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Tax Reform Advisory: International Provisions

December 28, 2017

On December 22, 2017, the President signed into law H.R. 1, informally known as the **"Tax Cuts and Jobs Act" (the "Act")**, implementing sweeping changes to the United States tax regimes generally applicable to businesses. Most provisions of the **Act will take effect as of January 1, 2018** and (except as noted below) generally will apply to tax years beginning after 2017. Certain highlights of the Act are discussed below.

Territorial Regime for Foreign Subsidiary Business Profits

New Dividends Received Deduction. The Act moves the United States to a so-called territorial system of international taxation, under which no US federal income tax is imposed on the operations of foreign corporate subsidiaries even when the profits are repatriated back to the United States in the form of dividends. But rather than simply excluding such dividends from gross income, the Act creates a new 100% dividends received deduction, contained in a new Code section 245A, for dividends received by a domestic corporation from a foreign subsidiary that is at least 10% owned by the domestic corporation. The deduction is not available to individuals or S corporations. As would be expected, no foreign tax credit is available for foreign taxes incurred with respect to any dividend that is eligible for the dividends received deduction. Moreover, the deduction-eligible dividends do not count as foreign source income for purposes of calculating the taxpayer's overall foreign tax credit limitation under section 904. A minimum one-year holding period is required to claim the deduction. The deduction does not apply to subpart F income. In addition, the deduction is not available to dividends received from a passive foreign investment company (PFIC).

Hybrid Dividend Exception. If a dividend is deductible by the foreign corporation paying the dividend (e.g., it is a hybrid dividend characterized as an interest payment for foreign tax purposes), then the dividend is not eligible for the dividends received deduction. If such a hybrid dividend is paid to a CFC by a lower-tier subsidiary, then it is treated as subpart F income and currently includible by the CFC's shareholders. In addition, no foreign tax credit is allowed for taxes incurred with respect to a hybrid dividend.

Transition Rule for Existing E&P. To transition existing offshore earnings into the new territorial regime, Section 965 is amended to provide for a mandatory immediate inclusion of all accumulated earnings and profits (E&P) of a "specified foreign corporation" into gross income. A specified foreign corporation includes for this purpose any CFC (regardless of whether its US shareholders are corporations or individuals) or any other foreign corporation (except for a PFIC) with respect to which a domestic corporation is a US shareholder. Such earnings and profits are required to be included in the income of US shareholders of the CFC by treating the earnings as subpart F income deemed to have been earned by the CFC in its last taxable year beginning before 2018 (i.e., 2017 for a calendar year CFC). A taxpayer who is a US shareholder of multiple CFCs one or more of which has an E&P deficit is permitted to reduce the section 965 inclusion by their pro rata share of such deficits. The amounts included by the US shareholder under section 965 are not includible in income as dividends a second time when they are distributed. A special dividends received deduction (not limited to domestic corporations) is allowed to the US shareholder who includes an amount under section 965. The amount of the deduction varies depending on whether the E&P of the relevant CFC is invested in a "cash position" (defined to include portfolio investments) or in business assets. In the case of a cash position, the deduction is an amount that would result in the section 965 inclusion being subject to an effective tax rate of 15.5% (determined by applying a hypothetical 35% tax rate to the net income after the allowable deduction). In the case of business assets, the deduction is an amount that would result in an effective tax rate of 8%, computed in a similar manner.

Foreign tax credits with respect to a section 965 inclusion are reduced by a percentage corresponding to the percentage of the dividends received deduction applicable to the inclusion (55.7% for cash position inclusions and 77.1% for other inclusions). It appears that this limitation on foreign tax credits may not apply to withholding tax paid with respect to a distribution of amounts previously included under section 965.

A number of special elections are available to US shareholders subject to a section 965 inclusion. A US shareholder is permitted to elect to pay the resulting tax liability on the section 965 inclusion in eight annual installments (8% in each of the first five years, 15% in the sixth year, 20% in the seventh year, and the remaining 25% in the eighth year. In the case of a REIT (which is subject distribution to requirements), an election is permitted to defer the section 965 inclusion (instead of the tax) over the same period. In the case of a subchapter S corporation, the shareholders of the corporation may elect to defer the tax on the section 965 inclusion indefinitely until the occurrence of one of the following triggering events: (1) the termination of the corporation's subchapter S election; (2) the liquidation or sale of substantially all of the assets of the corporation; or (3) a transfer of the corporation's stock by the shareholder. Significantly, a distribution of the income on which the tax was deferred appears not to be a triggering event. Upon the occurrence of a triggering event, the affected shareholder may then make the eight-year deferral election to pay the tax. **Individual shareholders may wish to consider transferring their stock in specified foreign corporations to a subchapter S corporation before the end of the year to benefit from this election.** Finally, a US shareholder who has NOL carryovers available may elect not to use the NOLs to offset the section 965 inclusion and to preserve the NOLs for use against future income (on which the tax would not have been eligible for the eight-year deferral election).

Repeal of Indirect Foreign Tax Credit. The section 902 indirect foreign tax credit (for dividends from foreign subsidiaries, which dividends are now exempt from tax) is repealed. However, the section 960 foreign tax credit for subpart F income inclusions (which remain taxable) and distributions of previously taxed subpart F income remains in place. There is a new separate limitation for foreign branch income (that is, income attributable to a foreign qualified business unit of the taxpayer) which will prevent foreign taxes imposed on a QBU from offsetting non-branch income.

CFC Changes

Expansion of CFC and US Shareholder Status. The ownership attribution rules relevant for determining whether a corporation is a controlled foreign corporation or whether a shareholder is a 10% "US shareholder" are expanded to treat a US entity as owning stock owned by an owner of the entity. This change is a very significant one, and will result in many foreign corporations becoming CFCs. A common example is a situation where a US individual owns a minority (but greater than 10% interest) in a foreign corporation and the balance of the shares are owned by a foreign parent of the individual. The ownership attribution rules do not attribute stock owned by a nonresident alien individual to a US family member. However, under the new rule, if the foreign parent owns an unrelated domestic corporation, then the parent's shares are attributed to that corporation and cause the foreign corporation to become a CFC. Surprisingly, this rule is effective retroactively for the last taxable year of the foreign corporation that begins before January 1, 2018 (e.g., for calendar year taxpayer, calendar year 2017) and any taxable year of a shareholder that ends during such year.

Another significant expansion to the definition of a US shareholder is the inclusion of a 10% shareholder by value rather than merely voting power (as was the case until now). However, the news is not all bad. Historically, being classified as a US shareholder under section 958 was generally something to be avoided, but for a domestic corporation under the new participation exemption regime, being a US shareholder entitles the taxpayer to the dividends received deduction. Unlike the preceding rule, this rule is effective only for taxable years of a CFC beginning on or after December 31, 2018.

For individual US shareholders of a CFC, there is no 50% deduction available and no foreign tax credit is allowed. As a result, the GILTI tax rate is the ordinary income tax rate, or 37%. Notwithstanding the "intangible" moniker, GILTI can include income from manufacturing, sales and services activities where the CFC does not have a sufficient amount of tangible depreciable property or does not have sufficient basis (or remaining basis) in that property. For many CFCs with individual shareholders, the GILTI tax will apply to virtually all of the CFCs' active business income, effectively ending future income deferral. Direct ownership of foreign corporations by US individuals may become a thing of the past, as such shareholders will in most cases be better off holding their CFC shares through a domestic corporation.

Elimination of the 30-Day Rule. The Act eliminates the 30-day rule in section 951(a) which currently protects shareholders from subpart F inclusions if the corporation was a CFC for an uninterrupted period of less than 30 days. This exception, often used by cross-border estate planners, provided taxpayers with a very useful planning technique in which a CFC with appreciated property could be liquidated within the first 29 days of the year (or sometimes within 29 days following the death of a foreign shareholder from whom a US beneficiary inherited the shares of the CFC) without triggering subpart F income. This provision applies to taxable years of a foreign corporation beginning after December 31, 2017, and to taxable years of a US shareholder with or within which such taxable year of the corporation ends.

New Tax on Low-Taxed Income of CFCs. The Act adds a new tax on "global intangible low-taxed income" (GILTI). The GILTI tax operates in a manner similar to subpart F requiring US shareholders of a CFC with GILTI income to include their proportionate shares of such income on a current basis. GILTI income is any low-taxed income of a CFC (that would not otherwise be subpart F income) that exceeds a 10% annual return on the amount of capital (i.e., the average quarterly adjusted tax basis) the corporation has invested into tangible depreciable property used in a trade or business. The GILTI tax has a unique feature that differentiates it from the rest of subpart F. Namely, a US shareholder's GILTI inclusion is determined at the shareholder level by aggregating the shareholder's proportionate share of the income in all of the shareholder's CFCs. This fiendishly complicated rule is actually taxpayer favorable, as it allows potential GILTI from a highly profitable CFC to be offset by losses from another CFC and to be blended with income from other CFCs with less profits or a higher cost of capital in their tangible assets.

The GILTI inclusion of a US shareholder that is a domestic corporation is accompanied by a deduction [contained in new Code section 250] that is equal to 50% of the amount of the inclusion. Given the new corporate tax rate under the Act of 21%, this results in the GILTI being subject to an effective tax rate of 10.5%. In addition, a shareholder that is subject to a GILTI inclusion is allowed a foreign tax credit under section 960 for 80% of the foreign tax paid by the shareholder's CFCs that is determined to be allocable to the GILTI income (even though only 50% of the GILTI is effectively taxable in the US). The effect of the modified foreign tax credit is that a foreign tax rate of 13.125% is sufficient to entirely eliminate the US corporate tax on the GILTI. Hence, the inclusion of the "low-taxed" moniker in the GILTI acronym. As the foreign tax credit declines below 13.125%, the US tax increases from zero to a maximum of 10.5% if no foreign tax is paid at all.

Export Incentives

Section 199 Repeal. The Act repeals the section 199 deduction for domestic production activities.

New Deduction for Foreign Derived Income of Domestic Corporations. The Act add a new deduction equal to 37.5% of a domestic corporation's foreign derived intangible income (FDII) which effectively reduces the tax rate on such income to 13.125%. Broadly speaking, FDII is income from the sale, lease or license of property to foreign purchasers for use outside the United States or from services provided to persons located outside the United States. However, FDII does not include any income derived through a CFC or through a foreign branch of the taxpayer. Thus, this provision effectively replaces the repealed section 199 deduction for domestic production activities. FDII is reduced by a 10% annual return deemed to be attributable to the taxpayer's capital invested in tangible property and calculated in a manner similar to the tangible property return taken into account for GILTI inclusions from a CFC, described above.

Pass-thru Deduction. The new 20% deduction for qualified business income from pass-thru entities is not available for income from a trade or business that is not conducted in the United States.

Rules Targeting Base Erosion

Base Erosion Minimum Tax. The Act imposes a new base erosion minimum tax (BEAT) of 10% (5% for 2018) on the modified taxable income of an applicable taxpayer which is calculated by adding back to the taxpayers income any deductions for payments made to related foreign parties and any depreciation claimed for assets purchased from such persons (as well as NOL carryovers attributable to such payments made in prior years). Applicable taxpayers to whom the BEAT applies are domestic corporations (other than RICs, REITs or S corporations) the average annual gross receipts of which for the preceding taxable years are at least $500 million and whose base erosion payments would otherwise result in a 3% (2% in the case of a bank or registered securities dealer) reduction in taxable income. The BEAT does not apply to the extent the payment to the related foreign person is effectively connected to a US trade or business of the foreign person or is subject to US withholding tax. The BEAT tax rate will increase to 12.5% after 2025. The BEAT tax rate on a bank or registered securities dealer is 1% higher than it is for other taxpayers.

Hybrid Payments. The Act provides for the disallowance of any deduction for hybrid payments made to a foreign related party where, due to a difference in the tax characterization of the payment (e.g., as an interest or a dividend payment) or the entity making or receiving the payment (e.g., where the paying or receiving entity is a hybrid entity) the recipient is not subject to tax on the payment in its country of residence or is entitled to an offsetting deduction with respect to the payment. This disallowance rule targets "double dips" and similar structures involving, for example, repos or Canadian “tower” financing structures.

Outbound Transfers. The Act repeals the foreign active trade or business exception to the gain recognition rule for outbound transfers to a foreign corporation under Code section 367(a). The Act codifies the authority of the Treasury Department (which has been the subject of much controversy) to more expansively tax outbound transfers of foreign goodwill and going concern value and to value intangible property transfers for purposes of section 367 and 482 on an aggregation basis and by considering the realistic alternatives to the transfer.

Partnership Aggregate Treatment

The Act reverses the result in the recent pro-taxpayer Tax Court case, Grecian Magnesite Mining v. Comm’r (and codifies the controversial position taken by the IRS in Revenue Ruling 91-32), and treats gain or loss recognized by a foreign partner on a sale of an interest in a partnership that is engaged in a US trade or business as effectively connected to the US trade or business and thus as taxable. There is also a new withholding tax requirement that requires the buyer of a partnership interest to withhold 10% of the amount realized unless the seller provides an affidavit that the seller is not a foreign person. If the buyer fails to withhold, then the withholding obligation shifts to the partnership itself. Until regulations are issued, the withholding tax apparently applies even to non-recognition transactions. The new rule does not apply to the extent the underlying assets of the partnership consist of US real property the gain on which is taxable under FIRPTA. The new characterization rule is effective for transfers occurring on or after November 27, 2017. The withholding tax on such transfers is effective for transfers after December 31, 2017.

PFICs

The Act would tighten the PFIC insurance company exception to limit the availability of the exception to entities that would be taxed as in insurance company if they were US corporations and whose applicable insurance liabilities exceed 25% of the foreign corporation's total assets. Elective relief is provided in certain cases where the foregoing percentage is below 25%, but over 10%, and the shortfall is due to run-off related circumstances (resulting from the winding down of the business) or ratings related circumstances (e.g., where required by a regulator as a condition of obtaining a rating to write new insurance business for the current year) involving the company's insurance business.