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NEWS

Changes Abound in New Tax Bill for Multinational Companies

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Perhaps some of the most extensive changes in H.R. 1, known as the Tax Cuts and Jobs Act (the “Act”), deal with the taxation of multinational companies. The taxation of foreign earnings has long been a point of contention between taxpayers and Congress. The rules reflect a new policy approach to the income of multinationals, as well as carrots and sticks for certain types of activities.

Due to the significant nature of the changes, additional guidance is expected from the IRS and Treasury. The discussion below provides some highlights of the Act, but additional guidance may provide different interpretations.

100% Deduction for Foreign Source Dividends

Historically, U.S. shareholders were taxed on the U.S earnings of foreign companies if a dividend was made or the anti-deferral subpart F or passive foreign investment company (PFIC) regimes applied.

Under the Act, the subpart F and PFIC regimes are left largely intact. However, new Section 245A provides a 100% dividends received deduction (DRD) for the foreign source portion of dividends received from a specified 10-percent foreign corporation by domestic corporations that are U.S. shareholders. A specified 10-percent foreign corporation is a foreign corporation in which any domestic corporation is a U.S. shareholder. A U.S. shareholder is a U.S. person who owns 10-percent or more of the vote *or value* of a foreign corporation. (See **Expansion of CFC Ownership** below). A one-year holding period is required to claim the DRD. No foreign tax credit or deduction is allowed for exempted dividends.

The provision applies to distributions made after December 31, 2017.

Comments:

- The DRD is only available to *C corporations*, excluding REITs and RICs. The DRD is intended to be available to domestic corporations owning foreign stock through partnerships if it would be available in the case of direct ownership.
- The Act provides coordinating provisions with Section 1248, basis adjustments and sales of lower-tier CFCs.
- The Act also provides for the inclusion of a “transferred loss amount” in the gross income of a domestic corporate transferor of foreign branch assets. The transferred loss amount is generally the excess of losses incurred by the branch after December 31, 2017 with respect to which the

transferor was allowed a deduction.

- The Act repeals the active trade or business exception under Section 367(a) for outbound asset transfers, effective for transfers after December 31, 2017.

Repatriation Toll Charge

To transition into the DRD exemption regime, the Act provides a one-time toll charge on accumulated post-1986 earnings of certain foreign corporations.

Specifically, a U.S. shareholder must include in income its pro-rata share of a deferred foreign income corporation's accumulated post-1986 accumulated earnings and profits ("E&P") determined as of either November 2, 2017 or December 31, 2017, whichever is greater. Certain deficits may be considered. The provision applies for the foreign corporation's *last tax year beginning before January 1, 2018*.

The provision provides for a participation exemption allowing a deduction in an amount that would result in a 15.5% rate of tax on accumulated post-1986 earnings held in the form of cash or cash equivalents and an 8% rate of tax on remaining earnings.

Limited foreign tax credits are allowed with respect to the taxable portion of the includible earnings.

A U.S. shareholder may elect to pay the net tax liability in eight installments of the following amounts: 8% in each of the first 5 years; 15% in the 6^{th} year; 20% in the 7^{th} year; and 25% in the 8^{th} year. The installments will be accelerated in the case of any failure to timely pay, a liquidation or sale of substantially all of the assets of the U.S. shareholder, a cessation of business by the taxpayer or similar occurrence to the day of such triggering event. An exception is available in the case of a sale of substantially all of the assets of the taxpayer if the buyer enters into an agreement to become liable for the remaining installments.

Special rules apply to S-corporation shareholders. Each S-corporation shareholder may elect to defer payment of the toll charge until the corporation ceases to be an S-corporation, there is a liquidation or sale of substantially all of the S-corporation's assets, or there is a transfer of the stock of the S-corporation. A transfer of S-corporation stock will not be considered a triggering event if the transferee enters into an agreement with the IRS to become liable for the remaining installments. An S-corporation becomes jointly and severally liable for a shareholder's payment of the deferred tax.

Shareholders who make the election must report the amount of the deferred net tax liability on the return for the year in which such election is made and on each return thereafter until the amount is assessed. Failure to report can result in an increase in tax assessment of 5% of the includible amount. S-corporations must report in their tax return the amounts includible and provide a statement to shareholders indicating their pro rata share.

Comments:

- Although the DRD only applies to C-corporations, the toll charge applies to *all* U.S. shareholders of CFCs, although, as noted, special rules may apply to S-corporation shareholders.
- The election of the installment method should now be an added item of due diligence and, where necessary, a point of negotiation in the course of an acquisition of an entity's stock or assets.
- Although the participation exemption deduction is available to all U.S. shareholders, the deduction is based on the corporate tax rate.
- PFICs are excluded from application of the toll charge.
- The IRS has issued Notice 2018-07 outlining regulations that it intends to issue to determine

amounts includible under the toll charge.

Inclusion of Global Intangible Low-Taxed Income

Congress and the IRS have long been concerned with companies moving mobile and intangible income offshore to lower-tax jurisdictions. As a stick to companies engaged in such planning and as a deterrent against new tax base erosion planning, new Section 951A provides that a U.S. shareholder of a CFC must include its pro-rata share of the CFC's global intangible low-taxed income ("GILTI") in its taxable income. Generally speaking, GILTI is low-taxed CFC income above a certain rate of return. Such income is included in the same manner as subpart F income.

Specifically, a U.S shareholder's GILTI is the excess of the shareholder's net CFC tested income for such taxable year over the shareholder's net deemed tangible income return. A shareholder's net deemed tangible income return is the excess of 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment ("QBAI") of each CFC over the interest expense taken into account in the net CFC tested income. In formulaic terms:

GILTI = Net CFC Tested Income – [(10% X QBAI) – Interest Expense]

Tested income is based on the gross income of each CFC, but does not include effectively connected income, Subpart F income, income excluded under the high-tax exception of Section 954(b)(4), related person dividends under Section 954(d)(3), and any foreign oil and gas extraction income. The QBAI is generally based on the quarterly average basis of the CFC's depreciable tangible business properties.

Although a foreign tax credit may be taken for GILTI, it is limited to 80% of the foreign taxes paid or accrued. No carryback or carryforward is allowed. A separate basket is created for GILTI.

The provision is effective for tax years of foreign corporations beginning after December 31, 2017 and tax years of U.S. shareholders in which or with which such tax years of foreign corporations end.

Deduction for Foreign-Derived Intangible Income and GILTI

Domestic C-corporations that are not RICs or REITs are allowed a 50% deduction for their GILTI and a 37.5% deduction for foreign-derived intangible income (FDII) for taxable years after December 31, 2017 and before January 1, 2026. This results in an effective rate of 10.5% on GILTI and 13.125% on FDII for domestic corporations.

For taxable years after December 31, 2025, the deduction is reduced to 37.5% for GILTI and 21.875% for FDII.

The FDII calculation is a complex definition based on multiple layers of defined terms. Very generally, FDII is the portion of an entity's income over a certain amount of return that is attributable to property sold, licensed or leased for use outside the U.S. and services provided to non-U.S. persons or property.

Comments:

- The deduction is only available to U.S. C-corporations.

Prevention of Base Erosion

Base Erosion and Anti-Abuse Tax

Under new Base Erosion and Anti-Abuse Tax (BEAT), applicable taxpayers will be required to pay a new tax equal to their base erosion minimum tax amount. At a high-level, the base erosion minimum tax amount equals 10% of the taxpayer's modified taxable income (not including deductible and certain other payments made to foreign-related parties) less the taxpayer's regular tax liability (based on taxable income reduced by deductible and certain other payments to foreign-related parties and reduced for certain credits).

Applicable taxpayers are generally C-corporations that are not RICs or REITs and have average gross receipts of at least $500 million for the prior three-year period and a base erosion percentage of at least 3%. The base erosion percentage is based on the ratio of deductible payments made to foreign-related parties to the taxpayer's total deductible payments (with some exceptions).

The Act provides for additional information reporting requirements under Form 5472 for base erosion payments.

The provision applies to base erosion payments paid or accrued in tax years beginning after December 31, 2017.

Hybrid Payments and Transactions

Deductions are denied for disqualified related party payments made pursuant to a hybrid transaction or by, or to, a hybrid entity. A disqualified related party payment includes any interest or royalty paid or accrued to a related party: (1) that is not included in income of the related party under tax laws of the country in which that party is a resident or (2) for which the related party is allowed a deduction under local tax laws. A hybrid transaction is a transaction, series of transactions, agreement or instrument in which interest or royalty payments are not treated as such under the local tax laws of the recipient's residence. A hybrid entity is one that is treated as fiscally transparent under local tax laws but not in the U.S. or *vice versa*.

Effective for taxable years beginning after December 31, 2017.

Expansion of Section 936(h)(3)(B) to Include Goodwill and Going-Concern

The definition of intangible assets under Section 936(h)(3)(B) is amended to include any goodwill, going concern value, or workforce in place. This modification makes it clear that the outbound transfer of goodwill is subject to Section 367(d) (especially considering the repeal of the active trade or business exception under Section 367(a)), and goodwill is included for purposes of Section 482.

Effective for transfers made in taxable years beginning after December 31, 2017.

Source of Gain or Loss from Sale of Partnership Interests

In Rev. Rul. 91-32, the IRS took the position that the source of gain or loss from the sale of a partnership interest is determined at the partnership level rather than the partner level. Accordingly, a foreign partner's gain or loss could be considered U.S. source (and thus subject to U.S. tax) to the extent of a partnership's unrealized gain or loss in assets that would be effectively connected with a U.S. trade or business if sold by the partnership. In July 2017, the Tax Court rejected Rev. Rul. 91-32 in *Grecian Magnesite Mining v. Commissioner*, stating that the foreign partner's gain or loss should be determined at the partner level and, thus, potentially not subject to U.S. tax as foreign source income (to the extent not related to U.S. real property).

The Act effectively codifies Rev. Rul. 91-32 and requires a transferee to withhold 10% of the amount realized on the sale or exchange of a partnership interest unless the transferor certifies that it is a U.S. person. If the transferee does not withhold, the partnership may be required to withhold by deducting the applicable amount from distributions to the transferee partner. These rules are now in addition to the withholding provisions already included in Sections 1445 and 1446.

The provisions are applicable to dispositions and exchanges made after November 26, 2017. Although the withholding requirements are applicable to dispositions and exchanges made after December 31, 2017.

Expansion of CFC Ownership

Under pre-Act law, whether a shareholder was considered a U.S. shareholder was determined under specific requirements. The Act contains modifications expanding the definition of who is considered a U.S. shareholder.

The constructive attribution rules are modified to treat a U.S. person as constructively owning foreign corporation stock owned by a related foreign person. For example, stock owned by a U.S. corporation's foreign parent. This modification is effective and applicable to the last taxable year of foreign corporations beginning before January 1, 2018 and each subsequent year.

The definition of U.S. shareholder is expanded to a U.S. person who owns 10% or more of the vote *or value* of all classes of stock of the foreign corporation. This modification is applicable to taxable years of foreign corporations beginning after December 31, 2017.

The requirement that a corporation must be controlled for 30 days before subpart F inclusions are required is eliminated. This modification is applicable to taxable years of foreign corporations beginning after December 31, 2017.

Modification of Foreign Tax Credits

Under pre-Act law, C-corporation shareholders owning at least 10% of the voting stock of a foreign corporation were allowed a deemed paid foreign tax credit for foreign taxes paid by the CFC when dividend distributions were made or subpart F income arose. Attributable foreign taxes were determined based on accumulated tax pools.

The indirect tax credit under Section 902 is repealed in its entirety. However, a deemed-paid credit is still allowed with respect to subpart F income inclusions under Section 960, as modified by the Act. For example, the Section 960 credit is now determined on a current year basis in an effort to eliminate the need to compute and track cumulative tax pools.

The changes are applicable to taxable years of foreign corporations beginning after December 31, 2017.

Miscellaneous Matters

- Taxpayers can increase the percentage of taxable income treated as foreign source on overall domestic loss recapture up to 100% (increased from 50% under pre-Act law).
- A separate foreign tax credit limitation basket is now included for foreign branch income.
- Gains from the sale of inventory will be allocated and apportioned between U.S. and foreign source based on the location of production with respect to the property. For example, income from the sale of inventory that is produced entirely in the U.S. will be U.S. source income even if title passes outside the U.S. Previously, if inventory was produced in one jurisdiction and sold in another, the sourcing would be split 50/50 between place of production and place of sale.
- Passive income for purposes of the PFIC determination will not include income derived in the active conduct of an insurance business by a foreign corporation that would be subject to tax under subchapter L if it were a domestic corporation and if its applicable insurance liabilities constitute more than 25% of its assets. This test replaces the “predominantly engaged in an insurance business” test under pre-Act law.
- The fair market value method of interest expense apportionment is repealed.
- The Act provides modifications to certain subpart F provisions dealing with oil-related income and shipping income.

Items in House and Senate Bills *NOT* Included in the Final Act

- Limitations and carve-backs to Section 956 (relating to CFC investments in U.S. property).
- Inflation adjustment to the *de minimis* exception for foreign base company income
- Making permanent the look-through rule of Section 954(c)(6).
- Limitation on interest deductions taken by domestic corporations that are members of an international or worldwide affiliated group based on the U.S. corporation’s share of the group’s EBITDA. However, note amendments to Section 163(j) disallowing a deduction for net business expense in excess of 30% of the business’s adjusted taxable income.
- Certain provisions applicable to U.S. possessions.

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