Skadden

The Tax Cuts and Jobs Act's Impact on Cross-Border Transactions

Partner

Nathan W. Giesselman / Palo Alto

Associate

Su Da / Palo Alto

Two years after the enactment of the Tax Cuts and Jobs Act (TCJA), the most significant tax reform enacted in a generation, taxpayers continue to encounter substantial uncertainty arising from interpretations of new statutory provisions, reinforcing calls for administrative guidance to provide more clarity.

The TCJA introduced comprehensive international tax reforms that have profoundly impacted multinational companies and cross-border transactions. The sweeping reform was intended to encourage multinational companies to remain or become U.S.-headquartered and to locate business operations in the United States through a variety of incentives. The TCJA reduced the U.S. corporate income tax rate from 35% to 21% and provided, as part of its participation exemption system, a 100% dividends-received deduction (DRD) for certain offshore dividends paid by 10%-or-more-owned foreign subsidiaries. The TCJA, however, also established the global intangible low-tax income (GILTI) and base erosion anti-avoidance regimes, which effectively impose minimum taxes on certain foreign income and deductible payments made to related foreign parties, and enacted various penalties on newly inverted companies and obstacles to post-inversion tax planning. The TCJA, coupled with ongoing global tax reforms (with both bilateral changes under the OECD framework and unilateral changes from individual countries) and potential challenges from supranational regulators (such as the World Trade Organization) will continue to contribute to uncertainties in structuring cross-border transactions and post-transaction restructurings.

Determining CFC Status

Whether an entity qualifies as a controlled foreign corporation (CFC) — a foreign corporation that is at least 50% owned, directly or via certain attribution rules, by 10%-or-greater U.S. shareholders — can significantly impact the U.S. tax consequences of a cross-border sale for both the buyer and the seller. This determination has been complicated by the TCJA's repeal of a long-standing provision that had previously limited the application of "downward attribution" so that a U.S. subsidiary would not be deemed to own stock held by its foreign parent. Legislative history suggests that the expansion of downward attribution was intended to deter taxpayers from entering into transactions in order to minimize the taxation of domestic owners of the CFC (so-called "de-control" transactions). However, the TCJA's wholesale repeal of this provision is much broader and has resulted in unintended consequences, with many more foreign corporations unexpectedly qualifying as CFCs, thereby triggering GILTI and/or Subpart F income inclusions, significant information reporting requirements and even disqualification from the portfolio interest exemption.

Structuring Acquisitions and Dispositions of CFCs

Asset Sales

The GILTI regime encourages U.S. acquirers to structure purchases of CFCs as taxable asset transactions in order to reduce the amount of their GILTI inclusions going forward. While an actual asset acquisition often is not possible for non-tax reasons, acquirers can make a so-called "Section 338(g) election" to treat what is in form a stock deal as an asset acquisition with similar consequences for U.S. tax purposes.

For both U.S. buyers and sellers, the TCJA has introduced additional variables that they need to take into account when determining whether a Section 338(g) election would be permitted on the disposition of CFC stock. From the buyer's perspective, a Section 338(g) election may reduce its post-acquisition GILTI

This article is from Skadden's *2020 Insights*.

Four Times Square
New York, NY 10036
212.735.3000

inclusion amount as a result of a basis step-up that can be written off in computing the amount of the GILTI inclusion for post-acquisition years. The election closes the taxable year of the acquired CFC at the time of the acquisition, allowing the buyer to avoid accounting for any pre-acquisition GILTI and/or Subpart F income. However, the election also eliminates the acquired CFC's earnings and profits (E&P), potentially limiting the buyer's ability to pay out tax-free dividends in later years.

From the seller's perspective, a Section 338(g) election results in potential GILTI and/or Subpart F income, which may be offset, in whole or in part, by foreign tax credits. Generally, U.S. corporate shareholders are currently entitled to a 50% deduction on GILTI (reducing the tax rate from 21% to 10.5%) and an 80% deemed-paid foreign tax credit with respect to GILTI inclusions. This 10.5% effective rate may in some instances make GILTI income arising from a Section 338(g) election preferable to gain from the sale of stock. The basis of the CFC stock increases by the amount of any GILTI and/or Subpart F income inclusions in the transaction year, such as those arising from the deemed asset sale. Furthermore, any gain the seller derives from the sale of CFC stock is recharacterized as a deemed dividend to the extent of the CFC's untaxed E&P (which includes non-GILTI and/or Subpart F income derived from the sale). For a U.S. corporate seller, this generally qualifies, subject to certain holding and other requirements, for the DRD.

Stock Sales

In the absence of a Section 338(g) election, gains derived by a U.S. seller from the sale of CFC stock are recharacterized as a deemed dividend up to an amount equal to the CFC's untaxed E&P and are generally eligible, subject to certain holding and other requirements, for the DRD. The interaction of the DRD with pre-TCJA law has enabled parties in certain CFC stock sales to eliminate tax on a portion, if not all, of pre-acquisition GILTI and/or Subpart F income. In a sale to a U.S. acquirer, any GILTI and/or Subpart F income of the CFC in the year of the sale would be taxable to the acquirer because any such income inclusion applies only to a U.S. shareholder of the company on the last day of its taxable year that it is a CFC (in this case, the acquirer and not the seller). Under pre-TCJA law, any such income inclusion is generally reduced by the current-year actual or deemed dividends paid to the seller (including the deemed dividend resulting from the sale) as long as such dividends do not exceed the pre-acquisition GILTI and/or Subpart F income. Given that these dividends generally qualify for the DRD, the portion of the CFC's pre-acquisition GILTI and/or Subpart F income that is offset by such dividends would no longer be subject to any tax under post-TCJA law.

Similarly, if the CFC remains a CFC after a sale to a foreign acquirer (due, for example, to downward attribution of the CFC's stock to a domestic subsidiary of the foreign acquirer), neither the seller nor the acquirer would bear the burden of any GILTI and/or Subpart F income in the year of sale because they would not be treated as U.S. shareholders of the CFC on the last day of such year. Furthermore, although any gain arising from the sale is treated as a deemed dividend to the seller to the extent of the seller's untaxed E&P, it generally qualifies for the DRD. Consequently, the seller has avoided taxation on all of the pre-acquisition GILTI and/or Subpart F income under post-TCJA law.

In contrast, if the company ceases to be a CFC following the sale to a foreign acquirer, the seller would be taxable on its pro rata share of any GILTI and/or Subpart F income from the year of the sale, as the U.S. shareholder of the company on the last day of such taxable year of the company that it is a CFC (which occurred on the closing date). Such pro rata share generally would be computed by looking at the seller's holding period compared to the entire taxable year, and multiplying such fraction by items of GILTI and Subpart F income for the entirety of such year (whether before or after the sale). Therefore, the seller may consider negotiating terms to minimize the generation of post-acquisition GILTI and/or Subpart F income, such as covenants limiting the acquirer's post-closing activities, or an indemnity right for inclusions attributable to post-closing income. Taxpayers would achieve similar economic results if the stock of a second-tier CFC (whose status as a CFC may cease if sold to a foreign acquirer as described above) is sold indirectly through a first-tier CFC (whose status as a CFC does not change as a result of the sale). The U.S. Department of Treasury issued temporary regulations to address planning opportunities arising from the application of the DRD to transactions discussed above. See "Challenging Tax Cuts and Jobs Act Regulations and IRS Guidance" for a more detailed summary and discussion of the validity of such regulations.

Joint Ventures

In the joint venture context, if a seller divests CFC stock held indirectly through a U.S. partnership, the tax consequences are further complicated under post-TCJA law. While U.S. and foreign partnerships are now treated as aggregates of their individual partners for GILTI and/or Subpart F purposes, this treatment does not apply in the context of deemed dividends attributable to gains from the sale of CFC stock, sometimes creating anomalous results for both U.S. and non-U.S. shareholders when they divest their interests in a U.S. partnership holding a CFC or when that partnership sells its interests in a CFC. Specifically, if the partnership sells CFC stock, U.S. shareholder partners (those indirectly owning 10% or more of a CFC through a domestic partnership) generally would have direct GILTI and/or Subpart F income inclusions for current CFC income under recent administrative guidance and would recognize their distributive share of deemed dividends arising from the sale, which generally would be eligible for the DRD for corporate partners. In contrast, U.S. taxpayers that are not 10% indirect owners holding a CFC through a domestic partnership generally would not have any GILTI and/or Subpart F inclusions for current CFC income but would recognize their distributive share of deemed dividends arising from the sale, which would not qualify for the DRD.

In addition, when U.S. and non-U.S. shareholder partners sell their interests in the partnership, any gain would be recharacterized as ordinary income to the extent the partnership would have a deemed dividend if the partnership sells the CFC stock for fair market value. Because ordinary income is not treated as a deemed dividend for tax purposes, the DRD would arguably not be available to such corporate partners with respect to that gain (which also cannot be offset by any foreign tax credits), even though the DRD would have offset any such gain if the partnership had sold the CFC directly.

As the preceding examples illustrate, cross-border buyers and sellers should continue to monitor developments. Further guidance relating to the TCJA may be issued, finalized and (potentially) challenged during the coming year, all of which may impact the U.S. federal income tax treatment of these sales.