S Corporations and the International Tax Provisions of the TCJA

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Introduction to New, “Territorial” System
Worldwide Taxation: The “Old” Rules

- U.S. citizens and residents, including domestic C corporations, taxed on worldwide income
- Double taxation avoided primarily through foreign tax credits
- Income earned through CFC
  - Generally qualifies for deferral
    - Subpart F rules relatively limited
      - Passive income
      - Certain related-party transactions
      - Investments in US property
  - Any income not previously taxed under Subpart F, taxed when repatriated
    - C corporations generally avoided double tax via “indirect” FTC – not allowed to individuals, S corps.
Overview of International Changes

- Supposed transition to territorial system
  - DRD
  - Transition tax
  - GILTI regime
- New FDII deduction
- Other Subpart F changes
  - Definition of US shareholder – now 10% of vote or value
  - Expansion of constructive ownership
  - Elimination of "30-day rule"
- Anti-base-erosion provisions
  - Base Erosion Anti-abuse Tax (BEAT) – section 59A
  - Deduction disallowance for certain hybrid payments – section 267A
  - Expanded earnings-stripping rules -- section 163(j)
New DRD
Dividends Received Deduction

- Effective 2018, 100% DRD allowed for foreign-source portion of dividends received by a C corporation that is a U.S. (10%) shareholder from a foreign corporation
  - Not limited to FCs that are CFCs
  - Any FC with C corporation US shareholder is a “specified 10–percent owned foreign corporation”
- N/A to US individuals, S corporations
  - Territoriality only for C corporations
  - And even for C corporations, limited by GILTI rules
- No credit for indirect foreign tax on deducted income
- Exceptions apply to PFICs and hybrid dividends
Section 965
Purpose of Section 965

- Sometimes referred to as “transition tax”
- Purpose was to deal with transition to new, supposedly territorial system where foreign dividends are typically untaxed pursuant to DRD
- Needed to decide what to do with pre–TCJA earnings
- Could potentially have decided to keep track of pre–TCJA vs. post–TCJA earnings and allow DRD only for latter
- Decided instead to tax all of the pre–TCJA earnings immediately (sort of)
- Hence, new section 965
To Whom Does Transition Tax Apply?

- All US shareholders of “deferred foreign income corporation” (DFIC)

- What is a DFIC?
  - Any “specified foreign corporation” with accumulated deferred post-1986 foreign income (sometimes referred to, for convenience, as “deferred earnings”)

- What’s a specified foreign corporation?
  - CFC
  - Any other FC with at least one US (i.e., 10%) shareholder that is a C corporation
  - In other words, includes any specified 10-percent owned foreign corporation whose dividends to a 10% C corporation shareholder are eligible for the new DRD

- Ironically, for non-C corporation US shareholders, section 965 “transition” tax applies, notwithstanding that they remain subject to worldwide taxation, and receive no benefits from the new, supposedly territorial tax regime
Impact of section 965 is to include in Subpart F income the deferred earnings as of November 2, 2017 or December 31, 2017 (whichever is greater)

Year of inclusion depends on DFIC taxable year

- If DFIC taxable year is calendar year, then US shareholder includes deferred earnings in income for US shareholder’s year that includes December 31, 2017.
- So, in simple case where taxable year of both DFIC and US shareholder is calendar year, the inclusion falls in the US shareholder’s 2017 tax year.
- While often discussed as a 2017 inclusion, may easily fall within 2018 instead, e.g., individual US shareholder of CFC with June 30 taxable year.

Must be mindful of section 898, which requires certain CFCs to use a majority US shareholder year in certain circumstances, subject to permissible 1–month deferral
Relief Provisions for All

- Reduced Rate – section 965(c) deduction
  - Accomplished via a deduction, per section 965(c)
  - Deduct portion necessary to reduce tax at max corporate rate to 15.5% for cash assets and 8% for non-cash assets
  - For 2017 inclusions, reduces tax rate on individuals to roughly 17.5% for cash assets and roughly 9.1% for non-cash assets
  - For 2018 inclusions, reduces tax rate on individuals to roughly 27.3% for cash assets and roughly 14.1% for non-cash assets (difference due to decrease in corporate rates)
  - Effectively treated as an exclusion, so avoid various deduction limitations do not apply

- Installment Method – section 965(h) election
  - Transition tax may be paid over 8 years: 8% for each of the first 5 years, then 15% in the sixth year, 20% in the 7th year and 25% in the 8th year
  - Must elect! Deadline cannot be extended with 9100 relief
  - Must be careful to avoid “acceleration events”
Distribution of Section 965 Amounts

- Entire section 965(a) inclusion, including amount deducted under section 965(c), becomes previously taxed earnings & profits ("PTEP"), assuming no section 962 election.
  - Distribution of PTEP generally not taxed.
  - However, section 1411 "ObamaCare" tax may apply.
  - Consider also state and local taxes
  - Absent election to contrary, inclusions under Subpart F rules not considered dividends for such purposes.
  - Under Notice 2019–01, "section 965 PTEP" gets distribution priority.

- Distribution of PTEP is not an acceleration event, so shareholders generally can access their PTEP even if they make section 965(h) elections

- However, be careful to avoid complete liquidation of CFC
“Permanent” Deferral for S Corporations

- S corporation shareholders can elect “permanent” deferral under section 965(i)
  - Must be made by due date of return; no 9100 relief
- Deferral terminates only upon a “triggering event”
  - Loss of S status
  - Liquidation or sale of substantially all assets of the S corporation, cessation of business by the S corporation, S corporation ceases to exist, or any similar circumstance
  - Disposition of S corporation stock by the taxpayer shareholder, including by gift or death
    - Prorated for partial dispositions
- S corporation has joint and several liability
- Difficult to come up with any tax policy justification for special treatment
- Special focus of this presentation is on “proper care and feeding” of permanent deferral election under section 965(i)
Assumptions

- U.S. Individual (USI) wholly owns the shares in a S-corporation (S Corp)
- S Corp wholly owns the shares in various CFCs (which are DFICs)
- S Corp had an income inclusion under section 965
- USI made a section 965(i) Election to defer the payment of such shareholder’s net tax liability under section 965 with respect to S Corp
- S Corp’s only assets are shares in CFCs; accordingly, such shares are substantially all of S Corp’s assets
More on Triggering Events (Examples)

351 Contribution to Domestic Corporation

- USI
- S Corp
- C Corp
- CFCs

721 Contribution to Foreign Partnership

- USI
- S Corp
- FP
- CFCs

Liquidation of CFCs

- USI
- S Corp
- CFCs

90%
More on Triggering Events (Final Example)

Foreign to Foreign Asset Reorganization(s)

Step 1 (actual or deemed): CFCs transfer all of their assets to New CFC for New CFC stock

Step 2 (actual or deemed): CFCs distribute New CFC stock to S Corp in liquidation

If only a single CFC, likely an “F” reorganization

Alternative: CFC reincorporates in another foreign country
What Happens After A Triggering Event?

- Taxpayer may still elect to pay tax in eight installments under section 965(h)
  ◦ Provided that triggering event is not also an acceleration event

- In case of disposition of S corporation stock, “permanent deferral” may continue if a transfer agreement meeting certain requirements is executed and timely filed with the IRS
Transfer Agreement Exception

Requirements
- Covered triggering event, *i.e.*, transfer of S corporation stock
- “Eligible section 965(i) transferor”
- “Eligible section 965(i) transferee”

Domestic pass-through entities not eligible transferees
- Grantor trust not eligible – but owner is eligible
- QSST not eligible – but beneficiary is eligible
- Other trusts eligible
- ESBT is eligible
- Estate is eligible

Transferee assumes liability for transition tax pursuant to transfer agreement with transferor

Transfer agreement must be timely filed with the IRS
- Generally, within 30 days of transfer,
- But in case of shareholder’s death, by April 15th of the following year
Further Triggering Event Considerations

- Only transfers that change ownership for federal income tax purposes are triggering transfers.
  - Thus, transfers to grantor trusts or QSSTs in which the transferor remains the tax owner are not triggering events
    - *But see Rothstein (2nd Cir.)*

- Be wary of *deemed* transfers, *e.g.*, 
  - Termination of grantor trust status

- Possibility of multiple triggering events, *e.g.*, 
  - Decedent to estate; estate to beneficiary

- Where there are several trustees, who is the 965(i) transferee? 
  - There can be only one.

- What about trust mergers, decanting, disclaimers, material modification of a trust, or judicial reformation? 
  - What about the severance of the trust?

- Consider effect of section 645 election
Section 951A – GILTI Tax
GILTI Overview

- GILTI included in income of US shareholders of CFCs, as ordinary income – much like Subpart F income
- Nominally applies to global intangible low-taxed income, but term is highly misleading
- GILTI technically not Subpart F income, but GILTI rules included in Subpart F
- Subject to one key exception, most non–Subpart–F income of a CFC is typically GILTI
Measuring GILTI

- Shareholder-level determination, based on certain items that flow from a US shareholders CFCs to the US shareholder.
  - Different than Subpart F income, which is measured at the CFC level
- US shareholders of CFCs are allocated tested income and tested loss from each CFC
- Must determine shareholder’s net CFC tested income, i.e., excess of US shareholder’s aggregate tested income less aggregate tested loss
- GILTI = US shareholder’s net CFC tested income - net deemed tangible income return
- Net deemed tangible income return = 10% of US shareholder’s aggregate share of the adjusted basis of the CFCs’ “QBAI,” i.e., assets that are used in a trade or business and depreciable (referred to as qualified business asset investment), reduced by certain interest expense taken into account in measuring the CFCs’ tested income
  - Typically, the net deemed tangible income return is relatively insubstantial
- A CFC’s tested income (or loss) generally is all of the CFC’s income (or loss) other than from:
  - Subpart F income;
  - Income that is effectively connected with a US trade or business; and
  - Certain high-taxed income
GILTI – High Taxed Income Exception

- As written in the statute, exception limited to high-taxed items that, if not high-taxed, would constitute Subpart F income
- Since Subpart F income historically disfavored, statute appeared to incentivize conversion of non–Subpart F income into Subpart F income to enjoy high-tax exception
- Under proposed regulations, not yet effective, high-taxed income exception will be expanded to include items that are not otherwise Subpart F income
GILTI Benefits for C Corporations

- Section 250 deduction allows a deduction equal to 50% of GILTI (reduced to 37.5% after 2025)
  - Given 21% corporate rate, effect of deduction (in a simple case) is to tax GILTI at a 10.5% effective rate (pre-2026)
- C Corporations may also claim a credit for 80% of the allocable foreign corporate taxes paid by their CFCs
  - In simple case, this means effective foreign tax rate of 13.125% (pre-2026) is sufficient to eliminate GILTI tax
- Generally not allowed to individuals or S corporations, but individuals electing under section 962 effectively enjoy such benefits
Taxation of Individuals & S Corporations (Assuming no Section 962 Election)

- Ordinary income tax rate of 37% applies
  - Qualified dividend treatment not available
- No section 250 deduction
- Indirect FTC
- GILTI is considered PTEP, so may be distributed later, generally with no tax
  - But section 1411 “ObamaCare” tax generally applies
  - Consider also state and local taxes
Electing individual taxed largely as if GILTI were earned by a C corporation holding company, i.e.,
- 21% corporate rate applies
- Section 250 deduction allows a deduction equal to 50% of GILTI (reduced to 37.5% after 2025)
  - This came as a pleasant surprise, as IRS/Treasury were reluctant
- 80% indirect FTC allowed
- In many cases, reduces current tax to zero

However, subsequent distributions generally not PTEP and instead taxed as dividends, per section 962(d).
- May potentially be qualified. Depends on whether CFC is a qualified foreign corporation (“QFC”).
  - Taxpayer in Smith case argued, unsuccessfully, that the dividend must be viewed as coming from a hypothetical domestic corporation
- For CFC to be QFC, generally must be organized in treaty country and eligible for treaty benefits, including satisfaction of “Limitation on Benefits” requirements
Section 962: State and Local Issues

- Need to consider laws of applicable state and locality
  - Some states do not follow federal and will only tax subsequent distribution

- For states that follow federal, query whether double taxation will be imposed
  - Section 962 does not expressly say that the GILTI amount is excluded from gross income, as the rules focus primarily on the amount of federal tax to be paid
  - Arguably, such an exclusion is implicit in the instructions to Form 1040
    - Note the comparison to certain PFIC amounts expressly excluded from gross income under section 1291, and similarity of the instructions for section 962 tax to those for section 1291 tax
    - Presentation on federal return may have substantial impact on state and local treatment
Given benefits allowed to C corporations, may be desirable for individuals and S corporations to interpose C corporations to manage GILTI taxation.

Less likely to be necessary now, given favorable federal treatment of section 962 election.

Moreover, consider:
- State/local issues noted above
- “Roach motel” effect – easy to get in; tough to get out

Consider also impact on section 965(h) and section 965(i) elections:
- Will be a triggering event
- Need a transfer agreement – will that be sufficient?
For Subpart F purposes, section 1373 treats S corporations like domestic partnerships.

Historically, Subpart F income included at partnership (and S corporation) level, so “small” shareholders of S corporations that are 10% shareholders had Subpart F inclusions as a share of the partnership (or S corporation) income.

GILTI caused IRS/Treasury to rethink this basic rule, e.g., because GILTI is determined at the level of the ultimate partner or S corporation shareholder.

Under the new GILTI regulations, domestic partnerships and therefore S corporations do **not** have inclusions of GILTI.

- A S corporation shareholder may have GILTI, but only if such shareholder is him/her/it-self a 10% US shareholder described in section 951(b).
- Thus, “small” S corporation shareholders have no inclusions.

This same “aggregate” approach applies to Subpart F income, as well as GILTI.

Domestic partnerships and S corporations continue to be US persons for purposes of determining who is a US shareholder and whether a foreign corporation is a CFC.
More on Major Subpart F Change

- Consequences of Paradigm Shift:
  - Problem: actual distributions from CFCs come to S corporations, not shareholders.
  - Uncertainty in S corporation mechanics with respect to inclusion, distributions, basis, and AAA.
  - But, problem should be solved. Point is, section 959(a) excludes PTEP distributions to shareholders who included them “…directly or through the chain of ownership described in section 958(a)….” That chain includes our newly minted “foreign partnership.” Section 958(a)(2).

- Caveat
  - New rules apply solely for purposes of who has GILTI and other inclusions under Subpart F
  - New rules do not prevent domestic partnerships and S corporations from being US shareholders and thereby causing CFC status
Final Comments on Subpart F Change

- GILTI–driven tax distributions to S corporation shareholders will provide an extra cash-flow windfall to “small” shareholders that are not taxed on their shares of the GILTI