U.S. Tax Reform Update

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U.S. Transition Tax

IRC Section 965

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Tax Cuts and Jobs Act 2017 (TCJA)

- **U.S. Internal Revenue Code (IRC), Section 965** - Treatment of Deferred Foreign Income Upon Transition to Participatory Exemption System

- Past: **Deferred Foreign Income**
- Present: **Transition/Repatriation**
- Future: **Participatory Exemption System**

- **Deferred Foreign Income**
  - U.S. Shareholder
  - Deferred Foreign Income Corporation
    - Accumulated Post-1986 Deferred Foreign Income
- **Transition/Repatriation**
  - Mandatory Income Inclusion
  - Participation Exemption – reduces inclusion amount
  - Effective Tax Rate = 8% - 15.5%
- **Participatory Exemption System**
  - IRC § 245A Dividend Received Deduction
  - IRC § 951a – GILTI (*Global Intangible Low-Taxed Income*)

Deferred Foreign Income

- **U.S. Shareholder of Foreign Corporation**
  - **Individual**
    - U.S. Citizen or Resident Alien
    - Taxed at higher rate marginal rates than Corp
    - No deemed foreign tax credit
    - Election to be treated as Corp (*IRC §962*)
  - **Corporation**
    - Incorporated in U.S.
    - Deemed foreign tax credit allowed
  - **Pass Through Entity**
    - Established/formed in US
    - Taxed at beneficial owner level

Deferred Foreign Income

- **Deferred Foreign Income Corporation (DFIC)**
  - Specified Foreign Corporation (**SFC**)
    - Controlled Foreign Corporation (**CFC**)
    - Foreign Corporation with 10% US Corp Shareholder
  - Accumulated Post-1986 Deferred Foreign Income
    - Accumulated E&P from all SFC's owned by a Shareholder
    - All Accumulated E&P except
      - Income effectively connected to US Trade or Business
      - Previously Taxed Income (**PTI**)
- **E&P Deficit Foreign Corporation**
  - Accumulated Post-1986 E&P Deficit
    - From all Deficit SFC's owned by a Shareholder
  - Offsets Accumulated E&P

Transition/Repatriation

- **Mandatory Inclusion**
  - Accumulated E&P less Accumulated E&P Deficit
  - Measuring date for determining E&P = 12/31/17 or 11/02/17.
    - Anti-Abuse Provision
- **Participation Exemption**
  - Deduction applied against mandatory inclusion
  - Creates effective tax rate of 8% or 15.5% for Shareholders in 35% tax bracket
  - Deduction calculation based on U.S. Shareholder's Aggregate Foreign Cash Position

Transition/Repatriation

- **Foreign Tax Credit (FTC)**
  - Deemed FTC Available only for U.S. Corporate Shareholders
  - FTC disallowed to the extent of participation exemption adjustment
  - FTC allowed on foreign withholding on subsequent distribution of PTI
- **Installment Arrangement**
  - 8 year Installment Election Available for Payment
  - Acceleration of Payment
    - Failure to pay installment timely
    - Sale, exchange or disposition of taxpayer's assets (*exception for eligible transferee*)
    - U.S. person becomes a non U.S. person

Transition/Repatriation

- **Previously Taxed Income (PTI)**
  - Undistributed but Taxed §965 inclusion becomes PTI
  - Two Types of PTI
    - Included PTI and Shielded PTI
  - State Tax Considerations
    - Conforming State vs. Non-Conforming State
  - Net Investment Tax Considerations (*IRC §1411*)
- **Section 962 Election**
  - Allows individual to elect Corporate tax treatment
  - PTI limited to amount of tax paid. Not entire inclusion amount

Example

- U.S. Shareholder owns 100% of Foreign Corp A (FCA) and Foreign Corp B (**FCB**).
- FCA has $10,000 Accumulated E&P.
- FCB has $5,000 E&P Deficit.
- FCA has balance sheet assets of $60,000 Cash and $40,000 Tools and Equipment.
- FCB has balance sheet assets of $35,000 Cash, $10,000 Accounts Receivable and $55,000 Building and Land.

Transition Tax Calculation

Accumulated E&P	
Foreign Corp A	10,000
Foreign Corp B	(5,000)
Deferred Foreign Income	**5,000**

	FCA	FCB	Total	Allocation	Participation Exemption
Cash	$60,000	$35,000	$95,000	52.5%	0.577142857
Accounts Receivable		$10,000	$10,000		
Tools and Equipment	$40,000	$55,000	$95,000	47.5%	0.771428571
			$200,000		

	Cash & A/R @ 15.5%	Other Assets @ 8%	Total	
Total E&P to be included	2,625	2,375	5,000	
Less §965(c) Participation Exemption	(1,515)	(1,832)	(3,347)	
Income Inclusion	1,110	543	1,653	
Tax Due Individual Shareholder			**$655**	
Tax Due Corporate Shareholder			**$579**	(*Less deemed FTC*)

Tax Cut & Jobs Act = Tax Practitioner Jobs Act

Illustration by Chris Gash

Sale of a Partnership Interest

The Law, the I.R.S.'s 1991 Published Position, the Magnesite Case, & the Tax Reform

Galia Antebi *Ruchelman P.L.L.C.*

Partnership Interest

Includes Interest in a Limited Liability Company

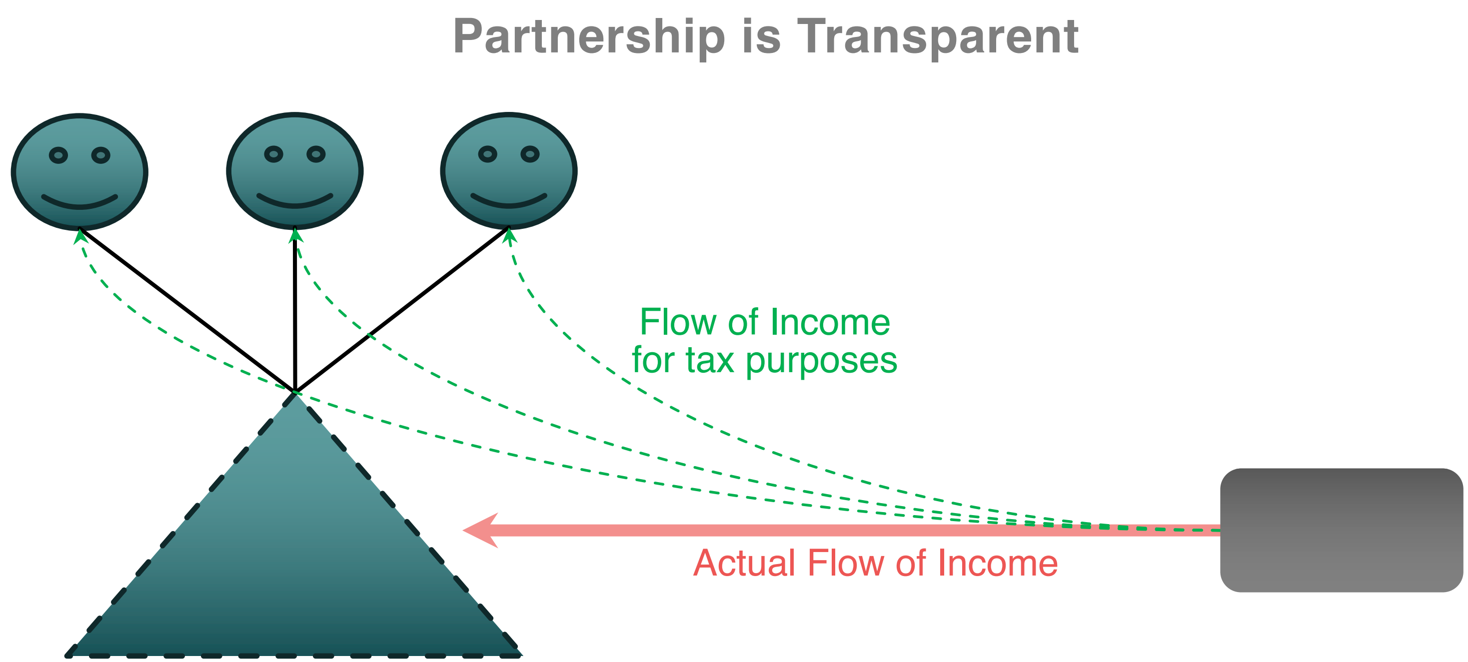
Entity Tax Classification

- U.S. Limited Liability Companies (**LLC**):
  - Disregarded from its sole owner, or
  - A partnership
  - Subject to election, a corporation
- Foreign entities

U.S. Tax Rules

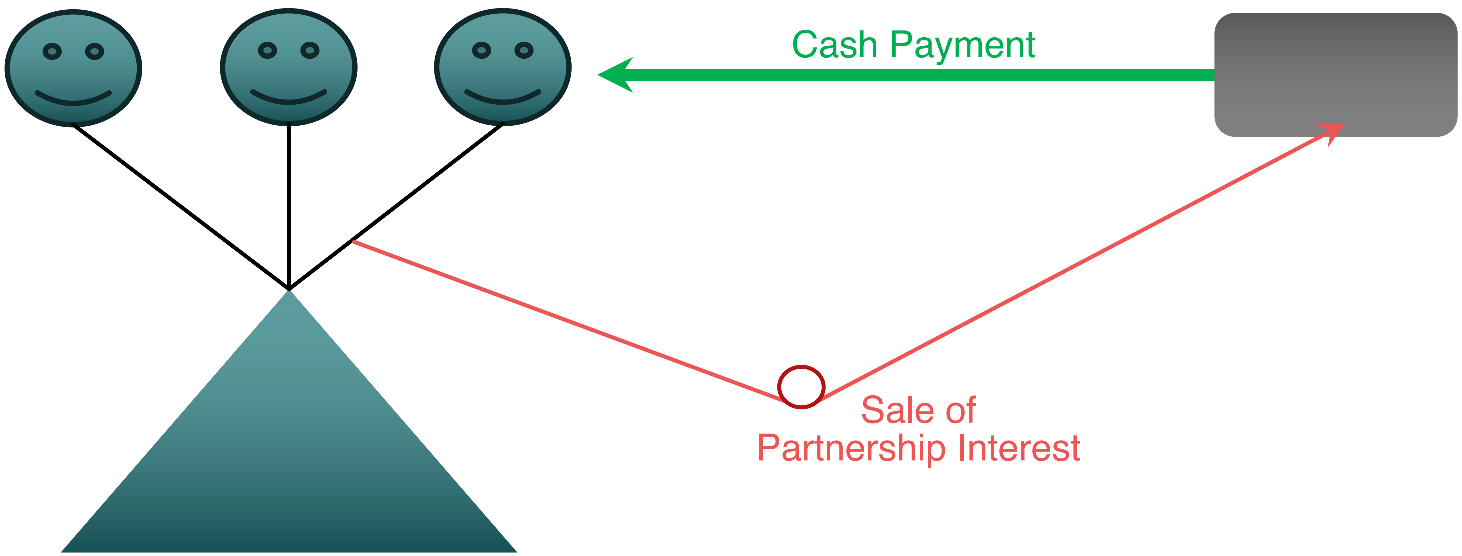
Partnerships, the one that could not decide how to be treated

- For calculating income derived through a partnership, the partnership is viewed as the aggregate of its members/partners

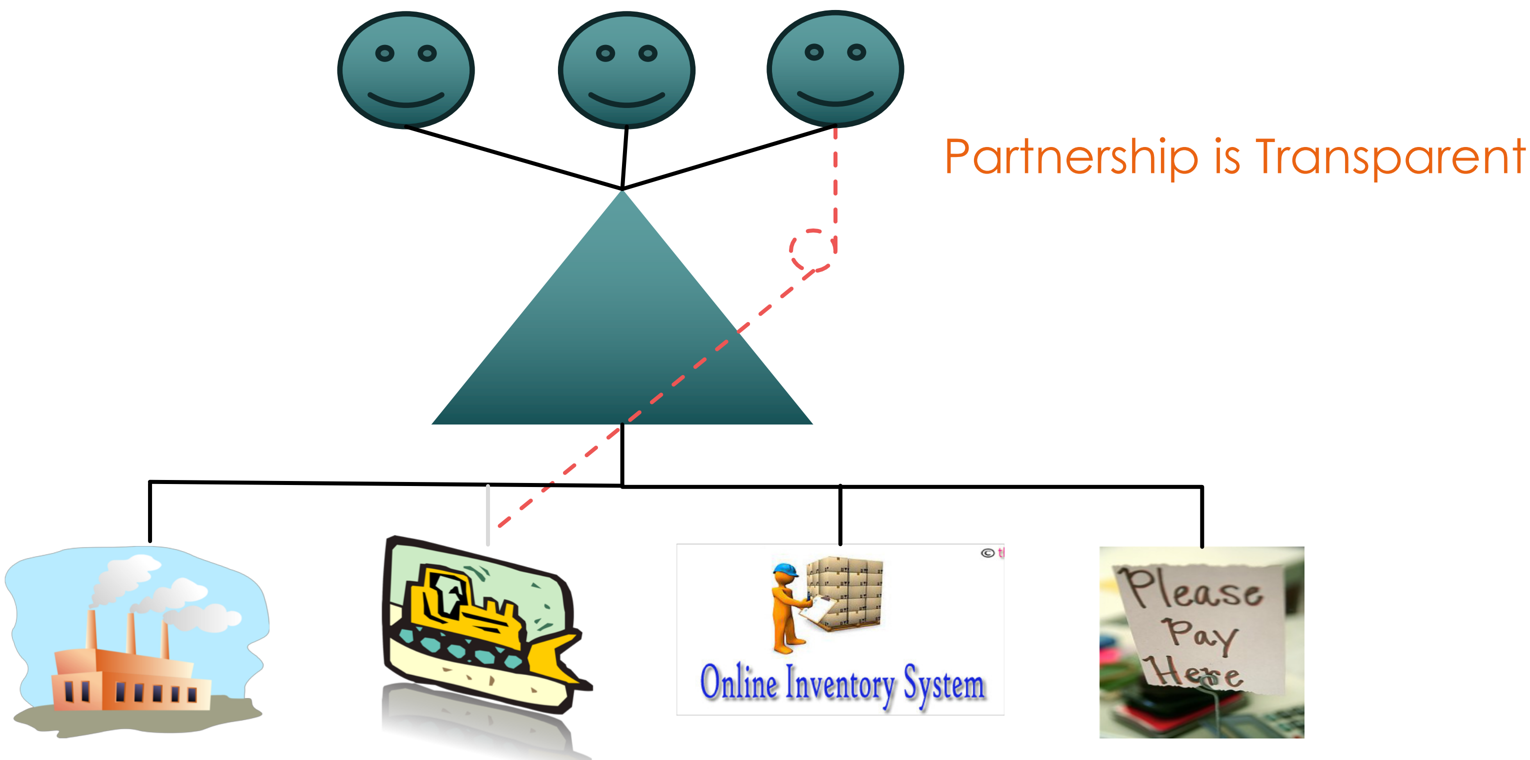


- When selling an interest in a partnership, the partnership is viewed as an entity

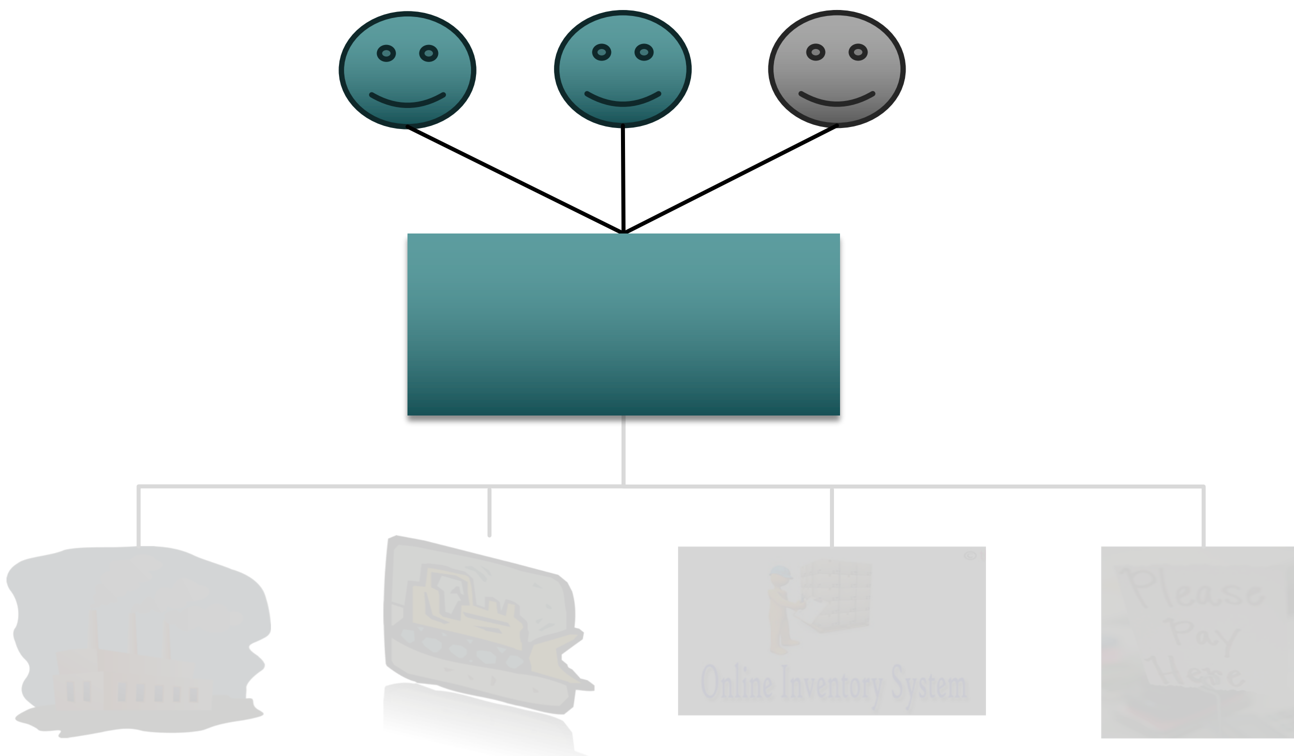
Transaction Yields Capital Gain Treatment



- Because capital gain may yield less tax than a sale by the partnership of assets, an opportunity to reduce tax could exist; to shut the opportunity, some or all of the gain may be ordinary income (hot assets)



- In comparison, a sale of stock in a corporation yields capital gain, regardless of the assets held by the corporation



Taxing a Non-U.S. Person

The Law

Taxation of a Sale

- Sale of interest in an LLC generally treated as sale of capital asset
- Capital asset sourced based on seller's residency
- Sale of interest in an LLC → not subject to U.S. tax
- Gain allocable to hot asset exception
- Source rules differ
  - E.g., sale of inventory held for sale in the U.S. is U.S. source
- U.S. source investment income may be taxed by a non-U.S. person if its treated as effectively connected income (**E.C.I.**)

The Tests for E.C.I.

- **The Asset-Use Test**
  - The income is derived from assets used in, or held for use in, the conduct of a trade or business in the U.S.
  - **Example**: interest arising from late paid accounts receivable and gain from sale of equipment
- **The Business Activity Test**
  - The activities of a U.S. trade or business are a material factor in the realization of the income, gain, or loss
  - **Example**: interest derived by a bank

Foreign Source Income

- Foreign source income and gains are not taxed unless:
  - An office or fixed place of business exists in the U.S. and
  - The sale of personal property is “attributable” to the U.S. office
- For income to be attributable to a U.S. office:
  - The office must be a material factor in the production of the gain
  - The office must regularly carry on activities of a type from which the gain is derived
- Where these factors exist, the source of the income becomes U.S. source income

Rev. Rul. 91-32

I.R.S.'s Long Standing Position

A Sale of a Partnership Interest is Attributable to the Partnership's U.S. Office

- Through the partnership, the partner itself has a U.S. office (or P.E. in the U.S.)
- A sale of a partnership interest is attributable to the U.S. office of the partnership
- The interest in the partnership is an asset used in the trade or business of the partner through the partnership
- The I.R.S. concluded that the gain from the sale is E.C.I.

Aggregate Theory Prevails in a Sale

- A sale of an interest in a partnership is viewed as an indirect sale of the underlying assets
- Gain attributable to E.C.I.-producing-assets is viewed as E.C.I.
- This position is an expansion on the pre-reform Code that only treated a sale of an interest as a sale of the underlying asset with respect to "hot assets"
- For 20 years, the ruling was dismissed as not supportable by U.S. tax law and no commentator argued its validity
- In 2012, the I.R.S. issued Field Agent Advice reiterating its position and announcing it would pursue the issue in examinations

Grecian Magnesite Case

A 2017 Case-law Rejecting the 1991 Ruling

Facts and the I.R.S. Arguments

- In December 2008 a Greek corporation, Grecian Magnesite Mining ("**GMM**"), redeemed its interest in a U.S. limited liability company, that elected to be treated as a partnership for U.S. tax purposes (the L.LC.)
- GMM recognized only the amount attributable to U.S. real property as gain on its U.S. tax return
- The I.R.S. claimed that the entire amount realized was E.C.I. by virtue of the interest in the partnership
- "Hot asset" allocation not raised

I.R.S. Arguments

- The aggregate theory should apply in this case because the same treatment that is given to real property should be given to other assets producing E.C.I.
- The source rule that relates to the sale by an office of its assets should be interpreted as including a sale of the office, even if the office belongs to the partnership
- The Court should give deference to the I.R.S. conclusion in Rev. Rul. 91-32

The Tax Court's Ruling

- The Court rejected the I.R.S. position in the old ruling, determining that it lacked statutory basis

Tax Reform Change

Change to E.C.I. Definition;
Adding a Withholding Obligation

E.C.I. to Extent of Unrealized Gain or Loss in the Partnership

- E.C.I. definition extended
- A sale of partnership interest is E.C.I. to the extent that the seller would have had E.C.I. had the partnership sold all of its assets for fair market value as of the date of sale
- The change in law is effective for sales after November 27, 2017

10% U.S. Withholding Imposed

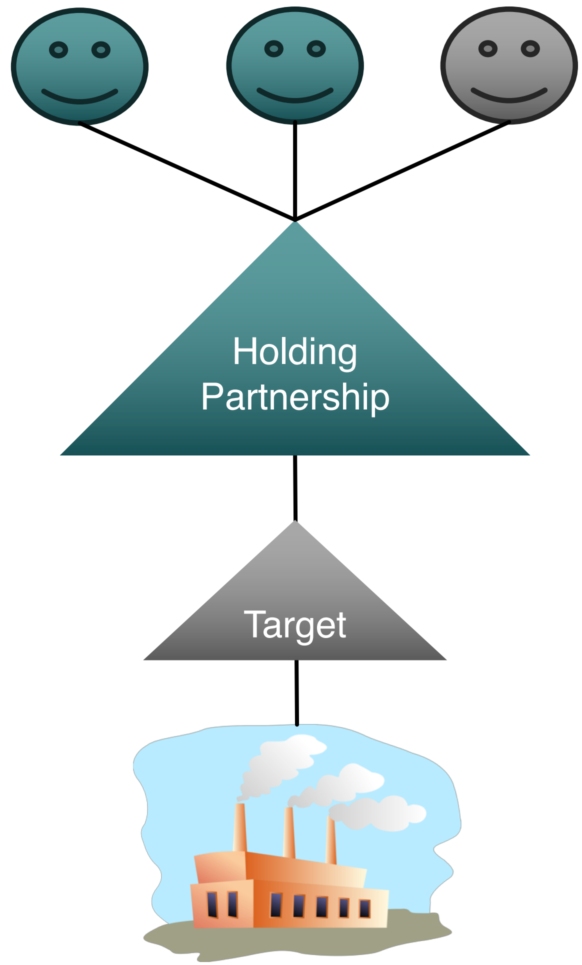
- 10% withholding tax obligation on buyers after December 31, 2017
- Withholding applicable to "**amount realized**"
- Exceptions apply if the seller provides a non-foreign certification
- F.I.R.P.T.A.-like advance withholding determination is expected to be allowed under anticipated regulations
- If buyer doesn't withhold, the partnership has the obligation to withhold from distributions to the buyer

10% of "Amount Realized"

- Amount realized includes seller's share of partnership liabilities assumed
  - Withholding amount could be greater than cash to be paid in the transaction
  - Difficulties estimating the correct withholding amount
  - Regulations are anticipated

Planning to Avoid Withholding

- Super-partnership structure
- Seller is a U.S. person - no withholding applicable



G.I.L.T.I. & F.D.I.I.

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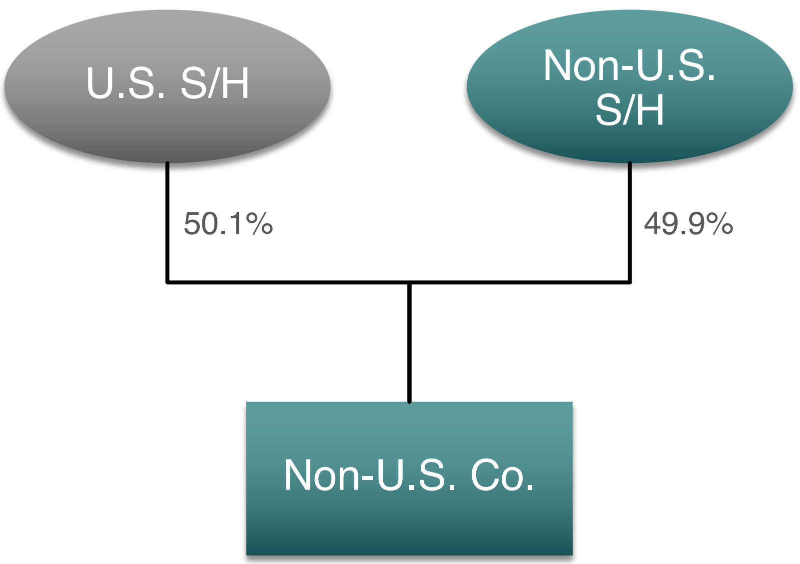
Changes to C.F.C. Rules

Summary of C.F.C. Regime

- **Definition of a 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



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

G.I.L.T.I.

Global Intangible Low-Taxed Income
A Case Study and the Law

G.I.L.T.I. – A Case Study

- Roger Clark is a well-established IT consultant, based in Toronto, Canada.
  - Knowing very little about the business world, and in particular, the tax system, he relied on a local accountant to help him set up the business and to maintain his business records.
- Bill is a partner in a local four partner CPA firm.
  - Bill prepares an annual Notice to Reader statement for Clark IT Consulting Inc. and prepares the company's annual corporate tax return.
  - The company was incorporated, in Canada, on February 1, 2015.
- Roger, having been born in the U.S., was and is aware of his U.S. tax filing obligations.
- He has always timely filed all of his U.S. returns and Bill's firm has assisted Roger with these filings.

G.I.L.T.I. – A Case Study, cont.

- Clark IT Consulting Inc. is a controlled foreign corporation (CFC) for U.S. tax purposes as Roger, being a United States person, owns 100% of the share of the company.
- The company has a December 31st year end in order to conform to the required year end under IRC §989.
- The company does not have any personal service contract income as defined in IRC §954(c)(1)(H).
- However, with the recent passing of the Tax Cuts and Jobs Act, Bill has now reached the point where he no longer feels comfortable in preparing Roger's U.S. tax filings.
  - He managed to address the repatriation tax issues but he has heard about the new GILTI provisions and doesn't know what to advise.
  - He has recommended that Roger reach out to a firm that specializes in U.S. tax to assist him on a go forward basis.

G.I.L.T.I. – A Case Study, cont.

- It is now February 15, 2019 and Roger wants our help in analyzing and preparing his U.S. personal income tax returns.
- He has provided the attached Income Statement for the year ended December 31, 2018.
- He did not take any dividends in 2018, only enough salary, $150,000, to cover his basic living needs.

Fixed Assets	
Building – purchased February 8th, 2015	$450,000
Land – purchased February 8, 2015	$120,000
Furniture and Fixtures – purchased March 10, 2015	$35,000
Various computers, monitors, etc. – purchased March 11, 2015	$75,450

- Book depreciation is equal to tax depreciation and reflects the maximum that could be claimed in the year.

G.I.L.T.I. (An Example)

Clark IT Consulting Inc Income Statement for the period ended December 31, 2018				
		Active Business	Subpart F	
Consulting services	1,013,534	1,013,534		
Investment Income	123,000		123,000	
Capital gains (on disposition of marketable securities)	65,000		65,000	
Gross Revenue	1,201,534	1,013,534	188,000	15.65%
Expenses				
Advertising and promotion	5,340	5,340		
Meals and entertainment	2,630	2,630		
Amortization of tangible assets	26,644	26,644		
Office expenses	5,200	5,200		
Property taxes (on office building)	24,000	24,000		
Insurance	3,500	3,500		
Wages and benefits	150,000	150,000		
Travel	12,500	12,500		
Computer related expenses	3,200	3,200		
Investment advisory fees	15,000		15,000	
	248,014	233,014	15,000	
Net Income	953,520	780,520	173,000	
Taxes (book provisions equal to 25%)	238,380	195,130	43,250	
After tax net income for book	715,140	585,390	129,750	

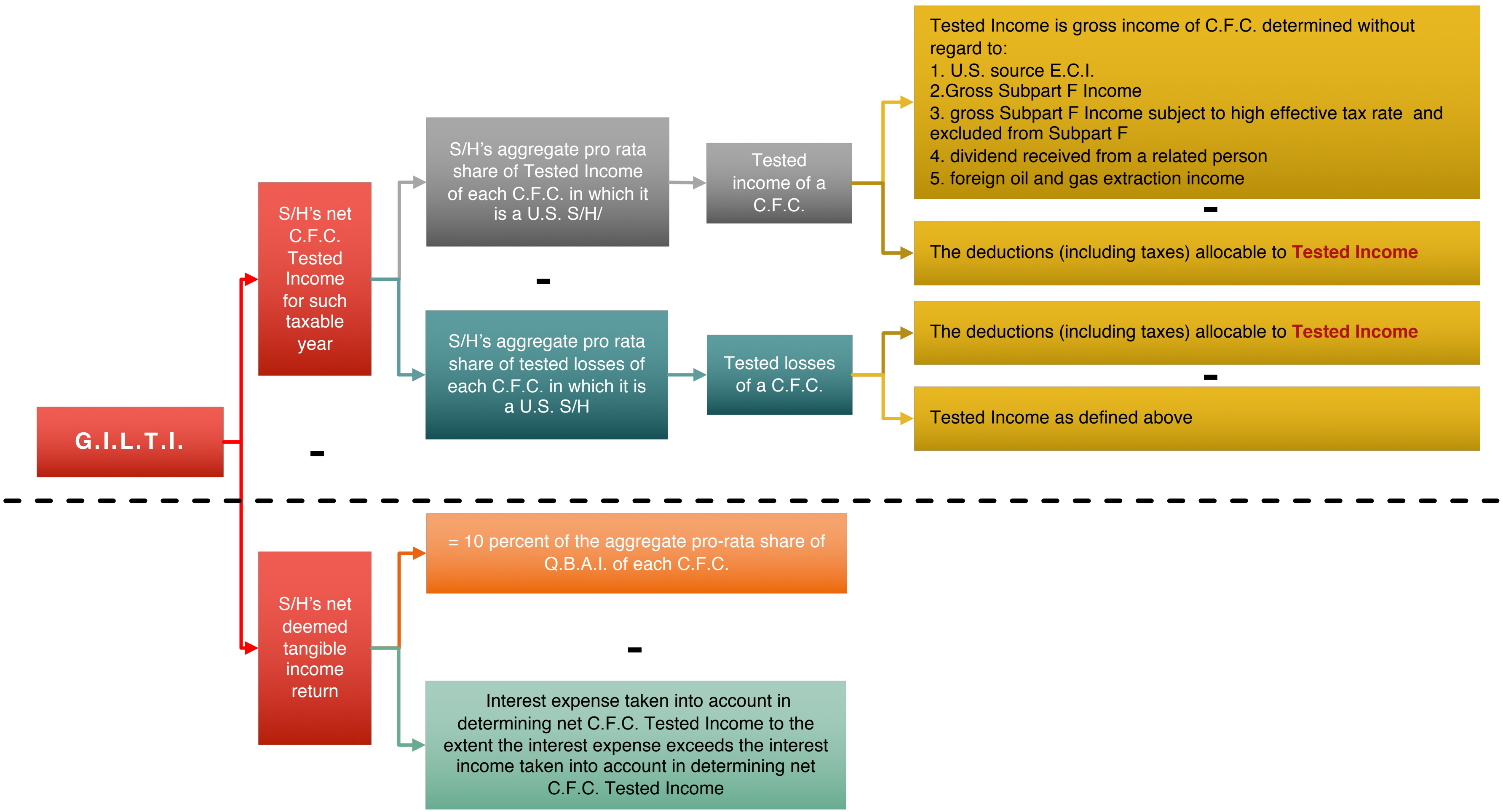
G.I.L.T.I. (An Example)

Clark IT Consulting Inc Income Statement for the period ended December 31, 2018			
	Total	Active Business	Subpart F
Canadian taxable income			
Book income	715,140	585,390	129,750
Addback book taxes	238,380	195,130	43,250
Addback book depreciation	26,644	26,644	
Addback 50% meals and entertainment	1,315	1,315	
Addback taxable capital gains	32,500		32,500
Deduct tax depreciation	(26,644)	(26,644)	
Deduct book capital gains	(65,000)		(65,000)
Taxable income	**922,335**	**781,835**	**140,500**
Basic Federal tax (@38%)	350,487	297,097	52,590
Federal tax abatement	(92,234)	(78,184)	(14,050)
Refundable portion of taxes on investment income	14,987		14,987
Small business deduction	(90,000)	(90,000)	
General rate reduction	(36,639)	(36,639)	
Federal tax payable	**146,601**	**92,274**	**54,327**
Provincial tax payable	**66,069**	**49,911**	**16,158**
Total actual taxes – agrees to corporate tax return	212,670	142,185	70,485
Refundable corporate tax	(43,087)		(43,087)
Adjusted for refundable corporate tax	**169,583**	**142,185**	**27,398**

G.I.L.T.I. (An Example)

Clark IT Consulting Inc Income Statement for the period ended December 31, 2018			
	Total	Active Business	Subpart F
Current year earnings and profits (E&P)			
Book income	715,140	585,390	129,750
Addback book depreciation	26,644	26,644	
Addback book tax provision	238,380	195,130	43,250
Deduct US tax depreciation computed under ADS	(29,840)	(29,840)	
Pre-tax E&P	950,324	777,324	173,000
Deduct actual taxes per corporate tax return	(212,670)	(142,185)	(70,485)
Addback addition to refundable account	43,087		43,087
Earnings and profits	**780,741**	**635,139**	**145,602**
Properly allocated corporate tax	**169,583**	**142,185**	**27,398**
Average tax rate		18.00%	16.00%
		< 18.9%	< 18.9%
US Corporate – tax rate	21.00%		
90% threshold	18.90%		

G.I.L.T.I. & F.D.I.I. I G.I.L.T.I.



U.S. Tax Reform I G.I.L.T.I. *Fanny Karaman*

Qualified Business Asset Investment ("**Q.B.A.I.**")

- average of aggregate adjusted bases
- in specified tangible property
  - any tangible property
  - used in the production
  - **of tested income**
- used in TB
- and of a type allowing 167 deduction
- determined as of the close of each quarter

Property, plant, and equipment not giving rise to the following items of gross income:

1. U.S. source E.C.I.
2. Gross Subpart F Income
3. Gross Subpart F Income subject to high effective tax rate and excluded from Subpart F
4. Dividend received from a related person
5. Foreign oil and gas extraction income

-

the deductions (including taxes) allocable to the above

G.I.L.T.I. Regulations

- 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

G.I.L.T.I. (An Example), cont'd.

Tested Income		**1,201,534**	**IRC §951A(c)(A)(i)**
Less US ECI		0	IRC §951A(c)(A)(i)(I)
Less subpart F income		(188,000)	IRC §951A(c)(A)(i)(II)
Less subpart F income subject to high tax kick out		0	IRC §951A(c)(A)(i)(II)
Less related party dividends		0	IRC §951A(c)(A)(i)(IV)
Less foreign exploration		0	IRC §951A(c)(A)(i)(V)
		1,013,534	
Less directly allocable expenses		(233,014)	IRC §951A(c)(A)(ii)
Addback book depreciation		26,644	
Less properly allocated taxes		(142,185)	
Less US ADS depreciation		(29,840)	
	(A)	**635,139**	
Deemed Tangible Income Return			
Qualified net business asset investment		452,097	(from ADS worksheet)
10% threshold	**(B)**	45,210	
GILTI	**(A) - (B)**	**589,929**	
Proof			
GILTI – Tested income		635,139	
Net subpart F income		173,000	
Taxes Associated with subpart F income		(27,398)	
Current year earnings and profits		**780,741**	

Consequences to U.S. Shareholders

- 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

G.I.L.T.I. Example

Roger Clark – Estimate of 2018 U.S. Personal Taxes	
Married filing separately – No IRC §962 Election	
Wages	150,000
Subpart F pickup	145,602
G.I.L.T.I. inclusion	589,929
Gross income	885,531
Standard deduction	(12,000)
U.S. Taxable Income	**873,531**
U.S. tax before F.T.C.	292,8956
F.T.C.	(49,614)
Section 962 tax	
Estimated U.S. Tax	**243,282**

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

Computation of IRC Section 962

G.I.L.T.I. Inclusion	*From G.I.L.T.I. worksheet*	589,929		
IRC §250 deduction	*50% of G.I.L.T.I. inclusion*	–294,965		
Subpart F	*Net of expenses*	145,602		
Properly allocated taxes	*From income statement adjusted worksheet*	169,583	Gross up	
Income for IRC §962 purposes		**610,149**	610,149	
			294,965	*50% G.I.L.T.I. deduction*
			45,210	*10% QBAI threshold*
			950,324	**Total Pretax E&P**
U.S. corporate tax	*at 21%*	128,131		
Foreign tax credit	*on subpart F income*	(27,398)		
Foreign tax credit	*Only 80% of "tested foreign income taxes" are eligible for foreign tax credit treatment*	(113,748)	*IRC §960(d)*	
Net taxes		**0**		

F.D.I.I.

Foreign Derived Intangible Income

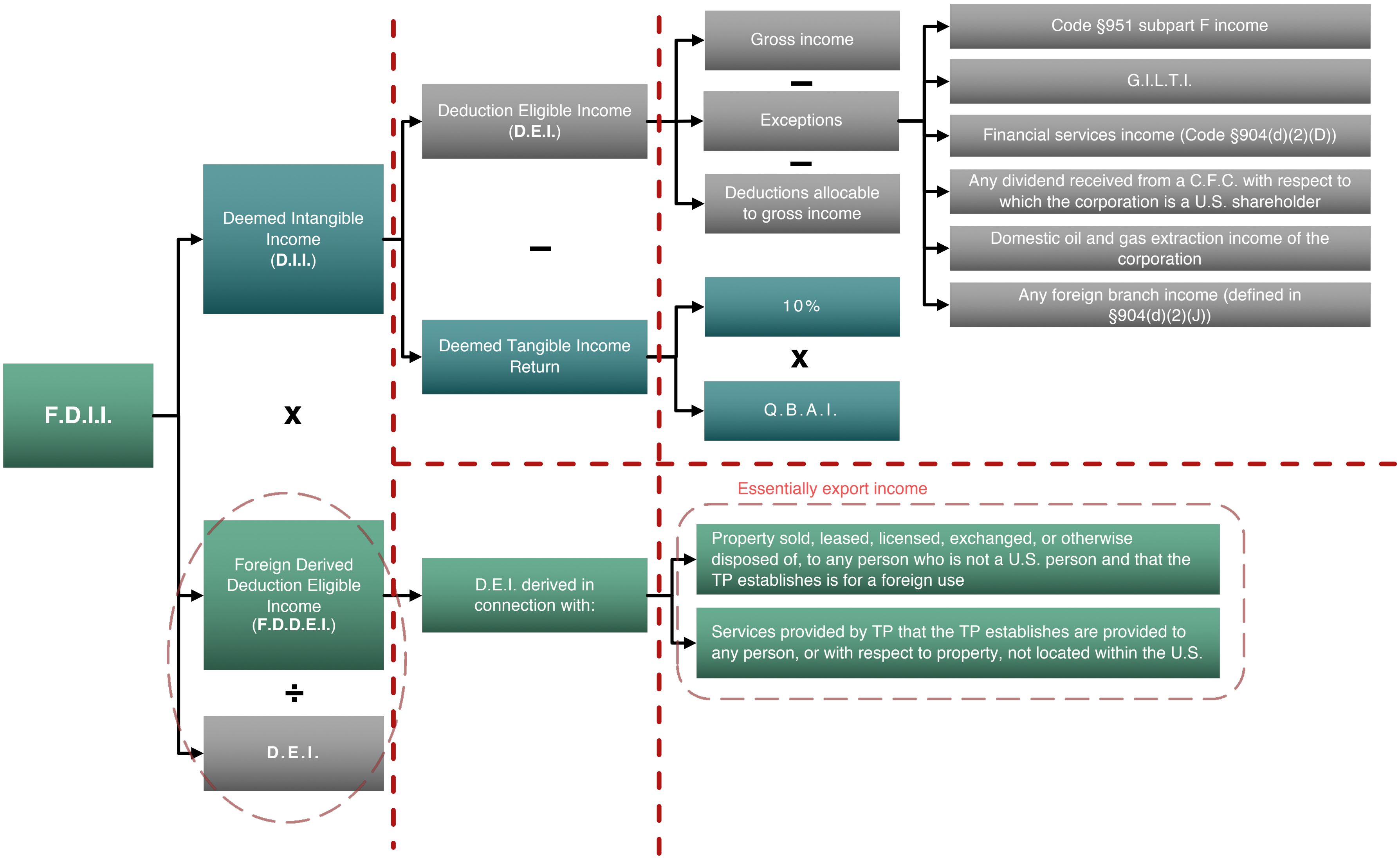
F.D.I.I. Calculation

- 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

F.D.I.I. Calculation

- 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.

G.I.L.T.I. & F.D.I.I. | F.D.I.I.



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Contact Information

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- Arthur R. Kerr II concentrates his practice in international and domestic taxation, business law, contracts, and real estate. His tax practice includes offshore and onshore planning and compliance for businesses and individuals, civil and criminal examinations and audits, collection matters, workouts, and tax controversies. He has extensive experience representing clients before the IRS and various state tax authorities.
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- Galia Antebi focuses her practice on the international and domestic tax aspects of business structuring for worldwide investments. She also advises individuals on inbound and outbound investments, as well as on pre-immigration, expatriation and estate planning, including trust issues and gift tax planning. She is co-chair of the F.A.T.C.A. practice and advises large N.F.F.E.'s and F.F.I.'s on F.A.T.C.A. matters.
- Prior to joining Ruchelman P.L.L.C., she worked as an attorney in the tax department of a major international law firm in New York City and at a leading, internationally-recognized Israeli law firm, where her practice focused on a variety of corporate issues as well as trust issues.

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- Fanny Karaman is a French *avocat à la cour* and U.S. tax lawyer concentrating her practice in the areas of U.S. and international taxation with a focus on cross-border issues in France and the U.S. She regularly advises entities and individuals on taxation of U.S. and European investments, estate and gift tax exposures, and corporate structuring with an emphasis on the treatment of French holdings under U.S. tax law.
- Language proficiency in French and German facilitates the major aspects of her practice. She practiced in Paris with small and mid-size international law firms advising on French-U.S. tax issues and with a boutique New York firm focusing on U.S.-German tax issues.

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