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International Provisions of Public Law No. 115-97 (the “TCJA”) (PowerPoint)

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INTERNATIONAL PROVISIONS of Public Law No 115-97 (the "TCJA")

William & Mary Tax Conference

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Preliminary: Key Domestic Changes

- **Reduced rates**
  - 21% corporate rate, previously 35%
  - 37% max individual rate, previously 39.6%
- **Limits on deductibility of interest expense**
  - 30% of adjusted taxable income
  - broader application than previously (discussed below)
- **Limits on use of NOLs**
  - Limited to 80% income offset
  - No carryback, but indefinite carryforward
- **Changes to expensing/depreciation rules**
  - 100% depreciation for certain qualified property
- **Special 20% deduction for qualified business income (QBI)**
  - Applicable to individuals/trusts-Reduces max rate to 29.6%
- **For individuals, deduction for "excess business losses" denied**

Overview: International Changes

- **Supposed transition to territorial system**
  - Transition tax
  - Dividends Received Deduction
  - Global Intangible Low Taxed Income (“GILTI”) regime
  - Repeal of deemed paid foreign tax credits for actual dividends but not for Subpart F and GILTI inclusions
- **New Foreign Derived Intangible Income (“FDII”) deduction**
- **Other Subpart F changes**
  - Definition of US shareholder
  - Expansion of constructive ownership
  - Elimination of “30-day rule”
  - Repeal of recapture for withdrawals of investments in shipping ops
  - Repeal of Foreign Base Company Oil Related Income
  - Extension of § 954(c)(6) look through rule

Overview: International Changes (cont'd)

» **Anti-base-erosion provisions**

- Base Erosion Anti-abuse Tax ("BEAT")
- Deduction disallowance for certain hybrid payments
- Old § 163(j) anti-earnings stripping provision for interest payments to related foreign person replaced with New § 163(j) limits on deductibility of business interest

What Looked Like It Would Change, But Didn't

» **§ 956 retained**

- House and Senate bills excepted C corporations from § 956, but final bill did not

» **§ 954(b)(3) de minimis rule**

- House and Senate bills provided for COLA adjustments to the $1,000,000 threshold, but final bill did not

» **§ 954(c)(6) related party look-thru rule**

- Since enactment has suffered from continuing sunset
- House and Senate bills would have repealed the sunset
- Final bill left the 2019 sunset in place

New "Territorial" System

Worldwide Taxation: The "Old" Rules

- U.S. citizens and residents, including domestic corporations, taxed on *worldwide* income
- Double taxation avoided primarily through foreign tax credits
- Income earned through CFC
  - Generally qualifies for deferral
    - Subpart F rules relatively limited
      - Passive income
      - Certain related-party transactions
      - Investments in US property
  - Any income not previously taxed under Subpart F, taxed when repatriated as actual dividends or §1248 deemed dividend on sale of shares

Transition Tax: New Section 965

Overview of Transition Tax

- Applies to U.S. shareholders of "deferred foreign income corporations" ("DFICs")
  - U.S. shareholder owns 10%
  - Directly, indirectly, or constructive ownership
- DFIC = FC with "accumulated post-1986 foreign income" if FC
  - Is a CFC or
  - Has at least one corporate U.S. shareholder (so-called "10/50 corporation")
- Once FC is DFIC, *all* U.S. shareholders subject to forced repatriation
- C corporations can claim indirect FTCs

What is Taxed When?

- Applies to last tax year of FC beginning *before* January 1, 2018.
  - So, for many, this was a 2017 issue!!
- Accumulated post-1986 foreign income included in Subpart F income, under § 965(a)
  - Measured as of 11/2/17 or 12/31/17, whichever greater
  - For convenience, “deferred earnings amount”
- Taxed at low rates, by mechanism of allowing deduction for majority of the income
- Tax due generally may be paid over eight years
  - Or maybe never!

Partial Deduction

- Effective tax rate depends on DFIC's "cash position"
  - To extent deferred earnings amount invested in cash (or similar assets) higher rate applies
- To the extent deferred earnings amount exceeds cash position, deduction allowed for 77.14% of inclusion, assuming 2017 taxable year
  - For C corporation taxed at highest rate, effective rate is 8%.
  - For individual taxed at highest rate, effective rate is 9.05%.
- To the extent of cash position, deduction allowed for 55.71% of inclusion, assuming 2017 taxable year
  - For C corporation taxed at highest rate, effective rate is 15.5%
  - For individual taxed at highest rate, effective rate is 17.54%.
- Careful about fiscal years!

Cash Position

- Cash
- Net accounts receivable
- FMV personal property actively traded on established market, commercial paper, certificates of deposit, Government securities
- Foreign currency
- Obligation with term of less than one year
- Other assets determined by IRS to be economically equivalent

Election to Pay in Installments

- Pay over eight years
  - First five installments: 8%
  - Sixth installment: 15%
  - Seventh installment: 20%
  - Eighth installment : 25%
- First installment due on due date of 2017 return
  - Without regard to extensions, it seems
  - Limited relief provided per Q&A
- Certain events accelerate tax due:
  - Penalty imposed for taxpayer’s failure to make required installment payment
  - Liquidation or sale of substantially all of taxpayer’s assets
  - Cessation of business by taxpayer or similar circumstance
- Apparently receipt of not-yet-taxed income, or sale of DFIC stock, does not accelerate!!

Special Election for S Corporations

- Need not pay any tax on deferred earnings amount until triggering event
- Triggering events
  - S corp ceases to be an S corp
  - Liquidation, sale of substantially all assets, cessation of business
  - Transfer of stock by S corp shareholder, including by reason of death
  - Cessation of business by taxpayer or similar circumstance
    - However, IRS may allow buyer to step into shoes and defer tax
- Interposition of S corp holding company
  - Some individuals transferred calendar year DFICs to S corps prior to 12/31/17
  - May still consider transfer fiscal year DFIC to S corp
  - Query whether any anti-abuse rule or doctrine should apply

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Special Problems for Individuals

- § 965(c) deduction
  - Federal limitations?
    - Seemingly not under Proposed Regulations
  - State/local limitations?
- Any state/local benefit to installment election?
- May wish to consider § 962 elections
  - if eligible
  - discussed below

DRD: New § 245A

Dividends Received Deduction

- Effective 2018, provides DRD for foreign-source portion of dividends received by *corporate* U.S. (10%) shareholders of foreign corporations
  - CFCs or "10/50" corporations
  - In case of CFCs, benefit diminished by "GILTI" rules (discussed below)
- N/A to individual U.S. shareholders
  - No territoriality for individuals
- § 902 repealed-No indirect credit for foreign tax on earnings paid up as dividends
- Exceptions from DRD apply to PFICs and hybrid dividends

Hybrid Dividend Exception to DRD

» No DRD for hybrid dividend
  - Reflects view that all income should be taxed *somewhere*, and especially that hybrids ought not be used to produce non-taxed income

» Hybrid dividend
  - DRD otherwise available under § 245A, and
  - CFC receives deduction or other tax benefit under laws of country where resident

» Special rule for tiered CFCs
  - If upper-tier CFC receives hybrid dividend from lower-tier CFC, treated as Subpart F income
  - Overrides § 954(c)(6) look through rule

Punishing the GILTI – New § 951A

Overview of GILTI Rules

- Effective 2018, U.S. shareholders of CFCs taxed on “global intangible low-taxed income” (“GILTI”) under Subpart F
  - Technically, not Subpart F income, but treated as such for most or all relevant purposes including Previously Taxed Income (PTI)
  - Ordinary income!
    - Even if CFC eligible to pay qualified dividends
  - Treated as PTI – can be distributed without being taxed again
- C Corporations can deduct 50% of GILTI - §250(a)(1)(B)
  - 37.5% for post-2025 years
- C Corporations can credit 80% of the CFC’s foreign taxes
  - So, foreign tax at rate of 13.125% sufficient to eliminate “GILTI tax” on C corporation (in simple case)
    - 50% of GILTI taxed at 21% = 10.5%
    - 80% of 13.125% foreign tax = 10.5%
- Individuals must consider § 962 election (discussed below)

What or (Who) Is GILTI?

- GILTI for a taxable year generally is excess of
  - U.S. shareholder's "net CFC tested income," over
  - U.S. shareholder's "net deemed tangible income return"
- Net CFC tested income generally is all income allocable to such U.S. shareholder from CFCs, with exceptions, e.g.,:
  - Subpart F income
  - Effectively connected income
  - High-taxed kick-out (HTKO) income
    - CAUTION-Kick out only applies if income would have been foreign base company income but for HTKO-§ 951A(c)(2)(A)(i)(III)
- U.S. shareholder's net deemed tangible income return
  - 10% of aggregate "qualified business asset investment" ("QBAI") allocable to such U.S. shareholder from CFCs (less certain interest expense)
    - QBAI = average tax basis in "specified tangible property" used in T/B and eligible for depreciation

Simple GILTI Example

- A wholly owned CFC owns land and a building, each worth $1,000
- The building has a basis of $100
- The CFC earns $100 of foreign-source income (assume no foreign taxes)
- QBAI is the $100 tax basis in the building-basis in land irrelevant
- The net deemed tangible income return is $10 (10% of $100)
- The GILTI is $90, assuming no exception applies ($100 - $10)
- If the sole shareholder is an individual, and does not make § 962 election, s/he pays $33.30 of US federal tax (37% * $90 = $33.30)
- If the sole shareholder is a C corporation, it pays $9.45 of US federal tax (21% * $45 (50% * $90) = $9.45)
- For simplicity, above assumes US shareholder has no other tax items

Section 962 Election

- Absent election
  - GILTI taxed at ordinary income rates
    - 50% (or, post-2025, 37.5%) corporate GILTI deduction not available
    - No "indirect" foreign tax credit
  - Subsequent distributions of GILTI by CFC considered PTI and not taxed again
- If individual elects under § 962
  - Initially pay "hypothetical corporate tax" at current corporate rates, as if held CFC stock through C corp.:
    - Indirect foreign tax credit allowed
    - Unclear whether corporate §250 GILTI deduction allowed. If so, indirect FTC limited to 80%
  - Subsequent distributions to U.S. shareholder generally not PTI
    - Probably constitute dividends, which may potentially be qualified
    - But, see *Smith v. Comm'r,* 151 T.C. No. 5 (2018)

New Deduction for Foreign Derived Intangible Income: Section 250

FDII Deduction

- Only allowed to C corps
- Deduction equal to 37.5% (or, post-2015, 21.875%) of FDII
- FDII = Deemed intangible income

  *

  Foreign-derived deduction eligible income

  Deduction-eligible income
- Deduction eligible income = nearly all income, except
  - Subpart F, GILTI, CFC dividends
  - Financial services income, foreign branch income
- Deemed intangible income = deduction eligible income over 10% of QBAI (similar to GILTI)
- Deduction-eligible income foreign derived if from:
  - Property sold by taxpayer to non-U.S. persons, if can demonstrate for "foreign use"
  - Services provided by taxpayer, if can demonstrate provided to any person, or with respect to property, located outside U.S.

Other Subpart F Changes

Expanded Definition of U.S. Shareholder

- Under prior law, U.S. person had to own stock possessing 10% of total *voting power*
  - taking into account indirect, constructive ownership
- Now, U.S. person must own stock possessing 10% of total voting power *or total value*
  - Effective 2018
- Under old law, a U.S. person could own a majority of the value of a foreign corporation, but if had less than 10% voting power no CFC
  - Substance over form issues
  - No longer works!

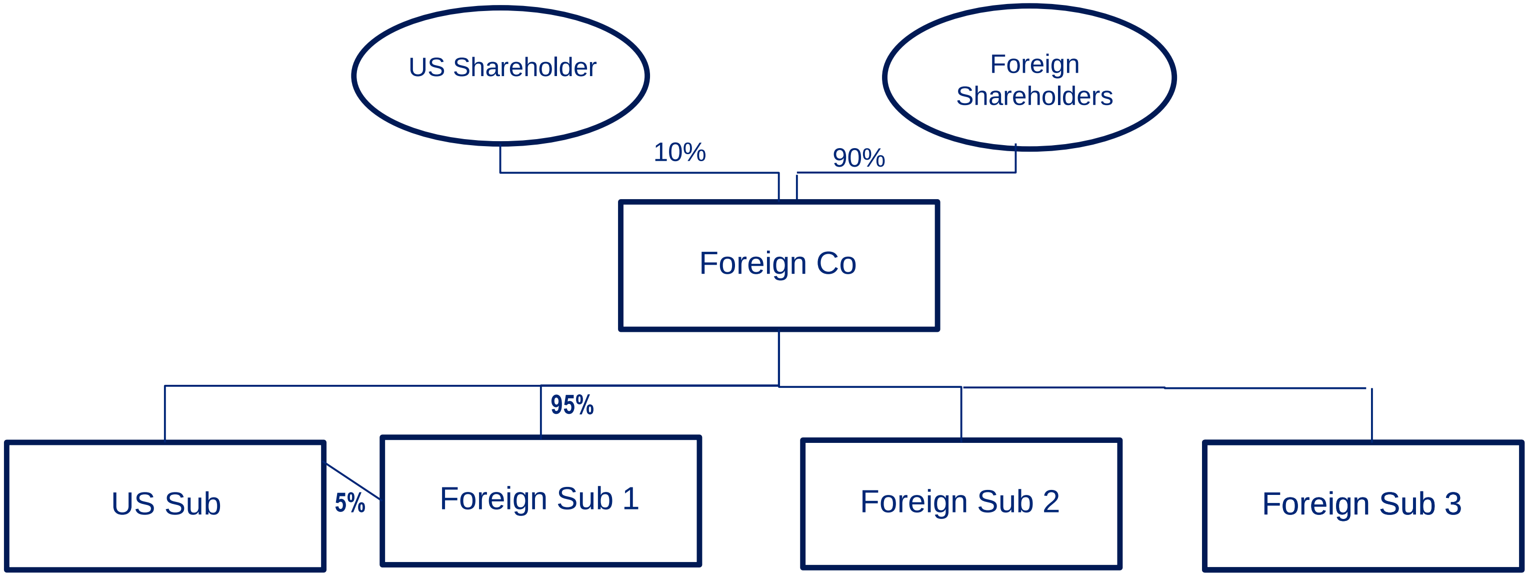
Elimination of “30-Day” Rule

- Under prior law, U.S. Shareholder did not have inclusions under Subpart F unless FC was a CFC for uninterrupted period of at least 30 days
- Convenient for U.S. children who inherited foreign corporations from foreign parents and for newly purchased foreign corporations
  - Could liquidate (including a deemed liquidation arising from a “check the box” election) within 29 days to make all “inside gain” disappear
  - Common structure for foreign parents who used foreign corporation to hold U.S. stocks to avoid U.S. estate taxes

Expanded Constructive Ownership Rule

- Subpart F uses § 318 constructive ownership rules for:
  - US shareholder status
  - CFC status
- § 318(a)(3) permits "downward" attribution, *e.g.*,
  - 50% shareholder to corporation
  - Partner to partnership
- § 958(b)(4) previously prohibited "downward attribution" from foreign person under § 318(a)(3)
- § 958(b)(4) repealed, effective 2017!!
  - May cause transition tax to apply unexpectedly
  - May cause portfolio interest surprises
  - May cause subpart F income and § 956 inclusions
  - Could cause unexpected filing obligations (Form 5471) but IRS provided some relief

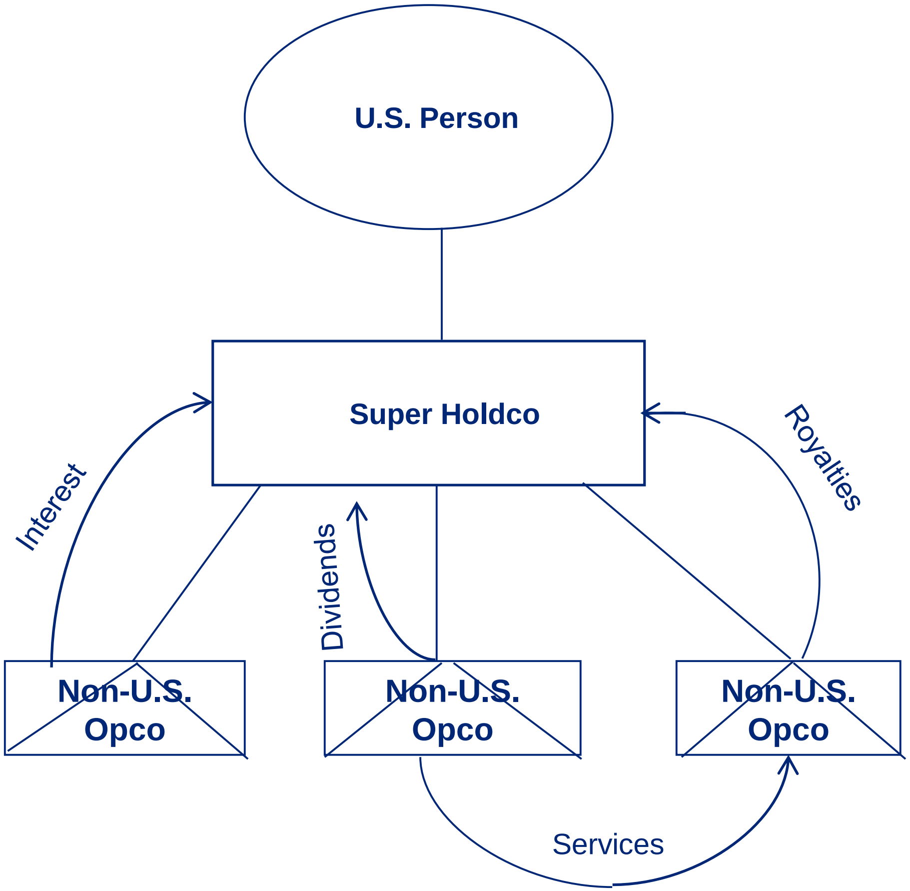
Impact of Downward Attribution under § 958



- Prior to the TCJA, Foreign Subs 1, 2 and 3 were not CFCs.
- The TCJA allowed "downward attribution" rules so that Foreign Subs 1, 2 and 3 are now considered CFCs. As a result, US Shareholder and US Sub could have § 951 inclusions of Subpart F income, § 956 amounts and GILTI.

Super Holdco Structure

- Minimize Subpart F income from intercompany interest, dividends, royalties, rents, and services
- Allows movement of cash between Opcos free of U.S. tax
- Facilitates sale of lower tier subsidiaries without Subpart F income
- BUT NOW MUST CONSIDER APPLICATION OF HIGH TAX KICK OUT AND GILTI



Anti-Base Erosion Provisions

New § 59A – The BEAT

- Only applies to "applicable taxpayer"
  - C corporation – U.S. or foreign owned
  - Average annual gross receipts for 3-year period at least $500,000,000!
    - Certain aggregation rules apply,
  - "Base erosion percentage" is at least 3% (or, for certain taxpayers, 2%)
- Base erosion percentage
  - Aggregate "base erosion tax benefits," divided by
  - Total amount of deductions (plus certain exclusions)
- Base erosion tax benefits generally include, among other things, all deductible payments to related foreign persons
  - Exception for payments of FDAP subject to US withholding tax
  - Exception for certain service fees qualifying for a modified version of the "services cost method" of pricing under the transfer-pricing rules
- BEAT imposes additional tax equal to 10% of "modified taxable income" over "regular tax liability" (with adjustments)

Simple Example

- » US C corporation has $2,000 gross income and $1,500 of deductions ($750 consists of interest paid to foreign related party, exempt from US withholding tax)
- » Regular taxable income is $500 ($2,000 - $1,500), and regular income tax is $105 (21% * $500)
- » For simplicity, assume no NOLs

- » Base erosion percentage is 50% ($750 of related party interest divided by $1,500 of total deductions), which is more than the 3% threshold
- » Modified taxable income is $1,250, after the $750 of related party interest is added back
- » Minimum tax is $125 (10% * $1,250). The corporation has $20 additional tax per the BEAT ($125 BEAT - $105 regular tax)

New § 267A – Anti- Hybrid Provision

- Disallows deduction for any
  - "Disqualified related party amount" paid or accrued
    - Pursuant to a "hybrid transaction" or
    - By or to a "hybrid entity"
- Disqualified related party amount
  - Rent or royalty paid or accrued to related party
  - Not included in income of (or deductible from) income of the related party under applicable foreign tax law (or taxed to a US shareholder under Subpart F)
- Hybrid transaction
  - One or more payments treated as interest or royalties for U.S. tax purposes are treated otherwise for foreign tax purposes,
- Hybrid entity
  - Fiscally transparent for US but not foreign tax purposes
  - Or vice versa

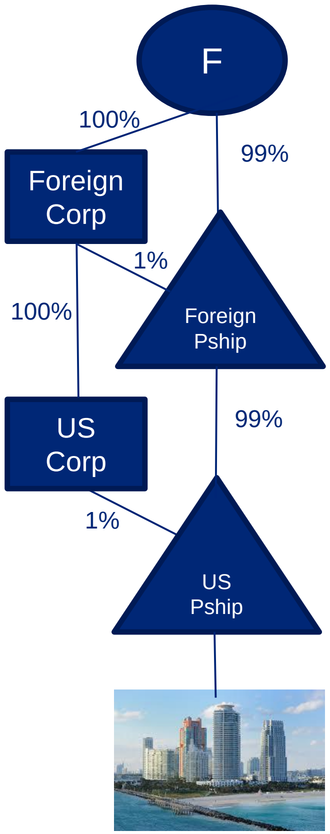
Stricter § 163(j)

- Designed to prevent "earnings stripping"
- Previously applied solely to (supposedly) thinly capitalized corporations paying interest to related (typically foreign) lender not subject to US tax, but TCJA modified
  - Now, generally applies to all taxpayers regardless of relationship of lender
  - Thin capitalization restriction (1.5-to-1 debt-to-equity safe harbor) of prior law removed
- Excessive business interest expense disallowed
  - *i.e.*, portion that exceeds 30% of adjusted taxable income
  - Pre-TCJA, excessive was portion over 50% (or less)
- Disallowed interest carried forward indefinitely

§ 163(j) Exemptions

- Exemption from 30% limit provided for
  - small businesses – under $25 million gross receipts
  - floor plan financing
  - certain activities deemed not a trade or business
    - an electing real property trade or business
      - must use straight line MACRS ADS depreciation
    - an electing farming business
    - certain utility type businesses

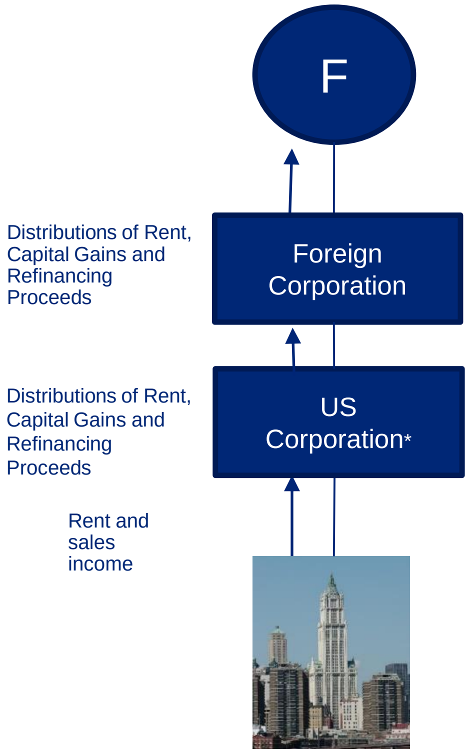
Pre-TCJA: Investment in U.S. Real Estate Through Two-Tiered Partnership



- Rental Income
  - ✓ Gross rental income taxable at 30% via withholding; or
  - ✓ Net rental income taxable at graduated rates up to 39.6%* (other than 1%)
- Long Term Capital Gains
  - ✓ LTCG on sale of US real property taxable at 20%* (other than 1%)
  - ✓ No FIRPTA withholding
- Estate Tax
  - ✓ U.S. estate may not apply

*plus state and local tax, where applicable

Pre-TCJA: Investment in U.S. Real Estate Through Foreign and U.S. Corporation



*** or LLC taxed as a corporation**

- <u>US Corporation's U.S. Tax Consequences</u>

✓ Rental Income:
- Net rental income taxable at graduated rates up to 35%*

✓ Gain from Sale:
- Gain on sale of US real property taxable at 35%*
- No FIRPTA withholding on sale of Real Property by Corporation

- <u>Foreign Corporation's U.S. Tax Consequences</u>

✓ Income Tax:
- Dividends subject to 30% withholding tax unless reduced by treaty
- No tax on liquidating distributions after sale of US real property

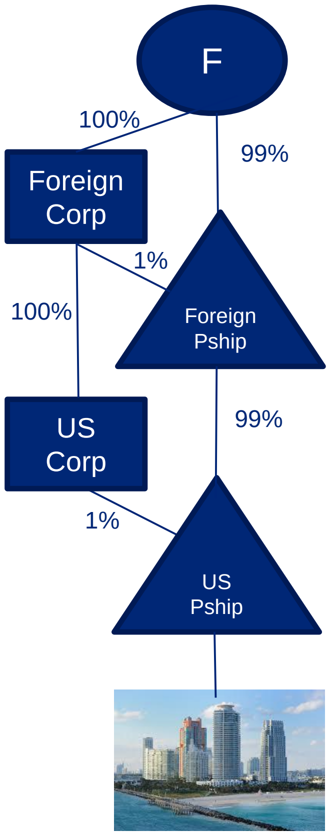
- <u>F's U.S. Tax Consequences</u>

✓ Income Tax:
- No U.S. tax on any distributions

✓ Estate Tax:
- No U.S. estate tax

*plus state and local tax, where applicable

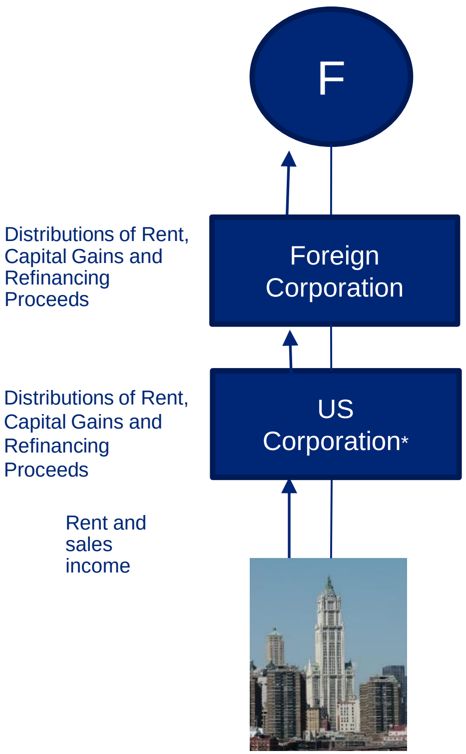
Post-TCJA: Investment in U.S. Real Estate Through Two-Tiered Partnership



- Rental Income
  - ✓ Gross rental income taxable at 30% via withholding; or
  - ✓ Net rental income taxable at graduated rates up to 37%* (other than 1%)
- Long Term Capital Gains
  - ✓ LTCG on sale of US real property taxable at 20%* (other than 1%)
  - ✓ No FIRPTA withholding
- Estate Tax
  - ✓ U.S. estate may not apply

*plus state and local tax, where applicable

Post-TJCA: Investment in U.S. Real Estate Through Foreign and U.S. Corporation



*** or LLC taxed as a corporation**

- <u>US Corporation's U.S. Tax Consequences</u>

✓ Rental Income:
- ❖ Net rental income taxable at 21%*
- ❖ Electing real property trade or business-interest fully deductible

✓ Gain from Sale:
- ❖ Gain on sale of US real property taxable at 21%*
- ❖ No FIRPTA withholding on sale of Real Property by Corporation

- <u>Foreign Corporation's U.S. Tax Consequences</u>

✓ Income Tax:
- ❖ Dividends subject to 30% withholding tax unless reduced by treaty
- ❖ No tax on liquidating distributions after sale of US real property

- <u>F's U.S. Tax Consequences</u>

✓ Income Tax:
- ❖ No U.S. tax on any distributions

✓ Estate Tax:
- ❖ No U.S. estate tax

*plus state and local tax, where applicable

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