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After Tax Reform, Should Your Multinational Group Be US-Parented?

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Prior to the December 2017 enactment of the “Tax Cuts and Jobs Act” (the “Act”), common tax wisdom was to avoid placing international operations under a U.S. corporation (a “US Topco”). The high U.S. corporate tax rate (35%) and the worldwide taxation of foreign profits (subject to deferral in some cases) made the United States very unattractive as a holding company jurisdiction. Now that the Act has lowered the headline corporate tax rate to 21% and adopted an exemption for most dividends from foreign corporations, the old wisdom has been turned on its head. Especially where an international group will be ultimately owned by individuals (including through private equity funds) who do not benefit from these and other changes, it may be time to consider placing international groups under a U.S. corporate umbrella.

What’s At Stake

Significance of CFC status. Many of the tax considerations for international groups going forward will turn on the application of the U.S. tax rules applicable to “US Shareholders” of “controlled foreign corporations” (“CFCs”). Under the Act, US Shareholders who are individuals (e.g., partners of private equity funds) fare far worse than US Shareholders that are domestic corporations (e.g., a US Topco).

A CFC is defined as a foreign corporation over 50% of the stock of which, by vote or by value, is owned by US Shareholders. Prior to the Act, a US Shareholder was generally defined as any U.S. person (including, importantly, a domestic partnership) that owned at least 10% of the *voting* stock of a foreign corporation. Many private equity funds were able to avoid US Shareholder status, and thus CFC status for their foreign portfolio companies, by ensuring that few or no U.S. persons owned 10% of the vote (and by holding foreign corporations only through foreign partnerships). But under the Act, a US Shareholder will include any U.S. person that owns at least 10% of a foreign corporation’s stock *by vote or by value*. When coupled with a change to the attribution of ownership rules (the precise application of which is currently unclear), we expect that many more foreign corporations will be treated as CFCs.

Exemption of dividends from foreign corporations. Most active foreign income of a CFC is not subject to current U.S. taxation. Under prior law, if the earnings of a CFC were actually paid out as a dividend, or deemed to be paid under special rules applicable to CFC investments in U.S. property, U.S. tax would be imposed on the dividend (or deemed dividend). For individual US Shareholders, this will remain true after the Act. But for US Shareholders that are domestic corporations, the Act puts into place a "participation exemption" in the form of a 100% dividends-received deduction for dividends from 10%-or-greater owned foreign corporations (including but not limited to CFCs).[1]

The new "GILTI" tax. In an effort to ensure that some minimal amount of tax is paid by U.S. taxpayers on their low-taxed foreign income, the Act features a new tax on "global intangible low-taxed income" ("GILTI"). Every US Shareholder of a CFC will be required to include in gross income its GILTI for the taxable year. But whereas US Shareholders that are domestic corporations will pay the GILTI tax at half the rate of the regular tax, US Shareholders who are individuals will pay the tax at their top marginal rate (37% under the Act). And whereas domestic corporations will be eligible to claim foreign tax credits for 80% of foreign taxes paid on GILTI income, individuals will not be entitled to any foreign tax credits.

GILTI is essentially the excess of the US Shareholder's share of the CFC's net income (not limited to intangible income) over a deemed 10% return on the CFC's adjusted basis in tangible depreciable property used in its trade or business (less allocable interest expense).

In summary. If CFC status for foreign corporations within the group cannot be avoided, it may be preferable to put those foreign corporations below a US Topco. While the foreign corporation would then clearly be a CFC, as summarized above the impact of the application of the CFC rules, including GILTI, are far less harsh where the CFC is owned by a domestic corporation.

Some Additional Considerations

FDII. In addition to the benefits described above, domestic corporations may also benefit from a new tax incentive contained in the Act, for income referred to as "foreign-derived intangible income" ("FDII"). The Act allows a U.S. corporation to claim a 37.5% deduction with respect to its FDII, effectively reducing the tax rate thereon to 13.125%. Generally, FDII is intended to capture income, over a base return on tangible property, derived from property sold or services provided in foreign markets. While sometimes referred to as a "patent box," it applies more broadly to foreign-derived income.

Implementation costs. Whether adopting, or transitioning to, a US Topco structure makes sense will ultimately depend on a variety of factors unique to each situation. If it requires a restructuring, the restructuring may involve moving foreign entities or assets under a US Topco, which could result in foreign taxes where such assets are held at a gain. And, if the current foreign-parented group owns a U.S. subsidiary, it will be important to distribute the U.S. subsidiary out from under the former foreign parent in order to avoid a "sandwich structure." Sandwich structures usually create significant tax leakage, both because of withholding taxes and because the former foreign parent, now a CFC under US Topco, would own an investment in U.S. property subject to subpart F taxation. A distribution by the former foreign parent of stock of the U.S. subsidiary to the new US Topco could also be subject to foreign taxation.

Whether or not the benefits of a restructuring will outweigh such costs, would depend on the specifics of the transaction, including the size of any built-in-gain and/or whether there are any losses to shield such gain.

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[1] All US Shareholders remain subject to the rules of "subpart F," which impose current taxation on certain passive and mobile income of CFCs. In addition, domestic corporations will not receive a dividend received deduction for deemed dividends; however, in many cases the deemed dividend may be treated as a distribution of previously taxed income under the subpart F rules.

Set forth below is a chart that summarizes some key differences between a US Topco structure and a foreign-parented structure that is a CFC to its US Shareholders.

Issue	**U.S. Topco**	**Foreign Topco**
FDII Applicable?	Yes	No
Reduced Tax Rate on GILTI	Yes 10.5%	No
Foreign Tax Credits	Yes (But limited to 80% of foreign taxes paid on GILTI)	No
Participation Exemption	Yes	No

Caveat. Once a US Topco is in place, it may be difficult to extract the foreign subsidiaries from beneath the US Topco without a significant U.S. tax cost. For example, a strategic buyer may wish to hold the foreign subsidiaries within its own offshore structure rather than under a U.S. corporation. In all cases, the potential benefits and costs of a US Topco structure will need to be carefully analyzed.

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