Lowenstein Sandler

Client Alert

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Key Foreign Tax Provisions

On December 20, 2017, Congress passed a statute originally named the Tax Cuts and Jobs Act (the "Act"), which enacts a broad range of changes to the Internal Revenue Code (the "Code"). The Act was signed by the President on December 22. This Alert briefly summarizes some of the key provisions of the Act affecting international aspects of U.S. income taxation.

Changes to Establish a Participation Exemption for Foreign Income

Except as otherwise described below, the changes described in this section are effective for distributions, sales or exchanges and transfers occurring after December 31, 2017.

Deduction for Foreign-Source Portion of Dividends from Certain Foreign Corporations. The Act largely eliminates the current rules that tax U.S. corporations on dividends attributable to foreign earnings of their foreign subsidiaries, by providing a dividends received deduction ("DRD") for the foreign-source portion of dividends received by a U.S. corporation from a foreign corporation as to which the U.S. corporation is a United States shareholder (that is, a United States person that owns, actually or under applicable constructive ownership rules, 10 percent or more of the voting power or total value of the stock of the foreign corporation). The foreign-source portion of the dividend is based on the ratio of the undistributed foreign earnings of the foreign corporation not previously subject to U.S. tax to the total undistributed earnings of such corporation (determined as of the close of the year of the dividend and without diminution by reason of dividends during such year). The U.S. corporation must satisfy a holding period requirement in order to be eligible for this DRD. Neither a foreign tax credit nor a deduction in respect of foreign taxes is allowed with respect to distributions in respect of which this DRD is allowed.

Hybrid Dividends. "Hybrid dividends," which are dividends received from a foreign corporation which derived a deduction or other tax benefit in a foreign country for such dividend, are not eligible for the new DRD. Where a hybrid dividend is received by a controlled foreign corporation (a "CFC") from another CFC, and a U.S. corporation is a United States shareholder of both CFCs, the U.S. corporation is required to include in gross income its pro rata share of such hybrid dividend. Neither a foreign tax credit nor a deduction in respect of foreign taxes is allowed with respect to hybrid dividends or related income inclusions.

Sales or Transfers of CFC Stock. The Act provides that where a U.S. corporation sells stock of a foreign corporation held for one year or more, any amount received by the U.S. corporation that is treated as a dividend under Section 1248 of the Code shall be treated as a dividend for purposes of the new DRD. In addition, for purposes of determining losses on a disposition of shares of a foreign corporation, a U.S. corporation generally must reduce its basis to reflect the amount claimed under the new DRD with respect to dividends on such shares.

Under the Act, when an upper-tier CFC transfers an interest in a lower-tier CFC and an amount is treated under Section 964(e) of the Code as a dividend, the foreign-source portion of such dividend is includible in the income of United States shareholders of the CFC, with the United States shareholders that are U.S. corporations potentially eligible for the new DRD with respect to such foreign-source portion.

Transfers of Foreign Branches With Losses. The Act generally requires a U.S. corporation to include in income an amount equal to the "transferred loss amount" when it transfers substantially all of the assets of a foreign branch to a foreign corporation as to which the U.S. corporation is a United States shareholder. The transferred loss amount is generally equal to the excess of the losses incurred by the foreign branch after December 31, 2017 over the foreign branch's subsequent income and any gains otherwise recognized on the transfer. The transferred loss amount inclusion is treated as income from U.S. sources.

Repeal of Section 367(a)(3). The Act repeals Section 367(a)(3) of the Code, thereby making it more likely that gain will be recognized on a transfer of property to a foreign corporation where such property is to be used in the conduct of a trade or business outside the United States.

Transition Rule for Current Deferred Income. The Act generally requires that United States shareholders of CFCs, and of other foreign corporations as to which a U.S. corporation is a United States shareholder, include in income, for their tax year in or with which the foreign corporation's last tax year beginning before 2018 ends, their pro rata share of the accumulated post-1986 deferred foreign income of such corporation that has not previously been subject to tax. Such United States shareholders are permitted a deduction so that the amount includable in respect of deferred income as a result of the transition rule is generally subject to an 8% rate of tax on the portion of the inclusion in excess of the United States shareholder's aggregate foreign cash position (based on the shareholder's pro rata shares of the cash positions of the foreign corporations) and a 15.5% rate of tax on the remainder of the inclusion. The Act limits the extent to which foreign tax credits or deductions are allowed for taxes paid or accrued with respect to the inclusion in respect of deferred income.

Taxpayers can elect to pay the tax liability associated with the inclusion of deferred income in annual installments over eight years (starting with the due date, without regard to extensions, for the tax year of the inclusion) The installment payments are accelerated in certain circumstances.

Where a United States shareholder is an S corporation, shareholders of the S corporation can elect to defer payment of the tax liability from the inclusion of deferred earnings until the tax year in which there is a termination of the S corporation's S status, a liquidation or sale of all of the assets of such S corporation or a transfer by the shareholder of S corporation's shares. Once the deferred tax is triggered, the S corporation shareholder can elect to pay the tax liability in eight installments.

Rules Relating to Passive and Mobile Income

Global Intangibles Low-Taxed Income Included in Gross Income of U.S. Shareholders. The Act requires United States shareholders of CFCs to include in gross income each year such shareholder's global intangible low-taxed income ("GILTI") for such year. GILTI is the excess of a United States shareholder's aggregate pro rata share of certain items of CFC gross income and related deductions over a deemed return based upon United States shareholder's share of the adjusted tax bases the CFCs have in depreciable tangible assets used in a trade or business for the production of such gross income.

GILTI, other than passive category income, is treated as subject to a separate limitation basket for purposes of Section 904, with no carryover or carryback of excess taxes.

The foregoing rules are effective for taxable years of foreign corporations beginning after December 31, 2017 and for tax years of United States shareholders in or with which such tax years end.

Deduction for Global Intangible Low-Taxed Income and Foreign-Derived Intangible Income. For tax years beginning after December 31, 2017, a U.S. corporation is permitted to deduct an amount equal to 50% of its GILTI inclusion and 37.5% of its foreign-derived intangible income ("FDII") for a tax year, with such deduction reduced if the sum of the U.S. corporation's GILTI and FDII exceeds the U.S. corporation's taxable income as determined without regard to the deductions for a portion of GILTI and FDII. The deduction percentages are reduced to 37.5% for GILTI and 21.875% for FDII for tax years beginning after December 31, 2025. FDII is based upon the corporation's deemed intangible income and the ratio of the corporation's foreign-derived deduction eligible income to its deduction eligible income.

Other Changes to Subpart F

Unless otherwise noted below, these changes are effective for tax years of foreign corporations beginning after December 31, 2017 and tax years of United States shareholders with or within which such tax years of foreign corporations end.

Elimination of Foreign Base Company Oil Income. The Act eliminates foreign base company oil related income as a category of subpart F income.

Treatment of Previously Excluded Subpart F Income Withdrawn from Investment in Foreign Base Company Shipping Operations. The Act repeals the requirement that a United States shareholder include in income such shareholder's pro rata share of previously excluded subpart F income of a CFC withdrawn from investment in foreign base company shipping operations.

Modification to Attribution Rules for Determining CFC Status. The Act modifies the constructive ownership rules that apply for purposes of determining CFC status and for certain other purposes in Subpart F by eliminating, effective prior to 2018, the rule that provides that the rules attributing stock ownership to partnerships, estates, trusts or corporation from partners, beneficiaries, grantors or shareholders cannot be applied to treat a United States person as owning stock which is owned by a person who is not a United States person.

Modification of "U.S. Shareholder" Definition. The Act modifies the definition of "United States shareholder" by extending it to include a United States person who owns or is treated as owning 10 percent or more of the total value of the shares of the foreign corporation.

Elimination of Requirement of 30-Day CFC Status before Subpart F Inclusions Apply. The Act requires subpart F inclusions if a foreign corporation is a CFC at any time during the tax year, rather than requiring, as under current law, that the foreign corporation be a CFC for an uninterrupted period of at least 30 days during the taxable year.

Prevention of Base Erosion

Limitation on Income Shifting Through Transfers of Intangibles. The Act, effective for transfers occurring after December 31, 2017, expands the application of Section 367(d) of the Code to include goodwill, going concern value, workforce in place and similar items, with the result that U.S. persons transferring such property to foreign corporations in transactions described in Section 351 or 361 will be treated as receiving amounts over the life of such intangible commensurate with the value of such intangible.

Certain Hybrid Transactions. Effective for tax years beginning after December 31, 2017, the Act disallows deductions for certain interest or royalties paid or accrued to a related party pursuant to a hybrid transaction or by or to a hybrid entity. For these purposes, a hybrid transaction is any transaction one or more payments with respect to which are treated as interest or royalty payments for U.S. tax purposes but are not so treated in the recipient's jurisdiction and a hybrid entity is an entity which is either fiscally transparent for U.S. tax purposes but not for purposes of the tax laws of the country where the entity is resident or subject to tax or not fiscally transparent for U.S. tax purposes but fiscally transparent for purposes of the tax laws of the country where the entity is resident or subject to tax.

Shareholders of Surrogate Foreign Corporations Not Eligible for Reduced Tax Rate on Dividends. The Act provides that dividends from a "surrogate foreign corporation" (generally, a foreign corporation that acquires properties of a domestic entity in an expatriation transaction described in Section 7874) that first became a surrogate foreign corporation after the date of the Act's enactment and is not treated as a domestic corporation are not eligible for the reduced income tax rate for qualified dividend income. This amendment applies to dividends received after the date of enactment of the Act.

Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts. The Act generally requires taxpayers, other than RICs, REITs and S corporations, that have average annual gross receipts for the prior three tax years of at least $500,000,000 and for whom the taxpayer's base erosion percentage for the tax year is 3 percent (2 percent for taxpayers that are part of an affiliated group that includes a bank or securities dealer) or more to pay an additional tax equal to the taxpayer's base erosion minimum tax amount. A taxpayer's base erosion percentage is generally based upon the ratio of (x) the taxpayer's tax benefits associated with amounts paid or accrued by the taxpayer to a foreign related person with respect to which a tax benefit is allowable to the taxpayer to (y) the taxpayer's total deductions for the year (with certain exclusions).

The base erosion minimum tax amount is 10% (5% in the case of tax years beginning in 2018 and 12.5% for tax years beginning after December 31, 2025) of the excess of the taxpayer's taxable income for the tax year computed without regard to base erosion tax benefits over the regular tax liability of the taxpayer for the year reduced by certain tax credits. Taxpayers affiliated with a bank or securities dealer determine their base erosion minimum tax amount using a rate that is 1 percentage point higher than other taxpayers.

The foregoing rules apply with respect to base erosion payments paid or accrued in tax years beginning after December 31, 2017.

<u>Changes to the Foreign Tax Credit Rules</u>

Repeal of the Section 902 Indirect Credit. The Act eliminates the Section 902 "indirect" foreign tax credit currently permitted to U.S. corporations receiving dividends from foreign corporations in which they hold 10 percent or more of the voting stock.

Determination of the Section 960 Credit on a Current Basis. The Act provides that where a U.S. corporation includes an amount in income under Section 951(a)(1), the U.S. corporation will be treated as having paid the portion of the foreign corporation's foreign income taxes that is properly attributable to such income. In addition, when a distribution from a foreign corporation is excluded from income under Section 959(a) (relating to earnings and profits previously taxed under subpart F), a U.S. corporation receiving such distribution will be treated as having paid any foreign taxes properly attributable to such distributed amount.

Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income. The Act, effective for tax years beginning after December 31, 2017, adds a new limitation basket to Section 904 of the Code for income, other than passive category income, of foreign branches.

Source of Income for Sales of Inventory. Effective for tax years beginning after December 31, 2017, the Act provides that gains and income from the sale of inventory property either produced (in whole or in part) within the United States and sold outside the United States or produced (in whole or in part) outside the United States and sold in the United States shall be sourced solely based upon production activities with respect to the property.

Election to Increase Percentage of Domestic Taxable Income. For tax years beginning after December 31, 2017, the Act allows taxpayers with overall domestic losses incurred in tax years beginning before 2018 that are applied in a tax year beginning after 2017 and before 2028 to treat, subject to limitations, up to 100% of the taxpayer's taxable income from U.S. sources as foreign source income.

<u>Other Changes Relating to Foreign Tax Provisions</u>

Except as otherwise noted below, the following provisions are effective for tax years beginning after December 31, 2017.

Treatment of Foreign Persons on Disposition of Interests in Partnerships Engaged in a U.S. Trade or Business. The Act, effective for dispositions occurring on or after November 27, 2017, treats a portion of the gain or loss recognized by a foreign person on a disposition of an interest in a partnership that is engaged in a trade or business in the United States as effectively connected with the conduct of a trade or business in the United States. Effective for dispositions after December 31, 2017, the Act generally requires transferees to withhold 10% of the amount realized on such a disposition.

Revision to Insurance Business Exception to PFIC Rules. The Act revises the exclusion for certain insurance income from treatment as passive income for purposes of the PFIC rules by replacing the requirement that the income be derived by a corporation predominantly engaged in an insurance business with a requirement that the applicable insurance liabilities of the corporation constitute more than 25% of its total assets (with an alternative test under which corporations not satisfying the 25% requirement may still qualify).

Repeal of Fair Market Value Method of Interest Apportionment. The Act provides that under Section 864 of the Code allocations and apportionments of interest expense are to be based upon the adjusted tax bases of assets rather than upon the fair market value of assets or gross income.

Repeal of the Earnings Stripping Rules and Imposition of New Limits on Interest Deductions. The Act repeals the current earnings stripping rules of Section 163(j) of the Code, which generally limit the extent to which a corporation can deduct interest paid or accrued to a related person where the rate of tax on such interest is reduced by treaty. The Act instead generally limits, for taxpayers with average gross receipts over a three-year period of $25,000,000 or more (subject to exceptions), deductions for interest incurred in connection with a trade or business to the sum of the business interest income of the taxpayer and 30% of the taxpayer's taxable income (as determined with certain adjustments). Unlike the prior earnings stripping rules, the new rules apply not only to corporations, but also to taxpayers that are not corporations, and include rules which apply the restrictions at the partnership level.

This Alert provides only a basic overview of what are complex and nuanced tax provisions. To learn more about the Act and its implications for you or your business, please contact one of the Lowenstein Sandler attorneys listed.

For more information about other provisions of the Act, please see the links below:

KEY CORPORATE & BUSINESS TAX PROVISIONS
KEY PARTNERSHIP TAX PROVISIONS
KEY INDIVIDUAL TAX PROVISIONS
KEY TAX-EXEMPT ORGANIZATION TAX PROVISIONS
KEY TRUST & ESTATE TAX PROVISIONS
KEY TAX PROVISIONS AFFECTING HEDGE FUNDS, PRIVATE EQUITY FUNDS AND OTHER INVESTMENT VEHICLES

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