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GILTI Until Proven Corporate: The CFC Dilemma of Individual U.S. Shareholders

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Skipping — in the interest of time and space — the issues surrounding which foreign corporations owned by U.S. persons are controlled foreign corporations (CFCs), how easy it is to be a U.S. shareholder, related attribution rules, as well as the 2017 Tax Act changes to each of these concepts, the §951A tax on global intangible low-taxed income (GILTI) applies to tax U.S. shareholders currently on non-subpart F income that previously would have been deferred.[1] For U.S. shareholders who are corporations, the GILTI tax is significantly more manageable than for U.S. shareholders who are individuals.

1. Section 250(a)(1)(B) allows domestic corporations a 50% deduction for the GILTI amount included in the gross income of the U.S. shareholder (reduced to 37.5% for taxable years after 2025).
2. Section 960(d)(1) allows a domestic corporation a foreign tax credit for 80% of the aggregate tested foreign income taxes paid or accrued by the CFC with respect to the GILTI.
3. Subject to the limitations of §951A(f)(2), all or a portion of the GILTI will increase the basis of the U.S. shareholder in the shares of the CFC.[2]
4. Subject to the same limitations, distribution of the GILTI will be received tax-free as previously taxed income.[3]
5. Section 245A allows domestic corporations receiving distributions of earnings and profits from the CFC that are attributable to the net deemed tangible income return excluded from tested income on which the GILTI tax is imposed, as well as other distributions of undistributed foreign earnings as defined by §245A(c)(3) to qualify for a 100% dividends received deduction.
6. Corporations are not subject to the tax on net investment income.[4]
7. Corporations are not subject to limitations on the deduction of state and local taxes (SALT) to which the GILTI may be subject.[5]

In contrast, individuals do not get the relief provided by items 1, 2, 5, or 6 and are subject to limited deductibility of SALT under §164(b)(6).

SOLUTIONS

There are solutions to the dilemma of a U.S. shareholder who is an individual. In the case of a U.S. shareholder living abroad, the most tax effective solution is to renounce U.S. citizenship. However, this solution has other ramifications adversely affecting the individual's ability to work and travel in the United States, as well as the possible imposition of an exit

[1] More precisely, GILTI is imposed on net CFC tested income as defined in §951A(c)(1) with only a small allowance for net deemed tangible income return as defined by §951A(b)(2).

All section references are to the Internal Revenue Code of 1986, as amended (Code), or the Treasury regulations thereunder, unless otherwise indicated.

[2] *See* §951A(f)(1)(A), §961(a).
[3] *See* §951A(f)(1)(A), §959(a).
[4] *See* §1411(a).
[5] *See* §164(b)(6).

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tax.[6] There are less dramatic — albeit considerably less tax-effective — alternatives available to U.S. shareholders who are individuals without regard to residence.

CREATE A BLOCKER

Since domestic corporations receive preferential treatment with respect to the tax on GILTI, transferring the shares of the CFC to a domestic corporation will create a U.S. shareholder entitled to all of the relief described above. Assuming contribution of the CFC shares to the domestic corporation qualifies under §351, formation of the domestic corporation will be a non-recognition event for U.S. tax purposes. The cost of the tax relief provided by the corporate blocker is, of course, a second layer of tax when the domestic corporation makes distributions to its U.S. shareholder who is an individual, including distributions of proceeds from the sale of CFC shares on exit. For individuals resident in a U.S. jurisdiction which subjects deemed or actual dividends to SALT, the blocker defers those taxes until GILTI and other income received by a domestic corporation are distributed, but no longer. Similarly, escape from the 3.8% tax on net investment income under §1411 is also merely deferred until distribution. The accumulated earnings tax[7] and the tax on personal holding income[8] make deferral of the second layer of tax (on dividends, net investment income, and SALT) problematic.

Of significantly greater importance to an individual U.S. shareholder resident in a foreign jurisdiction, contribution of the CFC stock to a U.S. domestic corporation is likely to be an immediate taxable event.[9] While revenue laws of many foreign countries provide relief from gain recognition on transfer of shares of one corporation to another corporation, relief is generally limited to corporate entities organized in the foreign jurisdiction.[10] Not only will the organization of the U.S. corporation likely be a taxable event under the revenue laws of the foreign country in which the U.S. shareholder resides, but the resulting gain recognized in the foreign jurisdiction may provide no basis increase for U.S. purposes absent treaty relief.[11] Interposition of a U.S. domestic corporation between the U.S. citizen or green card holder resident in a foreign country and the CFC may result in the application of anti-deferral rules in the foreign jurisdiction in which the CFC is resident.[12]

SECTION 962 ELECTION

In lieu of organizing a real domestic corporation, the U.S. shareholder of the CFC who is an individual may masquerade as a domestic corporation by making an election under §962. The effect of the election is to treat the income caught by the anti-deferral rules of subpart F (including GILTI) to be included in the gross domestic income of the individual who is a U.S. shareholder of the CFC at income tax rates applicable to corporations and to allow such individual a foreign tax credit for eligible foreign taxes paid by the CFC.[13] The election is made on an annual basis by filing a statement attached to the income tax return of the individual U.S. shareholder and is applicable to all CFCs of that individual.[14]

Whether individuals making a §962 election will be able to benefit from the §250 deduction applicable to GILTI remains an open question. Neither §951A nor the legislative history surrounding its enactment refer to §962. Reg. §1.962-1(b)(1)(i) prohibits ''any deduction'' of the U.S. shareholder from reducing the sum of amounts included in gross income under §951(a) and §78. Query whether the no-reduction rules of this Regulation will be applied to prohibit reduction of GILTI.

Unlike an actual blocker, the §962 election does not create the same second layer of tax. Distributions of earnings and profits from the CFC do not pass through a corporate entity in order to arrive at the individual U.S. shareholder. However, the basis increase in the shares of the CFC is limited to the amount of U.S. tax

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[6] *See* §877A.

[7] *See* §531.

[8] *See* §541.

[9] See, e.g., Canada Income Tax Act (''ITA'') §85.1, which generally limits tax-free rollovers to transfers to Canadian domestic corporations.

[10] *See, e.g.*, ITA §85.1. While ITA §85.1(3) allows transfers to a foreign corporation which qualifies as a foreign affiliate, such transfers are limited to shares of another foreign affiliate. Similarly, ITA §85.1(5) specifically addresses share exchanges in which shares of one corporation are transferred to a Canadian foreign corporation, but only if the shares transferred were issued by another Canadian foreign corporation.

[11] *See, e.g.*, Convention between Canada and the United States of America with Respect to Taxes on Income and on Capital, art. XIII, ¶ 7.

[12] For example, in the structure in question, the U.S. corporation is likely to be regarded as a Canadian controlled foreign affiliate as defined in ITA §95(1), resulting in immediate taxation of foreign accrual passive income of the blocker to its shareholder residing in Canada and the possibility of two layers of Canadian tax on income of the CFC distributed through the blocker to the Canadian resident individual. *See* ITA §91(1).

[13] §962(a)(1), §962(a)(2).

[14] *See* Reg. §1.962-2(b), §1.962-2(c)(1). The election requires information regarding each CFC with respect to which the individual is a U.S. shareholder and all other entities in the chain of ownership, amounts on a CFC-by-CFC basis included in the electing individual's gross income, the individual's share of earnings and profits of each CFC, and the amount of distributions during the taxable year of the individual from each CFC.

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paid by the electing shareholder holder.[15] Similarly, §959 relief is also limited to U.S. taxes paid.[16] Distributions from the CFC in excess of U.S. taxes paid at the corporate rate are not treated as previously taxed income. To the extent the indirect foreign tax credit under §960 did not fully offset the U.S. tax on the GILTI and subpart F income inclusions, the distributions are effectively taxed twice. For CFCs in jurisdictions which do not have the benefit of a tax treaty with the United States, dividends from the CFC will be taxed at ordinary income rates.[17] Those dividends will also be subject to the 3.8% tax on net investment income and SALT which is limited in its deductibility for many U.S. residents. Absence of the corporate blocker means no dividends received deduction is available for distributions from the CFC.

ACTUAL OR DEEMED LIQUIDATION OF THE CFC

Since deferral of foreign income earned by a CFC is now limited to the deemed tangible income return of §951A(b)(2), forgoing deferral of the tax on foreign income earned by a CFC (especially in the case of an individual) barely makes the situation worse. Unfortunately, giving up deferral barely makes the situation better as actual and deemed liquidations (via check-the-box) tend to be taxable events in cases in which the CFC holds assets with net unrealized appreciation. Further, the check-the-box election is not available in the case of CFCs organized as entities identified in Reg. §301.7701-2(b)(a). Actual liquidation may also be a taxable event in the foreign jurisdiction and may be subject to foreign withholding in the case of shareholders not resident in that jurisdiction.

In the case of a foreign jurisdiction with a relatively high rate of tax, the deferral lost by liquidation of the CFC provided only limited benefit. Foreign taxes paid post liquidation should in most cases be fully eligible for a foreign tax credit. To the extent foreign income is also subject to SALT, additional taxes on the foreign income will apply with limited deductibility. However, liquidation may eliminate the tax on net investment income under §1411 depending upon the assets owned by the former CFC and individual shareholder's involvement in any trade or business conducted post liquidation.[18]

SECTION 954(b)(4) ELECTION

If the CFC's income is properly characterized as foreign base company income or insurance income, an election under §954(b)(4) is a comprehensive solution to both GILTI and subpart F anti-deferral regimes.[19] Post–tax reform, the election is available for CFCs in more jurisdictions inasmuch as the reduction in U.S. corporate rates from 35% to 21% means the effective foreign tax rate necessary to make the election need only be more than 18.9%. Unfortunately, the cost of deferral is not just a foreign tax rate nearly equivalent to the U.S. corporate rate, but also a second layer of tax by the United States when the shareholder of the CFC receives a distribution of the CFC's foreign earnings. The tax on net investment income and, in the case of many U.S. residents, SALT with limited deductibility will also apply. In this respect, the §954(b)(4) election works much like an actual blocker, but with a true deferral, instead of a mere reduction, of current U.S. tax.

The §954(b)(4) election is made on a year-by-year, CFC-by-CFC basis.[20] It can be made only by the controlling U.S. shareholders of the CFC as determined by Reg. §1.964-1(c)(5): generally, those U.S. shareholders who in the aggregate own more than 50% of the stock of the CFC.[21] The election must be made on the original return of the controlling U.S. shareholders.[22] All U.S. shareholders of the CFC with respect to which the election is made are bound by the election.[23] The election applies to all items of foreign personal holding company income which are eligible for exclusion under the high-tax exception.[24]

It is incumbent on the taxpayers making the §954(b)(4) election to establish the effective rate of

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[15] §961(b)(i).

[16] *See* §962(d).

[17] §1(h)(11)(B)(i)(II); §1(h)(11)(C). *See Smith v. Commissioner,* 151 T.C. No. 5 (2018). For further discussion of this issue, see Parnes, Gutwein, and Semanski, *Challenges of TCJA to U.S. Individuals with Foreign Business Interests*, 192 J. Tax'n 6 No. 57 (Nov. 2018); Zhang and Rabinovits *The End of Eternity: Anomalies in Transition to Territoriality*, 159 Tax Notes 621 (Apr. 30, 2018).

[18] *See* §1411(c)(1)(A).

[19] *See* §951A(c)(2)(A)(i)(III); Prop. Reg. §1.951A-2(c)(1)(iii).

[20] *See* Reg. §1.954-1(d)(5). Election solely for purposes of avoiding the tax on GILTI may be unnecessary. The New York State Bar Association Tax Section comments on §951A observe that high-tax income is excluded from tested income (automatically) either because of the exclusion for all subpart F income in §951A(c)(2)(A)(i)(II) or under the exclusion for high-tax subpart F income with respect to which the election under §954(b)(4) is made as referenced in §951A(c)(2)(A)(i)(III). *See* New York Bar Association Tax Section Report on the GILTI Provisions of the Code (Report No. 1394, May 4, 2018) III.A.1. n.11. However, the election is necessary in order to exclude foreign base company income and insurance income from the computation of subpart F income.

[21] Reg. §1.951-1(d)(5)(i).

[22] *Id.*

[23] Reg. §1.954-1(d)(5).

[24] Reg. §1.954-1(d)(4).

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the foreign tax.[25] The effective tax rate is determined with respect to each of the net items of income specified in Reg. §1.954-1(c)(1)(iii)(A). The effective foreign tax rate is the U.S. dollar amount of foreign income taxes paid or accrued with respect to the net item of income determined as if an election under §962 had been made divided by the U.S. dollar amount of the net item of income increased by the amount of foreign income taxes.[26] The only foreign taxes considered are foreign income taxes creditable under §960.[27]

In addition to needing a high enough effective foreign tax rate to be eligible to make the §954(b)(4) election, the election's efficacy to avoid the tax on GILTI requires planning into subpart F. This may severely limit the circumstances in which it is a viable solution. The proposed regulations under §951A require that the exclusion from tested income must arise ''solely'' by reason of the §954(b)(4) election.[28] The preamble to the proposed regulations explains this by observing ''the exclusion does not apply to income that would not otherwise be subpart F income or to categories of income that do not constitute subpart F income due to exceptions other than the high tax exception (for example, as a result of an exception to foreign personal holding company income under section 954(c)(6) or section 954(h)).''[29]

CONCLUSION

Aside from expatriation, there is no perfect solution to the GILTI dilemma of individuals who are U.S. shareholders of a CFC. The preferred solution for any individual confronted with GILTI will be dependent not only on the tax circumstances of that individual, but also on the circumstances of the particular CFCs in which the individual is a U.S. shareholder. For this reason, generalizations are not only difficult, but also hazardous because facts and circumstances not only differ from individual to individual and CFC to CFC, but also from year to year. Solutions such as the §962 and §954(b)(4) elections which can be made on a year-by-year basis may be preferable because of their flexibility. In this regard, the §954(b)(4) election can be made on a CFC-by-CFC basis; whereas, the §962 election applies to all CFCs in which the individual is a U.S. shareholder. However, the §954(b)(4) election must be made by U.S. shareholders owning a majority of the CFC stock; whereas, the §962 election can be made by any U.S. shareholder. Further, availability of the §954(b)(4) election is dependent on planning into subpart F, which, even if possible, is likely to represent a reversal of significant prior planning and structure. Consequently, the staging necessary to make the election belies the flexibility of its mechanics. Similarly, liquidations of CFCs or formations of domestic blockers are structural solutions not easily varied from year to year.

For CFCs whose income is subject to high effective foreign tax rates, actual or deemed liquidation of the CFC is enticing because the high foreign tax rate mutes the benefit of deferral. Liquidation may come at a tax cost to the extent of unrealized gain in CFC assets, but escapes the second layer of tax that haunts an actual blocker or the §954(b)(4) election. Double taxation is also possible with the §962 election, but some relief is provided to the limited extent U.S. taxes are actually paid as a result of that election. However, until the availability of the §250 deduction is affirmed by the Internal Revenue Service, the §962 election should be used with caution. The §954(b)(4) election or liquidation of the CFC may result in more efficient use of foreign tax credits which are limited to 80% of foreign taxes paid in the case of the corporate blocker and, perhaps, the §962 election as well. The §954(b)(4) election, as well as the §962 election, are also preferable on exit as they do not create a double tax on sale of the CFC shares, as would be the case with an actual blocker.

Where true deferral is the objective, formation of an actual corporate blocker in the case of CFCs which are in low-tax jurisdictions or the §954(b)(4) election in the case of CFCs in high-tax jurisdictions seem to be preferable choices. However, for the reasons explained, conveyance of the CFC shares to a U.S. domestic corporation in the case of an individual resident in a foreign jurisdiction is likely to be tax prohibitive. Hence the desirability of the §954(b)(4) election.

Expatriation is looking better and better.

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[25] *See* §954(b)(4).

[26] Reg. §1.954-1(c)(2).

[27] Reg. §1.954-1(d)(3). Creditable taxes include war profits and excess profits taxes, as well as income taxes. §960(e).

[28] Prop. Reg. §1.951A-2(c)(1)(iii).

[29] REG-104390-18, 83 Fed. Reg. 51,072 at 51,075 (Oct. 10, 2018).

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