

Callous Neglect: The impact of United States tax reform on nonresident citizens

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Abstract

US tax rules are complex and nowhere more so than the international provisions. However, due to the US practice of citizenship-based taxation, nonresident US citizens are frequently impacted by US international tax rules aimed at multinational corporations and high net worth US residents. The international provisions in the US tax reform legislation enacted in December 2017, the “Tax Cuts and Jobs Act” (TCJA), are no exception. While the benefits, such as a 100% dividend received deduction for distributions from foreign subsidiaries, are largely limited to US domestic corporations; the costs, such as “repatriation” of accumulated foreign earnings and a new global minimum tax, apply to controlled foreign corporations (CFCs) owned by individual *US Shareholders*¹ including local corporations owned by US citizens resident in other countries. Thus, for example, Australian corporations owned by Australian citizens or residents subject to US citizenship-based taxation could be subject to potentially *devastating* new US taxes with no corresponding benefit. How did this come about, and why has Congress neglected to consider these serious unintended consequences?

These new taxes have been implemented through the US CFC regime which is found in a portion of the US Internal Revenue Code known as “Subpart F.”² Prior to TCJA, Subpart F allowed the deferral of active CFC business income earned outside of the US until an actual corporate distribution (dividend) was made to the US shareholders. Aimed at large multinationals such as Apple, and the large amounts these corporations have stashed overseas in order to defer US taxation, the §965 transition tax imposes retroactive US taxation on the accumulated undistributed earnings of CFCs since 1986. New §951A imposes a tax on “Global Intangible Low Taxed Income” (GILTI), which re-defines certain non-US active business income as US-source and subject to immediate US taxation even if not distributed to US shareholders.

There is no indication in the legislative record that Congress considered the disparate impact of these rules on US-resident shareholders relative to those resident in other countries. This paper quantifies the effects of the new law on Australian-resident US Shareholders of CFCs, demonstrating that the effect of these new taxes on nonresident citizens was not considered. In particular, the timing difference between US taxation and host country taxation will lead to double taxation that may not be mitigated by tax treaties. While these provisions of TCJA may make sense when applied to US-resident shareholders of CFCs, the disparate impact on non-resident US taxpayers is another illustration of the problems that ensue when a country imposes the same rules on both residents and nonresidents.

I. Introduction

In December 2017 the US enacted sweeping tax reform impacting both domestic and international taxation. The international provisions of the Tax Cuts and Jobs Act (TCJA)³ represent a fundamental shift in the way the US taxes multinational corporations. While there have been several papers⁴ addressing the impact of these provisions on large multinationals, such as Apple, there has been little discussion of the impact of these provisions on individual entrepreneurs, especially those US citizens who are residents (and taxpayers) in other countries. This population is especially hard hit by the new

¹ US Shareholder is defined in §951(b) as a US person (defined in §957(c)) that owns directly or constructively 10% or more of a foreign corporation.

² Subpart F is found in 26 USC sections 951 – 965.

³ *An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*, Pub Law 115-97. Originally submitted to Congress with a short title of *The Tax Cuts and Jobs Act* (TCJA), this short title was ruled out of order in the final Senate vote on the bill, but has become the popular name for the legislation.

⁴ See, for example, Avi-Yonah, Reuven S., *The International Provisions of the TCJA: A Preliminary Summary and Assessment* (December 23, 2017). U of Michigan Public Law Research Paper No. 605; or Clausing, Kimberly A., *Profit Shifting Before and After the Tax Cuts and Jobs Act* (October 29, 2018). Available at SSRN: <https://ssrn.com/abstract=3274827>.

legislation because they are more likely than US residents to run their small businesses in corporate form and because of the particularly complex US tax treatment of non-US corporations. Under the new rules, it has become difficult for nonresident US citizens⁵ to run small businesses which contribute to the economies of the countries where they live.

The United States is alone among developed countries in claiming tax jurisdiction based on citizenship, regardless of where those citizens are physically resident and whether they are also tax residents or citizens of other countries.⁶ Nonresident citizens are a very small portion of the US tax base. For tax year 2016, there were just under 150 million US individual tax returns filed. Of these 764,580 were filed with a taxpayer address outside of the US, including returns filed by overseas military and civilian government employees. Thus, tax returns filed by nonresident citizens represent less than 0.51% of total returns filed and less than 0.53% of the total reported individual income tax collected by the Internal Revenue Service (IRS).⁷ Politically, these nonresident citizens have very little impact as their votes are spread across all Congressional districts based on their last place of residence (or their parents' last place of residence if they have never lived in the US), and their level of participation in US elections is very low.⁸

Given the small constituency of nonresident citizens, the concerns of these citizens about the impact of US laws on their everyday lives are often ignored by Congress.⁹ This is particularly evident when the international provisions of the 2017 tax reform are considered. Reporting on the new law focused on the lower corporate tax rate and the change from the previous worldwide tax system for US multinational corporations to a territorial system. However, just as the prior system of corporate taxation was not really worldwide,¹⁰ the new law is not purely territorial.¹¹ Rather than simplify the overly complex US international tax system, TCJA has added layers of complexity that are only now beginning to be understood by US tax professionals. For US-based multinational corporations, the benefits of lower tax rates and partial exemption of foreign income were tempered by a transition tax on previously deferred foreign income as well as an extension of the US tax base to cover "Global Intangible Low-Taxed Income" (GILTI) and a "Base Erosion Anti-Abuse Tax" (BEAT). While the benefits of TCJA

⁵ It should be noted that the majority of US citizens residing in Australia are also Australian citizens (ABS data from the 2016 census show that 54.8% of Australian residents born in the US are Australian citizens, this is a subset of US citizens as it does not include US citizens by descent or naturalisation, most of whom would be dual citizens).

⁶ For discussions on the justification or lack of justification for using citizenship as a basis for taxation see MS Kirsch, *Taxing Citizens in a Global Economy*, NYU Law Review (82), 2007; A Christians, *Human Rights at the Borders of Tax Sovereignty*, <https://ssrn.com/abstract=2924925>, 2017; R Mason, *Citizenship Taxation*, Southern California Law Review (89), 2016; and M Cabezas, *Reasons for Citizenship-Based Taxation?*, Penn State Law Review (121), 2016.

⁷ Source: author's computations from data available at <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>

⁸ The Overseas Citizen Population Analysis Report, available from the Federal Voting Assistance Program at <https://www.fvap.gov/info/reports-surveys/overseas-citizen-population-analysis> shows that 6.9% of eligible overseas voters actually voted in the 2016 US elections.

⁹ In July 2015, the Senate Finance Committee's *International Tax Bipartisan Tax Working Group Report* noted on page 80 that nearly three-quarters of the 347 submissions received were about the taxation of nonresident citizens, but the working group declined to respond to the issues raised by these submissions. (The report is available at <https://www.finance.senate.gov/imo/media/doc/The%20International%20Tax%20Bipartisan%20Tax%20Working%20Group%20Report.pdf>)

¹⁰ See, for example, Fleming, J. Clifton, Jr.; Peroni, Robert J.; Shay, Stephen E. (2009), *Worse than Exemption*, Emory Law Journal 59 pp79-149.

¹¹ See, for example, Shaviro, Daniel N. (2018), *The New Non-Territorial U.S. International Tax System*, Tax Notes, July 2, 2018; and Fleming, J. Clifton, Jr.; Peroni, Robert J.; Shay, Stephen E. (2018), *Expanded Worldwide Versus Territorial Taxation After the TCJA*, Tax Notes 161(10) December 3, 2018.

apply only to US corporate taxpayers, both the transition tax and GILTI apply to all *US Shareholders*¹² of *Controlled Foreign Corporations*¹³, including individuals and nonresident citizens.

The purpose of this paper is not to enter the debate over whether it is appropriate for the US to assert tax jurisdiction so widely, but to explore the consequences of this tax jurisdiction when US law is written based solely on domestic politics and with only domestic taxpayers in mind. This paper proceeds by quickly summarising the previous modified territorial US tax system for CFCs, then illustrates the new rules in TCJA with a numerical example that shows the different treatment of corporate shareholders relative to individual shareholders. While the impact of TCJA on corporations has been analysed before, the impact on nonresident citizens has not been explored.

II. The Evolution of US International Tax Provisions

The subpart F Controlled Foreign Corporation rules were added to the US tax code in 1962 to address the problem of US-resident taxpayers moving easily mobile passive income into foreign corporations and out of the reach of the Internal Revenue Service (IRS).¹⁴ Prior to TCJA, the active business income of a CFC was not generally subject to US taxation until those profits were distributed as a dividend. Certain types of income could not be deferred and were taxed to US Shareholders as they occurred – mainly passive income and other easily moveable income – whether a distribution was made or not. The prior system had considerable complexity in determining how deductions were allocated or apportioned between deferred and currently taxed income and in determining how much foreign tax was available as a credit to offset US tax (and avoid double taxation).

Double taxation of CFC income is avoided by allowing corporate shareholders to treat taxes paid by their foreign subsidiaries as if they had been paid directly by the shareholder, known as “deemed paid” foreign tax. Individual US Shareholders of CFCs could elect to be taxed on subpart F income at corporate rates, including the ability to use this deemed paid foreign tax to offset US tax on subpart F income. This election, available under §962, was rarely used by individuals for several reasons: the US corporate tax rate was generally higher than individual US tax rates; if the §962 election were made, subsequent dividends would be taxable in the US, while without the election those subsequent dividends were treated as previously taxed income; and finally, foreign tax paid on CFC distributions was often sufficient to fully offset US tax for shareholders resident in countries with higher individual income tax rates than the US.

Because US Shareholders were not taxed by the US until CFC profits were distributed, many large corporations built up huge reserves of deferred foreign income. One measure of this deferred foreign income for public companies can be found in annual reports as “indefinitely reinvested foreign earnings.” The indefinitely reinvested foreign earnings of US public companies were estimated to be over US\$2.6 trillion as of 2016.¹⁵ Numerous articles in the press, as well as academic articles, argued

¹² See note 2, *supra*.

¹³ Defined in §957(a) as a foreign corporation with more than 50% ownership by US Shareholders.

¹⁴ US Shareholders of CFCs are subject to extensive reporting of corporate information on Form 5471. There is no data on how many individual US shareholders file form 5471, but IRS data on 2014 corporate filings of form 5471 (<https://www.irs.gov/pub/irs-soi/14it02cfr.xls>) included 2917 Australian incorporated CFCs with total assets of US\$483,785,483,000, gross receipts of US\$176,672,221,000, and accumulated E&P of US\$63,278,357,000, of which US\$3,753,243,000 was Previously Taxed Earnings and Profits (PTEP).

¹⁵ Public corporations are required to keep track of deferred taxes. When tax is deferred “indefinitely” because the firm has no plans to repatriate funds from foreign subsidiaries, this amount must be tracked and disclosed as “indefinitely reinvested foreign earnings” under US accounting standards. The \$2.6 trillion estimate comes from a report by Audit Analytics covering Russell 1000 companies.
<https://www.auditanalytics.com/blog/indefinitely-reinvested-foreign-earnings-still-climbing/>

that this deferral of US tax should be curtailed and that the US should impose tax on the accumulated deferral.¹⁶

TCJA replaced the former system, which taxed CFC active business income only when distributed as a dividend, with an exemption system where foreign source dividends received by domestic corporations from their CFCs are completely exempt from US tax under new §245A. As part of this move, Congress enacted IRC §965 to tax the previously deferred foreign earnings of CFCs through a deemed repatriation. To address the issue of globally mobile intangible income, §951A added a tax on Global Intangible Low-Taxed Income (GILTI). Domestic corporations were further encouraged to increase export transactions by a new deduction from US source income for “Foreign Derived Intangible Income” (FDII). Finally, large corporations were discouraged from shifting income through related party transactions by the new Base Erosion Anti-Abuse Tax (BEAT). In designing the new system, Congress made most of the benefits available only to US C Corporations,¹⁷ while both the transition tax and GILTI apply to all CFCs, including those owned by individuals or pass-through entities.

It is important to note that the premises underlying tax reform do not apply to most nonresident citizens, especially those residing in high tax jurisdictions. There is no deferral when foreign tax credits on dividends will eliminate any future US tax liability. Nonresident citizens were not “hiding” income outside of the US, they were running businesses, and paying taxes, where they live. Any US tax they pay due to TCJA is tax on non-US source income that would never have been collected by the US under prior law. The following sections will explore in detail the two provisions that affect individual US Shareholders of CFCs, the transition tax and GILTI.

III. Transition Tax

A. Overview

§965 provides that deferred foreign income, measured as accumulated post-1986 earnings and profits not previously taxed under the US subpart F regime, is to be included in US taxable income of the shareholder in the last taxable year which begins before January 1, 2018. For calendar year shareholders with calendar year CFCs, this would be calendar year 2017. Given that TCJA was introduced in Congress on 2 Nov 2017, and signed into law on 22 Dec 2017, US shareholders of CFCs did not have any time to plan to mitigate the effect of this tax. While these changes were probably not much of a surprise to multinational corporations with in-house tax departments, nonresident US citizens running small businesses were caught unaware. Furthermore, the IRS has not yet finalised the regulations under §965, which were published in the Federal Register as proposed regulations on 9 August 2018,¹⁸ even though the last possible extended due date for a 2017 calendar year tax return was 15 December 2018.¹⁹ For small businesses owned by nonresident citizens, compliance is nearly impossible.

For corporate shareholders, retaining income in foreign subsidiaries deferred payment of US tax at a rate of 35% (offset by foreign tax credits). Not all of the income retained overseas would have been eventually repatriated to the US, as some would have been reinvested to grow foreign operations.

¹⁶ For example: Desai, M.A. and Hines Jr, J.R., 2003. *Evaluating international tax reform*. National Tax Journal, pp.487-502.; Grubert, H. and Altshuler, R., 2006. *Corporate Taxes in the world economy: reforming the taxation of cross-border income* (No. 2006, 26). Working papers, Department of Economics, Rutgers University; Fleming, J. Clifton, Jr., Peroni, Robert J., and Shay, Stephen E. (2017), *Getting from Here to There: The Transition Tax Issue*, Tax Notes v154 no 13 p69-78.

¹⁷ Known as C Corporations because rules for corporate transactions are found in Subchapter C of the US tax code.

¹⁸ See note 22.

¹⁹ Most individual US taxpayers report on a calendar year basis. Their wholly owned CFCs would be required to report on either a December or November year end. Thus, a large portion of the individual US Shareholders impacted by the transition tax would have been required to report this income on a calendar year 2017 tax return.

Furthermore, any repatriation would have been in the future, so requiring a full 35% tax payment on deferred overseas income would have been unreasonable. As an acknowledgement of this, Congress allowed for a deduction that would bring the effective tax rate on deferred foreign income down to either 15.5% or 8%. Congress further allowed that the US parent company could spread the payment of the tax on this deemed repatriation over a period of eight years with no interest charge.

Most of the complexities surrounding the transition tax relate to the measurement of foreign cash holdings (taxed at 15.5%) and how shareholders compute the tax due when there are multiple foreign subsidiaries with different accounting periods, related party transactions, and some subsidiaries with accumulated deficits. The IRS provided guidance on these and other issues through a series of notices,²⁰ FAQs,²¹ and proposed regulations.²²

B. Computing the §965 inclusion

The starting point for computing the transition tax is the CFC's accumulated post-1986 earnings and profits (E&P). 'Earnings and profits' is a US tax concept similar to retained earnings. It is computed using US tax accounting rules, which are based on US GAAP. The US Shareholder will have been reporting this number annually on Form 5471.²³ The base for the transition tax, *deferred foreign income*, is computed as accumulated post-1986 E&P less any amounts attributable to either income effectively connected with a US trade or business or income previously taxed under the subpart F regime.²⁴ Each CFC will increase its subpart F income by the larger of deferred foreign income as measured on 2 November 2017 or 31 December 2017. Where a US Shareholder has multiple CFCs including both CFCs with accumulated deferred foreign income and CFCs with accumulated deficits, it is possible to use the deficits to reduce deferred foreign income.

Under §965(c), a deduction is allowed against deferred foreign income based on the shareholder's *aggregate foreign cash position*. To compute aggregate foreign cash position, the shareholder aggregates across all CFCs owned their pro-rata share of cash and cash equivalents.²⁵ This aggregate foreign cash position is measured on the final day of each CFC's inclusion year, and measured again as an average ending balance from the last two tax years ending before 2 November 2017²⁶ and the larger of the two values is used. Once aggregate cash position has been computed, the deduction under §965(c) is computed under a formula that will result in corporate taxpayers paying a net tax of 15.5% on foreign cash holdings (up to the amount of deferred foreign income) and 8% on the balance of deferred foreign income (if any).

To clarify how the statute works, consider the impact on ExampleCo, an Australian corporation that is wholly owned by a US taxpayer.²⁷ Table 1 contains the balance sheet of ExampleCo at 31 December 2017.²⁸ ExampleCo has \$800,000 of deferred foreign income. ExampleCo will compute its foreign cash

²⁰ Notice 2018-07 issued 27 December 2017; Notice 2018-13 issued 19 January 2018; Rev. Proc. 2018-17 issued 13 February 2018; Notice 2018-26 issued 2 April 2018; and Notice 2018-78 issued 1 October 2018.

²¹ "Questions and Answers about Reporting Related to Section 965 on 2017 Tax Returns" available at <https://www.irs.gov/newsroom/questions-and-answers-about-reporting-related-to-section-965-on-2017-tax-returns>

²² "Guidance Regarding the Transition Tax Under Section 965 and Related Provisions," 83 Fed. Reg. 39514 (9 August 2018) (Proposed 965 Regulations)

²³ <https://www.irs.gov/forms-pubs/about-form-5471>

²⁴ See §965(d)(2). Deferred foreign income does not include any accumulated E&P that arose while the corporation was not a CFC under US tax rules.

²⁵ See the definition of "cash position" in §965(c)(3)(B), which includes cash, net accounts receivable, and traded financial securities.

²⁶ The CFC's last US tax year which begins before 1 January 2018.

²⁷ A technical Appendix is available by request from the author. The numbers here are drawn from the extended example provided in that Appendix.

²⁸ See Table 1 for a list of simplifying assumptions.

position as cash plus accounts receivable net of accounts payable, or $230,000 + 80,000 - 30,000 = \$280,000$. The deduction under §965(c) is computed with the following formula:²⁹

$$\begin{aligned} & \text{foreign cash position} \times 55.7\% \\ & + (\text{deferred foreign income} - \text{foreign cash position}) \times 77.1\% \\ & 280,000 \times 55.7\% + 520,000 \times 77.1\% = \$556,880 \end{aligned}$$

So ExampleCo's owner can deduct \$556,880 from deferred foreign income of \$800,000 for a net increase to US taxable income of \$243,120.³⁰

How this shows up on the US Shareholder's US tax return will depend on whether the shareholder is a US corporation or individual. Corporations are able to treat a portion of Australian taxes paid by ExampleCo as if these taxes had been paid directly by the shareholder under rules provided in §960. This computation is shown in Table 2, leaving \$91,170 of foreign taxes that can be used as a deemed paid credit. When a deemed paid credit is allowed, the shareholder is required under §78 to increase taxable income by the amount of the taxes deemed paid. Once the corporate US Shareholder has paid the transition tax, the associated \$800,000 of E&P becomes Previously Taxed E&P (PTEP), and may be distributed without paying further US tax. Furthermore, if ExampleCo has been more than 80% owned by a corporate US Shareholder for 12 months or more, any dividend paid by ExampleCo to the US Shareholder is exempt from Australian tax under Article 10 of the US/Australia Tax Convention.

C. How the rules differ for individual US Shareholders

Individual US Shareholders will compute the amount of the net §965 inclusion in the same way as a corporate US Shareholder. The difference comes in the way tax is computed and the treatment of subsequent dividends. An individual with subpart F income³¹ may elect under §962 to be taxed on that subpart F income at the rates applicable to corporations. As part of this election, the individual shareholder is allowed to use the §960 deemed paid foreign tax credit to treat the taxes paid by the CFC as if they had been paid directly by the shareholder. The cost of this election, however, is that the shareholder's PTEP with respect to the CFC is increased only by the amount of tax actually paid on the subpart F income (after foreign tax credits). As shown in Table 2, an individual shareholder electing to use §962 would be taxable on \$334,290 at the corporate tax rates in effect for 2017. Since only the §965 inclusion is included in this computation, the individual shareholder will get the benefit of the progressive rate structure for small corporations and will pay US tax of \$22,453 after application of foreign tax credits. This means that the first \$22,453 of dividends paid after 2017 will not incur US tax. Australian tax paid on those dividends will, however, be available to offset other US taxable income in

²⁹ In the case of a CFC that does not report on a calendar year basis, the percentages used to compute the §965(c) deduction will differ to account for the change in US corporate tax rate from 35% to 21% as of 1 January 2018.

³⁰ The calculations that are specific to a given CFC are done in that corporation's functional currency, which is the currency in which the CFC does business and keeps its books and records. Figures are converted to US dollars when aggregated at the US Shareholder level. In this example the exchange rate is assumed to be 1AUD=1USD for ease of exposition.

³¹ §965 works by treating deferred foreign income as subpart F income (see §965(a)).

the general limitation category³² after reduction under §965(g). Once PTEP is exhausted, dividends will be classified as “Qualified Dividends”³³ and taxed at the reduced rate applicable for capital gains.³⁴

Absent the §962 election, the individual shareholder will include the subpart F income from §965 in their personal taxable income, to be taxed at their marginal tax rate,³⁵ and will increase PTEP by the entire \$800,000 of deferred foreign income. While tax paid by ExampleCo will not be available to offset the US tax on the §965 inclusion, any unused general limitation foreign tax credits from 2008-2017 will be available to offset the tax. When subsequent dividends are paid, any Australian tax paid (after reduction under §965(g)) will be added to general limitation foreign tax credits and can be used to offset any US tax in that category.³⁶ Due to the allocation rules for computing foreign tax credits, the result is dependent on what other items of income are on the shareholder’s individual tax return. For comparison, if the individual shareholder has \$100,000 in salary and about \$6,000 in passive income in addition to this §965 inclusion, they will end up owing approximately \$73,000 in US tax after application of foreign tax credits, compared to the zero US tax liability they would have faced under pre-TCJA rules.³⁷

The transition tax represents a deemed repatriation of the accumulated earnings of a CFC. There is no realisation event. It will apply to any foreign corporation³⁸ where more than half of the shares are owned (either directly or through attribution rules in §318) by US Shareholders (who must own at least 10% to be counted). The purpose of this addition to tax is stated in the title of §965: “Treatment of deferred foreign income upon transition to participation exemption system of taxation.” However, individual US shareholders are not given the benefit of the new participation exemption system of taxation; they are not allowed to exclude future deferred foreign income from US taxation under §245A. Furthermore, for Australian-resident US citizens (most of whom are also Australian citizens), the idea that they should “repatriate” corporate earnings to the US defies logic.

IV. GILTI

A. Overview

GILTI (Global Intangible Low Tax Income) is the gift that keeps on giving – claiming US tax jurisdiction over the income of corporations owned by US “persons” on an ongoing basis. While the transition tax was painful, it was a one-off. For calendar year taxpayers, GILTI (§951A) will apply starting with calendar year 2018 US tax returns. GILTI has been poorly understood. The underlying concept was to prevent erosion of the US tax base through the transfer of mobile income outside of the

³² Foreign taxes paid are allocated to various foreign tax credit limitation categories under §904(d). The foreign tax credit limitation is computed separately for each category. §965 income will most likely be from active business income of the CFC, and therefore will be in the general limitation category. Proposed regulations – Proposed 965 Regulations (note 22, *supra*) and 83 Fed. Reg. 63200, 7 December 2018 (Proposed FTC Regulations) – detail the operation of foreign tax credits for §965, including the reduction under §965(g). Notice 2019-01 (<https://www.irs.gov/pub/irs-drop/n-19-01.pdf>) outlines proposed regulations that the IRS plans to issue on the ordering of PTEP, which will affect which category foreign taxes paid on CFC distributions will be allocated to.

³³ §1(h)(11) and Notice 2004-70 (<https://www.irs.gov/pub/irs-drop/n-04-70.pdf>).

³⁴ Qualified dividends and capital gains are taxed at 0%, 15%, or 20% depending on taxable income (§1(h)(11)).

³⁵ Prior to TCJA, the top individual tax rate was 39.6%.

³⁶ The extended example in the Appendix illustrates how the §965 transition tax might affect the US tax liability of an individual US Shareholder. See note 27.

³⁷ If the §965 inclusion were the only item of income on the US return, US tax would be \$60,197. The higher result in the text is due to the interaction of foreign tax credit limits and higher progressive marginal tax rates. Details available in the Appendix (see note 27).

³⁸ Technically, it applies to entities that are classified as a corporation under 26 CFR 301.7701-2 or 26 CFR 301.7701-3. See Victor E. Fleischer, *If It Looks Like a Duck: Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 Colum. L. Rev. 518 (1996), and Willard B. Taylor, *Blockers, Stoppers, and the Entity Classification Rules*, 64 Tax Law. 1 (2010) for a discussion of US entity classification rules.

US, where the income can now be earned and repatriated free of US taxation due to the new dividend received deduction in §245A.³⁹ Global Intangible Low Tax Income, however, is a poor description of what this provision actually measures. Rather than attempting to measure intangible income directly, §951A exempts from US taxation CFC active business income equal to 10% of net fixed assets and includes any remaining CFC income in the US taxable income of the CFC's US Shareholders using the mechanism of subpart F. Corporate shareholders are allowed a 50% deduction against GILTI under §250 which is not available to individual shareholders.

Under prior law, undistributed income of a CFC was only taxable in the US if it was classified as "Subpart F" income – this was essentially passive income (e.g. interest and dividends) on which insufficient foreign tax had been paid plus some related party income. Active business income could be retained inside the CFC and US tax would be paid when the income was distributed. With GILTI that changes. Now some of the active business income of a CFC can be classified as GILTI and included in the taxable income of US Shareholders whether distributed or not. This is a significant shift in US tax policy.

Under the new US tax rules, any "foreign-source" profit earned in foreign subsidiaries can be distributed to the US parent company tax free, while "US-source" and passive income is taxed to the US parent as earned. This provides a challenge: How does the US ensure that the profit properly allocable to US-generated intellectual property is allocated to the US parent company (taxable in the US) and not to some foreign subsidiary with a very low tax rate?

The idea behind the way Congress has decided to measure GILTI starts with the false dichotomy between tangible and intangible income. Income that can be traced to tangible assets cannot be allocable to US-source intellectual property (IP). So, Congress decided that any income earned inside a Controlled Foreign Corporation (CFC) in excess of an arbitrary "reasonable" return on tangible assets (defined as the net value of depreciable assets) must really be income from globally mobile intangible income. And, since the CFC is US-owned, any income from intangible assets is implicitly treated as being due to US-generated intangibles.

There are (at least) two flaws in this chain of reasoning. First – there are more ways to generate income than the two identified – using fixed assets and easily mobile intangible assets. Consider a retail store where premises are often leased rather than owned and the only depreciable assets are shop fittings. The income is earned from investment in inventory, which is not a depreciable fixed asset and will not count as tangible for GILTI. Similarly, income in a service business, like a hairdresser or accountant, is earned from the labour of the proprietor and employees, not really from the investment in fixed assets.

The second flaw is the implicit assumption that any IP or other intangible asset owned by a "US-owned" business is properly treated as income that should be taxed currently by the US if an "insufficient" foreign tax rate applies. Google, for example, have engineers working in several countries generating IP. Google Maps was developed by two Australians and two Danish brothers who had founded a company called Where 2 Technologies in Sydney, Australia. Where 2 was acquired by Google in 2004.⁴⁰ Further development of Google Maps was done in Google's Sydney office. Even if you could disentangle intangible and tangible income, the assertion that the US has the right to set the minimum

³⁹ Senator Orrin Hatch in a press release dated 10 November 2017, said "The Senate proposal also modernizes our international tax system, giving incentives, or "carrots," to attract economic activity to the United States. It also provides "sticks" to patrol against companies eroding our tax base by moving capital, including intellectual property, to low-tax jurisdictions simply to lower their tax bills." (emphasis added) (<https://www.finance.senate.gov/chairmans-news/hatch-the-senate-tax-bill-is-exactly-what-the-middle-class-needs>).

⁴⁰ Hutcheon, Stephen, Revealed: the whiteboard doodles that became Google Maps, Sydney Morning Herald, 26 August 2014 (<https://www.smh.com.au/technology/revealed-the-whiteboard-doodles-that-became-google-maps-20140826-108een.html>)

tax rate on all intangible income of “US-owned” foreign corporations is overreach by the US Congress. Given the intricacies of the recently proposed regulations GILTI can easily override legitimate tax concessions offered by sovereign nations in a bid to stimulate their own economies. It is highly unlikely that an Australian-based CFC owned and operated by an Australian-resident dual citizen is eroding the US tax base by moving income on US-generated IP from the US to a low tax jurisdiction.

B. Computing GILTI

GILTI is defined as CFC “Tested Income” less “Deemed Tangible Income Return” (DTIR). While the components are first computed at the corporate level, they are aggregated at the US Shareholder level before taking the difference. Tested income is defined as the gross income of the CFC reduced by:

- US-source business income (effectively connected income)
- Subpart F income
- Any income that would have been subpart F income but was excluded because the effective foreign tax rate was greater than 90% of the US corporate tax rate (the high-tax exception provided by §954(b)(4))
- Dividends received from certain related parties
- Foreign oil and gas extraction income
- Deductions allocable to any remaining gross income

There is some controversy on what Congress intended with the high tax exception. As drafted and confirmed in the proposed regulations, this appears to apply only to certain types of (mainly passive) income that would otherwise have been classified as “foreign base company income” under §954 or insurance income under §953. Thus, all active business income is included in tested income, even if it is subject to foreign tax rates in excess of 18.9% (= 90% of 21%).⁴¹

The second part of the GILTI computation is DTIR, which is defined as 10% of “qualified business asset investment” (QBAI) less any interest expense included in the computation of tested income (excluding interest paid to another CFC owned by the same shareholder). QBAI is defined as the depreciated value of property eligible for depreciation under §168. This definition excludes tangible property that is not depreciable such as land or inventory.

Table 3 shows how the GILTI inclusion is computed for ExampleCo. Given the assumption that there are no differences in income or deductions computed for financial accounting purposes and under US tax rules, ExampleCo will have \$150,000 of Net Tested Income. Since we have also assumed that ExampleCo’s expenses do not include any interest expense, DTIR will be 10% of the \$490,000 of QBAI. This leaves GILTI of \$150,000 less \$49,000 or \$101,000. ExampleCo paid \$50,000 in foreign taxes leaving \$150,000 of net profit after tax. Since only \$101,000 of this net profit is GILTI, only \$33,667 is treated as foreign tax allocable to GILTI.⁴²

C. Computing Tax on GILTI

How this translates into actual US tax liability depends on whether the US Shareholder is a corporation or an individual. As with the transition tax, an individual has the option of electing under §962 to be taxed as a corporation on all subpart F income for the year, including GILTI. Table 4 summarises the difference in the impact of GILTI on ExampleCo’s US Shareholder depending on whether the

⁴¹ In the Proposed 951A Regulations (83 Fed. Reg. 51072, 20 October 2018), section I.C.2 clearly states that the high-tax exception applies as described in the text above. Several commentators have argued that this is contrary to Congressional intent, including a public comment on the proposed regulations submitted on behalf of the Ministry of Finance of the Government of Israel (<https://www.regulations.gov/document?D=IRS-2018-0013-0006>).

⁴² This is computed as $\frac{101,000}{150,000} \times 50,000 = 33,667$

shareholder is a US domestic corporation or an individual. Corporations have the benefit of claiming foreign taxes paid by ExampleCo as well as a 50% deduction from GILTI provided by §250(a)(1)(B). The conference report on TCJA⁴³ explains that the intent was that GILTI would generate a US tax liability only where CFC income incurs an effective foreign tax rate below 13.125%. However, the deduction provided by §250 is available only to corporate taxpayers, while GILTI applies to all US shareholders, regardless of entity type. While one might think that an individual making an election under §962 would be able to use this deduction, this is not the case. §962 provides that an individual can compute tax using corporate rates and use the deemed paid FTC from §960, but deductions are not allowed. Because of the inability to use the §250 deduction, an individual US shareholder making a §962 election will be subject to additional US tax on their GILTI inclusion if the effective foreign tax rate paid by the CFC is less than 26.25%.

For corporate taxpayers and individuals electing corporate treatment under §962, the amount of deemed paid foreign tax that is actually available as a foreign tax credit is limited by §960(d) to 80% of the allocable foreign tax. It is the interaction of this 80% limit with the 50% deduction that gives an effective minimum tax rate on GILTI of 13.125% for corporate taxpayers. As shown in Table 4, if ExampleCo pays Australian tax at a rate of 25%, an individual US Shareholder of ExampleCo would owe \$1,346 of US tax on the GILTI inclusion.

Without the §962 election, an individual US Shareholder will include GILTI on their US return and pay tax at their personal tax rate. Since no Australian tax would have been paid personally on this income, US tax will greatly exceed available foreign tax credits. This will be exacerbated by the provision in §904(d) for a separate FTC category for §951A (GILTI) income with no carryback or carryforward of unused credits allowed. The US foreign tax credit system divides US taxable income into a number of categories, and computes the credit separately for each category.⁴⁴ To get a foreign tax credit, foreign taxes must be paid on income in that category. Since GILTI is not taxable in Australia, there will be no foreign taxes allocable to the GILTI FTC category. To deal with this problem, there is a look-through rule that provides for dividends paid out of Previously Taxed Earnings and Profits (PTEP) to be categorised based on the provision under which that E&P was previously taxed. So, when ExampleCo pays dividends out of PTEP generated by a GILTI inclusion, any Australian tax on those dividends will be foreign tax paid in the GILTI FTC category. Determining which PTEP a given distribution is paid out of will be crucial in determining the shareholder's US tax liability in the year distributions are made. Generally, PTEP is distributed on a Last-In-First-Out basis, but the IRS has proposed to make an exception to this general rule for PTEP generated by §965 (the transition tax).⁴⁵ If finalised, this exception will be devastating for individual shareholders who did not make the §962 election for the transition tax because they will need to distributed all of their pre-2018 E&P before they can make any distributions that will generate foreign tax paid in the GILTI FTC category. Furthermore, foreign taxes paid on distributions of PTEP generated by §965 appear to be subject to the FTC reduction in §965(g). The bottom line is that it will be very difficult for individuals to offset US tax on GILTI with foreign tax credits if a §962 election is not made.

Unlike the transition tax, there is time for US shareholders to plan to minimise their GILTI tax liability. The easiest adjustment is to pay out sufficient salary or other deductible expenses to reduce CFC income to below DTIR. This will probably increase Australian taxable income, so any planning needs to consider the entire tax profile of the US shareholder. The other option is to stop being treated as a corporation for US tax purposes. In some cases, it may be possible to use the entity classification rules, and what is known as a "check the box" election to treat the business as a partnership or disregarded

⁴³ The conference report discussion of GILTI can be found at 163 Cong. Rec. H10116 Daily Edition December 15, 2017 (<https://www.congress.gov/crec/2017/12/15/CREC-2017-12-15-pt1-PgH9943-6.pdf>).

⁴⁴ See note 32.

⁴⁵ Notice 2019-01 (<https://www.irs.gov/pub/irs-drop/n-19-01.pdf>).

entity for US tax purposes. This is more likely to be feasible for newer businesses, as it may entail recognising unrealised gains. Alternatively, the Australian company can be contributed to a new US domestic company owned by the taxpayer. Interposing a US C Corporation will allow use of the §250 deduction, reducing the US tax paid on GILTI to zero in most cases.

V. Impact on nonresident individuals

Prior to TCJA, Australian-resident US citizens with CFCs would have had substantial US compliance costs, but generally they would have had very little US tax due. Active business income would not have been taxed at all until distributed to shareholders, and at that time the Australian tax paid on the distribution would have been available to offset any US tax. The transition tax blindsided many of these taxpayers. Any transition tax liability represents US tax on Australian source income that will eventually be taxed by Australia when dividends are paid. Unless the distribution (and Australian tax) was paid in 2018, the Australian tax paid will not be available to carryback to 2017 to offset the US tax on the same income. This clearly impacts individuals more severely than corporations, as a corporate US Shareholder owning more than 80% of the CFC will be eligible for a treaty provision that exempts dividends from Australian tax. In other words, the US always had priority in taxing distributions from Australian companies to their US corporate parent company, so the transition tax just changes the timing of US tax on that income. For Australian-resident US shareholders, however, Australia has priority on taxing distributions, and with the transition tax, the US is taxing income that it was generally not able to collect tax on previously.

Another aspect that was clearly ignored by Congress, is that nonresident US citizens are living under different legal and tax systems to the US.⁴⁶ Therefore, the factors that inform the choice of business entity are completely different. US-resident individuals rarely own their small businesses through C Corporations. The incentives in the US tax code are for individuals to use S-Corporations or LLCs treated as pass-through entities. These entities provide limited liability without the double taxation of the US classical tax system. Nonresident citizens, however, are more likely to use corporate structures for their small businesses. In particular, those who live in countries that do not have a social security agreement with the US will find that a pass-through entity or sole proprietorship exposes them to US Self-Employment Tax, a form of Social Security tax that often duplicates social insurance required in their resident country. Forming a corporation and drawing a salary avoids Self-Employment tax, but only if the corporation is taxed in the US as a corporation subject to GILTI.

The transition tax and GILTI impact only those nonresident US citizens who have already been filing Form 5471 to report their small business as a CFC. The compliance rate among nonresident US citizens is notoriously low,⁴⁷ indicating that many long-term US emigrants have not been complying with US tax law. Many of those not in compliance have not previously been aware of their US tax obligations. This is changing with the advent of FATCA. The ATO is reporting the Australian bank accounts of Australian-resident US citizens (most of whom are dual citizens), to the IRS on an annual basis. While the IRS has not yet figured out how to use this data, eventually it will. It is unclear, though, whether they will ever try to collect from nonresident citizens in high tax countries like Australia, since enforcement costs will likely exceed any US tax collections. Furthermore, the IRS has little ability to compel compliance from Australian residents with no US assets. For those small business owners who are not currently compliant, the transition tax and GILTI could be a deterrence to coming into

⁴⁶ See Alpert, Karen, *Investing with One Hand Tied Behind Your Back – An Australian Perspective on United States Tax Rules for Non-Resident Citizens* (January 8, 2018 – Available at <https://ssrn.com/abstract=3097931>) for further details on the tax problems faced by nonresident US citizens.

⁴⁷ As noted above, there were 764,580 returns filed for 2016 from outside the US. Based on the number of joint returns filed (256,390), this represents about 1 million adult nonresident citizens, which is less than a fifth of the 5.5 million voting age US citizens abroad estimated by the Federal Voting Assistance Program (see notes 7 and 8).

compliance. And those who have been compliant face some difficult choices. Some will consider noncompliance. Those who comply will either pay US tax on Australian source income, draining assets from the Australian economy, or they will generate FTC to offset the US liability by accelerating Australian tax, to the detriment of their business and their ability to contribute to the Australian economy on an ongoing basis.

VI. Conclusion

With TCJA, the US system for taxation of international business has been fundamentally changed. Deferral of active business income by multinational corporations is gone, replaced with a system that exempts a small portion of foreign income, and imposes a minimum worldwide tax rate of 13.125% on the rest. To pay for this change, deferred foreign income was subject to a deemed repatriation tax. While the benefits of this new system (exempt dividends and a lower corporate tax rate) are available only to corporate taxpayers, individual taxpayers are subject to two costly provisions: GILTI and the transition/deemed repatriation tax. These provisions particularly impact nonresident citizens because they are more likely to choose a corporate entity when setting up business. Furthermore, the limits on using foreign taxes to offset US tax on GILTI make it difficult to use taxes paid to the source country to eliminate double taxation.

US law must be written to benefit the US economy and domestic taxpayers, but, if the US is to continue to assert tax jurisdiction over nonresident citizens, then the laws applied to these citizens should not be overly burdensome relative to the costs imposed on similarly situated US residents. The transition tax and GILTI impose clear double taxation on nonresident citizen entrepreneurs who have been contributing to their local economy.

Given the impact of these new taxes, it is not surprising that there has been some resistance among individual US taxpayers who own CFCs. Several organisations have been actively lobbying Congress and the US Treasury for relief.⁴⁸ In addition, an advocate for the rights of nonresident citizens has crowd-sourced funding to launch a lawsuit against the US Treasury for failing to consider the impact of the §965 and §951A regulations on small businesses as required by the Regulatory Flexibility Act.⁴⁹ However, in spite of repeated letter-writing campaigns by affected taxpayers,⁵⁰ Congress has failed to show any concern for the disparate impact of these new taxes on nonresident citizens, demonstrating callous neglect. Therefore, host countries should consider how they might protect their own citizens and residents from this extraterritorial overreach by the US government.

⁴⁸ See, for example: “American expat groups turn up heat on US lawmakers over tax” at <https://www.internationalinvestment.net/internationalinvestment/news/3504436/american-expat-heat-us-lawmakers-tax>; American Citizens Abroad at <https://www.americansabroad.org/transition-tax-legislation-update/>; Democrats Abroad at https://www.democratsabroad.org/carmelan/democrats_abroad_expats_tax_reform_advocacy_-_2018_year_in_review; and Republicans Overseas at <http://republicansoverseas.com/wp-content/uploads/RO-Transition-Tax-Overview.pdf>.

⁴⁹ Mr Silver’s website (<http://www.smallbusinessesfortaxfairness.com/>) outlines his advocacy to date.

⁵⁰ For example, <http://www.americansabroadfortaxfairness.org/>.

Table 1: US Tax Basis Balance Sheet of ExampleCo at 31 December 2017

Assets	
Cash and Cash Equivalents	230,000
Accounts Receivable	80,000
Inventory	320,000
Property Plant and Equipment	450,000
Total Assets	<u>1,080,000</u>
Liabilities	
	<u>30,000</u>
Net Assets	<u><u>1,050,000</u></u>
Equity	
Paid in Capital	250,000
Retained Earnings	800,000
Total Equity	<u><u>1,050,000</u></u>

Assumptions

- All amounts are in ExampleCo’s functional currency, which is AUD. For ease of explanation, it assumed that the relevant exchange rate is 1AUD=1USD.
- It is assumed that there are no differences between income and retained earnings as computed on ExampleCo’s books and as computed under either US or Australian tax principles. The existence of book/tax differences will complicate without adding insight.
- ExampleCo keeps its books and records on a calendar year basis.
- ExampleCo was formed after 1986, has been a US CFC for its entire existence with no change in share ownership, and has had no subpart F income in any prior year.
- Under these assumption Retained Earnings will be equal to Earnings and Profits and “Accumulated post-1986 deferred foreign income” as defined in §965(d)(2).
- The numbers for both E&P and cash on 31 December 2017 exceed the amounts computed on the alternative measurement dates provided by the statute.
- Since 1986, ExampleCo has paid an accumulated A\$300,000 in Australian corporate income tax.
- No dividends were paid during 2017.

Table 2: US Tax Computation for Corporate Shareholders and Individual Shareholders choosing to make a §962 election

Computation of Tax under §965	
Net §965 Inclusion ^a	243,120
§78 Gross up (see below)	<u>91,170</u>
Increase to Taxable Income	<u>334,290</u>
Tax at 2017 US Corporate Rates ^b	117,002
Less Foreign Tax Credit	<u>91,170</u>
Net increase to tax	<u><u>25,832</u></u>
Computing the §78 Gross up	
Total foreign tax deemed paid ^c	300,000
Deduct Applicable Percentage (69.61%) ^d	<u>208,830</u>
Allocable Foreign Tax	91,170

^a Computed in the text as $800,000 - (280,000 \times 55.7\% + 520,000 \times 77.1\%) = 243,120$

^b Computed a flat 35% tax rate that applies to large corporations. An individual electing to be taxed as a corporation under §962 would use the graduated rates in §11 (as it existed before TCJA) resulting in tax of \$113,623 and net tax after credits of \$22,453.

^c This amount was assumed in the list of assumptions in Table 1.

^d This reduction in foreign tax available for credit is required by §965(g). The applicable percentage is the percentage of deferred foreign income included in income after the deduction allowed by §965(c). It is computed as $\frac{280,000}{800,000} \times 55.7\% + \frac{520,000}{800,000} \times 77.1\% = 69.61\%$

Table 3: ExampleCo 2018 GILTI Computation

Income	
Revenue	800,000
Deductible Expenses	<u>600,000</u>
Taxable Income	200,000
Foreign Tax Paid	<u>50,000</u>
Net Profit	<u>150,000</u>
QBAI	490,000
Net Tested Income	150,000
DTIR (=QBAI×10%)	<u>49,000</u>
GILTI	<u>101,000</u>
Allocable Foreign Tax	33,667

Assumptions

- All amounts are in ExampleCo’s functional currency, which is AUD. For ease of explanation, it assumed that the relevant exchange rate is 1AUD=1USD.
- It is assumed that there are no differences between income and retained earnings as computed on ExampleCo’s books and as computed under either US or Australian tax principles. The existence of book/tax differences will complicate without adding insight. This assumption means that ExampleCo’s Net Tested Income for 2018 is \$150,000.
- ExampleCo has no interest expense.
- ExampleCo keeps its books and records on a calendar year basis.
- ExampleCo has US\$800,000 of Previously Taxed Earnings and Profits (PTEP), entirely due to the §965 inclusion from 2017. The Applicable Percentage for reducing foreign tax credits allocable to this PTEP is 70.9475%

Table 4: ExampleCo 2018 Tax Computation

Shareholder:	Corporation	Individual A	Individual B
GILTI	101,000	101,000	101,000
§78 Gross up	33,667	33,667	-
Total	134,667	134,667	101,000
§250 deduction ^a	67,334	-	
Taxable GILTI	67,333	134,667	101,000
Tax	14,140	28,280	26,151
Available FTC (80%) ^b	26,934	26,934	-
Net Tax due	0	1,346	26,151

Assumptions

- All amounts are in USD. For ease of explanation, it assumed that the relevant exchange rate is 1AUD=1USD.
- Tax for Individual B is computed assuming other income of \$100,000 in salary and \$7,200 in passive income including dividends, interest, and capital gains. Without the GILTI inclusion, Individual B would have had zero net US tax due to application of foreign tax credits. Details are available in the Appendix (see footnote 27).

^a A 50% deduction is allowed only to corporate taxpayers by §250(a)(1)(B).

^b As limited by §960(d).