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# 'Who's on Top?' Reconsidering U.S. Parents After Tax Reform

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Prior to the enactment of the 2017 tax reform act, formerly referred to as the Tax Cuts and Jobs Act (the "Act"), common tax wisdom was to avoid placing international operations under a U.S. parent corporation (a "U.S. Topco"). The aversion to using a U.S. Topco where a non-U.S. one was available was usually ascribed to the high U.S. corporate tax rate (35%) and to the worldwide taxation of foreign profits only partially ameliorated by stingy foreign tax credit rules. It was for these sorts of reasons that many U.S. corporations considered "inverting" below foreign ones.

Today, of course, the corporate tax rate has been reduced to only 21% (and in some cases lower, as noted below). The Act also adopted a 100% exemption for most dividends from foreign corporations. These and other changes call for a reconsideration of whether a multinational group might be best off with a U.S. Topco. This is particularly true if the alternative is the use of a foreign parent that would be a controlled foreign corporation (CFC) owned in part by individuals, including through partnerships.

Many of the tax considerations for international groups going forward will turn on the application of the U.S. tax rules applicable to U.S. shareholders of CFCs. These rules now include not only subpart F and §956, which have been retained largely unmodified, but also the new GILTI (Global Intangible Low-Taxed Income) tax in §951A.[1] As is by now well known, the Act changed the definition of a U.S. shareholder to include any U.S. person that owns at least 10% of the stock of a foreign corporation, by vote or by value. (A CFC is still a foreign corporation over 50% of the stock of which, by vote or by value, is owned by one or more such U.S. shareholders.) In addition, the Act repealed §958(b)(4), thereby enabling "downstream" attribution of stock from foreign to U.S. persons, which can cause foreign corporations to be CFCs under circumstances not presented under prior law.

## CFCs of Domestic Partnerships

Foreign corporations owned by domestic partnerships present difficult CFC issues. It is the position of the Internal Revenue Service that a domestic partnership is a U.S. person for purposes of these rules and not simply an aggregation of its partners. If a domestic corporation owns at least 10% of the stock of a foreign corporation that qualifies as a CFC, the partnership will be treated as a U.S. shareholder for these purposes. What's more, it is the position of the IRS that every U.S. person who is a partner of that domestic partnership is treated as a U.S. shareholder for these purposes, even if he or she owns a very small interest that would not approach 10% of the stock of the foreign corporation on a look-through basis.

These IRS positions now have even greater consequences in light of the new GILTI regime and the changes to the CFC definitions just noted.

So, what are the reasons that the owners of a foreign corporation might want to transfer their stock into a new U.S. Topco? To begin with, U.S. shareholders that are domestic corporations will be entitled to exclude from income 100% of most dividends received from CFCs and other 10%-or-greater-owned foreign corporations. But U.S. shareholders that are individuals do not benefit from that exclusion. As a result, they will pay tax on dividends (as well as on

[1] All section references are to the Internal Revenue Code of 1986, as amended.



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subpart F inclusions) at individual rates, generally 37%.[2]

Second, every U.S. shareholder of a CFC will be required to include in gross income its GILTI for the taxable year. GILTI is essentially the excess of the U.S. 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). Whereas U.S. shareholders that are domestic corporations will pay the GILTI tax at half the regular corporate rate, i.e., 10.5%, U.S. shareholders who are individuals will pay the tax at their regular 37% rate. And whereas a U.S. shareholder that is a domestic corporation will be eligible to claim foreign tax credits for 80% of foreign taxes paid on GILTI income, individuals are not entitled to claim such credits.

Third, domestic corporations may 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.

**Evaluating Benefits of a U.S. Parent**

Whether a U.S. Topco structure makes sense will ultimately depend on a variety of factors unique to each situation. If a restructuring is required, it may entail moving foreign entities or assets under U.S. Topco, which could result in foreign taxes where such assets are held at a gain. 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 risk significant tax leakage, both because of cross-border withholding taxes and because the stock of the U.S. subsidiary owned by the former foreign parent (now a CFC under U.S. Topco) would constitute an investment in U.S. property subject to §956. A distribution by the former foreign parent of stock of the U.S. subsidiary to the new U.S. Topco could be subject to foreign taxation.

This note has addressed the salient considerations involved when a decision of where to place the top company in a multinational structure is being made prospectively. It therefore does not address the consequences of the deemed repatriation tax under the Act (§965 of the Code). If, for example, a foreign parent corporation became a CFC owned by a partnership of individuals effective for a period to which the deemed repatriation tax applied, the decision to place a new U.S. Topco on top of that CFC will need to take into account any basis and previously taxed income created by that new tax. It will also require consideration of how the election to defer payment of the tax will apply in future years.

Whether the benefits of a restructuring would outweigh such costs depends on the specifics of the transaction, including the size of any built-in-gain and/or whether there would be any losses to shield such gain. Once a U.S. Topco is in place, it may be difficult to extract the foreign subsidiaries from beneath the U.S. 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 U.S. Topco structure would need to be carefully analyzed.

[2] Dividends may in some cases qualify for the 20% rate provided in §1(h)(11).



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