A FOREIGN LAWYER'S GUIDE TO U.S. INTERNATIONAL TAX LAW

PART II: U.S. TAX REFORM

Stanley C. Ruchelman

Fanny Karaman

Part II: U.S. Tax Reform

I. Recap of Core Concepts
II. Dividends Received Deduction
III. G.I.L.T.I.
IV. F.D.I.I.
V. B.E.A.T.
VI. Q.B.I.
VII. Hybrid Payments

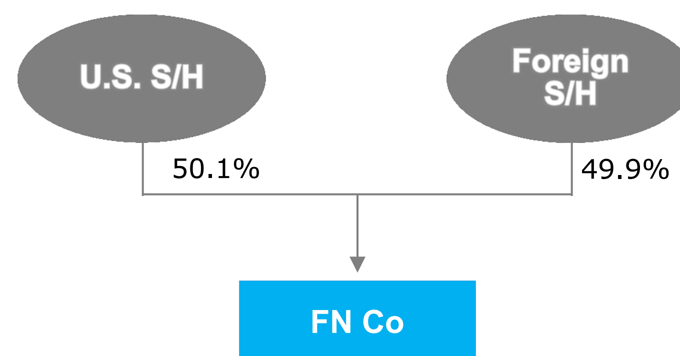
I – RECAP OF CORE CONCEPTS

Recap of Core Concepts

- Corporate Status Under Entity Classification Rules:
  - A non-U.S. entity that is
    - A *per se* corporation or
    - Provides limited liability to all owners
  - A non-U.S. corporation may be subject to C.F.C. and P.F.I.C. regimes under pre-T.C.J.A. tax law
  - In the absence of a tax treaty with hybrid entity rule, foreign treatment of entity is not relevant

Recap of Core Concepts

- C.F.C. =
  - Non-U.S. corporation +
  - By vote or value,
    - 10% U.S. shareholders ("U.S. S/H's") +
    - More than 50% U.S. S/H's
  - Ownership may be direct, indirect, and constructive (from another person)
  - Major recent issue – C.F.C. status because of unrelated U.S. investment by a non-U.S. owner of a non-U.S. company



Recap of Core Concepts

- Consequences of C.F.C. status:
  - Subpart F income inclusion at the U.S. S/H level for
    - Foreign Personal Holding Company
    - Foreign Base Company Sales Income
    - Foreign Base Company Services Income
  - Actual Distribution not required
  - Previously taxed income rules apply to actual dividend
  - No indirect F.T.C. for individual U.S. S/H in the absence of a Code §962 election to be treated as a U.S. corporation for Subpart F Income

Recap of Core Concepts

- P.F.I.C.:
  - Non-U.S. corporation +
  - U.S. person is not a U.S. S/H
  - Either:
    - Foreign Personal Holding Company Income items comprise 75% of gross income, or
    - The average adjusted basis in assets that produce Foreign Personal Holding Company Income comprises 50% of the average adjusted basis in all assets

Recap of Core Concepts

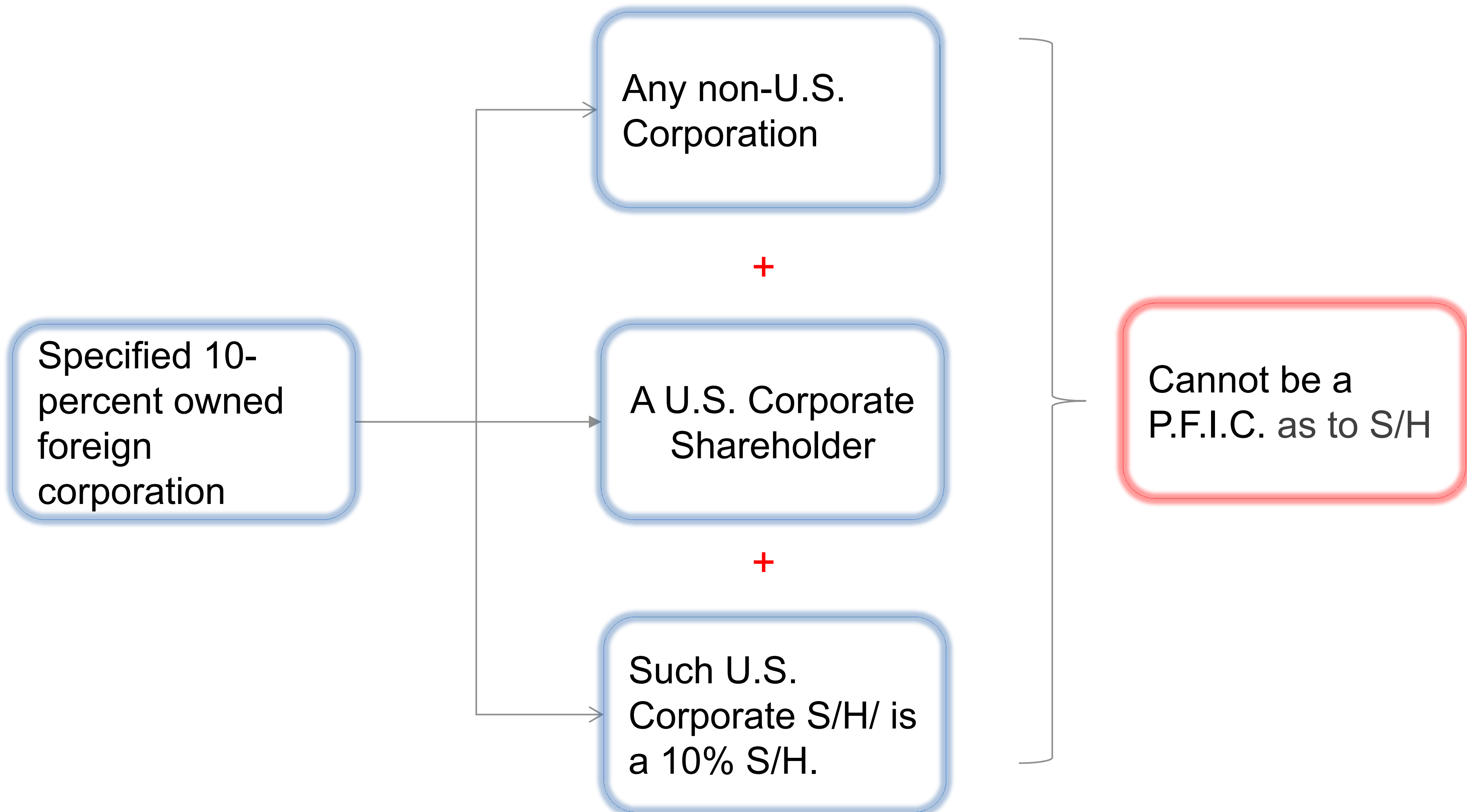
- Consequence of P.F.I.C. status:
  - Tax is deferred until excess distribution is received or P.F.I.C. shares are disposed, each of which trigger P.F.I.C. taxation
  - At triggering event:
    - Excess distribution or gain is allocated to each day in entire holding period +
    - For each prior P.F.I.C. year in throwback period, taxed at highest income tax rate + late payment interest as if income taxes were paid late for each such year
    - For prior year non-P.F.I.C. year in throwback period, taxed as ordinary income
  - Unexpectedly negative treatment for arriving resident holding C.I.V. or owning continental European life insurance policy

II – DIVIDENDS RECEIVED DEDUCTION

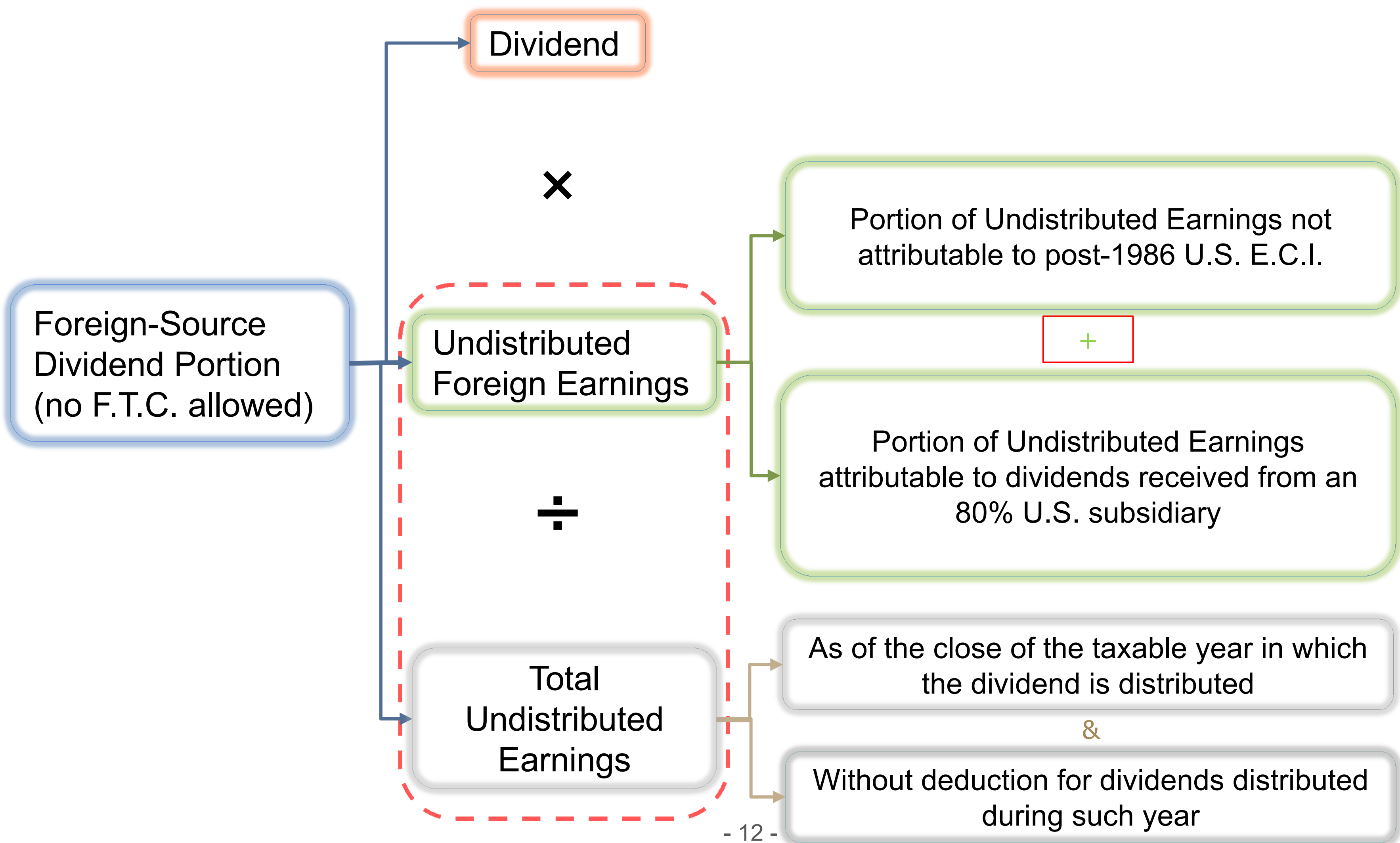
II - Dividend Received Deduction

- New Code §245A;
- Allows for a dividend received deduction (“D.R.D.”) if:
  - A “specified 10-percent owned foreign corporation” distributes a dividend, not a P.F.I.C.
  - A U.S. corporation, which is a U.S. S/H, receives a dividend
  - Dividend must be “foreign source income”
    - Dividend is pro-rated if the foreign corporation has U.S. source income
    - U.S. portion has its own D.R.D. under Code §245
  - Shares must be held for specified period
  - The taxpayer must own ≥10% of foreign corporation at all times during the specified period

II - Dividend Received Deduction

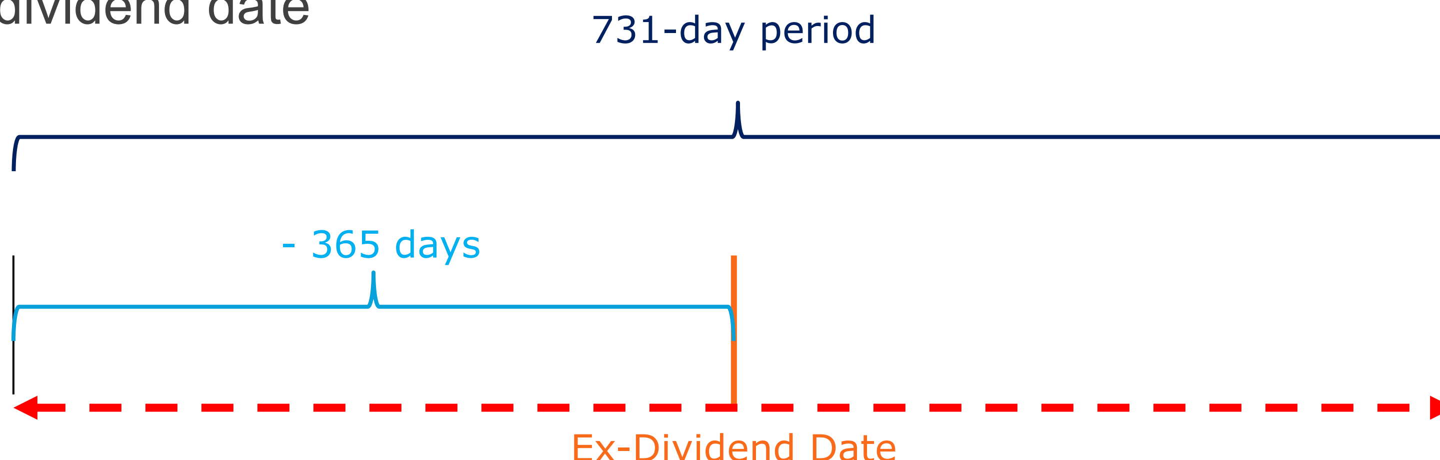


II - Dividend Received Deduction



II - Dividend Received Deduction

- Holding Period Requirement
  - Code §246(c)(5)
  - 1-year holding period requirement: >365 days during the 731-day period that begins on the date that is 365 days before the ex-dividend date

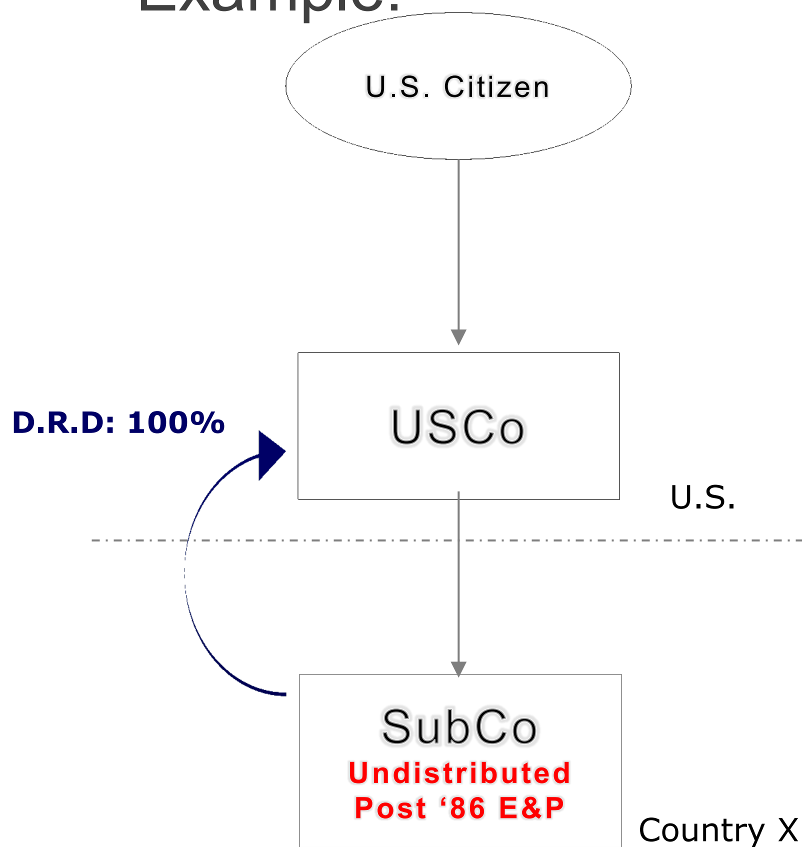


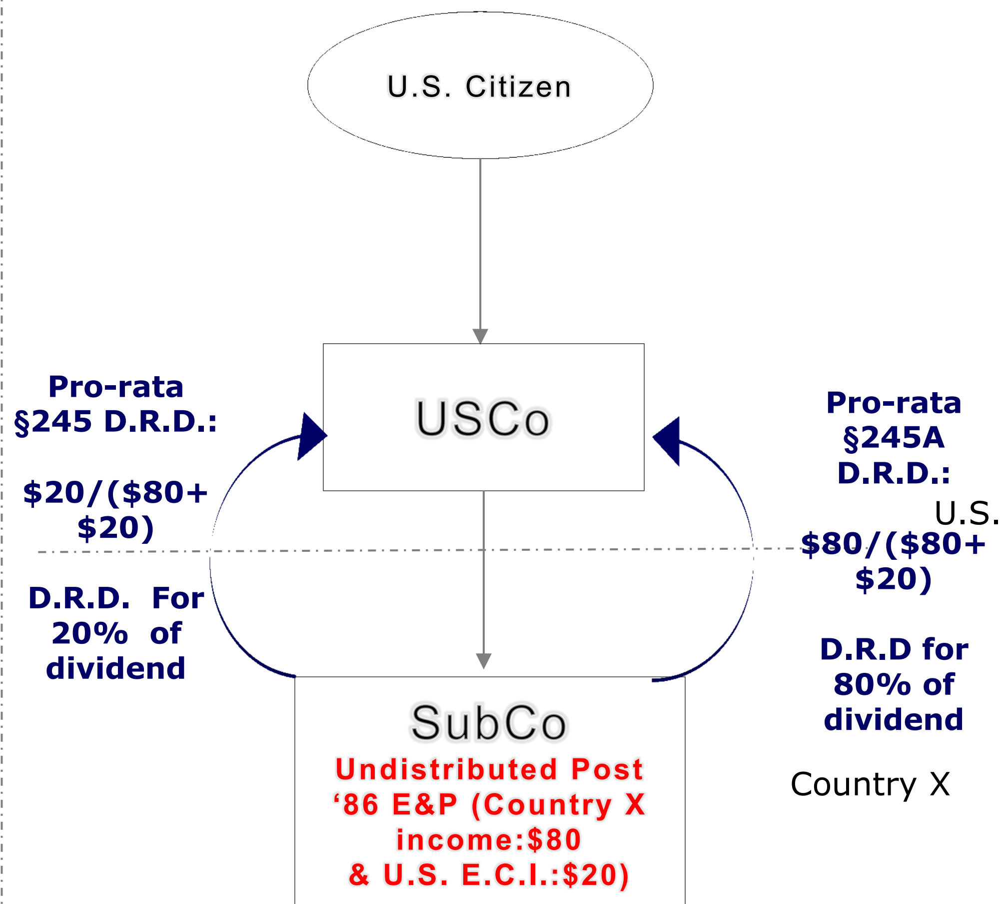
II - Dividend Received Deduction

- D.R.D. applies to:
  - C.F.C. receiving a dividend from a ≥10% owned corporation
  - Gain from the sale of shares in a lower-tier subsidiary to the extent converted into dividend income under Code §1248
- Hybrid Dividends
  - A hybrid dividend exists when the distributing C.F.C. receives a deduction or other tax benefit imposed by any foreign country
    - Payment under Luxembourg C.P.E.C.
    - Possibly dividend in Canada from refundable dividend tax on hand ("RDTOH") account
    - Possibly the foreign equivalent of dividends received deduction for payor of dividends to avoid accumulated earnings tax
  - No D.R.D. for hybrid dividends received from a C.F.C.
  - If a C.F.C. receives a hybrid dividend from another C.F.C.:
    - No D.R.D.
    - Dividend is Subpart F income
    - No F.T.C.

II - Dividend Received Deduction

- Example:





III – G.I.L.T.I.

III - G.I.L.T.I.

- Code §951A
- G.I.L.T.I. = "Global Intangible Low-Taxed Income"
- Affected Taxpayers:
  - U.S. S/H of C.F.C.'s
- G.I.L.T.I. computation begins with "Tested Income" which is gross income of a C.F.C. reduced by certain items including:
  - E.C.I. taxed in the U.S.
  - Subpart F income
  - Dividends from related party
  - Subpart F Income taxed a rate >18.9%, which is 90% of U.S. rate
  - Deductions, including taxes, property allocable to Tested Income and not E.C.I., Subpart F Income, and related party dividends
- Tested Loss is the excess of deductions over Tested Income

III - G.I.L.T.I.

- In a U.S. tax return of a U.S. S/H, G.I.L.T.I. is the excess of:
  - Its aggregate net tested income of all C.F.C.'s, over
  - A routine return of 10% on the U.S. S./H.'s aggregate pro-rata share of the bases in depreciable tangible property of all C.F.C.'s
- G.I.L.T.I. is included in gross income in same manner as Subpart F (basis, P.T.I., etc.) and is allocated among shareholders in proportion to their share of the G.I.L.T.I.

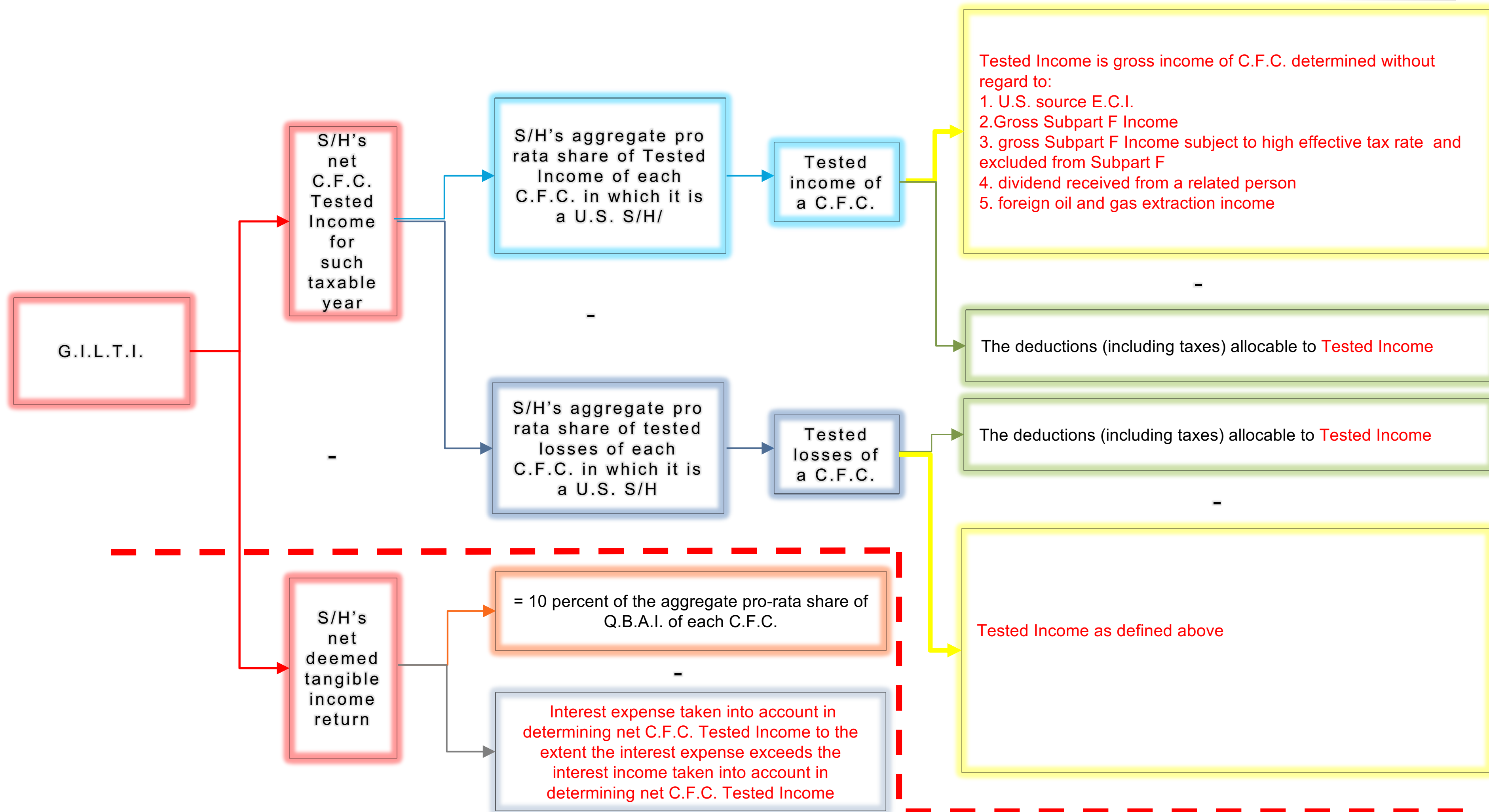
III - G.I.L.T.I.

- Consequence to U.S. S/H's:
  - G.I.L.T.I. is the excess of:
    - A S./H.'s aggregate net tested income of all C.F.C.'s, over
    - A routine return of 10% on the U.S. S./H.'s aggregate pro-rata share of the depreciable tangible property of all C.F.C.'s
  - If U.S./S.H. is a corporation, it is entitled to a 50% deduction (Code §250(a)(1)) → effective tax rate of 10.5%.
  - F.T.C. only for corporate U.S. S/H's (80% of F.T.C.)
  - A separate F.T.C. limitation exists for G.I.L.T.I.
  - No carryover of 80% of F.T.C. in excess of F.T.C. limitation

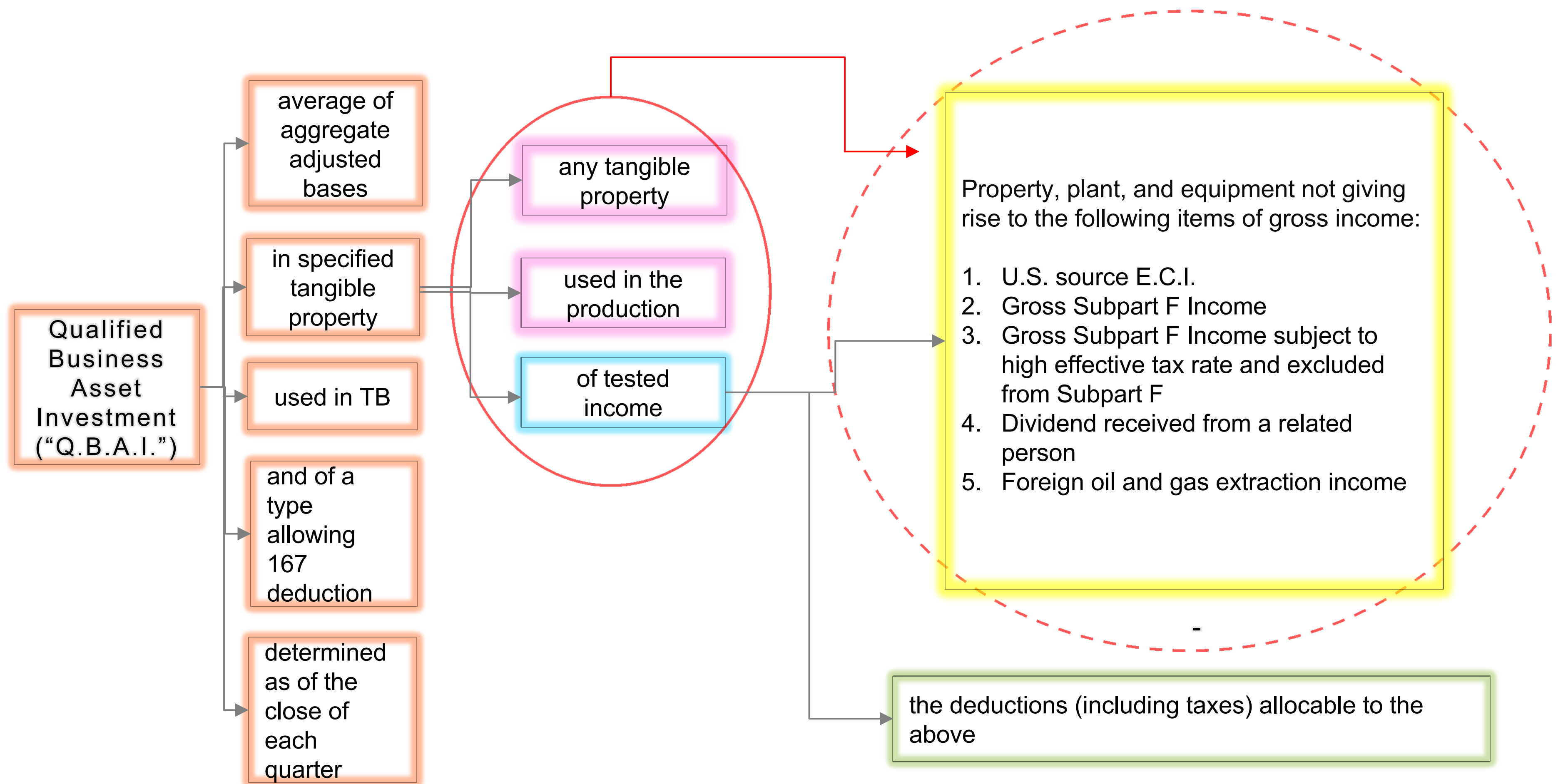
III - G.I.L.T.I.

- Consequence to U.S. S/H's:
  - Special treatment for individuals making a Code §962 election
    - For the inclusion, the individual is treated as a corporation
      - Indirect F.T.C. allowed for 80% of foreign taxes
      - 50% deduction should be allowed, subject to I.R.S. guidance
    - For an actual dividend
      - The character of a foreign dividend remains
      - Net U.S. corporate tax paid on inclusion is treated as P.T.I.
      - Withholding tax on actual dividend is creditable

III - G.I.L.T.I.



III - G.I.L.T.I.



IV – F.D.I.I.

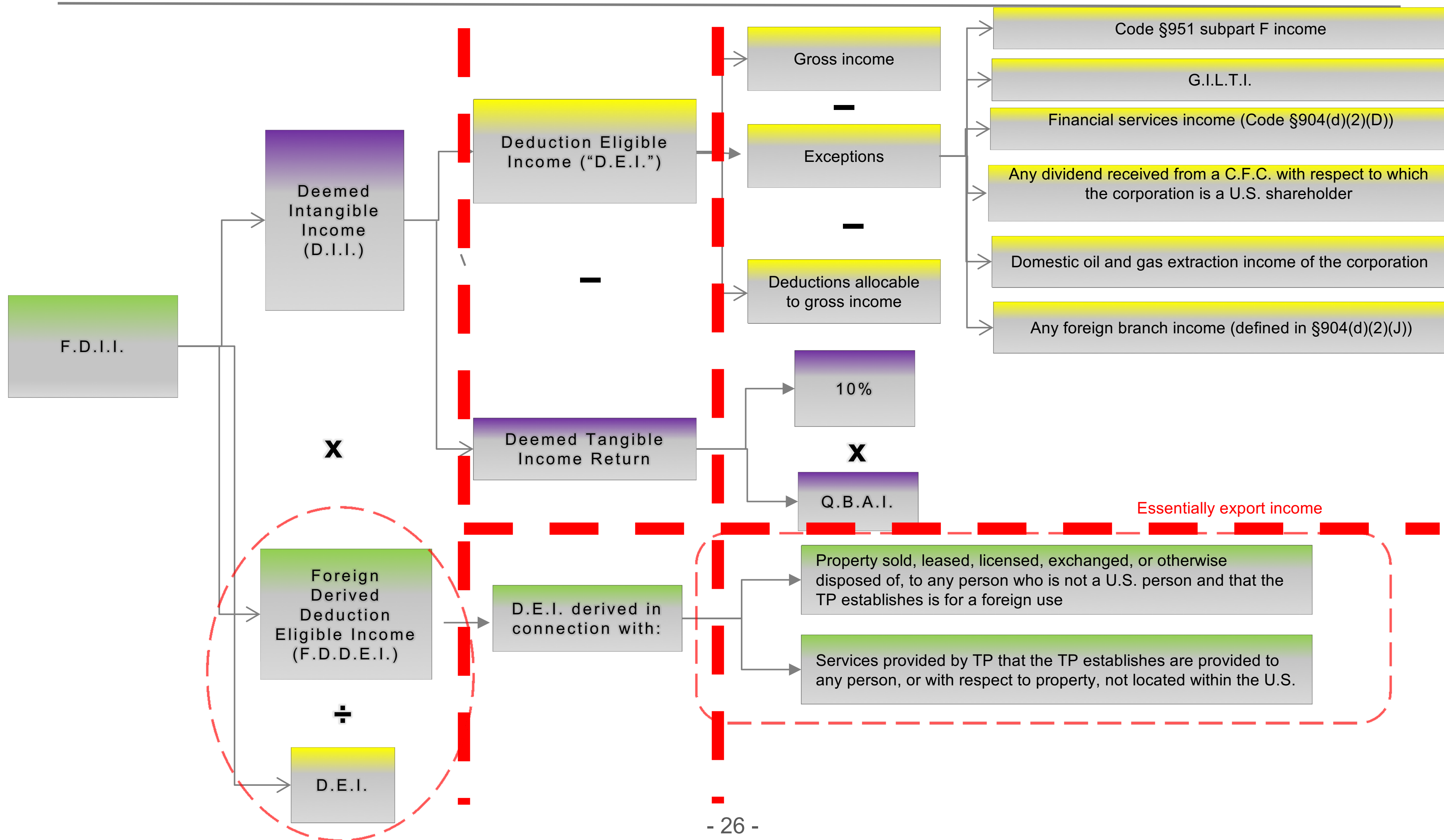
IV - F.D.I.I.

- The foreign-derived intangible income ("F.D.I.I.") is a deduction for U.S. corporations to expand sales of products and services abroad
  - It applies only to C-corporations operating in the U.S.
  - It does not apply to income of foreign branches
  - It does not apply to individuals who operate a business through an L.L.C.
- F.D.I.I. is determined under formula
  - Starting point is deemed intangible income ("D.I.I.")
  - F.D.I.I. is the portion of D.I.I. determined by a ratio
    - The numerator is foreign-derived deduction eligible income ("F.D.D.E.I.")
    - The denominator is deduction eligible income ("D.E.I.")
- D.I.I. means all D.E.I. in excess of "deemed tangible income" return ("D.T.I.") of 10% of the average bases in depreciable tangible property

IV - F.D.I.I.

- D.E.I. equals gross income of a U.S. corporation in excess of
  - Income connected with operations conducted outside the U.S. directly or through a C.F.C
  - Allocable deductions (including taxes)
- F.D.I.I. means D.E.I. derived in connection with property that is sold by the taxpayer to any person who is not a U.S. person.
  - The sale of property must be made for use, consumption, or disposition outside the U.S. by the purchaser.
  - The furnishing of services must be provided to any person not located in the U.S. or provided with respect to property not located in the U.S.

IV - F.D.I.I.



V – B.E.A.T.

V - B.E.A.T.

- Applicable Taxpayer
  - C-Corporation other than R.I.C. or R.E.I.T.
  - Average annual gross receipts (over 3 year period) ≥ $500 million
  - Base erosion percentage of at least 3% (2% for certain financials)
  - Aggregation rules apply
- Base Eroding Payment
  - Certain Deductible payments
  - To related foreign person
- B.E.A.T. tax liability (10% of MTI) exceeds regular tax liability (without the benefit of certain credits)

V - B.E.A.T.

- The Base Erosion and Anti-abuse Tax (“B.E.A.T.” Regime)
  - A 10% alternative minimum tax (5% in 2018)
  - For large corporations
  - That significantly reduce U.S. tax liability
  - Through the use of cross-border payments to related persons
- Applicable Taxpayer
  - C-Corporation
  - Average annual gross receipts (over 3-year period) > $500 million
  - If the applicable taxpayer is a foreign corporation, only gross receipts that produce E.C.I. are taken into account
  - Base erosion payments to related parties amount to at least 3% of total deductions (2% for certain banks and securities dealers)
  - Aggregation rules apply treat corporations that would be considered to be a single employer under Work Opportunity Credit rules of Code §52

V - B.E.A.T.

- B.E.A.T. Regime Computations
  - An applicable taxpayer pay a tax equal to the "base erosion minimum tax amount"
    - 10% of the taxpayer's "modified taxable income" is compared with the regular tax liability (5% in 2018)
    - In determining regular tax liability for a company claiming business tax credits under Code §38, the following credits are reversed, thereby reducing the disparity between modified taxable income and regular tax liability:
      - The R&D credit allowed under Code §41
      - 80% of other credits listed in Code §38, capped at the base erosion minimum tax amount determined without this adjustment

V - B.E.A.T.

- Example
  - U.S. Sub is owned by Non-U.S. Multinational Group
  - U.S. Sub reports taxable income of $100,000 after taking into account $200,000 of base erosion payments to related parties outside the U.S.
  - U.S. regular tax on income of $100,000 before credits is $21,000 ($100K x 21%)
  - U.S. Sub claims R&D credit of $2,000, renewable electricity production credits of $1,000, and $1,500 of other tax credits for a total of $4,500 of total credits
  - U.S. Sub has a regular tax liability $16,500 prior to applying the B.E.A.T. Regime
  - Under the B.E.A.T. Regime, U.S. Sub adjustments regular tax to $19,300 as follow:
    - Tax after credit is $16,500.
    - To that amount, $2,000 is added back for the R&D credit, increasing regular tax to $18,500.
    - To that amount, $800 is added back to income representing 80% of $1,000 renewable energy credits, increasing regular tax to $19,300.
  - Modified taxable income is $300,000 ($100,000 regular tax income + $200,000 of base erosion payments)
  - Total tax liability under B.E.A.T. Regime is $30,000 ($300,000 x 10%)
  - Excess tax attributable to F.C.U.'s is $10,700

V - B.E.A.T.

- Excludes COGS (except for newly inverted companies) & other payments that reduce gross receipts, such as selling expenses
  - Query: are manufacturing royalties that are embedded in COGS excluded?
- Includes
  - Interest expense coordinated with Code §163(j) by allocating limitation to unrelated payments first; this increases adjusted taxable income by allowing more related party interest to be caught by B.E.A.T. Regime
  - Payments for the acquisition of property that gives rise to a depreciation and amortization deduction
  - Payments for services (with exception for services eligible for the Service Cost Method)
  - Premiums or other consideration for any reinsurance payments taken into account under sections 803(a)(1)(B) or 832(b)(4)(A)

V - B.E.A.T.

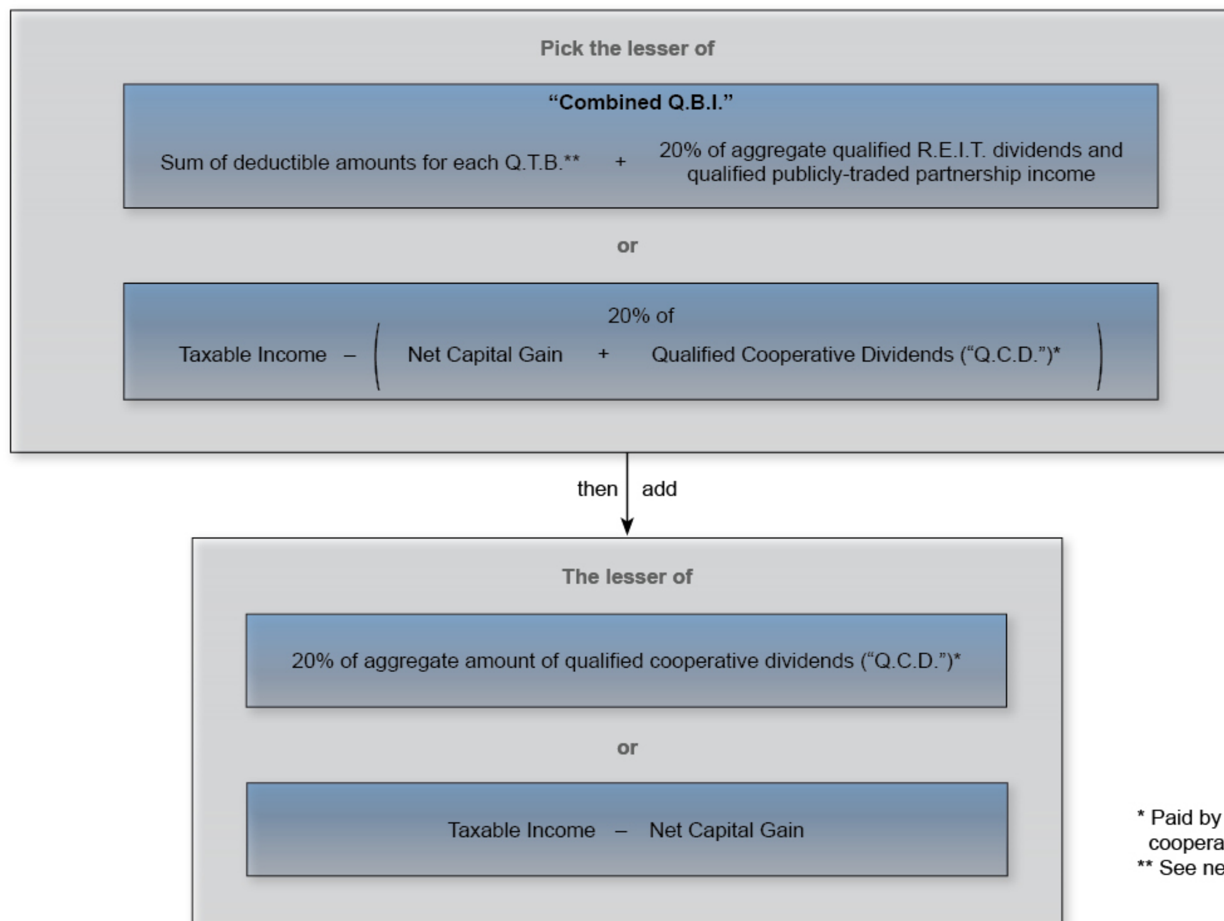
- Identifying foreign entities that are related parties
  - It is treated as owning shares in the U.S. corporation that represent at least 25% of the voting power or the value of all shares issued and outstanding.
    - Rules of constructive ownership are applied, using 10% ownership threshold for attributing shares of stock in one corporation, owned by a second corporation, to the shareholders of the second corporation
  - It is related, under principles of Code §267(b) or Code §707(b)(1), to the corporation or to a 25% foreign owner of the corporation
  - It is treated as related to the taxpayer under the arm's length transfer pricing principles of U.S tax law, meaning that one party controls the other or they are both under common control, no matter how exercised.

VI – Q.B.I.

VI – Q.B.I.

- Q.B.I. = “Qualified Business Income”
- Taxpayers other than C-corporations may be entitled to the Q.B.I. deduction (generally referred to as a “20% deduction”)
- Applies to U.S. and non-U.S. Taxpayers – the income must be U.S. source
- The following items of income may give rise to the deduction:
  - Q.B.I.
  - Qualified publicly traded partnership income
  - Qualified R.E.I.T. dividends
  - Qualified cooperative dividends

VI – Q.B.I.

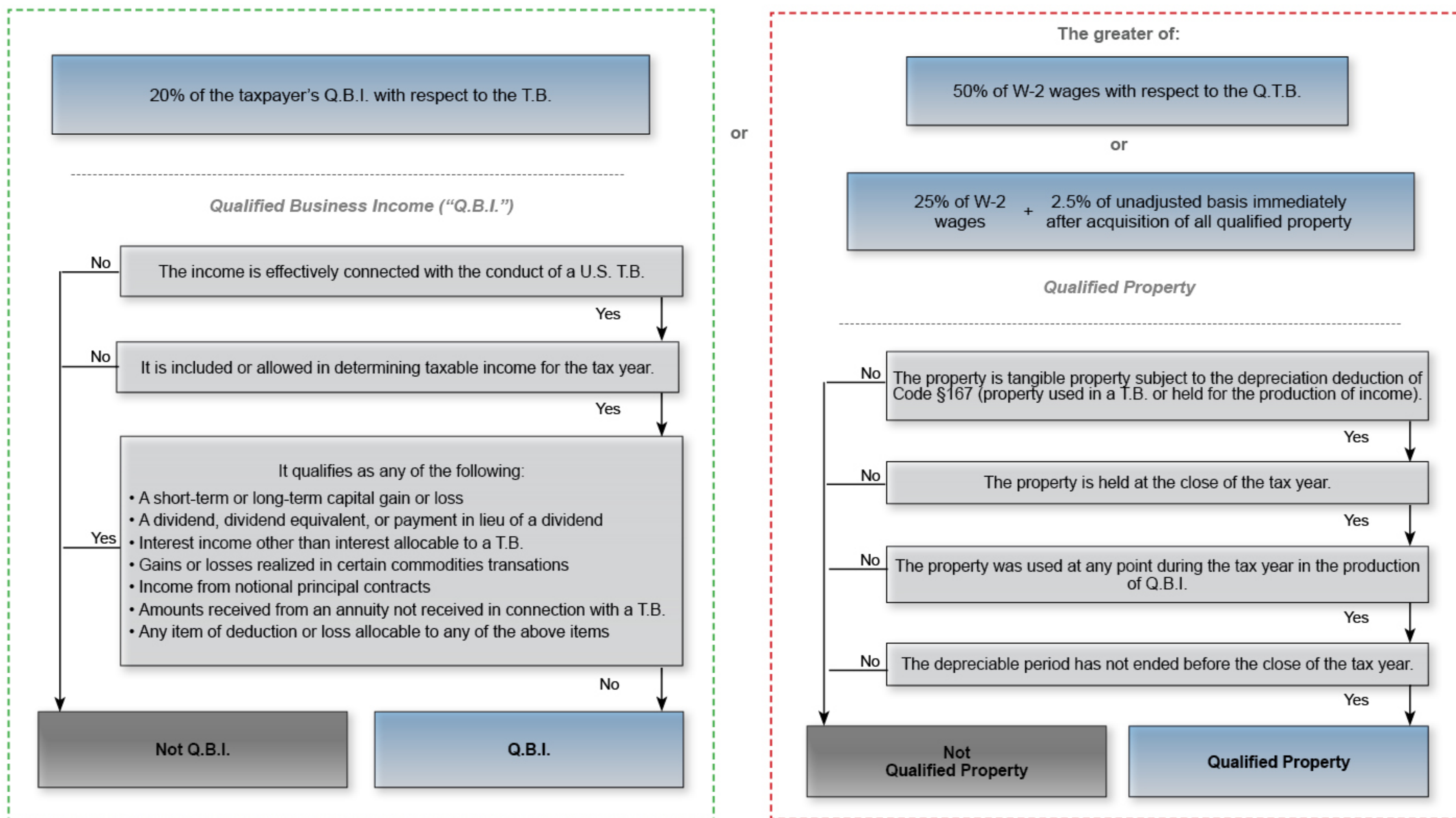


* Paid by certain tax exempt entities & cooperatives under subchapter T
** See next diagram

VI – Q.B.I.

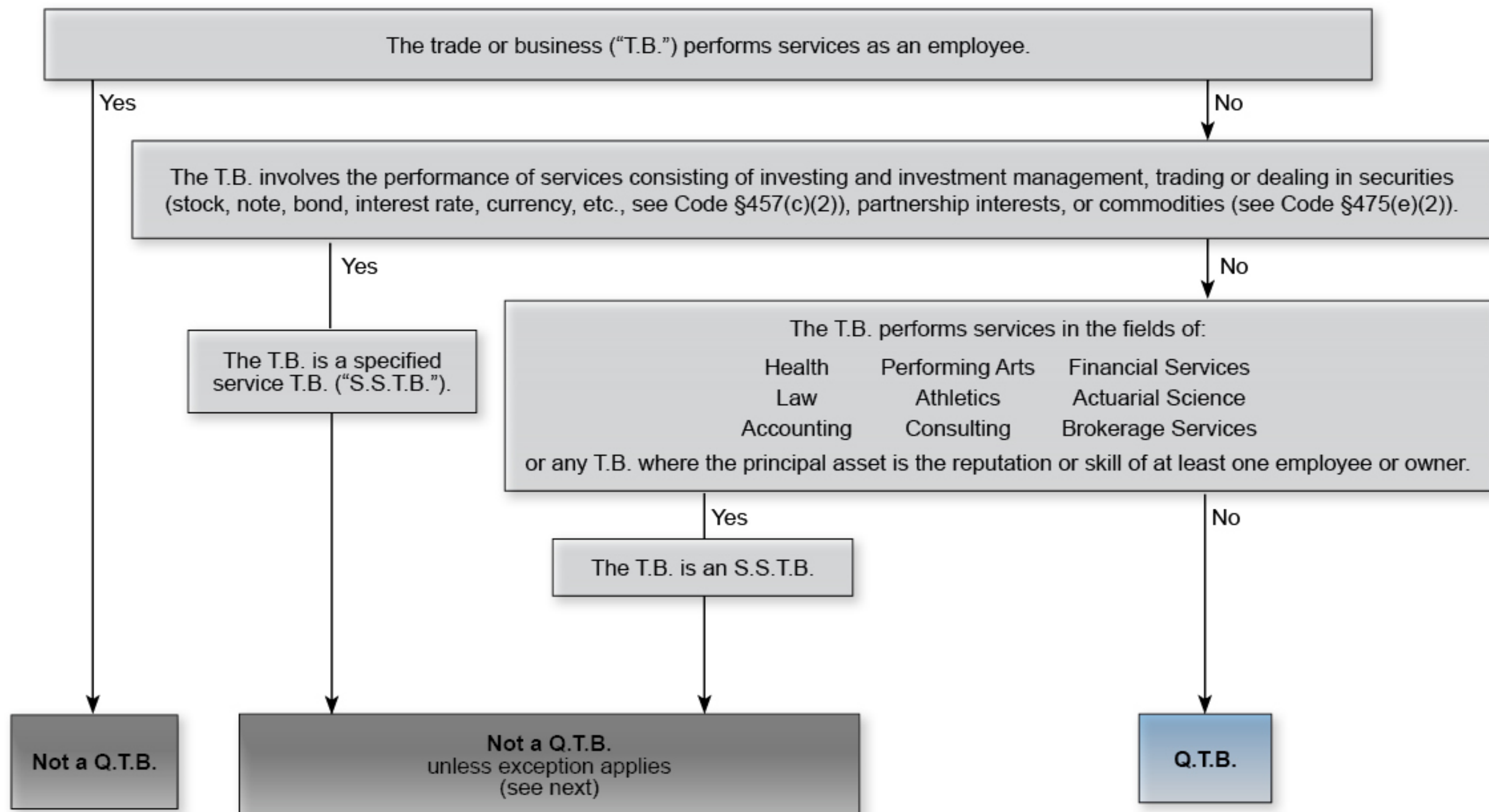
DEDUCTIBLE AMOUNT FOR EACH Q.T.B.

The deductible amount is the lesser of:



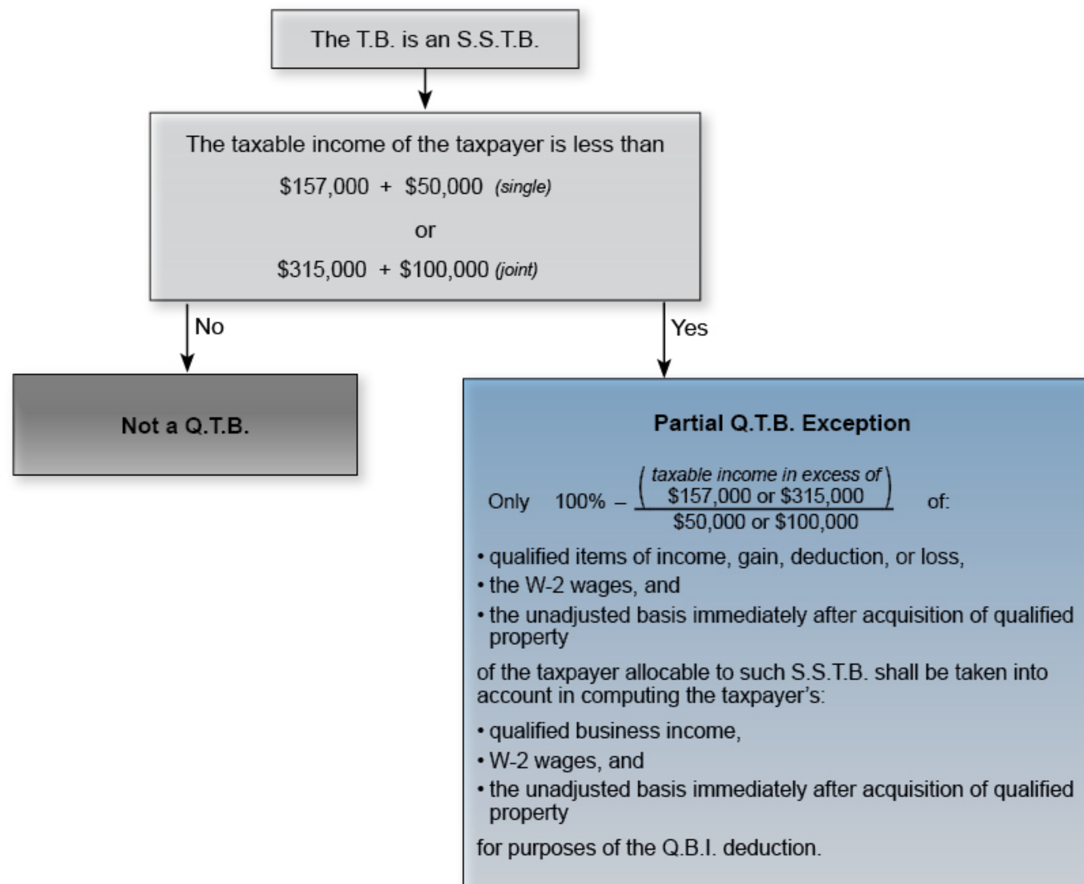
VI – Q.B.I.

QUALIFIED TRADE OR BUSINESS ("Q.T.B.")



VI – Q.B.I.

Q.T.B. EXCEPTION FOR CERTAIN S.S.T.B.'S



VII – HYBRID PAYMENTS

Hybrid Payments

- Code §267A – deduction disallowed for certain hybrid payments made from U.S.
  - Disallows deduction for Disqualified Related Party Amount
    - Paid or Accrued pursuant to a hybrid transaction, or
    - Paid or accrued by, or to, a hybrid entity
  - "Disqualified Related Party Amount":
    - Interest or royalty paid or accrued to a related party if:
      - Not included in income of related party, or
      - Related party can deduct amount
      - Exception: subpart F inclusion in the hands of a U.S. shareholder under Code §951(a)

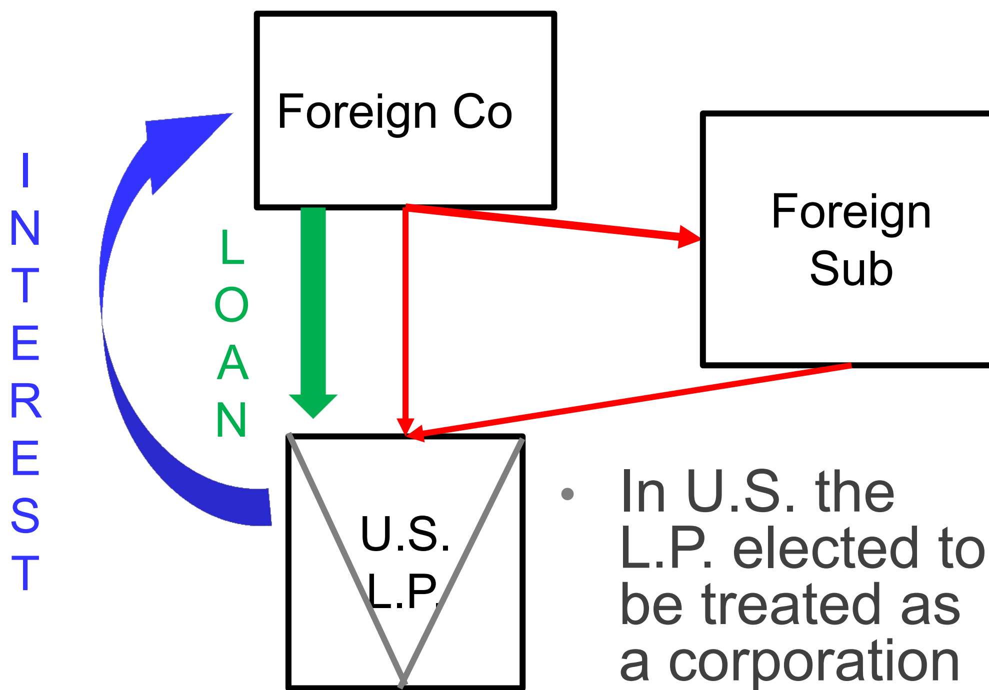
Hybrid Payments

- Code §267A
  - "Related Party":
    - An individual, corporation, trust, or estate which controls (or is controlled by) the payor, or
    - A corporation, partnership, trust, or estate which is controlled by the same person/persons which control the payor
    - "Control""
      - Corporation: Direct or indirect ownership of more than 50% (vote or value)
      - Partnership, trust, estate: Direct or indirect ownership of more than 50% by value of beneficial interest therein
    - Code §958 attribution rules apply

Hybrid Payments

- Code §267A
  - Hybrid Transaction:
    - Payment of interest or royalty from a U.S. person, but the receipt of payment is not taxable in foreign country or the recipient is entitled to a deduction
  - Hybrid entity:
    - Treated as fiscally transparent in the U.S. but not for purposes of foreign country, or
    - Treated as fiscally transparent in foreign country but not in the U.S.
    - Proposed Regs to be issued by year end with final Regs. by June 2019

Hybrid Payments



- In U.S. the L.P. elected to be treated as a corporation
- Interest is a hybrid payment

- Foreign Co and Foreign Sub formed in Country C
- In Country A, U.S.L.P. is treated as a partnership
- Under Country C tax law, partners cannot do business with themselves
- Transactions between partners and partnership are eliminated

Important Notice

This presentation is not intended to be legal advice. Reading these materials does not create an attorney-client relationship. The outcome of each case stands on its own merits.