FTC Planning

35th Annual TEI-SJSU High Tech Tax Institute

November 4, 2019

Anne Devereaux
Internal Revenue Service

Will Skinner
Fenwick & West

Adam Halpern
Fenwick & West

Kristen Proschold
Intuitive Surgical, Inc.

Rob Morris
Norton Rose Fulbright

Connect. Engage. Impact.

2

FTC Overview Post-TCJA

- Section 901 is basically unchanged. Withholding taxes and branch taxes remain fully creditable (subject to the new § 904).
- Section 902 is repealed. Dividends from CFCs don't carry deemed paid FTCs, but instead, are generally eligible for the § 245A DRD.
- Section 960 is expanded. Section 960 is the exclusive means of obtaining deemed paid credits, which arise with respect to (i) GILTI inclusions, (ii) § 951(a) inclusions, and (iii) in certain cases, PTEP distributions.
- Section 904 is revived. The new GILTI and foreign branch baskets, together with the reduced corporate tax rate, will put many companies in limitation.

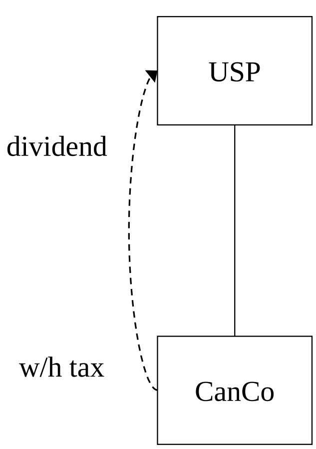
Connect. Engage. Impact.

3 Current Status of FTC Guidance

- Two provisions of the proposed FTC regulations (Dec. 2018) were finalized in the GILTI final regulations package (Jun. 2019):
  - Reg. § 1.78-1, including the rule that the § 78 gross-up is not treated as a dividend for § 245A purposes
  - Portions of Reg. § 1.861-12, primarily focusing on the E&P adjustment to CFC stock basis for purposes of interest expense apportionment
- Both rules were finalized with retroactive effect, and apply to calendar year taxpayers starting in 2018.
- The remaining FTC regulations are still in proposed form. However, the final regulations have been sent to OIRA and are expected to be released soon. It is expected that they will also apply retroactively.

Connect. Engage. Impact.

4 Withholding Taxes

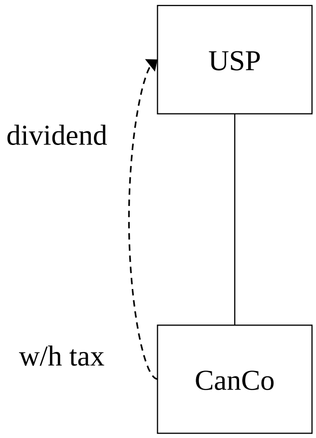


- Withholding taxes on “live E&P” dividends will likely not be creditable, § 245A(d).
- For PTEP distributions, different creditability rules will apply for taxes imposed on PTEP in different “groups”-- § 965(a), 965(b), GILTI, etc.
- Taxes imposed on non-dividend distributions should be creditable.
- Companies will also need to navigate § 904 limitation and basketing issues.

Connect. Engage. Impact.

5

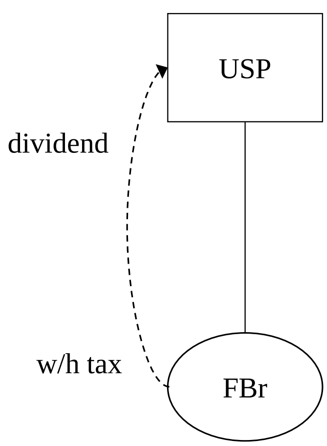
Withholding Taxes



- Proposed § 1.960-3(c) provides that PTEP is assigned to a PTEP account at the CFC level that corresponds to the inclusion year and the § 904 basket of the inclusion at the U.S. shareholder level.
- For example, a CFC could have a GILTI basket PTEP account, even though the CFC's income cannot initially be assigned to the GILTI basket.

6

Withholding Taxes



- Proposed § 1.904-6(a)(2)(iii) states that a gross basis withholding tax on a remittance from a foreign branch is attributable to a timing difference in taxation of the income out of which the remittance is made.
- The withholding tax is assigned to the § 904 category to which a § 987 gain or loss would be assigned under § 1.987-6.

7

Deemed Paid Taxes

- Proposed § 1.960-2 provides for separate calculation of the deemed paid taxes from a CFC in each separate basket and in each separate “income group” within a basket:
  - Multiple Subpart F income groups based on § 1.954-1(c)
  - A single tested income group
  - A single “residual” income group
- In a Subpart F group, deemed paid taxes are equal to the U.S. shareholder’s proportionate share of the CFC’s “current year taxes” in that group.
- In the tested income group, deemed paid taxes are similarly equal to the proportionate share of current year taxes, but are also adjusted for the § 960(d) 20% haircut and inclusion percentage.

Connect. Engage. Impact.

8

Deemed Paid Taxes

- Foreign taxes assigned to the residual income group are never deemed paid, and effectively disappear.
- Current year taxes attributable to a “base difference” are treated as related to the residual group, and effectively disappear.
- Foreign taxes are never deemed paid with respect to an amount included under § 956.
- Foreign taxes other than current year taxes are not deemed paid in the current year under § 960(a) or (d), but may be deemed paid in another year if they are attributable to a timing difference.
- PTEP distributions and § 960(b) deemed paid taxes are carved out from this system and treated separately under proposed § 1.960-3.

Connect. Engage. Impact.

9

GILTI Basket Issues & Planning

- Companies with an effective foreign tax rate below 13.125% will have excess limitation in the GILTI basket.
- Tax on GILTI will equal the residual percentage of GILTI as contemplated by the Conference Report; allocation of expenses to the GILTI basket will likely have no effect.
- GILTI basket PTEP distributions will carry tax consequences.
  - Section 986(c) FX gain or loss will result in a corresponding increase or decrease in tax liability
  - Section 960(b) foreign taxes will reduce tax liability dollar-for-dollar
- Additional foreign taxes on GILTI (resulting from a foreign audit, for example) will generally be creditable, subject to the 20% haircut under § 960(d), but will require an amended return.

Connect. Engage. Impact.

10

GILTI Basket Issues & Planning

- Companies with sufficient taxable income and an effective foreign tax rate above 13.125% will be in limitation in the GILTI basket.
- Tax on GILTI will equal 21% of allocated expenses.
- GILTI basket PTEP distributions will likely have no effect.
  - Unless it is very large, § 986(c) FX gain or loss will merely increase or decrease FTC limitation correspondingly
  - Section 960(b) foreign taxes will be caught in limitation
- Additional foreign taxes on GILTI will be an absolute cost.

Connect. Engage. Impact.

11

GILTI Basket Issues & Planning

- Companies with insufficient taxable income will be in limitation in the GILTI basket and will also forfeit the § 250 deduction.
- No cash tax on GILTI, but NOLs equal to 21% of GILTI will be lost, effectively full double taxation.
- Planning in this scenario isn't easy. The goal should probably be to minimize CFC income.
  - Checking the box on CFCs to make them U.S.-owned FDEs probably makes things worse
  - Electing to deduct foreign taxes at least eliminates the § 78 gross-up on GILTI; the election could later be changed

Connect. Engage. Impact.

12

GILTI Basket Issues & Planning

- Proposed GILTI high-tax exception might be helpful
  - Reducing the GILTI inclusion in most cases will reduce the expense allocations to GILTI basket income. But remaining CFC income subject to GILTI could be taxed at an average foreign rate below 13.125%, resulting in residual U.S. tax.
- Planning into Subpart F income might be more helpful
  - Similar to proposed HTE, but can be done selectively
  - Can elect high-tax exception or take general basket Subpart F inclusion and credits
  - Need to consider difficulty of transforming non-Subpart F income into Subpart F income
- No cookie-cutter solutions; modeling will be important

Connect. Engage. Impact.

13

Source of Income / Expense Allocation New Challenges

- Source of income and allocation of expense is used to determine the Section 904 limitation on the foreign tax credit on a basket by basket basis.

- With TCJA, these issues are more relevant for Tech Companies because:
  - Worldwide inclusion of GILTI requires an annual FTC calculation
  - Lower US tax rates, particularly on GILTI, make excess credits more likely
  - More baskets and the single year FTC calculation within the GILTI basket put more pressure on utilization of credits generated

- Planning to maximize the utilization of foreign tax credits under Section 904 will therefore, be more important.

Connect. Engage. Impact.

14

The Branch Basket – A Mystery Wrapped in an Enigma

- Under the proposed regulations, the branch basket is determined based on the books and records of the disregarded entity that owns the branch, as adjusted to apply US tax principles.

- Disregarded payments to/from a branch must be reallocated between baskets based on the allocation of expense under Reg 1.861-8, ***as it would apply if the payment were regarded***.

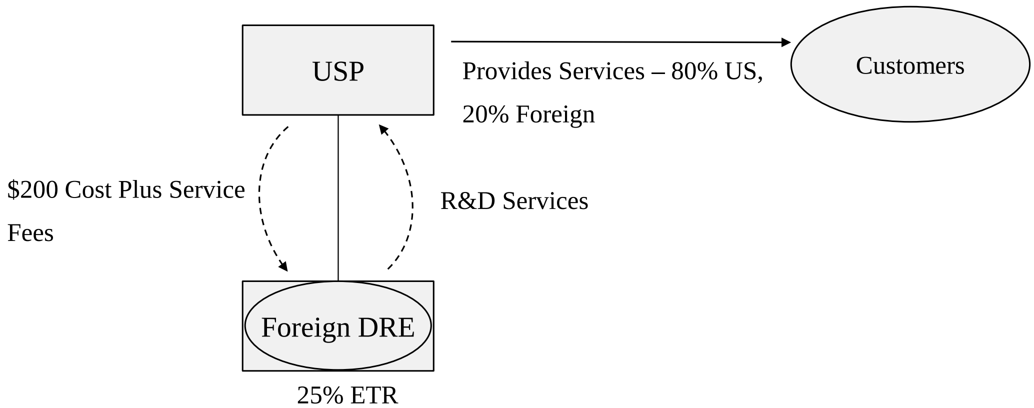
- Sales of property between the branch and its owner also give rise to reallocation based on how cost of goods on a regarded sale would have been allocated .

- Licenses or transfers of intangible property between branch and its owner give rise to reallocations under the same principles. Section 482 and Section 367(d) principles apply to determine the consequences of a branch to owner license or transfer of property.

Connect. Engage. Impact.

15

Branch as a Service Provider

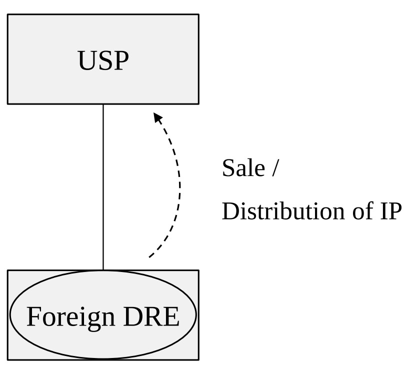


- Cost-plus service fees are disregarded payments. Assume under Section 1.861-8 that service fees would be apportioned 80%/20% US/Foreign.
- $200 of USP's income is allocated to branch basket. That gross income would seem to be $160 US source and $40 foreign source.
- USP may need to invoke Treaty resourcing to claim FDRE's taxes as a credit.

Connect. Engage. Impact.

16

IP Transfer Involving a Branch



- Under the proposed regulations, the IP transfer from branch to owner is treated as if it were a regarded transaction subject to Sections 482 and 367(d). Income equal to the arm's length payment for the IP is attributed to the branch basket.
- Consider FDII implications due to branch basket carve out from FDII.

Connect. Engage. Impact.

17

FDII / Source of Income Overlap

- The foreign tax credit operates based on source of income rules found primarily in Sections 861-865 of the Code: e.g., the title passage rule, "place of use" for IP, and the residence of the seller rule for non-inventory property.

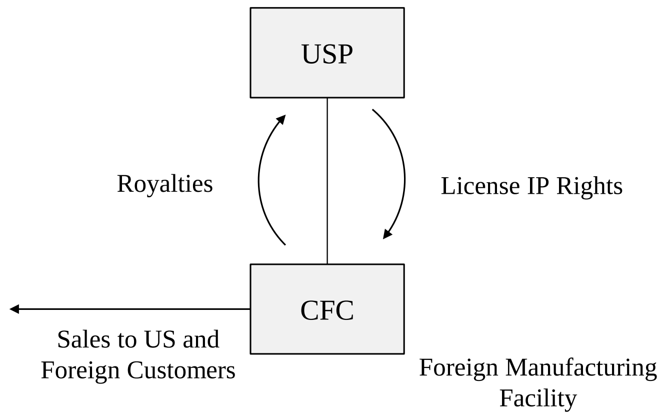
- The foreign derived intangible income (FDII) deduction is based on sales, leases or licenses of property to a foreign person for use, consumption or disposition outside of the US, and provision of services to a person or with respect to property located outside of the United States.

- Foreign use / consumption for FDII purposes and foreign source for FTC limitation purposes are overlapping and different concepts.

Connect. Engage. Impact.

18

FDII on Royalty Income



- Under FDII proposed regulations, CFC's "foreign use" of the IP depends on the location of the end customer of the product made and sold. Foreign manufacture does not constitute "foreign use."

- What about the place of use of the IP by the CFC for source of income purposes? See, e.g., *Sanchez v. Commissioner*.

Connect. Engage. Impact.

19

Source of Income from Inventory Property

- TCJA amended IRC Section 863(b) for “producers” of inventory property, to repeal the longstanding 50/50 source of income rule and instead source income solely to the location of the taxpayer’s production assets.
- Sections 861(a)(6)/862(a)(6) remained in place for property purchased and resold by the taxpayer without manufacture or production. Title passage continues to govern source of income there.
- For software transactions, new Prop. Reg. 1.861-18 would repeal title passage rule for downloaded products and source income based on the customer’s location.

20

Source / FDII - Product Sales

- FDII depends on the foreign customers’ place of use, consumption or disposition of the inventory.
- Source of income now depends on several factors, including:
  - Whether taxpayer is “producer” / “manufacturer” of inventory for Sec. 863(b) purposes?
  - Place of manufacture
  - Place of sale
  - Special rule for digital goods if taxpayer is not the “producer” of the goods under Sec. 863(b) purposes

21

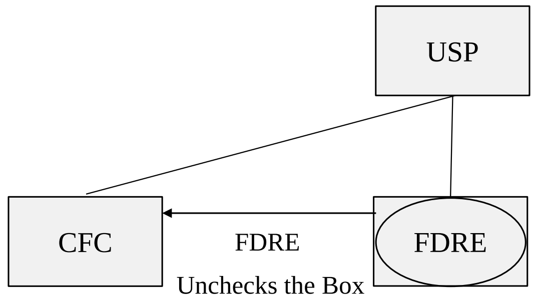
Dispositions of Branches

- For FTC basket purposes, proposed regulations state that gain or loss on the sale of a DRE or partnership interest is generally not allocated to the branch basket. I.e., the gain is generally not "pushed down" to the branch.
  - Contrast DCL final regulations and FDII proposed regulations.
- Gain or loss, therefore, may be allocated largely to the general basket. Source of income determined under generally applicable rules, such as Section 865 and Section 861/862.
- Where the taxpayer has pre-TCJA carryovers from the branch activity, special taxpayer-favorable elections may be available, such as elective 100% ODL recapture (Sec. 904(g)(5)) and the special branch carryover election in the Proposed Regulations.

Connect. Engage. Impact.

22

Dispositions of Branches



- What is the source, basket and FDII treatment of the following items of income:
  - Section 367(a) gain
  - Section 367(d) royalty income
  - OFL/ DCL recapture income
- Does the answer differ with a sale of FDRE's interests to CFC vs. unchecking the box?

Connect. Engage. Impact.

23

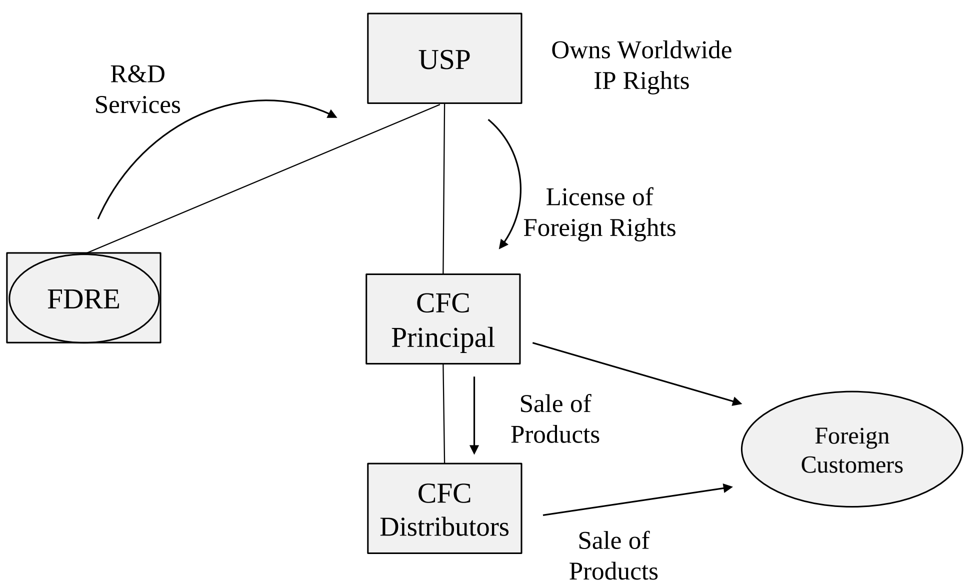
Expense Allocation Issues- R&E Expense (Reg. 1.861-17)

- Current Reg. 1.861-17 includes complex rules that were the product of a careful compromise. Proposed Regulations released in 2018 did not yet update R&E regulations for post-TCJA environment.
- Two methods are available based on taxpayer's election to use gross income or product sales within the 3-digit SIC code to apportion R&E expense between US and foreign soruces.
- 25% or 50% exclusive apportionment to predominant geographic location of the taxpayer's R&D activity.
- Election of gross income method is a binding election for five years, absent IRS consent to change. Proposed Regulations allowed taxpayers to change back to sales for first post-TCJA year without IRS consent.

Connect. Engage. Impact.

24

R&E Expense Allocation – Example



Connect. Engage. Impact.

25

R&E Expense Allocation Example – Questions / Issues

- Under the gross income method, does R&D expense relate to the general basket royalty, the GILTI basket tested income of the CFCs or both categories?
- How do the new rules under Section 904(b)(4) affect the allocation of R&E expense?
- Impact of Foreign branch R&D activities on exclusive apportionment

Connect. Engage. Impact.

26

Expense Allocation Issues- Interest Expense

- Proposed regulations adopt new rules for allocation of interest expense that reflect the reduced rate of tax on GILTI and the treatment of earnings eligible for Section 245A.
- Repeal of FMV method of apportionment makes tax book value method mandatory, requiring consideration of the stock basis of CFCs, as adjusted for PTI.
- Other changes in the Proposed FTC Regulations:
  - Special rules for Specified Partnership Loans (SPLs) between a partner and a partnership
  - Special rules for hybrid instruments in the debt-netting rules of 1.861-10

Connect. Engage. Impact.

27

Claiming The Foreign Tax Credit For Disputed Foreign Taxes

- For 2013, 6,542 corporations claimed foreign tax credits totaling $118.3 billion against their U.S. income tax liability.
- Foreign tax credits, plus other credits, enabled these corporations to reduce their U.S. income tax by 35.9 percent.[1]
- IRS has signaled through its training materials and litigating positions an increased aggressiveness in contesting foreign tax credit claims.

[1] https://www.irs.gov/pub/irs-soi/soi-a-coftc-id1706.pdf

Connect. Engage. Impact.

28

The "Compulsory" Requirement

- The foreign tax payment must be "compulsory" to be creditable.
- "An amount paid is not a compulsory payment … to the extent that the amount paid exceeds the amo
- "A t … x will
- "Although defendant presents sound policy reasons for requiring a taxpayer to exhaust all litigation remedies before being entitled to a foreign tax credit, the statute, the regulations, and the applicable revenue rulings do not reflect defendant's policy concerns." *International Business Machine Corp. v. United States*, 38 Fed. Cl. 661 (1997).

"A taxpayer need not undertake extraordinary efforts to contest a foreign tax liability before the tax will be creditable on taxpayer's U.S. return."

Connect. Engage. Impact.

29

When Is A Payment Compulsory?

► An a hat
the a t
exce hat is
cons ions
of fo r's
reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and
prac ble
tax t to a
fore yer's
tax l e to
use
foreign tax. An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts.

if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce,

In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts.

TEI
Connect. Engage. Impact.

30

Reasonably Interpreting And Applying Foreign Law

- Taxpayers may rely on advice obtained in good faith from foreign tax advisors.
  - Be prepared to provide evidence of the advice.
- Taxpayers need not alter its form of doing business, its business conduct, or the form of any business transaction.
- Does the taxpayer have actual or constructive notice regarding the interpretation or application of foreign law?

TEI
Connect. Engage. Impact.

31

Exhausting All "Effective and Practical" Remedies

- Must pursue remedies that are "effective and practical" considering "the amount at issue and likelihood of success."
  - IRS has characterized this as "a reasonable business approach."
- Advice obtained in good faith from foreign tax advisors
  - *International Business Machine Corp. v. United States*, 38 Fed. Cl. 661 (1997).
  - *Schering Corp. v. Commissioner*, 69 T.C. 579 (1978).

Connect. Engage. Impact.

32

Exhausting All "Effective and Practical" Remedies (Cont'd)

- Must a taxpayer request Competent Authority Assistance?
  - The IRS view is that there are "few exceptions" to the "rule" that taxpayers must pursue competent authority assistance to exhaust their remedies in a treaty country.
  - *Proctor & Gamble Co. v. United States*, 106 A.F.T.R. 2d 2010-5311 (S.D. Ohio 2010).
  - *Coca-Cola Co. v. Commissioner*, 147 T.C. 198 (2016).

Connect. Engage. Impact.

33

Requesting Competent Authority Assistance

- Procedures set forth in Rev. Proc. 2015-40.
  - Taxpayers are encouraged to file request after a competent authority issue arises or is likely to arise.
- Consider pre-filing conference (recommended for some issues).
- Consider Treaty Notification.
  - Treaty Notification may be appropriate where (a) treaty country is considering but has not yet proposed an adjustment; (b) the treaty country has proposed an adjustment but the related party in the treaty country decides to pursue administrative or judicial remedies in the foreign country; or (c) the terms of the applicable treaty require notification to be made to the competent authority within a certain time period.
  - Must provide annual notification until a complete competent authority request has been filed

Connect. Engage. Impact.

34

Watch Out For Time Limitations In Treaties

- Beware of treaty provisions that may provide time limitations for requesting Competent Authority Assistance. For example,
  - notified of the case <u>within four and a half years</u> from the due date or the date of filing the return in that other state, whichever is later."
  - presented <u>within three years</u> from the first notification of that action." (emphasis added)

Connect. Engage. Impact.

35

Must You Accept A Proposed Competent Authority Resolution?

- Field Service Advice 1998-293
  - "[T]here is authority that taxpayer may not claim a credit for the tax that Japan is willing to concede in a competent authority settlement but which taxpayer is unwilling to accept."
  - "It is possible that the Government would have an argument that [redacted text] in refusing to accept a competent authority settlement . . . has made a voluntary payment to Japan in the amount of tax that the Japanese competent authority is willing to concede."
- Field Attorney Advice 20125202F
  - "Although the proposed CA settlement was based on a smaller amount of constructive dividend than it ultimately obtained through its litigation and settlement with the Foreign Tax Agency, the exhaustion of remedies requirement is based on reasonable expectations at the time the avenue of relief is foregone, not hindsight."

Connect. Engage. Impact.

36

Settlements Outside Of Competent Authority

- Foreign Tax Advisors
  - Make sure your documentation is in order.
- Settlements of more than one issue are evaluated on an overall basis.
- What are other companies doing?
  - Revenue Ruling 77-267 ("[s]ince the monetary settlement reached is comparable to a refund obtained in good faith by a similarly situated taxpayer, the portion of the United Kingdom taxes claimed but not returned . . . will constitute creditable taxes . . ..")
- Amnesty programs
  - Private Letter Rulings 8323094 and 8339036

Connect. Engage. Impact.

37

Be Mindful Of The Statute Of Limitations

- Section 6511(d)(3)(A) provides that the statute of limitations for filing refund claims for an overpayment attributable to foreign taxes is 10 years from the due date of the federal income tax return for the year to which the foreign tax relates ("10-Year Period").
- For example, the 10-Year Period for a taxpayer to file a claim for refund for the tax year ended December 31, 2009 expires on March 15, 2020.
- Revenue Ruling 58-55, 1958-1 C.B. 266
  - "A foreign tax for the purpose of such credit is accruable for the taxable year to which it relates even though the taxpayer contests the liability therefor and such tax is not paid until a later year." *See also The Cuba Railroad Company v. United States*, 124 Fed. Supp. 182 (S.D.N.Y. 1954).
- *Albemarle Corp. and Subsidiaries v. United States*, 118 Fed Cl. 549 (2014), aff'd 797 F.3d 1011 (Fed Cir. 2015).
- New Section 905(c)

Connect. Engage. Impact.

38

Making Protective Claim For Refund In Competent Authority Request

- Protective claim for refund may be made by either: (a) including the claim in Competent Authority Request, or (b) filing a letter making a protective claim under Rev. Proc. 2015-40 in relation to an issue on which competent authority assistance may be requested. See Rev. Proc. 2015-40, Sections 11, 2.02, Tab 3 of Appendix.
- A protective claim must: (a) fully advise the IRS of the grounds on which credit or refund is claimed; (b) contain sufficient facts to apprise the IRS of the exact basis of the claim; (c) describe and identify the contingencies affecting the claim; (d) state the year for which the claim is being made; (e) be verified by a written declaration under penalties of perjury, and (f) be filed before the expiration of the period of limitations. Rev. Proc. 2015-40, Section 11.

Connect. Engage. Impact.

39

Protective Claims For Refund Outside Of Request For Competent Authority Assistance

- Field Attorney Advice 20125202F
  - "[A] valid protective claim need not state a particular dollar amount or demand an immediate refund, but it must be sufficient to put the Service on notice that a tax refund is sought, focus the Service's attention on the merits of the claim, and identify the specific years for which a refund is sought."
- Sample Language
  - The amount of the refund requested by the company is contingent upon the resolution of the foreign tax assessments. After the dispute with the foreign tax authority regarding the foreign tax assessments is ultimately resolved, the company will file an additional refund claim that amends this protective claim to account for any additional foreign tax credit for which the company is entitled for the 20XX tax year.

Connect. Engage. Impact.

40

Issues To Consider When Preparing The Refund Claim

- Variance Doctrine
  - Claim for refund must state the basis for the refund sufficient to apprise the IRS of the exact basis thereof.
  - Refund suit can't be brought on a ground that IRS has never had an opportunity to consider at administrative level.
- Joint Committee Review

Connect. Engage. Impact.

41

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, DC 20224

LARGE BUSINESS AND INTERNATIONAL DIVISION

Contact Person:

Employee ID Number:

Contact Telephone Number:

Date:

Tax Periods

We have been advised that the congressional Joint Committee on Taxation has completed its consideration of our special report (made to satisfy the requirements of section 6405 of the Internal Revenue Code of 1986) on these income tax returns and has taken no exception to the conclusions reached by the Internal Revenue Service.

Joint Committee Specialist

cc: Robert C. Morris

Letter 1574 (P) (Rev. 10-2010)

Connect. Engage. Impact.