CPA Practice **Advisor**

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

to raise revenue over the next decade, not balloon the deficit.

Apr. 10, 2018



The changes to the international tax rules are an outlier in the 2017 tax code overhaul—unlike the rest of the reforms, the international provisions are projected to raise revenue over the next decade, not balloon the deficit. The talking points for the 2017 tax act (Pub. L. No. 115-97) focused on simplifying the

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

the one-time repatriation tax, as discussed below).

Especially in comparison with the other reforms, the changes to the international rules weren't so much about goosing the economy as they were about modernization. The thought was that multinationals had become so adept at manipulating our 20th century tax code that something had to be done to squeeze what little revenue from them that we can. The end result is an acronym soup and a tricky web of rules that is vastly more complicated than the one that preceded it.

However, at a conceptual level, the reforms aren't that hard to understand.

The Message and the Mess Beneath

Regardless of the actual intent of the international reforms, the messaging still revolved around economic stimulus: specifically, that the changes would inject the economy with corporate cash that had been "locked out" abroad. The idea was that the old rules created a twofold problem:

1) U.S. companies were unable to bring back their hoards of foreign profits (estimated by the GOP in 2016 to surpass \$2 trillion) because doing so would expose them to prohibitively high U.S. tax rates; and

2) U.S. companies, burdened by such high U.S. tax rates, were unable to compete effectively with foreign businesses.

(There was some debate about how "anti-competitive" the old international tax system actually was for U.S. multinationals, given the vast fortunes many U.S. companies were able to amass—note problem 1, above.)

GOP lawmakers in their 2016 "Blueprint" for tax reform said they wanted to end the U.S. system of "worldwide taxation," in which U.S. businesses were generally taxed

on all income wherever earned, and move to a "territorial system," in which active

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

Congress added new anti-abuse taxes that actually expand the categories of foreign income subject to current U.S. tax, albeit at lower rates than under the previous system.

The mechanism by which Congress provided for territoriality is the new "participation exemption," which in general provides U.S. C corporations—and only C corporations—a 100% deduction for the foreign-source portion of dividends they receive from certain foreign subsidiaries, resulting in zero U.S. tax for those distributions. In practice, however, there are a multitude of exceptions, and this provision applies to only a small slice of foreign income.

What about the locked-out profits? Can corporations bring back their \$2 trillion of offshore funds tax free under the participation exemption? No. Those funds that were in limbo under the previous system are all now subject to tax, but not at a top rate of 35%, as under prior law, or even 21%, the new corporate rate. This new tax is informally referred to as a "repatriation" or "transition" tax and is set at rates of 15.5% for cash and cash equivalents and 8% for other investments. It can be offset by any applicable foreign tax credits (which are scaled down to reflect the lower tax rates).

Taxpayers hit by the repatriation tax do not have to pay it all at once but can elect to pay it over eight years. According to the Joint Committee on Taxation, this tax alone is expected to bring in about \$338.8 billion of revenue.

Burdens without benefits. The transition tax is imposed on "United States shareholders" of "specified foreign corporations," both of which are defined terms, but "United States shareholders" is not limited to corporations. It also includes pass-through entities and even individuals. This is broader in scope than the participation exemption, which is available only to U.S. *C corporations*. In other words, many

taxpayers that are subject to the transition tax will not receive the corresponding

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

were included in the act. (Or at least the likely reasons why—there wasn't much congressional explanation of the policy behind these provisions.)

Under prior law, the tax code provided incentives for companies to move income offshore, in general due to the possibility of achieving low (or zero) foreign tax rates as well as indefinite deferral from U.S. taxation. For companies that profited primarily from highly mobile income sources like intangible property, offshoring income wasn't that hard to accomplish. The rights to intangible property can "reside" almost anywhere. Consider some of the firms that had the largest amounts of profits stashed abroad: Apple Inc., Microsoft Corp., Cisco Systems Inc., and Google parent Alphabet Inc.

Switching from a worldwide to a territorial system without adding additional protections would heighten those incentives enormously—by allowing not just deferral from U.S. tax but total exemption.

Thus, Congress added new rules to strengthen and expand upon previously existing tax code provisions that subject certain types of mobile foreign income to current U.S. taxation.

GILTI as charged. The main way in which the 2017 tax act attempts to provide "teeth" to its territorial system is through its new tax on "global intangible low-taxed income" (GILTI).

The GILTI tax has gotten a lot of attention, maybe because of the playful acronym, which is not accidental. The provision targets what had become emblematic of successful tax planning: highly profitable income streams parked in low-tax jurisdictions. The GILTI tax works alongside pre-existing Subpart F rules to widen the net that subjects foreign income to current U.S. taxation. In general, Subpart F—which was also strengthened as part of the tax act—seeks to

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

The GILTI tax generally applies only to income subject to foreign tax rates of 13.125% or less. This is because foreign tax credits (FTCs) can be used to offset the GILTI tax, but only up to 80% of the foreign taxes paid on that income. The GILTI tax rate is currently 10.5% (that is, the full corporate tax rate of 21% minus a 50% deduction). Thus, an 80% credit on a 13.125% tax rate would yield an amount equal to offset the 10.5% GILTI tax (13.125% x 80% = 10.5%). No carrybacks or carryforwards are allowed for the GILTI FTC, so excess credits in any given year cannot be used in other years.

That foreign tax rate threshold will increase beginning in 2026, however. At that time, the GILTI tax will generally apply to income taxed at foreign tax rates of about 16.4% or less, rather than 13.125% or less. (This is because the GILTI deduction is scheduled to decrease from 50% to 37.5%).

Fee-fi-fo-fum. FDII (foreign-derived intangible income) is a companion to the GILTI tax, but it's a deduction rather than a tax, so it's something businesses will try to attain rather than avoid. It doesn't have quite as catchy a name as GILTI, and there doesn't seem to be a consensus yet on how to pronounce it—"fiddy" with a short i or "foddy" with a long o.

The deduction could be viewed as an export incentive. It is calculated using similar concepts as GILTI. In a nutshell, the deduction is available to U.S. corporations that sell, license, or lease property to foreign persons for use outside the United States or that provide services for people or property outside the United States.

Looking at the combined effect of GILTI and FDII, there seems to be an unintended new incentive, which some have characterized as "perverse": Companies get a benefit by increasing the amount of tangible depreciable property (business equipment) they locate *outside* the United States. By locating such property offshore, taxpayers decrease their potential GILTI tax and increase their potential FDII deduction, both

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

sophisticated multinational companies. (And, yes, there's an acronym for that: BEPS.)

As an example of these problems, consider a loan made between related business entities, one located in a high-tax country and one located in a low-tax country. The entity residing in the high-tax country pays interest on the loan—thereby creating deductions for those interest payments and reducing its tax bill—and the entity in the low-tax country happily collects the income. Even if the low-tax entity has to pay tax, it will do so at a much lower rate. Because the related parties are both part of one big corporate family, the overall effect is to shift the income from a high tax rate to a low one.

Under prior law, the main code provision protecting against this type of profit shifting operated by limiting deductions for interest payments between related parties. However, the rule was not extremely effective.

The 2017 tax act scrapped that interest limitation rule, replaced it with a new one, and also added the BEAT, which targets related-party base erosion payments more broadly, not just interest, encompassing a wide variety of deductible payments such as royalties, service payments, and certain reinsurance deductions.

The BEAT is calculated as a sort of alternative minimum tax. That is, it compares a company's tax liability both with and without taking into account certain bad "base erosion" payments. If the company is too successful in reducing its tax liability by virtue of those payments, the BEAT tacks on extra tax.

The BEAT has been a focus of international ire as a potential violation of existing tax treaties and WTO trade restrictions. It's not clear yet whether foreign countries will indeed raise those challenges or how they would be resolved.

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us

current U.S. taxation, albeit at much lower rates than under prior law.

Simplification, by contrast, was not even remotely accomplished. The 2017 tax act added new rules on top of old ones and brought about a level of complexity that has left even veteran tax attorneys scratching their heads as they try to understand how all the new rules will interact.

To a large degree, the new international tax regime is still a work in progress. We are in the early stages of implementation. The rules will be substantially refined by IRS and Treasury guidance, possibly by new legislation, and if nothing else, by case law as it plays out over the years to come.

Also, notably, the act did not put an end to international tax planning. The reduction in the corporate tax rate was significant and will alleviate some of the pressure to make otherwise inefficient business decisions purely for tax reasons. However, with income streams in the billions (with a "b"), small percentage reductions in effective tax rates can make a big difference in a company's bottom line. Given the enormous complexity of the new system, there will be plenty of planning opportunities to be found.

And rest assured that creative tax lawyers are already looking for them.

John Myrick works with the Tax and Accounting Acquisitions group at Bloomberg Tax.

Hello. It looks like you're using an ad blocker that may prevent our website from working properly. To receive the best experience possible, please make sure any blockers are switched off and refresh the page.

If you have any questions or need help you can email us