Ecovis Americas

August 2020

MITIGATING THE IMPACT OF GILTI

Ragini Subramanian
International Tax & Business Services Manager
Marcum LLP - Greenwich

The Tax Cuts and Jobs Act (TCJA) of 2017 introduced a new IRC section 951A, which requires a United States Shareholder (U.S. Shareholder) of a Controlled Foreign Corporation (CFC) to include for each tax year, in gross income for U.S. tax purposes, her (or its) pro-rata share of the CFC's GILTI income (CFC's gross income after allowed exclusions and deductions). The GILTI income is taxed at the U.S. Shareholder's marginal tax rate (individual 37% and corporation 21%). The tax is payable even where no distribution from the CFC is received. A corporate U.S. Shareholder can seek 50% GILTI income deduction under IRC section 250 and an 80% deemed paid credit under IRC Sec. 960(d), thus mitigating the impact of the GILTI tax regime.

The individual U.S. Shareholder can also avail herself of these provisions plus 21% tax on GILTI income, provided she makes an election under IRC section 962 ("section 962 election" or "962 election"). On the face of it, making a section 962 election may seem like a great idea; however, it may not be so in every case. The U.S. taxpayer must consider the other alternatives outlined below and undertake a detailed review of many competing factors before making this election.

The alternatives may include:

1. Creating a U.S. blocker corporation ("U.S. blocker") to be the U.S. Shareholder of the CFC (as opposed to individual's direct ownership of the CFC).
2. Making or not making a section 962 election.
3. Choosing a path where the GILTI tax regime does not apply, e.g., if possible:
a. Make a check-the-box election to treat the CFC as a partnership.
b. Make a check-the-box election to treat the CFC as a disregarded entity ("DRE").
c. Operate a new foreign business as a partnership or a DRE/foreign branch.

With a 21% tax rate, 50% GILTI income exclusion, 80% deemed paid credit, and 10% dividend received deduction for distribution from a CFC, a U.S. blocker generally provides the most tax advantage. If one wants direct ownership of the CFC, the choice of alternatives becomes a challenging exercise. In the year of GILTI income inclusion, a 962 election can be comparable to U.S. blocker due to the above tax treatment. However, this comparability vanishes at dividend distribution because an individual cannot get 100% dividend deduction and because dividends are subject to the ordinary rate (37%) in the U.S.

If tax treaty is available, the ordinary tax on dividend is mitigated somewhat. If section 962 election is not made, the GILTI income is taxed at the ordinary rate, but at dividend distribution, no further tax is payable on this previously taxed income (except, e.g., foreign withholding tax, or 3.8% U.S. NIIT may apply). Thus, unless the CFC is located in a high-tax jurisdiction with favorable treaty, making or not making a 962 election likely results in the overall same tax liability; except that an individual not making a section 962 election pays tax at GILTI income inclusion while an individual making a section 962 election pays tax when distribution is received.

That said, if the CFC is not likely to make any distributions or minimal distributions, making a section 962 election, in lieu of establishing a U.S. blocker corporation, can make a lot of sense. A check-the-box election helps take the foreign entity out of the GILTI tax regime. With U.S. tax only in the year income was recognized and generally none at distribution, the tax filings become far easier for a check-the-box election. Foreign tax credit regulations should also be factored into choosing one alternative over the other, as excess foreign tax credit for 951A category income cannot be carried back or forward.

This can be a loss of a major tax advantage in a high-tax CFC jurisdiction. If the choice is made in favor of a U.S. blocker, one should look at exit strategy and available preferential U.S. treatment for U.S. domestic corporations. Finally, a choice of one alternative over the other requires not only a detailed personalized discussion of all applicable issues, but most importantly requires a mathematical modelling exercise.