Bloomberg Tax

Daily Tax Report®

Foreign Corporations

INSIGHT: Bring That CFC on Home: Domesticating Individually-Owned CFCs After Tax Reform

BY LEIGH-ALEXANDRA BASHA AND KEVIN HALL

Public Law 115-97, which became law on Dec. 22, 2017, and is commonly referred to as the Tax Cuts and Jobs Act (the ''Act''), comprehensively changed the rules governing U.S. persons with non-U.S. businesses and investments. Supporters promised that the Act would reduce taxes and compliance costs for both individuals and corporations. But several changes in tax reform have a disparate impact on non-corporate U.S. shareholders of foreign corporations compared with their corporate counterparts. Many such non-corporate shareholders face an expensive tax increase. They may attempt to mitigate this increase by transferring their shares to a U.S. corporation or making a Section 962 election.

This article examines the new rules governing U.S. individuals who own foreign corporations and suggests using the Section 965 ''transition tax'' to facilitate the domestication of such foreign corporations, thereby extracting the shareholder and corporation from the new outbound tax regime. Such a domestication may have been prohibitively costly before tax reform despite potentially providing long-term tax savings. This article refers to U.S. ''individual'' shareholders of foreign corporations, but the principles generally apply to other non-corporate shareholders such as trusts.

1) ***No participation exemption.*** The Act provides a full dividends received deduction (commonly referred to as the participation exemption) for certain dividends received by a U.S. corporation from a 10-percent owned foreign corporation. But U.S. *individuals* who own foreign corporations are not eligible for the participation exemption. Dividends received by individuals remain taxable either as qualified or non-qualified dividends (at either a 23.8 percent or 40.8 percent top rate, respectively).

2) ***Higher transition tax rate.***. Newly enacted Section 965 (commonly referred to as the transition tax) requires 10-percent U.S. shareholders of certain foreign corporations (referred to as specified foreign corporations, or SFCs) to include their share of the SFC's previously untaxed earnings and profits (E&P), referred to as deferred foreign income, as Subpart F income during the corporation's last tax year beginning before Jan. 1, 2018. The transition tax is intended, in part, to prevent deferred foreign income earned under the prior system of taxing foreign earnings from permanently escaping U.S. taxation via the new participation exemption. As mentioned above, individuals are not eligible for the participation exemption. They nevertheless are subject to the transition tax, and at higher rates than U.S. corporations. The transition tax's policy underpinnings are weaker for individuals who own SFCs, but the tax still applies.

The transition tax rate is determined by allowing U.S. shareholders a deduction against the required Subpart F income inclusion. The deduction percentage is the percentage that would reduce the maximum corporate tax rate to 15.5 percent or 8 percent. The 15.5 percent rate applies to the extent the deferred foreign income is attributable to the SFC's ''aggregate foreign cash position.'' Any untaxed deferred foreign income in excess of this amount generally is subject to the 8 percent rate. Because the deduction percentage is tied to the corporate tax rate and because the maximum individual income tax rate exceeded the corporate tax rate during 2017, individuals may be subject to a higher transition tax rate than corporations. A maximum 17.5 percent transition tax rate applies to an individual shareholder's share of an SFC's deferred foreign income that is attributable to the SFC's aggregate foreign cash position and a maximum 9.05 percent tax rate applies to the individual's share of any remaining deferred foreign income. Higher rates may apply to shareholders of fiscal year SFCs. Both corporate and individual shareholders may elect to pay the transition tax in installments over an eight-year period. Individual taxpayers must have made the election by April 17, 2018, for most SFCs.

3) ***No GILTI deduction.***. The Act added new Section 951A, which requires U.S. shareholders of controlled foreign corporations (CFCs) to include their pro rata share of the CFC's global intangible low-taxed income (GILTI). A CFC is any foreign corporation that is more than 50 percent owned by U.S. shareholders. Only those U.S. shareholders who own (directly, indirectly, or constructively) 10 percent or more of the foreign corporation's stock (by vote or value) are treated as U.S. shareholders for this purpose. A GILTI inclusion is treated as Subpart F income for many purposes.

The calculation of GILTI is complex. Very generally, however, GILTI is the excess of a U.S. shareholder's pro rata share of a CFC's income reduced by an allowable return equal to 10 percent of the CFC's adjusted tax basis in certain depreciable tangible property. U.S. corporate shareholders currently are allowed a 50 percent deduction against any GILTI and can, subject to limits, credit foreign taxes paid by the CFC to offset the U.S. tax resulting from GILTI inclusions. Individual shareholders of CFCs are not eligible for either of these benefits. Instead, they are subject to tax at ordinary income tax rates (currently reaching 37 percent) on any GILTI inclusions without any foreign tax credit offsets.

The following (simplified) example illustrates the disparate impact of the GILTI regime on individual owners of CFCs. Assume a CFC operates an active services business in a jurisdiction that imposes a 30 percent income tax rate. The CFC business has no tangible depreciable assets and generates $100 of net taxable income annually that is not otherwise classified as Subpart F income. The following chart compares the tax consequences to a U.S. corporate shareholder to those of a U.S. individual shareholder:

	C Corporation CFC Shareholder	Individual CFC Shareholder
GILTI	$100	$100
Less 50% Deduction	$50	$0
Foreign Tax (30%)	$30	$30
Tentative U.S. Tax	$10.50 ($50 x 21%)	$25.90 ($70 x 37%)
Foreign Tax Credit	$10.50	$0
U.S. Tax	$0	$25.90
Pre-Distribution Worldwide Tax Rate	**30%**	**55.9%**

Whether by design or not, the Act has surprisingly harsh consequences for many U.S. individual shareholders of foreign corporations. These consequences have prompted international tax planners to search for ways to mitigate the impact of the transition tax and the changes to the outbound tax rules, particularly in the new tax on GILTI. Two commonly proposed solutions attempt to put individual shareholders in parity with C corporation shareholders: (1) transferring stock of the CFC to a domestic C corporation, and (2) making a Section 962 election. Each option has benefits and drawbacks.

Domestications, Post-TCJA

A third, but often overlooked, option is using the transition tax to facilitate a domestication, thereby extracting the foreign corporation from the CFC rules. A domestication can, in certain circumstances, significantly reduce the worldwide tax on earnings of an individually-owned CFC. Once a CFC has domesticated, it can either remain a U.S. C corporation or, if eligible, elect S corporation status. The preferred status will depend on a number of factors, including the nature of the corporation's foreign business and the applicable local tax rules.

Corporations can change their place of organization in a tax-free ''Type F'' reorganization, which can be accomplished in a variety of ways. When a CFC is domesticated (*i.e.*, converted into a U.S. corporation), however, Section 367(b) provides that certain U.S. shareholders of the CFC must include, as a deemed dividend, the ''all earnings and profits'' amount (the ''All E&P Amount'') with respect to the CFC. The All E&P Amount generally is the U.S. shareholder's pro rata share of the CFC's E&P accumulated during the U.S. shareholder's holding period.

The All E&P Amount is reduced by E&P attributable to ''previously taxed income.'' The E&P subject to the transition tax becomes previously taxed income. A U.S. shareholder's amount of previously taxed income resulting from the transition tax will frequently equal the shareholder's All E&P Amount and therefore reduce the All E&P Amount to $0. If the All E&P Amount is $0, the domestication generally will not trigger any U.S. federal income tax.

Before the Act, a domestication typically would have triggered an immediate tax liability (rather than a liability payable in installments under the transition tax) at either ordinary income tax rates or qualified dividend tax rates (rather than the reduced 17.5 percent or 9.05 percent rates under the transition tax). The Act therefore facilitates planning that previously may have been prohibitively costly.

Post-Domestication S Election

A domestic corporation is eligible to elect to be classified as an S corporation only if it satisfies several requirements. Notably, an S corporation cannot have any non-U.S. shareholders. (The Act relaxed this rule by allowing non-U.S. persons to be beneficiaries of electing small business trusts that are S corporation shareholders.) A pre-domestication restructuring therefore may be required to permit non-U.S. individuals to own an interest in an S corporation's business, for example by owning interests in a partnership in which the S corporation is also a partner. With proper planning, a CFC with non-U.S. shareholders typically can be restructured so that the corporation is eligible to make an S election after it is domesticated.

A CFC can typically be domesticated without affecting its status under local tax or other laws. A domestication could be effectuated by, for example: (1) forming a new U.S. corporation (HoldCo); (2) transferring the shareholder's interests in the CFC to HoldCo; and (3) electing to classify the CFC (and any of its subsidiaries) as a disregarded entity for U.S. tax purposes. A fourth, and optional, step would be electing to classify HoldCo as an S corporation.

Potential Benefits of a Domestication Coupled With an S Election

U.S. individual shareholders of foreign corporations cannot credit foreign taxes paid by the corporation. And they are taxed on dividends received from foreign corporations—either as qualified dividends or ordinary dividends. The federal tax rate on ordinary dividends currently reaches 40.8 percent, while the tax rate on qualified dividends is limited to 23.8 percent. U.S. shareholders of foreign corporations therefore are effectively subject to two levels of tax on the foreign corporation's earnings: the tax imposed by the local country and U.S. tax on dividends from the foreign corporation. This double taxation can be eliminated if the foreign corporation is domesticated and elects to be classified as an S corporation.

U.S. shareholders of an S corporation are taxed immediately on their share of the S corporation's income. But the U.S. tax on this income is offset, via a foreign tax credit, by their share of any creditable foreign taxes paid (or treated as paid) by the S corporation. All local income taxes generally will be creditable if the U.S. shareholder's federal income tax on the S corporation's income exceeds the local country income tax on such income. The U.S. shareholder would then pay any residual U.S. federal tax, effectively resulting in a single-level of corporate income tax. Distributions from the S corporation post-domestication generally would be tax free.

Because of the credibility of local income taxes, foreign corporations that are subject to relatively high local income taxes (particularly, taxes exceeding the new 21 percent U.S. corporate rate) may be prime candidates for domestication. And because distributions can be made free of U.S. tax, shareholders who intend to receive regular distributions from the foreign corporation generally will avoid the U.S. tax that would be imposed on such distributions. For foreign corporations that are not qualified foreign corporations, this would avoid the potential 40.8 percent tax on ordinary dividends.

The benefits of a domestication can be illustrated using the simple example below. As a reminder, we assumed that a CFC operates an active services business in a jurisdiction that imposes a 30 percent income tax rate. The CFC has no tangible depreciable assets and generates $100 of net taxable income annually. The third column summarizes the consequences to a U.S. individual owning the foreign business through a branch (e.g., a foreign disregarded entity) owned by an S corporation.

	C Corporation CFC Shareholder	Individual CFC Shareholder	S Corporation Disregarded Entity Owner
GILTI	$100	$100	$0
Less 50% Deduction	$50	$0	$0
Foreign Tax (30%)	$30	$30	$30
Tentative U.S. Tax	$10.50 ($50 x 21%)	$25.90 ($70 x 37%)	$37 ($100 x 37%)
Foreign Tax Credit	$10.50	$0	$30
U.S. Tax	$0	$25.90	$7
Pre-Distribution Worldwide Tax Rate	**30%**	**55.9%**	**37%**
Tax on Distribution	$16.66 ($70 x 23.8%)	$0	$0
Post-Distribution Worldwide Tax Rate	**46.66%**	**55.9%**	**37%**

The immediate effective tax rate on income earned by the foreign branch after the domestication exceeds the tax rate that would apply if the business were operated by a CFC owned by a U.S. C corporation. However, no additional U.S. federal income tax will be imposed on distributions from the S Corporation to its shareholder. Distributions from the C corporation to its individual shareholder, on the other hand, would be subject to an additional 23.8 percent tax. If cash is distributed regularly, owning the business through an S corporation may result in significant worldwide tax savings. The savings would be even greater for a business operating in a jurisdiction imposing higher income tax rates. Notably, the Act added a new foreign tax credit ''basket'' for foreign branch income. This could both introduce complexity and limit the foreign tax credit benefits for a company with operations around the world in diverse tax rate environments.

Domesticating a foreign corporation may provide other benefits as well. For example, the foreign corporation will no longer be subject to the Subpart F income rules, including the new tax on GILTI. This may provide greater flexibility for corporations that previously structured their operations to avoid generating Subpart F income. A domestication will avoid the GILTI rules, which promise to be burdensome. They require CFCs to complete a number of complicated, and previously unnecessary, calculations. For example, CFCs have to compute the 10 percent allowable return on assets based on the adjusted tax basis of such assets, applying U.S. tax principles. For most CFCs, this will be a time-consuming and costly endeavor.

Other Considerations

If a C corporation converts to an S corporation, Section 1374 imposes a corporate-level tax (the ''built-in gains tax'') on unrealized gains that existed at the date a C corporation converted to S status if such gain is recognized within five years of the conversion. S corporations that anticipate selling assets during this five year period should therefore obtain a valuation of the assets shortly after the domestication. In addition, in unusual circumstances, a domesticated corporation could have accumulated E&P. If it did, and if the S corporation earned passive income in excess of certain limits, the S corporation could be subject to corporate level tax or its S election could terminate.

Domestication Without an S Election

Rather than electing S corporation status, a newly domesticated corporation may choose to remain a C corporation in order to take advantage of the reduced corporate income tax rate and potentially the deduction for "foreign derived intangible income" (FDII). New Section 250 provides a 37.5 percent deduction for any FDII earned by a U.S. C corporation (the deduction is scheduled to decrease to 21.875 percent in 2026). In general, FDII is income derived in connection with property sold, leased, or licensed, and services provided to, foreign persons.

After the 37.5 percent FDII deduction, income derived from providing sales, services, or rights to foreign persons is effectively taxed at a 13.125 percent rate. Only domestic C corporations are eligible for the FDII deduction, and the FDII deduction does not apply to business profits attributable to a foreign branch. Although this option should not be ignored, it frequently will result in similar or less favorable federal income tax consequences as those that would result from contributing the shares of the foreign corporation to a U.S. holding corporation or making a Section 962 election.

Conclusion

U.S. individual shareholders of foreign corporations face a new, and daunting, international tax regime. They should carefully evaluate alternative restructurings in response to changes made by the Act. In many cases, a Section 962 election or an actual transfer of the stock in a foreign corporation may be the best course of action. But for certain U.S. shareholders, a post-transition domestication coupled with an S election may transform an immediate tax hit into long-term tax savings.

Leigh-Alexandra Basha is a partner in McDermott Will & Emery's Washington, DC, office and focuses her practice on domestic and international estate and tax planning. Kevin Hall is an associate in McDermott's Washington office and focuses his practice on domestic and international tax matters for multinational companies and high-net-worth individuals.