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Legal Alert: Worldwide Territoriality: International Tax Proposals Broaden the Base

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On November 16, 2017, the House of Representatives passed a much-anticipated tax reform bill, titled the Tax Cuts and Jobs Act (the House Plan), which was first introduced on November 2, 2017. The passage of the House Plan comes as the Senate is debating its own tax reform proposals. On November 21, 2017, the Senate Finance Committee released legislative text of the tax reform bill, titled the Tax Cuts and Jobs Act (the Senate Plan), which the Committee passed on November 16, 2017. The Senate Plan, like the parallel House Plan, would reduce the maximum corporate tax rate from 35% to 20% and move away from the current worldwide system of taxation to a territorial regime. However, both proposals also broaden the base of income subject to current US tax through the inclusion of a one-time tax on undistributed earnings of foreign subsidiaries of US corporations and the expansion of the existing subpart F rules by imposing a minimum tax on the earnings of foreign subsidiaries of US corporations. Additional limitations on the ability of US corporations that are members of multinational groups to deduct interest expense and certain payments to related foreign persons also mitigate the potential benefit from the proposed rate reduction and shift toward a territorial system.

The House Plan and the Senate Plan are far-reaching and contemplate significant changes to how the US would tax individuals, domestic businesses and multinational businesses. See the prior Eversheds Sutherland alerts on the House Plan and the Senate Finance Committee's Description of the Chairman's Mark to the Senate Plan and the Senate Finance Committee Description of the Chairman's Modification to the Chairman's Mark to the Senate Plan, both prepared by the Joint Committee on Taxation. This legal alert focuses on the international tax reform proposals that are included in the House Plan and the Senate Plan.

See the Eversheds Sutherland Tax Reform Law blog for more information, including the text and in-depth analysis of the House Plan and the Senate Plan.

Shift "Toward" a Territorial System

Both the House Plan and the Senate Plan propose a new 100% dividends received deduction (DRD) for the "foreign-source portion" of dividends received by a US corporation from a "specified 10%-owned foreign corporation" of which it is a United States shareholder. A "specified 10%-owned foreign corporation" generally is a foreign corporation (other than a passive foreign investment corporation (PFIC)) with respect to which a domestic corporation is a "United States shareholder." Existing rules define "United States shareholder" as a US person who has a 10% voting interest in a foreign corporation. The Senate Plan would revise the definition of a United States shareholder to also include a US person who has a 10% interest in the value of a foreign corporation. (The expansion of the definition of United States shareholder in the Senate Plan has certain incidental implications discussed below.)

The foreign-source portion of a dividend generally is the portion of the dividend that is attributable to earnings of the distributing foreign corporation that are not attributable to the conduct of a US trade or business or dividends received from a domestic corporation, 80%

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of the stock of which is held by the distributing foreign corporation. The DRD would apply to a current-year dividend, even if the distribution is in excess of the foreign corporation's accumulated earnings and profits (E&P) (i.e., a nimble dividend). Under the Senate Plan, the DRD would also apply to the foreign-source portion of amounts that are characterized as dividends under section 1248 provided a holding period requirement is met. The Senate Plan also includes a corresponding provision to provide a DRD benefit with respect to amounts that are characterized as dividends under section 964(e)(1) as a result of the sale of controlled foreign corporation (CFC) stock by another CFC so that such amount is not subject to the expanded subpart F-type provisions discussed below.

No foreign tax credits would be allowed for any taxes paid or accrued with respect to any dividend that qualifies for the DRD, and the foreign-source portion of a dividend for which the DRD is allowed is not treated as foreign source income for purposes of the foreign tax credit limitation.

Eversheds Sutherland Observation: Taking into account the significant previously taxed income (which can generally be distributed to the United States without additional US tax cost independent of the DRD) that will be created in many foreign subsidiaries by the transition tax and the minimum tax proposals discussed below, the DRD may have limited practical significance for many US corporations.

Both the House Plan and the Senate Plan include a holding period requirement to qualify for the DRD. Under the House Plan, the distributing corporation's stock must have been held for at least 180 days during the 361-day period beginning on the date that is 180 days prior to the dividend; the Senate Plan requires the share of stock to be held for at least 365 days during the 731-day period beginning on the date that is 365 days prior to the dividend.

The participation exemption under the Senate Plan would be applicable as of the tax year of foreign corporations beginning after December 31, 2017, whereas the corresponding provision of the House Plan would be applicable to distributions made after December 31, 2017, regardless of fiscal years.

Certain other corresponding changes also would be made under the House Plan and the Senate Plan, including elimination of section 956 deemed distributions for corporate US shareholders related to CFC investments in US property. The House Plan authorizes the Secretary to issue regulations to address United States shareholders that are partnerships with a corporate partner; the Senate Plan does not include a similar provision, but the related Joint Committee on Taxation summary indicates that the change is intended to apply to corporate US shareholders that hold their interest in the CFC through a domestic partnership.

The House Plan and the Senate Plan also include rules preventing distributions from a foreign corporation from increasing a loss with respect to the sale of the shares of such foreign corporation, and a requirement that losses of foreign branches be recaptured as US-source income on the transfer of substantially all of the assets of the foreign branch to a foreign corporation.

Eversheds Sutherland Observation: The recapture requirement for losses of a foreign branch is an expansion of existing rules applicable to outbound transfers of branch assets under section 367. Those rules limit the recapture of net branch losses to the amount of gain recognized on the exchange. The House Plan and the Senate Plan require recapture of the full amount of any loss attributable to the branch, though the Senate Plan limits the recapture in a particular taxable year to the amount of DRD allowed for such year, with any excess recapture carried forward to subsequent taxable years. The Senate Plan eliminates the existing branch loss recapture rule in connection with eliminating the active trade or business exception under section 367(a) for outbound asset transfers. The House Plan retains the current section 367(a) rules except that it requires section 367(a) branch loss recapture income to be treated as US-source, and provides rules to coordinate section 367(a) branch loss recapture with the new loss recapture rule.

Eversheds Sutherland Observation: The US-source rule is similar to the prior rule under section 367(d)(2)(C) relating to the transfer of intangibles, which was repealed in 1997. Most US companies were able to avoid the negative effect of the US-source rule by structuring a transaction as a license with a royalty rather than a sale. Avoiding the proposed US-source rule in the context of transfers of loss branches may not be as easy.

<u>Current Inclusion of Deferred Foreign Earnings</u>

The Transition Tax

In consideration of the shift to the DRD regime, the House Plan and the Senate Plan impose a one-time transition tax on the net previously untaxed foreign E&P of a “specified foreign corporation.” The House Plan defines “specified foreign corporation” as any CFC or any other foreign corporation with a corporate United States shareholder (excluding a PFIC that is not also a CFC), whereas the Senate Plan defines “specified foreign corporation” as any CFC or any other foreign corporation with respect to which a corporate United States shareholder is permitted to claim foreign tax credits pursuant to current section 902 (excluding a PFIC). Under both the House Plan and the Senate Plan, the tax is imposed by increasing the subpart F income of specified foreign corporations for their last taxable year beginning before January 1, 2018 and requiring current inclusion by the United States shareholder, subject to a deduction for a portion of the deemed dividend.

Eversheds Sutherland Observation: Under both the House Plan and the Senate Plan, an individual United States shareholder of a specified foreign corporation is subject to the transition tax, notwithstanding that such shareholder cannot benefit from the DRD going forward.

Complicated netting rules apply for purposes of determining the net previously untaxed E&P that is subject to inclusion, including rules that generally allocate deficits among positive E&P pools of other specified foreign corporations. While the House Plan allows netting among United States shareholders, this provision is absent from the Senate Plan. The House Plan and Senate Plan tie the determination of E&P to the higher amount either on the date that the proposed legislation was introduced, or December 31, 2017.

The amount of the deduction with respect to the one-time inclusion depends on the amount of cash and cash equivalents held by the specified foreign corporations. Under the House Plan, after applying the deduction, taxpayers are subject to an effective tax rate of 14% on net undistributed foreign earnings up to the amount of the cash and cash equivalents held by the foreign corporations; and, a 7% effective tax rate would apply to net undistributed earnings in excess of the amount of cash and cash equivalents. In the Senate Plan, the 14% effective tax rate is replaced with a 10% effective tax rate, and the 7% effective tax rate is replaced with a 5% effective tax rate.

Eversheds Sutherland Observation: There are differences in the way that cash equivalents are determined under the House Plan and the Senate Plan, particularly with respect to the treatment of intercompany amounts, that may be significant to some taxpayers.

Foreign tax credits with respect to the deductible portion of the deemed inclusion are disallowed under both the House Plan and the Senate Plan. As to the taxable portion of the deemed inclusion, a proportionate amount of any foreign tax credits is allowed. The House Plan provides that the inclusion is disregarded for purposes of the overall foreign loss (OFL) recapture rules in section 904—meaning that taxpayers that have current year positive foreign source income generally should be able to claim foreign tax credits with respect to the inclusion even if they have an OFL account from prior years. However, an OFL in the year of the transition rule inclusion would preclude the taxpayer from claiming any foreign tax credits with respect to the deemed inclusion. The House Plan includes a special 20-year carryforward for excess foreign tax credits generated as a result of the deemed inclusion. By contrast, the Senate Plan allows taxpayers to elect to not apply net operating losses (NOLs) to offset the tax on the deemed inclusion, which may preserve the ability to claim foreign tax credits with respect to the deemed inclusion.

The Senate Plan also includes an anti-inversion provision, which requires a US corporation to pay the full 35% rate on the deferred foreign earnings for which a DRD was allowed under the transition tax if the US corporation inverts within 10 years after enactment. No foreign tax credits would be available to offset the tax.

In both the House Plan and the Senate Plan, the United States shareholder is permitted to pay the tax on the deemed inclusion over eight years. The House Plan provides for the payments in equal installments; the Senate Plan provides for the payment of 8% of the liability in each of the first five years, 15% in the sixth year, 20% in the seventh year, and 25% in the eighth year.

Protections Against Base Erosion

With the move toward a territorial system, the House Plan and the Senate Plan both propose significant changes to existing international tax rules that target base erosion. In other words, those provisions are intended to prevent US taxpayers from shifting profits to jurisdictions outside of the United States where the profits may be subject to little or no tax. Although the specifics of the House Plan and the Senate Plan differ, generally they would:

- Impose a minimum tax on the worldwide income of US multinationals;
- Limit the ability of US corporations to deduct interest expense on debt that is in excess of a proportionate share of worldwide debt; and
- Significantly limit the ability to claim US tax deductions for payments to related foreign persons.

In addition to proposals that target transactions that erode the US tax base, the Senate Plan includes provisions that encourage the transfer of non-US intangibles from CFCs to corporate United States shareholders, allowing foreign income attributable to such intangibles to be effectively taxed at a 12.5% rate.

Worldwide Minimum Tax

The House Plan and the Senate Plan include provisions that treat certain low-taxed income of CFCs as subject to current US tax similar to the current taxation of subpart F income. The specifics of each proposal are discussed in greater detail below.

The House Plan would subject 50% of a United States shareholder's foreign high return amount (FHRA) to current US tax, effectively subjecting such income to US federal income tax at a rate of 10%. The FHRA is (a) the excess (if any) of the United States shareholder's net CFC tested income, **over** (b) a routine return (7% plus the federal short-term rate) on the CFCs' aggregate adjusted bases in depreciable tangible property. The income subject to the tax is reduced by reference to a percentage of the combined depreciable tangible asset basis of the assets held by the CFCs, intended to reflect an ordinary return on such assets. The provision is applied to CFC income and assets in the aggregate, and then any inclusion is allocated among CFCs pursuant to specific allocation rules.

The provision treats the FHRA income as a separate basket for foreign tax credit purposes and allows a foreign tax credit for 80% of the foreign taxes paid related to such income (though only 50% of such foreign taxes are included as a gross-up). As a result, if the effective tax rate on the earnings of a United States shareholder's CFCs is at least 12.5% and the United States shareholder is able to fully utilize the related foreign tax credits, there would be no residual US tax on the FHRA inclusion, regardless of the CFCs' basis in tangible assets.

Eversheds Sutherland Observation: The operation of the foreign tax credit rules, and particularly the limitations in section 904, will be critical in determining the impact of FHRA on a taxpayer. For example, to the extent expenses of the US group are allocated to the FHRA basket under section 861, the ability to use the related foreign tax credits will be limited, and the FHRA provision will result in residual US tax regardless of the effective tax rate of the CFCs. Further, full expensing under the House Plan and the Senate Plan may result in NOLs for the years following enactment of the legislation. Under current rules, a United States shareholder with an NOL would not be entitled to use the foreign tax credits with respect to the FHRA, and those credits would not be carried forward. Thus, the income may be subject to tax at a much higher effective rate, taking into account the non-US tax on the income.

The Senate Plan includes a similar proposal that subjects the global intangible low-taxed income (GILTI) of CFCs to current US tax similar to the current taxation of subpart F income. Similar to the FHRA, the GILTI is subject to current US tax and the United States shareholder is permitted a 50% deduction, effectively subjecting the GILTI to US federal income tax at a rate of 10% for taxable years after 2018, when the 20% corporate tax rate applies. The GILTI is based on the combined earnings of CFCs in which a taxpayer is a United States shareholder. In order to increase the revenue effects from the proposal, for taxable years beginning after December 31, 2025, the deduction is reduced from 50% to 37.5% (the 50% rate applies for taxable years beginning after December 31, 2017). However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, the reduced deduction would be repealed effective for taxable years beginning after December 31, 2025 (i.e., the 37.5% rate would never take effect).

Similar to the FHRA, the GILTI is defined in the Senate Plan as (a) the excess (if any) of the United States shareholder’s net CFC tested income, over (b) a routine return (10%) on the CFCs’ aggregate adjusted bases in depreciable tangible property (based on the average quarter-end amounts). The GILTI is based on a net earnings calculation, taking into account the combined earnings of CFCs in which a taxpayer is a United States shareholder, similar to the FHRA. The income subject to the GILTI tax is reduced by 10% of the combined depreciable tangible asset basis of the assets held by the CFCs, intended to reflect an ordinary return on such assets. The base in the Senate Plan is fixed at 10% of the depreciable tangible asset basis, as compared to the House Plan under which the permissible return over the depreciable tangible asset base fluctuates with interest rates.

Eversheds Sutherland Observation: Several proposed amendments to the Senate Plan have suggested that additional revenue could be raised by modifying the GILTI rules to require the determination to be made on a country-by-country basis, rather than aggregating overall net earnings. An aggregation approach essentially averages the high and low or no-tax jurisdictions and permits opportunities to favorably affect the calculations. Although the details of any such proposals are uncertain, minimum tax provisions in prior legislation could be a model for such an approach.

The provision also treats GILTI inclusions as a separate basket for foreign tax credit purposes and, in the case of CFCs with positive net GILTI, allows a foreign tax credit for 80% of the foreign taxes paid related to such income (though only 50% of such foreign taxes are included as a section 78 gross-up after giving effect to the 50% deduction). As a result, similar to the FHRA, for taxable years beginning after 2018, if the effective tax rate on the earnings of a United States shareholder's CFCs with positive E&P is at least 12.5% and the United States shareholder is able to fully utilize the related foreign tax credits, there would be no residual US tax on the GILTI inclusion that is subject to tax in the United States, regardless of the CFCs' basis in tangible assets

Eversheds Sutherland Observation: Because the GILTI provision is effective for taxable years of foreign corporations beginning after 2017, and the reduction in the corporate tax rate is not effective until taxable years beginning after 2018, there would be one year where the GILTI provision applies at the current 35% corporate tax rate, meaning (subject to having sufficient tax basis in depreciable tangible assets to eliminate the GILTI inclusion) residual US tax would apply unless the effective tax rate on the earnings of a United States shareholder's CFCs with positive E&P is at least 21.875%.

Eversheds Sutherland Observation: Similar to the point made above with respect to FHRA, for taxpayers that have significant expenses allocated to the GILTI basket, OFLs or overall domestic losses and, as a result, are not able to fully utilize available foreign tax credits with respect to GILTI inclusions, the worldwide effective rate of tax on this income could be substantially in excess of 20% unless changes are made to NOL, OFL and separate limitation rules.

Deductible Payments to Related Foreign Persons

In addition to imposing a minimum tax on income earned by a United States shareholder's CFCs, the Senate Plan and the House Plan both put severe limitations on the ability of a domestic corporation to effectively claim a deduction for payments to a related foreign person. The House Plan achieves this result through a 20% excise tax on deductible payments to related foreign corporations; the Senate Plan's base erosion and anti-abuse tax (BEAT) imposes a 10% minimum tax on a taxpayer's income calculated by adding back certain payments to related foreign persons. Each is described in more detail below.

The House Plan imposes a 20% excise tax on the gross amount of certain payments by US corporations to related foreign corporations, if the average aggregate annual amount of such payments for the group exceeds $100 million. The tax generally applies to deductible payments and payments that are included in costs of goods sold, inventory, or the basis of a depreciable or amortizable asset. Excluded from the calculation are interest (which is subject to other limitations discussed below), purchases of commodities, fixed and determinable amounts (such as royalties or rents) that are otherwise subject to tax under section 881(a) unless subject to a reduced rate under an income tax treaty, and services payments with no mark-up under the section 482 services cost method.

Eversheds Sutherland Observation: The exception for payments for which there is no mark-up is unlikely to apply in many cases because the section 482 services cost method is generally limited to back-office-type support services and, in any event, the country in which the related foreign person is organized may require such a mark-up under its transfer pricing laws.

The excise tax also does not apply to payments to related foreign persons that are effectively connected with the recipient's conduct of a US trade or business (ECI). The proposal would allow a foreign corporation to elect to treat specified payments received from a related domestic corporation as ECI attributable to a deemed US permanent establishment, and thereby subject the payments to US tax. If a foreign corporation elects to treat the payments as ECI, the foreign corporation is not permitted to deduct its actual expenses, and the rules instead allow a deduction with respect to deemed expenses based on the worldwide non-US margins for the product line to which the payment relates, as determined based on the group's worldwide consolidated financial statements. If the ECI election is made, a credit is permitted for foreign taxes deemed paid with respect to the income, but the credit is limited to 80% of the amount of taxes paid or accrued.

Eversheds Sutherland Observation: Because the ECI election does not take into account actual expenses, under the excise tax proposal some United States shareholders may consider electing to treat their foreign subsidiaries as branches, such that the income and expense of the foreign subsidiary is taken into account directly in the US tax return of the United States shareholder.

Eversheds Sutherland Observation: Because the election deems the foreign subsidiary to have a US permanent establishment, this may raise questions under US income tax treaties.

The Senate Plan eschews the excise tax approach in favor of the BEAT, which imposes a 10% minimum tax on a taxpayer's income calculated by adding back certain deductions attributable to payments to related foreign persons. The 10% tax on the taxpayer's taxable income without such deductions is compared to the regular tax liability on the taxpayer's taxable income with the deductions, reduced by credits other than the research credit (so as to provide the benefit of the research credit, but not other credits, against the minimum tax). For taxable years beginning after December 31, 2025, a 12.5% rate would apply rather than the 10% rate, and no reduction of the minimum tax by the research credit would be permitted; however, if the cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, these changes would not take effect.

Base erosion payments are generally amounts paid by a taxpayer to a related foreign person that are deductible by the taxpayer or create depreciable or amortizable asset basis. The related deductions are disallowed for purposes of calculating the BEAT, such that if a taxpayer purchases an amortizable or depreciable asset from a related foreign person, the annual amortization deduction would be added back for purposes of calculating the BEAT. Cost of goods sold is generally not subject to the BEAT, because it is a reduction in gross income rather than a deduction. However, for inverted corporations, base erosion payments also include payments to a surrogate foreign corporation (but only if such person first became a surrogate foreign corporation after November 9, 2017) or other related foreign corporations that reduce gross receipts.

This provision would apply to US corporations (other than regulated investment companies, real estate investment trusts or S corporations), which have average annual gross receipts of at least $500 million for the three preceding taxable years and which have a base erosion percentage (generally, deductible payments to foreign affiliates over total deductions) of 4% or higher for the taxable year.

Eversheds Sutherland Observation: Although similar in their intended effect, the BEAT and the excise tax can have differing impacts. The BEAT is limited to the taxpayer's taxable income, so if the taxpayer does not have taxable income taking into account the deductible payments to related foreign persons, no additional tax is due (although, a portion of any carryforward NOL may be subject to the BEAT). Additionally, if the payments to related foreign persons are not material compared to the taxpayer's total deductions, the BEAT generally will not apply to the taxpayer. The excise tax, on the other hand, results in additional US tax liability regardless of the net income or the other expenses of the US corporation.

Limitations on the Deduction for Interest Expense

Both the House Plan and the Senate Plan modify the existing rules in section 163(j) that limit deductions for interest expense paid to related persons. In each plan, the current provisions are replaced with a general limitation applicable to all business interest expense paid by a US taxpayer. The House Plan limits deductible net business interest expense to 30% of the taxpayer's earnings before interest, taxes, depreciation and amortization (EBITDA). The Senate Plan applies the same net interest limitation, but excludes any domestic production activities deduction under section 199 (generally relevant for one taxable year before the repeal of section 199 is effective under the Senate Plan) and does not exclude depreciation and amortization. Thus, under the Senate Plan, taxpayers that have any depreciation or amortization expense will have a lower threshold for deductibility of interest. This provision would not apply to certain regulated public utilities or real property trades or businesses. Any disallowed interest expense may be carried forward for five years under the House Plan or indefinitely under the Senate Plan.

Eversheds Sutherland Observation: Because the Senate Plan takes into account depreciation and amortization in determining the 30% threshold, the inclusion of full expensing for capital expenditures in the initial years of the plan can have a material impact on the amount of interest that can be deducted by a US taxpayer. It is important to consider the interaction of all of the tax reform proposals in determining their potential impact.

In addition to the expanded interest expense limitations under section 163(j), the House Plan and the Senate Plan each impose a further limitation on deductions for interest paid by US corporations that are part of a multinational group of corporations. Both plans impose limits based on the leverage of the US taxpayer relative to the leverage of the worldwide group, but they differ as to their basis for comparison.

The House Plan disallows the deduction of interest expense of a US corporation to the extent it exceeds 110% of the corporation's share of the group's net interest expense. The US corporation's share is its proportionate amount of the group's net interest expense based on the EBITDA of the US corporation, versus the worldwide group, and is based on the financial reporting for the group.

Eversheds Sutherland Observation: Differences in the treatment of debt for book versus tax purposes would be important in determining the interest expense limitation. For example, rent paid in leasing transactions may or may not affect EBITDA based on the treatment of the transactions for book purposes, but may give rise to interest expense for tax purposes to the extent treated as financings. In addition, amortization and depreciation rules for accounting and tax frequently diverge. Understanding the differences may be significant in determining the impact of this provision on a US taxpayer.

The House Plan's EBITDA-based limitation is imposed in addition to the 30% limitation discussed above, with taxpayers only being allowed to deduct the interest expense allowed under the more restrictive of the two limitations as applied to them. Interest expense disallowed under either provision may be carried forward for up to five years.

The Senate Plan imposes a similar limitation, but requires a comparison based on the debt-to-equity ratio of the US taxpayer relative to the debt-to-equity ratio of the worldwide group. Specifically, under the Senate Plan, interest expense is limited to the extent that indebtedness of the US members of the worldwide group exceeds 110% of the amount that the indebtedness of the US members of the worldwide group would be if the ratio of such indebtedness to the US members' "total equity" was proportionate to the ratio of the worldwide group's total indebtedness to its total equity. Total equity means the excess of money and other assets over indebtedness. In determining total equity, the amount taken into account is the corporation's basis in its assets, and intragroup debt (with respect to the US group or the worldwide group, as relevant) and equity of members of the worldwide group are disregarded. In determining the debt-to-equity ratio, an asset's adjusted basis is used.

Eversheds Sutherland Observation: Because the Senate Plan uses tax basis in determining the debt-to-equity ratio, many taxpayers could see their US interest expense fully disallowed under this provision.

Similar to the House Plan's approach, the Senate Plan's debt-to-equity-based limitation is imposed in addition to the 30% limitation discussed above, with taxpayers only being allowed to deduct the interest expense allowed under the more restrictive of the two limitations as applied to them. Any interest expense disallowed under either provision may be carried forward indefinitely.

Additional International Proposals

Foreign-Derived Intangible Income

The Senate Plan includes a provision that would subject foreign-derived intangible income (FDII) to current US tax at an effective rate of 12.5% for taxable years beginning after 2018 (and 21.875% for 2018) by allowing a current deduction for 37.5% of FDII up to the total taxable income of the US taxpayer. The aggregate deduction for FDII and GILTI is limited to total taxable income calculated without respect to such deductions, so the deduction for FDII and GILTI cannot contribute to an NOL that may carry forward.

FDII is generally equal to all income earned in the United States in excess of a deemed ordinary return on tangible assets multiplied by the fraction of income earned in the United States that is attributable to property sold to a non-US person for foreign use or to services provided outside the United States. For this purpose "sold" encompasses any lease, license, exchange or other disposition. Special rules are provided to address sales or services provided to related parties or to domestic intermediaries.

For taxable years beginning after December 31, 2025, the deduction for FDII is reduced from 37.5% to 21.875%. However, if cumulative aggregate on-budget federal revenue from all sources for the period beginning October 1, 2017, and ending September 30, 2026, exceeds certain thresholds, the reduced deduction would be repealed effective for taxable years beginning after December 31, 2025 (i.e., the 21.875% rate would never take effect given its effective date).

Eversheds Sutherland Observation: Combined with the GILTI provisions and the proposal that would permit US taxpayers to cause CFCs to distribute intangible assets to the United States without US tax, the FDII may provide incentives for US taxpayers that hold intangible assets offshore to repatriate those assets, subject to the potential foreign tax cost of such a transfer.

Expanded Ownership Attribution

Both the House Plan and the Senate Plan would expand current constructive ownership rules to include "downward attribution" from a foreign person to a related person for purposes of applying the subpart F rules. The practical effect is to cause all foreign subsidiaries (but not a foreign parent) in a multinational group that includes a US corporation to be treated as CFCs for US tax purposes. Unless the US member of the multinational group has a direct or indirect (rather than constructive) interest in the foreign corporation, the US member generally would not be required to include any income of such CFCs as subpart F income as a result of this expanded constructive ownership.

Eversheds Sutherland Observation: The expansion of the attribution rules will require the filing of Forms 5471 with respect to all entities in a multinational group (excluding a foreign parent) that includes a US corporation. This could be a substantial compliance burden on multinational groups that include US corporate subsidiaries.

The Senate Plan also expands the current United States shareholder definition to include a 10% interest in the value of a foreign corporation (currently, the rules require a 10% voting interest). This change increases the number of corporations that can be treated as CFCs, and could cause some corporations that are not currently CFCs to be treated as CFCs going forward. It also expands the number of foreign corporations that must be considered for purposes of determining the one-time inclusion of deferred foreign earnings discussed above. This provision in the Senate Plan is effective for the last taxable year of foreign corporations beginning before January 1, 2018.

Related-Party Look-Through Rules

Both the House Plan and the Senate Plan make permanent the related-party look-through rules for dividends, interest and royalties between CFCs. This change is in line with the move toward a territorial system, such that first-tier CFCs could then distribute dividends to US corporate shareholders that may be eligible for the 100% DRD.

Elimination of the 30-Day Rule

Both the House Plan and the Senate Plan eliminate the so-called “30-Day Rule” pursuant to which a United States shareholder includes any subpart F income in its gross income only if the foreign corporation was a CFC for an uninterrupted period of 30 days or more during its taxable year. The elimination of this provision will foreclose certain planning opportunities that US multinationals have used to minimize the potential impact of subpart F, particularly in connection with acquisitions of foreign corporations that were not previously subject to US tax.

Repeal of Indirect Foreign Tax Credit Rules

Both the House Plan and the Senate Plan call for the repeal of section 902 indirect foreign tax credits, in line with the shift toward a territorial system, and the elimination of the related E&P and foreign tax credit pooling rules. As a result, foreign tax credits related to inclusions of subpart F income, FHRA income or GILTI are based on the foreign taxes paid by the relevant foreign corporation in the year of the inclusion that are related to the included income.

<u>Next Steps</u>

Republicans aim to pass a tax bill by the end of the year. The House passed the House Plan on November 16, 2017. The Senate Finance Committee passed the Senate Plan on a party-line vote on November 16, 2017, and the Senate Plan is expected to be considered by the Senate the week of November 27, 2017. If the Senate passes a bill, a conference would take place between the House and the Senate in order to agree on a single piece of legislation, unless the House were to pass the same bill. Once legislation has been agreed upon and passed by the House and the Senate, it would then be sent to the President for his signature.

Notably, Republicans have chosen to advance the Senate Plan under the budget reconciliation process, which permits certain legislation to be passed in the Senate without the possibility of a filibuster (meaning it can be passed with 50 rather than 60 votes). Under the Senate's Byrd rule, legislation passed this way can only make changes outside the 10-year budget window (i.e., be permanent, as opposed to sunsetting) if the legislation is not projected to increase the federal deficit outside of the 10-year budget window. It is not yet clear what total impact the Byrd rule will have on the Senate Plan, but many of the modifications made during the Senate Finance Committee mark-up appear to have been driven by budgetary considerations. Given the extensive changes contemplated by the Senate Plan (and the parallel House Plan), individuals and businesses will need to carefully follow and consider the potential impact of proposed tax reform.

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