US tax reform: A sea change for international taxation
The Dbriefs Tax Reform series
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Polling question #1

How would you describe the US’s new tax system?

• Territorial tax system/Participation exemption system
• Full inclusion system with Foreign Tax Credits
• Other
• Don’t know/Not applicable
Big picture changes in the tax system
Tax Reform

Overview of key provisions

• New Tax System Effectively Ends Deferral
  – Subpart F, Sec. 956, and GILTI subject to full inclusion, offset by FTCs
  – Only earnings equal to 10% of foreign tangible asset basis eligible (less interest) for deferral and 100% DRD for corporate owners.

• Additional FTC baskets with expense apportionment

• Foreign Derived Intangible Income eligible for a deduction

• Transition Tax
  – Complex calculation with different measurement dates for E&P and cash, complex rules for deficits and potential for different inclusion dates

• Interaction of provisions adds complexity and potential for double taxation

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Transition tax

<table>
<thead>
<tr>
<th></th>
<th>Cash</th>
<th>Non-cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>15.5%</td>
<td></td>
<td>8%</td>
</tr>
</tbody>
</table>

---

US tax reform: A sea change for international taxation
Transition tax
Transition tax

- Under tax reform, the United States is moving from a system whereby foreign earnings were generally taxed upon receipt of a dividend (deferral) to a system whereby, for most US MNCs, a significant portion of foreign earnings will be included on a US tax return currently.

- The transition tax is required to transition to the new system. The transition tax requires 10% direct and indirect shareholders to pay tax on the amount of post-1986 untaxed earnings (reduced by certain deficits and offset by a reduced FTC) at a reduced rate of tax.

- Corporate transition tax rate:
  - 15.5 percent on cash and cash-equivalent assets; and
  - 8 percent on non-cash assets.

- There is an election to pay the transition tax in increasing installments over eight years.
Transition tax example
Basic structure
Transition tax example

Analysis

<table>
<thead>
<tr>
<th></th>
<th>Accumulated E&amp;P</th>
<th>Tax Pool</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC 1</td>
<td>1,100.00</td>
<td>50.00</td>
</tr>
<tr>
<td>CFC 2</td>
<td>100.00</td>
<td>80.00</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>1,200.00</strong></td>
<td><strong>130.00</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>12/31/2015</th>
<th>12/31/2016</th>
<th>FY15-16</th>
<th>12/31/2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate Cash</td>
<td>1,000.00</td>
<td>500.00</td>
<td>750.00</td>
<td>1,100.00</td>
</tr>
<tr>
<td>A/R Net of A/P</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

E.g., stocks, bonds, Treas. bills, bank certs. of dep., bankers’ acceptances, corp. commercl. paper & other money mkt. instruments

<table>
<thead>
<tr>
<th></th>
<th>12/31/2015</th>
<th>12/31/2016</th>
<th>Average</th>
<th>12/31/2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aggregate Cash Equivalents</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Aggregate Cash Balance</td>
<td>1,100.00</td>
<td>600.00</td>
<td>850.00</td>
<td>1,200.00</td>
</tr>
</tbody>
</table>

Cash Balance (higher of average of 12/31/15 and 12/31/16 balance, or 12/31/17 balance)

- 1,200.00

Residual

- 1,200.00

Total E&P
Transition tax example
Analysis (cont.)*

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Determine E&amp;P</td>
</tr>
<tr>
<td>2A</td>
<td>Calculate Deemed Deduction for Cash</td>
</tr>
<tr>
<td>2B</td>
<td>Calculate Deemed Deduction for Non-Cash</td>
</tr>
<tr>
<td>3</td>
<td>Determine Inclusion</td>
</tr>
<tr>
<td>4A</td>
<td>Calculate Gross up by Cash Tax Credit</td>
</tr>
<tr>
<td>4B</td>
<td>Calculate Gross up by Non-Cash Tax Credit</td>
</tr>
<tr>
<td>5</td>
<td>Determine Taxable Income</td>
</tr>
<tr>
<td>6</td>
<td>Determine Tax at 35%</td>
</tr>
<tr>
<td>7</td>
<td>Reduce by FTC</td>
</tr>
<tr>
<td></td>
<td>Net Tax</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Step</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Total E&amp;P Inclusion</td>
</tr>
<tr>
<td>2A</td>
<td>Deduction Allowed for Cash</td>
</tr>
<tr>
<td>2B</td>
<td>Deduction Allowed for Non-Cash</td>
</tr>
<tr>
<td>3</td>
<td>Subtotal</td>
</tr>
<tr>
<td>4A</td>
<td>Section 78 Gross-Up for Cash</td>
</tr>
<tr>
<td>4B</td>
<td>Sec. 78 Gross-Up for Non-Cash</td>
</tr>
<tr>
<td>5</td>
<td>Total Taxable Income</td>
</tr>
<tr>
<td>6</td>
<td>Tax at 35%</td>
</tr>
<tr>
<td>7</td>
<td>Foreign Tax Credit</td>
</tr>
<tr>
<td></td>
<td>Net Tax</td>
</tr>
</tbody>
</table>

ETR: 12.4%

Section 78: Any taxes deemed paid by a domestic corporation for the taxable year generally needs to be included in the gross income of such corporation for such year.

*Please note that this example assumes a calendar year taxpayer
Polling question #2

Which statement below most closely matches your perception of the global intangible low-taxed income (GILTI) provision?

• Good for my organization and will make the U.S. more competitive
• Will not have a significant impact to my organization
• Unsure, as I’m still learning the implications of the provision to my organization
• Don’t know/Not applicable
GILTI—Global Intangible Low-Taxed Income
GILTI—Global Intangible Low-Taxed Income

• GILTI is a new category of income that ends the deferral of taxation on a significant portion of foreign earnings. Under the GILTI regime, for many US MNCs a significant portion of foreign earnings are now taxed currently at a reduced rate.

• GILTI income is generally income earned by foreign corporations in which a US person owns 10 percent (directly or indirectly). The income, minus a specified tangible property return, is included in the income of the US shareholders. A US domestic corporation shareholder will generally be able to take a deduction on the GILTI amount and is entitled to a reduced foreign tax credit.

  - The deduction is 50 percent of the GILTI amount, limited to taxable income, from 2018 to 2025, and 37.5 percent starting in 2026.

  - When combined with the 21 percent corporate income tax rate, the effective US tax rate on GILTI is 10.5 percent for the years 2018 through 2025 and 13.125 percent starting in 2026, minus a reduced foreign tax credit.
• Many new terms of art have been created for the GILTI calculation, and the calculation itself is complicated

• The core of the GILTI calculation is to start with the foreign corporation’s gross income (excluding certain items) and then to reduce that gross income by the foreign corporation’s deductions, including taxes

  – The remainder is then reduced further by a deemed 10 percent return on the tax basis of depreciable tangible property (minus any relevant interest expense). This final amount is the GILTI amount included in income by each US shareholder of the foreign corporation

  – The tax liability resulting from the GILTI inclusion is reduced by a 50 percent deduction before 2025 and a 37.5 percent deduction minus a reduced foreign tax credit
GILTI example

**GILTI calculation**

**Global Intangible Low Taxed Income**
- Net CFCs tested income: $425 + $100 = $525

  CFC1 tested income: $425
  $500 Gross Income
  - $75 Allocable deductions and taxes
  $425

  CFC2 tested income: $100
  $100 Gross income
  - $0 Allocable taxes
  $100

- GILTI: $525 – ($0 Tangible Asset Basis) = $525

**FTC calculation**
- Inclusion percentage: $525/$525 = 1
- Aggregate taxes: $75 + $0 = $75
- Deemed paid credit: 80% * 1 * $75 = $60
- §78 gross-up: 100% * 1 * $75 = $75

**Total §951A Inclusion**
- Grossed-up GILTI: $525 + $75 = $600
- Less deduction for foreign-derived intangible income: $600 * 50% = $300

**Scenario 1**
- US taxpayer WITH Foreign Tax Credit limitation
  - Residual US tax: $600 – $300 = $300
  - Less FTC: $60
  - Residual Tax = $3

**Scenario 2**
- US taxpayer WITHOUT Foreign Tax Credit limitation
  - Residual US tax: $600 – $300 = $300
  - Less FTC = $0
  - Residual Tax = $63

**Key takeaway**

Taxpayer’s foreign tax credit position can have a profound impact on the application of GILTI. Consider the following scenarios:
- US NOLs
- Significant 861 interest allocations
- Individual taxpayers

* No expenses other than interest expense and taxes

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### US taxation of GILTI

#### Taxable income limitation

<table>
<thead>
<tr>
<th>USP</th>
<th>Tested Income: $100</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Taxes: $0</td>
</tr>
<tr>
<td></td>
<td>QBAI: $0</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>CFC1</th>
<th>Taxable Loss: ($50)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(without regard to GILTI)</td>
</tr>
<tr>
<td></td>
<td>FDII: $0</td>
</tr>
</tbody>
</table>

#### GILTI calculation

**USP**
- Net CFC tested income: $100 (CFC1 gross income)
- GILTI: $100
- Deemed paid taxes: $0
- § 78 gross-up: $0

**Residual US tax**
- Gross income in GILTI basket: $100 (CFC1 GILTI)
- GILTI deduction:
  - Sum of FDII ($0) + GILTI and related § 78 gross-up ($100) = $100
  - Taxable income determined without regard to FDII/GILTI deduction = $50 ($100 GILTI + ($50) taxable loss); *Taxable income limitation under section 250(a)(2) applies*
  - Excess of FDII + GILTI and related § 78 gross-up = $50; Amount of FDII and GILTI reduced proportionately by the $50 excess; GILTI reduced by total $50 excess because no FDII
  - GILTI deduction is 50% x ($100 - $50 excess) = $25
- Total inclusion after deduction: $75
- US tax: $25 x 21% = $5.25
- Effective US tax on GILTI: $75 x 21% = $15.75
- Effective US tax rate on GILTI = 15.75% (i.e., more than the 10.5% minimum US tax)

#### Key takeaways

- The taxable income limitation under section 250(a)(2) applies if the sum of FDII and GILTI (including the related § 78 gross-up) exceeds the taxable income of the domestic corporation (determined without regard to the FDII/GILTI deduction, but with regard to the FDII and GILTI amounts).
- The taxable income limitation results in an effective US tax higher than the 10.5% minimum US tax.
US taxation of GILTI

Effect of expense apportionment to GILTI basket

### No expense apportionment to GILTI

**USP**
- Net CFC tested income: $140 CFC1 gross income - $40 foreign taxes = $100
- GILTI: $100
- Deemed paid taxes: 80% x 100% x $40 = $32
- § 78 gross-up: 100% x 100% x $40 = $40

**USP**
- Residual US tax
  - GILTI inclusion less 50% deduction: 50% x ($100 + $40) = 50% x $140 = $70
  - US tax before FTC: 21% x $70 = $14.70
  - FTC: $14.70*
  - Residual US tax: $0

*Assumes no expenses allocated and apportioned to the GILTI basket

### Expense apportionment to GILTI

**USP**
- Net CFC tested income: $140 CFC1 gross income - $40 foreign taxes = $100
- GILTI: $100
- Deemed paid taxes: 80% x 100% x $40 = $32
- § 78 gross-up: 100% x 100% x $40 = $40

**USP**
- Residual US tax
  - GILTI inclusion less 50% deduction: 50% x ($100 + $40) = 50% x $140 = $70
  - US tax before FTC: 21% x $70 = $14.70
  - FTC: $14.70*
  - Assume that ($70) of expenses is allocated and apportioned to the GILTI basket:
    - FTC limitation: 21% x ($70 - $70 expense) = $0; No FTCs allowed.
    - Residual US tax: $14.70 ($14.70 of FTCs permanently lost)

### Key takeaways

- Every $1 of expense allocated and apportioned to the GILTI basket results in additional US tax ($0.21), regardless of the foreign effective rate on the GILTI.
US taxation of GILTI
Individual and Section 962(b) election

Residual US tax calculation WITHOUT Section 962(b) election

<table>
<thead>
<tr>
<th>US individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Net CFC tested income: $100 CFC1 gross income - $13.125 foreign taxes = $86.675</td>
</tr>
<tr>
<td>• GILTI: $86.675</td>
</tr>
<tr>
<td>• § 960 deemed paid taxes and § 78 gross-up: N/A for individuals</td>
</tr>
</tbody>
</table>

Residual US tax calculation WITH Section 962(b) election

<table>
<thead>
<tr>
<th>US individual</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Net CFC tested income: $100 - $13.125 = $86.675</td>
</tr>
<tr>
<td>• GILTI: $86.675</td>
</tr>
<tr>
<td>• Deemed paid taxes: 80% x 100% x $13.125 = $10.50</td>
</tr>
<tr>
<td>• § 78 gross-up: 100% x 100% x $13.125 = $13.125</td>
</tr>
<tr>
<td>• Total inclusion: $100 ($86.675 GILTI + $13.125 § 78 gross-up)</td>
</tr>
</tbody>
</table>

Key takeaways

- US individuals are not eligible for § 960 deemed paid credit associated with GILTI or the 50% GILTI deduction under § 250.
- Consider making a section 962(b) election to mitigate the U.S. tax on a GILTI inclusion. In such case, a U.S. individual should be taxed at the corporate income tax rate on his or her GILTI, and may be eligible for the 80% deemed paid credit under § 960(d).
  - Query whether the § 962(b) election results in eligibility for individuals to apply the 50% deduction under § 250. If a U.S. individual is not eligible for the 50% GILTI deduction, the U.S. residual tax threshold on GILTI would be 26.25% (= 21% / 80%).
FDII—Foreign-Derived Intangible Income
FDII—Foreign-Derived Intangible Income

• FDII is a new type of income category for US corporations
• Many new terms of art have been created for the calculation of FDII, and the calculation itself is complicated
• FDII is income derived from:
  – Sales or other dispositions of property to a foreign person for a foreign use;
  – A license of IP to a foreign person for a foreign use; and
  – Services provided to a person located outside of the United States.
• Special rules apply to related-party transactions, but many related-party transactions are likely to qualify if the property or services is for use by a third party outside the United States
• US corporations are required to include FDII in gross income but then will be allowed a deduction on the FDII
  − From 2018 through 2025, the deduction is 37.5 percent, and starting in 2026 it is 21.875 percent.
  − When combined with the 21 percent corporate income tax rate, the effective US tax rate on FDII is 13.125 percent for 2018 through 2025 and 16.406 percent starting in 2026.
• The deduction is available for US corporations owned by non-US MNCs.
FDII example

Basic facts

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales of Products for use in the US</td>
<td>200.0</td>
</tr>
<tr>
<td>Sales of Products for use outside the US</td>
<td>300.0 *</td>
</tr>
<tr>
<td>Total Deductible Eligible Revenue</td>
<td>500.0</td>
</tr>
<tr>
<td>Cost of Goods Sold</td>
<td>100.0</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>400.0</td>
</tr>
<tr>
<td>Allocable Deductions including Interest</td>
<td>100.0</td>
</tr>
<tr>
<td>Potential FDII Eligible Income</td>
<td>300.0</td>
</tr>
<tr>
<td>Other Income / (Deduction) for non-FDII Eligible Activities</td>
<td>0.0</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>300.0</td>
</tr>
</tbody>
</table>

**USCo P&L**

- **US Customers**: $200 Revenue
- **Foreign Customers**: $300 Revenue

**Qualified Business Asset Investments (QBAI)**

100 **

*We have assumed that this qualified as foreign-derived deduction eligible (FDDEI). FDDEI means any deduction eligible income that is derived in connection with property sold to a non-U.S. person and is for foreign use, or services provided by the taxpayer to a non-US person or with respect to property not located in the United States. The term 'foreign use' means any use, consumption, or disposition that is not within the United States.

**Same definition as in GILTI.
### Step 1: Determine Deduction Eligible Income (DEI)

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>400.0</td>
</tr>
<tr>
<td>Less GILTI</td>
<td>0.0</td>
</tr>
<tr>
<td>Less Subpart F Income</td>
<td>0</td>
</tr>
<tr>
<td>Less Financial Services income</td>
<td>0</td>
</tr>
<tr>
<td>Less Dividend Received from CFC</td>
<td>0</td>
</tr>
<tr>
<td>Less Domestic Oil and Gas Extraction Income</td>
<td>0</td>
</tr>
<tr>
<td>Less Foreign Branch Income</td>
<td>0</td>
</tr>
<tr>
<td><strong>Adjusted Gross Income</strong></td>
<td><strong>400.0</strong></td>
</tr>
<tr>
<td>Less Deduction(Including Interest) and Taxes Allocable to Gross Income</td>
<td>100.0</td>
</tr>
<tr>
<td><strong>DEI</strong></td>
<td><strong>300.0</strong></td>
</tr>
</tbody>
</table>

\[ h = a - b - c - d - e - f - g \]

### Step 2: Reduce by Routine Return

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Identify QBAI</td>
<td>100.0</td>
</tr>
<tr>
<td>Apply Routine Return Factor</td>
<td>10%</td>
</tr>
<tr>
<td>Less Interest expense incl in allocable deductions w/o Interest income</td>
<td>0</td>
</tr>
<tr>
<td><strong>Routine Return</strong></td>
<td><strong>10</strong></td>
</tr>
</tbody>
</table>

\[ n = k \times l - m \]

### Step 3: Determined Deemed Intangible Income ("DII")

\[ o = j - n \]

This example assumes that all of the deductions are allocable to DEI, although that will not always be the case.
FDII example
Analysis (cont.)

**Step 4: Determine Ratio of FDDEI to DEI (FDDEI DEI)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Revenue</td>
<td>300.0</td>
</tr>
<tr>
<td>Cost of good sold</td>
<td>60</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>240.0</td>
</tr>
<tr>
<td>Allocable deductions</td>
<td>60</td>
</tr>
<tr>
<td>Taxes</td>
<td>0.0</td>
</tr>
<tr>
<td>FDDEI</td>
<td>180.0</td>
</tr>
<tr>
<td>FDDEI/DEI Ratio</td>
<td>60.0%</td>
</tr>
</tbody>
</table>

\[
w = \frac{v}{j}
\]

**Step 5: Determine Foreign Derived Intangible Income (FDII)**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine Initial FDII (DII x FDDEI/DEI)</td>
<td>174</td>
</tr>
<tr>
<td>Less Limitation of FDII based on Taxable Income</td>
<td>0</td>
</tr>
<tr>
<td>FDII</td>
<td>174</td>
</tr>
</tbody>
</table>

\[
z = x - y
\]

**Step 6: Determine FDII Deduction**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>FDII Deduction Factor</td>
<td>37.5%</td>
</tr>
</tbody>
</table>

AA
FDII example

Summary

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>300.0</td>
</tr>
<tr>
<td>FDII Deduction</td>
<td>65.3</td>
</tr>
<tr>
<td>Adjusted Taxable Income</td>
<td>234.75</td>
</tr>
<tr>
<td>Tax Rate</td>
<td>21%</td>
</tr>
<tr>
<td>Total Tax</td>
<td>49.3</td>
</tr>
<tr>
<td>USCO ETR</td>
<td>16.433%</td>
</tr>
</tbody>
</table>

Note: For FDII, the larger the QBAI, more revenue will be subject to US taxation
Polling question #3

Do you believe the base erosion and anti-abuse tax (BEAT) provision will deter US corporate profit shifting?

• Yes
• No
• Don’t know/Not applicable
BEAT—Base Erosion Anti-Abuse Tax
BEAT–Base Erosion and Anti-Abuse Tax

• BEAT could apply to both US-parented and non-US parented MNCs. BEAT will potentially apply to a US corporation or the US branch of a foreign corporation that makes payments to a foreign related party for which a deduction is allowable (i.e., payments included in SG&A and below). Payments included in COGS are not subject to BEAT.

• BEAT is an alternative tax computation. The US company is required to pay the greater of its regular tax liability or its BEAT tax liability.

• BEAT applies only if the US corporation or branch has a “base erosion percentage” of 3 percent or more (2 percent for certain banks and securities dealers) and the US corporation or branch has a three-year average annual gross receipts amount of greater than $500 million.
  − Special aggregation principles are used for these computations, which may eliminate non-US MNCs groups with a US presence of less than $500 million.
  − Special rules apply to determine the base erosion percentage.
BEAT example

For purposes of the BEAT computation, assume that:
1. USCo has $20 of other deductible costs with 3rd parties;
2. USCo qualifies as an Applicable Taxpayer (i.e., that the $500 million threshold, etc., has been satisfied);
3. The $200 payment for services by USCo is a payment for which a deduction is allowed in the taxable year; and
4. Taxable year is 2019.

BEAT

- **Base Erosion Tax Benefit:** $200
- 3% Safe harbor: Does not qualify
  - USCo base erosion percentage: 90.9%
    - $200 / $220 = .909 or 90.9%
- **BEMTA**
  Modified taxable income * 10% – (Regular tax liability (“RTL”) – R&E credits)
  - **MTI:** $280
    - $300 Gross income
    - $220 Deductions (without regard to any base erosion tax benefit)
    - $280
  - **RTL:** $16
    - $300 Gross Income
    - $220 Deductions
    - $80
    - $16.8 Corporate Rate
  - **Residual US tax**
    - $280 * 10% = $28
    - Less RTL = $16.8
    - BEMTA = $11.2

Key takeaways

- Total US tax of $28
- If CFC1 is not subject to sufficient tax, the base erosion payment could also be subject to GILTI
Polling question #4

Which new tax provision is expected to have the most significant impact to your organization?

- GILTI: Global Intangible Low-Taxed Income
- BEAT: Base Erosion and Anti-Abuse Tax
- 163(j): Interest Expense Limitation Computation
- FDI: Foreign Derived Intangible Income
- None of the above; other
- Don’t know/Not applicable
Interest Expense Limitation—Section 163(j)
Interest expense limitation (§163(j))

Overview

• For every business (regardless of form) deduction for business interest limited to:
  – Business interest income + 30% of adjusted taxable income (ATI)

• Business interest: interest paid or accrued on indebtedness allocable to a trade or business

• Adjusted taxable income (ATI): taxable income computed without regard to—
  – Items (income, gain, deduction, or loss) not allocable to a trade or business
  – Business interest or business interest income
  – The bill’s deduction for certain pass-through income
  – NOL deductions
  – Depreciation, amortization, or depletion for taxable years beginning before January 1, 2022

• Disallowed interest to be carried forward indefinitely

• No carryforward of excess limit

• Unclear whether additional adjustments provided for in current §163(j) proposed regulations will also apply in computing ATI

• Unclear whether existing disallowed interest expense will carry forward to new §163(j) regime

• Applies to partnerships at entity level (see separate slide for pass-through considerations)
Interest expense limitation (§163(j))
Application to pass-through entities

• Interest limitation **applies at the entity level** to limit partnership interest expense deductions (interest allowed is part of non-separately stated partnership income or loss)

• Partner adjusted taxable income (ATI) does not include distributive share of partnership income, except for its share of “**excess taxable income**”
  – Avoids double counting ATI but allows partner to deduct more business interest if the partnership could have deducted more business interest

• It appears, but it is not entirely clear, that the interest expense that is allowed at the partnership level and allocated to partners is not retested at the partner level

• Partnership allocates “**excess business interest expense**” to partners in the year of disallowance (reducing outside basis):
  – Treats the excess as paid or accrued by the partner in succeeding years (unlimited carryforward)
  – Partner allowed to deduct excess business interest expense in succeeding year when allocated excess taxable income from the partnership
  – **Outside basis is increased for unused excess business interest expense upon disposal** or transfer and unused excess business interest expense does not carryforward further

• Similar rules apply to **S corporations**
Question and answer
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