CLIENT ALERT

Tax Reform in Small Bites: Phantom Income for Funds and their Investors

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This is one in a series of articles analyzing the impact of tax reform on investment funds and their portfolio companies. Click here to see all articles in the series.

As part of shifting closer to a “territoriality system” of international tax, the Tax Cuts & Jobs Act (TCJA) imposes a one-time “deemed repatriation” tax on accrued earnings of certain foreign corporations. Limited partners and sponsors of investment funds with foreign investments could recognize a significant amount of phantom income as a result of this provision. Furthermore, investment funds will need to consider this potential liability in future acquisitions of foreign corporations (or of U.S. corporations with foreign subsidiaries).

The deemed repatriation inclusion applies where a foreign corporation is a “controlled foreign corporation” (CFC) ***or*** where a foreign corporation has at least one 10 percent shareholder that is a U.S. corporation. Generally, a CFC is a foreign corporation that is at least 50 percent owned by 10 percent U.S. shareholders. Investment funds have often structured ownership of foreign investments to avoid CFC classification. However, the TCJA also changed the attribution rules for determining CFC status. As a result of that change, many foreign corporations that were not formerly CFCs have become CFCs, with the change retroactive to 2017. For example, this change in status will likely affect foreign corporations owned by a foreign parallel partnership, where the foreign partnership has the same owners as the U.S. fund.

The “10 percent U.S. shareholder” of the CFC (*e.g.*, the U.S. fund) will be required to include in income its pro rata share of the amount deemed repatriated from the CFC. The inclusion is effective on December 31, 2017, for CFCs with a calendar taxable year, or on the last day of a CFC’s 2017-2018 fiscal year, for other CFCs. The rate of federal income tax on the inclusion depends on the type of assets held by the CFC—generally the rate is 15.5 percent for cash and certain other liquid assets, and 8 percent for other assets. Generally, the liability can be paid over an eight-year period.

Investment funds that currently own or on December 31, 2017 owned, interests in foreign corporations should consider whether they (and their limited partners and sponsors) will be subject to this deemed repatriation tax, and if so, should begin to quantify their liability for any resulting tax. Funds making investments in foreign corporations (or U.S. corporations that have foreign subsidiaries) will need to do due diligence to determine whether they could be inheriting a deemed repatriation liability.

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