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Tax Alert

News Concerning Recent Developments in Tax Law

COZEN O'CONNOR

Federal Tax Legislation: Major Changes to International Taxation

On December 22, 2017, President Trump signed into law a comprehensive tax reform bill commonly known as the Tax Cuts and Jobs Act (the Act). The Act makes major changes to federal income and estate tax law, including numerous changes affecting businesses, individuals, tax-exempt organizations, the taxation of compensation arrangements, and fundamental aspects of U.S. international taxation. The Act is the largest overhaul of the Internal Revenue Code since 1986 and will have substantial effects on taxpayers across all industries.

Previous Alerts addressed key business tax changes that are made under the Act. This Alert focuses on developments in the area of international tax and is one of a series of Alerts that Cozen O'Connor will be issuing on select topics of the Act. Except as otherwise indicated, the provisions summarized below are generally effective for tax years beginning after December 31, 2017.

Overview

Although U.S. persons (e.g., citizens, resident individuals, and domestic corporations) generally are taxed on their worldwide income, foreign income earned by a foreign corporation owned by a U.S. person has historically not been subject to U.S. tax until the income was distributed as a dividend to the U.S. corporation. The tax law, however, contained and still contains a number of anti-deferral regimes, most notably "Subpart F," which require certain U.S. persons to take into account specific types of foreign income of certain "controlled foreign corporations," even if not distributed.

The new law is designed to encourage repatriation of U.S. profits to the United States. Accordingly, there are a number of new provisions relating to the return of foreign income to the United States on a tax-free basis, while at the same time, however, expanding the reach of the anti-deferral provisions of the existing tax law.

These provisions represent a sea change in the approach to taxation of foreign income and accordingly, tax structures, and assumptions that have been in place for decades either no longer apply or need to be re-examined. The following discussion is a summary of certain, (though not all) new international-related tax provisions in the Act.

Participation Exemption System for Taxation Of Foreign Income

For tax years of foreign corporations that begin after December 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end, certain foreign income that is distributed by a foreign corporate subsidiary to its U.S. shareholder/corporate parent will not be subject to tax. The mechanism for the exemption is through a "dividends received deduction" or a DRD. The DRD provides for a 100 percent deduction for the "foreign-source portion" of dividends received from a specified 10 percent owned controlled foreign corporations (CFC) by a domestic corporation that is a U.S. shareholder of such a foreign corporation. The foreign-source portion of a dividend is that amount that bears the ratio to the dividend as the undistributed foreign earnings of the specified 10 percent-owned foreign corporation bears to the total undistributed earnings of such foreign corporation.

Another related feature of the new provisions of the Act is that no foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD. There is also a minimum holding period requirement to obtain the benefit of the DRD and it is only available to regular C corporations (e.g., not regulated investment companies or real estate investment trusts).

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Related Practice Areas

- International
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As a related provision to the new DRD, the Act further provides that where gain on the sale of the stock of a foreign corporation would otherwise be treated as a dividend under Code Section 1248, such amount would be treated as a dividend for purposes of applying the new DRD.

The Act, however, imposes a cost for the new model of taxation of international income. U.S. shareholders owning at least 10 percent of a specified foreign corporation must include in income, for the corporation's last tax year beginning before 2018, the shareholder's pro rata share of the net post-1986 historical earnings and profits of the foreign subsidiary to the extent such earnings and profits (E&P) has not been previously subject to U.S. tax. Specified foreign corporations generally include CFCs and all other foreign corporations with at least one U.S. corporation as a U.S. shareholder.

The cash/cash equivalent portion of such E&P is taxed at a 15.5 percent rate, and the remaining E&P is taxed at 8 percent. Taxpayers may elect to pay the tax over eight years, with smaller installments in the earlier years and larger installments later. Special rules apply for S corporations and REITs with respect to the deemed repatriation, which allow further deferral of the payment of the tax.

Practice Points

- It is worth noting that the DRD appears only to apply to distributions that are actually treated as dividends. While for some purposes under the tax code, the income required to be taken into account as a result of the application of the Subpart F rules is treated as a dividend, as a technical matter the income inclusion required by Subpart F is not dividend income. Accordingly, it would appear that the DRD would not apply to a Subpart F inclusion, but only to an actual dividend distribution. Thus, to obtain the benefit of the DRD in the face of Subpart F income, the foreign subsidiary would need to actually distribute the funds to its U.S. parent.
- Although the dividend is not subject to any U.S. federal income tax, it may still be subject to a withholding tax on the distribution from a foreign subsidiary back to the U.S. parent. Because, as noted above, there is no foreign tax credit or deduction available with respect to the payment of any such foreign tax, the dividend distribution may come at an unexpected cost.
- Taxpayers in the past may have been hesitant to use a C corporation to hold stock of a foreign corporation due to the imposition of the corporate level tax and, moreover, may not have benefited from the benefit of deferral with the use of a foreign corporation due to the impact of the Subpart F rules. Under the new rules, however, the impact of the double tax would generally be eliminated with the DRD. Thus, taxpayers should seriously consider the use of a C corporation for foreign investment.
- The analysis, however, is more complicated, as another factor should be considered in evaluating the benefits and costs of using a C corporation for foreign holdings. Even where a C corporation is not being utilized (or where an actual distribution of a foreign subsidiary's income is not made) and, therefore, the taxpayer would not obtain the benefit of the new DRD, it is important to bear in mind that with the significant reduction of the corporate tax rate, the application of Subpart F may be less prominent. Under existing law (and not impacted or changed by the Act), where the foreign tax rate is at least 90 percent of the U.S. corporate tax rate, Subpart F will not apply to certain types of income. With the new 21 percent corporate tax rate, so long as the foreign corporate tax rate is at least 19 percent, the CFC may not be subject to Subpart F inclusions. Thus, a U.S. shareholder may choose to maintain its deferral with a foreign subsidiary — without the need to actually distribute the foreign profits — and not rely on the DRD.

Expansion of Definitions Related to "Controlled Foreign Corporations" and the Reach of Subpart F and Other Anti-Deferral Regimes

As noted above, although the DRD is intended to shift the taxation of foreign income to a territorial system of taxation, the Act did not repeal the existing anti-deferral regime of Subpart F and in many respects expanded it. For example, a U.S. shareholder of any CFC has to include in gross income its global, intangible low-taxed income (GILTI) in a manner generally similar to inclusions of Subpart F income. This provision is designed to tax certain foreign intangible income subject to low-foreign tax rates.

Subpart F now becomes the mechanism by which certain other taxes are implemented. Moreover, the definitions of a CFC or a U.S. shareholder of a CFC, critical thresholds for the application of Subpart F, have been expanded.

Key definitions relating to CFCs and Subpart F have been expanded as follows:

- Under pre-Act law, a U.S. shareholder of a CFC was defined as one who owned 10 percent of the voting stock of the CFC. Under the new law, the definition is expanded to include those who own 10 percent of the value of the CFC.
- Previously, there was a minimum consecutive 30-day holding period requirement for a U.S. shareholder to be subject to the income inclusion rules of Subpart F. Under the Act, that requirement was eliminated.
- Finally, the attribution rules for related parties to determine U.S. shareholder ownership in a CFC have been expanded under the Act.

Accordingly, taxpayers should be aware that ownership structures that previously would have been safe from the application of Subpart F now may be subject to those rules.

The Act also denies a deduction for certain payments to a related party that are treated differently for tax purposes in its home jurisdiction than for U.S. tax purposes. Certain adjustments are made to Code Section 367 and related code sections dealing with the transfer of intangible assets to foreign related parties. Moreover, a new excise tax is imposed with respect to “base erosion payments” for high-income corporations ($500 million of gross income) for certain payments (e.g., royalties) to related parties.

The intention of these provisions is to encourage operations in the United States by imposing an additional tax on payments to related foreign entities and by expanding the reach of anti-deferral regimes beyond the historic Subpart F and transfer pricing provisions. Thus, while the touchstone of the new changes to the international area of taxation is shifting toward a territorial model of taxation, the Act, at the same time, strengthens and expands anti-deferral regimes of the tax law.

Other Changes

The Act makes various other changes to provisions of the foreign tax credit system, some of which are related to the other foregoing changes set forth above, adjustments to the passive foreign investment company (PFIC) rules, as well as a number of other changes.

As noted in previous Alerts, given the breadth of the Act, the above highlights only some of the major changes to the rules impacting international taxation. Cozen O’Connor will be issuing future Alerts on select topics and provide periodical updates.

To discuss any questions you may have regarding the Act or how it may apply to your particular circumstances, please contact any of the following lawyers: Dennis L. Cohen **at** dcohen@cozen.com **or 215-665-4154,** Thomas J. Gallagher **at** thomasgallagher@cozen.com **or 215-665-4656,** Rory Moore **at** rorymoore@cozen.com **or 215-665-4658,** Richard J. Silpe **at** rsilpe@cozen.com **or 215-665-2704, or** Joshua C. Weinberger **at** jweinberger@cozen.com **or 215-665-2173.**