Tax Cuts and Jobs Act of 2017—International Tax Provisions and Provisions Affecting Exempt Organizations

By Robert E. Ward*

Robert E. Ward outlines the international tax provisions and provisions affecting exempt organizations of the recently enacted Tax Cuts and Jobs Act of 2018.[1]

ROBERT E. WARD, J.D., LL.M. is an Attorney with WardChisholm, P.C., in Vancouver, British Columbia and Bethesda, Maryland.

Establishment of Participation Exemption System for Taxation of Foreign Income

Act Section 14101: Deduction for Foreign-Source Portion of Dividends Received by Domestic Corporations from Specified 10-Percent Owned Foreign Corporations

The Act moves the U.S. tax system toward a territorial system of taxation of business income. This is done by providing domestic corporations with a 100-percent deduction for dividends attributable to foreign-source income paid from foreign corporations in which the domestic corporation owns at least 10 percent of the combined voting power of all classes of stock with voting rights in the corporation or at least 10 percent of the total value of all shares of the foreign corporation's stock within the meaning of Code Sec. 951(a) as amended by the Act (a "*U.S. shareholder*"). Consistent with exclusion of foreign-source income, no credit or deduction is allowed for taxes paid with respect to that income.

The 100-percent dividends received deduction is not available to shareholders of foreign corporations which are passive foreign investment companies ("*PFICs*") that do not satisfy the definition of a controlled foreign corporation ("*CFC*"). Individuals, corporations exempt from tax under Code Sec.

501, S corporations, registered investment companies ("*RICs*"), and real estate investment trusts ("*REITs*") which are shareholders in foreign corporations are not eligible for the deduction. Even in the case of eligible foreign corporations which pay dividends to qualifying domestic corporations, the 100-percent dividends received deduction is not available for hybrid dividends (generally, dividends with respect to which the foreign corporation receives an income tax deduction or other tax benefit in computing income subject to tax in its home or other foreign country). Deemed dividends under Code Sec. 78 for foreign taxes are also excluded from the deduction.

In order for a domestic corporation to be eligible for the dividends received deduction the shares of the foreign corporation must be held by the domestic corporation for at least 365 days during the 731-day period starting one year before the ex-dividend date with respect to the dividend distribution. At all times during the 365-day holding period, the domestic corporation must qualify as a U.S. shareholder and the foreign corporation cannot have been characterized as a PFIC (unless it was also a CFC).

The foreign-source character of a dividend is determined by the ratio of the foreign corporation's undistributed foreign earnings and profits to its total undistributed earnings and profits (computed as required by Code Secs. 964(a) and 986) as of the taxable year of the foreign corporation from which the dividend is distributed. Undistributed foreign earnings are generally defined as undistributed earnings of the foreign corporation which are not attributable to

- the foreign corporation's income that is effectively connected with the conduct of a U.S. trade or business or
- any dividends received directly or indirectly by the foreign corporation from an 80-percent owned U.S. corporation (determined by vote or value).

Observation: In certain circumstances the 100-percent dividends received deduction under new Code Sec. 245A will result in basis reductions to the stock of the foreign corporation under Code Secs. 1059 and 1061. As a result, the 245A deduction provides deferral of taxation of foreign-source income, in lieu of relief.

Act Sections: 14101 and 14102(a)-(c).

Effective Date: Effective for distributions made after December 31, 2017.

Code Sections Affected: New Code Sec. 245A added. Code Sec. 246(c) amended by adding subsection 246(c)(5). Code Sec. 904(b) amended by adding subsection 904(b)(5).

Sunset Date: None.

Act Section 14102: Special Rules Relating to Sales or Transfers Involving Specified 10-Percent Owned Foreign Corporations

Sales and Dispositions of Shares of 10-Percent Owned Foreign Corporations

The Act extends the favorable treatment of dividends received from 10-percent owned foreign corporations to sales and exchanges of foreign corporation stock. In order to qualify the seller must have owned the stock of the foreign corporation for at least one year.

Dividends eligible for the 100-percent dividends received deduction will reduce the domestic corporation's basis in the foreign corporation's stock for purposes of computing losses on the sale or exchange of the foreign corporation's stock, unless the basis was previously reduced because of characterization of the dividend as an extraordinary dividend under Code Sec. 1059. Similar rules apply in the case of a sale of a lower tier foreign corporation if both the foreign corporation owned by the domestic corporation and its subsidiary qualify as CFCs (generally, the domestic parent corporation owns directly or indirectly more than 50 percent by vote or value of the stock of the CFCs).

Act Sections: 14102(a)-(c).

Effective Date: Effective for sales and exchanges after December 31, 2017.

Code Sections Affected: Code Sec. 1248 amended by adding subsection 1248(j). Code Sec. 961 amended by adding subsection 961(d). Code Sec. 964(e) amended by adding subsection 946(e)(4).

Sunset Date: None.

Repeal of Active Trade or Business Exception to Gain Recognition on Transfer of Appreciated Property to Foreign Corporations

Code Sec. 367(a) taxes U.S. persons (individuals or business entities) which transfer appreciated property to foreign corporations in exchange for stock by canceling the non-recognition rule of Code Sec. 351. As a result, the property transferred to the foreign corporation is deemed to have been sold for an amount equal to the fair market value of the foreign corporation's stock received in exchange for the property. An exception has been available to this treatment for property transferred to a foreign corporation for use by the foreign corporation in the active conduct of a trade or business outside of

the United States. The Act repeals the active trade or business exception.

In addition to changing the prior non-recognition rule for transfers of property to a foreign corporation for use in the conduct of an active trade or business, the Act also creates a special rule for incorporations of foreign branches of domestic corporations if the domestic corporation will own at least 10 percent of the newly incorporated foreign corporation's stock (determined by vote or value). In such a case, the domestic corporation will recognize income in an amount equal to the "transferred loss amount." The transferred loss amount equals the sum of the deductible losses of the foreign branch incurred after December 31, 2017, in excess of the branch's taxable income after the year in which the loss was incurred and any overall foreign losses recognized under Code Sec. 904(f)(3). The transferred loss amount will be recognized and included in the gross income of the domestic corporation for the year in which the transfer occurs. The transferred loss amount will be reduced by gains recognized by the taxpayer on incorporation of the foreign branch. The transferred loss amount which is required to be recognized will be treated as U.S. source income. The IRS is directed to issue regulations to provide for basis adjustments in the shares of the foreign corporation's stock owned by the domestic corporation to reflect the transferred loss amount required to be included in income.

Act Sections: 14102(d) and (e).

Effective Date: Transfers after December 31, 2017.

Code Sections Affected: Code Sec. 367(a) amended. New Code Sec. 91 added.

Sunset Date: None.

Act Section 14103: Treatment of Deferred Foreign Income upon Transition to Participation Exemption System of Taxation

One of the high-profile issues which the drafters of the Act have addressed is the deferral of U.S. taxation on the foreign earnings of U.S. corporations. This has been done by treating deferred foreign income as income taxable in 2017 under subpart F of the Internal Revenue Code. The accelerated taxation applies to all CFCs, as well as any foreign corporation (other than a PFIC which is not a CFC) with respect to which one or more domestic corporations are U.S. shareholders. Characterization as subpart F income will require the U.S. shareholders of that foreign corporation (whether domestic individuals or corporations) to include the deferred foreign income in gross income in the last taxable year of the foreign corporation which begins before January 1, 2018. Provisions are included to reduce the subpart F income required to be recognized by the U.S. shareholders for amounts attributable to deficits in the earnings and profits of other foreign corporations owned by the U.S. shareholders.

The provision applies to "accumulated post-1986 deferred foreign income." The accumulated foreign income taken into account is determined by the post-1986 earnings and profits of the foreign corporation (other than those previously subject to U.S. income taxation or attributable to the effectively connected income of a U.S. trade or business ("*ECI*")) on either November 2, 2017 or December 31, 2017, depending upon which date yields the greater amount. The post-1986 earnings and profits are computed in accordance with the provisions of Code Secs. 964(a) and 986.

Foreign earnings recognized under this provision will be subject to a 15.5-percent rate of tax in the case of foreign earnings held in cash and an 8-percent rate of tax in the case of foreign earnings in other forms of property (17.5 percent and 9 percent, respectively, in the case of U.S. shareholders who are individuals). The tax liability arising from the taxation of foreign earnings may be paid in increasing installments over an eight-year period (8 percent of the net tax liability in each of the first 5 years; 15 percent in year 6; 20 percent in year 7; and 25 percent in year 8).

The IRS is directed to issue regulations which will provide corresponding treatment to shareholders of deferred foreign income corporations which do not satisfy the definition of a U.S. shareholder. Special rules apply in the case of U.S. shareholders which are S corporations and U.S. shareholders which are REITs. The IRS has provided considerable guidance: Notice 2018-07, Notice 2018-13, Rev. Proc. 2018-17, Notice 2018-26, and Questions and Answers about Reporting Related to Code Sec. 965 on 2017 Tax Returns (*irs.gov*, March 13, 2018).[2]

Observation: The transition tax under new Code Sec. 965 is imposed in the last taxable year of the foreign corporation which begins before January 1, 2018. Code Sec. 898 requires that specified foreign corporations use a taxable year which conforms to the taxable year of the specified foreign corporation's majority U.S. shareholder (more than 50 percent of specified foreign corporation's stock determined by vote or value) or in the manner prescribed by regulations when there is no majority U.S. shareholder. Code Sec. 898(b) defines a specified foreign corporation as a CFC with respect to which more than 50 percent of the stock of the CFC is owned by a U.S. shareholder determined by vote or value. Application

of Code Sec. 898 in the context of the transition tax is unclear. It may be

- fully applicable as illustrated in proposed Reg. §1.898-2(b)(4) example 1,
- not applicable at all based on the literal language of Code Sec. 965(f)(1) (which makes no reference to Code Sec. 898), or
- applicable only to the first CFC in the chain of specified foreign corporations as illustrated in Rev. Proc. 2018-17, section 3.01 example 1.

Effective Date: Last taxable year of the deferred foreign income corporation which begins before January 1, 2018.
Code Section Affected: Code Sec. 965.
Sunset Date: None.

Modifications Related to Foreign Tax Credit System

Act Section 14301: Repeal of Code Sec. 902 Indirect Foreign Tax Credits; Determination of Code Sec. 960 Credit on Current Year Basis

Code Sec. 902 provides a foreign tax credit for foreign income taxes attributable to subpart F income on which U.S. shareholders are taxable. Consistent with the emergence of a territorial system of taxation and the exemption of foreign earnings from U.S. tax, the credit for foreign taxes deemed to have been paid with respect to subpart F income is repealed.

Foreign taxes continue to be deemed to have been paid on income previously subject to inclusion under subpart F, thereby providing relief for foreign taxes paid with respect to that income.

Effective Date: Taxable years of foreign corporations beginning after December 31, 2017 and taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation end.
Code Sections Affected: Code Sec. 902 repealed. Code Sec. 960(a) amended. Code Sec. 78 amended.
Sunset Date: None.

Act Section 14302: Separate Foreign Tax Credit Limitation Basket for Foreign Branch Income

Code Sec. 904 limits a taxpayer's foreign tax credit to the amount of U.S. taxes that are attributable to the taxpayer's foreign-source taxable income. The basic purpose of the foreign tax credit limitation found in Code Sec. 904 is to ensure that foreign taxes are not used as a credit against U.S. tax on any U.S.-source income.

The Act requires foreign branch income to be allocated to a specific foreign tax credit basket pursuant to Code Sec. 904(d)(2). The Act provides that the term "foreign branch income" means the business profits of a U.S. person which are attributable to one or more qualified business units (that is, any separate and clearly identified unit of a trade or business of a taxpayer which maintains separate books and records) in one or more foreign countries. What constitutes "business profits" will be established by the Secretary of the Treasury. However, the Act provides that business profits of a qualified business unit do not include passive category income.

Effective Date: Taxable years beginning after December 31, 2017.
Code Section Affected: Code Sec. 904.
Sunset Date: None.

Act Section 14303: Source of Income from Sales of Inventory Determined Solely on Basis of Production Activities

The Act amends the sourcing rules of the Internal Revenue Code to distinguish income derived from sales or exchanges of inventory property as either foreign-source income or U.S. source income based upon where the property was produced (inside or outside the United States).

Effective Date: Taxable years beginning after December 31, 2017.
Code Sections Affected: Code Sec. 863(b).
Sunset Date: None.

Modification of Subpart F Provisions

Act Section 14201: Current Year Inclusion of Global Intangible Low-Taxed Income by U.S. Shareholders

Act Section 14202: Deductions for Foreign-Derived Intangible Income and Global Intangible Low-Taxed Income

The Act creates two categories of income subject to preferential rates of tax: global intangible low-taxed income ("*GILTI*") and foreign-derived intangible income ("*FDII*"). Despite the use of the term "intangible" in both titles, neither GILTI nor FDII is limited to income realized from intangible assets.

GILTI: The Act expands the definition of subpart F income (that is, income earned by a CFC which is subject to current taxation to the CFC's U.S. shareholders) to include a new category of subpart F income labeled "global intangible low-taxed income." In general terms, GILTI is the excess of the U.S. shareholder's aggregate net tested income over an assumed return of 10 percent on the U.S. shareholder's aggregate *pro rata* share of the tangible depreciable property of the CFC (the "qualified business asset investment" ("*QBAI*")). Tested income does not include ECI, traditional subpart F income, foreign oil and gas income, high-taxed exception income if elected (that is, foreign base company income as defined in Code Sec. 894 which is subject to effective tax rate of at least 18.9 percent), and related party dividends subject to tax under Code Sec. 954(d)(3). Tested income is then further diminished by deductions allocable to that income under rules similar to those set forth in Code Sec. 954(b)(5). QBAI is the average of the aggregate adjusted basis (as of the end of each quarter) of tangible depreciable property (using the straight-line method of depreciation) used in a trade or business to produce tested income. The QBAI is multiplied by 10 percent (the "*deemed tangible income return*") and then reduced by interest expense used to compute tested income, unless the interest is paid to another CFC owned by the same U.S. shareholder.

A deemed paid foreign tax credit under Code Sec. 960 is allowed for foreign taxes attributable to tested income ("*GILTI Foreign Taxes*"). The deemed foreign tax credit is limited to 80 percent of the U.S. shareholder's inclusion percentage multiplied by the GILTI Foreign Taxes. The inclusion percentage is the domestic corporation's GILTI over its aggregate tested income. GILTI is a separate basket for foreign tax credit purposes. No carryovers or carrybacks of excess foreign tax credits are allowed. Foreign taxes deemed paid under Code Sec. 960 are treated as additional GILTI for purposes of the gross-up under Code Sec. 78. The gross-up under Code Sec. 78 applies to the full amount of the GILTI Foreign Taxes after application of the inclusion percentage but before the 50-percent deduction discussed below.

Domestic corporations who are U.S. shareholders of CFCs are eligible for a 50-percent deduction under newly enacted Code Sec. 250. The 50-percent deduction applies to both the GILTI included in the U.S. shareholder's gross income and the amount of the Code Sec. 78 gross-up discussed above. While U.S. shareholders who are individuals or domestic corporations are subject to the tax on GILTI, only U.S. shareholders which are domestic corporations are eligible for the deduction under Code Sec. 250. Similarly, only U.S. shareholders which are domestic corporations are eligible for the deemed paid foreign tax credit under Code Sec. 960 for GILTI Foreign Taxes.

Planning: The GILTI of a U.S. shareholder is calculated on an aggregate basis based on the U.S. shareholder's interest in all CFCs. Consequently, the tested loss of one CFC is taken into account to offset the tested income of other CFCs. However, aggregation of the tax attributes of the loss CFC is not complete.

- QBAI of a CFC with a tested loss is ignored: it does not increase the deemed tangible income return subject to exclusion from GILTI.
- Based on the legislative history of the Act, foreign taxes paid by a CFC with a tested loss do not appear to be creditable.
- The tested loss of a CFC reduces the inclusion percentage. This has the effect of reducing the foreign taxes deemed paid with respect to the GILTI inclusion for CFCs with positive tested income.

FDII: Foreign derived intangible income is best understood as the inverse of GILTI. GILTI is a "second tier" of subpart F income on which U.S. shareholders of CFCs are automatically taxed. In contrast, FDII is a category of income realized by domestic corporations derived from sales of goods and services to foreign persons for consumption and disposition outside the United States. Computations of both GILTI and FDII provide an allowance for the U.S. shareholder's aggregate *pro rata* share of the depreciable tangible property (the deemed tangible income return discussed above) on QBAI. However, in the computation of the tax on GILTI the deemed tangible income return benefits taxpayers inasmuch as it is the only income of a CFC which remains deferred. In contrast, the deemed tangible income return in the case of FDII is a carve-out which does not qualify for the deduction for FDII and, consequently, disadvantages taxpayers because it is taxed at the same rate as other income of the domestic corporation. The relief provided by the deductions attributable to GILTI and FDII are both only available to U.S. domestic corporations. However, in the case of GILTI the deduction applies to income of a CFC deemed taxable to its U.S. shareholders who are domestic corporations. In contrast, FDII arises from a domestic corporation's sales of good and services to foreign persons. Because the deduction is claimed by the domestic corporation, it benefits all the corporation's shareholders, whether individuals or entities.

Deduction eligible income in the case of FDII is the gross income of a domestic corporation reduced by any subpart F income, any GILTI, any financial services income (as defined in Code Sec. 904(d)(2)(D)), any dividends received from CFCs, any domestic oil and gas

extraction income, and any foreign branch income (as defined in Code Sec. 904(d)(2)(J)). The deduction eligible income is further reduced by deductions, including taxes, properly allocable to such income. Generally, to be eligible for the FDII deduction the deduction eligible income must be attributable to:

- sales of property to non-U.S. persons for use outside the United States and
- sales of services to persons not located in the United States or with respect to property which is not located within the United States.

The determination of foreign use must be established to "the satisfaction of" the Secretary of the Treasury.

Property sold for further manufacture or modification within the United States will not be treated as sold for foreign use even if the property is actually used, consumed, or further disposed of outside the United States. However, a limited exception is provided for sales of property to related parties who are not U.S. persons (for example, a CFC of the domestic corporation) if the property is ultimately sold by the related party to an unrelated party which is not a U.S. person for foreign use (again, established to the satisfaction of the Secretary of the Treasury). In the case of services, services provided to a customer or client who is located in the United States are not eligible for the FDII deduction even if the services are used by that client or customer to provide services to persons located outside the United States. Services provided to related parties are only eligible for the FDII deduction if the related party is not located in the United States and the services are not substantially similar to services provided by the related party to persons located within the United States. A related party for this purpose is any member of an affiliated group as defined in Code Sec. 1504(a), using a common ownership threshold of more than 50 percent instead of at least 80 percent.

Both FDII and GILTI are subject to special deductions. FDII is subject to a deduction of 37.5% and GILTI is subject to a deduction of 50%, making the effective tax rates on FDII 13.25% and on GILTI 10.5% for taxable years beginning before 2026. In the case of taxable years beginning after December 31, 2025 the deductions will be reduced from 37.5% to 21.875% in the case of FDII and from 50% to 37.5% in the case of GILTI. The deductions for FDII and GILTI are available only to U.S. corporations (other than RICs and REITs). The Conference Committee Report accompanying the Act describes these deductions as being available only to C corporations. However, the statute does not appear to have this limitation as it describes the deduction as being available to "domestic corporations."

Act Sections: 14201 and 14202.

Effective Date: Taxable years of foreign corporations beginning after December 31, 2017 and to taxable years of the U.S. shareholder with or within which such taxable years of the foreign corporation end.

Code Sections Affected: New Code Secs. 951A and 250 enacted. Code Sec. 960 amended by adding subsection 960(d).

Sunset Date: Sunset Date: None.

Act Section 14212: Repeal of Inclusion Based on Withdrawal of Previously Excluded Subpart F Income from Qualified Investment

Consistent with the deemed repatriation of deferred foreign income as the result of the Act's amendments to Code Sec. 965 and other moves toward territoriality, the Act repeals Code Sec. 955 in its entirety.

Effective Date: Taxable years of foreign corporations beginning after December 31, 2017 and to taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation end.

Code Section Affected: Code Sec. 955 repealed.

Sunset Date: None.

Act Section 14213: Modification of Stock Attribution Rules for Determining Status as a Controlled Foreign Corporation

The United States has long had two anti-deferral regimes applicable to foreign corporations. One are the rules related to PFICs which are designed to deter the use of foreign corporations as holding companies for passive investments. The other are the rules of subpart F which are designed to result in immediate U.S. income taxation of certain income earned through foreign corporations. The Act makes several changes to the rules of subpart F. Some of those provisions are discussed below.

Amendment of Stock Attribution Rules for Determination of CFC Status

Code Sec. 957(a) defines a *CFC* as any foreign corporation if more than 50% of the total combined voting power of all classes of stock of the foreign corporation entitled to vote or more than 50% of the total value of the stock of the foreign corporation is owned by U.S. shareholders on any day during the taxable year of the foreign corporation.

Ownership of the stock of the foreign corporation may be direct, indirect, or constructive.

Constructive ownership rules are found in Code Sec. 958(b) and include a provision which prevents stock owned by a non-U.S. person from being attributed to a U.S. person. The Act repeals this provision. As a consequence, stock owned directly or indirectly by a partner or beneficiary of an estate will be attributed to the partnership or estate even though the partner or beneficiary is not a U.S. person (that is, a non-resident alien individual or entity organized under the laws of another country). Similarly, stock owned directly or indirectly by the beneficiary of a trust will be considered as owned by the trust even though the beneficiary is not a U.S. person. Stock owned by the settlor of a grantor trust will be treated as owned by the trust even though the settlor is not a U.S. person. Finally, corporations will be considered to own stock owned directly or indirectly by any shareholder which owns directly or indirectly more than 50 percent of the stock of that corporation, even though the shareholder is not a U.S. person.

Observation: The amendments made to Code Sec. 958(b) by the Act will result in more foreign corporations being regarded as CFCs. However, those changes to the constructive ownership rules of 958(b) will not necessarily result in more U.S. persons becoming subject to subpart F inclusion because Code Sec. 951(a)(1) cross-references Code Sec. 958(a) (direct and indirect ownership provisions) and not Code Sec. 958(b) (constructive ownership provisions). That is, the amount of a CFC's subpart F income which is included in the gross income of a U.S. shareholder is based on the U.S. shareholder's direct and indirect ownership of the CFC stock, not stock owned constructively.

Observation: While constructive ownership is not considered in determining the share of the CFC's subpart F income subject to inclusion in the U.S. shareholder's gross income, it is considered for information reporting purposes. Form 5471 does take constructive ownership into account to determine who has a reporting obligation under Code Sec. 6038(a)(4). U.S. persons who own directly, indirectly, or constructively 10 percent or more of the total combined voting power or total value of all classes of stock of a CFC on the last day of the CFC's taxable year are category five filers for purposes of Form 5471.

Effective Date: The last taxable year of foreign corporations beginning before January 1, 2018 and taxable years of U.S. shareholders in or with which such taxable years of the foreign corporation end.

Code Section Affected: Code Sec. 958(b) is amended by deleting subsection 958(b)(4).

Sunset Date: None.

Act Section 14214: Modification of Definition of U.S. Shareholder

Under prior law the determination of whether the shareholder of a foreign corporation is a U.S. shareholder for purposes of the CFC rules was based upon ownership of voting stock. The Act amends the Code to base the determination of U.S. shareholder status on either voting rights or the value of the stock of the foreign corporation (at least 10 percent in each case).

Effective Date: Taxable years of foreign corporations beginning after December 31, 2017 and taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation end.

Code Section Affected: Code Sec. 951(b).

Sunset Date: None.

Act Section 14215: Elimination of Requirement that Corporation Must Be Controlled for 30 Days Before Subpart F Inclusions Apply

Under prior law, the U.S. shareholder must own the stock of the foreign corporation for at least 30 days during the calendar year in order for the subpart F income of the CFC to be included in the gross income of the U.S. shareholder. The Act eliminates the 30-day requirement and subjects the U.S. shareholder to subpart F inclusion if the requisite 10-percent ownership by vote or value of the stock of the CFC is met at any time during the calendar year.

Observation: The Act did not repeal the requirement of Code Sec. 951(a)(1) that the amount of the subpart F income inclusion is determined based on the stock of the CFC which is owned on the last day of the CFC's taxable year.

Effective Date: Taxable years of foreign corporations beginning after December 31, 2017 and taxable years of U.S. shareholders with or within which such taxable years of the foreign corporation end.

Code Section Affected: Code Sec. 951(a)(1).

Sunset Date: None.

Prevention of Base Erosion

Act Section 14221: Limitations on Income Shifting Through Intangible Property Transfers

The Act directs the IRS to issue regulations to establish appropriate values for intangible property so as to deter transfers of goodwill, going concern value, work force in place,

and any other asset not attributable to tangible property or the services of any individual. The regulations are directed to prevent abuse of the preferential treatment of income produced by foreign-based intangible assets transferred from U.S. corporations to related foreign corporations.
Effective Date: Transfers in taxable years beginning after December 31, 2017.
Code Section Affected: Code Sec. 936(h)(3)(B).
Sunset Date: Sunset Date: None.

Act Section 14222: Certain Related Party Amounts Paid or Accrued in Hybrid Transactions or with Hybrid Entities

The Act disallows deductions for interest and royalty payments between related parties in connection with hybrid transactions or made by or to hybrid entities. Generally, a hybrid entity is an entity respected as a separate entity under the laws of one country, but regarded as a passthrough entity under the laws of another country. Hybrid transactions take advantage of similar disparities in countries' tax treatment of certain payments. For example, instruments which one country regards as stock and another country regards as debt allow interest to be deducted by the payor in the country which regards the hybrid instrument as a debt obligation but treated as a dividend in the country of the recipient and entitled to relief (such as the 100-percent dividend received deduction under new Code Sec. 245A).

The Act prohibits deductions for interest or royalties paid or accrued to a related party not subject to income taxation under the laws of the country where the related party is resident or with respect to which the related party is allowed a deduction under the tax laws of that country. The prohibition does not apply to transactions with respect to which the amount paid is included in the gross income of a U.S. shareholder under subpart F.

Related parties for purposes of the statute are individuals, corporations, partnerships, trusts, or estates which control or are controlled by a CFC or any of the foregoing entities which are controlled by the same person or persons who control the CFC as determined pursuant to Code Sec. 954(d)(3). The statute directs the IRS to issue regulations and guidance necessary and appropriate to carry out the purposes of the statute, including those circumstances expressly described by the statute, and to establish requirements for record keeping and information reporting consistent with Code Sec. 6038A.

Effective Date: Taxable years beginning after December 31, 2017.
Code Section Affected: New Code Sec. 267A added.
Sunset Date: None.

Act Section 14223: Shareholders of Surrogate Foreign Corporations Not Eligible for Reduced Rate Dividends

Dividends paid to individuals from domestic corporations and certain foreign corporations qualify for a preferential 0-, 15-, or 20-percent rate depending on the taxable income of the taxpayer. The Act denies preferential rates to shareholders of foreign corporations which have acquired substantially all of the properties held directly or indirectly by a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership with respect to which the shareholders of the domestic corporation or partners of the domestic partnership, respectively, own 60 percent or more (by vote or value) of the stock of the foreign corporation.
Effective Date: Dividends received after the date of enactment.
Code Section Affected: Code Sec. 1(h)(11)(C)(iii) amended.
Sunset Date: None.

Act Section 14401: Base Erosion and Anti-Abuse Tax

The Act attempts to staunch the flow of deductible payments which erode the U.S. tax base by imposing a "base erosion minimum tax" on deductible payments made to related parties by corporations (other than RICs, REITs, and S corporations) with average annual gross receipts for the three immediately preceding taxable years of at least $500 million. In addition, the corporation's payments to foreign related parties must be at least 3% of its total deductions (2% in the case of taxpayers who are members of an affiliated group that includes a bank or registered securities dealer). Parties related to the taxpayer for purposes of computing the amount of base erosion payments are 25-percent owners (by vote or value) of the taxpayer, persons related (within the meaning of Code Sec. 267(b) or 707(b)(1)) to the taxpayer or any 25-percent owner of the taxpayer, and any other person related to the taxpayer within the meaning of Code Sec. 482.

The tax is equal to 10 percent of an amount by which the "modified taxable income" of a C corporation

exceeds that corporation's regular tax liability (as defined by Code Sec. 26(b)) reduced by most tax credits allowed in determining that liability. The term "modified taxable income" for this purpose means the taxable income of the C corporation determined without regard to deductible payments to related foreign persons including payments for depreciable property, reinsurance payments, and payments to surrogate foreign corporations as defined by Code Sec. 7874(a)(2)(B) or members of the same expanded affiliated group as the surrogate foreign corporation. Exceptions are made to the definition of base erosion payments for payments in the ordinary course of business which are unrelated to certain derivatives. The 10-percent rate is reduced to 5 percent for taxable years beginning in 2018 and increased to 12.5 percent (along with certain other adjustments) for taxable years beginning after December 31, 2025.

The Act also imposes reporting requirements to disclose the identity of related parties and the amounts involved in transactions with those parties and provides for an increase in the penalty for failure to file Form 5472 from $10,000 to $25,0000.

Effective Date: Base erosion payments paid or accrued in taxable years beginning after December 31, 2017.

Code Sections Affected: New Code Sec. 59A added and Code Sec. 6038A(b) amended.

Sunset Date: None.

Exempt Organizations

Act Section 13602: Excise Tax on Excess Tax-Exempt Organization Executive Compensation

The Act creates new Code Sec. 4960 which imposes an excise tax of 21 percent on the amount by which the remuneration of a covered employee of an applicable tax-exempt organization exceeds $1,000,000, including any excess parachute payments made to a covered employee.

Remuneration is considered paid when there is no substantial risk of forfeiture of the rights to such remuneration. The tax-exempt organization is liable for the tax.

Tax-exempt organizations subject to the excise tax are those which are:

1. exempt from taxation under Code Sec. 501(a),
2. a farmer's cooperative described in Code Sec. 521(b)(1),
3. have Code Sec. 115(1) excluded income, or
4. are a political organization described in Code Sec. 527(e)(1).

A covered employee for purposes of the excise tax is any employee or former employee of an applicable tax-exempt organization who is one of the five highest paid employees for the taxable year or was a covered employee for any preceding taxable year beginning after December 31, 2016.

The Act defines remuneration as wages including amounts required to be included in gross income, but not including a designated Roth contribution. Also excepted from the definition of remuneration is any payment made to a licensed medical professional in exchange for the performance of medical or veterinary services by that professional.

The Act includes in the remuneration paid to a covered employee the compensation paid by the tax-exempt organization employing the covered employee and by organizations related to the tax-exempt employer. Related organizations are persons or governmental entities which control or are controlled by the employer, a supported or supporting organization with respect to the employer, or (in the case of an employer which is a voluntary employees beneficiary association) establish, maintain, or make contributions to the employer. When remuneration from more than one employer is taken into account, each employer is liable for a *pro rata* share of any resulting tax.

Included in remuneration subject to the excise tax are excess parachute payments. A parachute payment is any compensatory payment to a covered employee if the payment is contingent upon termination of the employee's employment with the employer and the aggregate present value of such compensation payments is equal to or greater than three times a base amount determined by reference to the annualized compensation of the covered employee. Parachute payments do not include payments under qualified plans (as described under Code Sec. 280G(b)(6)), payments made under or to certain annuity contracts, payments made to a licensed medical professional in exchange for the performance of medical or veterinary services by that professional, or payments made to an individual who is not a highly compensated employee under Code Sec. 414(q).

The IRS is directed to issue regulations to prevent avoidance of the tax imposed under new Code Sec. 4960.

Effective Date: Taxable years beginning after December 31, 2017.

Code Section Affected: Code Sec. 4960 added.

Sunset Date: None.

Act Section 13701: Excise Tax Based on Investment Income of Private Colleges and Universities

The Act imposes an excise tax on certain private educational institutions equal to 1.4 percent of the institution's net investment income for the taxable year. Net investment income subject to the excise tax is determined by rules similar to those of Code Sec. 4940(c) and includes the net investment income of the educational institution and any organization whose primary purpose is the support of that institution.

The excise tax applies to any private educational institution which (i) had at least 500 full-time students during the preceding taxable year, (ii) more than 50 percent of the students were located within the United States, and (iii) the aggregate fair market value of the institution's assets per student in the preceding taxable year is at least $500,000 per student. The excise tax does not apply to state or public colleges or universities, as defined under Code Sec. 511(a)(2)(B).

Effective Date: Taxable years beginning after December 31, 2017.

Code Section Affected: Code Sec. 4968 added.

Sunset Date: None.

Act Section 13702: Unrelated Business Taxable Income Separately Computed for Each Trade or Business Activity

The Act requires a charitable organization with multiple businesses unrelated to its charitable purpose to separately compute the net income or loss for each unrelated business. Net loss from one unrelated business may not be applied to reduce the net income from another unrelated business. Net operating losses from one unrelated business may only be used to offset the net income from that unrelated business in a subsequent taxable year and may not offset the net income from any other unrelated business.

Observation: The American Bar Association Section of Taxation provided comments on June 21, 2018 to Acting IRS Commissioner David Kautter regarding regulatory implementation of requirements of the Act.

Effective Date: Taxable years beginning after December 31, 2017. However, net operating losses incurred in a taxable year beginning prior to January 1, 2018 may continue to offset an organization's unrelated business income tax without regard to the amendment.

Code Section Affected: Code Sec. 512(a) amended by adding subsection 512(a)(6).

Sunset Date: None.

Act Section 13703: Unrelated Business Taxable Income Increased by Amount of Certain Fringe Benefit Expenses for Which Deduction Is Disallowed

The Act adds new Code Sec. 512(a)(7) which increases the unrelated business taxable income of certain tax-exempt organizations by the amount of certain fringe benefits provided to the organization's employees which are not directly connected with an unrelated business the organization regularly conducts.

The fringe benefits affected by this provision are: (i) qualified transportation fringe benefits described in Code Sec. 132(f), (ii) any parking facility used in connection with qualified parking as defined in Code Sec. 132(f)(5)(C), and (iii) any on-premises athletic facility as defined in Code Sec. 132(j)(4)(B).

The Act specifically instructs the IRS to issue regulations to carry out the purposes of this section.

Effective Date: Amounts paid or incurred after December 31, 2017.

Code Section Affected: Code Sec. 512(a) amended by adding subsection 512(a)(7).

Sunset Date: None.

Act Section 13705: Repeal of Substantiation Exception in Case of Contributions Reported by Donee

Code Sec. 170(f)(8)(A) requires a taxpayer making a charitable contribution of $250 or more to a charitable organization to obtain from that charity a contemporaneous written acknowledgment indicating whether the charity provided anything of value to the taxpayer in exchange for the contribution. Code Sec. 170(f)(8)(D) contained an exception to that rule if the charity instead files a return with the IRS in accord with regulations issued by the IRS. The IRS never issued those regulations. The Act repeals the exception in its entirety.

Effective Date: Contributions made in taxable years beginning after December 31, 2016.

Code Section Affected: Code Sec. 170(f)(8)(D) stricken.

Sunset Date: None.

ENDNOTES

* This article would not have been possible without the able assistance of other lawyers in the Bethesda office of WardChisholm, P.C.: Richard S. Chisholm, Alison Keller-Micheli, Bridget A. Alzheimer, and Alyson Hoffman.

[1] H.R. 1, known as the "Tax Cuts and Jobs Act of 2017" (the "Act"), was passed by the House on December 20, 2017 and by the Senate on December 19, 2017. The Act was signed into law by President Trump on December 22, 2017. The Joint Explanatory Statement of the Committee of Conference released on December 15, 2017 (the "Explanation") explains the provisions of the Act, as well as the differences between the House bill, the Senate amendment, and the Act.

[2] Notice 2018-07, IRB 2018-04 (January 2, 2018); Notice 2018-13, IRB 2018-06 (Feb. 5, 2018); Rev. Proc. 2018-17, IRB 2018-09 (Feb. 9, 2018); Notice 2018-26, IRB 2018-16 (April 16, 2018).