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International Tax ADVISORY ▪

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Tax Cuts and Jobs Act – First Impressions Regarding International Tax Reform

On November 2, 2017, House Ways and Means Committee Chairman Kevin Brady (R-TX) released H.R. 1, the Tax Cuts and Jobs Act. During the week of November 6, the Ways and Means Committee marked up the bill and approved the amended bill by a vote of 24-16 along party lines. On November 16, the House passed the bill by a 227-205 vote. Thirteen Republicans voted against the bill, and no Democrats voted in favor of it. Meanwhile, Senate Finance Committee Chairman Orrin Hatch (R-UT) released his Chairman's Mark of the Tax Cuts and Jobs Act on November 9. During the week of November 13, the Senate Finance Committee (SFC) marked up the bill and approved the Chairman's Modified Mark and manager's amendment by a vote of 14-12 along party lines on November 16, 2017. The budget reconciliation process is being used for this legislation, which means that in the Senate only 51 votes are needed for passage, rather than the usual 60.

Both the House bill and the SFC bill contain many provisions that would drastically change the U.S. international tax rules. Although both bills contain similar features, the SFC bill would make more extensive changes to the U.S. international tax rules than would the House bill.

Participation Exemption System for the Taxation of Foreign Income

Both bills propose replacing the current U.S. worldwide tax system with a territorial system of taxation. Under the current worldwide tax system, U.S.-headquartered corporations pay tax on their income regardless of whether it is earned in the U.S. or overseas. Under a territorial system, the U.S. would only tax the U.S. income of a corporation and would generally exempt all foreign income. Moving to a territorial system would more closely align the U.S. with its peers, since the U.S. is currently the only G7 nation that uses a worldwide system.

Both bills propose to transition the U.S. from a worldwide tax system to a territorial tax system by implementing a participation exemption. This system is meant to allow U.S. companies to compete on a more level playing field against foreign multinationals and to eliminate the "lock-out" effect, which under current law encourages U.S. companies to avoid repatriating their foreign earnings back into the U.S.

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Both bills provide for a 100% deduction for the foreign-source portion of dividends received by domestic corporations from certain foreign corporations they own a 10% or greater interest in. The 100% dividend exemption applies only to foreign-source dividends and does not apply to Subpart F income or U.S. source income of foreign corporations (i.e., U.S. effectively connected income or dividends from 80% owned domestic corporations). No foreign tax credit or deduction would be allowed for any foreign taxes paid or accrued on any such exempt dividend. Under both bills, direct ownership is not required, and so dividends may be "received" indirectly by the U.S. corporate shareholder through partnerships if they would otherwise qualify.

Deemed Repatriation

In connection with the transition from a worldwide system to a territorial system, both bills include a deemed repatriation provision. Both provisions would apply to the last taxable year that ends before January 1, 2018, and both contain many of the same elements. For example, both provisions would apply to all U.S. shareholders, including individuals that are not eligible for the 100% dividends exemption, provided they own at least 10% of the stock of the foreign corporation. Both provisions use a bifurcated rate structure for cash and cash-equivalent earnings (14% in the House bill and 10% in the SFC bill) and non-cash earnings (7% in the House bill and 5% in the SFC bill). Additionally, both proposals would allow for payment of the deemed repatriation tax in installments over eight years to reduce the sting of the payments.

Although both proposals contain many of the same elements, there are some key differences between the two. The deemed repatriation rates in the House bill are significantly higher than the rates in the SFC bill. In the SFC bill, the "post-1986 earnings" subject to the deemed repatriation are limited to the period in which a U.S. person held a 10% or greater interest in the foreign corporation, while the House bill contains no such limitation. In the SFC bill, the installment payments would be backloaded, increasing from 8% in the first five years to 25% in the eighth year, while in the House bill the installments would be equal for all eight years. Additionally, in the SFC bill, the proposal would allow taxpayers to elect to preserve net operating losses and coordinate net operating loss, overall domestic loss, and foreign tax credit carryforward rules upon the transition to participation exemption system.

Provisions for the Prevention of Base Erosion and Profit Shifting

In moving to a territorial tax system, the U.S. is keenly aware that it needs to protect its tax base, which will be significantly more limited. Both the House bill and the SFC bill contain provisions meant to codify the U.S. Treasury Department's ongoing efforts to limit the exploitation of gaps and mismatches in tax rules to artificially shift profits to low-tax countries and prevent base erosion. The bills approach dealing with this problem in different ways.

Tax on foreign high returns

The House bill contains a provision that would require a U.S. shareholder of any controlled foreign corporation (CFC) for any tax year to include in gross income 50% of its "foreign high return amount" determined for that tax year. This provision would effectively establish a global minimum tax on foreign earnings. Foreign high returns are measured as the excess of the U.S. shareholder's share of its CFC's net income over a routine return (7% plus the federal short-term rate for the month in which the tax year ends) on the CFC's aggregate adjusted bases in depreciable tangible property, adjusted downward for interest expense. Of note, this provision would be particularly relevant for U.S. taxpayers with significant offshore intangible property because this property would not be considered a qualified business asset investment. The foreign high returns amount does not include income effectively connected with a U.S. trade or business (ECI), Subpart F income, certain income that meets the requirements for the active finance exemption from Subpart F income, income from the disposition of commodities produced or extracted by the taxpayer, or certain related-party payments. A U.S. corporation that includes a foreign high return amount in income would be able to take a foreign tax credit against such income, but the credit would be limited in the following ways: (1) the amount of the credit would be limited to 80% of the foreign taxes paid; (2) the credit would not be allowed against U.S. tax imposed on other foreign-source income; and (3) the credit would not be allowed to be carried back or forward to other tax years.

Tax on global intangible low-taxed income

The SFC bill does not include a provision relating to foreign high returns. Instead, the SFC bill contains a similar provision that would require a U.S. shareholder of any CFC to include in gross income for a taxable year its global intangible low-taxed income (GILTI) in a manner similar to inclusions of Subpart F income. This provision would apply to all U.S. shareholders, including individuals, and would essentially tax foreign earnings that exceed 10% of the aggregate of depreciable property used in a trade or business. U.S. corporations will be able to take a foreign tax credit against GILTI, but the credit will be limited to 80% of the product of the corporation's inclusion percentage multiplied by the aggregate tested foreign income taxes paid or accrued, for tested income, by each CFC. Additionally, the proposal would create a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. In addition to this GILTI provision, the SFC bill includes new incentives to develop or bring back intellectual property and export its usage. The SFC bill would allow a U.S. corporation to take a deduction equal to 37.5% (21.875% for taxable years after December 31, 2025) of the lesser of (1) the sum of its foreign-derived intangible income plus the amount of GILTI that is included in its gross income; or (2) its taxable income. As a result, the tax rate on intangibles would only be 12.5% for taxable years after December 31, 2017, and before January 1, 2026, and would be 15.625% for taxable years after December 31, 2025.

Limitation on deductibility of net interest expense

Both proposals include provisions that would limit the deduction for net interest expense of multinational groups based on a ratio tied either to earnings or debt-to-equity calculations. To the extent the U.S. corporation's share of the group's global net interest expense exceeds 110% of the applicable ratio, the U.S. corporation's net interest expense would be limited. The provision in each bill differs due to the ratio used. The House bill uses an earnings ratio based on the U.S. corporation's share of the group's earnings before interest, taxes, depreciation, and amortization (EBITDA). The SFC bill uses a debt-to-equity ratio calculated comparing the debt of the U.S. members of the group to the debt of the worldwide group.

Additionally, the provision in each bill differs slightly due to the way the multinational group is defined—the House bill uses the concept of an international financial reporting group (IFRG), while the SFC bill uses the concept of a worldwide affiliated group. An IFRG is a group of entities that includes at least one foreign corporation engaged in a U.S. trade or business, or at least one domestic corporation and one foreign corporation, and prepares consolidated financial statements and has annual global gross receipts of more than $100 million. The worldwide affiliated group concept in the SFC bill does not require a minimum level of gross receipts; rather, it only requires that the group meet a modified definition of "affiliated group" in Section 1504.

Finally, both bills would significantly revise Section 163(j). Both bills propose to disallow the deduction for net interest expense exceeding 30% of the business's adjusted taxable income. Both bills would also broaden the scope of Section 163(j) so that it would generally apply to every business, regardless of its form. While the proposals in both bills are generally similar, there are several differences between the two. The SFC bill would permit disallowed deductions to be carried forward indefinitely, while the proposal in the House bill would only allow disallowed deductions to be carried forward for five years. Additionally, both bills would exempt certain businesses from the provision, such as real property trades or businesses, public utilities companies, and businesses with annual gross receipts below a certain threshold. The gross receipts threshold in the SFC bill is $15 million—much lower than the $25 million threshold in the House bill.

Excise tax on certain payments from U.S. corporations to related foreign corporations

The House bill proposes to impose an excise tax on certain payments from domestic corporations to related foreign corporations and an election to treat such payments as ECI. Under this provision, non-interest payments made by a U.S. corporation to a related foreign corporation that are deductible, includible in costs of goods sold, or includible in the basis of a depreciable or amortizable asset would be subject to a 20% excise tax unless the related foreign corporation elected to treat the payments as U.S. ECI. The proposal permits a foreign tax credit to apply to 80% of foreign taxes paid or accrued. The proposal would apply only to IFRGs with payments from U.S. corporations to their foreign affiliates totaling at least $100 million annually. The U.S. tax benefit afforded to multinational companies that make deductible payments between U.S. and foreign affiliates would be eliminated by this provision. This provision could lead to double taxation because the U.S. tax is imposed on a gross basis and the amount is still includible in the foreign corporation's income. U.S. and foreign businesses, as well as individuals and interest groups across the political spectrum, have expressed a great deal of opposition to the provision as it was originally written. In response, the House Ways and Means Committee amended the provision to address some U.S. business concerns, and the amendment is reflected in the discussion above.

Base erosion minimum tax on certain payments to foreign affiliates

The SFC bill does not contain an excise tax provision like the provision in the House bill. However, the proposal includes a provision intended to reach a similar result: the "base erosion minimum tax." This provision effectively requires a domestic corporation that makes deductible payments to a foreign affiliate to pay the higher of: (1) a tax equal to 10% (12.5% for years after December 31, 2025) of its income without any deduction for such otherwise deductible payments to its foreign affiliate (the "base erosion payments"); and (2) its regular corporate tax liability, reduced only by the R&D tax credit. The base erosion minimum tax would apply to domestic corporations (other than a RIC, REIT, or S Corp) that have gross receipts exceeding $500 million annually and that have a "base erosion percentage" of 4% or higher for the taxable year. The base erosion percentage is calculated by dividing the domestic corporation's total base erosion payments by its total deductible payments.

Finally, the SFC bill also contains an anti-base-erosion provision targeted at hybrid entities. The proposal would deny a deduction for disqualified payments to a related party pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified payment is any interest or royalty payment to a related party to the extent (1) there is no corresponding income inclusion to the related party under the law of the country where it is resident for tax purposes; or (2) the related party is allowed a deduction for that amount under the tax law of such country.

Looking Ahead

Comprehensive tax reform is moving rapidly, with the objective of sending a bill to the President by the end of 2017. Further changes may be made as the legislative process continues. We will continue to monitor these developments as the tax reform process progresses in the coming weeks and provide further updates.

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