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International Tax ADVISORY ■

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# International Tax Reform Is Here

The Tax Cuts and Jobs Act, signed into law on December 22, 2017, represents the biggest change to U.S. tax law since adoption of the 1986 Code. In addition to rate cuts and various individual and corporate reforms, the Act introduces several major changes to existing U.S. international tax laws. While the reform effort is intended to make U.S. companies more competitive while guarding the U.S. tax base, the rushed legislative process and complexity of the international provisions have already spurred a number of technical and interpretive questions. But for now, savvy (and flexible) taxpayers may have opportunities to optimize their situation in the new landscape while we await further guidance from the IRS and Treasury.

## 100% Dividends-Received Deduction

Perhaps the single biggest update to the U.S. international tax regime is its move from a worldwide system of tax to a territorial one. To do this, the Act provides domestic C corporations an exemption, or a 100% dividends-received deduction (DRD), for foreign-source dividends from "specified 10%-owned foreign corporations" for tax years of foreign corporations beginning on or after January 1, 2018. The DRD would also apply to amounts treated as dividends under Section 1248 on the sale or exchange by a domestic corporation of stock in a foreign corporation held for at least one year.

A specified 10%-owned foreign corporation means any foreign corporation—other than a passive foreign investment company that is not also a controlled foreign corporation (CFC)—in which any domestic corporation is a 10% or more U.S. shareholder. To claim the DRD, the domestic corporation must hold the foreign corporation's stock for more than 180 days during the 361-day period beginning on the date 180 days before the ex-dividend date. No foreign tax credit or deduction is allowed for taxes paid or accrued on dividends qualifying for the DRD. REITs and RICs are not eligible for the DRD, and the exemption does not apply to "hybrid dividends," i.e., dividends from a CFC for which the CFC received a deduction or other tax benefit for taxes imposed by a foreign country.

## Mandatory Repatriation Tax

To transition to the new participation exemption system, new Section 965 requires all U.S. shareholders (as defined in Section 951(a)(1)) to include in income their share of the accumulated post-1986 deferred foreign earnings of all "deferred foreign income corporations" (DFICs). DFICs include CFCs and any foreign corporation in which at least one domestic corporation is a U.S. shareholder. The amount deemed repatriated is the greater of the deferred foreign earnings as of November 2, 2017, or December 31, 2017. The repatriation inclusion is made in the last taxable year of the DFIC beginning before January 1, 2018—e.g., in 2017 for a calendar-year company. In some cases, a U.S. shareholder may have a Section 965 inclusion in two years—e.g., a calendar-year U.S. shareholder that owns calendar-year and non-calendar-year CFCs.

Section 965 allows a DRD for purposes of the repatriation inclusion, resulting in the application of a 15.5% rate to earnings held in cash or cash equivalents and an 8% rate to earnings held in illiquid assets. But it seems that individuals who do not make a Section 962 election could suffer slightly higher rates than 15.5% or 8% on the deemed repatriation, given that the associated DRD is based on the corporate rate. The DRD mechanism is used as the basis for several other provisions, such as the amount treated as exempt income for partnership and S corporation U.S. shareholders after the inclusion year(s), determining the disallowed foreign tax credit, reducing the Section 78 gross-up, and coordinating net operating loss (NOL) carryovers.

In addition to the DRD, Section 965 offers a number of provisions that may soften the blow of the repatriation tax. Previously taxed income (PTI) reduces the amount subject to inclusion, and deficit-netting rules at the CFC, shareholder, and affiliated or consolidated group levels may significantly reduce the repatriation inclusion. Taxpayers may apply NOLs (or preserve them) and claim a foreign tax credit (albeit reduced to reflect the DRD). Finally, taxpayers can elect to pay any resulting liability in backloaded installments over eight years. For S corporation shareholders, special rules apply that effectively permit indefinite deferral of the repatriation tax until the S corporation is sold, liquidated, or otherwise disposed.

Given the repatriation tax's potential immediate impact, there has been a clamor for clarification of numerous terms and computations required by Section 965. On December 29, 2017, the IRS issued Notice 2018-7, announcing and describing future regulatory guidance on key aspects of the repatriation tax, namely (1) the determination of "aggregate foreign cash position," including preventing double-counting across multiple inclusion years; (2) the determination of accumulated post-1986 deferred foreign income; (3) the coordination with the basis adjustment rules of Section 961 for distributions in an inclusion year; (4) the treatment of groups filing a consolidated return for purposes of Section 965; and (5) the determination of associated foreign currency gain or loss under Section 986(c).

## Global Intangible Low-Taxed Income (GILTI)

For tax years beginning after December 31, 2017, new Section 951A requires U.S. shareholders of CFCs to include their share of GILTI in current income, similar to other Subpart F inclusions. Broadly speaking, GILTI means the excess of a U.S. shareholder's share of CFC income (as defined in Section 951A(c)) over the shareholder's deemed return on the CFC's tangible assets (as defined in Section 951A(b)(2)) for the year. GILTI does not include effectively connected income (ECI) unless subject to reduced tax under a treaty, Subpart F income, income subject to the "high-tax kickout" under Section 954(b)(4), related-party dividends, or foreign oil and gas income. Note that income qualifying for certain exceptions from Subpart F can increase GILTI (e.g., rents derived in an active business).

A foreign tax credit is allowed for taxes paid on GILTI, but the credit is limited to 80% of the foreign taxes, has a separate limitation basket, and cannot be carried back or forward to other years. For U.S. shareholders that are C corporations (other than REITs or RICs), a deduction is allowed for up to 50% of the GILTI inclusion amount, resulting in an effective tax rate of 10.5% for GILTI. (The deduction decreases to 37.5% of GILTI for tax years that begin after December 31, 2025.) Individual shareholders generally are not entitled to the GILTI deduction, but should evaluate whether they could benefit from a Section 962 election to be treated as a corporation under the CFC and GILTI rules and, accordingly, get the GILTI deduction.

The tax on GILTI is intended to ensure U.S. taxpayers pay at least some U.S. tax on low-taxed or untaxed income of a CFC, above a nominal return on a CFC's hard assets. To that end, GILTI, despite its name, reaches more than what is typically considered income from "intangibles."

## Foreign-Derived Intangible Income (FDII) Deduction

To encourage domestic corporations to develop intangibles in the U.S., the Act provides for a deduction of up to 37.5% of a domestic corporation's FDII for the year—yielding an effective federal tax rate of 13.125% on such income. FDII is a corporation's deemed intangible income, based on a formula, from serving foreign markets after allowing for a 10% return on the corporation's depreciable business assets. FDII does not include Subpart F income, dividends, or GILTI. The deduction decreases to 21.875% of FDII for tax years that begin after December 31, 2025 (resulting in an effective tax rate of 16.406% on such income). The FDII deduction is likely most beneficial to C corporations with relatively insignificant fixed assets, such as companies in services or technology sectors.

## Subpart F Updates

The Subpart F regime for CFCs remains largely intact, though the Act does introduce some important updates. Effective for tax years after December 31, 2017, the Act eliminates the 30-day rule of Section 951(a) in determining whether a foreign corporation constitutes a CFC and expands the definition of U.S. shareholder to include U.S. persons who own at least 10% by value—though neither of these changes apply for purposes of the repatriation tax of Section 965. The Act also modifies the stock attribution rules of Section 958(b)—including for purposes of Section 965 repatriation—so that a U.S. corporation can be treated as constructively owning stock held by its foreign shareholder (though only U.S. shareholders with some direct or indirect ownership in a CFC would be subject to Subpart F, GILTI, and Section 965 inclusions).

## Base Erosion and Anti-Abuse Tax (BEAT)

As its name suggests, the BEAT of new Section 59A is meant to combat base erosion. The BEAT applies to corporate taxpayers (other than REITs, RICs, and S corporations) that are part of a group with average gross receipts of $500 million over the preceding three years and a 3% or higher "base erosion percentage." ECI of foreign affiliates is included for purposes of the gross receipts threshold. The base erosion percentage basically means the ratio of deductions for base erosion payments (i.e., deductible payments to a foreign related party) to total deductions. Functioning like a minimum tax, the BEAT kicks in if a corporation's base erosion payments reduce its U.S. tax liability to less than 10% of its "modified taxable income" (12.5% for tax years beginning after December 31, 2025). For affiliated groups that include a bank or securities dealer, a 2% base erosion percentage threshold applies, and the applicable BEAT rate is 11% (13.5% for tax years after 2025).

Base erosion payments do not include amounts paid for costs of goods sold (unless paid to an expatriated entity or foreign members of its expanded affiliated group), for services eligible for the services cost method under Section 482 and with no markup component, and for certain "qualified derivative payments" made in the ordinary course of business.

Taxpayers should evaluate whether they come within the scope of the BEAT and, if so, consider whether they can take steps to mitigate their BEAT exposure. For example, rather than paying related-party royalties for manufacturing intangibles, a group might adopt a contract manufacturing arrangement or use third-party bank debt rather than related-party debt. Some commentators have suggested that the BEAT runs afoul of WTO rules and nondiscrimination provisions of existing U.S. income tax treaties and, consequently, could spur other countries to retaliate.

## Anti-Hybrid Provisions

The Act denies deductions for related-party interest or royalties paid or accrued in hybrid transactions or to or from hybrid entities. Specifically, any interest or royalty paid or accrued to a related party is not deductible for U.S. tax purposes to the extent the amount (1) is not included in the income of the related party under the tax law of the country the related party is a tax resident of or subject to tax; or (2) the related party is allowed a deduction on such amount under the tax law of such country. The disallowance does not apply, however, to any amounts included in the gross income of a U.S. shareholder of a CFC under Section 951(a).

A "hybrid transaction" is "any transaction, series of transactions, agreement, or instrument" in which one or more payments are (1) treated as interest or royalties for purposes of Chapter 1 of the Code; and (2) "not so treated for purposes of the tax law of the foreign country of which the [recipient of the payment] is resident … or is subject to tax. A "hybrid entity" is an entity "treated as fiscally transparent for purposes of [Chapter 1 of the Code] but not so treated for purposes of the tax law of the foreign country of which [it] is resident … or is subject to tax," or vice versa.

Taxpayers should review their existing organizational and debt structures to determine the potential impact of the anti-hybrid disallowances. In light of these new provisions, taxpayers may benefit from the use of more conventional debt rather than hybrid instruments.

## Foreign Tax Credit Changes

Apart from foreign tax credit rules implicated by new international provisions, the Act makes several changes to existing rules. The indirect or deemed paid foreign tax credit of Section 902 is repealed. However, Section 960 is amended to preserve the treatment of a corporate U.S. shareholder as paying foreign taxes attributable to its Subpart F inclusions and to PTI distributions, including distributions through tiered CFCs. A U.S. corporate shareholder of a passive foreign investment company treated as a qualified electing fund will also be treated as paying foreign taxes on PTI distributions of the qualified electing fund if the shareholder meets the ownership requirements of former Section 902. The Act also adds a new foreign tax credit limitation category to Section 904(d) for nonpassive income of a foreign branch.

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