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New Tax Law May Result in Additional Taxes for Certain US Persons who Directly or Indirectly Own Equity in a Foreign Corporation

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Executive Summary

The new federal tax rules (informally known as the Tax Cuts and Jobs Act ("TCJA")), signed into law on December 22, 2017, significantly expand the situations in which a foreign corporation will be treated as a "controlled foreign corporation" (a "CFC") and expand the types of income of the CFC that certain US shareholders must include annually on their tax returns. In particular, foreign corporations that are owned by a foreign parent might now be CFCs if the foreign parent also directly or indirectly owns at least one US corporation or if the foreign parent has an owner that also directly or indirectly owns a US corporation. As a result of this expansion, many US shareholders who were not previously affected by the CFC rules are now subject to annual income inclusions. In addition, there is now a new tax (the "GILTI" tax) imposed on US shareholders who hold an interest in a CFC. Thus, many US shareholders who were previously subject to the CFC rules are now subject to additional annual income inclusions. Some of these changes are effective for the 2017 tax year.

Expansion of CFC Regime

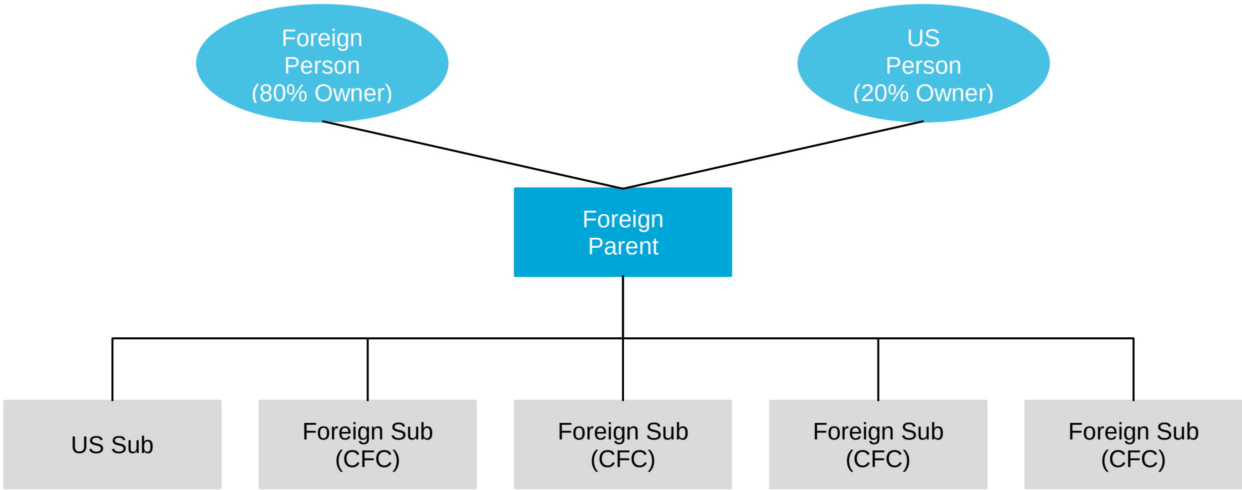
In order for a foreign corporation to be treated as a CFC, more than 50% of the stock of the foreign corporation must be owned, directly or indirectly, by one or more US persons who own at least 10% of the stock of the foreign corporation (such 10% or greater US shareholder, a "US Shareholder"). Two changes made by the TCJA expand the situations in which a foreign corporation will be treated as a CFC.

"Downward Attribution"

The change that is likely to have the broadest application is the change to the so-called "downward attribution" rule. Prior to the change, an "owner" of stock of a foreign corporation (for purposes of testing whether US Shareholders own more than 50% of a CFC) generally had to be a direct or indirect shareholder of the foreign corporation. As a result of the change to the "downward attribution" rule, a sister company to the foreign corporation is now treated as an "owner" of the foreign corporation. This is because under the new "downward attribution" rule, the stock owned by a foreign person (such as stock of a foreign subsidiary owned by a foreign parent) now is "attributed to" (deemed owned by) a lower-tier US person (such as a US subsidiary of the foreign parent) for purposes of determining whether a foreign corporation is treated as a CFC. Thus, if a foreign parent with one or more foreign subsidiaries also owns at least 50% of one US corporation, all foreign subsidiaries of the foreign parent that are more than 50% owned by such foreign parent (and that are treated as corporations for US federal income tax purposes) generally will be CFCs under the new rules because the US subsidiary will be deemed to own the foreign subsidiaries (satisfying the CFC requirement that US Shareholders own more than 50% of the stock of the foreign corporation).

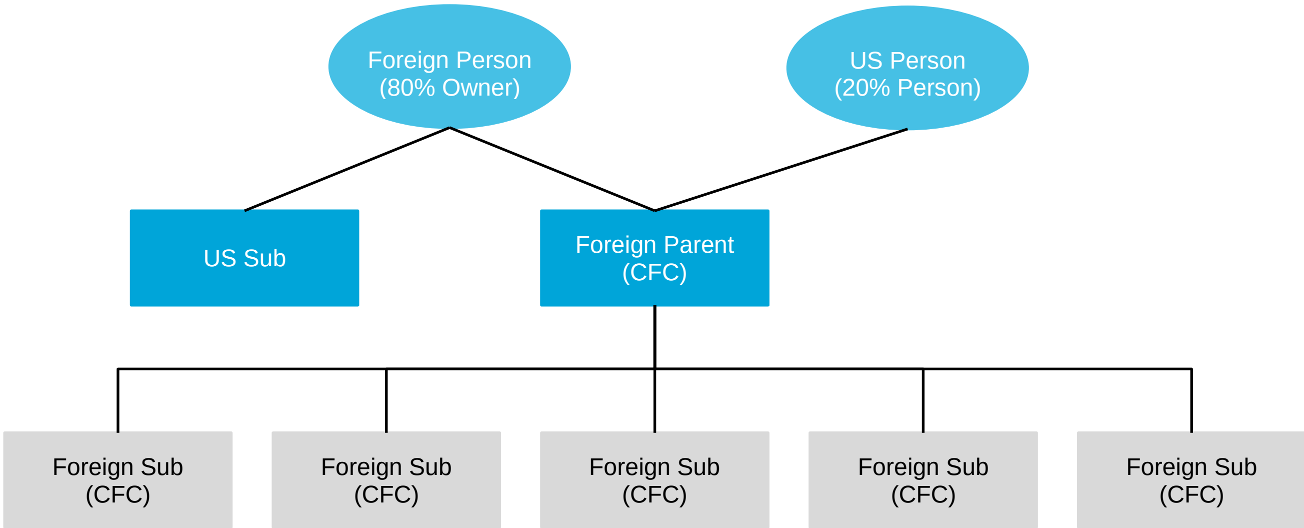
In the below example of the application of the "downward attribution" rule (Example 1), before the change to the downward attribution rule, the Foreign Subs would not have been CFCs because the US Persons who were US Shareholders directly or indirectly owned only 20% of Foreign Subs. As a result of the new tax rules, however, all of the Foreign Subs in Example 1 are now CFCs because the US Sub is deemed to own 100% of each of the Foreign Subs.

Example 1



Additionally, if a co-investor in Foreign Parent is a foreign person with a US affiliate, the change in the "downward attribution" rule can result in the entire group of foreign companies becoming CFCs even if there is no US subsidiary in the group. In the below example of the application of the "downward attribution" rule (Example 2), before the change to the "downward attribution" rule, Foreign Parent and Foreign Subs would not have been CFCs. As a result of the new tax rules, however, Foreign Parent and Foreign Subs are now CFCs because the US subsidiary of Foreign Person is now deemed to own 80% of Foreign Parent, thereby increasing the amount of Foreign Parent and (indirectly) Foreign Subs treated as owned by US Shareholders to more than the threshold 50% required under the CFC rules.

Example 2



10% Vote or Value

Under prior law, a "US Shareholder" was defined as a US person who owned, directly or indirectly, 10% or more of the total combined voting power of the stock of a CFC. Because the definition of US Shareholder only looked to voting stock, CFC and US Shareholder status could be avoided in some instances by limiting the amount of voting stock any US investor could own to 9.9% while preserving targeted economics by having the US investor acquire non-voting stock. Under the new law, a US Shareholder is now defined as a US person that owns 10% or more of the vote or value of the stock of a CFC. As a result of the change in law, a US person who owned, directly or indirectly, less than 10% of the vote but at least 10% of the value of the stock of a foreign corporation is now a US Shareholder under the CFC rules.

Consequences of being a US Shareholder of a CFC

Who is a "US Shareholder?"

These changes to the CFC rules, which have turned many foreign corporations that were not previously CFCs into CFCs, have prompted US persons who directly or indirectly own interests in these foreign corporations to question whether they are "US Shareholders" of a CFC subject to potential annual income inclusions discussed further below. As discussed above, a US Shareholder is a US person who directly or indirectly owns at least 10% of the vote or value of a foreign corporation. In a simple structure where a foreign corporation is directly owned by individuals, it generally is easy to determine whether someone is a US Shareholder. Many foreign corporations are owned, however, by funds or other investment vehicles where it is difficult to determine the level of ownership by specific individuals. In addition, the CFC rules have many "attribution" rules that operate to aggregate the ownership of related persons. Although these rules are complex, here are few simple guidelines to determine "ownership" under the CFC rules:

- To determine whether an individual is a US Shareholder of a particular foreign corporation, start with that foreign corporation, look at its direct shareholders and, for any direct shareholder that is not an individual, keep looking through such shareholder entity (and its shareholders) until you determine the individuals who indirectly own the foreign corporation. Any US individual who directly or indirectly owns at least 10% of the foreign corporation (aggregating such US individual's ownership through all chains) is a US Shareholder.
- If you find a US entity (other than an LLC or partnership that is a disregarded entity for US tax purposes) in the ownership chain that directly or indirectly owns at least 10% of the vote or value of the foreign corporation, that US entity is a US Shareholder. If the entity is a US corporation, that US corporation will be subject to the CFC rules applicable to US Shareholders. If the entity is an LLC or partnership (that is not disregarded) any US person who is a member or partner, regardless of whether such US member or partner indirectly owns 10% of the foreign corporation, will be subject to the CFC rules applicable to US Shareholders.
- Entities managed by the same manager generally are not treated as "related" except to the extent they have common ownership. Thus, common "cross" ownership of entities must be determined and a US person's ownership through multiple entities must be aggregated. Funds often consider the list of their owners to be confidential—but if it is necessary to determine cross-ownership among funds, an accountant or lawyer can review potential cross ownership on a confidential basis.
- The "downward attribution" rules described above result in certain US entities being treated as US Shareholders for purposes of determining whether a foreign corporation is a CFC. If these US entities are US Shareholders solely due to the "downward attribution" rules, however, these US entities are not subject to the CFC rules applicable to US Shareholders.

Consequences Under Existing Law

Under existing provisions of the CFC rules, any US Shareholder who owns a CFC at the end of the tax year generally must include in its income its pro rata share of (i) certain passive types of income (such as interest, dividends, gains, rents and royalties) of the CFC regardless of whether the income is distributed as a dividend by the CFC and (ii) the CFC's investments in "US property." "US property" includes a loan made to a US person if such loan is owned by or guaranteed by the CFC (or if the CFC pledged its assets or had more than 65% of its voting stock pledged to secure the loan). For example, if a foreign corporation provided a guarantee or pledged its assets or had more than 65% of its voting stock pledged for a loan to a US person (perhaps because under prior law, such foreign corporation was not a CFC) and, due to the change in tax rules (in particular the "downward attribution" rule), the foreign corporation is now a CFC, a US Shareholder of such CFC might have an income inclusion of the full principal amount of the loan beginning as soon as the 2017 tax year (see discussion below regarding the effective dates for the TCJA). There is no "grandfather" provision to this rule—loans and guarantees/pledges already in place in 2017 are subject to this new rule.

New "GILTI" Provision

The TCJA added a new inclusion rule for certain CFC income, titled "global intangible low-taxed income" ("GILTI"). The new rule, which is designed to subject greater amounts of CFC income to a minimum tax, requires each US Shareholder of a CFC to include annually in its income its pro rata share of the CFC's GILTI.

In general, GILTI equals the CFC's aggregate net income, reduced by 10% of the CFC's adjusted tax basis in depreciable tangible personal property. The required income inclusion is determined by a complicated formula, and the resulting inclusions could be substantial. While the new GILTI rule affects both corporate and non-corporate US Shareholders, it likely will result in significantly higher costs to non-corporate US Shareholders, such as individuals and trusts.

Under the new GILTI rule, corporate US Shareholders are entitled to certain GILTI relief provisions which may reduce the potential impact of the new inclusion requirements. For example, corporate US Shareholders are entitled to reduce their GILTI by 50%. The US federal corporate tax rate under the TCJA is 21%. Consequently, corporate US Shareholders are subject to an effective US corporate minimum tax of 10.5% on GILTI. Furthermore, corporate US Shareholders are entitled to claim a credit for foreign taxes paid or accrued by the CFC on the GILTI, which may reduce or eliminate additional US federal income tax obligations (to the extent foreign tax credits are available).

In contrast, non-corporate US Shareholders are not eligible for comparable relief. They are not able to deduct 50% of their GILTI, and generally cannot claim a credit for foreign taxes paid or accrued by the CFC on the GILTI. Additionally, they are subject to a US federal income tax rate of up to 37%.

Effective Dates for New Provisions

The "downward attribution" rule is effective for the last taxable year of the foreign corporation beginning prior to January 1, 2018. Thus, a foreign corporation that is a calendar year taxpayer could have become a CFC beginning with the 2017 tax year, and there is no grandfathering provision. The changes to (i) add "value" to the US Shareholder definition (thus now "vote or value") and (ii) the addition of the GILTI provision are effective for a corporation's tax years beginning after December 31, 2017 and for a shareholder's tax year that includes such corporation's tax years ending after December 31, 2017. Thus, all of these new CFC provisions are currently effective and could already have had significant impacts on US Shareholders for the 2017 tax year.

Possible Mitigation of Effects of New Tax Law

The consequences of the TCJA on minority US Shareholders of entities that are now CFCs can be significant and, based on the legislative history, may not have been intended. There is an effort by interested parties to either have the Treasury issue official guidance or have Congress act to mitigate the impact of these new rules. It is not clear, however, whether there will be any actions taken to mitigate the impact of these new rules. Thus, as of now, these new rules are effective and taxpayers are required to follow them.

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