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Tax Cuts and Jobs Act: Treasury Updates and Practical Applications for Private Equity

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Polling Question 1

- Are you:

A. A tax professional

B. An international tax professional

C. A finance professional e.g. CPA

A. Other

DISCUSSION AGENDA

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- OVERVIEW OF THE TAX CUTS AND JOBS ACT
- INDIVIDUAL HIGHLIGHTS
- ESTATE AND GIFT TAX CHANGES
- KEY BUSINESS PROVISIONS
- STOCK VERSUS ASSET ACQUISITIONS: BUY-SIDE VERSUS SELL-SIDE ISSUES
- CHOICE OF ENTITY: BUY-SIDE CONSIDERATIONS
- DEBT-FINANCING: BUY-SIDE CONSIDERATIONS
- SELECT INTERNATIONAL PROVISIONS

OVERVIEW OF THE TAX CUTS AND JOBS ACT

INTRODUCTION – KEY CHANGES

- The Tax Cuts and Jobs Act ("TCJA") was a significant overhaul of U.S. tax law.
  - The changes have impacted multiple facets of M&A transactions, pre- and post-acquisition intra-group restructurings, joint ventures, and restructurings of financially distressed companies.

- The corporate tax rate was reduced to 21%.
  - While a welcome change, taxpayers should note that interest expense was curtailed and NOL utilization impacted (e.g., no more carrybacks).
  - Let us not forget the one-time repatriation that occurred under Sec. 965.

- Corporate AMT was eliminated for tax years beginning after December 13, 2017.
  - Any taxpayer with AMT credit carry-forwards can claim a refund of 50 percent of the remaining AMT credits (in excess of regular tax for the year) in tax years beginning in 2018, 2019 and 2020. Thereafter, a taxpayer can claim a refund for all such credits in the tax year beginning in 2021.
  - Good News: Corporations will be able to recover their AMT credit carryovers via refunds. This is essentially "found money" as it may not have been utilized under prior law.

INTRODUCTION – KEY CHANGES (CONTINUED)

- Expensing and capitalization of M&A transaction expenses were not impacted by new law.
- Taxpayers can still utilize Sec. 368 tax-free reorganizations and Sec. 355 tax-free spinoffs, as those provisions were untouched.
- Carried interest regime was slightly impacted.
- Elections under Sec. 338 are still available.

INDIVIDUAL HIGHLIGHTS

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- Highest income tax rate was reduced to 37% for both single and joint filers.
- Standard deduction increased to $12,000 for individuals and $24,000 for joint filers.
- Personal exemptions suspended from 2018 through 2025.
- State and local property and income tax deductions substantially curtailed.

ESTATE AND GIFT TAX CHANGES

ESTATE AND GIFT TAX CHANGES

- The tax exemption for federal estate, gift and generation-skipping transfer (GST) tax exemptions rises to $11,200,000 per person beginning January 1, 2018 and sunsets 2025 (subject to inflation adjustment).

- This amounts had been $5,600,000 under prior law.

- In our experience these changes have spurred business succession planning in 2018.

- Estate planning with carried interest still has a pitfall due to Sec. 2701.
  - Sec. 2701 was enacted years ago due to concern that an individual can transfer the appreciation in an asset to the next generation at a low gift tax value, while maintaining control of the asset. Sec. 2701 imposes a gift tax liability equal to the value of all interests in a fund, those transferred, as well as those retained, if an individual transfers a carried interest while still retaining an interest in the same entity, even if it is of a different class.
  - “Vertical slicing”: Sec. 2701 should not apply to the transfer of a percentage interest in the GP as long as the transfer includes a proportionate share of all capital interests and the carried interest held or deemed held by transferor through the GP.

KEY BUSINESS PROVISIONS

BONUS DEPRECIATION

- For property placed in service after Sept. 27, 2017, and before Jan. 1, 2023, 100% expensing.
- For property placed in service after Dec. 31, 2022, and before Jan. 1, 2024, 80% expensing.
- For property placed in service after Dec. 31, 2023, and before Jan. 1, 2025, 60% expensing.
- For property placed in service after Dec. 31, 2024, and before Jan. 1, 2026, 40% expensing.
- For property placed in service after Dec. 31, 2025, and before Jan. 1, 2027, 20% expensing.

- TCJA eliminated the requirement that the original use of the qualified property commence with the taxpayer. Significant driver of transactions in 2018.

- Opportunity to create "fresh" NOLs not subject to limitations of legacy NOLs.

- Purchase price allocation is now *even more* of a critical facet of an asset-based transaction. Complete expensing does not apply to 15-year intangibles, land and some real estate interests. Therefore, purchasers will attempt to allocate more purchase price to assets eligible for bonus depreciation.

INTEREST EXPENSE LIMITATION

- Sec. 163(j) was completely revamped. Interest expenses are significantly limited under new law. This impacted tax models and tax structures for investments that were in place.

- Calculation discussed in depth later, but this limitation has impacted portfolio companies. Any unused expense due to the limitation is carried forward similarly to an NOL and there is no grandfathering of existing debt.

    - Leveraged deals are less appealing due to the limitation and the clear impact on operational cash flow.

    - We have noted increased use of preferred equity in transactions and decreased in leveraged deals due to the Sec. 163(j) limitation.

    - Unused interest expense is a tax attribute similar to an NOL, but is likewise subject to limitations under Sec. 382.

CARRIED INTEREST

- TCJA modified the holding period required for carried interests to benefit from capital gains rates. Changed from greater than one year to greater than three years.

- The greater than three-year holding period applies to gains from the sale or redemption of an "applicable partnership interest" and, also, gains attributable to the partnership's direct or indirect sale of assets to the extent allocated to the owner of the applicable partnership interest.

- Applicable partnership interest: interest in a partnership transferred to a taxpayer in exchange for services performed in connection with the raising or returning of capital, and either investing in (or disposing of) or developing specified assets.

  - Specified assets: securities; commodities; real estate assets; cash and derivatives.

  - Applicable partnership interest does not include: partnership interest held by a C corporation or a partnership interest that is a capital interest.

- The more than three-year holding period applies to capital gains a taxpayer may recognize on or after January 1, 2018. There is no grandfathering rule.

NOL DEDUCTION

- No carrybacks; unlimited carryforwards.
- Limited to 80% of income.
- We have advised clients to be aware of any open tax years of targets acquired.
- Potential negative impact on sellers of portfolio companies: M&A transaction costs may create NOLs for sellers.
  - For example, assume the transaction costs in 2019 create an NOL and the company is sold in 2020. Prior to TCJA, the seller could have carried back the NOL to a period prior to 2019 and potentially obtain a refund on tax paid.

SECTION 199A DEDUCTION

- 20% deduction for qualified business income ("QBI") of pass-through entity (a partnership, S-corporation, a sole proprietorship). The Sec. 199A deduction is discussed in greater detail later in our presentation.

- QBI: net amount of qualified items of income, gain, loss and deduction with respect to any qualified trade or business of the taxpayer.

- For a taxpayer in the 37% tax bracket, the net effective tax rate is reduced to 29.6%.

- Important to remember that QBI must be US-sourced income. Significant clarity was provided through the final regulations released in 2019.

- The Sec. 199A deduction is useful for pass-throughs generating QBI as it may reduce the amount of tax distributions they are required to distribute to fund tax payments of investors. In tandem with other benefits of pass-through entities (e.g., step-up on exit and basis increases to investors), the Sec. 199A deduction makes pass-through further appealing.

STOCK VERSUS ASSET ACQUISITIONS: BUY-SIDE VERSUS SELL-SIDE ISSUES

STOCK VERSUS ASSET ACQUISITIONS UNDER TCJA – BUY-SIDE CONSIDERATIONS

- STRATEGY: has it been better to structure a transaction as a stock or assets transaction since TCJA?

  - Corporate Buyer: value of step-up in basis now reduced due to lower corporate tax rate.

  - Pass-Through and Individual Buyer(s): value of step-up virtually unchanged as highest federal individual tax rate reduced slightly from 39.6% to 37% (apart from state income tax and NIIT where applicable).

  - Bonus depreciation now applicable to previously used property (specifically depreciable tangible property). This provides opportunity to create "fresh" NOLs for Buyer. This changed not only the concept of bonus depreciation, but the increased the appeal of asset deals.

STOCK VERSUS ASSET ACQUISITIONS UNDER TCJA – BUY-SIDE CONSIDERATIONS

- <u>NOLs</u>:
  - Value of NOLs has decreased due to the new 80% limitation.
  - Buyer can immediately expense previously used tangible property.
  - NOLs continue to be subject to potential Sec. 382 limitations (where applicable).
  - Buyer must consider that NOLs cannot be carried back. Buyer should be mindful of any unresolved tax controversies for a prior year.
    - <u>Illustration</u>: Target is acquired in February 2018 and generates an NOL in 2020, the 2020 NOL cannot be carried back to 2018.

STOCK VERSUS ASSET ACQUISITIONS UNDER TCJA – SELL-SIDE CONSIDERATIONS

- Corporate Seller: asset sales subject to overall federal reduced income tax rate of 21%.
  - U.S. corporate seller of a foreign subsidiary (10% or greater ownership) may opt for a sale of the foreign assets.
    - Rationale: the new participation exemption system (discussed later) does not apply to sale of foreign stock. Corporate seller benefits by selling foreign assets and distributing dividends thereafter due to the participation exemption (i.e., no tax).

CHOICE OF ENTITY: BUY-SIDE CONSIDERATIONS

CHOICE OF ENTITY: NEW SECTION 199A DEDUCTION FOR PASS-THROUGHS

- CONSIDERATION: if a new entity is created to facilitate a transaction, should a buyer form a C corporation or a pass-through entity (e.g., REIT, LLC) for that purpose?

- Prior to TCJA, the corporate tax rate of 35% was a negative factor against corporations in this context.

- BUT, pass-throughs may be eligible for new Sec. 199A deduction (20%).

- The preference for flow-through entities will not be as obvious going forward despite double taxation inherent in C corporation structures.
  - Highly recommended that detailed tax models be utilized. More important now.
  - Consider qualified small business stock sale benefits under Sec. 1202 (exit strategy).

- REITs are potentially attractive because REIT dividends qualify for the new Sec. 199A deduction (20%) without limitation.

DEDUCTION FOR PASS-THROUGH ENTITIES

- Effective for taxable years beginning after December 31, 2017 (subject to a sunset at the end of 2025).
- Generally allows an individual taxpayer (and a trust or estate) a **deduction for 20%** of the individual's **domestic qualified business income** from a **partnership, LLC taxed as a partnership, S corporation, or sole proprietorship, subject to limitation.**
- TCJA contains a wage-based limitation.
  - Limitation is the greater of:
    - (i) 50% of the wages paid with respect to the qualified trade or business; or
    - (ii) the sum of 25% of the W-2 wages with respect to the qualified trade or business plus 2.5% of the unadjusted basis (determined immediately after an acquisition) of all qualified property.
  - The 50% of wages limitation does not apply in the case of a taxpayer with income of **$315,000 or less for married individuals filing jointly** ($157,500 for individuals), with phase-out over the next $100,000 of taxable income for married individuals filing jointly ($50,000 for other individuals).
- Individual's **qualified business income** for the tax year is the net amount of domestic qualified items of income, gain, deduction, and loss (determined by taking into account only items included in the determination of taxable income) with respect to the taxpayer's "qualified business." If the amount of qualified business income for a tax year is less than zero (i.e., a loss), the loss is treated as a loss from qualified businesses in the next tax year subject to certain adjustments.

CHOICE OF ENTITY: THE NEW SECTION 199A DEDUCTION

- TCJA has implemented a new 20% deduction for qualifying pass-through income, but it is limited to tax years beginning after December 31, 2017 and before January 1, 2026.

- The deduction is not available to specified "service trades or businesses" unless the income is below specified dollar thresholds.

    - Which businesses? In general, trade or business involving the performance of services such as law and accounting, health care, financial services or any trade/business where principal asset of such trade or business is the reputation or skill attributable to employees/owners.
        - "Reputation or skill" was narrowly defined (pro-taxpayer) under the final regulations. This vague facet of the law created concern until clarification provided.

DEBT-FINANCING: BUY-SIDE CONSIDERATIONS

DEBT-FINANCING: OLD SECTION 163(j) VERSUS NEW SECTION 163(j)

- <u>The Old Sec. 163(j)</u>: imposed limitations on the ability to deduct interest expense. Limitations based on debt/equity ratios, amount of taxable income, and relationship between parties. Effectively repealed.

- <u>The New Sec. 163(j)</u>: applies to any debt outstanding on January 1, 2018 – there is no grandfathering of debt incurred prior to this date.
  - Applies to all taxpayers and all debt.
    - Domestic and foreign.
    - Individuals, C corporations, S corporations, REITs and partnerships.
    - Applies to both related party debt and debt with third parties.
  - <u>The Limitation</u>: for any taxable year, the interest expense deduction (paid or accrued) for a taxpayer is limited to the sum of three components:
    - All "business interest income" plus;
    - 30% of **"adjusted taxable income"** (discussed on next slide); plus
    - All "floor plan financing interest."
  - <u>Excluded Trades or Businesses</u>:
    - Real property trade or business has the option to elect out of Sec. 163(j). The election is irrevocable.
      - Trade-off: election requires usage of longer depreciation periods (ADS).
    - Certain regulated public utilities
    - Small business (i.e., taxpayers meeting the three-year **$25 million** gross receipts test of Sec. 448(c)).

DEBT-FINANCING: ADJUSTED TAXABLE INCOME UNDER SECTION 163(j).

- <u>Adjusted Taxable Income</u>

  - The method of calculation will be different for taxable years beginning after December 31, 2021.

  - **For tax years beginning before January 1, 2022**: adjusted taxable income is calculated under general tax principles (instead of GAAP), but the following items must be added back:
    - Items of income, gain, deduction, or loss not properly allocable to a trade or business;
    - Business interest income and expense;
    - NOL deductions;
    - The 20% deduction under Sec. 199A (if applicable);
    - Depreciation, amortization or depletion deductions.

  - **For tax years beginning after December 31, 2021**:
    - Same addbacks as above, **except taxpayers cannot add back depreciation, amortization or depletion deductions**.
    - Adjusted taxable income will likely be a lower number for this period and the limitation will be consequently more severe.

DEBT-FINANCING: SECTION 163(j) AND BUY-SIDE CONSIDERATIONS

- Unlimited Carryforward: any interest deduction disallowed due to the new limitations under Sec. 163(j) may be carried forward to any successive tax year.

- Applied to corporate acquisition vehicles: simple application as the disallowance will be a corporate attribute that carries forward.

- Applied to partnership acquisition vehicles: the limitation is calculated at the partnership level.
  - Any amounts disallowed by operation of Sec. 163(j) (i.e., excess business interest expense) is allocated to the partners in the same manner as non-separately stated income and loss.
  - Excess business interest expense will immediately reduce a partner's outside basis, but outside basis will be increased by any unused excess business interest expense upon sale of the partnership interest.
  - Excess business interest expense can only be used to reduce "excess taxable income" allocated to a partner from that partnership in a future year.
  - Any excess taxable income (i.e., excess of 30% of partnership's "adjusted taxable income" over the amount by which partnership's business interest expense exceeds its "business interest income") is allocated to the partners in the same manner as non-separately stated income and loss.

DEBT-FINANCING: SECTION 163(j) AND BUY-SIDE AND SELL-SIDE CONSIDERATIONS

- Buy-Side Considerations:
  - Regardless of choice of entity (flow-through versus corporation), debt financing as part of acquisition is now less attractive under the new Sec. 163(j).
    - The lower corporate tax rate does mitigate the brunt of any potential interest expense deduction disallowance.
  - Once again, tax modelling critical to comparing choice of entity if debt financing will be utilized for mergers and acquisitions.
    - 5-10 year investments must incorporate the limitation calculation change that will occur for taxable years beginning after December 31, 2021.
      - Depreciation, amortization, etc. will no longer be available as an addback to increase adjusted taxable income for Sec. 163(j) purposes (i.e., lower adjusted taxable income → lower 30% limit → potentially more interest expense disallowed).

DEBT-FINANCING: SECTION 163(j) AND BUY-SIDE AND SELL-SIDE CONSIDERATIONS

- <u>Buy-Side Considerations</u>:
  - Alternatives to explore have include leasing scenarios, equity financings, interest equivalents, or usage of the real estate trade or business exclusion (or other available exception).
  - Significant impact on cross-border mergers and acquisitions.
    - Multinational structures have considered alternative jurisdictions to originate debt in their structures. The U.S. will not be attractive to originate debt, particularly for tax years beginning after December 31, 2021 when the limitation becomes more stringent.
- <u>Sell-Side Considerations</u>:
  - Sellers may experience less opportunities to finance buyers (e.g., accept a note).
  - Any financing should continue to be arm's-length.

SELECT INTERNATIONAL PROVISIONS

SEVEN 'OBSERVATIONS' ON INTERNATIONAL PROVISIONS

1. Everything you learned before 2018 is no longer valid.
2. Even if you're completely up to date now, you'll be out of date next week. Smaller CPAs don't (can't) understand the new law
3. International compliance costs will soar
4. Investors in investment partnerships, family offices may have unexpected tax liabilities. Do you have to help fund them?
5. New law contains great opportunities (for US C corporations)
6. There is a whole mess of elections you should be considering
7. All your tax planning structures may be horribly compromised

EVERYTHING YOU LEARNED PRIOR TO 2018 IS OUT OF DATE…

- GILTI provisions layer draconian complexity onto Subpart F
  - Your investors may have unexpected tax liabilities
- FDII provides incredible 'export' incentive for C corporations
  - Should you convert?
- Interest limitation rules completely changed (Sec. 163(j))
  - What about existing debt structures
- Definition of a CFC widened
  - 5471 filings, GILTI
- Anti-avoidance rules for hybrid payments ("double dips")
  - Review existing structures
- Basic 'check-the-box' planning may need review
  - 'Unchecking' may be expensive
- …

YOU'LL BE OUT OF DATE NEXT WEEK

- Malta has interesting tax structure:
  - Tax rate is 35%
  - Get 6/7 refund on distribution
- Taxpayers have used Malta to avoid subpart F using 'high-tax' exception
  - 35% > 90% of highest US corporate tax rate
- Structure is 'aggressive' but supportable
- Closed down by change on page 66 of 312 pages of proposed regulations for foreign tax credits issued November 28, 2018

INTERNATIONAL COMPLIANCE COSTS WILL SOAR…

- *Notice 2019-01 – PTI Distributions by a CFC*
- Modifies the ordering rules of § 959 (can affect the foreign tax credit and forex consequences of a distribution)
- Increases Previously Taxed E&P (‘PTEP’) groups to 16
  - Full employment for your CPA!
  - Form 5471 explosion
- We’re not done yet! Does not address timing of adjustments to tax basis in CFC stock
  - The 2006 proposed regulations on § 959 and § 961 will be withdrawn, and new regulations will be released (anticipated early 2019)

SCHEDULE P (Form 5471) (December 2018)

Department of the Treasury Internal Revenue Service

Previously Taxed Earnings and Profits of U.S. Shareholder of Certain Foreign Corporations

► Attach to Form 5471.
► Go to *www.irs.gov/Form5471* for instructions and the latest information.

OMB No. 1545-0704

DRAFT AS OF September 28, 2018 DO NOT FILE

Name of person filing Form 5471		Identifying number
Name of foreign corporation	EIN (if any)	**Reference ID number** (see instructions)

a Separate Category (Enter code—see instructions.) . . . ►

b If code 901j is entered on line a, enter the country code for the sanctioned country (see instructions) . . . ►

Previously Taxed E&P (see instructions)

	Important: *Enter amounts in functional currency.*	**(a)** Earnings Invested in U.S. Property (section 959(c)(1)(A))	**(b)** Section 965(a) Inclusion (section 959(c)(1)(A))	**(c)** Section 965(b)(4)(A) (section 959(c)(1)(A))	**(d)** Section 951A Inclusion (section 959(c)(1)(A))	**(e)** Earnings Invested in Excess Passive Assets (section 959(c)(1)(B))	**(f)** Subpart F Income (section 959(c)(2))	**(g)** Section 965(a) Inclusion (section 959(c)(2))	**(h)** Section 965(b)(4)(A) (section 959(c)(2))	**(i)** Section 951A Inclusion (section 959(c)(2))	**(j)** Total
1a	Balance at beginning of year (see instructions)										
1b	Beginning balance adjustments (attach statement)										
1c	Adjusted beginning balance (combine lines 1a and 1b)										
2	Reduction for taxes unsuspended under anti-splitter rules										
3	E&P attributable to distributions of previously taxed E&P from lower-tier foreign corporation										
4	E&P carried over in nonrecognition transaction										
5	Other adjustments (attach statement)										
6	Total current and accumulated E&P (combine lines 1c through 5)										
7	Amounts reclassified to section 959(c)(2) E&P from section 959(c)(3) E&P										
8	Actual distributions of previously taxed income										
9	Amounts reclassified to section 959(c)(1) E&P from section 959(c)(2) E&P										

For Paperwork Reduction Act Notice, see instructions. Cat. No. 49203F **Schedule P (Form 5471) (12-2018)**

Schedule P (Form 5471) (12-2018) Page **2**

DRAFT AS OF September 28, 2018 DO NOT FILE

Previously Taxed E&P (see instructions) *(continued)*

	Important: *Enter amounts in functional currency.*	**(a)** Earnings Invested in U.S. Property (section 959(c)(1)(A))	**(b)** Section 965(a) Inclusion (section 959(c)(1)(A))	**(c)** Section 965(b)(4)(A) (section 959(c)(1)(A))	**(d)** Section 951A Inclusion (section 959(c)(1)(A))	**(e)** Earnings Invested in Excess Passive Assets (section 959(c)(1)(B))	**(f)** Subpart F Income (section 959(c)(2))	**(g)** Section 965(a) Inclusion (section 959(c)(2))	**(h)** Section 965(b)(4)(A) (section 959(c)(2))	**(i)** Section 951A Inclusion (section 959(c)(2))	**(j)** Total
10	Amounts included as earnings invested in U.S. property and reclassified to section 959(c)(1) E&P (see instructions)										
11	Other adjustments (attach statement)										
12	Balance at beginning of next year (combine lines 6 through 11)										

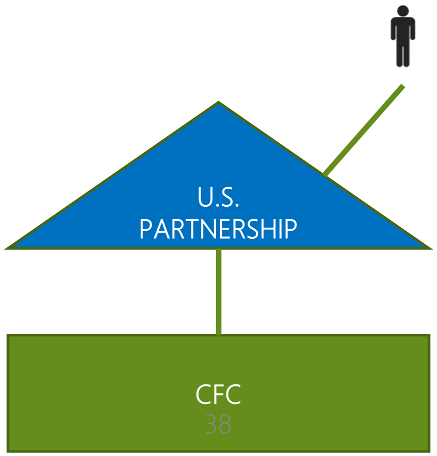
Schedule P (Form 5471) (12-2018)

CHANGES TO CFC RULES

- CFC: foreign corporation that is directly or indirectly controlled by 10% U.S. shareholders who collectively own more than 50% of the foreign corporation's stock, either by vote or value.
  - Prior law was solely focused on ownership of voting stock; now any stock counts (vote or value).
  - Elimination of 30-day rule: Prior law contained 30-day minimum holding period of CFC stock. This rule is now eliminated.

- Two types of attribution: upward attribution and downward attribution.

- Upward Attribution: governed by Sec. 318(a)(2). Taxpayer owns CFC stock owned through partnerships, estates, trusts and corporations. Example:



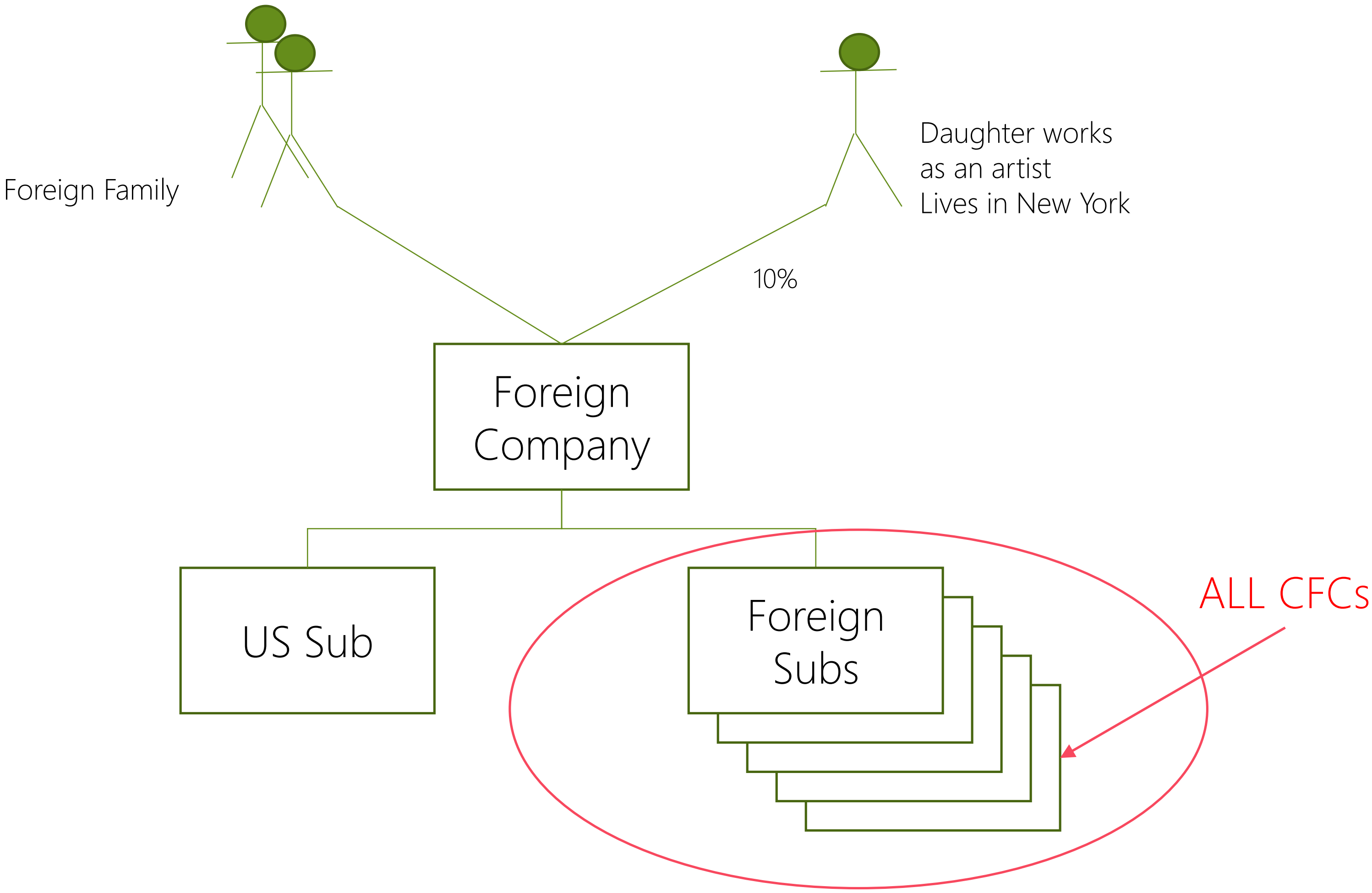
Upward attribution rules operate to ensure this partner in the U.S. partnership is deemed to own CFC stock.

CHANGES TO CFC RULES – DOWNWARD ATTRIBUTION

- Downward Attribution: governed by Sec. 318(a)(3). Attributes ownership downward from partners, beneficiaries or stockholders to their respective partnerships, estates, trusts, and corporations.
  - Prior to TCJA, downward attributions from foreign persons to U.S. persons did not apply.
  - Under new law, there is now(?) downward attribution from foreign persons.
  - Leads to “nightmare” scenarios

DOWNWARD ATTRIBUTION

Good News:
Technical correction



DOWNWARD ATTRIBUTION: TECHNICAL CORRECTIONS

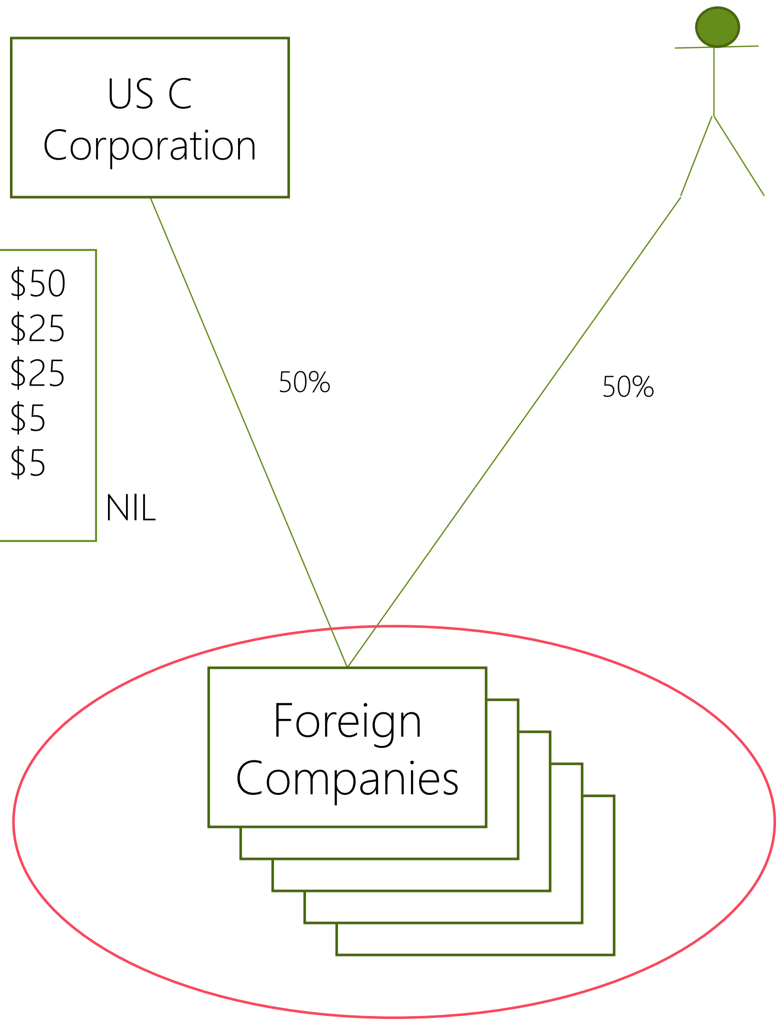
- Form 5471 Instructions
  - If no actual 10% US shareholder, then don't bother filing
- Technical corrections
  - Restores the language of § 958(b)(4) as a general rule but provides an exception for limited downward attribution that is consistent with the narrow intent of the Act in new proposed § 951B
  - Provides that a USP that would directly, indirectly, or constructively own more than 50 percent of a foreign corporation if downward attribution is applied is taxable on the subpart F income of the foreign corporation as if such corporation were a CFC, and the foreign corporation is treated as a CFC of which the USP is a US shareholder for purposes of applying §§951A and 965 to the USP
  - Also includes a provision granting Treasury regulatory authority to determine when any such USP or foreign corporation should be considered a US shareholder or CFC, respectively
  - Includes a provision granting Treasury regulatory authority to prescribe anti-avoidance measures consistent with the intent of the provision

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI)

Intended to be "punitive" measure – particularly for "Google" companies (companies that have aggressively driven down their global tax rate - e.g. "Irish-Dutch sandwich").

- New Sec. 951A: GILTI income included in gross income of United States shareholders.
- Together with lower US corporate tax rate and FDII (discussed later) intended to discourage income-shifting to foreign jurisdictions, by subjecting such income to current U.S. tax.
- Domestic C corporations can obtain a deduction equal to 50% of the GILTI inclusion, with 80% foreign tax credit (FTC)
- For C corporations = 13.125% effective global tax rate on CFCs.
- Pass-throughs (investment partnership, individuals, family office…) taxed at 37% with no FTC!!!
  - §962 election may mitigate some of the impact; made at the individual level

GILTI: C corporations versus individuals



US Individual

GILTI	$50	
Deduction	$25	
Taxable	$25	
US tax @21%	$5	
FTC @80%x$7.50	$5	
US tax		NIL

GILTI	$50	
Deduction	$0	
Taxable	$50	
US tax @37%	$18	
FTC	$0	
US tax		$18

- Income before tax $100
- Combined tax rate of 15%
- Total tax $15

GILTI (CONTINUED)

- GILTI is the excess of the CFC's aggregated net "tested income" over its "net deemed tangible income return"
- Net deemed tangible income is 10% of Qualified Business Asset Investment (QBAI), over net interest expense.
- Computations are done on an aggregated basis, allowing loss entities to offset others with tested income within the group, but not below zero.
- Tested income is gross income without regard to certain exceptions:
  - Effectively connected income, Subpart F income, Income excluded under the high-tax exception, Dividends received from certain related parties
- Net tested income is the excess of tested income over deductions; net tested losses occur when deductions exceed gross income.

QBAI CALCULATION

- Ironically QBAI encourages MNEs to shift assets offshore
- Prop. Reg. 1.951A-3 provides rules for calculating QBAI
  - The tax basis in specified tangible property for purposes of calculating QBAI is determined using ADS under § 168(g)
  - ADS must be applied even if the tangible property was place in service prior to TCJA
  - "Dual use property" (*i.e.*, tangible property used in the production of both gross tested income and other gross income) is treated as specified tangible property based on the "dual use ratio"
- A tested loss CFC will not have any QBAI

ANTI-ABUSE RULES

- Prop. Reg. 1.951A-3(h) includes two anti-abuse rules in calculating QBAI
  - Property is disregarded if CFC (i) acquires property with a principal purpose of reducing the GILTI and (ii) holds such property temporarily. Property held for less than 12 months is treated as acquired with a principal purpose and temporarily held
  - "Disqualified basis" is disregarded. "Disqualified basis" Is increase in basis from "disqualified transfer" - transfer of property between related CFCs
- Prop. Reg. 1.951A-2(c)(5) includes an anti-abuse rule for purposes of determining tested income (tested loss)
  - Any deduction or loss attributable to "disqualified basis" in any depreciable amortizable property is disregarded in determining tested income (tested loss)

FOREIGN-DERIVED INTANGIBLE INCOME (FDII)

- Domestic C corporations afforded a deduction of 37.5% of the sum of its FDII. Attractive incentive!
- Pass-throughs might want to consider forming a C corporation to deal with foreign sales

Restrictions and Requirements

- Effective date: taxable years beginning after December 31, 2017. FDII is available only to C corporations (not RICs or REITs).
- FDII = "deemed intangible income" multiplied by the percentage of its "deduction eligible income" that is foreign-derived.
- Does NOT apply to branch income
- Subject to a taxable income limitation, determined without regard to the deduction (i.e. loss companies).
- Deduction for FDII is reduced to 21.875% for taxable years beginning after December 31, 2025.

FOREIGN BRANCH INCOME BASKET

- The determination of "foreign branch income" affects both the foreign tax credit limitation and FDII
  - § 904(d)(1)(B) creates a separate foreign tax credit basket for foreign branch income
  - § 250(b)(3)(A)(i)(VI) provides that foreign branch income is excluded from "deduction eligible income" for purposes of FDII
- § 904(d)(2)(j) defines "foreign branch income"
  - the business profits of a US person attributable to a QBU in a foreign country
  - Gross income is attributable to a foreign branch if recorded on the foreign branch's separate books and records
- Prop. Reg. 1.904-4(f)(2)(vi) provides that gross income "attributable to" a foreign branch must be adjusted to reflect <u>disregarded payments</u> between the foreign branch and its owner

SEC. 956 GUARANTEES AND PLEDGES FROM CFCs

Remember when your tax adviser said "you can't pledge foreign assets, or get a CFC guarantee for that loan!!"

- Proposed regulations (October 31, 2018) reduce determined under §956 to the extent the U.S. shareholder would be allowed a deduction under § 245A if it had received a distribution in the amount otherwise determined under § 956
- U.S. shareholder first determines its § 956 amount ("tentative § 956 amount")
- A C corp. U.S. shareholder determines whether it would have been allowed a deduction under § 245A if it received as a distribution from the CFC an amount equal to the tentative § 956 amount ("hypothetical distribution")
- Computed on an aggregate basis
- Only helps C corporation shareholders

SOME ELECTIONS TO CONSIDER…

- Prop. Reg. §1.904-2(j)(1) provides rules for foreign tax credits carried forward to tax years beginning after December 31, 2017
  - Generally, excess credits are allocated to the same post-2017 separate basket as the pre-2018 separate basket
  - However, taxpayers may elect to allocate excess credits under § 901 (but not under §902 or 960) in the general basket to the foreign branch income basket (to the extent such foreign taxes would have been assigned to the foreign branch income basket)
- Example:
  - US taxpayer T owns 100% of foreign company FC
  - FC has made a check-the-box election to be disregarded as a separate entity
  - FC has generated excess FTCs through end 2017 in general limitation basket
  - In 2018 and future years income of FC will fall in the 'branch' basket
  - Consider electing to assign brought forward credits to branch basket

Sec. 962 ELECTION FOR GILTI

- May be made where a US individual has GILTI income
- Creates fictional US C corporation between the taxpayer and the CFC
  - 21% tax on GILTI
  - Foreign tax credit (80%)
- Subsequent distributions are taxed at 20% qualified dividend rate (plus 3.8% NIIT)
- Made at the individual level
- Applies to all CFCs in that year
- Requires calculations to determine benefit/wisdom

NO TAX LAW WOULD BE COMPLETE WITHOUT ANTI AVOIDANCE…

1. Hybrid payments
2. Hybrid dividends
3. Interest limitations
4. BEAT payments

SEC 267A: HYBRID PAYMENTS OVERVIEW

- Deduction disallowed for certain interest and royalties paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity
- Addresses 'hybrid' deduction for payor, no income inclusion for payee
- Consistent with hybrid arrangements under the Organization for Economic Co-operation and Development's (OECD's) base erosion and profit shifting (BEPS)
- Broad and specific regulatory authority granted to carry out the purposes of § 267A
- Effective for taxable years beginning after December 31, 2017

HYBRID DIVIDENDS

- Similarly Sec. 245A(e) addresses hybrid dividends
  - Dividend that is deductible by the payor
  - E.g. Luxembourg PECs
- No deduction available under Sec. 245A
- Dividend remains taxable in US

BEAT PAYMENTS

- Applies to corporations
  - not regulated investment company, REIT, or S corporation;
- Gross receipts of at least $500 million over the three-year period ending with the preceding tax year
- ”Base erosion percentage" (Sec. 59A) must be at least 3%
- Overview of BEAT calculation
  - Similar to AMT
  - Determine base-erosion payments, base-erosion tax benefits, and base-erosion percentage.
  - The BEAT equals 10% (5% for 2018; 12.5% after 2025) of the taxpayer's "modified taxable income" over the regular tax liability
  - Modified taxable income = Taxable income + Base-erosion tax benefits + Base-erosion percentage of NOL deduction
  - Base-erosion minimum tax = (10% × Modified taxable income) - Regular tax liability net of certain credits

Questions

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Simcha B. David is a Tax Partner and a member of the Financial Services Group. He has more than 15 years of experience that encompasses both the tax accounting and tax legal side of the profession. His focus is on financial services and investment management entities, and he frequently advises on all aspects of tax planning and compliance for financial services firms and their related entities. His clients cover a wide variety of asset classes, including hedge funds, private equity funds, and funds of funds.

Simcha assists clients by providing tax consulting and compliance services. He works with clients on the tax implications of the initial structuring of their fund entities, review of their partnership and offering documents, tax implications of various types of securities transactions, and general tax issues and planning opportunities that arise during the life cycle of a fund.

Simcha started his career in tax in the accounting field, having spent a number of years at EisnerAmper. He attended law school in the evenings and served as an Associate Editor of the Hofstra Law Review Journal. Previously, he held a position at a prestigious New York law firm, where he focused on the legal side of hedge fund and private equity fund formation.

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Jon Zefi is a Principal and a member of the Tax Advisory Services Group. Widely recognized as an expert in state and local as well as federal and international tax matters, Jon has provided tax planning and compliance advice to public companies and privately held businesses, with a focus on mergers and acquisitions, restructuring transactions, tax rate minimization, tax risk mitigation, transfer pricing, and corporate taxation (Subchapters C and S).

Jon has over fifteen years of extensive experience in representing clients in domestic and international corporate reorganizations; acquisitions and divestitures; joint ventures and technology transfers; and private equity and investment funds. Jon regularly counsels clients with regard to tax-efficient structuring of domestic and international operations. For individuals and families of means, he has advised on the formation of investment and estate planning structures that provide tax efficiency and asset protection while minimizing estate taxes.

Jon has represented clients in over thirty state and local jurisdictions, handling audits and providing consultation involving state and local matters such as income and franchise taxes; sales and transaction taxes; and unclaimed property. In addition, he has represented public and privately held businesses as well as individuals before the Internal Revenue Service.

Prior to joining the firm, Jon served as a Tax Principal and a leader in state and local taxation issues for a national accounting firm. In addition, he served as a Tax Principal in the National Tax Office for a national accounting firm.

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