Reducing the Effects of GILTI to Individuals and Trusts Through the High-Tax Exception to GILTI, Code Sec. 962 Elections and Corporate Contributions

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The GILTI regime under Code Sec. 951A captures a significant amount of income earned by a controlled foreign corporation ("CFC[1]") that is not otherwise treated as Subpart F income. The U.S. federal income tax liability associated with GILTI (the "GILTI tax") is dramatically different to a U.S. shareholder (within the meaning of Code Sec. 951(b)) that is a domestic corporation compared to a U.S. shareholder that is an individual or trust. Individuals and trusts are subject to GILTI tax at federal rates of up to 37 percent, plus the 3.8 percent Medicare Tax, plus applicable state and local taxes. Absent planning, no indirect foreign tax credit is available to offset the income tax liability imposed. On the other hand, domestic corporations are generally subject to tax on GILTI inclusions at a rate of 10.5 percent plus applicable state and local taxes. Furthermore, a domestic corporation may utilize an indirect tax credit of 80 percent of the amount of foreign taxes paid on such GILTI.

Because the liabilities are so excessive, individuals and trusts have chosen, in an "*if you can't beat them, join them*" mentality, to either restructure into domestic corporate ownership or to make a so-called Code Sec. 962 elections to reduce the tax liability associated with the GILTI tax. These remedies certainly have benefits but with those benefits come some downsides. Recently proposed regulations providing for a high tax exception to GILTI give a trust or individual U.S. shareholder an additional option to minimize the sting of a GILTI tax inclusion. In fact, through planning with these techniques, especially the Code Sec. 962 election, the GILTI tax may actually leave individual and trust U.S. shareholders in a better place. Although, the GILTI tax was initially viewed as

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punitive, the GILTI tax and other revisions to the Tax Code incorporated into the Tax Cuts and Jobs Act may be utilized in a manner that is advantageous to individual and trust shareholders.

Summary of GILTI Regime

Similar to Subpart F, GILTI is an anti-deferral regime applicable to U.S. shareholders of CFCs.[2] GILTI is the excess of a U.S. shareholder's net CFC tested income for such taxable year over its net deemed tangible income return.[3] Net CFC tested income is any excess of the U.S. shareholder's *pro rata* share of the tested income of each CFC for which it is a U.S. shareholder over its *pro rata* share of each such CFC's tested loss.[4] A U.S. shareholder's net deemed tangible income return is 10 percent of the shareholder's *pro rata* share of the CFC's tax basis in tangible personal property used by its CFCs in the production of the tested income (reduced by certain interest expense).[5]

The high tax exception, a corporate contribution and a Code Sec. 962 election are all planning tools for GILTI.

As its name suggests, Congress presumably intended that GILTI apply only to income that is subject to a low rate of tax in the source country.[6] Unfortunately, the mechanisms that were created to ensure this result are only applicable to U.S. shareholders that are domestic corporations. That is, a domestic corporation can make a Code Sec. 250 deduction equal to 50 percent of the GILTI inclusion. This deduction effectively reduces the current 21 percent federal corporate rate to 10.5 percent on a GILTI inclusion.[7] Second, a domestic corporation may elect to use a foreign tax credit equal to 80 percent of the foreign taxes paid on GILTI income. This credit effectively ensures that a CFC that pays an effective rate of foreign tax of 13.125 percent or more would pay no additional U.S. federal tax liability on a GILTI inclusion.[8] As the Code Sec. 250 deduction is not available to trust and individual U.S. shareholders, these taxpayers are subject to tax on a GILTI inclusion at federal rates of up to 37 percent plus applicable state and local tax. Furthermore, this rate may be applicable even if the CFC incurred a significant tax liability in the source country on earning the tested income. Finally, the Medicare tax of 3.8 percent also may apply to a GILTI inclusion.

The GILTI High-Tax Exception

Recent proposed regulations would allow a shareholder to make a high tax exception to GILTI inclusions. This exception applies to the extent that the net tested income of a U.S. shareholder from a qualified business unit exceeds 90 percent of the U.S. federal corporate income tax rate. Thus, if the effective foreign tax rate exceeds 18.9 percent, a taxpayer could elect for the high tax exception to apply. This option provides simplicity. When applicable, the high tax exception would result in the CFC retaining the undistributed profits as E&P. As such, a subsequent distribution of this E&P would be a taxable dividend to the trust or individual shareholder of the CFC. If the CFC is incorporated in a country that has entered a double tax treaty with the United States or a U.S. possession, the dividend may qualify for the reduced qualified dividend rates. Otherwise, unless the stock of the CFC is readily tradeable on an established U.S. securities market, the dividend likely would be subject to tax at ordinary income rates.

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Alternative Forms of Relief from GILTI

In addition to the high tax exception, an individual or trust shareholder of a CFC may consider contributing the shares of the CFC to a domestic C corporation or making a Code Sec. 962 election. The theory behind both of these options is to obtain the Code Sec. 250 deduction and foreign tax credits on a GILTI inclusion. These options may be better than the high tax exception for two reasons. First, the high tax exception applies at a higher effective rate of foreign tax paid by the CFC (18.9 percent) compared to the foreign rate of tax whereby the foreign tax credit completely offsets the U.S. tax liability of GILTI (13.125 percent). Thus, if the foreign effective tax rate is below 18.9 percent, the high tax exception would not apply but a Code Sec. 962 election or corporate drop down would partially or completely eliminate a GILTI tax liability through the foreign tax credit mechanism. Second, when the high tax exception applies the earnings and profits of a corporation do not become previously taxed earnings and profits ("PTEP"); they remain E&P of the CFC. On the other hand, a GILTI

inclusion creates PTEP of the CFC regardless of the fact that the income inclusion is fully or partially offset by foreign tax credits. This latter point is discussed in more detail below.

A trust or individual U.S. shareholder may contribute shares of a CFC to a domestic corporation thereby resulting in the domestic corporation becoming a U.S. shareholder of the CFC. The short-term benefits of this strategy are clear. The contribution, when structured properly, should qualify as a tax-free Code Sec. 351 contribution. GILTI earned by a domestic corporation should receive the benefit of the Code Sec. 250 deduction and flow-through of foreign tax credits.[9] Moreover, a distribution of the CFC's PTEP should not be subject to further U.S. federal income tax. Furthermore, if the CFC has any E&P (that is not otherwise PTEP) a distribution of such amount from the CFC to domestic corporation may qualify for the Code Sec. 245A participation exemption that allows for tax-free repatriations of CFC earnings. A subsequent dividend distribution from the domestic corporation to its individual or trust shareholder should qualify for the reduced qualified dividend rate of 20 percent, plus applicable 3.8 percent Medicare tax and applicable state and local taxes. This is especially beneficial when the CFC's country of incorporation has not entered a double tax treaty with the United States, such that dividends received from the CFC directly would have been taxed at ordinary income rates.

On the other hand, a contribution by an individual or trust of a CFC to a domestic corporation may result in more cost than benefit in the long term. That is, if an individual or trust were to sell a CFC, the gain on such sale may be long-term capital gain. Long-term capital gains are subject to federal income tax at a preferential 20 percent rate, plus applicable Medicare and state and local taxes. To the extent that the CFC has E&P, then some or all of this gain may be recharacterized as a dividend under Code Sec. 1248. However, because GILTI in many cases converts large amounts of a CFC's profits to PTEP, the recharacterization of gain under 1248 is less common. Thus, the tax liability on a sale of CFC stock by an individual or trust may be a modest 20 percent. On the other hand, a sale of CFC stock by a domestic corporation shareholder is subject to two layers of tax. The sale by a domestic corporation would be subject to the 21 percent federal corporate tax rate plus applicable state and local tax. However, any capital gain from the sale that is recharacterized as a dividend under Code Sec. 1248 may be tax-free to the domestic corporation. A liquidation or distribution of the sale proceeds would be subject to an additional 20 percent federal tax plus applicable Medicare tax and state and local tax. On the bright side, by making a 338(g) election it is possible that the corporation's tax liability on the sale could be reduced to 10.5 percent because the election may convert the income characterization to GILTI. To the extent the corporation does not distribute the funds it earns from a CFC sale, it should be mindful of the accumulated earnings tax and the personal holding company tax. These two tax regimes may effectively force the domestic corporation to incur the second layer of tax by distributing the sale proceeds.

A Code Sec. 962 election is a shareholder level election that is made on an annual basis. By making a 962 election, an individual and trust is treated solely for purposes of Subpart F and GILTI inclusions as if it is taxed as a domestic corporation. Therefore, the applicable tax rate on a GILTI inclusion would be equal to the rates that a corporation receives. Moreover, the foreign tax credit is available to the shareholder. When the Code Sec. 962 election is made, GILTI and Subpart F income of the CFC is treated as PTEP which is classified as either "*Excludable Section 962 E&P*" to the extent of the income tax paid by the U.S. shareholder, or "*Taxable Section 962 E&P*" to the extent of the excess of Code Sec. 962 E&P over Excludable Code Sec. 962 E&P. A later distribution of the Excludable Code Sec. 962 E&P is not subject to additional federal tax but a later distribution of Taxable Code Sec. 962 E&P will incur another layer of tax as a dividend. If the dividend is paid from a non-treaty country, the dividend likely will be subject to ordinary income rates of up to 37 percent plus applicable Medicare and state and local taxes.

For corporate owned CFCs, the question of whether the CFC has E&P or PTEP is largely irrelevant because the recently enacted Code Sec. 245A participation exemption allows for tax-free distributions of E&P to a domestic shareholder. Also, Code Sec. 956 does not apply to CFCs that are owned by domestic corporations when the requirements of Code Sec. 245A are met. On the other hand, Code Sec. 245A is not applicable and Code Sec. 956 is applicable to trust and individual owned CFCs. Code Sec. 956 imposes an immediate tax on the U.S. shareholder's proportionate share of the CFC's E&P if the CFC invests in U.S. property. U.S. property includes things such as loans to U.S. borrowers and investments in U.S. real estate. Importantly, Code Sec. 956 does not apply to a CFC's PTEP, including Taxable Code Sec. 962 E&P. Thus, a CFC with only PTEP may be able to invest in U.S. property without triggering a taxable Code Sec. 956 inclusion.

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Conclusion

The high tax exception, a corporate contribution and a Code Sec. 962 election are all planning tools for GILTI. The high tax exception has some promise to provide simplicity in planning for GILTI where the U.S. shareholder's effective tax rate on tested income exceeds 18.9%. However, the corporate contribution and Code Sec. 962 election provide tax benefits regardless of the effective rate of tax. Moreover, the Code Sec. 962 election and corporate contribution result in GILTI being treated as PTEP to the CFC, which may allow for the CFC to invest in U.S. property without being subject to an immediate tax. However, a corporate contribution may result in significantly higher U.S. tax liability for a later sale of the CFC. On the other hand, a distribution of Taxable Code Sec. 962 E&P from a CFC incorporated in a country that has not entered a tax treaty with the United States is subject to tax at ordinary income rates. The same ordinary income treatment applies for distributions from high-tax exception electing CFCs incorporated in non-treaty countries. Taxpayers should engage in thoughtful planning in choosing the best path forward.

ENDNOTES

[1] A CFC is any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, or the total value of the stock of such corporation, is owned by United States shareholders ("U.S. shareholders") on any day during the taxable year of such foreign corporation. Code Sec. 957(a).

[2] Code Sec. 951A.

[3] Code Sec. 951A(b)(1).

[4] Code Sec. 951A(c)(1).

[5] Code Sec. 951A(b)(2).

[6] *See* Conference Report to the Tax Cuts and Jobs Act, at 494.

[7] *Id.*, at 498.

[8] However, it is possible that traditional expense allocation and income apportionment principles can result in a lower foreign tax credit limitation, thereby resulting in a significantly higher overall U.S. federal tax rate than 13.125 percent.

[9] However, this contribution could be a transition tax acceleration event resulting in the taxpayer being immediately required to pay all deferred transition tax. Also, local law may impose a transfer tax or income tax on such transfer.

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