Bloomberg Tax

Tax Management
International Journal™

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

By Robert E. Ward, J.D., LL.M.[*]
WardChisholm, LLP
Vancouver, British Columbia and Bethesda, Maryland

The subject matter of this article was recently addressed in this same space.[1] However, new developments — at least one of which materialized between submission and publication — more than merit revisiting the topic. Such is the nature of tax law. The prior article considered the unhappy treatment of individual U.S. shareholders of controlled foreign corporations (CFCs) and offered four solutions to improve the U.S. tax treatment. Recent developments materially benefit two of the proposed solutions (creation of a blocker and the §962 election)[2] and provide a fifth alternative: regulatory implementation of a GILTI high-tax exemption. Each is discussed in limited detail by this update.

The §962 Election Gets Better

Within days of publication of the prior article, Treasury released proposed regulations providing guidance to determine the amount of the deduction for global intangible low-tax income (GILTI) and foreign-derived intangible income which included proposed regulations under §962.[3] One of the concerns expressed in the prior article was whether individuals making the §962 election would benefit from the 50% deduction under §250 when computing the tax on GILTI. The Internal Revenue Service has resolved this uncertainty in favor of taxpayers.[4] The proposed regulations apply to taxable years of foreign corporations ending on or after March 4, 2019 and with respect to U.S. shareholders who make the §962 election for taxable years in which or with which those taxable years of the foreign corporations end.

The Corporate Blocker Alternative Gets Better

The prior article identified five advantages which corporate U.S. shareholders enjoy in the computation of the GILTI tax. Final regulations under §956 have created another benefit to an individual's ownership of a CFC through a domestic corporation. U.S. shareholders are required to include in gross income amounts invested by a CFC in U.S. property (as defined in §956(c)).[5] Final regulations issued under §956 on May 23, 2019, change this result for corporate U.S. shareholders, reducing the §956 amount to the extent a distribution by the CFC to the corporate U.S. shareholder would qualify for the 100% deduction for foreign-source dividends under §245A. The hypothetical distribution is attributed to the earnings and profits described in §959(c)(2), then to the earnings and profits described in §959(c)(3).[6] Under the final regulations, the amount which would otherwise be included in the income of a corporate U.S. shareholder under §956 (the ''aggregate tentative §956 amount'') is reduced by the deduction under §245A that the corporate U.S. shareholder would be allowed if an amount equal to the aggregate tentative §956

---

[*] Robert E. Ward, J.D., LL.M. is a fellow of the American College of Tax Counsel who advises businesses and individuals on U.S. international and domestic tax matters from his firm's offices in Vancouver, British Columbia and Bethesda, Maryland.

[1] *See* Ward, *GILTI Until Proven Corporate: The CFC Dilemma of Individual U.S. Shareholders*, 48 Tax Mgmt. Int'l J. 135 (Mar. 8, 2019).

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

[3] REG-104464-18 (Mar. 6, 2019).

[4] *See* Prop. Reg. §1.962-1(b)(1)(i)(B)(3).

[5] *See* §951(a)(1)(B).

[6] Reg. §1.956-1(a)(2)(ii)(C).

amount were instead received as a distribution from the CFC.[7] If the shares of the CFC are owned indirectly by the corporate U.S. shareholder through a domestic partnership, the partnership first reduces its §956 amount by the combined amount of deductions under §245A which all of the partners would be allowed if the partnership received a distribution from the CFC equal to its aggregate tentative §956 amount.[8]

The final regulations apply to taxable years of CFCs beginning on or after July 22, 2019, and to taxable years of U.S. shareholders in which or with which those taxable years of the CFCs end. However, U.S. shareholders may apply the guidance of the regulations to taxable years of CFCs beginning after December 31, 2017 and to the taxable years of the U.S. shareholder in which or with which those taxable years of the CFCs end if the U.S. shareholder and all persons related to the U.S. shareholder (within the meaning of §267 or §707) consistently apply the relief provided by the final regulations to all CFCs in which they are a U.S. shareholder for taxable years of those CFCs beginning after December 31, 2017.[9]

Another Alternative: the GILTI High-Tax Exclusion

Perhaps the most significant development since publication of the prior article was the June 14, 2019. release of proposed regulations which allow corporate and individual U.S. shareholders of a CFC to exclude from gross income subject to GILTI all tested income subject to an effective tax rate of more than 18.9%.[10] The proposed regulations provide a welcome shortcut to take advantage of §951A(c)(2)(A)(i)(III) which excludes from tested income high-tax income excluded from foreign base company income and insurance income for subpart F purposes.[11] Rather than planning into subpart F to make the §954(b)(4) election to take advantage of the exclusion from GILTI under §951A(c)(2)(A)(i)(III), the proposed regulations simply exempt the income by taxpayer election. Finding that §954(b)(4) is not explicitly restricted to foreign base income and insurance income, an election under §954(b)(4) can be made for non-subpart F income to take advantage of the GILTI high-tax exclusion.[12] Consistent with the regulations under §954, the election must be made by the CFC's controlling domestic shareholders (as defined in §1.964-1(c)(5)).[13]

The election under §954(b)(4) pursuant to Prop. Reg. §1.951A-2(c)(6) applies to all items of gross tested income attributable to a qualified business unit (QBU), as defined by reference to §989(a) and the regulations issued thereunder.[14] The effective foreign tax rate is computed for each tentative net tested income item of each QBU for each CFC inclusion year.[15] The effective foreign tax rate is determined by dividing (a) the U.S. dollar amount of foreign taxes paid or accrued by the CFC with respect to a tentative net tested income item by (b) the U.S. dollar amount of the tentative net tested income item increased by the foreign taxes paid or accrued with respect to the tentative net tested income item.[16] Tentative net tested income items are determined by reducing tentative gross tested income items by deductions allocated and apportioned to tentative gross tested income items applying the principles of Reg. §1.960-1(d)(3).[17]

In the case of a disregarded entity owned by a CFC which is a QBU, disregarded payments between the CFC and its disregarded entity must be taken into account in order to properly compute the effective tax rate on tentative net tested income items of each business unit. The adjustment is illustrated in the proposed regulations by an example in which a CFC and the disregarded entity it owns conduct business in separate foreign countries.[18] Because the disregarded entity is a separate QBU, the effective tax rate applicable to its tentative net tested income items is determined separately from the effective foreign tax rate of the tentative net tested income items of the CFC.[19] Payments from the disregarded entity to the CFC reduce the tentative gross tested income of the disregarded entity. Taxes paid by the disregarded entity are subtracted from its gross tested income to arrive at the tentative net tested income of the disregarded entity. The effective tax rate is then determined on an item-by-item basis by dividing (a) the foreign taxes paid or accrued with respect to each item of net tested income by, (b) the amount of each item increased for the foreign taxes to which it was subject. Presumably, the

[7] *See* Reg. §1.956-1(a)(2)(i), §1.956-1(a)(3) *Ex.* 1.

[8] Reg. §1.956-1(a)(2)(iii), §1.956-1(a)(3) *Ex.* 4.

[9] Reg. §1.956-1(g)(4).

[10] *See* REG-101828-19 (June 21, 2019).

[11] *See* §954(b)(4).

[12] *See* Preamble II.A.

[13] *Compare* Prop. Reg. §1.951A-2(c)(6)(v)(A)(1) *with* Reg. §1.954-1(d)(5)(i).

[14] *See* Prop. Reg. §1.951A-2(c)(6)(ii)(A)(1).

[15] Prop. Reg. §1.951A-2(c)(6)(ii)(A)(1), Prop. Reg. §1.951A-2(c)(6)(iii). The CFC inclusion year is any taxable year of a foreign corporation beginning after December 31, 2017 if the foreign corporation was a CFC at any time during such year. Reg. §1.951A-1(f)(1).

[16] Prop. Reg. §1.951A-2(c)(6)(iii).

[17] Prop. Reg. §1.951A-2(c)(6)(ii)(B).

[18] *See* Prop. Reg. §1.951-2(c)(6)(vi)(A).

[19] The example posits that the income of the disregarded entity is excluded from the income of the CFC because of §954(h).

ISSN 0090-4600

disregarded payment to the CFC from its disregarded entity could be subject to the same analysis based on foreign taxes in the CFC's country of activity, but the example does not consider this.

The election under §954(b)(4) pursuant to Prop. Reg. §1.951A-2(c)(6) is made by the controlling domestic shareholders (as defined in Reg. §1.964-1(c)(5)) by attaching a statement to the income tax return of each controlling domestic shareholder for the year in which or with which the CFC's taxable year ends (subject to additional information required by administrative pronouncements or rules provided in forms and instructions).[20] The election is effective for all tentative gross tested income items of the CFC that meet the effective rate test for the CFC inclusion year and binds all U.S. shareholders of the CFC.[21] Once made, the election is effective for all subsequent inclusion years of the CFC until revoked by the controlling domestic shareholders.[22] If revoked, any subsequent election will not be effective for inclusion years beginning within 60 months of the close of the CFC inclusion year for which the previous election was revoked.[23] If a new election is made, it cannot be revoked with respect to any CFC inclusion year which begins within 60 months of the close of the CFC inclusion year for which the subsequent election was made.[24] However, the IRS Commissioner has discretion to allow elections and revocations to be made before expiration of the 60-month period if a change in control has occurred.[25] A change in control occurs when more than 50% of the total combined voting power of all classes of stock of the CFC at the beginning of the year for which the election or revocation is desired to be made are owned by persons who did not own "any interest" in the CFC as of the close of the CFC inclusion year for which the prior election or revocation became effective.[26] Persons included in this determination include any related person as described in §267(b) or §706(b)(1).[27]

The proposed regulation is effective for years of CFCs beginning on or after the date of publication of the Treasury decision adopting the proposed regulations as final regulations in the Federal Register and to taxable years of U.S. shareholders in which or with which those taxable years of the CFC end.[28]

[20] Prop. Reg. §1.951A-2(c)(6)(v)(A)(1).

[21] Prop. Reg. §1.951A-2(c)(6)(v)(B); Preamble II.A.

[22] Prop. Reg. §1.951A-2(c)(6)(v)(C).

[23] Prop. Reg. §1.951A-2(c)(6)(v)(D)(2)(i).

[24] *Id.*

[25] Prop. Reg. §1.951A-2(c)(6)(v)(D)(2)(ii).

[26] *Id.*

[27] *Id.*

[28] Prop. Reg. §1.951A-7(b).

Conclusion

For individual U.S. shareholders owning shares of CFCs, the observations made at the conclusion of the prior article regarding the relative advantages and disadvantages of the different responses to the high cost of the GILTI tax are largely unchanged by the recent developments. As discussed in this article, forming a domestic corporate blocker now has the added advantage of facilitating investments in U.S. property (including loans to U.S. persons from the CFC) without incurring a tax under §956. Particularly for individual U.S. shareholders residing in the United States, the corporate blocker alternative has become more compelling. When compared with either the §962 election or the election under §954(b)(4) pursuant to Prop. Reg. §1.951A-2(c)(6), planning into subpart F and making the §954(b)(4) election for high-tax income may still be preferable because of the more targeted nature of the §954(b)(4) election.[29]

This author's informal and completely unscientific polling of professionals preparing returns for individual U.S. shareholders resident in the lower mainland of British Columbia has revealed an almost universal reliance on the §962 election. That election is effective to significantly reduce the GILTI tax to which the individual U.S. shareholder would be subject but still leaves the GILTI of the CFC subject to a 10.5% rate. The Canadian corporate rate is often high enough to allow 100% of the GILTI tax to be creditable in computing the Canadian income tax liability of the CFC.[30] Consequently, the §962 election will likely remain preferable if the Canadian effective tax rate is not more than 18.9%. For CFCs exposed to higher rates of Canadian or other resident country tax rates sufficient to take advantage of the GILTI high-tax exclusion, the choice between the §962 election and the election under §954(b)(4) pursuant to Prop. Reg. §1.951A-2(c)(6) may be driven by the treatment of the U.S. shareholder when receiving distributions from the CFC. For U.S. purposes, these distributions will be mostly subject to U.S. taxation in the case of the §962 election[31] but in many cases fully exempt from U.S. taxation in the case of the §954(b)(4) election pursuant to Prop. Reg. §1.951A-2(c)(6) because of the §245A deduction.

[29] The §954(b)(4) election is made on an item-by-item basis (as described in Reg. §1.954-1(d)(1), §1.954-1(c)(1)(iii)) and can be made inconsistently with regard to such items from year-to-year. Reg. §1.954-1(d)(5).

[30] However, the high rate of Canadian tax will be reduced for Canadian-controlled private corporations which claim the small business deduction of Income Tax Act (Canada) §125(1).

[31] The basis increase in the shares of the CFC is limited to the amount of U.S. tax paid by the shareholder making the §962 election. *See* §961(b)(1). Distributions from the CFC in excess of U.S. taxes paid are not treated as previously taxed income. *See* §962(d).

ISSN 0090-4600

In the case of an individual U.S. shareholder resident in a foreign country, if the foreign tax rate is sufficient to allow 100% of the U.S. tax to be fully offset by a foreign tax credit, the choice between the two elections (that is, §962 or §954(b)(4) pursuant to Prop. Reg. §1.951A-2(c)(6)) may be driven by the relative ease with which the elections can be made, the flexibility for revocation or subsequent election, and the scope of the persons and entities affected. The §962 election applies to all CFCs of the electing shareholder. Those CFCs may be subject to different effective foreign tax rates which impact the desirability of the election.[32] In contrast, the high-tax election under the proposed regulations may require the cooperation of other shareholders in order to involve the requisite majority but applies to the CFC only with respect to which the election is made. However, as with the high-tax election under §954, the high-tax election under the proposed regulations binds all U.S. shareholders of that CFC, thereby apparently nullifying any §962 election of a minority U.S. shareholder.[33] These observations and conclusions are subject to further developments. Such is the nature of tax law.

---

[32] *See* Reg. §1.962-2(b), §1.962-2(c)(1).

[33] Above, n.21.

ISSN 0090-4600