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Tax Act: Significant International Provisions

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Double Taxation of Overseas Earnings

Prior to the Tax Act, the principal method for avoiding the double taxation of overseas corporate earnings—once by the local country and a second time by the United States as the multinational's home country—was the foreign tax credit ("FTC"). Although the FTC regime was (and is) notoriously complex, its fundamental principle has been easy to grasp: although the United States will tax the worldwide earnings of U.S. corporations, it will (albeit subject to numerous limitations) grant a credit for foreign income taxes imposed on those earnings.

The Act makes some changes to the mechanics of the FTC, but its principal thrust is to make the FTC a secondary method for avoiding the double taxation of overseas corporate earnings. Under the "modified territorial system" introduced by the 2017 legislation, a U.S. corporation holding at least a 10% interest in an overseas subsidiary will generally be entitled to a 100% dividends-received deduction for distributions received from that subsidiary. Neither the foreign income taxes paid on the earnings out of which the dividend is deemed paid nor any foreign withholding taxes imposed on the dividend are now eligible for either the FTC or any deduction for taxes.

The FTC, with some technical changes brought about by the Act, remains the mechanism of choice for avoiding double taxation of overseas earnings in other situations, including:

- U.S. multinationals having interests in foreign corporations below the 10% threshold, or suffering inclusions of constructive dividends under certain "anti-deferral" rules (notably "Subpart F" of the Code, applicable to "controlled foreign corporations" earning certain classes of disfavored income, and the passive foreign investment company ("PFIC") regime);
- U.S. owners, other than corporations, owning stock in foreign corporations (in any amount); and
- U.S. taxpayers earning foreign income through branches or pass-through entities.

However, several notable changes to the FTC regime were simultaneously introduced by the Act, including:

- foreign branch income is segregated into a new separate FTC basket (i.e., isolating income and taxes from foreign branch operations from the taxpayer's other income and taxes);

- income from inventory sales will be sourced to the United States or overseas solely by reference to the place where the inventory was produced (prior to the Tax Act, inventory sales income was sourced partly to the place of production and partly to the place of sale pursuant to apportionment methods specified in Treasury regulations); and
- foreign taxes imposed on certain intangible income (discussed below) are only eligible for credit to the extent of 80% of that intangible income.

Transitional Repatriation Tax

Over many years a large number of U.S. multinationals have accumulated substantial amounts of undistributed earnings in foreign subsidiaries. In general, these “stranded” or “permanently reinvested” earnings have not borne any U.S. corporate income tax, and have attracted foreign taxes that, under the pre-Act FTC regime, would have carried out foreign tax credits in the event of their eventual repatriation.

In part to combat the tax planning that has gone into the creation of these deferred earnings, but also to rationalize the taxation of earnings derived under the pre-Act international tax rules, the Act introduced a one-time transitional tax on a notional repatriation of the accumulated deferred earnings of such foreign subsidiaries; the tax is imposed at a flat 15.5% rate to the extent of earnings backed by cash and designated cash-equivalents, and at 8% on any balance. Subsequent actual distributions of those earnings may be received tax-free in the United States, but without the benefit of any foreign tax credits.

The deemed repatriation occurs at the end of the last taxable year beginning before January 1, 2018. Thus, for calendar year multinationals, the transitional tax was triggered at the end of 2017; others will recognize the repatriated earnings at the end of their 2018 fiscal years.

Because the deemed repatriation is treated as subpart F income for federal income tax purposes, whether it will be included in net income for state tax purposes depends on the state's tax treatment of subpart F income. Some states eliminate subpart F income or provide a dividends-received deduction for all or a portion of subpart F income. In addition, the special federal tax rates applicable to the deemed repatriation are implemented via deductions for the portion of the repatriation amount necessary to bring the effective federal rate down to the desired figure (8% or 15.5%); the effective rate of state tax on any repatriation inclusions will depend on whether a state conforms to or decouples from those federal deductions. The rules allowing for the federal tax from repatriation inclusions to be paid over eight years likely will not apply to any state tax resulting from such inclusions. Taxpayers will also need to be mindful of any state tax consequences resulting from the actual repatriation of foreign earnings, which may be taxable in certain states, and the effect of any deemed repatriation inclusions on the calculation of apportionment factors. It is possible that states may specifically address some of these subjects in legislation or other guidance.

Intangible Income

Since 1962, certain U.S. shareholders in a “controlled foreign corporation” (“CFC”) have been required to include in income their pro rata shares of “Subpart F income,” including several types of passive or mobile income earned by the CFC, as well as the amount of its earnings deemed invested in U.S. property. The Tax Act introduces a new, residual class of Subpart F income called “global intangible low-taxed income” (“GILTI”). In summary, the GILTI provisions apply a minimum tax of between 10.5% and 13.125% (depending on the level of any foreign taxes imposed on GILTI, for which an 80% FTC is allowed) on a CFC's residual income after taking out enumerated items—particularly (i) other classes of Subpart F income and (ii) a hypothetical 10% return on the qualified tangible assets of the CFC used in a trade or business.

As a corollary to the GILTI provisions, the Tax Act introduces a deduction for domestic corporations earning either (i) “foreign-derived intangible income” (“FDII”) or GILTI: the deduction equals (i) 37.5% of the corporation's FDII and (ii) 50% of its GILTI. The intent of these provisions is to reduce the incentive for U.S. corporations to move their intellectual property offshore (though the playing field has not been completely leveled).

It is worth noting that, by using a “subtractive” definition of intangible income (i.e., all income not specifically excluded), the scope of the FDII and GILTI rules may be substantially broader than might be assumed from the labels applied to those classes of income.

Subpart F (CFCs)

In addition to the GILTI provisions described above, the Tax Act modifies the Subpart F rules in certain other respects:

The class of U.S. shareholders required to include Subpart F income in their own incomes was expanded to include U.S. holders of at least 10% of a CFC's outstanding shares by value. Previously, the threshold was 10% of the outstanding voting power of the CFC's shares (that threshold remains applicable as an alternative basis for identifying members of the class). This change brings the determination of such U.S. shareholders into line with the historic (and continuing) definition of a CFC, which is cast in terms of a 50% control threshold measured by either voting power or value.

Historically, CFC status had to subsist of a 30-day period during a given year in order to affect U.S. shareholders in that year. The Tax Act removed this 30-day “*de minimis*” rule.

Deductible Intercompany Payments

The Act creates a 10% alternative minimum tax designed to keep a U.S. corporation from stripping earnings out of the United States through deductible payments to foreign affiliates. This “base erosion” tax applies to a domestic C corporation other than a RIC or a REIT (i) having average annual gross receipts of at least $500,000,000 for the three-year period ending with the preceding tax year, and (ii) making deductible amounting to at least 3% of its other deductions (with certain adjustments). The base on which the tax is due is computed by modifying taxable income in several respects—notably by adding back deductible payments to foreign affiliates and certain other deductions. Special rules apply to certain banks and securities dealers.

The minimum tax also applies to foreign corporations engaged in a U.S. trade or business in computing the tax on their income effectively connected with that trade or business.

Miscellaneous Transfers to Foreign Corporations

Otherwise tax-free incorporation and reorganization transactions are generally treated as taxable to the extent that U.S. persons transfer property to foreign corporations as part of those transactions. Historically, transfers of tangible property were excluded from this treatment to the extent used in the foreign corporate transferee's active trade or business. The Tax Act eliminates this exception.

Separately, transfers of enumerated items of intangible property to foreign corporations have been treated as taxable sales of the property in exchange for hypothetical contingent payments tied to the value or use of the transferred intangible. There has been some uncertainty as to the inclusion of goodwill, going concern value and workforce-in-place as cognizable items of intangible property for this purpose. The Tax Act explicitly adds those categories to the relevant class of intangible.

Read more commentary from WilmerHale lawyers on the Tax Act.

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