PUBLICATION

Tax Overhaul Draws New Boundaries Around International Business

Authors: Stuart M. Schabes, Michael M. Smith, Robert L. Ash
December 22, 2017

The newly passed tax legislation significantly alters the landscape for international business. The final Republican tax cut bill moves the U.S. from a so-called "global taxation regime" to a territorial taxation regime in which profits earned by U.S. companies abroad are exempt from U.S. taxes, subject to anti-abuse rules and a new base erosion anti-abuse tax (BEAT) on certain income. As part of this transition, the U.S. government will allow deemed repatriation of currently deferred foreign profits at a rate of 15.5 percent for liquid assets and 8 percent for illiquid assets. The bill also includes a number of other changes to the manner in which international activities of U.S.-based corporations are taxed.

This area represents a significant change in policy, albeit a polarized approach, as taxes on U.S. companies operating abroad will be computed on a territorial basis, while those of individuals will be computed on the more traditional worldwide basis. The following are some of the bill's highlights in this area. Given the complexities of these provisions, this is initially described in an overview format, with more detailed analysis to be issued in the near future.

New System of Territorial Taxation Adopted

Historically, the U.S. has taxed companies (generally at the 35 percent rate) on their worldwide income, including income earned in foreign countries (subject to deductions and credits for tax paid to foreign countries), as well as income of foreign subsidiaries generally when that income is repatriated to the U.S. parent company in the form of dividends (including deemed dividends attributed to a controlled foreign corporation (CFC), which dividends are commonly called Subpart F income). Generally, the U.S. does not otherwise tax foreign business profits earned through a foreign subsidiary. This has made it possible for domestic corporations to defer payment of the residual U.S. tax attributed to earnings of the foreign subsidiary operating in a low tax jurisdiction.

The bill changes the overall tax structure to a "territorial" system whereby income earned outside the U.S. is taxed at lower rates or exempted entirely. This is accomplished by providing that dividends received by a U.S. "C" corporation from its 10 percent or more foreign subsidiaries that have met a one-year holding period requirement are exempt from U.S. taxation, with certain exceptions. The rule would also apply to stock held in a partnership in a manner that would look through the partnership and characterize stock as owned by its partners to attempt to make the dividend tax-free. Moreover, special rules consistent with the tax-free treatment of dividends will apply to gains and losses on sales of stock in the foreign subsidiary by the parent to adjust the taxable gain or loss on sales of stock in the foreign subsidiary to take into account a portion of the purchase price that should be tax free (or added back to reduce the loss) due to retained earnings of the foreign subsidiary that otherwise would have been tax free if distributed.

Controlled Foreign Corporations

A CFC is a foreign corporation generally in which U.S. shareholders who each own 10 percent or more of the stock together own more than 50 percent of the total outstanding stock. Under the bill, new and very complicated rules apply to the CFC income called "global intangible low-taxed income" (GILTI). The GILTI includes certain gross income that exceeds a deemed return utilizing a return base of 10 percent of a CFC's aggregate adjusted basis of its prorated share of certain business asset investment of each CFC, subject to adjustments. The effective rates of the tax after an offsetting deduction available only to corporate shareholders of a CFC are 10.5 percent starting for taxable years after December 31, 2017, and 13.125 percent for taxable years after December 31, 2025.

Base Erosion

The base erosion anti-abuse tax (BEAT) is a new tax to help curtail excessive earnings stripping through payments to foreign affiliates. BEAT is generally imposed on larger companies having at least $500 million annual gross receipts, which is generally computed using the amount by which a company's taxable income, computed without regard to base eroding payments to related corporations and taxed at a 10 percent rate, exceeds the company's regular corporate tax liability minus certain tax credits. BEAT contains an initial tax rate of 5 percent in 2018 rising to 10 percent in 2019 through 2025 and then 12.5 percent starting in 2026.

Deemed Repatriation of Deferred Earnings and Intangibles

Even though dividends would no longer be taxed, the bill will require companies and individuals that are 10 percent or greater shareholders of a CFC to pay a "one time toll" (deemed taxable dividend) on certain accumulated earnings that otherwise would have been subject to dividend tax as if those earnings had been distributed. The toll applies to post-1986 earnings and profits of the CFC accumulated through November 2, 2017, or December 31, 2017 (whichever date resulted in the greatest amount), and applies even if never distributed, at the rate of 15.5 percent for the portion held as liquid/cash type assets and 8 percent for the portion held as illiquid assets. This repatriation tax is deemed to occur at the end of the 2017 taxable year, but may be paid over an eight-year period.

Additional Tax Applied

U.S. Intangibles

The bill expands taxation of foreign income derived from U.S. intangibles. The tax rate on such income for taxable years beginning after December 31, 2017, and before January 1, 2016, is 13.125 percent, and thereafter is 16.406 percent.

Sales by Foreign Persons of Interests in Partnerships Doing Business in the U.S.

The U.S. Tax Court recently held that a foreign person generally is not taxable on the sale of an interest in a partnership engaged in a U.S. trade or business, rejecting the contrary position argued by the IRS. The bill codifies the IRS position, effective for sales after November 27, 2017. Moreover, the bill requires the purchaser to withhold and pay to the IRS 10 percent of the amount realized by the foreign person, effective for sales after December 31, 2017.

Additional Resources:

- New Tax Plan Changes Rules on Health Coverage, Employee Benefits and Executive Compensation
- No Business Left Behind – New Tax Bill Ushers in Significant Changes for All Companies
- Tax Change for the Tax-Exempt: How Will Organizations – and Their Donors – Be Affected?
- Table: Key Differences Between House, Senate, and Final Bill
- Subscribe to Receive Future Tax Legislation Alerts from Baker Donelson