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International Tax ADVISORY ■

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State of Uncertainty: GILTI Considerations for Individuals

The Tax Cuts and Jobs Act of 2017 (TCJA) expands other antideferral provisions in Subpart F with a new tax on current inclusions of global intangible low-taxed income (GILTI) incurred by 10% U.S. shareholders of controlled foreign corporations (CFCs). The tax is imposed on the shareholder's allocable share of net "tested income" (generally based on a CFC's gross income after certain applicable exclusions and allocable deductions) exceeding a 10% return on a CFC's adjusted basis in tangible, depreciable business assets (but only to the extent of the excess of such return over the interest expense taken into account in determining such shareholder's net CFC tested income). GILTI appears intended to approximate a residual tax on low- (or un-) taxed intangible income of a CFC, but in operation it can apply to other CFC income and at significantly higher effective tax rates for noncorporate shareholders.

Domestic C corporations that incur GILTI are eligible for a deduction equal to 50% (37.5% for taxable years beginning after 2025) of the sum of their GILTI inclusions and the associated gross-up for foreign tax credits (the Section 250 deduction). Deemed-paid credits for foreign taxes of a CFC are creditable for domestic C corporations that are 10% U.S. shareholders in computing their tax on GILTI, subject to a 20% haircut. Under the new "participation exemption" in Section 245A, domestic C corporations also receive a dividends-received deduction for certain dividends received from specified 10%-owned foreign corporations. Noncorporate taxpayers are ineligible for these benefits.

To potentially mitigate the effects of the new tax on GILTI, individuals can make an election under Section 962, which generally allows individuals (including trusts and estates, and partners or S corporation shareholders) that are 10% U.S. shareholders to be treated as though they made their investment in a CFC through a domestic C corporation for purposes of determining their tax on Subpart F income. Section 962 was popular when disparities between individual and corporate tax rates were greater and is of renewed importance after the TCJA lowered corporate tax rates significantly. An election under Section 962 is made year-by-year (but once made applies to all CFCs in which the individual is a 10% U.S. shareholder for that year) and causes GILTI to be taxed at corporate rates, currently 21%. Individuals that make Section 962 elections are also eligible for deemed-paid foreign tax credits from a CFC under Section 960. When amounts are actually distributed from a CFC and attributable to earnings and profits for which a Section 962 election applied, those amounts are subject to tax but are reduced by U.S. federal income tax imposed as a result of the Section 962 election.

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The full effects of a Section 962 election on certain aspects of the GILTI regime unfortunately remain unclear – namely, whether an individual that makes a Section 962 election is eligible for the Section 250 deduction from GILTI and whether actual distributions attributable to a CFC's earnings and profits subject to a Section 962 election can qualify for the reduced rates applicable to "qualified dividends." Proposed regulations on GILTI were issued last month but do not address its interaction with a Section 962 election. In the meantime, the Tax Court in *Smith v. Commissioner*, 151 T.C. No. 5 (Sept. 18, 2018), recently held that, when taxpayers that had made a Section 962 election received an actual distribution from a CFC organized in a nontreaty jurisdiction, the dividend was ineligible for tax at preferential rates. Even though the implied effect of a Section 962 election is to treat a 10% U.S. shareholder as if it had made its investment in a CFC through a domestic C corporation, the Tax Court determined that actual distributions of taxable Section 962 earnings and profits should not be treated as made by a hypothetical domestic C corporation (and thus potentially eligible for preferential tax rates) but should instead be treated as actually made by the CFC (and under the facts of the case were thus ineligible for preferential tax rates). Additional GILTI guidance is expected later this year.

Individuals could contribute their interests in any CFCs expected to generate significant tax on GILTI into a new or existing domestic C corporation. This alternative should take into account other considerations, such as various anti-abuse provisions of the Code, a likely renewed interest in the accumulated earnings and personal holding company tax provisions, and issues arising at the time of exit. Entering into corporate form is like swimming into a lobster pot –easy to get in, but uncomfortable to get out.[1] One less uncomfortable exit could involve a conversion to an S corporation, but consideration should be given to the Section 1374 tax on built-in gains inherited by S corporations from C corporations, which currently applies for five years after the beginning of S corporation status. Despite these considerations, a contribution to a domestic C corporation may provide a greater degree of certainty for purposes of the Section 250 deduction and the participation exemption than a Section 962 election, at least until additional GILTI guidance is issued.

For more information, please contact Brian Harvel at 404.881.4491 or Danny Reach at 704.444.1272.

[1] *See* Bittker & Eustice, *Federal Income Taxation of Corporations & Shareholders* ¶ 2.01[3] (2018).

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