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# House and Senate conferees agree to overhaul foreign tax rules

Tax Alert | December 18, 2017

On Friday, Dec. 15, the House and Senate conferees agreed to a final version of the *Tax Cuts and Jobs Act and issued a Joint Explanatory Statement* that explains the bill. The bill will likely be voted on by the Senate and House early this week and, if approved, will then go to the President for his signature.

The text of the conference committee report and the Joint Explanatory Statement can both be downloaded.

Here is a summary of some of the key international tax provisions of the bill. Unless noted otherwise, these provisions would apply as of Jan. 1, 2018.

- **Establishment of Territorial Tax system** The final bill would establish a "territorial" system of taxation, for the first time in U.S. history, under which U.S. corporations may deduct dividends received from a "specified" foreign corporation. A one year holding period applies before a corporation may take this deduction Individuals may not claim a dividends received deduction for such amounts.
- **Mandatory taxation of deferred foreign earnings at reduced rate** U.S. corporations and individuals who own at least 10 percent of the voting shares of a foreign corporation must take into current income – for 2017 -- their pro rata share of the untaxed earnings of the corporation. Such income would be subject to tax at reduced rates under a two-tier regime. Earnings attributable to cash or cash equivalents held in a foreign corporation would be taxed at a 15.5 percent rate while all other earnings would be taxed at a rate of eight percent. Earnings for this purpose could not be reduced by current year distributions, accordingly, dividends paid in 2017 will not be taxed as regular dividends but will be taxed under these new rules. Taxpayers may elect to defer payment of the actual additional taxes resulting from this mandatory inclusion over an 8-year period. However, the first payment will be due on the date when the taxpayer's final tax payment for 2017 is otherwise due, so taxpayers should be prepared to pay an additional amount with their 2017 extension.
- **Retention of rules requiring inclusion of income upon investment in U.S. property by CFC** In a surprising change, the final bill deletes the proposal to repeal the current law rule that results in the taxation of offshore earnings corresponding to an investment in U.S. property made by a controlled foreign corporation (CFC). The conferees likely retained this provision in order to raise revenue.
- **Special tax rates for offshore intangible income** While the final bill sets the overall domestic corporate tax rate at 21 percent, the bill also provides special tax rates for foreign intangible income earned directly or indirectly through a controlled foreign corporation. In particular, the bill imposes a 13.125 percent effective tax rate for intangible income earned directly and a 10.5 percent rate for intangible income earned through a foreign corporation. For this purpose, the bill broadly defines intangible income through a "subtractive" method as the corporation's total gross income minus an appropriate assumed rate of return on certain of the corporation's tangible assets. While the resulting effective tax rates are higher than the effective "zero" rate that applies to dividends paid by foreign corporations out of foreign earnings, they are lower than the general domestic corporate rate of 21 percent.
- **Sales of inventory sourced exclusively based on location of production** The final bill would change the current law rule that treats income from the sale of inventory -- produced in one country and sold in another – as derived in part from both countries.

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Instead, such sales would be sourced according to the location of production. This could significantly limit the extent to which taxpayers with U.S. production activities may claim a foreign tax credit, since they will have less foreign source income.

- **The final bill drops an earlier proposal to accelerate the required worldwide allocation of interest** Following current law, these rules will take effect in taxable years beginning after Dec. 31, 2020.
- **Separate basket for foreign tax credits arising from foreign branches** The final bill would require taxpayers to apply the foreign tax credit limitations of current law under a method that treats the taxpayer's separate branches as separate sources or "baskets" of foreign source income. This would make it more difficult for taxpayers to claim foreign tax credits.
- **No extension of "look through" rules for certain controlled foreign corporations** The final bill would not extend an expiring rule that characterizes income received from a controlled foreign corporation by reference to the underlying income of the controlled foreign corporation. With the expiration of that rule, taxpayers will likely have more "subpart F" income which will be generally subject to the normal domestic corporate tax rate of 21 percent -- and will not enjoy any offsetting dividends received deductions or similar benefits. A wide variety of taxpayers currently rely on this rule and such taxpayers may wish to consider restructuring options.
- **Base Erosion and Anti-Abuse Tax (BEAT)** To prevent the erosion of the U.S. corporate tax base, the final bill would impose a 10 percent tax on U.S. corporations that make excessive taxdeductible payments to related foreign persons. This tax operates somewhat like an alternative minimum tax. It is triggered where, broadly speaking, 10 percent of the corporation's "modified" taxable income (determined without regard to a wide variety of deductible payments made to foreign related persons) exceeds the corporation's regular corporation income tax. Determining modified taxable income is quite complex and will require considerable analysis. The rules apply only to corporate taxpayers with average annual gross receipt of at least $500 million, and only if they have a "base erosion percentage" of three percent or higher. The tax rate increases to 12.5 percent in taxable years beginning after Dec. 31, 2025. Companies with significant taxdeductible payments to related persons, such as those with global supply chains, should carefully assess the impact of this provision.
- The final bill clarifies that goodwill, going concern value, and workforce in place constitute "intangibles" under the rules that govern outbound transfers.
- **PFIC Insurance Exception** The House-Senate Conference Agreement provides detailed rules regarding the application of the exception to the Passive Foreign Investment Company regime for foreign insurance companies.
- **The final bill repeals the "fair market value" method of apportioning interest expense for purposes of determining foreign tax credits** Current law allows taxpayers to elect the "fair market value" method of apportioning interest expense, which may benefit taxpayers that have significant intangible assets with high value but low tax basis. The final bill would disallow the use of this method, forcing taxpayers to apportion based on tax basis. That change coulc limit the ability of certain taxpayers to claim a foreign tax credit.

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RSM will continue to provide updates regarding developments in the legislative process, as well as regarding the potential impact of the final legislation on specific industries, entity types, and specific fact patterns.

Please see our additional tax alerts for details regarding the individual, domestic business, and pass-through aspects of the conference agreement on the final proposed legislation.

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