GILTI – COSTLIER FOR NON-C CORPORATE SHAREHOLDERS

By Rolando Garcia and Angela Qian

CURRICULUM: Tax

LEVEL: Basic

DESIGNED FOR: Tax professionals

OBJECTIVES: To describe and provide guidance on the Global Intangible Low-Taxed Income (GILTI) Section 951A provision of the Tax Cuts and Jobs Act

KEY TOPICS: GILTI inclusion regime requirements, calculations, impact of the GILTI rules on shareholders, Section 962 election and operational strategies

PREREQUISITES: None

ADVANCED PREPARATION: None

Tax professionals with clients involved in cross-border activities have had to deal with the international tax provisions enacted by the Tax Cuts and Jobs Act (TCJA)[1]. Last year, 2018, was arguably a frustrating year for both practitioners and clients due to the timing in which both the Internal Revenue Service (IRS) and the Treasury Department rolled out guidance and proposed regulations, creating an aura of haste.

As 2018 unfolded, the focus shifted from the Section 965 transition tax (Section 965(a)) to the Global Intangible Low-Taxed Income (GILTI), Section 951A provision of the TCJA. Congress felt that, without such an inclusion regime, the participation exemption system (Section 965(c)) created by the TCJA "could incentivize taxpayers to allocate income – in particular, mobile income from intangible property – that would otherwise be subject to the full U.S. corporate tax rate to controlled foreign corporations (CFCs) operating in low- or zero-tax jurisdictions.[2]"

What is GILTI?

The GILTI inclusion regime requires any U.S. shareholder (whether such ownership is direct or indirect as through a partnership, S corporation or trust) of a CFC and who owns stock in the CFC on the last day of the CFC's tax year is subject to U.S. federal income tax on the owner's pro-rata share of the CFC's GILTI (Section 951A(a)). A CFC is any foreign corporation in which U.S. shareholders own more than 50% of the foreign corporation's stock by value or vote (Section 957(a)).

Prior to enactment of the GILTI regime, foreign earnings and profits of a CFC were permanently deferred until distributed, except for certain types of income; e.g., Subpart F income (Section 951(a)). After passage of the TCJA, while these foreign earnings and profits of a CFC are still permanently deferred until distributed, GILTI is now included as one of the exceptions to that rule, along with those in Section 951(a).

Mathematically, GILTI is the excess (if any) of the shareholder's net CFC tested income for the tax year over the shareholder's net deemed tangible income return (DTIR) for the tax year (Section 951A(b)). These are, of course, defined terms.

Tested income is the gross income of the foreign corporation less the following enumerated items:

- U.S. effectively connected income (IRC Sec 952(b));
- Subpart F gross income (Section 952(a));
- Gross income excluded, due to high foreign taxes exception (Section 954(b)(4));
- Any dividend received from a related person (Section 954(d)(3));
- Any foreign oil and gas extraction income (Section 907(c)(1)); and
- Deductions (including taxes) properly allocable under (Section 954(b)(5)).

The net DTIR is the excess, if any, of 10% of the aggregate of the shareholder's pro-rata share of the qualified business asset investment (QBAI), over the amount of interest expense taken into account in determining net CFC tested income (Section 951A(b)(2)).

The QBAI is the average of the corporation's aggregated adjusted basis as of the close of each quarter of the tax year in specified tangible property used in trade or business of the CFC and of a type with respect to which a deduction is allowable under Section 167 (Section 951A(d)(1)). The adjusted basis is determined by using the alternative depreciation system (Section 951A(d)(3)(A)). Table 1 on the following page includes examples of the GILTI calculation.

Up to this point, the methodology described above is identical for U.S. shareholders of CFCs, whether they be C corporations, pass-through entities, trusts or individuals. A U.S. C corporation, however, is entitled to a deduction equal to 50% of GILTI amount, with this deduction percentage decreasing from 50% to 37.5% after December 31, 2025 (Section 250(a)(3)). In addition, a C corporation with a GILTI inclusion will be eligible for an 80% deemed foreign tax credit (Section 960(d)(1)).

Like all of the foregoing GILTI concepts, this 80% amount follows suit in that it brings in additional concepts and calculations. A C corporation will be deemed to have paid foreign income taxes equal to 80% of the product of (i) the C corporation's inclusion percentage (defined later) multiplied by (ii) the aggregate tested foreign income taxes paid or accrued by CFCs (Section 960(d)(1)).

The inclusion percentage is the ratio of (A) the corporation's GILTI divided by (B) the aggregate amount of the C corporation's pro-rata share of each CFC's positive tested income with respect to the corporation (Section 960(d)(2)).

These deemed taxes will increase the GILTI inclusion in the same way as the Section 78 gross-up. As a result, the amount grossed up is equal to the entire amount of the inclusion percentage and aggregate tested foreign income taxes, even though only 80% are used when computing the deemed-paid credit.

Thus, after all the dust is settled, the GILTI rules generally impose a U.S. corporate minimum tax of 10.5 percent (50% x 21%) and, to the extent foreign tax credits are available to reduce the U.S. corporate tax, may result in no additional U.S. federal income tax being due.

Non-C Corporation U.S. Shareholders Pay More

U.S. shareholders that are not C corporations are not entitled to the 50% deduction or the deemed paid foreign tax credit (Section 250(a)(1)(A)). In addition, GILTI may very well be taxed at the highest U.S. marginal federal income tax rate of 37%. In total, non-corporate shareholders face taxation on GILTI at a 37% rate without the benefit of a credit for any foreign taxes imposed on the CFC's GILTI.

Because of this unbalanced impact of the GILTI rules to non-C corporation U.S. shareholders, it is important that these taxpayers with investments in foreign corporations assess the U.S. federal income tax impact of the GILTI provisions on their foreign investments and consider whether it may be beneficial to take advantage of one of the planning ideas discussed below.

Use of a Domestic C Corporation Blocker

A non-C corporation U.S. shareholder may want to consider transferring its interest in its CFC to a U.S. C corporation. There should be no adverse U.S. income tax consequences if the transfer is made pursuant to Section 351, which provides that no gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange, such person or persons are in control (as defined in § 368(c)) of the corporation (Section 351(a)).

A U.S. C corporation holding company for CFCs would be particularly beneficial where the CFCs have foreign tax credits that could essentially eliminate the U.S. corporation's U.S. tax liability, as described above. Going forward, the non-C corporation U.S. shareholder would not be taxed on the GILTI until distributed by the U.S. holding company to the shareholder in the form of dividends, so the U.S. taxation of the GILTI would essentially be deferred until distributed by the U.S. C corporation to its shareholder, at ostensibly qualified dividend rates.

Having said this, some collateral issues to consider include:

- Uncertainty as to future CFC stock sale;
- Adverse foreign country consequences of transferring CFC stock to a U.S. corporation;
- Section 877A exit tax planning; and
- Viability for U.S. persons residing in a foreign country, where foreign country tax will be prohibitive if the CFC is held through a U.S. corporation.

Elect Section 962 Treatment

Section 962 provides a special rule that allows U.S. individual shareholders, including U.S. individual partners of partnerships and U.S. individual shareholders of S

TABLE 1. GILTI CALCULATION EXAMPLES

	CFC1	CFC2	CFC3	
Net CFC Tested Income				
Gross Income	12,000,000	8,500,000	9,000,000	
Less: Deductions allocable to gross income under 954(b)(5)	(6,000,000)	(11,000,000)	(7,000,000)	
	6,000,000	(2,500,000)	2,000,000	
Ownership %	100%	100%	100%	
	6,000,000	(2,500,000)	2,000,000	
			Net Tested Income	5,500,000
Net Deemed Tangible Income Return				
Qualified Business Asset Investment:	Average qtrly	Average qtrly	Average qtrly	
Specified Tangible Property	30,000,000	35,000,000	30,000,000	
Pro-rata share of tangible property from a partnership	0	0	0	
	30,000,000	35,000,000	30,000,000	
Ownership %	100%	100%	100%	
	30,000,000	35,000,000	30,000,000	
Applicable %	10%	10%	10%	
	3,000,000	3,500,000	3,000,000	
Interest expense taken into account in determining the shareholder's net CFC tested income for the tax year to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income	(100,000)	(100,000)	(100,000)	
	2,900,000	0	2,900,000	
		Net deemed tangible income return		5,800,000
			GILTI Income	0

	CFC1	CFC2	CFC3	
Net CFC Tested Income				
Gross Income	11,000,000	8,500,000	9,000,000	
Less: Deductions allocable to gross income under 954(b)(5)	(6,000,000)	(10,000,000)	(3,000,000)	
	5,000,000	(1,500,000)	6,000,000	
Ownership %	100%	100%	100%	
	5,000,000	(1,500,000)	6,000,000	
			Net Tested Income	9,500,000
Net Deemed Tangible Income Return				
Qualified Business Asset Investment:	Average qtrly	Average qtrly	Average qtrly	
Specified Tangible Property	30,000,000	35,000,000	30,000,000	
Pro-rata share of tangible property from a partnership	0	0	0	
	30,000,000	35,000,000	30,000,000	
Ownership %	100%	100%	100%	
	30,000,000	35,000,000	30,000,000	
Applicable %	10%	10%	10%	
	3,000,000	3,500,000	3,000,000	
Interest expense taken into account in determining the shareholder's net CFC tested income for the tax year to the extent the interest income attributable to the expense is not taken into account in determining the shareholder's net CFC tested income	(100,000)	(100,000)	(100,000)	
	2,900,000	0	2,900,000	
		Net deemed tangible income return		5,800,000
			GILTI Income	3,700,000

corporations, to elect to be taxed on subpart F amounts included in their gross income at corporate rates and to get the benefit of Section 960 foreign tax credits with respect to such income, similar as for a U.S. C corporation (Section 962(a)); 962 is an annual election (Section 962(b)).

The purpose behind Section 962 is "to avoid what might otherwise be a hardship in taxing a U.S. individual at high bracket rates with respect to earnings in a foreign corporation which he does not receive. This provision gives such individuals assurance that their tax burdens, with respect to these undistributed foreign earnings, will be *no heavier than they would have been had they invested in an American corporation doing business abroad.*" (S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), reprinted at 1962-3 C.B. at 798.)

Following through on its prognostication that the "Treasury Department and the IRS intend to modify §1.962-1(b)(1)(i) to provide that, in computing the amount of tax due as a result of a Section 962 election, the Section 965(c) deduction may be taken into account,[3]" the IRS issued proposed regulations indicating the GILTI deduction under

Section 250 would be available for an individual who makes a Section 962 election[4].

The benefits to non-C corporation U.S. shareholders of making a Section 962 election, therefore, are (1) GILTI is subject to U.S. tax at the 10.5% corporate rate, given that the aforesaid Section 250 50% deduction is allowed, rather than the higher 37% U.S. individual tax rate and (2) U.S. tax on GILTI may be offset by foreign tax credits.

It is critical to note that, despite the general rule that distributions from previously taxed earnings and profits will not trigger additional income tax (Section 959(a)), this rule does not apply if you make the Section 962 election (Section 962(d)). So, taxpayers who make the Section 962 election get taxed once at corporate tax rate when they report GILTI and again when the CFC distributes cash to the shareholder. Based on the *Smith* decision cited below, there is no assurance that the CFC distributions will be eligible for qualified dividend rates.

In addition to quantifying this option, other issues to consider include whether GILTI is subject to the net investment 3.8% income tax, as well as the Tax Court decision in *Barry M. Smith v. Commissioner*, which stands for the proposition that distributions from the CFC to the U.S. C corporation holding company and then on to the individual shareholder are not deemed dividends for purposes of potentially characterizing them as "qualified" dividends (*Barry M. Smith v. Commissioner,* 151 T.C. No. 5 (2018)).

The issue in this context is the tax characterization of the cash distribution. This issue arises whenever the CFC is located in a non-treaty jurisdiction, such that dividends paid by such a CFC do not qualify for a qualified dividend rate under Section 1(h)(11). When an actual distribution is made from such a CFC, the question is whether the distribution should be treated as coming from the CFC and hence be classified as ordinary income or instead as coming from the deemed C corporation created by the Section 962 election and thus be classified as qualified dividends.

In *Smith*, the taxpayer made Section 962 elections with respect to its Subpart F income inclusions from CFCs and thus later argued that the distributions were from a deemed domestic corporation and, therefore, should be taxed as a qualified dividend subject to the reduced 20% tax rate. The position of the IRS was the taxpayer received the distribution from a foreign corporation. The tax court rejected the taxpayer's argument, noting that Section 962 did not deem a domestic corporation to exist for federal tax purposes. (Id.)

Owning Foreign Operations in Pass-Through Form

It may also make sense to have non-C corporation U.S. shareholders set up foreign operations through foreign entities that they elect to treat as pass-throughs for U.S. federal income tax purposes under the check-the-box rules. Of course, this presupposes that the foreign entity is not a "per se" corporation, generally an entity that has no restrictions on the transfer of shares (Section 301.7701-2). Reg. §301.7701-3 allows entities "not classified as a corporation" to "elect its classification for federal tax purposes." The election, made on Form 8832, allows entities to be treated as (1) associations, (2) partnerships or (3) disregarded entities for U.S. income tax purposes (Id).

This would render a change of the foreign corporation's status from CFC to a foreign partnership or foreign disregarded entity and no longer subject to GILTI, as GILTI is applicable only to CFCs. As a result, all income from the foreign entity will need to be picked up annually, but taxes paid or accrued become creditable. The reader will recall that such credits are unavailable under the GILTI regime unless the U.S. shareholder is a C corporation or makes a Section 962 election.

If this option is selected, there may be a couple of overriding tax implications to factor into the analysis. In essence, the foreign corporation is treated as liquidating and distributing its assets to its parent. This may require the application of IRC §311(b) (relating to the deemed sale of assets at FMV in a corporation) or IRC §1248 (relating to the distribution of E&P and tax pools of a foreign corporation to a U.S. C corporation). In fact, if the election is effective after Dec. 31, 2017, the unrealized appreciation of the CFC is considered additional income on the deemed liquidation, which may cause a one-time high GILTI inclusion (Section 1248). In addition, the tax effect in the local country must be considered.

Operational Strategies

While the above represent options available at the practitioner level, the foreign corporation can make some strategic decisions that may contribute to the tax cause of its U.S. shareholder, whether the shareholder is a non-corporate or corporate shareholder.

Increase QBAI. The reader will recall that any GILTI inclusion will be reduced by 10% of QBAI. Several ways that QBAI can be increased by the CFC include:

- Purchasing property that has been previously leased;
- Merging a loss CFC that holds QBAI with a profitable CFC; and
- Making a Section 338(g) election upon acquisition of stock in a CFC, which will effect a stock purchase as an asset purchase to attain a higher basis in eligible assets.

Avoid CFC or U.S. Shareholder Status. The reader will recall that a CFC is a foreign corporation owned more than 50% by vote or value by U.S. shareholder(s). A U.S. shareholder is a U.S. person who owns 10% or more by vote or value of a foreign corporation (Section 951(b). Taking the Section 318(a) attribution rules into account, it may be possible to attain %'s below either one of these thresholds. Additionally, Section 957(c) creates a U.S. person exception for some residents of Puerto Rico and other U.S. possessions with respect to certain corporations organized in these jurisdictions.

Take Away

The new GILTI regime creates an entirely new category of taxable income potentially affecting all taxpayers who are U.S. persons with ownership in a CFC. As a result of GILTI, income of a U.S. shareholder's CFCs is now part of the U.S. shareholder's annual U.S. federal income tax analysis. The effect of GILTI on non-corporate taxpayers who are U.S. shareholders of CFCs is particularly harsh. Such taxpayers would be prudent to evaluate their exposure under GILTI and investigate planning and restructuring alternatives.

Clearly, no single approach applies to every existing or planned foreign investment, and taxpayers will want to structure their operations only after contemplating and modeling all the relevant factors that will impact their ownership in foreign corporations.

Footnotes

1. Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, 131 Stat. 2054 (2017)
2. See Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 365 (Comm. Print 2017) ("Senate Explanation")
3. Notice 2018-26, 2018-16 IRB 480
4. Prop. Treas. Reg. § 1.962-1(b)(1)(i)(B)(3), 84 Fed. Reg. 8188, 8229 (Mar. 6, 2019).

About the Authors

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CPE ARTICLE: GILTI – COSTLIER FOR NON-C CORPORATE SHAREHOLDERS

By Rolando Garcia and Angela Qian

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1. A controlled foreign corporation (CFC) is any foreign corporation in which U.S. shareholders own more than _____ of the foreign corporation's stock by value or vote.

A. 75%
B. 50%
C. 25%
D. 10%

2. Two of the benefits to non-C corporation U.S. shareholders of making a Section 962 election are:

A. Global Intangible Low-Taxed Income (GILTI) is subject to U.S. tax at the 10.5% corporate rate, given that the Section 250 50% deduction is allowed, rather than the higher 37% U.S. individual tax rate
B. U.S. tax on GILTI may be offset by foreign tax credits
C. Both A and B
D. Neither A nor B

3. The focus shifted from the __________ transition tax to the GILTI Section 951A provision of the TCJA as 2018 unfolded.

A. Section 907
B. Section 954
C. Section 957
D. Section 965

4. In total, non-corporate shareholders face taxation on GILTI at a 37% rate without the benefit of a credit for any foreign taxes imposed on the CFC's GILTI.

A. True
B. False

5. A C corporation with a GILTI inclusion will be eligible for a deemed foreign tax credit of:

A. 50%
B. 60%
C. 70%
D. 80%

6. Ways that QBAI can be increased by the CFC include:

A. Purchasing property that has been previously leased
B. Merging a loss CFC that holds QBAI with a profitable CFC
C. Making a Section 338(g) election upon acquisition of stock in a CFC, which will effect a stock purchase as an asset purchase to attain a higher basis in eligible assets.
D. All of the above

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7. The GILTI rules generally impose a U.S. corporate minimum tax of:

A. 10.5%
B. 12.5%
C. 15.5%
D. 25%

8. The Tax Court decision in _______________ stands for the proposition that distributions from the CFC to the U.S. C corporation holding company and then on to the individual shareholder are not deemed dividends for purposes of potentially characterizing them as "qualified" dividends.

A. *Barry M. Smith v. Commissioner*
B. *Ronald A. Caselli v. Commissioner*
C. *Bradford J. Sarvak v. Commissioner*
D. None of the above

9. Section 957(c) creates a U.S. person exception for some residents of Puerto Rico and other U.S. possessions with respect to certain corporations organized in these jurisdictions.

A. True
B. False

10. A single approach can apply and should be used for every existing or planned foreign investment.

A. True
B. False

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