International Tax Updates: Year-End Planning Considerations

November 20, 2024

forvis mazars

Agenda

1. Nonresident Alien’s Renting and Selling US Real Property
2. Pillar Two
3. New DCL Regulations and Pillar Two Implications

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Nonresidents & U.S. Real Property

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1. Investment in U.S. Real Property
2. How the Income Is Taxed
3. Disposition of U.S. Real Property Interest (USRPI)
4. Definitions: USRPI & USRPHC
5. Partnerships & USRPI
6. Withholding Tax on Dispositions

Investment in U.S. Real Property

Direct ownership

Indirect ownership

- Corporation
- Partnership

Debt investment

How the Income Is Taxed

Rental Income

- 30% withholding tax on a gross basis if treated as fixed, determinable, annual, or periodical (FDAP) income
- Taxed at applicable rates if treated as income effectively connected to a U.S. trade or business (ECI)
  - Net Election under Sections 871(d) or 882(d)
  - Individuals – 37%
  - Corporations – 21%

Interest Income

- 30% withholding tax unless reduced by income tax treaty
- 0% withholding if debt qualifies for portfolio interest exemption

Disposition of U.S. Real Property Interest

USRPI

01

Gain or loss treated as ECI under §897

02

Section 1445 imposes a 15% withholding tax of the amount realized on the disposition of USRPI

03

Key Issues:

- Is the asset a USRPI?
- If a domestic corporation of U.S. Real Property Holding Corporation (USRPHC)?
- Is it being disposed in a taxable or nontaxable transaction?
- Is there a withholding obligations?

Definitions
USRPI & USRPHC

USRPI Defined

- Direct interest in real property in the United States
  - Land
  - Buildings
  - Personal property “associated” with the use of real property
  - Property used in operation of a facility, *e.g.,* hotel
- Interest in U.S. Real Property Holding Corporation (USRPHC)
  - Determination of USRPHC status is complex
  - Foreign corporations are not USRPHC unless election under §897(i) is made
- Interest in a partnership to the extent gain on disposition would be attributable to USRPIs

USRPHC Defined

- Domestic corporation if the FMV of its USRPIs equals or exceeds 50% of all its interest in real property & other assets used or held for use in an active trade or business
  - Startup trap – ownership of a USRPI before business operations commence may trigger USRPHC status as business operations must commence for other assets to be counted as used or held for use
- “Look Through” rules apply for determining assets
  - Proportionate value of underlying assets in 50% or greater own subsidiaries or partnerships
- Section 318 constructive ownership rules apply

Partnerships & USRPI

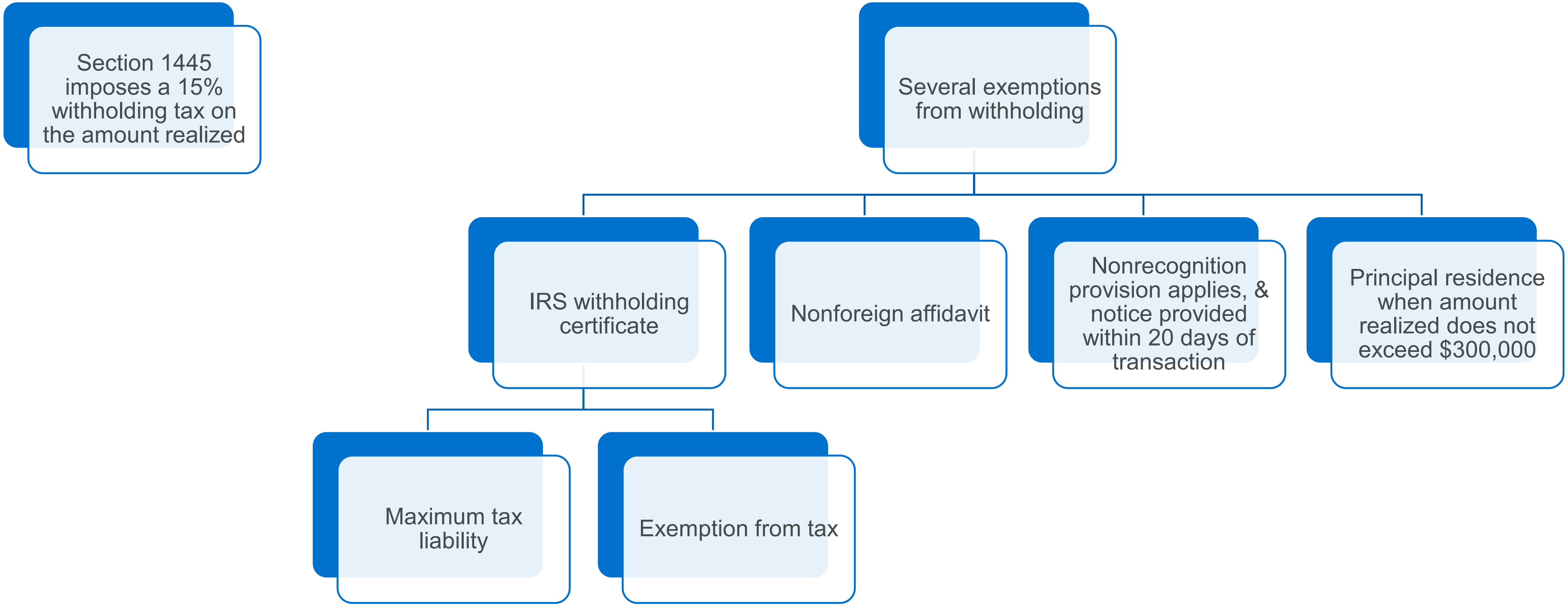
Under §897, partnerships are not explicitly treated as USRPIs

- Money or property received in exchange for an interest in a partnership is treated as from sale or exchange of USRPI if attributable to real property

50/90 Partnership treated in its entirety as a USRPI for withholding tax purposes

- 50% of gross value of partnership assets are USRPIs & 90% of partnership assets consist of USRPIs & cash or cash equivalents

Withholding Tax on Dispositions



Section 1445 imposes a 15% withholding tax on the amount realized

Several exemptions from withholding

- IRS withholding certificate
  - Maximum tax liability
  - Exemption from tax
- Nonforeign affidavit
- Nonrecognition provision applies, & notice provided within 20 days of transaction
- Principal residence when amount realized does not exceed $300,000

Summary

U.S. Real Property	Nonresident Individual	Domestic Corporation	Foreign Corporation	Domestic Partnership Owned by Nonresident Individual	Foreign Partnership Owned by Nonresident Individual
Rental Income Withholding (no ECI election)	30% of gross rental income	N/A	30% of gross rental income	30% on Distributive Share of gross rental income	30% of gross rental income
Rental Income Withholding with election to treat as ECI (not a final tax)	N/A with submission of Form W-8ECI	N/A	N/A with submission of Form W-8ECI	37% of Distributive Share of net rental income	37% of Distributive Share of net rental income
Rental Income with ECI election – Actual tax (final)	Graduated ordinary tax rates on net rental income – up to 37%	21% of net rental income	21% of net rental income	Graduated ordinary tax rates on net rental income – up to 37%	Graduated ordinary tax rates on net rental income – up to 37%
Disposition of USRPI – Withholding (not a final tax)	15% of sale proceeds	N/A	15% of sale proceeds	25% on depreciation recapture; 20% on remaining long-term gain	15% of sale proceeds
Disposition of USRPI – Actual Tax (final tax liability)	25% on depreciation recapture; 20% or 15% on remaining long-term gain	21% of gain	21% of gain	25% on depreciation recapture; 20% or 15% on remaining long-term gain	25% on depreciation recapture; 20% or 15% on remaining long-term gain

Pillar Two & Considerations on Mergers & Acquisitions

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1. OECD Pillar Two Overview
2. Accounting for Acquisitions
3. Tax Due Diligence
4. Tax Planning & Structuring

OECD Pillar 2 Overview

$ Multinational enterprise (MNE) groups with annual revenue exceeding €750 million in two of the last four fiscal years

Designed to achieve a 15% minimum tax rate

- Applicable & collectible with respect to any jurisdiction regardless of whether such jurisdiction has enacted Pillar Two
- Based off complex jurisdictional top-up tax computations

Global Anti–Base Erosion (GloBE) interlocking charging rules:

- Income Inclusion Rule (IIR) – 2024
- Undertaxed Payment Rule (UTPR) – 2025
- Qualified Domestic Minimum Top–Up Tax (QDMTT) – 2024

OECD contemplates global taxing jurisdictions to adopt a unified approach

OECD Pillar 2 Overview

Illustration

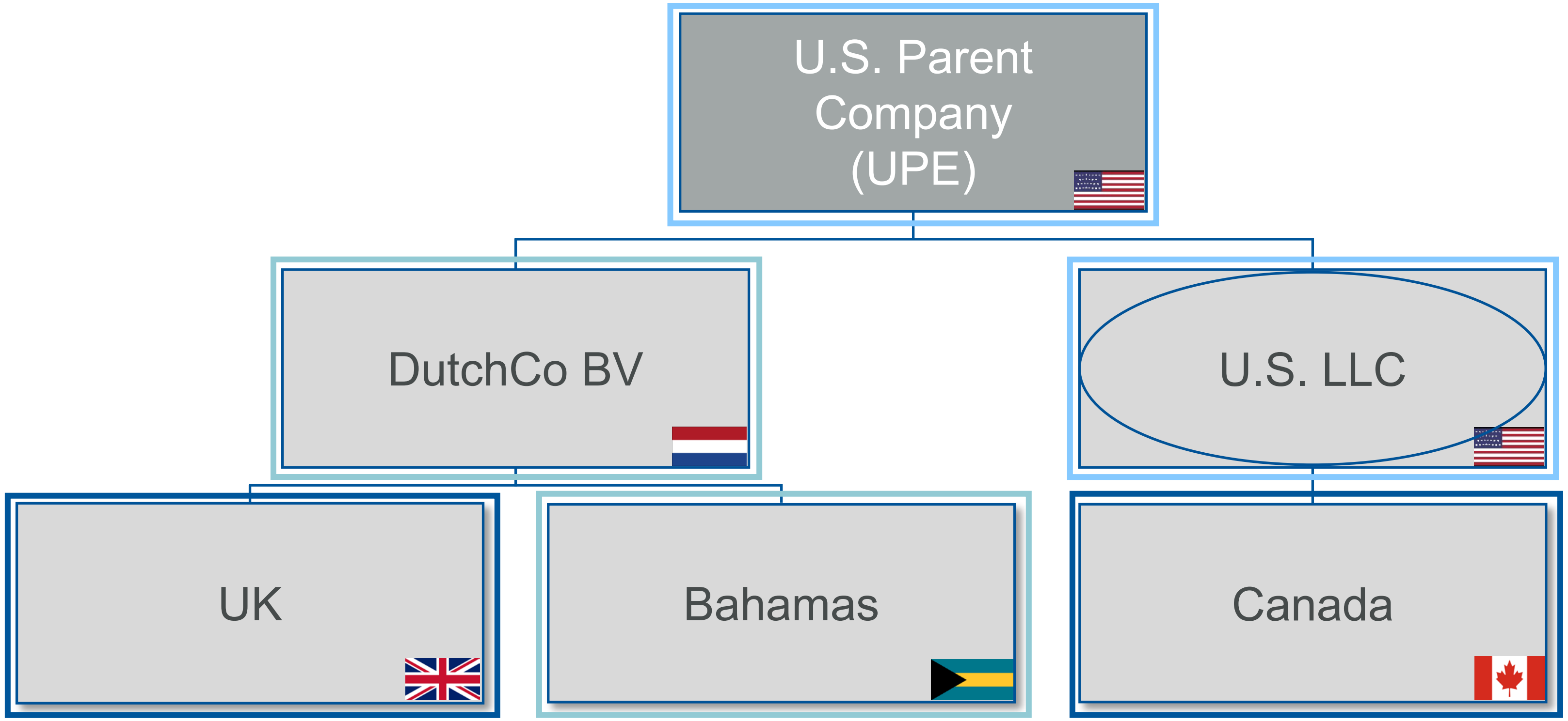
Legend

☐ UTPR Application

☐ IIR Application

☐ QDMTT Application

- DutchCo BV, Canada, & UK will collect Top–Up Tax with respect to their share based on their QDMTTs.
- DutchCo BV will collect Bahamas's share of Top–Up Tax through application of its IIR.
- DutchCo BV, Canada, & UK will collect Top–Up Tax on behalf of UPE & U.S. LLC through their UTPR.



Accounting for Acquisitions

- Purchase accounting adjustments
  - Financial accounting generally allows for fair market value upon acquisition to be pushed down
  - GloBE generally ignores purchase accounting adjustments except in certain situations
    - Thus, use historical carrying values
      - Key – must preserve records
  - Do these rules apply to transaction that occurred prior to Pillar Two?

Tax Due Diligence

Collection of data to:

- Evaluate positions taken especially transfer pricing
- Asses potential top-up taxes
- Value of potential tax attributes
- Impact on transaction pricing

Impact on integration post acquisition & future tax planning

- For example, use of tax credits & tax incentives (past & future)

Deferred tax liabilities

- DTLs not settled within 5 years generally included in effective tax rate
- Who pays for that? Seller or purchaser?

Tax Planning & Structuring

Considerations

- Asset versus stock purchase
- Carve-outs
- Intangible property transfers
- Financing structures

Negotiate & allocate the risks of structuring/restructuring between the parties

Impact of financing structures on effective tax rates

Supply chain restructuring post acquisition

- Impact of transfer pricing

DCL Proposed Regulations

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1. Overview of DCL Regulations
2. Calculation of DCL
3. Proposed Changes to Calculation
4. Interaction With Pillar 2
5. DPL Rules

Overview of DCL Regulations

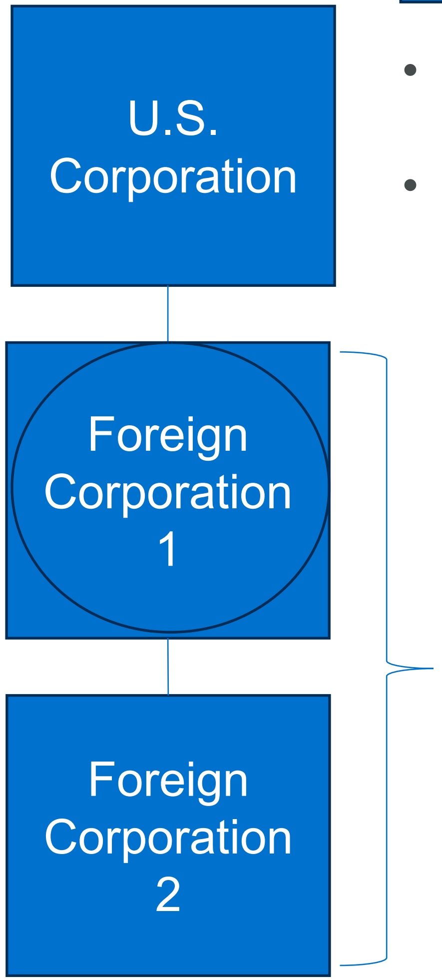
- Purpose is to prevent U.S. corporate taxpayers from double dipping on the same economic loss in the United States & a foreign jurisdiction
- A domestic C corporation has a DCL if it has a loss attributable to a foreign DRE, foreign branch, or foreign hybrid partnership & such activity/entity is subject to an income tax in a foreign country. Such loss can flow into the domestic C corporation but could also offset income of a foreign corporation.
  - A Dual Resident Corporation can also be subject to the DCL rules.
- Loss can be utilized on the U.S. tax return of the domestic C corporation
  - If there is no “foreign use” of the DCL &
  - If a domestic use election is made

Example
Prevent “Double Dipping”

Background

- 100% owned by U.S. Corporation
- Disregarded entity for U.S. tax purposes
- Taxed as corporation in foreign country
- Foreign country has cons income tax regime
- $100 DCL after eliminating transactions

- Owned by Foreign Corporation 1
- Treated as corporation for U.S. tax purposes
- $200 gross income under U.S. & foreign country tax principles



Result

- U.S. Corp cannot deduct DCL unless it can make domestic use election
- Cannot make election since DCL has been put to a “foreign use”

- Foreign corporations file consolidated tax group in foreign country
- $100 DCL offsets $200 income

Calculation of DCL

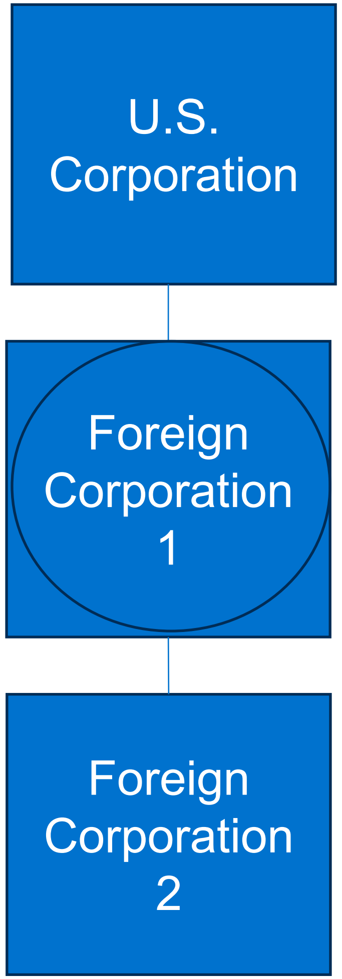
- DCL is calculated in accordance with U.S. tax principles
- Items that are disregarded for U.S. tax purposes are disregarded for DCL purposes
- Hybrid entity separate units & interests in transparent entities rely on items on books & records of the entity
  - Adjust for disregarded transactions
- Branch/Permanent Establishment – items of income/loss are attributed to such entity based on domestic owner’s items of income & expense

Example

Calculating DCL

Background

- 100% owned by U.S. Corporation
- Disregarded entity for U.S. tax purposes
- Taxed as corporation in foreign country
- Foreign country has cons income tax regime
- $500 inc for services provided to U.S. Corp



U.S. Corporation

Foreign Corporation 1

Foreign Corporation 2

Result

- $500 income disregarded for U.S. tax purposes
- $500 income eliminated in calculating DCL

Proposed Changes to Calculation of DCL

- Interaction with Section 1502 (Intercompany Transactions)
  - Section 1502 will not redetermine a loss under the DCL rules
    - If loss between a Separate Unit & another member of the group (not the SU's domestic parent) is deferred under section 1502, then the intercompany rules under 1502 would not redetermine the loss as not (eventually) subject to the DCL rules.
  - The counterparty's income would not be adjusted if the expense is a DCL subject to the limitation.
- Items arising from ownership of stock are not taken into account for purposes of computing DCL
  - Includes Subpart F, GILTI, & dividends
  - Does not apply to portfolio stock
- Domestic owner's items of income/expense cannot be attributed to hybrid entity separate unit that relies on its books & records

DCL Rules & Interaction With Pillar 2

- Notice 2023-80 provides that qualified domestic minimum top-up tax (QDMTT) & may be creditable taxes in certain situations, but a top-up tax under the Income Inclusion Rule (IIR) & the Under Taxed Payment Rule (UTPR) are not creditable foreign income taxes.
- QDMTT & IIR may be considered an income tax for DCL purposes
- Loss used to compute a jurisdiction QDMTT or IIR is considered a foreign use for DCL purposes
- Pillar 2 will not impact DCL rules for DCLs incurred beginning before August 6, 2024
    - This includes future foreign use

DCL Rules & Interaction With Pillar 2
Continued

- If a separate unit is incorporated in a foreign jurisdiction that does not have an income tax but is subject to IIR in another foreign jurisdiction, then interest in such entity is treated as a hybrid entity separate unit
- DCL rules will apply to the extent a loss is utilized to qualify for one of the Safe Harbors, thus there will be a foreign use

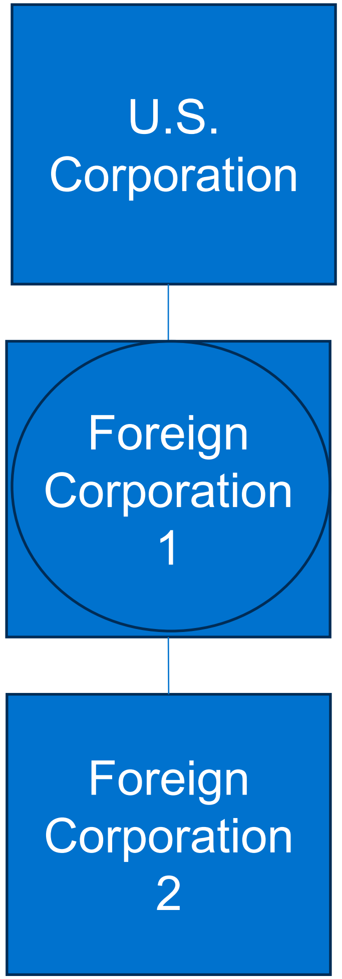
Example

QDMTT

Background

- 100% owned by U.S. Corporation
- Disregarded entity for U.S. tax purposes
- Foreign country does not have income tax
- $100 loss after eliminating transactions

- Owned by Foreign Corporation 1
- Treated as corporation for U.S. tax purposes
- $200 gross income under U.S. tax principles

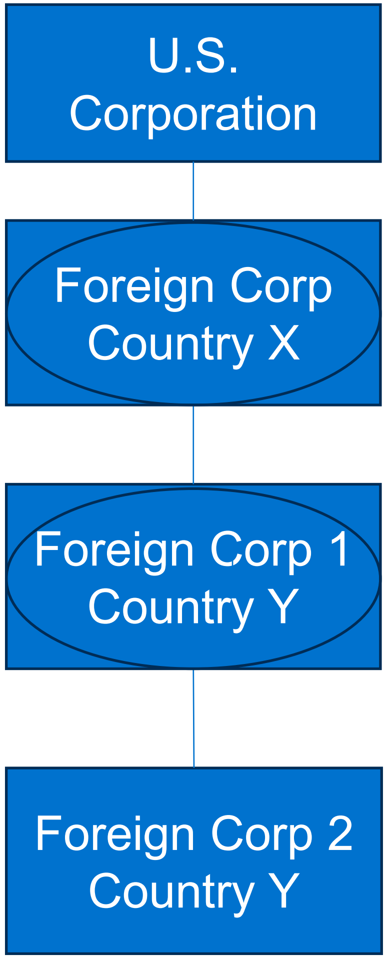


Result

- $100 loss not a DCL because no possibility of “double dip”
- However, if foreign country enacts QDMTT, presumably loss would offset income of Foreign Corporation 2
  - QDMTT would be considered income tax for DCL purposes

Example
IIR

Background



- Owned by U.S. Corporation
- Disregarded entity for U.S. tax purposes
- IIR

- Owned by Foreign Corp Country X
- Disregarded entity for U.S. tax purposes
- No income tax or QMDTT
- $100 loss after eliminating transactions

- Owned by Foreign Corp 1 Country Y
- Treated as corporation for U.S. tax purposes
- $200 gross inc under U.S. tax principles

Result

- $100 DCL put to “foreign use” & not deductible to U.S. Corporation

- $100 loss of Foreign Corp 1 combines with $200 income of Foreign Corp 2, subject to Country X IIR & pays top-up tax

Disregarded Payment Loss Rules

- Applies to a foreign disregarded entity that makes certain payments to its U.S. owner that are deducted for foreign tax purposes but not included in income for U.S. tax purposes
  - Interest, royalties, or structured payments
  - Intended to address deduction or no inclusion situations
- If DPL rules are triggered, taxpayer is required to recognize taxable income up to the entire amount of the disregarded payment
- Will have to determine if have disregarded payment entities
  - "Specified eligible entity" that is a foreign tax resident but is disregarded, *i.e.*, not a corporation, for U.S. federal tax purposes
- Domestic corporation is deemed to consent to the application of the DPL rules by ownership of a DRE

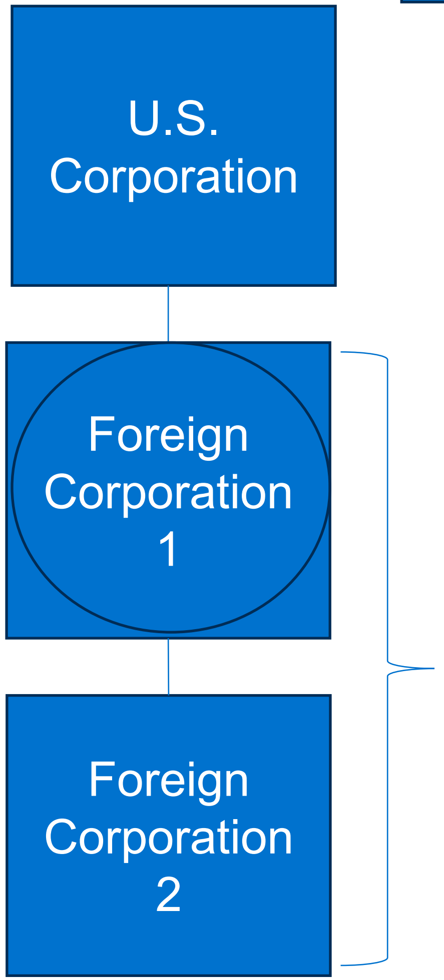
Disregarded Payment Loss Rules
Continued

- Does the DPE have a DPL?
  - DPL exists if Items of Deduction exceed Items of Income
    - Items of Deduction are deductions allowed under foreign law, disregarded for U.S. tax purposes, & would be treated as interest, royalty, or structured payment if regarded
    - Items of Income is income treated as income for foreign law, disregarded for US tax purposes, & if regarded would constitute receipt of interest, royalty, or structured payments
- Must certify DPL to avoid the income inclusion for the current year & next five years
  - No foreign use for prior years, current year, or next five years
- Triggering events are foreign use or failure to file certifications
- Operate independently from DCL rules

Example
DPL Rules

Background

Result



- 100% owned by U.S. Corporation
- Disregarded entity for U.S. tax purposes
- U.S. Corp loans funds to Foreign Corporation 1 to acquire Foreign Corporation 2
- $100 interest expense paid to U.S. Corp

- Owned by Foreign Corporation 1
- Treated as corporation for U.S. tax purposes
- $200 gross income under U.S. & foreign country tax principles

- Foreign corporations file consolidated tax group in foreign country
- $100 loss is not a DCL & offsets $200 gross income
- $100 loss is a DPL

Thank you!