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

MONDAY, JULY 18, 2022, 1:00-2:50 pm Eastern

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July 18, 2022

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Agenda

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

II. Basic Entity Classification Rules for Foreign Entities owned by U.S. Persons

- When is a foreign entity's classification "relevant" so that a choice must be made?
- Per Se Corporations *vs.* Eligible Entities
- The default classification regulations for domestic and foreign entities
- Substantive tax effects of making a CTB election (or change in classification)

III. The Increased U.S. Tax Stakes (since 2017) for U.S. Persons in Selecting TYPE of Foreign Entity

- End of "US tax deferral privilege" for foreign corporate subsidiaries
- Six ways the purview of Subpart F broadened: navigating pitfalls
- § 951A GILTI taxes virtually all CFC's operating income (creating phantom income)
- § 245A 100% DRD: maximizing the partial participation exemption
- § 267A limits the use of "hybrid entities" for tax arbitrage (anti-BEPS measure)

IV. Advanced Tax Considerations in CTB Election and Foreign Entity Selection Process

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- Entity selection in light of § 962 election
- Entity selection in light of Final High-Tax GILTI Exclusion Regs
- Entity selection in light of the new Foreign Branch Basket of FTC Regs
- Outbound transfers to foreign corporations vs. to foreign partnerships
- Disposition of partnership interests by foreign partners - § 864(c)(8)
- "Check & Sell" transactions
- § 338(g) elections

V. Completing IRS Form 8832

- Mechanics and Pitfalls
- Late elections

VI. Advanced Entity Selection Considerations in light of Final Anti-Hybrid § 267A Regs & Foreign Rules

VII. Key Takeaways and Q&A.

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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.

A Business Entity's Classification is *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 (under US federal tax system). Instead, income, profits, and losses are treated as "flowing thru" to 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 multifactor 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 effectively 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 arguably:

- **Vulnerable to Manipulation** *(optionality was already built in!)*
- **Uncertain** (often requiring an investigation into foreign company law)
- **Complex and expensive to apply** (need to continually monitor for changed circumstances and amended 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 the desired *tax* classifications— 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. Check-the-Box Entity Classification Rules for Foreign Entities

- When does a foreign entity's classification become "relevant" so that a classification must be made?
- Per Se Corporations vs. Eligible Entities
- Default Classification Regs
- Substantive tax effects of making a CTB 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 Partnerships, a Treasury regulation provides otherwise. IRC §7701(a)(4).
- **Foreign**: In respect to 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. Entity must be a "business entity" (i.e., not a trust), AND
  3. Entity must *not* be a "deemed corporation" as defined (i,e., not a "per se corporation" in slang terms).
- **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 "deemed corporation" list in Reg. § 301.7701-2(b)(8) or as so defined.

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 foreign 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 tax transparent partnership (or disregarded branch)—i.e., a tax "flow-through"-- by another country.
- **Regular Hybrid**: An entity that the U.S. views as a tax transparent partnership or disregarded entity, and another non-U.S. jurisdiction views as a tax opaque corporation.
- **Reverse Hybrid**: An entity the U.S. views as a tax-opaque corporation, and the other country views as a tax transparent 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 – The KEY 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.*** ***See*** Reg. 301.7701-3(d).
  - **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.*

KEY effects of a CTB Election: Can Often 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 because there would be deemed outbound transfers of property.)

- 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 the partnership has a related foreign partner, raising §704(c) concerns.)

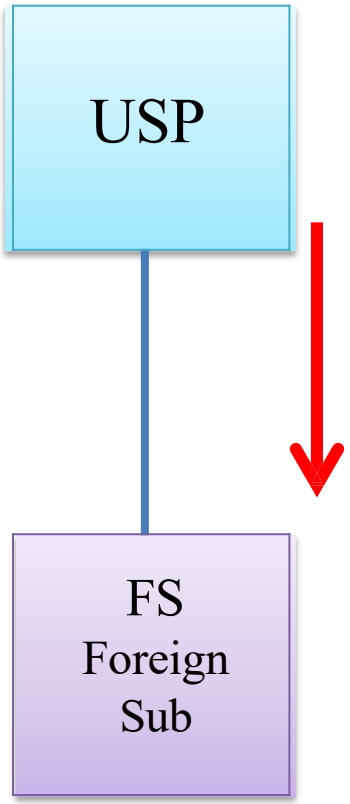
- If an eligible entity classified as an association elects to be disregarded as an entity separate from its owner, the association is deemed to distribute all of its assets and liabilities to its single owner in liquidation of the association. (Again, the liquidation must be tested under §§ 331and 332.)

- 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)?)

CTB Election Effect: Could Trigger §367(a) &/or (d)
But also *might* create a planning opportunity

- § 367 now results in income or gain recognition on all outbound transfers of tangible and intangible property.
- But if the transferor is a US C-Corp, tax is imposed at a 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).**



USP transfers tangible and intangible assets to FS

Effect of CTB Election – Example

Planning for Inbound Asset Transfers in light of § 245A

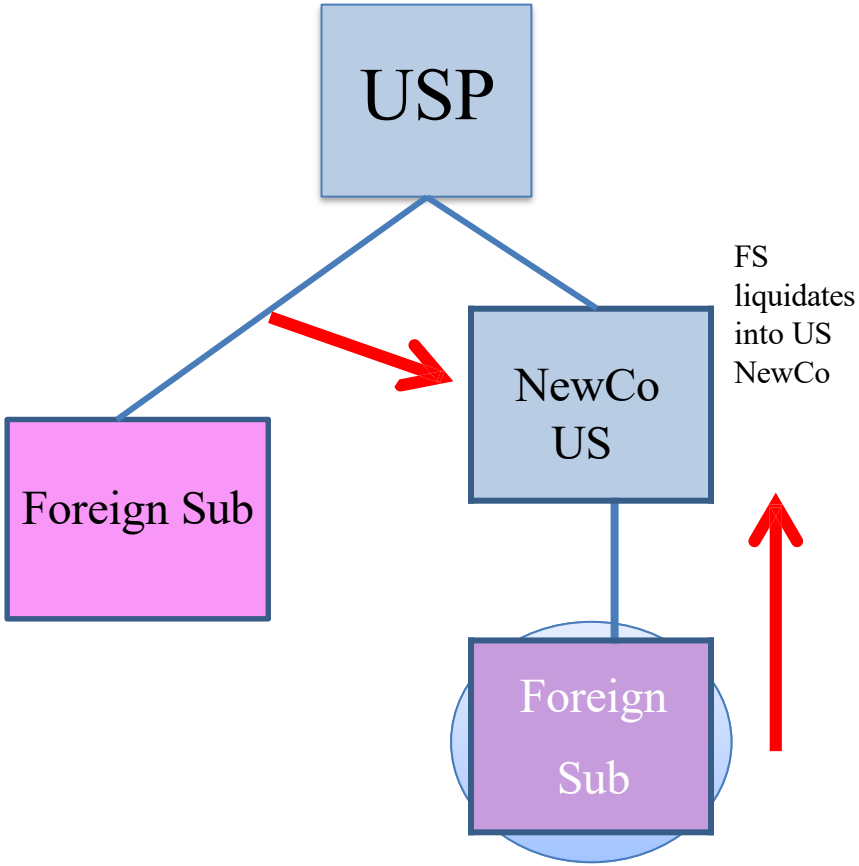
Assumed Facts:

- USP contributes the stock of FS to Newco US, 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 332 liquidation.

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.

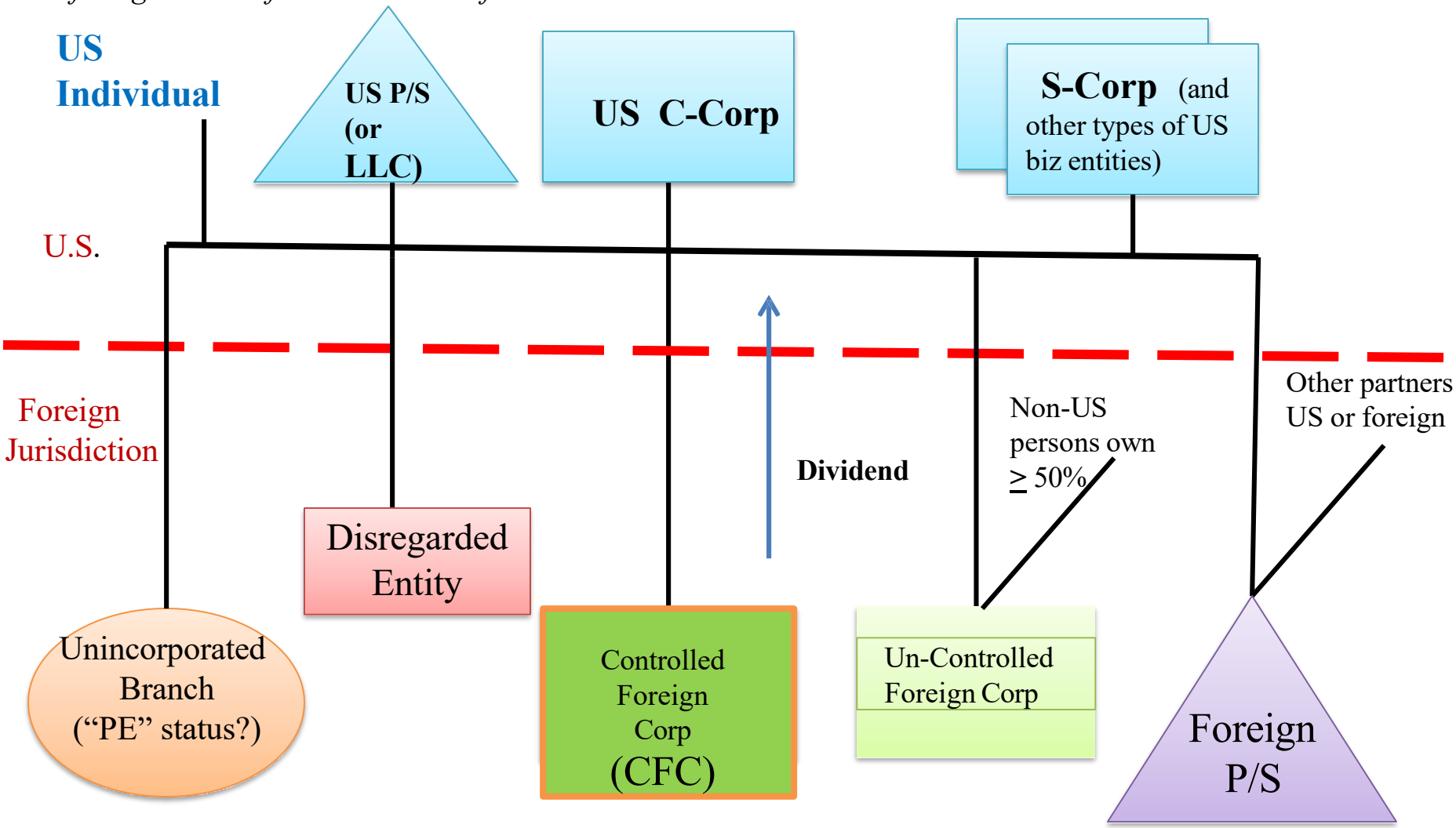


III. Increased U.S. Tax Stakes in Selecting the Type/Form of the Foreign Entity

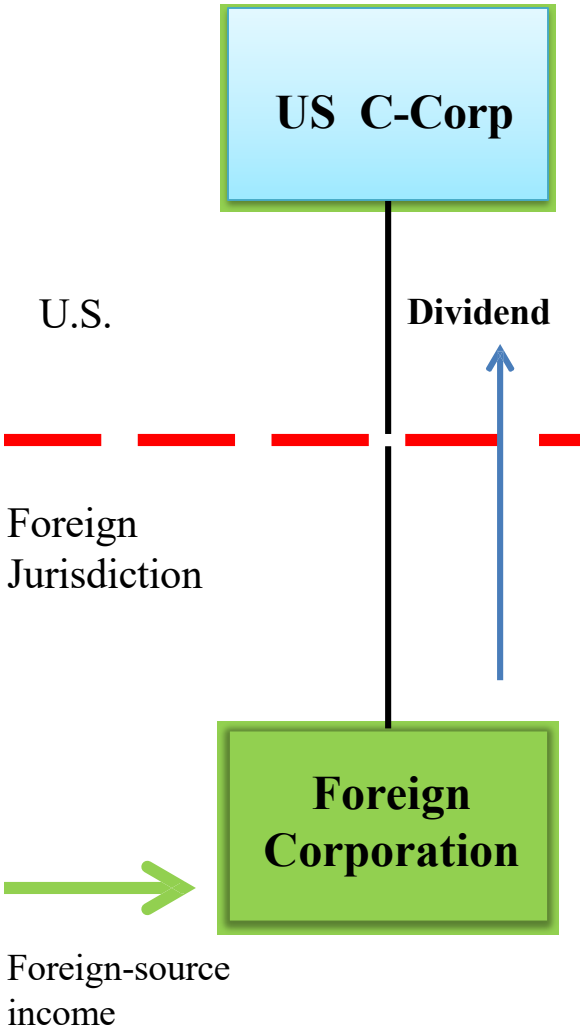
- End of U.S. Tax Deferral Privilege for foreign corporate subsidiaries
- Six Ways subpart F's purview was broadened – navigating the pitfalls
- § 951A GILTI taxes almost all the operating income of a CFC currently (phantom income)
- § 245A 100% DRD: but only available to C Corps
- § 267A limits use of hybrid entities for tax arbitrage

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."*



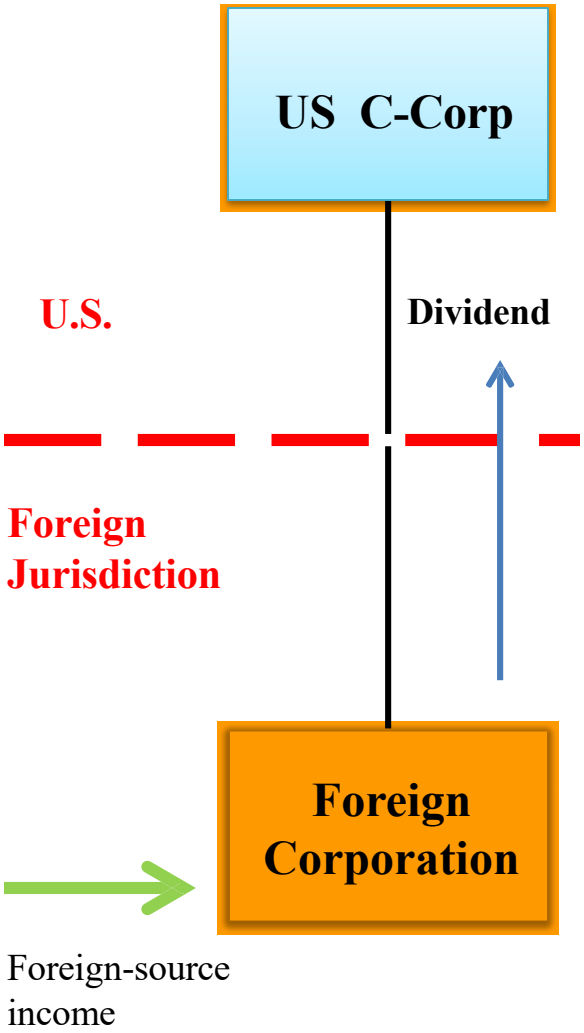
TCJA Drastically Changed How a Foreign Subsidiary's Income of a US Corporation is taxed



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).

Post TCJA: Generally No More Deferral – Foreign 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, and 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).**

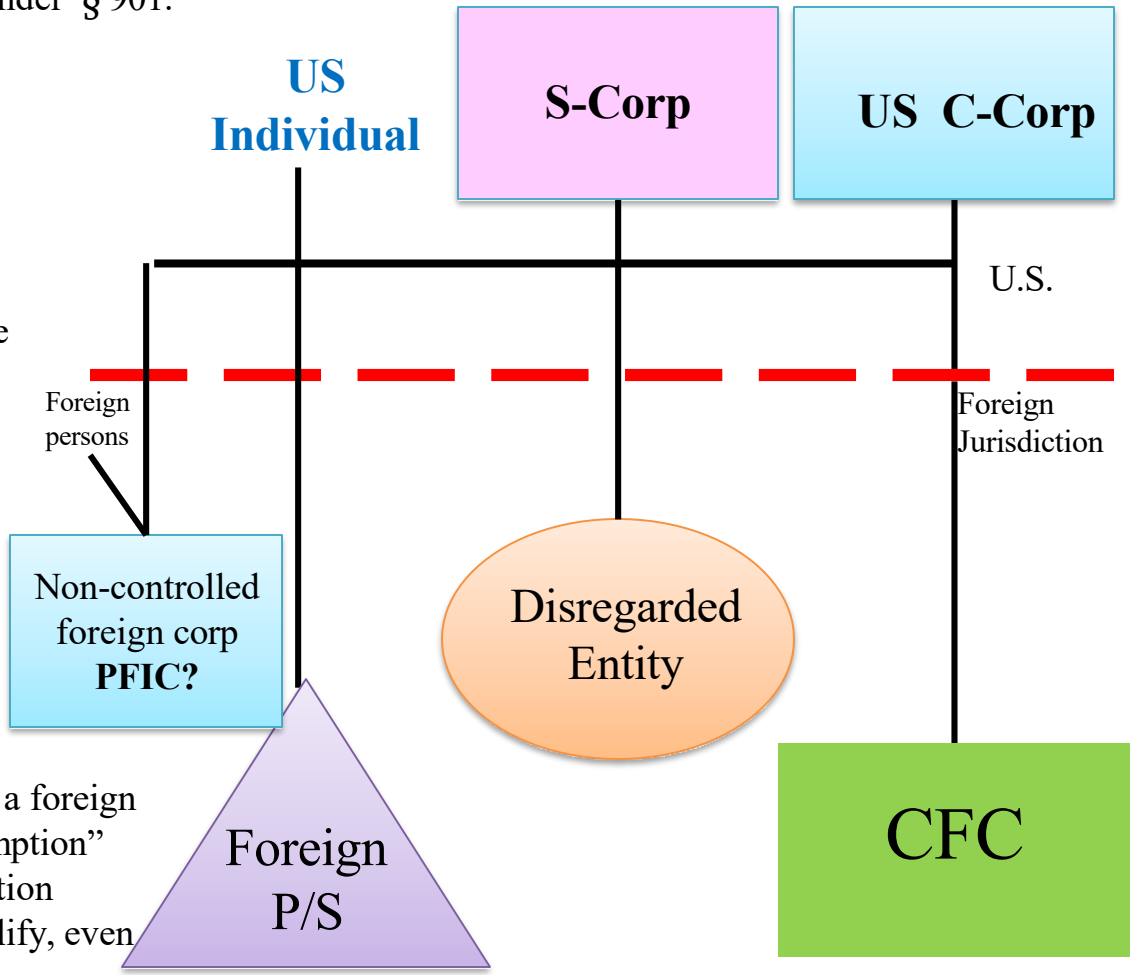
Three categories of foreign-source income of foreign Subs are now EXEMPT . *But these may not amount to much due to the breadth of the new GILTI minimum tax.* They include:

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%).

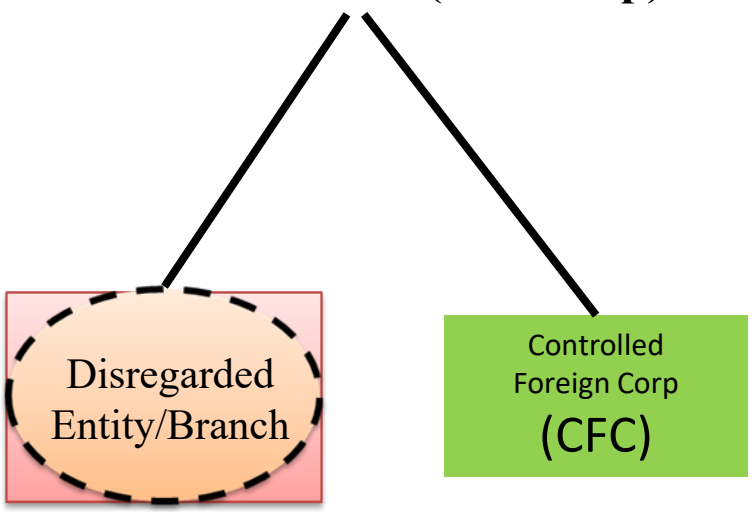
A Few Basic Observations of Tax Stakes in Business Entity Selection

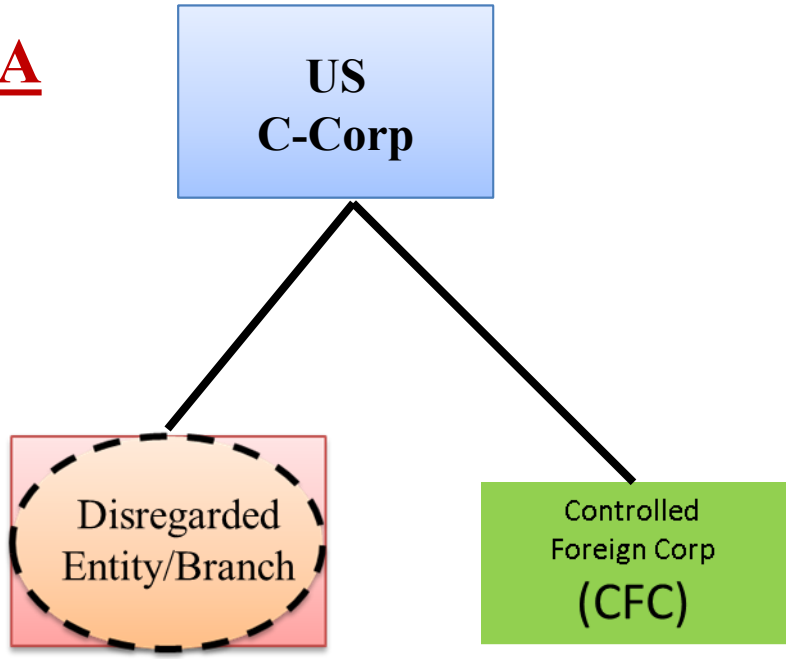
- When foreign entity is a "tax transparent" entity (i.e., P/S, DE, or branch), its US members are taxed currently with no tax deferral, and get a direct FTC under § 901.
- But when foreign entity is a CFC, 10% "US shareholders" are subject to current tax under:
  - Subpart F – § 951(a)
  - GILTI – § 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, even if a § 962 election is made.



Tax Stakes & Considerations in Selecting Foreign Branch v. Foreign Corp (Pre-TCJA)

PRE – TCJA





Branch Income:

- No deferral; Taxed at max rate of 39.6%.
- Individual entitled to a direct FTC under § 901(a). Foreign taxes imposed on the branch NOT in a separate branch basket. (So, some cross crediting allowed.)

CFC Income:

- US tax deferral allowed unless until E&P distributed OR Subpart F or PFIC rules ended deferral.
- Tax rate = US individual rate (max 39.6%).
- Due to time value of money, tax deferral ultimately = a tax exemption.
- Direct FTC under § 901(a).

Branch Income:

- No deferral; Taxed at max rate of 35%.
- US Corp entitled to a direct FTC under § 901(a). (No deemed FTC.) Foreign taxes imposed on the branch NOT in a separate branch basket. (So, some cross crediting allowed.)

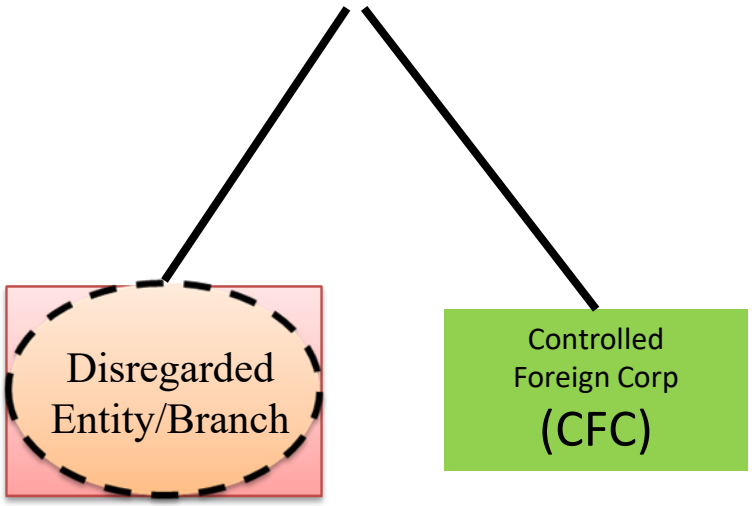
CFC Income:

- US tax deferral allowed unless until E&P distributed OR Subpart F or PFIC rules ended deferral.
- Tax rate = US corporate rate = 35%
- Due to time-value of money, tax deferral ultimately = a tax exemption.
- Direct FTC under § 901(a), and deemed FTC under § 902.

Tax Stakes & Considerations in Selecting Foreign Branch v. Foreign Corp (POST-TCJA)

POST – 2017 TCJA

US Individual (or S-Corp)



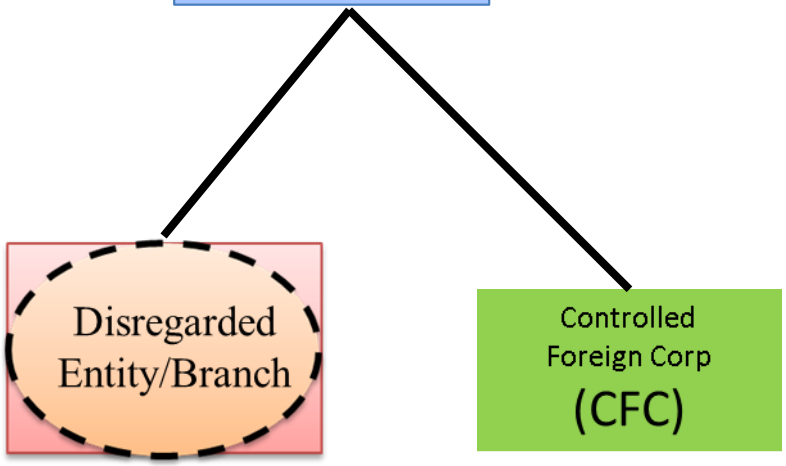
Branch Income:

- Still no deferral; Taxed at max rate of 37%
- Individual entitled to a direct FTC under § 901(a).
- Limited FTC utilization because foreign taxes are in separate branch basket.

CFC Income:

- US tax deferral greatly diminished by GILTI regime. QBAI (if any) is exempt.
- US Individual rate = max of 37% , UNLESS § 962 election is made to get (a) lower 21% corp rate, (b) 50% GILTI dd under § 250 (10.5% nominal).
- FTCs for GILTI in separate basket, w/20% haircut & no carryovers.
- Also, non-Corp not qualified for § 245A 100% DRD, even if § 962 elected.

US C-Corp



Branch Income:

- No deferral; Taxed at max rate of 21%.
- US Corp entitled to a direct FTC under § 901(a). (No deemed FTC.) Foreign taxes imposed on the branch now in a separate branch basket, limiting cross-crediting.

CFC Income:

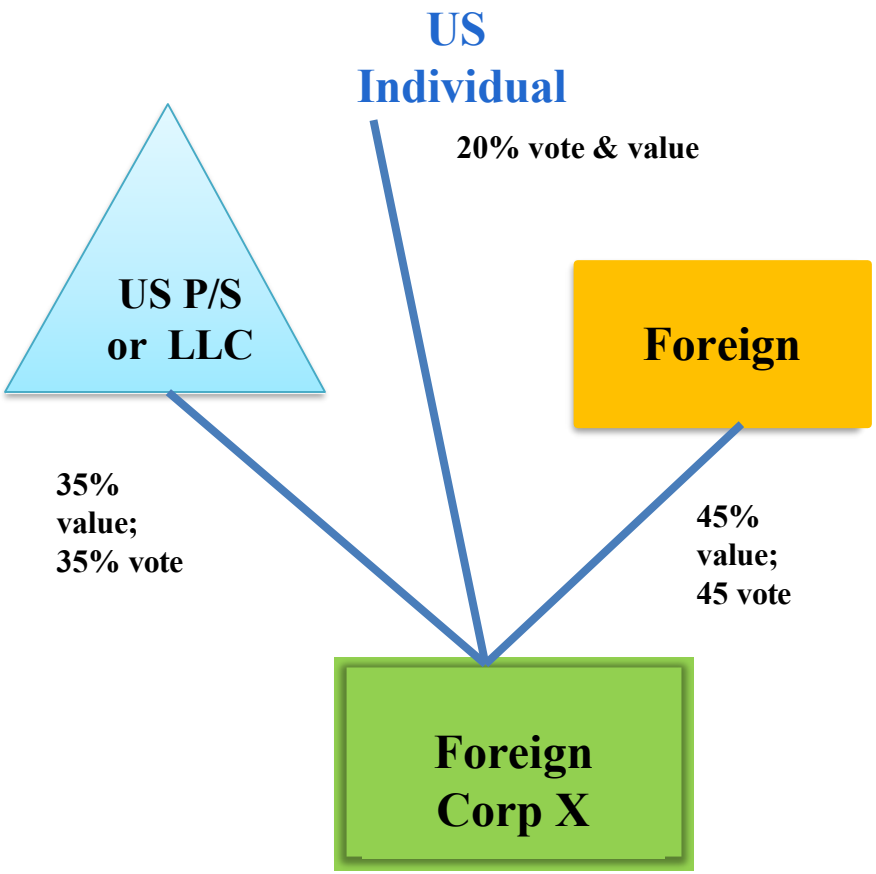
- US tax deferral is greatly diminished due to GILTI regime. QBAI, if any, is exempt. Tax rate = US corporate rate = 21% on Subpart F income; nominal 10.5% on GILTI, but GILTI FTCs are in separate basket w/20% haircut and no carryovers. (So might be better to have Subpart F income than GILTI—modeling often required to determine).
- 245A 100% DRD allowed to US Corp on "dividends" from SFC or CFC..

2017 Tax Act's 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.*



Above: Foreign Corp X 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 X would NOT be a CFC.

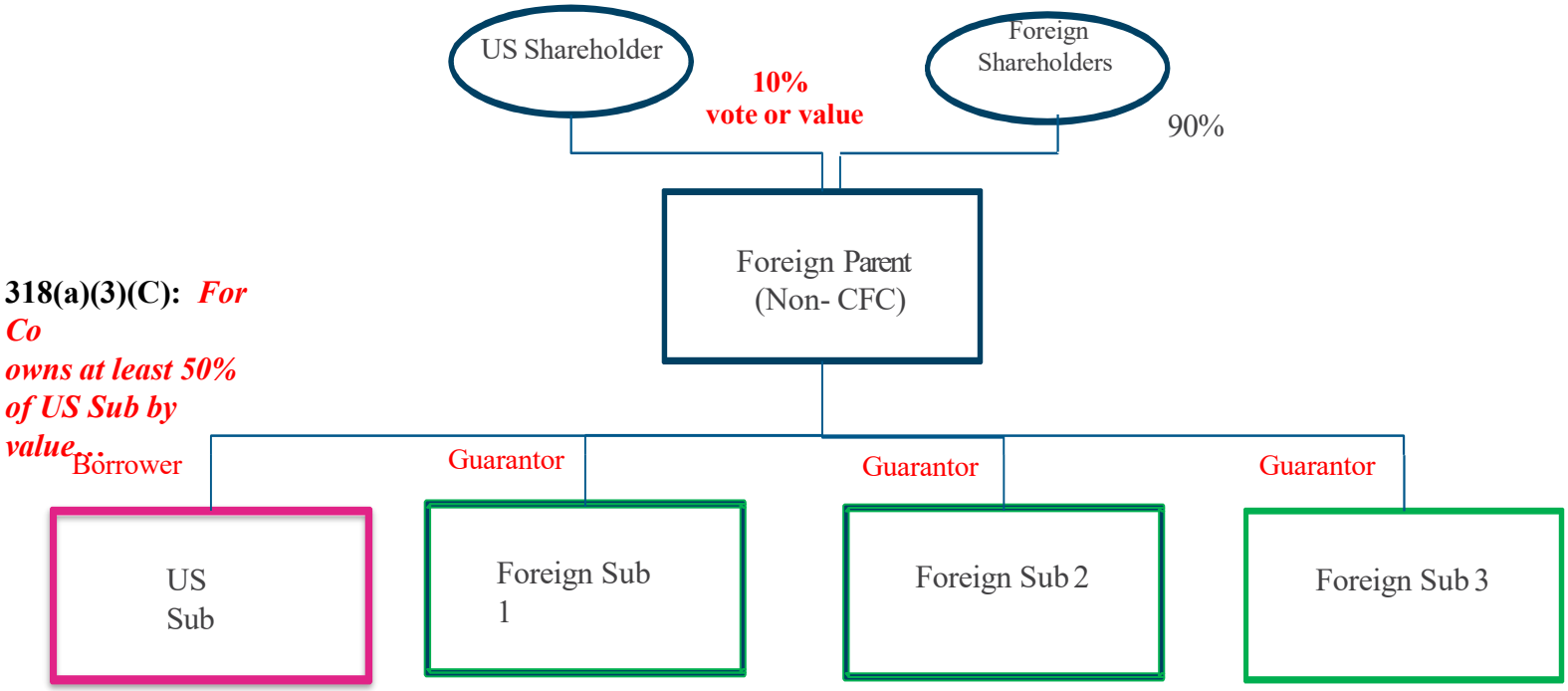
2017 Tax Act's Expansion of Subpart F:

6 ways TCJA expanded purview of Subpart F

1. § 951(b) definition of "US shareholder" was broadened to include a value test -- after TCJA, test for "US shldr" is a US person owning at least EITHER 10% of vote **OR *10% of value*** of a foreign corporation (directly, indirectly through foreign entities, or constructively through modified § 318 attribution rules).
2. The § 951(b) definition of "U.S. shareholder" was broadened to make it apply "for purposes of this title," – (i.e., Title 26—the whole U.S. Internal Revenue Code)—instead of just for purposes of Subpart F.
3. § 958(b)(4) was repealed! Prior to TCJA's repeal, it had turned-off the downward stock attribution rules of § 318(a)(3)(A) through (C), which rules operate to impute stock owned by a foreign person to a US person (in identifying US shldrs and CFCs).
4. TCJA 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. TCJA 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 shlders" 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")

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

- **Convert the Foreign "Pop-Up" CFCs to "Disregarded Entities" with CTB Election**
  - Treated by US taxable "liquidations" triggering a § 1248 dividend, but the "§1248 amount" may be zero, if E&P already picked up by the Transition Tax.
  - *This strategy would likely could not have avoided the 2017 imposition of the one-time Transition Tax* unless a retroactive CTB election could be made—NOT likely allowed under final § 965 regulations
- **Make Maximum Use of the *High Foreign Tax Exception/Exclusion*** to reduce both Subpart F & GILTI income
- **Elect § 962 to Treat the Foreign Dividends "as if" they were received by a U.S. C Corporation.**
  - *But see Smith v. CIR*, Tax Ct. (2018)(no qualified dividend treatment allowed – C-corp is not real).
- **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)
- **Interpose a US C-corp 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)
- **Actually liquidate the CFCs** (But usually not pragmatic…and then the "liability shield" is lost. Also expensive!)
- **Take "Wait & See" attitude:** Wait and see if Congress adopts any Technical Corrections Bill - several have already died in the US House of Reps...and it's been almost 5 years since TCJA's enactment!

Comparing U.S. cross-border 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

IV. Advanced Tax Considerations in Foreign Entity Selection and CTB Election

- Impact of GILTI
- Entity selection in light of § 962 election
- Entity selection in light of Final High-Tax GILTI Exclusion Regs
- Entity selection in light of the new Foreign Branch Basket of FTC Regs
- Outbound transfers to foreign corporations vs. to foreign partnerships
- Disposition of partnership interests by foreign partners - § 864(c)(8)
- "Check & Sell" transactions
- § 338(g) elections

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The GILTI Regime and IRS Form 8832 Entity Classification Elections

Ronald Kalungi, JD, LLM

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI)

- Under IRC Sec. 951A, U.S shareholders of a Controlled Foreign Corporation (CFC) must include their share of the Global Intangible Low-Taxed Income (GILTI) in their U.S. federal gross income.
- GILTI was intended to be an anti-base erosion, minimum tax provision intended to discourage multinational corporations (MNCs) from using intangible property (IP) to shift profits out of the U.S. Its tax base, however, extends beyond IP assets and investments.
  - GILTI: Excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return.
  - U.S. shareholder and Controlled Foreign Corporation concepts mirror Subpart F.
    - GILTI inclusion treated similarly to Subpart F in many ways, but not technically a component of Subpart F.
  - **An IRC section 250 deduction of 50% of GILTI is available, but ONLY for C Corporations, or individual shareholders that elect to be taxed as C corporations under section 962.**
    - Makes the effective tax rate 10.5%
    - For non-corporate U.S. shareholders who do not elect to be taxed as C corporations under section 962, the GILTI tax rate can be as high as 37%.
    - For taxable years beginning after December 31, 2025, the deduction will be reduced to 37.5%, resulting in an effective tax rate on GILTI of 13.125%.

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

- GILTI Application
  - Functionally, GILTI essentially is a tax imposed on U.S. shareholders of a CFC on the excess of an assumed 10% rate of return on an investment in a CFC (i.e., 10% of the adjusted cost basis of the tangible assets (Qualified Business Asset Investment) of the CFC used in the production of income).
    - GILTI imposes a minimum tax on foreign earnings that exceed the 10% rate of return on investment amount.
  - **A U.S. corporate shareholder is eligible for an indirect foreign tax credit with respect to foreign income taxes paid on GILTI, but the FTC is limited to 80% of the foreign taxes paid on GILTI. The FTC is not available to an individual U.S. shareholder unless the individual shareholder makes a section 962 election to be taxed as a C corporation on GILTI.**

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

- Income subject to GILTI tax becomes part of a CFC's Previously Taxed Earnings and Profits (PTEP) and is not subject to U.S. federal income taxation again when distributed.
- Income subject to GILTI provisions is not is not eligible for the participation Dividends Received Deduction (DRD) under Code section 245A.
- Section 951A introduced a new FTC basket for GILTI foreign taxes.
- Is GILTI subject to SALT income tax?
  - It depends on the income tax provisions of a given state. For instance, PA currently does not tax GILTI.

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

- *GILTI Computation Illustration: U.S. Corporate Shareholder versus U.S. individual shareholder disparity.*
- *Example:*
- *Scenario 1*: A U.S. corporation directly owns stock in a Swiss GmbH, a CFC. The GmbH's net income is $50,000, on which $6,685 of Swiss corporate income tax was paid. The Swiss GmbH has a loan, on which it incurred $2,000 of interest expense and has a Qualified Business Asset Investment (QBAI)(e.g., an intangible asset) of $180,000.
- *Scenario 2*: The facts are the same as in scenario 1 above, except that the U.S. shareholder is a U.S. individual, instead of a U.S. corporation. The U.S. individual does not make a section 962 election to be taxed as a U.S. C corporation on GILTI.

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

			U.S. Shareholder	
Step	**Item**	**CFC**	**Corporation**	**Individual**
Step 1: Tested Income	a. Tested income	$ 50,000	$ 50,000	$ 50,000
	b. Tested Loss	-	-	-
	c. Net CFC tested income		$ 50,000	$ 50,000
	d. Tested foreign income taxes	$ 6,685	$ 6,685	$ 6,685
	e. Foreign ETR on tested income (d. / c. * 100%)	13.37%	13.37%	13.37%
Step 2: QBAI	f. Qualified Business Asset Investment (QBAI)	$180,000	$180,000	$180,000
	g. 10% of QBAI (f. * 10%)		$ 18,000	$ 18,000
	h. Interest expense	$ 2,000	$ 2,000	$ 2,000
	i. Net deemed tangible income (g. – h.)		$ 16,000	$ 16,000

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

Step 3: Calculate GILTI	j. GILTI (c. – i.)		$34,000	$34,000
Step 4: U.S. Inclusion	k. Inclusion percentage (%) (j. / c. *100%)		68%	68%
For U.S. corporate shareholders only.	l. Deemed foreign tax credit (FTC) before 20% reduction (d. * k.)		$ 4,545.00	
For U.S. corporate shareholders only.	m. Deemed FTC after 20% reduction (l. * 80%)		$ 3,636.64	
	n. Grossed-up GILTI (j. + l.)		$38,545.80	$34,000
For U.S. corporate shareholders only.	**o. 50% GILTI deduction (n. * 50%)**		**$19,272.90**	
	p. Taxable income before FTC and expense		$19,272.90	$34,000
	q. Expense allocated to GILTI basket.		-	-
	r. GILTI for FTC limitation		$19,272.90	$34,000
	s. U.S. federal income tax rate		21%	37%
For U.S. corporate shareholders only.	**t. FTC limitation (p. *s.)**		**$ 4,047**	
	u. GILTI Taxable income before FTC		$19,272.90	$34,000
	v. U.S. federal income tax rate		21%	37%
	x. U.S. tax liability before FTC (u. * v.)		$ 4,047	$12,580
For U.S. corporate shareholders only.	**y. FTC**		**$ 4,047**	
	z. U.S. tax on GILTI (x. – y.)		**$ 0**	**$12,580**

GLOBAL INTANGIBLE LOW-TAXED INCOME (GILTI) (CONT'D)

- In the foregoing example, what tips the GILTI scale in favor of a U.S. corporate shareholder is the availability of the 50% GILTI deduction and the 80% FTC to a U.S. corporate shareholder, and the non-availability of these tax attributes to a U.S. individual shareholder.
- It is these attributes that result in the U.S. corporate shareholder owing no GILTI tax, whereas the U.S. individual shareholder owes substantial GILTI tax on the same GILTI amount.
- Making a section 962 election creates parity in the treatment of a U.S. corporate shareholder and U.S. individual shareholder with respect to GILTI taxation.

SECTION 962 ELECTION

- IRC section 962 allows an individual (or trust or estate) U.S. shareholder of a CFC to elect to be subject to corporate income tax rates on amounts that are included in the individual's gross income under section 951(a), or GILTI under section 951A.
- Section 962 was enacted, along with the rest of the subpart F regime, in 1962 and became effective beginning in the tax year 1963.
  - The top individual tax rate at the time was 91%; whereas the top corporate tax rate was 52%.
  - By enacting section 962, Congress intended to give individual taxpayers a means of reducing the current tax burden on "phantom income"/deemed income created by the subpart F regime to the lower corporate rate.

SECTION 962 ELECTION (CONT'D)

- The section 962 election is made on a year-by-year basis.
- For any year the election is made, it applies to all CFCs and all §951(a) income. This includes: Subpart F (e.g., FPHCI), §956, and §951A (GILTI).
- An individual taxpayer cannot elect to include certain CFCs and exclude others.
- For purposes of computing the §962 tax due, a credit for income taxes paid

at the CFC level is allowed under §960.

- The limitations under §904 apply as they regularly would to a corporation. Reg 1.962-1(b)(2).
- FTCs in the GILTI basket cannot offset §962 tax due in other baskets (e.g., the general and passive baskets).
- A gross up for indirect foreign taxes is required under §78.

SECTION 962 ELECTION (CONT'D)

Deductions

- General rule – no deductions are available when computing the tax due
- under the §962 election.
- §250 deduction for GILTI is available.
- §245A DRD is not available to offset §956 inclusions
- Taxpayers making the election have an increase in basis under §961 only for
- the U.S. tax actually paid under the election.
- The election does not change the payor of the dividend for the purposes of determining whether the dividend is Qualified Dividend Income (QDI) or the source of the dividend (i.e., whether U.S. source or foreign source). *See Barry M. Smith v. Commissioner, 151 TC 41.*
  - "These [section 962] provisions do not create hypothetical corporations or change real-world facts. They simply provide a mechanism that enables an individual U.S. shareholder to elect what he or she may deem more desirable tax treatment." – Judge Lauber.

SECTION 962 ELECTION (CONT'D)

- The §962 election has two potential benefits:
  - Permanent reduction in tax liability (e.g., GILTI being subject to a lower tax rate due to the 50% GILTI deduction and 80% FTC, and actual dividend distributions being subject to a preferential QDI rate because the distributing corporation is a treaty country-based Qualified Foreign Corporation); and/or
  - Deferral (i.e., the taxpayer-friendly tax regime it enables creates an opportunity for deferral by taxpayers of actual distributions of income).
- In order to determine when to make the election, taxpayers will need to project the tax liability with and without the election both on a current and fully distributed basis.
  - If there is a reduced tax liability on a fully distributed basis the election should be made.
  - If there is an increased tax liability on a fully distributed basis, then taxpayers must weigh the benefit of deferral vs the increased tax cost.

SECTION 962 ELECTION (CONT'D)

Factors in favor of making the election.

- §951A GILTI represents large portion of the total §951(a) income.
- The foreign corporation is a treaty country-based Qualified Foreign Corporation whose dividends qualify for QDI treatment.
- Significant deemed paid foreign tax credits are available.
- Large difference between corporate (21%) rate and individual income tax rate (up to 37%).
- Significant time period between income inclusion and eventual distribution.
- High importance of deferral to taxpayer (time value of money).

SECTION 962 ELECTION (CONT'D)

Factors against making the election.

- §951A GILTI represents a small portion of the total §951(a) income.
- Foreign corporate tax paid is low - jurisdiction with low/no tax, NOLs in foreign country, incentive rates.
- Individual has NOLs or foreign tax credits (withholding tax) that can offset §951(a) liability.
- Distributions are made from foreign corporation on a regular basis.
- Deferral is not important to the taxpayer.

MAKING THE SECTION 962 ELECTION

- The election is made by attaching a statement to a taxpayer's income tax
- return. The statement must include the following:
  - I. Name, address, and taxable year of each CFC of which the taxpayer is a U.S. shareholder.
  - II. Any foreign entity through which the taxpayer is an indirect owner of a CFC under §958(a).
  - III. The §951(a) Subpart F income and section 951A GILTI included in the §962 election on a CFC-by-CFC basis.
  - IV. Taxpayer's pro-rata share of E&P and taxes paid for each applicable CFC.
  - V. Distributions actually received by the taxpayer during the year on a CFC-by-CFC basis with details on the amounts that relate to (1) excludible §962 E&P; (2) taxable §962 E&P; and (3) E&P other than §962.

MAKING THE SECTION 962 ELECTION (CONT'D)

- The election needs to be made with the taxpayer's return.
- There is no additional guidance on the timing of the election (original return, timely filed return, etc.). In *Dougherty v. Commissioner 60 T.C. 917 (U.S.T.C. 1973),* the taxpayers were allowed to make the election on an amended return after they determined that they had a 951(a) liability. In GCM 36325, the IRS fully acquiesced in *Dougherty*.

MAKING THE SECTION 962 ELECTION (CONT'D)

Sample Election

Statement of Election by Individual Stockholder to be Taxed on Income from his Controlled Foreign Corporations at Corporate Rates

Rich Greenbucks

SSN: xxx-xx-xxxx

Form 1040, Tax Year Ending 12/31/2021

Taxpayer hereby elects, under Code Sec. 962, to be subject to tax at corporate rates on amounts that are included in taxpayer's gross income for calendar year 2021 under Code Sec. 951A. Taxpayer also elects to have the benefit of a credit for certain foreign taxes paid with regard to the earnings and profits attributable to such amounts.

The following information is submitted pursuant to the requirements of Treas. Reg Sec.1.962-2(b):

1. Taxpayer qualified as a U.S. shareholder for calendar year 2021 of (names and addresses of the foreign companies), each a controlled foreign corporation whose tax years ended on December 31, 2021.

MAKING THE SECTION 962 ELECTION (CONT'D)

2. The corporations' gross income for calendar year 2021 which was included in taxpayer's gross income for calendar year 2021 under Code Sec. 951A, was $xx,xxx,xxx.

3. Taxpayer's pro-rata share of the Global Intangible Low-Taxed income of said corporations (determined under Reg. Sec. 1.951A-1) for calendar year 2021 was $xx,xxx,xxx, with respect to which $x,xxx,xxx foreign income taxes were paid.

4. During calendar year 2021, taxpayer received no distribution from such corporations of excludable Code Sec. 962 earnings and profits and no distribution of taxable Code Sec. 962 earnings and profits. Taxpayer received no other distributions from such corporations during or for calendar year 2021.

5. Taxpayer did not qualify as a United States shareholder of any other Controlled Foreign Corporation for calendar year 2021.

MAKING THE SECTION 962 ELECTION (CONT'D)

§962 Election Statement

- Supporting statement to show the relevant tax calculations.
- No direct guidance on what needs to be included on the statement apart from the requirement that it must show how the tax was determined. *Tip*: it is generally a good idea to show the methodology for tax computations in the statement so that the return can be followed.
- Form 8992 and Form 8993 filings would be required. When a §962 election is made, there is GILTI, and a §250 deduction is taken (50% deduction on GILTI).
- Form 1118 (instead of 1116) is required when a foreign tax credit is taken under the section 962 election regime.
- The §962 tax is reported directly on the taxpayer's income tax return and added to any other income taxes due.

THE GILTI HIGH TAX EXCLUSION

- For U.S. shareholders owning CFCs operating in high tax jurisdictions, the GILTI high tax exclusion offers a tax planning alternative.
- Unlike the section 962 election which only reduces, but may not eliminate entirely, the GILTI tax, income that qualifies for the GILTI high tax exclusion is not subject to GILTI tax at all.
- The IRS issued the GILTI high tax exclusion (GILTI HTE) final regulations on July 20, 2020.
- Under the regulations, a U.S. shareholder of a CFC can exclude from its GILTI inclusion items of the CFC's gross tested income if the CFC's effective foreign tax rate on the GILTI gross tested income exceeds 18.9 percent (i.e., 90% of the U.S. corporate income tax rate, which, currently, is 21%) and the U.S. shareholder elects for the taxable year to exclude the high taxed income.
- The election is made on an annual basis. This allows U.S. shareholders flexibility in modeling their tax situations on a year-by-year basis and choosing to make the election only in years in which it makes economic sense to do so.

THE GILTI HIGH TAX EXCLUSION (CONT'D)

- The election is made on a tax return (an original or amended return) by attaching a statement.
- The election applies on a consistent basis to all CFCs owned by the same domestic controlling U.S. shareholders (i.e., shareholders who own more than 50% of the CFC stock) and to all of the CFC's U.S. shareholders (in this regard, a controlling U.S. shareholder notifies non-controlling U.S. shareholders of the decision to make the election).
- The 18.9% foreign effective tax rate determination is made on a "Tested Unit" basis.
  - A tested unit includes a (1) CFC; (2) an interest in a pass-through entity (not treated as fiscally transparent under foreign law, e.g., foreign entities that elect to be treated as pass-through entities for U.S. federal income tax purposes by filing Form 8832) held by a CFC; and (3) certain branches of a CFC.
  - *Note*: A foreign entity that is treated as a corporation under foreign law can be treated as a tested unit even if it elects to be treated as a pass-through entity for U.S. federal income tax purposes by Filing Form 8832 with the IRS.
  - *Note further*: A reverse hybrid entity (i.e., an entity that elects on Form 8832 to be treated as a corporation for U.S. federal income tax purposes but is treated as a pass-through entity under foreign law) is not eligible to be treated as a tested unit.
  - All tested units of a CFC located or resident in the same country are required to be combined as a single tested unit.

THE GILTI HIGH TAX EXCLUSION (CONT'D)

- The foreign effective tax rate determination is based on the books and records of each tested unit, and gross income is determined under U.S. federal income tax principles, with certain adjustments to reflect disregarded payments, which serve as a reasonable proxy for determining the amount of gross income of the tested unit that is likely to be subject to tax in the foreign country of the tested unit.
- The effective tax rate is computed by dividing the U.S. dollar amount of foreign income taxes paid or accrued on the foreign taxable income by the U.S. dollar amount of the foreign taxable income, which is grossed up by the amount of such foreign income taxes. *Example*: Income taxes paid in Foreign Country: $100; Foreign Country taxable income: $400. The effective tax rate is 20% ($100 Foreign Country income tax paid / $500 ($400 Foreign Country taxable income plus the $100 gross up for the Foreign Country income taxes paid).
- The regulations apply to taxable years of CFCs beginning on or after July 23,2020, and for years of U.S. shareholders in which, or with which, such tax years of foreign corporations end.
- Taxpayers may elect to apply the final regulations retroactively for tax years beginning after December 31, 2017, and before July 23, 2020, provided certain consistency requirements are met. This creates opportunities for amending tax returns and claiming tax refunds in certain circumstances.

THE GILTI HIGH TAX EXCLUSION (CONT'D)

GILTI HTE Statement – Treas. Reg. section 1.951A-2(c)(7)(viii)

- The statement must include:
  - The name and address of each CFC (or other tested unit);
  - The U.S. shareholder's shareholding in each CFC (or other tested unit) (e.g., class of shares, number of shares per class and percentage of shareholding per class);
  - A description of how the U.S. taxpayer determined that a CFC's foreign income was subject to foreign tax at an effective tax rate that is greater than 18.9% (i.e., 90% of the U.S. corporate income tax rate, which, currently, is 21%);
  - A description of the accounting standards under which the CFC's books and records were prepared and its corporate tax base (especially taxable income) determined; and
  - The amount of tentative gross tested income the U.S. taxpayer is seeking to exclude from GILTI inclusion under the GILTI HTE.

THE SUBPART F HIGH TAX EXCLUSION

- On the same day the GILTI HTE final regulations were issued (July 20,2020), the IRS also issued proposed subpart F high tax exclusion regulations (proposed regulations) under section 954(b)(4).
- The proposed regulations would conform the historic subpart F high tax exclusion to the more recent GILTI HTE. Thus, the proposed regulations significantly revise the subpart F high tax exclusion by combining both exclusions into a unified rule that is modeled on the GILTI HTE.
- Since the subpart F high tax exclusion and GILTI HTE will be combined into a single rule, the proposed regulations, once finalized, would withdraw the GILTI HTE final regulations.
- Under the proposed regulations, a single unified election applies for purposes of both Subpart F and GILTI, with such election applicable to all high-taxed incomes of all CFCs that are members of a CFC group. Thus, the proposed regulations eliminate the ability to apply the Subpart F high-tax exclusion to particular CFCs and particular items of income of CFCs.

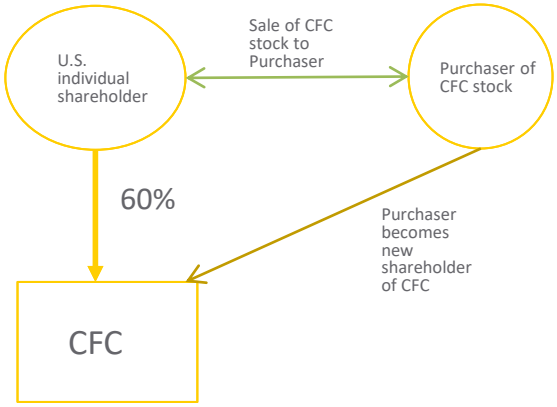
THE SUBPART F HIGH TAX EXCLUSION (CONT'D)

- The proposed regulations would modify the approach for determining gross income attributable to each tested unit. Unlike the GILTI HTE final regulations that use the separate set of books and records as the starting point for determining a tested unit's gross income, the proposed regulations would use applicable financial statements instead.
- The proposed regulations list different types of financial statements (in order of priority) that may be relied on under this determination, with the higher priority given to audited financial statements prepared in accordance with U.S. Generally Accepted Accounting Principles (US GAAP) or International Financial Reporting Standards (IFRS).
- The proposed regulations would apply to taxable years of CFCs and their U.S. shareholders beginning after the date of publication of the final regulations in the federal register.

PLANNING INTO THE SUBPART F REGIME?

- Factors that make the idea of planning into the Subpart F regime worth considering:
  - No FTC haircut (unlike under the GILTI regime which allows only 80% of the foreign taxes to be claimed as FTCs).
  - Utilization of excess FTCs (no FTC carryback or carryforwards under GILTI).
  - Utilization of NOLs (GILTI tested loss cannot be carried forward).
- Before the Subpart F high tax exclusion proposed regulations are finalized, it is plausible for a U.S. taxpayer to plan into Subpart F by making a GILTI HTE election and not making Subpart F HTE election on the same CFC income. *Note*: It is these types of "pick and choose" strategies that the proposed Subpart F HTE regulations seek to curb.
- Like most tax planning strategies, modeling would be key in determining whether planning into Subpart F would make economic sense to a given U.S. shareholder.

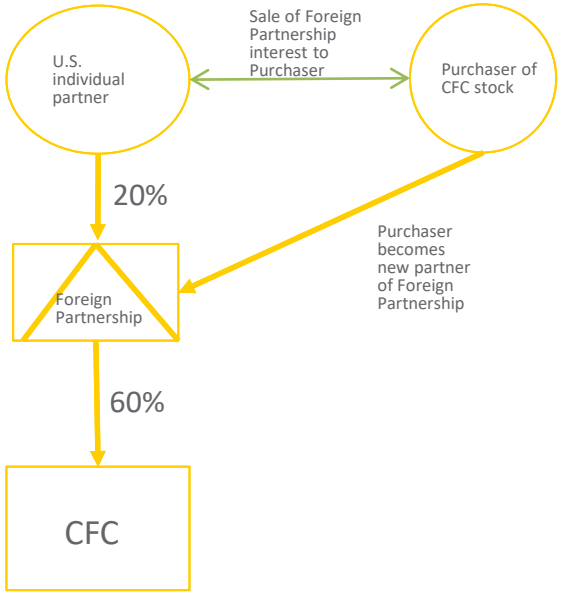
DISTRIBUTIONS AND SALES OF CFC STOCK UNDER DIFFERENT ENTIY MODELS



Section 1248 Considerations

- Under IRC section 1248, gains derived from the sale or exchange of stock of a foreign corporation (whether or not a CFC at the time of sale) by a person who was a 10% U.S. shareholder at any time during the preceding 5 years while the foreign corporation was a CFC is recharacterized as a dividend to the extent of the post-1962 accumulated E&P of the foreign corporation attributable to such stock, and only for periods during which the 10% U.S. shareholder held the stock while the foreign corporation was a CFC.
- Under section 1248(j), if the 10% U.S. shareholder is a U.S. domestic C corporation, gains recharacterized as dividends under section 1248 ("Section 1248 amounts") may qualify for the Dividends Received Deduction under section 245A if the U.S. domestic corporation held the stock for more than 1 year prior to the sale of such stock.
- Section 1248 amounts may also qualify for Qualified Dividend Income treatment if the foreign corporation whose stock is being sold is deemed to be a Qualified Foreign Corporation (e.g., CFCs established and operating in certain countries with which the United States has concluded income tax treaties that contain comprehensive exchange of information provisions).

DISTRIBUTIONS AND SALES OF CFC STOCK UNDER DIFFERENT ENTIY MODELS



Section 1248 Considerations (Cont'd)

- U.S. individual partner indirectly sells his indirect equity interest in the CFC when he sells his partnership interest to Purchaser.
- Section 1248 amounts for U.S. individual partner will be pro rated (i.e., such amounts will be 12% of the CFC's untaxed E&P – 20%*60%*100%).
- *Note*: Any previously taxed income received by the U.S. individual partner (e.g., actual dividend distributions and GILTI) from the CFC would reduce the untaxed E&P that is subject to section 1248 and correspondingly reduces the amount of deemed dividends subject to tax at ordinary income tax rates.

Outbound Transfers to foreign "corporations" vs. "partnerships" (1 of 2)

- The otherwise applicable "non-recognition" provisions of Code §§ 351, 354, 356, 361, 332 and/or §721 may be "turned-off" depending on whether the outbound transfer of property by a US person is to a foreign "corporation" or a foreign "partnership."
- **Outbound transfers to a foreign *corporation*** can trigger the application of Code § 367 and/or § 7874 (the anti-corporate inversion rules).
- **§ 367(a)(1) – General Rule:** "If, in connection with any exchange described in section 332, 351, 354, 356, or 361 , a US person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be treated as a corporation."
  - **General rule is one of taxation unless an exception applies.** If the transaction does not qualify as a "reorg" under § 368, then § 367 does not apply (transfer is treated as a sale, which might yield a better result—e.g., installment sale treatment under § 453A). § 367(a)(3) was repealed: Transfers of property to an active foreign trade-or-business are no longer excepted from 367(a).
  - Intangibles - § 367(d): Almost all outbound transfers of intangibles are not taxed as sales due to broader definition of "intangible."
- **§ 7874 – General Rule:** focuses on ownership of the new foreign parent by the historic shareholders of the "inverted" domestic entity—both for purposes of its application and its effects.
  - **If historic Shldrs of US Corp receive > 50% of NFP:** Deal is *generally taxable to U.S. Shrlds* of the U.S. Corp under §367.
  - **If historic Shldrs of U.S. Corp own at least 60%, but < 80% of NFP:** Restrictions are imposed on the inverting U.S. Corp, but NFP is respected for U.S. tax purposes as a foreign (non-U.S.) corporation. But U.S. Corporate group is taxed on "inversion gain" (as defined).
  - **If historic Shldrs own 80% or more of NFP:** Then NFP will be treated as a U.S. corporation for U.S. TAX purposes (even though it remains a foreign corporation for other legal purposes) -- a tax disaster! (U.S. tax planning is rendered meaningless; multiple juridical taxation could now be a real risk).

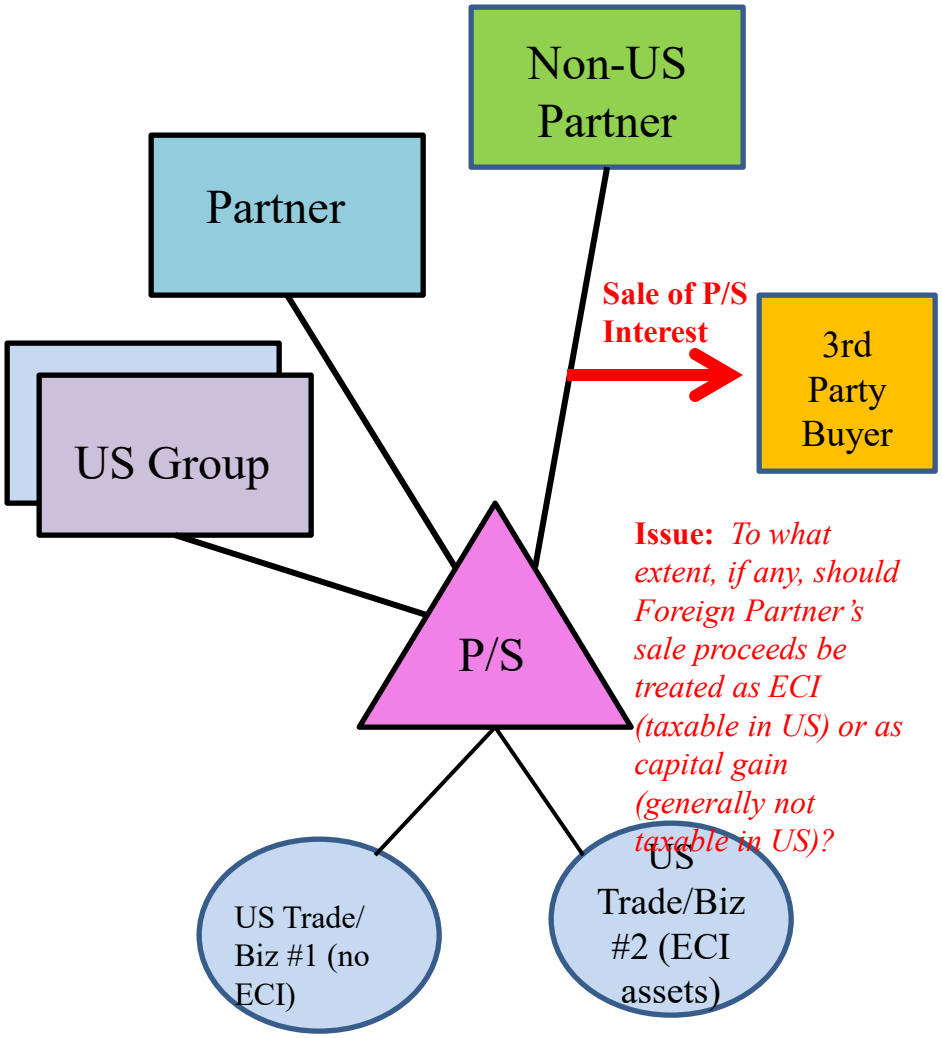
Outbound Transfers to foreign "corporations" vs. "partnerships" (2 of 2)

- Outbound transfers of appreciated property ***to a foreign partnership*** may trigger the application of Code § 721(c)—thus overriding the non-recognition rule of 721(a).
  - Code § 721(c) was enacted as a corollary to §367(a).
  - Code 721 and the Regulations promulgated thereunder override the non-recognition of gain upon a contribution of "section 721(c) property" to a "section 721(c) partnership."
  - Reg. § 1.721(c)-3 describes the gain deferral method, which may be applied in order to avoid the immediate recognition of gain upon a contribution of section 721(c) property to a section 721(c) partnership. The regulations contain special "acceleration events" for purposes of applying the gain deferral method.
- **"Section 721 partnership"defined in Reg. § 1.721(c)-1:** A partnership (domestic or foreign) is a section 721(c) partnership if there is a contribution of §721(c) property to the partnership and, after the contribution and all transactions related to the contribution
  - **(A)** A related foreign person with respect to the U.S. transferor is a direct or indirect partner in the partnership; and
  - **(B)** The U.S. transferor and related persons own 80 percent or more of the interests in partnership capital, profits, deductions, or losses (with "relatedness" determined under the attribution rules of §§ 267(b) or 707(b)(1)).
- ***Caution:*** Always check application of §§367, 7874 and 721(c) (and Regs) before checking the box on an entity; it could trigger an outbound transfer of property (or inbound LQ).

Potential PITFALL: Dispositions by Foreign Partners of Interests in ***Partnerships*** with a "U.S. Trade or Business"

BACKGROUND

- **Rev. Rule 91-32:** IRS rules that a foreign partner who sells an interest in a P/S is subject to US taxation if that P/S is engaged in a US trade/biz through a US office, to the extent the gain is attributable to property of the P/S which was used to produce "effectively connected income" (ECI).
  - Many US taxpayers tried to ignore this Revenue Ruling, arguing any gain should be capital gain—not taxable in US.
  - Obama Administration, in its proposed budget, recommended codifying Rev. Rul. 91-32 and adding a withholding obligation.
- ***Grecian Magnesite v. CIR*, 149 T.C. (2017):** US Tax Court rejected Rev. Rule 91-32, holding that gain or loss recognized by a foreign partner disposing of a P/S interest is generally not considered ECI (or effectively connected loss) with respect to any US trade/biz that partnership may be conducting.
- **New IRC § 864(c)(8):** Enacted as part of the 2017 TCJA. Treats as ECI the foreign partner's "distributive share of the amount of gain (or loss) which would have been ECI if the partnership entity has sold all of its assets at FMV just prior to the foreign partner's disposition (but reduced for any gain already subject to the FRPTA regime).
  - § 864(c)(8) effectively reverses the result obtained in *Grecian Magnesite* court opinion, issued earlier in the year 2017.



Example: Disposition of P/S Interest (with US Trade/Biz) by Foreign Partner

(1 of 2)

Facts:

Foreign Co. sells its 30% interest in US P/S to an unrelated party on Feb. 14, 2018, realizing a $450 gain. Is any of it subject to US tax as "ECI"?

Analysis:

- Under §864(c)(8), For Co's $450 realized gain is treated as income "effectively connected with the conduct of a US trade/business to extent such gain does not exceed its distributive share of gain that would be ECI had the P/S sold all of its assets at FMV as of date of sale/exchange of such interest (but reduced by real property gains that would already be separately taxed as ECI under the FIRPTA regime).

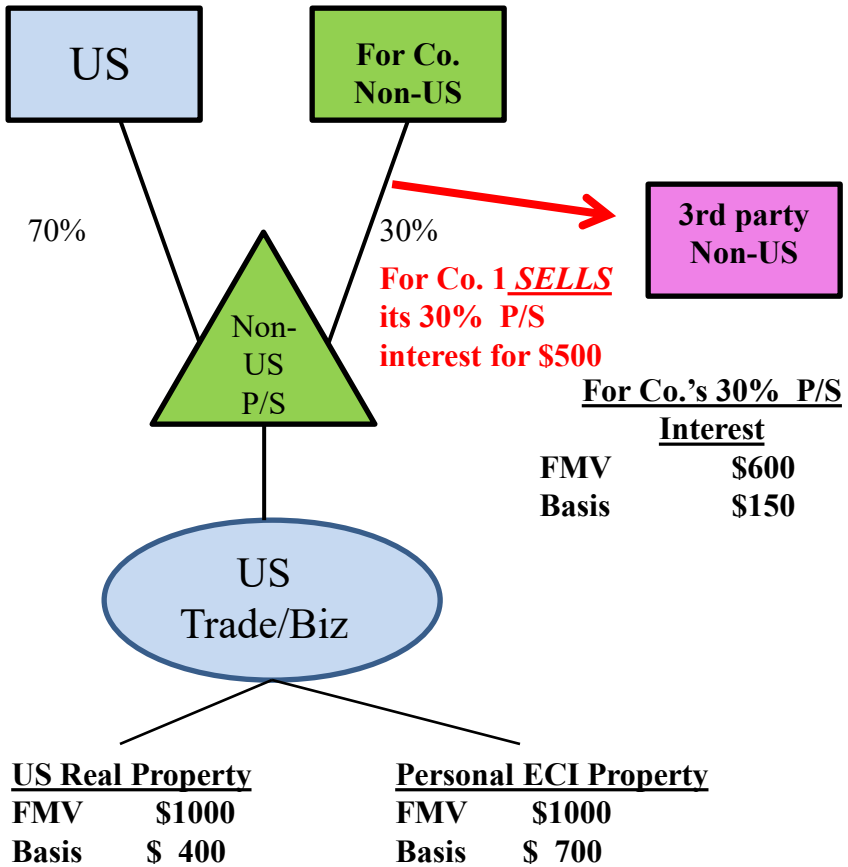
- Hypothetical sale of all of P/S's assets would result in $600 US Real Property gain, and $300 ECI gain in personal property assets, for a total of $900 ECI gain. (NOTE: FIRPTA gains are treated as ECI under that tax law.)

- § 864(c)(8) provides that the amount treated as ECI in the hypothetical asset sale is reduced by the amount that would already be taxed as ECI under the § 896(g) of the FIRPTA regime—here $600.

- Thus, 30% of the inherent $600 FIRPTA gain (i.e., $180) is allowed to first offset For Co.'s OUTSIDE gain on the sale of its P/S interest--($450 realized gain less $180 = $270. How much of the remaining outside gain is treated as ECI to For Co?

- For Co.'s 30% distributive share of the $900 total ECI gains = $270. That $270, representing For Co's share of total ECI gain is also offset by 30% of the FIRPTA gain: ($270 - $180 =**$90**).

- **Thus, under § 864(c), $90 of For. Co.'s realized gain on the sale of its P/S interest is treated as ECI—and taxed in the U.S.** (This makes sense as $90 equals For Co.'s 30% distributive share of the ECI gains on the personal property held by the P/S , which assets are effectively connected with a US Trade or Business.)



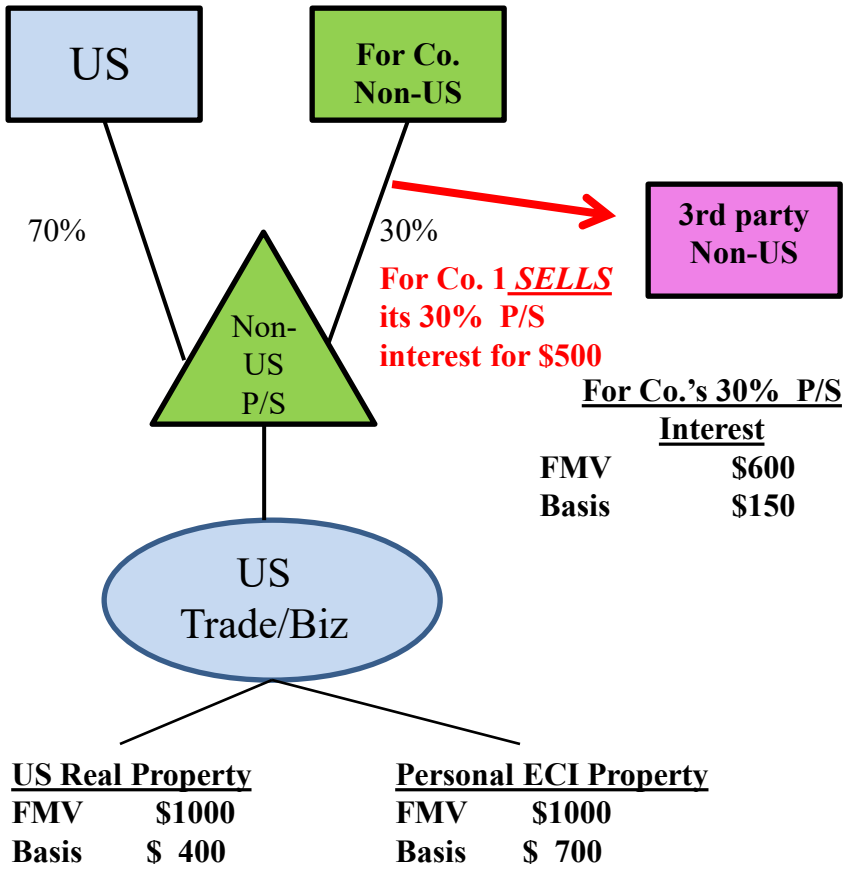
Example continued: Disposition of P/S Interest (with US Trade/Biz) by Foreign Partner (2 of 2)

- **Facts:**

  Foreign Co. sells its 30% interest in US P/S to an unrelated party on Feb. 14, 2018, realizing a $450 gain. Is any of it subject to US tax as "ECI"?

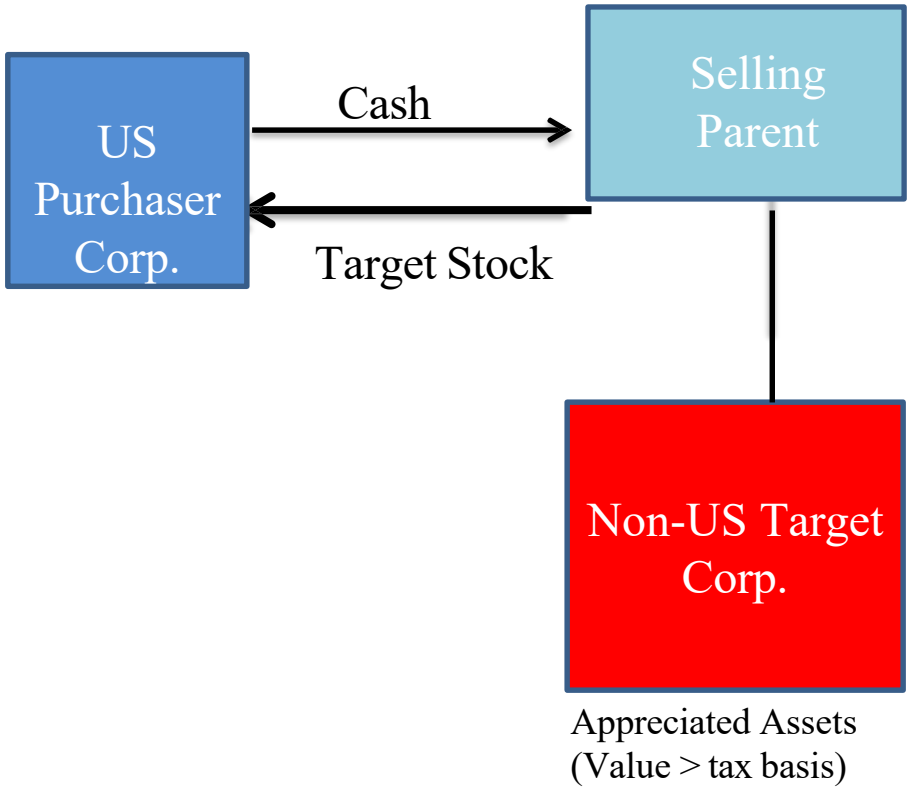
- **Analysis of transferee withholding duty under §1446(f) and Notice 2018-29:**

- §1446(f) became effective Jan. 1, 2018, and it applies to this sale of For Co's P/S interest which occurred on Feb. 14, 2018.
- Section 10 of Notice 2018-29 provides that if a transferee is required to withhold on an "amount realized" under §1446(e)(5) or Reg. § 1.1445-11T(d) *only FIRPTA withholding applies.*
- However, there is no FIRPTA withholding in this example because the P/S assets are not 90% US Real Property Interests and cash. Thus, withholding under new 1446(f) conceivably applies to the ENTIRE amount realized—i.e., 10% w/h X $600 = $60.



Foreign entity selection to qualify for §338(g) election
(or to replicate some of its effects with a CTB election)

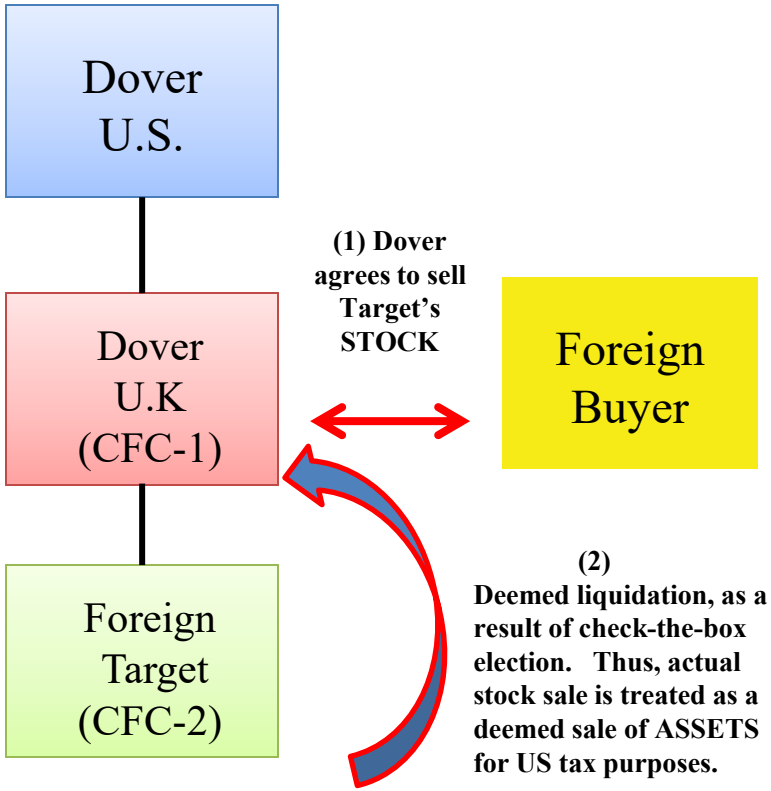
- The § 338(g) election, although a historical relic in the purely domestic area, is important in cross-border M&A. Why? The fictional sale of Old Target's assets to New Target is fully taxable, which:
  - Allows Buyer to avoid cumbersome & expensive calculations of basis, E&P pools, and FTCs (even after enactment of § 901(m)).
  - Gives Buyer a stepped up basis in assets acquired (even though it is, in actuality, a stock sale).
- Post TCJA, the effects of a 338(g) election can be both detrimental and beneficial (to Buyer and Seller), so modeling is required.
- **Purchaser and Target must be a corporations** or a DE owned by a corp (but Purchaser cannot be an individual or a partnership). **Neither Purchasing Corp nor Target need be US corporations.** See IRS CCA 2007- 006.
- Purchasing corp must make a QSP– a "qualified stock purchase" defined as transaction (or series) where it acquires by "purchase" 80% control (vote + value) of Target's stock during the 12-month "acquisition period."
- Purchasing Corp. may elect s338(g) unilaterally without the consent of the Seller or Target (unless contractually bound to get consent, which should always be on Seller's M&A checklist). Election deadline is 15th day of 9th month beginning after the month in which the "acquisition date" occurs (when 80% control is acquired).



CTB Potential Pitfall -- "Check-and-Sell" Transactions:

GILTI now makes these deemed "asset-sale" deals less desirable (while §1248 dividend on an actual stock sale may qualify as exempt under § 245A).

Dover makes a retroactive Check-the-Box Election to be treated as selling assets (not stock) for US tax purposes



Assumed facts: See Dover v. Commissioner, 122 TC 324 (2004).

- U.S. parent, Dover, owns CFC1 (Dover UK), which owns CFC 2, the foreign target. Dover U.K contracts to sell Target STOCK to Foreign Buyer. The gain on the stock sale is likely to be "foreign personal holding company income" under § 954(c) and thus taxable under Subpart F. When Dover realizes this, it makes a retroactive CTB election (after the sale closes!!) to treat the Target as a tax transparent entity for US tax purposes. The CTB election causes (1) a deemed liquidation of the Target, and (2) a deemed sale of its ASSETS (even though the stock is what is actually being sold , and the UK sees it as a stock sale).
- Under pre-2017 TCJA law, a deemed sale of CFC2's assets used in its T/Biz generally escaped Subpart F income (due to Reg. §1.954-2(e) which excepts sales of active trade/business assets).
- **But post-TCJA, although the <u>deemed ASSET SALE</u> escapes immediate taxation under Subpart F, the gain will likely constitute "tested income" for GILTI purposes** (Reg. § .954-2(e)(2)'s exception does not apply within GILTI regime). The GILTI income will increase stock basis—so is not necessarily a terrible result for Selling Parent.
- Thus, the U.S. parent would include the gain from the deemed sale of assets in GILTI. **(Check-and-Sell deal's benefits may be nullified.)**

Compare <u>actual CFC STOCK SALE</u> (i.e., No CTB election):

- Sale of the CFC stock must be tested for "dividend" status under §1248 (original purpose was to ensure that US shareholders of a CFC were taxed at ordinary rates on any E&P of a CFC upon exit). However, for a US corporate seller, the portion re-characterized as a dividend under §1248 is now potentially eligible for DRD under §245A.
- The foreign-source portion of any §1248 dividend is treated as Subpart F income of the Seller. § 964(e)(4)).
- The US shareholder is entitled to a DRD under § 245A to the same extent that it would have been if that amount of subpart F income were physically distributed to it. See § 964((e)(4)(A)(iii).
- All prerequisites for § 245A's application must be met. For example, individuals and S-Corps that are "US shareholders" as defined by 951(b) cannot qualify for the § 245A DRD.

More Check-the-Box Strategies to Consider in Cross-border Structures

- **Check out Available Tax Treaty Benefits for Non-US Operations:** For example, for an individual investing in a high-tax jurisdiction with a US treaty, remember to consider electing pass-through treatment for the non-US operations. Why?
- **Always ask what type of US parent (entity?) will be most tax efficient**: For example, consider converting the U.S. investor making an investment abroad into a C-Corporation if it will have CFCs (so it can take advantage of the lower GILTI rate, and also the § 245A 100% DRD).
- **Toggle between Subpart F and GILTI to Optimize**: Consider "planning into" Subpart F. Why?--to avoid GILTI as the results under GILTI could be worse! (E.g., create a branch to have services performed outside the CFC's country of incorporation)
- **Maximize QBAI in GILTI:** Check the box to flow-through status to combine QBAI in a chain of CFC where one CFC is a "income CFC" and another is a "loss CFC" (more QBAI means less GILTI exposure).
- **CTB to avoid § 59 BEAT:** Consider using foreign entity selection to avoid foreign "base erosion payments" to a "related foreign person" for § 59A BEAT purposes (a payment of interest to an unincorporated foreign branch may not be a "base-eroding payment" to a related foreign person for BEAT purposes. Why? Because you cannot pay off a loan to yourself.)

V. Completing IRS Form 8832

- Mechanics and Pitfall
- Late Elections

Preparing IRS Form 8832, and Late Elections

IRS FORM 8832: ENTITY CLASSIFICATION ELECTIONS

- Business entities classified as corporations ("per se" corporations) are not eligible to change their classifications by filing Form 8832 (Entity Classification Election).

Default classifications

- Domestic entities
  - A business entity with two or more members is classified as either a corporation or partnership for U.S. federal income tax purposes.
  - A business entity with only one owner is classified as a corporation or disregarded entity.
- Foreign entities
  - A business entity with two or more members, with at least one member who does not have limited liability, is classified as a partnership for U.S. federal income tax purposes.
  - A business entity with only one owner is classified as a disregarded entity if its sole owner does not have limited liability.
  - A business entity all of whose members have limited liability is classified as an association/corporation.

IRS FORM 8832: ENTITY CLASSIFICATION ELECTIONS (CONT'D)

- A Form 8832 entity classification election is required only when an eligible entity (i.e., a business entity that is not a "per se" corporation) intends to change its default classification.
- An eligible entity can change its default classification by electing the desired classification on and filing Form 8832. The effective date of a regular election *cannot be more than 75 days prior to the date on which the election is filed* or more than 12 months after the date on which the election is filed.

Late Entity Classification Relief under Rev. Proc. 2009-41

- Rev. Proc. 2009-41 late entity classification election relief is available to an eligible entity that failed to file a duly completed Form 8832 within 75 days from the effective date of the desired election.
  - Effective date: The date when the entity became relevant for U.S. federal income tax purposes (e.g., date of formation, date of acquisition of an equity interest in an existing entity, etc.).

IRS FORM 8832: ENTITY CLASSIFICATION ELECTIONS (CONT'D)

- In order to qualify for relief under Rev. Proc. 2009-41, the following requirements must be met:
  - The entity (or affected person) must not have filed a U.S. federal income tax return for the first year of the election because the due date has not passed, or
  - The entity (or affected person) has timely filed all required U.S. federal income tax returns (or, if not timely filed, within 6 months of the original due date) consistent with the desired election for all the years for which the election is to be effective, and no inconsistent returns have been filed during any of the relevant tax years;
  - The entity has reasonable cause for its failure to timely file the election; and
  - The requested effective date of the election is not more than 3 years and 75 days prior to the filing date of the Form 8832.

LATE ELECTION: SECTION 9100 RELIEF – RULING REQUEST

- Treas. Reg. section 301.9100-3 provides an alternative for entities that do not meet the requirements of Rev. Proc. 2009-41. This provision allows late election relief to an entity by way of filing a ruling request with the IRS.
- A 9100-3 relief procedure is the most expensive of all entity classification alternatives available.
  - It involves paying an IRS user fee, which currently is $12,600 (Rev. Proc. 2022-1 Appendix A).
  - Incurring substantial professional fees on engaging the services of a professional tax advisor to draft the private letter ruling (PLR) request.
- The administrative processing time for a PLR request by the IRS is significantly long.

LATE CHANGE OF CLASSIFICATION RELIEF UNDER REV. PROC. 2010-32

- Rev. Proc. 2010-32 provides corrective relief for certain partnership or disregarded entity classification elections. The Rev. Proc. provides a more cost-effective and faster alternative to the 301.9100-3 letter ruling process for a late change of entity classification.
- The relief applies to an entity classified as a partnership that wants to change its classification to that of a disregarded entity (because it has subsequently realized, after making the initial election, that it has only one member instead of at least two), or an entity classified as a disregarded entity that wants to change its classification to that of a partnership (because it has subsequently realized, after making the initial election, that it has at least two members instead of only one).
- If a qualified entity (i.e., an entity that is eligible to make an entity classification election) files an otherwise valid Form 8832 to be classified as a partnership for U.S. federal income tax purposes but it is later determined that the entity had a single owner for federal tax purposes as of the effective date of the election, the IRS will treat the Form 8832 as an election to treat the entity as a disregarded entity for federal tax purposes, provided that:

LATE CHANGE OF CLASSIFICATION RELIEF UNDER REV. PROC. 2010-32 (CONT'D)

- The entity's actual single owner and purported owners as of the effective date of the election file original or amended returns consistent with the treatment of the entity as a disregarded entity for any taxable year that would have been affected if the election had been made to treat the entity as a disregarded entity for federal tax purposes;
- All required amended returns are filed before the close of the period of limitations on assessments under IRC section 6501(a) (e.g., the general 3-year statute of limitations) for any relevant taxable year; and
- A corrected Form 8832 is filed with the appropriate IRS Center and a copy of the corrected Form 8832 is attached to the single owner's amended return for the taxable year during which the original election was made. The statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32" must be included across the top of the corrected Form 8832. Additionally, the corrected Form 8832 must satisfy all other Form 8832 compliance requirements.

LATE CHANGE OF CLASSIFICATION RELIEF UNDER REV. PROC. 2010-32 (CONT'D)

- If a qualified entity files an otherwise valid Form 8832 to be classified as a disregarded entity for U.S. federal income tax purposes but it is later determined that the entity had two or more owners for federal tax purposes as of the effective date of the election, the IRS will treat the Form 8832 as an election to classify the entity as a partnership for federal tax purposes, provided that:
  - The entity files information returns and its actual owners file original or amended returns consistent with the treatment of the entity as a partnership for any taxable year that would have been affected if the original election had been made to treat the entity as a partnership for federal tax purposes;
  - All required amended returns are filed before the close of the period of limitations on assessments under IRC section 6501(a) (e.g., the general 3-year statute of limitations) for any relevant taxable year; and

LATE CHANGE OF CLASSIFICATION RELIEF UNDER REV. PROC. 2010-32 (CONT'D)

- A corrected Form 8832 is filed with the appropriate IRS Center and a copy of the corrected Form 8832 is attached to the owners' amended returns for the taxable year during which the original election was made. The statement "FILED PURSUANT TO REVENUE PROCEDURE 2010-32" must be included across the top of the corrected Form 8832. Additionally, the corrected Form 8832 must satisfy all other Form 8832 compliance requirements.

PREPARING IRS FORM 8832

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: ☐ Address change ☐ Late classification relief sought under Revenue Procedure 2009-41
☐ 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)

PREPARING IRS FORM 8832 (CONT'D)

Form 8832 (Rev. 12-2013) Page 2

Part I **Election Information** (Continued)

6 **Type of entity** (see instructions):

- **a** ☐ A domestic eligible entity electing to be classified as an association taxable as a corporation.
- **b** ☐ A domestic eligible entity electing to be classified as a partnership.
- **c** ☐ A domestic eligible entity with a single owner electing to be disregarded as a separate entity.
- **d** ☐ A foreign eligible entity electing to be classified as an association taxable as a corporation.
- **e** ☐ A foreign eligible entity electing to be classified as a partnership.
- **f** ☐ A foreign eligible entity with a single owner electing to be disregarded as a separate entity.

7 If the eligible entity is created or organized in a foreign jurisdiction, provide the foreign country of organization ▶ _____

8 Election is to be effective beginning (month, day, year) (see instructions) . . . . . ▶ _____

9 Name and title of contact person whom the IRS may call for more information

10 Contact person's telephone number

Consent Statement and Signature(s) (see instructions)

Under penalties of perjury, I (we) declare that I (we) consent to the election of the above-named entity to be classified as indicated above, and that I (we) have examined this election and consent statement, and to the best of my (our) knowledge and belief, this election and consent statement are true, correct, and complete. If I am an officer, manager, or member signing for the entity, I further declare under penalties of perjury that I am authorized to make the election on its behalf.

Signature(s)	Date	Title

Form 8832 (Rev. 12-2013)

PREPARING IRS FORM 8832 (CONT'D)

- Employer Identification Number (EIN)
  - Must be obtained by the eligible entity by filing Form SS-4 prior to filing Form 8832.
  - Indicating "Applied For" in the EIN box is not acceptable.
- Rev. Proc. 2010-32 relief in the case of a determination of an incorrect number of owners.
  - How to complete Lines 3 and 4 on page 1 and Line 6b, c, e, and f (Type of entity) on page 2 depends in part on a determination of the number of owners of the eligible entity filing Form 8832. If it is discovered subsequently that the original determination of the number of owners was incorrect, the Rev. Proc. 2010-32 relief procedure allows the entity to file a corrected Form 8832 based on an accurate determination of the number of owners.

PREPARING IRS FORM 8832 (CONT'D)

- Consent Statement and Signature(s)
  - Must be signed by each member of the electing entity who is an owner at the time the election is filed; or
  - Any officer, manager or member of the electing entity who is authorized (under local law or organizational documents) to make the election.

PREPARING IRS FORM 8832 (CONT'D)

Form 8832 (Rev. 12-2013) Page 3

Part II **Late Election Relief**

11 Provide the explanation as to why the entity classification election was not filed on time (see instructions).

Under penalties of perjury, I (we) declare that I (we) have examined this election, including accompanying documents, and, to the best of my (our) knowledge and belief, the election contains all the relevant facts relating to the election, and such facts are true, correct, and complete. I (we) further declare that I (we) have personal knowledge of the facts and circumstances related to the election. I (we) further declare that the elements required for relief in Section 4.01 of Revenue Procedure 2009-41 have been satisfied.

Signature(s)	Date	Title

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

PREPARING IRS FORM 8832 (CONT'D)

Part II: Late Election Relief

- The reasonable cause statement. When formulating a reasonable cause statement for a late election, the administrative purpose underpinning the issuance of Rev. Proc. 2009-41 should be borne in mind. The IRS issued Rev. Proc. 2009-41 to provider a more cost-effective and faster relief alternative to the 9100-3 letter ruling relief with respect to the elections filed outside of the regular 75-day filing period.
- Thus, the IRS likely does not apply the "reasonable cause" standard to late elections the same way it does apply such standard to taxpayer requests for the abatement/waiver of penalties for delinquent filings of returns (e.g., information returns such as Forms 5471).

PREPARING IRS FORM 8832 (CONT'D)

Part II: Late Election Relief

- Given the administrative purpose behind Rev. Proc. 2009-41, as set forth on the preceding slide page, the following is a non-exclusive list of explanations that may constitute reasonable cause:
  - The owners of the electing entity never received professional tax advice on the necessity of making the election at the time the entity was formed or acquired, and received such advice after the 75-day filing period had run out;
  - The owners of the electing entity initially received incorrect professional tax advice that the election was not necessary at the time the entity was formed or acquired, but later obtained a second opinion from a more competent tax advisor that the election was necessary, after the 75-day period had run out;
  - An officer of the electing entity responsible for filing the election had a medical condition that kept him away from work for a period of time, and by the time he returned to the office the 75-day filing period had run out; and

PREPARING IRS FORM 8832 (CONT'D)

Part II: Late Election Relief

- Internal administrative confusion as to which officer of the electing entity was responsible for filing the election, which gets sorted out only upon realization that the 75-day filing period for the election was missed.

Who signs the late election relief statement?

- Must be signed by each member of the electing entity who is an owner at the time the election is filed; or
- An authorized representative of the eligible entity (e.g., officer, manager or member); and
- Each affected person (i.e., a person who is required to attach a copy of the Form 8832 to their U.S. federal tax or information return for the tax year that includes the effective date of the election).

PREPARING IRS FORM 8832 (CONT'D)

Post-Form 8832 Filing Compliance Obligations

- If the electing entity is required to file a federal tax or information return for the tax year of the election, a copy of the Form 8832 must be attached to that return.
- If the electing entity is not required to file a federal tax or information return for the tax year of the election, a copy of the Form 8832 must be attached to the federal tax returns of all direct or indirect owners of the entity for that year.
- Failure to attach a copy of the Form 8832 does not invalidate an otherwise valid election, but penalties may be assessed by the IRS for this non-compliance.

RONALD KALUNGI

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- Ronald provides international tax consulting and tax compliance services to a broad base of clients, including multinational corporations, partnerships, S corporations and high net worth individuals.
- Ronald is a member of the American Bar Association, the New York State Bar and District of Columbia Bar Associations.

Thank you!

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VI. Advanced Entity Selection Considerations in light of U.S. Anti-Hybrid Regulations issued under § IRC 267A

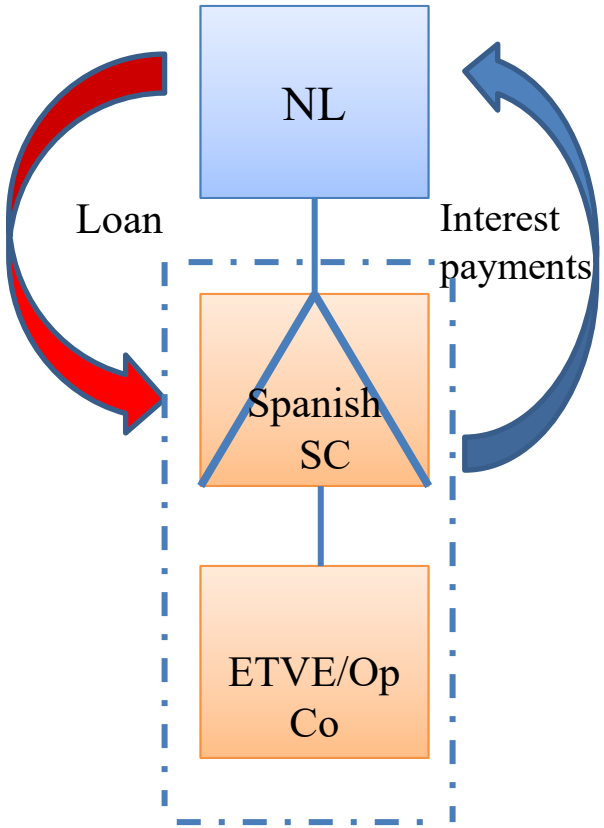
- The perceived problems with hybrid entities: potential tax arbitrage and creation of "stateless income"
- OECD's recommended fix
- Final U.S. § 267A anti-hybrid regulations

The Perceived Abuse in Hybrid Arrangements

- **Hybrid arrangements**, such as those involving hybrid entities or hybrid instruments are viewed as abusive because their use can erode the tax bases of both jurisdictions involved in a transaction.
- A **"hybrid entity"** is one that is viewed as tax transparent in one country, but as a separate corporate taxpayer in another country. The use of hybrid entities can result in income that is not taxed in any country because, for example, each country views the item as not being received by a person taxable within its own jurisdiction or, alternatively, the item is eligible for some beneficial treatment.
- A **"hybrid instrument"** can result in an income deduction in the country viewing the instrument as "debt" and in one country where the payor resides, with no income inclusion (or beneficial treatment) in the country that treats the same payment as "equity" received by a resident recipient.
- **Hybrid arrangements typically involve:**
  - A payment in one country where the payor resides, with no corresponding income inclusion where the recipient resides (or a favorable rate of taxation). This is called "Deduction—No Inclusion" **("D/NI")** in BEPS speak)
  - A double deduction for the same expense. This is called "Double Deduction" **("DD")** in BEPS speak); OR
  - Multiple claims of foreign tax credit relief for the same foreign tax paid.

Classic Example of Hybrid Entity

SC is a Hybrid Entity



Spanish Financing Structure –

"Sociedad Colectiva"

- Assume Netherlands views the SC (a *Sociedad Colectiva*) as tax transparent—i.e., a disregarded branch.
- Assume Spain treats the SC as a corporate taxpayer—i.e., a regarded entity for tax purposes.
- The SC is a "hybrid entity" because the two countries relevant to the transaction classify the SC differently for tax purposes.
- **Result:**
- Netherlands does not tax NL on the receipt of interest because it views NL as having made a loan to itself.
- Under Spanish tax law, SC may deduct the interest it pays against the income of its tax group formed by SC and the ETVE (75% participation exemption). In addition, there may no w/h tax or (a preferential rate) under the Netherlands-Spain treaty.
- The payment is deductible from income in Spain, but not included in income of the recipient the Residence country– resulting in a "deduction—no inclusion" ("DD/NI" in BEPS speak).
- Results under EU law—ATAD II? EU Parent-Sub Directive ?

Nails in "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 Senate's provision was enacted--very similar to Obama proposal!)

J. **USA:** Proposed Regulations under 267A issued in 2018. **Final Regulations issued in April 2020 (T.D. 9896).**

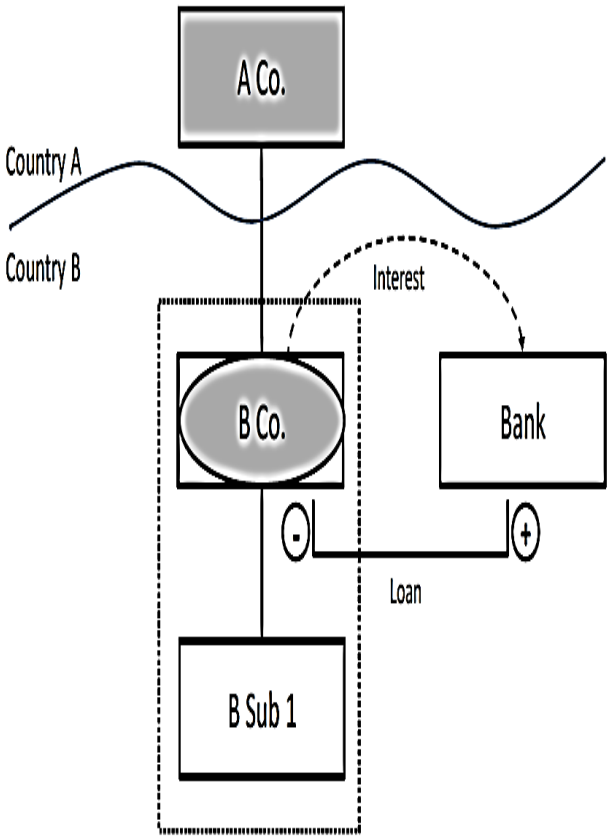
IRC § 267A

(Pub. L. 115–97, title I, § 14222(a), Dec. 22, 2017, 131 Stat. 2219.)

- **§ 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:*** Treasury issued the 2018 Proposed Regulations on December 20, 2018, which took full advantage of its grant of regulatory authority and dramatically reshaped the statutory framework. The Final 2020 Regulations largely follow the Proposed Regulations, with a few changes based on comments received. In many ways the U.S. Final Regulations go further than the OECD BEPS Action #2 recommendations.

Structures new IRC § 267A does not reach

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).

OECD's BEPS Action 2: Neutralizing the Effects of Hybrid Mismatch Arrangements"

- **The 2015 Report on Action 2 makes recommendations** for domestic legal rules to neutralize "mismatches" in tax outcomes that arise in respect of "hybrid mismatch arrangements" (HMA)
- "**Hybrid Mismatch Arrangement**" (HMA): "exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.
- Action 2 addresses inconsistencies caused both by hybrid entities and hybrid instruments.
- With respect to hybrid entities, Action 2 targets payments made by or to a hybrid entity that give rise to one of three types of mismatches:

  a. **deduction / no inclusion (D/NI)** outcomes, where the payment is deductible under the rules of the payer jurisdiction but not included in the ordinary income of the payee;

  b. **double deduction (DD) outcomes,** where the payment triggers two deductions in respect of the same payment; and

  c. **indirect deduction / no inclusion (indirect D/NI) outcomes,** where the income from a deductible payment is set-off by the payee against a deduction under a hybrid mismatch arrangement.

OECD's Recommended "Fix": Adopt "Primary" and "Defensive" Rules

- **In the Deduction/No Inclusion ("D/NI") situation:**
  - **Primary rule:** to the extent a payment gives rise to a D/NI outcome, domestic law should deny a deduction for such payment in the **payer's jurisdiction**
  - **Defensive rule:** But if such deduction is not denied (or taken anyway), domestic law should require such payment to be included as ordinary income in the **payee jurisdiction**
  - **Recommended Application:** D/NI rule applies to (i) related party or control group transactions and (ii) structured arrangements
  - **Recommendation:** Participation exemption and similar dividend relief should not apply to the payee if payment is deductible by the payer, whether or not parties are related. (However, if the payment is treated as "tax exempt" income in and of itself in payee jurisdiction, that will not create a D/NI situation. See Interim Report 9/2014.
- **In the Double Deduction ("DD") situation:**
  - **Primary rule:** to the extent a payment gives rise to a DD outcome, deny the deduction at the **parent level**
  - **Defensive rule:** deny the deduction at the **payer level**
  - **Application:** DD rule has broader application

EU Directive (ATAD 2) now addresses hybrid mismatches with 3rd (non-EU) countries

- May 2017: Council of European Union adopted a directive amending the original "Anti-Tax Avoidance Directive" (ATAD). This "ATAD 2" extends scope of ATAD to hybrid mismatches *involving non-EU countries*.
- ATAD 2 sets minimum rules that neutralize hybrid mismatches, where at least one of the parties involved is a corporate taxpayer in an EU Member State.
- In addition to expanding the territorial scope of the ATAD to third countries, ATAD 2 also expands the scope to address
  - hybrid permanent establishment (PE) mismatches, hybrid transfers, imported mismatches,
  - reverse hybrid mismatches and dual resident mismatches.
- ATAD 2 explicitly states that Member States should use the applicable explanations and examples outlined in Action 2 of the OECD's BEPS reports as a source of illustration or interpretation to the extent that they are consistent with the provisions of the ATAD 2 and EU Law.
- Deadline for implementation by Member States: Jan. 1, 2020 (to transpose the Directive into national laws and regulations) and Jan. 1, 2022 for the implementation of reverse hybrid mismatches).
- Implications: expected to have a significant effect on tax planning by multinational companies operating in the EU.
- **AND the "MULTILATERAL INSTRUMENT:** An historic multilateral tax treaty (explicitly binding) signed by 68 countries in June 2017, as result of OECD's BEPS initiative) also includes anti-hybrid mismatch rules—most of which were opted into by the signatory countries.

Final § 1.267A Anti-Hybrid Regs

of Final Reg.§1.267A-1—7 (T.D. 9896, published in Fed. Reg. April 8, 2020)

- **The Code - IRC § 267A:** generally disallows a deduction for interest or royalties paid or accrued in certain transactions involving a hybrid arrangement when U.S. law would otherwise allow a deduction, but the payee does not have a corresponding income inclusion under foreign tax law—i.e., a deduction/no-inclusion (D/NI) outcome or a double deduction outcome (DD).
- **General Rule under Final Reg. §1.267A-1(b):** A deduction for any interest or royalty paid or accrued (a "specified payment") is disallowed to the extent it is
  1) a **disqualified hybrid amount**, as described in Reg. §1.267A-2 (hybrid and branch arrangements);
  2) a **disqualified imported mismatch amount**, as described in Reg. §1.267A-4 (payments offset by a hybrid deduction); or
  3) **a specified payment for which the requirements of the anti-avoidance rule of Reg. § 1.267A-5(b)(6) are satisfied.**
- **"Relatedness" is required!!!** (In this respect, the U.S. anti-hybrid rules is narrower in scope than BEPS recommendations.) Thus, the disallowance rule of Reg. §1.267A-1(b) only applies if the specified recipient of the payment--could be a tax resident or taxable branch to which the payment is made, an investor, or even just a "home office"--is "related to" the specified party making the interest or royalty payment. "Related" defined by reference to § 954(d)(3) (i.e., > 50% vote OR value control, held directly, indirectly, or (presumably also) constructively under § 218, as modified by § 958(b).
- **A specified party**" is generally a U.S. person, a CFC or a U.S. taxable branch, and the payee must be related to the specified party.

Final § 1.267A Regs (continued)

Long-Term Deferral – the 36-month rule

- Long-term deferrals of "income inclusions" may cause a "deduction/no inclusion" (D/NI) outcome.
- A specified payment will be treated as made under a hybrid transaction if the tax year in which a the specified recipient recognizes the payment under its tax law **ends more than 36 months after** the end of the tax year in which a deduction for the payment would otherwise be allowed for US tax purposes. (*In other words, the income inclusion in the recipient's country must occur within 36 months after the end of the payer's tax year to be considered an "income inclusion" for purposes of § 267A*.)
- The Final Regulations modify the bright-line 36-month rule from the Proposed Regs.
  - A "reasonable expectation" standard applies: If, at the time of the specified payment, it should be reasonable to expect that the payment will be taken into account and included in income within the 36-month period.
  - If a specified payment will never be recognized under the tax law of a specified recipient (because, for example, the tax law does not impose an income tax), the Final Regs clarify that the long-term deferral provision does not apply.
  - The Final Regs treat a specified payment as included in income if the payment is included in income in a prior tax period.

Effective Dates of Reg. §1.267A

- Code § 267A generally applies to tax years ending on or after December 20, 2018, provided that such tax years begin after Dec. 31, 2017 (i.e., for a calendar year taxpayer effective date is January 1, 2018). However, taxpayers with short tax years beginning after Dec. 31, 2017, and ending before Dec. 20, 2018, may apply the § 267A Final Regulations in their entirety for such period.
- Most provisions in the Final Regs are subject to special applicability-date rules. The following rules generally do not apply until tax years beginning on or after Dec. 20, 2018:
  - Interest-free loans and similar arrangements
  - Disregarded payments
  - Deemed branch payments
  - Branch mismatch payments
  - Disqualified imported mismatch amounts rules
  - Structured payments (i.e., interest equivalents), and Structured arrangements (unless the structured arrangement was entered into pre-TCJA, in which case the effective date applies to tax years beginning after December 31, 2020)
  - Rules regarding swaps with significant non-periodic payments only apply to notional principal contracts entered into on or after April 8, 2021, unless the taxpayer exercises his/her discretion to apply such rules to pre-April 8, 2021 notional principal contracts.

VII. Key Takeaways and Q&A

Key Takeaways
on Foreign Entity Selection (Post – US Tax Reform)

- The choice of entity calculation starts with whether to use a US corporation to make the outbound investment (as opposed to an S-corp, or pass-through entity (LLC taxed as a partnership), or an individual)
- There is no "one size fits all" structure
- CFC status will impose more compliance costs (especially due to new GILTI regime under Section 951A)
- There is essentially no more deferral . Call it a "quasi-territorial regime" but emphasis is on QUASI (very quasi). Foreign tax credit analysis is even more difficult than analyzing interaction between Subpart F and GILTI!!
- Avoiding § 951(a) Subpart F income will still usually be cost effective because it is taxed at a higher rate (21%) as opposed to GILTI (10.5% for lucky corporations) —but not always!
- Occasionally, because of limited FTCs with the GILTI regime, results under the longtime Subpart F regime may be better!
- Just like foreign entity selection was used for decades to avoid Subpart F income, same techniques may be used to plan "into" Subpart F.
- Foreign entity selection may be used to avoid the application of the Subpart F, GILTI, and even the BEAT, and careful modeling with the right foreign entity selection can mitigate the impact of these taxes (even if you cannot avoid them).
- Path to true territoriality is making full use of the Subpart F and GILTI High Tax Exceptions and Exclusions, and then repatriate untaxed E&P under §245A..
- Hybrid mismatches (entities and instruments) are under attack globally! Be aware of the US and increasing codification of BEPS-inspired anti-hybrid rules that effectively neutralize the former tax advantages of using hybrid entities.
- No § 245A DRD for hybrid dividends (also no FTC or deduction or 78 gross-up)!
- Hybrid mismatches are often impossible to avoid; they arise organically--and can still be benign.
- Determining the optimal corporate structure requires more thought than in the past *(and a little "betting")*
- Until the US Treasury Department tells us otherwise, in some cases the law doesn't seem to work the way it should, or the way Congress apparently thought it would.
- Expect more administrative guidance from the U.S. Treasury Department (and OECD recommendations).
- **And finally: Not every cross-border structure needs to be *changed*, but each cross-border structure should be *reexamined* in light of 2017 US Tax Act, the numerous sets of implementing Treasury Regulations, and other recent (and forthcoming) global tax law changes!**

Thank you!

Questions

and

Comments?