Controlled Foreign Corp. Restructuring For US Taxpayers

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Few areas of the tax law were as heavily impacted by the Tax Cuts and Jobs Act as the rules governing the taxation of foreign income. TCJA introduced a number of changes targeting U.S. multinationals doing business abroad, including, among other things, a 100 percent deduction for qualifying foreign source dividends from foreign subsidiaries, a transition tax on deferred foreign income of specified foreign corporations, the new global intangible low taxed income, or GILTI, tax regime and other provisions impacting U.S. owners of closely held foreign companies.

These provisions were intended to reduce incentives for U.S. companies to shift earnings overseas while at the same time moving the U.S. corporate tax regime to a more territorial system. However, they have a disparate impact on U.S. citizens and residents who own closely held companies overseas or who are beneficiaries of offshore succession planning structures. In particular, changes to the controlled foreign corporation, or CFC, regime will force a re-examination of many existing structures. In considering possible workarounds, U.S. taxpayers face a rapidly changing tax and legal landscape both in the U.S. and abroad and will need to carefully weigh the impact of any restructuring proposals on their tax planning overseas.

Overview of CFC Rules

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

If a foreign corporation is a CFC, then United States shareholders of the CFC who own their shares directly or indirectly through foreign entities or trusts may be taxed currently on the “ Subpart F” income of the CFC (i.e., as a phantom income inclusion) even if such income is not distributed. Subsequent distributions of this previously taxed income generally are tax-free. Subpart F income includes most types of passive investment income and certain types of related party sales and services income, but does not include most types of active business income from an operating company. However, TCJA broadened the categories of income subject to phantom income inclusions under the new GILTI regime.

TCJA and Changes to CFC Rules

TCJA introduced several key changes to the CFC rules:

- Expansion of the definition of United States shareholder.
- Expansion of attribution rules.
- Transition tax on deferred foreign income of specified foreign corporations (including CFCs).
- The new GILTI tax regime, which dramatically expands the types of income of a CFC that are currently includable in a United States shareholder's gross income.
- Elimination of the "30-day rule" which formerly required 30 consecutive days of CFC status in a given year before United States shareholders would be subject to phantom income inclusions under the CFC rules.

Elimination of Voting Control Requirement

Until this year, a U.S. person was not considered a United States shareholder for purposes of the CFC rules unless he or she owned at least 10 percent of the corporation's voting stock. However, the voting stock requirement was eliminated by TCJA. Taxpayers will no longer be able to avoid United States 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 will also impact 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.

Downward Attribution

TCJA modified the attribution rules to allow "downward" attribution from non-U.S. shareholders, partners and beneficiaries to U.S. corporations, partnerships and trusts. As a result of these changes, ownership of U.S. and foreign subsidiaries by a common foreign parent that is not itself a CFC can cause the foreign subsidiaries to become CFCs due to attribution of ownership from the foreign parent down to the U.S. subsidiaries. This can expose U.S. owners of the foreign parent (who did not previously have to worry about the CFC rules) to phantom income inclusions from the foreign subsidiaries. This situation also rises with foreign investment fund structures where U.S. and non-U.S. companies are held under the same fund umbrella.

Transition Tax

United States shareholders of CFCs already have had to wrestle with the impact of the new transition tax on their 2017 tax returns. The transition tax under Section 965 affects United States shareholders of "specified foreign corporations." A foreign corporation is a specified foreign corporation if it either is a CFC or has at least one 10 percent shareholder that is a U.S. corporation. If a specified foreign corporation has post-1986 earnings not previously subject to tax in the U.S. which accrued while it was a specified foreign corporation, then its United States shareholders may be taxed on such earnings in the last taxable year of such corporations beginning before Dec. 31, 2017. For U.S. individuals with stock in specified foreign corporations that follow a calendar year (or who are majority shareholders), this generally will result in a transition tax for the 2017 tax year.

The transition tax was introduced in tandem with a 100 percent dividends received deduction available to U.S. corporations that receive foreign source dividends from foreign subsidiaries if certain ownership and holding period requirements are satisfied. However, unlike the dividends received deduction, which is available only to U.S. corporations, the transition tax applies to corporate and noncorporate United States shareholders alike.

The repatriated earnings are taxable to United States shareholders as Subpart F income under Section 951(a), but with a partially offsetting deduction under Section 965(c) designed to reduce the effective tax rate to a range of 8 percent to 15.5 percent (with the rate dependent on the amount of foreign cash and equivalents held in the foreign corporation). For individuals subject to the transition tax in 2017, the effective rate may be slightly higher due to the mechanics of the deduction, ranging from 9 percent to 17.5 percent.

For purposes of calculating the tax base, accumulated deficits in one specified foreign corporation potentially may offset accumulated earnings in another. A number of adjustments may be required to account for intercompany transactions. In many cases, United States shareholders will be taxed on earnings accrued by the corporation before they became shareholders of the CFC. However, the tax may be paid over an eight-year period.

GILTI Tax

Prior to the new tax law, the CFC rules generally did not 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 long-standing recognition that operating income of a bona fide business does not present the same potential for abuse as more "mobile" types of income, such as passive investment income. However, TCJA gutted this distinction with the introduction of the new GILTI regime, which taxes United States shareholders of CFCs on their pro rata shares of global intangible low-taxed income.

Although GILTI was targeted at income from intangibles held in low-tax jurisdictions without a clear business nexus, the term is defined broadly enough to pick up most types of operating income. Under Section 951A, if a CFC's modified gross income (excluding certain items such as Subpart F income and income that is effectively connected with a U.S. trade or business) exceeds a benchmark return of 10 percent of the CFC's adjusted basis in depreciable tangible property used in a trade or business (with certain adjustments for interest expenses), then the excess is taxable to the United States shareholders as ordinary income in the same manner as Subpart F income.

GILTI calculations are made on an aggregate basis taking into account the various CFCs owned by a United States shareholder. However, many of the mechanics have been left to the IRS to sort out in regulations. Although the IRS has issued notices and proposed regulations clarifying various aspects of the transition tax, no such guidance has been issued with respect to the GILTI tax. Further, there are unexplained ambiguities and omissions in the statute itself. For example, there has long been a "high tax" exception for Subpart F income of a CFC that is taxed in its own country at a rate greater than 90 percent of the highest corporate tax rate that would apply in the U.S. Section 951A preserves this exception for Subpart F income itself, but inexplicably fails to extend it to GILTI.

What makes the GILTI regime so problematic for individuals is the disparate treatment of corporate and noncorporate shareholders. Domestic C corporations that are United States shareholders of CFCs are eligible for a 50 percent deduction with respect to GILTI. This is on top of a general reduction in corporate tax rates to 21 percent, meaning that U.S. corporations will 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. Corporate shareholders also can claim foreign tax credits under Section 960 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. They can reduce the tax rate to 21 percent and claim the 80 percent foreign tax credit by making a Section 962 election (discussed later in this piece), but many of the mechanics of this election and how it interacts with the transition tax and GILTI provisions are still unclear.

Elimination of the 30-Day Rule

Under prior law, if a foreign corporation was not a CFC for an uninterrupted period of at least 30 days or more during a taxable year, then there was no Subpart F income inclusion for the United States shareholders. This rule was very useful in situations where a non-U.S. individual needed a foreign blocker to invest in U.S. situs assets but ultimately wanted to pass ownership to a U.S. beneficiary. The 30-day 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, thereby stepping up the basis of the underlying assets and preventing Subpart F income inclusions for the U.S. owners 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.

Illustrations

The following examples illustrate how existing structures may be impacted by the changes outlined above. The first example covers the impact of the transition and GILTI tax regimes on closely held family businesses overseas. The second example covers the elimination of the 30-day rule and its impact on succession planning structures set up for U.S. beneficiaries.

Example 1: Impact of Transition and GILTI Taxes on Closely Held Family Business

Many U.S. individuals with stock in closely held family businesses overseas find themselves facing significant tax liabilities for prior year earnings — in some cases going as far back as 1987. Take the example of a Country X corporation conducting an active services business in Country X. The company 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 migrated back and forth between Country X and the U.S. Enough U.S. family members own 10 percent or more of the company to trigger CFC status.

Transition Tax in 2017

Assuming most of the company'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 phantom income. However, with the enactment of TCJA, earnings accrued in prior years while the company was a CFC would now be subject to the transition tax under Section 965.

The deferred foreign income would be taxed as Subpart F income, but generally at an effective rate ranging from 9 percent to 17.5 percent (slightly higher than the rates that would apply to a domestic corporation), depending on cash and other liquid assets held by the CFC. This tax may be paid in installments over an eight-year period if the taxpayer makes an election under Section 965(h). The first payment already has come due and failure to timely make an installment payment can cause subsequent installments to be accelerated, but proposed regulations issued on Aug. 1, 2018, offer some relief from the acceleration provisions for taxpayers who inadvertently missed their first installment payment.

The transition tax can present both opportunities and pitfalls:

- U.S. family members who live abroad may have a significant tax event in the U.S. this year, but with no corresponding income inclusion in their country of residence. A subsequent distribution of this previously taxed income in a later tax year may be tax-free in the U.S. but fully taxable in the other country. A U.S. family member who lives in the U.S. potentially may be able to claim a foreign tax credit for foreign dividend withholding taxes imposed on such distribution even though the distribution itself would be tax-free in the U.S. However, a U.S. family member who is a tax resident of another country could face potential double taxation if the other country does not grant the taxpayer a tax credit for the transition tax paid in the U.S.

- Assuming no complications with foreign tax credits, some United States shareholders may actually benefit from the transition tax if the CFC will be paying dividends in the future that are not eligible for qualified dividend treatment because the CFC is not incorporated in a treaty jurisdiction. This is because earnings subject to Section 965 would be taxed at a much lower rate under Section 965 than if they were distributed as a taxable dividend.

Section 962 Election

U.S. family members might consider making a Section 962 election for the 2017 tax year to mitigate the transition tax. Section 962 allows an individual who is a United States 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. This would enable him or her to utilize a portion of the indirect foreign tax credits under Section 960 for foreign taxes paid by the CFC on the repatriated earnings. This also brings the effective tax rate down to the same 8 percent to 15.5 percent range that would apply to U.S. corporations. 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 recently issued proposed regulations clarify that the offsetting deductions would be available.

The Section 962 election does come at a cost. Future distributions of previously taxed income would be taxable to the extent they exceed the actual tax paid, meaning that where foreign tax credits offset the transition tax liability there would be additional taxes to pay down the road. It is not fully settled whether future distributions would be considered U.S. or foreign source income or whether they would be eligible for qualified dividend treatment.

GILTI Tax: 2018 and Future Tax Years

Going forward, the U.S. family members will have to contend with GILTI tax exposure. Operating income that previously was carved out of the CFC rules will now flow up to the United States shareholders as GILTI, which is taxed at a 37 percent rate (not including the 3.8 percent Medicare tax or state income taxes), with no credit for foreign taxes paid by the company itself in Country X. There are a number of options for mitigating GILTI tax exposure, each with its own trade-offs:

- “Checking the box” (filing an entity classification election) to treat the foreign company as a partnership for U.S. tax purposes.

- Contributing stock in the foreign company to a new U.S. corporation in order to take advantage of more favorable rules for U.S. corporate shareholders.

- Making a Section 962 election to reduce the tax rate on GILTI and tax advantage of indirect foreign tax credits.

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, but items of income, gain, loss and deduction would retain their character. U.S. owners would be able to claim foreign tax credits with respect to income tax paid by the company in the foreign country, subject to certain limitations. However, there are potential drawbacks, particularly for a company that is already a going concern:

- The election would trigger a deemed liquidation of the company. The inside gain would be taxable to the United States shareholders as GILTI, which could make this option prohibitively costly from a U.S. tax standpoint for an existing business.

- 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 company when it liquidates.

- Not all foreign business entities are eligible to check the box. For example, if the company is an SA, 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.

Contributing foreign company stock to new U.S. corporation

U.S. family members could contribute their stock to a new U.S. corporation, or “Newco.” If the 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 and possibly down to 2-3 percent or less after the 80 percent foreign tax credit is taken into account. Subsequent distributions of foreign source income from the foreign company potentially could be eligible for the 100 percent dividends received deduction under Section 245A. Even taking into account the 23.8 percent shareholder-level tax on distributions from the 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.

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

- If the foreign company was subsequently sold at a gain, there would be two levels of federal income tax in the U.S. — a 21 percent corporate level tax and an additional 23.8 percent tax from the liquidation of Newco. This may not be a good option if the shareholders anticipate a sale in the near term. This issue could be further compounded if corporate tax rates go up again.

- 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.

- The contribution of shares to Newco might actually be taxable in Country X or another jurisdiction. Further, Country X could have its own CFC rules, in which case U.S. family members who live in Country X may be trading one tax problem for another.

- Future distributions from the foreign company to Newco may be subject to dividend withholding tax in Country X.

Section 962 Election

A Section 962 should reduce the tax rate on GILTI to the 21 percent corporate tax rate and enable U.S. family members who make the election to claim the 80 percent foreign tax credit. (Individual shareholders who make the election do not appear to be eligible for the 50 percent deduction available to U.S. corporations.) Future distributions in excess of the actual tax paid generally would be taxable. As previously noted, many of the mechanics of how this election interacts with the transition tax and GILTI provisions 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, at least pending further guidance, than putting the CFC shares under a new corporate structure.

Example 2: Impact of TCJA on Foreign Blocker Structures

As previously discussed, non-U.S. individuals frequently invest in U.S. securities and other U.S. situs assets through foreign “blocker” corporations to shield themselves from U.S. estate tax exposure. The foreign blocker often will be held through a foreign grantor trust to facilitate succession planning. If the trust qualifies as a grantor trust, then income earned in the trust during the grantor’s lifetime will be deemed to have been earned by the grantor and will not be taxable to the U.S. beneficiaries on distribution.

If ownership of the foreign blocker will pass to U.S. owners (including a foreign trust with U.S. beneficiaries or a U.S. trust), it is critical to plan ahead both to step-up the inside basis of the company’s assets and to mitigate application of the CFC rules.

Post-Mortem Entity Classification Elections

Whether the foreign blocker corporation is held directly by the non-U.S. decedent or through a foreign grantor trust, it generally will be necessary to unwind the blocker structure after the death of the owner/grantor if the assets will be inherited by U.S. persons or if the trust has U.S. beneficiaries. The reason for this is that the U.S. heirs or beneficiaries could be subject to phantom income inclusions from gains and other income recognized by the foreign blocker corporation if it is a CFC. If the blocker is held by a foreign trust, it is often advisable to domesticate the trust as well.

The blocker structure can be unwound by filing an entity classification election to treat the foreign blocker as a disregarded entity for U.S. tax purposes. If such an election is filed, the corporation is deemed to have been liquidated at the end of the day immediately preceding the effective date of the election. This serves two key purposes: preventing the foreign blocker from becoming a CFC after the grantor dies; and stepping up the basis of the underlying assets to reduce taxes on future gains.

In order to be able to make the election, the foreign blocker corporation must be a "foreign eligible entity," meaning that the IRS must not have designated entities of this type as "per se" corporations in Department of the Treasury regulations or other guidance. The election generally must be filed within 75 days of the effective date, although it is possible to seek IRS permission for a late election.

Post-Mortem Planning Before TCJA

Before TCJA, as long as the blocker did not own U.S. real estate or certain partnership interests, a single foreign blocker would suffice. After the owner/grantor died, the trustee or executor would check the box effective at least two days and no more than 29 days after the date of death in order to prevent the blocker from becoming a CFC long enough (30 days) to trigger Subpart F income inclusions for the U.S. beneficiaries. As long as the decedent either owned the corporation directly or, in the case of a blocker owned by a foreign trust, held the requisite retained powers over the trust, the outside basis in the shares would be stepped up at death under Section 1014 and the subsequent election would trigger a deemed liquidation that would step up the inside basis of the blocker's assets without triggering additional taxes.

Impact of 30-Day Rule on Post-Mortem Planning

The elimination of the 30-day rule means that even if a foreign corporation is a CFC for only a day or two, it can carry out Subpart F income to the United States shareholders on a fractional basis. However, checking the box effective prior to the date of death would cause the owner to have held U.S. situs assets through a foreign disregarded entity at the time of death, with potentially disastrous U.S. estate tax consequences. In most cases where significant U.S. situs assets are involved, the estate tax exposure from checking the box prior to death will be greater than the phantom income inclusion under the CFC rules if the entity classification election is filed to terminate CFC status effective a few days after death.

Fractional Inclusion Rule

If income of a CFC is includable in a United States shareholder's income for a portion of a year, 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 ending on the date of its deemed liquidation.

- The numerator should be two days (the day of death and the day after) because there will usually be an incentive to terminate CFC status as soon as possible after death to minimize the inclusion fraction without exposing the decedent to estate tax.

- The denominator will depend on how late in the year the corporation is liquidated. The earlier in the year that the decedent dies, the greater the inclusion ratio and thus, the greater the phantom income inclusion.

To give an example, suppose there is $50 million of inside gain recognized upon the deemed liquidation. If the owner/grantor dies on the 99th day of the year and the election is filed effective on the 101st day of the year with a deemed liquidation one day prior to that (on the 100th day), then the inclusion ratio will be 2 percent (two days divided by 100 days), resulting in $1 million of Subpart F income. However, if the deemed liquidation is on the 10th day of the year, then the inclusion ratio will be 20 percent (two days divided by ten days) and $10 million of gain could flow up to the new U.S. owners or beneficiaries as Subpart F income.

Post-Mortem Planning Options After TCJA

There are a number of strategies for working around the elimination of the 30-day rule. However, each presents its own tradeoffs. There is no "one size fits all" approach that works for every situation:

Harvesting Gains

Phantom income may be reduced by harvesting gains while the decedent is alive to minimize the amount of unrealized appreciation recognized when the blocker is deemed liquidated. The key is having the investment managers on board and keeping transaction costs to a minimum.

Segregating Non-U.S. Assets

Non-U.S. situs assets can be held directly or through a disregarded entity (if needed for non-U.S. reasons) so that basis is automatically stepped up at death without risking Subpart F exposure with respect to those assets.

Avoiding or Minimizing U.S. Situs Assets

Some planners may simply choose to avoid or minimize investments in U.S. equities.

Two-Tier Blocker Structure

A two-tiered blocker structure can hedge against the risk that a post-mortem entity classification election could trigger a large Subpart F income inclusion if the owner dies early in the year (resulting in a high fractional inclusion ratio). In this scenario U.S. situs assets would be held in a foreign blocker corporation owned in equal shares by two foreign holding companies. The election for the lower tier company would be filed with an effective date (and deemed liquidation) prior to death. Thus, the lower tier company would never become a CFC in the first place. Elections would be filed for the two parent companies effective two days after death.

- There generally would be a fractional inclusion as with a single blocker structure because the parent companies would be CFCs for two days and would have recognized gain from the deemed liquidation of the lower tier company when it checked the box before them.

- However, if the owner dies in the first 75 days of the year, the election for the lower tier company and resulting gain from its deemed liquidation would be pushed back into the prior taxable year. Subpart F income of the upper tier CFCs would not include gains they recognize in the prior taxable year. In other words, this structure functions as somewhat of an “insurance policy” against the grantor dying early in the taxable year when the fractional inclusion would be greatest. However, in most other cases there will be some tax leakage.

- This structure is not suitable for all situations. Not only are there transaction costs in putting the structure in place, but there would be ongoing annual service company fees for the two additional holding companies.

The bottom line is that many existing structures will need to be reviewed. As noted above, there is no one structure that will work for all situations and some individuals may simply decide to leave existing structures in place and try to manage potential Subpart F exposure going forward. The key is to take appropriate steps now — before the blocker becomes a CFC.

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