ACC DOCKET
INFORMED. INDISPENSABLE. IN-HOUSE.

International Tax Provisions are Already in Effect: Is Your Company Ready?

Corporate, Securities, and Governance


ON/C
CE
MRC
M-
M+
7
8
9
%
4
5
÷
1
2
6
×
0
3
−
.
=
+


ON/C
CE
MRC
M-
7
8
9
%
4
5
÷
1
2
6
×
0
3
−
.
=
+

CHEAT SHEET

- ***Foreign corporate earnings.*** Under the recently created Tax Cuts and Jobs Act, taxation and participation exemption of foreign corporate earnings have significantly changed. A newly imposed “toll tax” on shareholders will help with the transition.
- ***Play it to the BEAT.*** The Base Erosion and Anti-Abuse Tax (BEAT) enforces a minimum tax in order to limit the benefits of transactions between international affiliates that might result in base erosion.
- ***Anti-hybrid rules.*** Deductions toward a hybrid transaction, or any transaction in which one or more payments are treated as interest or royalties for federal income tax purposes, are no longer permitted. Instead, the secretary authority may issue relevant regulations.
- ***Intangible property.*** New provisions deter companies from transferring intangible property to foreign jurisdiction without incurring tax. The Act also permits the IRS to value those properties on an aggregate basis.

The Tax Cuts and Jobs Act (the Act), signed into law on December 22, 2017, represents the most comprehensive change to US tax laws since 1986. In addition to substantial cuts in tax rates (the corporate rate was reduced from 35 percent to 21 percent) and various other tax reforms, the Act fundamentally alters existing US international tax laws. The changes are intended to make US corporations with foreign operations more competitive in part by transitioning from the current worldwide system of taxation to a quasi-territorial system.

The Act also made significant changes to the taxation of foreign companies doing business in the United States (inbound investment), some of which will increase the amount of income subject to US tax but at a substantially lower rate. The international tax provisions of the Act are complex and contain many ambiguities. Consequently, regulations from the US Treasury and guidance from the Internal Revenue Service (IRS) will be necessary for taxpayers to be able to fully and confidently implement the new system. However, given that there was no transition period for the Act, taxpayers are faced with the significant task of determining tax liability and making estimated tax payments in 2018 without the benefit of such clarity. This article will summarize the most significant changes impacting multinational corporations with operations in the United States.

New participation exemption for foreign corporate earnings

The Act provides a new participation exemption in the form of a 100 percent dividends received deduction (DRD) to a US corporate shareholder for the foreign-source portion of dividends received from a “specified 10-percent owned foreign corporation.” The DRD would also apply to amounts treated as dividends on the sale or exchange by a domestic corporation of stock in a foreign corporation held for at least one year. No foreign tax credit or deduction will be allowed for taxes paid or accrued on dividends qualifying for the DRD. The DRD will reduce the US corporation’s tax basis in the stock of the foreign subsidiary.

The DRD does not apply to foreign income from partnerships, branches, or disregarded entities with direct foreign operations. If, however, a domestic corporation indirectly owns stock of a foreign

corporation through a partnership and the domestic corporation would qualify for the DRD with respect to dividends from the foreign corporation if the domestic corporation had owned such stock directly, the domestic corporation will be allowed a DRD with respect to its distributive share of the partnership's dividend from the foreign corporation.

A complicating factor in analyzing the impact of the new participation exemption system is that the Act removed the rule that prohibited downward attribution from a foreign person to a US person. As a result, in the case of a foreign-owned US corporation, the foreign parent's interest in a non-US subsidiary is attributed to the US corporation. The non-US subsidiary will be considered controlled by the US corporation and its income will now be subject to various aspects of the US international tax regime, including Subpart F, the toll tax, and GILTI, as described further below.

Surprisingly, the Act retained a prior law requiring that a US shareholder include in income the earnings of a controlled foreign corporation (CFC), which are invested in certain US property, including loans or credit support the debt of a related US borrower. The retention of this provision means that such investments will continue to be subject to the regular tax at the level of US shareholders with foreign tax credits (FTCs) potentially available to offset double taxation. Finally, as discussed below, the participation exemption will not apply to any "hybrid dividend."

Taxation of previously deferred foreign corporate earnings

In order to transition to the new participation exemption system, the Act imposes a "toll tax" by requiring US shareholders owning at least 10 percent of a foreign subsidiary to include in income their pro rata share of the accumulated post-1986 deferred foreign earnings of all "deferred foreign income corporations" (DFICs), determined as of the higher accumulation of such earnings either on November 2, 2017 or December 31, 2017. DFICs include CFCs and any foreign corporation in which at least one domestic corporation is a US shareholder. A US shareholder is permitted to reduce the aggregate deferred earnings by aggregate deficits of its DFICs. Excluded from the calculation are earnings that were accumulated by a foreign corporation before it became a DFIC.

The toll tax is imposed on deferred foreign earnings at an effective rate of 15.5 percent to the extent of a US shareholder's aggregate foreign cash or cash equivalent assets and an effective rate of eight percent for the remainder. The IRS has issued temporary guidance providing that certain intercompany payables and receivables are to be disregarded in calculating cash equivalents. The guidance also states that financial instruments and derivatives will be identified as cash equivalents in forthcoming regulations, but such regulations will include exceptions for "bona fide hedging transactions."

Foreign income taxes associated with the taxable portion of the mandatory inclusion may be claimed as credits but the value of such credits is reduced by 55.7 percent to the extent the inclusion is attributable to foreign cash and cash equivalents and by 77.1 percent for the remainder of the inclusion. The repatriation inclusion is made in the last taxable year of the DFIC beginning before January 1, 2018. An election is available to pay the resulting tax in installments over eight years: Eight percent 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, all without an interest charge, although there are triggers that will accelerate the payment (e.g., sale of all or substantially all of the assets of a taxpayer).

Taxation of foreign-derived intangible income

The Act includes an incentive for US companies to develop intangibles in the United States and to sell goods and provide services to foreign customers. The Act provides for a deduction of up to 37.5 percent of a domestic corporation's foreign-derived intangible income (FDII) for the year — producing an effective federal tax rate of 13.12 percent on such income. The deduction decreases to 21.87 percent of FDII for tax years that begin after December 31, 2025 (producing an effective tax rate of 16.41 percent on such income). The amount of the FDII deduction may be reduced if the sum of the US shareholder's FDII and GILTI (defined below) exceeds its taxable income.

FDII is intended to be an approximation of the domestic corporation's taxable income from exploiting intangible property outside the United States, and is defined as a formula allowing for a 10 percent return on the corporation's depreciable business assets. A US corporation's FDII is the amount of its "deemed intangible income" that is attributable to sales of property (including licenses and leases) to foreign persons for use outside the United States or the performance of services to persons, or with respect to property, located outside the United States. A US corporation's deemed intangible income generally is its gross income that is not attributable to a CFC or foreign branch, and which is not financial services income or domestic oil and gas extraction income, reduced by (1) related deductions (including taxes) and (2) an amount equal to 10 percent of the aggregate adjusted basis of its tangible depreciable assets (other than assets that produce excluded categories of gross income, such as branch assets).

The Act also includes special rules for foreign related-party transactions. A sale of property to a foreign related person does not qualify for FDII benefits unless the property is ultimately sold to an unrelated foreign person, or used by a related person in connection with sales of property or the provision of services to an unrelated foreign person for use outside the United States. A sale of property is treated as a sale of each of the components thereof. The provision of services to a foreign related person does not qualify for FDII benefits if the services are substantially similar to services provided by the foreign related person to persons located in the United States.

The FDII provisions are effective for tax years beginning after December 31, 2017.

Taxation of global intangible low-taxed income

As part of the effort to incentivize US-based multinationals to bring assets onshore, the Act requires a US shareholder of CFCs to include in income its global intangible low-taxed income (GILTI). GILTI will generally equal (1) the aggregate net income of the CFCs reduced by (2) 10 percent of the CFCs' aggregate basis in associated tangible depreciable business property minus certain allocable interest expense. With respect to 10 percent shareholders that are corporations, FTCs, in a separate basket, will generally be available for 80 percent of the foreign taxes imposed on the income included as GILTI. No carryover is allowed for excess credits.

In general, when a US person is (1) a 10 percent US shareholder of a CFC on any day during the CFC's tax year, during which the foreign corporation is a CFC; and (2) the US person owns a direct or indirect interest in the CFC on the last day of the tax year of the foreign corporation in which it is a CFC (without regard to whether the US person is a 10 percent shareholder on that day), then the US person would be required to include in its own income its pro rata share of the GILTI amount allocated to the CFC for the CFC's tax year that ends with or within its own tax year. A US shareholder would increase its basis in the CFC stock for the GILTI inclusion.

While a GILTI inclusion by a US shareholder is taxable at the regular 21 percent corporate rate, the amount of the inclusion is equal to 50 percent of GILTI, thus resulting in an effective rate of 10.5

percent. The 50 percent deduction is scheduled to be reduced to 37.5 percent beginning in 2026. The tax on GILTI is intended to ensure US taxpayers pay at least some US tax on low-taxed or untaxed income of a CFC, above a nominal return on the CFC's hard assets. Just as with the FDII, the presumption under GILTI is that 10 percent is a fair return on the amount paid for tangible assets and any income exceeding that percentage is deemed to have been generated by intangible assets.

Although GILTI income may be offset by FTCs, the GILTI regime creates a new, separate FTC limitation basket, and credits are limited to 80 percent of the deemed paid FTCs. Excess GILTI basket FTCs may not be used in any other tax year.

The GILTI regime is effective for taxable years beginning after December 31, 2017.

New base erosion and anti-abuse tax

The Act creates a new Base Erosion and Anti-Abuse Tax (BEAT) minimum tax to limit benefits of transactions between US and non-US affiliates in a multinational group that result in so-called "base erosion." The BEAT applies to corporate taxpayers that are part of a group with average gross receipts of US$500 million over the preceding three years and a three percent or higher "base erosion percentage." The BEAT applies to both US-parented and non-US parented structures.

The minimum tax is the excess of 10 percent of the corporation's modified taxable income over its regular tax liability for the year (as adjusted for certain credits). The 10 percent rate applies beginning in 2019 following a five percent transition rate that applies in the 2018 taxable year, and the rate rises to 12.5 percent in taxable years beginning after 2025. The rate applicable to banks and securities dealers for any year is one percentage point higher than the generally applicable rate.

A corporation's modified taxable income is determined by adding back to taxable income current year deductions for base erosion payments to related foreign persons. For this purpose, a foreign person is related if it is treated as owning at least 25 percent of the stock of the taxpayer (by vote or value) or satisfies various other relationship or control tests. Direct, indirect, and constructive ownership is taken into account for purposes of the ownership tests. There is no exception to the definition of base erosion tax benefits for payments made to US branches or non-US partnerships with US partners.

Base erosion payments generally include (1) amounts paid or accrued to a related foreign person for which a deduction is allowable; (2) amounts paid or accrued to a related foreign person in connection with the acquisition of depreciable or amortizable property; (3) certain reinsurance payments paid to a related foreign person; and (4) certain payments to expatriated entities that are members of the entities expanded affiliated group that represent cost of goods sold.

Excluded from the definition of base erosion are payments for (1) cost of goods sold (except for corporations that expatriate from the United States after November 9, 2017); (2) services representing cost reimbursement with no mark-up; and (3) derivatives that are marked to market for tax purposes (generally by banks or swap dealers). Also excluded are payments that are subject to full US withholding taxes, and if a base erosion payment is subject to a reduced US withholding tax rate under a tax treaty, then the exclusion from modified taxable income is computed proportionately in comparison to the statutory US withholding tax rate.

A *de minimis* exception states that the BEAT does not apply to companies whose foreign related party payments are less than three percent of total deductions (two percent for certain banks and

securities dealers) used in calculating taxable income.

The BEAT provisions are effective for amounts paid or accrued in taxable years beginning after December 31, 2017.

Modified net interest expense limitations

The Act imposes new limitations on interest deductions. Under prior law, the so-called earnings stripping limitations required a corporation to suspend related-party interest deductions (or interest on debt guaranteed by a related party) that exceeded 50 percent of “adjusted earnings” (essentially, a tax basis EBITDA calculation), if its debt-equity ratio exceeded 1.5 to one.

The Act replaces the “earnings stripping” limitations, which were previously applicable only in the international context, with a general cap on net business interest expense equal to 30 percent of adjusted taxable income (ATI). The Act eliminates the debt-equity ratio threshold and applies the 30 percent limit to all interest deductions (rather than just related-party interest). Excess amounts are suspended, rather than permanently disallowed, and become deductible when the limitation is not exceeded. All other interest expense limitations based on specified characteristics of the debt instrument remain, and the 30 percent limit applies on top of those other limitations.

In computing ATI, any non-business income, gain, loss, and deduction are excluded, and business interest expense, NOLs, and depreciation and amortization are added back. For tax years beginning on or after January 1, 2022, depreciation and amortization are not added back (an “EBIT” test), and it is expected that the limitation will have a significantly greater impact to US taxpayers at that point in time. ATI includes earnings regardless of whether they are earned in the United States or abroad, as long as such earnings are included in the borrower’s taxable income. So for example, GILTI would increase ATI, but receipt of any dividends exempt under the new participation exemption would not increase ATI.

These new limitations on the deductibility of net interest expense are effective for taxable years beginning after December 31, 2017 with no grandfathering of existing debt and no transition period.

New anti-hybrid payment rules

The Act disallows a deduction for any disqualified related-party amount paid or accrued pursuant to a hybrid transaction, or by, or to, a hybrid entity. A disqualified related-party amount is any interest or royalty paid or accrued to a related party if (1) there is no corresponding income inclusion to the related party under local tax law or (2) such related-party is allowed a deduction with respect to the payment under local tax law.

A hybrid transaction is any transaction, series of transactions, agreement, or instrument under which one or more payments are treated as interest or royalties for federal income tax purposes but are not so treated for purposes of the tax law of the foreign country of which the entity is resident or is subject to tax. A hybrid entity is one that is treated as fiscally transparent for federal income tax purposes (e.g., a disregarded entity or partnership) but not for purposes of the foreign country of which the entity is resident or is subject to tax (hybrid entity), or an entity that is treated as fiscally transparent for foreign tax law purposes but not for federal income tax purposes (reverse hybrid entity).

The Act also grants the secretary authority to issue regulations or other guidance necessary or

appropriate to carry out the purposes of the provision and sets forth a broad list of issues such guidance may address. Such guidance may provide rules for the following: (1) denying deductions for conduit arrangements that involve a hybrid transaction or a hybrid entity; (2) applying the provision to branches or domestic entities; (3) applying the provision to certain structured transactions; (4) denying some or all of a deduction claimed for an interest or a royalty payment that, as a result of the hybrid transaction or entity, is included in the recipient's income under a preferential tax regime of the country of residence of the recipient and has the effect of reducing the country's generally applicable statutory tax rate by at least 25 percent; (5) denying a deduction claimed for an interest or a royalty payment if such amount is subject to a participation exemption system or another system that provides for the exclusion of a substantial portion of such amount; (6) determining the tax residence of a foreign entity if the entity is otherwise considered a resident of more than one country or of no country; (7) exceptions to the provision's general rule to (a) cases in which the disqualified related-party amount is taxed under the laws of a foreign country other than the country of which the related party is a resident for tax purposes, and (b) other cases that the Secretary determines do not present a risk of eroding the US income tax base; and (8) requirements for record keeping and information.

The anti-hybrid payment rules are effective for tax years beginning after December 31, 2017 with no grandfathering of existing arrangements and no transition period.

New limitations on income shifting involving intangible property

The Act includes a series of provisions designed to make it more difficult for a US person to transfer intangible property to a foreign jurisdiction without incurring tax. It amends the definition of intangible property to include workforce in place, goodwill (both foreign and domestic), and going concern value and makes clear that existing outbound transfer rules apply to intangibles. Second, the Act provides the IRS with authority to specify the method to be used to determine the value of the intangible property, both with respect to outbound restructurings of US operations and to intercompany pricing allocations. Specifically, when multiple intangible properties are transferred in one or more transactions, the IRS may value the intangible properties on an aggregate basis when that achieves a more accurate result. Finally, the Act codifies the "realistic alternative principle," which generally looks to the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled transaction undertaken. These changes are apparently intended to stem a series of judicial losses the IRS has recently sustained in litigating transfer pricing cases. They apply to transfers made in tax years beginning after December 31, 2017.

Impact on state tax liability and compliance

The impact of the Act at the state level is both varied and uncertain. Some states, the so-called rolling conformity states, automatically adopt changes to federal tax law as they are made, whereas others adopt federal tax law as of a specified date. As state legislatures now begin to consider whether and how their state will follow the federal tax law, they either may couple with or decouple from all or various portions of the law. In any case, it is expected that state income tax will now represent a larger portion of a multinational taxpayer's US tax liability given the generally broader tax base and significantly lower federal rate.

In states where Section 163(j) is followed, taxpayers could face significant interest limitation mismatches, resulting in substantially higher limitations in certain states. At the federal level, the Section 163(j) limitation is computed by taking into account the EBITDA and interest expense of all of

the corporations included in the US consolidated filing group. In separate corporation filing states, where interest expense limitations will be computed without the benefit of the inclusion of earnings of other US affiliates, a corporation that is more highly leveraged could be subject to state interest deductibility limitations even where there is no limitation at the broader federal level.

The international provisions of the Act present some of the most significant questions in terms of state tax impact. For instance, states will need to determine whether they will enact their own toll tax on the deemed repatriation, and if so, how they will treat the reduced federal effective rate equivalent. States will also need to determine whether and how to follow the federal election to pay the tax over the eight-year period. Further, for the toll tax, GILTI, and FDII, the composition of state filing groups will be different than that of the federal consolidated tax group, resulting in additional state inclusion and deduction calculations. The state-by-state treatment of the international provisions of the Act is certain to result in increased tax compliance costs for corporations having a presence throughout the United States.

Conclusions and recommendations

Companies should review their existing international structures and consider the impact of the Act on their global effective book and cash tax rates. While legislative technical corrections and regulatory guidance will clarify and possibly amend certain provisions within the Act, companies should not wait for such guidance before taking action.

The Act establishes some interesting new tax benefits for US corporations operating overseas. **The lower overall corporate tax rate combined with the participation exemption regime moves the US tax system closer to international norms in some respects. The participation exemption, in general, allows tax-free repatriations of earnings that would have been subject to US tax if earned by a branch or disregarded entity.** This will be particularly beneficial to repatriations from low-tax jurisdictions because the US taxes on those repatriations would be only partially offset by foreign tax credits. Further, the FDII provision should incentivize companies to develop intellectual property on-shore.

Counteracting the potential benefits from the application of the participation exemption regime and the FDII are the BEAT, the 30 percent interest expense cap, and the GILTI. Although the 10.5 percent GILTI tax rate compares favorably with the general corporate tax rate on earnings of a US corporation flowing up through a disregarded entity or foreign branch, a taxpayer with GILTI income could have previously avoided US taxation on such income for an indefinite period through permanent foreign reinvestment. Taxpayers subject to GILTI should evaluate options to either on-shore IP or realign IP or other non-capital intensive activities within its group structure, particularly in foreign-parented groups.

Taxpayers subject to the BEAT should evaluate if payments can be restructured to reduce the amounts added back to regular taxable income in calculating modified taxable income. It may be possible, for example, to bifurcate service fees into cost and mark-up components, with the BEAT applying only to the mark-up component. The status of the BEAT under the United States' income tax treaties and trade agreements is being questioned by US trading partners so it's possible, but not likely, that the impact will be lessened through regulatory easing.

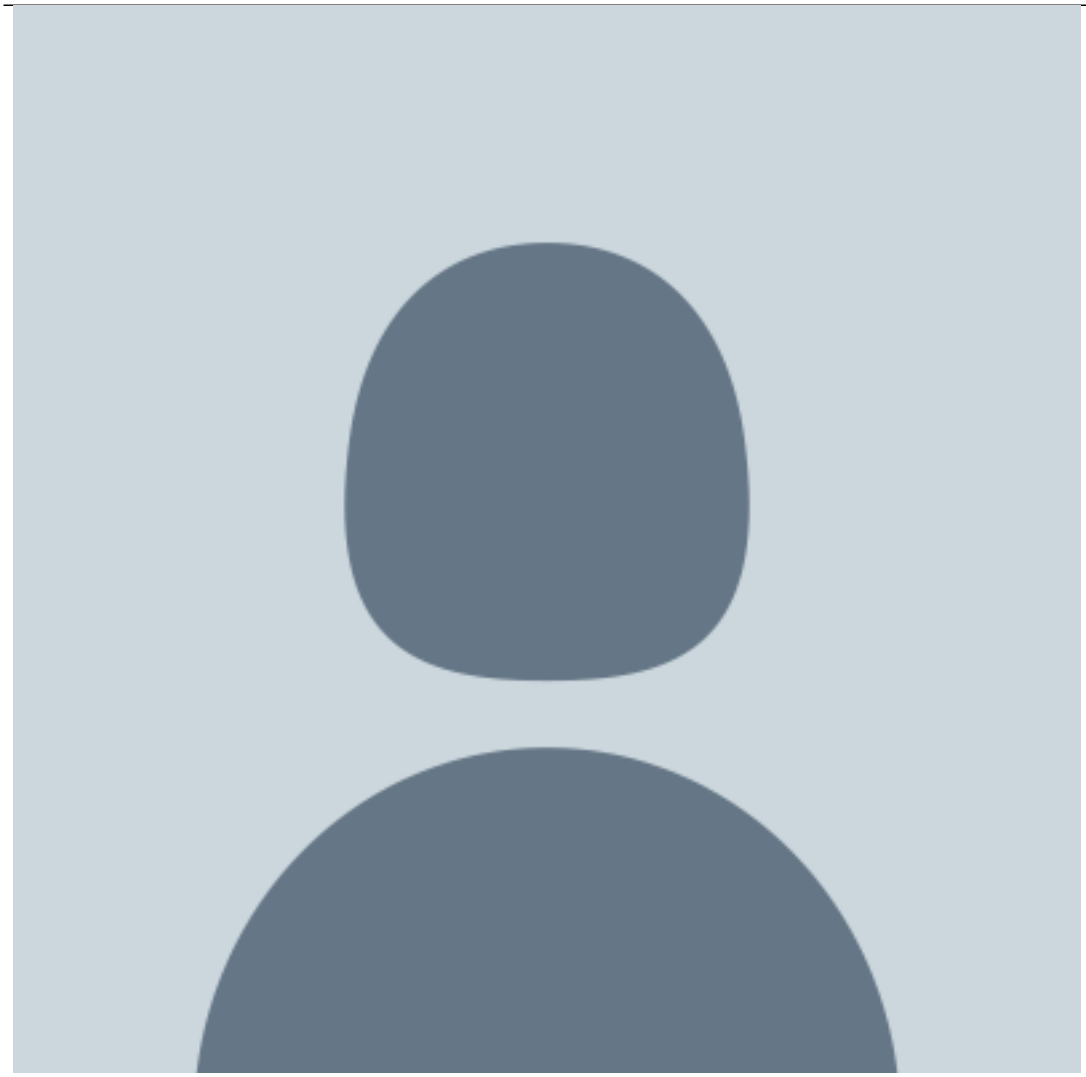
Leveraged US companies may face a substantial increase in their taxable income as a result of the 30 percent cap on business interest expense, particularly in 2022 and later years, due to the change from EBITDA to EBIT. In some cases, decreased US tax rates and the 30 percent cap will provide an

additional incentive for a US borrower to favor debt paying lower rates of interest, even though the lender will require additional security or shorter maturities. Similarly, issuances of convertible debt with lower interest rates or preferred stock or leasing may become more desirable alternatives.

Overseas debt may also become more appealing under the new quasi-territorial international tax system, because paying tax in a foreign country with relatively high rates could otherwise become an incremental tax cost, since the benefits of foreign tax credits are now significantly limited. The interaction of the reduced tax rate in the United States, the 30 percent interest limitation, and a potential interest limitation imposed by the BEAT should also incentivize foreign-headquartered multinationals to decrease the amount of intergroup leverage in their US subsidiaries.

Finally, since the new participation exemption does not apply to dividends received on hybrid securities classified as equity for US tax purposes but as debt for non-US tax purposes, and because there is no grandfather rule, US corporations holding such securities should immediately review the impact of the new law on their continued viability.

Beth Anne Stanford



Senior Tax Counsel

InterContinental Hotels Group

She handles federal, international, and state tax planning and controversy.

Julian A. Fortuna

Partner

Taylor English

At the tax practice group of Taylor English located in Atlanta, Fortuna focuses his practice on domestic and international tax planning and tax controversy matters.