Forry, John

To: Forry, John
Subject: How U.S. Tax Reform Affects International Tax Considerations

From: Ellis, Scott
Sent: Monday, January 8, 2018 2:55 PM
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How U.S. Tax Reform Affects International Tax Considerations

The U.S. Senate passed the final version of the bill introduced as the Tax Cuts and Jobs Act (TCJA) in the early hours of Dec. 20, 2017, with the House of Representatives voting again the same day to pass the reconciled tax reform bill. President Trump signed the tax reform bill into law Dec. 22, an extensive summary of which can be found here.

This Quarterly International Tax Update provides brief descriptions of selected international tax provisions-based on the more extensive summary above-and adds a few observations about the impact of such provisions.

International Provisions Background

Prior to enactment of the tax reform bill, U.S. individuals and businesses generally were taxed on their worldwide income, but with important caveats. For example, active business income earned by foreign subsidiaries was generally not subject to U.S. tax until actually repatriated to its U.S. shareholders as dividends. Thus, some multinational businesses were able to combine foreign tax planning strategies (aimed to reduce foreign tax liabilities) with U.S. tax planning strategies (designed to migrate offshore earnings to lower-taxed foreign subsidiaries) and thereby defer U.S. tax on those foreign earnings.

Observation: Estimates vary, but U.S. companies appear to have at least $2 trillion of foreign earnings held in cash, cash equivalents, and illiquid assets overseas that have not been subject to U.S. tax.
One-Time Repatriation Tax on Accumulated Foreign Earnings

This tax reform imposes a one-time tax on a 10 percent or greater U.S. shareholder’s share of most accumulated and previously untaxed foreign earnings and profits after 1986 of a controlled foreign corporation (CFC)—or of another foreign corporation having a U.S. corporate shareholder with at least 10 percent ownership—regardless of whether such profits are actually repatriated. For any shareholder that is a U.S. corporation, individual, or partnership, deemed repatriated earnings held in cash and cash equivalents will be taxed at 15.5 percent and remaining earnings held in illiquid assets will be taxed at 8 percent. (For 10 percent U.S. corporate shareholders, a partial foreign tax credit is allowed in proportion to the taxable amount of the repatriated earnings.) U.S. shareholders may elect to pay this one-time tax in installments over a period of eight years: 8 percent of the liability in each of the first five years, 15 percent in the sixth year, 20 percent in the seventh year, and 25 percent in the eighth year. A special provision for S corporations defers the tax until the S corporation sells substantially all of its assets, ceases to conduct business, changes its tax status, or the electing shareholder transfers its stock.

Observation: This tax is based on the greater of accumulated foreign earnings and profits at Nov. 2, 2017 or Dec. 31, 2017, so routine calculations of each U.S. shareholder’s earnings and profits (or a comprehensive E&P study) will be necessary to determine the amount at each of the two dates. Since the first tax installment generally is due April 17, 2018, U.S. businesses and other shareholders have a very short time to determine the proper amount.

Useful information: Treasury and IRS have issued Notice 2018-07 and News Release IR-2017-212 to provide guidance for computing this tax.

Territorial System

As a fundamental change from prior law, U.S. corporations will no longer be taxed on certain non-US income, under rules similar to the so-called participation exemption used in a number of foreign countries. More specifically, a U.S. corporation that owns 10 percent or more of a foreign corporation (other than a passive foreign investment company that is not also a CFC) is entitled to a 100 percent deduction for the foreign-source portion of dividends received from such a corporation. Under a similar concept, constructive dividends arising from a U.S. corporation’s sale or exchange of stock in a foreign subsidiary held for more than one year will be treated as a dividend for purposes of this 100 percent dividends-received deduction. All amounts eligible for the 100 percent dividends-received deduction will reduce the U.S. corporation’s basis in its stock of the foreign corporation for purposes of determining any loss on the eventual disposition of such stock. This deduction is only available to C
corporations that are not regulated investment companies (RICs) or real estate investment trusts (REITs).

**Observation:** Any foreign taxes attributable to the income that gives rise to the dividend will not be eligible for the foreign tax credit or deduction. In addition, for a foreign corporate dividend to be eligible for the deduction, the foreign corporation’s stock must be held for more than 365 days during the 731-day period beginning 365 days before the ex-dividend date.

**Taxable foreign income:** A U.S. corporation remains taxable on income from its foreign branches, Subpart F income of its CFCs, and certain intangible low-taxed income as described in the section immediately below.

**Important caveat:** A U.S. individual, partnership or S corporation is not eligible for the exclusion of non-U.S. income, or for the foreign corporation dividends-received deduction even if the 10 percent ownership threshold is met. For such persons, pre-reform U.S. tax planning for foreign income—such as use of a so-called Interest Charge Domestic International Sales Corporation (IC-DISC)—may be useful.

**Global Intangible Low-Taxed Income**

A new provision designed to reduce a multinational business’s incentive to shift profits to CFCs taxes the global intangible low-taxed income (GILTI) of a CFC currently to its U.S. corporate and other shareholders to the extent its aggregate net income exceeds a routine return. The provision applies to U.S. shareholders in tax years of a CFC beginning in 2018 or later.

**Observation:** In order to focus on intangible income of CFCs, GILTI is defined as the excess of the U.S. shareholder’s “net CFC-tested income” over the shareholder’s “net deemed tangible income” return. As described in our more extensive summary of the law, these are complexly defined terms that will require careful tax accounting.

U.S. corporate shareholders of CFCs (but not individuals, partnerships or S corporations) can deduct 50 percent of GILTI income for tax years beginning in 2018 through 2025 and 37.5 percent of GILTI thereafter. U.S. corporate shareholders of CFCs can also claim a foreign tax credit with respect to included GILTI amounts, but such credit is limited to 80 percent of the foreign tax paid, and any unused foreign tax credits cannot be carried forward or carried back to other tax years.

**Foreign-Derived Intangible Income**

In contrast to adding the GILTI tax to disincentivize U.S. persons moving intangible profits abroad, the new law also provides an incentive to keep
intangible assets in the U.S. and to encourage U.S. export activity by allowing a U.S. corporation (but not other U.S. persons) to deduct 37.5 percent of its foreign-derived intangible income (FDII) for taxable years beginning in 2018 through 2025 and 21.875 percent thereafter. FDII of a U.S. corporation is generally income from the sale of property to a non-U.S. person for a foreign use or from services provided to any person or with respect to property located outside the U.S. and, to the extent considered U.S. income, will otherwise be fully taxable to the corporation.

**Observation:** As described in our more extensive summary of the law, FDII excludes several categories of income that should be carefully examined, including income from any foreign branch, thereby focusing the deduction on U.S.-generated income.

**U.S. Base Erosion Provisions**

To supplement the foregoing exclusions and deductions reducing taxation of non-U.S. income—with limitations on the same as described above—the new law is designed to prevent erosion of the U.S. domestic tax base by increasing the tax cost associated with shifting profits overseas to avoid or substantially delay U.S. taxation.

First, the new base erosion anti-abuse tax (BEAT) is an alternative minimum tax on corporations that have annual gross receipts for the three prior years of at least $500 million and make payments to foreign related parties in excess of a threshold amount. These include payments deductible against U.S. taxable income such as interest, royalties, and service fees (but do not include costs of goods sold). The BEAT tax rate is 5 percent for tax years beginning in 2018, 10 percent for tax years 2019 through 2025, and 12.5 percent thereafter.

Second, an outbound transfer of goodwill, going concern value, or in-place workforce to a foreign corporation in an otherwise tax-free transaction will be subject to U.S. taxation (either through current gain recognition or deemed annual royalties). In addition, the IRS is authorized to value intangible property transferred offshore on an aggregate basis (rather than asset-by-asset) if such valuation achieves a more reliable result.

**Observation:** Further base erosion provisions deny deductions for certain payments of interest and royalties to related parties involving a so-called hybrid transaction or hybrid entity with differing tax treatments in the U.S. and abroad. These also clarify that certain dividends received by an individual as a result of an inversion of a U.S. corporation to a foreign corporation are not qualified dividends eligible for lower dividend tax rates and increase the excise tax on stock compensation in such an inversion.

**Additional Changes**
Please consult our more extensive summary of the law for significant but fairly complex changes to the U.S. rules for foreign tax credits, CFCs and CFC shareholders. Other changes affect *inter alia* U.S. investments by foreign subsidiaries of U.S. persons, sourcing of income from international inventory sales, allocation of interest expense among related parties, and sales of U.S. partnership interests by foreign persons.

**Observation:** For businesses and individuals with international operations or income, advice from qualified international tax professionals is advisable to address these additional changes.

**For More Information**

If you need additional support or guidance, please feel free to contact John Forry at JForry@cbiz.com or (646) 345-0586.