



All information contained herein is current as of February 6, 2018. For continued guidance and observations regarding the new tax law, read *TaxNewsFlash*.

# New Tax Law: International Provisions and Observations

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In the context of international tax, the Public Law 115-97 (popularly, if not officially, referred to as the “Tax Cuts and Jobs Act”) substantially eliminates any element of deferred taxation of foreign income within a U.S.-parented multinational group—generally income is taxed as earned, or is permanently exempt from U.S. taxation. Despite allowing permanent exemption for a residual class of income, the new law generally retains subpart F to provide full and immediate taxation of the classes of income that are captured by pre-enactment law, and furthermore subjects a new, very broad, class of income (“global intangible low-taxed income” or “GILTI”) to immediate taxation at a reduced rate. The new law does, however, also grant the benefit of a reduced rate to a new class of income earned directly by a U.S. corporation (“foreign-derived intangible income” or “FDII”). As a transition from the former deferral regime to these new rules, existing untaxed earnings of “specified foreign corporations” are deemed repatriated and taxed at a reduced rate that depends upon the extent to which the earnings are matched by cash held offshore.

The new law also contains provisions intended to curtail base erosion. Interest expense is limited to 30% of adjusted taxable income (a measure which initially tracks to EBITDA but transitions to a more stringent standard of EBIT), and deductions are disallowed for transactions involving related parties and hybrid instruments or transactions. The new law also adopts (with modifications) a novel new alternative minimum tax focused on deductible payments made by U.S. persons to related foreign persons (the “Base Erosion and Anti-Abuse Tax” or “BEAT”).

Certainly, the sum total of these changes represents a significant expansion of the base of cross-border income to which current U.S. taxation applies.

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## Establishment of participation exemption system for taxation of foreign income

### Add U.S. participation exemption

The new law adds a new Code section 245A that allows a domestic corporation that is a U.S. shareholder (as defined in section 951(b)) of a specified 10% foreign corporation a 100% dividends received deduction (DRD) for the foreign-source portion of dividends received from the foreign corporation (a 100% DRD). The 100% DRD is available only to domestic C corporations that are neither real estate investment trusts nor regulated investment companies.

For the purposes of new section 245A, the term “specified 10% foreign corporation” is defined as any foreign corporation with respect to which any domestic corporation owns at least 10%. Passive foreign investment companies (PFICs), however, are specifically excluded from the definition; thus dividends from PFICs do not qualify for the 100% DRD.

The foreign-source portion of a dividend equals the same proportion of the dividend as the foreign corporation’s undistributed foreign earnings bears to its total undistributed earnings. A foreign corporation’s undistributed foreign earnings consists of all undistributed earnings except for income effectively connected with the conduct of a trade or business in the United States and dividend income received from an 80%-owned domestic corporation. Total undistributed earnings include all earnings without reduction for any dividends distributed during the tax year.

The new law provides that a DRD is not available for any hybrid dividend, which is generally defined as an amount received from a controlled foreign corporation (CFC) for which the foreign corporation received a deduction or other tax benefit related to taxes imposed by a foreign country. Additionally, to the extent a domestic corporation is a U.S. shareholder with respect to tiered CFCs, a hybrid dividend paid from a lower-tier CFC to an upper-tier CFC is treated as subpart F income to the upper-tier CFC, and the U.S. shareholder is required to include in gross income an amount equal to the shareholder’s pro rata share of subpart F income.

A corporate U.S. shareholder may not claim a foreign tax credit (FTC) or deduction for foreign taxes paid or accrued with respect to any dividend allowed a 100% DRD. Additionally, for purposes of calculating a corporate U.S. shareholder’s Code section 904(a) FTC limitation, the shareholder’s foreign source income does not include (i) the entire foreign source portion of the dividend, and (ii) any deductions allocable to a 100% DRD (or stock that gives rise to a 100% DRD).

In addition to owning 10% of the voting power of the foreign corporation, a domestic corporation needs to satisfy a holding period requirement. Specifically, a domestic corporation is not permitted a 100% DRD with respect to a dividend paid on any share of stock that is held for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the dividend is paid. Additionally, the foreign corporation must qualify as a specified 10% foreign corporation and the

domestic corporation must likewise qualify as a 10% shareholder at all times during the period.

The 100% DRD provision applies to distributions made after December 31, 2017 and is expected to reduce revenues by approximately \$223.6 billion over 10 years.

#### **KPMG observation**

The 100% participation exemption system moves the United States away from a worldwide tax system in the direction of a territorial tax system for earnings of foreign corporations, but only to the extent those earnings are neither subpart F income, nor subject to the minimum tax rule discussed below. The participation exemption provision largely follows the participation exemption proposal in the House bill, which in turn was modeled after a 2014 tax reform discussion draft introduced by the then-chairman of the Ways and Means Committee. For corporations earning only foreign source income, the mechanics of the new participation exemption are largely irrelevant.

The explanatory statement indicates that the term “dividend received” should be interpreted broadly. As an example, the explanatory statement describes a domestic corporation that indirectly owns stock of a foreign corporation through a foreign partnership. According to the example, the domestic corporation will be allowed a participation DRD with respect to its distributive share of the partnership’s dividend from the foreign corporation if the domestic corporation would qualify for the 100% DRD with respect to dividends from the foreign corporation if the domestic corporation had owned the stock directly.

#### **Add special rules relating to sales or transfers involving specified 10% owned foreign corporations**

The new law allows certain deemed dividends under Code section 1248 to qualify for a 100% DRD. Specifically, if a domestic corporation has gain from the sale or exchange of stock of a foreign corporation that it has held for at least one year, any amount that is treated as a dividend under Code section 1248 is eligible for the 100% DRD. The provision also includes special subpart F inclusion rules that allow a U.S. shareholder a 100% DRD with respect to gain on the sale of foreign stock by a CFC that is treated under section 964(e) as a dividend to the selling CFC.

The new law provides two loss limitation rules. First, it provides that if a U.S. shareholder that is a domestic corporation has received a dividend from a foreign corporation that is allowed a 100% DRD, solely for the purposes of determining the domestic corporation’s loss on the sale of stock of the foreign corporation, the domestic corporation reduces its basis in the stock of the foreign corporation by an amount equal to the 100% DRD.

Second, the new law requires domestic corporations to recapture foreign branch losses in certain foreign branch transfer transactions. If a domestic corporation transfers substantially all the assets of a foreign branch (within the meaning of Code section 367(a)(3)(C)) to a 10%-owned foreign corporation of which it is a United States shareholder after the transfer, the domestic corporation must include in gross income the “transferred loss amount” (TLA) with respect to such transfer.

The TLA is defined as the excess (if any) of:

- The sum of losses incurred by the foreign branch and allowed as a deduction to the domestic corporation after December 31, 2017, and before the transfer, over
- The sum of (1) any taxable income of such branch for a tax year after the tax year in which the loss was incurred, through the tax year of the transfer, and (2) any amount recognized under the section 904(f)(3) “overall foreign loss recapture” (OFLR) provisions on account of the transfer.

The amount of the domestic corporation’s income inclusion under this provision would be reduced by all gains recognized on the transfer, except gains attributable to “branch loss recapture” under section 367(a)(3)(C).

Lastly, the new law repeals the active trade or business exception of section 367(a)(3) for transfers made after December 31, 2017.

The provision requiring basis adjustments to a foreign corporation’s stock applies to distributions made after December 31, 2017.

The provisions relating to section 91 inclusions are effective for transfers made after December 31, 2017.

The combined provisions are expected to increase revenues by approximately \$11.8 billion over 10 years.

#### **KPMG observation**

The new law is similar to provisions in the House and Senate bills, with two important exceptions. First, the new law follows the Senate bill in repealing the section 367(a)(3) active trade or business exception; the House bill contained no such provision. The repeal of the section 367(a)(3) active trade or business exception is consistent with the Senate bill’s theme of disfavoring the use of foreign branches.

Second, the 2014 reform proposal and the Senate bill would have limited section 91 inclusions to the section 245A DRD amount, with the excess amount carried forward subject to the same section 245A limitation. The new law does not include this limitation.

Unfortunately, like the House and Senate proposals, the new law fails to provide clear rules for coordinating section 91 inclusions with dual consolidated loss recapture, thus creating uncertainty with respect inclusions attributable to these potentially overlapping regimes.

#### **Mandatory repatriation**

The new law includes a transition rule to effect the participation exemption regime. This transition rule provides that the subpart F income of a specified foreign corporation (SFC) for its last tax year beginning before January 1, 2018, is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of November 2 or December 31, 2017 (a measuring date). A taxpayer generally includes in its gross income its pro rata share of the deferred income of each SFC with respect to which the taxpayer is a U.S. shareholder, which will be computed on a



consolidated basis pursuant to Notice 2018-07. This mandatory inclusion, however, is reduced (but not below zero) by an allocable portion of the taxpayer's share of the foreign E&P deficit of each SFC with respect to which it is a U.S. shareholder and the taxpayer's share of its affiliated group's aggregate unused E&P deficit.

The transition rule includes a participation exemption, the net effect of which is to tax a U.S. shareholder's mandatory inclusion at a 15.5% rate to the extent it is attributable to the shareholder's aggregate foreign cash position and at an 8% rate otherwise.

#### **KPMG observation**

The new law includes two measuring dates for determining an SFC's deferred income. The new law's November 2 measuring date adds complexity to the transition rule because it requires each SFC to calculate its deferred income on a date that is not likely to coincide with regular reporting cycles. Additionally, the inclusion of the December 31 measuring date requires SFCs to compute their deferred income twice because the E&P taken into account under the transition rule is the greater amount.

#### *SFC and U.S. shareholder definitions*

An SFC is a foreign corporation that is a controlled foreign corporation (CFC) or foreign corporation that has at least one domestic corporate U.S. shareholder. The new law revises the definition of "U.S. shareholder" in section 951(b) to include any U.S. person that owns at least 10% of the vote or value of a foreign corporation. However, this change is made effective for tax years of foreign corporations beginning after December 31, 2017, and thus, does not apply for purposes of the new law's transition rule.

The new law removes section 958(b)(4) for the last tax year of foreign corporations beginning before January 1, 2018 and all subsequent tax years and for the tax years of a U.S. shareholder with or within which such tax years end. Thus, "downward attribution" of stock ownership from foreign persons is taken into account for purposes of determining whether a U.S. person is a U.S. shareholder of a foreign corporation for purposes of the new law's transition rule.

#### **KPMG observation**

A "U.S. shareholder" includes domestic corporations, partnerships, trusts, estates, and U.S. individuals that directly, indirectly, or constructively own 10% or more of an SFC's voting power. As a result, noncorporate U.S. shareholders are exposed to inclusions under the new law's transition rule if the SFC is a controlled foreign corporation or any foreign corporation with at least one domestic corporate U.S. shareholder, even though the participation exemption regime for dividends from foreign subsidiaries in the new law only applies to corporate U.S. shareholders.

The new law's repeal of section 958(b)(4) applies for purposes of determining whether a foreign corporation is an SFC and also for purposes of determining whether a U.S. person is a U.S. shareholder. For example, if a domestic corporation owns 9% of a foreign affiliate, and the remaining 91% of the foreign affiliate is owned by the domestic corporation's foreign parent, the foreign affiliate is an SFC and the domestic corporation is a U.S. shareholder of the affiliate. Therefore, the domestic corporation would have to include its pro rata share of the foreign affiliate's deferred income, although the amount



of the domestic corporation's mandatory inclusion would be based solely on its direct and indirect ownership (here, 9%) of the foreign affiliate and only take into account E&P accrued during periods the foreign affiliate was an SFC. Also, foreign income taxes paid or accrued by the foreign affiliate are not attributed to the domestic corporation's mandatory inclusion because the domestic corporation does not own at least 10% of the foreign affiliate's voting stock. These consequences could affect the domestic corporation's estimated tax liability.

#### *Deferred income and E&P deficits*

Deferred income is an SFC's E&P accumulated in tax years beginning after December 31, 1986, for the periods in which the corporation was an SFC, determined as of the measuring date (i.e., November 2 or December 31, 2017) and that are not attributable to effectively connected income that is subject to U.S. tax or amounts that if distributed would be excluded from a U.S. shareholder's gross income under the section 959 previously taxed income (PTI) rules (either previously or in the tax year to which the transition rule applies) (post-1986 E&P). For these purposes, an SFC's post-1986 E&P are not reduced for dividends during the mandatory repatriation year, other than dividends distributed to another SFC.

A U.S. shareholder can reduce, but not below zero, its pro rata share of an SFC's post-1986 E&P by an allocable portion of the shareholder's pro rata share of its SFCs' post-1986 E&P deficits (aggregate E&P deficit); the new law clarifies that hovering deficits are included for these purposes. A U.S. shareholder allocates its aggregate E&P deficit to its SFCs with positive post-1986 E&P in proportion to the amount of their post-1986 E&P. The post-1986 E&P of an SFC that is reduced by an allocable portion of a U.S. shareholder's aggregate E&P deficit is treated as PTI beginning with the SFC's last tax year that begins before January 1, 2018. Additionally, if an SFC's post-1986 E&P deficit is used to offset another SFC's post-1986 E&P, the E&P of the SFC with the post-1986 E&P deficit is increased, for tax years beginning with the SFC's last tax year that begins before January 1, 2018, by the amount of the offset.

After allocating its aggregate E&P deficit, a U.S. shareholder that would otherwise have deferred income (i.e., the aggregate of the U.S. shareholder's pro rata share of its SFCs' post-1986 E&P exceeds its aggregate E&P deficit) can reduce its deferred income by its share of its affiliated group's aggregate unused E&P deficit. An affiliated group's "aggregate unused E&P deficit" is the sum of each group member's "unused E&P deficit," which generally is the amount by which a group member's aggregate foreign E&P deficit exceeds the aggregate of its pro rata share of its SFCs' post-1986 E&P. An affiliated group's aggregate unused E&P deficit is allocated to each group member based on the relative amount of each member's deferred income. Note that these rules which mandate netting first within a chain owned by a single shareholder and then across to chains owned by other members of an affiliated group appear to be changed within consolidation by the rule announced in Notice 2018-07 that would treat all members of the consolidated group as a single U.S. shareholder. The transition rule includes a rule that adjusts the application of these affiliated group "netting" rules to group members that are not wholly owned (measured by value) within the group.

The new law provides a special rule for REITs that excludes deferred foreign income from a REIT's gross income for purposes of the 95% and 75% gross income tests of section 856(c). Additional details with respect to this provision can be found in the REIT discussion in this report.

#### **KPMG observation**

The new law requires computation of post-1986 E&P without regard to certain current year dividends. In particular, it is clear that dividends paid by an SFC to its U.S. shareholders during the mandatory repatriation year fail to reduce the E&P available for mandatory repatriation (although such E&P may be converted to PTI and thus not taxed upon receipt).

The new law's definition of post-1986 E&P only includes E&P of a foreign corporation accumulated during periods when the foreign corporation was an SFC. The new law does not, however, define post-1986 E&P by reference to the period that a U.S. shareholder has directly or indirectly owned an SFC. Thus, it appears that a U.S. shareholder must include its pro rata share of an SFC's post-1986 E&P that accumulated during periods the foreign corporation was an SFC as a result of another U.S. shareholder's ownership.

The new law recognizes that basis adjustments to the stock of SFCs may be necessary to account for a U.S. shareholder's inclusion of deferred income or such shareholder's use of a SFC's deficit to offset deferred income. The new law anticipates that the Treasury will issue regulations that will address the timing of adjustments to the basis of the stock of SFCs. These anticipated regulations would appear to be aimed at alleviating the potential for gain recognition on the distribution of amounts treated as PTI as a result of the transition rule. The new law also anticipates regulations that will reduce the basis of SFCs with deficits.

#### *Participation exemption*

Under the new law's participation exemption, a U.S. shareholder is taxed at reduced rates on its mandatory inclusion. The portion of the inclusion attributable to the U.S. shareholder's aggregate foreign cash position is taxed at 15.5% and the remaining portion is taxed at 8%. The participation exemption uses a deduction to achieve these reduced rates. The amount of a U.S. shareholder's deduction is the sum of the amounts necessary to tax its mandatory inclusion attributable to its aggregate foreign cash position at 15.5% and the remaining portion at 8% using the highest corporate tax rate in effect for the year of the inclusion.

A U.S. shareholder's "aggregate foreign cash position" is the greater of: (i) the aggregate of its pro rata share of its SFCs' cash positions as of the close of their last tax year beginning before January 1, 2018; or (ii) one half of the aggregate of its pro rata share its SFCs' cash positions as of the close of their last two tax years ending before November 2, 2017. An SFC's "cash position" generally is the sum of its cash, net accounts receivable, and fair market value of certain other liquid assets (e.g., actively traded personal property, commercial paper, certificates of deposit, government securities, short-term obligations, and foreign currency). In Notice 2018-07, the IRS clarified that accounts receivable or payable and short term obligations between related

SFCs will be disregarded to the extent that the SFCs share common ownership under a U.S. shareholder (thus following the consolidation regime). The Notice also notes that certain financial instruments and derivatives (e.g., notional principal contracts, options, forwards, etc.) will be identified as cash equivalents in forthcoming regulations but that such regulations will include exceptions for “bona fide hedging transactions.”

The new law includes a “double counting” rule that prevents a U.S. shareholder from taking into account the cash position of an SFC attributable to the SFC’s net accounts receivable, actively traded personal property, or short-term obligations, if the U.S. shareholder demonstrates to the satisfaction of the Secretary that it takes into account such amount with respect to another SFC. Noncorporate entities are treated as SFCs for purposes of determining a U.S. shareholder’s aggregate foreign cash position if an SFC owns an interest in the entity and the entity would be treated as an SFC of the U.S. shareholder if it was a foreign corporation. The determination of a U.S. shareholder’s aggregate foreign cash position is subject to an anti-abuse rule. Notice 2018-07 sets forth a series of examples that highlight the types of transactions resulting in double-counting or double non-counting that will be mitigated through forthcoming regulations.

#### **KPMG observation**

The new law ties the calculation of its deduction to the corporate income tax rate, even though its deduction applies to corporate and noncorporate U.S. shareholders. It is possible that section 962 may be elected by individual U.S. shareholders to mitigate this negative impact.

As noted above, amounts included by U.S. shareholders under the transition rule and post-1986 E&P of SFCs that are reduced by deficits are treated as PTI for purposes of section 959. Foreign currency movements between the date PTI is created and the date of distribution may generate foreign currency gains and losses under section 986(c). The explanatory statement accompanying the conference agreement anticipates that the Treasury will provide regulations that will allow a similar participation exemption to reduce the amount of such gain or loss.

The new law provides a list of assets that are considered to be included in the U.S. shareholder’s cash position. The new law does not provide that “blocked” assets (i.e., those that cannot be distributed under local law) are excluded from a U.S. shareholder’s cash position.

The new law’s double counting rule limits, but does not eliminate, the potential for the cash positions of a U.S. shareholder’s SFCs to be double counted. For example, the new law’s double counting rule does not appear to apply to short-term obligations between SFCs with different U.S. shareholders. Also, if a calendar-year-end U.S. shareholder has a calendar-year-end SFC and a fiscal-year-end SFC, it appears that the U.S. shareholder’s aggregate foreign cash position applies to the deferred income of both SFCs. Specifically, the U.S. shareholder determines its aggregate foreign cash position once, notwithstanding that it includes the deferred income of its calendar-year-end SFC in its tax year ending December 31, 2017, and the deferred income of its fiscal-year-end SFC in its tax year ending December 31, 2018. That is, it appears that for purposes of determining the rate at which its fiscal-year-end SFC’s deferred income is taxed, the U.S. shareholder’s aggregate foreign cash position is not reduced for the

amount of its calendar-year-end SFC's deferred income that was already attributed to its aggregate foreign cash position. Notice 2018-07 provides a method to mitigate double counting of the aggregate cash position when a U.S. shareholder holds interests in SFCs with respect to which the section 965 inclusion will occur in different taxable years (e.g., a calendar year U.S. shareholder owning both 11/30 and 12/31 year-end CFCs). Specifically, the aggregate foreign cash position that is taken into account in the inclusion year will be the lesser of the U.S. shareholder's aggregate foreign cash position in or aggregate section 965(a) inclusion in that taxable year. Further, in determining a U.S. shareholder's aggregate cash position, any amount taken into account in a subsequent taxable year will be reduced by the amount taken into account in the preceding taxable year.

### *Foreign tax credits*

The new law allows the use of foreign income taxes associated with the taxable portion of the mandatory inclusion. Foreign tax credits are disallowed to the extent that they are attributable to the portion of the mandatory inclusion excluded from taxable income pursuant to the participation deduction (55.7% of the foreign taxes paid attributable to the cash portion of the inclusion taxed at 15.5%; 77.14% of the foreign taxes paid attributable to the noncash portion of the inclusion taxed at 8%). Foreign tax credits disallowed may not be taken as a deduction. The U.S. shareholder's section 78 gross-up is equal to the portion of the foreign taxes attributable to the U.S. shareholder's net mandatory inclusion (i.e., the foreign taxes attributable to the gross mandatory inclusion less such taxes attributable to the participation deduction).

### **KPMG observation**

The new law allows foreign income taxes associated with the taxable portion of a U.S. shareholder's mandatory inclusion to offset the U.S. tax on such amount. The new law "haircuts" the foreign tax credits associated with a U.S. shareholder's mandatory inclusion by 55.7% for foreign income taxes associated with the portion of the inclusion attributable to the shareholder's aggregate foreign cash position and 77.1% for foreign income taxes associated with the other portion of the inclusion. These percentages are equal to the amount of the U.S. shareholder's mandatory inclusion that is offset by the participation exemption that is calculated using a corporate tax rate of 35%. As noted above, the amount of the participation exemption may be reduced to the extent that the corporate tax rate is 21% for the tax year of the mandatory inclusion; however, the amount of disallowed FTCs does not appear to be similarly adjusted. Additionally, a U.S. shareholder's section 78 gross-up appears to exceed the amount of foreign taxes allowed as a credit when the corporate tax rate is 21% because, although the amount of the haircut remains unchanged, the amount of foreign taxes attributable to the U.S. shareholder's net mandatory inclusion would increase due to a reduction in the amount of the participation exemption. As a result, it appears that the net impact on US tax liability ought to be the same whether an amount is included in income during 2017 or during 2018.

The new law does not address the use of foreign tax credit carryforwards to offset a U.S. shareholder's mandatory inclusion or the carryforward of foreign tax credits not used in the tax year in which a U.S. shareholder takes into account its mandatory

inclusion. Thus, it appears that the current rules regarding foreign tax credit carryforwards apply to the transition rule. As a result, it appears that a U.S. shareholder can use existing foreign tax credit carryforwards against its mandatory inclusion and the foreign tax credit carryforward period remains 10 years.

#### *Overall foreign loss recapture*

The conference report did not discuss the impact of the mandatory inclusion on a U.S. shareholder's overall foreign loss (OFL) or separate limitation losses (SLLs).

#### *Net operating loss election*

The new law allows taxpayers to elect out of using net operating losses (NOLs) to offset the mandatory inclusion from the bill's transition rules. This rule allows taxpayers to avoid reducing their foreign source income from the mandatory inclusion to preserve the use of foreign tax credits in such year and it allows taxpayers to preserve their NOLs for future use.

#### *Payment*

The new law provides that the tax assessed on a U.S. shareholder's mandatory inclusion is payable in the same manner as its other U.S. federal income taxes and that such tax assessed may be paid over an eight-year period. The new law requires that 8% of the tax be paid in each of the first five years, 15% in the sixth year, 20% in the seventh year, and 25% in the eighth year. Only the U.S. federal income tax due on the mandatory inclusion is eligible to be paid in installments. The new law would accelerate the payment of the tax upon the occurrence of certain "triggering events," which include an addition to tax for failure to timely pay any installment due, a liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 case), or a cessation of business by the taxpayer to the date of such triggering event. The new law does not provide for any exceptions to acceleration.

The new law allows REITs to distribute their deferred foreign income to their shareholders over an eight-year period using the same installment percentages that apply to electing U.S. shareholders. Additional details with respect to this provision can be found in the REIT discussion in this report.

#### *S corporations*

The new law provides that if an S corporation is a U.S. shareholder of an SFC, each shareholder of the S corporation may elect to defer paying its net tax liability on its mandatory inclusion until its tax year that includes a "triggering event" with respect to the liability. A net tax liability that is deferred under this election appears to be assessed as an addition to tax in the electing shareholder's tax year as the bill provides that the electing shareholder (and the S corporation) would be liable, jointly and severally, for the net tax liability and related interest or penalties.

A "triggering event" for purposes of this provision includes the corporation ceasing to be an S corporation; a liquidation or sale of substantially all of the assets of such S corporation; a cessation of business by such S corporation; such S corporation ceasing to exist or similar circumstances; and a transfer of any share of stock of the S corporation (including by death or otherwise), except that the transfer is not a triggering



event if the transferee enters into an agreement with the Secretary under which the transferee is liable for net tax liability with respect to the stock. However, if the transfer is a triggering event (because the transferee does not assume the tax liability), then it is a triggering event only with respect to so much of the net tax liability as is properly allocable to the transferred stock.

An S corporation shareholder that elects to defer paying its net tax liability under the new law's transition rule may also elect to pay this liability in equal installments over an eight-year period after a triggering event has occurred. However, this election is available only with the consent of the Secretary if the triggering event is a liquidation, sale of substantially all of the S corporation's assets, termination of the S corporation or cessation of its business, or a similar event. The first installment must be paid by the due date (without extensions) of the shareholder's U.S. federal income tax return for the year that includes the triggering event.

If any S corporation shareholder elects to defer paying its net tax liability, the S corporation is jointly and severally liable for the payment of the deferred tax as well as any penalty, additions to tax, or additional amounts attributable thereto, and the limitation on collection is not treated as beginning before the triggering event.

#### **KPMG observation**

The new law provides a deferral election that is available only to shareholders of S corporations that hold the S corporation stock at the time of the mandatory repatriation of deferred foreign income. This applies generally to S corporations that held stock in a CFC or SFC as of December 31, 2017, in situations where the CFC or SFC has income that has not been included in the shareholder's income (i.e., deferred foreign income). The S corporation shareholders can elect to defer tax on the inclusion until a "triggering event." As a result of the deferral election, there is potentially a very lengthy deferral on the tax on the repatriation income. Once a triggering event occurs, the shareholder who elected deferral can then choose to use the 8-year installment method to pay the tax.

#### *Recapture from expatriated entities*

The new law includes recapture rules that are intended to deter inversions. Under these rules, if a U.S. shareholder becomes an "expatriated entity" within the meaning of section 7874(a)(2) at any point during the 10-year period following the enactment of the bill, (i) the shareholder would be denied a participation deduction with respect to its mandatory inclusion, (ii) the shareholder's mandatory inclusion would be subject to a 35% tax rate, and (iii) the shareholder would not be able to offset the additional U.S. federal income tax imposed by the recapture rules with foreign tax credits. An entity that becomes a domestic corporation under section 7874(b) is not subject to these recapture rules. The additional tax from these recapture rules arises in, and is assessed for, the tax year in which the U.S. shareholder becomes an expatriated entity.

#### **KPMG observation**

For purposes of the new law's recapture rules, an "expatriated entity" is a domestic corporation or domestic partnership the assets of which are acquired by a "surrogate foreign corporation," which is not treated as a domestic corporation under section 7874(b), in a "domestic entity acquisition" and any U.S. person related to such domestic

corporation or domestic partnership under sections 267(b) or 707(b)(1). A domestic entity acquisition occurs when a foreign corporation directly or indirectly acquires substantially all of the properties directly or indirectly held by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership. A foreign corporation is a surrogate foreign corporation that is not a domestic corporation under section 7874(b) if it completes a domestic entity acquisition and in the acquisition, the former shareholders of the domestic corporation or former partners of the domestic partnership, as applicable, receive at least 60% but less than 80% of the vote or value of the foreign corporation's stock "by reason of" (e.g., in exchange for or with respect to) their domestic corporation stock or domestic partnership interests, as applicable, and after the acquisition does not have substantial business activities in its country of creation or organization. The U.S. anti-inversion rules are extremely complex and include many ambiguous provisions.

The incorporation of the U.S. anti-inversion rules complicates the new law's transition rule and could have unintended consequences. In particular, because the definition of expatriated entity includes U.S. persons that share a section 267(b) or 707(b)(1) relationship with the target entity in a domestic entity acquisition, the new law's inversion recapture rules may apply to U.S. shareholders other than the target entity. Given the punitive treatment of the amounts subject to the new law's inversion recapture rules, the rules likely would be an important diligence item for future merger and acquisition transactions.

## Rules related to passive and mobile income

### Current-year inclusion of global intangible low-taxed income by United States shareholders

Section 14201 of the new law adds Code section 951A, which requires a U.S. shareholder of a CFC to include in income its "global intangible low-taxed income" (GILTI) in a manner similar to subpart F income. Corporate shareholders generally are allowed a deduction equal to 50% of GILTI, which will be reduced to 37.5% starting in 2026. In general, GILTI is determined at the U.S. shareholder level as the excess of all CFCs' net income over a deemed return on tangible assets.

In general, when a U.S. person is (i) a 10% U.S. shareholder of a CFC (taking into account the broad constructive ownership rules applicable in subpart F) on any day during the CFC's tax year during which the foreign corporation is a CFC; and (ii) the U.S. person owns a direct or indirect interest in the CFC on the last day of the tax year of the foreign corporation on which it is a CFC (without regard to whether the U.S. person is a 10% shareholder on that day), then the U.S. person would be required to include in its own income its pro rata share of the GILTI amount allocated to the CFC for the CFC's tax year that ends with or within its own tax year. A U.S. shareholder would increase its basis in the CFC stock for the GILTI inclusion, which generally would be treated as "previously taxed income" for subpart F purposes.

**GILTI.** In general, GILTI is described as the excess of a U.S. shareholder's "net CFC tested income" over its "net deemed tangible income return," which is defined as 10% of



its CFCs' "qualified business asset investment," reduced by certain interest expense taken into account in determining net CFC tested income.

Under the new law, the full amount of GILTI is included in a U.S. shareholder's income. Corporate shareholders are allowed a deduction equal to 50% of GILTI for 2018 through 2025, which will be decreased to 37.5% beginning in 2026. As a result, the effective tax rate on GILTI when a shareholder is allowed the 50% deduction would be 10.5%<sup>1</sup> prior to 2026. The deduction for GILTI is limited when the GILTI inclusion and FDII (described below) exceed the corporation's taxable income, determined without regard to the GILTI and FDII deductions. Because the GILTI deduction is limited by taxable income, net operating losses would be absorbed against the gross amount of GILTI before any GILTI deduction is allowed, and there is no carryforward for the foregone portion of any GILTI deduction due to the limitation to taxable income.

### **KPMG observation**

Similar to other amounts calculated under subpart F, the GILTI amount is included in a U.S. shareholder's income each year without regard to whether that amount was distributed by the CFC to the U.S. shareholder during the year.

Although lowering the U.S. statutory rate from 35% to 21% presumably reduces the incentives to erode the U.S. tax base by shifting profits outside the United States, this provision reflects a concern that shifting to a territorial tax system could exacerbate base erosion incentives because any shifted profits could be permanently exempt from U.S. tax. The inclusion of GILTI in a U.S. shareholder's income is intended to reduce those incentives further by ensuring that CFC earnings that exceed a deemed return on its tangible assets are subject to some measure of U.S. tax (at a rate potentially as low as 10.5% through 2025<sup>2</sup> when the 50% deduction described above is allowed).

Both the reduction in the corporate tax rate and the exemption from income of dividends received from CFCs are described as increasing the competitiveness of U.S. corporations and levelling the playing field with foreign multinationals. It is worth noting that an immediate tax, which in many cases will be imposed on most of a CFC's earnings, even at an effective rate of 10.5% for corporate shareholders (after taking into account the 50% deduction described above) would be comparatively unfavorable to the CFC regimes of most of the major trading partners of the United States, which typically tax CFC earnings in much more limited circumstances.

**Individual shareholders.** Noncorporate U.S. shareholders generally are subject to full U.S. tax on GILTI inclusions, based on applicable rates. The new law clarifies that applicable U.S. shareholders can make a Code section 962 election with respect to GILTI inclusions, pursuant to which the electing shareholder would be subject to tax on the GILTI inclusion based on corporate rates, and would be allowed to claim FTCs on the inclusion as if the shareholder were a corporation.

<sup>1</sup> This effective rate would increase to 13.125% when the deduction is reduced in 2026.

<sup>2</sup> The effective tax rate on GILTI would be commensurately higher starting in 2026 after the GILTI deduction is reduced to 37.5%.

### KPMG observation

Although the interaction of the corporate-level GILTI deduction with Code section 962 is not entirely clear, reducing an electing shareholder's GILTI inclusion by the GILTI deduction would be consistent with treating the electing shareholder as a domestic corporation, which fits within the general framework of section 962.

**Net CFC tested income.** The new law defines “net CFC tested income” as, with respect to any U.S. shareholder for any taxable year, the excess of the shareholder's aggregate pro rata share of the tested income of each CFC for which the shareholder is a U.S. shareholder for such taxable year over the aggregate pro rata share of the tested loss of each such CFC. For this purpose, “tested income” of a CFC generally is described as the gross income of the CFC other than (i) ECI; (ii) subpart F income; (iii) amounts excluded from subpart F income under the Code section 954(b)(4) high-tax exception; (iv) dividends received from a related person (as defined in Code section 954(d)); and (v) foreign oil and gas extraction income, over deductions allocable to such gross income under rules similar to Code section 954(b)(5) (or to which such deductions would be allocable if there were such gross income). Tested loss is defined to mean the excess of deductions allocable to such gross income over the gross income.

**Net deemed tangible income return.** Under the new law, the “net deemed tangible income return” is defined as the excess of 10% of the aggregate of each CFC's qualified business asset investment (QBAI) over the amount of interest expense taken into account in determining the shareholder's net CFC tested income, to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income. QBAI is determined as the average of the adjusted bases (determined at the end of each quarter of a tax year) in “specified tangible property” that is used in the production of tested income and that is subject to Code section 167 depreciation. The conference explanation states that specified tangible property would not include property used in the production of a tested loss, so a CFC that has a tested loss in a taxable year would not have any QBAI for that year.<sup>3</sup> For purposes of computing QBAI, the adjusted basis of property is determined under the alternative depreciation rules of Code section 168(g), and by allocating the depreciation deductions ratably to each day during the period in the tax year to which the depreciation relates.

### KPMG observation

The net deemed tangible income return is determined by applying a 10% fixed rate of return to QBAI, and reducing the result by the interest expense taken into account in determining net CFC tested income, to the extent the interest income attributable to the expense is not taken into account in determining net CFC tested income. As a result, interest expense incurred between a U.S. shareholder's CFCs generally will not reduce the deemed return, but the deemed return will be reduced for interest expense incurred by a CFC as a result of debt owed to an unrelated person or to related CFCs that are owned outside the U.S. shareholder's chain. In many cases, the deemed return on tangible assets will be negligible, for example because (i) the CFC's primary value-

<sup>3</sup> Footnote 1536 of the Conference Report at page 642.

driver is intangible assets (notably, no relief is given for a return on intangible assets even when a taxpayer has purchase basis in the assets); or (ii) the CFC's tangible property is substantially depreciated. In such cases, the tax base on which the tax is imposed may be a U.S. shareholder's ratable share of tested income without reduction for any exempt return.

**Deemed-paid foreign tax credit.** For any amount of GILTI that is includible in a U.S. corporate shareholder's income, the new law provides for a limited deemed paid credit of 80% of the foreign taxes attributable to the tested income (as defined above) of the CFCs. The foreign taxes attributable to the tested income are determined using an aggregate computation at the U.S. shareholder level, as the product of (i) the domestic corporation's "inclusion percentage," multiplied by (ii) the aggregate foreign income taxes paid or accrued by each of the shareholder's CFCs that are properly attributable to tested income of the CFC that is taken into account by the U.S. shareholder under section 951A. Thus, taxes attributable to a CFC that earns a tested loss for a taxable year do not appear to be taken into account.

The inclusion percentage is the ratio of the shareholder's aggregate GILTI divided by the aggregate of the shareholder's share of the tested income of each CFC. This ratio presumably is intended to compare the amount included in the U.S. shareholder's income and subject to tax in the United States (the GILTI), to the amount with respect to which the relevant foreign taxes are imposed (the tested income), to determine the relevant percentage of foreign taxes that should be viewed as deemed paid for purposes of the credit.

The new law computes the section 78 gross-up by reference to 100% of the related taxes, rather than by reference to the 80% that are allowable as a credit. Although the gross-up amount is included in income as a dividend, it is not eligible for the Code section 245A 100% DRD, but is eligible for the GILTI deduction.

In addition, the new law creates a separate basket for these deemed paid taxes to prevent them from being credited against U.S. tax imposed on other foreign-source income. Moreover, any deemed-paid taxes on GILTI are not allowed to be carried back or forward to other tax years.

These rules are effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to JCT, the GILTI rules (including the GILTI deduction) will increase revenues by \$112.4 billion over 10 years.

### **KPMG observation**

The conference report's explanatory statement includes a simple example illustrating the interaction of the 50% deduction with the 20% haircut on foreign tax credits, which concludes that U.S. tax would not be owed when the effective foreign tax rate on the underlying income is 13.125%. This conclusion is misleading for several reasons, including: (i) a taxpayer may not have sufficient income to take the full GILTI deduction, due to a current-year loss from other activities or an NOL carryforward; (ii) there will always be leakage of the foreign tax credit when there is at least one tested loss CFC

because, although the GILTI inclusion is computed by allowing an offset for tested losses, the denominator of the “inclusion percentage” is the aggregate of all tested income without offset for tested losses; and (iii) taxpayers may be required to allocate expenses to the GILTI basket, precluding them from obtaining the full benefit of taxes paid with respect to their “tested income.”

In addition, because there is no carryforward or other provision to mitigate the consequences of timing differences between U.S. and foreign income tax laws, it is possible that U.S. shareholders whose CFCs generally are subject to significant foreign taxes may nonetheless owe residual U.S. tax in a particular year if significant income is recognized in that year for U.S. tax purposes but not for foreign tax purposes. For large multinationals this issue may be mitigated by the ability to average across CFCs, but cyclical businesses nevertheless could be especially susceptible to this problem. Moreover, by precluding carryover, the new deemed FTC provision may put some taxpayers in a position where they are better off deducting rather than crediting the relevant foreign taxes they are deemed to pay under the provision.

### Illustration of GILTI computation from KPMG modeling tool

	2018	2019	2020
<b>Global intangible Low-Tax Income (GILTI)</b>			
Net CFC Tested Income	97.2	106.1	111.2
Applicable percentage allowed as a return on QBAI	10%	10%	10%
Amount of qualified business asset investment (QBAI)	32.0	34.0	70.0
Interest expense include in NCTI where matching interest income not in NCTI	-	-	-
Tentative GILTI includible in gross income	94.0	102.7	104.2
Sec. 78 gross-up on tentative GILTI	9.7	10.8	10.8
GILTI includible in gross income	103.7	113.5	115.0
<b>Foreign tax credit on GILTI</b>			
GILTI amount	94.0	102.7	104.2
Net CFC tested income	97.2	106.1	111.2
Aggregate net CFC tested losses	3.0	3.5	4.2
Gross tested income of CFCs (gross active annual non-US E&P)	100.2	109.6	115.4
Inclusion Percentage	93.8%	93.7%	90.3%
Gross tested income of CFCs, unreduced by non-US taxes	110.5	121.1	127.4
Blended ETR on all non-US E&P at CFCs with tested income	9.4%	9.5%	9.4%
Tested Foreign Income Taxes	10.3	11.5	12.0
Haircut percentage on tested foreign income taxes	80.0%	80.0%	80.0%
GILTI: Foreign tax credit amount	7.8	8.6	8.6

**KPMG observation**

To mitigate the impact of these rules in 2018, U.S. shareholders with a calendar year should consider electing a November 30 year-end for their CFCs, in which case the income of their CFCs would not be subject to the tax until December 1, 2018. In the case of a U.S. shareholder with a fiscal year, that U.S. shareholder generally would be exempt from the tax until the first day of the CFC's fiscal year beginning in 2018 (for example, a CFC with a September 30 year-end would become subject to the tax beginning October 1, 2018).

**Add deduction for foreign-derived intangible income**

In conjunction with the new minimum tax regime on excess returns earned by a CFC, the new law provides a 13.125% effective tax rate on excess returns earned directly by a U.S. corporation from foreign sales (including licenses and leases) or services, which would increase to 16.406% starting in 2026. Specifically, for tax years 2018-2025, the new law allows a U.S. corporation a deduction equal to 37.5% of its "foreign-derived intangible income" (FDII). Starting in 2026, the deduction percentage is reduced to 21.875%. The deduction for FDII is limited when the GILTI inclusion and FDII exceed the corporation's taxable income, determined without regard to the GILTI and FDII deductions. The deduction is not available for S corporations or domestic corporations that are RICs or REITs.

The new law contains complex rules for determining the amount of a U.S. corporation's FDII. At a high level, a U.S. corporation's FDII is the amount of its "deemed intangible income" that is attributable to sales of property (including licenses and leases) to foreign persons for use outside the United States or the performance of services to persons, or with respect to property, located outside the United States. A U.S. corporation's deemed intangible income generally is its gross income that is not attributable to a CFC or foreign branch, and which is not financial services income or domestic oil and gas extraction income, reduced by (i) related deductions (including taxes) and (ii) an amount equal to 10% of the aggregate adjusted basis of its tangible depreciable assets (other than assets that produce excluded categories of gross income, such as branch assets).

Thus, a domestic corporation is subject to the standard 21% tax rate to the extent of a fixed 10% return on depreciable assets and a 13.125% (increased to 16.406% as of 2026) tax rate on any excess return that is attributable to exports of goods or services.

The new law also includes special rules for foreign related-party transactions. A sale of property to a foreign related person does not qualify for FDII benefits unless the property is ultimately sold to an unrelated foreign person, or used by a related person in connection with sales of property or the provision of services to an unrelated foreign person for use outside the United States. A sale of property is treated as a sale of each of the components thereof. The provision of services to a foreign related person does not qualify for FDII benefits if the services are substantially similar to services provided by the foreign related person to persons located in the United States.

The provision is effective for tax years beginning after December 31, 2017.



**KPMG observation**

The preferential rate on deemed intangible income attributable to export activities presumably is intended to encourage U.S. corporations to keep (or relocate) production activities in the United States. Interestingly, under the new law, income earned from an active business conducted overseas would generally be taxed at full U.S. rates if undertaken in the form of a branch, while if conducted through a CFC the majority of the income would still be taken into account currently in the United States via the GILTI regime but would be eligible for tax at a reduced rate. It is not entirely clear why the law creates such incongruous treatment for activities conducted through a foreign branch as opposed to a CFC.

**Other modifications of subpart F provisions****Eliminate inclusion of foreign base company oil-related income**

Section 14211 of the new law repeals section 954(g) of the Code. As a result, there would no longer be full U.S. tax currently imposed on foreign oil-related income of a foreign subsidiary.

This provision is effective for tax years of foreign corporations beginning after December 31, 2017 and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

The JCT has estimated that this provision would reduce revenues by approximately \$4 billion over 10 years.

**KPMG observation**

While the repeal of section 954(g) of the Code would exclude foreign oil related income from subpart F income, the income may be subject to current U.S. taxation under the new “global intangible low-taxed income” (GILTI) rules, which effectively impose a minimum tax based, in part, on a CFC’s gross income, subject to certain exceptions. Although “foreign oil and gas extraction income” is excluded from GILTI, there is no similar exclusion for “foreign oil-related income.”

**Repeal of inclusion based on withdrawal of previously excluded subpart F income from qualified investment**

Section 14212 of the new law repeals section 955 of the Code. As a result, there no longer is current U.S. tax imposed on previously excluded foreign shipping income of a foreign subsidiary if there was a net decrease in qualified shipping investments.

The provision is effective for tax years of foreign corporations beginning after December 31, 2017, and to tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to the JCT, this provision will reduce revenues by less than \$50 million over 10 years.

## **Modification of stock attribution rules for determining status as a controlled foreign corporation**

Section 14213 of the new law eliminates a constructive ownership rule in section 958(b)(4) of the Code that prevents downward attribution of stock owned by a foreign person to a U.S. person. As a result, for example, stock owned by a foreign corporation would be treated as constructively owned by its wholly owned domestic subsidiary for purposes of determining the U.S. shareholder status of the subsidiary and the CFC status of the foreign corporation.

The provision applies to the last tax year of foreign corporations beginning before January 1, 2018, and all subsequent tax years of a foreign corporation, and for the tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to the JCT, this provision, along with the deduction for dividends received, would reduce revenues by approximately \$223.6 billion over 2018-2027. This provision alone, though, likely would increase revenues as a result of expanding the scope of taxpayers subject to the subpart F rules.

### **KPMG observation**

A primary impact of this provision would be to cause minority U.S. owners of foreign subsidiaries in an inverted group to be treated as U.S. shareholders of CFCs as a result of attribution from the majority foreign owner. These residual owners would become subject to the subpart F rules, including the new GILTI rules. Nonetheless the downward attribution of ownership from foreign persons can have broader implications than the de-controlling transactions that the provision aims to render ineffective. For example, the foreign subsidiary of a foreign corporation that also owns a U.S. subsidiary could be treated as a CFC solely as a result of downward attribution from the foreign parent corporation to the U.S. subsidiary. In that case, a 10% U.S. owner of the foreign parent corporation could be treated as the owner of the foreign subsidiary CFC. This provision applies to the last tax year beginning before January 1, 2018, and thus applies for purposes of the mandatory repatriation provision.

## **Modification of definition of U.S. shareholder**

Section 14214 of the new law revises the definition of U.S. shareholder in section 951(b) of the Code to include a U.S. person who owns at least 10% of the value of the shares of the foreign corporation. As a result of this provision, a U.S. person would be treated as a U.S. shareholder of a foreign corporation for subpart F purposes when the person owns at least 10% of either the voting power or the value of the foreign corporation.

The provision is effective for the tax years of foreign corporations beginning after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to the JCT, this provision will increase revenues by approximately \$1.3 billion over 10 years.



### **KPMG observation**

This provision increases the scope of U.S. persons who are required to include amounts in income under the subpart F rules and potentially increases the amount of subpart F income that current U.S. shareholders would be required to include in income, when the value of a shareholder's stock in a foreign corporation exceeds the voting power of the stock.

### **Elimination of requirement that corporation must be controlled for 30 days before subpart F inclusions apply**

Section 14215 of the new law eliminates the requirement in section 951(a) of the Code for a foreign corporation to constitute a CFC for an uninterrupted period of at least 30 days in order for a U.S. shareholder to have a current income inclusion. As a result, for example, a U.S. shareholder could have a current subpart F inclusion when a CFC generates subpart F income during a short tax year of less than 30 days.

The provision is effective for tax years of foreign corporations beginning after December 31, 2017 and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

According to the JCT, this provision will increase revenues by approximately \$600 million over 10 years.

## **Prevention of base erosion**

### **Adds limitations on income shifting through intangible property transfers**

The new law amends the definition of intangible property in section 936(h)(3)(B) (which applies for purposes of sections 367(d) and 482) to include workforce in place, goodwill, going-concern value, and "any other item" the value or potential value of which is not attributable to tangible property or the services of an individual. The new law also removes the flush language of section 936(h)(3)(B), which limits section 936(h)(3)(B) to intangibles that have substantial value independent of the services of any individuals, to make clear that the source or amount of value of an intangible is not relevant to whether that type of intangible is within the scope of section 936(h)(3)(B).

Additionally, the new law clarifies the authority of the Commissioner to specify the method used to value intangible property for purposes of both the section 367(d) outbound transfer rules and the section 482 intercompany pricing rules. Specifically, when multiple intangible properties are transferred in one or more transactions, the IRS may value the intangible properties on an aggregate basis when that achieves a more reliable result. The law also codifies the realistic alternative principle, which generally looks to the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken.

The provision applies to transfers in tax years beginning after December 31, 2017. Additionally, the new law states that no inference is intended with respect to the application of section 936(h)(3)(B) or the authority of the Secretary to provide by

regulation for such application with respect to tax years beginning before January 1, 2018.

#### **KPMG observation**

The new law provision is identical to a provision in the Senate bill. By expanding the scope of section 936(h)(3)(B), this provision would make it more difficult for a U.S. person to transfer intangible property outbound without incurring tax. The provision also resolves prospectively long-standing uncertainties regarding the scope of section 936(h)(3)(B) and, in particular, the application of section 367(d) to outbound transfers of goodwill, going concern value, and workforce in place. Although recent regulations under section 367 required that outbound transfers of goodwill and going concern value are taxable under section 367(a) or (d), the IRS expressly declined to address whether goodwill, going concern value, and work force in place are section 936(h)(3)(B) intangibles.

#### **Limit deduction of certain related-party amounts paid or accrued in hybrid transactions or with hybrid entities**

The new law disallows a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity.

A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (i) there is no corresponding income inclusion to the related party under local tax law or (ii) such related party is allowed a deduction with respect to the payment under local tax law. A disqualified related-party amount does not include any payment to the extent such payment is included in the gross income of a U.S. shareholder under section 951(a) (i.e., a “subpart F” inclusion). A related party for these purposes is determined by applying the rules of section 954(d)(3) to the payor (as opposed to the CFC referred to in such section).

A hybrid transaction is any transaction, series of transactions, agreement, or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not so treated for purposes of the tax law of the foreign country of which the entity is resident or is subject to tax.

A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The new law also grants the Secretary authority to issue regulations or other guidance necessary or appropriate to carry out the purposes of the provision and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity; (2) applying the provision to branches or domestic entities; (3) applying the provision to certain structured transactions; (4) denying some or all of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient’s income under a preferential tax regime

of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25%; (5) denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or other system that provides for the exclusion of a substantial portion of such amount; (6) determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country; (7) exceptions to the provision's general rule to (a) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (b) other cases that the Secretary determines do not present a risk of eroding the U.S. income tax base; and (8) requirements for record keeping and information reporting in addition to any requirements imposed by section 6038A.

The provision is effective for tax years beginning after December 31, 2017 and does not appear to contain grandfathering rules.

#### **KPMG observation**

The new law attempts to neutralize the effects of hybrid mismatch arrangements by denying deductions for interest and royalty payments made to related parties under hybrid arrangements that give rise to income that is not taxed in any jurisdiction (stateless income). Similar proposals have been included as part of President Obama's FY 2017 Budget Proposal and in the recommendations issued pursuant to Action 2 of the OECD BEPS project (Recommendations).

The new law's provision is written broadly and would appear to apply to many of the transactions and structures addressed by the Recommendations, including the use of hybrid instruments and payments to and from reverse hybrids and disregarded payors. For example, an interest payment made with respect to a hybrid financial instrument held by a related party could be affected if there is no corresponding income inclusion by the related party.

The new law does not appear to be limited to interest or royalties paid by a U.S. payor and may apply to such payments made by a U.S. person or a non-U.S. person, including payments between foreign related parties.

Other portions of the Recommendations may be implemented through Treasury Regulations. These provisions could include rules that apply to imported mismatch arrangements, branch structures or domestic entities, and deductible dividends that are excluded pursuant to a participation exemption. The explanatory statement accompanying the conference agreement anticipates that the Treasury will issue regulations that apply the provision to branches (domestic or foreign) and domestic entities even if such entities do not meet the statutory definition of a hybrid entity. As a result, interest or royalty payments by a U.S. LLC that has elected corporate status for U.S. tax purposes to its foreign parent could be affected under regulations if the foreign parent does not have an income inclusion as a result of the U.S. LLC being treated as disregarded under the tax laws of the country of the foreign parent.

Hybrid entities also potentially implicate the dual consolidated loss rules. Specifically, a domestic corporate owner of a foreign hybrid entity is subject to the dual consolidated

loss rules, if the foreign hybrid entity incurs a loss for U.S. tax purposes. The new law does not alter the dual consolidated loss rules.

### **Surrogate foreign corporations not eligible for reduced rate on dividends**

The new law's anti-base erosion provisions include a rule that prevents dividends from surrogate foreign corporations to individuals from qualifying for the reduced tax rate applicable to qualified dividends. This rule only applies to corporations that first become surrogate foreign corporations after the bill is enacted and are not treated as a domestic corporation under section 7874(b).

This rule is effective for dividends received after the date of enactment (i.e., December 22, 2017).

### **Modifications related to foreign tax credit system**

#### **Repeal section 902 indirect foreign tax credits; determination of section 960 credit on a current-year basis**

The new law repeals the deemed paid foreign tax credit under section 902 of the Code and retains but modifies the deemed paid foreign tax credit under section 960 of the Code.

Section 902 of the Code deems a U.S. corporate shareholder of a 10%-owned foreign corporation to have paid a portion of the foreign corporation's foreign income taxes when it receives or is deemed to receive a dividend from that foreign corporation. Section 960 of the Code provides a similar deemed paid credit for subpart F inclusions. Under the new law, the allowable credit under section 960 of the Code is based on current-year taxes attributable to subpart F income rather than the "pooling" approach that applied under sections 902 and 960.

The new law also provides rules applicable to foreign taxes attributable to distributions of previously taxed income (PTI), including from a lower-tier to an upper-tier CFC. These rules are not explained in any further detail, but appear to allow foreign taxes as credits under section 960 in the year the PTI is distributed. The new law grants the Secretary authority to promulgate regulations and guidance such that the amended section 960 credit would, as under pre-enactment law, be computed separately for each category or "basket" of income under Code section 904(d).

The new law makes conforming amendments to other Code provisions to reflect the repeal of Code section 902, including amending Code section 78 to treat the "gross-up" for deemed paid taxes as a dividend.

The amendments are effective for tax years of foreign corporations beginning after 2017 and to tax years of United States shareholders with or within which such tax years of foreign corporations end.

**KPMG observation**

The repeal of section 902 of the Code may have significant consequences for domestic corporations eligible to claim section 902 deemed-paid credits with respect to dividends from 10%-owned foreign corporations that are not CFCs because foreign income taxes paid or accrued by such corporations could no longer be claimed as FTCs. Moreover, the change from the pooling regime to a current-year foreign tax regime could also significantly affect the foreign tax credit calculation, as the pooling regime serves to blend effective foreign tax rates that may differ from year to year due to U.S. and foreign timing differences and rate changes.

**Separate foreign tax credit limitation basket for foreign branch income**

The new law creates a new foreign tax credit limitation basket for foreign branch income. Under the provision, foreign branch income is a U.S. person's business profits attributable to one or more qualified business units (QBUs) in one or more countries. Generally, a QBU is defined in section 989 of the Code as "any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records." The new law grants the Secretary the authority to establish rules for determining what constitutes "business profits"; however, the legislation explicitly excludes passive income from the definition.

This provision is effective for tax years beginning after 2017.

**KPMG observation**

Similar to creating a separate basket for GILTI, as discussed below, this provision would operate to prevent cross-crediting of foreign taxes attributable to low-tax subpart F income with those attributable to high-tax branch income. It apparently would also prevent general limitation foreign tax credit carryforwards from pre-effective date years from offsetting the U.S. tax on such branch income.

**Determine source of income from sales of inventory solely on basis of production activities**

The new law revises the general rule under Code section 863(b), which sources income from inventory property produced in one jurisdiction and sold in another jurisdiction by allocating 50% of sales income to the place of production and 50% to the place of sale (determined based on title passage). Under the revised provision, income from inventory sales would be sourced entirely based on the place of production. Thus, if inventory property is produced in the United States and sold outside the United States, sales income would be 100% U.S. source. If inventory property is produced partly within and partly without the United States, income from the sales would be partly U.S. source and partly foreign source.

According to the JCT, this provision will increase revenues by approximately \$500 million over 10 years.

This provision is effective for tax years beginning after 2017.



**KPMG observation**

The change eliminates the beneficial title passage rule of pre-enactment law and replaces it with a rule that is meant to reflect solely the economics of production. The provision eliminates a significant means under pre-enactment law for generating general limitation foreign source income. It could also have the unintended result of encouraging companies to expand foreign production.

**Amend section 904(g) to allow increased overall domestic loss recapture**

The new law modifies the overall domestic loss (ODL) recapture rules of section 904(g) to allow taxpayers to elect to recapture a pre-2018 unused ODL for any “applicable tax year” by substituting a percentage greater than 50% (but not greater than 100%) in section 904(g)(1). An applicable tax year is any tax year of the taxpayer beginning after December 31, 2017 and before January 1, 2028. Under section 904(g)(1), a taxpayer with an ODL account recaptures an amount not greater than 50% of its U.S. source taxable income for a tax year (limited to the amount of its ODL account) and treats such income as foreign source income for foreign tax credit purposes. The election would thus allow taxpayers to recapture their ODL accounts, and recharacterize U.S. source income as foreign source income, more rapidly than under pre-enactment law.

According to the JCT, this provision will decrease revenues by approximately \$2.3 billion over 10 years.

**KPMG observation**

It will be more challenging under the new law for taxpayers with foreign tax credit carryovers from pre-effective date years to utilize those credits given the creation of new foreign tax credit limitation baskets for GILTI and branch income, as described above. The ODL election allows taxpayers to accelerate the use of those credits in years subsequent to enactment of the new law by recharacterizing a greater amount of U.S. source income as foreign source (and typically general limitation) income for foreign tax credit purposes.

**Limit foreign tax credits for global intangible low-taxed income**

The new law adds a new FTC basket for taxes associated with “global intangible low-taxed income.” For more details regarding those rules, see the discussion of global intangible low-taxed income in the “Rules related to passive and mobile income” section above.

**Inbound provisions****Add base erosion and anti-abuse tax (BEAT)**

The final sentence in the “Unified Framework” released by Republican leadership on September 27 was an opaque statement that “the committees will incorporate rules to level the playing field between U.S.-headquartered parent companies and foreign-headquartered parent companies.” The new law implements this principle by creating a

new base-erosion-focused minimum tax (the base erosion and anti-abuse tax or BEAT) that in many cases would significantly curtail the U.S. tax benefit of cross-border related-party payments made by large multinationals.

*Scope—Applicable taxpayers making base erosion payments*

The BEAT applies to domestic corporations that are not taxed on a flow-through basis (that is, not S Corps, RICs, or REITs), are part of a group with at least \$500 million of annual domestic (including effectively connected amounts earned by foreign affiliates) gross receipts (over a three-year averaging period), and which have a “base erosion percentage” (discussed below) of 3% or higher for the tax year (or 2% for certain banks and securities dealers, which are also subject to a higher BEAT rate, as discussed below). The provision also applies to foreign corporations engaged in a U.S. trade or business for purposes of determining their effectively connected income tax liability.

The targeted base erosion payments generally are amounts paid or incurred by the taxpayer to foreign related parties for which a deduction is allowable, and also include amounts paid in connection with the acquisition of depreciable or amortizable property from the foreign related party. The new law also specifically includes cross-border reinsurance payments as base erosion payments. This category includes any premium or other consideration paid that is taken into account as a reduction in either life insurance gross income under section 803(a)(1)(B) or insurance company taxable income under section 832(b)(4)(A). Finally, for taxpayers that after November 9, 2017, become part of an “inverted” group, determined by reference to section 7874, base erosion payments also include “any amount that constitutes reductions in gross receipts” of the taxpayer when paid to the surrogate foreign corporation or any member of its expanded affiliated group.

There are two main exceptions to the provision’s scope for otherwise deductible payments. The first is for any “amount” paid or incurred for services that qualify “for use of the services cost method under section 482 (determined without regard to the requirement that the services not contribute significantly to fundamental risks of business success or failure)” and that reflects the total cost of the services without markup. The second is for “qualified derivative payments” for taxpayers that annually recognize ordinary gain or loss (e.g., mark to market) on such instruments, and subject to several exceptions.

The definition of a foreign related party is drawn from section 6038A and includes any 25% foreign shareholder of the taxpayer, related persons thereto, and any other person related to the taxpayer under the section 482 rules.

Base erosion payments are subject to the provision when they give rise to a “base erosion tax benefit,” meaning the tax year in which a deduction for the payment is allowed. If base erosion payments form part of a net operating loss (NOL), the base erosion tax benefit is taken into account as part of the section 172 deduction in the carryback or carryover year.

For base erosion payments that are subject to Chapter 3 withholding, the payment is not subject to the rule (that is, it is not added back to modified taxable income, as discussed below). For payments that are subject to a reduced rate of withholding under



a Treaty, the exclusion is done proportionately in comparison to the statutory withholding rate.

The base erosion percentage used for the 3% (or 2%) threshold requirement, and for the portion of an NOL deduction that is taken into account, is determined by dividing the aggregate amount of base erosion tax benefits of the taxpayer for the tax year by the aggregate amount of the deductions allowable to the taxpayer for the year, but excluding NOLs, the participation exemption, the deduction allowed under new section 250 for foreign intangible income, and also any payments that qualify for the services cost method or qualified derivative exceptions discussed above.

### **KPMG observation**

The BEAT includes within its scope almost every outbound payment made by corporations subject to the rule, except for payments treated as COGS or otherwise as reductions to gross receipts (subject to regulatory authority for the Secretary to write anti-avoidance regulations). This limited exception is unavailable for taxpayer groups that “invert” after November 9, 2017. Other than for such inverted groups, the BEAT therefore does not apply, for example, to payments for inventory manufactured outside the United States.

Payments that are treated as full inclusion subpart F income or as GILTI may also be fully subject to the BEAT, even though there may be no net tax benefit for payments subject to full inclusion and only a reduced tax benefit for payments included in GILTI. Although the threshold of deductible payments to foreign affiliates that is necessary for the BEAT to become a positive tax liability may not be met for many U.S.-headquartered companies, the provision requires careful maintenance and may affect companies that, for example, subcontract to or otherwise make significant deductible services payments to their foreign subsidiaries.

The provision is expected to affect certain industries disproportionately. In particular, with the explicit inclusion of related-party cross-border reinsurance, which is very common within the insurance industry, large segments of the insurance market could be very significantly impacted.

The exception for services that qualify for the services cost method is ambiguous. The services cost method is entirely a product of regulations (Reg. section 1.482-9) and other administrative guidance, and includes a number of requirements. In addition to a general exclusion for services that contribute significantly to the risks of business success or failure, which the new law explicitly turns off, the guidance includes a number of additional requirements, including numerous categories of services that are ineligible as “excluded activities.” It is unclear whether Congress intends for these additional regulatory exclusions to apply. It is also unclear what effect future regulatory changes may have on the availability of the exception, though providing a reference to the existing services cost method may indicate that only the current rules are intended to apply for purposes of the exception. In practice, many services contracts that could otherwise qualify for the services cost method nevertheless include a mark-up, which is often required by the transfer pricing rules in the foreign recipient’s jurisdiction. It appears based on a Senate floor colloquy that it may be intended that taxpayers can implement “self-help” in these cases by restructuring the contracts into separate “cost”

and “profit” component payments and qualify the cost portion for the exception.<sup>12</sup> Whether this option is confirmed in future guidance, or whether Treasury interprets the rule to provide for this economic result without requiring taxpayers to alter their business affairs to achieve it (which would be an easier solution but has not been foreshadowed), would significantly affect the utility of the exception.

The exception for qualified derivative payments was reported as a significant concession to the financial services industry. Banks and securities dealers are otherwise treated less favorably in that they are subject to higher BEAT tax rates and a lower base erosion percentage de minimis threshold.

The addback for the BEAT occurs in the year the deduction is allowed. As a result, base erosion payments that are capitalized into depreciable or amortizable basis are taken into account as the capitalized costs are recovered.

Furthermore, the focus on allowed deductions indicates that an amount must otherwise be deductible after the application of other limitations before it is taken into account as a base erosion tax benefit. For interest expense, the new law confirms this point but also includes an unfavorable “stacking” rule for taxpayers that pay both unrelated and related-party interest in a given year. The stacking rule requires taxpayers to treat the limitation imposed under section 163(j) attributable entirely to unrelated party interest to the extent thereof. Thus, for example, if a taxpayer has \$100 of interest expense in a given year, \$60 of which is paid to related parties and \$40 to unrelated parties, and the taxpayer is allowed to deduct only \$70 under section 163(j), the entire \$60, rather than only a proportionate amount (e.g., 70%), is subject to the BEAT.

The general effective date provisions (see *infra*) apply to base erosion payments that are paid or accrued in tax years beginning after December 31, 2017. Plainly, no part of an NOL arising in a year prior to that effective date could arise from an amount paid or accrued after the effective date. Thus, unless a retroactive effect was intended, the base erosion percentage of any pre-effective date NOL ought to be zero when absorbed in post-enactment years. Nevertheless, the provision’s use of “any tax year” in defining the base erosion percentage and the definition of modified taxable income could be interpreted to mean that pre-effective year NOL deductions are subject to the BEAT as “add-backs” when absorbed in post-enactment years. That the provision does not clearly address whether the base erosion percentage for an NOL carryover deduction is determined in the year the NOL arises, or when absorbed, contributes to the ambiguity. These are among the many points that await confirmation in future developments.

### *BEAT computation*

The tax liability increase is determined through a multi-step formula used to derive the base erosion minimum tax amount. This amount equals the excess of 10% of the taxpayer’s modified taxable income (MTI) for the year (5% for 2018), over an amount equal to the pre-credit regular income tax liability reduced (but not below zero) by any credits, other than the research credit and a certain amount of “applicable section 38 credits” that include the low-income housing credit, renewable energy production credit, and energy credits allowed in that year. Applicable section 38 credits are only included to the extent of 80% of the lesser of the credits or the base erosion tax amount otherwise computed.

MTI is the taxpayer's taxable income, with the base erosion tax benefit amount (including the base erosion percentage of an NOL deduction) added back

The BEAT computation is modified to raise additional revenue for tax years beginning after December 31, 2025 through the following changes which take effect in such years: (i) the 10% of MTI input will increase to 12.5% of MTI; and (ii) the tax liability against which 12.5% of MTI is compared is simply regular income tax liability minus all credits, which appears to remove the previously retained benefit of the research credit and qualifying section 38 credits.

Banks and registered securities dealers are subject to a one percentage point higher BEAT rate in every year: 6% for 2018, 11% for 2019- 2025, and 13.5% thereafter.

### **KPMG observation**

The BEAT formula allows taxpayers to retain, at least initially, the benefit of the research credit and some benefit for the three categories of applicable section 38 credits. The latter category appears responsive to reports that the BEAT could have disrupted financing of development in certain markets, such as renewable energy and low-cost housing, which depend on the availability of such credits to attract investors. The following example may help illustrate the formula's application using the 10% BEAT rate.

Assume the ABC U.S. Consolidated Group (ABC) has pre-credit regular tax liability of \$21,000 (corresponding to \$100,000 of taxable income after the 21% corporate income tax rate takes effect). ABC claims \$5,000 of tax credits overall, of which \$2,000 constitute research credits and \$1,000 are applicable section 38 credits. Thus, the "floor" that the BEAT must cross is  $\$21,000 - (\$5,000 - \$2,800 (\$2,000 \text{ plus } 0.8 * \$1,000)) = \$18,800$ . For companies that are taxpayers, this formula thus effectively adds back the research credit [\$2,000] and 80% of the [\$1,000] of applicable section 38 credits to the otherwise final tax liability [\$16,000].

The BEAT would be owed to the extent that ABC's MTI equaled more than \$188,000 (that is,  $\$18,800 \times 10$ , or  $/0.1$ ). Stated differently, ABC would have to deduct more than \$88,000 of base erosion tax benefits for the year to be subject to the BEAT.

### *Reporting and penalties*

The new law introduces new reporting requirements under the Code section 6038A regime (Form 5472) to collect information regarding applicable taxpayers' base erosion payments. The provision also increases that reporting regime's \$10,000 penalty to \$25,000.

The provision applies to payments paid or accrued in tax years beginning after December 31, 2017. It is estimated to increase revenues by approximately \$149.6 billion over 10 years.

### **KPMG observation**

The BEAT is a significant new provision and revenue raiser among the new law's international provisions. It will operate in tandem with the new interest deduction limitations, and the disallowance for payments involving hybrid transactions and hybrid

entities, to significantly curtail the tax benefit of deductible payments made by U.S. groups to their foreign affiliates. The provision is partially phased in through the lower tax rate in 2018 and then will ramp up in post-2025 years. The JCT scoring line for the provision commensurately projects that nearly a third of the projected revenue will arise in 2026 and 2027.

The provision's status under the United States' income tax treaties and trade agreements has already been questioned by U.S. trading partners in news reports. In particular, the BEAT raises issues regarding the nondiscrimination clauses contained in most U.S. tax treaties. For example, Paragraph 24(4) of the U.S. Model Tax Treaty is implicated because the provision effectively denies a portion of the deductions for payments made to foreign entities where payments made to similarly-situated domestic entities remain fully deductible. While the conference report does not include any statement indicating whether Congress specifically intended to override tax treaties in this regard, the scope of the BEAT would be significantly reduced if it were to be made subject to existing tax treaties, which would be hard to reconcile with the sizable revenue estimate by the JCT. As a general matter, legislation and treaties are on equal footing for U.S. purposes, with the result that the later in time prevails in case of clear conflict, suggesting that the new law would be likely to apply even if it would result in overriding existing tax treaties.

## Other provisions

### Modify insurance exception to the passive foreign investment company rules

The new law modifies a pre-enactment law exception from passive income that prevents certain investment income derived from the active conduct of an insurance business from causing a foreign corporation to be a passive foreign investment company (PFIC). Section 14501 of the new law amends this exception in the PFIC rules to apply only to a foreign corporation whose applicable insurance liabilities constitute more than 25% of its total assets as reported on the corporation's applicable financial statement for the last year ending with or within the tax year. Applicable liabilities of any property and casualty or life insurance business include loss and loss adjustment expenses and certain reserves, but do not include unearned premium reserves.

An applicable financial statement is a statement for financial reporting purposes that is made on the basis of generally accepted accounting principles (GAAP), on the basis of international financial reporting standards (IFRS) if no GAAP statement is available, or, "except as otherwise provided by the Secretary in regulations," on the basis of the annual statement required to be filed with the applicable insurance regulatory body, but only if neither a GAAP nor IFRS statement is available. Unless otherwise provided in regulations, GAAP means U.S. GAAP.

Section 14501 of the new law provides potential relief to a foreign corporation that cannot meet the new 25% test by giving the Secretary regulatory authority to allow a U.S. person owning stock of such a foreign corporation to elect to treat it as a qualifying insurance company if (1) its applicable liabilities equal at least 10% of its assets, and (2)

(a) the foreign corporation is predominantly engaged in an insurance business, and (b) the failure to satisfy the greater than 25% threshold is due solely to runoff-related or rating-related circumstances involving such insurance business.

Section 14501 of the new law applies to tax years (presumably of foreign corporations being tested for PFIC status) beginning after December 31, 2017.

The JCT has estimated that this provision also will increase revenues by approximately \$1.1 billion over 10 years.

The text of this provision of the new law is materially the same as section 14501 of the Senate bill and section 4501 of the House bill, and has the same effective date and revenue effect.

#### **KPMG observation**

This provision largely tracks prior legislative proposals that were described as addressing a perceived abuse whereby some insurance activities were used to shelter large investments. The change may also have an impact on non-U.S. insurance companies that insure long-tail and catastrophic risks.

U.S. persons owning stock of a corporation treated as a PFIC because it is ineligible for the active insurance exception in Code section 1297(b)(2)(B) would be required to begin filing Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund, and to consider available PFIC-related elections.

Under Code section 6501(c)(8), a U.S. person that fails to file Form 8621 for a year generally would have the statute of limitations for its tax return for that year kept open until three years after the U.S. person furnishes the required information to the IRS.

Section 14501 of the new law also could require the Department of the Treasury to issue new regulations, and the IRS to amend Form 8621, for taxpayers to take advantage of the election it provides to U.S. shareholders of certain affected foreign corporations that fail the new 25% test.

#### **Repeal fair market value method of interest expense apportionment**

The new law requires taxpayers to allocate and apportion interest expense of members of an affiliated group using the adjusted basis of assets and prohibits the use of the fair market value method.

According to the JCT, this provision will increase revenues by approximately \$600 million over 10 years.

This provision is effective for tax years beginning after 2017.

#### **KPMG observation**

Taxpayers that use the fair market value method to value assets when allocating interest expense are required to switch to the adjusted basis or “tax book value” method. Such a switch could have a dramatic effect on the foreign source income calculation for certain taxpayers.

**Modify Code section 4985 excise tax**

The new law increases the section 4985 excise tax rate from 15% to 20%. This tax is imposed on certain stock-based compensation of corporate “insiders” when a domestic corporation becomes an “expatriated corporation” through an inversion transaction in which a shareholder of the domestic corporation recognizes gain.

The provision is effective upon date of enactment. The JCT has estimated that this provision will increase revenues by approximately \$100 million over 10 years.



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