Recently proposed Treasury Department regulations may provide a measure of relief for Americans abroad owning businesses through entities that are taxed as foreign corporations – in particular, corporations that are taxed as controlled foreign corporations. These can be subject to complex and punishing new rules enacted in 2017 as part of the large "tax reform" law. This is not an easy subject, but getting it right can save a lot of tax and angst. Peter Palsen explains.

IRS Proposes Additional GILTI High-Tax Relief

Peter Palsen

June 19, 2019

On June 14, 2019, proposed regulations were released that would provide an election that, when effective, could eliminate the application of the GILTI anti-deferral rule to earnings of a controlled foreign corporation (CFC) that have been subjected to foreign taxes at an effective rate greater than 18.9%. As currently proposed, the election would be effective for CFC tax years beginning on or after the regulations are finalized (and thus would not be available for calendar year 2018 tax returns).

When effective, the new election should be considered by U.S. individuals owning CFCs. Americans abroad owning foreign corporations (or foreign entities that at first glance don't appear to be a "corporation" but in fact are treated as a corporation under U.S. tax law) will want to weigh the benefits of this election with alternative structures and relief provisions.

The primary beneficiaries of the new election would be U.S. corporations that either (1) face the disallowance of expenses associated with GILTI inclusions or (2) have U.S. tax losses that would otherwise be absorbed by high-tax GILTI income. In the latter case, foreign taxes associated with the GILTI income could otherwise become unusable – thus creating a double-tax situation that would be alleviated by the proposed regulations. In the case of U.S. corporate owners, earnings of a CFC that are not treated as GILTI can be exempted from U.S. tax upon later distribution under the participation exemption system.

Unfortunately for U.S. individual owners of CFCs (including ownership through flow-through entities for tax purposes), there is no participation exemption available, and thus earnings exempted from GILTI by the new election would remain taxable upon later distribution. If this situation sounds familiar, it is because the same treatment (high-tax exemption from GILTI subject to later tax on distribution) is available to individuals by making a Section 962 election (the "962 election").

Although the two elections can create a similar result, the 962 election offers potential advantages over the proposed regulation election:

1. The 962 election is already effective and sanctioned by the IRS as a means for individuals to mitigate harsh results under GILTI – furthermore, by the time a choice is available regarding which election to use, many impacted individual taxpayers will have already filed a 962 election with their 2018 tax return.
2. The 962 election generally only requires a foreign tax rate of 13.125% to avoid GILTI (versus the 18.9% rate threshold of the proposed regulation election);

3. The 962 election permits earnings and taxes of multiple CFCs to be blended and exempted in aggregate – the proposed regulation exemption would only apply to those CFCs (or in some cases separate operating units of CFCs) that are high-taxed, thus continuing to subject low-tax earnings of other units to GILTI.
4. In the case of the proposed regulations, if the rate of foreign tax (determined under complex U.S. rules) is 18.8% on a separate unit basis, the income of such unit/CFC will not qualify for the proposed regulation relief – alternatively, the 962 election is a credit system that offsets U.S. tax by available foreign taxes, leaving only a residual to pay if the foreign taxes are insufficient for full offset.

With respect to this last item (i.e., the application of a “cliff” in the proposed regulations), it should be noted that a 962 election generally must be made on a timely filed return (with extensions). The courts have allowed the election to be made on an amended return where the need for the election was not determined until after the original return had been filed. However, it is unclear if an audit redetermination of the tax rate to an amount below the 18.9% cliff would permit a late 962 election.

So what are the potential advantages of the proposed regulation election over the 962 election? If an individual is subject to state income taxes, the ability to deflect the GILTI inclusion without running through the 962 mechanics might be beneficial. Although the 962 election has been available for many years, its historic use has been sparse and most states have not addressed its application. Double taxation or extensive correspondence could result.

It is also possible that the proposed regulation election might result in reduced tax preparation costs. One of the leading on-line expatriate tax provider firms is currently quoting a fee of $885 for the 962 election using the corporate Form 1120 reporting method. Alternatively, the proposed regulations merely require a statement to be attached to the return of the controlling shareholder. (In fact, the instructions to the 2018 Form 1040 only reference a requirement to attach a statement to support the tax due under the 962 election, but the general practice has been to attach Form 1120 and also the corporate foreign tax credit Form 1118.)

In conclusion, the proposed regulation election is a positive development that creates another alternative that should be considered by individuals to reduce the unfavorable impacts of GILTI.

Peter Palsen is an International Tax Principal at Biegel-Waller LLP in Columbia, MD.