



Warning: U.S. Tax Regulations Impact Completed Foreign Sales Retroactively and Domestic Partnerships

IN SHORT

The Situation: On June 14, 2019, the IRS and U.S. Treasury released more than 500 pages of proposed, temporary, and final regulations addressing the taxation of U.S.-controlled foreign corporations.

The Development: Retroactive regulations may increase U.S. taxation of completed sales of foreign corporations, which may be lessened with a mitigating tax election. Proposed regulations relieve some tax restrictions on holding stock in foreign subsidiaries through domestic partnerships with minority partners.

Looking Ahead: Proposed regulations, effective when finalized, may exempt high-taxed foreign earnings from U.S. taxation.

Introduction

On June 14, 2019, the IRS and U.S. Treasury released more than 500 pages of regulations addressing the taxation of U.S.-controlled foreign corporations. Some changes were retroactive to December 31, 2017. They may increase U.S. taxation on completed sales of foreign corporations, and the tax may be even higher unless an election is timely filed with the IRS. Other changes are taxpayer favorable. Notable provisions include:

Harsh Regulations Apply Retroactively

Prior to the regulatory guidance, U.S. tax could be avoided, in some situations, on gain recognized on sales of stock in a controlled foreign corporation ("CFC") after December 31, 2017, to the extent attributable to the CFC's income in the year of sale and on CFC dividends distributed in the year of sale. This was possible if the CFC's tax year did not close with the transaction, which was usually the case. The new rules, issued with retroactive effect, impose a full federal income tax at 21% on any such gain and dividends.

To mitigate the new rule's impact, the regulations provide an election under which the controlling U.S. shareholders may close the CFC's tax year on the sale date. If the election is made, the gain or dividends may be eligible for a 50% deduction resulting in a 10.5% U.S. tax rate, and the tax may be further reduced by foreign tax credits. The election must be filed with the controlling U.S. shareholders' tax returns, and each U.S. shareholder must enter into a written, binding agreement mandating the election.

The regulations also apply to less common situations where taxpayers undertook transactions eliminating current or future U.S. taxation of the CFC's foreign earnings. The regulations deny the intended benefit retroactively.

All foreign stock transactions completed after December 31, 2017, should be reviewed to assess whether these rules apply or a mitigating election is possible. Pending transactions should include this as a tax diligence item.

Relief for Minority Partners in U.S. Partnerships Owning CFCs

In a welcome development, proposed regulations generally relieve minority partners owning less than 10% of a U.S. partnership (including a limited liability company treated as a tax partnership) that holds CFCs from being subject to the anti-deferral rules of global intangible low-taxed income ("GILTI") and so-called subpart F rules relating to CFCs. The proposed rules

will be effective when finalized, but taxpayers may rely on them immediately if applied consistently.



The proposed rules remove an impediment to using domestic partnerships, though there are situations where a foreign partnership, limited liability company, or alternative investment vehicle is preferred for tax or other reasons.



The current rules steer many private equity and other investment vehicles to use foreign partnerships and limited liability companies. The proposed rules remove an impediment to using domestic partnerships, though there are situations where a foreign partnership, limited liability company, or alternative investment vehicle is preferred for tax or other reasons. Relevant structures should be reviewed.

Potential GILTI High-Tax Exception

In a promising development, proposed regulations would allow U.S. shareholders of CFCs to elect to avoid current taxation of GILTI in some cases. This exception is intended to better align the GILTI regime with Congress's stated intent of imposing current U.S. taxation on only low-taxed foreign income, and it applies to GILTI already subject to foreign taxation at an effective rate greater than 18.9%. The election is made by the CFC's controlling shareholders, applies to all U.S. shareholders of the CFC and all related CFCs, and is effective indefinitely unless revoked. Upon revocation, a new election cannot be made for another five years. The exception is not available, however, until the proposed regulations are finalized.

THREE KEY TAKEAWAYS

1. Taxpayers should consider making the year-ending tax election for sales that have already closed, which can be made on an original or amended tax return of the U.S. shareholder.
2. Buyers should include contractual protection on other planning techniques targeted by the new regulations.
3. Investors should review the structure of PE and other investment vehicles to determine if a domestic partnership may be appropriate.



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