US tax reform : the « transition tax » on foreign earnings and its impact on Luxembourg CFCs of US groups

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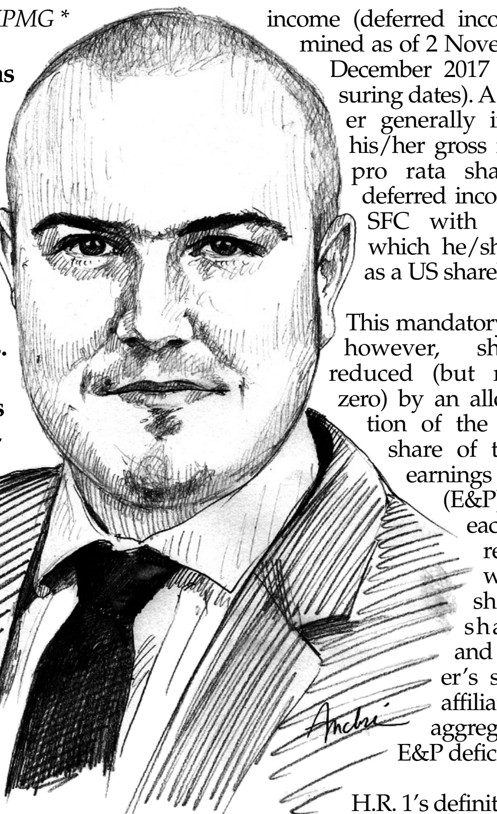

The recent US tax reform has probably been the most important topic for discussion for tax professionals, accounting and finance teams, and CFOs over the last two months. However, as is often the case when it comes to taxes, its impact goes way beyond the mere tax and accounting spheres. A significant number of Luxembourg resident companies being direct or indirect subsidiaries of US groups, it is worth trying to better understand the new tax environment in which such US groups are evolving, so as to better anticipate the potential impact of this new tax environment on their foreign subsidiaries, including those resident in Luxembourg.

Background

On 22 December 2017, President Trump signed into law H.R. 1, originally known as the "Tax Cuts and Jobs Act." The new law makes fundamental changes to the taxation of multinational entities. In general, H.R. 1 shifts away from the previous system of worldwide taxation with deferral and towards a participation exemption regime with current taxation of certain foreign income. To accomplish this, H.R. 1 includes several features, including:
- a 100% deduction for dividends received from 10%-owned foreign corporations (so-called "dividend received deduction" or DRD);
- a new minimum tax on "global intangible low-taxed income" (GILTI);
- as a transition to the new regime, deemed repatriation of previously untaxed "old earnings" (a 15.5% rate applies to earnings attributable to liquid assets and an 8% rate applies to earnings attributable to illiquid assets).

This article will focus on the last of these three elements.

Mandatory repatriation mechanism

The newly enacted Internal Revenue Code section 965 imposes a transition tax on untaxed foreign earnings of foreign subsidiaries of US companies by deeming those earnings to be repatriated. It's been well documented that US multinational corporations have housed an estimated $2-3 trillion of earnings offshore. The US Institute on Taxation and Economic Policy reported in a 2016 study that 73 % of Fortune 500 companies have at least one subsidiary offshore (from a US standpoint).

Generally speaking, US companies will now be taxed on foreign earnings held as cash and cash equivalents at a 15.5% rate and on the remaining non-cash earnings at an 8% rate. This provision replaces the previous tax regime for which US businesses were able to defer paying a 35% tax on repatriated earnings by stockpiling profits offshore. It aims to move the US to a more territorial system, hence the idea of a "transition tax."[1] The end result of the H.R. 1 will be an immediate tax hit on corporate profits with the benefit of avoiding US taxes in the future, even on earnings that businesses bring back to the States.

Payment of the transition tax can be undertaken in one payment or by way of eight instalment payments. If instalments are chosen, 8% of the net tax liability is made in each of the first five of such instalments, 15% in the sixth, 10% in the seventh, and 25% in the final or eighth instalment.

After paying such a one-time transition tax, US companies will no longer be able to defer payment of US tax on foreign earnings. Instead they will have to decide whether earnings are truly onshore or offshore in the current year, and then be taxed just on the onshore earnings.

If we go into further detail, H.R. 1 includes a transition rule to effect the participation exemption regime. This transition rule provides that the subpart F income of a specified foreign corporation (SFC)[2] for its last tax year beginning before 1 January 2018 is increased by the greater of its accumulated post-1986 deferred foreign income (deferred income) determined as of 2 November or 31 December 2017 (two measuring dates). A US taxpayer generally includes in his/her gross income the pro rata share of the deferred income of each SFC with respect to which he/she qualifies as a US shareholder.[3]

This mandatory inclusion, however, should be reduced (but not below zero) by an allocable portion of the taxpayer's share of the foreign earnings and profits (E&P) deficit of each SFC with respect to which he/she is a US shareholder and the taxpayer's share of its affiliated group's aggregate unused E&P deficit.

H.R. 1's definition of post-1986 E&P only includes E&P of a foreign corporation accumulated during periods when the foreign corporation was an SFC. The new law does not, however, define post-1986 E&P by reference to the period that a US shareholder has directly or indirectly owned an SFC. As a result, it appears that a US shareholder must include its pro rata share of an SFC's post-1986 E&P that accumulated during periods when the foreign corporation was an SFC as a result of another US shareholder's ownership.

As mentioned above, under H.R. 1's participation exemption, a US shareholder is taxed at reduced rates on its mandatory inclusion. The portion of the inclusion attributable to the US shareholder's aggregate foreign cash position is taxed at 15.5% and the remaining portion is taxed at 8%. The participation exemption uses a deduction to achieve these reduced rates. A US shareholder's "aggregate foreign cash position" is the greater of: (i) the aggregate of the pro rata share of its SFCs' cash positions as of the close of their last tax year beginning before 1 January 2018; or (ii) one half of the aggregate of the pro rata share its SFCs' cash positions as of the close of the their last two tax years ending before 2 November 2017. An SFC's "cash position" generally is the sum of its cash, net accounts receivable, and fair market value of certain other liquid assets (e.g. actively traded personal property, commercial paper, certificates of deposit, government securities, short-term obligations, and foreign currency). The amount of a US shareholder's deduction is the sum of the amounts necessary to tax its mandatory inclusion attributable to its aggregate foreign cash position at 15.5% and the remaining portion at 8% using the highest corporate tax rate in effect for the year of the inclusion.

Once hit by the applicable tax rate, such amounts qualify for section 959's previously taxed income (PTI) rules, meaning that they will not be subject to tax a second time at the level of the US parent company upon effective repatriation/distribution.

H.R. 1 having been elaborated and enacted in very short period of time, not all its aspects are 100% clear or even consistent with previous US tax provision remaining in force. Where legally possible, however, the Treasury Department and the Internal Revenue Service (IRS) endeavour to bring some clarity via the issuance of notices and future regulations.

Double counting risk and Notice 2018-07

A good example of the concerns raised by certain provisions of H.R. 1 that are being solved step-by-step by the guidance issued by the Treasury Department and the IRS would be the mandatory repatriation mechanism and the risk of double counting.

H.R. 1 includes a "double counting" rule that prevents a US shareholder from taking into account the cash position of an SFC attributable to the SFC's net accounts receivable, actively traded personal property, or short-term obligations, if the U.S. shareholder demonstrates that it takes into account such an amount with respect to another SFC. However, whereas the new law's double counting rule limits, it does not fully eliminate the potential for the cash positions of a US shareholder's SFCs to be double counted. In particular, such a rule does not appear to apply to short-term obligations between SFCs with different US shareholders. Also, diverging calendar years between a US parent company and its SFCs could have raised concerns about potential double-counting risks.

On 29 December 2017, the Treasury Department and the IRS released an advance version of Notice 2018-07 as guidance for computing the one-time "transition tax" under H.R. 1. Notice 2018-07 describes regulations that the Treasury and IRS intend to issue, including rules for determining the amount of cash and cash equivalents and rules for determining the impact of intercompany transactions (including distributions) on the amount of foreign earnings subject to the transition tax. The guidance further provides background on section 965, describes regulations that the Treasury and IRS intend to issue, describes the effective dates of these future regulations, and requests comments and provides contact information.

The guidance should help ease U.S. companies' worries about complying with the transition tax. Indeed, prior to Notice 2018-07, it wasn't clear how companies should calculate the transition tax. Reading H.R. 1, there was a concern that the amount of cash would be overstated in cases where the tax years/financial periods of two foreign subsidiaries of the same US parent company end on different dates since such a situation could result in the parent company having to treat a transaction between the two subsidiaries two times. In this respect, Notice 2018-07 provides with a useful example to understand where the double counting issue could arise for a US parent company (USP) holding two foreign subsidiaries (respectively CFC1 and CFC2):

> For example, assume USP, a calendar year taxpayer, wholly owns CFC1, which has an inclusion year ending December 31, 2017, and CFC2, which has an inclusion year ending November 30, 2018. In addition, assume that USP's pro rata share of the cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is $100, with the result that USP's aggregate foreign cash position is $200.
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> Under section 965(c), the amount allowed as a deduction in the taxable year of a United States shareholder for which the United States shareholder takes a section 965(a) inclusion amount into gross income is based on the aggregate foreign cash position of the United States shareholder. One interpretation of section 965(c) could result in the 15.5 percent rate equivalent percentage applying to as much as $400 of the aggregate section 965(a) inclusion amounts of CFC1 and CFC2 taken into account by USP, because USP's aggregate foreign cash position for its 2017 taxable year (in which CFC1's section 965(a) inclusion amount is taken into account) is $200 and its aggregate foreign cash position for its 2018 taxable year (in which CFC2's section 965(a) inclusion amount is taken into account) is also $200.

To avoid such double counting, the guidance provides the IRS with the authority to clarify the situation in favour of the parent company. The IRS could now adjust the USP's earnings "to ensure that a single item of a specified foreign corporation is taken into account only once" according to Notice 2018-07. In practice, the Treasury and IRS intend to issue regulations providing that in the case of a US shareholder that has a section 965(a) inclusion amount in more than one taxable year, the aggregate foreign cash position taken into account in the first taxable year will equal the lesser of the US shareholder's aggregate foreign cash position or the aggregate of the section 965(a) inclusion amounts taken into account by the US shareholder in that taxable year. Furthermore, the amount of the US shareholder's aggregate foreign cash position taken into account in any succeeding taxable year will be its aggregate foreign cash position reduced by the amount of its aggregate foreign cash position taken into account in any preceding taxable year.

Example from Notice 2018-07:

> (i) Facts. USP, a domestic corporation, owns all of the stock of CFC1, a foreign corporation, which owns all of the stock of CFC2, also a foreign corporation. USP is a calendar year taxpayer. CFC1's inclusion year ends December 31, 2017, and CFC2's inclusion year ends November 30, 2018. The cash position of each of CFC1 and CFC2 on all relevant cash measurement dates is $200, with the result that USP has an aggregate foreign cash position of $400. For its 2017 taxable year, USP takes into account CFC1's section 965(a) inclusion amount of $300, and for its 2018 taxable year, USP takes into account CFC2's section 965(a) inclusion amount of $300.
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> (ii) Analysis. USP's aggregate foreign cash position taken into account in 2017 is $300, the lesser of USP's aggregate foreign cash position ($400) or the section 965(a) inclusion amount ($300) that USP takes into account in 2017. The amount of USP's aggregate foreign cash position taken into account in 2018 is $100, USP's aggregate foreign cash position ($400) reduced by the amount of its aggregate foreign cash position taken into account in 2017 ($300).

Notice 2018-13

On 19 January 2018, the IRS further released an advance version of Notice 2018-13 as additional guidance concerning the transition tax imposed under new section 965 of the IRS code.

Notice 2018-13 announces that the Treasury and IRS intend to issue regulations for determining amounts included in gross income by a United States shareholder under section 951(a)(1) by reason of new section 965. The guidance describes in particular[4] a modification that the Treasury and IRS intend to make with respect to regulations under section 965 that were described in Notice 2018-07. However, the above regarding the double counting risk is not affected by these changes.

Based on official communication, the Treasury and IRS expect to issue additional guidance in the future.

Conclusion

The most striking headline number after the transition tax is the estimated trillions of US corporate cash that will be brought back in the US. At least two factors could combine to undercut this estimation. One is the concentrated ownership of the offshore cash in question. The second is historical precedent. The 2004 Homeland Investment Act allowed a similar one-time repatriation of overseas cash at an effective corporate tax rate of 5.25%. Studies found however that the largest cash-repatriating companies used funds for dividends, share repurchases, or executive compensation although the act specifically prohibited it. There are no such prohibitions in the H.R. 1. The consequences of the US tax reform on employment in the US and outside the US, in particular on treasurer functions, will also have to be monitored.

Not all potential impacts of the different measures constituting the US tax reform have been fully identified and measured yet, essentially due to the complexity of the new rules (we are far from the simplification announced), their hard-to-assess interactions, and the sustainability of certain of these rules.[5]

However, given the significant number of Luxembourg resident companies being direct or indirect subsidiaries of US groups, and more generally considering the game changer that the US tax reform constitutes, monitoring such impacts on overseas subsidiaries (from a US standpoint) as they are clarified step-by-step by the Treasury and IRS, as well as US tax professionals, it is key for many actors of the Luxembourg market.

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1) Going forward, in contrast with the abovementioned reduced rates, US companies will see their maximum tax rates on domestic income slashed from a previous maximum of 35% to a flat 21% rate.
2) An SFC is a foreign corporation that is a controlled foreign corporation (CFC) or a foreign corporation that has at least one domestic corporate US shareholder.
3) A "US shareholder" includes US domestic corporations, partnerships, trusts, estates, and US individuals that directly, indirectly, or constructively own 10% or more of an SFC's voting power. As a result, non-corporate U.S. shareholders are exposed to inclusions under the new law's transition rule if the SFC is a controlled foreign corporation or any foreign corporation with at least one domestic corporate US shareholder, even though the participation exemption regime for dividends from foreign subsidiaries in the new law only applies to corporate US shareholders.
4) Notice 2018-13 provides background on section 965 and the repeal of section 958(b)(4), describes the regulations that the IRS and Treasury intend to issue with respect to section 965, and describes the effective dates of the regulations and other guidance and requests comments. The guidance also provides taxpayers targeted relief from certain unintended regulatory and reporting consequences arising from a change to existing stock attribution rules in the recent tax legislation.
5) As part of the H.R. 1, Congress added section 250 to the Internal Revenue Code, which effectively creates a new preferential tax rate for income derived by domestic corporations from serving foreign markets. A corporation pays an effective rate of 13.125% (rather than 2%) on its above-routine income arising from foreign markets. This new deduction is described as a deduction for foreign-derived intangible income (FDII). Several European Union finance ministers have indicated that they may challenge the FDII deduction under World Trade Organization rules, claiming that the deduction provides an impermissible export subsidy.