EXPLORING THE NEW "TERRITORIAL" TAX SYSTEM
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EXPLORING THE NEW "TERRITORIAL" TAX SYSTEM

By Robert J. Wolfer, CPA

I. NEW ELEMENTS OF A TERRITORIAL SYSTEM

a. C-corporations are now given a 100% Dividends Received Deduction (DRD) for the foreign-source portion of dividends from a "specified 10%-owned foreign corporation," effectively allowing them to earn and repatriate foreign-source income without U.S. tax.

b. The fine print - §245A:

   i. A "specified 10%-owned foreign corporation" is generally any foreign corporation with a U.S. shareholder who owns 10% or more of the stock entitled to vote. A Passive Foreign Investment Company (PFIC) that is not also a Controlled Foreign Corporation (CFC) is excluded from the definition.

   ii. A one-year holding period is required in order to claim the deduction.

   iii. The DRD is not allowed for hybrid dividends. A hybrid dividend is one for which the foreign corporation received a tax benefit in a foreign country. An example would be a payment from a foreign corporation that it treats as interest expense in its home country, but is treated to the recipient as a dividend in the U.S.

   iv. Because the new deduction effectively eliminates the double tax, no foreign tax credits are available with respect to dividends that qualify for the deduction. Accordingly, the indirect, or deemed paid, credit in §902 has been repealed for tax years beginning after December 31, 2017.

c. While domestic C-corporations might want to consider converting foreign branches to CFCs in order to take advantage of this new provision, taxpayers should consider new §91, which provides for a recapture of branch losses upon transfer of branch assets to a 10% owned foreign corporation. Additionally, taxpayers will want to consider the effects of §367 on any conversion, including the changes discussed in V(c), below.

d. While not a worldwide vs. territorial change, the reduction in the corporate tax rate from a maximum of 35% to a flat rate of 21% will be a significant factor in multinationals' tax planning. U.S. rates in effect prior to 2018 were the highest among OECD countries, but the 21% rate is below the OECD average, which in 2015 was roughly 25% according to the Tax Foundation.

II. THE CUTOFF: ONE-TIME DEEMED REPATRIATION

a. Because territorial taxation is intended to apply to qualified foreign-source income earned in 2018 and future years, foreign earnings of a deferred foreign income corporation (DFIC) accumulated after 1986 and before 2018 are still subject to U.S. taxation and not eligible for the DRD. Rather than allow these earnings to continue being deferred, they are now considered to be repatriated during tax year 2017 and are includible in income of the U.S. shareholder.

b. The mechanism for inclusion is found in §965. Deferred, post-1986 foreign income of a DFIC, calculated as of November 2, 2017 or December 31, 2017, whichever is larger, is considered to be Subpart F income.

   i. A DFIC is defined as either a CFC or a foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder (10% ownership threshold), which has accumulated post-1986 deferred foreign income greater than zero.

    ii. Only earnings accumulated while the U.S. ownership met the above thresholds is considered in the calculation

c. While the 100% DRD for 2018 and future years is only available to C-corporations, this 2017 mandatory repatriation is applicable to all taxpayers that are defined as a "U.S. shareholder," as described in III(b), below. Note that this definition includes C and S-corporations as well as noncorporate taxpayers.

d. There are several provisions to mitigate the effect of this potentially large inclusion.

    i. A deduction is available such that the amount of the inclusion related to the foreign corporation's liquid assets is taxed at an effective rate of 15.5% and the remainder is taxed at an effective rate of 8%. The deduction operates by reducing taxable income to an amount that, when multiplied by a 35% rate, would result in the 15.5% or 8% rate. It appears that taxpayers subject to a rate of other than 35% on the included income would see a different result, although Treasury may address this under its regulatory authority.

        1. If the taxpayer becomes an expatriated entity at any point within 10 years of enactment, there is a recapture provision that brings the effective rate of this tax back up to 35%.

    ii. Foreign tax credits related to the included income will be allowable. However, they will be reduced to make them proportionate to the 15.5% and 8% effective rates on the income. Because the applicable foreign tax credit is under §960, it appears the credit is generally only available to U.S. shareholders who are C-corporations.

        1. Individuals who are considered to be U.S. shareholders may be able to make an election under §962 in order to use the §960 credit against this income. However, this would require careful consideration as there are numerous pros and cons to the election, and it may result in higher overall tax in some cases.

    iii. For partnerships and S-corporations, there is a special rule found in §965(f)(2) that allows tax basis to be increased by the full amount of the inclusion by treating the amount of income offset by the 15.5% and 8% effective rate deduction as nontaxable income which increases basis. However, unlike tax basis, an S corporation's accumulated adjustments account will be decreased by the deduction.

    iv. Taxpayers can elect to pay the resulting tax liability over an 8-year period, weighted toward the back end of the 8 years. <u>This election must be made with a timely filed 2017 return.</u>

    v. S corporation shareholders can elect to defer payment of the tax until a triggering event, such as the date the S corporation ceases to be an S corporation, it liquidates or sells substantially all of its assets, or the shareholder transfers any share of stock in the S corporation. <u>This election must be made with a timely filed 2017 return.</u> Note also that upon transfer of stock, the triggering event can be further delayed if the transferee agrees to assume the tax liability. Once a triggering event occurs, the 8-year repayment period begins.

    vi. Deferred foreign income and foreign E&P deficits can be netted.

    vii. Taxpayers may elect not to apply net operating loss (NOL) deductions to this income. The election may be desirable as it would preserve the NOL deduction to be used against income taxed at the taxpayer's full rate.

III. WHAT ABOUT SUBPART F AND §956 INCLUSIONS?

a. Despite the shift toward a territorial system, tax reform legislation <u>did not repeal</u> the anti-deferral provisions of Subpart F and §956, both of which trigger current U.S. taxation of certain CFC earnings. But if C-corporations can take a 100% DRD on dividends from CFCs, shouldn't they be exempt from these provisions as well? Or do they still serve a purpose against abuse of a territorial system? In its form prior to 2018, Subpart F existed to prevent deferral on certain types of income that were seen as easy to locate in any country, such as passive investment income and "base company" income, where a related party in a low-tax country is involved in a transaction, and allocated some of the profit, but in reality, no substantial activity took place in the low-tax country. For individuals, including owners of passthroughs, these provisions will continue to serve this purpose. For C-corporations, the target now is not so much deferral as it is exclusion.

i. **Example:** Taxpayer's subsidiary (SUB-A) manufactures a product in country A and sells it to another subsidiary (SUB-B) of the taxpayer in country B. SUB-B then sells the product to customers in country C. Assume country A has a higher tax rate than country B. If SUB-A had sold directly to customers in country C without running the product through country B, more of the profit would have been taxable in country A at a higher rate. Because neither the manufacturing activity nor the ultimate customer was in country B, the profit earned by SUB-B in country B would be considered Foreign Base Company Sales Income subject to Subchapter F treatment.

ii. Without these provisions in place, many U.S.-based multinationals would be able to use the territorial part of the new law to further erode the U.S. tax base by incorporating subsidiaries with little real activity in low-tax countries with the purpose of absorbing profit that may otherwise be taxable in the U.S.

b. Subpart F was also expanded to cast a wider net, resulting in more foreign corporations being treated as CFCs.

i. Under old law, a "U.S. shareholder" was defined as a U.S. person owning 10% or more of the voting stock of a foreign corporation. Effective for taxable years beginning after December 31, 2017, the definition is expanded to also include a U.S. person owning 10% or more of the value of the foreign corporation's stock. This will curtail the ability to use nonvoting stock as a Subpart F planning tool.

ii. Previously, a foreign corporation was considered a CFC only if U.S. shareholders (defined above) collectively owned more than 50% of the vote or value of the foreign corporation for an uninterrupted period of 30 days or more, pursuant to §951(a)(1). The 30-day exception has now been repealed. Taxpayers will need to take extra precaution to avoid creating a CFC for a brief period of time in the midst of a transaction if there is potential for Subpart F income. This is effective for taxable years beginning after December 31, 2017.

iii. In determining whether a foreign corporation is a CFC, §958 includes attribution and constructive ownership rules to calculate stock ownership percentages of U.S. persons. Under old law, stock held by foreign persons was not attributed to U.S. persons, pursuant to §958(b)(4). Effective beginning in <u>tax year 2017</u>, §958(b)(4) has been repealed, and stock held by foreign persons can now be attributed to U.S. persons.

1. **Example – Old Law:** During 2016, foreign Corporation A owns 50% of U.S. Corporation B and 45% of foreign Corporation C. B owns 30% of C. The remaining 25% of C stock is owned by unrelated foreign shareholders. Under old law, B was treated as only owning 30% of C, because there was no attribution from foreign persons, and the result is that C is not a CFC.

2. **Example – New Law:** Same facts as above, but during 2017. A's 45% ownership in C is now attributed to B, and B is considered to own 75% of C. The result is that C is a CFC.

iv. Foreign base company oil related income in §954(a)(5) and the inclusion of amounts withdrawn from qualified shipping operations in §955 have both been removed from Subpart F.

v. Because Subpart F income receives worldwide tax treatment, the §960 foreign tax credit remains in place to mitigate double taxation.

c. §956, which treats CFC earnings invested in U.S. property like Subpart F income, was retained. Both the House and Senate versions of tax reform contained a repeal of the provision for C-corporations, but final legislation did not.

i. This could create a trap for taxpayers, because while actual dividends received from a CFC may receive the 100% deduction, there is currently no corresponding deduction available if the repatriation occurs by way of a §956 inclusion rather than a dividend. Because of how the inclusion operates, it may still be unadvisable for CFCs to invest in U.S. property, and U.S. shareholders may still need to avoid receiving guarantees from CFCs or pledging CFC stock or assets.

ii. The §960 deemed paid credit still applies to §956 inclusions, and coupled with the 21% corporate tax rate, may prove to remove much of the sting associated with the inclusion.

IV. ADDITIONAL RETAINED ELEMENTS OF WORLDWIDE TAXATION

a. Income from a foreign branch (disregarded entity) or partnership is still included in U.S. income, and related foreign tax credits are still allowed.

i. There is a new foreign tax credit limitation basket for foreign branch income.

ii. For purposes of the foreign tax credit limitations, income from the sale of inventory is now sourced 100% based on production activities, rather than 50% production and 50% where title passed.

b. U.S. noncorporate taxpayers (including S-corporations) are not given a DRD for foreign-source dividends, and are still subject to U.S. taxation on worldwide income. <u>The benefits of the territorial system only apply to dividends received by domestic C-corporations from their specified 10% owned foreign corporations.</u>

c. IRS Reporting: Because of the worldwide provisions that were retained, there appears to have been <u>no reduction</u> in requirements to report foreign activity to the IRS. Accordingly, taxpayers will continue to file forms such as 5471, 5472, 3520, 1042-S, 8865, and the FBAR. In fact, the penalty for failure to file Form 5472 is being increased from $10,000 to $25,000.

d. Notably, <u>individuals are still subject to taxation on worldwide income</u>. U.S. citizens and U.S. residents will still rely on provisions such as the foreign earned income exclusion and the foreign tax credit to manage their U.S. tax liabilities on foreign-source income.

V. WORLDWIDE TAXATION – NEW BASE EROSION PROVISIONS

a. A new tax on global intangible low-taxed income (GILTI) has been enacted. The tax is imposed on U.S. shareholders of CFCs, and is generally computed as a tax on the U.S. shareholder's share of foreign-source earnings of the CFC that exceeds a 10% rate of return on tangible, income-producing assets such as machinery and equipment.

i. For C corporations only, there is a 50% GILTI deduction and 37.5% deduction for foreign derived intangible income, which is intended to represent the portion of export sales attributable to U.S. intangible assets.

ii. These calculations are complex, with numerous definitions and carve-outs, and are found in new §951A and §250. Note that foreign tax credits can be used against the income.

iii. The overall effect is a global minimum tax on income considered to be derived from intangible assets.

b. Net interest expense (interest expense in excess of interest income) is limited to 30% of adjusted taxable income (taxable income without deductions for interest, NOLs, depreciation, amortization, or depletion).

    i. An exception exists for businesses with average gross receipts less than $25 million

c. There were two changes to §367, which restricts tax-deferral benefits (such as §351) upon outbound transfers to foreign corporations.

    i. The "active trade or business" exception in §367(a)(3) has been repealed.

    ii. The definition of intangible property in §367(d) which is subject to the disallowance has been expanded to include workforce in place, goodwill, and going concern value.

d. A Base Erosion Anti-Abuse Tax (BEAT) applies to taxpayers with over $500 million of gross receipts. The tax described in §59A, functions like a minimum tax. It is calculated as 10% of taxable income calculated without deductions for "base erosion payments," and without tax credits. To the extent that amount exceeds the taxpayer's regular tax liability, net of credits, the taxpayer owes the incremental amount of tax.

    i. A "base erosion payment" is any amount paid or accrued to a foreign related party which is deductible to the taxpayer, including the purchase of depreciable or amortizable property.

    ii. In lieu of 10%, the rate is 5% for 2018, and 12.5% for years after 2025.

    iii. An exception also exists for taxpayers with base erosion payments of less than 3% of their total deductions.

e. Tax reform brought about new restrictions on hybrid transactions and hybrid entities. Hybrid transactions are generally ones which produce a different tax result under U.S. tax law and foreign tax law, such as a payment treated as deductible to the U.S. taxpayer but not taxable to the foreign related party. Hybrid entities are those that are treated as transparent (partnership or branch) for U.S. purposes, but are treated like a C-corporation in the applicable foreign country. A reverse hybrid is one treated as a corporation for U.S. tax purposes but transparent in the foreign country.

    i. §267A disallows a deduction for interest or royalties paid to a related party where there is no taxable income inclusion by the related party, or where the related party receives a deduction under the tax law of its country.