IMPACT OF THE TAX CUTS AND JOB ACT ON U.S. INVESTORS IN FOREIGN CORPORATIONS

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INTRODUCTION

This article addresses provisions of the Tax Cuts and Jobs Act of 2017 ("T.C.J.A.") that affect certain U.S. investors in foreign corporations on a go-forward basis and a one-year transition period for the 2017 taxable year.

DIVIDENDS RECEIVED DEDUCTION FOR DIRECT INVESTMENT IN SPECIFIED FOREIGN CORPORATIONS

Prior Law

Generally, individuals that are U.S. citizens or residents and domestic corporations are considered to be U.S. persons that are subject to tax on worldwide income.[1]

The American Jobs Creation Act of 2004 adopted Code §965, a temporary provision to encourage U.S. multinational companies to repatriate foreign earnings. During a specific period of time, certain dividends received by a U.S. corporation from a controlled foreign corporation ("C.F.C.") were eligible for an 85% dividends received deduction.

The temporary deduction was subject to a number of general limitations:

- It generally applied only to cash repatriations in excess of a base amount by reference to a three-year base period.
- The amount of dividend eligible for the deduction was generally limited to the amount of earnings identified in audited financial statements as being permanently invested outside the U.S., so that no deferred tax provision existed for potential U.S. tax at the time of a repatriation event.[2]
- To qualify for the deduction, dividends were required to be invested in the U.S. according to a domestic reinvestment plan approved by the taxpayer's senior management and board of directors.

No foreign tax credit or deduction was allowed for foreign taxes attributable to the deductible portion of the dividend.[3] Taxpayers were permitted to specifically identify which dividends were treated as carrying the deduction and which dividends were not.

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[1] Code §7701(a)(30).

[2] Financial Accounting Standard 109 (Accounting for Income Taxes).

[3] Code §965(d)(1),(2).

T.C.J.A.

In General

Code §245A provides a 100% deduction for the foreign-source portion of dividends received from specified 10%-owned foreign corporations (the "D.R.D.") by domestic corporations that are U.S. Shareholders, within the meaning of Code §951(b), of the corporation making the distribution. The D.R.D. is available only to C-corporations that are not R.I.C.'s or R.E.I.T.'s. A specified 10%-owned foreign corporation is any foreign corporation[4] with respect to which a domestic corporation is a U.S. Shareholder, even if the foreign corporation is not a C.F.C.

The term "dividends received" is interpreted broadly, consistent with the meaning of the phrases "amount received as dividends" and "dividends received" under Code §§243 and 245. Thus, the dividend may be received directly or through a partnership, provided the indirect ownership percentage in the foreign corporation is at least 10%.

Foreign-Source Portion of a Dividend

D.R.D. treatment is available only for the foreign-source portion of dividends received by a domestic corporation from a specified foreign corporation. The foreign-source portion of any dividend is the amount that bears the same ratio to the dividend as the undistributed foreign earnings bears to the total undistributed earnings of the foreign corporation. Undistributed earnings are the amount of the earnings and profits of a specified 10%-owned foreign corporation as of the close of the taxable year in which the dividend is distributed and not reduced by dividends distributed during that taxable year. Undistributed foreign earnings are the portion of the undistributed earnings attributable to neither income described in Code §245(a)(5)(A) nor Code §245(a)(5)(B), without regard to Code §245(a)(12).

"D.R.D. treatment is available only for the foreign-source portion of dividends received by a domestic corporation from a specified foreign corporation."

Hybrid Dividends

The D.R.D. is not available for any dividend received by a U.S. Shareholder from a C.F.C. if the dividend is a hybrid dividend. A hybrid dividend is an amount for which a deduction would be allowed under the D.R.D. rules except that the specified 10%-owned foreign corporation received a deduction or other tax benefit in any foreign country. Where the foreign corporation benefitted from a tax deduction for the payment, the D.R.D.is not available to the recipient U.S. Shareholder.

Example

U.S. Corporation B is the sole shareholder of Foreign Corporation Y. Foreign Corporation Y issued a series of contingent participating equity certificates ("C-PEC's") to U.S. Corporation B. Among other provisions, the term of the C-PEC's is 100 years, no coupon is attached to the instrument, dividends are payable when and as declared by the Board of Directors, and only when and if the issuer has sufficient profits and cash flow. Under the law of its country of residence, Foreign Corporation Y is entitled to treat the C-PEC's as debt so that distributions are tax deductible. In the U.S., the C-PEC's are treated as equity and the distributions are treated as dividends. The C-PEC's are hybrid instruments and U.S. Corporation B is not entitled to the benefit of the D.R.D.

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[4] Other than a P.F.I.C. that is not also a C.F.C.

If a C.F.C. with respect to which a domestic corporation is a U.S. Shareholder receives a hybrid dividend from any other C.F.C. with respect to which the same domestic corporation is a U.S. Shareholder, the hybrid dividend is treated for purposes of Code §951(a)(1)(A) as Subpart F income of the recipient C.F.C. (notwithstanding Code §954(c)(6)).[5] Consequently, the U.S. Shareholder must include an amount in gross income under Subpart F.

Foreign Tax Credit Disallowance

A U.S. corporation that receives a dividend that qualifies for the D.R.D. may not claim a foreign tax credit or deduction for foreign income taxes that are imposed on the payment. For purposes of computing the foreign tax credit limitation under Code §904(a), the dividend and any deductions properly allocable or apportioned to it are disregarded.

Holding Period Requirement

To be entitled to claim the benefit of the D.R.D., three conditions must be met:

- First, the domestic corporation must hold the requisite interest in the specified foreign corporation for more than 365 days in the 731-day period beginning on the date that is 365 days before the ex-dividend date in the declaration. Typically, dividends are declared with regard to shareholders owning shares on a specific date, known as the record date. If shares are publicly traded on an exchange, the exchange will set the ex-dividend date. The ex-dividend date typically is two business days before the record date.
- Second, the foreign corporation must be a specified 10%-owned foreign corporation at all times during the holding period.
- Finally, the taxpayer must be a U.S. Shareholder with respect to such specified 10%-owned foreign corporation at all times during the period.

The provision applies to distributions made after December 31, 2017. For purposes of determining a taxpayer's foreign tax credit limitation under Code §904, it applies to deductions claimed in taxable years beginning on or after December 31, 2017.

Comment

With this new provision, the U.S. effectively moves into a territorial tax system. In comparison to prior law, where domestic companies were taxed on worldwide income, the current law does not tax certain U.S. domestic companies on dividend income earned outside the U.S.

Note, however, the D.R.D. is not a full participation exclusion in a European sense: Capital gains derived from the disposition of a specified 10%-owned foreign corporation are not tax free. In that regard, the D.R.D. is more akin to the Canadian system of dividends from exempt surplus.

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[5] In broad terms, Code §954(c)(6) excludes a cross-border, intercompany payment of interest or royalties from being Foreign Personal Holding Company Income where the payment involves C.F.C.'s that are related and the payment is treated as an expense that reduces an item of income for the payor that is not an item of Subpart F income.

MANDATORY REPATRIATION UNDER CODE §965

Prior Law

Before the T.C.J.A., the principal anti-deferral mechanism of U.S. tax law was Subpart F. In specified circumstances, it caused a U.S. Shareholder of a C.F.C. to be taxed on a current basis on certain categories of income earned by the C.F.C. Tax was imposed on the U.S. Shareholder even if cash or property was not distributed. Deferral of income and U.S. tax was terminated immediately.

A C.F.C. generally is defined as any foreign corporation in which U.S. Shareholders own stock representing more than 50% of the voting power or value of the corporation. A U.S. Shareholder is a U.S. person who owned 10% or more of the total voting power of that foreign corporation.

If the U.S. Shareholder was a corporation, it could claim a foreign tax credit for the foreign taxes paid by the foreign corporation, whether or not a C.F.C., at the time dividends were received or an inclusion in income occurred by reason of Subpart F.[6] If foreign operations were conducted by a branch of a U.S. person, direct foreign tax credits could be claimed for the tax paid by the foreign branch. If a U.S. person received dividends, interest, or royalties, foreign withholding taxes imposed at the time of payment were also creditable.[7]

T.C.J.A.

Scope of Earnings and Profits Subject to the Transition Tax

The transition from a foreign tax credit system to eliminate double taxation for intercompany dividends received from a C.F.C. or a 10%-owned foreign corporation that is not a C.F.C. requires that the post-1986 pool of deferred earnings and profits must be taken into account under the old system so that post-2017 earnings can benefit from the D.R.D. provided by new Code §245A. The pool of earnings is taken into account in the 2017 tax return, with an election to spread the tax payment over eight years.

New Code §965 requires any U.S. Shareholder of a specified foreign corporation to include in income its *pro rata* share of the accumulated post-1986 deferred foreign income of the corporation. A specified foreign corporation is a foreign corporation that has at least one U.S. person that owns shares representing 10% or more of the combined voting power of all classes of shares in the foreign corporation.[8] A P.F.I.C. that is not a C.F.C. is excluded from the list for that U.S. person.

The mechanism for requiring an inclusion of pre-effective-date foreign earnings is Subpart F but in a somewhat adjusted way for 10% shareholders of a foreign corporation that is not a C.F.C. Remember, the term "U.S. Shareholder" means a U.S. person that holds shares representing 10% or more of the voting power of the foreign corporation. A U.S. Shareholder of a specified corporation includes the deferred foreign income in its last taxable year that begins before January 1, 2018, as additional Subpart F income. The inclusion is the greater of the aggregate

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[6] Code §§902 and 960.

[7] Code § 901.

[8] Code §951(b).

post-1986 accumulated foreign earnings and profits as of November 2, 2017, or December 31, 2017, (whichever date is used is referred to as "measurement date"). In Notice 2018-13, the I.R.S. announced that all computations that are called for in the statute on or as of November 2, 2017, may be made on or as of October 31, 2017. The use of the month-end date must be elected by the taxpayer and is offered to ease the compliance obligation of measuring amounts on a date other than a month end.

This transaction applies to all the U.S. Shareholders – within the meaning of Subpart F – of a "deferred foreign income corporation." This means individuals as well as corporations. A deferred foreign income corporation is any specified foreign corporation that has accumulated post-1986 deferred income that is greater than zero. The portion of post-1986 earnings and profits does not include earnings and profits accumulated by the foreign corporation prior to the time it obtained the status of a specified foreign corporation with regard to the U.S. person holding its shares.

Accumulated Post-1986 Deferred Foreign Income

A specified foreign corporation's accumulated post-1986 deferred foreign income on the measurement date is based on all post-1986 foreign earnings and profits that are not previously taxed. Ignored for this purpose are earnings and profits that are attributable to income that is effectively connected with the conduct of a trade or business in the U.S., provided that such income is actually taxed in the U.S. If the U.S. business income is not taxed because of the application of an income tax treaty and the absence of a permanent establishment, the earnings and profits arising from the U.S. businesses are not excluded.

Also excluded are earnings and profits that are attributable to Subpart F income that has been included in the gross income of a U.S. Shareholder. In Notice 2018-13, the I.R.S. addressed a fact pattern in which a C.F.C. had 100u of post-1986 earnings and profits previously taxed for its U.S. Shareholder. In addition, in subsequent years it had deficits of 90u. Although the post-1986 accumulated profits are a positive 10u, for purposes of Code §965, the previously taxed income is not taken into account. Thus, the C.F.C. is a deficit C.F.C. and the deficit is 90u.

The pool of post-1986 foreign earnings and profits is not reduced by distributions during the taxable year to which Code §965 applies. This reflects the general ordering rule of Subpart F and actual dividends – Subpart F applies first and dividends are not taxed a second time if and to the extent attributable to previously taxed income. For individuals, this means they are taxed at ordinary income rates and not favorable long-term capital gains tax rates that might otherwise apply to qualified dividends.

As mentioned above, a U.S. Shareholder that is subject to Code §965 must determine its aggregate earnings and profits. This is determined on each of two dates and the date on which the amount is greatest is the measurement date.

The pool of post-1986 earnings and profits of a U.S. Shareholder is reduced by foreign earnings and profits deficits that are properly allocated to that U.S. Shareholder. If more than one specified foreign corporation is owned and some have net positive earnings and profits and others have deficits, the deficits will reduce the amount taken into income. The deficits are allocated among the specified foreign

corporations on a *pro rata* basis determined by reference to positive earnings and profits among the specified foreign corporations owned.

Where a deficit C.F.C. has more than one class of shares, the deficit must be allocated among the various classes of shares, especially where unrelated persons hold separate classes. Notice 2018-13 addresses this fact pattern. The earnings and profits deficit is allocated first among the shareholders of the corporation's common stock and in proportion to the value of the common stock held by such shareholders.

Distributions of Previously Taxed Income

Code §961(d)(2) provides that to the extent that an amount excluded from gross income under Code §959(a) exceeds the adjusted basis of the stock in the C.F.C., the excess is treated as gain from the sale or exchange of property. Notice 2018-07 addressed a fact pattern in which a C.F.C. receives distributions from a C.F.C. with positive earnings and profits in 2017 that are attributable to previously taxed income by reason of the Subpart F inclusion under Code §965. The amount of gain recognized under Code §961(b)(2) will be reduced (but not below zero) by the Subpart F inclusion. This gain-reduction rule will extend to cover intermediate distributions within a chain of C.F.C.'s.

Tax Rate Imposed on Inclusion

Instead of prescribing a fixed tax rate on the Code §951 inclusion, Code §965 allows a deduction to be applied to net income that is calculated to achieve a specific tax rate. It is referred to as the rate equivalent percentage method. In substance, the equivalent of a partial D.R.D. is computed so that the tax imposed will equal the target rate when divided by net income before the deduction. As a result, the total deduction from the amount of the Code §951 inclusion is the amount necessary to result in a 15.5% rate of tax on accumulated earnings held in the form of cash or cash equivalents and an 8% rate of tax on all other earnings. The calculation is based on the highest rate of tax applicable to corporations in the taxable year of inclusion (*i.e.*, the last taxable year that begins before 2018) even if the U.S. Shareholder is an individual.

According to the Conference Committee Report, the use of rate equivalent percentages is intended to ensure that the rates of tax imposed on the deferred foreign income is similar for all U.S. Shareholders, regardless of the year in which Code §965 gives rise to an income inclusion. Individual U.S. Shareholders, and investors in U.S. Shareholders that are pass-thru entities, generally can elect application of corporate rates for the year of inclusion. Code §962 is the basis of the election. Under that provision, the actual cash distribution by a C.F.C. to a U.S. individual is not treated as a dividend paid from previously taxed income. Instead, it generally is treated as if the dividend is received from the hypothetical U.S. corporation entitled to claim a credit for foreign income taxes paid by the C.F.C. As a result, there are two inclusions of income for U.S. income tax purposes: the Subpart F inclusion by the hypothetical U.S. corporation and the hypothetical dividend from that U.S. corporation. This could result in a tax that is greater than the tax paid by a corporation. That would not have occurred under the House Bill, which called for a reduced tax rate on the inclusion and no tax for U.S. Shareholders that are individuals. On the other hand, even where an actual U.S. corporation is a U.S. Shareholder, the individuals who are its shareholders would be taxed when the proceeds of a Subpart

F inclusion, received as a dividend from previously taxed income, are paid to the individuals as dividends.

In addition, the increase in income that is not taxed by reason of the partial D.R.D. is treated as income exempt from tax for purposes of determining the outside basis of an interest in a partnership or an S-corporation, but not as income exempt from tax for purposes of determining the accumulated adjustments account of an S-corporation.

“The aggregate cash position of a U.S. Shareholder is the average of the sum of the shareholder’s pro rata share of the cash position of each specified foreign corporation owned.”

The foreign taxes treated as paid or accrued by a domestic corporation are limited to those taxes in proportion to the taxable portion of the Code §965 inclusion.

Determination of Cash Position

For purposes of computing the tax on the inclusion of earnings represented by cash on the balance sheet, the statute provides a broad meaning to the term “cash.” The cash position of an entity consists of all cash, net accounts receivables, and the fair market value of similarly liquid assets, specifically including personal property that is actively traded on an established financial market (other than stock in the specified foreign corporation) government securities, certificates of deposit, commercial paper, and short-term obligations. In Notice 2018-13, the I.R.S. announced that a loan that must be repaid on the demand of the lender or within one year of such demand will be treated as a short-term obligation, regardless of its stated term.

The cash position of a U.S. Shareholder in a specified foreign corporation generally does not include the cash attributable to a direct ownership interest in the partnership, unless the partnership would be a specified foreign corporation with respect to the U.S. Shareholder were the entity a foreign corporation. In broad terms, this means that the U.S. person must hold a 10% interest in the partnership.

To avoid double counting of cash assets, a U.S. Shareholder may disregard accounts receivable and short-term obligations of a specified foreign corporation if that shareholder can establish that the amounts have been taken into account already by that shareholder with respect to another specified foreign corporation.

The I.R.S. is authorized to expand the list of items that are economically equivalent to cash and to disregard transactions that have the principal purpose of reducing the aggregate foreign cash position. Specifically targeted are (i) a change in entity classification, accounting method, and taxable year, or (ii) intragroup transactions such as distributions or liquidations.

The aggregate cash position of a U.S. Shareholder is the average of the sum of the shareholder’s *pro rata* share of the cash position of each specified foreign corporation owned. Two methods are provided for determining the cash position. The method that produces the greater amount of cash must be used.

- Under the first method, the cash of such specified foreign corporation is measured as of the close of the last taxable year which begins before January 1, 2018.
- Under the second method, the cash position is measured on the last day each of the two taxable years immediately preceding November 2, 2017, and is the average of the values on those two days.

Limitations on Assessment Extended

The limitations period for assessment of tax is six years from the date on which the return reflecting the Code §951 inclusion is filed.

Installment Payments – In General

A U.S. Shareholder may elect to pay the net tax liability resulting from the Code §951 inclusion in eight installments that are back-loaded as to amounts. In each of the first five years following the income inclusion, 8% of the tax must be paid. For the sixth year, the installment payment is 15% of the net tax liability reported in 2017. In the seventh year, the installment increases to 20% of the 2017 reported tax liability, and the final 25% is paid in the eighth installment. Payments are due on the due date of each year's tax return, determined without extensions. Interest generally does not accrue on the principal balance of tax due.

The eight-year payment period can be accelerated by the tax equivalent of a default. The events that trigger acceleration are any of the following:

- A failure to pay timely any required installment
- A liquidation or sale of substantially all of the U.S. shareholder's assets (including in a bankruptcy case)
- The U.S. shareholder ceases business
- Another similar circumstance arises

The unpaid portion of all remaining installments is due on the date of the event (or, in a title 11 case or similar proceeding, the day before the petition is filed).

Installment Payments – S-Corporations

Shareholders of an S-corporation may elect to defer the start of the eight-year payout period. The deferral is elected at the shareholder level, not the level of the S-corporation. The deferral continues until the occurrence of any of the three following events:

- A change in the status of the corporation as an S-corporation
- A liquidation, sale of substantially all corporate assets, termination of the company or end of business, or similar event, including reorganization in bankruptcy
- A transfer of shares of stock in the S-corporation by the electing taxpayer, whether by sale, death, or otherwise, unless the transferee of the stock agrees with the I.R.S. to be liable for net tax liability in the same manner as the transferor[9]

Because the deferral election is made at the level of a shareholder, an S-corporation must report the Code §965 inclusion amount and the deduction that is allowed to arrive at the proper amount of tax. The election to defer the tax is due not later than

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[9] Note that partial transfers trigger the end of deferral for the portion of stock sold, and the S-corporation still has the reporting obligation.

the due date for the return of the S-corporation for its last taxable year that begins before January 1, 2018.

Payment Period for R.E.I.T.'s

A R.E.I.T. is an entity that, when properly set up and operated, allows individuals to (i) invest in real property, (ii) benefit from a diversified portfolio, (iii) have the investment managed professionally, and (iv) have income and gains taxed only at the investor level to the extent dividends are distributed. In essence, it is the equivalent of a mutual fund for real estate investments.

Like an S-corporation, a R.E.I.T. computes income but is not a taxpayer in most instances. Consequently, if a R.E.I.T. is a 10% investor in a specified foreign corporation or is a U.S. Shareholder of a C.F.C., it must determine its *pro rata* share of the increase in Subpart F income in accordance with the rules described above for other taxpayers. The Subpart F inclusion is taken into account for purposes of determining the R.E.I.T.'s taxable income under Code §857(b).

To prevent a R.E.I.T. from being exposed to U.S. tax if it fails to distribute the Subpart F inclusion to shareholders, a R.E.I.T. may elect to take amounts into income over a period of eight years. In each of those years, it may claim a proportional amount of the partial D.R.D. based on the percentage of Subpart F income recognized in that year. Beyond this deferred recognition provision, neither the R.E.I.T. nor the recipient of the distribution may elect to use the installment method to pay the tax. Should a R.E.I.T. be liquidated, cease to operate its business, or distribute substantially all its assets, the balance of the required inclusion not yet taken into income is accelerated and required to be included as gross income as of the day before the event.

SALES OR TRANSFERS INVOLVING SPECIFIED 10%-OWNED FOREIGN CORPORATIONS

Prior Law

As mentioned above, domestic corporations generally were taxed under a worldwide tax system, so that both U.S. and foreign-source income were taxed. Where a U.S. corporation was a U.S. Shareholder of a C.F.C. with Subpart F income, the U.S. corporation was required to include and pay tax on its *pro rata* share of Subpart F income, even if not distributed. Once a C.F.C.'s earnings were taxed under Subpart F in the hands of its U.S. Shareholder, those earnings were not again taxed when actually distributed in the form of a dividend.[10] Generally, a Subpart F inclusion in a U.S. tax return resulted in an increase in the U.S. Shareholder's basis. Subsequent actual distributions were treated as previously taxed income to the extent of previously taxed earnings and profits. This treatment applied to dividends distributed directly to a U.S. Shareholder and to upper-tier C.F.C.'s as dividends made their way up a corporate chain. In the absence of unusual circumstances, the actual distribution closed the loop beginning with the income inclusion, then the basis increase in shares held, and actual cash payment. Upon the receipt of the dividend from previously taxed income, no additional income was realized by the U.S. Shareholder and its basis in the shares of C.F.C. stock is reduced.

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[10] Code §959(a)(1).

When the shares of a C.F.C. were sold, a portion of the value of the shares may have been attributable to retained earnings within the company. Code §1248 recharacterized gains on sale of C.F.C. stock as dividend income to the extent of previously untaxed earnings and profits attributable to the stock sold. This treatment ensured that deferred earnings were not converted into capital gains, which were taxed at more favorable rates in certain circumstances at different points in time.

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Sales of Stock by U.S. Persons

Any amount received in the case of the sale or exchange by a domestic corporation of a stock in a foreign corporation held for the requisite holding period, is treated as a dividend for purposes of the D.R.D., if it is treated as a dividend under Code §1248.

Accompanying Reduction in Basis When Determining Loss from Stock Sale

Solely for the purpose of determining a loss from the sale of shares in a specified foreign corporation, a domestic corporate shareholder's adjusted basis in the stock of a specified 10%-owned foreign corporation is reduced by an amount equal to the portion of the D.R.D. received with respect to such stock. The reduction in basis is disregarded to the extent the basis in the specified 10%-owned foreign corporation's stock was previously reduced pursuant to Code §1059, relating to basis reduction resulting from the distribution of an extraordinary dividend.

Sale by a C.F.C. of a Lower-Tier C.F.C.

Comparable treatment is provided for sales by C.F.C.'s in lower-tier C.F.C.'s.[11] Thus, if for any taxable year of a C.F.C., an amount is treated as a dividend under Code §964(e)(1) because of a sale or exchange by the C.F.C. of stock in another foreign corporation held for a year or more, the following treatment is provided:

- The foreign-source portion of the dividend is treated as Subpart F income of the selling C.F.C. for purposes of Code §951(a)(1)(A).
- A U.S. Shareholder with respect to the selling C.F.C. includes in gross income for the taxable year of the shareholder an amount equal to the shareholder's *pro rata* share[12] of the foregoing amount treated as Subpart F income.
- The deduction under Code §245A(a) is allowable to the U.S. Shareholder with respect to the Subpart F income included in gross income in the same manner as if the Subpart F income were a dividend received by the shareholder from the selling C.F.C.

Comment

For U.S. individuals that have invested in a foreign corporation that does not qualify for treaty benefits under an income tax treaty with the U.S., consideration should be given to creating a U.S. corporation to hold the shares of that foreign corporation. The D.R.D. does not contain the any requirement under which the corporation paying the dividend must qualify for benefits under a tax treaty with the U.S.

[11] Code §964(e)(4).

[12] Determined in the same manner as under Code §951(a)(2).

Consequently, the U.S. corporation may claim the D.R.D., and the dividend to a U.S. individual is a qualified dividend.

ACTIVE TRADE OR BUSINESS EXCEPTION REPEALED FOR ASSET TRANSFERS TO FOREIGN CORPORATIONS

Prior Law

Code §367(a)(1) provided that transfers of appreciated property by a U.S. person to a foreign corporation in connection with any exchange described in Code §§332 (subsidiary liquidation into a parent corporation), 351 (transfer to a controlled corporation, generally upon incorporation), 354 (exchange of shares incident to a reorganization), 355 (corporate spinoff of a business to shareholders), or 361 (transfer of assets incident to a reorganization) was currently taxable to the transferor. Several exceptions were provided to the mandatory recognition. Among them, Code §367(a)(3)(A) provided that, subject to any claw-back provision in the I.R.S. regulations, gain would not be recognized in connection with a transfer of property to a foreign corporation for use in the active conduct of a trade or business conducted outside of the U.S.

T.C.J.A.

The T.C.J.A. amended Code §367(a) by eliminating the exception for transfers of property to a foreign corporation that will be used by that corporation in the active conduct of a trade or business. Transfers of those assets are now subject to recognition of inherent gain even if used in a trade of business by the foreign corporation.

The provision is effective for transfers made after December 31, 2017.

INCORPORATION OF FOREIGN BRANCH WITH ACCUMULATED LOSSES

Prior Law

Under Code §367(a)(3)(C) of prior law, a domestic corporation that transferred substantially all of the assets of a foreign branch to a specified 10%-owned foreign corporation with respect to which it was a U.S. Shareholder after the transfer was required to include in gross income an amount equal to the transferred loss amount, subject to certain limitations. The transferred loss amount was

- the amount by which accumulated losses incurred by the foreign branch for which a deduction was allowed to the domestic corporation exceeded
- the sum of certain taxable income earned by the foreign branch.

The provision focused on the losses of a specific branch. If the U.S. corporation operated several branches that reported a net loss in the aggregate, the overall foreign loss recapture rules were applied prior to the branch loss recapture rules. Consequently, if gain were recognized by reason of the overall foreign loss recapture rules, that gain was added to the taxable income of the branch for purposes of the branch recapture rules.

> ***"Foreign tax credit planning strategies designed to maximize credits while minimizing income have come to an end."***

For purposes of the branch loss recapture rules, only taxable income of the foreign branch in taxable years after a loss was first incurred was taken into account. The transferred loss amount was reduced by the amount of gain recognized by the taxpayer on account of the transfer. Gross income recognized on the transfer was treated as derived from U.S. sources so that U.S. tax could not be reduced by a foreign tax credit.

T.C.J.A.

As mentioned above, the T.C.J.A. repealed the general exemption from tax for transfers to a foreign corporation of certain assets that would be used in the active conduct of a trade or business abroad. The exemption was granted under Code §367(a)(3). When that Code section was repealed, the gain recognition provision for transfers of substantially all of the assets of a foreign branch having accumulated net losses was also repealed.

The T.C.J.A. adopts Code §367(a)(3)(C) of prior law as new Code §91. The amount of gain taken into account under Code §91 is reduced by the amount of gain recognized under Code §367(a)(3)(C) of prior law with respect to losses incurred before January 1, 2018. This allows the prior law provision to control through the end of 2017 and Code §91 to apply once the old law is no longer effective.

CONCLUSION

The new territorial tax system may require companies to reexamine their business structures with regard to international operations. In addition, the transitional rule regarding mandatory repatriation of post-1986 earnings and profits of foreign subsidiaries will affect all U.S. corporations or U.S. individuals that own 10% or more of the voting shares in a foreign corporation, directly or through a tax transparent entity. Foreign tax credit planning strategies designed to maximize credits while minimizing income have come to an end. With the elimination of Code §960(c), which addresses the foreign tax credit that may be claimed when a C.F.C. makes a taxable investment in U.S. property, perhaps the foreign tax credit can be computed in a more straightforward way.[13]

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[13] In 2010, Code §960(c) was adopted to prevent U.S.-based multinational groups from increasing foreign tax credits by making a taxable investment in U.S. property, which would occur if a loan were made to a related party in the U.S. Under the "hopscotch" rule of Code §956, the income flowed directly from the C.F.C. investor to the U.S. Shareholder. The tax credit for an inclusion under Code §956 could be greater than the available credit from an actual distribution of a similar amount up a chain of corporations. As such distributions no longer generate taxable income or creditable taxes, there apparently is no reason for the concept of Code §960 to outlive its actual presence in U.S. tax law.

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