THE FORGOTTEN SOLDIER: OUTBOUND PLANNING FOR INDIVIDUALS AND PASS-THROUGH ENTITIES AFTER TAX REFORM

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During the months leading up to the enactment of the 2017 tax legislation commonly referred to as the Tax Cuts and Jobs Act of 2017 ("TCJA") on December 22, 2017, American Citizens Abroad, an organization based in Geneva, made a valiant attempt to persuade Congress to eliminate citizenship-based taxation for U.S. citizens and replace it with the system that prevails in just about every other country in the world, civilized and some not so civilized. These efforts elicited no sympathy from Congress. No doubt one reason is that the millions of Americans for whom the proposed relief was requested generally do not vote and, even if they did, they have little or no electoral clout.

But Congress went one step further. It enacted a comprehensive reform of the U.S. system of taxing the income of foreign corporations controlled by U.S. persons. The reform was primarily directed at U.S. multinational corporations. Others in this volume will have written at length about this reform, which traded the traditional deferral accorded to the business profits of foreign corporations for a system that taxed most of it at a reduced rate without deferral. We may all form our own views about whether this was good or bad for business – truthfully, the even more important change for corporations was the drastic cut in the corporate tax rate.

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In the process, however, Congress essentially eliminated deferral for U.S. individuals who own controlled foreign corporations ("CFCs"), including all those nonresident citizens, but did not grant the exemption or rate reduction accorded to U.S. corporations. On the contrary, it bestowed immediate taxation on those individuals on most of their income and *increased* the rates, sometimes drastically.

Before their defeat in the November 2018 elections, Republicans in the House (although not their Senate colleagues) set out to pass Tax Reform 2. However, not a word was said in this package about the treatment of U.S. individuals who transact business abroad through CFCs. Their plight, as explained below, remains unabated.[2]

1. Some Background

For decades, the United States has employed what is sometimes referred to as the classical system for taxing income earned by corporations. First, the income was taxed at the corporate level. Then, it was taxed again at the individual shareholder level. Arguably, the second level of taxation was deferred until the corporation made distributions or the shareholder sold shares, although there were significant exceptions.

Not surprisingly, taxpayers sought ways to avoid the double taxation of the same income before it could actually be spent by the economic owners. Congress helped somewhat by allowing certain corporations to elect pass-through status through the vehicle of an S election and by moderating the taxation of collective investment vehicles. Taxpayers organized themselves through partnerships and then the advent of the limited liability company allowed for a single level of taxation without the need for a general partner required to undertake unlimited liability. The 1996 entity classification regulations largely removed any doubt about the viability of this position. Congress meekly responded in 2003 by reducing the tax on distributions to individuals by U.S. C corporations (and certain foreign C corporations) to the rates applicable to long-term capital gains. This hardly made a dent. By this decade, the traditional C corporation had become a greatly diminished presence in the world of closely held businesses.

In the international arena, U.S. citizens and residents who conducted business abroad in foreign corporations were also subject to double taxation. The United States largely ceded the first level of taxation of the income of U.S.-owned foreign corporations to the foreign countries where the income was earned but it then taxed any dividends to U.S. shareholders either at capital gains rates (if the requirements for qualified dividend treatment were met) or at ordinary rates (in all other cases). It also punished the U.S. shareholders if they tried to extract funds from the corporation by some means other than a dividend.

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[2] We should note that on December 20, 2018, a solitary Republican congressman, Rep. George Holding of North Carolina, introduced a bill, H.R. 7538 (the "Tax Fairness for Americans Abroad Act of 2018"), that would effectively eliminate taxation of foreign income and gains of otherwise tax compliant nonresident U.S. citizens. The text of the bill is at https://www.congress.gov/bill/115th-congress/house-bill/7358/text. The bill has no other sponsors and its fate in the newly elected Congress is unknown.

Not surprisingly, U.S. citizens and residents sought out ways to mitigate the double tax burden. The ways to do this became fairly well-known and it does not seem the Internal Revenue Service ("IRS") offered up too much resistance. A U.S. citizen living in a high tax country could establish a corporation in his or her country of residence. Such a corporation was often a tax efficient vehicle in the foreign country, offering lower local taxes on undistributed income that was often needed to fund expansion. By ensuring that the corporation was an eligible entity, the U.S. shareholder could have the corporation make a check the box election and have the foreign corporate taxes creditable. If the U.S. citizen was living in a low- or no-tax jurisdiction, he or she might establish a holding company in a treaty country with favorable internal tax laws, such as the Netherlands or the United Kingdom, and place the business in a lower-tier subsidiary classified as a pass-through entity by means of a check-the-box election. The taxpayer could thereby defer taxation on business income until it was repatriated and the cost of repatriation was limited to a capital gains tax on the dividend.

This kind of planning was not available to those who did not obtain competent advice, which could be hard to find in foreign countries, not to mention costly. For those who did, it was possible for many U.S. individuals, particularly those who live in a foreign country, to cope with the substantive tax burdens. For many, a bigger problem was the overwhelming burden of U.S. reporting requirements – FBARs, Form 8938, Forms 5471, 8865 and 8858, Form 8621, Form 3520 and 3520-A and others – and the life-altering penalties for noncompliance, which apply with high levels of ferocity not only to tax evaders but also to those who simply didn't know any better (and were on the whole very poorly served by the tax advisory community). Before about 2008, U.S. individuals were rarely troubled by the IRS, but all of this changed in the wake of the UBS scandal, which was followed by an aggressive and wide-ranging campaign to enforce the laws as they were written, often with a high price to re-enter the fold of the compliant.

Few however could have expected the blows that Congress landed on them just before Christmas 2017. The blows consisted of a one-two punch of repatriation tax under section 965 for 2017 followed by the GILTI regime for future years.[3] Generally, these rules represented a significant boon to U.S. corporations and a sucker punch to U.S. individuals who own CFCs (and certain other foreign corporations), particularly but not at all limited to those who live abroad. In the spirit of kicking someone when they are down, Congress also significantly expanded the reach of the CFC regime with such changes as the expanded definition of "United States shareholder", the repeal of downward attribution and the repeal of the 30-day rule, as well as other changes, in addition to the surprising failure to repeal section 956. (Of course, for corporations, the IRS subsequently proposed the effective repeal of section 956 – but for individuals, it remains.)[4]

In this article, we will be looking at future planning for U.S. individuals who own shares in foreign corporations. We will not spend much time on section 965, for which little planning is currently possible. Nor will we spend time on classical Subpart F income, particularly passive investment

[3] Except as may otherwise be expressly indicated, all "section" and "IRC" references are to the Internal Revenue Code of 1986, as amended.

[4] See Notice of Proposed Rulemaking, "Amount Determined Under Section 956 for Corporate United States Shareholders", REG-114540-18, 83 FR 55324-9 (November 5, 2018).

income. The Subpart F rules have expanded their scope because of the changes mentioned in the preceding paragraph, but what constitutes Subpart F income is largely unchanged.[5]

Rather, we will look at the new world of planning by individuals for business operations abroad. We will briefly review existing rules, explain the principal changes made by the TCJA, go over the problems these changes create for individuals, and then look at some planning possibilities. Spoiler alert: There is often no magic solution. True relief from many onerous aspects of the TCJA can only come from Congress. Do not hold your breath.

2. The Old

2.1 Objectives of Outbound Investors

Because U.S. taxpayers are taxable on their worldwide income, their two principal objectives in the international arena have been to keep the effective tax rate (that is the combined effect of all U.S. and foreign taxes) as low as possible and to defer the recognition of income for U.S. tax purposes.

Management of the effective tax rate required maximizing the use of foreign tax credits and exemptions and rate reductions allowed by tax treaties and local laws. That is, U.S. taxpayers with business or investment activities could expect to pay tax in foreign countries on such activities, but the foreign tax could be reduced by exemptions and rate reductions under treaties and the U.S. tax on such income generally could be offset by credits for foreign tax paid on foreign income.

The principal technique for deferring recognition of business income required the U.S. person to conduct business operations through a foreign corporation and to ensure that the income of the foreign corporation, typically a CFC, was (1) not effectively connected with the conduct of a U.S. trade or business ("effectively connected income" or "ECI") and (2) not any type of "Subpart F income" that is currently taxable under the CFC rules.[6] The CFC rules were intended to counteract deferral that Congress considered to be inappropriate, *e.g.*, for certain passive or "portable" income. Quite often, the rules went further than mere counteracting and in particular U.S. taxpayers needed to take steps to prevent transactions that in a purely domestic context would have generated capital gain from generating ordinary income in the international arena.

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[5] One qualification: There has always been an exception from the definition of "foreign base company income" for income subject to an effective rate of income tax imposed by the foreign country greater than 90% of the maximum corporate tax rate. IRC section 954(b)(4). Before 2018, that rate was 35%, requiring an effective foreign tax rate that exceeds 31.5%); from 2018, the corporate tax rate is 21%, so the effective foreign tax rate to exceed dropped to 18.9%.

[6] In order for income to be ECI, among other requirements, it generally must either be U.S.-source or fall within one of three specified categories of foreign-source income. IRC section 864(c). The three categories of foreign source income that may potentially be taxed as ECI are: rents or royalties from certain intangible property derived in the active conduct of a U.S. trade or business; certain dividends, interest, or amounts received for the provision of guarantees of indebtedness earned by banks and other financial business, and certain income is derived from the sale or exchange of inventory. IRC section 864(c)(4)(B).

The TCJA did not change these objectives but it has radically changed planning for deferral.

2.2 Anti-deferral Regimes

Before the TCJA, the principal regimes for counteracting deferral using foreign corporations were the CFC rules and the PFIC rules for corporations that (in general) were not CFCs but had high concentrations of passive income or assets.

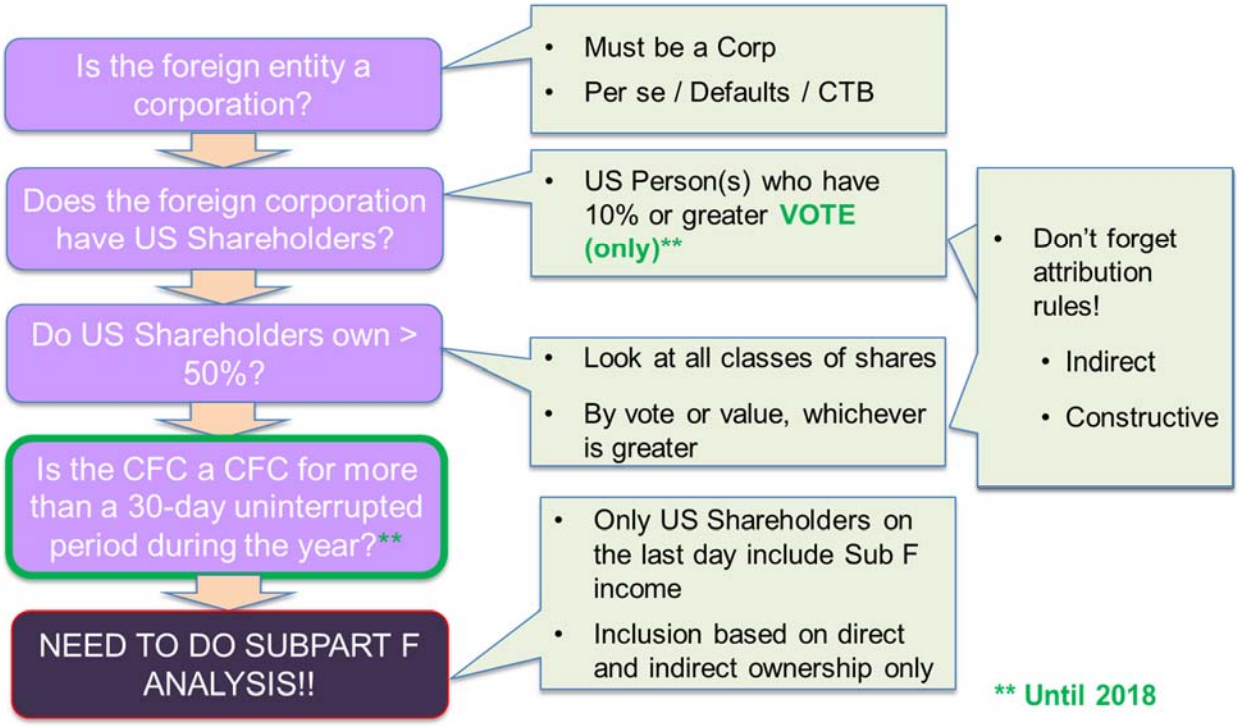
(a) Controlled Foreign Corporations. Foreign corporations do not pay U.S. tax unless they do business or invest in the United States.[7] This is true even if all shareholders are U.S. persons.

However, "United States shareholders" of CFCs are subject to special rules, set forth in Subpart F of the Internal Revenue Code

A "United States shareholder" was defined under the pre-TCJA law as a U.S. person who owns directly, indirectly or by attribution, shares carrying at least 10% of the combined voting power of the shares of the foreign corporation.[8] The following diagram summarizes the analysis that had to be done when a foreign corporation has a mix of shareholders (United States shareholders, other U.S. persons and foreign persons). As we shall see, the TCJA has modified part of the analysis:

[7] See IRC sections 881 (taxation of U.S. source income of foreign corporations not connected with a U.S. trade or business) and 882 (taxation of U.S. source income of foreign corporations that is effectively connected with a U.S. trade or business).

[8] IRC section 951(b). The rules governing indirect ownership and ownership by attribution are set out in sections 958(a) and (b) respectively, as well as by Treasury Regulations under those sections. The use of the term "United States shareholder" is unfortunate, because the appellation does not make clear that it does not include a U.S. person who owns less than 10% of the shares. Therefore, a foreign corporation with 46% of its shares owned by U.S. person A (a United States shareholder) and 54% of its shares owned by six 9% shareholders is not a CFC, even if all six of the 9% shareholders are U.S. persons. The statutory term leaves no convenient shorthand way to describe shareholders who are U.S. persons but own less than 10% of the shares.



Two major consequences flow from being a United States shareholder of a CFC.

First and foremost, the CFC's "Subpart F income" is taxed to U.S. shareholders every year as ordinary income to the extent of the U.S. shareholders' respective interests in the earnings and profits of the CFC.[9] Subject to the new "GILTI" rules discussed below, the CFC's other income generally is taxed to U.S. shareholders only when earnings and profits are distributed as a dividend. If the CFC is a qualified resident of a treaty country, the dividend may be taxed at the same favorable rates applicable to long-term capital gain. Otherwise, the dividend will be taxable as ordinary income.

Second, where a CFC invests in U.S. assets, then with significant exceptions, the amount invested will be included as ordinary income up to the amount of the U.S. shareholder's interest in the earnings and profits of the CFC that have not been previously taxed under Subpart F.[10]

In addition, when a U.S. person sells voting shares of any foreign corporation in which the U.S. person held 10% or more of the combined voting power at any time during the previous five years, then the gain recognized is included in the U.S. person's gross income as a dividend, to the extent

[9] Many CFCs conduct their business in foreign currency and keep records according to local laws and regulations. The challenges posed by U.S. requirements to compute earnings and profits and other items in dollars, under U.S. tax accounting principles, are outside the scope of this article.

[10] IRC section 956. Ordinary income treatment applies even if the taxpayer would have been entitled to treat an actual dividend out of the same income as a qualifying distribution entitled to capital gains treatment.

of the earnings and profits of the foreign corporation attributable to the shares that were accumulated during the period or periods of ownership while the foreign corporation was a CFC.

Several categories of income constitute Subpart F income. The most important of these is "foreign base company income", which in turn has several subcategories:

- Foreign personal holding company income:[11] Various categories of investment income (such as dividends, interest, rents and royalties) as well as capital gains from the sale of property that either generates such income or does not generate income at all. The income in this category of income is known as "foreign personal holding company income". Significant exceptions and limitations, often referred to as "look-through rules", apply where the dividends, interest, rents or royalties were paid to the CFC by a related person and certain other requirements were satisfied.[12] A further significant exception applies to rents and royalties derived in an active trade or business and received from persons who are not related to the CFC.[13]

- Foreign base company sales and services income: Foreign base company sales income is income from the purchase of property from a related party and its resale to another party or the purchase of property from an unrelated party and its resale to a related party, in each case if the property is manufactured and sold for use outside the CFC's country of incorporation.[14] Foreign base company services income is income earned outside the CFC's country of incorporation from services performed (or deemed by certain expansive regulations to have been performed) for or on behalf of a related person.[15]

There are two key exceptions to the definition of foreign base company income. The first is where what would otherwise be foreign base company income (before any deductions), plus certain insurance income, is less than than $1 million or 5% of the gross income of the CFC, whichever is less.[16] The second is for income that is subject to an effective rate of tax in a foreign country that exceeds 90% of the maximum U.S. corporate tax rate.[17] On the other hand, if the foreign base company income (again without deductions but excepting high tax income) exceeds 70% of gross income, the entire income of the CFC, but now taking deductions into account, will be treated as foreign base company income.[18]

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[11] IRC section 954(c). The term "foreign personal holding company" is another unfortunate term, since it conjures up certain outdated foreign personal holding company rules that were repealed in 2004.

[12] IRC section 954(c)(3).

[13] IRC section 954(c)(2)(A) (active rents and royalties); Treas. Reg. § 1.954-2(c) and (d). The regulations clearly narrow the scope of the statute so that active rents and royalties must meet requirements more stringent than simply being earned in the active conduct of a trade or business.

[14] IRC section 954(d).

[15] IRC section 954(e).

[16] IRC section 954(b)(3)(A).

[17] IRC section 954(b)(4). See the discussion in paragraph 5.6 below.

[18] IRC section 954(b)(3)(B).

Because income that escaped current taxation under Subpart F was not taxed until distributed to the shareholders, section 956 imposes immediate taxation on such income if it is repatriated by indirect means, specifically, by being invested in U.S. property, such as loans to U.S. persons. The income could however be invested in U.S. bank accounts or any corporation that was not a United States shareholder of the CFC and where the United States shareholders in aggregate owned less than 25% of the combined voting power. There are other exceptions.[19]

(b) Passive Foreign Investment Company. The passive foreign investment company ("PFIC") rules, enacted in 1986, are the counterpart to the CFC rules.

The alleged purpose of the PFIC rules was to level the playing field between U.S. and foreign collective investment vehicles. (There is therefore no minimum percentage ownership requirement for U.S. shareholders of PFICs.) The former enjoyed tax exemption because of the requirement to distribute their income and pass through their capital gains, but of course this created current taxation for their U.S. investors. The latter largely enjoyed tax exemption (except on U.S. source dividends) but with no requirement to distribute income or pass through gains to U.S. investors, so the U.S. investors enjoyed a valuable deferral. However, the definition of a PFIC goes far beyond offshore funds. It applies to any foreign corporation if, for any year, either 75% or more of its gross income is passive or 50% or more of assets produce passive income (or would produce passive income if sold). An exemption applies to certain start-ups but a corporation that takes more than a year or two to produce business income will likely be a PFIC, at least with respect to the original shareholders.

Since 1997, there has been an "overlap rule" pursuant to which a foreign corporation that is a CFC generally is not treated as a PFIC in the case of a United States shareholder.[20] However, once a foreign corporation is a PFIC in the hands of a shareholder, it remains a PFIC forever so far as that shareholder is concerned, even if the PFIC ceases to meet the definition of a PFIC described below, unless the shareholder elects to mark the shares of the PFIC to market as of the last day of the last taxable year in which the corporation met the PFIC tests or makes one of certain other elections.[21] It is in fact perfectly possible for a corporation to be a PFIC with respect to one U.S. person and not with respect to another.[22]

The PFIC rules recognize that the shareholder does not control the distribution of PFIC profits and therefore does not require a U.S. person to pay tax on PFIC income as it is earned. Instead, it provides for a main regime that allows deferral at a cost, sometimes a very heavy cost, and two elective regimes that allow for current taxation either of the PFIC's income or of gain on an annual deemed disposal of the PFIC shares.

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[19] See IRC section 956(b)(2).

[20] IRC section 1297(d). We won't go into the rather complicated transition rules that apply to foreign corporations that were both CFCs and PFICs in 1997 and in certain other circumstances.

[21] IRC section 1298(b)(1), the so-called "once a PFIC, always a PFIC rule."

[22] For example, a U.S. person who holds less than 10% of the shares of a foreign corporation that meets the definition of a PFIC is subject to the PFIC rules even if other U.S. persons are United States shareholders who are treated as holding non-PFIC shares pursuant to the overlap rule.

More specifically, the principal PFIC regime applies to "excess distributions" by the PFIC. A distribution is an excess distribution if it exceeds 125% of the average of distributions by the foreign corporation in the three preceding taxable years. In addition, any capital gain by a U.S. person from a disposition of the stock of the PFIC is treated as an excess distribution.[23] An excess distribution is then allocated to (i) the year of the distribution, (ii) the PFIC years other than the year of the distribution, and (iii) all years that the corporation was not a PFIC in the hands of the shareholder. The income allocated to the current year and the non-PFIC years is taxed at the highest Federal income tax rate in the current year. The income allocated to the PFIC years other than the current year is taxed at the highest Federal income tax rate applicable in each of the years to which the income was allocated (in other words, broadly speaking for individuals, 39.6% for years prior to 2018 and 37% after that until 2026). The tax on the amounts so allocated is subject to an interest charge at the applicable underpayment rate.

Under the qualified electing fund (QEF) regime, a U.S. holder of PFIC stock can elect out of deferral, using a limited look-through mechanism.[24] The shareholder must recognize as ordinary income a pro rata share of the ordinary earnings and profits of the QEF for the taxable year of the fund and as long-term capital gain a pro rate share of the QEF's net capital gain for the year. However, there is no pass-through of foreign tax credits for foreign tax imposed on the QEF.

A QEF election cannot be made without the cooperation of the foreign corporation because of the requirement that the corporation provide an annual information statement to enable the shareholder to make the relevant computations.[25] Many offshore funds do not make this information available. Typically, funds do not even permit U.S. taxpayers (other than tax-exempt entities such as pension funds) to be shareholders. But such funds cannot always avoid having foreign holders who become U.S. persons or foreign entities that have or acquire U.S. owners or beneficiaries. Those U.S. persons will likely find that they cannot make a QEF election.

If a U.S. holder makes a QEF election with respect to a PFIC for the first year in which such U.S. holder is considered to directly or indirectly own stock of the PFIC, then the PFIC is referred to as a "pedigreed QEF" and the principal PFIC regime described above will not apply to such U.S. holder.

As an alternative to QEF treatment, a U.S. holder of marketable PFIC stock can elect to mark such PFIC stock to market. The result will be ordinary income rather than capital gain, but no interest charges, provided that the election is made for the first year in which the U.S. holder is considered to directly or indirectly own such stock. Where the result is a loss rather than a gain, the loss is

[23] IRC section 1291(a)(2). Moreover, gain generally must be recognized on any transfer of PFIC stock if there is not full recognition of gain – see section 1291(f). The IRS considers that a gift, even a gift to charity, will trigger gain recognition under this provision.

[24] The term "QEF" is yet another misleading term. A foreign corporation does not elect QEF status. The election is made by the U.S. shareholder and different U.S. shareholders of the fund may make different decisions on whether to elect.

[25] IRC section 1295(a)(2).

allowed a deduction but not in excess of unreversed inclusions with respect to such stock.[26] Appropriate basis adjustments are made to account for the mark-to-market gains and losses.

The PFIC rules were not directly changed by the TCJA. However, the expanded reach of Subpart F, described below, and the reduction in the corporate tax rate (and the consequently lower threshold for income to be treated as high tax foreign personal holding company income) both will have some practical impact. The former will cause more U.S. persons to become U.S. shareholders of CFCs (and so not subject to the PFIC rules) and the latter may reduce a foreign corporation's passive income for purposes of determining whether it meets the income and assets tests.

2.3 Outbound Planning – Before and After 2017

Planning for foreign activities of U.S. taxpayers has historically focused on deferring tax and avoiding or mitigating double taxation by the source country and the United States. In addition, since 2004, individuals have sought to secure the benefit of capital gains rates on dividends. On the defensive side, U.S. taxpayers have tried to avoid or limit the impact of the Subpart F rules and the PFIC rules.

A discussion of the numerous facets of Subpart F planning is beyond the scope of this article. We will say only that trying to avoid characterization of income as FBCI has kept numerous taxpayers and their professional advisors fully engaged. The same can be said of avoiding PFIC status for minority investments or even equal joint venture holdings in foreign corporations.

The TCJA has changed the outbound landscape, particularly with respect to investment in foreign corporations. It started with the ending of deferral for pre-2018 earnings. Then, going forward, amid a flood of complex new rules, the universe of CFCs has been expanded and deferral has been largely eliminated for individual U.S. shareholders of CFCs, with some limited exceptions described below. Individuals and closely held business were singled out for particularly harsh treatment.

The new legislation included some additional provisions primarily of relevance to large multinational corporations, including a controversial break for "foreign-derived intangible income" and the base erosion anti-abuse tax. These aspects of the TCJA are outside the scope of this article.

3. The New

3.1 Expanded Reach of Subpart F

While the TCJA retains the existing Subpart F rules, it made several changes that expanded the potential pool of CFCs and U.S. persons who are subject to CFC reporting and related income inclusions as well as the scope of income on which such U.S. persons will be subject to tax.

[26] IRC section 1296.

(a) Definition of "United States shareholder". Before the TCJA, a U.S. person was a United States shareholder only if they owned, directly, indirectly or by attribution, 10% or more of the voting stock of the foreign corporation. Effective for taxable years of foreign corporations that begin after December 31, 2017, a U.S. person is a United States shareholder if they own, directly, indirectly or by attribution, 10% or more of the stock by vote **or** value. This change not only extends the reach of Subpart F, but also adds a level of complexity to the CFC analysis.[27]

(b) Downward Attribution from Foreign (Non-Individual) Persons. The stock ownership attribution rules that permeate Subpart F are found in section 958(a) and (b). Section 958(a) provides for direct stock ownership and indirect stock ownership through foreign entities. Section 958(b) provides rules for determining stock owned constructively through modified section 318 rules.

Section 318(a)(3) attribution rules provide for downward attribution of stock held by a shareholder, partner or beneficiary to a corporation, partnership or trust, respectively. Prior to the TCJA, section 958(b)(4) prevented that downward attribution rule from attributing stock of a foreign corporation owned by a foreign person to a U.S. entity. The TCJA repealed this rule, thus allowing downward attribution from a foreign person to a U.S. entity, effective for the last tax year of a foreign corporation beginning before January 1, 2018; so this is retroactive to January 1, 2017, for calendar year foreign corporations. The section 958(b)(1) attribution limitation that prevents attribution from a nonresident alien individual to a U.S. individual is unchanged.

With this change to the constructive ownership rules, a U.S. corporation, partnership or trust in which a foreign person is a shareholder, partner or beneficiary, respectively, is now considered to own the stock in a foreign corporation owned by the foreign person for purposes of determining whether the U.S. person is a United States shareholder of the foreign corporation and whether the foreign corporation is a CFC. To attribute a foreign person's stock to a U.S. corporation, the foreign person must own more than 50% of the U.S. corporation.

The application of downward attribution is likely to create CFCs where there were none before. Assume for example that a U.S. individual A owns a 20% interest (by vote and value) in foreign parent P. All of the other shareholders of P are foreign persons. P owns 60% of domestic subsidiary DS and 70% of foreign subsidiary FS. Prior to the repeal of section 958(b)(4), neither P nor DS is a CFC. After the repeal, however, the downward attribution of FS stock held by P to DS causes FS to be a CFC. U.S. individual A indirectly owns 14% of FS, so A would now have to annually file a Form 5471 because she is a United States shareholder of a CFC, and she could have a deemed income inclusion under Subpart F, Section 956 or GILTI (discussed below).[28] DS also would have

[27] Stock value has been a factor under the constructive ownership rules in §958(b), which apply in determining if a U.S. person is a United States shareholder and if a foreign corporation is a CFC, but not in determining the U.S. person's income inclusion under Section 951(a).

[28] The Senate Finance Committee explanation of the bill that became the TCJA suggests that lawmakers did not intend that this situation cause FS to be a CFC as to A. However, the statute as written does not reflect that suggested intent.

to file a Form 5471 as a United States shareholder of a CFC, but would not have a deemed income inclusion as a constructive owner.[29]

Another collateral consequence to consider is whether the downward attribution rules that create a CFC would disqualify the "new" CFC from a U.S. portfolio interest exemption. Generally, a foreign corporation's interest income that qualifies as "portfolio interest" is not subject to U.S. tax.[30] Excluded from the definition of portfolio interest is interest received by a CFC from a related person within the meaning of section 864(d)(4). In the example above, if FS loaned funds to DS, FS, now a CFC because of the downward attribution, receives interest income from DS, who is a "related person" within the meaning of section 864(d)(4). That interest would not qualify for the portfolio interest exemptions post-TCJA whereas it would have qualified pre-TCJA.

(c) Elimination of Requirement That Foreign Corporation Be a CFC For At Least 30 Days. Prior to the TCJA, income earned by a foreign corporation that would otherwise qualify as Subpart F income of a CFC was not subject to U.S. tax if the foreign corporation was not a CFC for an uninterrupted period of at least 30 days. This 30-day rule has been repealed, effective for taxable years of foreign corporations beginning after December 31, 2017, As a result, a United States shareholder could have a deemed income inclusion under Subpart F, section 956 and/or the GILTI rules, even if the foreign corporation is a CFC for only one day during its taxable year, so long as the United States shareholder owns the CFC on the last day of the CFC's taxable year.

In the private client practice, this elimination can have a significant impact on a typical inbound inheritance planning strategy used for nonresident aliens with U.S. heirs. A typical structure for this type of client was for the nonresident alien to hold his or her U.S. investment assets in a foreign blocker corporation that was solely owned by a revocable (grantor) trust. During the grantor's lifetime the foreign blocker would not be a CFC and any U.S. beneficiary would not be taxed on its income. At the death of the nonresident grantor, the trust would become a nongrantor trust with U.S. beneficiaries. The trust, if structured properly, can receive a step up in basis in its shares in the foreign corporation as of the date of death. If the foreign corporation remained in the structure and the U.S. beneficiaries owned enough of the foreign blocker under attribution rules to cause the foreign blocker to become a CFC, the Subpart F rules had no impact until at least 30 days after the grantor's date of death. To avoid that result, the trust was able to make a check-the-box election effective within 30 days after the nonresident's death to treat the foreign corporation as a partnership or disregarded entity, resulting in a constructive liquidation of the foreign corporation, and providing the trust a stepped up basis in the underlying investments without creating any taxable Subpart F income. The U.S. beneficiaries were able to avoid taxation under Subpart F, recognition of gain upon the constructive liquidation, as well as any gain upon an actual distribution of the assets.

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[29] The IRS has provided relief from filing Form 5471 for a U.S. person that is a United States shareholder with respect to a CFC if no United States shareholder, including such person, owns, within the meaning of section 958(a) (direct and indirect ownership) stock in such CFC, and the foreign corporation is a CFC solely because such U.S. person is considered to own the stock of the CFC owned by a foreign person under section 318(a)(3). *See* Notice 2018-13, sec. 5.02; Instructions to Form 5471 (Rev. December 2018).

[30] See IRC section 881(c).

With the elimination of the 30-day requirement, the constructive liquidation arising from the check-the-box election would cause the CFC to recognize Subpart F income, taxable to the U.S. beneficiaries. A distribution of the assets to the U.S. beneficiaries would have the same effect. Practitioners who have been relying on this strategy will need to consider alternatives to avoid, or at least reduce, the potential increase in U.S. estate and/or income taxes that would otherwise arise as a result of this change.

(d) Effect of Reduction in Corporate Rate on High Tax Kick-Out. As noted previously, one of the key exceptions to the definition of foreign base company income under the Subpart F rules is for income that is subject to an effective rate of income tax imposed by a foreign country of greater than 90% of the maximum U.S. corporate tax rate.[31] Prior to the TCJA, that would require a foreign tax rate exceeding 31.5%. Effective for tax years beginning after December 31, 2017, the foreign tax rate must only exceed 18.9%.

The items of Subpart F income for which the high tax exception is elected are excluded from inclusion under the GILTI rules (discussed below) as well, allowing for such income to escape U.S. taxation until earnings and profits attributable to that income are distributed.[32]

3.2 One-Time Transition Tax and GILTI

The TCJA added two provisions that generally result in the imposition of additional U.S. tax on a foreign corporation's income that under previous rules would otherwise be deferred until distributed to a U.S. shareholder. The Transition Tax is a one-time mandatory deemed repatriation tax, at a reduced rate, for certain previously unrepatriated earnings of foreign corporations owned by U.S. persons. The foreign corporations impacted include not only CFCs, but also non-CFCs that have one or more domestic corporations as a United States shareholder. The inclusion under the GILTI rules, which only applies to CFCs, generally will include most of a CFC's business income, after allowing for a reduction for a 10% return on the CFC's adjusted tax basis in its depreciable tangible property.

(a) Transition Tax. The Transition Tax under section 965 is a one-time tax applicable to U.S. persons who directly or indirectly own, or are treated as owning via attribution, 10% or more of the voting stock of a "specified foreign corporation" ("SFC"). SFCs include foreign corporations that are CFCs as well as foreign corporations with respect to which one or more domestic corporations is a United States shareholder.[33] Affected U.S. persons must include in taxable income their pro rata shares, determined under rules similar to those that apply for purposes of Subpart F inclusions, of certain post-1986 accumulated earnings and profits of such foreign

[31] IRC section 954(b)(4).

[32] See the discussion in paragraph 5.6 below.

[33] The Transition Tax applies the pre-TCJA definition of United States shareholder and looks only to the ownership of voting power and not the value of the stock.

corporation[34] with respect to the last tax year of the SFC that begins before January 1, 2018. For inclusion purposes, the United States shareholder must be a direct or indirect owner; constructive ownership not enough.

The applicable tax rate on the deemed repatriated earnings is achieved via a deduction and depends on a calculation of the cash and other current assets owned by the SCFs compared to other types of property. With respect to calendar year United States shareholders owning interests in calendar year foreign corporations, for their years that ended on December 31, 2017, the tax rate on unrepatriated earnings invested in cash and other current assets was approximately 15.5% for corporate shareholders and approximately 17.5% for non-corporate shareholders. The remaining portion was taxed at approximately 8% for corporate shareholders and approximately 9.05% for non-corporate shareholders. Higher rates will apply to noncorporate shareholders in 2018. Foreign tax credits may be available to reduce the tax due, subject to rules that disallow any credit (or deduction) for foreign taxes allocable to the portion of the deferred earnings for which a deduction was allowed.

The United States shareholder may elect to pay the resulting tax in installments over an 8-year period, as long as (i) the election to so pay is made by the due date, including extensions or additional time that would have been granted had the taxpayer requested an extension, of the shareholder's tax return in which the transition tax is reportable and (ii) the first installment is paid by the due date, without regard to extensions, of such tax return.[35] No late election relief is available.

The first installment, as well as future installments, must be paid separately from estimated and extension tax payments.[36] The IRS has provided limited relief for certain taxpayers who did not timely pay the first installment.[37]. Failure to timely pay future installments, as well as certain other events, may accelerate the remaining transition tax installments in full.

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[34] The undistributed, non-previously-taxed post-1986 foreign earnings of the foreign corporation is determined as of November 2, 2017, or December 31, 2017, whichever is higher, but only for the time when the foreign corporation was a "specified foreign corporation."

[35] The IRS allows an individual U.S. citizen or resident whose tax home is outside the United states who is entitled to an extension of time to file and pay tax to the fifteenth day of the sixth month following the close of a taxable year (generally June 15) under Treas. Reg 1.6081-5 to pay the section 965 tax by that extended due date. Prop. Reg. section 1.965-7(b)(a)(iii)(B), Notice 2018-26, sec. 3.05(e); IRS Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns.

[36] See Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns and Questions and Answers about Reporting Related to Section 965 on 2018 Tax Returns on the IRS website for further information on payments, forms to file and application of tax overpayments.

[37] If an individual's net tax liability under section 965 in the individual's 2017 taxable year is less than $1 million, the individual makes a timely election under section 965(h), and the individual did not pay the full amount of the first installment by the due date under section 965(h)(2), the failure to make the payment will not result in an acceleration event under section 965(h)(3) so long as the individual pays the full amount of the first installment (and its second installment) by the due date for its 2018 return (determined without regard to extensions). See Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns, Q& A16,

Curiously, S corporation shareholders can defer the start of the 8-year period indefinitely, subject to certain triggering events. The election to defer payments is due by the due date for the shareholder's return, taking into account any extensions, for the taxable year that includes the last day of the taxable year of the S corporation in which the S corporation has transition tax inclusion. No late election relief is available. The S corporation shareholder must report its deferred net tax liability on its return for each subsequent tax year until the liability has been fully assessed. The failure to so report may result in an addition to tax of 5% of such deferred net tax liability.

(b) GILTI – The (Very) Basics. The TCJA added a new category of income that, in many respects, is treated in the same manner as Subpart F income. United States shareholders of CFCs are subject to tax on their share of the CFC's Global Intangible Low Taxed Income ("GILTI") under new section 951A. Ironically, the income subject to tax under these rules may not be derived from intangibles and may not be low-taxed income. GILTI generally includes the CFC's business income, reduced by 10% of the adjusted tax basis of the CFC's depreciable tangible personal property (less certain interest expense).

(1) GILTI Computation. While the statute is full of definitions of particular terms used in calculating the amount of GILTI subject to tax, the computation, in very basic terms, is as follows:

a) CFC's gross income, excluding:

- Effectively connected income
- Subpart F income
- High foreign tax FPHC income (effective rate exceeding 90% of U.S. corporate rate)
- Dividends received from a related person
- Foreign oil and gas extraction income

b) Less: deductions allocable to such included gross income

c) Less: the excess of 10% of the aggregate of such shareholder's pro rata share of the CFC's adjusted tax basis (average determined on a quarterly basis) in depreciable tangible personal property used in a trade or business over allocable interest expense.

(2) GILTI Taxation. A United States shareholder's pro rata share of the total GILTI of its CFCs is subject to tax in the largely same manner as Subpart F income included in gross income under section 951(a)(1)(A), i.e., as ordinary income. As is the case for many of the TCJA's changes to the taxation of the income of foreign corporations controlled by U.S. persons, the GILTI rules are significantly more favorable to C corporation shareholders than to individual and trust shareholders

(whether they own their CFC stock directly or through pass-through entities). New section 250 allows C corporation United States shareholders to deduct 50% of the GILTI amount[38] and the section 960 deemed paid credit rules allow only such corporate shareholders a credit for a pro rata share of up to 80% of the foreign income taxes imposed on the GILTI of their CFCs. The deduction and the deemed credit are not available to non-C corporation shareholders, making the GILTI rules much more harsh for non-C corporation shareholders if steps are not taken to reduce or defer taxes on GILTI.

4. Identifying Problems Relevant to Individuals

As should be clear from the discussion above, the application of the GILTI regime to individuals who are United States shareholders (or who own interests in domestic pass-through entities that are United States shareholders) of CFCs is quite harsh. Consistent with the rules applicable to Subpart F income, GILTI inclusions are taxed at ordinary rates, which are currently much higher than corporate rates, and indirect foreign tax credits are not available. Moreover, the section 250 deduction of 50% (or, for taxable years beginning after 2025, 37.5%) of a C corporation's GILTI is not allowed to individuals. An example helps illustrate just how dramatic the effect of GILTI can be to a non-corporate United States shareholder.

Assume Moe, a U.S. citizen, owns 100% of FCo, a CFC. During the year, FCo earns $1,000,000 of income all of which is characterized as GILTI.[39] FCo is subject to a 20% income tax in its home jurisdiction. The following table illustrates Moe's global effective tax rate:

	Income (Deduction)	**Tax**
Gross Income – GILTI	$1,000,000	
Foreign Tax (20%)		$200,000
Federal Tax (37%)		$296,000
Distribution from FCo to Moe	$800,000	
PTI	($800,000)	
Foreign withholding tax (15%)	$120,000	$120,000
State Tax (8%)		$64,000
Net Investment Income Tax (3.8%)		$30,400
Total Taxes		**$710,100**
Effective Tax Rate: 71%		

[38] This deduction is reduced to 37.5% beginning in 2026.

[39] This is not an unreasonable assumption. It is not uncommon for a closely-held CFC to have very little tangible assets that would generate QBAI, especially in the case of service businesses.

The results are staggering: A 71% effective tax rate, of which approximately 50% will be paid when earned.[40]

Now, contrast the above with the situation where Moe owns FCo through Newco, a U.S. corporation:

	Income (Deduction)	**Tax (Credit)**	
Gross Income – GILTI	$1,000,000		
Foreign Tax (20%)		$200,000	
GILTI Deduction (until 2026) (Sec. 78 gross up)	(500,000)		
Net GILTI	$500,000		
Federal Tax (21%)		$105,000	
Deemed Paid Credit (80%x20% = $160,000)		($105,000)	
Total tax before FCo makes distribution to Newco			$200,000
Distribution from FCo to Newco	$800,000		
Federal tax ($0 because PTI)		0	
Foreign tax withholding (5%)		$40,000	
State Tax (7%)		$56,000	
Total taxes on distribution from FCo			$96,000
Distribution from Newco to Moe	$704,000		
Federal Tax (20%)		$140,800	
State Tax (8%)		$56,320	
Net investment Income Tax (3.8%)		$26,752	
Total Tax on distribution from Newco			$223,872
Total taxes at all levels			**$519,872**
Effective Tax Rate: 52%			

By interposing a U.S. corporation to hold the shares of FCo, Moe has reduced his global effective tax rate by approximately 20%. Moreover, because of the section 250 deduction and the 80% indirect foreign tax credit, Moe is only subject to a 20% tax rate when the income is earned. All the other taxes arise when distributions are made from FCo and Newco – the timing of which, Moe can control.

[40] Note that it is currently unclear whether Moe might find some relief under IRC section 960(c) for the foreign withholding tax on the dividend of the previously-taxed GILTI to Moe.

Accordingly, is the message simply for Moe to interpose a U.S. corporate holding vehicle? While this may be an attractive solution, which will be discussed further below, there are often times where such a solution is not possible. The following are a few examples of why the use of a U.S. corporation may not make practical sense.

First, U.S. expatriates who are income tax residents in a foreign country may not be able to utilize a U.S. corporation holding company vehicle, which may create a sandwich for foreign country purposes. As an example, suppose Larry is living and working in London and is considered a U.K. income tax resident under U.K. law. It likely makes sense for a variety of reasons for Larry to conduct his business through a U.K. entity, which will almost assuredly be classified as a foreign corporation for U.S. tax purposes. Thus, under U.S. law, Larry will be the owner of a CFC and be subject to the Subpart F and GILTI regimes. However, for U.K. purposes, it could be disastrous to interpose a U.S. entity above the U.K. entity, which for U.K. purposes could give rise to additional layers of taxation that would otherwise be avoided by Larry holding the U.K. entity directly.

Second, temporary U.S. persons exiting in the short-to-medium term also may find it overly costly to utilize a U.S. corporation holding company vehicle, which is not attractive once that individual ceases to be a U.S. person.

Finally, U.S. beneficiaries of foreign trusts also do not practically have the ability to interpose a U.S. corporation. The attribution rules discussed above may result in a foreign corporation being a CFC if there are U.S. beneficiaries that can be attributed control of the corporation. However, it is likely impractical to interpose a U.S. corporation as a holding company of the CFC, especially if there are also foreign beneficiaries. Moreover, there is no way for the U.S. beneficiaries to hold their beneficial interests in the foreign trust through a U.S. corporation.

These are but a few examples of situations where the seemingly obvious choice to interpose a U.S. corporation may simply not viable. Therefore, we next explore planning techniques available to non-corporate United States shareholders of CFC, including expanding upon use of a U.S. corporate holding vehicle, but also including alternative structures where a U.S. corporate vehicle is not a viable solution.

5. Planning

5.1 Introduction

Individuals faced with GILTI regime will wish to consider several different planning options, including the following:

- Holding their direct or indirect interests in the CFC through a domestic holding company classified as a C corporation (see paragraph 5.2).

- Converting the CFC to a partnership or disregarded entity for U.S. federal tax purposes (see paragraph 5.3).

- Making a section 962 election (see paragraph 5.4).

- Taking steps to avoid CFC or United States shareholder status (see paragraph 5.5).

- "Backwards" planning for the high-taxed income exception (see paragraph 5.6).

5.2 Domestic C Corporation Holding Company

As should now be obvious, an individual who holds CFC stock through a domestic C corporation ("Holdco") will enjoy preferential taxation of GILTI in several respects. Such preferences include the lower corporate rate of 21%, the 50% (or 37.5%) GILTI deduction under section 250, and the ability to claim indirect foreign tax credits (albeit subject to a 20% "haircut," such that no more than 80% of the foreign taxes paid by the CFC will be creditable). Moreover, the domestic corporation pays no tax at all on distributions of QBAI or high tax kickout income.

Accordingly, subject to the viability of the other alternatives, the Holdco approach has much to recommend it. On the other hand, C corporations are sometimes referred to as "roach motels," because it's easy to get in, but not so easy to escape. Taxpayers and their advisors must take care to consider the long-term consequences and not just the short-term benefits before checking in. This is particularly true in the case of temporary U.S. taxpayers, such as a foreign entrepreneur who moves to the United States for a temporary period of time to establish or expand their U.S. business but with the intention of returning home. For such taxpayers, eliminating the U.S. holding company on their return to their home country corporation may be both essential for home country tax purposes and prohibitively expensive in the United States.

In this regard, one key consideration is the type of an exit. For example, if is expected that stock of the CFC will be sold to a foreign purchaser for cash, having Holdco in the mix is likely to be problematic. If Holdco sells its CFC stock, Holdco will pay a U.S. corporate income tax that presumably could have been avoided if the individual shareholder had sold the CFC stock directly; and the shareholder-level tax typically would need to be paid as well.[41] In this regard, some may view the expected leakage at the current corporate rate of 21% to be acceptable, but there is no guarantee that the corporate rate will not increase substantially in the future.

Moreover, even prior to sale, taxpayers and their advisors will need to consider whether the GILTI can be accumulated within the CFC, or else within Holdco, or whether it will be necessary for Holdco to pay taxable dividends to the individual shareholders. The ability to accumulate income within a corporation on a tax-free basis is constrained by the personal holding company rules and the accumulated earnings tax.[42] Although the accumulated earnings tax has had little practical significance for several decades, the gap between the maximum corporate and individual rates has

[41] A possible solution is to sell the stock of Holdco, rather than the CFC stock, but even in the not-so-likely event that the foreign purchaser is willing to buy Holdco stock, a substantial discount to the purchase price should be expected.

[42] *See* IRC sections 541 and 531.

brought renewed attention to the tax and all its uncertainties and it is not known if the IRS will enforce the tax with a heavy or light touch.

Finally, as with any cross-border structure, it is critical that foreign tax consequences be considered. For example, although the transfer of CFC stock to a domestic C corporation will likely be a taxfree incorporation under section 351, it may potentially be taxed in the jurisdiction in which the CFC is resident as well as the jurisdiction where the individual shareholder resides, if that is not the United States. It should certainly not be assumed that the foreign country has an equivalent to section 351 or, if it does, that it does not have an equivalent to section 367. Moreover, in the case of U.S. citizens or even green card holders who reside in a foreign country, the interposition of Holdco may create a "sandwich" structure for foreign tax purposes, and foreign tax consequences of such a structure may be quite unfortunate. It is also necessary to consider whether the change in structure will favorably or unfavorably affect the withholding rate when the CFC pays dividends to Holdco, instead of Holdco's individual shareholder. It should not be assumed, for example, that the interposed domestic C corporation will automatically qualify for reduced dividend withholding rates under treaties (0% or 5% v 15%) in those countries that impose such taxes.[43]

5.3 Converting the CFC to a Partnership or DRE

Another possible approach, particularly where deferral is no longer available, is simply to eliminate the corporate structure. For example, if the CFC is an eligible entity, filing an entity-classification to convert the CFC into a partnership (or, if the CFC has only one owner, a disregarded entity) may be beneficial. If the foreign entity conducts its business in a high-tax country, the ability to claim foreign tax credits (thereby avoiding or limiting double taxation) may be extremely valuable.

Of course, where partnership or DRE status is not chosen from the outset, taxpayers must keep in mind that, for an existing entity, the change in status may trigger a substantial amount of gain.[44] Moreover, the foreign tax consequences of the partnership or DRE status would need to be considered, particularly as the foreign entity may be or become a hybrid, that is, an entity classified as a corporation for foreign tax purposes but transparent for U.S. tax purposes. Various bilateral

[43] A miscellany of foreign countries do not impose taxes on dividends paid to foreigners, particularly out of income that has been taxed at the corporate level: Australia, Mexico, the Netherlands and the United Kingdom are examples. But many countries do and those countries may have anti-avoidance rules designed to limit the use of treaties to reduce withholding rates in situations deemed abusive.

[44] In such cases, an alternative transaction involving a transfer to an S corporation pursuant to a corporate reorganization may be worthy of consideration.

and multilateral measures have been promulgated both in the United States[45] and abroad[46] to counteract perceived or actual tax avoidance resulting from hybridity.[47]

5.4 Section 962 Election

The highlighted passages refer to the question of whether the section 250 deduction is available to individuals who make an election under section 962. When we wrote the article, there was some debate among the authors concerning this question – the article ultimately reflected the views of the pessimists. However, Treasury and the IRS, in a rare act of mercy towards individual taxpayers in the international area, confirmed that where an individual taxpayer elected to pay tax as if it were a corporation, the section 250 deduction would be allowed. See Prop. Reg. § 1.962-1(b)(1)(i)(B)(*3*) (84 FR 8188, March 6, 2019), available at https://www.federalregister.gov/documents/2019/03/06/2019-03848/deduction-for-foreign-derived-intangible-income-and-global-intangible-low-taxed-income (viewed May 21, 2019).

As has been discussed thoroughly throughout this article, U.S. individual shareholders of CFCs earning income that would be categorized as either traditional Subpart F or GILTI are subject to harsher income tax treatment than U.S. corporate shareholders. First, the rate differential between individuals and corporations is now significant – 37% for individuals versus 21% for corporations. Second, individuals cannot take an indirect foreign tax credit for taxes paid by the CFC, which is afforded to U.S. corporate shareholders.[48] Finally, with respect to GILTI, the section 250 deduction is (probably) not available to individuals.

This treatment, as mentioned above, has encouraged a shift to a U.S. corporate holding structure through which the shares of the CFC are owned. This planning, indeed, can often result in the optimal structure and be the recommended course of action. However, such restructuring has its costs, and for certain taxpayers, it is simply not a palatable solution. We have highlighted certain of the reasons why it may be impractical to interpose a U.S. corporate holding structure above. Does that mean, then, that these individuals are destined for effective tax rates that can approach

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[45] The old: IRC section 894 and, in particular, Treas. Reg. § 1.894-1(d). The new: IRC sections 267A and 245A.

[46] OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, Action 2 (see Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, dated October 5, 2015 (available at www.oecd.org/ctp/neutralising-the-effects-of-hybrid-mismatch-arrangements-action-2-2015-final-report-9789264241138-en.htm); European Union Anti-Tax Avoidance Directive, Directive 2016/1164 (June 20, 2016) (available at https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=uriserv:OJ.L_.2016.193.01.0001.01.ENG&toc=OJ:L:2016:193:TOC), as amended by Council Directive regarding hybrid mismatches with third countries (May 12, 2017) (available at http://data.consilium.europa.eu/doc/document/ST-6661-2017-INIT/en/pdf).

[47] The amended EU Council Directive has useful summary of what it regards as the four general types of hybrid mismatch: First, hybrid mismatches that result from payments under a financial instrument; second, hybrid mismatches that are the consequence of differences in the allocation of payments made to a hybrid entity or permanent establishment, including as a result of payments to a disregarded permanent establishment; third, hybrid mismatches that result from payments made by a hybrid entity to its owner, or deemed payments between the head office and permanent establishment or between two or more permanent establishments; lastly, double deduction outcomes resulting from payments made by a hybrid entity or permanent establishment.

[48] See IRC section 960.

upwards of 70% depending on the tax rates imposed in the CFC's home jurisdiction and other taxes imposed by the individual's state or country of residence? Or is a tool available, other than the alternatives already discussed, that provides the best of both worlds? Well, not quite, but for some taxpayers section 962 may get us close.

Section 962 was enacted with the original Subpart F provisions in 1962.[49] Its intended purpose was to provide parity between U.S. individual shareholders investing directly in CFCs and those investing through a U.S. corporation. Section 962 provides that an in individual who is a "United States shareholder"[50] may elect to have the tax imposed on an inclusion under section 951(a)[51] be the amount of tax which would be imposed under sections 11 and 55 if such amounts were received by a domestic corporation.[52] Section 962 also allows an electing individual to benefit from section 960, which provides an indirect foreign tax credit on Subpart F inclusions. In other words, non-corporate United States shareholders of a CFC may make an election to have a Subpart F or GILTI inclusion taxed in certain respects as though it was received by a fictional U.S. corporation. U.S. corporate tax rates will apply to the inclusion and an indirect foreign tax credit is available for taxes paid by the CFC. Thus, parity is achieved, right? Well not quite.

A currently unresolved issue with respect to the application of section 962 to GILTI is whether the section 250 deduction is available. Section 962 provides that the amount of tax specified in section 11 shall be applied to "amounts which are included in [the taxpayer's] gross income under section 951(a)."[53] Moreover, treasury regulation section 1.962-1(b)(1) provides that for purposes of applying section 11, "taxable income" shall mean the sum of the Subpart F and GILTI inclusions and the section 78 gross-up for foreign taxes paid by the CFC. It further provides that "such sum shall not be reduced by any deduction of the United States shareholder."[54]

Therefore, the literal reading of section 962 as implemented by the regulations suggest that "taxable income" for purposes of applying section 962 means the gross section 951(a) inclusion and not the traditional definition of "taxable income" as found in section 11, which would include corporate level deductions. On the other hand, though, not allowing the section 250 deduction appears to be contrary to the legislative intent behind section 962, which aimed for an individual to pay the same amount of tax as a corporation for purposes of the section 951(a) inclusion. It is also arguable that the regulations are not consistent with the plain language of the statute, which says nothing about denying deductions, especially deductions that would be allowed to a corporation. Section 250 regulations are anticipated imminently, and it is hoped this issue will be resolved, preferably in favor of individuals; but for many reasons a favorable resolution seems

[49] Pub. L. 87-834, Sec. 12(a), Oct. 16, 1962.

[50] As defined in IRC section 951(b).

[51] IRC section 951(a) is the section that provides that Subpart F inclusions are includible in the taxpayer's gross income. GILTI inclusions are includible in gross income via section 951(a) and thus section 962 is also available with respect to a GILTI inclusion. See IRC section 951A(f)(1)(A).

[52] IRC section 962(a)(1).

[53] Id.

[54] Treas. Reg. section 1.962-1(b)(1).

highly unlikely. Pending the issuance of regulations under section 250, many practitioners have understandably taken the position that the section 250 deduction is unavailable.

An example helps illustrate the application of section 962, specifically to GILTI; for purposes of this example, we assume that no section 250 deduction is available. Assume Curly owns 100% of FCo, a CFC. In 2018, FCo earns $1,000,000 of GILTI and pays $250,000 of foreign tax. If Curly does not make a section 962 election, he would include $750,000 in his gross income, which would be subject to U.S. tax at a rate of 37% ($277,500). If Curly does make a section 962 election, he would include $1,000,000 in his gross income, which would be subject to U.S. tax at a rate of 21% ($210,000). Against the U.S. tax, Curly is entitled to a foreign tax credit of 80% of the foreign taxes paid ($200,000).[55] Thus, Curly pays a net $10,000 in U.S. taxes.

The above discussion has to this point been limited to the application of section 962 solely with respect to the section 951(a) inclusion. But what happens on a distribution from the CFC? In the case of an individual who does not make an election, the GILTI inclusion becomes previously taxed income ("PTI")[56] and is not subject to further U.S. federal income tax.[57] In the case of a section 962 election, section 962(d) makes clear that notwithstanding section 959(a)(1) (the provision that prevents Subpart F inclusions from being taxed a second time when actually distributed), a distribution of earnings and profits for which a section 962 election was made is to be included in the gross income of the U.S. shareholder (the "taxable section 962 E&P") other than an amount equal to the amount of U.S. tax paid at the time of the election (the "excludible section 962 E&P"). Thus, in the above example, the $10,000 Curly paid can be distributed U.S. tax-free as excludible section 962 E&P. The rest of the distribution, the taxable section 962 E&P, is included in Curly's gross income upon receipt.

The characterization of the distribution to Curly has given rise to some interesting questions. First, is the distribution properly characterized as a dividend? Section 962 only provides that the taxable section 962 E&P must be "included in gross income," but does not specify the mechanism for inclusion (e.g., a regular corporate distribution versus a Subpart F or GILTI inclusion). Second, if the distribution is a dividend, if received from a CFC located in country without an income tax treaty with the United States, can the dividend be treated as a qualified dividend by virtue of the section 962 election? A recent Tax Court case, *Smith vs. Commissioner*,[58] provided answers to both questions.

With respect to the first question, it does not appear that either party took the position that the distribution should be anything other than a dividend and the Tax Court based its analysis on the notion that the distribution was properly characterized as a dividend. Thus, it seems fairly clear that a distribution of taxable section 962 E&P is characterized as a dividend.

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[55] See IRC section 960(d).

[56] See IRC section 951A(f)(1)(A) providing that a GILTI inclusion is treated as a Subpart F inclusion for purpose of IRC section 959.

[57] Although at the time of the distribution, unless an election is made otherwise, the 3.8% net investment income tax will apply. Applicable state tax will also apply upon receipt of the distribution.

[58] 151 T.C. No. 5 (2018).

With respect to the second question, the Tax Court held that for purposes of determining whether the dividend is a qualified dividend subject to preferential tax rates, the usual analysis governs; if the distribution is not from a qualified foreign corporation, the dividend is not qualified and is taxed at ordinary income tax rates. The taxpayer in the case sought to have the dividend treated as being made from a fictitious U.S. corporation (deemed to exist on account of the section 962 election), but this argument was rejected.

Expanding upon the prior example, if FCo is a qualified foreign corporation (and the holding period requirement is met), then the distribution of the $750,000 is divided into two - $10,000 of excludible section 962 E&P and $740,000 of taxable section 962 E&P. The $740,000 of taxable section 962 E&P will be subject to U.S. tax at a rate of 20% ($148,000). If FCo was not a qualified foreign corporation, the $740,000 of taxable section 962 E&P would be subject to tax at a rate of 37% ($273,800). In either case, if the foreign country imposed a tax on the dividend (typically by requiring the tax to be withheld), it would seem that the tax would be creditable. That is because it is a foreign tax imposed directly on the U.S. taxpayer.

There remain several issues with section 962, which make its application to the new paradigm of U.S. taxation of U.S. shareholders of CFCs difficult to measure. For instance, take the scenario of an individual who holds a 2% interest in a U.S. fund, which owns 100% of a CFC. Here, the individual would not be a United States shareholder and thus not able to make a section 962 election[59] despite being allocated his/her share of the domestic fund's Subpart F or GILTI. Moreover, the domestic fund does not have the ability to make the section 962 election on behalf of its partners. Nor could a foreign non-grantor trust indirectly owned by U.S. beneficiaries be able to make the election – it would seem that the election could only be made by a U.S. beneficiary treated as indirectly owning at least 10% of the shares under the impenetrable rules relating to indirect ownership of foreign trusts.

The state tax treatment of amounts for which a section 962 election has been made is also unknown. A state-by-state analysis will be necessary, but there are situations where it is fathomable to see state tax being paid twice – once on the inclusion and again on the distribution.

Finally, for those U.S. shareholders that are temporary U.S. persons, it is not clear what happens upon an exit from the United States. For instance, take the situation where a U.S. person is in the United States on a temporary work assignment for a period of three years. During her time present in the United States, she is a U.S. shareholder of a CFC that generates significant GILTI. Each year, the individual makes a section 962 election and because of the foreign tax rate, no U.S. tax is paid (i.e., the 80% indirect foreign tax credit offsets the entirety of the GILTI inclusion). Following an exit from the United States, what happens to the taxable section 962 E&P? As the *Smith* case makes clear, the taxable section 962 E&P does not become the E&P of a domestic corporation, which could have resourced the E&P from foreign to U.S. And there is nothing in section 962 or its regulations that cause a deemed inclusion prior to the individual's exit from the

[59] IRC section 962(a) refers only to U.S. shareholders who are individuals (and presumably domestic non-grantor trusts) as having the ability to make a 962 election. See also Treas. Reg. § 1.962-2(a).

United States. Does this taxable section 962 E&P escape U.S. taxation entirely? It would absolutely seem so.

5.5 Avoiding CFC or U.S. Shareholder Status

As noted above, a foreign corporation generally is a CFC only if "United States shareholders" collectively own (directly, indirectly, or constructively) stock representing more than 50%, by vote or value, of the total outstanding stock of the foreign corporation.[60] For this purpose, a "United States shareholder" is any U.S. person that owns (directly, indirectly, or constructively) stock representing at least 10%, by vote or value, of the total outstanding stock of the foreign corporation.[61] Moreover only United States shareholders (and U.S. owners of interests in domestic pass-through entities that are United States shareholders) are subject to the provisions of Subpart F, including the new GILTI rules.

While these rules have been broadened somewhat under the TCJA,[62] the fundamental principles are unchanged. Thus, for example, a U.S. individual who directly or indirectly owns stock in a foreign corporation may avoid the Subpart F rules, including the GILTI regime, by limiting her or her interest so as to avoid United States shareholder status. For example, suppose that Robin, a U.S. citizen, is considering the purchase of 10% of the stock of FC, a CFC that is wholly owned by another, unrelated U.S. person. If Robin does not wish to be punished by the GILTI rules, she may wish to reduce her purchase, *e.g.*, to 9.9%.

Alternatively, suppose that stock of FC, a foreign corporation, is 55%-owned by Noah, a U.S. citizen, and 45%-owned by Pierre, a nonresident alien. If Noah were to sell 5% of his stock in FC to Pierre, so that each owns stock with 50% of the vote and value, FC may cease to be a CFC and Noah may then be able to avoid the GILTI rules.

Of course, efforts to decontrol a CFC (or even to avoid CFC status in the first place) may be scrutinized by the IRS. Taxpayers and their advisors would be well advised to ensure that the substance of such transactions is consistent with their form if they wish to avoid unfortunate surprises.[63] Moreover, taxpayers who can successfully avoid Subpart F must be sure to consider potential consequences under the PFIC rules. As noted above, the PFIC rules were left untouched by the TCJA.

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[60] IRC section 957(a).

[61] IRC section 951(b).

[62] *See* 3.1(a) and 3.1(b), above regarding the expanded definition of United States shareholder and the repealed prohibition on downward attribution.

[63] *See*, *e.g.*, Garlock v. Commissioner, 58 T.C. 423 (1967), for a case in which the purported decontrol of a CFC (through the issuance of voting preferred stock to an unrelated foreign shareholder) was disregarded as lacking substance. *See also* Treas. Reg. §1.957-1(a)(2) ("Any arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained.")

5.6 Upside Down – Investing in High Tax Foreign Country Real Estate

As noted above, one of the exceptions from the GILTI pertains to high-taxed income, which is excluded from the scope of tested income. Taking advantage of the exclusion requires an election, which must be made in accordance with regulatory requirements. The election is made by the controlling U.S. shareholders and is binding on all U.S. shareholders.[64]

To be more precise, the exception is for "any gross income excluded from the foreign base company income (as defined in section 954) and the insurance income (as defined in section 953) of such corporation by reason of section 954(b)(4)[.]"[65] Unfortunately, this exception only applies to income that would be foreign base company income ("FBCI"), or insurance income described in section 953, but for the high-taxed exception set forth in section 954(b)(4). Accordingly, active business income that does not fall within any category of FBCI (and is not insurance income) cannot be excluded from tested income for GILTI purposes under the high-taxed exception.

The result of this is that, for individuals subject to Subpart F, in high tax countries, FBCI may now be preferable to non-FBCI. And what constitutes a high tax country has been considerably expanded. With the reduction of the maximum U.S. corporate tax rate to 21%, FBCI will be considered high-taxed if it is taxed at an effective rate of greater than18.9%, *i.e.*, 90% of 21%, instead of greater than the 31.5%, *i.e.*, 90% of 35% that prevailed before 2018. The nominal corporate rate in a significant majority of our major trading partners is greater than 18.9%.[66]

Planners are cautioned to take account of the fact that effective rates of foreign tax and nominal rates are generally not the same – factors such as differences in the tax base, the timing of foreign currency conversions and the allocation of deductions can affect the result. The applicable regulations, with their multi-step processes and detailed rules, are not for the faint of heart.[67]

Accordingly, in appropriate cases, taxpayers may wish to consider heretofore "backwards" tax planning that, for example, treats rent income not as active but as passive rent income, a type of FBCI.[68] Taxpayers will be aided by the historically narrow interpretation of the active rents exception in the regulations defining FBCI.[69]

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[64] Treas. Reg. § 1.954-1(d)(5); Treas. Reg. §1.964-1(c)(5) (definition of controlling United States shareholders).

[65] IRC section 951A(c)(2)(A)(i)(III).

[66] Some examples: Australia (30%), Brazil (34%), Canada (26.5%), People's Republic of China (25%), France (33%), Germany (30%), Italy (24%), Japan (30.86%), Mexico (30%), the Netherlands (25%), Russia (20%), Spain (25%), Switzerland (18%), Taiwan (20%). Notable exceptions: The United Kingdom (19% and scheduled to go down further) and Ireland (12.5%). Source: KPMG Corporate Tax Rates Table (available at https://home.kpmg/xx/en/home/services/tax/tax-tools-and-resources/tax-rates-online/corporate-tax-rates-table.html).

[67] Treas. Reg. § 1.954-1(d), which also incorporate the rules of Treas. Reg. § 1.904-4(c).

[68] Foreign personal holding company income is a type of FBCI, and passive rent income is a type of foreign personal holding company income. IRC sections 954(a)(1) and (c)(1)(A).

[69] See footnote 64 above.

6. The Message

In practice, there are will rarely be a perfect solution to the problems that have been created for individuals who own foreign corporations. There are a series of palliative choices that have to be made based on a careful analysis of the specific circumstances.

A great deal will depend on timing: Is the income generated abroad required to be returned to the United States? Does it need to get into the hands of the individual shareholders or is it desirable or even necessary for it to remain in corporate solution? Where does the individual reside? Might this change and if so when? How might U.S. taxes and planning interact with taxes and planning in the foreign country or in the states? Is an exit foreseen and, if so, when?

As in many other areas of taxation under the TCJA, there will be no substitute for modeling using a range of assumptions.[70] Spreadsheet expertise and access to sophisticated modeling software will be critical.

The way the TCJA was enacted, with little or no bipartisanship and using the budget reconciliation process to avoid a filibuster by the Democratic minority in the U.S. Senate, makes the new law, particularly the reduced corporate income tax rate, vulnerable in two ways: In the short term, the Democratic party has shown little interest in and some hostility to technical corrections, even though some of those are sorely needed, much as the Republican party did in the case of possible technical corrections to the Affordable Care Act. In the longer term, should the Democratic party retake the presidency and control of the Senate, it is likely to seek to undo or change many aspects of the new law. All of this injects further uncertainty in an already uncertain situation and makes long-term planning a serious challenge. Nowhere is this truer than in the case of individuals and closely held business with foreign business activities.

[70] For an example in another area created by the TCJA, see Sullivan, "Economic Analysis: A Spreadsheet to Calculate the New Passthrough Deduction" Tax Notes (April 3, 2018).