

Client Alert

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Individual US Taxpayers Eligible for GILTI Deduction if Electing Corporate Tax Treatment

On March 4, 2019, the IRS released Proposed Regulations providing that individual US shareholders of controlled foreign corporations (CFCs) will be eligible to apply a 50 percent deduction on taxation of global intangible low-taxed income (GILTI), subject to making an already available election to be taxed at corporate rates. These regulations impact the planning options for many individual US taxpayers owning non-US closely held businesses. The Proposed Regulations arrive on the heels of months of speculation as to whether the US Treasury would act to address the perceived unfair impact of the GILTI provisions on individual US taxpayers.

Controlled Foreign Corporations – Anti-Deferral Rules and GILTI

US shareholders¹ of a CFC have long been subject to US federal income taxation on the “Subpart F” income of the CFC. Subpart F income consists generally of types of income that are easily shifted from one jurisdiction to another, including passive income. The purpose of the CFC rules is to prevent the deferral of US taxation through the use of lower-taxed non-US entities. The 2017 Tax Cuts and Jobs Act (TCJA) significantly expanded the scope of the CFC anti-deferral tax regime applicable to US shareholders of CFCs with the introduction of current taxation on GILTI amounts.

Effective from January 1, 2018, US shareholders are now currently taxed on a CFC’s GILTI amount, which is essentially the CFC’s income excluding Subpart F income (already subject to anti-deferral provisions), income effectively connected with the conduct of a US trade or business, and other specified types of income, less a deemed return on the CFC’s tangible depreciable assets (e.g., buildings). For US corporate shareholders, the GILTI regime functions as an effective global minimum tax; however, the TCJA’s deduction and credit mechanisms necessary to achieve this goal do not extend to individual or pass-through US shareholders (including partnerships), leaving them measurably worse off than corporate shareholders in the same position.

Unfair: GILTI Impact on Individual US Shareholders

The problem for individual US shareholders of a CFC stems from the disparate treatment of individual and corporate taxpayers under the TCJA legislation in the application of relevant deductions, tax rates and credits.

¹ A US shareholder for this purpose is any US person who owns directly or indirectly at least 10 percent (by vote or value) of the shares in a Controlled Foreign Corporation.

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While the GILTI rules subject more CFC income to what is essentially a minimum overall rate of tax for US shareholders, this rate was offset for corporate taxpayers by a 50 percent deduction permitted under section 250 of the Code. A corporate US shareholder thus has a lower GILTI tax rate of 10.5 percent (half the new reduced corporate income tax rate of 21 percent). Furthermore, corporate taxpayers are able to offset the GILTI tax with foreign tax credits under section 960 of the Code (which is 80 percent of creditable foreign taxes). If the income of the CFC is subject to an effective foreign tax rate of at least 13.125 percent, the corporate US taxpayer would consequently owe no US tax on the GILTI amount. The percentage deduction permitted is scheduled to be reduced in 2026, when the minimum GILTI rate for corporate taxpayers will increase to 13.125 percent. However, any amount subject to adequate foreign tax at the CFC level may continue to be fully offset by foreign tax credits.

In contrast, an individual US shareholder of a CFC is subject to far more negative treatment with respect to GILTI amounts: (1) higher US individual marginal income tax rates up to 37 percent; (2) no section 250 deduction to offset the GILTI tax percentage; and (3) no ability to credit indirect foreign taxes paid by the CFC against the GILTI tax amount. Thus, where a corporate taxpayer may end up owing no GILTI tax based on the lower corporate tax rate, section 250 deduction and foreign tax credits, an individual taxpayer may instead owe tax at the highest marginal rate of 37 percent.

Almost Fair: Section 962 Election

This disparate treatment of GILTI taxation of corporate and individual US taxpayers clearly resulted in an unfair result to individual US shareholders of a CFC. A corporate taxpayer could pay little or in many cases no tax on GILTI amounts, whereas individual taxpayers would be subject to tax on these CFC earnings at higher individual rates with no deferral.

An option to address this disparity already existed prior to the introduction of the Proposed Regulations, in the form of an election under section 962 of the Code. This election permits individual US shareholders of a CFC to elect to be taxed at corporate income tax rates on the Subpart F income and GILTI inclusions of the CFC. The section 962 election also allowed foreign tax credits to be applied on foreign taxes paid by the CFC with respect to the Subpart F and GILTI amounts.

The legislative intent of the section 962 election was to ensure that the tax burden of individual US taxpayers would be no higher than if they had invested in a US corporation doing business abroad. The downside is two layers of taxation: first, the corporate tax on amounts to a fictitious US corporation resulting from the election; and second, tax at individual rates on the distribution from the CFC to the individual US shareholder. The upside is



deferral of the individual tax (until the CFC makes a distribution), and perhaps no corporate tax if fully offset by foreign tax credits.

However, the section 962 does not result in all the benefits of an actual US corporation. For example, as was decided in a 2018 Tax Court case, the election does not convert non-qualified dividends into qualified dividends. Thus, if the CFC is in a non-tax treaty jurisdiction, dividends paid from the CFC to the individual would be subject to taxation at ordinary individual income tax rather than lower qualified dividend rates. Further, prior to the Proposed Regulations, the section 962 election did not permit application of the section 250 deduction. Thus, depending on applicable foreign income tax rates, individuals remained at a significant disadvantage compared to those investing in a CFC via a US corporation and would now have to weigh potential US corporate taxation against deferral of the US individual tax.

More Equal Footing: Proposed Regulations and Change to Section 962 Election

The Proposed Regulations have addressed this further disparity, clarifying that individual US shareholders who make the section 962 election will also be permitted to take the section 250 deduction with respect to their GILTI inclusion amounts.

This treatment under the Proposed Regulations will result in individual US taxpayers who choose to make the 962 election seeing a decrease in US taxation of their GILTI inclusion amounts from 37 percent down to 10.5 percent, also subject to further reduction by applicable foreign tax credits. These individuals should now stand on more equal footing with corporate US shareholders, able to defer taxation at individual tax rates until a later date when distributions are made from the CFC.

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Making a section 962 election will not only reduce the tax liabilities of individual US shareholders but also their tax planning and compliance costs in many situations, providing an efficient and effective alternative to further corporate planning. In some cases, such use of corporate vehicles may also carry negative tax consequences in the jurisdiction of the CFC. The Proposed Regulations thus introduce not only a measure of fairness and simplification for individual US shareholders in the domestic context, but assist such investors in their investments internationally. For many individual US shareholders of non-US closely held businesses or with significant foreign holdings, the section 962 election is worth serious consideration as part of their tax and corporate planning.

*This client alert was prepared by **Gregory Walsh** (Zurich), **Elliott Murray** (Geneva) and **John Cacharani** (Zurich), with insights from **Patrick Cox** (New York).*