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Cross-Border Provisions of Tax Cuts and Jobs Act: Implications and Planning Considerations

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The recently enacted Tax Cuts and Jobs Act of 2017 ("TCJA") is the most comprehensive U.S. tax legislation in over 30 years. The sweeping changes to the U.S. Internal Revenue Code (the "Code") affect virtually every aspect of U.S. federal taxation and will have far-reaching impacts in many industries. This article focuses on selected reforms to the international tax system and how U.S. corporations and individuals should start to consider adapting their tax planning.

Many of TCJA's corporate tax changes were ostensibly designed to make the United States a more competitive jurisdiction and bring its taxing system in line with international norms. The headline change for corporations is a reduction in the income tax rate from 35% to 21%. In the final bill, the rate change is immediate, effective for tax years beginning after December 31, 2017 (but see Code section 15, allowing a proration of the rate change for taxpayers on fiscal years other than the calendar year).

Of similar importance, TCJA fundamentally alters the U.S. international corporate tax regime. Under prior law, the United States had a mixed corporate tax system: a corporation was subject to U.S. tax based on its worldwide income but was able to defer tax on much of the income of its foreign subsidiaries until earnings were repatriated. TCJA has been described by proponents and detractors alike as a shift to a "territorial" system, comparable to those found in many other developed countries, but that's not entirely accurate. Consistent with a territorial system, TCJA adopts a participation exemption for dividends from "specified 10-percent owned foreign corporations," provided that certain holding period requirements are met (with a transition tax, discussed further below, applicable to earnings deferred under the prior regime). But as discussed below, TCJA moves in the opposite direction in some ways, by imposing a new U.S. tax on the income of certain high-margin specified 10-percent owned foreign corporations. In other words, rather than shifting from a mixed system to a territorial system, TCJA can be better described as shifting from a mixed system to a different kind of mixed system.

Following are some of our observations on likely high-level international effects of TCJA on international taxpayers' planning.

The United States Still Isn't an Optimal Holding Company Jurisdiction

Although the participation exemption and the lower corporate rate provided by TCJA should combine to make the overall U.S. tax environment more friendly for multinationals, TCJA does not quite mark the arrival of the United States as a holding company jurisdiction – that is, a country whose laws can be readily used for tax planning by non-U.S. investors into non-U.S. companies. This is so for a number of reasons.

First, TCJA contains new provisions intended to discourage the shifting of profits to foreign subsidiaries, which Congress continues to believe should be subject to headquarter-company taxation. The anti-profit-shifting principle is manifested in a new tax on so-called "global intangible low-taxed income," or "GILTI" (pronounced "guilty," probably not by accident). The phrase is a bit of a misnomer, because neither "intangibles" nor "low-taxed income" need be involved. In very broad terms, GILTI consists of the excess "tested income" of a controlled foreign corporation ("CFC") over a 10% return on the CFC's "qualified business asset investment," or "QBAI." QBAI is the

total tax basis of the CFC's depreciable, tangible property used in the production of tested income. The overarching concept is that 10% is deemed to be a normal return on tangible asset investment; income exceeding that amount is, in effect, conclusively presumed to have been generated by intangible assets that have been shifted offshore – whether or not any intangible assets are actually used, or where any such intangibles have been developed. A U.S. corporation is also able to take a deduction equal to 50% of its GILTI – meaning the effective rate of tax is 10.5%, or half of the normal 21% corporate tax rate. (The 50% deduction is scheduled to be reduced to 37.5% beginning in 2026, which was apparently necessary under Senate budget rules.) A U.S. corporation with GILTI will be able to claim a credit for foreign taxes paid by the relevant foreign subsidiary, similar to subpart F inclusions under current law, but with a 20% "haircut"; the net result is that an effective foreign tax credit rate of at least 13.125% (10.5% divided by 80%) should generally offset the U.S. tax in full, using the rates through 2026. Thus, the GILTI tax might be palatable to multinationals whose foreign subsidiaries either bear relatively high effective tax rates, or operate in low-margin, capital-intensive industries (i.e., where a return of less than 10% on tangible assets is the norm). Other multinationals, however, may expect to pay current tax in the U.S. on income that used to be deferred, sometimes indefinitely.

Second, TCJA does not particularly accommodate exit strategy. Typically, the ability to dispose of subsidiary shares in a tax-efficient manner is an important criterion in selecting a holding company jurisdiction, and many countries' participation exemptions apply to gains on the sale of shares as well as dividends. TCJA does not contain such a feature. Instead, as under prior law, gain on the sale of shares continues to be subject to U.S. tax, albeit at the new, lower rate. As under prior law, gain is generally recharacterized as a dividend to the extent of the CFC's previously untaxed earnings, and that amount should be excludable under the participation exemption; but any gain attributable to additional capital appreciation would remain taxable.

Third, existing subpart F provisions applicable to CFCs continue to apply. Counterintuitively, section 956 of the Code, which historically has taxed a deemed dividend with respect to any investment by a CFC in U.S. property (including a loan to its parent), continues to exist, even though an actual dividend will no longer be taxable. Other CFC rules imposing current U.S. tax on passive and related-party income also remain intact, and will continue to need to be monitored by U.S. holding corporations. Both subpart F income and section 956 inclusions will continue to result in deemed dividends for U.S. tax purposes, includible at the 21% rate less any deemed-paid foreign tax credits.

Finally, the prevalence of robust limitation on benefits ("LOB") provisions in U.S. tax treaties would also be a hurdle to efficient use of a U.S holding company in many cases. LOB provisions are generally used to deny treaty benefits to companies residing in countries with little connection to the entities making or receiving payments. Such provisions continue to be an obstacle to avoiding withholding taxes on dividends paid to U.S. holding companies.

Because of these factors, the United States has not yet been elevated into the category of countries whose participation exemptions facilitate third-country equity investments.

However, U.S. Corporations Will Now See New Advantages in Using Foreign Subsidiaries

If TCJA doesn't quite put the United States on the map as a holding company jurisdiction, it does create interesting new benefits for U.S. corporations operating overseas through foreign subsidiaries. The GILTI tax is new, but at 10.5% it compares favorably with the tax rate, even under the new law, for earnings of a U.S. corporation through a disregarded entity or foreign branch. The participation exemption, in general, allows tax-free repatriations of earnings (GILTI or otherwise) that would have been subject to tax if earned by a branch or disregarded entity – a permanent benefit that did not exist under prior law. This new benefit is particularly important for repatriations from low-tax jurisdictions because the US tax on those repatriations were, at best, only partially offset by foreign tax credits.

U.S.-Based Multinationals Will Need to Prepare for a Transitional Tax

As we discussed in the introduction, prior law contained a mixed worldwide corporate income tax regime of nominal taxation of corporations' worldwide income but indefinite deferral of much of the income of their foreign subsidiaries. This regime incentivized multinational corporations to accumulate significant assets offshore. The participation exemption is intended to eliminate this incentive – but with a special provision for all the earnings that were accumulated in foreign subsidiaries under the old rules.

As a tradeoff and revenue offset for the participation exemption, TCJA imposes a transitional tax (the "Transition Tax") for 10% U.S. shareholders of foreign corporations with accumulated earnings as of December 31, 2017, or if greater, November 2, 2017 (the date the original version of TCJA cleared the Senate). Note that this applies whether or not a foreign corporation was a CFC. The Transition Tax is imposed on all post-1986 accumulated earnings of specified foreign corporations owned by such shareholders, at a rate of 15.5% to the extent of the specified foreign corporations' cash or cash equivalents, and 8% on the remainder of such earnings. These reduced rates are accomplished by a targeted dividends received deduction. TCJA allows U.S. taxpayers to pay the Transition Tax over an installment schedule over eight years: 8% in each of the first five years, 15% in the sixth year, 20% in the seventh year and 25% in the eighth year.

The Transition Tax does include some welcome, common-sense accommodations. It excludes earnings that were accumulated by a foreign corporation before it became a "specified foreign corporation." This important exclusion, which had not been contained in the original House bill, means that a U.S. shareholder that had acquired a foreign-owned foreign corporation before TCJA's effective date does not need to include that foreign corporation's earnings accumulated before the acquisition – a sensible outcome, considering that the multinational had not been keeping any earnings offshore before the acquisition date. TCJA also generally permits a U.S. shareholder to offset accumulated losses in one corporation against positive earnings in another corporation in computing a U.S. shareholder's Transition Tax. The Transition Tax can also be offset by a proportionate amount of the foreign taxes paid by the specified foreign corporation, using a similar mechanism to subpart F inclusions under current law, though reduced to reflect the concessional rate. And because a foreign corporation's cash position is determined at the end of the last taxable year beginning before January 1, 2018, an entity with a fiscal year other than the calendar year may have opportunities to improve its balance sheet before the Transition Tax takes effect (though we note that TCJA directs the Secretary of the Treasury to issue regulations or other guidance to prevent the avoidance of the Transition Tax).

The Internal Revenue Service has already issued guidance on the implementation of the Transition Tax, in the form of a Notice of Proposed Regulations (the "Notice"). An important aspect of the Notice is a helpful clarification of the treatment of transactions between related parties that could, absent such guidance, result in double-counting of a group's total accumulated earnings or cash position. Among other things, the Notice helpfully clarifies that certain related-party transactions will be disregarded in determining the aggregate cash position of a multinational group. Another useful clarification is that Transition Tax inclusions will create previously taxed income to shelter future inclusions for U.S. shareholders, such as under section 956. Less helpfully to the financial sector, the Notice takes the position that derivatives (such as notional principal contracts and futures contracts) are treated as cash equivalents equal to their fair market value, thus increasing the amount taxable at the higher 15.5% rate.

Hybrid Financing Structures Should Be Revisited

The new participation exemption does not apply to a "hybrid dividend," which TCJA generally defines as a dividend for which the paying CFC has received a deduction (or other tax benefit) in a foreign country. Notable examples would be a distribution on preferred equity certificates ("PECs") issued by a Luxembourg company; on mandatorily redeemable preferred shares ("MRPS") issued by companies in certain countries; or on any hybrid security that is classified as equity for U.S. tax purposes but as debt for non-U.S. tax purposes. The hybrid dividend provisions apply with equal force to dividends between CFCs, which will be treated as subpart F income without the benefit of CFC look-through provisions. This exception can be viewed as a partial implementation of the "Hybrid Mismatch Arrangements" action plan under the OECD's base erosion and profit shifting ("BEPS") project. These arrangements are common in international tax planning, and will need to be addressed by those who have them in place.

International Businesses May Benefit from Selling to Foreign Customers

TCJA provides favorable taxation for "outbound" transactions, or sales to foreign customers, which is a major shift in U.S. tax policy. In a move that is already causing considerable international controversy and threats of lawsuits from U.S. trading partners, TCJA provides domestic corporations with reduced rates of U.S. tax on their foreign-derived intangible income ("FDII"). The determination of FDII starts with property sold or services provided outside the United States – specifically: (1) property that is sold to any person who is not a United States person for a foreign use; or (2) services provided to any person, or with respect to property, not located within the United States. Foreign use

means any use, consumption, or disposition that is not within the United States. Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties. These foreign sales of goods and services are known as Deduction Eligible Income.

From Deduction Eligible income, a taxpayer subtracts expenses allocable to the production of that income. From that, subtract an amount deemed to be a 'normal' return of 10%, on the tangible assets used to generate this income (identical to the subtraction of QBAI from GILTI as described above). This will yield FDII to which the favorable rates will apply (subject to some special rules when assets are used for more than one purpose, and income is earned or expenses incurred from or with respect to both eligible and other sources).

The favorable rates are implemented via a special deduction of 37.5% of FDII for taxable years beginning before 2026, and 21.8755% for taxable years beginning in 2026 and later. Thus, with a 21% corporate tax rate, the effective tax rate on FDII is 13.125%, increasing to 16.406% in 2026.

International Businesses Should Re-Evaluate Their Supply Chains

While the favorable FDII regime is meant to encourage sales to customers outside the United States, TCJA adds a new tax on large multinational corporations making sizable deductible payments to foreign affiliates (the "Base Erosion and Antiabuse Tax," or "BEAT"). Its application is limited to certain C corporations with average revenues in excess of $500 million for the past three years that engage in substantial intercompany transactions with foreign affiliates (defined by reference to a 25% common ownership, or owned-by standard). Transactions subject to BEAT include any deductible amounts paid or accrued by a taxpayer to, and the purchase of depreciable property from, a foreign affiliate. There are significant exceptions: for example, services which meet the services cost method under U.S. transfer pricing regulations, and goods which are part of cost of goods sold. And if the total of all these related party transactions is less than 3% of the taxpayer's total deductions (as adjusted for certain payments that are excepted from BEAT and otherwise), BEAT will not apply.

After the total 'base erosion payments' are determined, they are added back and a new modified taxable income base is determined. To that, a 10% tax is imposed and the regular tax, if less, is subtracted. The difference is the BEAT. 10% may sound like a relatively low comparison point, implying that the tax base would have to be more than halfway eroded before BEAT starts to apply. But the "regular tax" is computed after giving effect to any foreign tax credits, so the apparently low 10% threshold may result in BEAT applying more often than one may think.

BEAT's focus on deductible payments, rather than income exclusions, may yield some surprising results. Consider, for example, U.S. Corp A, which hires its foreign subsidiary, CFC A, to distribute property overseas on A's behalf. U.S. Corp A earns $100 and pays CFC A $30 fee, earning a net of $70. By contrast, U.S. Corp B sells property to its foreign subsidiary, CFC B, for $70; CFC B resells the property in its own name for $100. These are economically identical results, but U.S. Corp A appears to have a BEAT add-back that U.S Corp B does not have. TCJA thus appears to have created tax distinctions based on legal relationships in a new way.

It is not clear from the statutory language whether BEAT will apply on a gross or net basis. Many global organizations, particularly financial institutions, have frequent payments between units that are netted to smaller amounts. If base erosion payments are calculated on a gross basis, BEAT could have a significant effect. (Note that a domestic branch of a foreign corporation – a customary form of doing business for a bank – is treated as if it were a separate corporation for this purpose). If helpful guidance is not soon issued, BEAT may have significant adverse effects on the financial sector.

For these reasons, every U.S. corporation with an international supply chain will need to re-evaluate its tax models based on BEAT. This applies not only to a foreign-owned corporation but to a U.S. parent as well. Any payment to a foreign affiliate is in the crosshairs.

Moving a Checked Business into a Foreign Subsidiary Isn't so Easy

Under prior law, a U.S. corporation was generally able to transfer foreign business assets into a foreign corporation (or, more commonly in recent years, to make a "check-the-box" entity classification election to convert a disregarded entity with such assets into a foreign corporation). TCJA repeals the active trade or business exception to Code section 367(a) that facilitated such a transfer. This rule provided an exception to immediate gain recognition when

certain property was transferred to a foreign corporation and was used in the foreign corporation's active trade or business. A long standing debate, most recently addressed in regulations finalized in 2016, centered on application of this exception to various forms of tangible and intangible property, including the treatment of foreign goodwill and going concern value. By repealing the exception entirely, TCJA appears to have mooted this debate and the 2016 regulations. As a result, any plans to move businesses to foreign subsidiaries – for example, to take advantage of the participation exemption – will be complicated.

U.S. Corporations Will Need to Review Their Capital Structures

TCJA imposes new limitations on interest deductions. New Code section 163(j) broadens prior thin-capitalization limits. Under prior law, a corporation was required to suspend related-party interest deductions that exceeded 50% of "adjusted earnings" (essentially, an EBITDA concept, replacing accounting concepts with income tax concepts), if its debt-equity ratio exceeded 1.5 to 1. TCJA reduces the limitation to 30%, and eliminates the debt-equity ratio threshold, and applies it to all interest deductions (rather than just related-party interest). As under prior law, excess amounts are suspended, rather than permanently disallowed, and deductible when the limitation is not exceeded. The new limitations may affect leveraged blocker entities set up for foreign investors in private investment funds—these structures should be reviewed as well. Notably, there is no grandfathering for existing debt under this new provision.

A much-discussed provision that would have forced a U.S. member of a multinational group to limit its interest deductions to the extent its debt-equity ratio exceeded a percentage of that of the overall group was eliminated from the final version of TCJA.

Non-U.S. Investors in Partnerships with U.S. Businesses Will Face Additional Tax on Exit

A foreign investor in a partnership is now subject to US tax, withholding and filing obligations in regard to gain on the disposition of a partnership interest to the extent the gain is attributable to partnership assets that would have given rise to effectively connected income if the partnership had sold such assets. This new provision expands prior law (which only applied to real estate assets), codifies a 1991 IRS revenue ruling and effectively overturns a 2017 Tax Court case. The buyer of the interest is required to withhold 10% of the amount realized by the seller; failing that obligation, the partnership is required to withhold that amount from future distributions to the buyer. Future guidance will be needed to address, among other points, the circumstances in which non-recognition provisions of the Code (such as section 721) may apply to defer recognition of gain under the new rule as well as procedures to avoid overwithholding. The new rule will as a practical matter burden partnerships, in connection with transfers of interests, to protect themselves and obtain information from partners about the details of every transfer of an interest by a foreign partner (e.g., the sale price of the interest; evidence of payment of any applicable withholding tax or of exemption).

Issues for U.S. Individuals with International Businesses

TCJA reduces income tax rates for individuals much less dramatically than for corporations: from a top marginal rate of 39.6% to 37% for years beginning after December 31, 2017. Moreover, the adoption of a new 20% deduction for "pass-through" business income is inapplicable to foreign income. TCJA's modest individual tax rate cut carries important cross-border planning implications.

The Transition Tax applies not only to corporate 10% shareholders of specified corporations, but to individual 10% shareholders as well. This provision is surprising because the Transition Tax is intended to pay for the transition to the territorial system; individual shareholders, however, do not benefit from the participation exemption. Worse, because the mechanism for reducing the Transition Tax rate to the 8%/15% levels is tied to the pre-TCJA corporate tax rate, individuals are likely to pay a higher rate than corporations. Individuals who hold their foreign corporation shares through S corporations can elect to defer the Transition Tax until there is a "triggering event" such as a disposition of the S corporation stock or termination of S corporation status. (Unfortunately, an individual who did not hold the shares through an S corporation as of November 2, 2017, cannot subsequently transfer them into an S corporation to take advantage of this provision.) Individual shareholders will also be subject to the GILTI tax, at full ordinary income tax rates.

How should an individual shareholder of a non-U.S. corporation adapt to the Transition Tax and the prospective GILTI inclusion? The answer might be to make an election under existing Code section 962. This provision has historically allowed a U.S. resident individual to make a special election to pay tax on any inclusion of subpart F income as if he or she were a U.S. corporation. Such an election would enable the U.S. resident to pay tax on such income at corporate income tax rates and claim deemed-paid foreign tax credits under Code section 960. With the Transition Tax – which, unlike subpart F income, cannot be avoided by planning – and the newly increased rate disparity, section 962 takes on increased importance under TCJA. Note, however, that subsequent actual distributions from a CFC are not eligible for exclusion as previously taxed income.

Minority Investors in Foreign Corporations May Now Be CFC Shareholders

Both existing law and TCJA impose requirements for a 10% U.S. shareholder to include income with respect to its CFC investments. Under prior law, whether a person was a 10% U.S. shareholder was determined solely by voting power. This was relevant both to determining whether the foreign corporation was a CFC and to determining if the shareholder was subject to the income inclusions. Under TCJA, a U.S. shareholder is now defined as one that owns 10% or more of the voting power or value of the foreign corporation's stock, which may impact specific planning to avoid CFC consequences in existing ownership structures.

A less talked-about provision in TCJA, and a potential trap for the unwary, is in the elimination of a rule on attribution of share ownership for CFC purposes. For example, if two entities under common ownership each own 6% of a foreign corporation, those 6% stakes may be combined under the attribution rules and treated as a single 12% ownership stake – that is, over the 10% threshold for CFC classification and income inclusion. Prior law had a special provision that turned off "downstream" attribution from a shareholder to a legal entity, largely preventing unwarranted CFC classifications. Most starkly, if a foreign parent corporation owns both a U.S. subsidiary and a foreign subsidiary, the foreign parent's ownership of the foreign subsidiary will be attributed to the U.S. subsidiary, causing the foreign subsidiary to be classified as a CFC. In this case, the U.S. subsidiary will not be subject to subpart F inclusions, but it will have material reporting requirements, with penalties (including extension of the statute of limitations) potentially applying for failure to report properly.

In other cases, the attribution rules could give rise to subpart F inclusions. Assume a foreign individual owns a U.S. corporation, USCo. The foreign individual owns 50% of a foreign corporation, FCo, and USCo owns 10% of FCo. Under prior law, although USCo was a 10% U.S. shareholder of FCo, FCo was not a CFC because U.S. shareholders did not collectively own over 50% of FCo. Now, the foreign individual's shares in FCo will be attributed to USCo, which, combined with USCo's directly held shares, will cause FCo to become a CFC. In this case, USCo will be subject to subpart F and GILTI tax with respect to its 10% direct interest.

This change was apparently intended to target certain inversion transactions, but will have more far-reaching consequences, including with respect to ownership by unrelated parties.

Conclusion

The above issues were just a few of the ones we identified as having particular significance. It is not an exaggeration to say that TCJA affects every aspect of the U.S. economy. With its emphasis on international issues, TCJA will have far-reaching implications for cross-border transactions, business and structures.

If you have questions about TCJA and how it could affect your cross-border tax planning, we would be happy to assist you.

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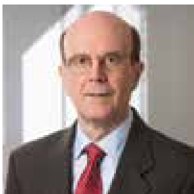

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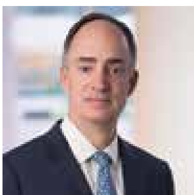

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