Growing Together

GUIDE

GILTI US Tax Reform
on USA Investor of PR Foreign Corp

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Possible Effects of the US 2017 Income Tax Reform on Corporation C Shareholders and other residents of United States that Own an interest in a Corporation organized in Puerto Rico

When the Tax Cuts and Jobs Act became law on December 22, 2017, Public Law Act 115-97 (USTR), most taxpayers were focused on the individual and business tax reform changes. However, tax provisions included in this bill have a significant impact on international taxpayers. Since Puerto Rico corporations are treated as foreign entities for US federal income taxes, some of these provisions may affect taxpayers having an interest in entities organized in Puerto Rico that are treated as corporations for US federal income tax purposes. Some of the provisions that need to be considered include a transition tax ("toll gate tax"), a "participation exemption" for foreign dividends, deemed repatriation of foreign earnings and profits, a base erosion minimum tax, and a minimum tax on undistributed income of controlled foreign corporations (CFCs) call "GILTI".

Puerto Rico Corporations and Puerto Rico limited liability companies that elect to be treated as corporations for tax purposes are considered foreign corporations under the United States (US) Internal Revenue Tax Code of 1986, as amended. If a U.S. Shareholder (as defined below) owns directly or indirectly 10% or more of a CFC (as defined below), the Global intangible low-taxed income ("GILTI") could apply.

Under the regular income tax regime, U.S. shareholders were not required to recognize income earned by a foreign corporation until that income was distributed to the U.S. shareholder as a dividend, unless the Subpart F income rules (as described below) were applicable. GILTI is a new category of deemed income which requires the recognition of a percentage of foreign earnings which were previously deferred.

The new GILTI rules result in a significantly higher tax cost for US shareholders of either a C Corp or any other corporation that own a corporation in Puerto Rico.

Puerto Rico Corporations with "excessive profits" from their foreign activities, equipment and inventory, and that export Goods or Services, may be subject to the GILTI tax even if they do not have intangibles.

The fiscal reform of the United States 2017 seems to target the intangible income of high-tech companies with intellectual property, such as patents and licenses. However, as the formula for calculating the tax demonstrates, the GILTI tax will be applicable to income well beyond intellectual property, and it is likely to affect companies with high profits regardless of the intellectual property they may have.

For taxable years commencing after December 31, 2017, at the beginning of the first fiscal year of a controlled foreign corporation (CFC), any US person who is a shareholder of a CFC and who directly or indirectly owns shares in the CFC on the last day of the fiscal year of the CFC is subject to the GILTI rules.

ABOUT GILTI

GILTI is a new category of deemed income that is treated in the same manner as the income of Subpart F for the purposes of applying numerous provisions of the Code (although it is not an income of Subpart F).

Despite its name, GILTI is not limited to income derived from intangible property nor is it limited to income from low taxes generated abroad. In general, the GILTI rules are intended to tax the income of a CFC that would not otherwise be subject to US taxes as Subpart F income or effectively connected income (ECI), to the extent that the income exceeds a notional return of the depreciable tangible property of CFC (10 percent of the adjusted tax base of property owned by the CFC).

A US shareholder is anyone from the USA (including US residents and nonresidents, US Trusts, US partnerships and US corporations) that directly, indirectly or constructively hold at least 10 percent of the CFC shares (by vote or by value).

A CFC is any foreign corporation where US Shareholders own more than 50 percent of the shares (by vote or value). The GILTI rules do not apply to a CFC whose only income is the passive investment income since that income would already be subject to taxes under the rules of Subpart F.

Only US shareholders who own (directly or indirectly) shares in the CFC on the last day of the CFC's fiscal year must include in their gross income its prorated participation of GILTI from CFC. For example, if US Shareholder A sells his share in a CFC to US Shareholder B during the fiscal year, and the CFC remains a CFC, US Shareholder B is the only one to include the CFC GILTI in the year of sale.

GILTI is treated as previously taxed income (PTI) for tax purposes and therefore is not subject to federal income tax when it is distributed (whether distributed to a US shareholder that does other than a C Corp or a US shareholder of C corporation). In addition, the GILTI inclusions treated as PTI increase the base in the CFC stock of the US shareholder that took into account the GILTI at the end of the year.

C- Corporation GILTI Tax rate

US C Corporation shareholders:
a) have the right to reduce their GILTI Taxable Revenue by 50 percent,
b) are subject to a federal corporate tax rate of only 21 percent, and
c) are entitled to claim a credit of up to 80 percent of foreign taxes paid or accumulated by the CFC in the GILTI computations.

Without taking into account the foreign taxes paid by any US Corporation (C-Corp), the new corporate tax rate of 21%, has the effective tax rate of 10.5% on GILTI Revenue (computed as 21% of 50%). If foreign tax credits are taken into account, the effective tax rate on corporations in GILTI would be 13.125% or more (calculated as 10.5% divided by 80%), including Puerto Rico.

GILTI tax rate for Other than a C Corp

For US shareholders of corporations not classified as C-Corps, the effective rate imposed on GILTI is much higher. The reason for this is that these other shareholders are not entitled to deduct 50 percent of their GILTI; and are subject to a federal income tax rate of up to 37 percent. These shareholders cannot generally claim a credit for foreign taxes paid or accrued by the CFC in GILTI.

As a result, these other US shareholders will be subject to the US federal tax on GILTI at a rate of 37 percent plus any foreign tax imposed on the CFC for its GILTI on the same tax year. For foreign entities doing business in Puerto Rico it entails a 41% rate unless the Puerto Rico entity has a preferential tax rate.

Prior to the GILTI rules, the active business income of a CFC owned by a non-C US shareholder was generally qualified to defer from US tax and, once distributed, may have qualified for a reduced rate of qualified dividends of 20 percent, resulting in an effective general tax rate of 20 percent on such income on a fully repatriated basis.

However, as a result of the GILTI rules, the active business income of a CFC is subject to a full federal income tax at a rate of 37 percent. GILTI not only eliminates deferral, but also increases the effective tax imposed on GILTI attributable to US shareholders of non C Corps.

Specific measures can be taken to reduce the general tax burden on US shareholders who are not a C Corp as a result of the GILTI. These steps may allow a non-C Corp US shareholder to obtain partial deferral of federal US federal income tax.

Due to the significant adverse impact of the GILTI rules for US shareholders that are not a C Corp, it is crucial that US citizens or foreign residents with investments in foreign corporations, assess the impact of the US federal income tax of the GILTI provisions on the foreign investments and consider whether it may be beneficial to take advantage of one of the planning ideas discussed below.

Calculation of GILTI

Ten percent of US shareholders of C-Corps or of any other entity must include their proportional share of GILTI in their current income for the corresponding fiscal year. The detailed GILTI calculation is included in the Getting Technical, Calculation of GILTI white paper.

Planning considerations under GILTI rules

Taking into account some planning options could reduce the impact of GILTI. Measures can be taken to allow non-Corporation C US shareholders of a Puerto Rico Corporation to claim a credit for foreign taxes imposed on their participation on a CFC GILTI and defer payment of the entire US GILTI tax.

These are the steps that a non-C Corporation US shareholder owner of Puerto Rico Corporation should take to reduce or delay GILTI taxes:

Consider a purchase of assets

A CFC may consider buying an asset or choosing a strategy of increasing assets in acquisitions of shares to increase the tax base of foreign tangible depreciable assets, thus avoiding the GILTI at the calculation.

Choose the Treatment of Section 962

The US IRS code provides a special rule for the income of Subpart F, which allows non C Corp US shareholders to choose the amounts to be included in their gross income at corporate rates and obtain the benefit of foreign tax credits related to said income. The GILTI rules expressly stipulate that GILTI is treated as included as Subpart F, so this rule should apply to both GILTI and the regular income of Subpart F. Therefore, the selection of the Section can be made by non C Corp US shareholders, including trusts of the US as well as other non C Corp US partnerships.

The non C Corp shareholders of US corporations can also make this choice if income is reported in an Annex K-1. The election can be made annually, but once made for a particular year; it applies to all CFCs in which the US shareholder of non C Corps owns shares at the end of that year.

The benefits for US shareholders that are not Corporation C in taking the election are:

(1) GILTI is subject to US taxes at the corporate rate of 21 percent instead of the highest non C Corp tax rate of 37 percent of the US.

(2) The US GILTI tax can be reduced with foreign tax credits, subject to the generally applicable foreign tax credit limitation rules.

3) A GILTI distribution for which an election was made will be subject to US taxes in the distribution to the extent that the distribution exceeds the amount of the US tax previously imposed on said income under the GILTI rules and said amount will not be treated as PTI.

However, non C-Corps who make this choice are subject to a second tax on subsequent distributions of corporate profits. It is not clear whether this election will allow the non C- Corp taxpayer to claim the deduction described above for GILTI income.

Own CFCs through a Corporation C

A US shareholder of a non C Corp. could consider transferring its participation in the CFC to a US corporation. A holding company of US C corporations for CFC would be particularly beneficial when the CFC has foreign tax credits that could substantially eliminate the tax liability of the US.

While the CFC GILTI will be included in the gross income of the US shareholder of corporation C, no additional United States tax is due assuming that foreign taxes are sufficient to eliminate the United States tax obligation.

The US shareholder of a non C Corp will not be taxed on GILTI until the holding company distributes it to the shareholder, so the US taxation of the GILTI would essentially be deferred until the US corporation C Corp distributes it to its shareholder. Since there may be other adverse consequences of placing a C corporation over a CFC owned by a US shareholder other than C Corp, the implications of this alternative must be carefully considered.

Taxpayers should be careful to avoid the rules of the personal holding company that could potentially subject this strategy to additional US taxes. In addition, actual distributions of shareholders' profits will generate a second tax on the dividend.

Own foreign operations in the form of a pass through, Check box Rule

In order to avoid the application of GILTI rules and obtain the benefit of foreign tax credits in the future, it may also make sense that a US shareholder of non C Corps transfer ownership to a Puerto Rico LLC foreign entity electing a pass-through entity treatment also elected for federal income tax to shareholders according to the allowable rules. Under the Check the box regulations US taxpayers may choose to treat eligible foreign entities as disregarded entities for US tax purposes. The GILTI tax only applies to the income generated by foreign entities considered a corporation according to US tax regulations.

This option is easier to obtain for CFCs of absolute ownership, but it may be difficult to achieve in the case of CFCs in which there are non-corporate US shareholders and shareholders of the US Corporation C.

However, this strategy requires careful planning to avoid unforeseen negative consequences and should not be undertaken without the contribution of an expert advisor.

Conclusion

The new GILTI regime is severely applied to US shareholders who are not from a Puerto Rico CFC Corp. Measures are available to reduce or partially defer the tax, but the particular circumstances of the taxpayer and the general tax position must be carefully considered to determine which steps make sense.