Choice of Entity and Structuring for Individual Investors and Closely-Held Businesses After Tax Reform (Part 2)

ABA Section of Taxation 2019 May Tax Meeting

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Agenda

- Inbound
  - Impact of Repeal of 951(a) 30-Day Requirement on Inbound Estate Planning
  - Impact of the corporate rate change on structuring individual inbound investment
  - NRAs as Beneficiaries of ESBTs
  - Sale of Partnership Interests under 864(c)(8)

- Outbound
  - 958(b)(4) Repeal
  - Triggering acceleration of tax under section 965(h) and (i)
  - Considerations for individual shareholders subject to GILTI
    - GILTI Basics
    - Corporations v. 962 elections v. pass-throughs
    - Avoiding GILTI and Subpart F Income
    - Considerations for U.S. Citizens Resident Abroad and Individuals Temporarily Present in the U.S.
  - Traps for the Unwary Upon Exit from CFCs
Impact of Repeal of 951(a) 30-Day Requirement on Inbound Estate Planning
TCJA Elimination of 30-Day Requirement

Before the TCJA
Check-the-Box Election

- If holding company qualifies for a CTB election, entity becomes either disregarded entity or a partnership.
- If classification of the entity was relevant for U.S. tax purposes, the election is treated as deemed taxable liquidation.
- CTB Election to have a deemed liquidation occur within 29 days of date of death avoided U.S. tax and achieved a basis adjustment.

Desired Result

- U.S. Shareholder has no subpart F income to report because corporation was not a CFC for at least 30 consecutive days.
- Foreign Holding Company (including U.S. situs assets) not subject to U.S. estate tax.
- U.S. situs and Non-U.S. situs assets receive a "step-up" in basis for little or no U.S. income tax.

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Inbound Planning after TCJA

- Repeal of the 30-day rule for CFCs presents new challenges for U.S. beneficiaries of NRA decedents. Possible solutions include:
  - Sales of shares of CFCs to foreign purchasers who may continue to hold or liquidate the corporation without incurring US tax; but be careful to make QEF elections if there are lower tier PFICs owned by the CFC;
  - CTB elections:
    - Use a corporate form that is eligible to make a CTB election; and
    - Segregate foreign and US assets in different CFCs.
  - Foreign partnerships as estate tax blockers or to minimize estate tax by using partnership level debt to reduce estate tax value;
  - Domestication of CFC followed by an S election and a sale/liquidation after the close of the 5-year gain recognition period;
  - Publicly traded PFICs as an alternative to a CFC to access US equity market;
  - Irrevocable non-grantor trust that is not includable in NRA grantor's estate;
  - Minimize the fraction of subpart F income taxable to US Shareholders upon liquidation of a CFC by carefully timing the CTB elections, for example, by using the "triple blocker plan."
If a timely retroactive CTB for FC #1 may filed to be effective in the prior taxable years of FC ## 2 and 3, e.g. if DOD is on or before March 16 for a calendar year FC, no subpart F income accruing to FC ## 2 and 3 attributable to the CTB for FC #1 will be taxable to the person who became a US Shareholder in the following taxable year, and if DOD is after March 16, only 1/76 (or less) of subpart F income of FC ## 2 and 3 will be taxed to the US Shareholder.
Impact of the corporate rate change on structuring individual inbound investment
Individual Ownership

- Individual
- NRA

$X m Equity

- LLC
  - Delaware

Ownership is 100% unless otherwise noted

U.S. Federal Tax Classifications
- Corporation/Trust
- Hybrid Entity
- U.S. Partnership
- Individual/Branch
- Disregarded Entity "DRE"

Ownership is 100% unless otherwise noted
Individual Ownership

Individual NRA

$X + Y m Equity

Holding LLC

Delaware

LLC 1

Delaware

LLC 2

Delaware

U.S. Federal Tax Classifications

- Corporation/Trust
- Hybrid Entity
- U.S. Partnership
- Individual/Branch
- Disregarded Entity "DRE"

Ownership is 100% unless otherwise noted
Individual Ownership

**Advantages**
- Long-term capital gains treatment available – smaller advantage 20% v 21% (was 35%)
- Single level of tax
- Profits and losses offset
- No imputed income for personal-use property
- LLCs provide limited liability; holding LLC can provide "presence"

**Disadvantages**
- Gift tax probably imposed on gift of LLC interest if LLC is disregarded entity (query effect of Suzanne Pierre case)
- Estate tax exposure
- Must file individual income tax returns and partnership returns
Individual Ownership (with partnership)

Individual NRA

$X + Y m Equity

Holding LLC

Delaware

Property 1 LLC

Delaware

Property 2 LLC

Delaware

Third Party
(could be spouse/family member/unrelated third party)

U.S. Federal Tax Classifications

- Corporation/Trust
- Hybrid Entity
- U.S. Partnership
- Individual/Branch
- Disregarded Entity "DRE"

Ownership is 100% unless otherwise noted
Individual Ownership (with partnership)

Ownership is 100% unless otherwise noted
Individual Ownership (with partnership)

Advantages
- Long-term capital gains treatment available – smaller advantage
- Single level of tax
- Should not have imputed income for personal use property, but less certain than with direct ownership
- Gift tax probably does not apply to gift of interest in LLC treated as partnership
- LLCs provide limited liability; holding LLC can provide "presence"

Disadvantages
- Estate tax exposure, but may have counterargument, especially if LLCs not engaged in trade or business; additional argument if offshore holding company classified as partnership inserted in structure
- Must file individual income tax returns and partnership returns
- § 1446 (over)withholding
- Treaty issues raised by LLC and foreign corp
Corporate Structure

ForHoldCo
Non-U.S.

$X m Equity

USCorp
Delaware

LLC 1
Delaware

LLC 2
Delaware

U.S. Federal Tax Classifications

- Corporation/Trust
- Hybrid Entity
- U.S. Partnership
- Individual/Branch
- Disregarded Entity "DRE"

Ownership is 100% unless otherwise noted

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Corporate Structure: Before 2017 Tax Act

Advantages

- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Consolidation of U.S. profits and losses
- No individual income tax filings (Note: This does not provide anonymity for ultimate beneficial owner.)

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Double taxation of profits at corporate and shareholder level, except on liquidation of USCorp following sale of all properties
- Potential inversion issue in converting an existing structure
Corporate Structure: Now

Advantages

- Low corporate rate on ordinary income (until distributed); capital gains rates for individuals and corporations nearly identical
- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Consolidation of U.S. profits and losses
- No individual income tax filings (Note: This does not provide anonymity for ultimate beneficial owner.)

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- Double taxation of profits at corporate and shareholder level, except on liquidation of USCorp following sale of all real properties
- Inversion issue remains unchanged
Corporate Structure (with multiple corporations)

Ownership is 100% unless otherwise noted

ForHoldCo

BVI

$Y m Equity

USCorp 1

Delaware

Property 1 LLC

Delaware

USCorp 2

Delaware

Property 2 LLC

Delaware

U.S. Federal Tax Classifications

☐ Corporation/Trust

▲ Hybrid Entity

▲ U.S. Partnership

○ Individual/Branch

○ Disregarded Entity "DRE"

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Corporate Structure (with multiple corporations): Before 2017 Act

**Advantages**
- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Can sell property of one U.S. corporation and pay corporate-level tax, but liquidation is then tax-free

**Disadvantages**
- Corporate tax rates on sale of properties (no capital gains preference)
- No consolidation of U.S. profits and losses
- Double taxation of operating profits at corporate and shareholder level
Corporate Structure (with multiple corporations): Now

Advantages

- Low corporate rate on ordinary income (until distributed); capital gains rates for individuals and corporations nearly identical
- No estate or gift tax on transfers of foreign stock
- No branch profits tax
- Can sell property of one U.S. corporation and pay corporate-level tax, but liquidation is then tax-free

Disadvantages

- Corporate tax rates on sale of properties (no capital gains preference)
- No consolidation of U.S. profits and losses
- Double taxation of operating profits at corporate and shareholder level
Corporate Structure (with financing)

Finance Company may be owned by person unrelated to owners of ForHoldCo under section 318(a), e.g.,
- Sibling, in-law, etc.
- Widely held (e.g., 11+ investors structure)
- Voting stock in borrower held by third party asset manager/property developer
Foreign Corporate Structure (with financing)

Advantages
- Deduction for interest (including contingent interest)
- Can avoid withholding on non-contingent interest if qualified for portfolio interest exemption
- No withholding on repayment of loan principal

Disadvantages
- Withholding on interest if lender is a "10 percent shareholder" or "10 percent partner" of borrower
- Debt-equity issues must be properly managed, and arm’s-length interest rate must be established
- Potential earnings stripping limitations but rules completely overhauled in 2017. Favorable for smaller investors and real estate businesses
## Rate Comparison

|                | Individual                  | Corporation                  |
|----------------|-----------------------------|------------------------------|------------------------------|
|                | 2017 | 2018+ | 2017 | 2018+|
| When *income* earned | 39.6% | 37.0% | 35.0% | 21.0% |
| When income distributed | 0% | 0% | 19.5% | 23.7% |
| Total (fully distributed) | 39.6% | 37.0% | 54.5% | 44.7% |
| When *capital gain* realized | 20.0% | 20.0% | 35.0% | 21.0% |
| When gain distributed (e.g. by LLC) | 0% | 0% | 0% | 0% |
| Total (fully distributed) | 20.0% | 20.0% | 35.0% | 21.0% |

Timing of distributions and exit is critical

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Subchapter S Corporations and NRA Investors
Subchapter S Corporations and NRA Investors

- S corporation may not have NRA shareholder – no change made by the 2017 Act

- But under the 2017 Act, ESBT can now have an NRA beneficiary on the theory that the taxpayer with respect to the S corporation income is the trust

- However, if ESBT were a grantor trust, the grantor would be the taxpayer and this could result in avoidance of U.S. tax if the grantor was foreign

- On April 18, 2019, IRS proposed regulations to require that if ESBT or a portion is a grantor trust, income, deductions and credits from the grantor portion must be reallocated to the S portion of the ESBT. Prop. Reg. sec. 1.641(c)-1(b)(1)(ii)
Sale of Partnership Interests under 864(c)(8)
Sales of Partnership Interests under 864(c)(8)

- Treats gain or loss on direct or indirect sale by an NRA or foreign corporation of an interest in a partnership engaged in a US trade or business as ECI.

- Gain or loss is treated as ECI to the extent of the portion of the partner’s distributive share of the amount of gain or loss which would have been ECI if the partnership had sold all of its assets on the date of sale.

  - Proposed regulations provide mechanics for determining amount of gain treated as ECI.
  - Separate limits provided for amounts treated as ordinary vs. capital.
  - Gain can be limited by treaty.
Withholding under 1446(f)

1446(f) requires a 10% withholding tax on the amount realized on a sale of an interest in a partnership if any portion of the gain on such sale would be treated as ECI under 864(c)(8)

- Exception where transferor provides an affidavit of non-foreign status
958(b)(4) Repeal
958(b)(4) Repeal

- Prior to TCJA, 958(b)(4) prevented downward attribution of share ownership from foreign shareholders, partners, or beneficiaries.
- Repeal of 958(b)(4) greatly expands the universe of CFCs, leading to surprising results.
5471 Filing Requirements

- Repeal of 958(b)(4) causes US Sub to be attributed ownership of Foreign Corp 2
- Foreign Corp 2 is a CFC
- US Sub is a US SH of Foreign Corp 2
- However, Notice 2018-13 and Instructions to Form 5471 eliminate filing requirement where ownership is due solely to downward attribution from foreign person
Effect of 958(b)(4) Repeal on Portfolio Interest Exception

- Under 881(c)(3), portfolio interest excludes interest earned by a CFC from a person related to the CFC, a US SH, or a person related to a US SH
  - "Related" is defined by reference to 267(b)
- Repeal of 958(b)(4) causes US Borrower to be attributed ownership of Foreign Corp 2
  - Foreign Corp 2 is a CFC
  - US Borrower is a US SH of Foreign Corp 2
- Portfolio interest exception no longer applies
Triggering acceleration of tax under section 965(h) and (i)
The IRC § 965 "Transition Tax" on U.S. Shareholders

US Shareholders may elect to defer the payment of the "transition tax", without interest, over 8 years under §965(h). US Shareholders of S corporations may defer the payment of "transition tax," without interest indefinitely under §965(i), until a "triggering event" occurs, and if a triggering event occurs and continued deferral under §965(i) is no longer possible, the US Shareholder may elect under §965(h) to pay the tax over 8 years.

The continued deferral allowed under §965(h) may be lost if an acceleration event occurs, but if the event is a "covered acceleration event" continued deferral is possible if prompt action is taken.

<table>
<thead>
<tr>
<th>Transition Tax Deferral Election</th>
<th>IRC §965(h) Deferral Election is Made By:</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Years</strong></td>
<td><strong>Amount Due</strong></td>
</tr>
<tr>
<td>1-5</td>
<td>8% (each year)</td>
</tr>
<tr>
<td>6</td>
<td>15%</td>
</tr>
<tr>
<td>7</td>
<td>20%</td>
</tr>
<tr>
<td>8</td>
<td>25%</td>
</tr>
</tbody>
</table>
The IRC § 965 "Transition Tax" Acceleration Events

- **Acceleration Events Defined:**
  - Failure to timely pay an installment
  - Liquidation, sale, exchange, or other disposition of substantially all of the assets of the person making the installment election, including bankruptcy or death (in the case of an individual)
  - In the case of a person who is not an individual, cessation of business by the person
  - Any event that results in the person no longer being a U.S. person
  - Change in membership of a consolidated group
  - A determination by the IRS that there was a material misstatement or omission in a transfer agreement

- **"Covered" Acceleration Events:**
  - Transfers to an "eligible transferee" (a "single United States person which is not a domestic pass-through entity…that acquires substantially all of the assets of an eligible section 965(h) transferor")
  - **Transfer agreement** (eligible transferee agrees to assume the deferred Transfer Tax liability and represents that is able to pay the tax) filed within 30 days of the acceleration event

**Query:**
Unclear whether a decanting, reformation, modification, merger, severance, or material modification of trusts is an acceleration event. If they are acceleration events, and if the transferee is a domestic flow-through entity, the transfer would not be a "covered" acceleration event and tax would be due immediately.

**Note:**
A transfer of shares is not necessarily an acceleration. Rather, it is a disposition of substantially all of the assets of the taxpayer that owes the Transition Tax.

**Note:**
Death is **NOT** a covered acceleration event.
The IRC § 965 "Transition Tax" Triggering Events (S Corporations)

- U.S. Shareholder that is an S corporation can defer the Transition Tax under IRC § 965(i) indefinitely until a "Triggering Event" occurs.

- Triggering Events Defined:
  - The U.S. Shareholder ceasing to be an S corporation;
  - The liquidation, sale, exchange or other disposition of substantially all of the assets of the S corporation, including bankruptcy, a cessation of the business of the S corporation;
  - A transfer of any shares of the S corporation (including by reason of death or otherwise) that results in a change of ownership for federal income tax purposes; and
  - The IRS determines that there has been a material misrepresentation or omission in a transfer agreement.

- "Covered" Triggering Events:
  - "Eligible transferee" (a single domestic person other than a domestic pass through entity); and
  - Timely filed transfer agreement.

Note:
A transfer of a portion of S corporation shares is a triggering event only as to the shares transferred.

Multiple transferees are allowable under IRC §965(i), and transfer agreements must be signed by each transferee.

Note:
Death of an S corporation shareholder can be a covered triggering event.

Note:
Following a triggering event, tax may continue to be deferred for another 8 years under IRC §965(h), even in the absence of a valid and timely filed transfer agreement.
Considerations for individual shareholders subject to GILTI
Overview

- GILTI basics
- Corporations v. 962 elections v. pass-through
- Considerations for U.S. residents abroad and individuals temporarily present in the United States
- Planning to avoid GILTI and subpart F income
Outbound Planning After 2017

- The 2017 Tax Act has changed the outbound landscape. Going forward, a flood of complex new rules and new acronyms
  - Limited future deferral due to tax treatment of GILTI
  - Expanded definition of CFC
    - Definition of "U.S. shareholder" (Old: 10% votes; New: 10% votes or value)
    - Downward attribution from foreign person
    - Elimination of requirement that foreign corporation be a CFC for at least 30 days during the year
  - But, some reduction in scope of Subpart F income due to the effect of reduction in corporate rate on the high-tax kickout
    - (Not covered in this presentation) BEAT and FDII
- Harsh treatment for individuals and closely held businesses, especially U.S. citizens resident in high-tax countries
GILTI Basics
Subpart F, GILTI and QBAI – Overview

<table>
<thead>
<tr>
<th>U.S. Shareholder</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFC</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Subpart F income</th>
<th>GILTI – section 951A (most business income)</th>
<th>Qualified business assets income (QBAI) and high taxed FPHC income</th>
</tr>
</thead>
</table>
| No change but note high tax kickout income increased due to cut in U.S. rate (i.e., passive and related-party income is not Subpart F income if foreign tax is 90% of 21% (18.9%), down from 90% of 35% (31.5%)) | 10% C corporation shareholders:  
  - Immediate taxation at 50% (10.5%)  
  - 80% foreign tax credit available  
  Individuals  
  - Full individual rates  
  - Must consider section 962 election | QBAI = 10% return on tangible depreciable assets  
  High foreign tax FPHC (threshold now 18.9%)  
  100% dividends received deduction for 10% C corporation shareholders  
  Other shareholders  
  - Deferral  
  - Sections 956 and 1248 not repealed |

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GILTI (Very) Basics – 1

GILTI =
- CFC net tested Income (computed on a consolidated or aggregate basis for each U.S. shareholder)
- Less net deemed tangible income return

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

Net deemed tangible income return =
- Qualified business asset investment ("QBAI") x 10%
- Less interest expense
GILTI (Very) Basics – 2

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

- 100% dividend received deduction ("DRD") for foreign source dividends and section 1248/964(e) amounts received from specified foreign corporations, but only if received by a U.S. C corporation shareholder
  - Limited to income that is neither Subpart F income nor-GILTI
  - Subpart F income and GILTI income don’t need DRD because treated as previously taxed income
- Minimum 366-day holding period
- No DRD for hybrid dividends from a CFC
  - Think PECs or instruments treated as debt in foreign country but equity in United States
- No FTC on income for which DRD allowed
## Typical Business Profile (Especially Individually-Owned)

### U.S. Individual

<table>
<thead>
<tr>
<th>Subpart F income</th>
<th>CFC</th>
<th>QBAI</th>
</tr>
</thead>
<tbody>
<tr>
<td>GILTI</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Application of GILTI

- Individual U.S. Shareholders of CFCs subject to harsh treatment on GILTI income:
  - Ordinary income treatment
  - Section 250 deduction not available to U.S. Shareholders
    - But IRS will allow deduction if U.S. Shareholder makes a Section 962 election
    - No indirect foreign tax credit
  - Uncertainty with respect to withholding taxes on later distributions of PTI arising from GILTI inclusion
The New Regime Is Favorable to C Corporations

<table>
<thead>
<tr>
<th>U.S. Corporation</th>
<th>CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subpart F income – taxed at 21% (instead of 35%)</td>
<td>GILTI – taxed at 10.5%, with allowance of 80% of indirect foreign tax credit</td>
</tr>
</tbody>
</table>

- New low corporate rate of tax
- Subpart F income and GILTI are repatriated tax-free
- Indirect foreign tax credit available
- IRS has proposed that section 956 amount will be reduced by the amount of the dividends received deduction under section 245A that a corporate shareholder would be allowed if the shareholder received as a distribution from the CFC an amount equal to the tentative section 956 amount with respect to its shares in the CFC – in effect repealing or at least gutting section 956 in the case of domestic corporations. Prop. Reg. sec. 1.956-1(a)(2)(i) (October 31, 2018).
Where a Foreign Corporation is Held by an Individual

<table>
<thead>
<tr>
<th>U.S. Individual</th>
<th>CFC</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subpart F income – taxed at 37%</td>
<td>GILTI – taxed at 37%</td>
</tr>
</tbody>
</table>

- No foreign tax credit is allowed except foreign withholding taxes
- Note that there is a potential for FPHC income (when it is taxed at more than 18.9% in a foreign jurisdiction) to be deferred while certain active business income is GILTI, even if it is high taxed
As the next slide shows, the combined effective tax rate for a U.S. individual can be in the 60% to 70% range using realistic assumptions. Most of the tax will be due when income is earned.
## Individual Holding Stock Directly

<table>
<thead>
<tr>
<th>Income (Deduction)</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income – GILTI</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Foreign Tax (20%)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Federal Tax (37%)</td>
<td>$296,000</td>
</tr>
<tr>
<td>Distribution from CFC</td>
<td>$800,000</td>
</tr>
<tr>
<td>PTI</td>
<td>($800,000)</td>
</tr>
<tr>
<td>Foreign withholding tax (15%)</td>
<td>$120,000</td>
</tr>
<tr>
<td>State Tax (assume 8%)</td>
<td>$64,000</td>
</tr>
<tr>
<td>Net Investment Income Tax (3.8%)</td>
<td>$30,400</td>
</tr>
<tr>
<td><strong>Total Taxes</strong></td>
<td><strong>$710,100</strong></td>
</tr>
</tbody>
</table>

Effective Tax Rate: 71%
Corporations, 962 Elections, Pass-throughs
Three Possible Solutions

- Interpose a domestic corporation
- Make a section 962 election
- Be taxed directly on the income
As the next slide shows, the combined effective tax rate using realistic assumptions could be in the low-50% range. However, only about half of this will be taxed when earned and the rest when fully distributed (two levels of distribution – CFC to U.S. Corp and U.S. Corp to individual).
# Holding Stock Through U.S. Corporation

<table>
<thead>
<tr>
<th>Income (Deduction)</th>
<th>Tax (Credit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income – GILTI</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Foreign Tax (assume 20%)</td>
<td></td>
</tr>
<tr>
<td>GILTI Deduction (Sec. 78 gross up)</td>
<td>(500,000)</td>
</tr>
<tr>
<td><strong>Net GILTI</strong></td>
<td>$500,000</td>
</tr>
<tr>
<td>Federal Tax (21%)</td>
<td></td>
</tr>
<tr>
<td>Deemed Paid Credit (80% x 20% = $160,000)</td>
<td>($105,000)</td>
</tr>
<tr>
<td><strong>Total tax before CFC makes distribution</strong></td>
<td>$200,000</td>
</tr>
<tr>
<td>Distribution from CFC to U.S. Corp.</td>
<td>$800,000</td>
</tr>
<tr>
<td>Federal tax ($0 because PTI)</td>
<td>0</td>
</tr>
<tr>
<td>Foreign tax withholding (5%)</td>
<td>$40,000</td>
</tr>
<tr>
<td>State tax on corporate income (7%)</td>
<td>$56,000</td>
</tr>
<tr>
<td><strong>Total taxes on distribution from CFC</strong></td>
<td>$96,000</td>
</tr>
<tr>
<td>Distribution from U.S. Corp</td>
<td>$704,000</td>
</tr>
<tr>
<td>Federal Tax (20%)</td>
<td>$140,800</td>
</tr>
<tr>
<td>State tax on individual income (assume 8%)</td>
<td>$56,320</td>
</tr>
<tr>
<td>Net investment Income Tax (3.8%)</td>
<td>$26,752</td>
</tr>
<tr>
<td><strong>Total Tax on distribution from C corporation</strong></td>
<td>$223,872</td>
</tr>
<tr>
<td><strong>Total taxes at all levels</strong></td>
<td>$519,872</td>
</tr>
</tbody>
</table>

**Effective Tax Rate:** 51.9%
Interposing a Domestic Corporation

- U.S. individual could structure ownership interest in foreign corporation through a domestic corporation
- Domestic corporation would be taxed only on Subpart F income at 21% and on GILTI at favorable rate of 10.5% (reduced by foreign tax credits). No tax at all on QBAI or high tax kickout income
- Individual shareholder of domestic corporation is taxed, but only when domestic corporation makes distribution of earnings and then only at long-term capital gains rates
- Restructuring of existing CFC holding will generally involve a taxfree incorporation under section 351, so no U.S. tax cost
But . . .

- Have to avoid personal holding company and accumulated earnings tax on undistributed earnings
  - AET can apply even if earnings retained in CFC
  - Not known whether IRS will enforce AET with heavy or light touch

- Have to consider foreign tax consequences
  - Foreign country may tax contribution of CFC shares to domestic corporation
    - Many countries do not have section 351 equivalent
    - Consider application of capital gains article of treaty
    - Do not assume that domestic corporation will automatically qualify for reduced dividend withholding rates (0% or 5% v 15%)
  - For U.S. citizen living in foreign country, may create "sandwich structure" with undesirable consequences
Section 962 Election – The Problem It Addresses

CFC had $1,000,000 of Subpart F income, and paid $300,000 of foreign tax, in 2017

Absent any election, U.S. individual is subject to U.S. tax as follows:

• $700,000 taxed at 39.6% = $277,200
• **Ordinary income rate!**
• **No foreign tax credit!**
• Although distribution is tax-free PTI, foreign withholding tax on distribution may be difficult to credit

2017:
$1,000,000 Sub F
$300,000 Foreign tax

Total tax = $300,000 foreign tax + $277,200 tax on Subpart F income = $577,200 in the year income earned + foreign withholding tax in year distributed
Corporate-level tax (when income earned): Holdco taxed at lower corporate rate of 35%
Holdco gets indirect FTC
So, Holdco tax = $350,000 - $300,000 = $50,000

Shareholder-level tax (on distribution from Holdco):
Shareholder-level U.S. tax = $650,000 x 23.8% = $154,700

Total tax:
$300,000 + $50,000 + $154,700 = $504,700 of which $154,000 would be deferred until Holdco distribution

2017:
$1,000,000 Sub F
$300,000 For. tax
Section 962 Election – Basic Rules

Corporate-type tax
U.S. Individual pays tax on the Subpart F income at *corporate* rates, taking into account *indirect FTC*
As in the case of domestic Holdco, corporate (type) tax paid by U.S. Individual after FTC is $50,000. ($350,000 - $300,000 = $50,000)

Second/shareholder-level tax:
Only $50,000 of Subpart F income is tax-free PTI. The remaining $650,000 is taxable to U.S. Individual when distributed under section 962(d)
So, U.S. Individual pays tax twice!

If the distribution of the $650,000 is a qualified dividend, then the total tax will be the same as in the example with domestic Holdco: $300,000 + $50,000 + $154,700 = $504,700
And, of course, the second tax is deferred, possibly for a long time

2017:
$1,000,000 Sub F
$300,000 For. tax
Section 962 Election – GILTI Example

GILTI – No 962 Election
$750,000 x 37% = $277,500
Total taxes $250,000 foreign + $277,500 GILTI = $527,500 (plus 3.8% on dividend from CFC)

GILTI – With 962 Election
Corporate-type tax* = $105,000 – (80% x $250,000)
i.e., no residual U.S. tax
Shareholder-level tax = $750,000 x (37% + 3.8%) = $306,000 or $750,000 x (20% + 3.8%)** = $178,500
Total U.S. tax = $178,500 (deferred until distribution)

* Assumes 50% GILTI deduction (IRS has confirmed this will be available)
** Assumes CFC is a qualified foreign corporation and dividend is a qualified dividend

2018:
$1,000,000 GILTI
$250,000 Foreign tax
Section 962 Election – Tax on the Distribution

- Under section 962(d), the E&P in excess of the U.S. corporate-type tax previously "shall, when such earnings and profits are distributed, notwithstanding the provisions of section 959(a)(1), be included in gross income ..."

- Is the distribution a *dividend*?

- If so, is the dividend *qualified*?

- See *Smith v. Commissioner*, 151 T.C. No. 5 (2018)
Section 962 Election – Who Can Elect?

- Domestic Fund, a U.S. shareholder, has GILTI
  - Or Subpart F income
  - Or an investment in U.S. property

- U.S. Individual would like to select section 962

- However, only U.S. shareholder, as defined in section 951(b), may elect

- In this case, U.S. Individual does not qualify
Section 962 Election – Taxpayer Becomes NRA

- Suppose a resident alien makes a section 962 election and later becomes an NRA

- Non-covered expatriate
  - Since *Smith* holds that any distribution is made by the foreign corporation, if no distribution is made until the resident alien is an NRA, theoretically there should be no tax on the distribution

- Covered expatriate
  - Under section 877A, taxpayer deemed to sell stock of CFC while still a resident
  - Gain will be taxed
    - Section 1248 may cause part of gain to be treated as dividend, which may be qualified dividend if CFC is a qualified foreign corporation
As the next slide shows, the combined effective tax rate using realistic assumptions could be in the mid-40% range. All of this would be taxable when earned.
Check the Box on Foreign Entity

<table>
<thead>
<tr>
<th>Income (Deductions)</th>
<th>Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Income</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Foreign Tax (20%)</td>
<td>$200,000</td>
</tr>
<tr>
<td>Federal Tax (37%)</td>
<td>$370,000</td>
</tr>
<tr>
<td>Foreign Tax Credit</td>
<td>($200,000)</td>
</tr>
<tr>
<td>State Tax (8%)</td>
<td>$80,000</td>
</tr>
<tr>
<td><strong>Total Tax</strong></td>
<td><strong>$450,000</strong></td>
</tr>
</tbody>
</table>

Effective Tax Rate: 45.0%
Assumption is that taxpayer materially participates, so no net investment income tax. Otherwise, add another 3.8% to the effective rate

Issues:
- May trigger capital gain and section 1248
- Not clear what the effect is on section 965 deferral
- May require initial foreign reorganization if foreign entity is a *per se* corporation
  - E.g., change SA to GmbH or Canadian company to ULC
Considerations for U.S. Citizens Resident Abroad and Individuals Temporarily Present in the U.S.
The True Forgotten Soldier: Expats and Temporary U.S. Persons

- U.S. expats income tax resident in a foreign country may not be able to utilize a U.S. corporation holding company vehicle
  - Interposing a domestic corporation may create a sandwich
  - There may be adverse foreign tax consequences
- 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.
  - Exit event may be cumbersome.
Foreign Country Limitations

- To mitigate harsh individual treatment, interposing a U.S. corporation as a holding company may seem like a logical solution.

- But, such reorganizations may have tax consequences in the CFC home country making such planning cost prohibitive.
Planning for Eventual Sale of CFC

- Interposing U.S. corporation holding vehicle to mitigate GILTI adds a second level of tax on sale of CFC stock that was directly held by U.S. individual shareholder
  - Might create tax friction, e.g. some jurisdictions may impose stamp duties
Avoiding GILTI and Subpart F Income
Upside Down – Investing in High Tax Country Real Estate

- Old Wisdom: Do your best to qualify real estate income as active rentals and therefore not Subpart F income
  - High tax kickout exemption difficult when U.S. corporate rate was 35%

- New Wisdom: If foreign corporate tax rate at least 18.9%, have income classified as foreign personal holding company and avoid classification as either Subpart F income or GILTI

- REALLY??
The Message

- It’s all about timing and projections
- Is distribution from foreign corporation needed?
  - May trigger state corporate tax
- Is distribution from U.S. corporation needed?
  - Triggers Federal and state income tax
  - But failure to distribute from foreign corporation to U.S. corporation or U.S. corporation to individual may lead to accumulated earnings tax
Traps for the Unwary Upon Exit From CFCs
338(g) Elections

US Individual

$100 FMV
$50 Basis

CFC in Treaty Jurisdiction

• Holds operating assets with $0 basis, $100 FMV
• $0 E&P
• No QBAI

• Pre TJCA, US SH is indifferent to 338(g) election
  • Without election, taxed on $50 at capital gain rates of 23.8%
  • With election:
    • Deemed sale of assets creates $100 of E&P.
    • $50 gain is treated as a dividend under 1248, but taxed at qualified dividend rates of 23.8% (Notice 2004-70)

• Post TCJA, 338(g) election is potentially disastrous
  • Without election, taxed on $50 at capital gains rates of 23.8%
  • With election:
    • Deemed sale of assets $100 of GILTI income taxed at ordinary rates
    • Basis increase under 961 causes $50 capital loss
The above presentation is based on the completeness and accuracy of facts and assumptions stated above and of any other information provided to us. If any of the foregoing is not entirely complete or accurate, it is imperative that we be informed immediately, as the inaccuracy or incompleteness could have a material effect on our conclusions. We are relying upon the relevant provisions of the Internal Revenue Code of 1986 as amended, the regulations thereunder, any applicable treaty, and the judicial and administrative interpretations thereof, which are subject to change or modification by subsequent legislative, regulatory, administrative, or judicial decisions. Any such changes also could have an effect on the validity of our conclusions. Unless you specifically request otherwise, we will not update our advice for subsequent changes or modifications to the law and regulations or to the judicial and administrative interpretations thereof.

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