FROM ONE CORPORATION TO ANOTHER: THE IMPACT OF THE 2018 TCJA ON DIVIDEND PAYMENTS

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Prior to 2018, foreign-source dividend income paid to a U.S. corporate shareholder was not deductible. For any foreign-source dividends, the U.S. corporate shareholder was only entitled to a foreign tax credit. The dividends received deduction, outlined in I.R.C. §§ 243 and 245, applies only to U.S.-source dividend income. As part of the 2018 Tax Cuts and Jobs Act ("the TCJA"), Congress added a new provision, I.R.C. § 245A, allowing U.S. corporate shareholders to claim a deduction for foreign-source dividends. The changes do not stop with foreign-source dividends. U.S.-source dividends were also impacted by the TCJA. This paper will address the overall changes that have occurred with the taxation of dividends under the TCJA using examples to illustrate the pre versus post Act impact.

Keywords: Dividend, Deduction, Foreign, U.S., Source

INTRODUCTION

Internal Revenue Code Sections 243 and 245 allow U.S. corporate shareholders to claim a deduction for dividend income paid from U.S.-source income. The dividends-received deduction ("DRD") was enacted to reduce the double tax burden on dividend payments from one corporation to another. The amount of the deduction is a specific percentage based on the corporate shareholder's ownership in the payer corporation. Many believed the pre-2018 Internal Revenue Code contained a tax wall for corporate shareholders since dividends produced from foreign-source income were excluded from the DRD provisions. The 2018 Tax Cuts and Jobs Act ("the *TCJA*") added a new internal revenue code section, I.R.C. § 245A, that allows U.S. corporate shareholders to claim a deduction for foreign-source dividends. Additionally, the *TCJA* modified the application percentages for U.S.-source dividend income. This article will examine the taxation of U.S. and foreign-source dividends prior to the 2018 Act and how the distributions are taxed under the current law (post-2017).

DIVIDENDS PAID FROM FOREIGN-SOURCE INCOME

Prior to the *TCJA*, the dividends-received deduction did not apply to a U.S. corporate shareholder who received a dividend derived from foreign-source income. If a U.S. corporate shareholder received a dividend from a U.S. or foreign corporation that was derived from foreign-source income, the payee corporation reported the full amount of the dividend as income with no offsetting deduction.

The direct foreign tax credit and the deemed paid foreign tax credit were enacted to alleviate some of the burden of double taxation on foreign-source dividends. Under I.R.C. § 901, a U.S. corporate shareholder can claim a credit for foreign taxes paid. I.R.C. § 903 provides that a U.S. person can claim a direct foreign tax credit for any foreign withholding taxes it incurs on a dividend from a foreign corporation.

Internal Revenue Code § 902 established the deemed paid credit system for U.S. corporate shareholders owning at least 10% of foreign affiliates. "Deemed paid" is a term that references how the foreign taxes paid by the foreign corporation can be made available as a credit to the domestic corporation. Because a dividend represents after-tax earnings paid to shareholders, i.e., is a distribution from earnings and profits, the amount received by the payee corporate shareholder is net of foreign taxes paid by the payer corporation. Following this theory, the domestic corporation is deemed to have paid the foreign income taxes attributed to the dividend distributed by the foreign corporation. In order to prevent a double tax benefit for the payee corporation, the payee corporation was required to gross up its dividend income by the amount of the deemed paid credit.

Assume Foreign Corporation had foreign-source taxable income of $20 million, was subject to a 25% tax rate and paid $5 million in foreign taxes. The corporation distributed $7 million to a U.S. corporate shareholder in 2016. The shareholder was in the 35% marginal bracket, and owned 30% of Foreign Corporation. The distribution was not subject to any withholding. Foreign Corporation had $15 million in post-1986 undistributed earnings. The deemed paid credit for the foreign tax paid was calculated as follows: ($5 million post-1986 foreign taxes x ($7 million dividend received / $15 million post-1986 E&P) =$2,333,333. The gross-up provision required the U.S. Shareholder to report total dividend income of $9,333,333. Under these facts, the U.S. Corporate Shareholder paid tax on the dividend of $3,266,667, and claimed a credit of $2,333,333 resulting in a total tax paid on the dividend of $933,333.

Assume, alternatively, that the distribution from Foreign Corporation to the U.S. corporate shareholder was subject to a 5% withholding tax. The U.S. Corporate Shareholder was entitled to a direct foreign tax credit equal to $350,000 for the 5% withholding tax. The U.S. Corporate Shareholder was also entitled to the deemed paid credit for the foreign taxes paid calculated as follows: ($5 million post-1986 foreign taxes x ($7 million dividend received / $15 million post-1986 E&P) =$2,333,333. The gross-up provision required the U.S. Shareholder to report total dividend income of $9,233,333. Under these facts, the U.S. Corporate Shareholder reported total dividend income of $9,333,333, paid tax on the dividend of $3,266,667, and claimed a credit of $2,683,333 resulting in a total amount paid of $583,333.

If the U.S. corporate shareholder owned only 5% of Foreign Corporation, the deemed paid credit did not apply. The U.S. corporate shareholder would report the full $7,000,000 as a dividend and report tax of $2,450,000. The shareholder could claim a direct credit for any withholding tax.

While the procedural rules for the taxation of U.S.-source dividend income stayed relatively the same, the rules governing taxation of foreign-source dividend income underwent substantial change with the *TCJA*. I.R.C. § 902, the deemed paid credit system, was repealed. I.R.C. § 245A was enacted. I.R.C. § 245A provides for a 100% dividends-received deduction applicable to foreign-source dividend income paid to a U.S. corporate shareholder who owns at least 10% in a foreign corporation (other than a passive foreign investment company). I.R.C. § 961(d) requires a corresponding decrease in stock basis for the deduction amount claimed.

Foreign Corporation has foreign-source taxable income of $20 million, is subject to a 25% tax rate and pays $5 million in foreign taxes. The corporation distributes $7 million to a U.S. corporate shareholder in 2019. The shareholder is in the 21% marginal bracket, and owns 30% of Foreign Corporation. Assume the foreign corporation has $15 million in post-1986 undistributed earnings. The

U.S. corporate shareholder is entitled, under I.R.C. § 245A, to claim a deduction for 100% of the dividend paid. The U.S. Corporate Shareholder reports total dividend income of $7,000,000, deducts the full $7,000,000, and pays tax on the dividend of $0. This generates a tax savings on the distribution of $933,333 over prior tax years.

Assume, alternatively, that the distribution from Foreign Corporation to the U.S. corporate shareholder is subject to a 5% withholding tax. The U.S. corporate shareholder is entitled, under I.R.C. § 245A, to claim a deduction for 100% of the dividend paid. Since the U.S. corporate shareholder is claiming the deduction under I.R.C. § 245A, the shareholder is not entitled to claim the direct credit. I.R.C. § 901[1].

If the U.S. corporate shareholder owns only 5% of Foreign Corporation, I.R.C. § 245A does not apply. In this scenario, the U.S. corporate shareholder who is now taxed at 21% reports total dividend income of $7,000,000 and pays tax on the dividend of $1,470,000. Since the shareholder is not able to claim a deduction for the dividend paid, the shareholder could claim a direct credit for any withholding tax.

The change for foreign-source dividend payments is only one piece of the international story under the TCJA. The transition tax, GILTI and BEAT provisions work to make the new international rules much more than a simple windfall for U.S. corporate shareholders who have invested in foreign corporations, and must be part of the overall tax consideration for U.S. corporate shareholders.

The transition from a worldwide system to a modified territorial system (no deduction for foreign-source dividends to a 100% deduction) included a cost, the transition tax. Internal Revenue Code § 965 requires a one-time step up in a U.S. Corporate shareholder's Subpart F income. The increase equals the U.S. Corporate shareholder's pro rata share of previously untaxed earnings and profits of specified foreign corporations, any controlled foreign corporation and any foreign corporation with a U.S. shareholder who owns at least 10%[2].

Internal Revenue Code § 951A expanded the definition of income to include global intangible low taxed income and requires that U.S. shareholder's include their GILTI income in gross income[3]. The calculation for GILTI starts with gross income from a controlled foreign corporation, other than, inter alia, effectively connected U.S. income, Subpart F income, and dividends from related persons[4]. The gross income amount is then reduced by expenses allocable to such income. The "tested income" is then reduced by the shareholder's deemed tangible income return,[5] which is based on 10% of the shareholder's pro rata share of tangible assets of each controlled foreign corporation.

The base erosion and anti-abuse tax ("BEAT") is an alternative minimum tax "determined, in part, by the extent to which the taxpayer has made deductible payments to foreign related parties[6]." The tax is equal to 5% (10% for 2017) of the taxpayer's modified taxable income minus the taxpayer's regular tax liability[7]. Modified taxable income is calculated by including any deductible base erosion payments to related parties (treated as essentially an AMT preference item)[8].

DIVIDENDS PAID FROM U.S.-SOURCE INCOME

U.S. corporate shareholders have been able to claim a dividends received deduction for U.S.-source income since the enactment of I.R.C. §§ 243 and 245 in 1954. The amount of the deduction is a percentage that is determined by the recipient corporate shareholder's stock ownership in the payer corporation. The *TCJA* made two changes in law that impact the taxation of U.S.-source dividends.

Prior to the *TCJA*, the dividends-received deduction was equal to the lesser of: 70%, 80% or 100% of the amount of dividend paid to the corporate shareholder or 70%, 80%, or 100% of the taxable income of the payee corporate shareholder[9]. If the payee corporation owned less than 20% of the payer corporation, the payee was entitled to a 70% deduction. If the payee corporation owned between 20%-79.99% of the payer corporation, the payee was entitled to an 80% deduction. If the payee corporation owned 80% or more of the payer corporation, the payee was entitled to a 100% deduction. The taxable income limitation (the lesser of rule) is not applicable if applying the deduction percentage to the dividend creates a net operating loss for the payee corporate shareholder. Moreover, the dividends-received deduction has a 45-

day holding period requirement and does not apply to preferred stock[10]. The corporate rate structure prior to the TCJA was a progressive structure based on corporate taxable income. The rates ranged from 15% to as high as 39%. For corporations with taxable income over $18,333,334 the tax rate was capped at 35%.

Many of the same rules and application procedures apply to U.S.-source dividends under the TCJA; however, two major changes impacting U.S.-source dividend payments went into effect under the new law—new dividends-received deduction percentages and a flat corporate tax rate. Under the new law, if the payee corporate shareholder owns less than 20% of the payer corporation, the payee corporate shareholder will be entitled to a 50% dividends-received deduction, a 20% reduction over prior years. If the payee corporate shareholder owns between 20%-79.99% of the payer corporation, the payee corporate shareholder will be entitled to a 65% dividends-received deduction, a 15% reduction over prior years. If the payee corporate shareholder owns more than 80% of the payer corporation, the payee corporate shareholder remains entitled to a 100% dividends-received deduction (no change from prior years).

The Change from 70% to 50%

The change in dividend percent and tax rate results in no additional burden or benefit for corporations that were in the highest bracket for 2017. Assume Paymaster Corporation, has U.S.-source taxable income of $20 million. Paymaster Corporation distributes $7 million to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 8% of Paymaster, and was in the 35% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $4,900,000 DRD ($7,000,000 x 70%) and would have incurred a tax liability on the dividend of $735,000 (($7,000,000-$4,900,000) x 35%). Since Recipient Corporation was in the 35% corporate tax bracket for 2017 it does not experience any additional tax burden or tax savings on the distribution under the new DRD percentage and corporate tax rate. In 2019, Recipient receives a $3,500,000 DRD ($7,000,000 x 50%) and incurs a tax liability on the dividend of $735,000 (($7,000,000-$3,500,000) x 21%).

If the payee corporate shareholder, Recipient Corporation, however, was in a lower tax bracket during 2017, for example, the 15% or 25% bracket, the payee will have an increased tax liability on any dividend distributions after 2017 while the *TCJA* provisions are in effect. Paymaster Corporation has U.S.-source taxable income of $40,000. Paymaster Corporation distributes $7,000 to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 8% of Paymaster, and was in the 15% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $4,900 DRD ($7,000 x 70%) and incurred a tax liability on the dividend of $315 (($7,000-$4,900) x 15%). In 2019, Recipient receives a $3,500 DRD ($7,000 x 50%) and incurs a tax liability on the dividend of $735 (($7,000-$3,500) x 21%), an additional $420 tax burden on the distribution under the new DRD percentage and corporate tax rate.

If Recipient was in the 25% corporate tax bracket for 2017, Recipient Corporation would have received a $4,900 DRD ($7,000 x 70%) and would have incurred a tax liability on the dividend of $525 (($7,000-$4,900) x 25%). In 2019, Recipient receives a $3,500 DRD ($7,000 x 50%) and incurs a tax liability on the dividend of $735 (($7,000-$3,500) x 21%), an additional $210 tax burden on the distribution under the new DRD percentage and corporate tax rate.

The Change from 80% to 65%

The change in dividend percent and tax rate results in an increased tax liability for corporations in the highest and lowest brackets. Assume Paymaster Corporation, has U.S.-source taxable income of $20 million. Paymaster Corporation distributes $7 million to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 39% of Paymaster, and was in the 35% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $5,600,000 DRD ($7,000,000 x 80%) and would have incurred a tax liability on the dividend of $490,000 (($7,000,000-$5,600,000) x 35%). In 2019, Recipient receives only a $4,550,000 DRD ($7,000,000 x 65%) and incurs a tax liability on the dividend of $514,500 (($7,000,000-$4,550,000) x 21%). Recipient Corporation experiences an additional tax burden of $24,500 on the distribution under the new DRD percentage and corporate tax rate.

Assume, alternatively, that Paymaster Corporation has taxable income of $40,000, and distributes $7,000 to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 39% of Paymaster, and was in the 15% corporate tax bracket for 2017. Recipient Corporation would have received a $5,600 DRD ($7,000 x 80%) and would have incurred a tax liability on the dividend of $210 (($7,000-$5,600) x 15%). In 2019, Recipient only receives a $4,550 DRD ($7,000 x 65%) and incurs a tax liability on the dividend of $515 (($7,000-$4,550) x 21%), an additional $305 tax burden on the distribution under the new DRD percentage and corporate tax rate.

If Recipient was in the 25% corporate tax bracket for 2017, Recipient Corporation would have received a $5,600 DRD ($7,000 x 80%) and would have incurred a tax liability on the dividend of $350 (($7,000-$5,600) x 25%). In 2019, Recipient receives only a $4,550 DRD ($7,000 x 65%) and incurs a tax liability on the dividend of $515 (($7,000-$4,550) x 21%), an additional $165 tax burden on the distribution under the new DRD percentage and corporate tax rate.

The taxable income limitation percentages have also been adjusted to reflect the percentage changes outlined in the TCJA. The shift here produces markedly different results from the scenarios where the dividend percentages are applied to the dividend paid.

The Change from 70% to 50%

Assume Recipient Corporation, has U.S.-source taxable income of $20 million. Paymaster Corporation distributes $22 million to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 8% of Paymaster, and was in the 35% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $14,000,000 DRD ($20,000,000 x 70%) and would have incurred a tax liability on the dividend of $2,800,000 (($22,000,000-$14,000,000) x 35%). In 2019, Recipient receives a $10,000,000 DRD ($20,000,000 x 50%) and incurs a tax liability on the dividend of $2,520,000 (($22,000,000-$10,000,000) x 21%).

Assume Recipient has U.S.-source taxable income of $40,000, and Paymaster distributes $45,000 to Recipient Corporation. Recipient Corporation owns 8% of Paymaster, and was in the 15% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $28,000 DRD ($40,000 x 70%) and incurred a tax liability on the dividend of $2,550 (($45,000-$28,000) x 15%). In 2019, Recipient receives a $20,000 DRD ($40,000 x 50%) and incurs a tax liability on the dividend of $5,250 (($45,000-$20,000) x 21%), an additional $2,700 tax burden on the distribution under the new DRD percentage and corporate tax rate.

If Recipient was in the 25% corporate tax bracket for 2017, Recipient Corporation would have received a $28,000 DRD ($40,000 x 70%) and incurred a tax liability on the dividend of $4,250 (($45,000-$28,000) x 25%). In 2019, Recipient receives a $20,000 DRD ($40,000 x 50%) and incurs a tax liability on the dividend of $6,250 (($45,000-$20,000) x 21%), an additional $2,000 tax burden on the distribution under the new DRD percentage and corporate tax rate.

The Change from 80% to 65%

Assume Recipient Corporation, has U.S.-source taxable income of $20 million. Paymaster Corporation distributes $22 million to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 39% of Paymaster, and was in the 35% corporate tax bracket for 2017. In 2017 Recipient Corporation would have received a $16,000,000 DRD ($20,000,000 x 80%) and would have incurred a tax liability on the dividend of $1,400,000 (($22,000,000-$16,000,000) x 35%). In 2019, Recipient receives only a $13,000,000 DRD ($20,000,000 x 65%) and incurs a tax liability on the dividend of $1,890,000 (($22,000,000-$13,000,000) x 21%). Recipient Corporation experiences an additional tax burden of $490,000 on the distribution under the new DRD percentage and corporate tax rate.

Assume, alternatively, that Recipient Corporation has taxable income of $40,000, and Paymaster distributes $45,000 to Recipient Corporation, a U.S. corporate shareholder. Recipient Corporation owns 39% of Paymaster, and was in the 15% corporate tax bracket for 2017. Recipient Corporation would have received a $32,000 DRD ($40,000 x 80%) and would have incurred a tax liability on the dividend of

$1,950 (($45,000-$32,000) x 15%). In 2019, Recipient only receives a $26,000 DRD ($40,000 x 65%) and incurs a tax liability on the dividend of $3,990 (($45,000-$26,000) x 21%), an additional $2,040 tax burden on the distribution under the new DRD percentage and corporate tax rate.

If Recipient was in the 25% corporate tax bracket for 2017, Recipient Corporation would have received a $32,000 DRD ($40,000 x 80%) and would have incurred a tax liability on the dividend of $3,250 (($45,000-$32,000) x 25%). In 2019, Recipient receives only a $26,000 DRD ($40,000 x 65%) and incurs a tax liability on the dividend of $3,990 (($45,000-$26,000) x 21%), an additional $740 tax burden on the distribution under the new DRD percentage and corporate tax rate.

CONCLUSION

A critical question covering the TCJA is whether the changes will increase or decrease a taxpayer's overall tax liability. Focusing just on dividends paid to a corporate shareholder alone, it is clear that there is not a clean-cut answer to that question. If a corporate shareholder receives a dividend derived from foreign-source income they will experience a lower tax liability produced by the dividend. Prior to 2018, a dividends-received deduction was not allowed for foreign-source dividends. The *TCJA* enacted a 100% dividends-received deduction for foreign-source dividends eliminating all tax liability associated with those dividends. In terms of U.S.-source income, it is more difficult to determine if the shareholder experiences a tax savings or an additional tax liability. All corporate shareholders are now subject to a flat tax rate of 21%, so if a shareholder, in prior years, was in a lower tax bracket (i.e. 15%) they will now experience a larger tax liability on the dividend. Additionally, the dividends-received deduction percentages were decreased under the TCJA. The only escapees of an increase in the tax liability associated with the payment of a U.S.-source dividend is the corporate shareholder in the highest bracket that owns less than 20% of the payer corporation and those corporations that wholly own their U.S. subsidiaries.

ENDNOTES

1. I.R.C. § 245A(d).
2. I.R.C. § 961(a).
3. I.R.C. § 951A(a).
4. I.R.C. § 951A(c)(2).
5. I.R.C. § 951A(a).
6. Joint Committee on Taxation, General Explanation of Public Law No. 115–97 (JCS–1–18), December 2018.
7. I.R.C. § 59A(a).
8. I.R.C. § 59A(c).
9. I.R.C. § 243
10. Id

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Joint Committee on Taxation, General Explanation of Public Law No. 115–97