TAX CUTS AND JOBS ACT OF 2017 INTRODUCES MAJOR REFORMS TO THE INTERNATIONAL TAXATION OF U.S. CORPORATIONS

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On December 22, 2017, President Trump signed into law the Tax Cuts and Jobs Act (“TCJA”) of 2017, P.L. 115-97, which introduced a set of tax cuts and other reforms that will affect substantially all U.S. taxpayers, both corporate and individual. The key feature of the new legislation was the reduction by 40 percent of the maximum federal corporate income tax rate from 35 percent to 21 percent, including qualified personal service corporations. The 21 percent corporate tax rate, which is a flat rate without a set of graduated set of lower rates on lower levels of taxable income, applies to the worldwide taxable income of a domestic corporation. On the international side, there are several major tax benefits that Congress has provided certain U.S. corporations with respect to overseas investments in controlled foreign corporations and export sales and services income. The new law also imposes anti-base-erosion tax on large multinational business enterprises. This article will discuss the four central or main provisions in the TCJA affecting international taxation.

First, U.S. corporations owning 10 percent or more of the stock of a foreign subsidiary are benefitted by a new 100 percent dividends received deduction under Section 245A in moving U.S. multinational corporate enterprises to a territorial based system through a participation exemption system for foreign dividend income from a foreign corporation other than a passive foreign investment company as defined in Section 1297. This change dramatically moved the U.S. for the first time to a territorial based tax system but only with respect to certain domestic corporations.

A second and also highly publicized reform was the tax-advantaged repatriation of untaxed, foreign accumulated earnings and profits held by U.S. corporations through 10 percent or greater stock ownership in foreign corporations (other than passive foreign investment companies as defined in Section 1297). It was estimated by the tax press that such untaxed earnings held offshore were in excess of $3 trillion. Pursuant to “new” Section 965, U.S. corporations can avail themselves of a repatriation tax rate of 15.5 percent on subject foreign accumulated earnings represented in the form of cash and cash equivalents, and eight percent on excess foreign accumulated earnings represented.
by non-cash and cash-equivalent assets. The tax on the repatriation can be elected to be paid over eight years on a back-end loaded series of payments with a special deferral rule for S corporations and their shareholders.

Third, the TCJA provides domestic corporations with reduced rates of U.S. income tax with respect to its foreign-derived intangible income (“FDII”) and global intangible low-taxed income (“GILTI”) derived in taxable years beginning after 2017 (FDII and GILTI are discussed in greater detail below). As set forth in new Section 250(a)(1), a domestic corporation is allowed a deduction an amount equal to the sum of: (i) 37.5 percent of its FDII for such taxable year; plus (ii) 50 percent of its GILTI which is included in gross income in accordance with Section 951A for such taxable year plus the gross-up dividend amount under Section 78 attributable to the GILTI inclusion under Section 951A. The deduction amount effective reduces the U.S. corporate income tax to 13.125 percent with respect to FDII and 10.5 percent with respect to GILTI, which are subject to further adjustment for foreign taxes directly or indirectly paid or accrued.

A fourth major change introduced in the TCJA with respect to the U.S. international taxation of corporations (other than an S corporation, REIT or real estate investment trust) is a base erosion “minimum” tax designed to prevent U.S. companies from stripping earnings out of the U.S. through deductible payments to foreign businesses. The tax is structured as an alternative minimum tax that applies when a multinational company reduces its regular U.S. tax liability to less than a specified percentage of its taxable income, after adding back deductible base eroding payments and a percentage of tax losses claimed that were carried from another year. The tax applies to deductible payments to foreign affiliates from domestic corporations, as well as on foreign corporations engaged in a U.S. trade or business in computing the tax on their effectively connected income (“ECI”) of 10 percent (five percent for taxable years beginning in calendar year 2018) of the modified taxable income of such taxpayer over an amount equal to the regular tax liability (per Section 26(b)) of the corporation for the taxable year reduced by certain credits.

**REPARTIATION OF FOREIGN-SOURCED ACCUMULATED EARNINGS AND PROFITS: NEW CODE SECTION 965**

Newly enacted Code Sec. 965 imposes a transition tax on U.S. domestic corporations and other U.S. persons owning 10 percent or more of the voting stock of a foreign corporation with respect to their pro rata shares of the accumulated (and untaxed) foreign earnings of such foreign subsidiaries by mandating a constructive repatriation (income inclusion) of such accumulated and untaxed foreign earnings and profits under Section 951(a)(1). Foreign earnings held in the form of cash and cash equivalents are taxed at a 15.5 percent rate and the residual untaxed foreign earnings are taxed a rate of eight percent. The “transition tax” may be paid in installments over an eight-year period. The mechanism for achieving the reduced rates of tax is a dividends received deduction amount under Section 965(c).

**REPARTIATION AMOUNT: SECTION 965(a) INCLUSION AMOUNT**

Under the new law, Code Sec. 965(a) provides that for the last taxable year of a deferred foreign income corporation (“DFIC”) beginning before January 1, 2018 (the “inclusion year”), the subpart F income of the DFIC shall be the amount determined under Section 952 and increased by the “Section 965(a) earnings amount,” which is the greater of: (i) accumulated post-1986 deferred foreign income as of November 2, 2017; or (ii) the same deferred foreign income determined as of December 31, 2017. The Section 965 earnings amount with respect to a DFIC is reduced by the amount of such U.S. shareholder’s aggregate foreign E&P deficit allocated in accordance with Code Sec. 965(b)(2), which sum represents the “Section 965(a) inclusion amount”. The repatriation inclusion only applies where the stock ownership threshold is met on the applicable date and with respect to a “specified foreign corporation.” The inclusion date is the last day of the taxable year of the foreign corporation ending in 2018. A calendar year domestic corporation owning shares in a fiscal year specified foreign corporation, for example, will be required to report its Section 951 inclusion with respect to its 2018 return. A specified foreign corporation is any foreign corporation that has at least one U.S. shareholder, i.e., a U.S. person owning, directly or indirectly, 10 percent or more of the voting stock of a foreign corporation. The predicate stock ownership test is obviously met by a CFC. Passive foreign investment companies (“PFICs”) that are not also CFCs may not be a specified foreign corporation.
Adopting a similar set of mechanical rules that run parallel to the rules pertaining to the participation exemption deduction under new Section 245A, as is discussed below, Section 965(c)(1) allows a deduction for the taxable year of a U.S. shareholder with respect to a Section 965(a)(1) inclusion amount that is included in gross income. The inclusion amount is the U.S. shareholder’s pro rata share of the post-1986 foreign accumulated earnings and profits of the deferred foreign income corporation as of the measurement date, i.e., November 2, 2017, or December 21, 2017. This amount is reduced by a U.S. shareholder’s pro rata share of post-1986 accumulated deficits in earnings and profits of specified foreign corporations. The amount of the deduction is equal to: (i) the U.S. shareholder’s eight percent rate equivalent percentage of the excess (if any) of (a) amount included in gross income, less (b) the amount of such U.S. shareholder’s aggregate foreign cash position per Section 965(c)(3)(A); plus (ii) the U.S. shareholder’s 15.5 percent rate equivalent percentage per Section 965(c)(2)(B).

The “aggregate foreign cash position” is defined in Section 965(c)(3)(A) as to a U.S. shareholder the greater of: (i) the aggregate of such United States shareholder’s pro rata share of the cash position of each specified foreign corporation of such United States shareholder determined as of the close of the inclusion year, or (ii) one-half of (a) the aggregate of such described in (i) plus (b) the aggregate foreign cash position over a two-year period as of the applicable “cash measurement date.”

The term “cash position” is defined in Section 965(c)(3)(B) as the sum of a specified foreign corporation’s (i) cash; (ii) net accounts receivable; plus (iii) the fair market value of certain assets, including actively traded property, certificates of deposit, short-term obligations, foreign currency, etc. Under Section 965(c)(3)(E), cash positions of certain non-corporate entities, such as a partnership or limited liability company, are taken into account as if such entity were a specified foreign corporation and there would be at least one U.S. shareholder if such entity were a foreign corporation.

For Section 951 inclusion amounts not allocable to the taxpayer’s aggregate foreign cash position, the allowable deduction under Section 965(c) is the amount included in gross income of the U.S. shareholder equal to the eight percent rate equivalent percentage, i.e., the amount of the deduction required from the highest tax rate set forth under Section 11 that would result in an eight percent rate of tax. This substantially lower tax rate for non-cash or cash equivalent inclusions has already inspired and will continue to motivate taxpayers subject to the inclusion in 2018 to have moved out of their cash and cash-equivalent positions before the applicable Section 951 inclusion amount date. The resulting tax stakes were the IRS to challenge this cash position reduction maneuvers will be quite high.

Where a U.S. shareholder sells stock of a CFC at a gain which results in dividend income in accordance with Section 1248, the deemed dividend recharacterization qualifies for the participation exemption under Section 245A.

**DFICS AND ACCUMULATED POST-1986 DEFERRED FOREIGN INCOME**

As to any U.S. shareholder, a DFIC is any specified foreign corporation of such U.S. shareholder that has post-1986 (positive) accumulated post-1986 deferred foreign income (as of a measurement date). Accumulated post-1986 deferred foreign income is the post-1986 E&P of a specified foreign corporation but reduced by: (i) income of the specified foreign corporation which is effectively connected with the conduct of a trade or business in the U.S. (“ECI”) and thereby subject to US income tax; and/or (ii) as to a CFC, the previously taxed income of a US shareholder under Section 969. Post-1986 accumulated foreign source E&P is determined in accordance with Code Sections 964 and 986, provided, however, that it only takes into account periods when the foreign corporation was a specified foreign corporation and without reduction of dividends distributed during the inclusion year other than dividends distributed to another specified foreign corporation.

The required income inclusion is reduced by the portion of aggregate foreign E&P deficit allocated to that person’s interest in an “E&P deficit foreign corporation.” The deficits of a foreign subsidiary accumulated prior to its acquisition by a U.S. shareholder may be taken into account in determining the aggregate...
foreign E&P deficit of a U.S. shareholder. The provision permits intragroup netting among shareholders in an affiliated group where there are one or more U.S. shareholders with a net E&P surplus and another with a net E&P deficit.

Example

U.S. corp. X has two domestic subs., Y and Z, which it owns 100 percent and 80 percent, respectively. Assume Y has a $10,000x net foreign accumulated E&P surplus and Z has a $5,000x net foreign accumulated E&P deficit. The net E&P surplus of Y may be reduced by the net E&P deficit of Z to the extent of the group’s ownership percentage in C, which is 80 percent.

DEFINITION OF SPECIFIED FOREIGN CORPORATION

U.S. shareholders falling within the scope of the repatriation of foreign earnings rule are required to include in gross income the Section 951 inclusion amount for its taxable year beginning in 2017 and make the required payment of the additional tax, net of applicable deductions by the due date of the return. Under Section 965(h), the U.S. shareholders may elect to pay the net tax liability under Section 965 over eight years under a back-end loaded payment allocation.

The deemed repatriation provision potentially applies to any “specified foreign corporation,” which term has two definitions as set forth in Section 965(e)(1). First, a specified foreign corporation is any foreign corporation that is a CFC, i.e., a foreign corporation in which U.S. shareholders (those U.S. persons owning 10 percent or more of the Corporation’s voting stock) own, directly or indirectly, more than 50 percent of the outstanding voting stock or value of the foreign corporation on any day of the taxable year in question.13 Under the constructive stock ownership rules in Section 958, Section 958(a)(2) provides that stock owned by or for a foreign corporation, foreign partnership, or foreign trust or estate is considered as owned proportionately by its shareholders, partners, or beneficiaries. Stock treated as constructively owned under Section 958(a)(2) is treated as actually owned by such person.

Example

U.S. partnership ABC owns 60 percent of the partnership interests in foreign partnership XYZ. Partnership XYZ owns 40 percent of the voting common of foreign corporation Q. Corporation Q is a 50 percent partner in foreign partnership TRS and TRS owns 100 percent of the stock of foreign corporation R. Under Section 958(a)(2) U.S. partnership ABC is considered to own 12 percent of the stock in R corporation.

A specified foreign corporation is any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder (10 percent corporation). In other words, the foreign corporation does not have to be a CFC as of the measuring date, it only has to have one or more U.S. shareholders and the foreign corporation may in fact not be a CFC. This greatly expands the number of U.S. shareholders that are subject to the Section 951 inclusion. Therefore, all U.S. shareholders of any foreign corporation in which one or more domestic corporations is a U.S. shareholder as of the measurement date, are required to recapture their pro rata shares of post-1986 accumulated E&P from foreign source income with respect to specified foreign corporation. The Section 951 inclusion amount is treated for purposes of Code Sections 951 and 961 as attributable to subpart F income of a CFC. However, if a passive investment company per Section 1297 with respect to the U.S. shareholder (10 percent) is not a CFC, then such foreign corporation is not a specified foreign corporation.

FOREIGN TAX CREDIT IMPACTS

Under Section 965(g), no creditable foreign tax (or alternatively, no deduction for foreign income taxes paid or accrued) is allowed under Section 901 to the extent of the applicable percentage of foreign taxes paid or accrued with respect to the repatriation income inclusion amount for which a deduction is allowed under Section 965(c)(1). This rule is designed to avoid increasing the U.S. tax rate with respect to the repatriation pegged rates of 15.5 percent (cash or cash equivalent) and eight percent (other). is defined in Code Sec. 965(g)(2) and is designed to reduce FTCs in proportion to the U.S. shareholders’ aggregate amount of accumulated foreign E&P that was reduced by virtue of the deduction allowed in Code Sec. 965(c)(2) in arriving at the 15.5 percent equivalent rate or eight percent equivalent rate. The disallowed portion of otherwise allowable FTCs is 71.4 percent of foreign taxes paid attributable to the portion of the Section 965 inclusion attributable to the aggregate cash position, plus 85.7 percent of foreign taxes paid attributable to the remaining portion of the Section 965 inclusion.14
ELECTION TO PAY TAX LIABILITY ATTRIBUTABLE TO REPATRIATION INCLUSION IN INSTALLMENTS

A U.S. shareholder of a deferred foreign income corporation may elect to pay the net tax liability from the mandatory Section 951 inclusion from a deferred foreign corporation in eight annual installments. This rule is set forth in Code Sec. 965(h). An election to pay tax in installments with respect to the aggregate net Section 951 inclusion is required to be made by the due date for the 2017 tax year tax return, which is the taxable year in which the pre-effective date CFC earnings are included in income. The first installment is payable on the due date of the tax return without regard to any extension of time for filing the return. Succeeding installments must be paid annually no later than the due dates (without extensions) for the income tax return for each succeeding year. Under Code Sec. 965(h)(1), an electing U.S. shareholder is required to pay the “net tax liability” as follows:

2. Eight percent of the total net tax liability for each of the first 5 installments;
3. 15 percent of the total net tax liability for the 6th installment;
4. 20 percent of the total net tax liability for the 7th installment;
5. 25 percent of the total net tax liability for the 8th installment.

Where a deficiency in income tax is later determined with respect to the amount of the “net tax liability,” the additional tax due may be prorated among all installment payments in most circumstances.

Under Section 965(h)(3) an acceleration of the total net tax liability becomes due where: (i) there is a failure to pay timely any required installment; (ii) there is a liquidation or sale of substantially all the assets of such S corporation, including in a title 11 or similar case, a cessation of business by such S corporation, such S corporation ceases to exist or any similar circumstance; and (iii) a transfer of any share of stock in such S corporation by the taxpayer (including by reason of death or otherwise). In the event of a transfer of less than all of an S shareholder’s stock in the S corporation, the transfer is a triggering event only with respect to that portion of the taxpayer’s net tax liability as is allocable to such stock.

Where an acceleration event occurs, a shareholder of the S corporation, in general, may still elect to pay the deferred net tax liability in eight equal annual installments in accordance with Section 965(h). But there are limitations on the eight year payout. Where the triggering event is a liquidation, sale of substantially all corporate assets, termination of the company or end of business or similar event, the installment payment election in unavailable. In each such circumstance, the entire net tax liability is due upon notice and demand. The installment election, where available after a triggering event, is due with the timely filed return for the year in which the event occurs determined without extensions of time.

SPECIAL RULES FOR S CORPORATIONS

Under Section 965(i)(1), in the case of any S corporation which is a U.S. shareholder of a deferred foreign corporation, each shareholder of such S corporation may elect to defer payment of such shareholder’s net tax liability under Section 965(a) until the shareholder’s taxable year which includes a triggering event, as defined in Section 965(i)(2). The election to defer the tax is due not later than the due date for the return of the S corporation for its last taxable year that begins before January 1, 2018.

There are three types of triggering events: (i) where the corporation ceases to be an S corporation, effective as of the first day of the taxable year that such corporation is not an S corporation; (ii) the liquidation or sale of substantially all the assets of such S corporation, including in a title 11 or similar case, a cessation of business by such S corporation, such S corporation ceases to exist or any similar circumstance; and (iii) a transfer of any share of stock in such S corporation by the taxpayer (including by reason of death or otherwise). In the event of a transfer of less than all of an S shareholder’s stock in the S corporation, the transfer is a triggering event only with respect to that portion of the taxpayer’s net tax liability as is allocable to such stock.

Where an acceleration event occurs, a shareholder of the S corporation, in general, may still elect to pay the deferred net tax liability in eight equal annual installments in accordance with Section 965(h). But there are limitations on the eight year payout. Where the triggering event is a liquidation, sale of substantially all corporate assets, termination of the company or end of business or similar event, the installment payment election in unavailable. In each such circumstance, the entire net tax liability is due upon notice and demand. The installment election, where available after a triggering event, is due with the timely filed return for the year in which the event occurs determined without extensions of time.

RECAPTURE OF REPATRIATION TAX RATE BENEFITS FOR EXPATRIATED ENTITIES

Under Section 965(l)(1) where a domestic corporation claimed a Section 965(c) deduction and the shareholder subsequently becomes an “expatriated entity” under Section 7874(a)(2) (but not an 80 percent entity treated as a domestic corporation under Section 7874(b)) at any time during the 10-year period
beginning on December 22, 2017 (as to when a surrogate foreign corporation first became a surrogate foreign corporation), then the income tax of the U.S. shareholder is increased for the first tax year in which the taxpayer becomes an expatriated entity by 35 percent (not the new 21 percent) of the amount of the deduction allowed under Section 965(c) and may not claim any foreign tax credits against the recapture tax.

DEDUCTION FOR FOREIGN SOURCE PORTION OF DIVIDENDS RECEIVED BY DOMESTIC CORPORATIONS FROM SPECIFIED 10 PERCENT OWNED FOREIGN CORPORATION

Under the TCJA, Section 245A provides that a domestic corporation which is a “U.S. shareholder” of a specified foreign corporation is permitted to deduct 100 percent of the foreign-source income allocable to the dividend. A specified foreign corporation is any foreign corporation other than a PFIC that is not a CFC. No foreign tax credit or deduction is allowed for any taxes paid or accrued or deemed paid or accrued for any dividend qualifying for the 100 percent DRD under Section 245A. Section 245A does not apply to any dividend received by a U.S. shareholder from a CFC where the dividend is a “hybrid dividend.”

Where the domestic corporation U.S. shareholder indirectly owns 10 percent or more of the voting stock of a foreign corporation through a foreign partnership or other fiscally transparent entity, such indirect ownership may qualify for the participation DRD with respect to dividends from the foreign corporation as if the domestic corporation had owned the stock directly.

The new law imposes a holding period requirement in order for the domestic corporation to qualify. The U.S. shareholder-corporation must have owned the shares of the specified 10 percent owned foreign corporation for more than 365 days during a period of 731 days commencing with the date which is one year before the date on which the shares become “ex-dividend” with respect to the dividend and the U.S. corporation is a U.S. shareholder at all times during such period. See a related rule under Section 246(c).

There are other applicable rules that need to be considered. Distributions sourced from previously taxed subpart F income under Section 959(d) does not constitute a dividend for purposes of Section 245A even if it reduces earnings and profits. Dividends treated as qualifying under the 100 percent DRD rule still reduce stock basis for purposes of determining loss.

The sale of stock by a CFC with respect to a lower-tier CFC described in Section 965(e)(1) that generates subpart F income will qualify for a participation exemption deduction under Section 245A. Gain from the sale or other taxable disposition of stock in a 10 percent or more owned foreign corporation, which is recharacterized as dividend income under Section 1248, will also qualify for the 100 percent DRD rule for a qualified U.S. corporation.

The benefits for C corporations qualifying under Section 245A are clear. With the 100 percent dividend deduction, the deemed dividend FTC rule in Section 902 with respect to dividends paid by a foreign corporation in which a domestic corporation was a U.S. shareholder could be repealed. Moreover, under the new law, in certain instances, a domestic corporation’s rate of tax on foreign source income may be lower than the 21 percent (flat corporate rate). This outcome will occur with respect to a dividend from corporation organized under the laws of a tax haven jurisdiction such as the Bahamas. Its zero percent corporate income rate (actually there is no corporate income tax in the Bahamas) will carry over to the U.S. eligible corporation. Under prior law the tax haven dividend scenario would have still resulted in 35 percent U.S. income tax to the domestic corporation. It is further important to recognize that taxpayers other than C corporations owning 10 percent or more of the stock of a foreign corporation may be subject to tax at regular U.S. tax rates which can be as high as 40.8 percent where the actual taxpayer is an individual who is subject to the net investment income tax under Section 1411 is factored into the mix.

INCLUSION IN GROSS INCOME BY U.S. SHAREHOLDERS OF CONTROLLED FOREIGN CORPORATIONS OF GILTI

Prior to the TCJA, U.S. persons owning shares of stock in a foreign corporation were, in general, not subject to tax until the shareholders received actual or constructive dividends from the corporation. Under the CFC provisions, however, U.S. persons who own 10 percent or more of the voting stock of a CFC are required to include in gross income their pro rata share of Subpart F income whether such income was distributed to such person. Subpart F income is defined in Section 952 and includes: (i) insurance income (Section 953); (ii)
Under new Section 951A, each person who is a U.S. shareholder under Section 951(b), i.e., a person owning 10 percent or more of the voting stock or value of all issued shares of the foreign corporation, must include in gross income, such U.S. shareholder’s pro rata share of GILTI as if such income were Subpart F income. In an elaborate set of definitional rules set forth in the statute, GILTI is the excess, if any, of the shareholder’s net CFC tested income over the shareholder’s net deemed tangible income return for the tax year. The shareholder’s net deemed tangible income return equals 10 percent of the aggregate of the shareholder’s pro rata share of the qualified business asset investment (“QBAI”) of each CFC with respect to which it is a U.S. shareholder. This provision is effective for taxable years of foreign corporations beginning after December 31, 2017, and for taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end.

There are important terms and definitions to apply under this new GILTI rule in Section 951(a) and corresponding deduction rule in Section 250. However, Section 250 only applies to domestic C corporations. The deduction for a domestic corporation’s GILTI income is 50 percent of such amount, thereby reducing the new flat 21 percent corporate income tax to only 10.5 percent and as further subject to reduction for deemed paid foreign taxes. In contrast, substantially higher rates of U.S. tax (up to 37 percent) will apply to GILTI derived by individuals, S corporations, trusts or estates, and such taxpayers may not be able to claim a credit for the foreign taxes imposed on its share of GILTI attributable to a CFC.

**NET CFC TESTED INCOME**

As to any U.S. shareholder, net CFC tested income is the excess of the aggregate of the shareholder’s pro rata share of the tested income of each CFC over the aggregate of its pro rata share of the tested loss of each CFC with respect to which it is a U.S. shareholder. The tested income of a CFC is the excess of gross income (without regard to certain exceptions to tested income) over deductions (including taxes) properly allocable to such gross income or tested gross income. The tested loss of a CFC is the excess of deductions allocable to the corporation’s gross income over the amount of such income.

**QUALIFIED BUSINESS ASSET INVESTMENT**

QBAI is the average of the aggregate amount of the CFC’s adjusted bases in specified tangible property used in its trade or business which is depreciable under Section 167. The computation is required to be made quarterly. The adjusted basis in the qualified property must be determined under the alternative depreciation system under Section 168(g).

**GILTI TREATED IN THE SAME MANNER AS SUBPART F INCOME**

The amount of a U.S. shareholder’s GILTI is allocated among each CFC with respect to which it is a U.S. shareholder. The portion of GILTI treated as being with respect to a CFC equals zero for a CFC with no tested income and, for a CFC with tested income, the portion of GILTI which bears the same ratio to the total amount of GILTI as the U.S. shareholder’s pro rata amount of tested income of the CFC bears to the aggregate amount of the U.S. shareholder’s pro rata amount of the tested income of each CFC with respect to which it is a U.S. shareholder. For a CFC with tested income, the following formula expresses how to determine the portion of GILTI treated as being with respect to the CFC.

**DEEMED PAID FTC CREDITS ATTRIBUTABLE TO TESTED INCOME OF A DOMESTIC CORPORATION U.S. SHAREHOLDER**

For amounts of GILTI includible in income of a domestic corporation (U.S. shareholder), the corporation’s deemed-paid credit is 80 percent of the product of the corporation’s inclusion percentage, as specifically defined, multiplied by the aggregate tested foreign income taxes paid or accrued as to tested income, by
each CFC to which the domestic corporation is a U.S. shareholder. The new GILTI rule for deemed-paid foreign taxes creates a separate foreign tax credit basket for GILTI, with no carryforward or carryback available for excess credits. For purposes of determining the FTC limitation, therefore, GILTI is not general category income, and income that is both GILTI and passive category income is considered passive category income. Under revised Section 78, the taxes deemed to have been paid are treated as an increase in GILTI for purposes of Section 78, determined by taking into account 100 percent of the product of the inclusion percentage and aggregate tested foreign income taxes (in lieu of 80 percent standard use in the determination of the deemed-paid credit).

While the impetus for the set of corporate tax reforms introduced in the TCJA was to stimulate direct investment in the U.S. in terms of a substantial increase in labor and capital, the GILTI provision, when combined with its sibling provision in Section 250, which grants a 50 percent deduction to a domestic corporation in reducing the 21 percent corporate tax rate to 10.5 percent (or lower after allocable FTCs are factored), may provide incentives for increased capital investment overseas.

GLOSSARY OF RELEVANT FDII TERMS:

“Foreign Derived Deduction Eligible Income”

Under Section 250(b)(4), the term “foreign-derived deduction eligible income” of the taxpayer (U.S. domestic corporation) derived in connection with: (A) property (i) which is sold by the taxpayer to any person who is not a U.S. person, and (ii) which the taxpayer establishes to the satisfaction of the IRS is for a foreign use; or (B) services provided by the taxpayer which the taxpayer establishes to the satisfaction of the IRS is for a foreign use; or (B) services provided by the taxpayer which the taxpayer establishes to the satisfaction of the IRS is for a foreign use; or (B) services provided by the taxpayer which the taxpayer establishes to the satisfaction of the IRS is for a foreign use. Foreign use means any use, consumption, or disposition that is not within the United States. Special rules for determining foreign use apply to transactions that involve property or services provided to domestic intermediaries or related parties. For purposes of the provision, the terms “sold,” “sells,” and “sale” include any lease, license, exchange, or other disposition.

“Property or Services Provided to Domestic Intermediaries”

Where a domestic corporation sells property to another person (other than a related party) for further manufacture or modification within the U.S., the property is generally not treated as sold for a foreign use even if such other person subsequently uses such property for foreign use. An exception to the general rule applies with respect to property: (i) that is ultimately sold by a related party, or used by a related party in connection with property that is sold or the provision of services, to another person who is an unrelated party who is not a U.S. person; and (ii) that the taxpayer establishes to the satisfaction of the Secretary is for a foreign use. Deduction eligible income derived in connection with services provided to another person (other than a related party) located within the United States is not treated as foreign-derived deduction eligible income, even if the other person uses the services in providing services the income from which is considered foreign-derived deduction eligible income.
“Applicable Rules For Related Party Transactions”

If property is sold to a related foreign party, the sale is not treated as for a foreign use unless the property is sold by the related foreign party to another person who is unrelated and is not a U.S. person and the taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use. Income derived in connection with services provided to a related party who is not located in the U.S. is not treated as foreign-derived deduction eligible income unless the taxpayer can establish that such service is not substantially similar to services provided by the related party to persons located within the U.S.

A “related party” for this purpose means any member of an affiliated group as defined in Section 1504(a) determined by substituting “more than 50 percent” for “at least 80 percent” each place it appears and without regard to Sections 1504(b)(2) and 1504(b)(3). Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member, with control being determined under the rules of Section 954(d)(3).

“Foreign-Derived Intangible Income (‘FDII’)”

The FDII of any domestic corporation is the amount which bears the same ratio to the corporation’s deemed intangible income as its foreign-derived deduction eligible income bears to its deduction eligible income. In other words, a domestic corporation’s FDII is its deemed intangible income multiplied by the percentage of its deduction eligible income that is foreign-derived.

“Deemed Intangible Income”

The term “deemed intangible income” is the excess (if any) of the U.S. corporation’s deduction eligible income less its deemed tangible income return. The deemed tangible income tax return is an amount equal to 10 percent of the corporation’s QBAI.

“Qualified Business Asset Investment (‘QBAI’)”

The term “qualified business asset investment” (‘QBAI’) is the average of the aggregate of the U.S. corporation’s adjusted bases, determined as of the close of each quarter of the taxable year, in specified tangible property used in its trade or business and is depreciable under Section 167. The adjusted basis in any property must be determined using the alternative depreciation system (“ADS”) under Section 168(g).

“Specified Tangible Property”

Specified tangible property means any tangible property used in the production of deduction eligible income. If such property was used in the production of deduction eligible income and income that is not deduction eligible income (i.e., dual-use property), the property is treated as specified tangible property in the same proportion that the amount of deduction eligible gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property.

WHAT ARE THE FDII AND GILTI DEDUCTIONS ALL ABOUT?

Congress did not stop with a 21 percent tax rate on C corporations on worldwide income. It reduced that rate substantially for foreign based business activities. Section 250 effectively resets the new maximum rate of corporate income tax on qualifying domestic corporations with respect to FDII at 13.75 percent and 10.5 percent with respect to GILTI. Foreign tax credits on GILTI can reduce the effective rate of U.S. tax to even zero percent. That would be the case if a foreign country taxes GILTI income at a rate of 18.9 percent or more. Where the sum of a domestic corporation’s FDII and GILTI amounts exceed its taxable income, the amount of FDII and GILTI for which a deduction is allowed is
reduced by an amount determined by such excess. The reduction in FDII for which a deduction is allowed equals such excess multiplied by a percentage equal to the corporation's FDII divided by the sum of its FDII and GILTI. The reduction in GILTI for which a deduction is allowed equals the remainder of such excess. The provision is effective for taxable years beginning after December 31, 2017.

The impact of the FDII and GILTI provisions will undoubtedly encourage U.S. corporations to continue to invest capital and labor overseas. While the "selling" of the TCJA was its ability to grow and revitalize our manufacturing base and attract foreign based companies to continue to invest in the states, it is also clear that Congress intended to increase the competitiveness of U.S. companies overseas through FDII, GILTI and of course the 100 percent dividends received deduction from 10 percent or more owned foreign corporations.

Our treaty partners have noticed this new "bonanza" that the TCJA grants U.S. domestic corporations including domestic groups that are part of a multinational enterprise of corporations. Cries of unfair export subsidies have already been heard from our European country treaty neighbors to the east and our Canadian treaty partner to the north. Looks like another round of WTO litigation may result reminiscent of the FISC and extraterritorial exemption WTO challenges that were previously raised.

**BASE EROSION AND ANTI-ABUSE TAX ("BEAT")**

The countries which make up the European Union as well as other industrialized nations have been quite concerned, as has the United States, with earnings stripping strategies employed by multinational business enterprises, to reduce if not eliminate taxable income from high-tax states in which business profits are derived to low-tax jurisdictions. The earnings stripping is generated through the use of foreign based affiliates which receive payments from operating companies located in the high-tax jurisdictions for interest, dividends, royalties and compensation for outsourced service income. As long as the payments are deductible from taxable income, earnings in the source of income jurisdiction are reduced. In a more elaborate form, the use of hybrid entities or entity mismatches may result in an offsetting deduction without a corresponding inclusion in the recipient's gross income.\(^30\)

The TCJA provided the United States' unilateral step forward in this area by imposing the BEAT. Under new Section 59A, domestic corporations (but not S corporations) and foreign corporations having effectively connected income in the U.S. with more than $500 million in average annual gross receipts for the three year taxable year period ending as of the preceding year, and over a minimum amount of certain types of related-party payments may be subject to a new 10 percent (five percent for taxable years beginning in calendar year 2018) minimum tax which is effectively a form of add-on tax to the regular 21 percent corporate tax rate.\(^31\) The computations are made by aggregating affiliated domestic and foreign related parties.

The BEAT is based on the domestic corporation(s) "modified taxable income" which is taxable income determined without regard to any "base erosion benefit" with respect to any "base erosion payment," or the "base erosion percentage" of any NOL allowed the year. This means, as a practical matter, that taxable income is increased for deductible amounts paid to a related foreign person for services, interest, rents and royalties. It also would include depreciation and amortization of property acquired from related foreign persons for property purchased after December 31, 2017.

There are certain foreign related-party payments that are not subject to the BEAT. This includes payments for cost of goods sold and payments for services provided at cost. In addition, certain tax credits (but not research and development credits, certain energy credits and 80 percent of low-income housing credits) are added to the minimum tax. While certain foreign based companies having U.S. subsidiaries may fall subject to the BEAT there will certainly be efforts to mitigate this exposure by attempting to allocate if not "dump" many forms of economic payments that would otherwise be characterized as fees, licensing payments, royalties, etc. into cost of goods sold.

After modified taxable income is determined, the BEAT rate of 10 percent (five percent for 2018) is applied. Where the BEAT amount is greater than the regular tax liability of the corporation (taking into account certain tax credits including foreign tax credits that reduce U.S. tax), then the excess amount is imposed as an additional tax on the corporation. The excess tax is not creditable in any subsequent year.
As with the other corporate tax reforms announced in the TCJA, much guidance will be needed with respect to the BEAT.

CONCLUSION

While there are other important provisions in the TCJA that will impact the taxation of domestic corporations, the four provisions highlighted in this article should give the reader a view of the “tall buildings” that first appear when looking at the new tax architectural landscape Congress has provided us.

Notes

1. The new law revised Section 172 pertaining to net operating losses (“NOLs”). Under prior law, a corporation’s NOL deduction was not subject to a limitation based on taxable income for regular tax purposes. An NOL in general could be carried back two years and carried forward 20 years unless the taxpayer elected to simply use the losses on a carryforward basis. The NOL permitted under the corporate alternative minimum tax was 90 percent of alternative minimum tax income. Under the TCJA, the NOL deduction is reduced to 80 percent of taxable income determined without regard to the NOL deduction and any excess is may only be carried forward. As revised, the NOL deduction is equal to the lesser of: (i) the aggregate NOL carryovers to that year, plus any available NOL carrybacks to that year; or (ii) 80 percent of taxable income (without regard to the NOL deduction). The 80 percent taxable income limitation does not apply with respect to NOLs of property and casualty insurance companies. Fiscal year taxpayers will not be subject to the 80 percent limitation for any taxable year beginning in 2017; only beginning with taxable years commencing in 2018.

2. Previously, former Section 965(a)(1), enacted by P.L. No. 108-357 (2004) (American Jobs Creation Act) provided a repatriation rule by allowing a U.S. shareholder of one or more controlled foreign corporations to elect a deduction of 85 percent of qualifying “cash dividends” with respect to foreign accumulated earnings and profits received during first taxable year beginning on or after October 23, 2004 through October 22, 2005. The deduction only applied to repatriations in excess of the average repatriation level for the “base period years,” as defined and further required that the dividend be invested in the U.S. pursuant to a domestic reinvestment plan. Former Section 965(b)(4). Ironically, the conference report to AJCA noted that “this is a temporary economic stimulus measure, and…there is not intent to make this measure permanent, or to ‘extend’ or enact it again in the future.” H. Rept. No. 755, 108th Cong., 2d Sess. 314 (Conf. Rep. 2004). See Giegerich, “One-Time Tax Break for Repatriation of Foreign Earnings: The Clock Is Ticking—Summary and Analysis of Guidance,” 108 Tax Notes 547 (Aug. 1, 2005); Yoder, “Notice 2005-64, Section 965 Qualifying Cash Dividends and Tax Computations,” 34 Tax Mgmt. Int’l J. 703 (2005). It was reported that 843 domestic corporations (out of 9,700 corporations with CFCs) claimed the Section 965 deduction under ACJA. Qualifying dividends were estimated to be $312.2 billion.

3. All references to Sections for purposes of this article are with respect to the Internal Revenue Code of 1986, as amended through P.L. 155-97, the Tax Cuts and Jobs Act (TCJA) of 2017 (12/22/2017).

4. For many U.S. shareholders, their post-1986 foreign source accumulated E&P were eliminated under the 2004 repatriation rules.

5. Under Section 245A, a participation exemption system is established for foreign income received by a specified 10 percent owned foreign corporation with respect to any domestic corporation which is a U.S. shareholder under Section 951(b). The zero percent rate is produced by allowing a 100 percent dividends received deduction (“DRD”) with respect to the foreign-source income portion of dividends received from the foreign corporation. The foreign-source portion of any dividend is based on the ratio of the foreign corporation’s post-1986 undistributed foreign earnings bears to the corporation’s total post-1986 undistributed earnings. Foreign tax credits (or deductions) (“FTCs”) are disallowed for any dividend for which a DRD is allowed. The TCJA also repeals Section 902 effective for taxable years beginning after 2017. Under Section 960, as amended by the TCJA, a deemed paid FTC will be allowed with respect to Section 951(a)(1) inclusions, but only to the extent “properly attributable” to the inclusion. Special rules under Section 960(b) apply for FTCs for distributions of previously taxed income. The amendments to Section 960 are effective for tax years of foreign corporation beginning after 2017 and U.S. shareholders’ tax years in which or with which such taxable years of foreign corporations end.

6. See Section 965(c)(1)(B).

7. Under Section 965(c)(3) “aggregate foreign cash position” is as to any U.S. shareholder the greater of: (i) the U.S. shareholder’s aggregate share of the cash position of each specified foreign corporation determined as of the close of the last taxable year of such specified foreign corporation which began before January 1, 2018; or (ii) one-half of the sum of (a) the aggregate of the sum described in (i) of this footnote; plus (b) the aggregate cash position of the foreign corporation as of the preceding taxable year.

8. See Section 965(c)(1)(A).

9. The applicable measurement dates are November 2, 2017 or December 31, 2017. See Section Section 965(a)(1), 965(a)(2). An anti-abuse provision is contained in the statute where Treasury, presumably by authority granted under regulations or notice, determines that a principal purpose of any transaction was to reduce the aggregate foreign cash position taken into account, in which case such transaction shall be disregarded. Section 965(c)(3)(F). The IRS released Notice 2018-7, 2018-4 IRB (Dec. 29, 2017) describing regulations that Treasury and the IRS intend to issue, including rules for determining the amount of cash and cash equivalents. Undoubtedly one area for coverage by the IRS under the “anti-abuse” rule will be
when related-party transactions in accounts receivable and short-term obligations will be disregarded in determining the aggregate foreign cash position.

10 See Section 1248(j).

11 See Section 965(d)(1).

12 See Section 965(d)(2). Section 951(a) permits the basis of a U.S. shareholder’s stock in a CFC and the basis of property of a U.S. shareholder by reason of which he is considered under Section 958(a)(2) as owning stock of a CFC, to be increased by the amount required to be included in gross income per Section 951(a). A reduction in basis rule is contained in Section 951(b).

13 See Section 957(a). Treas. Reg. Section 1.957-1(c), Ex. 8 (so-called "50-50 deadlock" on CFC status. Prior to the TCJA, Section 951(b) defined a U.S. shareholder as a U.S. person owning 10 percent or more of the corporation’s voting power. Stock attributions rules are used in making this determination under Section 958. See, e.g., Framatone Connectors USA, Inc. v. Comm’r, 118 T.C. 32 (2002), aff’d, 108 Fed. Appx. 683 (2nd Cir. 2004).

14 Section 965(g)(4) coordinates the FTC cutback with the amount of the required foreign tax credit gross-up under Section 78 based on the amount of FTCs that reflect the amount of foreign source accumulated E&P and that were subject to tax. The gross-up amount equals the total foreign income taxes multiplied by a fraction: (i) the numerator is the taxable portion of the increased subpart F income, i.e., the ¶951 inclusion; and (ii) the denominator is the total increase in subpart F income.

15 See Section 245A(b). It should be noted that a “purging distribution” of a PFIC by a U.S. shareholder under Section 1291(d)(2)(B) does not qualify for the 100 percent DRD under Section 245A.

The TCJA also changed the dividends received deduction percentages for dividends from U.S. corporations other than a 100 percent owned domestic subsidiary under Section 243. Under prior law, for example, the 70 percent DRD for a dividend otherwise taxable at 35 percent would be reduced to 10.5 percent. Under the TCJA, the 70 percent DRD under Section 243 has been reduced to 50 percent and the 80 percent DRD for 20 percent or more owned corporations is now 65 percent. See Sections 243(a)(1), 243(c)(1). The reductions were designed to yield essentially the same outcomes achieved at the corporate maximum tax rate of 35 percent under the 21 percent flat rate under the TCJA.

16 See Sections 901 (former) 902, 960, 164.

17 A hybrid dividend for this purpose is an amount received by a CFC as a dividend which would have otherwise qualified under Section 245A and with respect to which the CFC received a deduction or other tax benefit with respect to any income or other taxes imposed by any foreign country or U.S. possession, Section 245A(e)(4).

18 See Section 1059.

19 Under the GILTI inclusion under Section 951(a)(1)(A), a person is treated as a U.S. shareholder of a CFC for any taxable year only if such person owns (per Section 958(a)) stock in the corporation on the last day, in such year, on which the corporation is a CFC. A corporation is generally treated as a CFC for any taxable year if the corporation is a CFC at any time during the taxable year.

20 As a formula, GILTI = Net CFC Tested Income - (10 percent x QBAI).

21 It is uncertain whether a non-domestic corporation taxpayer receiving GILTI income will require that such income be subject to the net investment income tax under Section 1411.

22 As a formula, Net CFC Tested Income = Sum of CFCC Tested Income-Sum of CFC Tested Loss.

23 Dual use property, i.e., tangible personal property used for the production of tested income and non-tested income, is treated as qualifying property in the same proportion that the amount of tested gross income produced with respect to the property bears to the total amount of gross income produced with respect to the property. If a building produces $1,000 x of tested gross income and $250x of subpart F income for a taxable year, then 80 percent ( = $1,000/$1,250) of a domestic corporation’s average adjusted basis in the building is included in QBAI for that taxable year.

24 As a formula, CFC’s GILTI = GILTI x Share of CFC’s Tested Income/Share of Aggregate CFC Tested Income.

25 As a formula, the Deemed-Paid Credit = 80 percent x GILTI/ Aggregate Tested Income x Aggregate Tested Foreign Income Tax.

26 As a formula, the Section 78 Gross-Up = 100 percent x GILTI/ Aggregate Tested Income x Aggregate Tested Foreign Income.


28 Under Section 951A(b)(1), the term GILTI means, as to any U.S. shareholder the excess of: (i) such shareholder’s net controlled foreign corporation tested income for such taxable year, over (ii) such shareholder’s net deemed tangible income return for such year. The “net deemed tangible income return” is defined in Section 951A(b)(2) (as the excess of: (i) 10 percent of the aggregate of such shareholder’s pro rata share of the qualified business asset investment of each controlled foreign corporation with respect to which such U.S. shareholder is a U.S. shareholder over (ii) the interest expense taken into account in determining the shareholder’s net controlled foreign corporation tested income to the extent the interest income attributable to such expense is not taken into account in computing such shareholder’s net controlled foreign corporation tested income.

29 This calculation can be set forth as follows:

\[
FDII = \frac{Deemed\text{Intangible\ Income}}{Foreign-Derived\text{\ Deduction\ Eligible\ Income}} \times \frac{\text{Foreign-Derived\ Deduction\ Eligible\ Income}}{\text{Deemed\ Intangible\ Income}}
\]

30 See OECD/G20 Base Erosion and Profit Shifting Project, Action 2, Neutralising the Effects of Hybrid Mismatch Arrangements, and Action 4, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, 2015 Final Report. Over 100 countries are reported as collaborating to implement the BEPS measures which are reflected in an Explanatory Statement and 15 separate Action papers.

31 The rate increases to 12.5 percent beginning in 2025. The BEAT does not apply to individuals, partnerships, trusts, real estate investment trusts or regulated investment companies.
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