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FOREIGN DIRECT INVESTMENT IN LIGHT OF U.S. TAX REFORM

A number of existing U.S. tax laws affect how non-U.S. persons are taxed on U.S.-source income and how transfers of U.S. assets by non-U.S. individuals may be subject to gift or estate tax. While these concepts remain relevant for foreign direct investment planning, recently enacted tax reform legislation (the "Tax Act") introduced a number of significant changes to U.S. tax laws that may impact how inbound investments should be structured. This article addresses options for inbound investing in the context of several of these changes.

Background: Key Tax Issues Affecting Foreign Direct Investments

Income Tax Considerations. Generally, an item of income is taxable to a non-U.S. person only if it is "sourced" within the United States. U.S.-source income includes rental income from U.S. real property, gains from the sale of U.S. real property and income from other business activities conducted in the United States. If a non-U.S. person's business activities within the U.S. rise to the level of a U.S. trade or business ("USTB"), U.S. income tax will apply with respect to income that is effectively connected with the USTB ("ECI").

For federal income tax purposes, a pass-through entity (including any partnership or LLC taxed as a partnership) is treated as an aggregation of separate partners rather than as a separate taxable entity. The partnership itself is not required to pay federal income tax; instead, the partnership is required to file an information return that states the name of each partner and the amount of income or loss derived from the partnership by each partner. The partner (whether an individual or a corporation) includes its distributive share of the partnership income or loss on a U.S. income tax return. Partnership income is currently taxed to the partners even if not actually distributed to them. Partnerships that operate a USTB and have ECI are required to withhold taxes on each foreign partner's allocable share of ECI, and each partner is required to file a U.S. tax return.

By contrast, U.S. business operations conducted through a corporation are subject to entity-level taxation at a maximum 21% tax rate.[1] U.S. corporations and foreign corporations with ECI must file U.S. income tax returns and pay the applicable tax. While the federal corporate tax rate is lower than the highest individual rate, distributions of corporate earnings will be taxed a second time (in the case of non-resident alien shareholders, via a 30% withholding) on the amounts distributed. Shareholders resident in countries with which the United States has entered into a bilateral tax treaty may benefit from a reduced withholding rate on distributions of corporate earnings.

A foreign corporation doing business in the United States can operate through a subsidiary or in branch form. If a foreign corporation is doing business in the United States in branch form, a "branch profits" tax is imposed on the after-tax earnings of the U.S. branch. This 30% tax is imposed on the "dividend equivalent amount," which is effectively a tax on ECI earned by the branch, with certain adjustments. The branch profits tax only applies if the investment is made through a foreign corporation; thus, a non-resident alien individual can invest either directly or through a foreign partnership without triggering the branch profits tax. A number of U.S. tax treaties reduce or eliminate the branch profits tax.

In general, non-U.S. persons are not taxed on gains from the sale of U.S. capital assets as long as the assets were not used in a U.S. trade or business. Gains realized by a non-U.S. person from the disposition of U.S. real property interests (including stock in a U.S. corporation that owns significant amounts of U.S. real property) are taxed as income effectively connected with a U.S. trade or business, and the tax code requires the purchaser to collect the tax via withholding.

<u>Gift and Estate Tax Considerations</u>. In addition to income tax exposure, a non-resident alien individual may be subject to gift tax if she transfers U.S. real estate or tangible personal property via gift during her lifetime. More importantly, she will be subject to estate tax if she owns assets situated in the United States at death.

The gross estate of a deceased non-resident alien ("NRA") includes real property located in the United States and interests in U.S. companies (*e.g.*, shares of stock in a U.S. corporation). Foreign corporate stock is generally not subject to U.S. estate tax when owned by a non-U.S. decedent, even if the foreign corporation owns U.S. real estate. Thus an NRA can avoid estate tax on U.S. real property or other business property by holding it through a non-U.S. corporation.

Changes in U.S. Tax Rules Affecting Inbound Investments

We address below how several of the more significant of the Tax Act's changes will impact inbound investments. Several issues not covered in detail here may also be relevant to inbound investments (for example, changes to the rules for when taxpayers can utilize net operating losses).

[1] Prior to 2018, the highest corporate tax rate was 35%. See the section below, *Changes in U.S. Tax Rules Affecting Inbound Investments*.

Reduction to the Corporate Tax Rate. The Tax Act reduced the highest corporate income tax rate from 35% to 21% - a 40% reduction -- beginning in 2018. The new rate benefits not only foreign corporations investing in U.S. businesses, but also non-resident alien individuals who want to invest in U.S. assets while mitigating the risk of estate taxation. These investors can structure their investments through a foreign corporation (to avoid estate tax) while benefitting from a reduced corporate-level income tax rate. Foreign corporations are generally still subject to the branch profits tax; however, many U.S. bilateral tax treaties reduce or eliminate this tax.

Deduction for Certain Income Earned by Pass-through Entities. Another significant change affecting inbound investments is the addition of Section 199A to the tax code, which provides for a 20% deduction for certain "qualified business income" earned by pass-through entities. Qualified business income is income earned by an active trade or business and generally excludes most passive income including capital gains, dividends, interest and notional principal contract income. Notably, rental income and royalty income are included in the definition of "qualified business income."

Section 199A is particularly complex, and it contains a number of exceptions and limitations that reduce or eliminate the benefit of the 20% deduction. Generally, the deduction is limited to the greater of:

- 50% of the W-2 wages the entity pays its employees; or
- 25% of the W-2 wages plus 2.5% of the value of depreciable property owned by the entity.

Thus, owners of businesses with significant W-2 wages and/or significant investments in depreciable property will benefit most from the deduction.

Taxpayers that are eligible for the 20% deduction include individuals, S corporations, partnerships, trusts and estates. The deduction will, if fully available, reduce the highest marginal tax rate on pass-through income from 39.6% for individual partners (effective for years prior to 2018) to 29.6%. As currently enacted, Section 199A is a temporary provision. It expires for tax years beginning after December 31, 2025.

New Limitations on Interest Deductibility. Business interest expenses that were deductible prior to the Tax Act may now be limited to 30% of the business' earnings. This limitation does not apply to businesses with average annual gross receipts for the current and prior two taxable years of less than $25 million. Additionally, at the taxpayer's election, the limitation does not apply to interest incurred by the taxpayer in any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

Summary

Non-U.S. persons that are contemplating new investments or already have established investments in U.S. business assets should reassess how their U.S. business interests are structured to take advantage of the recent changes to U.S. tax laws. Inbound investors need to consider not only changes to the income tax rates, but also remember that Section 199A expires after 2025.

As with all inbound investments by non-resident alien individuals, avoiding U.S. estate tax remains a key consideration. The significantly lower corporate tax rate makes foreign corporations more attractive both as a means to reduce income tax and to avoid U.S. estate tax. Foreign corporations are particularly attractive if the entity qualifies for relief from the branch profits tax under an applicable U.S. tax treaty.

Foreign direct investment structures that utilize debt should be reviewed to analyze the impact of the Tax Act's interest deductibility limitations. This is especially important for non-U.S. investors as they commonly utilize debt strategies to realize interest income free from U.S. withholding taxes. Business entities that make interest payments may find their interest deductions limited by these new rules.

The Tax Act adds additional complexity to an already complicated tax environment in which there is no one-size-fits-all answer. INBLF's member law firms can help you design a business plan that addresses the relevant U.S. tax issues in the context of your business goals and objectives.