Mastering Complex Consolidated Return Reporting: 163(j), NOLs, GILTI, Tax Attributes, Tax Allocations and Section 382

TUESDAY, JULY 16, 2019, 1:00-2:50 pm Eastern

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Mastering Complex Consolidated Return Reporting: 163(j), NOLs, GILTI, Tax Attributes, Tax Allocations and Section 382

July 16, 2019

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Strafford Webinar – July 16, 2019

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Your Panel

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Agenda

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Objectives

By the end of this course, you will be able to:

- Identify the basis of calculating GILTI, FDII and the Section 250 deduction in consolidation
- Identify issues related to the calculation of section 163(j)
- Identify the basics related to intercompany transactions under 1.1502-13
- Allocate certain tax attributes among consolidated return members
- Calculate the consolidated section 382 limit and NUBIG

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The Basics of Consolidated Return Eligibility

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Consolidated Returns

- The Internal Revenue Service doesn't require corporations to file consolidated tax returns with their subsidiaries, but it does allow them to do so.
- Before a corporation can file a consolidated return, it must satisfy certain stock ownership and voting requirements.
  - Only corporations that are members of an affiliated group have the option of filing a consolidated return.
  - An affiliated group exists when one parent corporation holds stock that satisfies the voting and value requirements of section 1504 in at least one other corporation.
    - Section 1504 at least 80 percent of value 80 percent of the shares that are eligible to vote (contrast 368(c) control)
    - Includes chains of includible corporations, for example, if a corporation owns 100 percent of a subsidiary that holds 100 percent of the stock in a third corporation, all three entities are members of the affiliated group and may file a single consolidated tax return.

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Consolidated Returns

- Ownership must be of an *includible* corporation:
  - Includible Corporation is defined by exclusion, any corporation other than:
    - Tax-exempt corporations
    - Life insurance companies
    - Foreign corporations
    - Regulated investment companies (RICs) and real estate investment trusts (REITs)
    - Domestic international sales corporations (DISCs)
    - S corporations
- Each subsidiary also must consent to be included
  - The initial return must include each subs Forms 1122
  - When a new member is added a new 1122 must be included

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Consolidated Returns

- Reconsolidation:
  - 5 years must elapse before reconsolidation
    - If a corporation is included in a consolidated return, and that corporation ceases to be a member of the group…
      - Such corporation many not be included in any consolidate return filed by the affiliated group before the 61st month beginning after it's first taxable year ceasing to be a member.
      - See Rev. Proc. 2002-32, PLR 201927002

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Consolidated Return Polling Question

- After deconsolidation, how long does a former group member have to wait to rejoin the consolidated group of the former parent?
  A. 3 years
  B. 5 years
  C. It depends…

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Consolidated Return Provisions Post-Reform

GILTI

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GILTI – In General

- Enacted 2017: §951A tax on global intangible low-taxed income (GILTI)
  - U.S. shareholder of a CFC is required to include its GILTI, currently as taxable income.
    - Regardless of whether any amount is distributed to the U.S. shareholder
    - Effective tax years beginning after 12/31/2017
- This rule generally subjects a U.S. shareholder to tax on the combined net income of its CFCs that (1) is not otherwise taxed in the U.S. on a current basis (e.g., not ECI, not subpart F) or specifically excluded (e.g., related dividends) and (2) exceeds a fixed routine return on the CFC's tangible depreciable assets.

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GILTI – In General

Additional Detail:

- GILTI: the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.
- Net CFC tested income: excess of the aggregate of the U.S. shareholder's pro rata share of the tested income of each CFC over the aggregate of its pro rata share of the tested loss of each CFC. Section 951A(c)(1).
- Tested income: excess of (i) the CFC's gross income:
    - (excluding US source ECI, subpart F income, income excluded from foreign base company income or insurance income by reason of the high-tax exception under section 954(b)(4), dividends received from a related person, and foreign oil and gas extraction income);
  - over (ii) deductions (including taxes) properly allocable to such gross income (or to which such deductions would be allocable if there were such gross income) under rules similar to rules of section 954(b)(5). Section 951A(c)(2)(A)
- Tested loss: excess (if any) of deductions (including taxes) properly allocable to the CFC's gross income determined without regard to the exclusions over the amount of gross income determined with regard to the exclusions.
- Shareholder's net deemed tangible income return: amount equal to 10 percent of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC with respect to which it is a U.S. shareholder, reduced by the amount of interest expense taken into account in determining its net CFC tested income to the extent the interest expense exceeds the interest income properly allocable to such expense that is taken into account in determining its net CFC tested income. Section 951A(b)(2).

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GILTI – In General

Additional Detail:

- QBAI: the average of a CFC's aggregate adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and of a type with respect to which a deduction is generally allowable under section 167. Section 951A(d)(1).
  - The adjusted basis in any property must be determined using the alternative depreciation system under current section 168(g).
  - Depreciation is ratably allocated on a daily basis to specified tangible property in the taxable year to which the depreciation relates.
- Specified tangible property: Property used in the production of tested income. Section 951A(d)(2)(A).
- Specified tangible property held in partnerships: A CFC takes into account its distributive share of the aggregate of the partnership's adjusted bases in tangible property to the extent that such partnership property otherwise meets the requirements for QBAI. Section 951A(d)(3).
  - A CFC's distributive share of the adjusted basis in partnership property is the CFC's distributive share of income with respect to such property.
- Preventing "double benefit" of losses:
  - Section 951A(c)(2)(B)(ii) provides that tested losses of a CFC taken into account in determining GILTI are added back to E&P of the CFC for subpart F E&P limitation purposes under section 952(c)(1)(A).

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GILTI – In General

Additional Detail:

- Deemed paid FTCs are available under section 960 with respect to 80% of: (i) the US shareholder's inclusion percentage, multiplied by (ii) the aggregate tested foreign income taxes of its CFCs. Section 960(d)(1).
- The gross-up under section 78 is 100% of the above amount (rather than 80%).
- The inclusion percentage is equal to:
  - (i) the US shareholder's GILTI amount, divided by
  - (ii) the US shareholder's aggregate pro rata share of the tested income of each CFC. Section 960(d)(2).
- Tested foreign income taxes: the foreign income taxes paid or accrued by a CFC that are "properly attributable" to the CFC's tested gross income. Section 960(d)(3).
- For purposes of determining the foreign tax credit limitation, a US shareholder's GILTI is separately basketed and excess credits are not available for carryover. Section 904(d)(1)(A) & (c).
  - GILTI is not general category income, and income that is both GILTI and passive category income is considered passive category income.
- GILTI basket income appears to be subject to normal expense allocation at the US shareholder level.

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GILTI – In General

Additional Detail:

- Section 250 deduction: A 50% deduction is allowed under section 250 against the sum of (i) amount of GILTI included in the US shareholder's gross income for the taxable year and (ii) section 78 gross-up. Section 250(a)(1)(B).
  - The deduction percentage is 37.5% for taxable years beginning after December 31, 2025
- Taxable income limitation: if
  - the sum of (i) FDII (separately discussed below) and (ii) GILTI otherwise taken into account by the US shareholder, exceeds
  - the taxable income of such US shareholder (determined without regard to the section 250 deductions),
- then FDII and GILTI is each proportionally reduced for purposes of determining the amount to be actually taken into account by the US shareholder. Section 250(a)(2).

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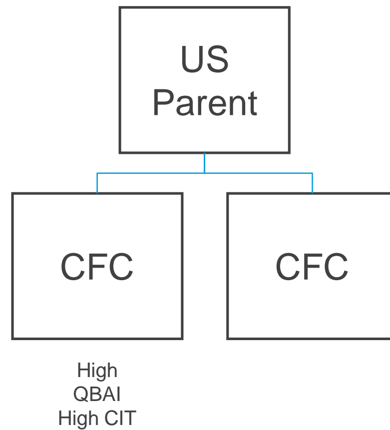
GILTI – General Overview - Example



	GILTI			
	Item	**CFC1**	**CFC2**	**US Parent**
1	Tested Income[1]	$105	$95	$200
2	Tested Loss	$0	$0	$0
3	Net CFC Tested Income			$200
4	Tested Foreign Income Taxes	$25	$5.50	$31
	Foreign effective tax rate on tested income	*19.2%*	*5.5%*	*13.2%*
5	Qualified Business Asset Investment[2]	$1,500	$200	$1,700
6	Net deemed tangible income (10% L5)			$170
7	Interest expense that reduced tested income	$50	$0	$50
8	Excess of L6 over L7			$120
9	GILTI (Excess of L3 over L8)			$80
10	Inclusion percentage (L9/L3)			40%
11	Deemed Paid Credit before 20% haircut (L10*L4)			$12.20
12	Deemed Paid Credit after 20% haircut (80%*L11)			$9.76
13	Grossed up GILTI (L9 + L11)			$92.20
14	50% Deduction (50% * L13)			$46.10
15	Taxable income before credit (L13-L14)			$46.10
16	US tax before credit (21% * L15)			$9.68
17	Foreign tax credit (L12)			$9.76
18	US Tax on GILTI (L16-L17)			$0.00

[1]Excess of gross income reduced by ECI, subpart F income, income that would be subpart F income but for high-tax exception and FOGEI, less allocable deductions

[2]Average of end-of-quarter adjusted bases in tangible depreciable property that generates tested income or loss, determined under ADS

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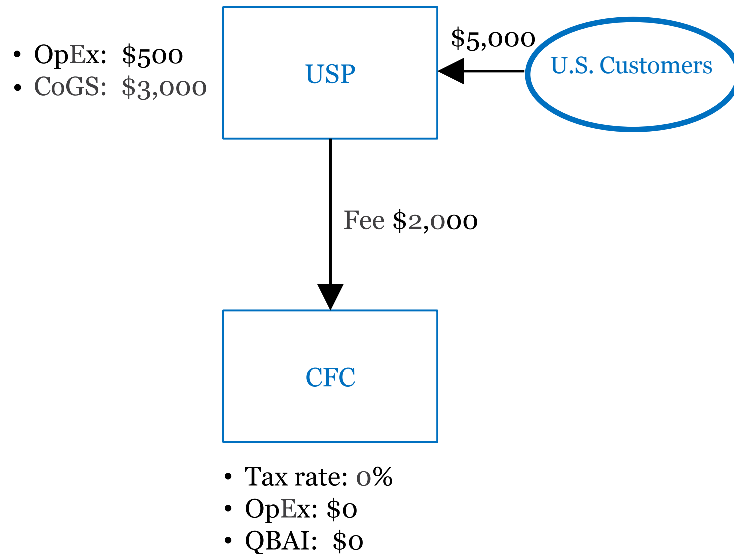
Sec. 250 Limitation and NOLs: Example



- USP has the following items of income, costs, and expenses:
  - Gross receipts from customers: $5000
  - COGS: ($3000)
  - NOL from domestic operations: ($500)
  - Intercompany payment to CFC: ($2000)
  - Gross GILTI inclusion on account of intercompany payment: $2000
  - FDII: $0
- USP thus has taxable income of $1500 before taking into account deduction under section 250.
- The sum of GILTI and FDII, $2000, exceeds taxable income by $500. As a result, the amount of GILTI eligible for the section 250 deduction is reduced by $500 (to $1500).
  - Section 250 deduction is $750.
  - USP's taxable income after taking into account section 250 deduction is $750
- In effect, the $500 reduction to GILTI for section 250 purposes offsets the ($500) NOL.
- Absent the taxable income limitation under section 250:
  - The deduction under section 250 would be $1000.
  - Taxable income would be only $500.

Sec. 250 Limitation and NOLs: Example

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GILTI – In Consolidation

Proposed Regulations §1.1502-51:

- Generally, to determine the consolidated group members GILTI inclusion, pro rata shares of tested low, QBAI, tested interest expense and tested interest of each member are aggregated.
- A portion of each aggregate amount is then allocated to each member of the group that is a US shareholder of a tested income CDC based on the proportion of such member's aggregate pro rata share of tested income to the total tested income of the group.
  - Consistent with the requirement in section 951A for an aggregate, US shareholder-level calculation and with the preamble.

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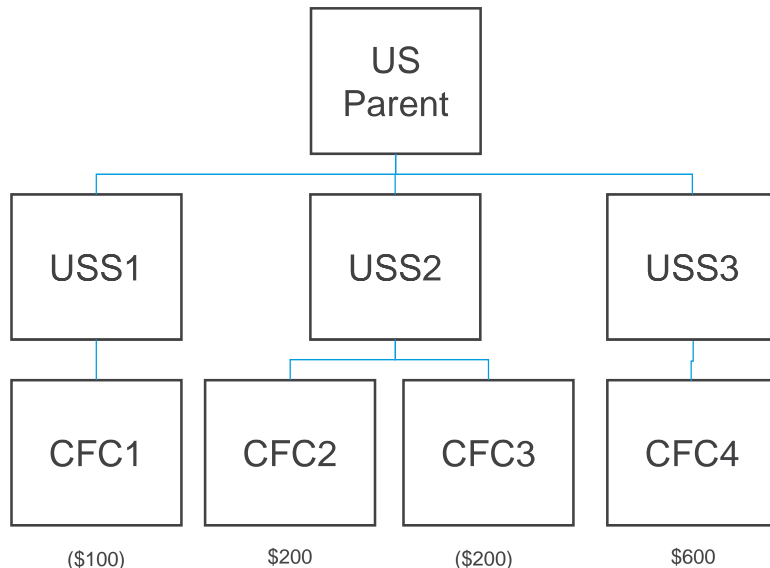
GILTI – In Consolidation - Example



- Absent the proposed regulations, the statute would seem to operate that would leave USS3 with $600 of CFC tested income, even though another member owns a CFC with a tested loss that would not otherwise offset income due to the structure. USS2 would have no net CFC tested income, thus avoiding an inclusion.
- The Proposed Regulations allow netting of tested losses against tested income of other group members.
  - Tested losses are aggregated and then allocated to members that own CFCs that generated tested income. The allocation is based on the ratio of tested income generated by the CFCs owned by any one member to the amount of tested income generated by all CFCs owned by the members.

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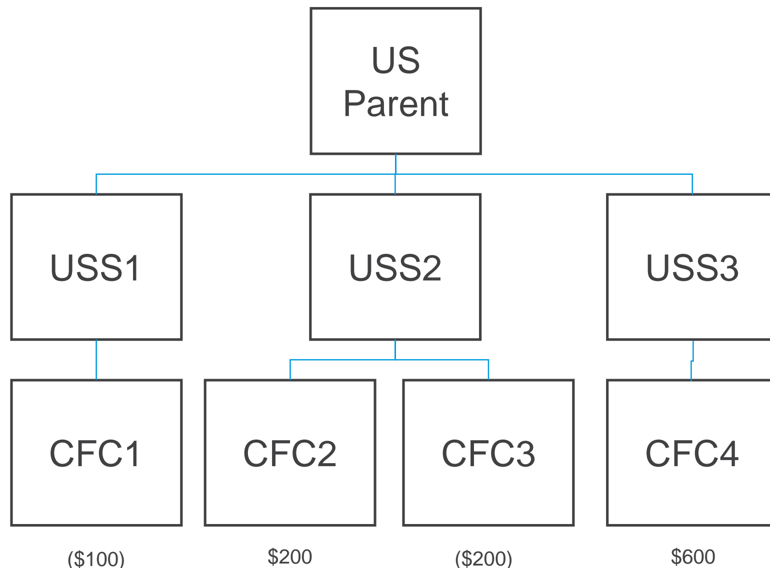
GILTI – In Consolidation – Example (Cont.)



- USS2 has $125 of net CFC tested income (CFC2's $200 income reduced by USS2's $75 share of loss)
- USS3 would have $375 of net CFC tested income (CFC4's $600 of tested income reduced by USS3's $225 share of tested losses from all CFC's)
- These rules prevent tested losses generated from a CFC owned by one member of a group from evaporating when another member of the same consolidated group owns a CFC that generated tested income.

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GILTI – In Consolidation – Stock Basis Considerations

Proposed Regulations §1.1502-51:

- Subject to the allocation of tested income and tested loss above, the group member makes an appropriate basis adjustment for the GILTI inclusion allocated to each member.
- Upon disposition by a member of a consolidated group of Section 958(a) stock in a CFC, under Prop. Reg. §1.951A-6(e)(8) and Prop. Reg. §1.1502-51(c), the must make a downward adjustment to the basis in its CFC stock to account for tested loss produced by such CFC that offset tested income produced by other CFCs held by members of the same consolidated group.
- Additionally, in connection with the application of those rules, Prop. Reg. § 1.1502- 32(b)(3)(ii)(E) and (iii)(C) provide for adjustments to the basis of the stock of a member to reflect those rules.

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GILTI Polling Question

- What type of taxpayer is eligible for the section 250 deduction?
  A. U.S. Partnership
  B. U.S. individual
  C. Domestic Corporation

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Consolidated Return Provisions Post-Reform

FDII

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FDII – In General

Summary of Rule:

- Domestic corporation may deduct an amount which is the lesser of
  - (1) the sum of 37.5% of its foreign-derived intangible income plus 50% of its GILTI that is included in its gross income, or
  - (2) its taxable income.
- Foreign-derived intangible income: with respect to a domestic corporation, the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income.

Foreign Derived Intangible Income	=	Deemed Intangible Income	X	FDDEI / DEI

- Legislative history indicates that the deduction is only available to domestic C corporations which are not RICs or REITS.
- Allowable deduction percentage decreases to 21.875% for FDII and 37.5% for GILTI for tax years beginning after December 31, 2025.

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FDII – In General

Summary of Rule (Continued):

- Deduction eligible income: the excess (if any) of:
  - The gross income of a domestic corporation excluding:
    - Subpart F income,
    - GILTI,
    - any financial services income (as defined in section 904(d)(2)(D)),
    - any dividend received from a CFC by its US shareholder,
    - any domestic oil and gas income of the corporation, and
    - any foreign branch income (as defined in section 904(d)(2)(J));
- Over the deductions (including taxes) properly allocable to such gross income.

Eligible Gross Income	-	Allocable Deductions (including taxes)	=	Deduction Eligible Income

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FDII – In General

Summary of Rule (Continued):

- Foreign-derived deduction eligible income: any deduction eligible income of the taxpayer that is derived in connection with:
  - (1) property that is sold by the taxpayer to any person who is not a US person and that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use; or
  - (2) services provided by the taxpayer that it establishes to the satisfaction of the Secretary are provided to any person, or with respect to property, not located within the United States.

- Foreign use: The sale of property to a foreign related party is not treated as for foreign use unless:
  - "Such property is ultimately sold by a related party, or used by a related party in connection with property which is sold or the provision of services, to another person who is an unrelated party who is not a United States person, and the taxpayer establishes to the satisfaction of the Secretary that such property is for foreign use."
- The TCJA further provides that a sale of property is treated as sale of its component parts.

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FDII – In General

Summary of Rule (Continued):

- Deemed tangible income return: with respect to any corporation, an amount equal to 10 percent of the corporation's QBAI as defined in section 951A(d) without regard to whether the corporation is a CFC.

Qualified Business Asset Investment	X	10%	=	Deemed Tangible Income Return

- Deemed intangible income: the excess (if any) of its deduction eligible income over its deemed tangible income return.

Deduction Eligible Income	-	Deemed Tangible Income Return	=	Deemed Intangible Income

- Foreign-derived intangible income: with respect to a domestic corporation, the amount which bears the same ratio to the corporation's deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income.

Foreign Derived Intangible Income	=	Deemed Tangible Income	X	FDDEI / DEI

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FDII – Example

Foreign-Derived Intangible Income:

- Amount which bears the same ratio to the deemed intangible income as
  - the foreign-derived deduction eligible income, bears to
  - the deduction eligible income

Example:

- Deduction Eligible Income (DEI)= $100
- Foreign-Derived Deduction Eligible Income (FDDEI) = $20
- Qualified Business Asset Investment (QBAI) = $250
- Deemed Tangible Income Return (DTIR) = QBAI x 10% = $25
- Deemed Intangible Income (DII) = DEI ($100) - DTIR ($25) = $75
- Ratio of FDDEI to DEI = $20/$100 = ⅕
- Foreign-Derived Intangible Income (FDII) = $75 x ⅕ = $15

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FDII – Section 250 Deduction

Section 250 Deduction:

- Section 250 deduction for FDII: Section 250 allows for a 50% deduction against both the gross GILTI inclusion and the section 78 gross-up. Section 250 also provides for a 37.5% deduction against foreign-derived intangible income.
  - The amount of GILTI and FDII eligible for deduction is limited to the taxable income of the domestic corporation determined without regard to the section 250 deduction.
  - Section 250(a)(2) provides that the amount of GILTI and FDII for which a deduction is allowed are proportionately reduced by any excess amount.
  - Note, the GILTI and FDII limitation is applied solely for purposes of determining the amount of deduction allowed under section 250 but does not otherwise affect the amounts of GILTI and FDII to be included in the domestic corporation's income.
- Since FDII is a net income amount (after taking into account allocable expenses), the section 250 deduction for FDII is computed on a net income amount, after allocation of expenses.
- NOLs effect on taxable income limitation: NOL carryforwards which reduce taxable income to an amount less than the sum of GILTI and FDII will have the effect of reducing the total deduction available to each. However, the FDII amount itself should already be net of NOLs to begin with.
- Since the section 250 deduction can provide a deduction on qualifying related party payments, it could potentially trigger application of section 267A, resulting in the denial of a deduction at the related payor level. This could have the effect of partially or entirely counteracting the benefit of the section 250 deduction in cases where a CFC makes a payment to a US shareholder to the extent that the elimination of the deduction increases the subpart F income of the CFC.

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FDII – Consolidated Groups

- In order to apply Section 250 to a member of a consolidated group, DEI, FDDEI, DTIR, and GILTI of all members of the consolidated group are aggregated.
  - These aggregate amounts and the consolidated group's consolidated taxable income are then used to calculate the group's overall deduction, which then is allocated among the group's members based on each member's respective proportionate contribution to the consolidated group's aggregate amounts of FDDEI and GILTI.
- Prop. Reg. §1.1502-50(c) addresses the impact intercompany transactions have on calculating a member's QBAI for calculating Deemed Tangible Income Return.
  - Gains or losses realized or deferred by a member in an intercompany transaction are not included in the assets basis.

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Consolidated Return Provisions Post-Reform

163(j)

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Section 163(j) - Generally

- The 2017 tax reform act revised section 163(j) (‘new Section 163(j)’) to generally limit deductions for net business interest expense to 30% of a company’s ‘adjusted taxable income’ (ATI).
  - Prior to release of the Proposed Regulations in 2018, the IRS issued Notice 2018-28, which provided initial guidance with respect to certain aspects of Section 163(j), including its application to consolidated groups and the carryforward of a taxpayer’s disallowed disqualified interest under ‘old’ Section 163(j).
  - The Proposed Regulations were silent on the interaction of the base erosion and anti-avoidance tax (BEAT), but reserved

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Section 163(j) - Generally

Prior Law:

- Under old Section 163(j), a taxpayer's net interest expense deduction for certain interest paid or accrued to a related party that was not subject to US tax (e.g., a foreign related party where US withholding tax was reduced by an income tax treaty) was limited to 50% of the taxpayer's ATI - roughly equivalent to earnings before interest, tax, depreciation, and amortization (EBITDA).
- The same treatment applied to certain interest paid or accrued to an unrelated party on a loan subject to a related-party guarantee. Prior law included a safe harbor under which the limitation did not apply if a taxpayer's debt-to-equity ratio was 1.5 to 1 or less. Disallowed deductions could be carried forward indefinitely, and a taxpayer's excess limitation (the excess, if any, of 50% of the taxpayer's ATI over net interest expense) could be carried forward for three years.

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Section 163(j) - Generally

New Section 163(j)

- New Section 163(j) limits business interest expense deductions to the sum of business interest income, 30% of ATI, and the taxpayer's floor plan financing interest for the tax.
- This new limitation broadly applies to the 'business interest' of any taxpayer (corporate or non-corporate) and regardless of whether the taxpayer is part of an 'inbound' group or an 'outbound' group.
- Unlike old Section 163(j), new Section 163(j) applies regardless of whether the interest payment is made to a US or foreign person, whether the interest recipient is related, or whether the interest recipient is exempt from US tax.

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Section 163(j) - Generally

New Section 163(j)

- ATI is taxable income computed without regard to
  - (1) items not properly allocated to a trade or business;
  - (2) business interest expense or business interest income;
  - (3) net operating losses;
  - (4) the Section 199A deduction; and
  - (5) for tax years beginning before January 1, 2022, deductions allowable for depreciation, amortization, and depletion.
- Thus, certain deductions are added back to taxable income, and certain income (e.g., business interest income) is subtracted.
  - Also adjusted for gain recognized in connection with the sale of stock of a member of a consolidated group.
- For tax years beginning before January 1, 2022, ATI is roughly equivalent to EBITDA (similar to old Section 163(j)).
  - However, for tax years beginning on or after January 1, 2022, ATI will be roughly equivalent to earnings before interest and taxes (EBIT).
- Similar to old Section 163(j), under new Section 163(j), a taxpayer may carry forward disallowed business interest expense indefinitely, but not excess limitation.

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Section 163(j) – Consolidated Groups

<u>New Section 163(j):</u>

- The Proposed Regulations generally provide that a consolidate group has a single section 163(j) limitation
- The new rules do not aggregate members of an affiliated group that do not file a consolidated return for purposes of applying the limitation (compare old 163(j)(6)(C).
- Calculating ATI:
  - The relevant taxable income in computing the ATI of a consolidated group is the consolidated group's taxable income determined under Treas. Reg. §1.1502-11, without regard to any carryforwards or disallowances under Section 163(j).
  - For a taxable year, if a member of a consolidated group is allowed a deduction under Section 250(a)(1) that is properly allocable to a nonexcepted trade or business, then for purposes of calculating ATI, consolidated taxable income for the tax year is determined as if the deduction were not subject to the limitation under Section 250(a)(2) and the regulations thereunder.
  - For purposes of calculating the Section 163(j) limitation of a consolidated group, the current year business interest expense, and business interest income of the consolidated group, respectively, is the sum of the current-year business interest expense and business interest income of all members of the consolidated group.

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Section 163(j) – Consolidated Groups (Continued)

New Section 163(j):

- Intercompany obligations are disregarded for purposes of determining the current-year business interest expense and business interest income of a member. In addition, intercompany obligations are disregarded for purposes of calculating the ATI of a consolidated group.
- Intercompany items and corresponding items are disregarded for purposes of calculating the ATI of a consolidated group to the extent those items offset in amount.

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Section 163(j) – Consolidated Groups (Continued)

New Section 163(j):

- Basis Adjustments:
  - With respect to investment adjustments, Proposed Regulation § 1.163(j)-4(d) provides that if a member of a consolidated group has a current-year business interest expense for which a deduction is disallowed in the current tax year under Section 163(j), basis in the stock of the member of the consolidated group is adjusted in a subsequent taxable year when the expense is absorbed by the consolidated group.
  - The Proposed Regulations also provide that the allocation of excess business interest expense of a member of a consolidated group from a partnership and the resulting decrease in basis in the partnership interest pursuant to Section 163(j)(4)(B) is **not** a noncapital, nondeductible expense for purposes of Treas. Reg. §1.1502-32(b)(3)(iii).
  - Similarly, an increase in a consolidated group member's basis in a partnership interest under Section 163(j)(4)(B)(iii)(II)—for purposes of reflecting excess business interest expense not deducted by the consolidated group—is not tax exempt income for purposes of Treas. Reg. § 1.1502-32(b)(3)(ii).

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Section 163(j) – Consolidated Groups (Continued)

New Section 163(j):

- Disallowed business interest expense carryforward:
  - Generally treat a consolidated group similarly to a C corporation for purposes of the disallowed business interest expense carryforward.
  - In addition, Proposed Regulation sec. 1.163(j)-5(b)(3) provides that disallowed business interest expense carryforwards from prior separate return limitation years are subject to the SRLY limitation.
  - The Proposed Regulations also provide rules regarding which member's business interest expense is deductible by the consolidated group in the current year and how much disallowed business interest expense leaves with a member departing the consolidated group.

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Section 163(j) – Consolidated Groups (Continued)

New Section 163(j):

- Limitations on disallowed business interest expense carryforwards from SRLYs:
  - On SRLY carryforwards, they may only be used:
    - First, by a consolidated group in a tax year to the extent such consolidated group has any remaining Section 163(j) limitation for that year subsequent to the application of Proposed Regulation §1.163(j)-5(b).
    - Second, to the extent the Section 163(j) limitation of the member of the consolidated group for that year exceeds the amount of the business interest expense of such member that already was taken into account by the consolidated group in that year pursuant to Proposed Regulation §1.163(j)-5(b).
    - Third, the SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis with non-SRLY limited disallowed business interest expense carryforwards from tax years ending on the same date.

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Section 163(j) – Consolidated Groups (Continued)

New Section 163(j):

- Overlap of SRLY and Section 382:
  - Proposed Regulation §1.163(j)-5(f) applies the principles of Treas. Reg. §1.1502-21(g) to disallowed business interest expense carryforwards when the application of the SRLY limitation results in an overlap with the application of Section 382.
    - Applying this overlap rule effectively prevents both the Section 382 limitation and the SRLY limitation from concurrently applying to disallowed business interest expense carryforwards in certain circumstances.
- Proposed Regulation §1.163(j)-11(a) provides rules regarding when a corporation that is subject to the Section 163(j) limitation joins a consolidated group whose tax year began before January 1, 2018, and thus is not subject to the Section 163(j) limitation.
  - Under this provision, the status of the acquiring group will control the application of Section 163(j) to a target during the period that the target is included in the acquiring group.

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Section 1202

- Do you have dynamic consolidated groups for which the complex 163(j) SRLY rules may be applicable?

  A. Yes
  B. No

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Consolidated Return Provisions Post Reform

NOLs

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Section 172 Overview

- Enacted an 80% taxable income limitation on the amount of section 172 deduction for NOLs
  - Section 172(a)(2) provided the deduction for the taxable year is the lesser of:
    - The NOL carryovers to such year, or
    - 80 percent of the taxable income computed without regard to the 172 deduction
- The new rules apply to NOLs arising in taxable years beginning after 12/31/2017
  - Old rules continue to apply to NOLs generated in years prior to 1/1/2018
- NOL carryback eliminated, unlimited carryforward

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Section 172 Overview

- Thus the potential that both provisions may apply if a taxpayer has both pre-2018 NOLs and post-2017 NOLs.
  - For example, if calendar year corporation XYZ has $100 million in NOLs generated through December 31, 2017 and incurs a $20 million NOL in the tax year ending Dec. 31, 2018, the applicable NOL rules would require XYZ to track the 2017 and prior NOLs separately from the 2018 NOL, which is subject to the limitation.
  - If in 2019 XYZ generated $100 million in income, it would appear that the entire $100M of 2017 and prior NOL would be available. If on the other hand, XYZ generated $110 million in income the answer appears less clear.
    - Could XYZ argue that they should be able to offset the additional $10M in income with $8 million of NOL, or is the utilization of the 2018 NOL zero because 80 percent of $110M is $88 million, which is less than the $100 million of NOL applied to the income in the current tax year?
    - A plain reading of the statute would appear to place a limitation of $0 on the 2018 NOL.

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Which comes first?

- As indicated above, the section 250 deduction can reduce the effective tax rate for GILTI and FDII, but it's subject to a taxable income limitations.
- So how do we layer in section 163(j) and 172?
  - Does taxable income include reductions to TI due to 172?
  - Does taxable income include reductions due to use of interest expense carryforwards?
  - Inclusion of these amounts deductions could reduce the benefit of the section 250 deductions.

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Which comes first (continued)?

- The proposed regulations apply the following five steps sequentially:
  - Compute the tentative amount of the FDII and section 250 deduction (Tentative Section 250 Deduction) taking into account all deductions except (i) section 163(j) interest deduction carryforwards or disallowances and (ii) section 172 NOL deductions.
  - Compute the section 163(j) interest deduction, taking into account the amount of the Tentative Section 250 Deduction, but without regard to any section 172 NOL deductions.
  - Compute the section 172 NOL deduction, taking into account the section 163(j) interest deduction, but without regard to the section 250 deduction (or the Tentative Section 250 Deduction).
  - Compute the FDII, taking into account the section 163(j) deduction and the section 172 NOL deduction (determined in previous steps).
  - Compute the section 250 deduction, taking into account the section 163(j) deduction and the section 172 NOL deduction (determined in previous steps).
- These proposed regulations apply to taxable years ending on or after March 4, 2019. However, for taxable years beginning on or before March 4, 2019, taxpayers may use reasonable documentation maintained in the ordinary course of the taxpayer's business to establish certain relevant facts.

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Issues in Intercompany Transactions

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Intercompany Transactions under Treas. Reg. §1.1502-13

- The purpose of the intercompany transaction regulations is to provide rules to clearly reflect the taxable income and tax liability of the group as a whole by preventing intercompany transactions from creating, accelerating, avoiding, or deferring consolidated taxable income or consolidated tax liability
- These regulations define "intercompany transaction" broadly.
  - An intercompany transaction is any "transaction between corporations that are members of the same consolidated group immediately after the transaction."
  - The regulations further use the nomenclature "S" as the member transferring property or providing services and "B" as the member receiving the property or services (Treas. Reg. §1.1502-13(b)(1)).

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Intercompany Transactions under Treas. Reg. §1.1502-13

- The matching rule requires that the attributes of the intercompany item and the corresponding item be redetermined to the extent necessary to produce the effect of a transaction between divisions of a single corporation.
- Once both the intercompany item and the corresponding item are calculated, the recomputed corresponding item must then be calculated.
- The acceleration rule requires items deferred under the matching rule to be taken into account when it first becomes clear that it is no longer possible to achieve single-entity treatment under the matching rule, generally when the selling or buying member leaves the group.

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Intercompany Transactions under Treas. Reg. §1.1502-13 (Example)

- S holds investment property with a basis of $100 and a fair market value of $200. In Year 1, S sells the property to B for $200. B holds the property for investment with a basis of $200. In Year 3, B sells the property to X, a nonmember, for $300.
  - S's sale to B is an intercompany transaction, because it involves a transfer of property between corporations that are members of the same consolidated group immediately after the transaction.
  - S's $100 gain is its intercompany item ($100 intercompany gain).
  - B's gain with respect to the property from the sale to X is its corresponding item ($100 corresponding gain).
  - If S and B were divisions of a single corporation, that hypothetical corporation would ignore the transfer between its divisions for tax purposes and would keep S's original basis of $100 in the property; the hypothetical single corporation would realize an amount of $300 upon the sale to X.
  - Thus, if S and B were merely divisions of a single corporation, the hypothetical corporation would recognize $200 of gain in Year 3 on the sale to X. The recomputed corresponding item is, therefore, a $200 recomputed gain.

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Allocating Tax Attributes

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Allocating Tax Attributes

In general:

- When a member leaves a loss consolidated group, a portion of the group's CNOL may be allocated to the deconsolidated member under Treas. Reg. § 1.1502-21(b)(2) (additional attributes as described above).
- If the consolidated group has an ownership change, the common parent may elect to apportion part or all of the group's Section 382 limitation to the former member.
  - Note that the election may apply to any SRLY loss carryovers of the former member as well as its portion of the CNOL. Any SRLY loss carried forward to its first separate return year that is Section 382 limited continues to be Section 382 limited, except that the limitation is reduced if a subsequent ownership change results in a smaller limitation.
  - A group's or subgroup's NUBIG may also be apportioned to a departing member.
  - A portion of the NUBIL of a group (or subgroup) is automatically allocated to a departing member if that member takes with it any BIL assets that were taken into account at the change date.

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Consolidated E&P

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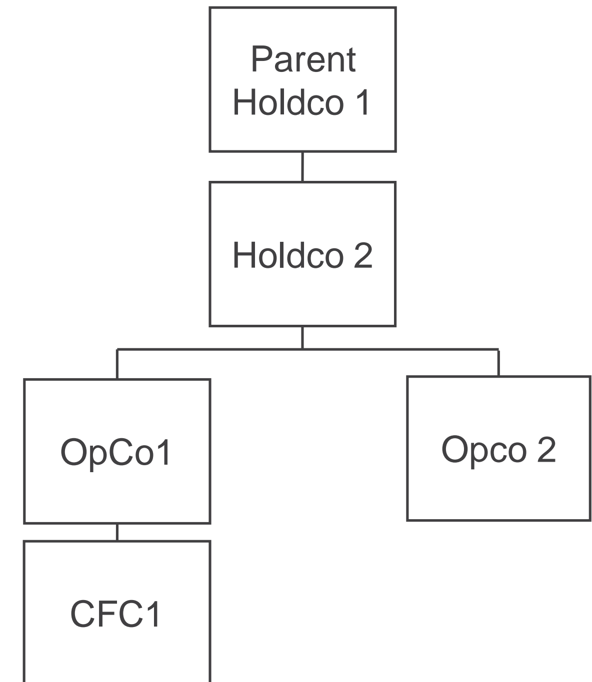
When is an E&P or stock basis study needed?

- When does E&P matter?



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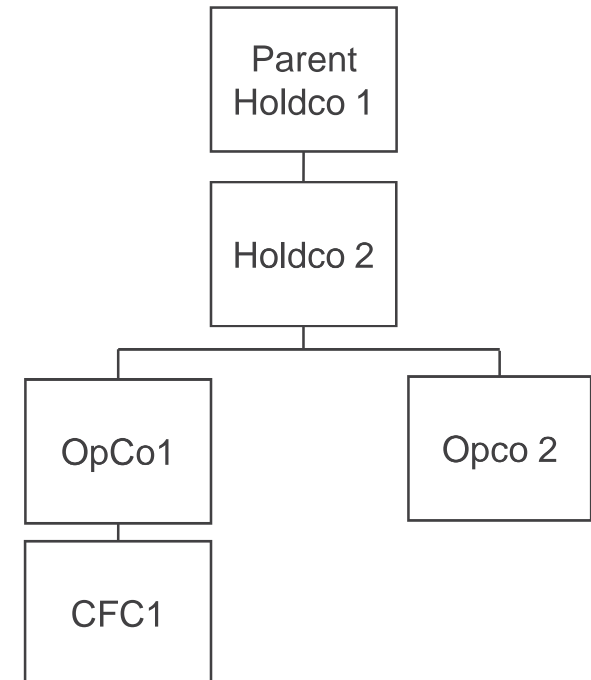
When is an E&P study needed?

- When does E&P matter?
  - Distribution by Parent to shareholders
    - Including redemption of Parent shares that receives distribution treatment under §301(c) rather than exchange treatment under §302(a)
    - Dividend to the extent of available E&P
    - Example = typical "dividend recap" of successful PE-owned portfolio company
  - Determining amount to distribute to zero out income if corp is a REIT or RIC
  - Recognizing subpart F income to the extent of available CFC E&P
  - Sale of CFC
  - Certain sales or spin-offs of a subsidiary where new owners will need E&P info
  - S corporations with C corp E&P or acquiring a C corp target and making a QSub election for target



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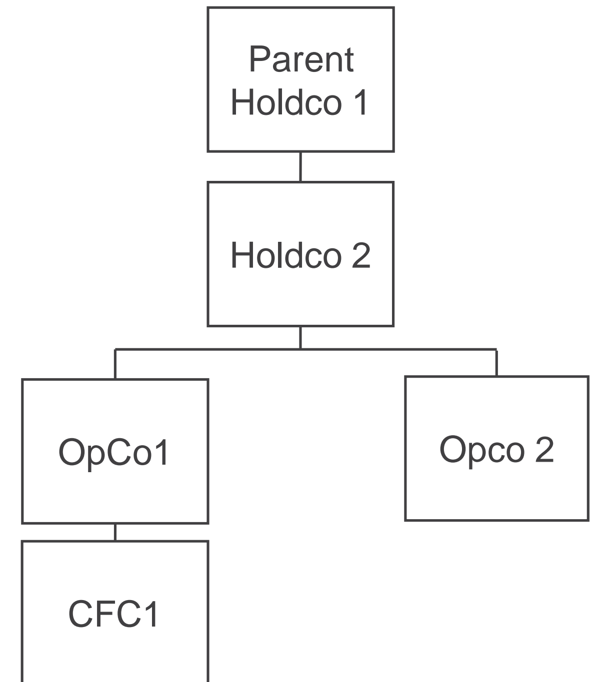
When is a stock basis study needed?

- When does consolidated stock basis matter?



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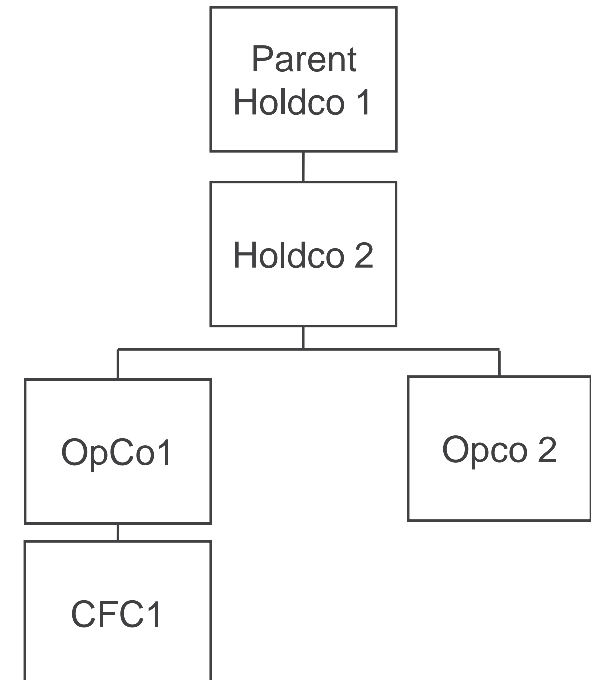
When is a stock basis study needed?

- When does consolidated stock basis matter?
  - Sale of subsidiary out of a consolidated group (or other disposition)
  - Worthless stock deduction
  - Liquidation (including deemed and de facto liquidations) of subsidiary within consolidated group



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What is E&P?

- No statutory or regulatory definition of E&P (earnings and profits)
- Governed by:
  - Case law, rulings
  - Code and regulations' provisions addressing specific categories of items
- E&P represents economic income available for distribution
- Intended to measure a corporation's ability to pay dividends
- Starting point for E&P is taxable income (computed in accordance with US federal income tax rules)

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E&P adjustments for nontaxable, nondeductible, and noneconomic items

- Consistent with the ability to pay concept, adjustments are made to E&P for items of economic income or expense that are not includible or deductible for fed tax
  - Income examples:
    - Exempt life insurance policy proceeds
    - Tax-exempt interest
  - Expense examples:
    - Nondeductible interest expense
    - Federal income tax expense
- Adjustments are also made for fed tax items of income and deduction that are noneconomic.
  - Examples include:
    - Dividends received deduction
    - Section 78 gross-ups included in taxable income by taxpayers claiming foreign tax credit
    - Section 199 domestic production activities deduction (repealed)

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E&P: accounting consistency rule, depreciation

- Another general principle of E&P computations is the accounting consistency rule
  - Accounting methods used for federal tax purposes generally apply for E&P purposes
- Examples include:
  - Pension costs
  - Amortization of original issue discount
  - Net operating loss (NOL) reduces E&P in the year incurred
- Similarly, gain realized but not recognized generally does not increase E&P – examples:
  - §1031 like-kind exchanges
  - Transactions qualifying under §351, §354, or §361
- However, depreciation for E&P purposes uses the alternative depreciation system (ADS)
  - Not MACRS
  - No bonus depreciation

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Consolidated E&P in general

- The rules for separate company E&P generally apply
- With modifications under consolidated return regulations generally geared toward single entity treatment of group
  - Tier up to parent
  - E&P elimination (e.g., upon liquidation or deconsolidation of subsidiary)
    - Not addressed in this presentation
  - Allocation of tax liability
    - Addressed later in this presentation

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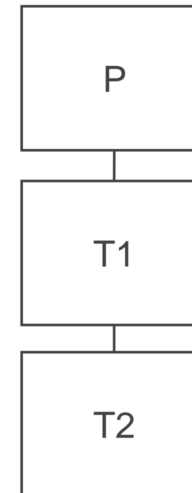
Earnings and profits – tier ups

- Tiering up of E&P
  - E&P of subsidiaries earned (or E&P deficit) during affiliation tier up to the common parent
  - For example, if subsidiary has ($5M) E&P deficit for a Tax Year 1, its parent has a ($5M) tier up adjustment reducing E&P for Tax Year 1
- New Holdco doesn't include target's historical E&P (pre-affiliation E&P)
  - Result: if new parent P acquires 2 year old T group in Year 3, T group's E&P from Years 1 and 2 does not affect whether distributions made by P are dividends (illustrated next slide)



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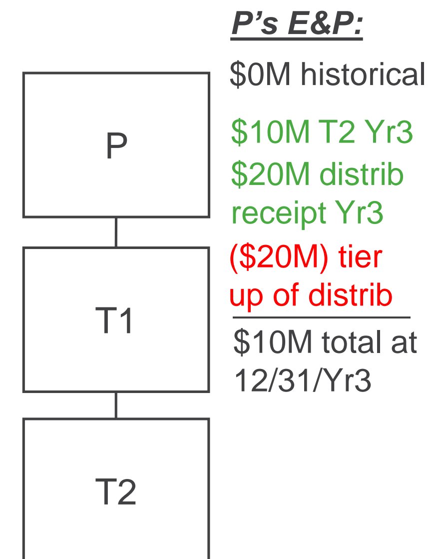
Earnings and profits – tier up illustration

- Newco P acquires 100% of T stock in Year 3, when T1 and T2 each have $20M of E&P
- P's E&P is zero on first day after acquisition
- P, T2 and T3 respectively earn $0, $0 and $10M separate co E&P in Year 3
- On 12/31/Year 3:
  - T2 distributes a $30M dividend to T1
  - T1 distributes a $30M dividend to P
- E&P results:
  - When $30M E&P is dividended up, recipient increases E&P by $30M and dividend distributing subsidiary decreases its E&P by $30M
  - Distributing sub's $30M decrease also tiers up to recipient's (its parent's) E&P, so net $0 adjustment to parent's E&P for each dividend
  - T2's $10M Year 3 E&P tiers up to both T1 and T2
  - P has $10M of E&P at 12/31/Year 3



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Consolidated Section 382

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Section 382 Basics

- Section 382 imposes a limitation on NOLs and other attributes when a loss corporation undergoes an ownership change.
- Under Section 382, an ownership change occurs when the ownership of shareholders owning 5% or more of the loss corporation increases by more than 50 percentage points within a three-year period.
- Once an ownership change occurs, the loss corporation's ability to use any pre-change losses each year is limited to the applicable Section 382 limitation, calculated as the value of the loss corporation's stock immediately before the ownership change multiplied by the applicable long-term tax-exempt rate.
  - As discussed above, for Section 382 purposes, a disallowed business interest carryforward under Sec. 163(j) is considered a pre-change loss and therefore is subject to the Section 382 limitation.

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Section 382 in Consolidation

- The regulations adopt a single-entity approach to an ownership change of an existing consolidated group or the acquisition of another group of affiliated corporations and the resulting limitations under Section 382.
- The ownership change testing rules, the computation of the Section 382 limitation, the BIL rules, and the other provisions of Section 382 generally also apply to consolidated groups.
- Generally… but of course the consolidated return rules are even more complex, because they must also cover minority shareholders and acquisitions of subgroups, as well as members entering and leaving the consolidated group.

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Section 382 in Consolidation (continued)

Ownership change:

- Parent Change Method:
  - Tested on a consolidated basis by examining stock changes of the common parent rather than testing each member of the group separately.
- Supplemental Change Method:
  - Under the parent change method, corporate groups could circumvent the Section 382 limitation by having a purchaser acquire shares of both the common parent and one or more of its subsidiaries.
  - Although the purchaser would have more than a 50 percent economic ownership of the group, there would not be a more-than-50-percent ownership change with respect to the common parent company.
    - Supplemental method: a 5 percent shareholder of the common parent is deemed to increase its percentage interest in the common parent by an amount equal to the value of the increase in its percentage interest in the subsidiary stock (determined on a separate-entity basis).

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Section 382 in Consolidation (continued)

<u>Ownership change (Example)</u>:

- P files a consolidated return with its subsidiary, S, and in 2001 the group had a CNOL that is carried to 2002.
- In 2002, B buys 49 percent of P and 20 percent of the shares of S, which in total represent more than a 50 percent economic interest in the P group.
  - Although B does not actually own more than 50 percent of P, there would be an ownership change under the supplemental method.
  - Note that ordinarily there would not have been an ownership change if an unrelated party purchased the shares of S, because the unrelated party is not also a 5 percent shareholder of P.

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Section 382 in Consolidation (continued)

Consolidated Section 382 Limit:

- Ordinarily, a consolidated group computes its Section 382 limitation by multiplying the loss group's value immediately before the change by the long-term tax-exempt rate.
- For this purpose, the group's value consists of the value of each member's stock, other than stock owned directly or indirectly by another member.

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Section 382 in Consolidation (continued)

Consolidated NUBIG/NUBIL:

- The Section 382 limitation also may be increased by built-in gains recognized during the five-year period beginning on the change date and for certain Section 338 gains.
- A loss corporation must have net unrealized built-in gain (NUBIG) exceeding a threshold amount on the change date to benefit from recognized built-in gain during the recognition period.
- Recognized BILs and certain built-in deductions (to the extent the loss corporation has NUBIL exceeding the threshold amount on the change date) during this period are treated as prechange losses subject to the Section 382 limitation.

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Section 382 in Consolidation (continued)

Consolidated NUBIG/NUBIL:

- In determining the group's net unrealized built-in gain (NUBIG) and net unrealized built-in loss (NUBIL), the threshold requirement applies on an aggregate basis and not on a member-by-member basis.
- Further, the group does not include any built-in gain or built-in loss on the stock of another member of the group, but looks to inside asset basis.
- Subgroup nuances.

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