FEATURE STORY

New Tax Act Brings Major Changes to U.S. International Taxation System

By Michael S. Goode and David J. Mittelstadt

A Brief Look at the New Participation Exemption

The Surprisingly International Tennessee

Tennessee has many international ties that often surprise practitioners. Some of the largest multinational companies in the world are headquartered here, and more than 147,000 Tennesseans are employed by foreign-based companies. In fact, Tennessee is the number one state for jobs created through foreign direct investment. Tennessee has frequently earned top marks for its business-friendly environment, and it is likely to be the beneficiary of increased investment by U.S. multinationals should they begin to repatriate overseas funds in response to favorable tax law changes.

Recent changes to international provisions of United States tax law, as well as significant reductions in federal corporate tax rates, create a very favorable environment for this repatriation. Those factors will be relevant to practitioners not only in international law, but in corporate, tax, and finance law as well. This article outlines some of the relevant changes in U.S. international corporate taxation, specifically regarding the new participation exemption.

Background: Why Companies Have Located Overseas

There are many reasons why U.S. multinationals may locate operations and jobs overseas and reinvest the proceeds of such operations outside the United States. However, there can be no doubt that a historically uncompetitive U.S. corporate tax system has been a contributing factor. The U.S. has long had one of the highest corporate tax rates in the developed world, with taxation on a worldwide basis mitigated mainly only by the foreign tax credit. This, plus the "classical" structure of the U.S. corporate tax system, has frequently placed U.S. multinationals at a significant corporate tax disadvantage versus their European and Canadian competitors, especially with respect to repatriated earnings.

Foreign competitors typically apply a territorial system of taxation. What this means is that these foreign competitors do not tend to be taxed in their home countries for their foreign operations. To put it more simply, those foreign competitors can bring home active operating income from their foreign subsidiaries without further home country taxation. Moreover, those foreign countries often integrate shareholder-level and corporate-level taxes in a single effective rate, unlike the double taxation of the United States. In order to mitigate these problems, U.S. multinationals shifted active operations overseas, and reinvested earnings overseas to enjoy a more or less permanent deferral of U.S. tax.

The New Tax Cut and Jobs Act Changes

The Tax Cuts and Jobs Act (TCJA) significantly ameliorates this situation. Effective for distributions made after 2017, new Code Section 245A introduces a participation exemption system for foreign income of a U.S. corporation received from foreign entities. To put it more simply, a quasi-territorial system is thereby created to allow, in the right circumstances, far less costly repatriation of foreign income and thereby encourage U.S. multinationals to transfer funds back to the United States.

As for a bit of the mechanics: The exemption essentially takes the form of a 100-percent deduction for the foreign-source portion of dividends received from a "specified 10-percent owned foreign corporation" by a domestic corporation that is a "United States shareholder" of such foreign corporations within the meaning of Code section 951(b). (Section 951(b) essentially provides a 10-percent ownership threshold based on votes/value, and applies the attribution rules of Code section 958.)

A specified 10-percent-owned foreign corporation, for this purpose, is any foreign corporation with respect to which any domestic corporation is a United States shareholder. However, passive foreign investment companies (PFICs) that are not also controlled foreign corporations (CFCs) are excluded. What is a CFC or a PFIC, you ask? We define those in the second to last section.

Dividends from foreign companies that are less than 10-percent owned by domestic corporations will not be eligible for the 100-percent deduction and will continue to be treated the same as under prior law. Furthermore, the new rules only benefit corporate U.S. shareholders (e.g., an individual or an LLC US shareholder will not benefit).

The Conference Report indicates that the term "dividend" is intended to be interpreted broadly. Thus, for example, it is likely to include income taxed to the U.S. company but received only indirectly, e.g., through a partnership vehicle.

There are also allocation rules that must be followed, which provide a way to separate U.S. and non-U.S. sourced income. These rules make sense, since the new 100-percent deduction applies only to the foreign source income component of the dividend. Thus if the paying foreign corporation also earned U.S. source income, the total dividend received by the US recipient corporation will have to be allocated between U.S. and non-U.S. source income. The foreign-source portion of any dividend is the amount that bears the same ratio to

continued on page 20

International Taxation

continued from page 19

the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. (This assumes, of course, that the payor has maintained sufficient records to track earnings from a U.S. source perspective).

Any amount that qualifies for the new deduction is then disqualified from carrying a foreign tax credit (unremarkable, otherwise the U.S. shareholder would derive a double benefit).

The deduction is also not available for any dividend received by a U.S. shareholder from a CFC if the dividend is a "hybrid dividend." This is basically defined to mean an amount received from the CFC that would otherwise qualify, but for which the CFC obtained a deduction or other tax benefit in respect of foreign company taxes.

There are, however, some further limitations that regard required holding periods in order to claim the deduction. A domestic corporation is not permitted the new deduction in respect of any dividend on any share of stock held by the domestic corporation for 365 days or less during the 731-day period beginning on the date that is 365 days before the date on which the share becomes ex-dividend with respect to the dividend. That is a rather complicated way of saying that the paying share has to be owned at least one year within a two-year-and-one-day window that begins a year before the dividend date and ends one year after. For purposes of determining if the holding period is met, the 10-percent owned foreign corporation must be such throughout the ownership period, and the U.S. corporation must be a U.S. shareholder throughout the period.

The Transition Tax

The new participation exemption deduction does not come without a cost. The TCJA also enacted complex provisions for a one-off inclusion to U.S. shareholders of foreign corporations' historic earnings and profits. A transition tax is generally imposed through the mechanism of a Subpart F inclusion (thus the earnings in question need not actually be distributed in order to be subject to tax). Subpart F is an anti-deferral regime discussed in the following section.

Tennessee is the number one state for jobs created through foreign direct investment.

The transition inclusion/tax essentially applies to the last taxable year beginning before Jan. 1, 2018. For such year, any U.S. shareholder of any CFC or other foreign corporation (other than a PFIC that is not also a CFC) that is at least 10-percent owned by a domestic corporation must include in income its pro rata share of the accumulated post-1986 foreign earnings of the corporation as of Nov. 2, 2017, or Dec. 31, 2017, whichever amount is greater.

Again, the rules presuppose that the foreign corporation has a robust enough accounting system to track earnings by U.S. source rules, back over 30 years. The blow struck by the mandatory inclusion is softened: a portion is deductible in such amount as to result in a tax rate on the inclusion of 15.5-percent (for earnings held in liquid form) or 8-percent (for the balance of the earnings). To further soften the blow, the resulting tax can be paid in installments over eight years. A portion of the foreign tax credit is disallowed, to reflect the fact that part of the earnings were deductible.

So What Are a CFC and a PFIC Anyway?

Now that we have described a major component of the TCJA's international provisions, we thought we would take a moment to explain some of the basics of Subpart F, which is the longstanding anti-deferral regime that remains in existence after the passage of the TCJA, and from which we can explain some of the terms discussed in this article. Note that this explanation is simplified, and that there are other complex rules regarding constructive ownership, among other rules, that exceed the scope of this article.

Central to Subpart F is the Controlled Foreign Corporation (CFC), which is a foreign corporation in which U.S. Shareholders own more than 50 percent of the total combined voting power of all classes of voting stock.

A U.S. Shareholder is a U.S. person owning 10 percent or more of the voting stock of the foreign corporation. One change in the TCJA is that for tax years after Dec. 31, 2017, the definition of U.S. Shareholder is expanded to include any U.S. person owning 10 percent more of the value of the shares of all classes of stock (in addition to the voting power as set forth above).

So let's say that you have a foreign corporation that meets this definition of a CFC, what does that mean as far as its U.S. Shareholders are concerned? Well, basically, they must include their proportionate shares of the CFC's "Subpart F" income in their own gross income. For our simplified purposes herein, Subpart F income tends to be of a type that has the characteristic of being easily movable and subject to low rates of tax, such as passive income, related-party sales and purchase income, etc. The logic of Subpart F is essentially not to allow deferral of taxation on income of foreign corporations that are majority controlled by a few U.S. persons when the income is easily movable to low-tax jurisdictions. (Prior to the enactment of Subpart F, many U.S. taxpayers achieved deferral of U.S. tax on such types of income by earning such income through foreign corporations in low-tax jurisdictions.)

Also be aware that there are a number of other changes to the CFC rules contained in the TCJA (such as oil-related income rule changes, repeal of taxing income when a CFC decreases investment, and elimination of the rule that requires a foreign corporation to be a CFC for an uninterrupted 30-day period) that attorneys practicing in international tax will need to review.

Another body of rules to be aware of when reviewing the international provisions of the TCJA is the set of PFIC rules, which provides another anti-deferral regime. Generally, a PFIC is a foreign corporation where 75 percent or more of its gross income consists of passive income or 50 percent or more of its assets consists of assets that produce passive income. Complex rules and elections govern PFICs, and as such, U.S. persons should generally be wary of owning PFICs (this is why owning foreign mutual funds is often disadvantageous, for example).

Conclusion

This article has provided a brief overview of the new quasi-territorial taxation system adopted by the TCJA. However, since many questions remain as to all of the specific details of how the law will be interpreted, it will be imperative to keep abreast of new rules and regulations that will be released by the IRS in the coming months implementing TCJA provisions. However, these provisions are important since, as we stated earlier, Tennessee is likely to be the beneficiary of increased investment by U.S. multinationals because of the repatriation of overseas funds in response to these favorable tax law changes.

MICHAEL S. GOODE is an attorney in the Nashville and Atlanta offices of Stites & Harbison PLLC. He helps businesses and families with their tax, business and estate planning needs. On an international level, he also assists companies and individuals with corporate and estate planning needs, including the resolution of reporting requirements. Rated AV Preeminent® by Martindale-Hubbell®, Goode earned a LL.M. in taxation from New York University. He has served as the chair of the Tax Section, and Estate Planning and Probate Section of the Tennessee Bar Association, and is also on the Executive Council of the TBA's International Section. He has written numerous articles and frequently lectures to both local and national audiences.

DAVID J. MITTELSTADT has engaged in transactional tax practice for almost 35 years. He is of counsel at Chambliss, Bahner & Stophel PC, previously working as a tax attorney in major national firms, spending more than seven years as the in-house U.S. Tax Counsel for the Canadian-controlled Thomson Corporation group (now Thomson Reuters). He also spent several years in his own tax practice. Mittelstadt's practice has spanned from representation on very large international transactions to representation of small, local and startup businesses. He is the current chair of TBA's Tax Section, and is admitted to practice in Tennessee, Georgia, Massachusetts and New York, and he is a member of The Honourable Society of Lincoln's Inn, one of England's four Inns of Court.