2017 Tax Reform:
Checkpoint Special Study on foreign income, foreign persons tax changes in the "Tax Cuts and Jobs Act"

On December 15, the Conference Committee-having reconciled and merged the differing House and Senate provisions into a single piece of legislation-released the final version of the "Tax Cuts and Jobs Act," a sweeping tax reform proposal. This article describes key tax changes affecting foreign income and foreign persons, including the exemption from U.S. tax for certain foreign income and the deemed repatriation of off-shore income.

The "Tax Cuts and Jobs Act" has largely taken shape at a breakneck speed over a two-month period, passed by the House on November 16 and by the Senate on December 2. Republican leaders are now saying that they have the votes necessary for passage, and it is generally expected that the measure will be approved in both the House and Senate early this week-without any Democratic support-then make its way to President Trump for his anticipated signature shortly thereafter. It will be the largest major tax reform in over three decades.

ESTABLISHMENT OF PARTICIPATION EXEMPTION SYSTEM FOR TAXATION OF FOREIGN INCOME

Deduction for Foreign-Source Portion of Dividends

Under pre-Act law, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether earned in the U.S. or abroad. Foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporations end, the current-law system of taxing U.S. corporations on the foreign earnings of their foreign subsidiaries when these earnings are distributed is replaced. The Act provides for an exemption (referred to here as a deduction for dividends received, or DRD) for certain foreign income. This exemption is provided for by means of a 100% deduction for the "foreign-source portion" of dividends received from specified 10% owned foreign corporations (generally, any foreign corporation other than a passive foreign investment company that is not also a controlled foreign corporation (CFC), with respect to which any domestic corporation is a U.S. shareholder) by domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of **Code Sec. 951(b).** The foreign-source portion of a dividend from a specified 10%-owned foreign corporation is that amount which bears the ratio to the dividend as the undistributed foreign earnings of the specified 10%-owned foreign corporation bears to the total undistributed earnings of such foreign corporation. (Code Sec. 245A(c), as added by Act Sec. 14101)

No foreign tax credit or deduction is allowed for any taxes paid or accrued with respect to a dividend that qualifies for the DRD. There is also a provision in the Act that disallows the DRD if the domestic corporation did not hold the stock in the foreign corporation for a long enough period of time.
The provision eliminates the "lock-out" effect under pre-Act law, which encourages U.S. companies to avoid bringing their foreign earnings back into the U.S. (Code Sec. 245A, as added by Act Sec. 14101)
The DRD is available only to C corporations that are not regulated investment companies (RICs) or real estate investment trusts (REITs).

Sales or Transfers Involving Specified 10%-Owned Foreign Corporations
Under pre-Act law, when a U.S. corporation sells or exchanges stock in a foreign subsidiary, the gain may be considered a dividend to the extent the foreign corporation has earnings and profits (E&P) that have not already been subject to U.S. tax. If foreign business is conducted through a branch of a U.S. corporation rather than a foreign subsidiary, the corporation owes U.S. taxes on the foreign earnings and deducts losses as though they accrued directly to the U.S. corporation.

New law. In the case of the sale or exchange after Dec. 31, 2017, by a domestic corporation of stock in a foreign corporation held for one year or more, any amount received by the domestic corporation which is treated as a dividend for purposes of **Code Sec. 1248,** is treated as a dividend for purposes of applying Code Sec. 245A (i.e., the provision described in "Deduction for foreign-source portion of dividends," above). (Code **Sec. 1248(j)**, as amended by Act Sec. 14102(a))

For dividends received in tax years that begin after Dec. 31, 2017, a domestic corporate shareholder's adjusted basis in the stock of a "specified 10-percent owned foreign corporation" is reduced by an amount equal to the portion of any dividend received with respect to such stock from such foreign corporation that was not taxed by reason of dividends received deduction allowable under Code Sec. 245A in any tax year of such domestic corporation, but only for the purpose of determining losses on sales and exchanges of the foreign corporation's stock. (Code Sec. 961(d), as amended by Act Sec. 14102(b))

If, after Dec. 31, 2017, a U.S. corporation transfers substantially all the assets of a foreign branch to a foreign subsidiary corporation, the "transferred loss" amount (i.e., the losses incurred by the foreign branch over certain taxable income earned by the foreign branch) must generally be included in the U.S. corporation's gross income. (Code Sec. 91, as added by Act Sec. 14102(d)(1))

Treatment of Deferred Foreign Income Upon Transition to New Participation Exemption System-Deemed Repatriation
Under pre-Act law, U.S. citizens, resident individuals, and domestic corporations generally are taxed on all income, whether earned in the U.S. or abroad. Foreign income earned by a foreign subsidiary of a U.S. corporation generally is not subject to U.S. tax until the income is distributed as a dividend to the U.S. corporation.

New law. Under the Act, U.S. shareholders owning at least 10% of a foreign subsidiary generally must include in income, for the subsidiary's last tax year beginning before 2018, the shareholder's pro rata share of the net post-'86 historical E&P of the foreign subsidiary to the extent such E&P has not been previously subject to U.S. tax. The portion of the E&P comprising cash or cash equivalents is taxed at a reduced rate of 15.5%, while any remaining E&P is taxed at a reduced rate of 8%.

At the election of the U.S. shareholder, the tax liability is payable over a period of up to eight years The payments for each of the first five years equals 8% of the net tax liability. The amount of the sixth installment is 15% of the net tax liability, increasing to 20% for the seventh installment and the remaining balance of 25% in the eighth year.

The Act provides a special rule for S corporations. Their shareholders are allowed to elect to maintain deferral on such foreign income until the S corporation changes its status, sells substantially all its assets, ceases to conduct business, or the electing shareholder transfers its S corporation stock.

The Act excludes the post-'86 historical E&P from the REIT gross income tests. In addition, REITs are permitted to elect to meet their distribution requirement to REIT shareholders with respect to the accumulated deferred foreign income over an 8-year period under the same installment percentages as apply to U.S. shareholders who elect to pay the net tax liability resulting from the mandatory inclusion of pre-effective-date undistributed CFC earnings in eight installments. (Code **Sec. 965**, as amended by Act Sec. 14103)

RULES RELATED TO PASSIVE AND MOBILE INCOME

Current Year Inclusion of Global Intangible Low-Taxed Income

Under pre-Act law, a U.S. person generally was not subject to U.S. tax on foreign income earned by a foreign corporation in which it owns shares until that income was distributed to the U.S. person as a dividend. Several anti-deferral regimes modified this general rule, including the Subpart F rules.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign corporation’s end, a U.S. shareholder of any CFC has to include in gross income for a tax year its global intangible low-taxed income (GILTI) in a manner generally similar to inclusions of subpart F income. GILTI means, with respect to any U.S. shareholder for the shareholder's tax year, the excess (if any) of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return. The shareholder's net deemed tangible income return is an amount equal to 10% of the aggregate of the shareholder's pro rata share of the qualified business asset investment of each CFC with respect to which it is a U.S. shareholder. GILTI does not include effectively connected income, subpart F income, foreign oil and gas income, or certain related party payments. GILTI is taxed at a rate of 10%.

Foreign tax credits are allowed for foreign income taxes paid with respect to GILTI but are limited to 80% of the foreign income taxes paid and are not allowed to be carried back or forward to other tax years. (Code Sec. 951A, as added by Act Sec. 14201)

Deduction for Foreign-Derived Intangible Income and GILTI

Under pre-Act law, the U.S. employed a worldwide tax system, under which U.S. persons were generally taxed on all income, whether derived in the U.S. or abroad. Foreign income earned by U.S. corporate shareholders through foreign corporations was generally subject to U.S. tax only when the income was distributed as a dividend to the U.S. corporate shareholder.

New law. For tax years that begin after Dec. 31, 2017, and before Jan. 1, 2026, in the case of a domestic corporation, a deduction is allowed in an amount equal to the sum of: (i) 37.5% of the foreign-derived intangible income (FDII) of the domestic corporation for the tax year, plus (ii) 50% of the GILTI amount (if any) which is included in the gross income of the domestic corporation under Code Sec. 951A for the tax year. FDII of a 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.

For tax years that begin after Dec. 31, 2025, the allowed deduction will decrease to (i) 21.875% of the FDII of the domestic corporation for the tax year, and (ii) 37.5% of the GILTI amount included in the gross income of the domestic corporation for the tax year. (Code Sec. 250, as added by Act Sec. 14202)

OTHER MODIFICATIONS OF SUBPART F PROVISIONS

Repeal of Foreign Base Company Oil-Related Income Rule

Subpart F income includes foreign base company income (FBCI). Under pre-Act law, foreign base company oil related income was included in the Subpart F income of U.S. Shareholders as a category of FBCI.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end, the Act eliminates foreign base company oil related income as a category of FBCI. (Code **Sec. 954(a)**, as amended by Act Sec. 14211)

Repeal of Rule Taxing Income When CFC Decreases Investments

Prior to the '86 Tax Reform Act, foreign base company shipping income (FBCSI) that was reinvested in the shipping operations of a CFC (a qualified shipping investment) was not included in Subpart F income. The previously excluded income was then recaptured if and when it was subsequently withdrawn from the qualified shipping investment. Although the '86 Tax Reform Act repealed the exclusion for qualified shipping investments, the recapture provision was retained.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders within which or with which such tax years of foreign corporations end the Act repeals **Code Sec. 955**. As a result, a U.S. shareholder in a CFC that invested its previously excluded subpart F income in qualified foreign base company shipping operations is no longer required to include in income a pro rata share of the previously excluded subpart F income when the CFC decreases such investments. (Code **Sec. 955**, as repealed by Act Sec. 14212)

Modification of CFC Status Attribution Rules

Under pre-Act law, a U.S. parent of a controlled foreign corporation (CFC) is subject to current U.S. tax on its pro rata share of the CFC's subpart F income. A foreign subsidiary is a CFC if it is more than 50% owned by one or more U.S. persons, each of which owns at least 10% of the foreign subsidiary. Constructive ownership rules apply in determining ownership for this purpose.

New law. For the last tax year of a foreign corporation that begins before Jan. 1, 2018, for all subsequent tax years of a foreign corporation, and for the tax years of a U.S. shareholder with or with which such tax years end, the Act amends the constructive ownership rules so that certain stock of a foreign corporation owned by a foreign person is attributed to a related U.S. person for purposes of determining whether the related U.S. person is a U.S. shareholder of the foreign corporation and, therefore, whether the foreign corporation is a CFC. (Code **Sec. 958**, as amended by Act Sec. 14213)

Expansion of Definition of "U.S. Shareholder"

Under pre-Act law, a U.S. shareholder for CFC purposes is a U.S. person who owns 10% or more of the total combined *voting power* of all classes of stock entitled to vote of the foreign corporation. (Code **Sec. 951(b))**

New law. For the last tax year of foreign corporations beginning before Jan. 1, 2018, and for tax years of U.S. shareholders with or within which such tax years of foreign corporation's end, the Act expands the definition of "U.S. shareholder" to also include any U.S. person who owns 10% or more of the *total value* of shares of all classes of stock of a foreign corporation. (Code **Sec. 951(b)**, as amended by Act Sec. 14214)

Elimination of 30-Day Minimum Holding Period for CFC
Under pre-Act law, a U.S. parent of a CFC is subject to current U.S. tax on its pro rata share of the CFC's subpart F income, but only if the U.S. parent owns stock in the foreign subsidiary for an uninterrupted period of 30 days or more during the year.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end, a U.S. parent is subject to current U.S. tax on the CFC's subpart F income even if the U.S. parent does not own stock in the CFC for an uninterrupted period of 30 days or more during the year. (Code **Sec. 951(a)(1)**, as amended by Act Sec. 14215)

PREVENTION OF BASE EROSION

Base Erosion and Anti-Abuse Tax
"Base erosion" refers to payments between a domestic corporation and related foreign parties that are deductible for U.S. tax purposes. While a withholding tax applies to many such payments under **Code Sec. 1441** or **Code Sec. 1442**, treaties frequently reduce the withholding tax and, at times, eliminate it altogether. If a withholding tax does not apply, deductible payments of interest, royalties, and management fees reduce the U.S. tax base. Under pre-Act law, there was no minimum tax that had to be paid on certain deductible payments to a foreign affiliate.

New law. With respect to base erosion payments (as defined below) paid or accrued in tax years that begin after Dec. 31, 2017, certain corporations with average annual gross receipts of at least $500 million are required to pay a tax, the "base erosion anti-abuse tax" (BEAT), equal to the "base erosion minimum tax amount" for the tax year. Except as provided at "Members of affiliated...," below, the base erosion minimum tax amount means, with respect to an applicable taxpayer for any tax year beginning before Jan. 1, 2026, the excess of 10% of the modified taxable income of the taxpayer for the tax year over an amount equal to the regular tax liability reduced (but not below zero) by the excess (if any) of credits allowed under Chapter 1 over an amount that includes the credit allowed under **Code Sec. 38** (general business credit) for the tax year allocable to the research credit under **Code Sec. 41(a)**.

Except as provided at "Members of affiliated...," below, the tax is 12.5% of the modified taxable income of the taxpayer for the tax year over an amount equal to the regular tax liability of the taxpayer for the tax year, for tax years beginning after Dec. 31, 2025. That is, the regular tax liability is reduced by an amount equal to all credits allowed under Chapter 1 (including the general business credit), for tax years that begin after Dec. 31, 2025. Members of affiliated groups that include a bank or securities dealer will pay the BEAT tax at an 11% rate, increasing to 13.5% after 2025.

Modified taxable income means the taxable income of the taxpayer computed under Chapter 1 for the tax year, determined without regard to any base erosion tax benefit with respect to any base erosion payment, or the base erosion percentage of any net operating loss deduction allowed under **Code Sec. 172** for the tax year. A base erosion payment generally means any amount paid or accrued by a taxpayer to a foreign person that is a related party of the taxpayer and with respect to which a deduction is allowable, including any amount paid or accrued by the taxpayer to the related party in connection with the acquisition by the taxpayer from the related party of property of a character subject to the allowance of depreciation (or amortization in lieu of depreciation).

The Act excludes an amount paid or incurred for services if those services meet the requirements for the services cost method under **Code Sec. 482** (excluding the requirement that the services not contribute significantly to fundamental risks of business success or failure) and if such amount is the total services cost with no markup, for tax years that begin after Dec. 31, 2017. There is also an exception for certain derivative payments made in the ordinary course of a trade or business. (Code Sec. 59A, as added by Act Sec. 14401)

Limitations on Income Shifting Through Intangible Property Transfers
Under **Code Sec. 367(d)**, a U.S. person that transfers intangible property-as defined in **Code Sec. 936(h)(3)(B)** -to a foreign corporation in an otherwise nonrecognition transaction is generally treated as having sold the intangible property in exchange for payments contingent on the property's productivity, use, or disposition. In these cases, the U.S. transferor includes an amount in income each year, over the useful life of the property.

New law. For transfers in tax years that begin after Dec. 31, 2017, the Act addresses recurring definitional and methodological issues that have arisen in controversies in transfers of intangible property for purposes of **Code Sec. 367(d)** and **Code Sec. 482**, both of which use the statutory definition of "intangible property" in **Code Sec. 936(h)(3)(B)**.

The Act revises that definition and confirms the authority to require certain valuation methods. It does not modify the basic approach of the existing transfer pricing rules with regard to income from intangible property. Under the Act, workforce in place, goodwill (both foreign and domestic), and going concern value is intangible property within the meaning of **Code Sec. 936(h)(3)(B)**, as is the residual category of "any similar item" the value of which is not attributable to tangible property or the services of an individual. (Code **Sec. 367(d)**, **Code Sec. 482,** and **Code Sec. 936(h)(3)(B)**, as amended by Act Sec. 14221)

Denial of Deduction for Certain Related Party Payments
No deduction is allowed for losses from sales or exchanges of property (except in corporate liquidations), directly or indirectly, between certain related persons. Under pre-Act law, there was no explicit disallowance of a deduction for any disqualified related party amount paid or accrued under a hybrid transaction or by, or to, a hybrid entity.

New law. For tax years that begin after Dec. 31, 2017, the Act denies a deduction for any disqualified related party amount 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 paid or accrued to a related party to the extent that: (1) there is no corresponding inclusion to the related party under the tax law of the country of which such related party is a resident for tax purposes, or (2) such related party is allowed a deduction with respect to such amount under the tax law of such country. In general, a hybrid transaction is one that involves payment of interest or royalties that are not treated as such by the country of residence of the foreign recipient. And, in general, a hybrid entity is an entity that is treated as fiscally transparent for federal income purposes but not so treated for purposes of the tax law of the foreign country or vice versa. (Code Sec. 267A, as added by Act Sec. 14222)

Surrogate Foreign Corporation Dividends Aren't Qualified
Qualified dividend income is taxed at capital gain, rather than ordinary income, rates. Generally, qualified dividend income includes dividends received during the tax year from domestic corporations and qualified foreign corporations.

New law. For dividends paid in tax years that begin after Dec. 31, 2017, any dividend received by an individual shareholder from a corporation which is a surrogate foreign corporation as defined in **Code Sec. 7874(a)(2)(B)** (other than a foreign corporation which is treated as a domestic corporation under **Code Sec. 7874(b))**, and which first became a foreign surrogate corporation after date of enactment, is not entitled to the lower rates on qualified dividends provided for in **Code Sec. 1(h)**. (Code **Sec. 1(h)**, as amended by Act Sec. 14223)

MODIFICATIONS RELATED TO FOREIGN TAX CREDIT SYSTEM

Repeal of Indirect Foreign Tax Credits; Change to CFC Shareholder Deemed-Paid Credit
Under pre-Act law, a U.S. corporation that owned at least 10% of the voting stock of a foreign corporation was allowed a deemed-paid credit for foreign income taxes paid by the foreign corporation that the U.S. corporation was treated as having paid when the income on which the foreign tax was paid was distributed to the shareholder as a dividend.

And, a 10% shareholder in a controlled foreign corporation (CFC) (a U.S. Shareholder) is allowed to take a deemed-paid credit for foreign taxes paid by the CFC on the portion of the CFC's earnings that the U.S. Shareholder is required to include in income under Subpart F.

New law. For tax years of foreign corporations that begin after Dec. 31, 2017, and for tax years of U.S. shareholders in which or with which such tax years of foreign subsidiaries end, no foreign tax credit or deduction is allowed for any taxes (including withholding taxes) paid or accrued with respect to any dividend to which the deduction for foreign-source portion of dividends described at "Deduction for foreign-source portion of dividends," above, applies. (Code **Sec. 902**, as repealed by Act Sec. 14301)
A foreign tax credit is allowed for any subpart F income that is included in the income of the U.S. shareholder on a current year basis. (Code **Sec. 960,** as amended by Act Sec. 14301)

Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income
The foreign tax credit limitation is calculated separately for certain categories (or "baskets") of income. Under pre-Act law, there were two such baskets: income was either passive category income or general category income.

New law. For tax years that begin after Dec. 31, 2017, foreign branch income must be allocated to a specific foreign tax credit basket. Foreign branch income is the business profits of a U.S. person which are attributable to one or more qualified business units in one or more foreign countries. (Code **Sec. 904(d)**, as amended by Act Sec. 14302)

Change in Rule for Sourcing Income from Sales of Inventory
Under pre-Act law, in determining the source of income for foreign tax credit purposes, up to 50% of the income from the sale of inventory property that is produced within the U.S. and sold outside the U.S. (or vice versa) may be treated as foreign-source income.

New law. For tax years that begin after Dec. 31, 2017, gains, profits, and income from the sale or exchange of inventory property produced partly in, and partly outside, the U.S. must be allocated and apportioned on the basis of the location of production with respect to the property. For example, income derived from the sale of inventory property to a foreign jurisdiction is sourced wholly within the U.S. if the property was produced entirely in the U.S., even if title passage occurred elsewhere. Likewise, income derived from inventory property sold in the U.S., but produced entirely in another country, is sourced in that country even if title passage occurs in the U.S. If the inventory property is produced partly in, and partly outside, the U.S., the income derived from its sale is sourced partly in the U.S. (**Code Sec. 863(b)** as amended by Act Sec. 14303)

Election with Respect to Foreign Tax Credit Limitation
Under pre-Act law, for purposes of the limitation on the foreign tax credit, if a taxpayer sustains an overall domestic loss for any tax year, then, for each succeeding year, an amount of U.S. source taxable income equal to the lesser of:
...the full amount of the loss to the extent not carried back to prior tax years; or
...50% of the taxpayer's U.S. source taxable income for that succeeding tax year, is recharacterized as foreign source income.

New law. For any tax year of the taxpayer that begins after Dec. 31, 2017, and before Jan. 1, 2028, the taxpayer may, with respect to pre-2018 unused overall domestic losses, elect to substitute, for the above 50% amount, a percentage greater than 50% but not greater than 100%. (Code Sec. 904(g)(5), as amended by Act Sec. 14304)

OTHER INTERNATIONAL REFORMS

Restriction on Insurance Business Exception to PFIC Rules
Under pre-Act law, U.S. shareholders of a passive foreign investment company (PFIC) are taxed currently on the PFIC's earnings. An exception to this rule applies to certain income derived in the active conduct of an insurance business.

New law. For tax years that begin after Dec. 31, 2017, there are additional requirements before this exception applies. (Code **Sec. 1297**, as amended by Act Sec. 14501)

Repeal of Fair Market Value of Interest Expense Apportionment
Taxpayers must determine U.S. source and foreign source income for various purposes. **Code Sec. 864(e)** provides rules for allocating interest, etc. for those purposes.

New law. For tax years that begin after Dec. 31, 2017, for purposes of such determinations, members of a U.S. affiliated group are not able to allocate interest expense on the basis of the fair market value of assets for purposes of **Code Sec. 864(e)**. Instead, the members have to allocate interest expense based on the adjusted tax basis of assets. (Code **Sec. 864(e)**, as amended by Act Sec. 14502)

Stock Compensation of Insiders in Expatriated Corporations
An excise tax is imposed on the value of the specified stock compensation held by disqualified individuals if a corporation expatriates and gain on any stock in the expatriated corporation is recognized by any shareholder in the expatriation transaction. Under pre-Act law, the excise tax was 15% of the value of the specified stock compensation (i.e., payments with a value that is based on (or determined by reference to) the value (or change in value) of stock in the corporation) held (directly or

indirectly) by or for the benefit of the individual or a member of the individual's family during the twelve-month period beginning six months before the expatriation date.

New law. For corporations first becoming expatriated corporations after the date of enactment of the Act, the excise tax on stock compensation in an inversion is increased from 15% to 20%. (Code **Sec. 4985(a)(1)**, as amended by Act Sec. 13604)