US Tax Reform: Benefits for Companies but Increased Burden for Individuals in Japan

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In brief

The US Tax Cuts and Jobs Act that was signed into law on December 22, 2017 is the most comprehensive US tax legislation in the last three decades. Most tax professionals, and the Internal Revenue Service ("IRS"), are still trying to determine the full implications of the laws and how they will be applied in practice. Despite this, two international tax issues primarily aimed at corporate taxpayers have already been identified as also impacting individuals.

Generally, US individual taxpayers who are self-employed (as one example, a "blue form" filer or *aoiro shinkoku sha*) and do not use a corporation to operate their business are not impacted by the transition tax (also known as the "toll tax") and the global intangible low-taxed income ("GILTI") tax. However, one or both of these taxes could affect US individual taxpayers who operate businesses through a Japanese corporation.

This alert is aimed at US individual taxpayers who own and operate their business in Japan through a Japanese corporation. Through this alert, we hope to raise general awareness of these two tax issues and some of their potential implications. This alert is not intended to, and does not cover all potential impacts of the law.

Please note that explanations have been simplified below to help with ease of understanding the general concepts and rules. However, the laws are complex and current guidance is limited and could change. Accordingly, professional US tax advice is strongly recommended.

In detail

1. Transition tax

Starting in 2018, US corporations will in general not be taxed on the dividends received from their foreign subsidiary corporations. To ensure that accumulated earnings of these foreign subsidiary corporations prior to 2018 are subject to tax however, the US will assess a transition tax on accumulated post-1986 deferred foreign income of certain foreign corporations that are owned or controlled by US shareholders. Post-1986 accumulated deferred foreign income means post-1986 earnings and profits with specified adjustments. While this tax is primarily aimed at large US corporations which have deferred paying US tax on retained earnings held by their foreign subsidiary corporations outside of the US, US individual taxpayers who operate their businesses through foreign corporations are also covered by this law.

- **Are you impacted?**

If you do not directly, indirectly or constructively (i.e. through other entities or through family members) own 10% or more in a foreign corporation then you are not impacted (please note that for US partnerships, in general, the threshold is determined by the size of the interest held by the partnership, even if you as an individual partner hold less than 10%).

If you do directly, indirectly or constructively (i.e. through other entities or through family members) own 10% or more in a foreign corporation that has retained earnings since 1986, then you are impacted if:

(1) The foreign corporation is owned more than 50% by US shareholders owning 10% or more (a controlled foreign corporation or "CFC"); or
(2) The foreign corporation is not a CFC but a US corporation owns 10% or more in the foreign corporation.

If either condition is met then the foreign corporation is considered to be a specified foreign corporation ("SFC").

Therefore, it's important to know your level of ownership in the foreign corporation but also equally important to know if there are other US shareholders of the foreign corporation, and if those US shareholders own more than 50% of the foreign corporation, or if a US corporation owns 10% or more of the foreign corporation.

In connection with Japan, a *kabushiki kaisha* ("KK") is defined under US tax law as a corporation, and could therefore be subject to the transition tax and GILTI. Other Japanese entities (such as a *godo kaisha* or "GK") could also be considered a foreign corporation under US tax law unless an election has been made for that entity to be treated as "pass-through" meaning that the US shareholders/owners in the Japanese entity have been reporting the entity's earnings on a current basis (even if there have been no distributions from the company) on their US individual tax returns. Please note that for some Japanese entities, the default treatment is a foreign corporation for US tax purposes unless an election is actively made (i.e., unless Form 8832 was completed and filed with the IRS).

To be clear, if you own a KK and it has post-1986 earnings and profits that have not been reported on a US tax return, these accumulated earnings and profits will be subject to the transition tax. Generally, there is no planning or special elections that can be made to avoid the transition tax.

- **How much is the transition tax?**

If you are subject to the transition tax then you will need to calculate the post-1986 earnings and profits retained in any SFC on November 2, 2017 and December 31, 2017.

You can exclude amounts that are "effectively connected" with a US trade or business and previously taxed in the US. In addition, post-1986 earnings and profits prior to the foreign corporation becoming a SFC can be excluded. Also, if you own other SFCs that have earnings and profits deficits, such deficits may be able to reduce the amount of income subject to the transition tax.

Your ownership portion of the greater of the amounts on November 2, 2017 and December 31, 2017 will be subject to the transition tax. For individual taxpayers, the tax rate is approximately 17.5% on cash and cash equivalent assets and 9.1% on non-cash assets assuming a full allowance of the participation exemption. However, there is still some uncertainty around how the deduction will be treated for individual tax purposes, including for alternative minimum tax purposes so these rates could be higher.

Also, please note that for foreign corporations that have a fiscal year end resulting in the transition tax being due in 2018 then the rates of tax are approximately 27.3% on cash and cash equivalent assets and 14.1% on non-cash assets, assuming a full allowance of the participation exemption. Again, there is still some uncertainty around how the deduction will be treated for individual tax purposes, including for alternative minimum tax purposes so these rates could be higher.

The good news is that, if you have foreign tax credit carryforwards on your US individual tax return, they could reduce the amount of the transition tax due.

On the individual's Japan income tax return, the transition tax may be limited or not likely be claimable as a foreign tax credit if the SFC subject to the transition tax is a Japan SFC and its income is not foreign source and/or if the tax would not be otherwise assessable against non-US citizens and non-US greencard holders.

- **When is the transition tax due?**

The transition tax is due on April 15, 2018. Fortunately, the IRS does allow for an election to be made to pay the transition tax in 8 annual instalments. The amount of each instalment may differ and ranges between 8% to 25% for the last instalment. Also, the IRS will not charge interest if the tax is paid in 8 instalments as long as the instalments are timely and sufficiently paid.

The election to pay in 8 instalments needs to be filed by the due date of the income tax return of the US shareholder making the election. For calendar-year individual taxpayers, the election would need to be filed on April 15th, 2018 and the first installment would also need to be paid on this date.

Failure to pay the instalments by the due dates results in the entire remaining amount of the transition tax falling due immediately.

- **Not just Japan**

While this alert is focussed on corporations in Japan, please note that other SFCs located outside of Japan also need to be accounted for and incorporated into the transition tax analysis.

2. Global Intangible Low-Taxed Income (GILTI)

For calendar year taxpayers, effective 2018, the US will tax US shareholders on a certain portion of their foreign corporations' income on an annual basis, even if there are no distributions. This is not just a one-time tax. The intention of this law is again aimed at US corporate taxpayers but US individual taxpayers are also subject to this law. Compounding the issue, certain deductions and foreign tax credits that alleviate the impact of the GILTI on corporate taxpayers are not available to individual taxpayers. In addition, there is no preferential rate of taxation on GILTI, as there is with respect to the transition tax, so this income could be taxed at the top marginal tax rate for individuals of 37% and possibly the net investment income tax (NIIT) of 3.8%.

- **Am I impacted?**

You are only impacted if you directly, indirectly or constructively (i.e. through other entities or through family members) own 10% or more in a CFC. If the foreign corporation is not owned more than 50% by US shareholders, then its earnings are not subject to the GILTI rules.

Also, please be aware that starting in 2018, the 10% level has been changed to include 10% of the voting power of all classes of stock or 10% of the total value of the stock in the foreign corporation (previously, it was just 10% or more of stock voting power).

- **But my Japan corporation has no intangible income…**

Contrary to the title, a foreign corporation does not need to have intangible income in order to have a portion of its annual earnings taxed. The calculation of GILTI is complicated but at a high level, it is the CFC's net tested income (which excludes and deducts certain amounts) less a 10% rate of return on the company's qualified business asset investment (or roughly, the company's tangible depreciable assets) less a specified amount of interest expense. The remaining net tested income is GILTI.

Generally, a company that holds a large amount of high cost basis tangible depreciable assets to produce the CFC's earnings can expect to have a lower GILTI. Whether the company holds any intangible assets at all is irrelevant.

- **How much is the tax on GILTI?**

Based on your ownership level in the CFC, your portion of the GILTI will be subject to tax. For the 2018 tax year, there is a deduction of 50% of the GILTI available, but only for US corporate taxpayers. The taxable GILTI is then taxed at the ordinary tax rates of up to 37% plus possibly NIIT of 3.8%. There is a foreign tax credit available to reduce the tax on GILTI but again, this is only available to US corporate taxpayers.

On the individual's Japan income tax return, the tax on GILTI may be limited or not likely be claimable as a foreign tax credit if the CFC subject to the tax is a Japan CFC and its income is not foreign source and/or if the tax would not be otherwise assessable against non-US citizens and non-US greencard holders.

- **When is tax on GILTI due?**

For calendar year individual taxpayers, the tax will be due on April 15th of the following year. Unlike the transition tax, there is no election available to pay the tax on GILTI in 8 annual instalments.

- **Not just Japan**

Similar to the transition tax, GILTI may be applicable to all of your CFCs and not just your CFC in Japan. Any net CFC tested losses could offset net CFC tested income and should be accounted for and incorporated into the GILTI calculation.

3. Summary:

For calendar-year foreign corporations, the transition tax is a one-time tax that will impact US individual taxpayers in the 2017 tax year and generally, no elections or tax planning are available to avoid this tax. Affected individuals should get an early start on their 2017 US taxes to calculate their post-1986 accumulated earnings and profits, especially if they wish to make the election to pay the transition tax in 8 annual instalments. To qualify for the election, the first instalment must be paid by April 15, 2018.

The tax on GILTI will come into effect starting in 2018, so affected individuals should review their situation to determine if there are any actions or planning that could be undertaken in regards to GILTI.

The interplay between US corporate tax and US individual tax laws that are involved with the transition tax and GILTI can be complex. Also, as the laws are relatively new and current guidance is limited and could change, it is important to stress again that professional US tax advice is strongly recommended for affected US individual taxpayers. US taxpayers in Japan are further advised to consider the potential Japanese corporate and individual tax impacts of any actions they may take in regards to the transition tax or GILTI tax so professional Japan tax advice in this regard is also advised.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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