KEY TAX INSIGHTS
U.S. MULTINATIONAL CORPORATION NEWSLETTER

Tax Implications of Exiting a Controlled Foreign Corporation

The income of a foreign corporation is not subject to federal corporate income tax unless the foreign corporation has income that is effectively connected with a U.S. trade or business *(or permanent establishment as provided in an applicable tax treaty)* or consists of certain types of U.S. source fixed or determinable annual or periodic income ("**FDAP**"). A foreign corporation's income from operations outside the U.S. is not subject to U.S. corporate income tax unless special rules apply.

A U.S. shareholder of a controlled foreign corporation ("**CFC**") may be subject to U.S. tax on their pro rata share of the CFC's income, even if that income is not distributed to the shareholder. Subpart F income is typically passive income of the foreign corporation. U.S. shareholders of a CFC include their pro rata share of subpart F income as taxable income for the year earned, even if the income is not distributed to the U.S. shareholders. Most income that is not subpart F income of the CFC will be subject to the global intangible low-taxed income ("**GILTI**") regime, where to the extent the CFC's income exceeds 10 percent of its aggregate basis in its tangible assets, the U.S. shareholders must include the excess as income for the year. Individual U.S. shareholders are taxed at ordinary income tax rates up to 37 percent on inclusions in income under both the subpart F and GILTI regimes. To the extent the CFC's income is neither Subpart F income nor GILTI income, the income will not be subject to U.S. tax until distributions are made to the U.S. shareholders.

Domestic C corporation shareholders are taxed on subpart F inclusions at a flat rate of 21 percent and can be taxed on GILTI inclusions at a rate of 10.5 percent. A C corporation shareholder is generally permitted to offset a distribution attributable to a dividend distribution with a 100 percent participation exemption.

The liquidation of a CFC can occur either through a check-the-box election *(if the CFC is*

WWW.KLUGCOUNSEL.COM INFO@KLUGCOUNSEL.COM +1 202-980-4788

TAX IMPLICATIONS OF EXITING A CONTROLLED FOREIGN CORPORATION

not a per se corporation) or through a typical liquidation. In a taxable liquidation, the CFC will recognize gain or loss on the liquidating distribution of its assets. Any gains from the liquidation could result in subpart F or GILTI inclusions. If the gain on the liquidating distribution do not constitute subpart F or GILTI income, then the gain to the CFC on the liquidating distribution is generally not subject to U.S. federal income taxation. If the liquidating distribution does constitute subpart F or GILTI income, then an individual U.S. shareholder of the CFC would generally pay tax at ordinary income tax rates on the resulting gain.

A U.S. individual shareholder may want to consider a section 962 election which would treat the individual U.S. shareholder as a domestic C corporation shareholder to reduce the tax rate and allow for foreign tax credits.

The U.S. shareholder would be treated as selling their stock in the CFC in exchange for the assets received in the liquidation. The Internal Revenue Code may require the capital gain to be reclassified as a dividend distribution. To the extent the gain is not recharacterized as a dividend distribution, the distribution is generally taxed to individual U.S. shareholders as a long-term capital gain. To the extent the gain is recharacterized as a dividend, the U.S. individual shareholder would be subject to tax at either ordinary income tax rates or qualified dividend tax rates.

The shareholder's basis in the CFC stock is increased by subpart F and GILTI inclusions attributable to the CFC liquidating gains. If a section 962 election is in effect, the shareholder's basis will only be increased by the amount of U.S. corporate tax paid on the inclusion. The shareholder's gain of a deemed liquidation may be less than with the actual sale of the stock to a third party. If the shareholder's tax home is in the U.S., the gain would be U.S. source and cannot be offset by foreign tax credits.

A shareholder of a CFC can liquidate the CFC in a tax-free transaction by contributing their stock in the CFC to an S corporation prior to liquidation. If the CFC stock is already owned by an S corporation and appropriate ownership level tests are met, the CFC can liquidate into the S corporation tax-free. In the alternative, the U.S. shareholder can transfer its CFC stock to an S corporation, after which the CFC would liquidate, and if certain ownership level tests are met, the liquidation can be tax-free as an F reorganization. The CFC generally would not recognize gain on the transfer of assets to the S corporation under either scenario. In both scenarios, the S corporation would be required to include the "*all E&P amount*" in income attributable to the CFC stock. The all E&P amount would not include amounts included in income as subpart F or GILTI inclusions. The shareholder's basis in the stock of the S corporation is equal to the shareholder's basis in the stock of the CFC, increased by the inclusion of the all E&P amount. The S corporation does not succeed to the E&P of the CFC, except to the extent that the E&P is effectively connected to a U.S. trade or business.

Prior to exiting a CFC, a shareholder should consult an appropriate tax professional to see if there are tax planning opportunities.

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