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a closer look

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SUBJECTS TRANSFER PRICING INTELLECTUAL PROPERTY VAT, GST AND SALES TAX CORPORATE TAXATION INDIVIDUAL TAXATION REAL ESTATE AND PROPERTY TAXES INTERNATIONAL FISCAL GOVERNANCE BUDGETS COMPLIANCE OFFSHORE

SECTORS MANUFACTURING RETAIL/WHOLESALE INSURANCE BANKS/FINANCIAL INSTITUTIONS RESTAURANTS/FOOD SERVICE CONSTRUCTION AEROSPACE ENERGY AUTOMOTIVE MINING AND MINERALS ENTERTAINMENT AND MEDIA OIL AND GAS

COUNTRIES AND REGIONS EUROPE AUSTRIA BELGIUM BULGARIA CYPRUS CZECH REPUBLIC DENMARK ESTONIA FINLAND FRANCE GERMANY GREECE HUNGARY IRELAND ITALY LATVIA LITHUANIA LUXEMBOURG MALTA NETHERLANDS POLAND PORTUGAL ROMANIA SLOVAKIA SLOVENIA SPAIN SWEDEN SWITZERLAND UNITED KINGDOM EMERGING MARKETS ARGENTINA BRAZIL CHILE CHINA INDIA ISRAEL MEXICO RUSSIA SOUTH AFRICA SOUTH KOREA TAIWAN VIETNAM CENTRAL AND EASTERN EUROPE ARMENIA AZERBAIJAN BOSNIA CROATIA FAROE ISLANDS GEORGIA KAZAKHSTAN MONTENEGRO NORWAY SERBIA TURKEY UKRAINE UZBEKISTAN ASIA-PAC AUSTRALIA BANGLADESH BRUNEI HONG KONG INDONESIA JAPAN MALAYSIA NEW ZEALAND PAKISTAN PHILIPPINES SINGAPORE THAILAND AMERICAS BOLIVIA CANADA COLOMBIA COSTA RICA ECUADOR EL SALVADOR GUATEMALA PANAMA PERU PUERTO RICO URUGUAY UNITED STATES VENEZUELA MIDDLE EAST ALGERIA BAHRAIN BOTSWANA DUBAI EGYPT ETHIOPIA EQUATORIAL GUINEA IRAQ KUWAIT MOROCCO NIGERIA OMAN QATAR SAUDI ARABIA TUNISIA LOW-TAX JURISDICTIONS ANDORRA ARUBA BAHAMAS BARBADOS BELIZE BERMUDA BRITISH VIRGIN ISLANDS CAYMAN ISLANDS COOK ISLANDS CURACAO GIBRALTAR GUERNSEY ISLE OF MAN JERSEY LABUAN LIECHTENSTEIN MAURITIUS MONACO TURKS AND CAICOS ISLANDS VANUATU

It is now extremely important to compute E&P accurately. For every USD100 of reductions to E&P, the taxpayer will save USD8 to USD15.50 of tax, permanently. This phenomenon creates a one-time opportunity to convert timing items into permanent tax reductions. While the Internal Revenue Service (IRS) has issued Notice 2018-26, highlighting that accounting method changes will not be permitted in order to reduce the toll charge, US multinationals must do a thorough review of every controlled foreign corporation (CFC) to identify whether a method of accounting has ever been established. Further, there are real and lingering legal questions looming (which will likely be settled in court) over whether the IRS has the authority to trump the Internal Revenue Code, as IRC § 446 requires taxpayers on an impermissible method of accounting to make the change immediately. Lest we not forget that if method changes are allowed for E&P, but not in the calculation of the toll charge, it may be more beneficial to drive accounting method changes into the post reform period (2018 and beyond) to reduce E&P after the toll charge computation, thereby reducing another product of tax reform: Global Intangible Low-Taxed Income (GILTI).

Foreign Tax Credits – Still Relevant In 2018? Absolutely

The TCJA made significant changes to the United States' foreign tax credit rules, especially for corporations around the utilization of "indirect" tax credits under IRC § 902 and the "basket" rules under § 904. New provisions, such as the passage of the new dividend, received deduction under § 245A for foreign dividends, and the new baskets for foreign branch income and GILTI have many taxpayers and practitioners wondering if there is much left to worry about in this area that has been a cornerstone of international tax planning and compliance for more than 50 years. This article makes the case that foreign tax credits are still extremely relevant and will continue to be an important part of multinational taxation in the United States for years to come.

The End Of The Indirect Credit?

For decades, "The Indirect Credit" by Gerald T. Ball was an essential treatise to be studied and used as a reference as an international tax practitioner. With the passage of the new dividends received deduction (DRD) for foreign dividends in the TCJA, indirect credits under § 902 will be much less of an issue, and Mr. Ball's treatise may spend a lot more time on the shelf. It is no longer necessary to track the E&P and tax pools of a CFC for purposes of the taxation of actual distributions to the US shareholders. The treatment of indirect credits for GILTI and Subpart F purposes is still alive, however, and we will address this further below.

The New Branch Basket

IRC § 904(d) as amended by the TCJA established a new basket for foreign taxes paid by a foreign branch of a US corporation. Under prior law, taxes paid by a foreign branch were generally included in the general limitation basket, as long as the branch was an active business. Under the new law, the branch basket is now the vehicle for claiming the credits paid by foreign branches. Significantly, the branch basket requires the netting of all branch income and losses to determine the amount of credits available to be taken in a year, and no carryforward of excess credits will be allowed. Given the reduced US corporate tax rate starting in 2018, which is now lower than that of most of the United States' trading partners, this new rule raises several key points for taxpayers to consider:

- Are taxpayers more likely to elect branch treatment for their high-taxed foreign subsidiaries in order to claim credits to offset income of lower-taxed foreign branches?
 - This could be especially true for manufacturing branches, such as Mexican maquiladoras that are now able to generate more foreign source income on sales in the United States as a result of the changes to § 863(b);
 - This is less attractive if they also have loss branches that would reduce the credit in the pool for that year.
- Are taxpayers more likely to generate unusable excess credits in the branch basket as a result of the new lower US rate compared to foreign countries and the mixing of losses and profits in the basket each year?

The New GILTI Basket

The new GILTI basket under § 904(d) is a significant area in which taxpayers and advisors are still learning how it will impact US multinationals. The GILTI provisions create a deemed dividend similar to Subpart F, but one that is taxed at a lower rate. Complicating matters further, there is a complex set of calculations that need to be made each year to determine the amount of indirect credits under § 960 that would be available to offset this income. Many taxpayers are now getting into the details of the impact of this new provision and are discovering the following:

- Just because a CFC has a higher tax rate than the roughly 13 percent needed to offset the tax from the 10.5 percent GILTI tax doesn't mean that there won't be some tax leakage under the Foreign Tax Credit (FTC) rules. Many companies are finding that their 861 allocations are causing them to pay residual US tax on their GILTI and is a similar problem that many companies had in the past with the full utilization of their 902 credits under the old regime;

- Like the branch basket, the new GILTI basket has a "use it or lose it" rule that allows the mixing of high- and low-taxed income in the current year, but no carryovers;
- To the extent that they have excess credits in their GILTI basket, many companies are considering the creation of GILTI structures for activities such as international purchasing that could allow for the utilization of additional excess credits if they are only subject to a 10.5 percent US tax.

General Limitation Basket – Down, But Not Out

The general limitation basket, despite the development that it will no longer have foreign dividend income, foreign branch income, or the new GILTI, remains an interesting subject for many US multinationals. Subpart F income will still fall into the general limitation basket to the extent it relates to active business income, such as foreign base company sales income under § 954 or other similar provisions. In addition, the overall domestic loss (ODL) rules relate primarily to the general basket, and many companies have substantial FTC carryforwards in this basket that could be utilized by a company that turns around in the United States and begins to generate ODL recapture. This may be of particular interest in sectors such as the energy industry as it turns around with the increasing price of oil.

Don't Forget About The Past

Finally, the changes to the FTC rules and the US corporate tax rate suggest that more companies could benefit from a carryback claim under § 911(d) and the ten-year statute of limitations on the use of FTCs. There is now a greater incentive for US multinationals to go back and scrub their FTC utilization for the last ten years to try and maximize the FTCs taken under a 35 percent tax rate. This would be important where they find excess credits in the general basket that were not used by their 2017 repatriation and cannot be used in the future because of a lack of general basket income. Accordingly, an asset that was previously considered a timing item that could be used in ten years may now need to be reserved against in the financial statements if there is no clear plan to utilize these credits in the future. A ten-year FTC review could be the cure to this problem.

FDII And GILTI – The Carrot And The Stick

Two key TCJA provisions affecting US multinationals, Foreign Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI), were designed to move the United States towards more of a territorial tax system and to either encourage more US taxable income

from intangible export sales to non-US customers, or penalize companies for earning excess profits outside the United States. Both of these provisions are new additions to the international tax toolkit, so a deeper analysis is helpful to understand more about how these new rules can work for or against multinational corporations (MNCs) relative to their historical planning.

FDII – The carrot – how much impact will this have?

At first blush, the FDII provisions provide a new incentive for US MNCs to export services and property to non-US customers. However, in application, the deduction associated with FDII is most beneficial to US-based manufacturers that perform almost all functions, including the ownership of raw materials, work in progress, and finished goods until the final sale of such goods. Domestic toll manufacturers and contract manufacturers that are not performing complete functions, such as the ownership of raw materials and the utilization of a profit center managing manufacturing functions, will have a low Qualified Business Asset Investment (QBAI) for FDII calculation purposes. This low QBAI amount will adversely affect the benefit provided by the FDII deduction, and thus, a greater benefit potential exists for full-fledged US-based manufacturers.

The FDII rules do clearly incentivize US manufacturers and intellectual property (IP) developers, such as software applications that are looking to expand domestic production to increase exports. As previously noted, an expansion in domestic production would increase the FDII deduction benefit and thereby reduce US taxable income. Additionally, US multinationals that primarily license IP and provide services to a principal CFC may optimize FDII by reviewing and reconsidering its royalty rates and calculation methods (*i.e.*, transfer pricing methodologies).

US MNCs see the potential in this new regime but are also wary of making long-term decisions on this basis, as we have experienced changes to previous export incentive regimes (Foreign Sales Corporation (FSC), *etc.*) based upon World Trade Organization (WTO) rules and other discrimination claims by our global trading partners. Further, transfer pricing incentives to recognize more profit in the United States represent a major change from decades of planning in the other direction. Foreign tax authorities have had it easy for years where the taxpayer was almost always on the other side of the table from the IRS. Starting in 2018, for maybe the first time, tax authorities in Canada, Mexico, China, and elsewhere will have to deal with the new reality that many MNCs are now incentivized to maximize profit in the US. The impact of all these factors will be interesting to see.

GILTI – The stick – new offshore costs and opportunities

Similar to the new analysis required for FDII, the new tax associated with the GILTI provisions must be managed by assessing opportunities to minimize the tax impact and look for ways to optimize the new rules. The impact of GILTI on US multinationals that provide services and sell patented and trademarked products with large margins has the potential to be extremely negative. This is because such businesses may have very little tangible property (*i.e.*, QBAI) with which to offset CFC-tested income subject to GILTI. As described briefly above, many of these companies are located in low-taxed jurisdictions that do not have sufficient underlying foreign taxes to offset the 10.5 percent tax each year. If the company has expense allocations against this income, the effective rate could be much higher than 10.5 percent.

For domestic exporters and IP companies, however, opportunities exist to manage the impact of GILTI on foreign earnings. For example, one approach is for a US MNC to increase its tangible asset base in its CFCs to offset includable tested income subject to GILTI. It may not be feasible to start moving assets across oceans to accomplish this objective, but in many cases, there are groups of companies within a country that have a different profile that need to be reorganized for GILTI purposes. Moving tangible assets from a loss company or a low-margin company into a high-margin company could be an easy solution. Mergers and check-the-box elections could also be an easy way to accomplish this without significant impact to local operations.

Additionally, a domestic exporter may review and revise its transfer pricing methods to determine whether income earned by one or more of its CFCs could be reduced or otherwise managed below the GILTI threshold. Regarding IP management, a new review of intangible assets should be performed to determine the optimal ownership location for tax purposes. Although CFCs will be subject to GILTI, there is now a stronger case for future IP to be developed in the United States to avoid GILTI and take advantage of the FDII benefit, which effectively taxes licensing income to foreign third parties or affiliates at 13.125 percent. If one considers the potential additional research and development credits that would be available with the IP development activity in the US, the effective rate on this income in the United States could be much lower.

Conclusion

This is the most exciting era in a generation for the tax professional. The smartest tax departments will run quantitative models to effectuate the most tax-efficient response to tax reform. Obstacles and opportunities abound, and the firms who convert the 2017 compliance process into a value-added exercise will run ahead of the curve.