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United States Tax Alert
The international tax provisions of the Tax Cuts and Jobs Act

On November 2, 2017, Kevin Brady (R-TX), Chairman of the House Ways and Means Committee, unveiled his opening bid on comprehensive tax reform - the Tax Cuts and Jobs Act, H.R. 1 (the "Bill").

With respect to the International rules, the Bill would:

- Enact a 100% deduction for dividends received from 10% or greater owned foreign subsidiaries after 2017, and tax (at up to 5% or 12%) foreign earnings that were still deferred as of those subsidiaries' last tax years ending before 2018
- Tax on a current basis half of a US shareholder's controlled foreign corporations' (CFCs') "foreign high return amounts," attributable to CFC tax years beginning after 2017
- Cap interest deductions, in tax years beginning after 2017, by reference to the lesser of:
  - 30% of adjusted taxable income, or
  - 110% of financial reporting group net interest expense multiplied by the ratio of US EBITDA to group EBITDA.
- Enact a excise tax and impose a 20% excise tax on amounts paid or incurred after 2018 by a domestic corporation to foreign corporate members of the payor's financial reporting group

Background

Congressional leaders and the Administration hope to enact the Bill before the 2018 election; ideally, before the end of December. Together with the Joint Committee on Taxation's description of the Bill (the "JCT Description"), and the Ways and Means Committee's section-by-section summary, there now are over 100 pages of

statutory language to replace the three-paragraph description of "territorial taxation of global American companies" and "stopping corporations from shipping jobs and capital overseas" that appeared in October's "Unified Framework" for tax reform.

Aside from the tax on previously-deferred foreign earnings as a way to clear the decks for the new participation exemption, and aside from the new provision on "foreign high return amounts," the Bill does not make major overall changes to the subpart F regime, but makes some notable *targeted* subpart F changes, including one that implicitly expands the scope of the CFC definition as applied to foreign-based multinationals.

Key changes

The participation exemption and the one-time taxation of presently-deferred earnings

Transition tax on US shareholders

The Bill provides that a US shareholder[1] of a "specified foreign corporation" (SFC) would generally have a subpart F income inclusion, in the year in which the SFC's last tax year beginning before 2018 ends, of the US shareholder's pro rata share of the "accumulated post-1986 deferred foreign income" of the SFC, net of the US shareholder's share of deficits (including "hovering deficits") of other SFCs allocated to the first SFC.[2]

- "Specified foreign corporation" includes both: (i) any CFC and (ii) any other foreign corporation that has a "US shareholder." For this purpose, the definition of "US shareholder" is expanded to include US persons to whom ownership of 10% of the voting shares would ordinarily *not* be attributed under present law's special subpart F attribution rules, but whose *foreign* owners own sufficient voting stock in the foreign corporation to make the US person a 10% voting stock shareholder under the general section 318 attribution rules.[3]

Alternative dates for determining the amount of earnings to be included in income

The amount of income subject to subpart F inclusion under the Bill is based on either accumulated post-1986 earnings and profits as of November 2, 2017, or as of December 31, 2017, "without diminution by reason of dividends distributed in the year that includes such date" - whichever is higher.

5% and 12% rates

The amount of the U.S. shareholder's share of post-1986 E&P that is attributed to cash or cash equivalents ("cash position") of the SFC is subject to a 12% transition tax. The remainder of the inclusion is subject to a 5% transition tax. This rate of tax is achieved by allowing a separate dividends received deduction equal to an amount that results in the respective 12% and 5% tax rate with respect to the respective amounts of post 1986 earnings attributed to cash and non-cash assets.

- The US shareholder's aggregate foreign cash position is generally based on the average of three amounts:
  - Its pro rata shares of its SFCs' cash positions on November 2, 2017;

- Its shares of its SFCs' cash positions at the close of each of their last taxable years ending before November 2, 2017; and
- Its shares of its SFCs' cash positions at the close of each of their next-to-last taxable years ending before November 2, 2017.

Foreign tax credits

The transition tax generally could be offset by a proportionate share of the foreign taxes deemed paid upon the inclusions, and by the full amount of the US shareholder's pre-existing foreign tax credit carryforwards (if any). The inclusion would not trigger overall foreign loss recapture.

Deferral of time for payment

At the election of the US shareholder, the tax liability attributable to the inclusion could be paid in eight equal annual installments. Where the US shareholder is an S corporation, a shareholder of the S corporation could elect to further defer his or her tax liability resulting from the subpart F inclusion of the S corporation under section 965.

Dividends by 10% foreign subsidiaries received after 2017 to domestic corporations

The Bill generally would grant domestic (US) corporations a 100% dividends received deduction (DRD) (new Code section 245A) for the "foreign-source portion" of any dividend made after 2017 and received from a foreign corporation (other than a non-CFC passive foreign investment company [PFIC]) by a domestic corporation that is a "US shareholder" in the foreign corporation (a "specified 10-percent owned foreign corporation").[4] Section 956 (which generally triggers the inclusion of CFC earnings in the gross income of a US shareholder by reference to "United States property" treated as held by the CFC) would no longer apply to US shareholders that are corporations.

- In the case of distributions of post-1986 undistributed earnings, the "foreign-source portion" is determined pursuant to rules similar to the present-law rules for determining a dividend's "US-source portion" (see Code section 245(a)). The foreign-source portion of distributions of pre-1987 earnings generally also would be determined via pooling, but in this case the pool would combine earnings accumulated from March 1913 through the foreign corporation's last taxable year beginning before 1987.

No foreign tax credits

The Bill disallows foreign tax credits and deductions for any taxes with respect to any dividend for which the DRD is allowed, and repeals section 902 (which treats a foreign corporation's corporate US shareholder as having paid a portion of the foreign income taxes paid or accrued by the foreign corporation when the shareholder receives a dividend from the foreign corporation). The foreign-source portion of a dividend for which the DRD is allowed is not treated as foreign source income for purposes of the foreign tax credit limitation.

Loss limitation

For purposes of computing any loss on the sale or exchange of stock in a specified 10% owned foreign corporation the Bill reduces the basis of such stock by the amount of the DRD derived from dividends with respect to such stock. Special recapture rules apply to increase the recapture of foreign losses attributable to foreign branch operations transferred to specified 10% owned foreign corporations; for example, the branch loss recapture is no longer limited by the amount of total built in gain that would not be recognized but for section 367(a).

> *Observation:* Like former Chairman Camp's 2014 bill, and unlike his 2011 discussion draft, the Bill limits the participation exemption to entities classified as corporations for US federal income tax purposes and does *not* exempt the income of a domestic corporation's foreign trade or business from US tax and continues to allow taxpayers to currently take the benefit of losses from foreign branch operations.

Income inclusion for foreign "high returns" — new section 951A

Under proposed new section 951A, a US shareholder would include in gross income 50% of its CFCs' income for the year that is deemed to represent "high" returns on investment. Generally, the provision results in the current inclusion of 50% of a US shareholder's pro rata share of the aggregate CFC net income[5] not currently subject to US tax, if it exceeds a set percentage of the US shareholder's pro rata share of the aggregate tangible depreciable asset basis of all its CFCs (so-called "foreign high return amount" [FHRA]).

> *Observation:* Under the 20% US corporate tax rate proposed by the Bill, new section 951A would ensure that the "high returns" on the "tested" income of a US shareholder's CFCs will bear current worldwide income tax at a rate (across all income of all of a US shareholder's CFCs) of no less than 10%; for example, in a case where no foreign tax was paid or accrued by a US shareholder's CFCs. However, the total worldwide tax often will be more than 10%. As a result, if the CFCs paid or accrued foreign income taxes attributable to the "tested" income in the inclusion year, but the average effective rate of such taxes for the year is less than *12.5%*, then there would be additional tax imposed by the United States.[4]

Against this inclusion the Bill would permit the US shareholder an indirect foreign tax credit for up to 80% of the CFCs' foreign taxes attributable to the shareholder's FHRA. The shareholder's section 951A inclusion and the associated deemed-paid foreign income taxes would constitute their own separate foreign tax credit limitation "basket," and any excess credits in the basket would essentially be "lost": they could not be carried over for use in any subsequent or prior year.

The relevant "tested" income of any CFC is generally its residual income after removing ECI,[6] related-party dividends, subpart F income, certain income that would be foreign personal holding company income if not for active business exceptions or the CFC look-through rule, and income that would be subpart F income but for the high-tax exception. The Bill provides for distinguishing credits and losses attributable to the tested income, on the one hand, and other types of income, on the other. Also, many of the rules that apply to subpart F income and section 951(a)(1)(A) inclusions would

apply, in the same or modified form, to the FHRA and the section 951A inclusions (e.g., sections 959, 961, 904(h), and 1248(b)).

Effective Date: Taxable years of foreign corporations beginning after 2017 (and the US shareholder years in or with which they end).

Excise tax on payments from domestic corporations to related foreign corporations

The Bill generally would impose a non-deductible 20% excise tax on so-called "specified amounts" paid or incurred by a domestic corporation (or by a foreign corporation in connection with the conduct of a US trade or business) to a foreign corporation that is a member of the same "international financial reporting group" (IFRG). The Bill excludes from the definition of IFRG any group whose annual average of total specified amounts from US members to foreign members does not exceed $100 million for the current and two preceding years. The excise tax also does not apply to a specified amount to the extent it is (or is treated under the election described below as) ECI and is subject to US income tax.

Specified amounts generally include amounts that are, for the payor, (i) deductible, (ii) includible in costs of goods sold, or (iii) includible in the basis of a depreciable or amortizable asset.

Specified amounts do not include, however:

- Interest;
- Amounts paid or incurred to acquire an actively-traded commodity or an identified hedge of such a commodity;
- Amounts with respect to which 30% tax is imposed under section 881(a) (or if the rate of tax imposed is reduced, then the same proportion of the amount as the rate of tax that is imposed bears to 30%);
- In the case of a payor that elects to use a "services cost method" for purposes of section 482, amounts paid or incurred for services if the amount is the total services cost with no markup.

The ECI election

The Bill allows the foreign recipient of a specified amount to make an election to treat the amount as ECI (other than for DRD or section 881 purposes) attributable to a US permanent establishment, and thus save the payor from liability for the excise tax. However, if a foreign recipient makes this election, only "deemed expenses" are allowed as a deduction against such amount. The deemed expenses are the amounts of expenses needed to achieve a net income ratio (the ratio of net income, before interest and income taxes, to revenues) from the specified amount for the year of receipt equal to the net income ratio of the IFRG for that year for the product line to which the specified amount relates, determined on the basis of the IFRG's consolidated financial statements. Once made, the election applies for all subsequent taxable years unless revoked with the consent of the Secretary of the Treasury.

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to any specified amount which the foreign recipient elects to treat as ECI.

Effective Date: The proposal applies to amounts paid or incurred after December 31, 2018.

Observations: As this proposal would impose full US tax on common business transactions including royalties paid to and inventory acquired from foreign affiliates, it would have an adverse impact on a wide range of large multinationals, both US- and foreign-parented.

In addition, and of particular importance, at the time of the issuance of this alert Kevin Brady has made public statements that in response to comments the House Ways and Means Committee is actively considering modifications to this provision of the Bill.

Limitations on Interest Deductibility

Revised section 163(j) limitation

The Bill would rewrite section 163(j) so as to cap deductions for "business interest" by reference to a fixed percentage of adjusted taxable income, similar to that imposed by other countries such as Germany. Under this provision, the "business interest" deduction of every taxpayer (corporate or otherwise) would be limited to the amount of the taxpayer's business interest income plus 30% of its business' adjusted taxable income. "Business interest" and "business interest income" are interest paid or accrued on indebtedness properly allocable to a trade or business, and includible interest income properly allocable to a trade or business, respectively. Any disallowed deductions would be carried forward for five taxable years. The proposal would not apply to a business with average gross receipts of $25 million or less, as well as to certain regulated utilities and real property trades or businesses.

Observation: The proposal would replace the present-law limitation on the deduction of "disqualified" interest (interest guaranteed by related foreign or tax-exempt persons, and interest payable to related persons and not subject to US tax), with a limitation applicable to *all* of a taxpayer's business interest deductions. The proposal would not retain the three-year "excess limitation" carryforward feature of present law, or its indefinite carryforward for disallowed expense.

Additional limitation on deductions of "International Financial Reporting Groups"

In addition to the revised section 163(j) limitation, the Bill would add a new limit (new section 163(n)) on the US interest deductions of certain corporations and members of an IFRG. For section 163(n) purposes, the term "international financial reporting group" is defined more broadly than it is for purposes of the proposed excise tax. For section 163(n) purposes, the IFRG is generally defined as a group of corporations filing a consolidated financial statement that (i) contains either a foreign corporation engaged in a US trade or business, or at least one domestic corporation and one foreign corporation, and (ii) has average gross receipts over a 3-reporting-year period exceeding $100,000,000.

The Bill would limit the interest deductions of a domestic corporation that is a member of an IFRG to the sum of:

- The "allowable percentage" of 110% of net interest expense of the domestic corporation, and
- The gross interest income of the domestic corporation.

Any disallowed interest expense can be carried forward for up to five tax years.

The "allowable percentage" for a domestic corporation for a given year is a ratio whose numerator is the IFRG's "reported" net interest expense (that is, the net interest expense reported on the IFRG's consolidated financial statement for the reporting year) multiplied by the domestic corporation's EBITDA for that year divided by the entire group's EBITDA for the year. The denominator of the "allowable percentage" ratio is the domestic corporation's "reported" net interest expense (defined above).

The section 163(n) limitation would apply in addition to the other rules for disallowance of interest expense in the Code, and taxpayers would be disallowed interest deductions pursuant to whichever provision denies a greater amount of interest deductions.

A foreign corporation's US interest deduction would be limited in a manner "consistent with the principles" of section 163(n).

> *Observation:* While the formula above is daunting at first glance, another way to conceive of section 163(n) might be to imagine an IFRG that computes all of its interest income and expense in accordance with US tax rules. In such a case section 163(n) would limit the US interest deductions of each US member of the IFRG to the sum of its gross interest income plus 110% of the IFRG's worldwide net interest expense multiplied by the ratio of the US member's EBITDA to the IFRG's EBITDA.
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> Viewed this way, it seems clearer that an IFRG whose members each incur, and carry from year to year, indebtedness, exactly in proportion to its own EBITDA for each year, and where each member pays the same interest rate on all loans, would likely find itself unencumbered by section 163(n). Presumably because none of these assumptions is likely to reflect real-world situations, the drafters built in a 10% cushion for variations between members' EBITDA shares and members' net interest expense shares. They also obviated the need to place each member's interest income and expense on a US tax accounting footing by comparing the group's consolidated financial reporting of interest income and expense with its US members' separate financial reporting of such interest.
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> Regardless of the 10% cushion and the absence of a need to convert financial statement numbers into tax concepts, however, in years when a group's US EBITDA relative to the group's EBITDA is low in comparison with the net interest expense of its US members relative to the net interest expense of the group, the US interest deductions of the group members could be significantly limited under this proposal.

Other changes to subpart F

The Bill would make some changes to existing subpart F rules. For example:

- The CFC look-through rules under section 954(c)(6) would be made permanent.
- The $1 million de minimis exception from foreign base company income would be indexed for future inflation.
- The Bill would eliminate the rule in present law that prevents a US shareholder from suffering a subpart F inclusion from a foreign corporation for a taxable year unless the corporation

was a CFC for an uninterrupted period of 30 days during that year.
- Consistent with the SFC definition discussed above in connection with the transition tax, and as noted above in connection with the participation exemption (new Code section 245A), the Bill would permanently modify the stock attribution rules of section 958(b) that apply for several subpart F purposes, including determining whether a US person is a US shareholder, and whether a foreign corporation is a CFC.
- The requirement that a corporation be a CFC for at least 30 days in order for a US shareholder to have a subpart F inclusion is removed.

Changes to sourcing rules for the sale of inventory

Consistent with the 2014 Camp bill, the Bill would source income from the production and sale of inventory property (section 863) *solely* by reference to the location of production activities - thus, not in any part based on the "place of sale," or "title passage" rule.

Provisions Related to Possessions of the United States

- The Bill would extend the deduction allowable with respect to income attributable to domestic production activities in Puerto Rico. Under the provision, eligibility of domestic gross receipts from Puerto Rico for the domestic production deduction would apply retroactively to tax years beginning after December 31, 2016 and before January 1, 2018.
- The Bill would extend the temporary increase in the limit on cover-over of rum excise taxes to Puerto Rico and the Virgin Islands. The $13.25 per proof gallon excise tax cover-over amount paid to the treasuries of Puerto Rico and the US Virgin Islands would apply retroactively to include imports after December 31, 2016, and would be extended to rum imported into the United States before January 1, 2023.
- The Bill would extend the American Samoa economic development credit. The credit for taxpayers currently operating in American Samoa would retroactively apply to tax years beginning after December 31, 2016, and be extended to tax years *beginning before January 1, 2023.*

Restriction on insurance business exception to passive foreign investment company rules

The PFIC exception for insurance companies would be amended to apply only if the foreign corporation would be taxed as an insurance company were it a US corporation and if loss and loss adjustment expenses, unearned premiums, and certain reserve constitute more than 25% of the foreign corporation's total assets (or 10% if the corporation is predominantly engaged in an insurance business, and the reason for the percentage falling below 25% is solely due to temporary circumstances).

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[1] Unlike the DRD provision of the Bill, this rule applies to all US shareholders, even if they are not domestic corporations.
[2] Currently, US shareholder status cannot be conferred by attribution, to a foreign-owned US subsidiary, of ownership of the stock in a foreign corporation owned by the foreign owner of the US subsidiary. See Code section 958(b)(4). However, under the Bill the definition of "US shareholder" with respect to a foreign corporation is, for section 965 purposes, expanded to encompass US persons that meet the 10% voting stock ownership threshold in the foreign corporation only via attribution to the US person of ownership of stock in the foreign corporation that is actually owned by the US person's foreign shareholder, partner, or beneficiary. Thus if a domestic corporation that owns only non-voting stock in a foreign subsidiary has a foreign parent that owns all the voting stock in the subsidiary, under the Bill the domestic corporation would owe transition tax on its pro rata share of the foreign subsidiary's accumulated post-1986 deferred foreign income.
[3] Currently, US shareholder status cannot be conferred by attribution, to a foreign-owned US subsidiary, of ownership of the stock in a foreign corporation owned by the foreign owner of the US subsidiary. See Code section 958(b)(4). However, under the Bill the definition of "US shareholder" with respect to a foreign corporation is, for section 965 purposes, expanded to encompass US persons that meet the 10% voting stock ownership threshold in the foreign corporation only via attribution to the US person of ownership of stock in the foreign corporation that is actually owned by the US person's foreign shareholder, partner, or beneficiary. Thus if a domestic corporation that owns only non-voting stock in a foreign subsidiary has a foreign parent that owns all the voting stock in the subsidiary, under the Bill the domestic corporation would owe transition tax on its pro rata share of the foreign subsidiary's accumulated post-1986 deferred foreign income.
[4] Under the Bill, "US shareholder" would continue to mean a US person that owns, directly or indirectly under Code section 958(a), or by attribution under section 958(b), at least 10% of the total combined voting power of all the classes of voting stock in the foreign corporation (see Code section 951(b)). However, effective for years of foreign corporations beginning after 2017, the Bill would amend section 958(b) so that, as in the case of the definition of "specified foreign corporation" in the Bill's version of Code section 965, US persons would be treated as owning shares in a foreign corporation that are actually owned by the US person's 50% foreign shareholder, partner, or beneficiary.
[5] A US shareholder aggregates its pro rata share of its CFCs' net gain or loss attributable to such amounts.
[6] Averaging of all foreign tax rates across all foreign income is achieved by having the FHRA, unlike subpart F income, determined at the US shareholder level, taking into account the US shareholder's pro rata shares of its CFCs' tested income, and attributable foreign taxes, globally.
[7] Income effectively connected with the conduct of a trade or business in the United States.

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