By **Carl A. Merino** & **James Murray**

U.S. Owners of Foreign Corporations Face New Hurdles

The innocent found GILTI

The Tax Cuts and Jobs Act of 2017 (TCJA) had a dramatic impact on U.S. owners of closely held foreign corporations. TCJA overhauled many international provisions of the Internal Revenue Code, but few areas saw as many changes as the controlled foreign corporation (CFC) rules. These changes were part of a broader constellation of provisions targeted at U.S. multinational corporations that were intended to reduce incentives for U.S. companies to shift earnings overseas without putting U.S. companies doing business abroad at a competitive disadvantage. These provisions generally operate to force the taxable repatriation of earnings from foreign subsidiaries (whether or not such earnings are actually distributed), but at reduced tax rates.

U.S. citizens and residents who own stock in closely held foreign corporations—particularly those subject to the CFC rules—have been greatly impacted by these changes. In many respects, they're treated more harshly than the multinational corporations these rules targeted. This has forced a re-examination of many existing structures, including outbound planning structures for U.S. persons and even certain inbound planning structures set up by non-U.S. investors.

Following is an overview of key changes to the CFC rules, with a focus on the new tax regime for global intangible low-taxed income (GILTI) and how it affects individual U.S. shareholders of CFCs. We consider the potential for phantom income and double taxation, as well as a number of mitigation strategies, with an eye toward balancing U.S. and foreign tax considerations. As the examples below illustrate, planning options depend greatly on a taxpayer's circumstances. For example, some options that may work for a U.S. citizen or resident living in the United States may not be viable for a U.S. citizen living abroad who's a tax resident of another country. There's no "one size fits all" approach that will work for everyone.

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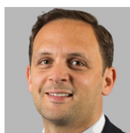

Overview of CFC Rules

U.S. shareholder and CFC status. A foreign corporation is a CFC if it's owned more than 50 percent (by vote or value) by "U.S. shareholders."[1] A U.S. person is a U.S. shareholder with respect to a CFC if he owns at least 10 percent of the CFC's stock (again, by vote or value).[2] For purposes of this test, a U.S. person may be treated as owning shares held by U.S. family members: spouses, parents, grandparents and children. There's also attribution—subject to certain limitations—from corporations, partnerships or trusts to shareholders, partners and beneficiaries (and vice versa).[3] There's no family attribution from siblings or from family members who are nonresident aliens.[4]

Phantom income inclusions. If a foreign corporation is a CFC, then U.S. shareholders of the CFC who own their shares directly or indirectly through foreign entities on the last day of the CFC's taxable year may be taxed currently on the "subpart F" income of the CFC (that is, as phantom income) based on their proportionate interests, even if no earnings are distributed.[5] Further, certain U.S. investments by a CFC can cause earnings that weren't previously taxable in the United States to be carried out to the U.S. shareholders in the same manner as subpart F income.[6] Subpart F income inclusions generally are limited to current year earnings and profits of the CFC (subject to a recapture rule).[7] Phantom income inclusions triggered by an investment

in U.S. property can pull up accumulated earnings and profits from prior years.[8]

"Traditional" subpart F income includes most types of passive investment income and certain types of related party sales and services income but doesn't include most types of active business income from an operating company. However, TCJA broadened the categories of CFC income subject to phantom income inclusions under the new GILTI regime to include most types of active business income.[9] Thus, even CFCs that earn primarily operating income from an active trade or business can generate significant amounts of phantom income for U.S. shareholders.

The basic measure of GILTI is the excess of a U.S. shareholder's "net CFC tested income" over the "net deemed tangible income return."

If a foreign corporation is a CFC for only a portion of its taxable year—for example, because a shift in beneficial ownership triggers CFC status midyear—then only a fraction of the total subpart F income for that year is taxable to the U.S. shareholders. The inclusion amount is the fraction of the total subpart F income recognized by the corporation during its taxable year (including income recognized before it became a CFC) determined by dividing the number of days of CFC status by the total number of days in the corporation's taxable year.[10] A similar fractional inclusion rule applies for purposes of determining the portion of CFC-level items that factor into the calculation of a U.S. shareholder's GILTI inclusion.[11] In both cases, there's no "closing of the books" when a foreign corporation becomes a CFC midyear.

Once earnings are taxed either as subpart F income or GILTI, they're tracked as "previously taxed earnings and profits." Subject to certain exceptions, these previously taxed earnings aren't taxed a second time when they're distributed by the CFC.[12] Additionally, amounts included in subpart F income or GILTI generally are added to the U.S. shareholder's basis in the stock of the CFC (or the interest in the intermediate entity that owns the CFC), reducing gains on future sales or redemptions.[13]

Changes to CFC Rules Under TCJA

TCJA introduced several key changes to the CFC rules, which have had the effect of broadening the reach of the CFC regime, both by pulling more foreign corporations and U.S. taxpayers into the net and by expanding the types of foreign income subject to current U.S. taxation:

1. Elimination of voting control requirement.
2. Modification of attribution rules.
3. Elimination of requirement that corporation be a CFC for 30 consecutive days in a taxable year for there to be a phantom income inclusion.
4. Transition tax on deferred foreign income of "specified foreign corporations" (including CFCs).
5. The GILTI tax, which dramatically expands the types of income of a CFC that are currently includible in a U.S. shareholder's gross income.

Each of these changes is discussed in more detail below:

Elimination of voting control requirement. Until TCJA went into effect, a U.S. person wasn't considered a U.S. shareholder for purposes of the CFC rules unless he owned at least 10 percent of the corporation's voting stock. However, TCJA eliminated the voting stock requirement.[14] Taxpayers will no longer be able to avoid U.S. shareholder status or prevent a foreign corporation from becoming a CFC by holding only nonvoting stock and concentrating ownership of the voting stock in the hands of non-U.S. shareholders. This provision was aimed at so-called "de control" transactions used by multinational groups to avoid the CFC rules, but it also impacts many family-owned businesses that until now were able to avoid CFC status by concentrating the voting stock in the hands of non-U.S. family members.

Modification of attribution rules. TCJA also modified the attribution rules to allow downward attribution from non-U.S. shareholders, partners and beneficiaries to U.S. corporations, partnerships and trusts.[15] As a result of these changes, ownership of U.S. and foreign brother-sister subsidiaries by a common foreign parent corporation that isn't itself a CFC can cause the foreign subsidiaries to become CFCs due to attribution of ownership of the foreign subsidiaries from the foreign parent

down to the U.S. subsidiaries, even though the U.S. subsidiaries have no direct or indirect stock ownership in the foreign subsidiaries. This can expose U.S. owners of the foreign parent, who didn't previously have to worry about the CFC rules, to phantom income inclusions from the foreign subsidiaries.[16] This situation also can arise with foreign investment fund structures, including many family-owned investment structures, when U.S. and non-U.S. companies are held under the same offshore fund umbrella.

Elimination of the 30-day rule. Under prior law, a foreign corporation had to be a CFC for an uninterrupted period of at least 30 days or more during a taxable year before there was a subpart F income inclusion for the U.S. shareholders. However, the 30-day requirement was eliminated from the Internal Revenue Code. Now, if a foreign corporation is a CFC for even one day of its taxable year, there could be subpart F income inclusion, albeit only on a fractional basis, taking into account the ratio of the number of days of CFC status to the total number of days in the foreign corporation's taxable year.[17]

Transition tax. Most U.S. shareholders of CFCs have already wrestled with the impact of the one-time transition tax on their 2017 tax returns, but it will still have an impact on future tax returns and payments. The transition tax under IRC Section 965 affected U.S. shareholders of specified foreign corporations (SFCs). A foreign corporation is an SFC if it either: (1) is a CFC, or (2) has at least one 10 percent shareholder that's a U.S. corporation.[18] If an SFC had post-1986 earnings not previously subject to tax in the United States, which accrued while it was an SFC, then its U.S. shareholders were taxed on such earnings in the last taxable year of such corporation beginning before Dec. 31, 2017.[19] For U.S. individuals with stock in SFCs that followed a calendar year (or who were majority shareholders), this generally would have resulted in a transition tax liability for the 2017 tax year.

The repatriated earnings were taxable to U.S. shareholders as subpart F income under IRC Section 951(a), but with a partially offsetting deduction under IRC Section 965(c) designed to reduce the effective tax rate to a range of 8 percent to 15.5 percent. The higher rate applied to the extent of the U.S. shareholder's proportionate share of foreign cash and equivalents held in the foreign corporation.[20] For individuals subject to the transition tax in 2017, the effective rate was often slightly higher due to the mechanics of the deduction, ranging from 9 percent to 17.5 percent. In many cases, U.S. shareholders were taxed on earnings accrued by the corporation before they became shareholders of the CFC.

The transition tax is payable in installments over an 8-year period if an election was timely filed.[21] Additionally, as confirmed by the IRS in guidance issued last December, amounts subject to the transition tax will be treated as previously taxed earnings and profits, meaning that subsequent distributions of such income generally will be tax free.[22] There will also be a basis step-up under IRC Section 961(a).[23]

TCJA created two new foreign tax credit baskets—one for GILTI and one for foreign base income.

GILTI

Prior to TCJA, the CFC rules generally didn't tax active business income of a CFC on a look-through basis, other than certain types of related party sales and services income. The overall distinction between active and passive income goes back to the original subpart F rules introduced in 1962 and reflects a longstanding recognition that operating income of a bona fide business doesn't present the same potential for abuse as more "mobile" types of income, such as passive investment income. However, TCJA largely eliminated this distinction with the introduction of the new GILTI regime, which taxes U.S. shareholders of CFCs on their pro rata shares of GILTI in roughly the same manner as subpart F income.[24] Although the GILTI regime was originally intended as an anti-base erosion measure to prevent U.S. companies from shifting mobile intangible income to low tax jurisdictions overseas, Congress adopted a formula that essentially taxes most active business income of a CFC in a manner similar to subpart F income, with some key computational differences.

Calculation of GILTI. The basic measure of GILTI is the excess of a U.S. shareholder's "net CFC tested income" over the "net deemed tangible income return."[25] Very broadly stated, this means that GILTI picks up the

excess of gross income (with certain carve-outs) over a hurdle rate intended to approximate a reasonable return on tangible depreciable property placed in service by the CFC.[26]

Many of the mechanics of these calculations were left to the IRS, which issued its first tranche of proposed regulations on Sept. 13, 2018 (the proposed GILTI regs).[27] The proposed GILTI regs were followed by proposed regulations on foreign tax credits issued on Nov. 28, 2018 (the proposed Foreign Tax Credit regs),[28] preliminary guidance on the tracking of previously taxed earnings and profits issued on Dec. 14, 2018 (Notice 2019-01)[29] and proposed regulations on the IRC

The transition tax and GILTI tax regimes may impact closely held family businesses overseas.

Section 250 deduction for GILTI and foreign-derived intangible income issued on March 4, 2019 (the proposed Section 250 regs).[30] IRS officials have indicated that they expect to issue final GILTI regulations in June 2019.[31]

Here's how GILTI generally is calculated:

- The "tested income" or "tested loss" of a given CFC is determined by: (1) taking the modified gross income, (2) excluding items already taken into account as subpart F income, items that would be subpart F income but for certain statutory exclusions and income that's effectively connected with a U.S. trade or business, and (3) netting out allowable deductions in a manner similar to how items of net income would be calculated to determine a CFC's subpart F income.[32] A U.S. shareholder's net CFC tested income is determined by taking the aggregate of his pro rata share of tested income and tested loss for each CFC.
- The net deemed tangible income return is determined by applying a hurdle rate of 10 percent to the U.S. shareholder's aggregate share of depreciable tangible property used in a trade or business of each CFC that generates tested income with certain adjustments for interest expenses (qualified business asset investment (QBAI)). The regulations don't include QBAI of a CFC that doesn't generate tested income in a given year.[33] QBAI of a tested income CFC is the average of the aggregate adjusted bases of its tangible depreciable property placed in service as measured at the end of each quarter.[34] Adjusted basis is determined using straight-line depreciation under IRC Section 168(g) from the date of acquisition of the depreciable property, with adjustments for partial years.[35] This generally means that as property is depreciated, it will contribute less and less to the hurdle rate, increasing the amount of income subject to GILTI.[36]
- The net deemed tangible income return is then subtracted from the U.S. shareholder's net CFC tested income to arrive at his GILTI inclusion.[37]

GILTI calculated on aggregate basis. One key difference between subpart F income and GILTI is that subpart F income is calculated on a CFC-by-CFC basis, whereas GILTI is calculated on an aggregate basis at the U.S. shareholder level, taking into account all of the CFCs owned by the U.S. shareholder. This reflects the origin of GILTI as a base erosion measure targeted at multinationals with intangible income spread across multiple foreign subsidiaries.[38]

IRC Section 951A(e)(1) provides generally that a U.S. shareholder's GILTI inclusion "shall be determined under the rules of section 951(a)(2) in the same manner as such section applies to subpart F income," but there are a number of computational differences introduced in the proposed GILTI regs to take into account the fact that both net CFC tested income and the hurdle rate are determined on an aggregate basis. For example, while subpart F income generally is capped by current year earnings and profits in a given basket (subject to recapture), there's no earnings and profits cap for GILTI.[39] This also presents complications for CFCs held by domestic partnerships in which some U.S. partners may have GILTI inclusions solely on account of their distributive shares of partnership income, while other U.S. partners might be U.S. shareholders in their own right because they own interests in the CFCs outside the partnership. In the latter case, the components of GILTI that flow up from the partnership must be aggregated with components from other CFCs.[40]

Previously taxed earnings and basis step-up. Per Notice 2019 01, Section 959 and 961 regulations will be amended to track previously taxed earnings and profits arising from GILTI inclusions, the transition tax and other new provisions introduced by TCJA and provide for associated basis adjustments for U.S. shareholders. This has implications for U.S. shareholders who wish to use foreign tax credits for foreign taxes paid by the CFC.[41] IRC Section 904(a) limits the availability of foreign tax credits by the ratio of foreign source income to worldwide income in the relevant income basket; hence, the need to track the associated foreign earnings. However, the mechanics of how different earnings pools will be tracked and how basis adjustments will be made are highly complex and won't be fully fleshed out until proposed regulations are issued. The IRS and Treasury Department have requested comments on a number of key points.

Separate basket for GILTI. TCJA created two new foreign tax credit baskets—one for GILTI and one for foreign base income.[42] Unlike income in the other foreign tax credit baskets, foreign tax credits for GILTI are capped at 80 percent of the associated foreign taxes paid and may not be carried forward to future tax years or back to preceding tax years.[43]

Disparate impact on individuals: lack of deduction or foreign tax credit. What makes the GILTI regime problematic for U.S. individuals and trusts that are U.S. shareholders is the disparate treatment of corporate and non-corporate shareholders under the GILTI regime. Domestic C corporations that are U.S. shareholders of CFCs are eligible for a 50 percent deduction with respect to GILTI.[44] This is on top of a reduction in corporate tax rates to 21 percent, meaning that U.S. corporations will generally be taxed at a 10.5 percent rate on GILTI until the deduction is reduced to 37.5 percent in 2026 and at a 13.125 percent rate thereafter.[45] Corporate shareholders also can claim foreign tax credits under Section 960(d) with respect to 80 percent of the foreign taxes allocable to GILTI, further reducing the effective tax rate.

In contrast, individuals are taxed on GILTI at a 37 percent rate (plus state income tax and the 3.8 percent Medicare tax as applicable), with no deemed credit under Section 960. However, there are measures that individuals who are U.S. shareholders of CFCs can take to bring their tax treatment closer to parity with their corporate counterparts. For example, they can reduce the tax rate on subpart F income to 21 percent and their tax rate on GILTI to 10.5 percent (with the Section 250 deduction) and claim indirect foreign tax credits against their remaining subpart F income and GILTI tax liabilities by making an IRC Section 962 election (discussed in the following illustration). Some of the mechanics of the Section 962 election and how it interacts with the transition tax and GILTI provisions won't be fully clear until final regulations are issued, but the proposed Section 250 regs allowing individuals, estates and trusts making the election to claim a Section 250 deduction to reduce their GILTI tax rate to 10.5 percent makes the election much more attractive relative to other mitigation strategies.

Example of Possible Impact

The transition tax and GILTI tax regimes could impact many closely held family businesses overseas. Consider this example:

X Co is a corporation incorporated in Country X, where it conducts an active services business with hundreds of employees at multiple locations. X Co was built up by the family patriarch, a nonresident alien for U.S. federal tax purposes, but now has majority U.S. ownership as second and third generation family members have come to the United States or become U.S. citizens. Enough U.S. family members own 10 percent or more of X Co (directly, indirectly or by attribution) to trigger CFC status. Some of these U.S. family members live in the United States, and some live in Country X or other jurisdictions. Country X doesn't have an income, gift or estate tax treaty with the United States.

One-time transition tax. Assuming most of X Co's income was operating income from an active business conducted in Country X, CFC status likely would have been manageable prior to TCJA because, generally, only passive income would have flowed up to the U.S. family members as subpart F income.[46] However, with the enactment of TCJA, earnings accrued in prior years while X Co was a CFC would have been subject to the transition tax in 2017 under Section 965.[47] The deferred foreign income would have been taxed as subpart F income, but generally at an effective rate of 9 percent to 17.5 percent (slightly higher than the rates that would apply to a domestic corporation), depending on the balance of cash and other liquid assets held by the CFC.

This tax may be paid in installments over an 8-year period if the taxpayer timely made an election under Section 965(h).

How a given taxpayer was affected by the transition tax would have depended on his particular circumstances:

- Absent a Section 962 election (discussed below), U.S. shareholders would have been subject to the transition tax in 2017 with respect to post-1986 earnings and profits accumulated after X Co became a CFC, without any foreign tax credits for the foreign corporate taxes paid by the CFC (although a deduction would be allowable against the earnings). There would be no corresponding income event in Country X. However, a subsequent distribution of this previously taxed income in a later tax year generally would be tax free in the United States, but could be subject to tax in Country X as a dividend.
- Foreign tax credits are limited by the ratio of foreign source income to worldwide income.[48] Thus, a foreign tax event that doesn't generate foreign source income in the United States may not be creditable in the same tax year. There's a limited resourcing rule in the IRC that's intended to correct for situations in which there's a subpart F income inclusion in one year and a foreign tax event in a subsequent year, but there still must be enough overall income for U.S. tax purposes for this to work.[49] Further, a U.S. shareholder who's a tax resident of another country could face potential double taxation if the other country doesn't grant the taxpayer a tax credit for the transition tax paid in the United States. There may be an opportunity to use certain excess foreign tax credits from other sources, depending on the basket the income is allocated to.
- Many shareholders filed elections under Section 962 to mitigate the risk of double taxation. Section 962 allows an individual who's a U.S. shareholder of a CFC to elect to be taxed (in part) in the same manner as a domestic corporation on the subpart F income of the CFC.[50] This would have enabled him to use a portion of the indirect foreign tax credits under Section 960 for foreign taxes previously paid by the CFC on the earnings subject to the transition tax.[51] This also would have brought the effective tax rate down to the same 8 percent to 15.5 percent range that would apply to U.S. corporations.[52] Subsequent distributions would then be taxable, but this may not have been an issue if such distributions would be subject to tax in Country X anyway. The mechanics of Section 962 are discussed in more detail in the GILTI discussion below.
- On the other hand, if Country X doesn't tax dividends paid by X Co to non-Country X shareholders (for example, taxpayers living in the United States), the transition tax could have been a windfall for some shareholders, particularly if X Co regularly pays dividends. Ordinary dividends from a non-treaty eligible foreign corporation are taxed at rates of up to 40.8 percent (including the 3.8 percent Medicare tax, but not including state or local taxes). However, the transition tax would have converted future dividends out of accumulated post-1986 earnings and profits into a transition tax liability imposed at a rate of 9 percent to 17.5 percent payable over eight years. Notwithstanding that the transition tax would have been imposed at roughly one-third of the rate that would have applied to actual dividends, the full amount subject to the tax would be tracked as previously taxed income. Thus, future distributions would come out tax free, even though the earnings were taxed at a greatly discounted rate.

> GILTI is taxable to individuals at rates of up to 37 percent (not including the 3.8 percent Medicare tax or state income taxes), with no credit for foreign taxes paid by the CFC (absent further elections or planning).

GILTI: 2018 and future tax years. Beginning with the 2018 tax year, U.S. family members will have to

contend with GILTI tax exposure. Operating income that previously was carved out of the CFC rules because it wasn't subpart F income could now flow up to the U.S. shareholders as GILTI. GILTI is taxable to individuals at rates of up to 37 percent (not including the 3.8 percent Medicare tax or state income taxes), with no credit for foreign taxes paid by the CFC (absent further elections or planning). Further, a CFC's hurdle rate will be limited to its adjusted basis in tangible depreciable property placed in service. To the extent it owns its own buildings and equipment used in the business and has sufficient basis in both, it may have a high enough hurdle rate to shield a fair amount of its income from GILTI. However, in the case of X Co, because it's a service business, it's likely that most of its operating income will be taxable to its U.S. shareholders in the year it's earned.

GILTI presents many of the same timing issues as the transition tax. U.S. shareholders have an income event in the United States in Year 1 when the CFC earns income that's treated as GILTI. However, there's no income event in Country X from the standpoint of the U.S. shareholders until earnings are actually distributed in the form of a dividend in Year 2. This creates potential for double (or triple) taxation:

- First, X Co itself is subject to corporate income tax in Country X.
- Second, the U.S. shareholders are taxed on all or a portion of the same income (subject to the hurdle rate) as GILTI.[53]
- Third, when X Co pays a dividend to its shareholders, that dividend may be tax free in the United States as a distribution of previously taxed earnings, but may be subject to tax in Country X or in another country where a U.S. shareholder resides. If his country of residence doesn't offer a foreign tax credit for the GILTI tax paid in the United States, and the timing of the distribution isn't appropriately managed, the taxpayer could be subject to a nearly confiscatory tax rate after all U.S. and Country X (or Country Y) taxes are taken into account.

There are a number of options for mitigating GILTI tax exposure:

1. "Checking the box" (filing an entity classification election) to treat the foreign corporation as a partnership for U.S. tax purposes.
2. Contributing stock in the foreign company to a new U.S. corporation to take advantage of more favorable rules for U.S. corporate shareholders.
3. Making a Section 962 election to reduce the tax rate on GILTI, take advantage of indirect foreign tax credits and avoid timing mismatches in the recognition of income in both countries.

Each of these strategies has its own trade-offs:

Checking the box. The owners could agree to file an entity classification election (IRS Form 8832) to treat the foreign company as a partnership for U.S. tax purposes. This would turn off CFC status. After the election, U.S. owners would be taxed on the underlying income on a flow-through basis (which isn't too dissimilar to the GILTI regime), but items of income, gain, loss and deduction would retain their character. Partners of a foreign partnership are entitled to a proportionate share of the foreign tax credits for any creditable foreign taxes paid by the partnership,[54] so U.S. owners would be able to claim foreign tax credits with respect to income tax paid by X Co in Country X.[55] However, there are potential drawbacks, particularly for a company that's already a going concern:

- The election would trigger a deemed liquidation of the corporation for U.S. federal tax purposes on the day immediately preceding the effective date of the election.[56] The inside gain would be taxable to the U.S. shareholders as GILTI, and there would be no foreign tax credits associated with the election itself to offset that liability. This could make this option prohibitively costly from a U.S. tax standpoint for an existing business that's appreciated in value.
- U.S. shareholders who live in Country X or another non-U.S. jurisdiction would have a stepped-up basis in the assets of the corporation for U.S. tax purposes, but not for Country X (or Y) purposes. A subsequent sale of those assets could be fully taxable in the other country without a credit for the U.S. tax paid when the election was made.
- Even without GILTI or potential subpart F exposure, the U.S. owners could recognize taxable gain on the deemed sale of their shares of the foreign corporation resulting from the deemed liquidation of the corporation.

- U.S. owners who are below the 10 percent ownership threshold for U.S. shareholder status and who thus wouldn't be subject to subpart F income or GILTI inclusions under the CFC rules may be better off if X Co remains a foreign corporation so that they can enjoy the benefit of deferral, particularly if X Co wouldn't otherwise be a passive foreign investment company.
- Not all foreign business entities are eligible to check the box. For example, if the company is an S.A.,[57] it may have to be converted into another corporate form, which could raise additional issues in Country X. In short, checking the box may be a more viable option for structuring new ventures than for restructuring existing ones.

Many of the mechanics of how the Section 962 election interacts with the transition tax and GILTI provisions, as well as how previously taxed income is accounted for, remain to be clarified.

Contributing X Co stock to U.S. Newco. U.S. family members could contribute their stock to a new U.S. corporation (Newco). If Newco owns at least 10 percent of the foreign company, the U.S. tax rate on GILTI would be reduced from 37 percent to 10.5 percent (plus the 3.8 percent Medicare tax as applicable) and possibly much lower after the 80 percent foreign tax credit is taken into account.[58] Subsequent distributions of foreign source income from the foreign corporation potentially could be eligible for the 100 percent dividends received deduction under IRC Section 245A. Even taking into account the shareholder level tax on dividends from Newco, this could significantly lower the effective tax rate on U.S. family members and match their income inclusions for tax purposes to the actual receipt of cash distributions. Although dividends from Newco would be taxable, they generally would be eligible for qualified dividend treatment (that is, taxable at a 20 percent rate, plus 3.8 percent Medicare tax as applicable). In a best-case scenario (that is, when GILTI is fully offset by foreign tax credits), U.S. shareholders who contribute their X Co shares to Newco could convert ordinary income into qualified dividends, reducing their effective tax rate by 17 percentage points.

However, there could be both U.S. and non-U.S. tax complications:

- If the foreign corporation was subsequently sold at a gain, there would be two levels of federal income tax in the United States—a 21 percent corporate level tax and an additional 23.8 percent tax from the liquidation of Newco.[59] This may not be a good option if the shareholders anticipate a sale in the near term. This issue would be further compounded if the X Co shares have already appreciated in value (because the built-in gain at the time the shares are contributed to Newco would be subject to the additional tax) or if corporate tax rates go up in the future. Taxpayers who plan to hold their shares long term may be willing to assume this risk, but it will be important to consider the monetization strategy.
- Newco will need to make sufficient distributions each year (or reinvest earnings in eligible ventures) to avoid the accumulated earnings and personal holding company taxes.[60]
- Although the contribution would be a nonrecognition event for U.S. tax purposes under IRC Section 351, it could be taxable in another country for U.S. shareholders who live abroad. Further, many other countries have adopted their own foreign anti-deferral rules similar to the CFC rules in the United States. For example, if Country X had adopted such a regime, a U.S. shareholder living in Country X who contributed his X Co stock to Newco would, for Country X purposes, have just transferred stock in a "domestic" company to a controlled "foreign" corporation, creating a sandwich structure that could subject him to phantom income inclusions in Country X and possibly to gain recognition on transfer.

- There also could be potential conflicts due to local anti-avoidance rules that may result in both the United States and Country X deeming any distribution to be domestic and, as such, not alleviate double taxation.
- Future distributions from X Co to Newco may be subject to dividend withholding tax in Country X as outbound transfers.

Section 962 election. A Section 962 election should reduce the tax rate on GILTI to 10.5 percent (the 21 percent corporate tax rate minus the 50 percent deduction for GILTI under Section 250) and enable U.S. family members who make the election to claim the 80 percent indirect foreign tax credit. There had been concern among practitioners that individuals who made the Section 962 election wouldn't be entitled to the Section 250 deduction. However, the IRS confirmed in the proposed Section 250 regs released on March 4, 2019 that individuals who make the election are entitled to the 50 percent deduction.[61] The tax rate would be 21 percent for "traditional" subpart F income (which isn't eligible for the Section 250 deduction), but foreign tax credits against subpart F income aren't subject to the same limitations as foreign tax credits attributable to GILTI.

Under Section 962(d), future distributions in excess of the actual tax paid aren't treated as previously taxed earnings, but rather are taxable distributions. The idea is that the taxpayer is electing to be taxed in part as a domestic corporation, so there should be two levels of tax (one at the notional corporate level and one at the shareholder level). However, this may not be an issue if those future distributions would have been taxable in Country X anyway. In fact, the election may solve a timing mismatch by reducing the impact of the U.S. tax event in the year GILTI is earned and shifting more of the U.S. tax burden to the year of distribution, when foreign tax credits from the taxes due in Country X from the dividend could be used to offset federal income taxes on the distribution. This could be critical for U.S. shareholders living abroad who may not have any other viable strategy to avoid a timing mismatch and an associated liquidity crunch when U.S. taxes would otherwise be due on their share of GILTI.

Due to the paucity of guidance on Section 962 over the years, there was an open question as to whether taxable distributions from a CFC out of earnings subject to a prior Section 962 election would be eligible for qualified dividend treatment (if the CFC was in a treaty jurisdiction) or would be considered foreign source income for crediting purposes (regardless of treaty eligibility). However, a recent case, *Smith v. Commissioner*,[62] shed some helpful light on both issues:

- The (simplified) facts involved a CFC organized in Hong Kong, which doesn't have a tax treaty with the United States.[63] The CFC reorganized in Cyprus in a transaction intended to qualify as an "F" reorganization. Distributions were made by the CFC both before and after it was reorganized in Cyprus. Following an audit in which the IRS determined that there was unreported subpart F income, the taxpayers amended their returns and made Section 962 elections with respect to the CFC. The question arose as to whether the subsequent distributions by the CFC (which were taxable under Section 962(d)) should be characterized as dividends from a foreign corporation or as dividends from a U.S. corporation, on the theory that the Section 962 election created a notional U.S. corporation for tax purposes.
- In this case, the taxpayer had little to gain from characterization of the subsequent distribution as a dividend from a Hong Kong corporation because the dividend wouldn't be a qualified dividend. Further, there was no foreign withholding tax to credit. Thus, the taxpayers argued that the distribution from the Hong Kong corporation should be treated as a qualified dividend from a domestic corporation. The Tax Court rejected this argument and held that Section 962(d) didn't operate to recharacterize the distribution as a dividend from a U.S. corporation.
- The question of whether a subsequent distribution made after the CFC was reorganized in Cyprus would be eligible for qualified dividend treatment wasn't resolved. There was a genuine issue of material fact as to whether the corporation was a resident of Cyprus for purposes of the United States–Cyprus income tax treaty and thus a qualified foreign corporation. However, the clear implication is that a dividend from a CFC subject to Section 962(d) is: (1) respected as a foreign source dividend, meaning that foreign withholding taxes should be creditable, and (2) potentially eligible for qualified dividend treatment if the corporation is

an eligible resident of a treaty jurisdiction.

Many of the mechanics of how the Section 962 election interacts with the transition tax and GILTI provisions, as well as how previously taxed income is accounted for, remain to be clarified. However, because the election can be made on a year-by-year basis, it may be less risky for many taxpayers than putting the CFC shares under a new corporate structure, at least pending further guidance.

On the other hand, there are situations in which a Section 962 election may not be able to fully mitigate the tax consequences of GILTI. For example, if X Co doesn't pay significant taxes in Country X and doesn't impose a tax on outbound dividends, a Section 962 election is helpful in bringing the tax rate on GILTI down to 10.5 percent and the tax rate on subpart F income down to 21 percent, but there won't be any foreign tax credits to offset the phantom income. [64] Further, this will come at the cost of making an otherwise tax-free distribution of previously taxed earnings fully taxable.

Although the IRS expects to issue final regulations by early summer, tax practitioners and their IRS counterparts will likely be sorting out the nuances of GILTI for years to come.

- The cost may be worth it if the subsequent distribution would be treated as a taxable dividend in Country X, in which case it would be important to avoid a timing mismatch.
- It also may be worth the cost of a second level of tax if Country X has a tax treaty with the United States and X Co is eligible for treaty benefits, in which case subsequent distributions would be taxed as qualified dividends at a 23.8 percent rate (including the 3.8 percent Medicare tax), bringing the combined federal tax rate to just under 32 percent (assuming no foreign tax credits or state income taxes).
- However, if X Co isn't organized in a treaty jurisdiction, then U.S. shareholders living in the United States may be better off contributing their shares to a U.S. Newco so that subsequent distributions from Newco will be eligible for qualified dividend treatment.[65] This would bring the combined federal tax rate on GILTI and subsequent distributions to just under 32 percent (before taking into account any state income taxes or foreign tax credits).

The bottom line is that it's critical to consider a taxpayer's particular circumstances in arriving at a strategy to manage GILTI. This consideration must include an analysis of the local tax implications in both the country where the corporation is resident or doing business and the country or countries where its U.S. shareholders reside.

High Tax Exception

As a general rule, the hurdle rate will be higher—reducing the amount of GILTI included in gross income of the U.S. shareholders—if a CFC owned by a U.S. shareholder uses a significant amount of tangible depreciable property in its business (such as factories and machinery) than if the business is more IP or services driven.[66] This is in keeping with the overall focus of the GILTI regime on forcing the repatriation of income from intangibles. However, as currently drafted, the GILTI provisions can inadvertently incentivize passive investments in certain circumstances:

- There's long been a "high tax" exception for subpart F income of a CFC that's taxed in a foreign country at an effective rate greater than 90 percent of the highest corporate tax rate that would apply in the United States.[67] As more and more countries reduced their corporate tax rates, this exception largely fell by the wayside. The historic 31.5 percent hurdle (90 percent of the 35 percent corporate tax rate in effect until TCJA) meant that fewer and fewer CFCs were taxed at a high enough rate outside of the United States to qualify.
- Now that U.S. corporate tax rates have come down to 21 percent, the high tax exception potentially

could shield subpart F income if the CFC is taxed at an effective rate above 18.9 percent. However, Section 951A preserves this exception only for income that's otherwise subpart F income.[68] On its face, it doesn't appear to cover active business income that would be picked up as GILTI rather than as subpart F income. Some commentators had hoped that the IRS might be able to offer relief in extending the high tax exception to non-subpart F income picked up by the GILTI regime. However, the Preamble to the proposed GILTI regs confirmed that the statutory language excludes from GILTI only income that's otherwise subpart F income.[69] If a CFC's earnings would be taxed at a high enough rate to qualify for the high tax exception, this now creates perverse incentives to ensure that the earnings would be considered passive income (and thus, subpart F income) to qualify for the high tax exception and take GILTI off the table.

- Until 2018, a U.S. shareholder who owned foreign rental properties located in another country through a CFC organized in that country generally would have wanted to qualify the rental operations as an active business to avoid subpart F income under Section 954(c)(2)(A). This would have required that the CFC manage the property and leasing operations actively with its own officers and employees. However, that same active rental income would now be subject to GILTI to the extent it exceeded the 10 percent hurdle rate. If the property was acquired recently and had a high basis, then the hurdle rate might be high enough to make GILTI exposure manageable, particularly with a Section 962 election to reduce the tax rate on GILTI and take advantage of indirect foreign tax credits. However, if the other country doesn't impose a withholding tax on dividends, the election comes at the cost of a second level of tax in the United States (without a corresponding foreign tax credit) when the U.S. shareholder receives dividends.
- If the other country's effective tax rate on the CFC's income is over 18.9 percent, then the U.S. shareholder would be better off if the rental income didn't qualify as an active business and was instead classified as traditional subpart F income. In that case, the U.S. shareholder wouldn't have any subpart F or GILTI income on account of the rent earned by the CFC because it would be excluded from both regimes under the high tax exception. Further, the U.S. shareholder wouldn't have to make a Section 962 election.

It's important to consider the type of income being generated, particularly now that the high tax exception is once again relevant in many jurisdictions. Given that the subpart F and GILTI regimes weren't fully meshed, there are still potential planning opportunities, as well as pitfalls. Although the IRS expects to issue final regulations by early summer, tax practitioners and their IRS counterparts will likely be sorting out the nuances of GILTI for years to come.[70]

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Endnotes

1. Internal Revenue Code Section 957(a).
2. IRC Section 951(b).
3. IRC Section 958.
4. Section 958(b)(1). Note that ownership could be attributed from a non-U.S. family member to a U.S. corporation, partnership or trust of which such non-U.S. person was a shareholder, partner or beneficiary.
5. Section 951(a).
6. Section 951(a)(1)(B) and IRC Section 956. The survival of this provision after the Tax Cuts and Jobs Act (TCJA) was a surprise to many practitioners. TCJA introduced a 100 percent dividends received deduction for foreign source dividends paid by a foreign subsidiary to its U.S. parent. If that foreign subsidiary instead made a U.S. investment that triggered Section 956, that investment could generate a subpart F income inclusion (assuming the U.S. parent owned enough stock of the subsidiary to cause it to be considered a controlled foreign corporation (CFC)).
7. IRC Section 952(c); Treasury Regulations Section 1.952-2.
8. Section 956(a)(2).
9. New Section 951A.
10. Section 951(a)(2).
11. Section 951A(e)(1).
12. IRC Section 959(a).
13. IRC Section 961.
14. Section 951(b) (as modified by TCJA).
15. IRC Section 958(b)(4), which prevented downward attribution, was repealed

by TCJA. However, Section 958(b)(1), which blocks family attribution from nonresident alien relatives, was left untouched.

16. Because subpart F income and global intangible low-taxed income (GILTI) inclusions are based on actual direct or indirect ownership, the U.S. subsidiaries wouldn't themselves be subject to phantom income inclusions with respect to earnings of the foreign parent or the foreign subsidiaries. Additionally, in Notice 2018-13 and the December 2018 revised Form 5471 instructions, the Internal Revenue Service added reporting exceptions that would exempt U.S. subsidiaries from unnecessary Form 5471 filings when their constructive ownership of a foreign corporation is solely by reason of downward attribution.
17. *See* Section 951(a)(2) (as modified by TCJA). The 30-day rule was useful in situations in which a nonresident alien whose estate benefited U.S. persons needed a foreign "blocker" corporation to invest in U.S. situs assets without risking a U.S. estate tax inclusion. This rule provided a 29-day window after the death of the non-U.S. owner during which the foreign blocker could "check the box" (file an entity classification election) to be disregarded for U.S. federal tax purposes, triggering a deemed liquidation that would step-up the basis of the underlying assets and prevent subpart F income inclusions for the U.S. beneficiaries under the CFC rules. The elimination of the 30-day rule means that it will be more difficult to unwind these structures after the non-U.S. person's death without some tax leakage.
18. IRC Section 965(e).
19. Section 965(a). For purposes of calculating the tax base, accumulated deficits in one specified foreign corporation potentially could offset accumulated earnings in another. A number of adjustments were required to account for intercompany transactions.
20. Section 965(c).
21. Section 965(h).
22. IRS Notice 2019-01 (Dec. 14, 2018). Earnings that would have been subject to the transition tax were they not offset by deficits in other specified foreign corporations are also treated as previously taxed earnings and profits and separately tracked as such.
23. *Ibid.* As discussed in Notice 2019-01, multiple accounts will have to be maintained to track the different categories of previously taxed earnings and profits.
24. As discussed below, there are a number of mechanical differences between how subpart F income and GILTI are calculated.
25. Section 951A(b).
26. As explained in the Preamble to the proposed GILTI regulations (proposed GILTI regs), Congress adopted this formulaic approach in part to avoid administrative difficulties in identifying income attributable to intangible assets.
27. REG-104390-18 (Sept. 13, 2018), 83 Fed. Reg. 51072 (Oct. 10, 2018).
28. The proposed Foreign Tax Credit regs included GILTI-related provisions primarily directed at U.S. corporations, but are also of possible relevance to non-corporate taxpayers who elect under IRC Section 962 to be taxed as corporations for purposes of the CFC rules. *See* REG-105600-18 (Nov. 28, 2018), 83 Fed. Reg. 63200 (Dec. 7, 2018).
29. Additional guidance on the tracking of previously taxed income and basis adjustments is pending per IRS Notice 2019-01. The IRS has requested comments on a number of open issues.
30. REG-104464-18 (March 4, 2019), 84 Fed. Reg. 8188 (March 6, 2019).
31. *See* BNA Daily Tax Report, "Treasury Pushing to Finish Final International Tax Rules By June" (Feb. 14, 2019).
32. *See* Prop. Treas. Regs. Section 1.951A-2. As explained in the Preamble, the proposed GILTI regs generally incorporate the approach used for subpart F income in Treas. Regs. Section 1.952 2 in looking to the losses that would be allowed to a domestic corporation. However, there are a number of open computational questions.
33. *See* Prop. Treas. Regs. Section 1.951A-3(c)(3).
34. Prop. Treas. Regs. Section 1.951A-3(c)(1).
35. Prop. Treas. Regs. Section 1.951A-3(e). The regulations provide for the use of the alternative depreciation system (ADS) in IRC Section 168(g) back to the date the property acquired, regardless of whether the property was acquired before or after the date of enactment of TCJA.
36. Because ADS entails straight-line depreciation, this will generally have the effect of slowing down the rate of depreciation and thus the associated

SPOT LIGHT

Self Reflection

Autoportrait à La Bastide-du-Vert by Henri Martin sold for £187,500 at Christie's Impressionist and Modern Art Day Sale in London on Feb. 28, 2019. A French Impressionist painter, Martin predominantly painted landscapes of French locales as well as numerous self portraits. He also completed a stint touring Italy. Martin became a member of the Legion of Honour in 1889.

decline of the hurdle rate.

37. Section 951A(a).
38. *See* Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 366 ("The Committee believes that calculating GILTI on an aggregate basis, instead of an a CFC by CFC basis, reflects the interconnected nature of a U.S. corporation's global operations and is a more accurate way of determining a U.S. corporation's global intangible income.")
39. *See* Section 951A(f); Notice 2019-01. This also requires special adjustments to the various previously taxed earnings tracking pools.
40. The proposed GILTI regs adopt a hybrid approach, with the components of GILTI determined at the partnership level for U.S. partners who aren't otherwise U.S. shareholders of any CFCs owned by the partnership and at the partner level for U.S. partners who are U.S. shareholders in their own right. *See* Prop. Treas. Regs. Section 1.951A-5.
41. As discussed below, only U.S. corporations can use indirect foreign tax credits for foreign taxes paid by the CFC under IRC Section 960(b). However, many individuals are now making elections under Section 962 to be taxed in part as domestic corporations to be able to claim such indirect foreign tax credits.
42. IRC Section 904(d)(1).
43. Section 960(d).
44. IRC Section 250.
45. Allocation of certain expenses to GILTI under the proposed Foreign Tax Credit regulations could impact the effective rate on GILTI.
46. If voting stock was concentrated in the hands of non-U.S. family members, X Co may have avoided CFC status altogether prior to TCJA, preventing application of the transition tax.
47. We've assumed for purposes of this illustration that the company has a calendar year. We note also that in many situations, particularly when there's a majority U.S. shareholder, IRC Section 898 would essentially force a calendar year for CFC reporting purposes.
48. Section 904(d).
49. Section 960(c)(1).
50. The election is also available to estates and trusts. If the CFC is owned by a U.S. or foreign partnership, only those partners who indirectly own at least 10 percent of the stock of the CFC are eligible to make the election (which must be made at the partner level). *See* Prop. Treas. Regs. Sections 1.962-2(a), 1.965-1(f)(9), 83 Fed. Reg. 39514 (Oct. 9, 2018); IRS Notice 2018-26, Section 5, Example.
51. In general, absent a Section 962 election, only U.S. corporations are eligible to claim indirect foreign tax credits for foreign taxes paid by a foreign corporate subsidiary.
52. There had been concerns among practitioners, based on language in the existing Section 962 regulations, that U.S. taxpayers who make the election might be ineligible to claim the offsetting deductions under Section 965(c) required to bring the effective tax rate down to the 8 percent to 15.5 percent range. However, the final transition tax regulations clarify that the offsetting deductions would be available. *See* Treas. Regs. Section 1.962-1(b)(1)(i)(8).
53. The Country X taxes paid would be treated as an expense that reduces gross income and thus GILTI, but it wouldn't be the same as a full credit, absent a Section 962 election.
54. Section 901(b)(5).
55. Note that if X Co has historic losses that offset its current Country X tax liabilities, there may not be any foreign tax credits to offset its U.S. income tax liabilities potentially necessitating tax distributions (although this would be an issue anyway under the GILTI and subpart F rules under the other two scenarios).
56. Treas. Regs. Section 301.7701-3(g)(1).
57. See Treas. Regs. Section 301.7701-2(b)(8). The designation of "S.A." in most jurisdictions means that the entity is a "per se" corporation and thus isn't eligible to elect pass-through treatment.
58. With an 80 percent foreign tax credit, the U.S. federal income tax on GILTI could be reduced to zero in this case if the effective foreign tax rate is over 13.125 percent.
59. Note that to the extent earnings weren't already picked up as subpart F income (including the transition tax) or GILTI, a portion of the gain could be recharacterized as a dividend under IRC Section 1248. This portion of the gain potentially could be eligible for the 100 percent dividends received deduction under IRC Section 245A, so it's possible that some of the gain would avoid corporate level tax.
60. *See* IRC Sections 531, 541.
61. Prop. Treas. Regs. Section 1.962-1(b)(1)(i)(B)(3). As explained in the Preamble to the proposed Section 250 regs, the IRS concluded that allowing the deduction was consistent with overall Congressional intent to put individuals who make a Section 962 election in the same after-tax position they would be in if they had invested through a domestic corporation.
62. *Smith v. Commissioner*, 151 T.C. 5 (2018).
63. Hong Kong isn't considered part of China for purposes of the income tax treaty between the United States and China. *See* IRS Notice 97-40.
64. As previously noted, this could be due to a low corporate tax rate in Country X or the availability of loss carryforwards that reduce the effective tax rate in Country X, but which don't have any impact on subpart F income or GILTI.
65. Assuming Newco owns at least 10 percent of X Co for a full year, it can receive foreign source dividends from X Co tax free under Section 245A.
66. This assumes the assets haven't already been depreciated.
67. Section 954(b)(4).
68. Section 951A(c)(2)(A).
69. Note that the proposed Foreign Tax Credit regulations introduced anti-abuse rules to prevent U.S. taxpayers from availing themselves of the high tax exception if it was reasonably certain that the foreign taxes paid by the CFC would be refunded to the shareholders on a subsequent distribution. *See* Prop. Treas. Regs. Section 1.954-1(d)(3) (as modified).
70. Note that a U.S. owner whose ownership is below the 10 percent threshold for U.S. shareholder status wouldn't want the rental activities to be passive, as this would likely cause the corporation to be treated as a passive foreign investment company.