

US Tax Cuts and Jobs Act significantly affects US private companies with outbound investments

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US and foreign individuals who conduct business and invest both in the United States (US) and globally may be significantly affected by the international tax provisions contained in the recently enacted *Tax Cuts and Jobs Act* (the Act).

The Act changes the taxation of US persons that own foreign businesses and includes new requirements with respect to foreign income inclusion and deduction items. Specifically, the Act reduces the top corporate tax rate to 21% and establishes a mandatory one-time transition tax (Transition Tax) to facilitate the transition toward a substantially modified system of international taxation.

The constructive ownership rules of the US controlled foreign corporation (CFC)¹ regime have also been amended and will have a significant impact on how US private companies must analyze ownership of foreign corporations.

This Alert also highlights other provisions of the Act that have an immediate impact on the foreign corporate stock ownership of US private companies. This includes an overview of the global intangible low-taxed income (GILTI) and foreign derived intangible income (FDII) regimes, as well as a few other provisions applicable to private companies.

Overview of relevant outbound US tax reform rules

Changes to stock attribution rules affecting US private companies

The Act repealed Internal Revenue Code² Section 958(b)(4), which generally prevented stock owned by a foreign shareholder from being attributed downward to a domestic subsidiary. As a result, the stock attribution rules under the Act now permit treating a US person as constructively owning certain stock of a foreign corporation that is held by a foreign shareholder (Downward Attribution).³ Accordingly, a US partnership, estate, trust, or corporation can be attributed ownership of a foreign corporation from a foreign partner, beneficiary, or shareholder for purposes of determining CFC status. For example, pre-Act, if a foreign parent owned 51% of a foreign subsidiary and a US subsidiary (of the foreign parent) owned the remaining 49%, the foreign subsidiary would not be a CFC because Section 958(b)(4) prevented the US subsidiary from being attributed ownership of the foreign parent's 51% interest. As a result of the repeal of this limitation, under these facts, the US subsidiary would, for purposes of determining US shareholder and CFC status, be treated as owning all of the foreign parent's stock in the foreign subsidiary, causing the foreign subsidiary to be a CFC. The US subsidiary's inclusion of any subpart F income, however, still would be limited to its directly held stock, and any stock indirectly held through foreign entities as determined under Section 958(a).

Some of the lesser known consequences of the stock attribution rules are:

- ▶ **Constructive ownership rules.** The constructive ownership rules under Section 958(b) apply the constructive ownership rules of Section 318. Under Section 318(a)(3), stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries.⁴ As a result, in the event the Downward Attribution rule applies to treat a foreign corporation as a CFC, there is concern that all US partners of the partnership will have a corresponding inclusion for both the Transition Tax and GILTI. However, the Internal Revenue Service (IRS) issued Notice 2018-13, stating that it intends to amend the instructions for Form 5471 to provide an exception from Category 5 filing (the CFC filing

requirement) for a US person that is a US shareholder with respect to a CFC if no United States shareholder (including such United States person) owns, within the meaning of Section 958(a), stock in such CFC, and the foreign corporation is a CFC solely because such United States person is considered to own the stock of the CFC owned by a foreign person under Section 318(a)(3).

- ▶ **US tax ownership rules.** The US tax ownership rules are applied to options in a manner to cause the option holder to be treated as a US shareholder and the foreign corporation to be treated as a CFC. For example, if options are held by a US and a non-US person, the US options are deemed exercised and the non-US options are deemed not to be exercised if this will cause the US person to be treated as a US shareholder. It does not matter if options are out of the money. However, the transition inclusion to the US person will be based on their actual share interest (not including unexercised options).
- ▶ **Non-voting preferred stock.** In general, non-voting preferred stock will not cause someone to be treated as a 10% or greater voting interest owner (a US shareholder) but this ownership will be relevant for inclusion purposes because accrued and unpaid dividends of preferred stock held by a US shareholder should receive priority allocation of deferred foreign earnings.
- ▶ **Convertible debt.** Convertible debt that is convertible into voting stock should be treated similar to options for purposes of determining if the bondholder is a US shareholder, but the amount of the Transition Tax inclusion will be limited to the actual ownership interest in the foreign corporation's outstanding voting and non-voting share classes at 31 December 2017.

The stock attribution rules under the Act apply to the last tax year of foreign corporations beginning before 1 January 2018, and all subsequent years, and to tax years of US shareholders in which such tax years of foreign corporations end.

The repeal of Section 958(b)(4) greatly expands the application of subpart F, by broadening the scope of entities subject to GILTI and the mandatory Transition Tax, as discussed further below. As a result, private companies need to do a comprehensive analysis of their offshore ownership structures to determine the impact this repeal has on their subpart F status. The CFC ownership rules are now more complex.

Application of Transition Tax to US individuals and trusts, their pass-through entities and closely-held C corporations

Section 965 of the Act treats as subpart F income US shareholders' pro rata share of a specified foreign corporation's (SFC) post-1986 deferred foreign income and levies the Transition Tax, at reduced rates, on such US shareholders' share of such amounts. An SFC is defined as either: (1) a CFC, or (2) any other foreign corporation (other than a passive foreign investment company (PFIC)) in which a domestic corporation is a 10% or greater US shareholder.⁵ An SFC of a US shareholder, which has accumulated post-1986 deferred foreign income, is referred to as a deferred foreign income corporation (DFIC). A DFIC's post-1986 deferred foreign income subject to the transition tax will be the greater of its earnings and profits as of 2 November 2017 or 31 December 2017 attributable to periods during which it was an SFC. The US Treasury Department and Internal Revenue Service issued Notice 2018-07 (Notice), providing guidance for computing the Transition Tax. The Notice describes regulations that the Treasury Department and the IRS intend to issue, effective for the last tax year of a foreign corporation that begins before 1 January 2018, and with respect to US shareholders, for the tax years in which tax years of the foreign corporations end.

US shareholders are subject to the Transition Tax at reduced rates depending on whether earnings are held in cash and cash equivalents or other assets. The reduced rates are achieved by allowing a deduction against the mandatory inclusion amount. The amount of the deduction depends on the inclusion year of the taxpayer. For C corporations, the deduction percentages result in a 15.5% tax rate on the aggregate foreign cash position and 8% for the remainder.⁶ However, the formula for calculating the deduction to reduce the effective rate under the Transition Tax is based on the highest pre-Act corporate tax rate of 35%, which is 4.6% lower than the highest pre-Act individual rate.⁷ Consequently, although unclear until further guidance is provided, the effective Transition Tax rates for individuals and trusts, whether direct US shareholders in DFICs or indirect US shareholders through S corporations, partnerships, or LLCs, are expected to be higher than the stated 15.5% and 8% applicable to C Corporations.

In general, taxpayers must pay Transition Tax on the date when the tax return for the last tax year beginning before 1 January 2018 is due, without regard to any extensions.

A US shareholder can elect to pay the net tax liability under the Transition Tax in installments over eight years (8% of the tax liability for the first five payments; 15% for the sixth payment; 20% for the seventh payment; and 25% for the final payment) with no interest charge. Taxpayers should consider paying their estimated tax based on 110% of their 2016 tax liability. Those who opt to still pay based on their anticipated 2017 taxable income should carefully review the annualized income installment method calculations and consider the possible underpayment penalties and interest. This election to pay the net tax liability over time should be made no later than the due date of the 2017 income tax return. Details related to who may make the election, how the election is made, and how the net tax liability is calculated need to be addressed in future guidance from the Treasury and IRS.

The Act provides a special deferral rule for S corporation shareholders. Each shareholder of an S corporation is eligible to make an election to defer payment of the Transition Tax until a "triggering event" occurs, as defined under the Act.⁸ An S shareholder's deferral election is due on a timely filed return, which includes the close of the S corporation's tax year where there is a mandatory inclusion (i.e., due date of 2017 tax returns for calendar year taxpayers).

Once the full amount of the Transition Tax has been determined, regardless of whether a deferral election has been made by a taxpayer, the deferred foreign income subject to the tax will qualify as previously taxed income (PTI) so that distributions of those amounts will not be subject to additional US income tax.⁹ Furthermore, if a taxpayer has made a deferral election, distributions in excess of the amounts of deferred foreign income on which tax already has been paid do not accelerate the payment of outstanding deferred Transition Tax. Further clarification is needed with respect to taking PTI into account for basis purposes where a taxpayer holds CFC interests indirectly through other entities. For example, it is currently not clear whether the basis of a partnership interest could be adjusted to account for Transition Tax PTI. This issue needs to be carefully monitored.

Beginning in 2018, the US shareholders of an SFC may be subject to the GILTI regime with respect to future foreign earnings of such SFC, as discussed in more detail below.

Example: Mr. X owns 80% of a DFIC. The DFIC's post-1986 tax-deferred earnings is US\$15,000,000¹⁰ as of 2 November 2017 and \$14,000,000 as of 31 December

2017. The DFIC distributed \$1,000,000 on 1 December 2017. For purposes of determining the DFIC's post-1986 tax-deferred earnings that will be subject to the Transition Tax, the distribution of \$1,000,000 is ignored. As a result, for the 2017 tax year, Mr. X has a mandatory subpart F inclusion of \$12,000,000 (80% of \$15,000,000), since the DFIC's 2 November E&P was greater than its 31 December earnings and profits. Assuming the DFIC's remaining assets are cash and cash equivalents, Mr. X's Transition Tax liability will be 2,104,800 ($\$12,000,000 \times 17.54\%$ ¹¹). If Mr. X elects to defer the payment of the Transition Tax, he will pay \$168,384 of the net tax liability for the first five payments; \$315,720 of the net tax liability for the sixth payment; \$420,960 for the seventh payment; and \$526,200 for the final payment. The \$1,000,000 distribution on December 1 will be non-taxable because it was subject to the Transition Tax and, therefore, will be treated as PTI.

Immediate action steps

Private companies should review their non-US holdings to identify the impact of the new tax law by no later than 31 January 2018. Before the due date of the 2017 tax return, private companies should first determine if any of their entities are US shareholders (under the historic definition of US shareholder), and whether they directly, indirectly, or constructively own interest in any SFCs (taking into account the Downward Attribution rules). This can be done by reviewing foreign filings (i.e., Form 5471, 8865, 8858) from prior years and reviewing updated ownership/structure charts and schedules of investments. Private companies also should perform a comprehensive analysis of ownership to determine whether a domestic corporation should be treated as a US shareholder under the new Downward Attribution rules.

As a next step, private companies should determine the amount, if any, of post-1986 deferred foreign income that will be subject to mandatory inclusion. Additionally, they should review the alternatives available to defer payment of the Transition Tax and the consequences of electing to defer on other planning/restructuring alternatives being considered in light of tax reform under the Act.

Private companies also should confirm whether there are any additional tax or reporting requirements for 2017 arising as a result of the Transition Tax. For example, the additional net tax liability arising from the Transition Tax will need to be properly reflected as subpart F income on the 2017 tax return, and will need to be reflected on the

appropriate filings (i.e. Form 5471, 8865, 8858). Also, private companies should be mindful that there may be substantial state income tax issues for US persons who live in states with state income tax to consider.

Other international tax reform changes affecting US private companies

Other international tax provisions of the Act that might affect private companies with non-US interest include:

- *Definition of US shareholder.* Currently, the definition of a "US shareholder" includes US persons who directly, indirectly, or constructively own 10% or more of the total combined voting power of a foreign corporation. The Act expands the definition of a US shareholder under Section 951(b) to include a US person who directly, indirectly, or constructively owns 10% or more of the value of a foreign corporation.
- *Elimination of CFC 30-day rule.* The Act repeals the exception from subpart F income inclusion for entities that were CFCs for 30 days or less. Under prior law, a US shareholder, as of the last day of the CFC's tax year, was required to recognize subpart F income with respect to a CFC only if that foreign corporation was a CFC for at least 30 consecutive days during its tax year. As a result of the elimination of the 30-day rule, a US shareholder will be required to recognize a subpart F inclusion with respect to a foreign corporation if the foreign corporation is a CFC at any time during the tax year.
- *100% exemption for foreign-source dividends.* Under prior law, C corporations were allowed a foreign tax credit for foreign income taxes paid on the income out of which the dividend was paid, but generally only when the foreign earnings were distributed to the US or were otherwise subject to US taxation. The foreign tax credit generally was available to offset, in whole or in part, the US tax owed on foreign-source income.

The Act provides C corporations that are US shareholders of an SFC a 100% percent deduction for the foreign-source portion of dividends received by domestic corporations that are US shareholders of an SFC from specified 10% owned foreign corporations.¹² Furthermore, any gain recognized by a C corporation on the sale or exchange of stock in a foreign corporation held for more than one year that is treated as a dividend under Section 1248, is treated as a dividend for purposes of the 100% deduction. No foreign

tax credit (or deduction for foreign taxes paid with respect to qualifying dividends) is permitted for foreign taxes paid or accrued with respect to a qualifying dividend.

The 100% deduction for foreign-source dividends is only available to US C corporations. Individuals, S corporations, partners and LLC members that are not US C corporations, do not qualify for this deduction.

- **GILTI and FDII.** Under the new GILTI rules, a US shareholder of any CFC has to include in gross income for a tax year its GILTI in a manner similar to inclusions of subpart F income. GILTI is gross income in excess of extraordinary returns from tangible depreciable assets excluding effectively connected income, subpart F income, high-taxed income, dividends from related parties, and foreign oil and gas extraction income. The definition of GILTI is broad enough to capture income that is not necessarily related to intangibles, such as fees for services.

Generally, FDII is the portion of a domestic corporation's deemed intangible income, determined on a formulaic basis, which is derived from non-US sources.¹³

The Act provides a C corporation with deductions with respect to both GILTI and FDII income inclusions, which results in reduced rates of US tax on GILTI and FDII. As a result, for a domestic corporation with tax years beginning after 31 December 2017 and before 1 January 2026, the highest effective tax rate on GILTI is 10.5% (so that if the CFC pays corporate tax of at least 10.5% in its local jurisdiction, a C corporation should not be subject to further US tax on the GILTI of that CFC). For tax years beginning after 31 December 2025, the effective tax rate on GILTI is 13.125%.¹⁴

FDII for a domestic corporation with tax years beginning after 31 December 2017 and before 1 January 2026, is provided an effective tax rate of 13.125% (so that if the C corporation has paid at least 13.125% corporate tax in the jurisdiction where its FDII is sourced, it should not be subject to further US tax on such FDII). For tax years beginning after 31 December 2025, the effective tax rate on FDII is 16.406%.

These GILTI and FDII deductions are only available to US C corporations. Individuals, S corporations, partners and LLC members that are not US C corporations do not qualify for these deductions.

Immediate action steps

These new rules may cause private companies who previously were exempt from US reporting requirements and subpart F income inclusions to report GILTI and subpart F income. Private companies need to review all of their foreign holdings, even if they do not make any distributions or generate income, to determine whether they will be required to report GILTI and subpart F income on their 2018 tax return. Private companies also may be able to benefit from the FDII rate on non-US source income earned by a domestic corporation. In this regard, private companies should review the activities of each US entity in the organizational structure to determine whether there are any opportunities to apply the FDII rate.

Private companies also need to review existing structures for GILTI impact on Q1 estimated tax payments. Operational and structural changes may be needed to address additional tax burden. Private companies may want to reconsider the type of entity used in the US as the parent company of their foreign business since the potential impact of the GILTI may affect their effective tax rates differently depending on the type of entity chosen. Any entity choice advice, including incorporating a current pass-through structure, should be provided following a comprehensive modeling exercise prepared in collaboration with an international tax professional.

Private companies should also begin assessing and modeling the potential implications on income tax accounting. This will include developing a formal implementation plan across the company's finance and tax functions.

Endnotes

1. Section 957(a) of the Code defines a CFC as any foreign corporation in which US shareholders own more than 50% of the value or voting power of the foreign corporation on any day during the tax year.
2. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
3. Note, a related person relationship is required for an actual inclusion. The legislative history indicates that the repeal of Section 958(b)(4) is not intended to result in downward attribution of ownership (under Section 318(a)(3)) to an unrelated US person as defined under Section 954(d).
4. S corporations are treated as partnerships for purposes of Section 318.
5. In the context of the Transition Tax, the pre-2018 definition of US shareholder applies: any US shareholder that owns 10% or more of the voting stock in the CFC. As discussed below, for tax years beginning after 1 January 2018, the definition of US shareholder has been amended to include a US person who owns 10% or more of the voting stock or value of a foreign corporation.
6. Section 962 allows a US shareholder who is an individual to make an election to be treated as a domestic corporation for purposes of determining: (1) the individual's gross income, and (2) the foreign tax credit. The regulations provide that a shareholder must file a statement "with his return for the [tax] year with respect to which the election is made." It is unclear whether the election is allowed with a return subject to an extension. Further, a Section 962 election is an annual election. Accordingly, an individual taxpayer can make the election when it will provide favorable results. For Transition Tax purposes, making the election results in effective tax rates of 15.5% on cash and cash equivalents and 8% on other assets. The potential tax impact of making a Section 962 election should be modeled out or reviewed before making any planning decisions. Potential advantages of the election are not without doubt, pending Treasury's clarification on qualified dividend income and "previously taxed income" (PTI) treatment for electing individuals.
7. The corporate rate is reduced to 21% in 2018 and the Transition Tax deductions are correspondingly reduced creating a 16% spread between the highest corporate rate and the highest marginal rate on individuals. Thus, this issue is even more problematic for fiscal year SFCs where there is a mandatory inclusion under the Transition Tax in 2018.
8. S corporation triggering events include: (1) the corporation ceasing to be an S corporation; (2) a liquidation or other ceasing of the corporation's existence, sale of substantially all the corporate assets, cessation of the business, or similar circumstances, and (3) deferring a shareholder's transfer of any shares in the S corporation, including by death (a triggering event only on a proportionate basis). Note that only US citizens and green card holders are eligible to be shareholders in an S corporation - admitting a foreigner or a temporary resident may cause the S corporation to cease and trigger the tax.
9. Note, a non-CFC is treated like a CFC for purposes of Section 951 and Section 961 only.
10. Currency references in this Alert are to US\$.
11. Although the prevailing view, based on the current mechanics of the Act, is that the effective Transition Tax rate applicable for individuals, trusts, whether direct US shareholders in DFICs or indirect US shareholders through S corporations, partnerships, or LLCs is 17.54% (cash and cash equivalents) and 9.05% (other assets), this is unclear until further guidance is provided.
12. Note, the 100% deduction is not available for dividends received from a CFC that receives a deduction or other tax benefit under foreign tax law for the dividend (hybrid dividend).
13. A domestic corporation's FDII for a tax year is the amount that bears the same ratio to its "deemed intangible income" as its "foreign-derived deduction eligible income" bears to its "deduction eligible income." These are defined terms in the Act. If the sum of a domestic corporation's FDII and GILTI amounts exceeds its taxable income determined without regard to the FDII and GILTI provisions, then the amount of FDII and GILTI for which a deduction is allowed is reduced by an amount determined by such excess. The reduction in FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII and GILTI. The reduction in GILTI for which a deduction is allowed equals the remainder of such excess.
14. Note, this is an estimated rate. Expense apportionment will impact the final rate. For example, the Section 78 gross-up may not be included in the same basket as the inclusion amount, which will have an impact on the final rate.

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