COMING TO THE U.S. AFTER TAX REFORM[1]

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INTRODUCTION

Non-U.S. emerging companies continue to migrate to the U.S. to seek venture capital funding. Many founders and their attorneys have asked if the 2017 Tax Cuts and Jobs Act ("T.C.J.A.") contains changes to the tax provisions that will affect the fundamental investment structure often used prior to its enactment. The answer to that question is dependent on the particular needs and priorities of each business or investor.

Given the time that has passed since the date of enactment of the T.C.J.A., the time for broad explanations is over. Instead, this article briefly mentions the obvious changes to the law and proceeds to focus on several "sleeper provisions" that have been the domain of "elite" international tax advisors. These provisions can be quite troublesome for those who do not devote hours each day to the intricacies of tax law after the T.C.J.A. As explained below in detail, the incidence of tax for U.S. persons that own foreign enterprises has expanded exponentially. The trip wires for taxation under Subpart F have multiplied. Even if tax exposure under Subpart F can be managed, the reward is not deferral. Rather, it is immediate tax under the global intangible low-taxed income ("G.I.L.T.I.") provisions. This may be fine for corporations because tax under the G.I.L.T.I. regime is low. But it may generate highly taxed income for individual U.S. Shareholders.

OVERVIEW OF THE T.C.J.A.

Obvious changes brought about by the T.C.J.A. are well known:

- A reduction of the corporate tax rate to 21%
- An elimination of Net Operating Loss ("N.O.L.") carrybacks and limit on the N.O.L. benefit to 80% of taxable income in the carryover year[2]
- A repeal of the U.S. deferral system on foreign earnings in favor of a quasi-territorial system that taxes G.I.L.T.I. of a Controlled Foreign Corporation ("C.F.C.") on a current basis
- The adoption of a dividends received deduction for U.S. corporations receiving dividends from 10%-owned subsidiaries, along with a catch-up transition tax in 2017 that purges C.F.C.'s and other foreign corporations ("F.C.'s") that are at least 10%-owned by one or more U.S. corporations

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1 The author wishes to thank Stanley C. Ruchelman for his review of this article.

2 Thus, 20% of taxable income is taxed at 21% and the balance is carried forward indefinitely.

- An imposition of a minimum tax on base erosion and anti-abuse tax ("B.E.A.T.") payments to related parties outside the U.S. in the context of large multinational groups

- A preferential tax regime for foreign derived intangible income ("F.D.I.I.") of U.S. corporate taxpayers

- A restriction on the deductibility of business interest expense

- More favorable expensing provisions for asset acquisitions

- Special deductions for individuals who own pass-thru entities in certain business sectors

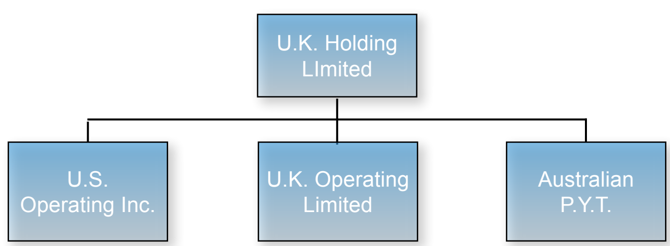
- A repeal of the corporate alternative minimum tax

SLEEPER PROVISIONS

Beginning in 2018, non-U.S. founders of non-U.S. businesses must navigate the sleeper provisions of the T.C.J.A. and their potential impact on F.C.'s and their U.S. investors. Founders and executives of certain F.C.'s will need to provide some of their U.S. investors with financial information so that they can meet their U.S. tax compliance requirements. In addition, the U.S. subsidiary of the F.C. may have incremental U.S. tax filings, which will provide detailed financial information regarding certain foreign affiliates owned in part by members of the foreign group and in part by others. Non-U.S. entrepreneurs looking to expand into the U.S. will need to acquire a basic understanding of the U.S. tax laws that will affect their global business and their U.S. investors.

TYPICAL F.C. HOLDING STRUCTURE

Generally, a non-U.S. startup that has successfully created a new scalable business at home will be encouraged to expand to the U.S. in order to intensify growth. A common structure employed is the following:



Under prior law, investors in U.K. Holding Limited ("U.K.H.L.") could potentially be either non-U.S. investors or U.S. investors, which can be further divided in two groups. Group 1 consists of U.S. investors who own shares representing less than 10% of the voting power of U.K.H.L. Group 2 includes U.S. investors who own shares representing 10% or more of the voting power of U.K.H.L. (commonly referred to as "U.S. Shareholders").

If Group 2 owns more than 50% of the shares, U.K.H.L. would be a C.F.C. for U.S. tax purposes. A C.F.C. today is subject to the anti-deferral rules of Subpart F and the new G.I.L.T.I. provisions (to be defined later), thus leading to current income for the U.S. Shareholders in Group 2, even if no cash distributions are received from U.K.H.L.

NEW U.S. SHAREHOLDER DEFINITION

The T.C.J.A. expands upon the circumstances in which an F.C. may be considered to be a C.F.C. by modifying the standard for an investor to be considered a U.S. Shareholder. As a result, the term U.S. Shareholder has been expanded to include an investor that owns shares representing 10% or more of the total value of shares of an F.C. Prior law looked only to the ownership of shares representing 10% or more of the total voting power of an F.C.[3]

While founders typically own voting stock, many venture capital funds may own "preferred shares" with no voting power but substantial value. For example, a venture capital fund may have invested all or most of its equity with a right of repayment that is senior to the rights of the common shares. In the past, a U.S. venture capital fund that holds only preferred shares with no voting power was not considered to be a U.S. Shareholder. Consequently, U.S. holders of non-voting preferred shares were not U.S. Shareholders for purposes of determining whether an F.C. were a C.F.C.

With the new expanded definition, that type of U.S. investor can be considered a U.S. Shareholder under the value-based test. Consequently, more F.C.'s will be C.F.C.'s, and more U.S. investors will be subject to the Subpart F regime and the G.I.L.T.I. provisions.

NEW DEFINITION OF C.F.C.

A C.F.C. is generally defined as any F.C. in which more than 50% of the total combined voting power of all classes of stock or of the total value of the stock is considered to be directly, indirectly, or constructively owned by U.S. Shareholders on any day of the taxable year.[4]

Constructive Ownership in an F.C.

In determining U.S. Shareholder and C.F.C. statuses, shares of stock owned directly, indirectly, and constructively in an F.C. are taken into account.[5] In contrast, only direct and indirect ownership — not constructive ownership — are taken into account in determining whether a U.S. Shareholder is required to include Subpart F Income in gross income and the amount to be included.[6]

The constructive ownership rules apply for purposes of determining whether (i) a U.S. person is a U.S. Shareholder; (ii) an F.C. is a C.F.C.; (iii) the stock of a domestic corporation is owned by a U.S. Shareholder of a C.F.C. for purposes of the rules taxing U.S. Shareholders when a C.F.C. makes a taxable investment in U.S. property; and (iv) a corporation or other person is related to the C.F.C. While the constructive ownership rules do not apply for purposes of determining the amount of gross income included in a U.S. Shareholder's income, they can cause actual U.S.

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3 Code §951(b).

4 Code §957.

5 Code §§958(a)–(b).

6 Code §951(a).

Shareholders of an F.C. that is not a C.F.C. to be taxed on a current basis under Subpart F income rules and G.I.L.T.I. rules.

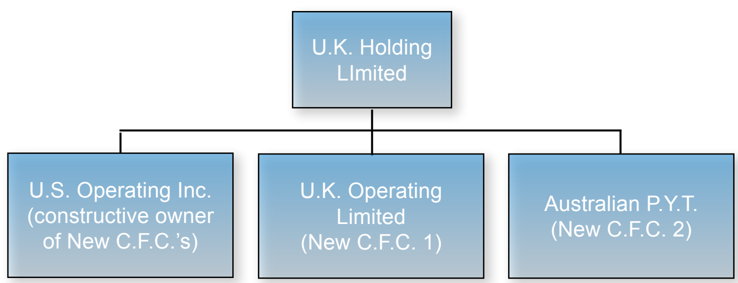
Loophole in Prior Law

Under prior law, a loophole existed that allowed tax deferred earnings of a C.F.C. to escape the U.S. tax regime when a U.S.-based group owning the C.F.C. inverted into a foreign-based group and the foreign parent acquired newly issued shares in the C.F.C. Prior law prevented ownership of the newly issued shares in the C.F.C. from being attributed to members of the U.S. group. As a result, in the right fact pattern, the C.F.C. could become an F.C. and dividends could be distributed to the foreign parent and loans could be made to U.S. affiliates without having to worry about taxation in the U.S. under Subpar F. Congress closed the loophole with the T.C.J.A., by eliminating the rule[7] that prevented the "downward" constructive attribution of stock owned by non-U.S. persons to a U.S. person.[8]

Example

For example, U.K. Operating Limited and Australian P.T.Y. are owned by a foreign parent, U.K.H.L. They can be attributed constructively to its U.S. subsidiary, U.S. Operating Inc. The repeal of the downward attribution rule leads to a surprising outcome where an innocent bystander, the U.S. Shareholder, is taxed.

In the diagram below, because U.K.H.L. owns 50% or more of U.S. Operating Inc., U.S. Operating Inc. takes the place of its parent, U.K.H.L., and is deemed to own the shares that U.K.H.L. owns in U.K. Operating Limited and Australian P.T.Y. As a result, the two latter F.C.'s become C.F.C.'s, which for purposes of this discussion we shall name as "New C.F.C.'s."



Initial Phase

If a U.S. person does not directly or indirectly own shares in U.K.H.L. representing 10% or more of the voting power or value of U.K.H.L., no income inclusion is mandated for U.S. Operating Inc. under Subpart F or the G.I.L.T.I. regime. However, there is a possibility that U.S. Operating Inc. would be required to file information returns on each of the New C.F.C.'s, although some language in the legislative history indicates that a comparable change was not made in the information reporting rules in Code §6038.[9] In any event, I.R.S. guidance issued in Notice 2018-13 waives the requirement for filing information returns where there are no direct or indirect U.S. Shareholders in the New C.F.C.'s.

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7 Code §958(b)(4).

8 Code §318(a)(3).

9 See the discussion of the Senate Amendment in the Conference Committee Report to PL 115-97, 12/22/2017, at note 1529.

Subsequent Phase

Over time, the company grows and raises new capital from U.S. investors. If one or more investors in U.K.H.L. owns sufficient shares to be considered a U.S. Shareholder of U.K.H.L. and the New C.F.C.'s, U.S. Operating Inc. (as the constructive owner of its foreign affiliates) must file information returns regarding the New C.F.C.'s. No information return is required with regard to U.K.H.L. because U.S. Operating Inc. is not a constructive owner of U.K.H.L. Failure to file these returns carries a $10,000 penalty for each C.F.C. for each year in which a compliance failure occurs.

In addition, the U.S. Shareholders of U.K.H.L., as indirect U.S. Shareholders of the New C.F.C.'s, must include in current income any Subpart F Income and G.I.L.T.I. of the New C.F.C.'s.

"The repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences."

Many international tax experts believe that the repeal of the downward attribution rule with respect to foreign parent companies has resulted in unintended consequences far beyond the loophole that concerned Congress. According to the Senate Finance Committee's explanation in the Senate bill, Congress intended for downward attribution to not apply in order for an F.C. to be treated as a C.F.C. with respect to a U.S. Shareholder not related[10] to the U.S. person (*e.g.*, U.S. Operating Inc.) to whom ownership of the F.C.'s stock was attributed.[11]

A technical amendment was proposed but was rejected as unnecessary. Now, there is a question as to whether the U.S. Treasury has the "authority" to create regulations limiting the application of this rule or whether taxpayers will have to wait for new legislation in a technical corrections bill.

EXECUTIVE RESPONSIBILITIES AND RESOURCES

U.S. Shareholders will be dependent on the financial management team of a C.F.C. to provide financial information that is needed to meet U.S. tax compliance obligations. In some countries, providing the necessary information regarding the identities of other shareholders may be prohibited. Even where not prohibited, financial management may be unwilling to provide information on a timely basis, if at all.

In these situations, the information gathering process must start well before the year end of the new C.F.C. The goal is to achieve congruence between the obligations of U.S. tax law and the agenda for financial management of the new C.F.C. It is critical for financial management to have a basic understanding of the fundamental concepts of Code §6038 in order to comply with these requests.

People with specific expertise will need to be assigned (*e.g.*, I.T. assistance for data accumulation programming) and additional funding will be required for the C.F.C. to perform these tasks on behalf of its U.S. Shareholders. An example of some of the information required is described in the definitions below.

REMAINING & NEW ANTI-DEFERRAL MEASURES

One of the major changes to the U.S. tax system is the move to a quasi-territorial

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10 Code §954(d)(3).

11 New York State Bar Association, Report on Section 965, no. 1388 (February 6, 2018), pp. 39–41.

system where dividends of C.F.C.'s are subject to a participation exemption and are not subject to tax when repatriated. Some substantial vestiges of the prior law remain to tax current U.S. Shareholders of C.F.C.'s.

Two continuing anti-deferral regimes and one new regime apply to 2018 and future years: Subpart F Income, investment in U.S. Property, and G.I.L.T.I. The most relevant concepts are briefly defined below.[12]

Subpart F Income

Despite the implementation of the T.C.J.A., the Subpart F rules remain in effect, and as the foregoing discussion indicates, are given broader scope. Subpart F Income includes foreign base company sales income, foreign base company services income, and foreign personal holding company income.[13]

- Foreign base company sales income is income derived in connection with the purchase of personal property from a related person and its sale to any person[14] whether in the form of profits, commissions, fees, or otherwise. Exceptions exist, *inter alia*, regarding sales of a product manufactured in the country of organization of a C.F.C. and sales of a product for use and consumption in the country of organization of a C.F.C.

- Foreign base company services income is income derived from performing services for, or on behalf of, a related person where the services are performed outside the C.F.C.'s country of organization.[15]

- Branches can be treated as separate companies when a sale to a branch yields the same tax effect overseas as a sale to a related person because of the disparity in tax rates between the branch and the home office.

- Subpart F is calculated on a C.F.C.-by-C.F.C. basis and an indirect foreign tax credit is available to offset some or all of the U.S. tax on such income.[16]

- The income inclusion under Subpart F is based on a concept of "earnings and profits," although the income inclusion is not treated as a deemed dividend.

The way in which Subpart F can apply to a software company will depend on the software product that will be marketed. If the software is developed by New C.F.C. 1 in the U.K. and sold as a shrink-wrap product to New C.F.C. 2 for distribution in Australia, no Subpart F Income arises in either country because the software is considered to be a copyrighted article. Because the article is "produced" in the U.K., New C.F.C. 1 does not have foreign base company sales income. The same result exists for New C.F.C. 2 in Australia because the article is sold for consumption and use in Australia.

If, on the other hand, the software is used as a service in an "SaaS" transaction, the key issue becomes foreign base company services income for services performed outside Australia by New C.F.C. 2.

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[12] A detailed discussion of the three regimes is beyond the scope of this article.

[13] Code §954(a).

[14] Code §954(d)(1).

[15] Code §954(e).

[16] Code §§901–960.

Investment in U.S. Property

The investment in U.S. property[17] provisions continue to apply as an additional mechanism to generate current income tax for a U.S. Shareholder of a C.F.C., but only to the extent the U.S. Shareholder has not previously included the earnings for the year as Subpart F Income.[18] Once earnings are included in income, the investment in U.S. property is treated as previously taxed income ("P.T.I.") that is not taxed a second time.

Generally, an investment in U.S. property eliminates sovereign risk and for that reason in treated as a form of repatriation of earnings that is taxed to a U.S. Shareholder.

The definition of taxable U.S. property includes

- tangible property located in the U.S.,
- stock of a domestic corporation that is related,
- an obligation of a U.S. person that is related, or
- any right to use in the U.S. a copyright, patent, invention, model, design, formula, process, or similar property right the C.F.C. acquired or developed for use in the U.S.

G.I.L.T.I.

The G.I.L.T.I. regime[19] applies to U.S. Shareholders of C.F.C.'s. G.I.L.T.I. applies only to income that is not already taxed in the U.S. either at the level of a C.F.C. or its U.S. Shareholders. Consequently, the first step in computing G.I.L.T.I. is to eliminate the items of C.F.C. income that produce current tax. These include the following items of income:

- Business income that is subject to net-basis taxation in the U.S.
- Dividends from a related C.F.C. that are not subject to tax in the U.S. at either the level of the C.F.C. or the level of its U.S. Shareholders because of Subpart F
- All other C.F.C. income that results in an immediate U.S. tax under Subpart F for its U.S. Shareholders

"The obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment."

The remaining income is referred to as "Tested Income."

In determining how much Tested Income is treated as G.I.L.T.I., actual economic drivers for generating income are ignored. Instead, all items of C.F.C. income are deemed to arise from either depreciable tangible property or intangible property used in the business. Inventory, work in progress, or supplies are excluded in the computation. If the C.F.C. is a foreign bank, the financial assets of the bank also are ignored.

The investment in tangible depreciable property is deemed to generate a 10% yield

17 Code §§956 and 951(a)(1)(B).

18 Code §959(a)(2).

19 Code §951A.

computed with reference to the adjusted basis of the property. That is reduced by interest expense allocated against the tangible depreciable property. The balance of the income is attributable to intangible property, which in turn gives rise to G.I.L.T.I.

For U.S. corporations, a 50% deduction is available for domestic shareholders to produce a U.S. tax imposed at the rate of 10.5%.[20] An indirect foreign tax credit can be claimed against G.I.L.T.I. but only to the extent the foreign taxes relate to the net tested income that generates G.I.L.T.I.[21] The Code §78 gross up of foreign taxes into income applies. Of the foreign income taxes that relate to G.I.L.T.I., only 80% are creditable.[22] In addition, no carryover of unused taxes is permitted.[23] As a result, to the extent foreign income taxes are not utilized as a credit in the year they arise, no benefit is obtained. When dividends are distributed, they are considered to be P.T.I. and are not taxed again.[24]

TAX COSTS FOR U.S. INVESTORS

For European companies hoping to drive down the Technology Silk Road, from London to New York to Silicon Valley, the broader definitions of a U.S. Shareholder and the expansion of the stock attribution rules will result in many more F.C.'s being viewed to be C.F.C.'s. Significant compliance and U.S. income tax costs could serve as a deterrent to marginal investments. For the F.C., the duty to provide more information for the U.S. investor adds to the cost of raising funds in the U.S. For the U.S. Shareholder, the obligation to recognize income on an accelerated current basis for an investment in a C.F.C. rather than an F.C. reduces the return on investment.

Table A illustrates the tax cost for an individual investor in an F.C. compared to the tax cost that would occur if the F.C. becomes a C.F.C. The table assumes that the F.C. is a tech company with intellectual property ("I.P.") but no tangible depreciable property, which causes the U.S. investor to be taxed under the G.I.L.T.I. provisions. In addition, the calculations assume that the F.C. would pay a dividend in year two, which would be considered a qualified dividend.

TABLE A

	U.S. Shareholder Holds Shares of a C.F.C., No Code §962 Election	U.S. Shareholder Holds Shares of a Non-C.F.C.
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**

20 Code §250(a)(3)(b).

21 Code §960(d)(1).

22 *Id.*

23 Code §904(c).

24 Code §951A(f)(1).

TABLE A		
	U.S. Shareholder Holds Shares of a C.F.C., No Code §962 Election	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$0.00	–
50% Deduction	–	–
Tax Rate	37%	–
U.S. G.I.L.T.I. Tax	$30.34	–
Worldwide Tax, Year 1	**$48.34**	**$18.00**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §959	-$82.00	$0.00
Net Dividend	$0.00	$82.00
***Dividend Tax to Individual**	**$3.12**	**$19.52**
Worldwide Tax, Years 1 & 2	$51.46	$37.52
Worldwide Effective Tax Rate	**51.5%**	**37.5%**
Net Earnings After Tax, Years 1 & 2	***$48.54***	***$62.48***
*The net investment tax applies to the dividend.		

C.F.C.

In year one, a C.F.C. has earnings of $100, which is considered to be G.I.L.T.I., and a local tax rate of 18%, generating $82 net after tax. The U.S. Shareholder would be taxable in year one at the rate of 37% of $82, resulting in a tax of $30.34 with no cash distributed to the U.S. Shareholder. The worldwide tax in year one would be $48.34 (*i.e.*, $18.00 + $30.34).

In year two, when an $82 dividend is paid, it is not taxable as it is considered to be P.T.I.; however, there is a 3.8% net investment tax on the distribution. The resulting two-year U.S. tax is $33.46, and the worldwide tax is $51.46. Assuming a constant flow of G.I.L.T.I., the investor has an inclusion in the second year that matches the inclusion in the first year.

Non-C.F.C.

On the other hand, an investor in an F.C. that is not a C.F.C. is not subject to the G.I.L.T.I. provisions. The F.C. makes no cash distribution in year one. The worldwide tax in year one is, therefore, the local tax of $18.

In year two, when a distribution is made, the U.S. Shareholder pays a tax on qualified dividends and net investment tax of 23.8% for a total of $19.52. The total U.S. tax is $19.52, and the worldwide tax is $37.52.

As the table shows, if the F.C. is a C.F.C., the worldwide effective tax rate is 51.5%, whereas if the F.C. is not a C.F.C. the effective tax rate would be 37.5% – a 37% increase in tax results from the expansion of the C.F.C. definition.

Note that tax calculations will vary with differences in facts and assumptions, tax rates in the state of residence of the U.S. investor, and the applicable effective tax rate in the foreign country.

Mitigating Factors

When considering the practical application of these rules, the results may not be quite so onerous.

If no U.S. Shareholder exists, the issues above are merely theoretical. On the other hand, if a U.S. Shareholder does exist, the main foreign operating company that owns the I.P. may be operating at a loss. Until earnings are generated, neither Subpart F nor investment in U.S. property issues will apply. Similarly, in early years, G.I.L.T.I. inclusions are not likely to exist in light of typical revenue streams in this sector. Further, such companies rarely pay dividends but hope to have an exit, via a sale of shares.

"Individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions."

POTENTIAL PLANNING OPPORTUNITIES

The "Delaware Flip"

One frequently discussed solution is to flip the F.C. group under a new U.S. parent ("Topco").

In some cases, moving foreign entities or assets under a U.S. Topco could result in foreign taxes (if unrealized gains exist) or trigger clawbacks of previously granted tax incentives. If a U.S. subsidiary exists as part of an F.C. group, it would need to be distributed out from under the foreign parent company in order to avoid the creation of a "U.S. Sandwich," which could result in potential income inclusions as "investments in U.S. property." Additionally, this distribution could be subject to taxes in the local country.

Of course, a Delaware Flip makes all remaining F.C.'s to C.F.C.'s but may provide savings under the foreign derived income rules if development activity occurs in the U.S.

The Code §962 Election

In spite of the challenges created by the T.C.J.A., planning opportunities can be employed by a U.S. Shareholder to mitigate potential U.S. taxes. For example, individuals can make a technical election under Code §962 to be taxed as a corporation with regard to income taxed under G.I.L.T.I., investment in U.S. property, and Subpart F provisions.

Code §962 was enacted as part of the original Subpart F regime with an intent to allow individuals who had invested in C.F.C.'s to have the same treatment they would have had if they invested through a U.S. corporation. The principal benefit is the deemed paid foreign tax credit allowed under Code §960. However, the election takes place annually and is often not perfect.

There are three major issues that limit the potential benefits of the election and appear to deviate from the original legislative intent:[25]

- First, if earnings of a C.F.C. are included in the income tax return of a U.S. individual under Subpart F, G.I.L.T.I., or investment in U.S. property provisions without an accompanying cash distribution, an actual dividend paid in a later year is considered to be P.T.I. and is normally not taxed again. In comparison, when an election is made by an individual under Code §962, the actual dividend from the foreign corporation is taxed a second time to the extent it exceeds taxes previously paid on the Subpart F inclusion.
- Second, the tax rate on the deemed dividend is a point of controversy with the I.R.S. The issue is whether the distribution should be treated as a qualified dividend[26] taxed at a rate that does not exceed 20%. The I.R.S. contends that the tax rate should be 37%.[27] Whichever rate applies, the net investment tax of 3.8% must be taken into account. There is currently a case in the Tax Court, *Smith v. Commr.*, addressing this matter. A request for summary judgment has been filed, and the matter may be resolved without a trial as the government's position seems weak in light of the Congressional purpose of a Code §962, which was to put an individual in the same place as having formed a U.S. corporation to act as the shareholder.
- Third, under the T.C.J.A., a 50% dividend received deduction is available to reduce the G.I.L.T.I. inclusion. This dividend received deduction is available to domestic corporations. The law does not state that it is available to individuals; although, given the purpose of the Code §962 election, one would expect that this benefit should be available.

Because of the current uncertainty regarding the calculation of the corporate tax under Code §962 alternatives, U.S. Shareholders should be cautious and evaluate the matter carefully before proceeding. Table B shows various results depending on which of these three issues are resolved in favor of the individual taxpayer.

TABLE B

	Result of Code §962 Election		
	Worst Case	**Mid Case**	**Best Case**
Non-U.S. Income	$100.00	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**	**$82.00**

25 S. Rep't No. 1881, 87th Cong., 2d Sess. 92 (1962).

26 Code §1(h)(11)(C).

27 *Smith v. Commr.*, No. 14900-15.

TABLE B			
	Result of Code §962 Election		
	Worst Case	**Mid Case**	**Best Case**
G.I.L.T.I.			
Income	$82.00	$82.00	$82.00
Gross-up	$18.00	$18.00	$18.00
50% Deduction	–	$50.00	$50.00
Tax Rate	21%	21%	21%
U.S. G.I.L.T.I. Tax	$21.00	$10.50	$10.50
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	-$14.00	-$14.00
F.T.C. Carryover	$0.00	$0.00	$0.00
U.S. Incremental Tax, Code §962(d)	$6.60	$0.00	$0.00
Worldwide Tax, Year 1	**$24.60**	**$18.00**	**$18.00**
Dividend to Shareholder	$82.00	$82.00	$82.00
P.T.I., Code §962(d)	-$6.60	$0.00	$0.00
Net Dividend	$75.40	$82.00	$82.00
Dividend Tax to individual	**$30.76**	**$29.17**	**$17.02**
Worldwide Tax, Years 1 & 2	$55.36	$47.17	$35.02
Worldwide Effective Tax Rate	**55.4%**	**47.2%**	**35%**
Net Earnings After Tax, Years 1 & 2	***$44.64***	***$52.83***	***$64.98***

In the "Worst Case," the absence of the 50% dividend received deduction results in a 21% tax rate. Thus, 80% of the $18 foreign tax is available as a $14.40 credit, leaving an incremental U.S. tax of $6.60 (*i.e.*, $21 - $14.40). The resulting worldwide tax in year one is $24.60. In year two, when a dividend is distributed to the individual, only $6.60 is allowed as P.T.I. or simply as a reduction to earnings and profits, leaving a total taxable income of $75.40. As the 20% qualifying dividend rate is not available, the dividend could be taxed at the 37% rate plus 3.8% net investment tax for a total tax of $30.76. The worldwide tax for year one and two is therefore $55.36. Certainly, selecting this alternative for a dividend-paying entity is not a good idea as the price of not making an election is only $51.46, as seen in Table A.

If some issues are resolved in favor of the individual taxpayer, the tax result could be more favorable. In the "Mid Case" calculation in Table B, the taxpayer would be entitled to a 50% dividend received deduction resulting in $10.50 of U.S. tax, which could be offset by an 80% foreign tax credit of $14.40. The additional $3.60 of excess foreign tax credit is lost because a carryover is not available, and the excess credit cannot be used against other foreign-source income. Therefore, the worldwide tax for year one is $18. In year two, when a dividend is distributed, only $10.50 is allowed as P.T.I., and $71.50 is taxable as a non-qualified dividend at 40.8%, resulting in a tax of $29.17. The worldwide tax for years one and two is $47.17. The Mid Case option results in a 17% decrease in the effective tax rate when compared to the Worst Case and is only 9% better than making no election.

Finally, if the original intent of the tax provision became a reality, the "Best Case" in Table B would be as follows. The taxpayer would be entitled to the 50% dividend received deduction along with the foreign tax credit as in the Mid Case for a worldwide tax in year one of $18. When a dividend distribution is paid in year two, only $10.50 would be available as P.T.I., leaving a dividend of $71.50. However, if the dividend were taxable as a qualified dividend at 20% plus the net investment income tax of 3.8%, the U.S. tax would be $17.02 resulting in a worldwide tax for years one and two of $35.02. The Best Case option reduces the tax by 35% in comparison to the Worst Case and is a slightly better alternative than holding shares in a U.S. domestic entity, as described below. Certainly, this option could be a real opportunity for an individual U.S. Shareholder.

The U.S. Domestic Holding Corporation

Another planning opportunity exists if an individual U.S. Shareholder were to hold investments in C.F.C.'s through a U.S. domestic corporation. Table C illustrates the tax results of this option under the same fact pattern as above.

TABLE C

	Domestic Company Holds Shares of a C.F.C.	U.S. Shareholder Holds Shares of a Non-C.F.C.
Non-U.S. Income	$100.00	$100.00
Non-U.S. Tax	$18.00	$18.00
F.C. Net Income	**$82.00**	**$82.00**
G.I.L.T.I.		
Income	$82.00	–
Gross-up	$18.00	–
50% Deduction	$50.00	–
Tax Rate	21%	–
U.S. G.I.L.T.I. Tax	$10.50	–
F.T.C. (80% G.I.L.T.I. limitation)	-$14.00	–
F.T.C. Carryover	$0.00	–
U.S. Incremental Tax, Code §962(d)	$0.00	–

TABLE C		
	Domestic Company Holds Shares of a C.F.C.	**U.S. Shareholder Holds Shares of a Non-C.F.C.**
Worldwide Tax, Year 1	**$18.00**	**$18.00**
Corporate Dividend from F.C.	$82.00	–
P.T.I., Code §959	-$82.00	–
Corporate 2nd Level of Tax	**$0.00**	**–**
Dividend to Shareholder	$82.00	$82.00
P.T.I., Code §962(d)	$0.00	$0.00
Net Dividend	$82.00	$82.00
Dividend Tax to individual	**$19.52**	**$19.52**
Worldwide Tax, Years 1 & 2	$37.52	$37.52
Worldwide Effective Tax Rate	**37%**	**37%**
Net Earnings After Tax, Years 1 & 2	***$62.48***	***$62.48***

In this calculation, the corporation gets a 50% dividend received deduction for a tax of $10.50 offset by the foreign tax credit of $14.40 as in the prior cases. The worldwide tax in year one is $18. In year two, the F.C. pays a dividend to the U.S. holding company; however, a full Code §959 deduction of P.T.I. is received. Therefore, no tax is due at the U.S. holding company level. The U.S. holding company pays a dividend to the U.S. Shareholder who pays a 23.7% dividend tax of $19.52 for a worldwide tax of $37.50.

When the worldwide tax costs of a U.S. domestic holding company holding an individual's shares in a C.F.C. is compared with the worldwide tax costs of an individual U.S. Shareholder holding shares in an F.C. that is not a C.F.C., the tax results are the same. We have come full circle.

Of course, different assumptions could have different outcomes. For example, if there were withholding taxes imposed by the non-U.S. country on the payments to the U.S. holding company or if there were different non-U.S. tax rates, the tax results would be different.

To summarize the results of this analysis, it is clear that if a U.S. Shareholder holds shares in a C.F.C. without any tax planning, the T.C.J.A. would result in an incremental tax cost of about 37%. The Code §962 election would be an option if it were possible to obtain favorable guidance on the application of both existing and new rules. At this point in time, holding shares in a domestic holding company appears to yield promising results.

<table>
<tr><th rowspan="3"></th><th colspan="4">U.S. Shareholder Holds Shares of a C.F.C.</th><th rowspan="3">Domestic Company Holds Shares of a C.F.C.</th><th rowspan="3">U.S. Shareholder Holds Shares of a Non-C.F.C.</th></tr>
<tr><th rowspan="2">No Election</th><th colspan="3">Code §962 Election</th></tr>
<tr><th>Worst Case</th><th>Mid Case</th><th>Best Case</th></tr>
<tr><td>Net Earnings After Tax, Years 1 & 2</td><td>$48.54</td><td>$44.64</td><td>$52.83</td><td>$64.98</td><td>$62.48</td><td>$62.48</td></tr>
</table>

OTHER PLANNING IDEAS

In addition to individual tax planning, there are other possible opportunities at the F.C. or subsidiary level to mitigate the impact of the T.C.J.A. Because of the peculiar application of the downward attribution rules in which the foreign parent is not eligible to be a C.F.C. even though its subsidiaries are C.F.C.'s, the possibility may exist to convert the parent company to the "trading company" where Subpart F and G.I.L.T.I. may not apply. Furthermore, it may be possible to convert corporate subsidiaries of foreign holding companies into pass-thru entities. However, deep dives into these strategies are beyond the scope of this article.

On a final note, one benefit resulting from the repeal of the downward attribution rule is the minimized tax exposure created by the Passive Foreign Investment Company ("P.F.I.C.") regime,[28] which sometimes applies to non-U.S. startups because of the proliferation of C.F.C.'s. An F.C. cannot be both a C.F.C. and a P.F.I.C. The C.F.C. rule trumps the P.F.I.C. regime.[29] Unfortunately, U.S. investors who own less than 10% of the F.C. could have P.F.I.C. issues that would result in current income gain or loss of qualified dividend treatment and the imposition of interest charges "deemed" ordinary and capital distributions.

CONCLUSION

In summary, non-U.S. emerging businesses looking to expand to the U.S. must carefully consider the growth path of their company, the availability of non-U.S. funding, as well as possible exit opportunities. Although it is true that venture capital funding is more abundant in the U.S. than in most other countries, many U.S. investors prefer to invest in U.S. corporations that hold the I.P. However, non-U.S. investors typically do not feel the same way. A strategic buyer could hold a new acquisition in his or her own offshore structure, shying away from a U.S. structure.

Furthermore, the reach of the U.S. tax authorities is extensive. Creating a Delaware Flip may not be the ideal solution. Creating a U.S. Topco is a one-way street and

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[28] Code §1291.

[29] Code §1297(d).

is virtually irreversible without the imposition of U.S. taxes on inherent asset gains. Although the current tax rate of 21% is attractive, many are not sure that the rate is politically sustainable. In addition, certain tax benefits not discussed in this article – like the F.D.I.I. provisions, which provide for only a 13.125% tax on a portion of income derived from servicing foreign markets with products or services – have been challenged by the World Trade Organization as illegal export subsidies.

While there are no easy answers or silver bullets, tax-planning opportunities exist for both U.S. Shareholders and non-U.S. corporations to mitigate some of the tax impact of the more onerous provisions in the T.C.J.A. The incremental cost of planning and complying with the new U.S. tax provisions are not to be underestimated. F.C.'s and their investors should examine their corporate structures and create models of various alternatives before drawing conclusions.