

In, Out, and Sometimes Upside Down: Choice of Entity in Cross-Border Transactions

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Agenda

- Overview
- Important International Tax Concepts
- Inbound
- Outbound
- Questions

Overview

- This presentation looks at inbound and outbound investment in operating businesses and real estate from the point of view of private investors – individuals, families, closely held business
- We will focus on structures and choice of entity in light of the 2017 tax legislation

Scope

- What we will cover:
 - ◆ Entity selection
 - ◆ 2017 Tax Act
 - Income tax changes
 - Some estate and gift tax changes
- Some of the many things we won't cover:
 - ◆ Joint ventures
 - ◆ Repatriation planning
 - ◆ Tax compliance
 - ◆ Financing
 - ◆ BEAT (base erosion and anti-abuse tax)
- In other words, we will scratch the surface – and we'll still run out of time

Important International Tax Concepts

Key Concepts

- Classifying income
- Application of source rules to different categories
- Classification of business entities
- Allocation of income in general
- Allocation of income among related parties
- Tax treaties can modify the application of the Internal Revenue Code to many of these concepts but rarely apply to state taxes

Class and Source of Income

- Income must first be classified
- Then, source of income must be determined according to a series of statutory rules
- The next two slides summarize U.S. statutory rules
- Treaties sometimes contain source rules

Class and Source of Income

Class	U.S. Source Rule
Interest	Interest paid by domestic corporation or non-corporate resident has a U.S. source; all other interest has foreign source
Dividends	Place of incorporation controls, but dividend from foreign corporation is U.S. source if and to the extent 25% or more of gross income from U.S. trade or business over 3-year period preceding year of dividend
Rents from real and tangible personal property	Place the property located or used
Royalties from intangible property	Place the property located or used (but this can be problematic)
Proceeds of sale of personal property	See next slide
Proceeds of sale of real property	Location of property (includes sale of any kind of USRPI)
Income from services	Place where services are rendered as employee or independent contractor

Source of Income: Sale of Personal Property

- General rule: Place of residence of the seller
 - ◆ Special residence rules for noncorporate sellers
- Key exceptions:
 - ◆ Sale of inventory: Title passage
 - ◆ Sale of depreciable property: Recapture sourced proportionately to depreciation
 - ◆ Sale of an intangible where the purchase price is in the form of a royalty
 - ◆ Sale through an office or fixed place of business
 - ◆ Sale of stock of an affiliate
 - ◆ Resourcing rules based on treaty obligations (intangibles and stock of affiliates)

Entity Classification

- The United States classifies every business entity as:
 - ◆ Corporation – taxed as if it were a separate person, except that a U.S. corporation with U.S. individual shareholders (and certain trusts) can make an S election to be treated like a partnership, or
 - ◆ Partnership – not taxed (transparent); income flows to the partners or other owners who pay tax on their share of partnership income.
 - ◆ If an entity would be classified as a partnership but has only one owner, it is “disregarded” and its income and assets are treated as belonging directly to the owner.
- In most cases, foreign limited company classified as follows:
 - ◆ By default, as a corporation
 - ◆ But can elect (“check the box”) to be classified as a partnership (two or more shareholders) or disregarded entity (one shareholder)
 - ◆ Regulatory exception where company will be treated as a corporation and no election is possible: China - Gufen Youxian Gongsi; Hong Kong and Singapore – PLC; Taiwan – Ku-fen Yu-hsien Kung-szu; U.K. and other jurisdictions – PLC; société anonyme in France, Switzerland (aka A.G.); Mexico – S.A. de CV; but no offshore companies on list except Panama

Entity Classification

- Basic classification of a corporation or partnership as domestic or foreign is simple – the place of organization is controlling. See sections 7701(a)(4) and (5).
- However, there are several rules that can cause a foreign corporation to be treated like a domestic corporation:
 - ◆ The anti-inversion rules of section 7874 and numerous regulations and notices
 - ◆ The stapled stock rule of section 269B
 - ◆ Elective rule for insurance companies – section 953(d)
 - ◆ Elective rule for treaty country holding U.S. real estate – section 897(i)
 - ◆ Elective rule to allow certain Canadian and Mexican corporations to be included in a consolidated group – section 1504(d)
- The anti-inversion rules in particular can interfere with structuring and restructuring of international operations.

Taxation of Business Entities

- Partnerships do not pay tax. They compute their income and the partners or owners pay tax on their share, whether or not the partnership retains or distributes the income.
- Corporations, as separate taxpayers, pay tax at 21%.
 - ◆ Domestic corporations pay tax on worldwide income.
 - ◆ Foreign corporations pay tax only on US-related income.
- U.S. shareholders of corporations pay tax when:
 - ◆ The corporation pays a dividend to them or they sell the shares, but
 - ◆ Earlier, or with additional taxes, if the corporation is a CFC or a PFIC (explained below).
- If corporation is (a) domestic or (b) located in a treaty country and certain qualifying conditions are met, individual U.S. shareholders may treat dividend as long-term capital gain – maximum rate currently 20%. Dividends from non-treaty countries and non-qualifying dividends are taxed as ordinary income – maximum rate currently up to 37%.

Foreign Tax Credits

- A country has jurisdiction to impose tax based on:
 - ◆ Place where income is earned (“source-based taxation”)
 - ◆ Residence or citizenship (“residence-based taxation”)
- Result: Source and residence countries may tax same income
- To avoid double taxation, the United States allows residents credit against Federal income tax, but not tax on NII, for foreign tax on foreign source income (this may be a violation of our treaties)
 - ◆ **Critically**, credit applies to foreign tax paid by partnership or S corporation but not if paid by foreign corporation (except withholding tax on dividend)
 - The 2017 Act repealed the indirect foreign tax credit for a domestic corporation owning 10% or more of the shares of a foreign corporation
 - However, indirect foreign tax credits are still available in the case of foreign tax paid by CFCs – see IRC section 960.
 - ◆ Credit cannot exceed U.S. income tax on foreign income – e.g., foreign tax \$40, U.S. tax \$35, \$5 excess can be carried over to a future year but cannot offset U.S. tax on U.S. income.
 - ◆ Many states allow individuals a deduction or credit for foreign tax. But many (including California, Illinois and Ohio) do not. (New York and Michigan allow a limited credit for Canadian provincial tax.)

Transfer Pricing

- Transactions between members of a controlled group must be priced to meet the “arm’s length” standard
 - ◆ This is the price that would be paid by uncontrolled parties
 - ◆ Pricing must be documented at the time of transactions
 - ◆ Taxpayer must maintain good records and documents concerning group transactions and pricing methods – independent economist studies may be needed to support pricing decisions
- Group transactions include:
 - ◆ Sales of goods and services
 - ◆ Group financing
 - ◆ Licenses and transfers of technology and other intellectual property

Transfer Tax Considerations: Quick Primer

■ U.S. Persons

- ◆ 40% tax on worldwide assets; indexed \$11.2 million lifetime exemption (reverts to indexed \$5.1 million in 2026)

■ NRAs

- ◆ 40% gift tax on U.S.-situs real property and tangible personal property (therefore, no tax on gift of U.S. stock)
- ◆ 40% estate tax on U.S.-situs assets (including U.S. stock); \$60,000 exemption unindexed

■ Basis step-up upon death

- ◆ Partnership: basis step-up on partnership interest can be pushed down to the property.
- ◆ Corporation: basis step-up on corporate shares cannot be pushed down to property
- ◆ Trust: Only if grantor trust and meets added requirements

INBOUND

Objectives of Inbound Investors

- Low effective tax rate
- Capital gains rates on sales of property and sale of business
- Avoid double taxation
- Avoid over-withholding
- Minimize exposure to U.S. estate law
- Confidentiality

The new tax laws have not changed these objectives

Inbound Changes - Overview

- Reduction in corporate income tax rate from 35% to 21%
 - ◆ Capital gains rates for individuals (20%) are still advantageous but not by much
- No change in estate or gift tax (still only \$60K exemption for NRAs)
- Taxation of dispositions of partnership interests (section 864(c)(8))
- Repeal and complete replacement of earnings stripping rules (section 163(j))

Foreign Person Disposes of Partnership Interests

■ Old law:

- ◆ Sale of interest in partnership with real estate triggers capital gain to the extent gain attributable to real estate; potential withholding under section 1445. IRC section 897(g). PATH Act 2015 increased withholding rate to 15%
- ◆ Sale of interest in partnership engaged in U.S. trade or business taxable to the extent gain attributable to such trade or business. Rev. Rul. 91-32. No withholding unless section 1445 applies
 - Rev. Rul. 91-32 questionable; IRS position was demolished in *Grecian Magnesite* case (2017)

■ New law:

- ◆ Sale of interest in U.S. ETB partnership treated as ECI. New section 864(c)(8)
- ◆ Withholding at 10% of amount realized on disposition of such an interest. New section 1446(f)
- ◆ Withholding suspended for sales of interests in PTPs; numerous unresolved problems (substantive and withholding)

Changed Landscape for Private Investors - 1

- Typical foreign individual or closely held investor has several key concerns, including:
 - ◆ Avoiding subjecting investment to estate tax exposure
 - ◆ Mitigating double taxation
- Main forms of double taxation
 - ◆ U.S. double taxation of income of C corporations (including foreign corporations due to branch level taxes)
 - ◆ Foreign and U.S. taxation of the same income
- Typical foreign/U.S. corporate structure eliminated estate tax exposure
 - ◆ Loss of individual long-term capital gains rates (especially relevant for real estate – see later slides)
 - ◆ High U.S. corporate rates, enhanced by state taxes and dividend withholding/branch level taxes, encouraged base shifting through interest payments, royalties and service fees

Changed Landscape for Private Investors - 2

- New corporate rate reduces base shifting incentive
 - ◆ For example, U.S. corporations used as cost-plus centers
 - ◆ Interest stripping through loans structured to obtain reduced treaty rate or portfolio exemption
 - ◆ Payments for intangibles and services
 - ◆ These tactics simply moved high taxed U.S. income to lower taxed foreign countries.
 - ◆ Now, U.S. income may be taxed at 21% or even less if eligible for FDII rate
- The new corporate rate is especially favorable for income that will not be repatriated from the U.S.
 - ◆ No reduction in 30% withholding on dividends, so availability of treaties and use of leverage to enable non-dividend repatriation will still be important
 - ◆ Have to be aware of the accumulated earnings tax, which can apply to domestic corporations owned by foreign persons

Welcome to Hotel California

■ Individual

- ◆ 20%/37% Federal plus 13.3% CA (not deductible)
- ◆ Total taxes on 33.3%/50.3%; no deferral
- ◆ Cannot sell business assets tax-free

■ Corporate structure

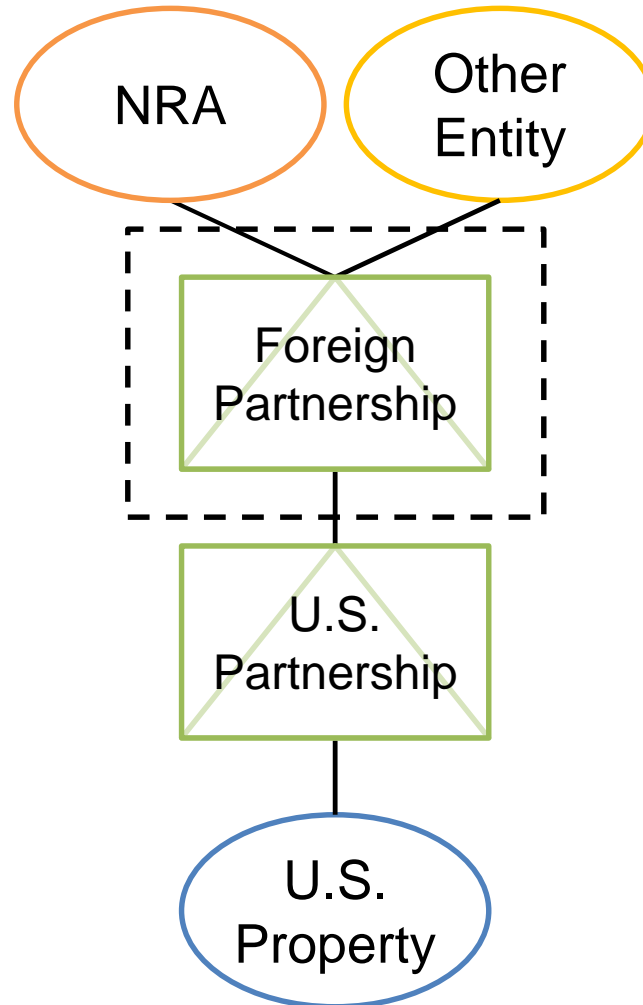
- ◆ 21% Federal plus 8.84% CA (deductible) = 28.0%
- ◆ 30% Federal withholding tax on dividends (effectively 21.6%, which is $30\% \times (100\% - 28.0\%)$)
- ◆ Total taxes on fully distributed income 49.6%, but can defer 21.7% by not paying dividends and distributing only on liquidation of C corporation
- ◆ Can sell corporate stock taxfree, except for U.S. real property interest

Example

- Client is based in Country A, wants to acquire real estate in the United States
- How should the client hold the real estate, in a partnership or a corporation?
- In this example, we will look at the tax consequences of: (1) rental income; (2) sale of property; (3) personal use
- Where rates are graduated, we assume maximum marginal rates

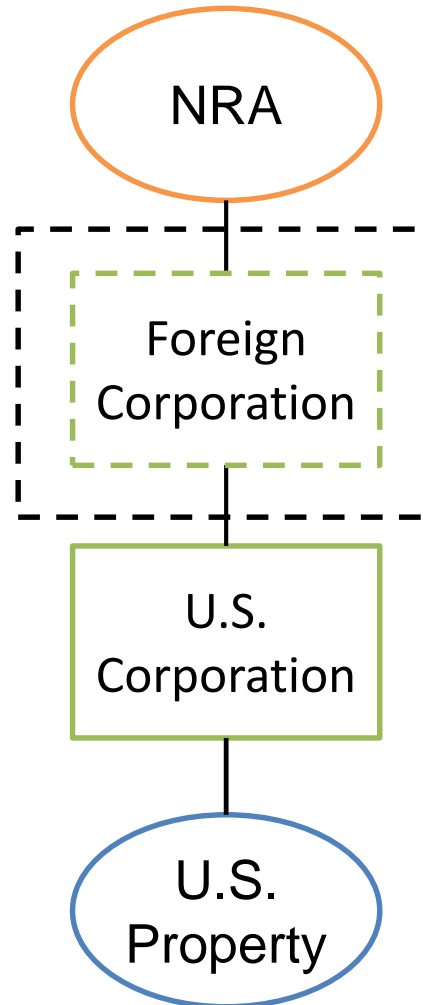
Example (continued)

- Holding U.S. property through a partnership:



Example (continued)

- Holding U.S. property through a corporation:



Partnership Rental Income

	Income (Deduction)	Tax
Annual Rental Income	\$1,000,000	
State Tax (CA: 13.3%) Non-Deductible		\$133,000
Adjusted Gross Income	\$1,000,000	
Federal Tax (37%)		\$370,000
Total Taxes Paid		\$503,000

Effective Tax Rate: 50.3%

Note: 3.8% tax on net investment income does not apply to nonresident aliens

Corporation Rental Income

	Income (Deduction)	Tax
Annual Rental Income	\$800,000	
State Tax (CA: 8.84%)		\$70,720
State Tax Deduction	(\$70,720)	
Adjusted Gross Income	\$729,270	
Federal Tax (21%)		\$153,149
Total tax, if income stays in corporation until liquidation		\$223,869
Non-Liquidating Distribution	\$729,270	
Tax (30%)		\$218,781
Total taxes paid, if income is distributed before liquidation		\$442,650

Effective Tax Rate: 28.0% if income stays in corporation until liquidation
 55.3% if income is distributed before liquidation

Partnership Sale of Property

	Income (Deduction)	Tax
Gain	\$10,000,000	
State Tax (CA: 13.3%) Non-Deductible		\$1,330,000
Adjusted Gross Income	\$10,000,000	
Federal Tax (Cap Gains 20%)		\$2,000,000
Total Taxes Paid		\$3,330,000

Effective Tax Rate: 33.3%

Partnership does not have to liquidate.

Corporation Sale of Property

	Income (Deduction)	Tax
Gain	\$10,000,000	
State Tax (CA: 8.84%)		\$884,000
State Tax Deduction	(\$884,000)	
Adjusted Gross Income	\$9,116,000	
Federal Tax (Cap Gains 20%)		\$1,914,360
Total Taxes Paid		\$2,798,360

Effective Tax Rate: 28.0%

Note: This rate requires corporation to have sold all U.S. real property interests in gain realization transactions and distribute cash to the shareholders.

Otherwise, shareholders may have further gain and/or there will be dividend withholding taxes.

Transfer Tax Concerns

	Partnership	Corporation
Transmission by Gift	No gift tax on gift of top tier partnership	No gift tax on gift of shares
Transmission on Death	Estate tax position uncertain	Estate tax if U.S. corporation shares held directly by NRA; can be avoided if U.S. corporation held by foreign corporation (but note inversion issue)
	Basis step-up in partnership interest which can be pushed down to property (section 754 election)	Basis step-up in shares but cannot be pushed down to property

Additional Planning

- Consider additional planning, especially by financing part of the purchase
 - ◆ Can generate interest deductions taxed to lender at 30% or possibly even less
 - ◆ Lending allows for repatriation of original capital without withholding
 - ◆ Section 163(j) earnings stripping rules overhauled in 2017
- These examples do not consider effects of tax treaties or home country taxation, but these must be taken into account unless NRA investor resident in zero tax jurisdiction.

Personal Use Property

- Avoidance of estate tax remains key concern
- Traditional double corporate structure (foreign corporation/domestic corporation), if implemented from beginning, addresses estate tax. However:
 - ◆ Structure presents problems resulting from personal use
 - Withholding (sections 1441 and 1445), even when there is no income
 - Consider owner or family paying fair rent (helps fund expenses)
 - ◆ Also, problems if structure inherited by U.S. heir(s)
 - ◆ Implementation post-acquisition may result in tax on capital gains and may raise corporate inversion issues
- Alternative: Foreign or domestic trust. Domestic may be preferable if U.S. residents will use property
 - ◆ Retained interest rules (section 2036) can apply if grantor retains right to use the property

OUTBOUND

Objectives of Outbound Investors

- Deferral
- Low effective tax rate
- Capital gains rates on sales of property and sale of business
- Avoid double taxation
- Avoid over-withholding

The new tax law has not changed these objectives but it has radically changed planning for deferral

Current Taxation v. Deferral

- U.S. persons are taxed on a current basis on income from all sources worldwide. There is almost no preferential treatment of income earned abroad
- Foreign persons are taxed only on income from U.S. sources
- It follows that, before 2017, the principal planning opportunity for a U.S. person, whether a large multinational or a closely held business, was to form or acquire a foreign corporation that paid no U.S. tax on foreign operations. U.S. tax would not be paid until foreign corporation distributed income to the U.S. person. This is known as “deferral”
- Before 2017, the principal vehicles for counteracting deferral using foreign corporations were the CFC rules and the PFIC rules

Controlled Foreign Corporations

- Foreign corporations do not pay U.S. tax unless they do business or invest in the United States
 - ◆ This is true even if all shareholders are U.S. persons
 - ◆ However, U.S. shareholders of foreign corporation are subject to special rules, especially the CFC rules
- Foreign corporation controlled by five or fewer U.S. persons is known as a “controlled foreign corporation”, or CFC
- Three major consequences of owning a CFC
 - ◆ CFC’s “Subpart F income” taxed to U.S. shareholders every year
 - ◆ CFC’s other income taxed to U.S. shareholders when:
 - Income is distributed as a dividend
 - U.S. shareholders sell the shares
 - CFC invests in U.S. assets – especially by lending to its U.S. shareholders

Subpart F Income

■ Investment income

◆ Dividends, interest, rent and royalties

- Some exceptions for inter-group payments – but often requires group members be in the same country (EU ≠ a single country)
- Doesn't include “active rents” or “active royalties” –narrowly defined

◆ Gains from assets producing dividends, interest, rents or royalties

■ Certain income from sales of goods and services

◆ “Foreign base company sales income”

- CFC buys goods from related party or sells goods to related party;
- and CFC did not manufacture or transform the goods

◆ “Foreign base company services income”

- CFC renders services outside its country of incorporation; and
- Renders services on behalf of related company or with “substantial assistance” from U.S. shareholder or other U.S. person

- Also, if CFC invests its property in the United States (including making loans to U.S. shareholders), this may give rise to taxation under Subpart F rules – section 956 (not repealed by 2017 Act)

PFICs

- PFIC taxation was supposed to level the playing field between domestic and offshore mutual funds
- However, definition of PFIC far broader than a foreign fund
 - ◆ Any company if 75% or more of annual income is passive or average assets in any year are at least 50% passive
 - ◆ Once a foreign corporation is treated as a PFIC with respect to a U.S. shareholder, it stays a PFIC even if it later ceases to meet the definition.
 - ◆ Tax on PFIC distributions in excess of 125% of rolling 3-year average and gains on sale of PFIC subject to potentially punitive interest charge
 - ◆ PFIC dividends are not eligible for qualifying dividend treatment
 - ◆ “Qualified electing fund” allows pass-through taxation of PFIC earnings but requires cooperation and information from PFIC
- For our purposes, danger is that foreign corporation that is not a CFC may unexpectedly turn out to be a PFIC
 - ◆ E.g., family-held real estate company with minority U.S. shareholder
 - ◆ Any 50:50 joint venture with a foreign partner risks being a PFIC if assets and income are not carefully monitored and managed

Outbound Planning – Before and After 2017

- Used to focus on:
 - ◆ Deferral
 - ◆ Secure benefit of capital gains rates on dividends
 - Typically, undertaken in U.S. tax treaty jurisdictions or common to have business established in treaty country
 - ◆ Consideration of Subpart F rules, especially related party transactions
 - ◆ Avoid PFIC status for minority and joint venture holdings
- The 2017 Tax Act has changed the outbound landscape.
 - ◆ Going forward, a flood of complex new rules and new acronyms:
 - Limited future deferral due to tax treatment of GILTI
 - Controversial break for FDII
 - Large corporations also subject to BEAT
 - ◆ Harsh treatment for individuals and closely held businesses

Deemed Repatriation of Pre-2018 Earnings

- Section 965 requires all U.S. shareholders (not just U.S. corporations) of CFCs and certain other foreign corporations to treat previously untaxed post-1986 earnings and profits as fully distributed
- Payment could be deferred over 8 years (or much longer in the case of S corporations)
- Although tax has already been incurred and cannot be planned for, still need to be very careful to avoid losing benefit of deferral
 - ◆ IRS says overpayment of other estimated taxes cannot be refunded and must be applied to deferred section 965 tax
 - ◆ Legislative fix may be needed but prospects uncertain

GILTI (Very) Basics – 1

■ GILTI =

- ◆ CFC net tested Income (computed on a consolidated or aggregate basis)
- ◆ Less net deemed tangible income return

■ “Tested income” = CFC gross income, except:

- ◆ ECI
- ◆ Subpart F income
- ◆ High foreign tax foreign income (effective rate of 90% of U.S. corporate rate)
- ◆ Dividends received from a related person
- ◆ Foreign oil and gas extraction income
- ◆ Less deductions allocable to such gross income

■ Net deemed tangible income return =

- ◆ Qualified business asset investment (“QBAI”) x 10%
- ◆ Less interest expense

GILTI (Very) Basics – 2

- Current inclusion as subpart F income
- 80% of foreign tax credits can be used against GILTI for C corporation shareholders
- Calculation of GILTI done at U.S. Shareholder level:
 - ◆ “**Net CFC Tested Income:**” Excess of shareholder’s pro rata share of the sum of tested income and tested losses from all of CFCs over
 - ◆ “**Net Deemed Tangible Income Return**”, i.e.:
 - Deemed 10% return on shareholder’s pro rata share of adjusted basis of tangible depreciable property of CFCs that earn **tested income**, reduced by
 - **Interest expense** taken into account in determining net tested income to the extent the related interest income is not taken into account in determining the shareholder’s net CFC tested income

Dividends Received Deduction

- 100% dividend received deduction (“DRD”) for foreign source dividends and section 1248/964(e) amounts received from specified foreign corporations, but only if received by a U.S. C corporation shareholder
 - ◆ Query what foreign income will actually be able to utilize DRD given the new GILTI rules
- Minimum 366 day holding period
- No DRD for hybrid dividends from a CFC
 - ◆ Think PECs or instruments treated as debt in foreign country but equity in United States
- No FTC on income to which DRD allowed

Subpart F – The Old

U.S.
Person

CFC

Subpart F income – section 951(a) (passive income unless taxed at 90% of U.S. corporate rate (31.5%); certain related party business income)	Other income (most business income and high taxed income taxed (90% of U.S. rate))
<ul style="list-style-type: none"> ■ Immediate taxation ■ Full rates (individuals cannot treat Subpart F inclusion as qualified dividend) ■ Actual dividend not taxed (PTI) ■ Basis in CFC increased by PTI (and reduced by distribution of PTI) ■ Foreign tax credit available: <ul style="list-style-type: none"> ◆ Foreign withholding tax when PTI distributed but timing issue ◆ Indirect credit only for C corporations 	<ul style="list-style-type: none"> ■ Deferred taxation. Deferral ends: <ul style="list-style-type: none"> ◆ When dividend paid (can qualify as qualified dividends, if CFC in treaty country) ◆ CFC invests in U.S. property (section 956) – treated like Subpart F income ◆ When shares sold (section 1248) ■ Foreign tax credit available: <ul style="list-style-type: none"> ◆ Foreign withholding tax ◆ Indirect credit only for C corporations

Subpart F, GILTI and QBAI – The New

U.S.
Person

↓
CFC

Subpart F income	GILTI – section 951A (most business income)	Qualified business assets income (QBAI) and high taxed foreign income
<ul style="list-style-type: none"> ■ No change but note high tax kickout income increased due to cut in U.S. rate (i.e., passive income is not Subpart F income if foreign tax is 90% of 21% (18.9%), down from 90% of 35% (31.5%)) 	<ul style="list-style-type: none"> ■ 10% C corporation shareholders: <ul style="list-style-type: none"> ◆ Immediate taxation at 50% (10.5%) ◆ Partial foreign tax credit available ■ Individuals <ul style="list-style-type: none"> ◆ Full individual rates ◆ Must consider section 962 election 	<ul style="list-style-type: none"> ■ QBAI = 10% return on tangible assets ■ High foreign tax (threshold now 18.9%) ■ 100% dividends received deduction for 10% C corporation shareholders ■ Other shareholders <ul style="list-style-type: none"> ◆ Deferral ◆ Sections 956 and 1248 not repealed

Favorable to Corporations

U.S.
Corp.



CFC

CFC		
Subpart F income – taxed at 21%	GILTI – taxed at 10.5%, plus 80% of indirect foreign tax credit	Qualified business assets income (QBAI) and high taxed foreign income - deferred

- Low taxes, and subpart F income and GILTI are repatriated tax-free

Where a Foreign Corporation is Held by an Individual

U.S.
Individual

CFC

CFC		
Subpart F income – taxed at 37%	GILTI – taxed at 37%	Qualified business assets income (QBAI) and high taxed foreign income - deferred

- No foreign tax credit is allowed except foreign withholding taxes
- Note that there is a potential for passive income (when it is taxed at more than 18.9% in a foreign jurisdiction) to be deferred while active business income is GILTI

Upside Down – Investing in Real Estate in a High Tax Country

- Old Wisdom: Do your best to qualify real estate income as active rentals and therefore for not Subpart F income
 - ◆ High tax kickout exemption difficult when U.S. corporate rate was 35%
- New Wisdom: If foreign corporate tax rate at least 18.9%, have income classified as foreign personal holding company and avoid classification as either Subpart F income or GILTI
- REALLY??

Three Possible Solutions

- **Interpose a domestic corporation**
 - ◆ Done using a section 351 tax-free incorporation
 - ◆ New corporation can take advantage of deductions and credits.
 - ◆ This is not a practical solution for U.S. persons living abroad, as it likely results in a sandwich structure
 - May trigger foreign tax for U.S. persons living abroad (many countries have no section 351 equivalent and/or impose transfer taxes)
- **Make a section 962 election (next slide)**
 - ◆ Individual is subject to tax on subpart F income, including lowering the corporate rate and the ability to claim foreign tax credits
 - ◆ Should apply to GILTI but not deduction that reduces rate to 10.5%
- **Be taxed directly on the income**
 - ◆ Done by checking box on any foreign corporation
 - ◆ Maximizes foreign tax credits
 - ◆ May not be impractical if foreign corporation is “per se” corporation and checking the box is not possible or requires reorganization (e.g., Canada – limited company to unlimited liability company) or results in transfer taxes. Election may also result in Subpart F income or capital gains tax

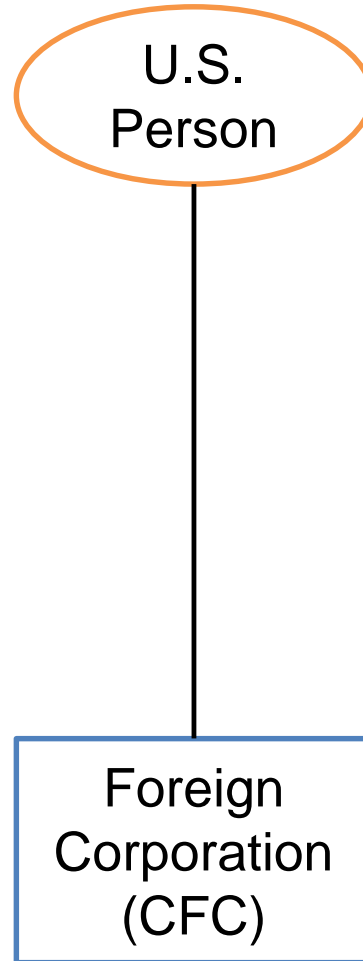
IRC Section 962

- Individual shareholder may elect to be treated as corporation for purposes of Subpart F:
 - ◆ Subpart F income taxed at corporate rates, with indirect foreign tax credit allowed
 - ◆ Not clear if new 50% deduction will apply – opinions differ, IRS guidance awaited
 - ◆ Income is not previously taxed income (PTI), therefore, tax paid at individual rates on actual dividends above tax paid due to the 962 election
 - Not clear if such dividends are/can be qualified dividends (currently being litigated in Tax Court)
- Section 962 historically not much used – but now, may become key, especially where U.S. C corporation cannot be interposed, as noted in previous slide

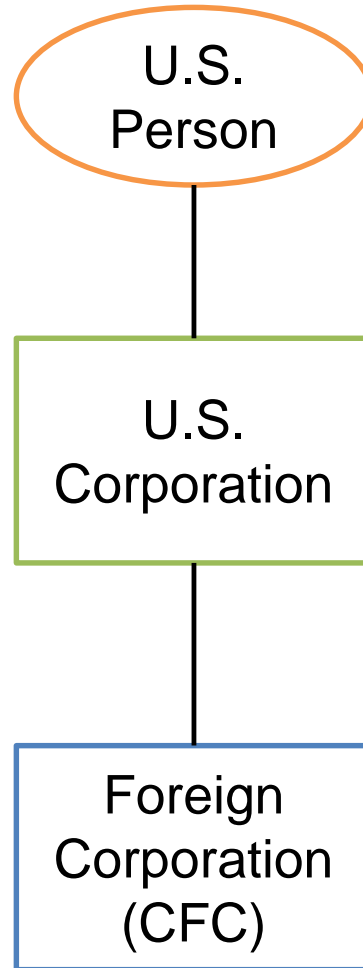
Example

- Client tells you that she wants to operate a business in a foreign low-tax jurisdiction
- How should she hold her foreign corporation interest?

Holding Stock Directly

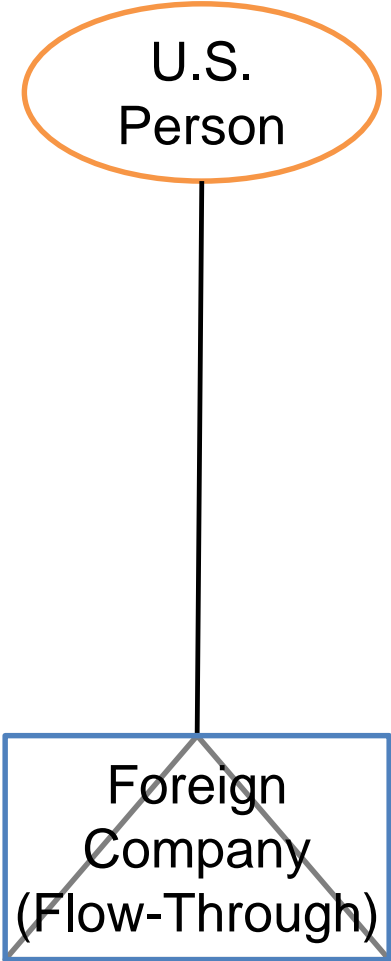


Holding Stock in U.S. Corporation



*Note that deferral is available here

Check the Box



Holding Stock Directly

	Income (Deduction)	Tax
Gross Income – GILTI	\$1,000,000	
Foreign Tax (10%)		\$100,000
Federal Tax (37%)		\$370,000
Distribution from CFC	\$530,000	
PTI	(\$530,000)	
State Tax (CA: 13.3%)		\$70,490
Net Investment Income Tax (3.8%)		\$20,140
Total Taxes		\$560,630

Effective Tax Rate: 56.1%

Holding Stock Through U.S. Corp.

	Income (Deduction)	Tax (Credit)	
Gross Income – GILTI	\$1,000,000		
Foreign Tax (10%)		\$100,000	
GILTI Deduction	(500,000)		
Net GILTI	\$500,000		
Federal Tax (21%)		\$105,000	
Deemed Paid Credit (80%x10%x21%)		(\$40,000)	
Total tax before CFC makes distribution			\$165,000
Distribution from CFC to U.S. Corp.	\$835,000		
Federal tax (\$0 because PTI)		0	
State Tax (CA: 8.84%)		\$73,814	
Total taxes on distribution from CFC			\$73,814
Distribution from U.S. Corp	\$761,186		
Federal Tax (20%)		\$152,237	
State Tax (CA: 13.3%)		\$101,238	
Net investment Income Tax (3.8%)		\$28,925	
Total Tax on distribution from C corporation			\$282,400
Total taxes at all levels			\$521,214

Effective Tax Rate: 52.2%

Check the Box on Foreign Entity

	Income (Deductions)	Tax
Gross Income	\$1,000,000	
Foreign Tax (10%)		\$100,000
Federal Tax (37%)		\$370,000
Foreign Tax Credit		(\$100,000)
State Tax (CA: 13.3%)		\$133,000
Total Tax		\$503,000

Effective Tax Rate: 50.0%

Assumption is that taxpayer materially participates, so no net investment income tax. Otherwise, add another 3.8% to the effective rate.

The Message

- It's all about timing
- Is distribution from foreign corporation needed?
 - ◆ May trigger state corporate tax
- Is distribution from U.S. corporation needed?
 - ◆ Triggers Federal and state income tax
 - ◆ But failure to distribute from foreign corporation to U.S. corporation or U.S. corporation to individual may lead to accumulated earnings tax

Other Changes

- United States shareholder – now defined as holder of 10% of value or voting power (was voting power only)
- Downward attribution – effective 1/1/2017 (sic)
 - ◆ Result: sister foreign corporations (but not parent) of foreign-controlled domestic corporations all become CFCs
 - ◆ IRS has indicated Form 5471 will not be required if CFC has no U.S. direct or indirect (as opposed to attributed) United States shareholders and corporation is CFC only because of downward attribution (Notice 2018-13)
 - ◆ Remember: Portfolio interest exemption does not apply to interest paid to CFC
- Repeal of section 367(a)(3), meaning no taxfree asset transfers to foreign corporations (other than certain intangibles), e.g., branch incorporation
- Expansion of intangibles covered by section 367(d)
- FDII (next slide) and BEAT (only large corporations)

Foreign Deemed Intangible Income

- U.S. C corporations taxed at 13.125% rate on income (above fixed routine return on tangibles) derived from foreign sales or services. IRC section 250
- Foreign-Derived Deduction Eligible Income =

Deemed intangible income \times $\frac{\text{Foreign-derived deduction eligible income}}{\text{All Deduction eligible income}}$

- ◆ **Deemed intangible income** = deduction eligible income – (10% x QBAI)
- ◆ **Deduction Eligible Income** = Gross income – exceptions – allocable deductions
- ◆ **Exceptions:** Subpart F income + GILTI + financial services income + CFC dividend + domestic oil and gas extraction income + foreign branch income
- ◆ **Foreign-Derived Deduction Eligible Income** = Deduction eligible income derived in connection with (1) property sold, leased or licensed to any foreign person for foreign use or (2) services provided to any foreign person or with respect to foreign property, if established to the satisfaction of the IRS

QUESTIONS

The above presentation is based on the completeness and accuracy of facts and assumptions stated above and of any other information provided to us. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, any applicable treaty, and the judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

In addition, it should be understood that presentations of this nature are for purposes of discussion and necessarily involve simplification and compression. Descriptions of tax law in this presentation should be the subject of additional more detailed analysis before compliance or planning is implemented in reliance thereon.