STEP Gold Coast -
Minimizing Tax on the Sale of Stock of CFCs
After the Tax Cuts and Jobs Act of 2017

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Jeffrey Rubinger
Bilzin Sumberg LLP
Relevant C Corporation Changes - New DRD and Reduction in Corporate Tax Rates

• Under Tax Cuts and Jobs Act of 2017 (2017 Tax Reform Act), C corporations can now claim a 100 percent dividends-received deduction for foreign-source dividends.
  – U.S. individuals, S corporations, partnerships, and trusts continue to be taxed on their worldwide income.
  – C corporations who are U.S. shareholders of CFCs, however, are still subject to U.S. federal income tax on subpart F income and Section 956 inclusions.

• C corporations are now subject to maximum federal income tax rate of 21 percent (down from 35 percent).
Controlled Foreign Corporations, In General

- A “U.S. shareholder” of a controlled foreign corporation (CFC) is required to include in its gross income a pro rata share of a CFC’s “subpart F” income and amounts included under Section 956, regardless of whether any income actually is distributed.

- In general, a CFC is a foreign corporation that is more than 50 percent owned (directly, indirectly, or constructively) by “U.S. shareholders.”

- A "U.S. shareholder" is defined as a U.S. person who owns, directly or indirectly (but not constructively), 10 percent or more of the total voting power of all classes of stock entitled to vote or the total value of all classes of stock.
  - The requirement for a U.S. shareholder who owns 10 percent or more of the total value of a CFC to include its pro rata share of a CFC's subpart F income and amounts included under Section 956 was added by recent tax reform.
Subpart F Income, in General

• In general, subpart F income includes
  – Passive income, *e.g.*, interest, dividends, royalties, capital gains, etc. ("foreign personal holding company income"), and
  – and income from related party sales ("foreign base company sales income") and related party service transactions ("foreign base company services income") that have little, if any, connection with the CFC’s country of incorporation.

• Section 956 inclusions generally consist of many types of investments in U.S. assets made by a CFC (including loans by a CFC to a U.S. shareholder as well as guarantees or pledges (of assets or shares) by a CFC of related U.S. party obligations).
GILTI - New Category of Subpart F Income under Section 951A

• The tax reform created a new category of subpart F income ("global intangible low-taxed income" ("GILTI") that originally was thought to be targeted at low-taxed intangible holding companies.

• U.S. individual shareholders (including partnerships and S corporations owned by individuals) are required to include the full amount of their share of the GILTI as ordinary income (at rates up to 37 percent).
  – U.S. C corporations are provided a 50 percent deduction (reduced to 37.5 percent in 2026) as well as a foreign tax credit of up to 80 percent of the amount of foreign taxes deemed paid.

• The GILTI inclusion is equal to the U.S. shareholder’s share of:
  – The CFC’s gross income (excluding ECI, subpart F income, and high-taxed income under Section 954(b)(4)); reduced by
  – The excess of (i) 10 percent of the CFC’s aggregate adjusted bases in depreciable tangible property used in its trade or business, over (ii) the CFC’s net interest expense.
GILTI (cont.)

• The CFC’s aggregate adjusted bases in depreciable, tangible property is measured using the average amount determined at the close of each quarter.
• Basis must be calculated using the alternative depreciation system under section 168(g) and allocating the depreciation deduction ratably to each day during the period to which the depreciation relates.
  – A look-through rule allows the CFCs to include the adjusted basis of such property held through a partnership.
• US shareholders of CFCs with relatively high interest expenses, or corporations with little basis in depreciable property, such as service corporations and corporations with high value intangibles, will generally determine that most of the foreign corporation’s income is treated as GILTI.
PTI and Basis Adjustments

• Section 959(a) provides that the earnings and profits of a CFC attributable to amounts included in the gross income of a U.S. shareholder, otherwise known as “previously taxed income” or “PTI,” shall not, when those amounts are later distributed to a U.S. shareholder, directly or indirectly through a chain of ownership, be again included in the gross income of such U.S. shareholder.

  — Distributions made by a CFC are considered to come first from PTI to the extent thereof.

• Section 961 provides rules for adjusting the basis of shares in a CFC that correspond with the PTI rules under Section 959.

• Section 961(a) provides for an increase in basis when a U.S. shareholder has a Subpart F or Section 956 inclusion, while Section 961(b) provides for a decrease in basis when the shareholder receives an amount that is excluded from gross income under Section 959(a).
Section 965 - Deemed Repatriation Tax

• Under New Section 965, a one-time deemed repatriation tax is imposed on any accumulated, untaxed earnings of certain foreign corporations.

• The tax is imposed on the greater of (1) the accumulated post-1986 deferred foreign earnings as of November 2, 2017, or (2) the accumulated post-1986 deferred foreign earnings as of December 31, 2017.
  — Amount treated as a subpart F inclusion.

• The earnings held as “cash or cash equivalents” (referred to as the “cash position”) are taxed at a rate of 15.5 percent, and all other earnings are taxed at a rate of 8 percent.

• The earnings are included in the income of a U.S. shareholder on the last day of the last taxable year of the foreign corporation that began before January 1, 2018, although a U.S. shareholder may elect to pay its net tax liability in eight installments.
  — S corporation shareholders can elect to defer paying tax indefinitely until certain triggering events occur.
Section 965 (cont).

- Section 965 applies to (i) any CFC, and (ii) any foreign corporation with respect to which one or more domestic corporations is a U.S. shareholder (10-percent corporation).
  - Does not include a PFIC that is not a CFC.
- “Cash and cash equivalents” include: (i) cash, (ii) net accounts receivable, (iii) personal property traded on a financial market, (iv) commercial paper, (v) certificates of deposit, (vi) state, federal, and foreign government securities, (vii) foreign currency, (viii) short-term obligations (i.e., obligations with a term of less than one year), and (ix) other assets that the IRS may identify.
Sale of Shares of Stock in CFC

- Under Section 1248(a), gain recognized on a U.S. shareholder’s disposition of stock in a CFC is treated as dividend income to the extent of the relevant earnings and profits accumulated while such person held the stock.
- Where the U.S. seller is a C corporation, this conversion of gain into a dividend is now essentially exempt from U.S. federal income tax because of the 100 percent DRD.
- With respect to individual U.S. shareholders who sell stock in a CFC, recharacterization of the gain as a dividend under Section 1248(a) may be taxable at either that same 23.8 percent rate as long-term capital gains (in the case of “qualified dividends” from treaty-resident CFCs) or at a higher 40.8 percent ordinary income tax rate (in the case of non-qualified dividends from CFCs not resident in treaty countries).
- It should be noted that if Section 965(a) applied to U.S. shareholder of a CFC, the U.S. shareholder's basis will be increased under Section 961 for the inclusion and the Section 1248(a) amount would be treated as PTI. Therefore, Section 1248 should have no relevance for U.S. shareholders who picked up income under Section 965 (even for S corporation shareholders who deferred tax).
Section 1248(b) Limitation

- Section 1248(b), however, provides for a ceiling on the tax liability that may be imposed on the shareholder receiving a Section 1248(a) dividend if (i) the taxpayer is an individual and (ii) the stock disposed of is a long-term capital gain asset.
- The Section 1248(b) ceiling consists of the sum of two amounts.
- The first amount is the U.S. income tax that the CFC would have paid if the CFC had been taxed as a domestic corporation, after permitting a credit for all foreign and U.S. tax actually paid by the CFC on the same income (the “hypothetical corporate tax”).
- The second amount is the addition to the taxpayer’s U.S. federal income tax for the year that results from including in gross income as long-term capital gain an amount equal to the excess of the Section 1248(a) amount over the hypothetical corporate tax (the “hypothetical shareholder tax”).
Section 1248(b) Limitation (cont.)

Example:
Assume a CFC has $100 of income and pays $5 of foreign taxes, and assuming the CFC would be in the 21 percent income tax bracket for U.S. federal income tax purposes under Section 11 based on its taxable income levels, the hypothetical corporate tax would be $16 ($21 U.S. tax minus a $5 foreign tax credit). (Prior to 2018, the hypothetical corporate tax would have been based on 35 percent).
Assuming the shareholder’s gain on the sale is $100, the hypothetical shareholder tax would be 23.8 percent of $79 ($95 Section 1248(a) dividend [after reducing earnings and profits by the $5 foreign taxes] less the hypothetical corporate tax of $16), or $18.80.
Adding together the hypothetical corporate tax and the hypothetical shareholder tax in this example thus yields $34.80 in U.S. tax on the $100 Section 1248 “dividend.”
Assuming the CFC in this example is not resident in a treaty country, the gain recharacterized as a $100 dividend triggered by Section 1248(a) would be taxable as ordinary income, at a maximum federal rate of 40.8 percent, resulting in $38.76 of tax (earnings and profits are only $95). Because this is greater than the Section 1248(b) ceiling of $34.80, the ceiling will apply, and the U.S. shareholder pays U.S. tax of $34.80.
• As the foreign tax burden increases, the Section 1248(b) limitation becomes even more relevant.
Section 1248(b) Limitation (cont.)

• Example:
  Assume a U.S. shareholder owns 100 percent of a Brazilian CFC that earns $100 of income for both Brazilian and U.S. tax purposes and pays $35 in Brazilian corporate tax on this income, leaving earnings and profits of $65 available for distribution to the shareholder. The tax on the Section 1248(a) dividend would be 40.8 percent of the $65 deemed dividend, or $26.52.
  The Section 1248(b) ceiling, on the other hand, would be $15.47, computed as follows: The hypothetical corporate tax in that case would be $0 ($21 US tax minus $35 Brazilian tax actually paid). The hypothetical shareholder tax would be 23.8 percent of $65 (i.e., the Section 1248(a) amount of $65, less the hypothetical corporate tax of zero), or $15.47.
  • In this case the Section 1248(b) amount is indeed significantly lower than the Section 1248(a) amount.
  • Therefore, the 1248(b) ceiling applies to limit the selling shareholder’s US tax to $15.47, in effect treating the shareholder as if he sold shares of a CFC located in a treaty jurisdiction.
Sale of Stock in Latin American CFCs

- Because Section 1248(b) only provides a benefit to taxpayers who own CFCs resident in non-treaty countries, and generally only where the CFC is subject to a relatively high effective tax rate, this provision has particular relevance to U.S. shareholders of CFCs located in Latin American countries.

- Most such countries, including (but not limited to) Colombia, Brazil, Argentina, Chile, Costa Rica, El Salvador, Guatemala, Nicaragua, Peru, and Uruguay have statutory corporate tax rates between 25 and 35 percent.

- And none of these countries has an income tax treaty with the United States. Thus, where a U.S. shareholder of such a “high-taxed” CFC sells his shares at a gain, the U.S. tax due on the Section 1248(a) amount will be more than the Section 1248(b) amount, so that Section 1248(b) will provide the U.S. shareholder with a significant tax benefit.
Using Malta to Avoid Subpart F Income (including GILTI) Under High Tax Exception

• Under Section 954(b)(4), a U.S. shareholder of a CFC is able to exclude from foreign base company income an item of income earned by a CFC if the taxpayer can show that the income was subject to an effective foreign income tax rate greater than 90 percent of the maximum federal income tax rate specified in Section 11.

• In addition, under Section 951A (GILTI), Section 954(b)(4) high-taxed income excluded from GILTI.

• The maximum rate of tax specified in Section 11 is currently 21 percent (used to be 35 percent).

• Therefore, the high-tax exception will apply to income earned by a CFC that is subject to an effective foreign tax rate of at least 18.9 percent (used to be 31.5 percent).
For purposes of this provision, the effective tax rate equals (1) the foreign income taxes paid, accrued, or deemed accrued with respect to the net item of income, divided by (2) the net item of FBC income (increased by the income taxes on the item).

The amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income is generally the amount a taxpayer would be deemed to have paid under Section 960 if the item of income were included in gross income under Subpart F.

In the case of an individual, this amount is determined as if an election under Section 962 has been made to treat the individual as a corporation for the purposes of Section 960.
High-Tax Exception and Malta (cont.)

• Regulation Section 1.954-1(d)(3)(i) specifically provides that the amount of foreign income taxes paid, accrued, or deemed accrued with respect to an item of income will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholder of all or part of such income.

• Further, Regulation Section 1.904-4(c)(7)(iii) (dealing with the "high-tax kick out" exception under the foreign tax credit rules) specifies that if the effective foreign tax rate imposed on a foreign corporation is reduced under foreign law upon the distribution of that income, the rules of Section 954(b)(4) are applied without regard to the possibility of a subsequent foreign tax reduction.
High-Tax Exception and Malta (cont.)

• An example in the Section 904(d) regulations (1.904-4(c)(8), Ex. 7) illustrates this concept:

• S, a CFC, is a wholly-owned subsidiary of P, a domestic corporation. P and S are calendar year taxpayers. In 1987, S's only earnings consist of $200 of passive income that is FPCHI that is earned in foreign country X.

• Under country X's tax system, the corporate tax on particular earnings is reduced on distribution of those earnings and no withholding tax is imposed.

• In 1987, S pays $100 of foreign tax. P elects to apply the Section 954(b)(4) high-tax exception to S's passive income that is subpart F income.

• In 1988, S distributes $150 to P. The distribution is a dividend to P because S has $150 of accumulated earnings and profits (the $100 of earnings in 1987 and the $50 refund in 1988).

• The example concludes that the $200 of FPCHI will be eligible for the Section 954(b)(4) high-tax exception to subpart F income, even though the effective foreign tax rate is reduced from 50 percent to 25 percent (which is less than the 31.5 percent generally needed to qualify under prior law) as a result of the $50 tax refund received in 1988.
High-Tax Exception and Malta (cont.)

• A similar result may be accomplished by forming a CFC that is tax resident in Malta.

• In general, Malta has a corporate income tax rate of 35 percent. Malta, however, applies an “imputation system” whereby the corporate income tax paid by the company is refunded to the shareholders when distributions are made to them. The amount of the refund depends on the type of income earned by the company.

• When dividends are paid by a Maltese company earning active income, the shareholders become entitled to claim refunds of 6/7 of the Maltese corporate income tax paid. This results in an effective corporate income tax rate of 5 percent.

• The refunds are payable within 14 days from the last day of the month in which the request is made to the Maltese tax authorities.
High-Tax Exception and Malta (cont.)

• Therefore, if a Maltese CFC earns, for example, passive income that would otherwise be characterized as foreign personal holding company income, that income should not be treated as subpart F income since the income initially will be subject to corporate income tax in Malta at a 35 percent rate.

• Based on the regulations previously discussed, this result should not be affected by a subsequent distribution of the earnings of the Maltese company that causes a reduction in the effective corporate income tax paid in Malta to a rate as low as 5 percent.

• Accordingly, if successful, this structure would allow a U.S. taxpayer to earn passive income or other types of potential subpart F income (foreign base company sales or services income) and have that income be deferred from U.S. federal income tax without incurring much in the way of foreign income taxes.
Use of Section 962 Election for CFC in High-Tax Jurisdiction

- Individual shareholders of CFCs are not eligible to claim foreign tax credits for foreign income taxes paid or incurred at corporate level for amounts included under Subpart F or Section 956 or GILTI.
  - Can only claim FTC for foreign withholding taxes.
- Section 962 treats individual shareholders of CFCs as domestic corporations for Section 951(a) inclusion purposes (i.e., subpart F, Section 956 inclusions, and GILTI) only, which allows them to claim indirect foreign tax credit on those inclusions.
- When actual distributions out of the E&P of the CFC are made, those amounts are included in the gross income (notwithstanding Section 959(a)) of the individual U.S. shareholders hands, minus the tax that was paid as a result of making the Section 962 election.
Section 962 Election - Example

- A U.K. CFC is wholly owned by one U.S. individual. The CFC makes a loan to its U.S. shareholder of $1 million. Assume U.K. CFC pays tax at 20 percent rate and earns $1 million.

- Without a Section 962 election, the CFC would be subject to $200,000 of U.K. corporate income tax and $296,000 of U.S. federal income taxes ($1 million of Section 956 inclusion (limited to $800,000 of E&P) x 37 percent U.S. tax rate), for effective tax rate of 49.6 percent.

- If shareholder makes Section 962 election, U.S. individual treated as domestic corporation for Section 951 purposes and thus eligible to claim foreign tax credit of $200,000. Therefore, $10,000 of U.S. taxes, for effective tax rate of 21 percent.

- When actual distribution of $800,000 is made, $790,000 of that will be taxable. However, taxpayer has ability to defer that distribution and if distribution is treated as being made from qualified foreign corporation (or a domestic corporation), amount should be taxed at qualified dividend rate.
  - Subsequent distribution is not treated as PTI under Section 959(a) except to the extent of $10,000.
• With lower U.S. corporate tax rates of only 21 percent, this election makes more sense than before.

• Section 962 election makes most sense when foreign corporation subject to relatively high rates of foreign tax.

• Higher rates of foreign tax effectively convert subpart F income (taxed at 37 percent) into income potentially taxed at qualified dividend income rates.

• In addition, the deemed U.S. C corporation should be able to deduct 50 percent of the GILTI inclusion, which individual shareholders cannot, and 80 percent foreign tax credit on GILTI inclusion.

• Election available to any category of subpart F income, Section 956 inclusions, and GILTI inclusion.

  – High-tax exception (i.e., foreign tax rate at least 90 percent of U.S. tax rate - 18.9 percent) for Subpart F inclusions may make this election less relevant. However, Section 956 inclusions not eligible for high tax exception.
Section 962 Election - How is Actual Distribution Treated?

- Is actual distribution treated as coming from hypothetical C corporation? If so, taxed currently at 23.8 percent.
- Or is actual distribution treated as coming from actual foreign corporation?
- If so, does that mean that is election is only beneficial when distribution coming from "qualified foreign corporations"?
- Legislative history indicates that the purpose of the provision is to give "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 [a domestic] corporation doing business abroad."
- Issue currently being litigated in Tax Court.