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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

William B. Sherman

November 8, 2018
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
§ 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  - House and Senate bills would have repealed the sunset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
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
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
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)
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
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

- **US Corporation’s U.S. Tax Consequences**
  - **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

- **Foreign Corporation’s U.S. Tax Consequences**
  - **Income Tax:**
    - Dividends subject to 30% withholding tax unless reduced by treaty
    - No tax on liquidating distributions after sale of US real property

- **F’s U.S. Tax Consequences**
  - **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

- **US Corporation’s U.S. Tax Consequences**
  - **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

- **Foreign Corporation’s U.S. Tax Consequences**
  - **Income Tax:**
    - Dividends subject to 30% withholding tax unless reduced by treaty
    - No tax on liquidating distributions after sale of US real property
  - **F’s U.S. Tax Consequences**
    - **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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