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The International Provisions of the GOP Tax Reform Act

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On December 22, 2017, President Trump signed into law tax reform legislation (the "Act")[1] formerly known as the Tax Cuts and Jobs Act. The Act includes the largest overhaul of the U.S. international tax system in the last 30 years. The key international tax provisions of the Act include the following:

Participation Exemption

The Act moves the United States closer to a territorial tax system by allowing domestic corporations (other than RICs and REITs) to deduct 100% of the foreign-source portion of dividends they receive from their foreign subsidiaries (the "DRD"). The DRD will also apply to certain gains from the sale of stock of foreign subsidiaries that are treated as dividends. The DRD is only available to a domestic corporation that owns 10% or more of the vote or value of a foreign corporation and for a dividend for which the foreign corporation did not receive a deduction (or other tax benefit) by a foreign country. Domestic corporations will not be able to claim a foreign tax credit or deduction for any foreign taxes paid with respect to dividends that qualify for the DRD.

Reduction of Basis of Certain Stock of a Foreign Corporation

For purposes of determining whether a loss is recognized, a domestic corporation that sells stock of a foreign corporation must reduce its basis in the stock to the extent of any dividends received with respect to such stock that were not taxed as a result of the DRD.

Certain Transfers to Foreign Corporations

Under the Act, the rules that allowed property used in an active trade or business to be transferred to a foreign corporation tax free no longer apply.

Additionally, if a domestic corporation transfers substantially all of the assets of a foreign branch to a foreign corporation with respect to which it owns 10% or more after the transfer, it must include in gross income an amount equal to the losses incurred by the foreign branch after December 31, 2017 that were deducted by the domestic corporation before the transfer over certain income and gains recognized by the foreign branch.

Mandatory Repatriation

The Act requires U.S. shareholders that own 10% or more of certain foreign corporations to include in income their pro rata share of the foreign corporations' deferred foreign income. A portion of that pro rata share of foreign earnings is deductible. The total deduction allowed is the amount necessary to

result in a 15.5% rate of tax on foreign earnings held in the form of cash or cash equivalents, and 8% rate of tax on all other earnings. The taxpayer can elect to pay this tax liability over a period of eight years.

Deduction with respect to Foreign-Derived Intangible Income

Under the Act, beginning after December 31, 2017, and before January 1, 2026, a domestic corporation (other than RICs and REITs) can deduct 37.5% of its foreign-derived intangible income ("FDII"). In very broad terms, the FDII of a domestic corporation is the deemed intangible income that the domestic corporation earns from making sales of property to non-U.S. persons for foreign use and for providing services to persons or with respect to property located outside the United States. The deemed intangible income of a domestic corporation is its gross income (not taking into account certain items such as Subpart F inclusions, GILTI, financial services income and dividends received from CFCs, among other things) over 10% of the aggregate of the domestic corporation's adjusted bases in specified tangible property used in a trade or business and of a type with respect to which a deduction is generally allowable under Section 167. Under the new corporate tax rate of 21%, the effective tax rate on FDII is 13.125% before 2026. For taxable years beginning after 2025 the deduction allowed is reduced to 21.875% resulting in an effective tax rate on FDII of 16.406%.

Current Year Inclusion of Foreign High Return Amounts or Global Intangible Low-Taxed Income by U.S. Shareholders

Under the Act, a U.S. shareholder of a CFC must include in gross income its global intangible low-taxed income ("GILTI") in a manner similar to inclusions of Subpart F income. Beginning after December 31, 2017, and before January 1, 2026, a corporate U.S. shareholder can deduct 50% of its GILTI. U.S. shareholders that are individuals are not eligible for this deduction. In very broad terms, GILTI is the intangible income that a CFC earns. Similarly to the determination of deemed intangible income for purposes of the calculation of FDII above, a U.S. shareholder's pro rata share of GILTI is deemed to be such shareholder's pro rata share of the CFC's gross income over 10% of the aggregate of the shareholder's pro rata share of the CFC's adjusted bases in specified tangible property used in a trade or business and of a type with respect to which a deduction is generally allowable under Section 167. Under the new corporate tax rate of 21%, the effective tax rate on GILTI for domestic corporations is 10.5% before 2026. For taxable years beginning after 2025 the deduction allowed is reduced to 37.5% resulting in an effective tax rate on GILTI for domestic corporations of 13.125%. For purposes of paying U.S. income tax on GILTI a corporate U.S. shareholder is allowed 80% of the foreign tax credits paid on such income. Thus, GILTI subject to a minimum foreign tax of 13.125% before 2026 should not be subject to any residual U.S. tax under this provision. GILTI subject to a minimum foreign tax of 16.406% after 2025 should not be subject to any residual U.S. tax under this provision.

Other Changes to the Subpart F Rules

The Act amends the ownership attribution rules to provide a "downward attribution" from a foreign person to a related U.S. person in circumstances under which prior law did not attribute such ownership. This change, however, only applies for purposes of determining whether a foreign corporation is a CFC. The Subpart F income that a U.S. Shareholder is required to include in gross income continues to be determined based on direct or indirect ownership of the CFC.

The Act expands the definition of U.S. shareholder to include any U.S. person who owns 10% of the total value of shares of all classes of stock of a foreign corporation. Under prior law, the determination

of whether a U.S. person was a U.S. shareholder was based on the ownership of 10% of the voting power of all classes of stock of a foreign corporation.

The Act eliminates the requirement that a corporation must be controlled for an uninterrupted period of 30 days before Subpart F inclusions apply.

Indirect Foreign Tax Credits

The Act repeals the deemed-paid foreign tax credit with respect to dividends received by a domestic corporation that owns 10% or more of the voting stock of a foreign corporation. The Act retains the deemed-paid foreign tax credit with respect to Subpart F inclusions.

Source of Income from Sales of Inventory

The Act changes the rules for sourcing gains from sales of inventory property. Under the Act, such gains are sourced to the place of production.

Base Erosion Minimum Tax

The Act imposes a new alternative minimum tax on certain corporations (other than RICs, REITs and S Corps.) that, through "base erosion payments," significantly reduce their U.S. federal income tax liability. In broad terms, "base erosion payments" are certain payments made by a U.S. taxpayer (including foreign corporations with U.S. trades or businesses) to foreign related persons that are deductible for U.S. federal income tax purposes (such deductions referred to as "base erosion tax benefits"). If these corporations have average annual gross receipts of $500 million or more for the three-year period ending with the preceding year and a base erosion percentage of 3% or more (2% or more in the case of banks and registered securities dealers), they are subject to a minimum tax equal to the excess of 10% (5% for 2018, and 12.5% for tax years beginning 2026) of such corporation's "modified taxable income" over its regular tax liability (as defined in Section 26(b)) subject to certain adjustments. "Modified taxable income" is a corporation's taxable income for the year computed without regard to any base erosion tax benefit. In very broad terms, base erosion percentage is equal to the base erosion tax benefits divided by the aggregate amount of certain credits allowed to the taxpayer for the year.

Limitations on Shifting Income through Intangible Property Transfers

The Act revises the definition of "intangible property" to include goodwill, going concern value, and workforce in place for purposes of outbound transfers of intangible property and the Internal Revenue Service's ability to allocate income among related taxpayers. Additionally, the Act codifies the use of realistic alternative principles to determine valuation in connection with such transfers of intangible property.

Denial of Deduction for Certain Interest and Royalty Payments to Related Parties

The Act denies a U.S. taxpayer's deductions for "disqualified related party amounts" paid or accrued pursuant to a "hybrid transaction" or by, or to, a hybrid entity. A "disqualified related party amount" is any interest or royalty payments paid or accrued to a related party if such related party does not have a corresponding income inclusion or is entitled to a deduction with respect to such amount, in each case, under the tax law of such related party's jurisdiction. A "hybrid transaction" is any transaction in which one or more payments are treated as interest or royalties for U.S. federal income tax purposes and not so treated for purposes of the foreign country where the recipient is resident for tax purposes or subject to tax. A "hybrid entity" is any entity that is treated as fiscally transparent for U.S. federal

income tax purposes but not so treated for purposes of the tax law of the foreign country of which the entity is a resident or vice versa. The Act provides authority for regulations or other guidance as necessary or appropriate to carry out the above, including addressing conduit arrangements, foreign branches, structured transactions, as well as low-tax jurisdictions.

Dividends Paid by Surrogate Foreign Corporations not Eligible for Reduced Rates

Under the Act, dividends received by individuals from surrogate foreign corporations are not eligible for qualified dividend rates. A surrogate foreign corporation is generally any foreign corporation (excluding corporations treated as domestic corporations under Section 7874(b)) that, after March 4, 2003, directly or indirectly acquired a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership and after the acquisition, 60% or more of such foreign corporation is held by former shareholders of the domestic corporation or former partners of the domestic partnership.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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[1] The Act is titled "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018."