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client alert

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U.S. TAX REFORM - INTERNATIONAL PROVISIONS

HIGHLIGHTS FOR NON-U.S. TAXPAYERS

On December 22, 2017, the U.S. President signed into law new tax reform legislation called the "Tax Cuts and Jobs Act of 2017" (the "**Tax Act**"), launching the most far reaching reform of U.S. tax rules in over 30 years. This Client Alert summarizes the key international provisions of the Tax Act that could significantly impact our cross border clients with U.S. inbound or outbound business. We are closely analyzing the new legislation and, in the coming weeks, will be releasing detailed client alerts focusing on specific aspects of the international provisions that will impact European businesses with U.S. nexus, including investment and financing structures.

In a nutshell, the international provisions of the Tax Act:

- Subject all 10% U.S. shareholders of a foreign corporation to an immediate but reduced tax on the accumulated earnings of the foreign corporation through a one-time deemed repatriation of those earnings

- Permit tax free repatriations of future foreign profits of foreign corporations to their 10% corporate U.S. shareholders via new participation exemption

- Expand the scope of the anti-deferral Subpart F regime, including a new category of currently taxed income called "global intangible low-taxed income"

- Introduce new anti-abuse provisions designed to prevent U.S. tax base erosion and income shifting to foreign affiliates.

MODIFIED TERRITORIAL SYSTEM FOR MULTINATIONALS

In addition to the cornerstone reduction of the U.S. corporate income tax rate from 35% to 21%, the Tax Act implements significant changes to the taxation of foreign income earned by U.S. companies by creating a modified territorial taxation system and a one-time repatriation tax on accumulated foreign earnings. U.S. multinational companies are studying the impact of this new approach on their foreign operations and undoubtedly will explore restructuring opportunities in order to better align with the new rules. This in turn could significantly impact their foreign subsidiaries and business lines.

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A. Participation Exemption

The Tax Act adopts a participation exemption system under which the foreign source portion of dividends received after 2017 by a 10% U.S. corporate shareholder from a foreign subsidiary is exempt from U.S. federal income tax via a 100% dividends received deduction mechanic. No foreign tax credit or deduction is allowed for any foreign tax paid or accrued (including withholding taxes) with respect to any exempted dividend. In addition, no deduction or foreign tax credit is permitted for certain hybrid dividends where the foreign corporation receives a deduction for foreign income tax purposes. Amongst other conditions, a minimum one year holding period must be satisfied for the participation exemption to apply.

While the participation exemption represents a move toward a territorial approach, many aspects of worldwide taxation remain, including the fact that this exemption only applies to 10% corporate shareholders and therefore does not change taxation of foreign dividends received by shareholders that are U.S. partnerships or individuals. Moreover, the existing Subpart F system remains in place (although somewhat modified, as discussed below), still subjecting 10% U.S. shareholders (individuals and corporates) to current tax on their share of certain categories of passive income earned by foreign subsidiaries that qualify as controlled foreign corporations (“**CFC**”). Similarly, the Passive Foreign Investment Company regime (“PFIC”) remains generally unchanged.

B. The Repatriation Tax

To avoid any windfall from the new participation exemption, the Tax Act introduces a one-time mandatory repatriation tax on a 10% U.S. shareholder’s allocable share of a foreign corporation’s untaxed and undistributed accumulated earnings and profits. The repatriation tax is meant to prevent previously untaxed deferred foreign earnings from escaping U.S. taxation altogether under the new participation exemption regime.

Although the participation exemption only benefits 10% corporate U.S. shareholders, the repatriation tax nonetheless applies to all 10% U.S. shareholders, including individuals and partnerships, if the foreign corporation is a CFC or with respect to which the 10% shareholder is a U.S. corporation, but does exclude shareholders in PFICs that are not CFCs.

The Tax Act sets the earnings as of November 2, 2017, or December 31, 2017, whichever is higher and the tax is applied at an effective rate of 15.5% on foreign cash and liquid assets, and 8% on all residual earnings and profits. The repatriation tax may be paid over a period of up to 8 years (without an interest charge) and the taxed income can thereafter be distributed without further taxation.

OTHER INTERNATIONAL PROVISIONS

A. Subpart F Expansion

The Subpart F system of taxing 10% U.S. shareholders currently on certain passive income categories is retained and expanded. In particular, a new category of Subpart F income is introduced called “global intangible low-taxed income” (“GILTI”). GILTI generally is comprised of passive income deemed to arise from high-value intangibles. The effective rate of tax applied to GILTI is 10.5% for U.S. corporate shareholders, while ordinary individual income tax rates apply to GILTI allocated to individual shareholders. However, earnings subject to the tax exclude a 10 percent return on certain investments, reduced by net interest expense. Like all Subpart F income, U.S. shareholders will be taxed on GILTI currently on an annual basis, regardless of whether such income is actually distributed by the CFC. GILTI is meant to

disincentive using CFCs in low-tax countries by countering the anticipated tax savings with the GILTI tax increase on U.S. shareholders.

The definition of a U.S. shareholder for Subpart F purposes also is expanded, starting for tax year 2018, to include not just U.S. shareholders owning 10% of the *voting* stock of a CFC but also those owning at least 10% of the *value* of a CFC. In addition, the attribution rules that apply to determine the total ownership by any particular U.S. shareholder are revised to include attribution of foreign corporation stock owned by a related foreign person. In particular, going forward a U.S. company in a foreign parented group not only will treat its 10% owned foreign subsidiaries as CFCs, but it may also need to treat its foreign sister companies as CFCs because it will be attributed its foreign parent's ownership of those sister companies. Finally, the Tax Act eliminates a previous limiting condition that a foreign company must first qualify as a CFC for 30 continuous days before the Subpart F rules are triggered.

These threshold changes should prompt all U.S. shareholders of foreign subsidiaries to revisit CFC status under the expanded Subpart F rules of the Tax Act. These changes will have the consequence of transforming certain foreign subsidiaries into CFCs overnight.

It is worth noting that Section 956 of the Subpart F regime remains in force under the Tax Act, notwithstanding its proposed (and expected) repeal in the proposed versions of the bill put out by both the House and the Senate. Section 956 generally taxes a U.S. shareholder on a deemed dividend amount tied to any U.S. investment by a CFC, including any collateral support provided by the CFC for a U.S. borrowing. The interplay of the 956 rule with the new participation exemption will need to be evaluated for both existing and new financings and investments.

B. Sale of Partnership Interest by a Foreign Person

The Tax Act codifies Revenue Ruling 91-32, treating gain recognized by a foreign person on the sale of a partnership interest as income effectively connected with a U.S. trade or business to the extent the partnership was engaged in a U.S. trade or business. As a result, the foreign person must file a U.S. tax return and pay the applicable "regular" U.S. federal income tax on the gain. In addition, a new 10% withholding tax is applied to the sale unless a non-foreign affidavit is provided by the seller (similar to system that applies under the Foreign Investment in Real Property Tax Act). The withholding tax will apply to sales occurring after December 31, 2017, however, the IRS has already indicated that it will not require or enforce the withholding until guidance is published. This new provision is interesting in part because it effectively overrides a very recent decision in July 2017 by the U.S. Tax Court (in the *Grecian Magnesite Mining* case) in which it was determined that a foreign partner could recognize capital gain on sale of an interest in a partnership engaged in a U.S. trade or business.

C. Base Erosion and Anti-Abuse (BEAT) Minimum Tax for Corporations

The Tax Act BEAT provision specifically targets U.S. corporations that substantially reduce U.S. taxable income through significant deductible payments, like royalties or interest, to foreign affiliates. BEAT effectively applies a minimum tax on a modified taxable income amount.

Any U.S. corporation (other than a RIC, REIT, or S-corporation) with average annual gross receipts of at least $500 million (on a group basis) over the prior three years, and that has made certain related party deductible payments (reflected in a "base erosion percentage" of at least 3% (2% for banks)) will be subject to BEAT starting in 2018. Very generally, the BEAT approach effectively requires U.S. companies to include in taxable income the deductible payments made to foreign affiliates. The initial BEAT rate in 2018 is 5%, increasing to 10% in

2019 until 2026, when it reaches 12.5%. The rate is increased 1% for taxpayers that include in their affiliated group banks or securities dealers.

The "base erosion percentage" is the taxpayer's base erosion tax benefits divided by its deductions. The taxpayer's "base erosion minimum tax" is calculated as the excess of 10% (5% in 2018) of the corporation's taxable income (ignoring certain deductions and benefits from "base erosion payments") over its regular tax liability. For this purpose, a "base erosion payment" includes any deductible (or depreciable or amortizable) amount paid or accrued by the taxpayer to foreign affiliate (related by at least 25% affiliation). Very generally, the minimum tax should begin to apply if the base erosion tax benefits exceed 110% of taxable income.

D. Foreign IP - Outbound Transfer Limitations and Income Deductions

Under an existing rule often referred to as the "super royalty" rule, U.S. persons making outbound transfers of intangible property are sometimes required to recognize deemed income akin to a royalty over a future period meant to reflect amounts commensurate to income derived from that intangible. This super royalty rule is a punitive measure designed to prevent U.S. taxpayers from transferring valuable intellectual property outside U.S. taxing jurisdiction. The Tax Act expands the reach of the super royalty rule by increasing the scope of intangible property to include goodwill, going concern value, workforce in place, and other elements of value not directly identified with tangible property or services. This expansion is in line with the overall fortification of U.S. policy against income shifting to foreign affiliates.

The Tax Act permits a U.S. corporation that is not a RIC, REIT, or S corporation to deduct 37.5% of its "foreign-derived intangible income" and 50% of its GILTI (percentage reduced after 2025). The "foreign-derived intangible income" is a function of its "deemed intangible income", income from selling, leasing, licensing, exchanging or disposing of property or services abroad, and its net income (subject to various exclusions). "Deemed intangible income" is net income (subject to various exclusions) reduced by a deemed 10% return on its basis in tangible depreciable property. This rather complex set of calculations and determinations ultimately subjects a U.S. corporation to a tax rate of approximately 13% on its foreign-derived intangible income.

E. Interest Expense Deductions

The Tax Act provides a new approach to interest deduction limitations, but it applies only to businesses with average gross receipts of more than $25 million over a three-year period. Businesses under that threshold are not subject to the new limitation, which also does not apply to investment interest. The new limitation rule replaces the long standing "earnings stripping" rule which applied only to deductions for interest paid by U.S. corporations to, or guaranteed by, related foreign parties if certain other factors were present.[1]

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[1] Notably, during the drafting period, both the House and Senate versions of the bill also limited the interest expense deduction of a U.S. corporation that is a member of a worldwide group, basing the proposed limitation on the U.S. corporation's relative share of EBITDA or on a comparison against the worldwide group's debt/equity ratio relative to that of the U.S. corporation. However, the Tax Act ultimately did not include any such provision.

Under the new limitation rule, interest deductions are limited for corporations and partnerships to 30% of adjusted taxable income. Until January 1, 2022, adjusted taxable income is computed without regard to depreciation, amortization and depletion (e.g., EBITDA); thereafter, adjusted taxable income will include those elements. Unlimited carry-forwards are permitted for disallowed interest deductions. The new rule applies to tax years beginning after December 31, 2017 and there is no grandfathering for existing debt instruments.

The Tax Act prevents deductions for interest and royalties paid to a foreign affiliate in respect of any hybrid transaction, entity, or instrument where there is no income inclusion in the foreign country, or under the Subpart F rules. The Tax Act gives significant leeway to the IRS to issue regulations preventing similar results from conduit or other structured transactions designed to play off discrepancies across tax regimes. ■

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