

Form 8832 Check-the-Box Entity Elections Under Section 7701: Selecting Entities for Foreign Operations

THURSDAY, SEPTEMBER 26, 2019, 1:00-2:50 pm Eastern

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September 26, 2019

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Thursday - September 26, 2019

Agenda

- I. The U.S. “Check-the-Box Regulations” - Background and How They Evolved
- II. Basic entity classification rules for foreign entities owned by U.S. individuals
 - A. The “Default Rules” for Domestic and Foreign Entities
 - B. Per Se Corporations and Eligible Entities
 - C. When does a foreign entity’s classification become “relevant” such that a choice must be made?
 - D. Tax Effects of Making the CTB Election
- III. Increased U.S. Tax Stakes for Individuals in Selecting the FORM of a Foreign Entity
 - A. The 2017 U.S. Tax Act Ended the “Deferral Privilege” formerly accorded foreign corporate subsidiaries
 - B. The Reach of Subpart F is now much broader due to 2017 Code amendments (creating many more CFCs!)
 - C. New § 951A GILTI rules will apply and tax almost all the operating income of a CFC currently (phantom income)
 - D. The § 965 Transition Tax applied in 2017 to “specified foreign corporations” (a mandatory deemed dividend)
 - E. New § 245A 100% DRD (the participation exemption); but only C Corps that are § 951(b) shs can take advantage of it
 - F. New § 267A limits the use of “hybrid entities” for tax arbitrage (an anti-BEPS measure)
- IV. Evaluating tax consequences as part of entity selection determination
 - A. Overview of Subpart F rules
 - B. GILTI regime
 - C. Section 962 election by an individual
 - D. Distributions and sales of CFC stock under different entity models
 - E. Review of provisions related to U.S. "territorial regime"
- V. Entity selection process and available elections
- VI. Completing Form 8832

I. The U.S. Check-the-Box Regulations



Background and How They Evolved

US Entity Classification Regulations: Background

- In late 1996, IRS and U.S. Treasury issued final so-called “Check-the-Box Regulations” under Treas. Reg. § 301.7701.
- Final Regs allowed any “eligible entity” (as defined) to ELECT its federal income tax classification—*i.e.*, as either a “corporation” or “partnership”
- Stated policy reasons for elective entity classification system:
 - **Simplification of pre-1997 classification system**, which required taxpayers or their advisors to examine the entity’s organizational documents and the law in which the entity was organized, and to continually monitor the entity and the law for changes so as to avoid inadvertent classifications.
 - **Fairness.** Pre-1997 classification system heavily favored well-advised taxpayers who had the resources to pay for sound tax advice. (This policy argument may not be as true in the international context because wealthier taxpayers are the ones that usually have cross-border issues.)
 - **Efficiency.** New classification system seen as reducing transaction costs.

Entities' classification- critical for legal & tax reasons

- “Corporation” (Subch. C)
 - Shareholders are not liable on entity’s debts --instead insulated.
 - Income is taxed at corporate level (§11) and again at the shareholder level (§301(a)(1), (3)) when that income is distributed as a § 316 dividend. (Exception: S-Corps, which are not taxed at entity level and which require a separate “S election”)
- “Partnership”
 - Partners (at least the GP) are personally liable (Exception: limited liability partnerships (LLPs) which emerged in US States in 1990s, along with LLCs)
 - Income is not taxed at entity level. Instead, income, profits, and losses are treated as “flowing thru” to the partners who are taxable on that income, whether or not it is actually distributed. (However, income & tax attributes are often computed & characterized at entity level.)

Pre-1997 Entity Classification Rules

- From 1960 until final adoption of CTB Regs, an entity's classification as either a "corporation" or "partnership" was determined by the multi-factor "Kintner Regs" (named in response to a 9th Circuit Court decision, *U.S. v. Kintner*, 216 F.2d 418 (9th Cir. 1954)).
- Pre-CTB "Kintner Regs" enumerated 6 attributes of a corporate venture:
 1. Presence of associates **
 2. Objective to carry on business **
 3. Continuity of Life
 4. Centralized management of the business
 5. Limited liability of the owners of the entity
 6. Free transferability of interests. *
- Factors No. 1 and No. 2 were generally ignored because they are not helpful since they are common to both corporations and partnerships.
- An entity possessing 3 or more of remaining factors--i.e., No. 4 through No. 6--was a "corporation" for U.S. tax purposes
- Entity possessing 2 or fewer of remaining factors was a "partnership" for U.S. tax purposes

* See Treas. Reg. § 301.7701-2 (prior to 1996 amendment).

New LLC and LLP entity statutes rendered multi-factor test obsolete

- In early 1990s, the multi-factor entity classification test was further complicated by new U.S. State laws that allowed for the creation of “limited liability companies” (LLCs) and “limited liability partnerships” (LLPs).
- All 50 U.S. states eventually adopted LLC statutes, which typically provided for both limited liability and centralized management—but not continuity of life or free transferability of interests.
- Thus, failing 2 of the last 4 Kintner factors, taxpayers could organize an LLC that would insulate LLC members from personal liability, yet be taxed as a partnership (with only one layer of tax).
- Eureka! *LLC statutes gave even unsophisticated taxpayers the opportunity to essentially elect the federal tax classification of their companies: Organize the company under the state’s “incorporation” law and be taxed as a C-Corp OR organized as an “LLC” and be taxed as a partnership.*
- Some states adopted similar laws for LLPs (limited liability partnerships), PLLCs (professional limited liability companies), etc. (Extent of liability & other characteristics differs from state to state).

Policy Problems motivated the 1997 adoption of the CTB Regs

- Although the former multi-factor, Kintner test seemed theoretically simple, they were in practice:
 - **Vulnerable to Manipulation** (*optionality was already built in!*)
 - **Complex and expensive to apply** (and to continually monitor for changed circumstances and amended law)
 - **Uncertain** (often requiring an investigation into foreign company law)
 - **Unfair** (Wealthier taxpayers had more opportunity to pay advisors to manipulate the factors)
 - **Distortive of economic reality.** (Transaction structures and locations, as well as organizing documents were designed to meet desired tax classification—rather than economic needs of the business). *

* See Staff of Joint Committee on Taxation, “Review of Selected Entity Classification and Partnership Tax Issues,” JCS-6-97, 1 (Apr. 8, 1997) (hereinafter “JCT Study”).

IRS Notice 95-14

- Acknowledging that LLCs had diminished the traditional distinctions between corporations and partnerships, IRS announced it was considering a move to an explicitly ELECTIVE system for categorizing entities.
- According to IRS, old system was costly to both taxpayers and the IRS, and had become essentially elective anyway.
- Longstanding debate raged over whether forthcoming elective system—the Check-the-Box Regs—should apply to foreign corporations in the international context.
- Final CTB Regs apply to both domestic **and foreign business entities.**

II. Basic “Check-the-Box” Entity Classification Rules for Foreign Entities

- A. “Per Se Corporations” and “Eligible Entities” - Definitions
- B. The Default Classification Rules for Domestic and Foreign Entities
- C. When does a foreign entity’s classification become “relevant” such that a choice must be made?
- D. Tax Effects of Making the Check-the-Box Election

Key Definitions for CTB Regs

- **Domestic**: a corporation or partnership created or organized in U.S. or under U.S. law or any U.S. State, unless in case of P/Ss, a Treas. Reg. provides otherwise. IRC §7701(a)(4).
- **Foreign**: Respecting a corporation or partnership-one that is not “domestic.” §7701(a)(5).
- **Business Entity**: Any entity that is not a “trust” as defined in Reg. § 301.7701-4. See Reg. § 301.7701-2(a).
- **Eligible Entity**: Any entity that meets 3 conjunctive requirements:
 1. Entity must exist separately from owners,
 2. Must be a “business entity” (i.e., not a trust), AND
 3. Must not be a “deemed corporation” as defined.
- **Deemed Corporation**: Reg. § 301-7701-2(b) provides that certain entities are automatically treated as “corporations” and not allowed to elect their tax classification. These so-called “per se corporations” include (1) entities formed under explicit U.S. state corporate statutes (not including the LLC statutes), and (2) certain foreign entities, as shown in the comprehensive list at Reg. § 301-7701-2(b). (There’s about 100...)
- **Per Se Corporation**: Slang tax term referring to any foreign entity included in the “per se corporation” in Reg. § 301.7701-2(b)(8).

Key Definitions for CTB Regs (cont'd)

- **Limited Liability**: With respect to “foreign eligible entities,” limited liability exists if the member has no personal liability for the debts of, or claims against, the entity by reason of being a member. **This determination is based solely on the statute/law pursuant to which the entity is organized (i.e., foreign law not U.S. law).** If that underlying statute/law allows the entity to specify in its organizational documents whether the member has personal liability, such documents may be relevant. If personal liability exists for purposes of this determination, it is not affected by any indemnity agreement. Reg. § 301.7701-3(b)(2)(ii).
- **Hybrid Entity**: A single business entity that is characterized inconsistently by two different tax jurisdictions relevant to a transaction or investment. *Eg.*, an entity that is viewed as a tax opaque corporation by one country, and as a flow-through partnership (or disregarded branch) by another country.
- **Regular Hybrid**: An entity that the U.S. views as a tax transparent partnership or disregarded entity, and another jurisdiction views as a corporation.
- **Reverse Hybrid**: An entity the U.S. views as a corporation, and the other country views as a flow-through partnership or branch.
- **Domestic Reverse Hybrid**: a reverse hybrid, organized in the United States.
- **But see IRC § 267A**: TCJA introduced a hybrid anti-abuse measure that disallows U.S. tax deductions for any “disqualified related party amount,” which is interest or royalties paid or accrued to a “related party” in a “hybrid transaction,” or paid to or by a “hybrid entity.” §267A(a).

CTB - General Operating and Default Rules

Reg. § 301.7701-2 and -3

- **General Rule**: Both domestic and foreign “eligible entities” are able to *elect* to be taxed as either a partnership or corporation for U.S. federal income tax purposes. *See* IRS Form 8832 (“Entity Classification Election”).
- **Important Default classifications apply if no affirmative election is made.**
Reg. § 301.7701-3b.
- **Default Rules for Un-electing **Domestic** “Eligible Entities”**:
 - Domestic entity w/multiple members : *default = partnership.*
 - Domestic entity w/1 member only: *default = disregarded entity (branch of its parent)*
 - (note that un-electing eligible domestic entities default to tax transparency)
- **Default Rules for Un-electing **Foreign** “Eligible Entities”**:
 - Foreign Entity where ALL members enjoy “limited liability”: *Default = corporation.*
 - Foreign Entity w/2 or more members and at least 1 member bears personal liability: *Default = partnership.*
 - Foreign Entity where there is only 1 member total, and such member bears personal liability: *Default = Disregarded Entity.*

When does classification of a foreign eligible entity (FEE) “become relevant”?

- **Foreign eligible entities (FEEs):** Unlike U.S. entities, foreign entities are subject to special rules as to when they must elect their classification for U.S. tax purposes.
 - FEEs formed on or after Oct. 22, 2003 have a classification only when it *becomes relevant*.
 - FEEs formed before Oct. 22, 2003 have a classification even if *not relevant*.
- **Classification of an FEE is relevant when it affects the liability of any person for U.S. federal tax or information purposes.**
 - **Example:** FEE’s classification would be relevant if US-source income is paid to the entity, and the amount to be withheld by the withholding agent would vary depending upon whether the entity is classified as a partnership or a corporation.
 - **Example:** FEE’s classification also becomes relevant on date some duty arises that will be affected by such classification. For e.g., when a U.S. person acquires an interest in the FEE necessitating the filing of Form 5471 (an Information Return of US Persons w/Respect to Foreign Corporations).

“Relevance of a foreign entity”

Why is this determination important?

- A foreign eligible entity is also deemed to be relevant on the effective *date of its entity classification election*.
- An entity whose initial classification is determined by default generally retains that classification until the entity makes an election to change its classification. ***A change in the classification of an entity can result in tax consequences to the entity and/or its shareholders. For example, a change in the classification of an entity classified as a corporation constitutes a deemed liquidation for U.S. tax purposes and may result in a stepped-up tax basis.***
- An initial CTB election for an entity that has never been previously relevant, however, does not result in a recognition event for U.S. tax purposes and therefore no basis step-up or step-down occurs!
- Consequently, the relevance of the foreign entity is critical in determining whether the entity classification election is treated as an “initial classification” or a “change in classification”—*the latter being treated as a recognition event.*

Effect of a CTB Election:

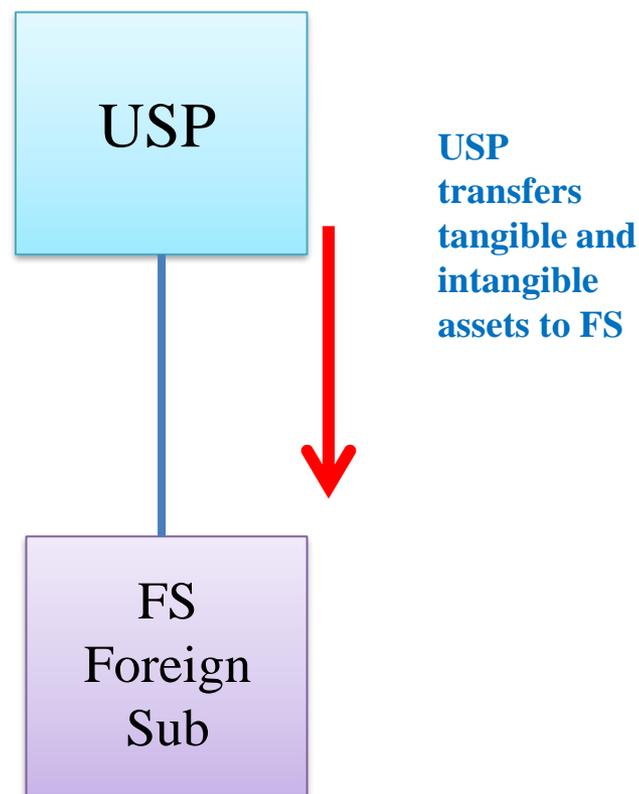
Usually Will Trigger an Immediate US Tax Recognition Event

- If an eligible entity classified as a partnership elects to be classified as an association (*i.e.*, a corporation), the partnership is deemed to (1) contribute all of its assets & liabilities to the corporation in exchange for stock (§ 351?), and immediately thereafter, the partnership is deemed to liquidate by distributing the stock of the association to its partners. (Contribution and LQ of the P/S could be taxable. Could trigger § 367(a) if the partnership is foreign.)
- If an eligible entity classified as an association elects to be classified as a partnership, the association is deemed to (1) distribute all of its assets and liabilities to its shareholders in liquidation, and (2) immediately thereafter, the shareholders contribute all of the distributed assets and liabilities to a newly formed partnership. (Deemed distribution could be taxable under §§331/336, and contribution could be taxable under § 721(c) regulations).
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association. (Again, the liquidation must be tested under § § 331 and 332.)
- If an eligible entity that is disregarded as an entity separate from its owner elects to be classified as an association, the owner of the eligible entity is deemed to have contributed all of the assets and liabilities of the entity to the association in exchange for the stock of the association. (Ask: does the contribution qualify for tax deferral under § 351? Is it an outbound transfer under § 367(a) and/or § 367(d)?)

Effect of CTB Election: Trigger Outbound transfer under §367(a) & (d)

But also might create a planning opportunity in light of TCJA

- § 367 now results in income or gain recognition on all outbound transfers of tangible and intangible property.
- But if transferor is a US C-Corp, tax is imposed at a reduced corporate rate of 21%.
- **FDII deduction under § 250?** If the assets transferred are for “foreign use,” can the §367(a) gain or a §367(d) deemed royalty inclusion could be considered “**foreign derived intangible income**” (FDII) and thus eligible for a deduction under §250 that could further reduce the rate to **13.125% ?**
- **Final Regs??**
 - Issue as to “related party”
 - “Foreign Use” requirement
 - “Sale” requirement
 - Foreign Branch Income Exception
 - Foreign tax treatment of the transfer (basis step-up on the sale, greater amortization dds)
 - Also, consider deductibility of actual or deemed royalty payments by (or US depreciation/amortization dd of) FS in its home jurisdiction.
 - Impact on the GILTI calculation
- Assume that USP incorporates its foreign branch, FS, turning it into a corporate sub. USP is deemed to transfer its branch assets to a “foreign corporation”, thus triggering § 367(a) and (d).



Effect of CTB Election – Example

Planning for Inbound Asset Transfers in light of § 245A

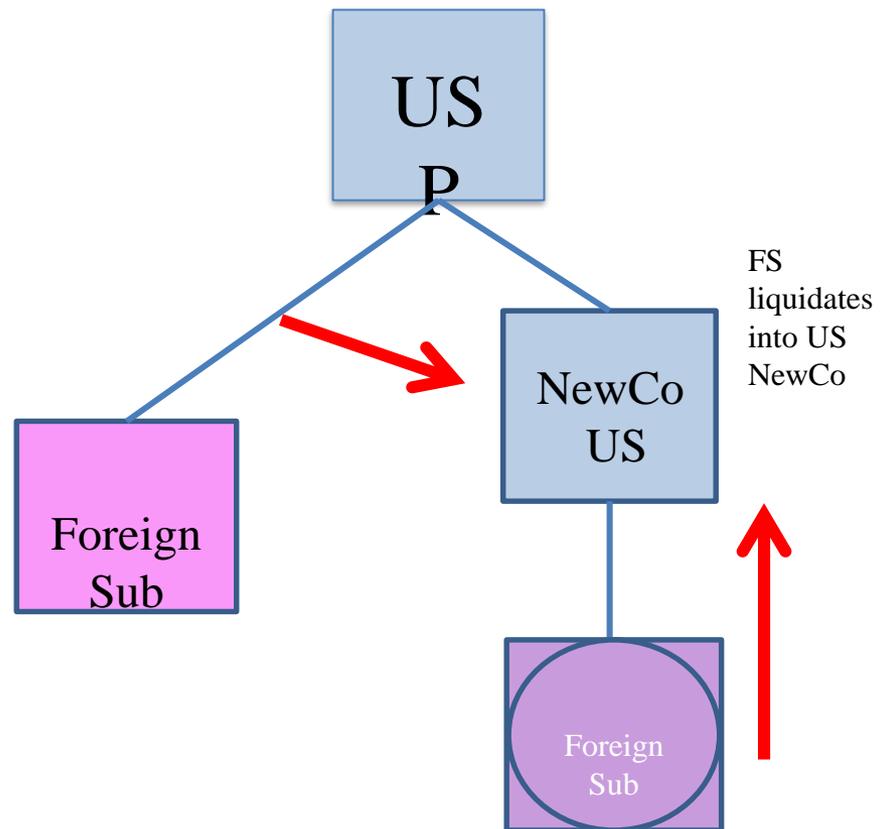
Assumed Facts:

- USP contributes the stock of FS to Newco U.S., after which FS elects to be treated as a disregarded entity for U.S. tax purposes. The transactions should qualify as an inbound “F” reorganization.
- Alternatively, FS elects to be a disregarded entity and is deemed to liquidate directly into USP in a section 332 transaction.

Analysis:

- **Pre-TCJA:** transaction would generally result in USP including the “**all E&P amount**” with respect to its FS stock in gross income as a dividend (generally, the E&P of FS attributable to the stock held by USP).
- **Post-TCJA:** Any “**all E&P amount**” dividend should be eligible for the DRD under §245A and effectively exempt from U.S. tax if received by a US C-Corporation (and other requirements under § 245A are met (e.g., 1-year holding period; not a “hybrid dividend”).
- The result would be the same in a *foreign-to-foreign reorganization* that resulted in the inclusion of dividend income equal to USP’s “§1248 amount” in the stock of FS (i.e., such amount may be effectively exempted from U.S. tax under §245A DRD).
- Don’t forget about possible impact on the BEAT tax; cf. § 311 distribution of assets from FS to USP.

- (1) USP contributes FS stock to NewCo.
- (2) FS elects to be treated as a disregarded entity, resulting in a deemed liquidation.



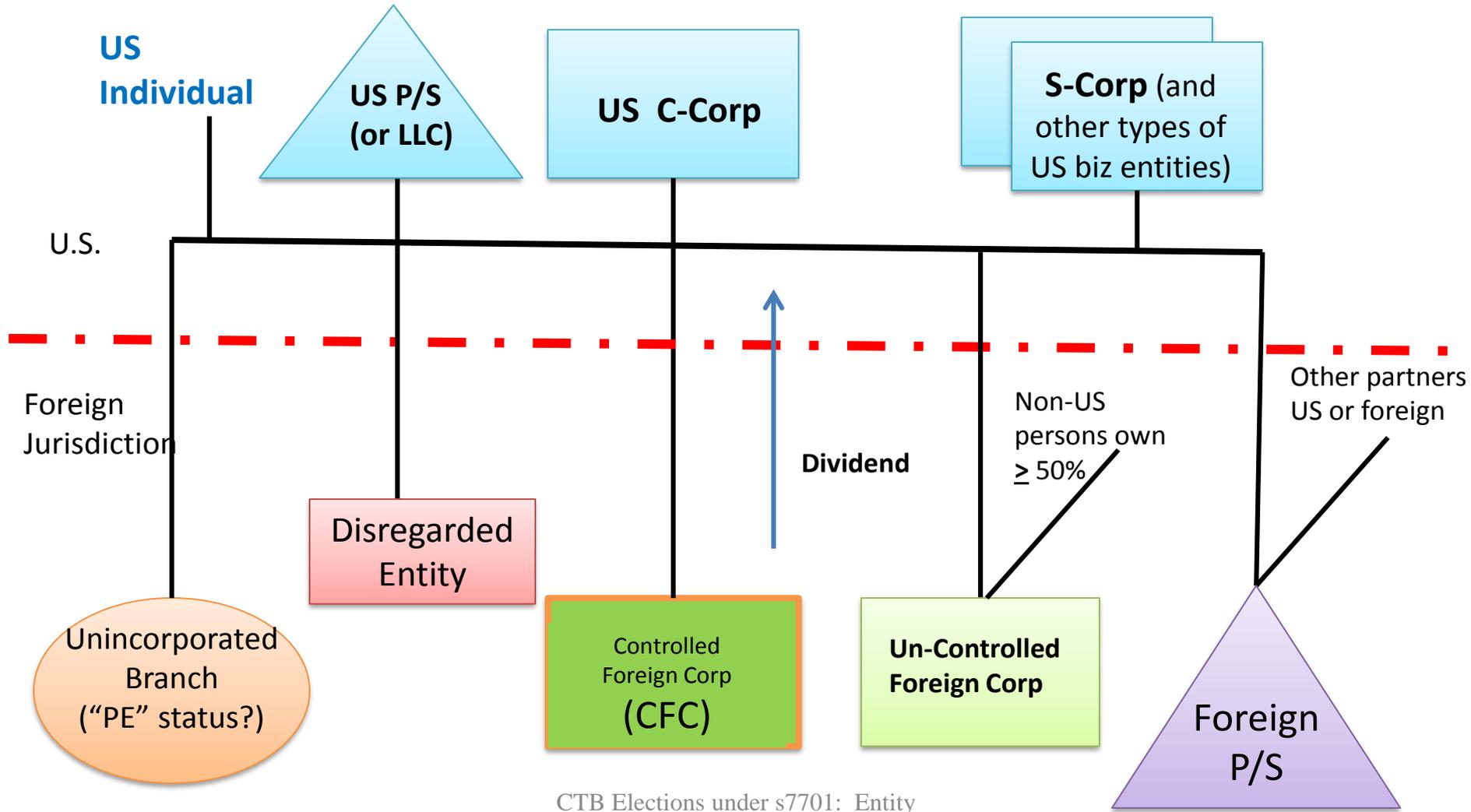
III. Increased U.S. Tax Stakes for Individuals in Selecting the FORM of a Foreign Entity



- A. The 2017 U.S. Tax Act Ended the “Deferral Privilege” formerly accorded foreign corporate subsidiaries
- B. The Reach of Subpart F is now much broader due to 2017 Code amendments (creating many more CFCs!) and possibly more Subpart F income
- C. New § 951A GILTI rules will apply and tax almost all the operating income of a CFC currently (phantom income)
- D. Deduction for Foreign Derived Intangible Income (FDII) – available only to C Corporations
- E. The § 965 Transition Tax applied in 2017 to “specified foreign corporations” (a mandatory deemed dividend)
- F. New § 245A 100% DRD (the participation exemption); but only C Corps that are § 951(b) shs can take advantage of it
- G. New § 267A limits the use of “hybrid entities” for tax arbitrage (an anti-BEPS measure)

Overview of Tax Stakes in Business Entity Selection

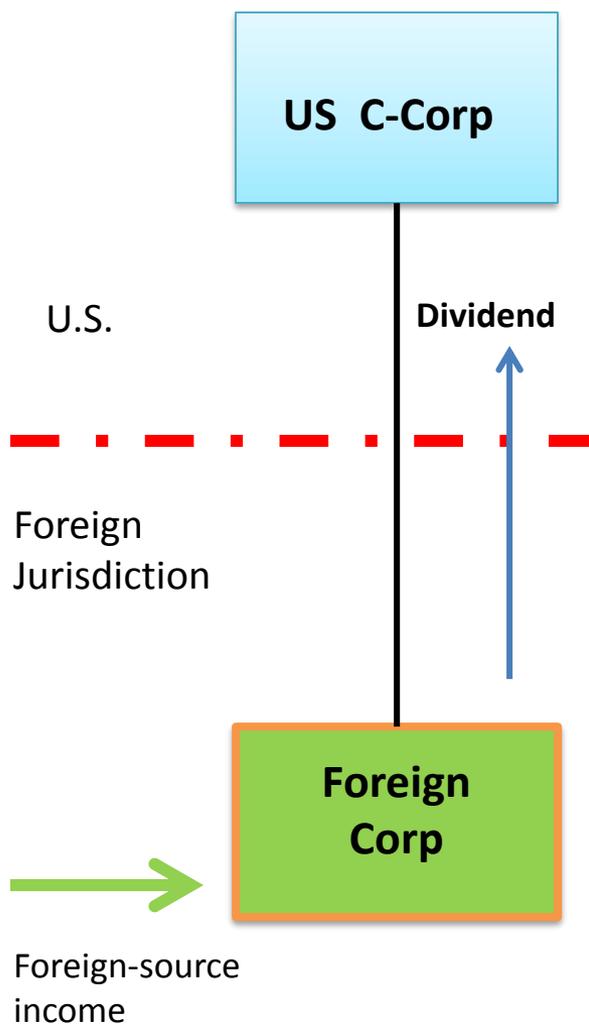
General Rule: *When a foreign venture rises to the level of “permanent establishment” status, then foreign entity selection becomes more relevant, and a choice needs to be made. Traditionally, choice was between “foreign E&P deferral” or “no deferral.”*



TCJA Drastically Changes How

Foreign Subsidiary Income of US Corporations is taxed

BEFORE 2017 US Tax Act

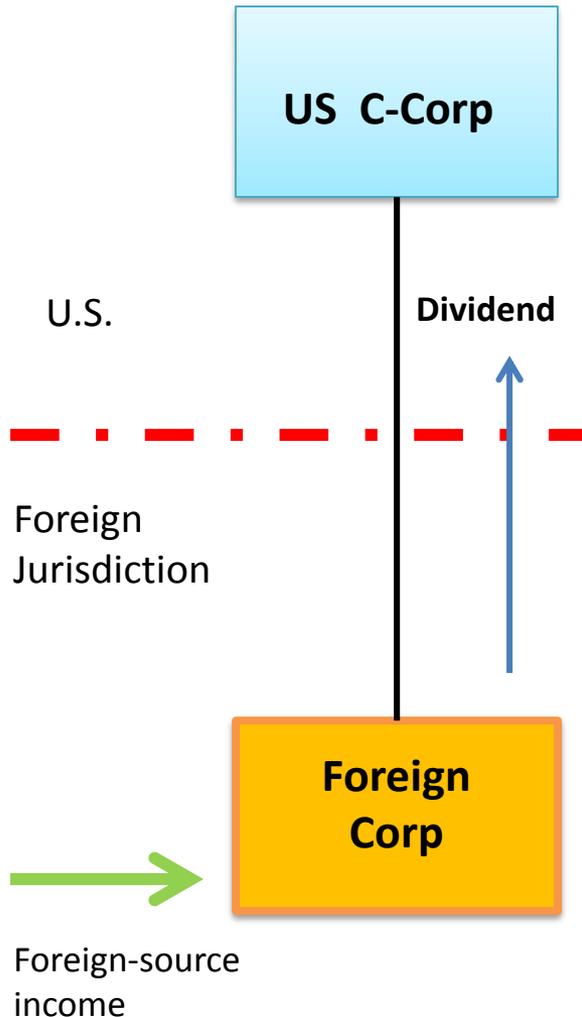


- **General Rule:** United States generally taxes US corporations on a “worldwide” basis—*i.e.*, US corporations taxed currently on both US-source income and foreign source income they receive. (Contrast with a pure “territorial jurisdiction,” which taxes its resident corporations only on income earned within its borders—not on foreign-source dividends and other foreign income).
- **Policy for Worldwide (“Residence-Based”) System:** Belief that capital is allocated more efficiently when investors’ choices about *where to invest* are not distorted by tax considerations. Economists believe it is more efficient if investments are made on the basis of pure economic fundamentals.
- **Deferral “Privilege” Exception:** **If a FOREIGN corporate Sub (of US corporate parent- as per diagram) earns foreign-source income, US corporate tax is not imposed on the foreign Sub’s income unless and until it is repatriated to the US—in an actual or deemed dividend. (Indefinite tax deferral is tantamount to a complete tax exemption due to time-value of money.)**
- **Policy Rationale:** US-owned foreign Subs need a “level playing field” to compete and should not have to pay both foreign and US taxes when their competitors do not. Thus, U.S. tax deferral is allowed so long as the foreign Sub can be viewed as truly competing in an active trade/business in its relevant market abroad. However, to the extent the foreign Sub receives income that is either “passive” or looks like “conduit income” (*i.e.*, earned through an low-tax branch/tax haven), the deferral “privilege” ends w/respect to that income, which is then taxed currently to its US shareholder(s) under one of several statutory anti-abuse regimes. Rationale: Foreign Sub is just there for tax advantages—not to compete in a foreign trade/business (*i.e.*, “capital import neutrality” policy objective no longer being served).
- **Foreign Tax Credits:** The corporate income taxes imposed by U.S. upon actual or deemed repatriation of a foreign Sub’s E&P may generally be offset with the foreign taxes already paid on that E&P via a tax credit (to extent it eliminates double juridical taxation).

TCJA Drastically Changes How Foreign Sub Income is Taxed:

No More Deferral—Sub's E&P is either taxed currently or exempted

AFTER 2017 US Tax Act



- **General Rule:** United States still generally taxes its US corporations on a “worldwide” basis—*but* at a much lower rate—i.e., 21% (down from 35%). However, the corporate tax base is broader with more foreign Subs’ E&P subject to US tax. Also, there is some foreign-source income that is completely exempt from U.S. corporate taxation. Thus, new system is still a “hybrid system” exhibiting attributes of both a residence-based AND territorial system.

- **“Deferral Privilege” Exception is formally eliminated:** Now, all income of a foreign subsidiary owned by a U.S. corporation will be either:

- **Taxed currently by US** (either under one of the pre-existing anti-abuse regimes (PFIC or expanded Subpart F) **OR** under the new very broad category of §951A “GILTI” income (*Global Intangible Low-Taxed Income*), which functions as a minimum tax, which can reach a foreign Sub’s income even if it’s not passive or conduit income; **OR**
- **EXEMPT from U.S. corporate taxation (forever).**

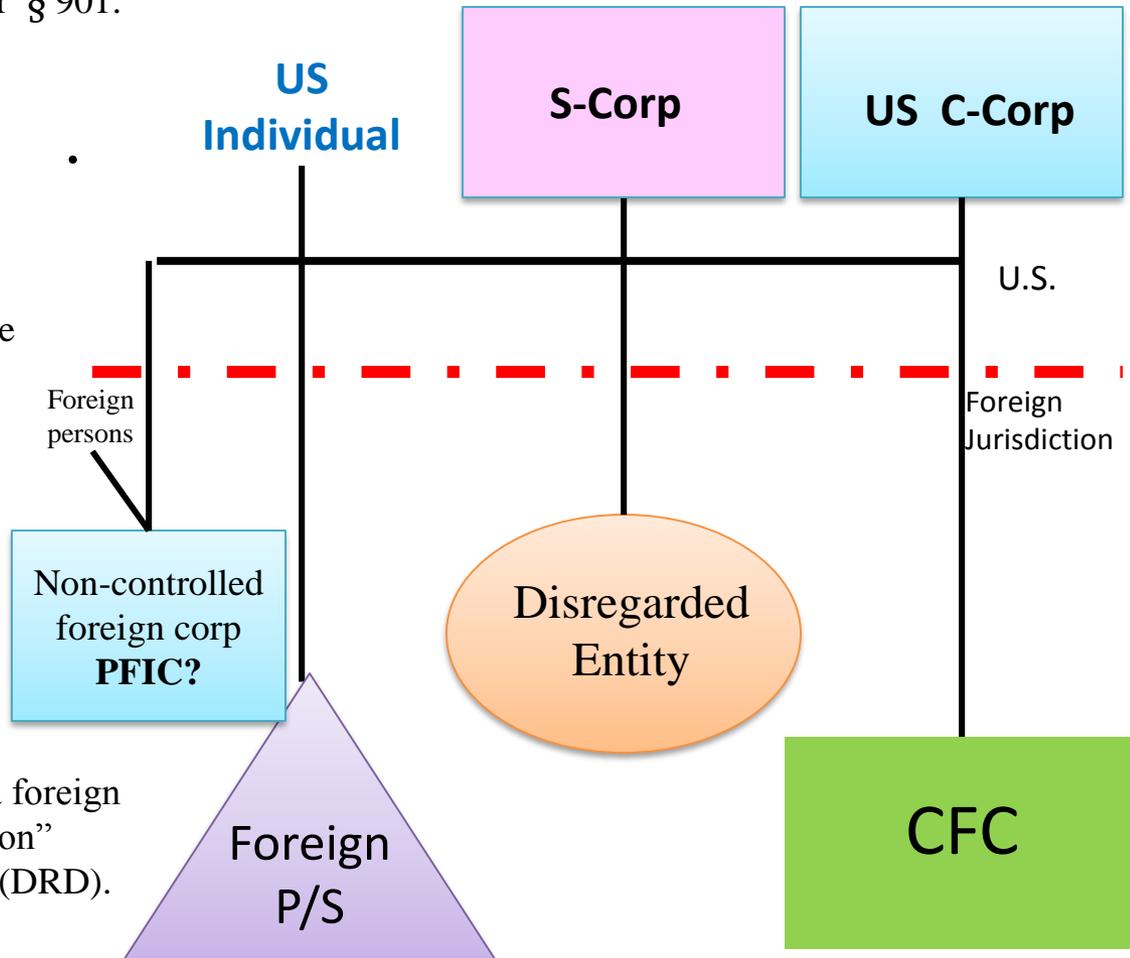
Three categories of foreign-source income of foreign Subs are now EXEMPT. *But these may not amount to much due to the breadth of the new GILTI minimum tax.* They include:

1. CFC’s earnings attributable to the 10% notional return in the GILTI regime (QBAI), which qualifies for the § 245A DRD when repatriated;
2. Income of 10% corporate “US Shareholders” of foreign Subs that do not qualify as CFCs (but do qualify as “specified foreign corporations” and so get the § 245A DRD); and
3. Pre-1987 E&P accumulated by foreign Subs, but only to extent of the pro rata share owned by 10% U.S. CORPORATE shareholders, since the §965 Transition Tax does not apply to those earnings and the §245A DRD applies when repatriated.

- **In Sum:** U.S. still has a “hybrid system” –i.e., part Residence-based (perhaps more so now) and part Territorial. Despite its new territorial attributes, the purview of US corporate tax is probably greatly expanded... but at a much LOWER rate—21% (vs. the former 35%).

A Few Basic Observations of Tax Stakes in Business Entity Selection

- When foreign entity is a “tax transparent” entity (i.e., P/S, DE, or branch), its US members are taxed currently with no tax deferral, and get a direct FTC under § 901.
- But when foreign entity is a CFC, 10% “US shareholders” are subject to current tax under:
 - Subpart F – § 951(a)
 - GILTI – § 951A, and
 - 2017 Transition Tax – § 965
 - but only US C-Corps are eligible for the 50% GILTI dd, or an indirect FTC absent a § 962 election)
- If the foreign entity is a non-controlled corporation, then should test for PFIC status (Passive Foreign Investment Company).
- Only US C-Corps are eligible for the FDII Deduction under 250.
- Only US “C-Corporations” owning 10% of a foreign Corp are eligible for the “participation exemption” —i.e., the 100% dividends-received deduction (DRD). Individuals and S- Corps do not qualify.

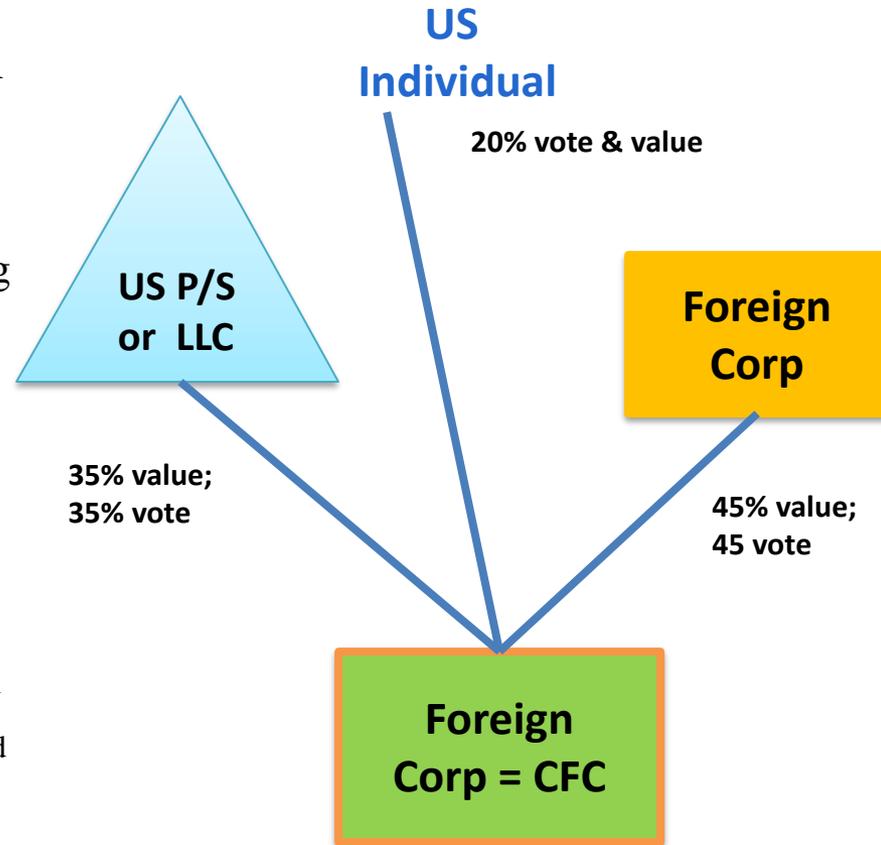


2017 Tax Act - Expansion of Subpart F:

Basically, when does Subpart F regime apply?

- Subpart F regime can potentially apply whenever there is a “controlled foreign corporation” (CFC).
- CFC is defined in § 958(a) as “any foreign corporation if > 50% of the total voting power OR > 50% of total value is owned by 10% “US shareholders” on any 1 day (TCJA eliminated the 30-consecutive day prerequisite.)
- For purposes of identifying “US shldrs” and testing for “CFC” status, stock ownership can be direct, indirect through foreign entities, or constructive. (Attribution rules of § 318 are incorporated by reference in Subpart F, but with modifications.)
- Beware of **control premiums and value discounts** (“drag along” & “tag along” rights)
- With respect to voting power, courts have looked to **power to control board of directors**.

See *Framatome v. Cir.* 118 TC (2002) (because the veto powers and supermajority requirements prevented US shldr from exercising powers over Japanese corp ordinarily exercised by a domestic board of directors, US shareholder did not have > 50% voting power. Court relied on *Alumax v. Cir.*, 109 TC 133 (1997), *aff'd 11th Cir.*



Foreign Corp is a “CFC” because the “US shareholders” (i.e., the US LLC and the US individual together own > 50% of the vote (and here, also 55% of the value). IF US individual owned only 5%, then there would be no CFC.

2017 Tax Act (TCJA)- Expansion of Subpart F:

6 ways the Act expanded purview of Subpart F

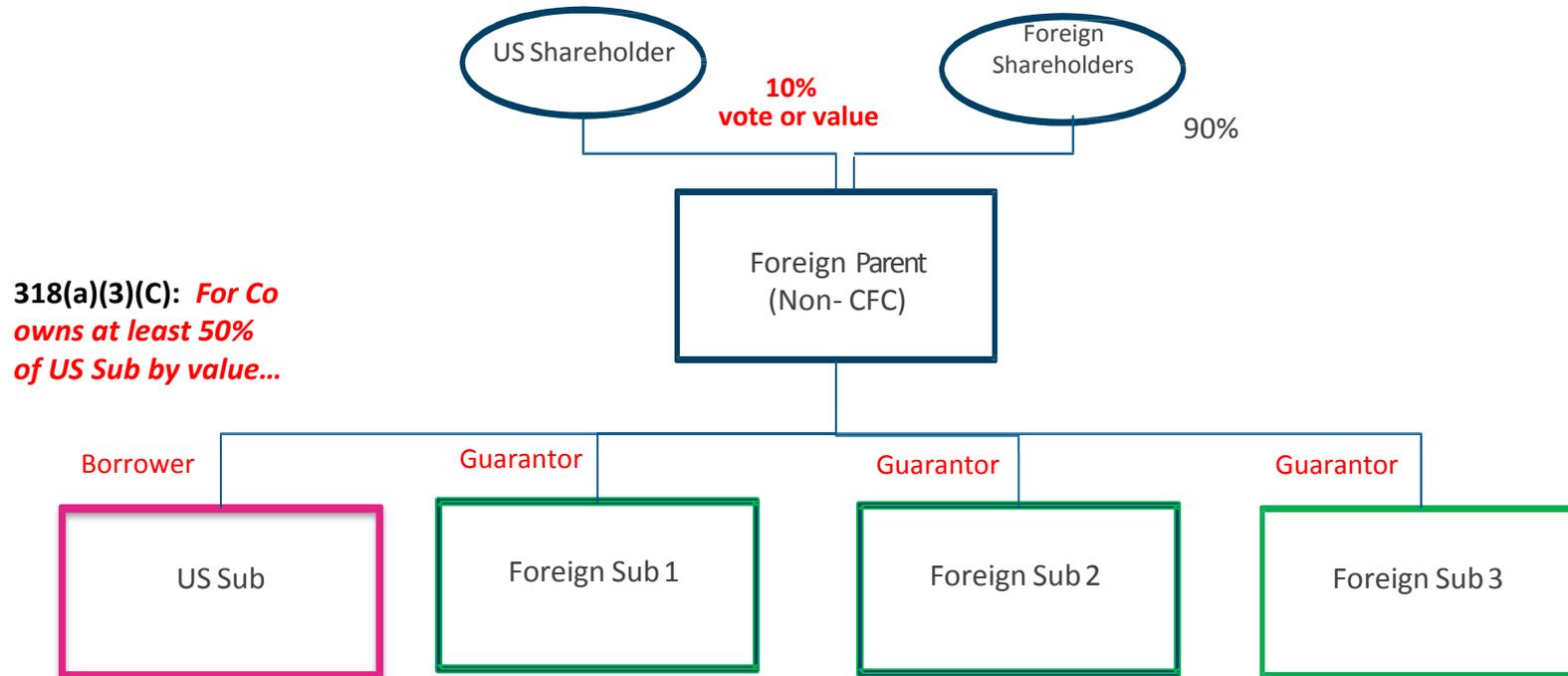
1. § 951(b) definition of “US shareholder” was broadened to include a value test -(after TCJA, the test for “US shldr” is a US person owning at least 10% of EITHER vote OR 10% of value of a foreign corporation (directly, indirectly through foreign entities, or constructively through modified § 318 attribution rules).
2. Amended § 951(b) to provide that the new definition of “U.S. shareholder” applies “for purposes of this title,” – (i.e., Title 26—the whole U.S. Internal Revenue Code)—instead of just for purposes of Subpart F as under pre-TCJA law.
3. Repealed IRC § 958(b)(4), which had (prior to repeal) turned-off the downward stock attribution rules of § 318(a)(3)(A) through (C) for purposes of imputing stock owned by a foreign person to a US person (in identifying US shldrs and CFCs).
4. Eliminated from § 951’s income inclusion rule the requirement that a foreign corporation must be a CFC for at least “an uninterrupted period of 30 days” during any taxable year in order for a US shldr to be taxed. (Now a foreign corporation need only be a CFC for 1 day.)
5. Added a broad new category of income to Subpart F—*i.e.*, § 951A “Global Intangible Low Taxed Income” (GILTI). Although § 951A GILTI is not technically within § 952’s definition of “Subpart F Income,” GILTI is part of Subpart F, and GILTI’s application thresholds are basically the same (*i.e.*, only “US shldrs” in a “CFC” are taxed on GILTI inclusions, as that new residual category is defined).
6. Added , to very end of Subpart F, new § 965 --“Treatment of deferred foreign income upon transition to participation exemption system of taxation” (*i.e.*, the “Transition Tax”)

Computing Subpart F Income:

Key Exceptions that also affect GILTI Computation (& vice versa)

- **Subpart F income targets 2 types of income:** (1) foreign passive income (as defined in § 954(c)) and (2) income that is conduit-like and earned between “related persons.” *See, e.g.*, § 954(d) (FBC sales income), § 954(e) (FBC services income).
- **Current Year E&P Limitation:** the Subpart F income that is taxed to US shareholders cannot exceed the CFC’s current E&P (a economic concept yielding different results from income). To extent Subpart F is not taxed due to the current-year E&P restriction, it may be “recaptured” in a subsequent year when non-Subpart F income is earned by the CFC. § 952(c)(1) and (2).
- **Qualified Accumulated (and Chain) Deficit Rule:** Certain “qualified deficits” in accumulated E&P (if the same type) can reduce a CFC’s Subpart F income (even the deficit is from a related CFC in the same vertical chain). §952(c)(1)(B) and (C).
- **High Foreign Tax Exception:** “Foreign Base Company Income” and “Insurance Income” do not include any “item” of income if the taxpayer establishes it was subject to an effective rate of foreign tax greater than 90% of the highest rate in § 11. (90% of 21% rate = 18.9%.) Thus, of a category of Subpart F income is being taxed by a foreign country at an effective rate > 18.9 %, the taxpayer may exclude it. (Regs clarify that indirect FTC “pools” were to be used—not item-by-item, which allowed for averaging. But newly proposed Regs, if finalized, will look to “qualified business units.”)
- **NB:** *The GILTI rules do not have either a “Current E&P Limit” or “Qualified Chain Deficit Rule”* so “tested income” can exceed current E&P, and prior-year deficits do not offset GILTI! The Final GILTI Regs (June 2019) *do adopt* a limited High Foreign Tax Exception. Proposed GILTI Regs (June 2019) would greatly expand the High Foreign Tax Exception as applied to GILTI (if the Regs are finalized, and if finalized, are likely to be prospectively applicable).

Repeal of § 958(b)(4) – Myriad Collateral Effects: “Pop-Up CFCs” & real, substantive Subpart F tax exposure



- Prior to the TCJA, Foreign Subs 1, 2 and 3 were not CFCs
- Because Foreign Parent Co owns US Sub stock w/at least 50% total value, § 318(a)(3)(C) is triggered. Thus, ALL the stock owned by Foreign Parent is treated as owned by US Sub--making US Sub both a § 951(b) “US shlr” and Foreign Subs 1, 2, and 3 “CFCs.”
- US Sub not taxed on constructive ownership (which is all it owns in this diagram).
- BUT the 10% US shlder (at the top) owns 10% of the CFC indirectly (through Foreign Corps) and thus IS taxed on its pro rata share of all Subpart F earnings of Foreign Subs 1, 2, 3. Also, the indirect US Shldr could also have tax under §§ 956 (Earnings invested in US Property); §951A (GILTI; § 965 Transition Tax (even though none of the foreign corps are “controlled” directly or indirectly by US shs).
- **Here, advisors should review income and earnings of each CFC. Also, need to review loan documentation requiring guarantees** (because under of § 956 Investment in US Property, any CFC guarantee of a U.S. obligation could trigger a deemed dividend).

Potential Solutions to Mitigate Unintended Tax Liability due to § 958(b)(4)'s repeal

1. **Convert the Foreign “Pop-Up” CFCs to “Disregarded Entities” with CTB Election**
 - Treated by US taxable “liquidations” triggering a § 1248 dividend, but the “all §1248 amount” may be zero, if E&P already picked up by the Transition Tax.
 - *This strategy would likely not avoid the 2017 imposition of the one-time Transition Tax unless a retroactive CTB election could be made—NOT likely allowed under final § 965 regulations*
2. **Make Maximum Use of the *High Foreign Tax Exception*** to reduce both Subpart F & GILTI income
3. **Elect § 962 to Treat the Foreign Dividends “as if” they were received by a U.S. C Corporation.**
But see Smith v. CIR, ___T.C. (2018)(no qualified dividend treatment allowed – C corp is not real).
4. **Create a U.S. Irrevocable Non-Grantor Foreign Trust** (to reduce the indirect U.S. shareholder’s interest to below 10% vote or value). How does this work? (If remaindermen are NRA children, might work under the § 318 attribution rules)
5. **Interpose a US C corporation between the § 951(b) individual /S-Corp US shareholder and the CFCs** (to get the 100% DRD under § 245A , and the 50% GILTI deduction under § 250). But some foreign countries forbid a foreign corporate (US) shareholder (*e.g.*, China, Lebanon if real estate)
6. **Actually liquidate the CFCs** (But usually not pragmatic...and then the “liability shield” is lost. Also expensive!)
7. **Take “Wait & See” attitude:** Wait and see if Congress adopts any Technical Corrections Bill (2 have already died in the US House of Reps).

CTB Election Tax Stakes:

GILTI Exposure – “Global Intangible Low Taxed Income”

- **§ 951A:** For tax years beginning after 2017, all US shareholders of a CFC are subject to current US tax on their GILTI inclusions. GILTI can potentially tax much or most of a CFC’s operating income....and it will be “phantom income.”
- **A US shareholder’s GILTI inclusion equals:** aggregated “net tested income” from all its CFCs (pro rata) minus a *routine return* (i.e., “fictional”) on certain qualified tangible assets.
- “Tested losses” from one CFC in a group can offset “tested income” in other CFCs, but not below zero.
- Some types of gross income are excluded from being classified as tested income including:
 - Income “effectively connected” with a US trade or business
 - Subpart F income
 - Income excluded from FBC income or insurance income by reason of the High Foreign Tax Exclusion of 954(b)(4).
 - Any dividend received from a related person
 - Certain foreign oil and gas income

CTB Election Tax Stakes:

GILTI Exposure – (Continued)

- “Qualified Business Asset Investment” (QBAI) is the reduction allowed against tested income, defined as 10% of the CFCs’ average aggregate adjusted tax bases in depreciable tangible property, adjusted downward for certain interest expense (collectively, referred to as “net deemed tangible income return”). Determined quarterly.
- Unlike an individual or S-Corporation, a domestic C Corp is allowed a 50% deduction of its GILTI amount (37.5% for tax years beginning after 2025), resulting in an effective tax rate on GILTI of 10.5% (13.125% for tax years beginning after 2025), subject to a number of complicating factors (e.g., limits on foreign tax credits). (See discussion of the 962 election below...)
 - Unlike Subpart F, GILTI has **NO “Current Year E&P Limitation.”** Thus, even if there is an E&P deficit, US shareholder can be taxed on GILTI.
 - **NO “Qualified Chain Deficit Rule”** in GILTI. If tested losses are not absorbed currently, they are lost forever.
 - **High Foreign Tax Exception** – yes, but limited. (Under the present Final GILTI Regs, income taxed at effective foreign rate >18.9% is excluded from GILTI, but only if the “sole reason” it was not Subpart F income was due to the §954(b)(4) exclusion. (Not consistent with legislative history. Proposed GILTI Regs, (2nd batch released June 2014), if finalized, would greatly expand this High Foreign Tax Exclusion for GILTI, and compute “high foreign taxed income” on a qualified business unit basis.

US Partnerships and S-Corps that own CFCs:

Impact of Final GILTI Regs (6/2019)

- **Proposed GILTI Regs published Oct. 2018:** provide the general mechanics and structure of the GILTI calculation.
- **Final GILTI Regs (June 2019):** generally retain the approach & structure of the proposed regulations, but with numerous modifications.
- **Final GILTI Regs did not adopt the “hybrid approach” of the Proposed GILTI Regs (published in Oct. 2019) because Treasury decided the hybrid approach was too complex and problematic.**
- S Corps are treated as “partnerships” for purposes of Subpart F and GILTI. § 1373(a).
- **Rejected “Hybrid Approach” of 2018 Prop. GILTI Regs:** The US shareholder-P/S determined its GILTI at entity level. Partners not qualifying as “US shareholders” (owning < 10%) were to be taxed on their distributive shares of GILTI. Partners qualifying as “US shareholders” were treated as owning the CFC stock directly, as IF the US P/S were a foreign P/S. Thus, GILTI was computed at the partner level for them. § 958(a)(2).
- **Final GILTI Regs – reject “hybrid approach”:** Instead, solely for purposes of determining the GILTI inclusion of any partner of a domestic P/S, each partner is treated as proportionately owning the stock of a CFC actually owned by the P/S as if the US P/S were a foreign P/S—i.e., a total “look-thru” approach as under § 958(a)(2). Because only a US person that is a 951(b) “US shareholder” can have a GILTI inclusion, a partner that is not a § 951(b) “US shareholder” not have a GILTI inclusion amount even through the P/S.
- **Thus, under the FINAL GILTI Regs,** a US-shareholder partnership does not have a GILTI inclusion amount, and therefore no partner of the P/S can have a “distributive share” of GILTI. *So, a partner that is not a § 951(b) “US shareholder” will have neither a distributive share of a GILTI inclusion (because the GILTI is not determined at the US P/S level) NOR a GILTI inclusion at its own shareholder level (because it owns < 10%).*

CTB Elections under s7701: Entity

Selection for Foreign Operations

PamFuller - RoyseLaw/Tully Rinckey

US Partnerships and S-Corps that own CFCs:

Impact of Final GILTI Regs (6/2019) (continued)

- **FILING problems:** Some partnerships and S-Corps issued K-1s and/or returns consistent with the hybrid approach under the Prop. GILTI Regs, although they are now required to follow the Final GILTI Regs.
- **Penalties can apply** to these entities for failure to file timely returns or filing returns that fail to include accurate info under § 6698(a) (P/Ss), § 6699(a) (S-Corps), § 6672(a) (failure to include all accurate info on a Schedule K1).
- **Notice 2019-46 provides relief** to the P/Ss and S-Corps that initially followed the Proposed GILTI regs. Recognizing that changing all their reporting could cause undue costs, Notice provides that P/Ss and S-Corps can apply the Prop. GILTI Regs for 2018, and also avoid penalties if certain notice requirements are met. (No penalty relief for partners and S-Corp members discussed...)
- **But Notice does not address plight of the partners who are not § 951(b) shareholders.** (Why should they be taxed on distributive shares of GILTI, when Final Regs provide otherwise?)
- **Form 8082:** These non-951(b) shareholder-partners may need to file Form 8082, “*Notice of Inconsistent Treatment or Administrative Adjustment Request*” with their tax returns (although not a final solution).
- **Partners need to track the K-1s** and compare with info finally released by the partnership or S Corp. Contact the entity and get info. Hopefully, the Regs promised in Notice 2019-46 will address these inconsistencies and unanswered questions.

US Partnerships and S-Corps that own CFCs:

Impact of Final GILTI Regs (6/2019) - EXAMPLE

ASSUMED FACTS: US partnership “PRS” owns 51% of foreign corporation FC1, which thus qualifies as a CFC. § 957(a). The other 49% shareholder is an unrelated foreign person. PRS has three US individual partners—A, B, and C—who are not related to each other. Partners A and B each own 46% of PRS. Partner C owns the remaining 8%.

RESULT: For purposes of determining whether FC1 is a “CFC,” PRS is considered a “US shareholder” as defined in § 951(b). Thus, PRS must file a Form 5471 since it is a Category 1, 4, and 5 filer as defined in Form 5471.

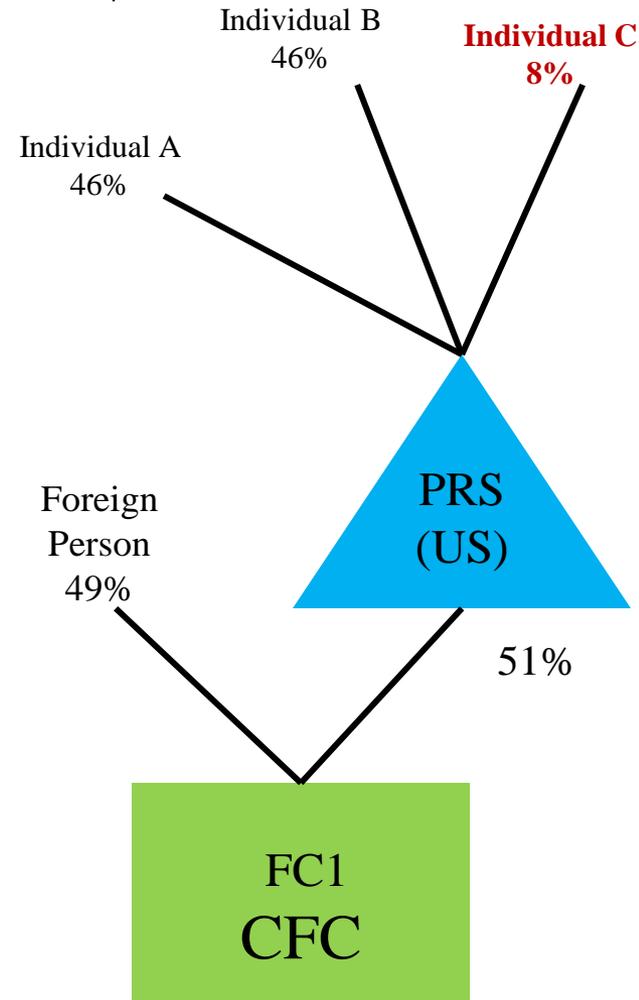
Final GILTI Regs: However, solely for purposes of determining how GILTI is computed, PRS is *not* treated as a US shareholder. Under the Final GILTI Regs, PRS does *not* have a GILTI inclusion that is allocated to its U.S. partners as a distributive share. Rather, the domestic partnership is treated as a foreign partnership for purposes of computing GILTI, employing a “look-through” approach.

Treatment of Partners A and B: They each indirectly own 23.46% of FC1, and are thus § 951(b) “US shareholders.” They will be taxed directly on their pro rata shares of tested income under the Final GILTI Regs. But no shareholder will have a distributive share of GILTI income through the partnership. Treat the Tested Income and Tested Losses as realized by them directly.

Treatment of Partner C: As an 8% partner of PRS, C indirectly owns only 4.08% of FC1. Thus, partner C is not a § 951(b) “US shareholder.” Therefore, under the Final GILTI Regs, partner C is not required to include his share of tested income from PRS in income as a distributive share. And, obviously, C will not realize any GILTI income directly.

Query - Impact of Notice 2019-46 on Partner C? Presumably, the partnership is allowed to bind the partners in its treatment of certain items. And, if PRS decides to apply the 2018 Proposed GILTI Regs’ “hybrid approach,” Partner C could file Form 8082, “*Notice of Inconsistent Treatment or Administrative Adjustment Request*”—but that might not be enough to avoid penalties if PRS subsequently provides notification of its intent to follow the 2018 Proposed GILTI Regs (as per the Notice), rendering the originally issued K-1 “accurate.” Notice 2019-46 does not address whether Partner C should amend its return or potentially be subject to an underpayment penalty.

- Note: The IRS and Treasury may decide to apply this aggregate approach to all of Subpart F income. See Preamble to Final GILTI Regs.



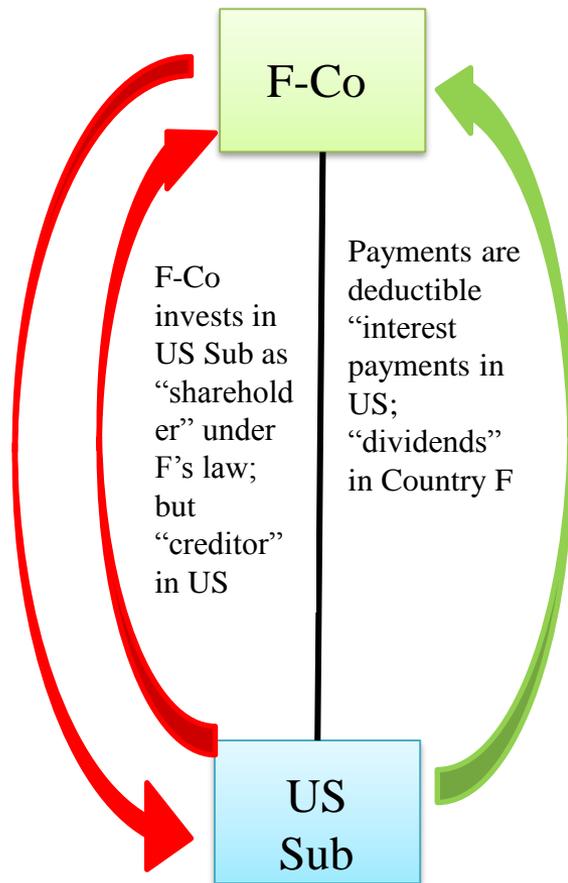
Key Considerations (other than foreign entity selection): Comparing U.S. international tax regimes' statutory tax rates and limits on foreign tax credit utilization

	Offshore				Onshore		
	§245A DRD	§951(a) Subpart F	§951A GILTI	Foreign branch	§956 Invest US property	§250 FDII	Non-FDII
Effective rates (%)	0	21	10.5	21	21	13.125	21
Foreign tax credits (%)	None	100%	80%	100%	100%	100%	100%
FTC Carryforward	None	10-yrs	None	10-yrs	10-yrs	10-yrs	10-yrs
Other	Creates exempt income/partially exempt asset For corps, PTI generally means little 245A	GL or passive	Separate Basket	Separate Basket	Converts Exempt Income Multiple year FTCs?	Most income U.S. source – no FTCs	Most income U.S. source – no FTCs Avoid/get in FDII

G. New § 267A limits use of “hybrid entities” for tax arbitrage

An anti-BEPS measure)

Classic Example of Hybrid Entity



- **Assumed Facts:**

- F-Co contributes money to US Sub, in exchange for an instrument, which is in legal “form” under the laws of F-Co’s country, a contribution in exchange for US Sub’s stock.
- Country F views the F-Co as holding “equity” in US Sub.
- The U.S. views the same transaction, in substance, as a “debt instrument” creating a debtor-creditor relationship, and “loan” for tax purposes.
- Because at least two countries relevant to the transaction view the instrument inconsistently, it is a “hybrid instrument.”
- Absent special rules, the U.S. would allow US Sub to deduct the “interest” payments on its U.S. tax return.
- At the same time, because Country F views the payments as “dividends” on equity, Country F would (absent special rules) allow F-Co to exempt them under any available special tax regime (e.g., a repatriation deduction or credit).
- Thus, the payments result in deductions in one jurisdiction (the U.S.), with no taxation of the full amounts in the country where the recipient resides. (i.e., “Deduction-No Inclusion” or “D/NI” in BEPS speak.)
- Traditionally, the U.S. has had no “bright-line” test for distinguishing “debt” from “equity,” but has applied substance-over-form principles. Unlike the U.S., many other countries look to the legal form of the instrument to determine its tax treatment, resulting in myriad opportunities for creating hybrid instruments and tax arbitrage.

Nails in the “Hybrid Coffin”

Escalating Limits on Hybrid Arrangements in Last 20 Years

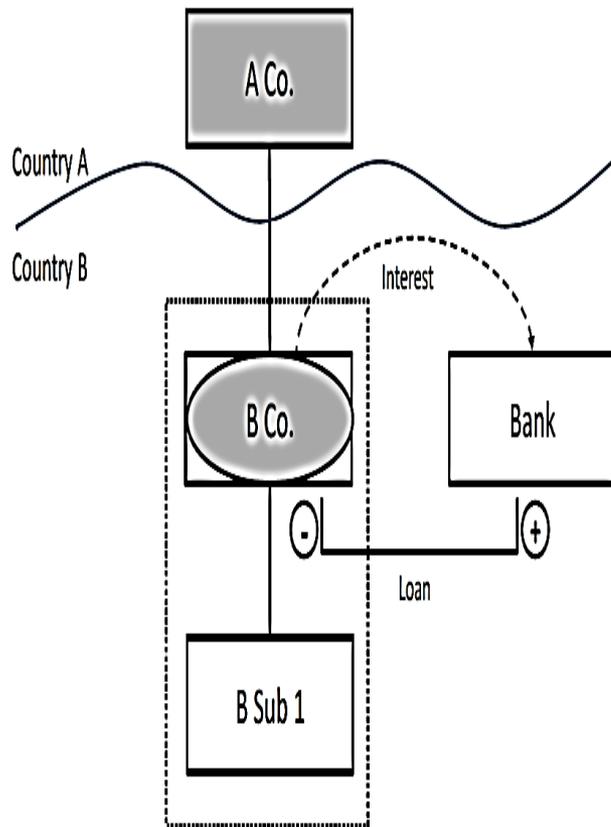
- A. IRC § 894 and Reg. § 1.894-1(d)(2)(ii) – Domestic law limits tax benefits of arrangements using domestic reverse hybrids
- B. IRS Notice 98-11, but soon withdrawn by Notice 98-35.
- C. U.S. Model Tax Treaty (going back to at the 1996 US Model Treaty): U.S. negotiating position has been to ensure that treaty benefits are limited when “fiscally transparent entities” are used to achieve double non-taxation. Stricter and broader anti-hybrid provisions in 2016 US Model Tax Treaty.
- D. OECD’s Partnership Report of 1999 – “The Application of the OECD Model Tax Convention to Partnerships”
- E. OECD/G20’s “BEPS” initiative – (Base Erosion Profit Shifting report, Action 2 “Neutralising the Effects of Hybrid Mismatch Arrangements”
 - 1. Oct. 2015: Final Report on Action 2 issued (expands on Sept. 2014 Interim Report)
 - 2. Aug. 22, 2016: “Branch Mismatch Structures” discussion draft released (detailed)
 - 3. OECD recommends changes to domestic law and OECD Model Tax Treaty.
 - 4. OECD’s Multilateral Instrument signed (containing anti-hybrid provisions)
- F. “Fruit of BEPS”: Implementation of Action 2 in an increasing number of countries’ domestic law (and EU)
- G. EU’s Anti-Tax-Abuse Directive (ATA Directive), Article 9 (ATAD I and ATAD II) and EU’s Amendment to Parent-Sub Directive
- H. Unilateral limits imposed by other countries (independent from OECD’s BEPS): UK’s “Hybrid Mismatch Rules” effective Jan. 1, 2017 (BREXIT?); Netherlands; Germany; France; Australian proposal
- I. USA: Obama Proposals; 2016 Model Tax Treaty restrictions; US Congress asked to fix “hybrid problem,” and **finally, in 2017, US Congress enacts IRC § 267A** (GOP’s amendment is very similar to Obama proposal.)

The U.S. Anti-Hybrid Rule

- **§ 267A disallows U.S. tax deductions for any “disqualified related party amount,” which is interest and royalties paid or accrued to a “related party” in a “hybrid transaction,” or paid to or by a “hybrid entity.” §267A(a).**
- **“Related party”** for § 267A purposes is defined by reference to “related person” in **§ 954(d)(3)** (substituting the payor for the CFC). Thus, related party includes an individual, corporation, partnership, trust or estate that controls, is controlled by, the payor, or where both payor and recipient of the interest or royalty are “controlled” by same person(s). Control means >50% ownership (by vote or value). Ownership can be direct, indirect, or constructive through labyrinthine attribution rules. See § 958(a), (b). (And, consider the scope of application given repeal of § 958(b)(4)).
- **“Hybrid Transaction” defined broadly** as “any transaction, series of transactions, agreement, or instrument one of more payments of which are treated as interest or royalties” for U.S. tax purposes and which are not so treated for purposes of the tax law of the recipient’s foreign country. (*E.g.*, Otherwise deductible interest payments that are considered dividends, subject to preferential treatment like participation exemption for foreign tax purposes.)
- **“Hybrid Entity”** is an entity treated as fiscally transparent in the U.S., but not for purposes of the tax law of the foreign country where the recipient is resident, or vice versa.
- **“Disqualified Related Party Amount”** is any interest or royalty paid or accrued to the extent that the payment:
 - Is not included in the income of the related foreign party under the tax law of the country in which the related party is resident or subject to tax **OR**
 - The related party will (also) be allowed a deduction with respect to the amount under the tax law of the foreign country
 - **Exception:** to extent such payment is included in income of a US shareholder under § 951(a) (Subpart F).
- **§ 267A(e) grants IRS/ Treasury Dept. broad regulatory authority** to write rules carrying out purposes of § 267A(a), including its application to conduit arrangements, branches, structured transactions, and for treating a “tax preference” as an “income exclusion” if the preference reduces the applicable statutory rate by 25%. Regs may also provide exceptions where an interest payment or royalty is taxed in a third country, or in cases that do not present a risk of tax base erosion.
- **Observation:** As drafted, and in the absence of liberalizing regulations, § 267A may literally disallow interest and royalty payments in common “Check-the-Box” structures involving eligible entities—e.g., payments to a related GmbH and Co. KG, viewed as tax transparent by Germany, but which could be treated as an opaque corporation for U.S. tax purposes.

Structures that new IRC § 267A does not target

Figure 6. Basic Double Deduction Structure Using Hybrid Entity



§ 267A, as drafted, apparently *does not disallow* the double deduction in this case because there is no “related party.” But other countries’ “hybrid mismatch rules” may apply. Does the grant of regulatory authority in §267A(e) give the U.S. Treasury latitude to address this structure in Regs? (i.e., imputing some kind of “related foreign party”?)

- **Assumed Facts:** Countries A and B classify B-Co inconsistently for tax purposes. Country A views B-Co as a tax transparent branch; Country B views B-Co as opaque.
- Thus, B Co is a hybrid entity.
- Country A deducts the interest payments made by its transparent foreign branch.
- B-Co, as borrower, also deducts the same interest payments to on its Country B tax return. (Alternatively, such deductions in B-Co may increase the B Co’s losses, which may offset profits under a tax consolidation regime.)
- If Country B is the United States, § 267A will *not disallow* the interest deductions because they are not being made to a “related [foreign] party.” (If Country A is the United States, the US dual consolidated loss rules will generally disallow any net loss of the B-Co group.)
- Still, but for a special rule, a “double deduction” would result (“double dip” or double deduction – “DD” in BEPS speak).
- **Note:** Obama proposal would have denied interest or royalty deductions arising from certain hybrid arrangements involving unrelated parties in appropriate circumstances, such as structured transactions.
- **BEPS Action 2:**
 - **Primary rule:** to the extent a payment gives rise to a DD outcome, deny the deduction at the **parent level**
 - **Defensive rule:** If A-Co Parent takes the deduction, then the tax law in Country B should deny the deduction at **payor level** (i.e., in Country B).



Checking the Box: Planning for Individually Owned CFCs

Strafford Webinar
September 26 2019



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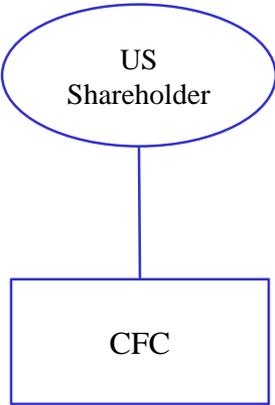
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Emphasis:
International Tax
Tax Planning
Tax Controversy

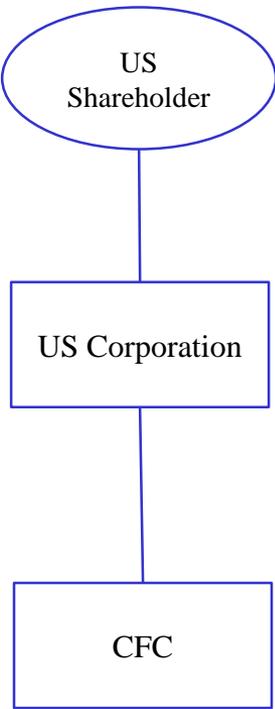
William R. Skinner, Esq. is a tax partner with Fenwick & West LLP, in Mountain View, CA. He graduated from Stanford Law School and was recognized as a Rising Star in Tax by California Super Lawyers. He focuses his practice on U.S. international corporate taxation, M&A taxation and tax controversies.

Overview of Structure Options for a US Individual Owning a CFC

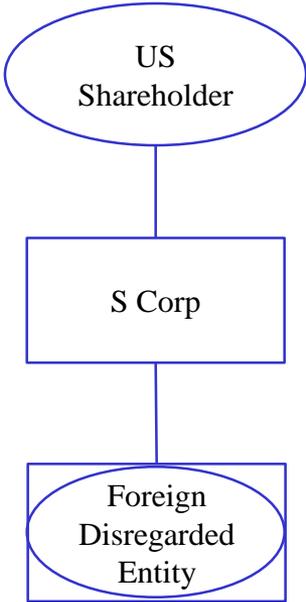
Status Quo:



Blocker C Corp:



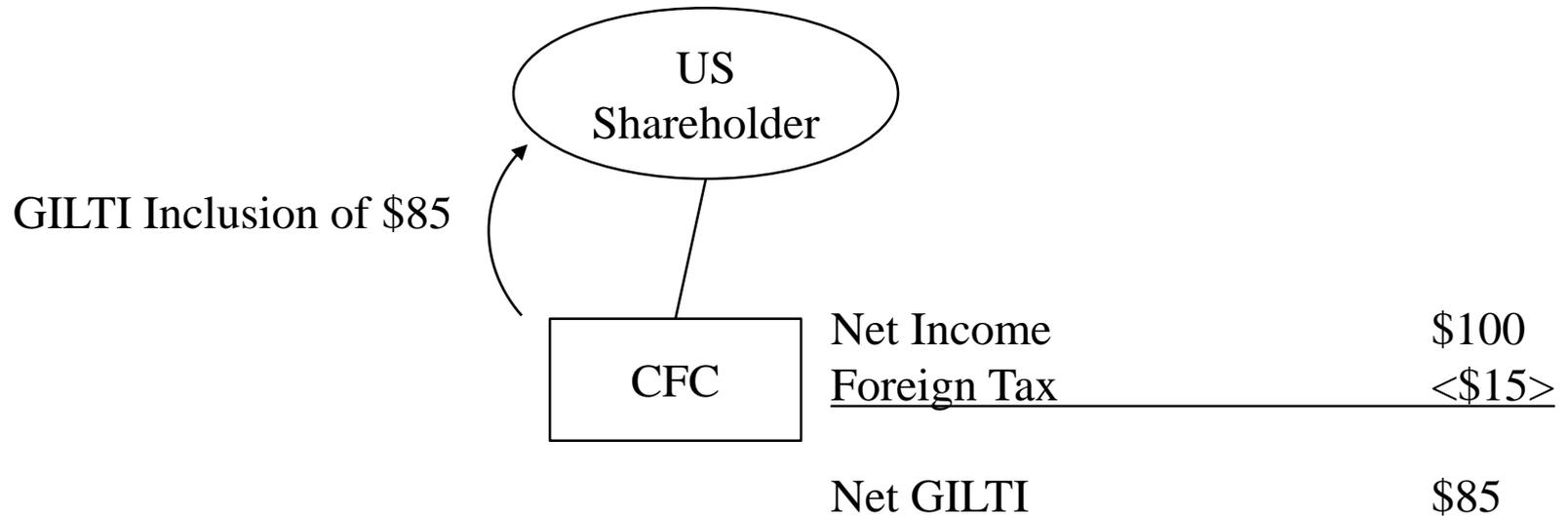
Check-the-Box Structure:



Drivers in Decisions on How to Structure a Closely Held CFC

- Foreign tax rates
 - Entity level
 - Shareholder level / Withholding tax
- Availability of “qualified dividend income” (Sec. 1(h)(11))
- Likelihood of sale
- Ability to Reinvest Earnings
- State & local tax rates on the shareholder

Directly Owned CFC – The Code Sec. 962 Election

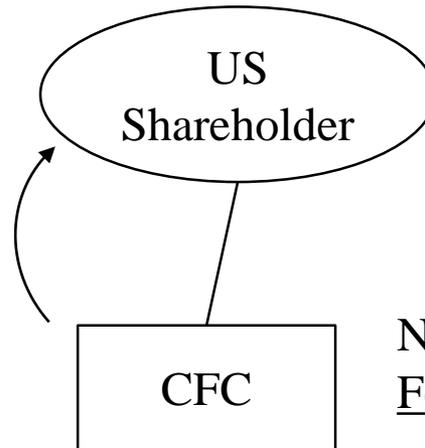


- Section 962 runs the GILTI inclusion through a hypothetical US C Corporation.

Directly Owned CFC – The Code Sec. 962 Election

Inclusion of \$85
 Fed Tax @ 37% = \$31.45

GILTI Inclusion of \$85



Inclusion of \$100
 Corp Tax @ 10.5% = \$10.5
Less Foreign Tax Credit <\$12>
 Net Fed Tax = \$0

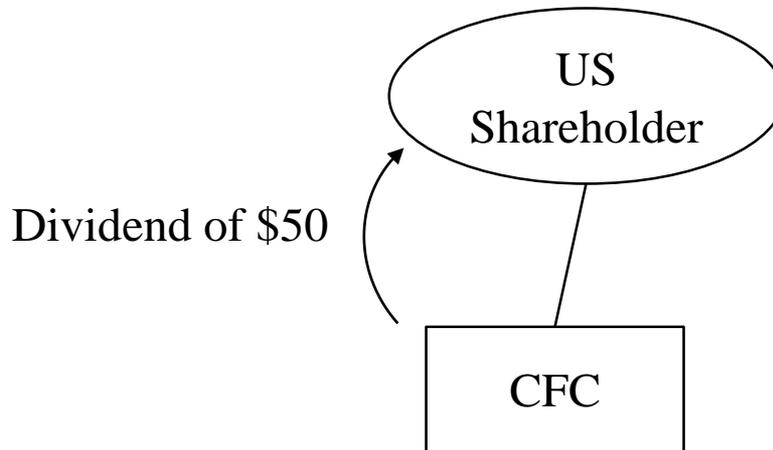
Net Income	\$100
<u>Foreign Tax</u>	<u><\$15></u>
Net GILTI	\$85

- Section 962 runs the GILTI inclusion through a hypothetical US C Corporation.
 - ✓ Hypothetical Rate is Corporate rate
 - ✓ Indirect Credits are available

Section 962 Does Not Avoid Shareholder-Level Tax

- CFC distributions out of Previously Taxed Income are tax-free under Section 959
- With Section 962 Election, amount taxed is limited to hypothetical C Corporation Tax.
- PTI is carved back accordingly. Sec. 962(d)
- Dividends, therefore, will be taxable to the individual when paid.

Actual Dividends Following Section 962



GILTI Inclusion - \$85
Tax under Sec. 962(a) - \$0

Net Income	\$100
Foreign Tax	<\$15>
Net GILTI	\$85

- PTI is carved back to the lesser of—
 - **GILTI Inclusion of \$85**
 - Tax under Sec. 962(a) of \$0
- Hence dividend is fully taxable.

Section 962 – Back to the Future?

- Prior to Tax Reform, individuals with proper planning could defer income from CFCs until repatriated
- Actual dividends may be qualified dividend income
- Low tax rate income may be deferred from US tax indefinitely

Section 962 – Back to the Future?

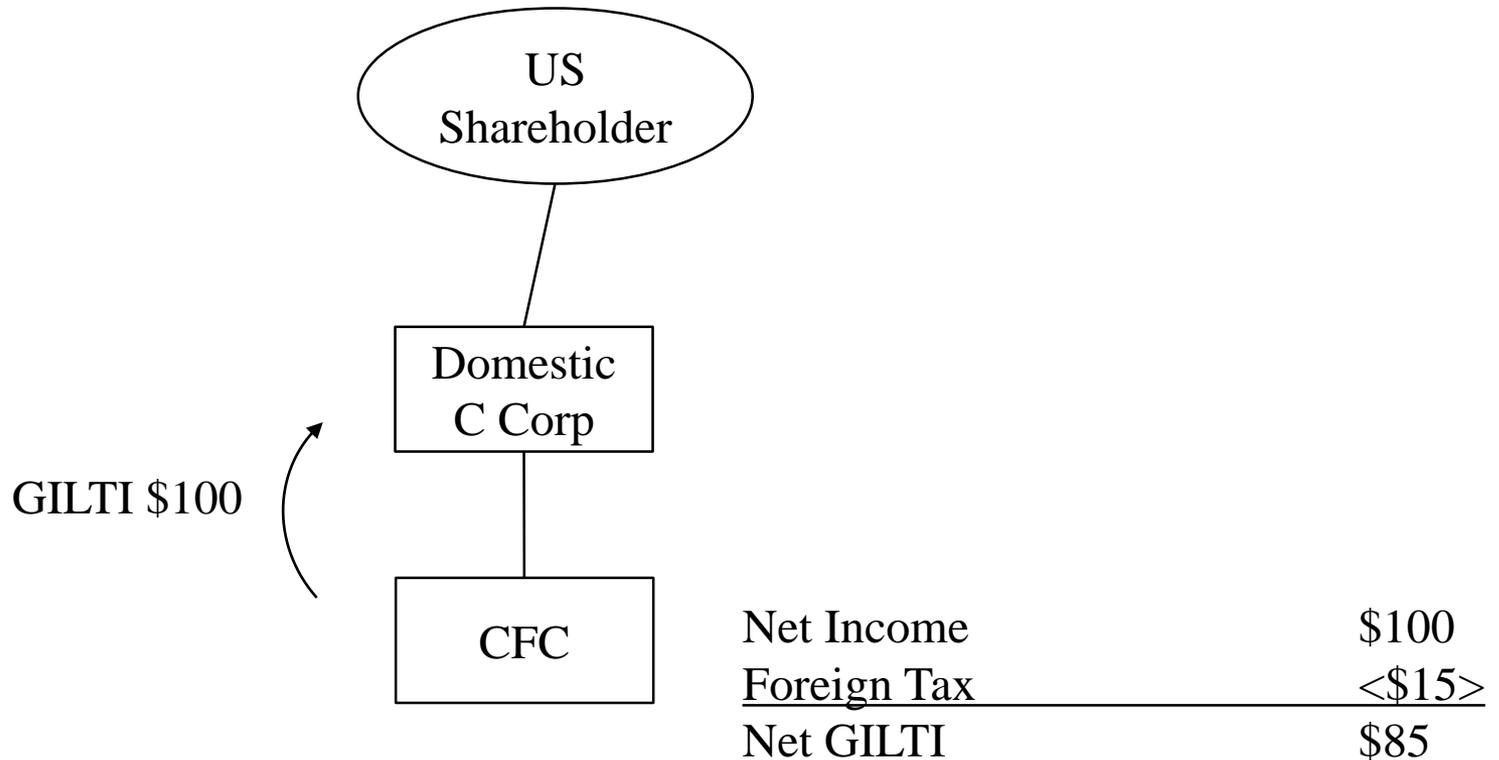
....Not Quite

- After Tax Reform, individuals with a Section 962 election can defer paying US tax on CFC income taxed at least at 13.125%.
- Low rate income subject to immediate top-up tax under GILTI
- Shareholder tax still applies on actual dividend
- Actual dividends may be qualified dividend income (???)

The Proposed High-Taxed Exception to GILTI

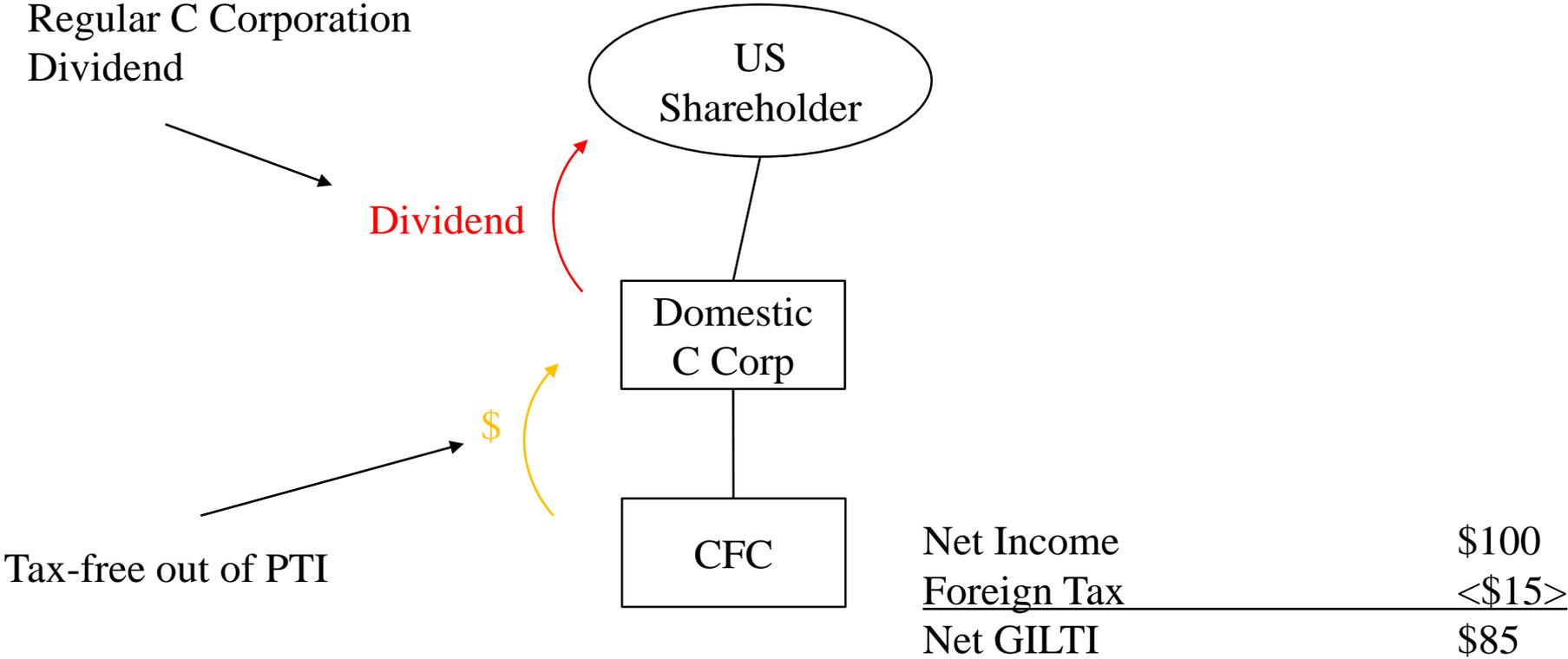
- Subpart F has long had a high-taxed exception for income subject to 90% of the US corporate tax rate (18.9%)
- Recent guidance proposes to extent high-taxed exception to GILTI
- Election is restrictive
 - Tax must be 90% of normal corporate rate (21%) not GILTI rate (10.5%)
 - Consistency requirement
 - 5-year binding election
- Election is prospective only.

The C Corporation Blocker – DIY Section 962



- Domestic C Corporation has GILTI and enjoys foreign tax credit for CFC's taxes.

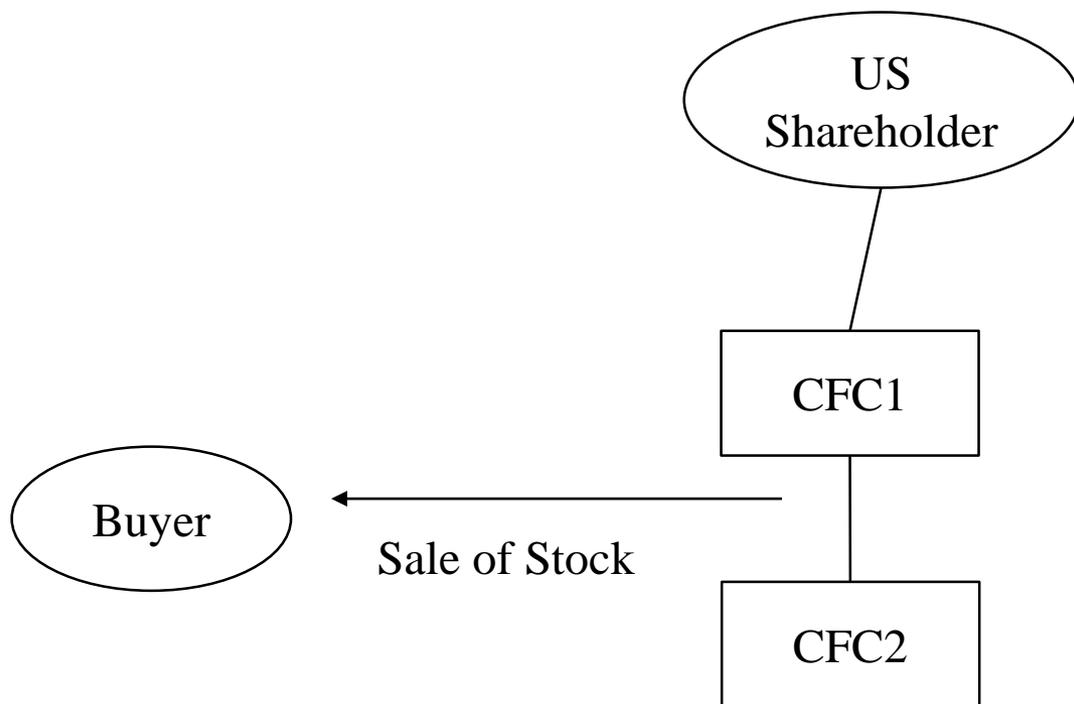
The C Corporation Blocker – Treatment of Actual Dividends



Use of Check-the-Box – Subpart F Income Planning

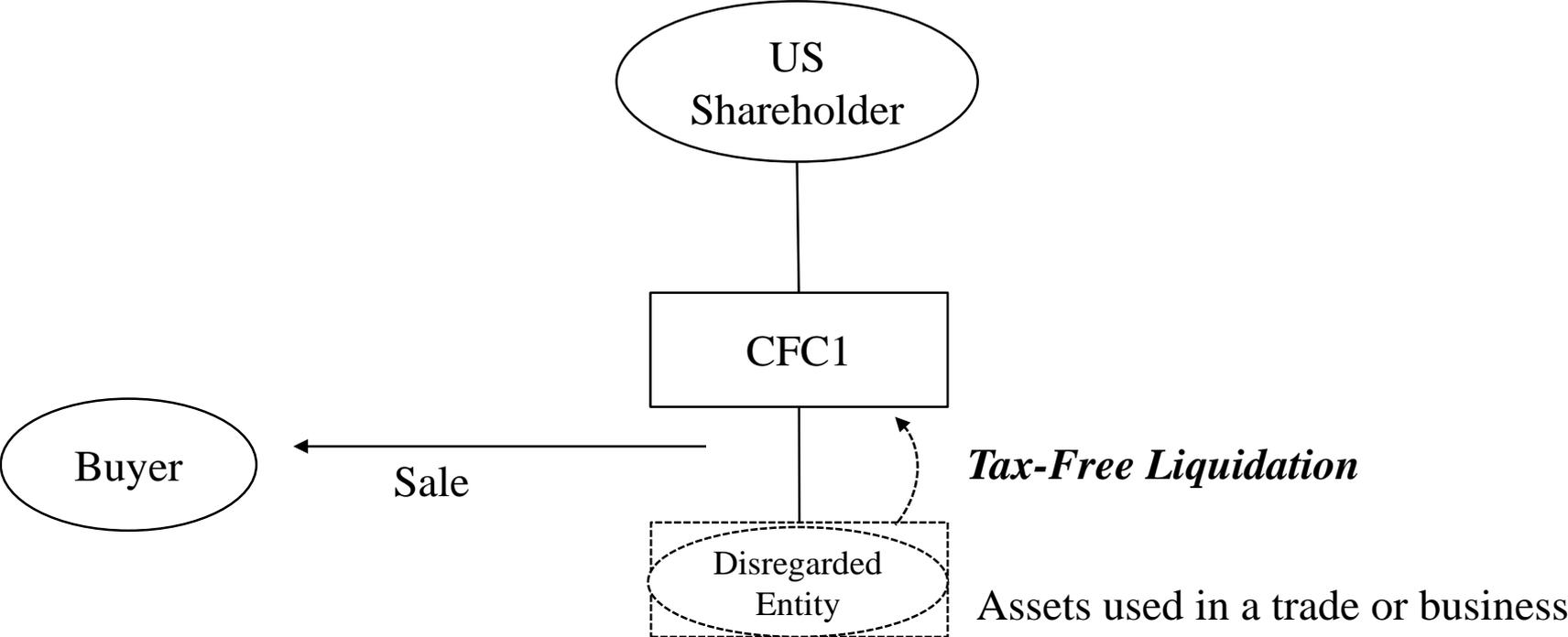
- Subpart F is generally worse than GILTI because it is taxed at full rates – 21% vs. 10.5%.
- Planning to avoid subpart F income is beneficial
- Check-the-box elections continue to be useful to manage subpart F issues

Use of Check-the-Box – the Check and Sell

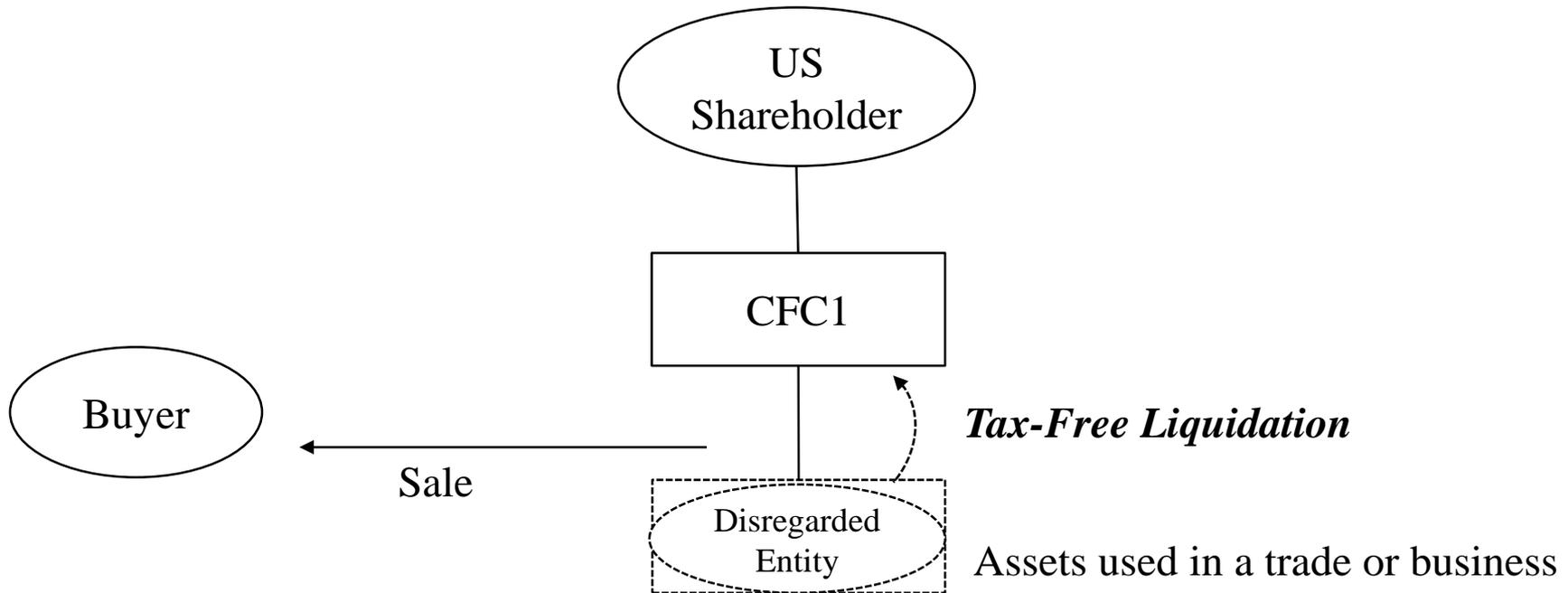


- Sale of CFC stock is subpart F income taxed to US shareholder at no less than 21%

Use of Check-the-Box – the Check and Sell



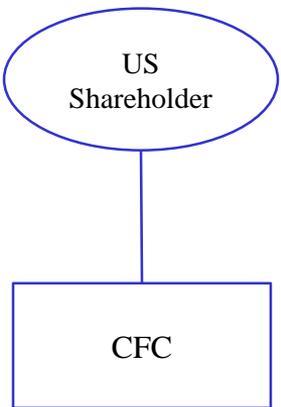
Use of Check-the-Box – the Check and Sell



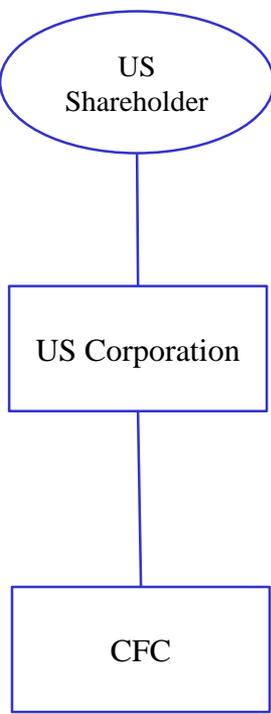
- ✓ Liquidation is tax-free
- ✓ CFC-1 sells assets rather than stock
- ✓ Sale of assets may produce GILTI

Overview of Structure Options for a US Individual Owning a CFC

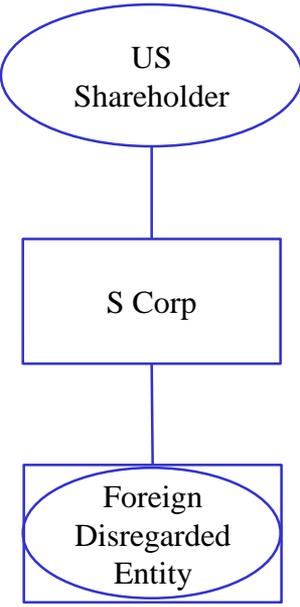
Status Quo:



Blocker C Corp:



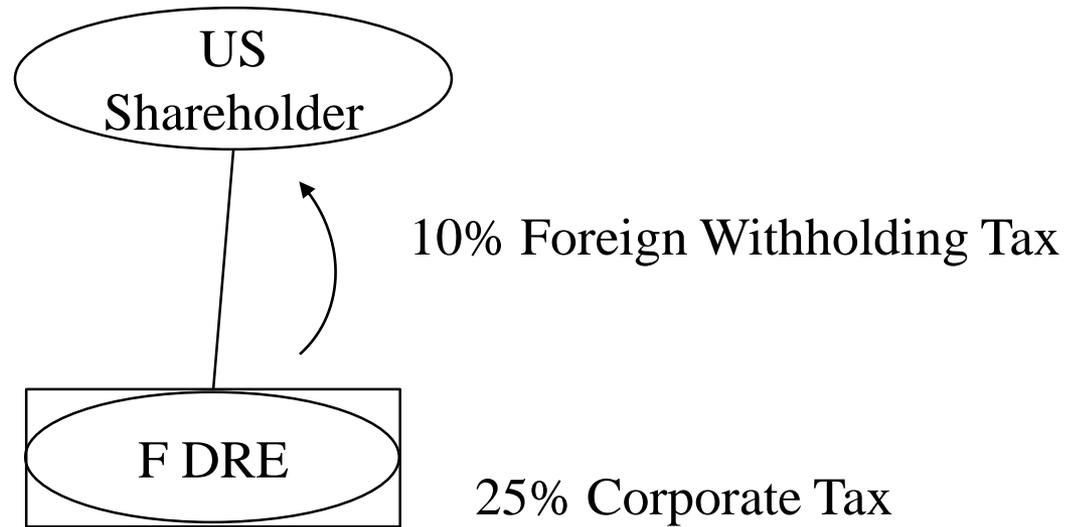
Check-the-Box Structure:



Why would a US person ever check the box?

- Gives us deferral – immediate US tax at full rates
- In return, there is only one level of tax on actual distributions from the branch
- Possibly better FTC usage
- Section 199A deduction for Qualified Business Income (???)

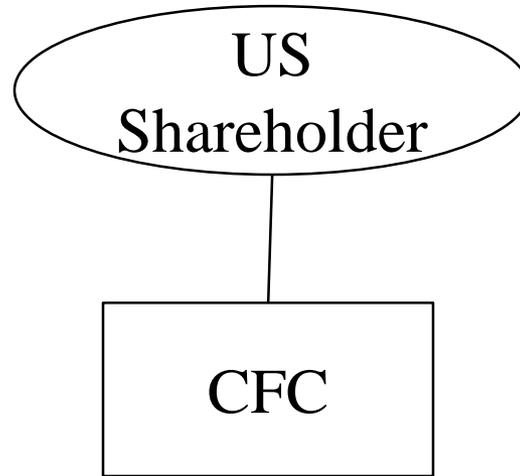
Checking-the-Box for High-Taxed Operations One and Done



- Shareholder reports flow-through income net of foreign tax credit for Corporate tax.
- No US tax on “dividends”
- Withholding taxes likely also creditable

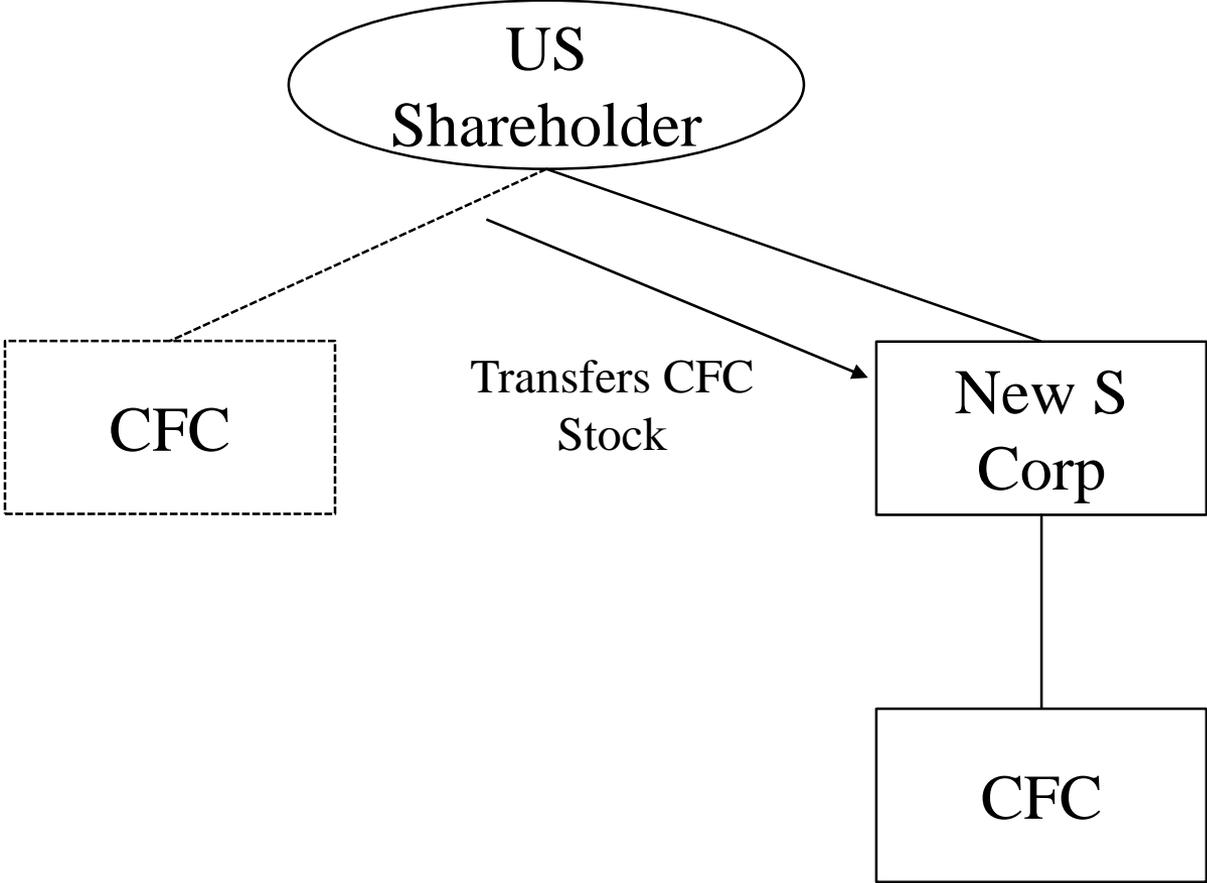
Checking-the-Box for High-Taxed Operations

Getting from Here to There

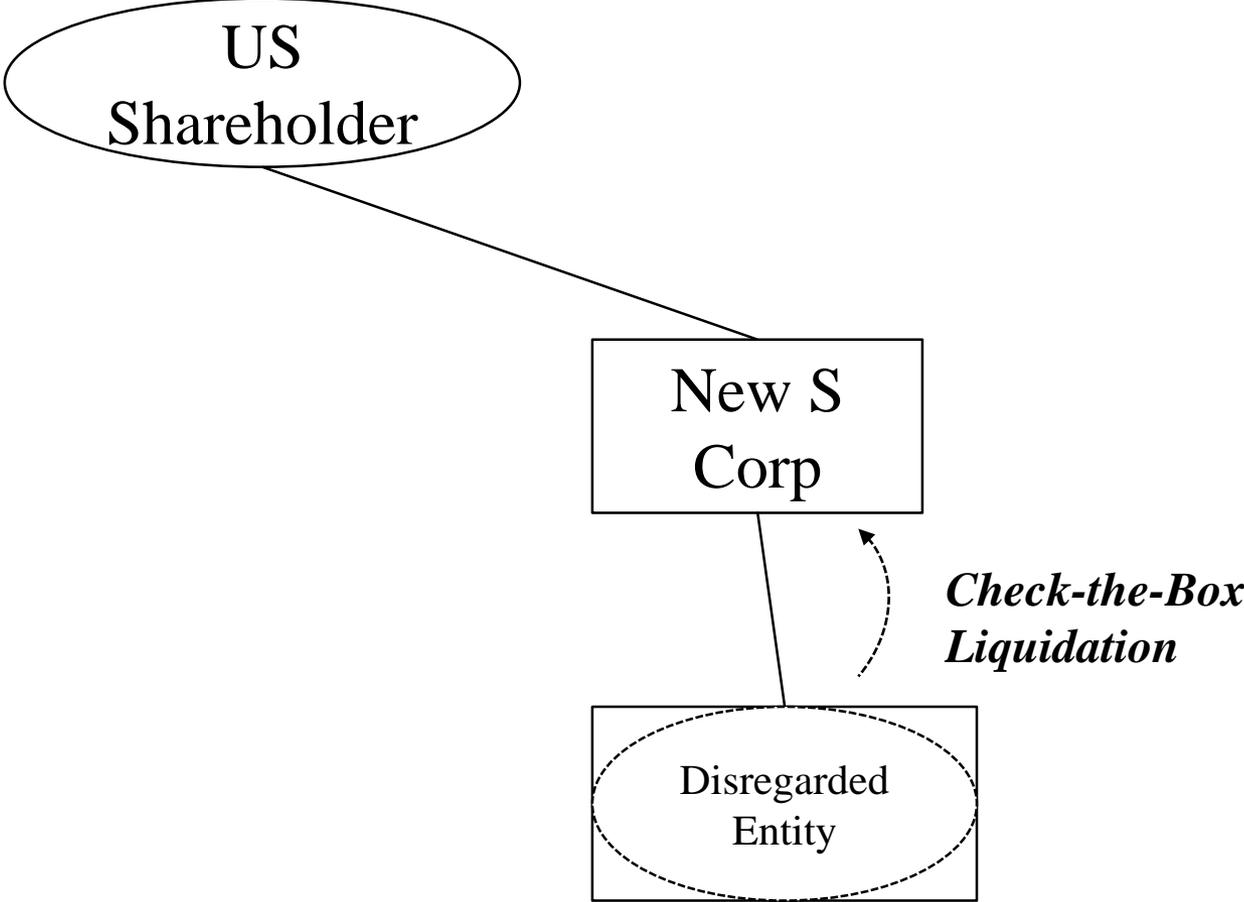


- US shareholder owns a CFC directly and wants to own a DRE.
- Can they simply check the box and move into pass-through solution?

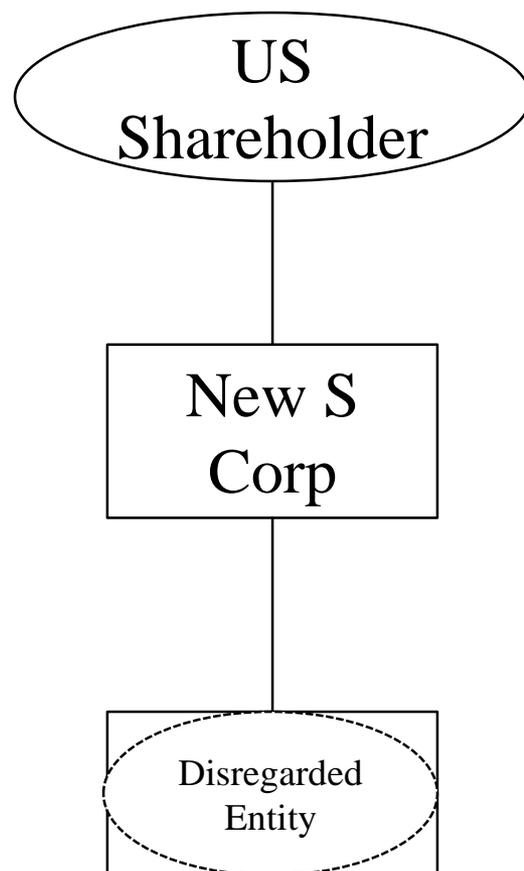
The Answer – the S Corp Reorganization



The Answer – the S Corp Reorganization



End Result





Form 8832 Check-the-Box Entity Elections under I.R.C. Section 7701: Selecting Entities for Foreign Operations

Alison N. Dougherty

September 26, 2019

<https://aronsonllc.com/person/alison-dougherty/>

<https://aronsonllc.com/u-s-expatriate-citizens-by-birth-and-their-u-s-tax-reporting-obligations/>

<https://aronsonllc.com/government-contractors-and-cross-border-payroll-tax-issues/>

<http://blogs.aronsonllc.com/tax/u-s-tax-foreign-persons-gain-sale-u-s-partnership-interest/>

<http://blogs.aronsonllc.com/tax/new-us-international-tax-rules/>

<http://blogs.aronsonllc.com/tax/new-form-5472-filing-requirement-u-s-disregarded-entities-owned-foreign-person/>

<http://blogs.aronsonllc.com/tax/reporting-foreign-accounts-offshore-assets/>

<http://blogs.aronsonllc.com/fedpoint/2012/06/28/international-tax-series-know-the-basics-of-entity-classification-and-check-the-box-when-forming-or-acquiring-a-foreign-company/>

<http://blogs.aronsonllc.com/tax/new-u-s-international-tax-reporting-disclosures-required-on-2016-u-s-federal-form-1065-partnership-tax-return/>

<http://blogs.aronsonllc.com/tax/us-companys-should-process-with-caution-when-filing-tax-returns-with-international-interest/>

<http://blogs.aronsonllc.com/tax/what-should-i-do-if-i-did-not-report>

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Form 8832 Check-the-Box Entity Classification Elections under I.R.C. Section 7701 – Entity Selection Process and Available Elections

- U.S. company structure
 1. C corporation
 2. S corporation
 3. Partnership including multi-member U.S. LLC
 4. Single member wholly-owned U.S. LLC

- Foreign company structure
 1. Foreign corporation (C corporation)
 2. Foreign partnership
 3. Foreign disregarded entity
 4. Foreign branch

Form 8832 Check-the-Box Entity Classification Elections under I.R.C. Section 7701 – Possible Benefits after TCJA

- TCJA and GILTI without check-the-box election for lower-tier CFC subsidiaries of other CFCs:
 - No use of QBAI to decrease GILTI with tested loss of lower-tier CFCs
 - Reduced foreign tax credits due to difference in numerator and denominator of inclusion % attributable to loss from lower-tier CFCs
- Benefits of check-the-box entity classification for lower-tier CFC subsidiaries of other CFCs after TCJA:
 - Use of loss from checked foreign disregarded entity as a deduction of CFC parent to decrease tested income
 - Use of QBAI of checked foreign disregarded entity with tested loss in GILTI calculation
 - Maximum use of foreign tax credits of CFC parent to offset GILTI tax liability

U.S. Federal Check-the-Box Entity Classification

Basic Terminology

- Limited liability - U.S. Treas. Reg. § 301.7701-3(b)(2)(ii)
 1. An owner does not have personal liability for any debts or claims against the entity
 2. Determination is based on the law under which the entity is organized and the organizational documents
 3. An owner has personal liability if the creditors of the entity can satisfy all or part of the debts or claims against the entity from the owner
 4. An owner has personal liability even if the owner makes an agreement where any person assumes the liability or agrees to indemnify the owner for the liability

U.S. Federal Check-the-Box Entity Classification

Basic Terminology

- Foreign corporation
 1. Listed - foreign entity on the per se foreign corporation list
 2. By default - All owners of the foreign entity have limited liability
 3. By election – all owners of a foreign eligible entity do not have limited liability

- Foreign partnership
 1. By default – more than one owner of foreign entity and at least one owner does not have limited liability
 2. By election – more than one owner of foreign eligible entity and all owners have limited liability

U.S. Federal Check-the-Box Entity Classification

Basic Terminology

- Foreign disregarded entity
 1. By default – foreign entity with one owner that does not have limited liability that is treated as an entity not separate from its single owner for U.S. Federal income tax purposes
 2. By election – foreign eligible entity with a single owner that does have limited liability that elects to be classified as an entity not separate from its single owner for U.S. Federal income tax purposes

U.S. Federal Check-the-Box Entity Classification

Basic Rules

- Foreign eligible entity
 1. foreign entity not included on the per se foreign corporation list
 2. Foreign entity that is a foreign corporation, foreign partnership, or foreign disregarded entity per default rule

- Foreign entity default rule - Classification unless election filed
U.S. Treas. Reg. § 301.7701-3(b)(2)(i)
 1. A partnership if it has two or more members and at least one member does not have limited liability.
 2. An association taxable as a corporation if all members have limited liability.
 3. Disregarded as an entity separate from its owner if it has a single owner that does not have limited liability.

U.S. Tax Advantages and Pitfalls with Income and Losses from Different Structures – Foreign Corporation

- Foreign corporation
 1. Not controlled by U.S. persons – Tax advantage of deferral
 2. Controlled by U.S. persons (CFC) – No deferral with I.R.C. § 951(a)(1)(A) Subpart F income, § 956 inclusion, § 965 transition tax inclusion, and § 951A GILTI inclusion
 3. 10% U.S. C corporation shareholder or U.S. individual shareholder with I.R.C. § 962 election may claim I.R.C. § 960 foreign tax credit with Subpart F income, transition tax inclusion, or GILTI inclusion
 4. U.S. shareholders cannot claim losses
 5. Form 5471 filing requirement in some circumstances

U.S. Tax Advantages and Pitfalls with Income and Losses from Different Structures – Foreign Partnership

- Foreign partnership
 1. No deferral
 2. Current year inclusion of U.S. partner's distributive share of income, gain, loss, deduction, and credit from foreign partnership on U.S. partner's U.S. tax return
 3. Foreign income taxes paid by foreign partnership pass through and are creditable to U.S. partner against U.S. tax on foreign source taxable income but subject to limitation
 4. U.S. partner deducts foreign partnership losses only to the extent of basis, at risk, and passive activity loss rules
 5. Form 8865 filing requirement in some circumstances

U.S. Tax Advantages and Pitfalls with Income and Losses from Different Structures – Foreign Disregarded Entity or Branch

- Foreign Disregarded Entity
 1. No deferral
 2. Current year inclusion of 100% of FDE's income and loss on U.S. owner's U.S. tax return
 3. Foreign income taxes paid by the FDE pass through and are creditable to U.S. owner against U.S. tax on FDE's foreign source taxable income
 4. Foreign taxes categorized in the separate branch foreign tax credit limitation basket
 5. Form 8858 filing requirement
- Foreign Branch
 1. No deferral
 2. Current year inclusion of 100% of branch income and loss on U.S. company's tax return
 3. Foreign income taxes paid on branch activity are creditable to U.S. company against U.S. tax on foreign source branch taxable income
 4. Foreign taxes categorized in separate branch foreign tax credit limitation basket
 5. Form 8858 filing requirement

Form 8832 Check-the-Box Entity Classification Election

Page One

Form 8832 (Rev. December 2013) Department of the Treasury Internal Revenue Service	Entity Classification Election ▶ Information about Form 8832 and its instructions is at www.irs.gov/form8832 .	OMB No. 1545-1516
Type or Print	Name of eligible entity making election Employer identification number	
	Number, street, and room or suite no. If a P.O. box, see instructions.	
	City or town, state, and ZIP code. If a foreign address, enter city, province or state, postal code and country. Follow the country's practice for entering the postal code.	
	▶ Check if: <input type="checkbox"/> Address change <input type="checkbox"/> Late classification relief sought under Revenue Procedure 2009-41 <input type="checkbox"/> Relief for a late change of entity classification election sought under Revenue Procedure 2010-32	

Part I Election Information

1 Type of election (see instructions):

- a Initial classification by a newly-formed entity. Skip lines 2a and 2b and go to line 3.
- b Change in current classification. Go to line 2a.

2a Has the eligible entity previously filed an entity election that had an effective date within the last 60 months?

- Yes. Go to line 2b.
- No. Skip line 2b and go to line 3.

2b Was the eligible entity's prior election an initial classification election by a newly formed entity that was effective on the date of formation?

- Yes. Go to line 3.
- No. Stop here. You generally are not currently eligible to make the election (see instructions).

3 Does the eligible entity have more than one owner?

- Yes. You can elect to be classified as a partnership or an association taxable as a corporation. Skip line 4 and go to line 5.
- No. You can elect to be classified as an association taxable as a corporation or to be disregarded as a separate entity. Go to line 4.

4 If the eligible entity has only one owner, provide the following information:

- a Name of owner ▶ _____
- b Identifying number of owner ▶ _____

5 If the eligible entity is owned by one or more affiliated corporations that file a consolidated return, provide the name and employer identification number of the parent corporation:

- a Name of parent corporation ▶ _____
- b Employer identification number ▶ _____

For Paperwork Reduction Act Notice, see instructions.

Cat. No. 22598R

Form **8832** (Rev. 12-2013)

Form 8832 Check-the-Box Election

Who must file?

- A foreign eligible entity that has more than one owner, all owners having limited liability, electing to be classified as a foreign partnership.
- A foreign eligible entity that has at least one owner that does not have limited liability, electing to be classified as an association taxable as a foreign corporation.
- A foreign eligible entity with a single owner having limited liability, electing to be a foreign entity disregarded as an entity separate from its owner.
- A foreign eligible entity electing to change its current classification (even if it is currently classified under the default rule).

Form 8832 Check-the-Box Election

When to file?

- Timely filed election – Effective date is not retroactive more than 75 days prior the date when the election is filed
- Prospective election – Effective date is not more than 12 months after the date when the election is filed
- 60-month limitation rule – Election cannot be changed within 60 months of the effective date of a prior election. This rule does not apply if the prior election was made by a newly formed eligible entity and was effective on the date of formation.
- Late election relief

Form 8832 Check-the-Box Election Late Election Relief

Rev. Proc. 2009-41, Section 4.01 late election requirements

- The entity did not obtain the requested classification as of formation date or when it became relevant or it did not obtain change in classification solely because Form 8832 was not filed.
- The entity (or affected person) has not filed a U.S. Federal tax or information return for the first year of election because the due date has not passed, OR
- The entity (or affected person) has timely filed all required U.S. Federal tax returns and information returns (or if not timely filed within 6 months of the original due date) consistent with the election for all years for which the election is to be effective and no inconsistent tax or information returns have been filed during any of the tax years.
- The entity has reasonable cause for its failure to timely file the election.
- Three years and 75 days from the requested effective date of the election have not passed.

Form 8832 Check-the-Box Election

I.R.C. Section 9100 Late Election Relief

- U.S. Treas. Reg. § 301.9100-3 allows Form 8832 check-the-box late election relief by filing a Private Letter Ruling request with the IRS.
- See Rev. Proc. 2019-1, Section 5.03(5) and (6).
- U.S. Treas. Reg. § 301.9100-3 late election relief by PLR is available if the requirements of Section 4.01 of Rev. Proc. 2009-41 are not satisfied.
- As a condition, must be able to make the following statement in the PLR request per Rev. Proc. 2019-1, Section 5.03(5).

All required U.S. tax and information returns of the entity (or, if the entity was not required to file any such returns under the desired classification, then all required U.S. tax and information returns of each affected person as defined in Section 4.02 of Rev. Proc. 2009-41) were filed timely or within 6 months of the due date of the respective return (excluding extensions) as if the entity classification election had been in effect on the requested date. No U.S. tax or information returns were filed inconsistently with those described in the prior sentence.

Form 8832 Check-the-Box Election Relief for Late Change of Election

- Rev. Proc. 2010-32 Election with Incorrect Number of Owners
 1. Foreign entity files election to be classified as a foreign partnership based on reasonable assumption that it had two or more owners as of the effective date of election and then it is later determined that the foreign entity only has one single owner, the IRS will allow a deemed election to classify the foreign entity as a foreign DRE
 2. Foreign entity files election to be classified as a foreign DRE based on reasonable assumption that it had one owner as of the effective date of the election and it is later determined that the foreign entity has two or more owners, the IRS will allow a deemed election to classify the foreign entity as a foreign partnership
- Requirements for late election change relief
 1. The entity and the entity's owners file original or amended U.S. Federal income tax returns consistent with the change in the classification
 2. Amended tax returns are filed by the close of the statute of limitations
 3. Corrected Form 8832 with late change of election box checked is filed and attached to the amended tax returns

Form 8832 Check-the-Box Election

U.S. Federal Tax Consequences of Election

- U.S. Federal tax consequences of filing the election:
 1. Partnership to corporation – Partnership contributes all assets and liabilities to corporation and then makes liquidating distribution of the stock to the former partners
 2. Corporation to partnership – Corporation makes liquidating distribution of all assets and liabilities to the shareholders who then contribute them to the partnership in exchange for partnership interests
 3. Corporation to DRE – Corporation makes liquidating distribution of all assets and liabilities to sole shareholder
 4. DRE to corporation – Sole member contributes all assets and liabilities of DRE in exchange for stock of the corporation

Form 8832 Check-the-Box Election

Completing Page One

- Need to obtain a U.S. FEIN for the foreign entity to report on the Form 8832
- Name, address and U.S. FEIN (required) for foreign entity filing the election
- Check box to indicate address change, late election relief under Rev. Proc. 2009-41 or late change of election under Rev. Proc. 2010-32
- Line 1 Type of election – Indicate whether initial election or change in election
- Line 2a – If change in election, was the prior election filed with an effective date in the last 60 months?
- Line 2b – If election was filed with effective date within last 60 months, was the prior election effective on date of formation of a newly formed entity? If no, then a change in election is not allowed.
- Line 3 – Does the entity have more than one owner? If yes, then entity can elect to be a corporation or partnership. If no, then entity can elect to be corporation or DRE.
- Line 4 – If entity has one owner, provide name and U.S. taxpayer ID number.
- Line 5 – If entity is owned by one or more affiliate entities that file a U.S. consolidated tax return, provide name and U.S. FEIN of the common parent corporation.

Form 8832 Check-the-Box Election

Completing Page Two, Part I Election Information

- Line 6 – Type of Entity
 1. A foreign eligible entity electing to be classified as an association taxable as a corporation.
 2. A foreign eligible entity electing to be classified as a partnership.
 3. A foreign eligible entity with a single owner electing to be disregarded as a separate entity.
- Line 7 - Country of organization
- Line 8 - Effective date of election
- Line 9 – Name and title of contact person

Form 8832 Check-the-Box Election

Completing Page Two, Part I Election Information

- Penalties of perjury consent statement with signature and date of officer, manager or member of the entity
 1. Must be signed by each member of the electing entity who is an owner at the time that the election is filed, or
 2. By any officer, manager or member of the electing entity who is authorized (under local law or the organizational documents) to make the election. The person signing the election represents to have such authorization under penalties of perjury.
 3. If an election is to be effective for any period prior to the time it is filed, each person who was an owner between the date the election is to be effective and the date the election is filed, and who is not an owner at the time the election is filed, must sign.

Form 8832 Check-the-Box Election

Completing Page Three, Part II

- Late election relief affidavit with statement of reason why election was not filed on time
- Signed and dated statement under penalties of perjury that Rev. Proc. 2009-41, Section 4.01 requirements are satisfied, the person signing the statement has examined the election and accompanying documents, has personal knowledge of the relevant facts and circumstances and that such facts and circumstances are true, correct and complete.
- Part II of Form 8832 must be signed by an authorized representative of the eligible entity and each affected person.
- Affected person is any person who would be required to attach the Form 8832 election to their respective U.S. Federal income tax return and file certain U.S. Federal international tax information returns to report ownership of the foreign entity.

ALISON N. DOUGHERTY
DIRECTOR, TAX SERVICES
ARONSON LLC



Alison N. Dougherty provides tax services as a Director at Aronson LLC. Alison specializes in international tax reporting, compliance, consulting, planning, and structuring as a subject matter leader of Aronson's international tax practice. She has extensive experience assisting clients with U.S. tax reporting and compliance for offshore assets and foreign accounts. She provides outbound U.S. international tax guidance to U.S. individuals and businesses with activities in other countries. She also provides inbound U.S. international tax guidance to nonresident individuals and businesses with activities in the United States. She has worked extensively in the area of U.S. international tax reporting and compliance with the preparation of the U.S. Federal Forms 5471, 926, 8865, 8858, 5472, 1042, 1042-S, 8621, 8804, 8805, 8813, 8288, 8288-A, 8288-B, 1116, 1118, 1120-F, 1040-NR, 3520, 3520-A, 2555, 5713, 8832, 8833, 8840, 8843, 8854, 8938, and FBAR. She has counseled U.S. taxpayers regarding the outbound formation, capitalization, acquisition, operation, reorganization, and liquidation of foreign companies. She has significant experience with U.S. Federal nonresident tax withholding, foreign partner tax withholding, and FIRPTA withholding. She works closely with nonresident individuals and businesses regarding inbound U.S. real property investment. She often assists U.S. taxpayers with IRS amnesty program disclosures of offshore assets and foreign accounts.

Alison completed the LL.M. (Master of Laws) in Securities and Financial Regulation in 2004 with academic distinction at Georgetown University Law Center. She completed the LL.M. (Master of Laws) in Taxation in 2000 and the Juris Doctor in 1999 at the University of Denver College of Law. She completed a Bachelor of Arts degree in Foreign Language in 1995 at Virginia Commonwealth University.

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