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Tax Reform Has Officially Arrived – What Does It Mean For US Expats? (Part II – Business Taxation)

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Introduction

Last week,[1] we started our review of the newly enacted Tax Cuts and Jobs Act ("TCJA"),[2] focusing on the personal taxation provisions. This week, we focus on the business taxation provisions that we believe will most significantly affect US expats with overseas businesses.

We do want to note upfront that while almost all of the TCJA provisions are effective beginning with the 2018 tax year (or sometimes in a later year), there are a few foreign business taxation provisions that already became effective with respect to the 2017 tax year.

Perhaps most importantly, as detailed below, a so-called "**transition tax**" is imposed on certain US shareholders with respect to the accumulated and previously untaxed earnings and profits generated by certain 10 percent-held foreign corporations through the 2017 tax year (or more technically speaking, through the last tax year beginning before the TCJA enactment date of December 22, 2017). Further detail is available on the transition tax later in this article.

For ease of understanding, we have broken down the TCJA provisions, into: (i) those that apply more generally to businesses, and (ii) those that apply more specifically to US expats with businesses operating overseas.

General Business Provisions

1. Corporate tax rate reduced dramatically

In one of the more dramatic changes to the US tax system under the TCJA, the US federal corporate tax rate is reduced to a flat rate of 21 percent.

2. AMT for corporations eliminated

While the alternative minimum tax ("AMT") is retained and modified for individuals, it is eliminated for corporations.

3. Modification of NOL deduction

The two-year carryback of net operating losses ("NOLs") and accompanying carryback provisions are repealed under the TCJA. The deduction can now be carried forward indefinitely, but is limited to 80 percent of taxable income.

4. New limitation for interest deductions

The TCJA completely rewrites Section 163(j), which acted to limit the deductibility of interest by a thinly capitalized corporation where the interest is paid to a related payee that is totally or partially exempt from US tax on the distribution.

The new Section 163(j) limits the deductibility of interest expenses of any business entity (whether or not in corporate form) paid to anyone (not just related parties) to 30 percent of "adjusted taxable income" (defined similarly to "EBITDA" by adding back to taxable income interest, any NOL or pass-through business deduction, and (until 2022 only) depreciation). Interest in excess of 30 percent is carried forward indefinitely. The new rule does not apply to: (1) taxpayers with average annual gross receipts for the three-year period ending with the prior tax year that do not exceed USD25m; and (2) real property trades or businesses that elect out of the limitation.

5. New deduction for pass-through income

Individuals, trusts, and estates may be eligible for a 20 percent deduction on so-called "qualified business income" earned through a sole proprietorship (including a wholly owned disregarded LLC), partnership, or S corporation. The 20 percent deduction is subject to a number of complex rules, including limitations based on taxpayer wages that phase in at certain taxable income thresholds (USD315,000 for married individuals filing jointly and USD157,500 for other individuals). The type of income eligible for the deduction is generally US trade or business income, so the deduction is not relevant for expats with income from a foreign trade or business.

6. Stricter qualification for like-kind exchanges

The TCJA makes two significant changes to the rule allowing for the deferral of realized gain on like-kind exchanges. First, the rule is modified to allow for like-kind exchanges only with respect to real property that is not held primarily for sale. Second, real property located in the United

States and real property located outside the United States are no longer considered property of a like kind.

Foreign Business Provisions

1. Establishment of "participation exemption" system for taxation of foreign income

In another of the more dramatic changes to the US tax system, the TCJA provides for a complete exemption for active foreign income (or non-Subpart F income) earned by certain US corporate taxpayers via a foreign subsidiary. The exemption is provided for by means of a 100 percent dividends received deduction ("DRD") for the foreign-source portion of dividends received from a "specified 10-percent owned foreign corporation" by domestic corporations that are US 10 percent shareholders of those foreign corporations. This new rule is intended to encourage companies to repatriate their active income to invest in the US economy.

While this new taxation regime doesn't negate other important foreign income regimes such as the CFC or PFIC regimes (which continue to apply to passive-type income, such as dividends and interest, earned by foreign corporations), it does have a significant ripple effect on a number of other rules relating to the taxation of foreign income. For instance, foreign tax credits are not allowed for taxes paid or accrued with respect to a dividend that qualifies for the new DRD. Also, as an example, in the case of a sale 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 under Section 1248 of the Code is treated as a dividend for purposes of applying the DRD.

2. One-time transition tax on deferred foreign income

As mentioned above, for expats who utilize a foreign corporation to operate their businesses overseas, there is one feature of the TCJA that already comes into play this filing season (*i.e.*, it is applicable to the 2017 tax year) for both US corporate **and** non-corporate shareholders (including individuals).

Under revised Internal Revenue Section 965, as part of the transition to the participation exemption system described above, the TCJA uses the mechanics under Subpart F to impose on US shareholders owning at least 10 percent of a foreign subsidiary a one-time mandatory "**transition tax**" on the undistributed, non-previously taxed post-1986 foreign earnings and profits ("E&P") of a "specified foreign corporation." A specified foreign corporation is defined

as (i) any CFC, and (ii) any foreign corporation with respect to which one or more domestic corporations is a 10 percent United States shareholder. The portion of the E&P comprising cash or cash equivalents is taxed at the rate of **15.5 percent**, while any remaining E&P is taxed at the rate of **8 percent**.

Section 965 specifies, importantly, that the transition tax applies to the greater of the accumulated post-1986 deferred foreign income (essentially the previously untaxed earnings and profits) of the foreign corporation determined as of **November 2, 2017 or as of December 31, 2017**. In order to prevent pre-transition tax avoidance planning, the section adds that E&P is determined by essentially ignoring dividends distributed during the 2017 taxable year (other than dividends distributed to another specified foreign corporation).

Also, importantly, Section 965 does not distinguish US corporate shareholders from other US shareholders, so the transition tax potentially applies to **any US person (including an individual)** owning at least 10 percent of a foreign subsidiary. This aspect of the transition tax seems at odds with the new participation exemption system which applies solely to US corporate shareholders, but as the House Bill specifies: "In contrast to the participation exemption deduction available only to domestic corporations that are US shareholders under subpart F, the transition rule applies to all US shareholders of a specified foreign corporation."

Other aspects of Section 965 that could potentially ease the pain of the transition tax include the following:

- US shareholders can elect to pay the transition tax over a period of up to eight years;
- In the case of foreign corporations held via an S corporation, US shareholders can elect to maintain deferral on the deferred foreign income;
- Deferred earnings of a US shareholder are reduced (but not below zero) by the shareholder's share of deficits from other specified foreign corporations;
- The transition tax does not apply to previously taxed earnings and profits;
- The portion of earnings subject to the transition tax does not include E&P that were accumulated by a foreign company prior to attaining its status as a specified foreign corporation.

It is important to emphasize here, however, that this description of the transition tax in this article is only a high-level summary.

3. Changes to the controlled foreign corporation (CFC) rules

The TCJA also makes a number of changes to the CFC rules, including:

- Creation of a new category of income called "global intangible low-tax income" ("GILTI"), which is taxed in a manner similar to inclusions of Subpart F income;
- Elimination of the 30-day minimum holding period for shareholders of a CFC to be subject to the Subpart F inclusion rules;
- Amendment to the constructive ownership rules so that certain stock of a foreign corporation owned by a foreign person is attributed to a related US entity for purposes of determining whether the related US entity is a US shareholder of the foreign corporation (which can determine whether the foreign corporation is a CFC). This change begins with the last tax year of the foreign corporation beginning before January 1, 2018;
- Expansion of the definition of "US shareholder" for CFC purposes to include any US person who owns 10 percent or more of the *total value* of shares in the foreign corporation (prior to this change, the CFC rules looked only to the percentage of voting interests). This change also begins with the last tax year of the foreign corporation beginning before January 1, 2018.

We also note that the change to the US corporate tax rate could dramatically affect the extent to which the Subpart F rules are applied to CFCs. As CFC owners know well, a US 10 percent shareholder of a CFC is required to include currently in income the Subpart F (generally passive) income of such CFC. However, Subpart F inclusions are generally not required for any item of income received by a CFC if such income was subject to an effective rate of income tax imposed by a foreign country greater than 90 percent of the maximum rate of the corporate tax rate (the so-called "high-tax exception"). Under the new 21 percent corporate rate regime, when income of CFC is subject to tax at an effective rate greater than 18.9 percent in its foreign country, the Subpart F inclusion rule should seemingly not be triggered.

Other Changes For Businesses

For the sake of completeness, the following are some of the other changes for businesses under the TCJA that are perhaps less relevant for expats but are still noteworthy:

- A three-year holding period requirement is required in order for so-called "carried interest" (a partnership interest received in connection with the performance of services) of individuals to be taxed as long-term capital gain rather than ordinary income;

- The additional first-year depreciation deduction is extended and modified (increasing the 50 percent allowance to 100 percent for property acquired and placed in service after September 27, 2017, and before January 1, 2023);
- The amount allowed to be expensed under Section 179 is increased from USD500,000 to USD1m;
- Recovery period for certain real property is shortened;
- For domestic corporations, the dividends received deduction is reduced for a less than 80 percent-owned corporation;
- New base erosion anti-abuse taxes (BEAT) for certain corporations with average annual gross receipts of at least USD500m.

Summary Chart Of Tax Reforms In TCJA (Business Taxation)

As a quick reference guide, here is a summary of the tax reforms in the TCJA that are of particular significance for US expats operating businesses:

Issue	Previous Law	New Law Under TCJA
Corporate Tax Rate	■ Graduated rates up to a maximum rate of 35 percent.	■ Flat rate of 21 percent.
Alternative Minimum Tax	■ Imposed on corporations.	■ Repealed for corporations.
NOL Deduction	■ Carried back two years and carried forward 20 years; ■ No percentage limitation.	■ No carryback but carried forward indefinitely subject to exceptions; ■ Deduction limited to 80 percent of taxable income.
Limitation on Interest Deduction (163(j))	■ Limits the deductibility of interest expenses paid by US corporations to foreign related parties to 50 percent of adjusted taxable income (ATI, or cash flow) on an annual basis (unless they have a debt to equity ratio below 1:5 to 1).	■ Limits the deductibility of interest expenses of any business entity (whether or not in corporate form) paid to anyone (not just related parties) to 30 percent of ATI; ■ Does not apply to: (1) taxpayers with average annual gross receipts that do not exceed USD25m; and (2) real property businesses that elect out.
Deduction For Pass-Through Income	■ Individuals pay tax at ordinary income tax rates on trade or business income earned via pass-through entities (LLC, S corp, or sole proprietorship) with no deduction.	■ Individuals earning pass-through income from a US trade or business eligible for 20 percent deduction, subject to certain limitations.

Issue	Previous Law	New Law Under TCJA
Like-Kind Exchanges	■ No gain or loss recognized (i.e., tax deferral) on exchange of a wide range of property for property of a like kind.	■ Like-kind exchange treatment limited to real property that is not held primarily for sale; ■ US real property and non-US real property are no longer considered property of a like kind.
Taxation of Corporation's Foreign Income	■ US corporations subject to taxation on worldwide income but foreign active income only taxed when repatriated.	■ US corporations essentially not subject to tax on foreign active income generated via a 10 percent-owned foreign subsidiary; ■ New system implemented through the use of a dividends received deduction.
Transition Tax on Deferred Foreign Income	■ N/A.	■ Mechanics under Subpart F used to impose on US shareholders owning at least 10 percent of a foreign subsidiary a one-time mandatory "transition tax" on the undistributed, non-previously taxed E&P of such foreign corporation; ■ Transition tax rate is 15.5 percent for cash or cash equivalents and 8 percent for other E&P.

Endnotes

1 See *Global Tax Weekly,* No. 271, January 18, 2018.

2 https://www.congress.gov/bill/115th-congress/house-bill/1