TAX REFORM AND INVESTMENT MANAGEMENT: CERTAIN INTERNATIONAL PROVISIONS

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In addition to the very significant changes to the domestic provisions of the Internal Revenue Code (the "Code"), the Tax Cut and Jobs Act (the "Act") made very significant changes to the taxation of foreign income of U.S. persons. This alert, which is part of our series of alerts on the impact of the Act with respect to the Investment Management industry, will discuss one of the more important foreign provisions that apply to investment funds. These changes appear to eliminate the benefit of deferral for income earned though controlled foreign corporations ("CFCs") above a permitted rate of return on capital invested in tangible property outside the United States by CFCs.

Most importantly, the changes to the foreign provisions of the Code include a new type of income referred to as Global Intangible Low-Taxed Income or "GILTI" (pronounced "guilty"). In general, GILTI includes all net operating income (taking into account allocable interest deductions) of a foreign corporation not otherwise taxed to U.S. shareholders in excess of a 10% return on the adjusted cost basis of the tangible assets of the company used in the production of such operating income. [1]

Any GILTI realized by a foreign corporation that is a CFC is taxed to the "U.S. shareholders" of that CFC, whether or not the income is actually distributed to such U.S. shareholders. The definition of a CFC is somewhat complicated. A CFC is a foreign corporation where more than 50% of the stock of which (by vote or value) is held by U.S. shareholders (i.e., U.S. persons holding directly or indirectly 10% or more of the stock of the foreign corporation by vote or value). For purposes of the CFC rules, prior to the Act, a U.S. shareholder only included U.S. persons holding directly or indirectly 10% or more of the stock of the foreign corporation determined by reference to vote rather than vote or value.

(Note that other types of income of a foreign corporation that is a CFC are already taxed to U.S. shareholders. These types of income include passive income such as dividends and interest and income that is deemed routed through tax havens. The taxation of this income has not significantly changed under the Act.)

Any GILTI of a U.S. shareholder that is a U.S. corporation (excluding S corporations) is also eligible for a special deduction, so that the effective U.S. federal income tax rate to such U.S. corporate shareholder is 10.5% for taxable years beginning after December 31, 2017 and before January 1, 2026. For taxable years beginning after December 31, 2025, the effective U.S. federal income tax rate on GILTI increases to 13.125%. A U.S. corporate shareholder is eligible for an indirect foreign tax credit with respect to non-U.S. income taxes paid on GILTI, but special rules also apply to limit to 80% the foreign tax credits available with respect to foreign taxes paid on GILTI. Any GILTI of an individual is subject to tax at regular income tax rates (a top rate of 40.8% in 2018 under the Act after accounting for the additional 3.8% tax that may apply to net investment income). It would appear that any GILTI of a U.S. tax-exempt organization and pension fund would not be subject to federal income tax unless such

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income constitutes "unrelated business taxable income." It is clear that any GILTI of a foreign person would not be subject to U.S. federal income tax.

The new GILTI provisions could apply to a domestic fund (typically, a private equity fund) that holds a majority of the stock of a foreign corporation. Such domestic private equity fund would be a U.S. shareholder of the foreign corporation and would be required to include on the K-1s of the investors and general partners of the fund their allocable share of the GILTI of the foreign corporation on an annual basis.

The GILTI provisions could also apply to a domestic fund holding 10% or more (by vote or value) of the stock of a foreign corporation if it and other U.S. persons (also holding 10% or more of such stock) hold more than 50% of the stock of such foreign corporation. For example, if a group of venture funds each took a minority position (10% or more) in a foreign corporation but together with other U.S. persons held more than 50% of the stock, the foreign company would be a CFC with the result that the GILTI of the foreign corporation would be reported by the funds and taxed to their partners or members under the GILTI provisions.

These rules may also apply to foreign funds depending on their mix of investors.

The Act also includes a participation exemption provision for dividends attributable to operating income. This participation exemption provides that corporations receiving such dividends are exempt from tax on such amounts. However, income subject to the GILTI provisions is not eligible for the participation exemption. Thus, the tax benefit of this provision will be limited in most cases.

In addition to talking to their tax advisors, fund managers generally may want to consider the following:

1. Consider whether any of their fund investments are in CFCs;
2. If a fund does have investments in CFCs, managers should review their tax distribution provisions to determine whether these provisions will be implicated if the fund has any GILTI that is allocated to their investors or managers; and
3. Consider whether investments in CFCs that are held by domestic funds should be moved into offshore alternative investment vehicles or whether there may be alternative ways to change the classification of such investments as CFCs.

The GILTI provisions became effective for taxable years of foreign corporations beginning January 1, 2018.

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[1] The new GILTI rules will not impact investments in a non-U.S. corporation held by private or registered funds to the extent such funds with respect to such an investment are U.S. shareholders in subsidiaries that are CFCs with a passive investment focus (e.g., trading stocks and securities or commodities) because under the general rules applicable to CFCs such income would likely be classified as "subpart F income" which is required to be included in the income of a U.S. shareholder as ordinary income on a current basis whether or not such income is distributed by the CFC realizing such income. This type of income is not treated as GILTI.

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KEY CONTACTS



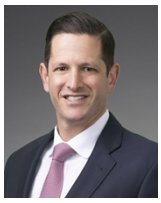
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