KNOW GREATER VALUE™

PKF O'CONNOR DAVIES
ACCOUNTANTS AND ADVISORS

International Tax Alert

U.S. Switches to Territorial Tax System

By Leo Parmegiani, CPA, Partner and Peter D. Baum, CPA, Partner

Unless you have been under a rock or in a long hibernation, you are aware that significant tax reform [Tax Cuts and Jobs Act (H.R.1)] has passed. The last such reform dates back to the Reagan years in the mid-1980s.

It may surprise you, but no area within the Act was more affected than the taxation of income earned outside the U.S. As a result of the new law, the U.S. international tax system has completely shifted course from taxing worldwide active business income to a territorial system whereby foreign-source income gets, in many cases, a free pass.

Global tax advisors and business executives will be scrambling over the coming months to decipher the new law and begin planning for the future. Creative structuring to reduce the impact of these rules is a must. In the words of federal judge Learned Hand [1872-1961]: ***Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. Over and over again, the Courts have said that there is nothing sinister in arranging affairs as to keep taxes as low as possible.***

So, let's follow the words of the good judge and arrange our tax affairs in the most beneficial manner.

This article will focus on two of the major provisions of the international tax reform:

- Exemption for Foreign-Source Dividends
- Deemed Repatriation of Earnings Tax

Future articles will cover:

- Global Intangible Low-Taxed Income (GILTI Tax)
- Base Erosion and Anti-Abuse Tax (BEAT)
- Interest and Royalty Payments to Related Foreign Hybrid Entities

U.S. Participation Exemption for Foreign-Source Dividends

Previously, earnings distributed by foreign corporations were taxed at the applicable corporate tax rate — generally 35% —which stopped many large multinational groups from bringing the cash back to the U.S. Because these dividends will no longer be taxed, the foreign tax credit provisions have also been modified. The new law does this in what is called a "participation exemption."

For years beginning after December 31, 2017, the law provides a 100% deduction for the foreign-source portion of dividends received by a domestic corporation from a specified foreign corporation (SFC) in which it is a U.S. shareholder. A specified 10%-owned foreign corporation is any foreign corporation, other than a passive foreign investment company (PFIC), that is not a controlled foreign corporation (CFC), in which any domestic corporation is a 10% U.S. shareholder. Only regular C corporations get this deduction. The 100% deduction would not be available to regulated investment companies (RICs) or real estate investment trusts (REITs). Going forward, no foreign tax credits will be available against any dividends that qualify for this exemption.

The U.S. shareholders will additionally need to determine the portion of the dividend that is foreign- source. The foreign-source portion of a dividend received from a specified 10%-owned foreign corporation is the amount that bears the same ratio to the dividend as the undistributed foreign earnings of the specified 10%-owned foreign corporation bears to its total undistributed earnings.

In addition to the 10% ownership voting power and/or value requirement, the domestic corporation would need to hold the stock for over 365 days in a 731-day period, beginning on the date that is 365 days before the date on which the dividend is paid.

PKF O'Connor Davies Observation

These provisions are designed to encourage U.S. corporations to bring back foreign earnings without the fear of another level of tax. However, it may also encourage businesses to generate more non-U.S. income by expanding overseas investments. Careful analysis will be required in future years. It should also be noted that this exemption is only available to C corporations. The exclusion is not available to S corporations, partnerships, individuals or trusts; therefore, foreign corporations owned by a U.S. person other than a C corporation will continue to pay the applicable dividend tax rate.

Deemed Repatriation of Foreign Earnings

Under the new law, there is a mandatory income inclusion — by each U.S. shareholder — of their pro rata share of their foreign subsidiary's post-1986 earnings and profits (E&P) as of the "measurement date." The measurement date is November 2, 2017 or December 31, 2017, whichever date produces the greater result. In other words, the earnings of the subsidiary will be deemed to have been repatriated back to the U.S. and be subjected to tax whether or not an actual distribution has been made. The tax will be imposed on U.S. domestic corporations that own at least a 10% interest in an SFC and any U.S. person who owns at least a 10% interest in a CFC.

The mandatory inclusion will be implemented by increasing the subpart F income of the SFC (treating a 10/50 company as a CFC solely for this purpose) in its last tax year beginning before January 1, 2018 (transition year) by the greater of its "accumulated post-1986 deferred foreign income" determined on November 2, 2017 or December 31, 2017.

The portion of the E&P attributable to cash and cash equivalents will be taxed at a tax rate of 15.5% and the portion attributed to the remaining assets will be taxed at 8%. However, there is a claw-back provision that would subject the entire mandatory inclusion amount to a 35% tax rate if a domestic corporation, which was subject to the transition tax, inverts within 10 years of the enactment of the law. Affected taxpayers may make an election to pay this "transition" tax over a period of up to eight years in increments of 8% for five years followed by payments of 15%, 20% and 25% in the sixth, seventh and eighth year, respectively.

If a U.S. shareholder has multiple SFCs, the accumulated earnings of each SFC are aggregated when determining the tax due. This allows accumulated deficits from one foreign entity to potentially offset accumulated earnings of another. A portion of foreign tax credits attributable to the taxable portion of the accumulated earnings pool will be allowed to offset the transition tax.

In the case of a subchapter S corporation that has a mandatory inclusion, the new law would permit each shareholder of the S corporation to elect to defer payment of its net tax liability with respect to the S corporation by reason of the mandatory inclusion until the tax year in which any of the following occurs first:

1. The corporation ceases to be an S corporation.
2. The S corporation liquidates or sells substantially all of its assets.
3. The S corporation ceases its business, ceases to exist or any similar circumstance.
4. The shareholder transfers shares in the S corporation; transfers of less than all of the stock in an S corporation are a triggering event only with respect to the transferred shares.

PKF O'Connor Davies Observation

This tax requires a complicated calculation and significant information gathering. Many small to medium sized businesses with foreign subsidiaries do not track E&P on a regular basis and those that do may not categorize the E&P by U.S. versus non-U.S. Other areas of concern include obtaining detailed balance sheets of the foreign corporations as well as local tax return(s) and reconciliation between local books, local tax and U.S. tax reporting. Our advice: begin planning for this tax season as soon as practical to ensure proper information is available and tax planning can occur.

Contact Us

The international tax team of PKF O'Connor Davies is closely following developments in the international tax arena as the IRS catches up to the new legislation and begins writing interpretive rules and regulations. We are available to assist in this analysis and how it affects our clients' unique facts and circumstances.

Contact any of our international tax partners. We are here to help.

Leo Parmegiani, CPA, Partner
lparmegiani@pkfod.com

Peter D. Baum, CPA, Partner
pbaum@pkfod.com

Leonard D. Levin, JD, Partner
llevin@pkfod.com

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, nine offices in New York, New Jersey, Connecticut and Maryland, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 28th on *Accounting Today*'s 2017 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by *Accounting Today.* In 2017, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by *Vault*.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in over 400 locations, in 150 countries around the world.