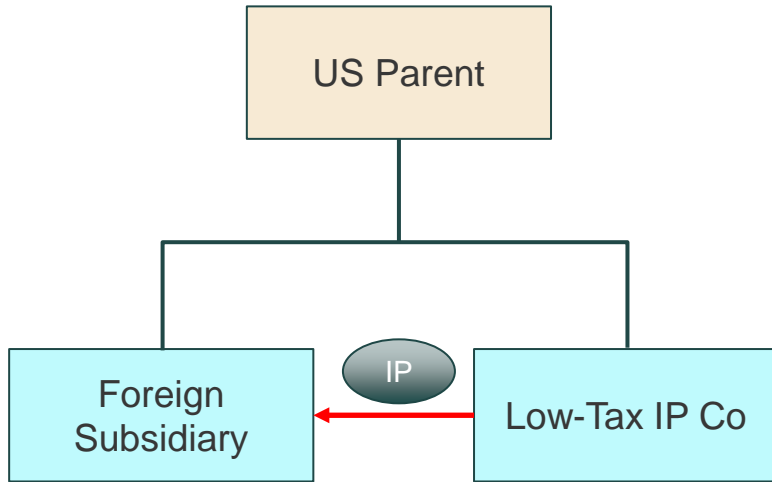
- Will FDII survive the WTO challenge?
- Various ambiguities arise concerning application of new US tax law
- Does existing structure have sufficient substance / DEMPE functions to survive challenges under BEPS?
- Is Low-Tax IP Co a hybrid or reverse hybrid entity?
- Comfortable with current transfer pricing positions

# Migrating IP to Other Foreign Jurisdictions



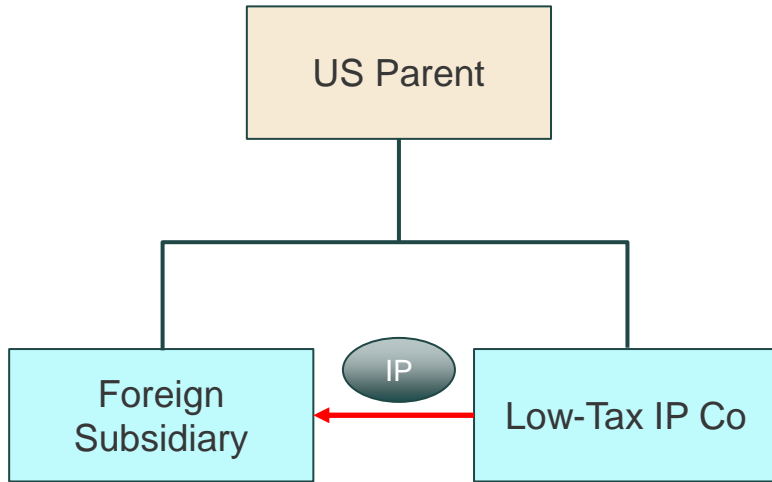
- Tax benefit from R&D deductions
  - Reduction of tested income
    - Consider jurisdictions offering super R&D deductions (such as Belgium)
  - Reduction of foreign taxes
  - How excess credit vs excess limitation in GILTI affect the result?
  - Consider disparate R&D treatments between US and foreign jurisdictions after 2022 and the impact to GILTI calculation

# Migrating IP to Other Foreign Jurisdictions (cont'd)



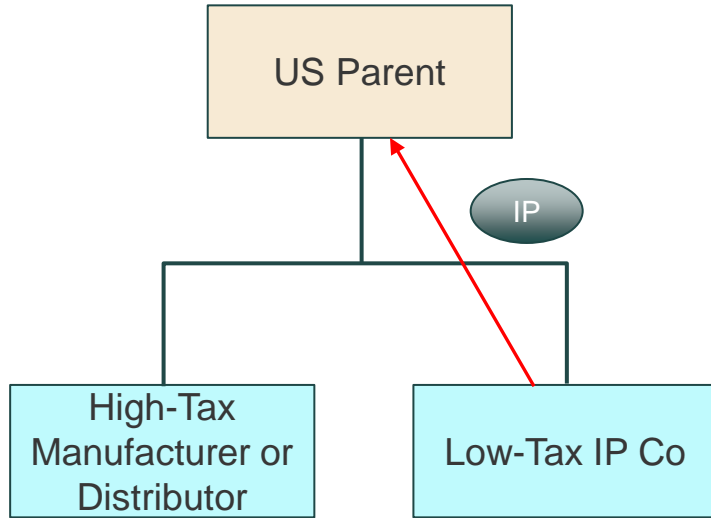
- Tax cost from IP profits
  - Probability weighted, after R&D profits from the IP
  - Impact to GILTI calculation
    - Increase in tested income
    - Increase in foreign taxes
    - How excess credit vs excess limitation in GILTI affects the result?

# Migrating IP to Other Foreign Jurisdictions (cont'd)



- Other considerations
  - Create additional amortization by stepping-up tax basis for foreign tax purposes
  - Sufficient substance / DEMPE functions to sustain challenges under BEPS?
  - Exit strategy – consider foreign exit tax?
  - Consider withholding tax incurred by implementing a new IP company structure

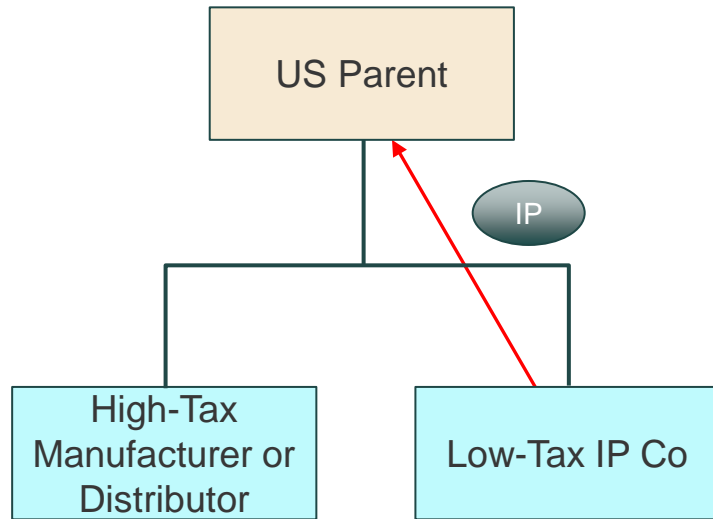
# Onshoring IP to US



- US onshoring may seem attractive if IP profits qualifies for FDII and US has DEMPE substance
- Tax cost from future profits
  - 21%?
  - Consider US and OUS product sale
    - US sales – 21%
    - OUS sales – 13.125%
- Reduce BEAT pressure?
  - Depends on whether already “in BEAT”
    - Increase amortization in the US
    - Reduce GILTI

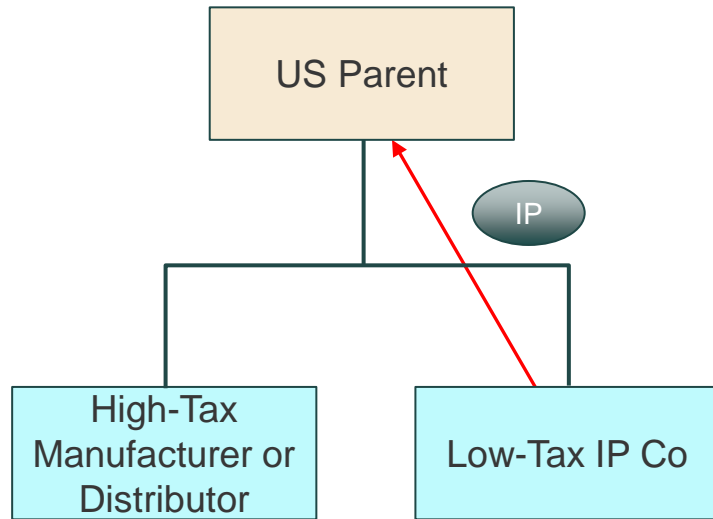


# Onshoring IP to US (cont'd)



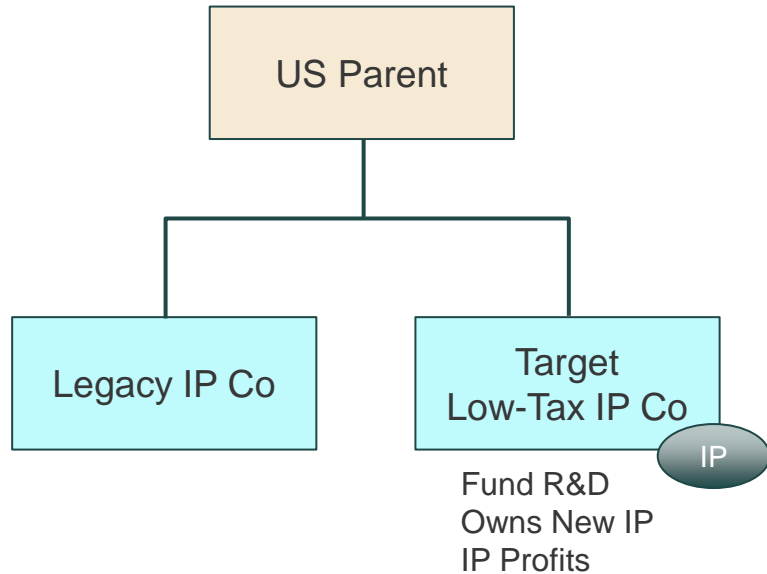
- Tax benefit from R&D deductions
  - 21%?
  - Consider § 861 allocation of R&D costs
    - Difficulties and ambiguities regarding allocation to FDII and GILTI in the absence of guidance
    - Treat FDII as a new basket for R&D allocation purposes?
      - Consider US source FDII vs foreign source FDII
      - Consider excess credit vs excess limitation in GILTI
  - Availability of R&D credit

# Onshoring IP to US (cont'd)



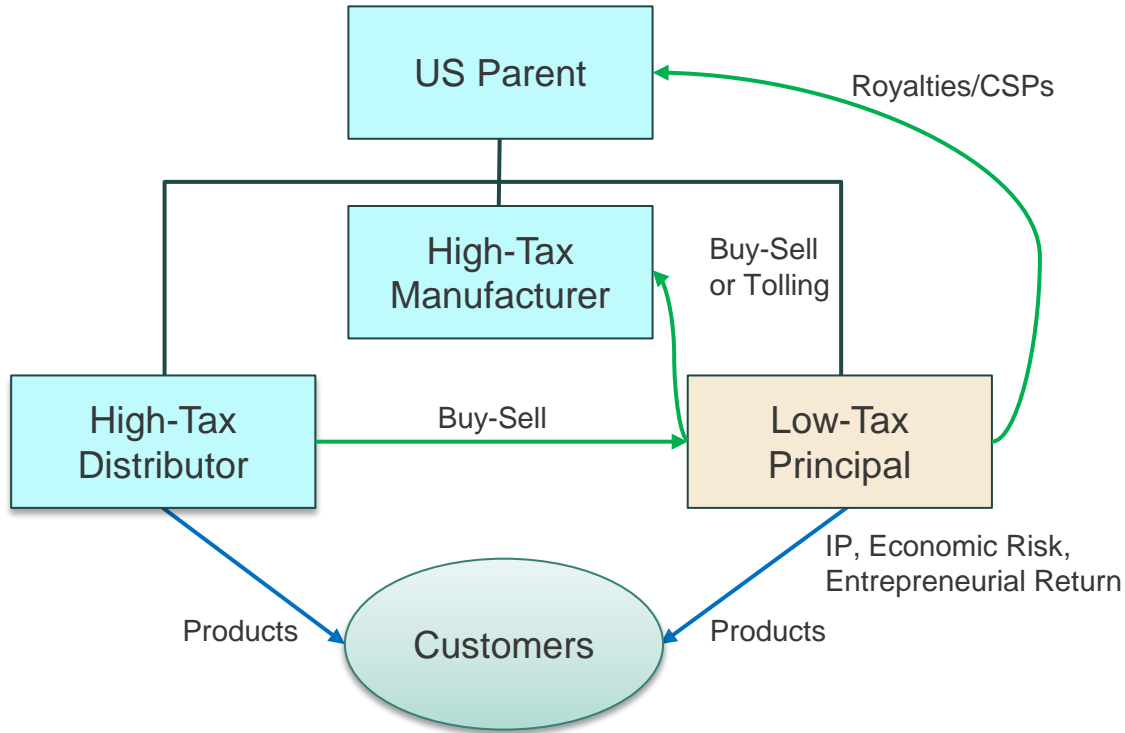
- Other considerations
  - Tax cost from inbound transfer of IP to US
    - Sales or dividend distributions
    - Subpart F income or GILTI?
  - Base erosion payment for US affiliate?
    - Royalties
    - Amortization from step-up IP basis
  - Avoid subpart F same country manufacturing requirements, providing flexibility for sourcing decisions
  - IP ownership aligns with DEMPE functions?

# Acquired IP



- Post-acquisition integration of acquired IP
  - Foreign exit taxes
    - Prior law - § 902 credits for foreign taxes
    - Current law - No § 902 credits
  - Consider § 901 credits (disregard target IP Co)
    - Foreign branch basket vs general basket
    - Apparent glitch in § 904(d)(2)(H) cross reference to foreign branch basket
- Section 338(g) election implications
  - § 197 amortization for GILTI
  - Integration implications
  - Consider § 956

# Outbound Product Supply Chain



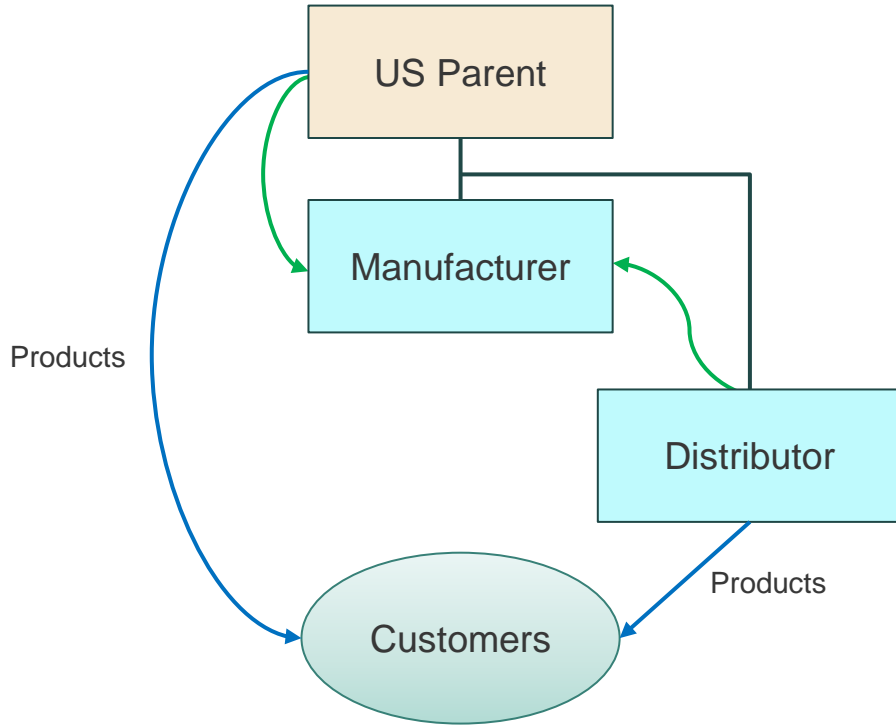
## ■ 2017 Issues

- Subpart F income
- PE
- Transfer Pricing
- Tax on Distribution

## ■ 2018 Issues

- Subpart F income
- Transfer Pricing
- GILTI
- FDII

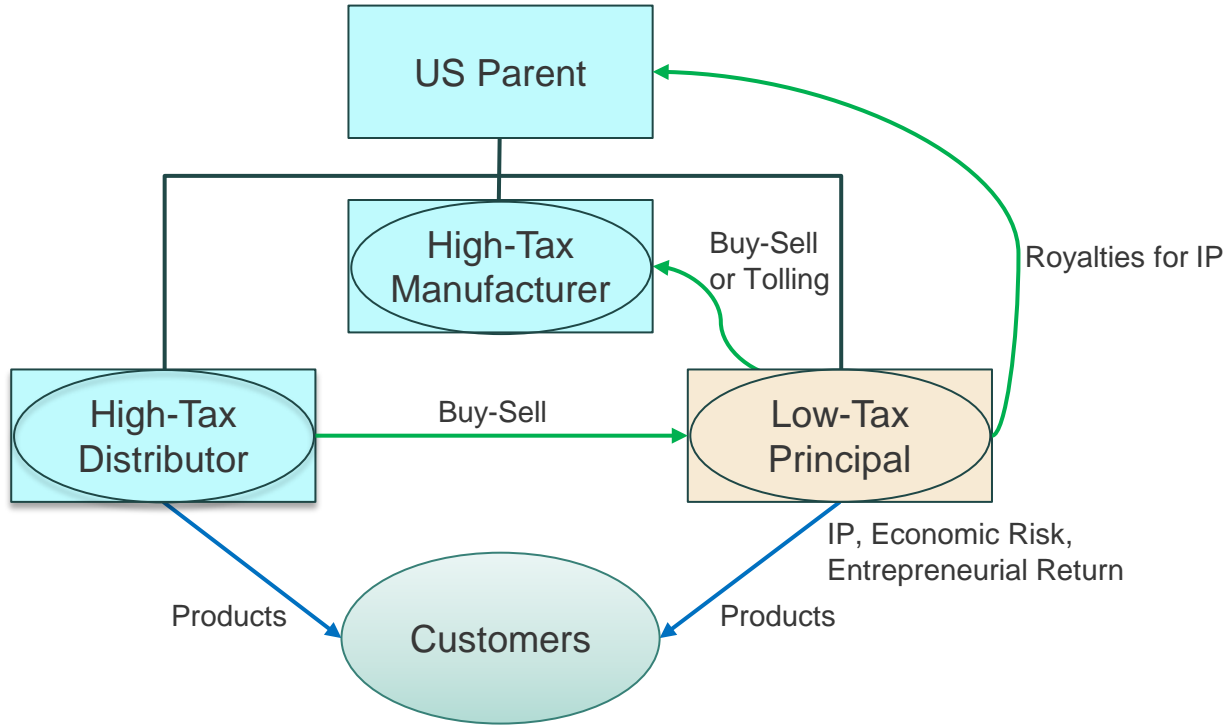
# Outbound Product Supply Chain – Export Model



## ▪ 2018 Issues

- Subpart F income
- Transfer Pricing
- GILTI
- FDII

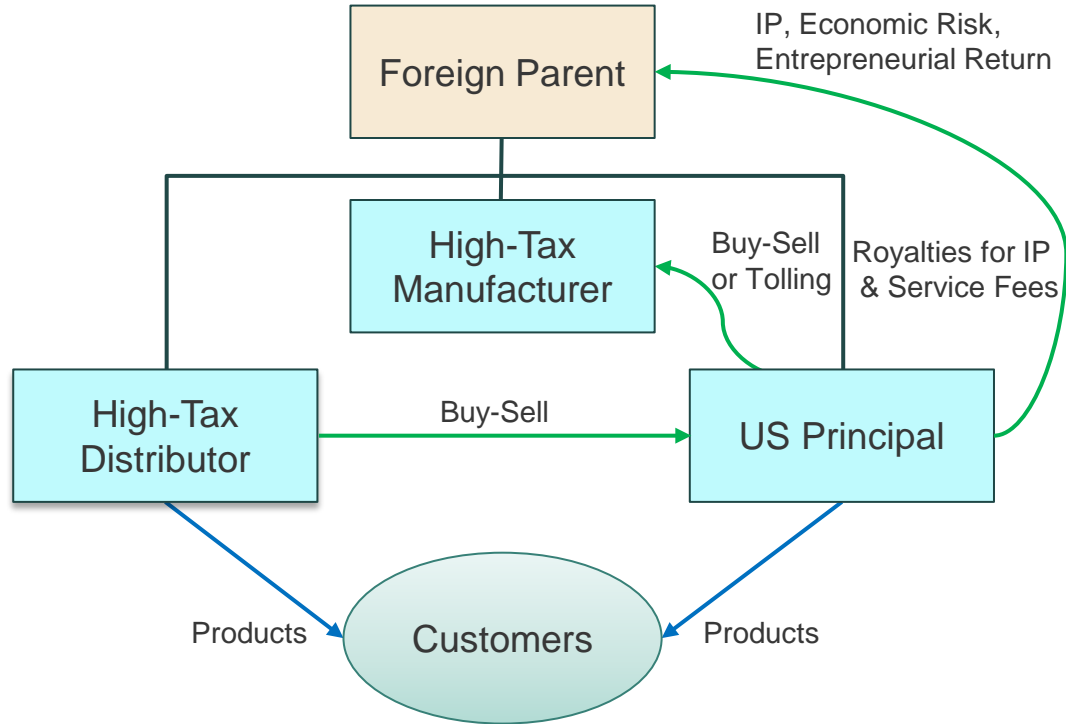
# Outbound Product Supply Chain –Branch Model



## ■ 2018 Issues

- Subpart F income
- Transfer Pricing
- GILTI
- FDII
- FTC Branch Income Basket

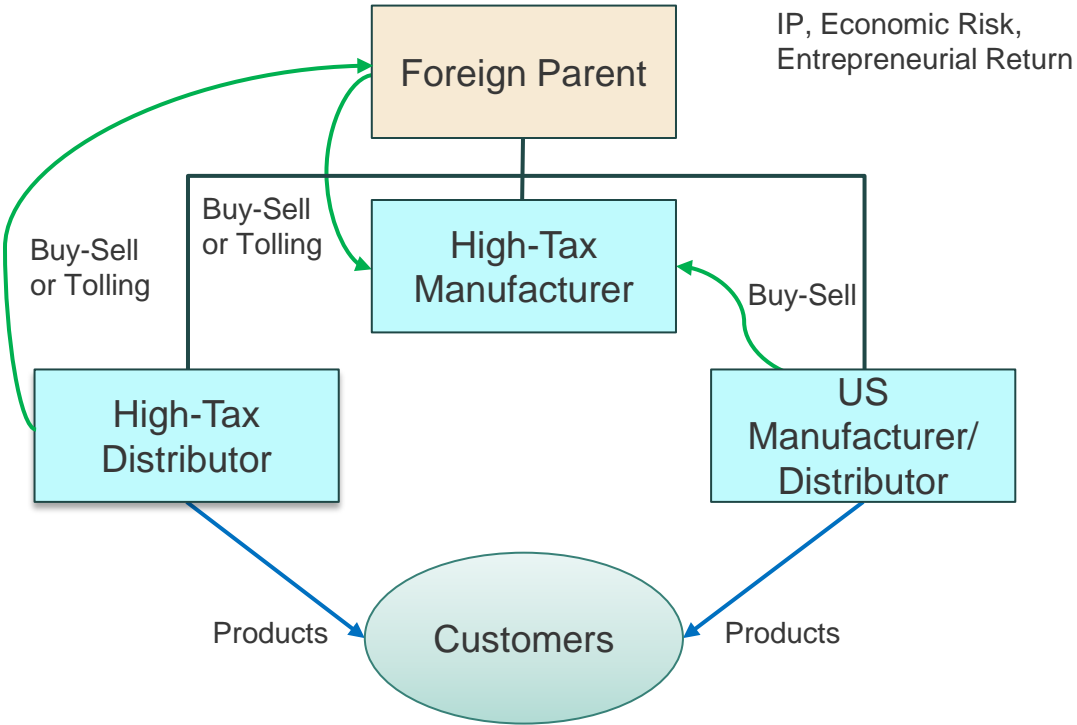
# Inbound Product Supply Chain



## ■ 2018 Issues

- Transfer Pricing
- BEAT
- FDII

# Inbound Product Supply Chain – No BEAT Payments

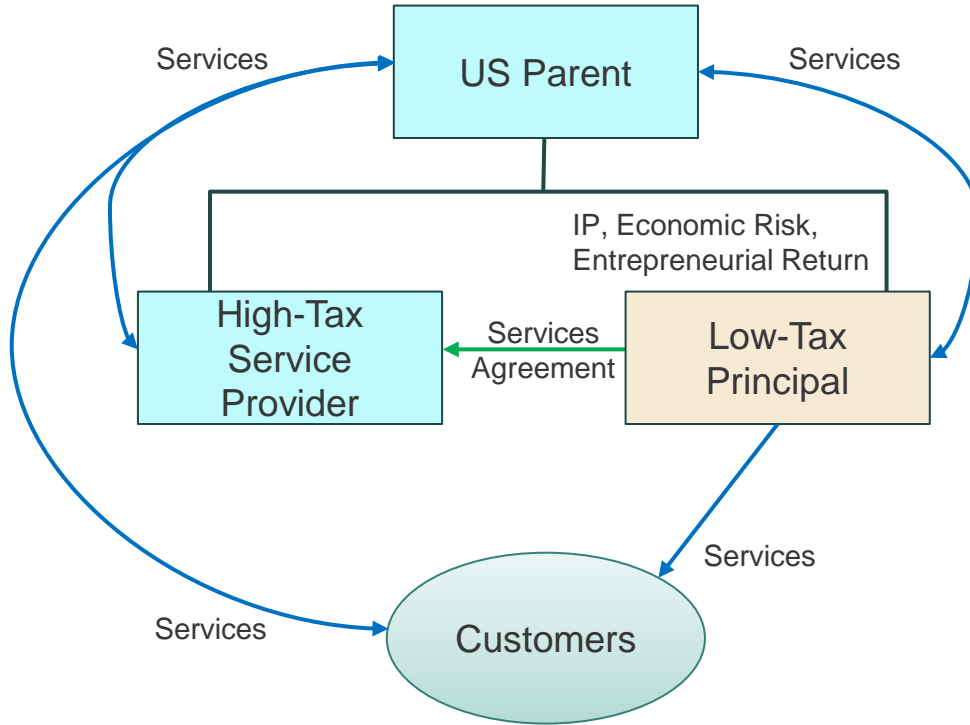


## 2018 Issues

- Transfer Pricing
- BEAT
- FDII
- Onshoring of IP?



# Services Supply Chain



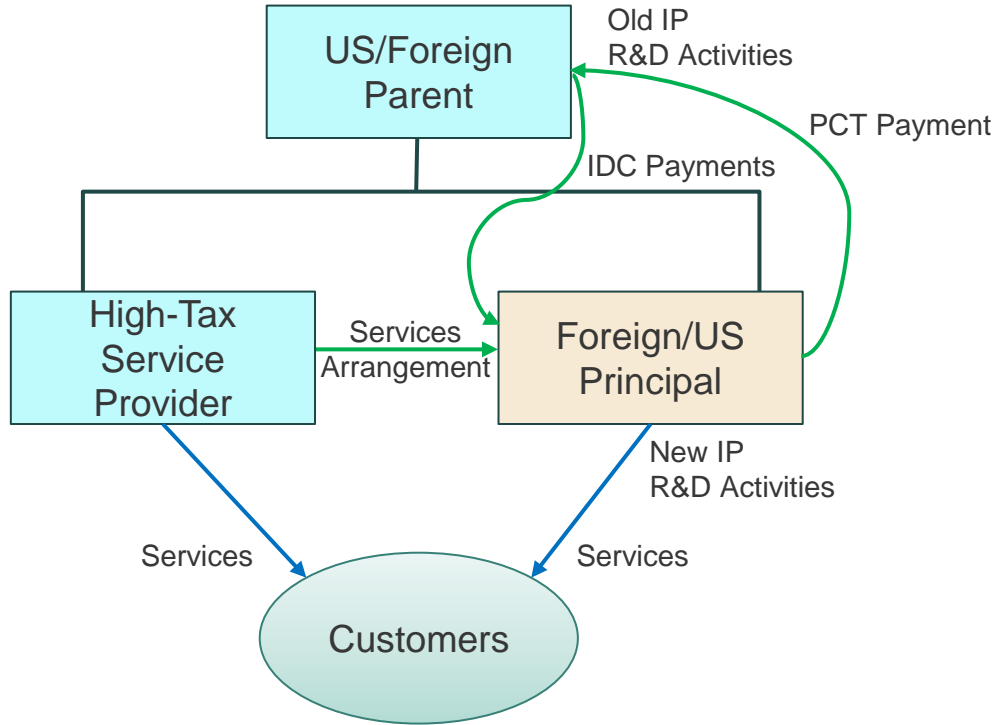
## ■ 2017 Issues

- Subpart F income
- PE
- Transfer Pricing
- Tax on Distribution

## ■ 2018 Issues

- Subpart F income
- Transfer Pricing
- GILTI
- FDII
- BEAT

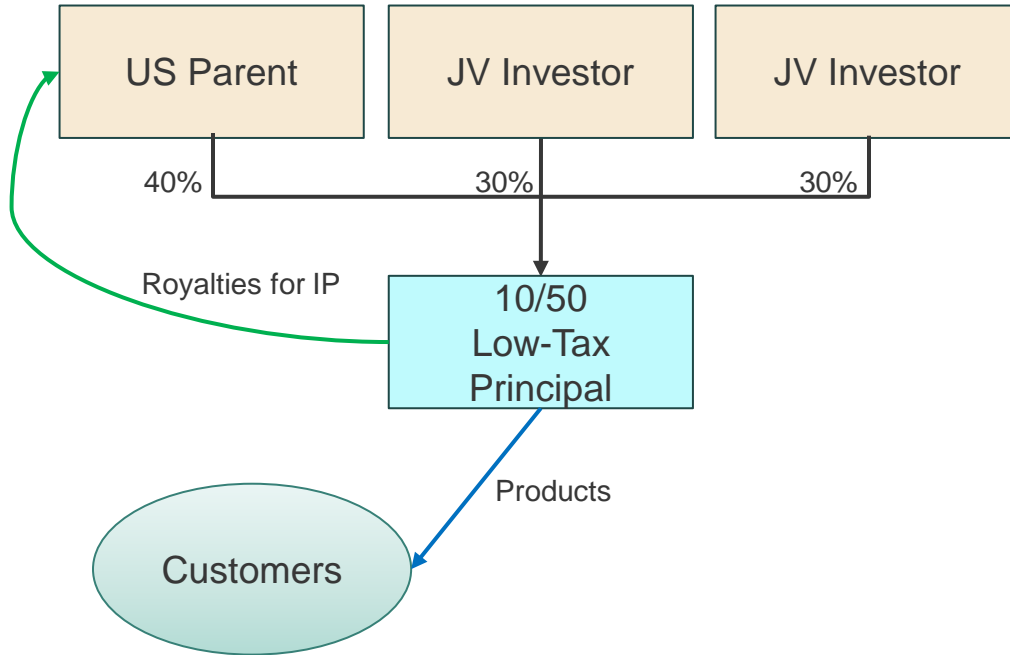
# Cost Sharing Arrangement Considerations



## 2018 Issues

- Transfer Pricing
- BEAT
- FDII

# 10/50 Company – True Territoriality!



## ■ 2018 Issues

- Not a CFC (but watch attribution)
- No GILTI
- Participation Exemption

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## Breakout Session II: Key Implications for Foreign Based Companies and Reaction of the EU

**Sandra McGill**, Moderator | Chicago  
**Alexander Lee** | Los Angeles  
**James Ross** | London  
**Antoine Vergnat** | Paris

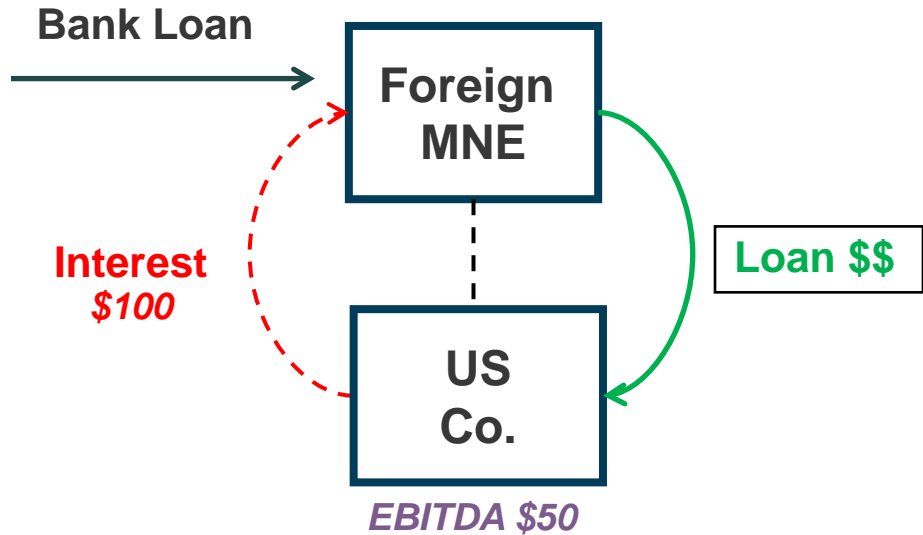
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# Impact of New Rules on Financing US Operations

# Change to US Interest Limitation Rules

- In a substantial rewriting and broadening of the US “earnings stripping” rules of section 163(j), the Tax Cuts and Jobs Act of 2017 generally limits a US taxpayer’s deduction for net business interest expense to 30% of the taxpayer’s adjusted taxable income for the taxable year.
- Unlike prior law, this is not solely an “International” provision. The new statute applies to all interest paid by US taxpayers, regardless of whether paid to a non-US related person or guaranteed by a non-US related person.

# Traditional Borrowing Structures: Impact of 163(j)



Interest Payments Fully Deductible at 35% and Corresponding income pick up at lower rate.

	<u>Prior Law*</u>	<u>Tax Reform (below threshold)</u>	<u>Tax Reform (exceeds threshold)</u>
United States Deduction	\$35	\$21	\$15
Foreign Income Inclusion	\$25	\$25	\$25

\*\* still had to navigate old #163(j) on intercompany debt

# Impact of Section 163(j) on Foreign MNEs

- Pushing Leverage into US Subsidiaries is Less Attractive:
  - Arbitrage limited by Interest Limitation Rules
  - Lower US corporate tax rate further impacts arbitrage
  - BEAT provisions add more complication
- FMNEs Might Consider Shifting Leverage from US to Other Foreign Jurisdictions.
  - Consider EU Directives that have a Similar Effect
  - Country-by-Country Analysis of Debt Limitation Provisions
  - Country-by-Country Analysis of Corporate Tax Rates
- Query: *Whether debt covenants will allow a shift of debt to other jurisdictions and what will be the cost?*



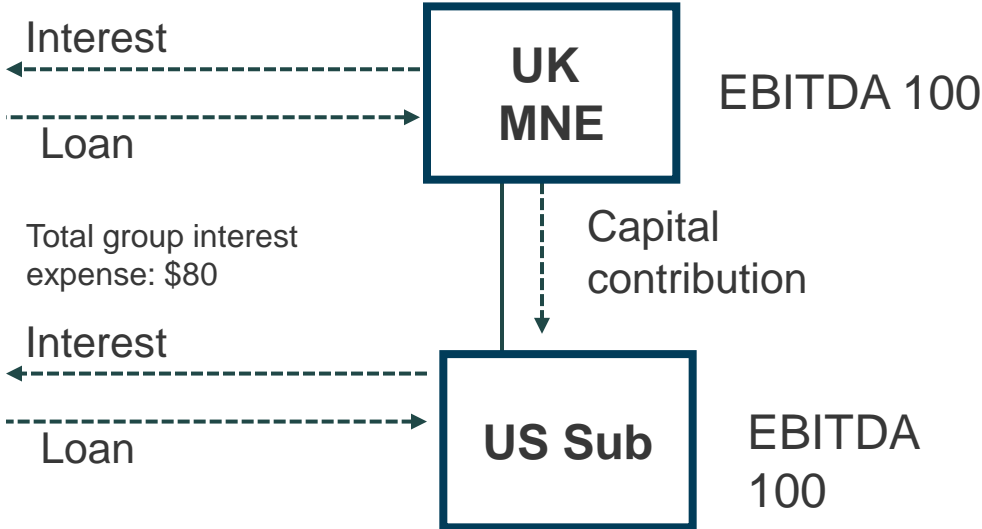
# EU Interest Limitation Rules – the Current Position

- Several EU Member States have imposed interest limitations that generally prevent saddling an entity with significant debt.
- These may include:
  - transfer pricing and/or thin-cap rules (applicable to all loans or exclusively those made by, or secured by, related parties);
  - anti-hybrid legislation;
  - general cap (e.g. 75% of net financial expenses);
  - specific anti-abuse or purpose-based limitations;
  - general anti-abuse legislation.

# EU Interest Limitation Rules – ATAD

- Limitation of interest deductibility was one of the key components of EU Anti Tax Avoidance Directive (“ATAD”).
- The EU ATAD limits the deduction of net borrowing costs up to the higher of (i) 30% of the EBITDA, or (ii) an amount of EUR 3 million.
- EU Member States can allow either (i) additional deductions up to group interest to EBITDA ratio; or (ii) full deductibility where borrower’s equity to asset ratio exceeds that of the group as a whole.
- Scope for EU Member States to postpone implementation of the limitation rules if they already have equally effective national rules.

# Interaction of US and EU Interest Limitation Rules



US: Interest deduction limited to **\$30** (30% x \$100 EBITDA).

UK: Interest deduction limited based on group interest ratio ( $\$80 \text{ group interest} / \$200 \text{ EBITDA}$ ) = 40% so UK allows interest deduction for **\$40**.

# Interaction of US and EU Interest Limitation Rules

US interest expense	US deduction (@ 21%)	UK interest expense	UK deduction (@ 19%)	Total deduction
70	30 (6.3)	10	10 (1.9)	8.2
50	30 (6.3)	30	30 (5.7)	12
40	30 (6.3)	40	40 (7.6)	13.9
30	30 (6.3)	50	40 (7.6)	13.9
10	10 (2.1)	70	40 (7.6)	9.7

Reduced incentive for foreign MNEs to push debt into US

# Anti-Hybrid Rules: Generally

- New section 267A to the Internal Revenue Code disallows deductions for interest and royalties paid or accrued to a related party pursuant to a “hybrid transaction” or by, or to, a “hybrid entity.”
- This rule bears certain parallels to the Organisation for Economic Co-operation and Development (OECD) proposals in BEPS Action 2 regarding hybrid instruments and hybrid entities.

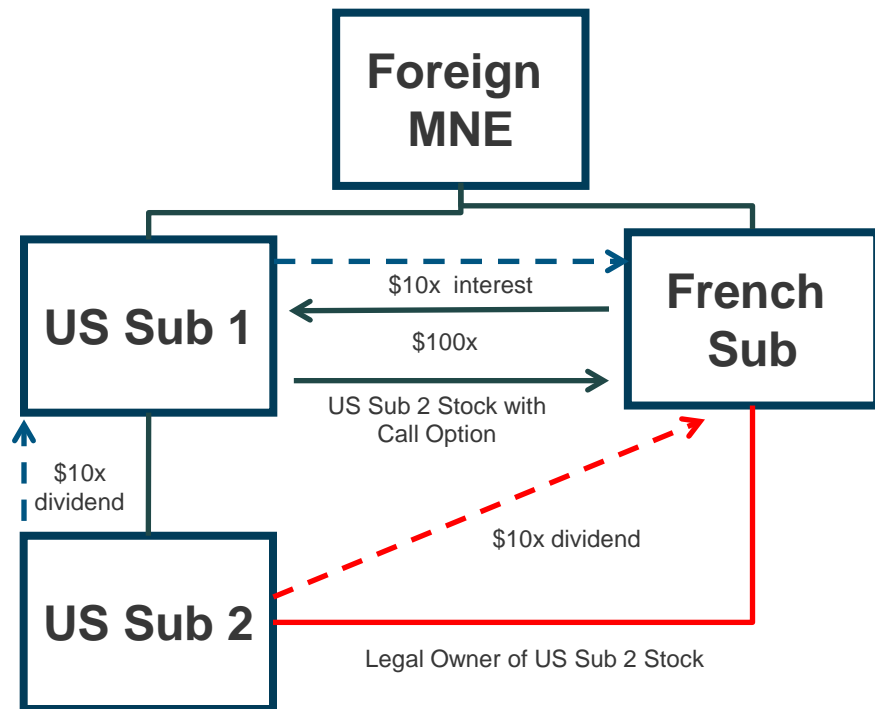
# US Anti-Hybrid Rules: the Mechanics

- Section 267A deductibility of interest and royalty payments where
  - The payment is either (1) made pursuant to a hybrid transaction or (2) made to a hybrid entity, and (2) the payment is either not included in the income of the foreign related party or is deductible from the taxable income of the related party in such related party's tax jurisdiction as a result of the hybrid nature of the payment or related-party entity.
  - A “hybrid transaction” is any transaction, series of transactions, agreement or instrument under which a payment treated as a payment of interest or royalties for US tax purposes is not so treated for relevant foreign tax purposes.
  - A “hybrid entity” is an entity that is fiscally transparent in one jurisdiction but not in the other.

# EU Anti-Hybrid Rules: Comparison to US Rules

- EU Anti-Hybrid Rules (in full force from 2020) operate similarly to section 267A, but:
  - apply to more situations (double deductions, branch mismatches, dual resident companies)
  - apply to imported (*i.e.* indirect) mismatches
  - require secondary counteraction where appropriate (*i.e.* state of receipt must recognize ordinary income if paying state does not deny a deduction)
- In the UK, a secondary counteraction applies if “it is reasonable to suppose that no...equivalent [provision] applies”
  - Is section 267A equivalent to the UK primary counteraction rules?

# Application of US and EU Anti-Hybrid Rules to REPO



## Hybrid Nature of REPO Arbitrage

- For US tax purposes, treated as a secured lending transaction whereby US Sub borrowed \$100x from French Sub and pledged its US Sub 2 stock as collateral. Payments to Foreign Sub treated as interest payments (funded by dividends from US Sub 2).
- For French tax purposes French Sub purchased US Sub 2 stock and legally owns US Sub 2 stock so payments received by it are treated as dividends. Because of participation exemption, dividends treated as 95%-tax exempt.
- Under new Section 267A, interest deduction generally disallowed to US Sub 1 because French Sub is not taxable on “dividend” from US Sub 1.
- Under EU rules, risk that income will be taxed in France as a result of the application of either EU anti-abuse provisions or the French GAAR
- Potential “whipsaw” – no US deduction and taxable income inclusion in France!

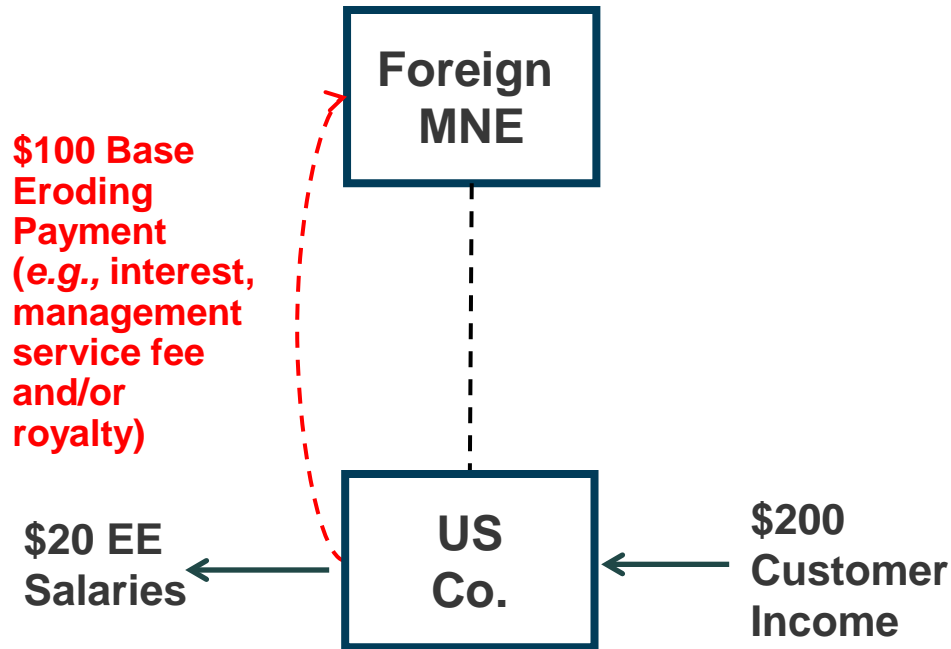


# Impact of BEAT and EU Reaction

# BEAT Generally

- New Section 59A imposes an additional tax on corporations that have at least \$500M of US gross receipts. In the case of foreign corporations take into account gross receipts of US branches and gross receipts of related US corporations.
- Calculated as:  $(10\% \times \text{Modified Taxable Income})$  LESS Regular Tax Liability.
- Modified Taxable Income is taxable income PLUS all deductible Base Eroding Payments Paid to Related Foreign Persons.
- Base Eroding Payments include deductible interest, royalties, certain service fees, and purchase of amortizable or depreciable assets but does not include COGS.

# BEAT: 3% De Minimis Exception

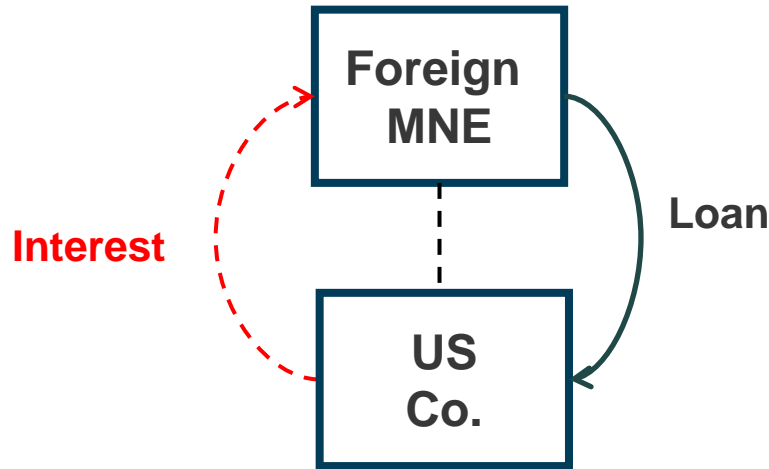


**De Minimis Exception: If Foreign MNE's Base Eroding Payments are less than 3% of its total US deductible expenses, BEAT does not apply.**

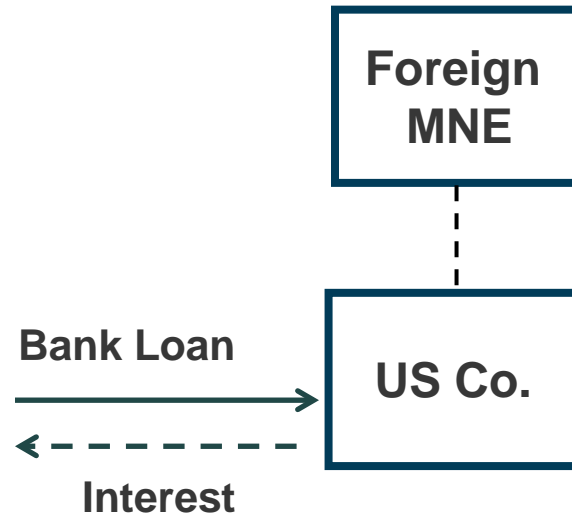
- Application:  $\$100/120 = 83.3\%$
  - De Minimis Exception does not apply.
  - BEAT:
    - $\$200$  gross income –  $\$20$  non-Base Eroding Payments =  $\$180 \times 10\% = \$18$
    - Regular Tax:  $\$200$  gross income -  $\$120$  deductions =  $\$80 \times 21\% = \underline{\$16.8}$
- BEAT = \$1.2**

# Minimizing BEAT: Replace Internal Debt with External Financing

## Base Eroding Interest Payment



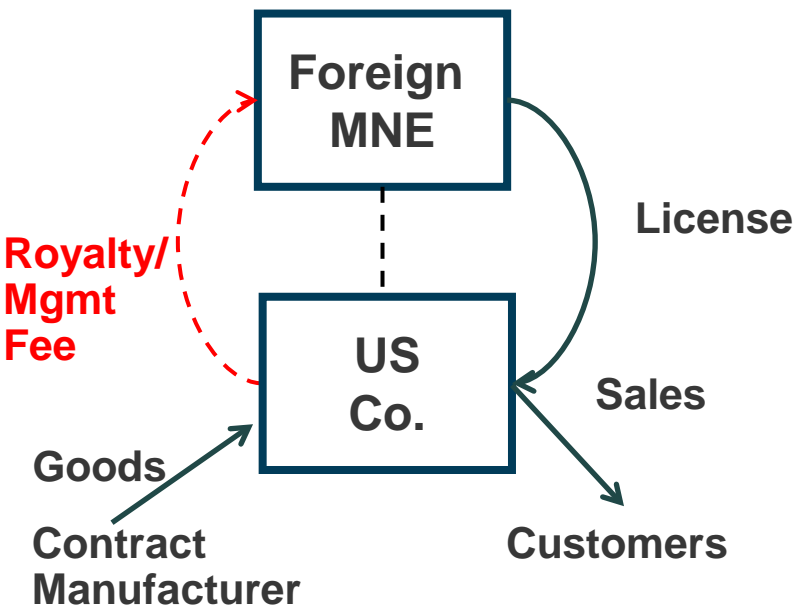
## Non-Base Eroding Interest Payment



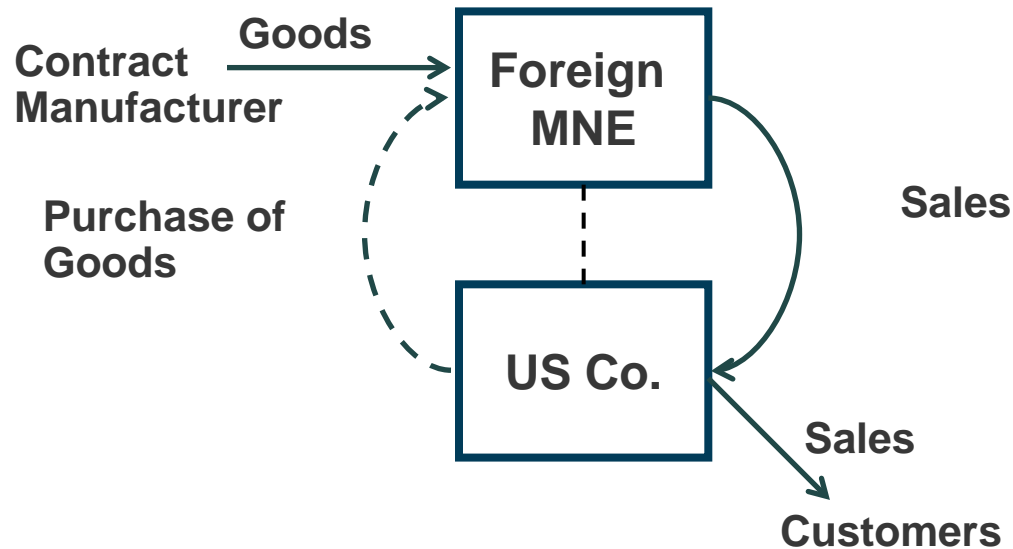
- Assumes 163(j) limit does not apply

# Minimizing BEAT: Restructure to Treat Royalty/ Mgmt Fees as Component of COGS

## Base Eroding Payment



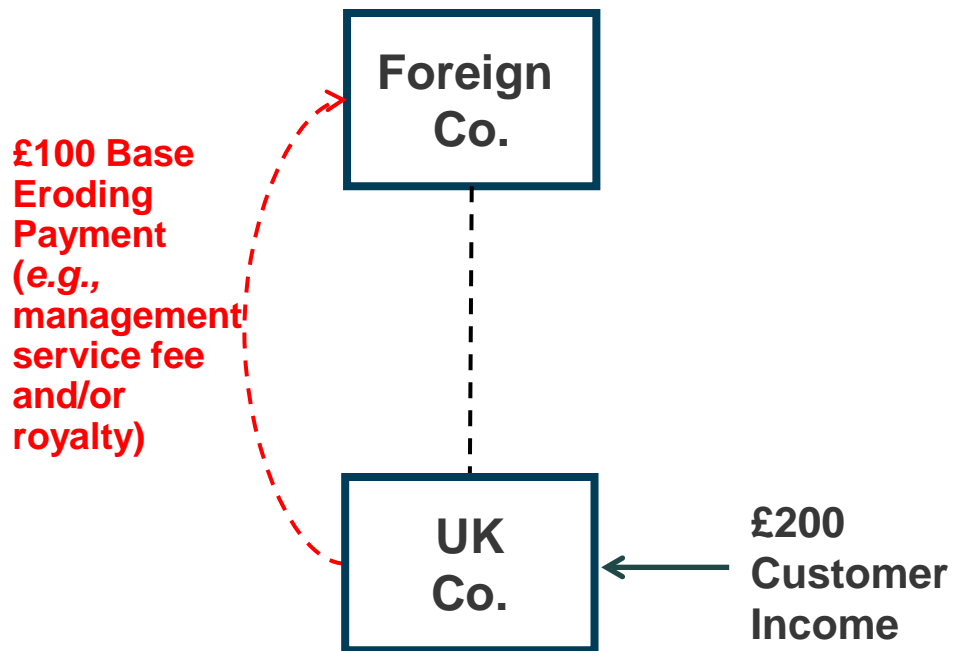
## Non- Base Eroding Payment



# Comparing BEAT and DPT

- BEAT in some ways mirrors efforts in Europe (and elsewhere) to tax more income within its borders.
- In 2015, UK introduced “diverted profits tax” (“DPT”), which taxes income that is considered to be inappropriately shifted to low-tax regimes:
  - provision that is within the scope of transfer pricing (but not a loan)
  - “effective tax mismatch outcome” (increased foreign tax < 80% of reduction in UK tax)
  - Transaction, or participation of foreign entity, lacks economic substance
- Does not apply to SMEs
- DPT operates by recharacterising relevant provision

# DPT example



- £100 payment to Foreign Co achieves tax reduction of £19
- If additional foreign tax is less than £15.2 (80% of £19) AND the arrangements lack economic substance, DPT will apply
- DPT applies to additional profits that would have been recognized had tax not been a consideration in structuring
- If this had meant no Base Eroding Payment, DPT = £25
- But DPT will not apply if a full transfer pricing adjustment is made

# EU Reaction to BEAT

- Does it violate nondiscrimination provisions of US tax treaties?
  - Article 24(4) of Model OECD Convention provides that interest royalties and other payments by a US company to a foreign company should not receive deductibility treatment different from similar payments made to US companies.
- Is it incompatible with WTO rules (inequitable treatment of domestic and foreign purchases)?
- EU undertaking survey of businesses to quantify impact of BEAT (and GILTI)
- OECD reviewing US tax reform at request of EU



# FDII: Comparison to “Patent Box” Regimes

# FDII: Generally

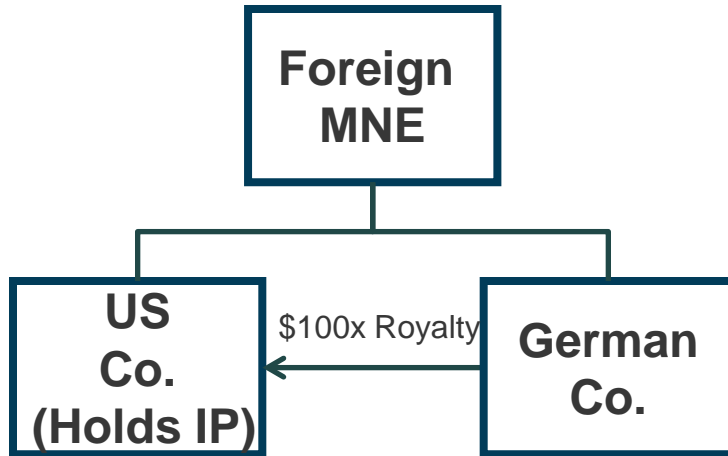
- Allows US corporations to reduce their gross income by 37.5% of their “foreign derived intangible income” (“FDII”) resulting in effective tax rate of 13.125% (until 2025).
- FDII includes:
  - royalties paid to foreign person for right to use IP outside the US
  - gain from sale to foreign person for property used outside the US
  - fees for services provided to any foreign person or with respect to foreign property
- Broader application than most patent box regimes because applies to more categories of income and to more categories of IP than patents.

# FDII – Comparison to Patent Box and BEPS Action 5 Impact

	FDII	BEPS-Compliant Patent Box Requirement
IP Income Determination	Objective: Income in excess of 10% return on depreciable fixed business assets Applies to royalties paid on all intangibles, not just patentable assets.	Subjective: Income from patents and software determined under transfer pricing rules
Nexus Requirement	No requirement	There must be direct nexus between income receiving benefits and qualifying R&D type expenditures contributing to that income

Consequence of not being BEPS compliant: Deduction disallowed or limited by EU based payor company (See e.g., German royalty barrier).

# FDII: Non-Compliance with Action 5



\$100x royalty  
reduced by  
37.5% FDII  
deduction

- US Co \$100 royalty subject to FDII reduction ( $100 - 37.5 = 62.5 \times 21\% = 13.125\%$ ).
- German Co. denies deduction for royalty because:
  - Royalty is subject to a preferential rate of taxation in the US;
  - that results in an effective rate of tax below 25%
  - the preferential regime is not compliant with BEPS Action 5 (*i.e.* there is no nexus requirement)
  - the recipient is not a German CFC
- Contrast with benefits from the Irish, Dutch and UK patent boxes, which benefit from lower effective rates but are BEPS-compliant and therefore not caught.

# EU Reaction to US Tax Reform

# Reduction in Corporate Tax Rates: Race to the Bottom?

- Overall decrease of corporate income tax rates among EU Member States
- Since 2009, EU corporate income tax rates have been reduced down to an average top rate of 21.9% in 2017.
- Largest reductions have been seen in Hungary (10.8%), in the UK (19% currently and 17% from 2020), in France (28.9% as from 2020 and 25.8% as from 2022), and in Italy (27.8%).
- Fear that reduction in US corporate income tax rate will further reduce tax revenues in EU Member States.

# Expansion of Tax Base: Digital Taxation

- Digital tax package released in March 2018 for a “fairer” taxation of digital activities within the EU:
  - Directive proposal on the corporate taxation of the “significant digital presence” (digital PE);
  - Directive proposal on a “digital services tax” on revenues (not profit) derived from certain digital services.
- The Directive on the digital services tax would enter into force in 2020 but is intended as an interim solution until the more comprehensive Directive on the corporate taxation of the significant digital presence is agreed on by the EU Member States and implemented in the EU.

# Expansion of Tax Base: Procedural Requirements

- From a procedural perspective, the draft directives will be submitted to the European Parliament for consultation and to the European Council for adoption.
- As is generally the case in tax matters, unanimity is required, and this would give veto rights to EU Member States such as Ireland, Luxembourg, Malta and Cyprus, which have historically attracted technology firms and may fear that their economy or the access of their citizens to services will be negatively affected if the EU goes ahead with this plan.
- Therefore, the odds of either of the Commission's proposals being adopted anytime soon seem uncertain at best.



# Directive Proposal on Digital Services Tax

- Targeted digital services would include:
  - The placing on a digital interface of advertising targeted at users of that interface, as well as the transmission of data collected about users that has been generated from such users' activities;
  - Intermediation services relying on network effects and consisting in online platforms that allow users to find and interact with other users and which also may facilitate the provision of goods or services directly between them.

# Directive Proposal on Digital Services Tax

- Scope:
  - Any entity would be subject to the tax if:
    - The total amount of its worldwide revenues exceeds €750 million in the relevant tax period; and
    - The total amount of its taxable revenues generated in the EU exceeds €50 million in the relevant tax period.
  - If the relevant entity belongs to a consolidated group, the revenues reported by such group will be decisive; however, it remains unclear whether the parent of that group will be the “taxable person.”

# Directive Proposal on Digital Services Tax

- Taxable base: 3% rate on the gross revenues generated by the entity and assessed in each EU Member State in proportion to:
  - The number of times an advertisement has appeared on the device of a user located in that EU Member State;
  - The number of users in that EU Member State having entered into purchase transactions;
  - The number of users in that EU Member State holding an account on that network; or
  - The number of users in that EU Member State from whom data so monetized has been generated as a result of such users having used a device to access the taxpayer's digital interface.

# Directive Proposal on Digital Services Tax

- Example:
  - Luxembourg-based entity carries out advertising business across the EU, including in France, Germany, Italy and in the UK;
  - The revenues generated in the EU amount to €60 million in the relevant tax period.
- The digital services tax would be assessed as follows:

	<u>France</u>	<u>Germany</u>	<u>Italy</u>	<u>UK</u>	<u>Total</u>
Number of times an advertisement has appeared on the device of a user located in that EU Member State	28,000,000	20,000,000	12,000,000	40,000,000	100,000,000
Taxable revenues	16,800,000 €	12,000,000 €	7,200,000 €	24,000,000 €	60,000,000 €
DST due in the relevant EU Member State	504,000 €	360,000 €	216,000 €	720,000 €	1,800,000 €

# Directive Proposal on Digital Services Tax

- Potential double taxation
  - In case of double taxation of the same revenues within the EU, the digital services tax charge is deductible from the corporate income tax base in the EU Member State of establishment, irrespective of whether both taxes are paid in the same EU Member State or in different ones;
  - Opened question for entities established outside the EU.
- Potential challenge under EU rules
  - Issue raised about a potential violation of the right to equality under the EU Charter of Fundamental Rights.

# Directive Proposal on Digital PE

- Targeted services are defined broadly to include:
  - All services delivered over the internet that are of a nature that renders their supply essentially automated, involving minimal human intervention and impossible to ensure in the absence of information technology;
  - The sale of software, website hosting services, the supply of e-books or online newspapers, and services for downloading or streaming music and movies.
- The sale of physical goods, even if performed online, and services realized in the physical world but delivered electronically would not be covered.

# Directive Proposal on Digital PE

- Scope: any entity would be deemed to have a “significant digital presence” if it fulfills one of the following criteria:
  - Its revenues from digital services in any EU Member State exceed a threshold of €7 million in the relevant tax period; or
  - The number of users of its digital services in any EU Member State exceeds 100,000 in the relevant tax period; or
  - The number of online business contracts for the supply of digital services entered into with users in any EU Member State exceeds 3,000 in the relevant tax period.
- Taxation will be assessed in the EU Member State where the users are based at the time of consumption.

# Directive Proposal on Digital PE

- Potential incompatibility with the provisions of currently applicable tax treaties to which EU Member States are parties.
- Exclusion from the territorial scope of the Directive of entities that are resident outside the EU in a country that has a tax treaty with the relevant EU Member State (unless that treaty incorporates rules similar to those of the Directive).
- The EU Commission encourages EU Member States to introduce provisions that mirror those of the Directive in their tax treaties.



# Expansion of Tax Base: Common Consolidated Corporate Tax Base

- Reactivation of the project with Emmanuel Macron's election and Angela Merkel's reelection.
- German-French initiative on a common corporate tax base for France and Germany.
- Renewed impetus at the EU level with the adoption by the European Parliament Committee on Economic and Monetary Affairs of the proposed CCCTB Directive in February 2018.

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# 2018 McDermott Tax Symposium

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Breakout Session III: Benefit or Burden: Impact of Tax  
Reform on Compensation Structures and Popular Fringe  
Benefits

David Fuller, Moderator | Washington, DC  
Andrew Liazos | Boston  
Samantha Souza | Washington, DC

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# Overview

- Structuring and Restructuring Compensation Arrangements
- Qualified Transportation Fringes
- Employer-Provided Cafeterias
- Working Condition Fringe Benefits
- Wage Withholding Tables
- Miscellaneous Fringe Benefits

# Structuring Compensation Arrangements

- Employee business expenses were previously deductible subject to the 2% floor.
  - **Types of Employee Business Expenses:** Tools, supplies, travel, meals, entertainment, advertising, uniforms
- Tax Reform Act eliminates employee itemized business expenses
- Tax savings from restructuring compensation arrangements:
  - **Employees:** Income tax savings and FICA tax savings
  - **Employers:** FICA tax savings

# Structuring Compensation Arrangements

- Adversely impacts the following industries:
  - Oil & Gas
  - Transportation
  - Construction
  - Financial services
  - Travel Nursing
- Impacts the following types of employees:
  - Employees with significant unreimbursed expenses (e.g., financial advisors in securities/insurance industries, commissioned sales agents)
  - Employees traveling away from home for long periods

# Structuring Compensation Arrangements

- Employees **may not** deduct any employee business expenses
- Employers **may** reimburse/pay for an employee's business expenses on a tax-free basis as:
  - (i) Accountable Plan Reimbursements—Section 62(c)
  - (ii) Working Condition Fringes—Section 132(d)
- Reasonable Belief Relief
  - Working condition fringe positions are sustained provided that the employer satisfies the reasonable belief test

# Structuring Compensation Arrangements

- **Example:** Tax impact of wage restructuring on \$100,000 commissioned sales agent with \$20,000 in deductible business expenses

## **Before—**

- FICA taxes--\$7,650 employer/\$7,650 employee
- Income taxes--\$100,000 of taxable wages
- Employer has \$100,000 compensation deduction

## **After—**

- FICA taxes--\$6,120 employer/\$6,120 employee
- Income taxes--\$80,000 of wages
- Employer has \$80,000 compensation deduction/\$20,000 business expense deduction

## **Total Tax Savings**

- Employee—approximately \$5,000
- Employer—approximately \$1,500

# Structuring Compensation Arrangements

## Action Items—

- Convert employees to independent contractors
  - Significant tax and HR issues associated with such planning
- Tunneling Beneath the 2% Floor is Now the “Big Dig”
  - IRS formally recognized methods to restructure taxable compensation into nontaxable reimbursements
  - PLR 9822044—nonelective wage reduction/expense reimbursement increase
  - PLR 199916011—elective wage reduction/expense reimbursement increase (obtained by MWE for financial services client)
  - Rev. Rul. 2012-25—recognizes IRS approach to wage restructuring versus wage recharacterization



# Structuring Compensation Arrangements

## Action Items—(cont'd)

- Road map to restructuring:
  - Prospective Only
  - Avoid employee elections in restructured arrangements
  - Unused expense accounts are forfeited
  - Structure as working condition fringe and secondarily as accountable plan
  - Internal/External review to substantiate relief under the reasonable belief standard
  - Consider former impact of AMT

# Structuring Compensation Arrangements

## Section 162(m) – What's Next?

- More flexible provisions for adjusting performance based awards
- Focus on new ways to deduct executive pay
- Interest in deferring the payment of equity awards
  - Difference between individual and corporate tax rates
  - Potential state tax savings for payments in 10 or more annual installments
- Protecting grandfathering, particularly for deferred compensation
- Insurance funding with repeal of corporate AMT
- Evaluation of state tax costs for plans that do not comply with § 162(m)

# Qualified Transportation Fringe Benefits

- Qualified Transportation Fringe Benefits
  - Transit passes
  - Employer provided parking
  - Bicycle commuting
- Employer QTF costs are no longer deductible
- QTFs are still exempt from wages:
  - Excludable from income (\$260 per month for transit/\$260 per month for parking)
  - Excludable from employer and employee FICA taxes

# Qualified Transportation Fringe Benefits

- **Action items**

- Forgo deductions
- Eliminate programs
- Review state and/or local government requirements
- Apply deduction disallowance based on strict statutory construction basis

# Employer-Operated Cafeterias/Eating Facilities

- Prior to 2018
  - Employer—100% deductible if
    - (i) provided for the convenience of the employer, or
    - (ii) qualified as a *de Minimis* fringe benefit
  - Employee—meals excluded from taxable wages
- After 2018
  - Employer—
    - 50% deductible through December 31, 2025
    - After 2025, no deduction is available

# Employer-Operated Cafeterias/Eating Facilities

## ▪ Action Items

- Implement new deduction limitations
- Review ongoing viability due to potential deduction disallowance and IRS attacks on the income exclusions
- IRS actively auditing employer cafeterias
  - Review to confirm conformity with Section 132 and/or 119
  - Obtain reasonable belief protection for operations
  - No change to the employee income exclusion

# Other Employer-Provided Meals

- Holiday parties and similar social events remain 100% deductible
- Meals provided to employees while traveling remain 50% deductible
- Expenses, other than meals, incurred for entertaining clients are no longer deductible
- Expenses for meals with clients may be partially deductible in certain instances

# Working Condition Fringe Benefits

- Excluded from income if the employee could have taken a deduction under Section 162 (ordinary and necessary business expense) or under Section 167 (depreciation) if the employee paid for the expense
  - Examples include
    - Corporate aircraft provided for security
    - Travel expense reimbursements
    - In-kind benefits
    - Legal fee reimbursement
- After Tax Reform, employees may no longer claim work-related deductions on their Forms 1040



# Working Condition Fringe Benefits

- **Action Items**

- Strengthen reasonable belief exclusion
- Do not change current approach
- Some employers based on unique facts may choose to enhance working condition fringe exclusions through wage restructuring
- Monitor IRS clarification of issue
  - All indications are that working condition fringe benefits are not eliminated

# Miscellaneous Fringe Benefits

- Other Employer-Provided Meals and Entertainment
- Qualified Moving Expense Reimbursements
- Employee Achievement Awards
- Unchanged popular fringe benefits:
  - Adoption assistance
  - Educational assistance
  - Dependent care spending accounts

# Withholding

- IRS designed 2018 withholding tables to function with prior years' Forms W-4
- IRS released new Form W-4 and withholding calculator
- Many employees have seen increases in net paychecks, but could be surprised at tax time if their withholding amount is incorrect

# Withholding

## ▪ **Actions Items**

- The 2017 version of Form W-4 can no longer be used, but previously submitted ones are acceptable
- Encourage employees to verify that the correct amount is being withheld by running their specific tax situation through the new IRS calculator
- Employees should file a new Form W-4 if their old form and/or the updated tables result in too much or too little withholding

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Panel III: State Tax After Reform

**Jane May**, Moderator | Chicago  
**Cate Battin** | Chicago  
**Diann Smith** | Washington, DC

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# Background: Federal Tax Reform

- Movement toward territorial system
- Limit incentives to move income overseas
- Tax base changes (broadening)
- Tax rate changes (reductions)

# State Relation to Federal

- All states with a corporate income tax conform to some extent
- Starting point: taxable income
- NOLs and Special Deductions
- Conformity to tax base, not sourcing or rates
- State modifications

# Basic Concept of State Tax Conformity

- Rolling vs. static
- Full vs. partial



# International Provisions

- Repatriation (IRC § 951(a), § 965(a), § 965(c))
  - Federal rule
  - State impacts:
    - Timing and consequence under state law
      - IRC § 965(a)
      - IRC § 965(c)
    - Relevance of DRD provisions
    - Constitutional issues

# International Provisions (cont.)

- GILTI (IRC § 951A, § 250)
  - Federal rule
  - State impacts:
    - Consequence under state law
      - IRC § 951A
      - IRC § 250
    - Relevance of DRD provisions
    - Constitutional issues

# International Provisions (cont.)

- FDII (IRC § 250)
  - Federal rule
  - State impacts:
    - Consequence under state law
    - Constitutional issues
- BEAT (and repeal of AMT) (IRC § 59A)
  - Federal rule
  - State impacts:
    - Consequence under state law
    - Constitutional issues

# Other Corporate Income Tax Base Issues

- Interest deduction (IRC § 163(j))
  - Implementation with state tax structures
  - Impact on interest add-back regimes
- NOLs (IRC § 172)
- Expensing of certain assets (IRC § 168(k); IRC § 179)
- Contributions to capital (IRC § 118)

# State Tax Implications of Federal Tax Reform

- Certain business taxes not impacted
  - Taxes not based on federal income or income computed under the IRC
    - *i.e.*, Ohio CAT, Washington B&O
  - Conformity to IRC in effect before December 23, 2017
  - *i.e.*, California, Hawaii, North Carolina, and South Carolina

# State Tax Implications of Federal Tax Reform

- States are updating conformity
  - Georgia
    - HB 918 (enacted)
    - Updates conformity as of February 9, 2018
  - West Virginia
    - HB 4135 and SB 265 (enacted)
    - Updates conformity as of January 1, 2018

# State Tax Implications of Federal Tax Reform

- States are updating conformity (cont.)
  - Idaho
    - HB 355 (enacted)
      - Taxable years beginning in 2017
      - Conformity as of December 21, 2017 (day before TCJA enacted)
      - Except also conforms to § 965
    - HB 463 (enacted)
      - Taxable years beginning 2018 or later
      - Updates conformity as of January 1, 2018

# State Tax Implications of Federal Tax Reform

- Affirmative decoupling from some or all provisions
  - Virginia (SB 230 and HB 154) (enacted)
    - Conformity as of February 9, 2018, **except** for TCJA provisions
    - But effectively adopts IRC § 965
  - Maryland (HB 875/SB 733)
    - Decouples
    - Unless Commissioner determines federal provisions decrease state tax base.
  - Georgia (HB 918) (enacted)
    - Decouples from IRC § 163(j) (interest expense limitations) and IRC § 118 (inclusion in gross income of certain capital contributions)



# State Tax Implications of Federal Tax Reform

- Despite general conformity, certain federal provisions may not have an impact
  - Current law decouples from certain provisions
    - Hawaii (SB 2821)
      - Updates conformity to December 31, 2017 BUT current law decouples from certain provisions including § 965 and 951A
    - South Carolina (HB 5162)
      - Update conformity to February 9, 2018 BUT current law decouples from certain provisions including § 965 and 951A
    - Many states already decouple from IRC section 168(k)

# State Tax Implications of Federal Tax Reform

- No impact despite conformity (cont)
  - Existing complete deduction for certain income
    - DRDs
    - Virginia (Va. Code Ann. § 58.1-402.C.7)
      - “[A]ny amount included [in federal income] by the operation of § 951 (subpart F income).”
    - West Virginia (W. Va. Code § 11-24-6(c)(9))
      - Deduction for foreign source income could apply to GILTI

# State Tax Implications of Federal Tax Reform

- No impact despite conformity (cont)
  - New deductions for certain income
    - New York: IRC section 965 income is “other exempt income”
    - Georgia (SB 328 (enacted) and HB 918 (enacted))
      - 100% DRD for GILTI and likely for 965 income

# State Tax Implications of Federal Tax Reform

- Conformity Complexities
  - DRD applies, but incomplete
    - Illinois guidance:
      - DRD applies to net 965 income and net GILTI
      - DRD can be a 70%, 80 % or 100% depending on ownership %.
    - Massachusetts: 95% DRD
    - Montana: 80% DRD

# State Tax Implications of Federal Tax Reform

- Conformity Complexities
  - Lack of guidance applying DRD to § 965 or GILTI
    - Tennessee – What is a dividend under Tenn. Code Ann. § 67-4-2006(b)(2)(A) DRD?
    - Washington, DC – Allows a deduction for Subpart F income but only as provided in IRC § 952. DC Code Ann. § § 47-1803.03(a)(16; 47-1801.04(46)

# State Tax Implications of Federal Tax Reform

- Conformity Complexities
  - Expense Disallowance
    - New York: deductions related to “other exempt income” disallowed
    - Connecticut (SB 11)
      - 10% of deducted dividends disallowed as a related expense
      - different percentage possible on taxpayer petition to commissioner
    - Administrative fiat risk

# State Tax Implications of Federal Tax Reform

- Constitutional Issues
  - GILTI in separate return states
  - Apportionment Issues
    - 163(j) applied on a pre- or post- apportionment basis?
    - 965/GILTI allocation as non-business dividend?
    - GILTI and 965 factor representation
      - Distortion standard
      - Options:
        - Factors of CFCs generating the income
        - GILTI/965 income in denominator
          - » Sourcing as a dividend?

# State Tax Implications of Federal Tax Reform

- Reference to Federal Form Issue
  - State tax forms may not accurately reflect the statutes
    - 965: Tennessee guidance re: transition tax statement
    - Special Deductions: New York
      - Tax Law: starting point is federal taxable income (including special deductions)
      - Tax return: starting point is Line 28 of the 1120, not Line 30



# State Tax Implications of Federal Tax Reform

- Unique Approaches
  - California
    - Generally static conformity
    - But, rolling conformity to water's-edge provision references
    - Existing provisions do not conform to federal repatriation provisions
    - Will tax any dividends upon actual receipt
    - Elimination for any worldwide combination years

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## Panel IV: New Considerations for Structuring M&A Transactions

APRIL 24 | CHICAGO

**Tim Shuman**, Moderator | Washington, DC  
**Caroline Ngo** | Washington, DC  
**Alejandro Ruiz** | Silicon Valley  
**Michael Wilder** | Washington, DC  
**Dan Zucker** | Chicago

# Agenda

- Key Changes Impacting Domestic M&A
- Cross-Border M&A – Section 338 Elections and Disposition Planning
- Post-Acquisition Integration

# Key Changes Impacting Domestic M&A

# Overview: Key Changes Impacting Domestic M&A

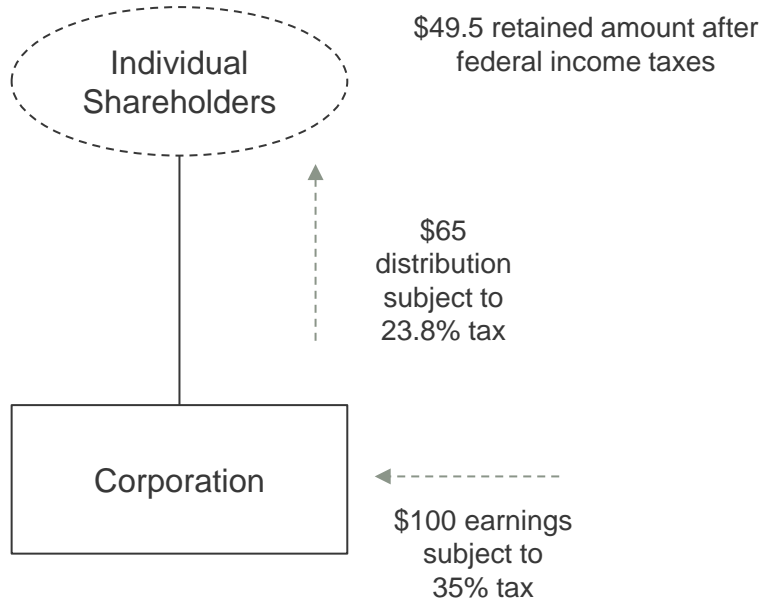
- Changes in Income Tax Rates
- Limitations on NOL Carryforwards and Carrybacks
- Full Expensing for Capital Assets
- Transition Tax
- Partnership Issues
- Business Interest Expense Limitations

# Changes in Income Tax Rates

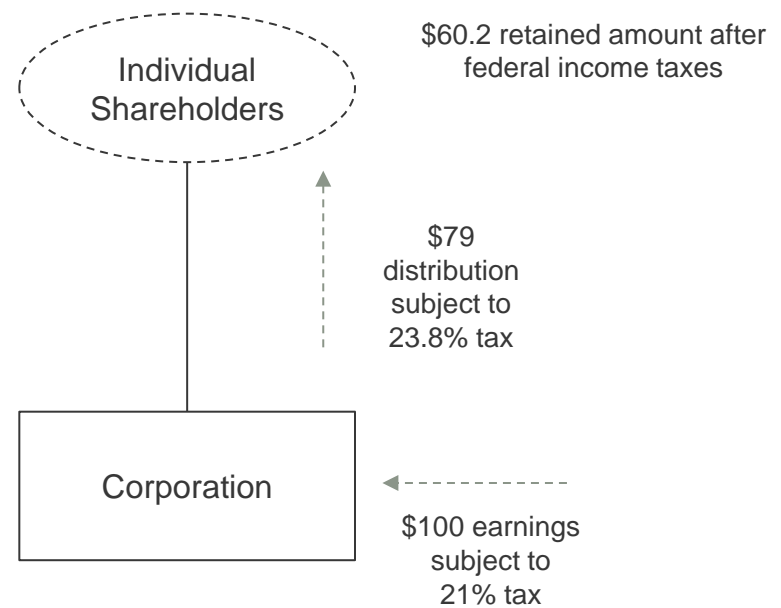
- 21% Corporate Income Tax Rate
  - Prior graduated rates with top rate of 35% now 21% flat rate
  - Effective for tax years after 12/31/17 and permanent going forward
  - Fiscal year taxpayers benefit from rate change starting 1/1/18 by applying a blended rate for the fiscal year based on the number of days of the fiscal year before and after the effective date
- Individual Rate Reduction
  - Highest marginal rate for individuals reduced from 39.6% to 37%; 3.8% net investment income tax retained
  - 29.6% effective federal rate to the extent the 20% “pass-through deduction” under Section 199A is available

# Changes in Income Tax Rates

## Before Tax Reform



## After Tax Reform



- 50.5% combined corporate & dividend tax rate compared to 39.6% top ordinary income tax rate

- 39.8% combined corporate & dividend tax rate compared to 37% top ordinary income tax rate

# Changes in Income Tax Rates

- Are businesses now inherently worth more – and therefore should command higher valuations – because their cash tax obligations are lower?
  - Adjustment of investment models for reduced corporate tax rate impact on cash taxes
- Reduced rates will change the estimated value of tax basis step-ups and acquired tax attributes (e.g., NOLs, tax basis in intangible assets, etc.)
  - Impact on the ability to market tax attributes upon exit – buyers will need to evaluate cost to compensate sellers for incremental taxes with reduced benefit for these acquired tax attributes
- There may be opportunities for more US asset deals over stock acquisitions because of the lower overall tax leakage for sellers due to lower corporate tax rates



# Limitations on NOL carryforwards and carrybacks

- Deduction for an NOL is limited to 80% of taxable income, determined without regard to the NOL deduction itself
- Carrybacks are disallowed
  - This change will affect negotiations regarding the payment of additional purchase price for tax benefits attributable to transaction deductions that give rise to an NOL in the taxable year of the closing of a transaction
- The lack of the ability to carry back any such NOL will eliminate sellers' ability to obtain the benefit of refunds of taxes paid in pre-closing periods
  - Increased emphasis on obtaining the benefit of NOL carryforwards realized by the buyer in post-closing periods

# Full Expensing for Capital Assets

- Bonus depreciation rules now allow taxpayers to deduct 100% of the cost of most tangible property (other than buildings and some building improvements) and most computer software in the year placed in service
  - This 100% depreciation deduction is decreased to 80% for most property placed in service in calendar year 2023, 60% in 2024, 40% in 2025, 20% in 2026, and 0% in 2027 and afterward
- In asset deals, increased focus on purchase price allocations to maximize benefit
- Change will result in increased deductions for buyers, and increased depreciation recapture recognized as ordinary income for sellers

# Transition Tax

- Section 965 requires that in the last taxable year of a deferred foreign income corporation (DFIC) that begins before January 1, 2018, the subpart F income of a DFIC in such transition year is increased by the accumulated post-1986 deferred foreign income as of the relevant measurement date under section 965(a)
- Amount included in a United States shareholder's gross income is taxed at 8% for non-cash assets, and 15.5% for cash assets
- A United States shareholder may elect to pay the net tax liability in eight annual back-loaded installments under section 965(h)

# Transition Tax

- Section 965 Reps and Covenants
  - To ensure transition tax is a pre-closing tax item, consider a rep that none of the CFC subsidiaries of target have a taxable year for US federal income tax purposes other than the year ending on December 31st
  - Address Potential Installment Payments
    - Covenant to make or not make any election under Section 965(h) to pay the net tax liability under Section 965 in eight installments
    - Indemnity for any taxes resulting from an election under Section 965(h) to pay the net tax liability under Section 965 in installments
      - May be taken into account as an upfront adjustment to the purchase price or over time

# Partnership Issues

- Qualified Business Income Deduction
  - 20% deduction for qualified business income through 2025 (sunset for tax years beginning after 2025), limited to greater of a) 50% of W-2 wages, or b) 25% of W-2 wages + 2.5% of capital assets
    - Meant to capture earnings from capital (and not wages)
  - Specified personal services businesses not eligible, except for taxpayers with taxable income <\$157,500/\$315,000 (deduction phased out over next \$50k/\$100k)
    - Personal services businesses include, among others, legal, financial, healthcare or any business where the principal asset is the reputation or skill of its employees or owners
  - Deduction for qualified business income may impact structure of management equity vehicles and employment companies due to the need for W-2 wages
  - 20% deduction may not be available for ordinary gain on partnership sales resulting in incremental tax cost on exit compared to asset sale inside of the partnership

# Partnership Issues

- Section 1061 extends the holding period to three years with respect to long-term capital gain recognized by service providers to investment funds from carried interests
  - Applies to the sale of the interest itself as well as with respect to gains allocated to such interest from sales below an investment fund
  - Does not apply to dividend income
  - Profits interests issued to executives of companies should be exempt from the change, even if they are held in an LLC owner on top of a corporation, as long as they do not also provide services to a related investment fund
  - An applicable partnership interest does not include an interest in partnership directly or indirectly held by a corporation
- Elimination of technical termination rule
  - Change in control for joint ventures and partnership structures will no longer result in short taxable years

# Business Interest Expense Limitations

- Business interest expense limited to the sum of business interest income plus 30% of adjusted taxable income (generally, EBITDA with certain tax adjustments through 2021, then 30% of EBIT beginning in 2022)
  - “Business interest” is defined as interest on indebtedness that is properly allocable to a trade or business; legislative history suggests that all of a corporation’s interest expense is “business interest” (external, related party, etc.)
  - Disallowed business interest expense is treated as paid in the next taxable year, but is subject to limitations similar to NOLs in any change in control transaction
- All taxpayers will need to determine interest limitation that could result in additional cash tax for tax years beginning after December 31, 2017, and should model impact
- Stricter limits on interest deductibility may drive different financing alternatives such as leases, guaranteed payments, or convertible debt instruments as potential avenues to mitigate limitations and/or reduce higher overall cost of debt due to limited interest deductions

# Cross-Border M&A – Section 338 Elections and Disposition Planning



# Section 338(g) Election Overview

- *Election.* Election is made unilaterally by Buyer (with notice requirement, if the target is a CFC)
- *Tax consequences.* When made, the election results in the following deemed transactions: (i) Old Target sells assets to New Target; (ii) Seller is treated as selling Old Target to Buyer
  - Results in two layers of federal tax events – Seller has gain/loss on stock, and Target has gain/loss on assets
  - If Target is a CFC, then deemed asset sale may give rise to subpart F or GILTI, and a basis step-up in the stock under section 961(a)
- *Clean slate for Target.* Target's tax year closes on the acquisition date, and its tax year closes; all attributes are wiped out (e.g., PTI accounts)
- *Go-forward impact.* Step up in basis in Target's assets may reduce future "tested income" for GILTI purposes; section 901(m) (covered asset acquisition rule) affects foreign tax credits

# New Considerations for Section 338(g) Elections – Highlights

- Section 338(g) election can turn CFC stock gain taxed at 21% into GILTI income taxed at 10.5%
- Due to large amounts of section 965 PTI in the system, 338(g) elections are more favorable to sellers, but buyers may prefer not making the election and inheriting a large PTI account
- If a CFC generates GILTI during the year of sale and no 338(g) election is made, seller's section 1248 amount should be excluded from income under section 245A
- New section 964(e), together with the GILTI provisions, may provide favorable results for a sale of lower-tier CFC with 338(g) election

# Alt. 1 Sale of Stock in First-Tier CFC with no E&P



$$\begin{array}{r} \text{FMV} = 300 \\ \text{AB} = \underline{0} \\ \text{Gain} = 300 \end{array}$$

$$\text{E\&P} = 0$$

Business assets (non-subpart F)

$$\text{FMV} = 300$$

$$\text{AB} = \underline{0}$$

$$\text{Gain} = 300$$

## Key Issues in 338 Analysis

- Seller's gain – stock gain @ 21% or GILTI @ 10.5%
- Buyer's basis step-up and application of section 901(m)

# Alt. 1 Sale of Stock in First-Tier CFC with no E&P – Seller Consequences

	Section 338(g) Election	No section 338(g) election
Asset gain for CFC Target	300 – tested income for GILTI purposes	N/A
Tax year close?	Yes	No
US Seller's basis in CFC Target stock	Increases by 300 under section 961(a)	0
Stock gain for US Seller	0	300
Total US tax cost to US Seller	31.5 (i.e., 300 x 10.5%)*	63 (i.e., 300 x 21%)

\* Section 338 election converts 21% taxed stock gain to 10.5% taxed GILTI

# Alt. 1 Sale of Stock in First-Tier CFC with no E&P – Buyer Consequences

	Section 338(g) Election	No section 338(g) election
Basis in CFC Target stock	300	300
Basis in CFC Target assets	300	0
Section 901(m)?*	Yes	No

\* Section 338 election provides basis step-up in assets, reducing future GILTI; but, results in section 901(m) applying

# Impact of Section 901(m) to US Buyer

- Section 901(m) provides that, in the case of a “covered asset acquisition” [generally, a transaction producing a basis step-up for US tax but not foreign tax purposes, including via a section 338(g) election], the disqualified portion of any foreign income tax generated by the relevant foreign assets is not creditable
- Section 901(m) reduces FTCs available for taxes paid by CFC Target after a section 338 election (essentially by reversing the benefits of the basis step-up for FTC purposes only)
  - *But*, section 338 election steps up basis, reducing tested income and US tax (pre-FTC); disallowed FTCs are still deductible
- Impact of section 901(m) depends on weighing the reduction in tested income versus the lost FTCs; depends on US Buyer’s GILTI posture
  - If US Buyer has excess credits in the GILTI basket, then section 901(m) should generally be neutral – reduction in tested income outweighs loss of FTCs
  - If US Buyer has excess limitation in the GILTI basket, then impact depends on foreign effective rate of the CFC Target (*i.e.*, the higher the effective rate, the more detrimental is the loss of FTCs)

# Key Code Sections for Disposition Structures

- Section 1248(j) – in case of sale by domestic corporation of stock of a foreign corporation held for more than 1 year, amount treated as a dividend under section 1248 is treated as a dividend for purposes of section 245A
- Section 245A – 100% DRD for dividends from 10-percent owned foreign corporation
- Section 951A(f)(1)(A) – GILTI inclusion is treated as subpart F income for purposes of section 951(a)
- Section 964(e) – gain recognized by CFC on sale of a foreign corporation is treated as a dividend under section 1248 principles; if stock held for more than 1 year, then (i) foreign-source portion of gain is subpart F income and (ii) US shareholder with inclusion is allowed section 245A DRD
- Section 951(a)(2)(B) – a person's pro rata share of subpart F income reduced by amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own such stock bears to the entire year

# Alt. 2 Sale of Stock in First-Tier CFC with Prior Year Untaxed E&P



$$\begin{aligned} \text{FMV} &= 300 \\ \text{AB} &= \frac{0}{300} \\ \text{Gain} &= \frac{300}{300} \end{aligned}$$

$$\text{E\&P} = 100$$

Business assets (non-subpart F)

$$\text{FMV} = 300$$

$$\text{AB} = \frac{0^{**}}{300}$$

$$\text{Gain} = 300$$

\*\* For simplicity, assumed that inside basis does not increase to reflect E&P

## Key Issues in 338 Analysis

- Seller's gain – stock gain (net of section 1248 dividend) @ 21% or GILTI @ 10.5%
- Buyer's basis step-up and application of section 901(m); PTI



# Alt. 2 Sale of Stock in First-Tier CFC with Prior Year Untaxed E&P – Seller Consequences

	Section 338(g) Election	No section 338(g) election
Asset gain for CFC Target	300 – tested income for GILTI purposes	N/A
Tax year close?	Yes	No
US Seller's basis in CFC Target stock	Increases by 300 under section 961(a)	0
Stock gain for US Seller	0	300, but 100 is deductible under 245A
Total US tax cost to US Seller	31.5 ( <i>i.e.</i> , 300 x 10.5%)	42 ( <i>i.e.</i> , 200 x 21%)

# Alt. 2 Sale of Stock in First-Tier CFC with Prior Year Untaxed E&P – Buyer Consequences

	Section 338(g) Election	No section 338(g) election
Basis in CFC Target stock	300	300
Basis in CFC Target assets	300	0
Section 901(m)?	Yes	No
PTI Account	N/A	100 (section 959(e))

# Alt. 3 Sale of Stock in First-Tier CFC with PTI



## Key Issues in 338 Analysis

- Seller – may have capital loss with section 338(g) election
- Buyer – PTI account eliminated with election

PTI = 100

Business assets (non-subpart F)

FMV = 300

AB = 0\*\*

Gain = 300

\*\* For simplicity, assumed that inside basis does not increase to reflect E&P

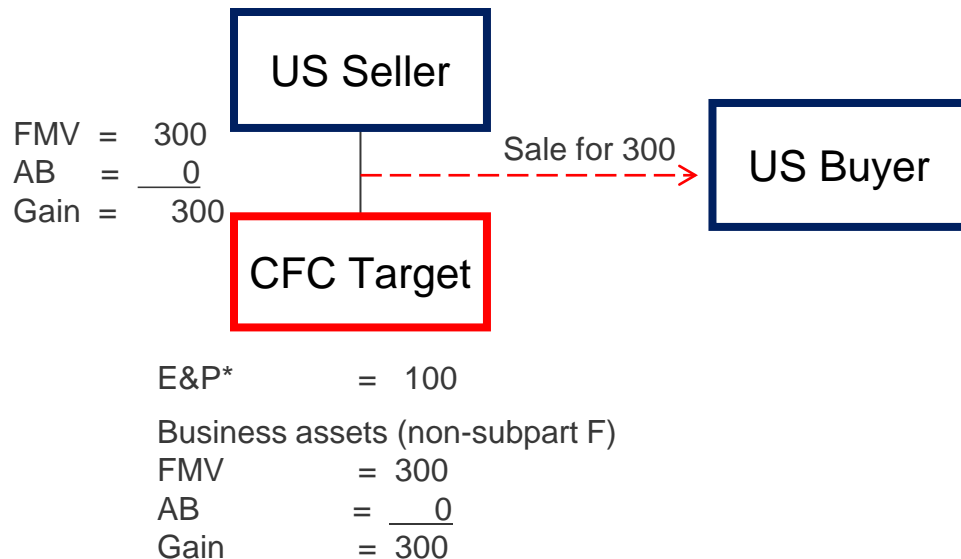
# Alt. 3 Sale of Stock in First-Tier CFC with PTI – Seller Consequences

	Section 338(g) Election	No section 338(g) election
Asset gain for CFC Target	300 – tested income for GILTI purposes	N/A
Tax year close?	Yes	No
US Seller's basis in CFC Target stock	Increases from 100 to 400	0
Stock gain for US Seller	0	200
Capital Loss Carryback for US Seller	100 capital loss (value of -21 for 2018 or later; -35 if carried back before 2018)	0
Total US tax cost to US Seller	-4.5 ( <i>i.e.</i> , 300 x 10.5% - 35)	42 ( <i>i.e.</i> , 200 x 21%)

# Alt. 3 Sale of Stock in First-Tier CFC with PTI – Buyer Consequences

	Section 338(g) Election	No section 338(g) election
Basis in CFC Target stock	300	300
Basis in CFC Target assets	300	0
PTI Account	N/A	100

# Alt. 4A Sale of Stock in First-Tier CFC with Current Year GILTI – Mid-Year Sale



## Facts

- US Seller sells CFC Target on 12/31

## Key Issues in 338 Analysis

- Seller's gain – application of section 1248(j)/245A
- Amount of GILTI inclusion for Buyer – application of section 951(a)(2)
- Buyer's basis step-up and application of section 901(m)

\* Non-Subpart F earnings for the entire year

# Alt. 4A Sale of Stock in First-Tier CFC with Current Year GILTI – Mid-Year Sale – Seller Consequences

	Section 338(g) Election	No section 338(g) election
Asset gain for CFC Target	300 – tested income for GILTI purposes	N/A
Tax year close?	Yes	No
US Seller's basis in CFC Target stock	Increases by 300 under section 961(a)	0
Stock gain for US Seller	0	300, but 50 deductible under 245A
Total US tax cost to US Seller	31.5 ( <i>i.e.</i> , 300 x 10.5%)	52.5 ( <i>i.e.</i> , 250 x 21%)

# Alt. 4A Sale of Stock in First-Tier CFC with Current Year GILTI – Mid-Year Sale – Buyer Consequences

	Section 338(g) Election	No section 338(g) election
Basis in CFC Target stock	300	300
Basis in CFC Target assets	300	0
GILTI Inclusion	50 (amount of GILTI post-acquisition)**	50 (after application of section 951(a)(2))
Section 901(m)?	Yes	No

\*\* For simplicity, this ignores possibility that Buyer's GILTI could be reduced by basis step-up from 338 election



# Alt. 4B Sale of Stock in First-Tier CFC with Current Year GILTI – End of Year Sale with No 338(g) Election



$$\begin{array}{r} \text{FMV} = 300 \\ \text{AB} = \underline{0} \\ \text{Gain} = 300 \end{array}$$

$$\text{E\&P}^* = 100$$

Business assets (non-subpart F)

$$\text{FMV} = 300$$

$$\text{AB} = \underline{0}$$

$$\text{Gain} = 300$$

## Facts

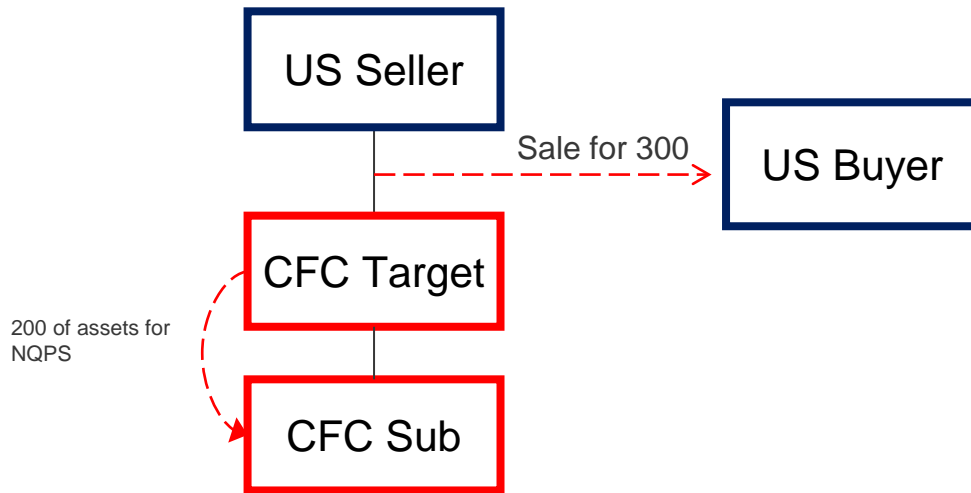
- US Seller sells CFC Target on 12/31

## Key Issues in 338 Analysis

- Seller's gain – 100 tax-free 245A dividend and stock gain @ 21%
- Buyer has no GILTI inclusion under section 951(a)(2)
- Buyer's basis step-up and section 901(m)

\* Non-Subpart F earnings for the entire year

# Alt. 4C Sale of Stock in First-Tier CFC – GILTI Planning Alternative with No 338(g) Election



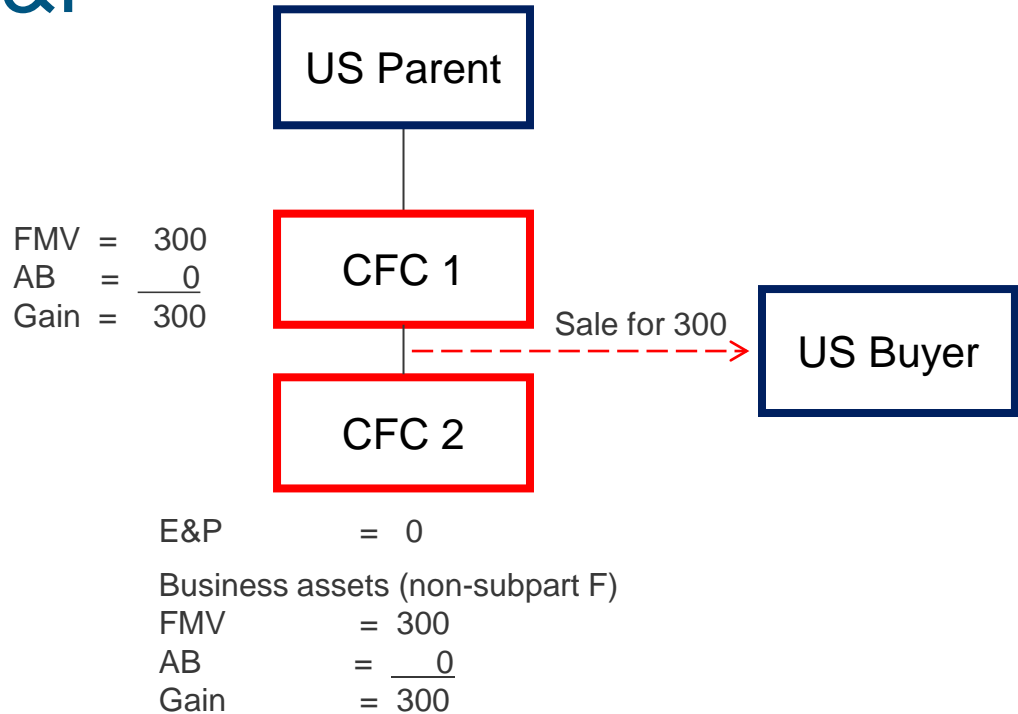
## Facts

- Same as Alt. 4B except CFC Target contributes 200 of assets (0 basis) to CFC Sub for section 351(g) nonqualified preferred stock / notes

## Key Issues in 338 Analysis

- CFC Target – recognizes 200 gain
- US Seller – 300 gain on stock, but entirely tax free under sections 1248(j) and 245A
- Similar planning if 200 of unwanted assets can be sold to an affiliate
- Consider section 1059(e)(1)(A)(i) “partial liquidation” rule

# Sale of Stock in Second-Tier CFC with no E&P



## Key Issues in 338 Analysis

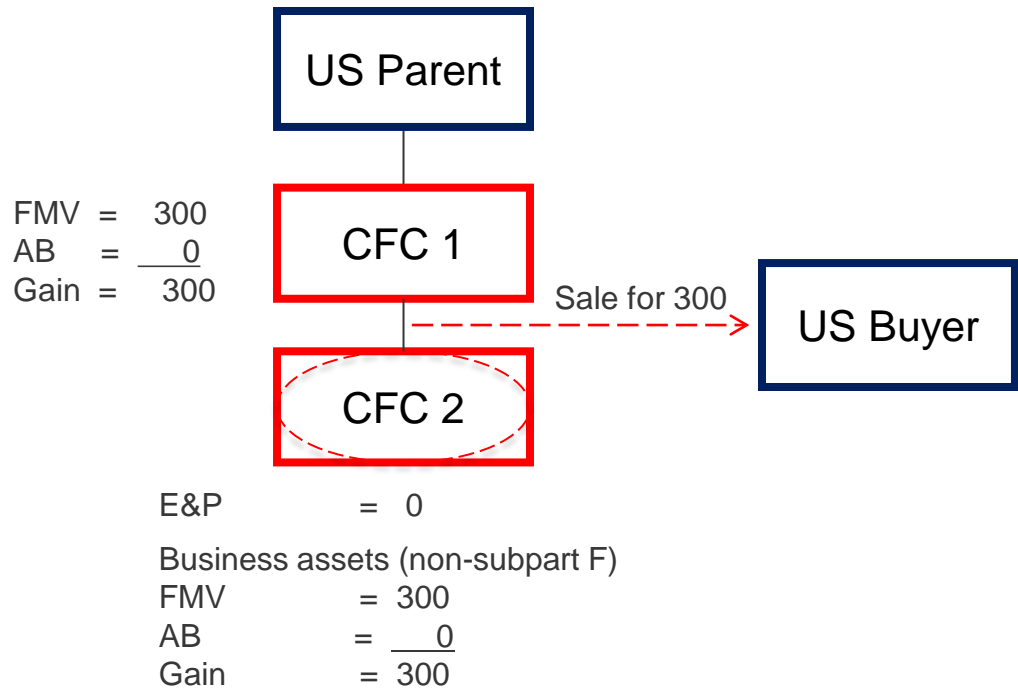
- Seller – Section 961(c) eliminates potential double taxation
- Buyer – Buyer’s basis step-up and application of section 901(m)

# Sale of Stock in Second-Tier CFC with no E&P – US Parent Consequences

	Section 338(g) Election	No section 338(g) election
Asset gain for CFC 1	300 – tested income for GILTI purposes	N/A
Tax year close for CFC 2?	Yes	No
CFC 1's basis in CFC 2 stock	Increases from 0 to 300 under section 961(c)	0
Stock gain for CFC 1	0*	300
Total US tax cost to US Parent	31.5 (i.e., 300 x 10.5%)	63 (i.e., 300 x 21%)

\* Section 961(c) applies only for subpart F purposes, potentially meaning that CFC 1 still generates 300 of E&P; this could be favorable if the E&P is considered non-PTI that could be distributed to US Parent tax free under section 245A

# Sale of Stock in Second-Tier CFC – Check and Sell



## Facts

- Step 1: CFC 2 checked to a DE
- Step 2: CFC 1 sells CFC 2

## Key Issues

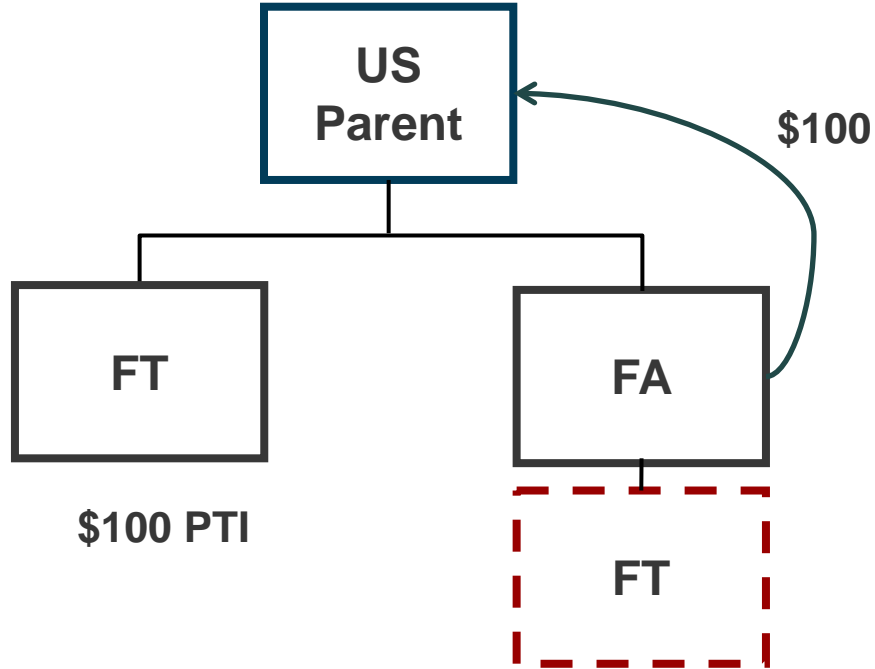
- CFC 1 – deemed to sell CFC 2 assets; recognizes 300 gain; PTI of 300
- US Parent – total tax is 31.5 (*i.e.*, 300 x 10.5)
- Same total tax as 338(g) election but avoids complexities of section 961(c) and 964(e)

# Cross-Border M&A – Post-Acquisition Integration

# Overview—post acquisition integration post-Tax Reform

- Dispositions for PTI tax-free and more common
- Dividend-equivalent transactions => consider section 1059
  - Structuring options to manage section 1059 include:
    - Distributions of PTI to US shareholder
    - Cash D instead of section 304 transaction
    - Others
- No foreign tax credits on dividends

# Sale of FT to FA—section 304 with PTI



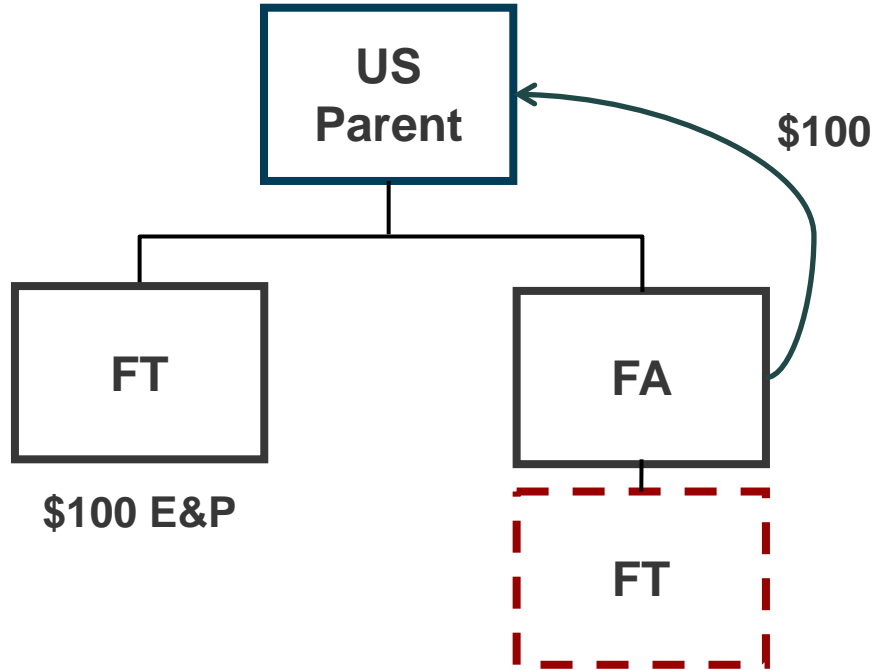
## Comments

- No tax on repatriation of PTI\*

\* CY PTI basis accrues end of year



# Sale of FT to FA—section 304 with untaxed E&P



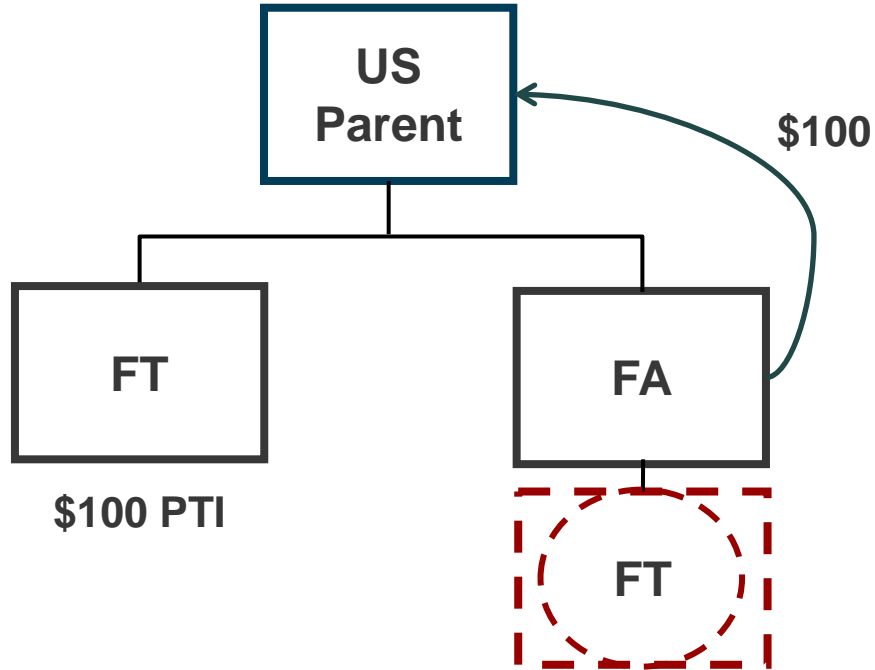
## Comments

- \$100 deemed dividend—tax free?
  - Revival of section 1059
  - Basis in FT  $\geq$  dividend of \$100?
- If seller is a CFC, does section 245A trump section 954(c)(6)?

# Revival of section 1059

- Section 1059(a)
  - Requires reduction in stock basis for *nontaxed* portion of extraordinary dividend
  - To extent nontaxed portion exceeds basis, recognize gain from the sale or exchange of stock
  - But not applicable if meet two year holding period
- Section 1059(e)(1)(A)
  - Even if meet two year holding period, redemption subject to above rules if: (1) part of a partial liquidation, (2) not pro rata as to all shareholders, or (3) section 304 transaction.

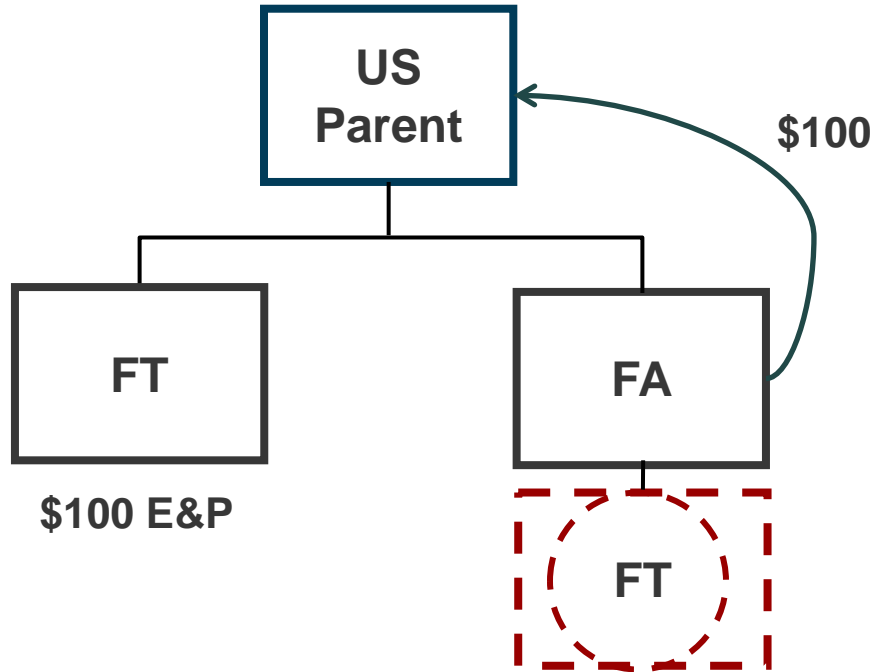
# Sale of FT to FA—cash D with PTI



## Comments

- No tax on repatriation of PTI
- Boot in cash D limited to gain
  - $Gain \geq PTI$ ?
- Not subject to section 1059 (b/c distribution of PTI to US Parent is not a dividend)

# Sale of FT to FA—cash D with untaxed E&P



## Comments

- No tax on repatriation of earnings
- Boot in cash D limited to gain
  - $Gain \geq E\&P$
- Not subject to section 1059 (b/c redemption *is* pro rata as to all shareholders)
  - Result if FA has E&P instead of FT?
  - Result if FT owned by US Sub of US Parent?

McDermott  
Will & Emery

# 2018 McDermott Tax Symposium

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## Panel V: Ethical Considerations and Guidance

APRIL 24 | CHICAGO

**Todd Welty**, Moderator | Washington, DC  
**Elizabeth Erickson** | Washington, DC  
**Kristen Hazel** | Chicago  
**John Lutz** | New York  
**Andrew Roberson** | Chicago

# Tax Compliance Post-Tax Reform

- We expect the IRS to scrutinize 2017 and 2018 returns.
- 2017 planning might include:
  - Accounting method and taxable year changes
  - Accelerated deductions or deferred income last year
  - Other planning to reduce foreign E&P
  - Foreign tax credit strategies
- 2018 strategies might include reasonable interpretations of the new tax laws by analogy to existing law but with the potential for adverse regulations, Notices or other administrative pronouncements post-transaction.

# Applicable Ethics Rules

- Internal Ethics Policies
- Circular 230
- State Ethical Rules
  - Rules of Professional Responsibility – Attorneys
  - Rules of Professional Conduct – CPAs
  - Principles of Appraisal Practice and Code of Ethics
- Sarbanes Oxley
- Foreign Corrupt Practices Act

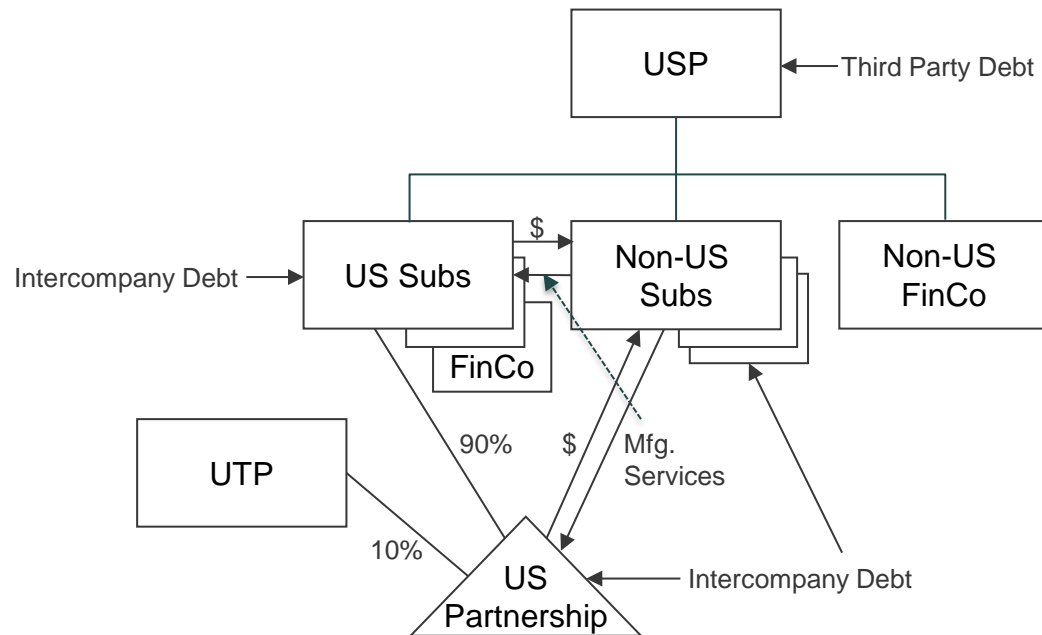
# Tax Compliance Post-Tax Reform

- **Compliance Strategies**
  - Tax Opinion
  - Ruling
  - Disclosure
  - Qualified Amended Return
- **Alternatives**
  - Rescission
  - Others?



# Base Case

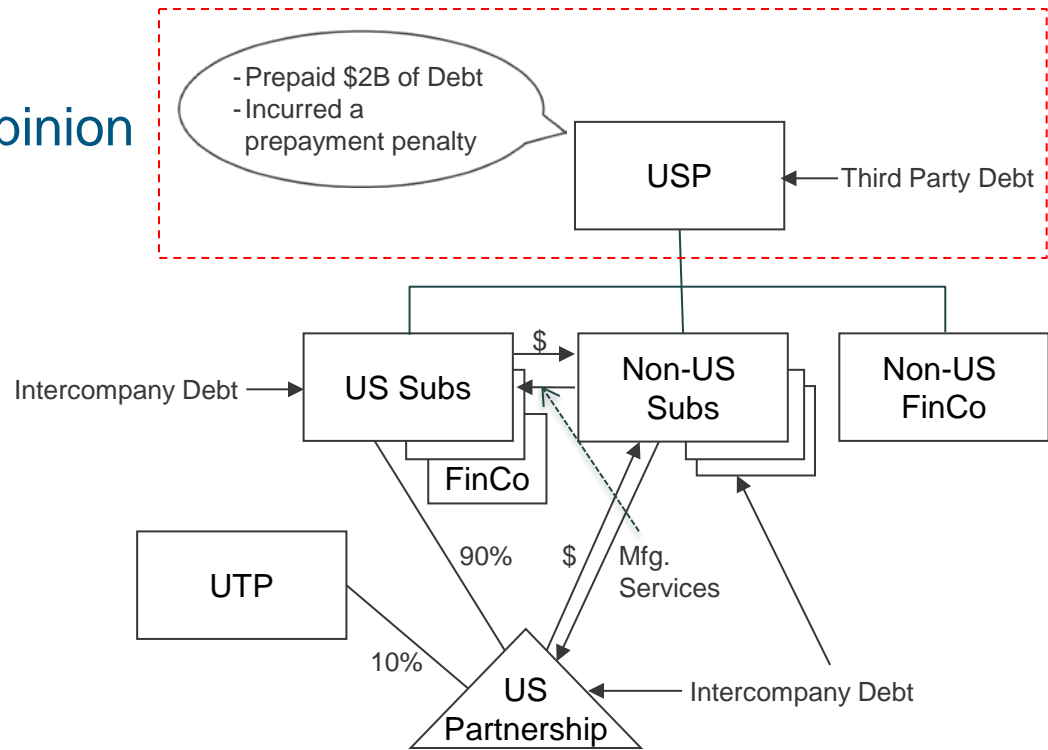
- USP has a BEAT issue
- In December 2017, USP pre-paid \$2B of debt and incurred a prepayment penalty
- In January 2018, US Partnership amended its partnership agreement to specially allocate expenses to UTP, a US tax indifferent party



# Case Study #1

## Compliance Alternatives - Tax Opinion

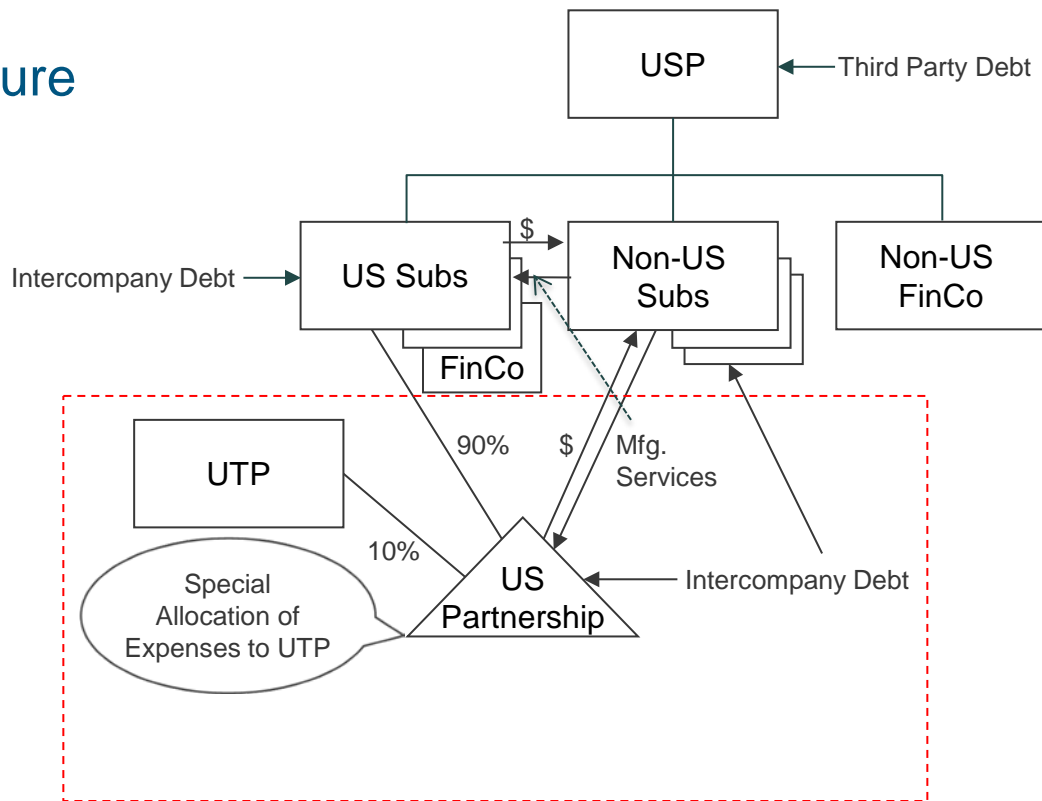
- Multiple Purposes
  - Fully develop legal theories
  - FIN 48 compliance
  - Penalty protection
- Sources
  - Law Firm?
  - Accounting Firm Engaged by Law Firm?
  - Both?



# Case Study #2

## Compliance Alternatives - Disclosure

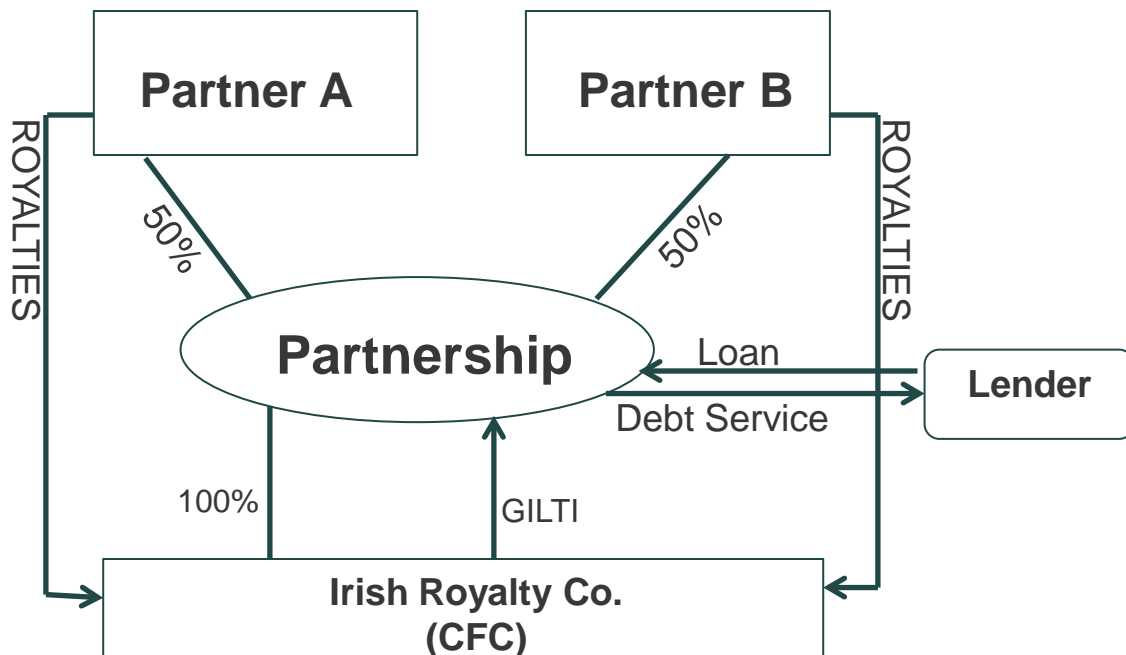
- When Should You Disclose?
  - Return Position Less Than Substantial Authority
  - Penalty Protection
  - Limitations Period Considerations
- How to Disclose
  - Form 8275 and form 8275-R
- Qualified Amended Return



# Case Study #3

## Resolving Statutory Conflict

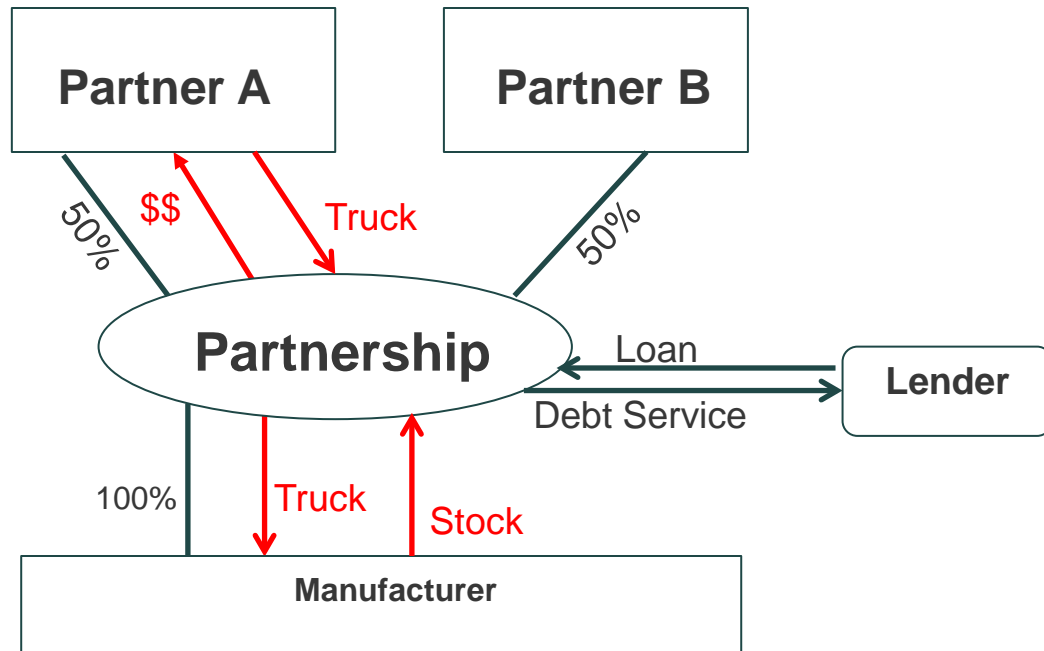
- Structure Implicates:
  - GILTI
  - BEAT
  - Section 163(j)
- Considerations:
  - Opinion
  - Ruling
  - Disclosure



# Case Study #4

## Rescission

- Unwind the transaction in its entirety
- IRS Guidance - two conditions:
  - Return each party to pre-transaction position as though original transaction had not occurred
  - Rescission must be completed in the same tax year as the original transaction
- Cross tax years?
- Tax transparent entities?



# Rescission

- **Rescission Clause:**

The Parties are entering into this Agreement on the understanding, and with the express intent and essential purpose: (1) of implementing [Transaction]; (ii) that the rights and obligations of the Parties specified in this Agreement shall be consistent with Applicable Law (in each case, as of the Effective Date); (iii) that the Parties have correctly estimated the material economic impact relating thereto; and (iv) that the Agreement shall not materially adversely affect pre-existing independent contractual arrangements of the Parties. In the event that prior to the end of the initial term there is a material change in fact or law that would in the Parties' estimation effectively preclude meeting the Parties' essential purpose, the Parties shall each be released from further obligations to each other and the Parties shall undertake all acts necessary or appropriate to restore the Parties prior to the end of such initial term to the relative positions that they would have occupied had this Agreement not been made.

# Guidance in Navigating Tax Reform Issues

- Tax reform requires analyzing current and future guidance
- Types of Guidance
  - Statutory
  - Legislative Materials (Committee Reports, Bluebook, etc.)
  - IRS Guidance
    - Published
    - Unpublished
  - Case law, particularly on extra-statutory doctrines (e.g., substance/form, step transaction)

# Weight of Authority of IRS Guidance



Source: GAO analysis of IRS documents. | GAO-16-720

IRS View – from recent GAO report



# Deference to IRS Guidance

- Important to know weight that will be afforded to tax reform guidance
- Regulations and other published guidance
  - *Chevron* deference
  - *Skidmore* deference
  - *Auer/Seminole Rock* deference
- Private Guidance
  - IRS administrative practice
  - May provide evidence that particular construction compelled by statute
  - May be “persuasive authority”

# Temporary Regulations

- Regulatory tax reform guidance will start in temporary form
- Generally afforded same weight as final regulations
- Must be finalized within three years
- Tool used by IRS to quickly shut-down transactions prior to receiving comments from taxpayers (similar use of Notices)

# Retroactive Regulations

- Opportunities for IRS to issue final regulations that relate back to tax reform provisions
- General rule – regulations should be prospective
- Exceptions
  - Relate to prior Notices
  - Issued within 18 months of enactment of statute
  - Necessary to prevent abuse
  - Correction of procedural defects

# Challenges to Regulations

- Tax reform will likely give rise to legal challenges to future IRS regulations
- Timing Issues
  - Pre-enforcement challenges
  - Post-enforcement challenges
- Potential arguments
  - No gap to fill (*i.e.*, statute is unambiguous)
  - Violates Administrative Procedures Act

# Reasonable Positions in Absence of Guidance

- Lack of guidance presents questions as to how taxpayers should report and take positions on tax reform issues
- Taxpayer's reasonable application of the law may be appropriate in absence of regulations or an ambiguity in the regulations
  - *Gottesman & Co. v. Comm'r*, 77 T.C. 1149 (1981)
- Beware of retroactive regulations
- Beware of lurking *Auer/Seminole Rock* issues if ambiguity in regulations

# Statutes of Limitation

- General rule – 3 years
- 6-year statutes
  - Substantial omission from gross income
  - Assessment of net tax liability due to pre-2018 accumulated deferred foreign income
  - Omissions of subpart F income and income from new tax on GILTI
  - Transition tax
- Improper filing of certain information returns (3 years after required information furnished; may keep entire return open)

# Penalties

- IRS increasingly asserting penalties during audit
- Accuracy-related penalties
- Basis/Valuation misstatements
- Economic substance
- Failure to file / properly report on certain information returns

# Penalty Defenses

- Reasonable Cause
  - Reliance on advisors
  - Issue of first impression: heightened importance in post-tax reform environment?
- Substantial Authority / Reasonable Basis
- Adequate Disclosure
  - Schedule UTP
  - Forms 8275 or 8275-R
  - Qualified Amended Returns



# Privilege Considerations

- Tax reform uncertainty may lead to the creation of more privileged materials to support positions
- Types of privileges
- Disclosure/waiver issues
  - On tax returns
  - To external auditors
  - To corporate audit committees
  - To IRS during examination
  - Reliance on reasonable cause defense to penalties