U.S. Tax Reform Highlights: New Tax Regimes Relating to Cross-Border and Offshore Activities

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The Tax Cut and Jobs Act (the "Bill") released on Friday would, if adopted, significantly change the current rules relating to cross-border and offshore activities of U.S. taxpayers. The Bill enacts a form of "territorial" tax system while retaining, subject to important modifications, the existing anti-deferral provisions relating to foreign operations of U.S. persons. The Bill also introduces a new anti-deferral measure that will tax so-called "global intangible low-taxed income." Finally the Bill introduces anti-base erosion provisions that will affect U.S. companies that engage in transactions with foreign affiliates.

The new rules are expected to have a significant impact on U.S. companies' conduct of their foreign operations. It should be noted that many of the new rules are highly technical and that their impact on a particular taxpayer would need to be assessed on a case-by-case basis.

Key provisions include:

Movement Toward a Territorial System

Participation Exemption System

The Bill introduces elements of a territorial system under which U.S. corporations with foreign subsidiaries will no longer be subject to tax when their subsidiaries' foreign earnings are repatriated into the United States. This is implemented through a dividend exemption system that allows U.S. corporations (that are not RICs, REIT or S corporations) a 100 percent deduction for the foreign source portion of dividends received from a 10 percent-owned controlled foreign corporation ("CFC"). The deduction is not available for hybrid dividends. A hybrid dividend is an amount for which a deduction is allowed to the CFC by a foreign country.

Mandatory Repatriation

As a transitional step, the Bill introduces a toll charge on foreign earnings of subsidiaries of U.S. corporations that have not been repatriated and thus have not been subject to U.S. tax. Mechanically, the toll charge will increase the U.S. shareholder's subpart F income by the amount of the deferred foreign earnings with respect to its last taxable year ending before December 31, 2018. The deferred earnings will be deemed repatriated and subject to the one-time toll charge at the following rates: 15.5 percent on earnings held in cash and cash equivalents and 8 percent on illiquid assets. With certain restrictions, deficits in foreign earnings and profits may reduce the aggregate foreign earnings subject to the toll charge. The rule generally applies to earnings of subsidiaries

that are CFCs and foreign corporations (other than PFICs) in which a U.S. person owns a 10 percent voting interest.

Changes to the Deferral Regime (Global Intangible Low-Taxed Income)

The Bill will require a U.S. corporate shareholder of a CFC to include in its income its share of the CFC's global intangible low-taxed income ("GILTI"), even if such income is not distributed to the shareholder. U.S. corporations will be taxed at a rate of 20 percent on the GILTI that they include in income. Credits for foreign taxes paid with respect to such income are still permitted but limited to 80 percent. In computing their GILTI, corporate U.S. shareholders subtract from (i) their "tested income" (i.e., generally, their active income excluding Subpart F income) an amount (ii) which is equal to a 10 percent return on the adjusted tax basis of active foreign tangible assets, adjusted downward for interest expense. Thus, GILTI would include income generated by fully depreciated tangible business assets notwithstanding that such income is generally not considered to be intangible income. The Bill creates a separate basket for GILTI for purposes of applying the foreign tax credit limitation.

Changes to Subpart F

The Bill retains the current subpart F regime with certain modifications.

The Bill broadens the definition of a U.S. shareholder of a CFC to include shareholders who own 10 percent or more of the CFC's stock by value in addition to shareholders who own 10 percent or more by vote under the current law. The Bill also allows attribution of stock held by foreign persons to U.S. persons for purposes of determining CFC status. It eliminates the requirement that a corporation must be controlled for 30 days before becoming a CFC.

The Bill repeals the treatment of foreign base oil related income as subpart F income.

The Bill retains Section 956 and does not include a look-through rule for related controlled foreign corporations.

Anti-Base Erosion Provisions

Base Erosion Minimum Tax

The Bill introduces a base erosion minimum tax on corporate taxpayers (other than RICs, REITs or S corporations) with average annual gross receipts for three years of $500 million or more. The rate of tax is 10 percent (a 5 percent rate applies for one year for taxable years beginning after year 2017) of modified taxable income, which is taxable income increased by any deductible payments (so-called base erosion tax benefit payments) made to a related foreign person. The tax does not apply if the total add-backs are generally no more than 3 percent of the total deductions of the taxpayer. Base erosion payments generally include any amount paid or accrued to a related foreign party with respect to which a deduction is allowed, but do not include "cost of goods

sold" (except for amounts paid to an inverted corporation), payments made pursuant to a derivative if taxpayer marks to market gains or losses with respect to such derivative, and amounts of fixed and determinable income that were subject to withholding tax.

The Bill does not include the provision that would limit the amount of net interest expense that may be deducted by a domestic corporation that is a member of a worldwide affiliated group.

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Please feel free to contact any of the persons listed below if you have any questions on this important development:

Marco Blanco
Co-chair, Partner
Tax Practice
mblanco@curtis.com
Geneva: +41 22 718 3518
Paris: +33 1 42 68 72 00

Klas Holm
Co-chair, Partner
Tax Practice
kholm@curtis.com
New York: +1 212 696 8800

Eduardo Cukier
Partner
Tax Practice
ecukier@curtis.com
New York: +1 212 696 6107