Impact of the New Tax Law on Business Structuring

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How the new tax bill impacts offshore business structuring – And what business owners need to do now

Most US entrepreneurs with global or virtual businesses know about the new lowered corporate tax rate, the end of tax deferral for foreign business earnings and the tax holiday to repatriate those retained earnings. But what do all those business related provisions in the new tax law mean for setting up the best offshore business structure? What are the next steps for entrepreneurs?

Tax holiday marks the end of tax deferral

Business owners with a non-US corporation could up to now defer US taxes on net income by leaving the money in the foreign business. The new tax law takes away this tax deferment. Now every business must pay US income tax on the accumulated retained earnings.

What that means is that shareholders who own at least 10% of a foreign subsidiary must include their portion of the undistributed previously tax-deferred earnings, all the way back to 1987, in their personal income for the subsidiary's last tax year. After applicable deductions, the shareholder's effective tax rate is 15.5% on his portion of the foreign cash position and 8% on non-liquid holdings such as real estate.

This is the so called tax holiday that the Googles, Apples and many expat entrepreneurs have been waiting for in order to bring their money back onshore. Of course, if you want the money to go to the shareholders, an additional dividend tax is due when it is distributed to them.

I am not ready to pay all now…so when?

To soften the immediate impact on the taxpayer, the new law allows electing to pay the tax over a period of eight years.

The payment schedule is as follows:

- 8% of the net tax liability for each of the first five installments,
- 15% of the net tax liability for the sixth installment,
- 20% of the net tax liability for the seventh installment, and
- 25% of the net tax liability for the eighth installment.

If this election is made, the first installment **must** be paid by the original due date of the tax return, without extension. For individuals this is April 17, 2018. Each succeeding installment is due on the April 15 tax deadline for each filing year.

New GILTI tax on foreign business income

Going forward, the IRS wants a share of any new foreign income that international companies earn – the so-called GILTI tax (pronounced "guilty" - no pun intended?). GILTI stands for Global Intangible Low-Taxed Income, which represents a new category of income.

The GILTI rules apply higher tax rates to GILTI attributed to individuals and trusts who own CFC stock (either directly or through LLCs or S corporations) than to C corporation shareholders.

Previously, a US person generally only had to pay tax on income earned through a foreign corporation when that income was distributed as a dividend. Now under the new rules, if a US person (not a C corp) is a 10% shareholder of a Controlled Foreign Corporation (CFC), he or she must include their portion of the foreign income on their personal tax return, regardless of whether or not it was received as a distribution to shareholders. This income would be taxed at a whopping 37%.

Under the GILTI rules, C corporation US shareholders can deduct 50% of their GILTI, which halves the effective corporate tax rate to 10.5%. In addition, they can claim foreign tax credits, lowering the US federal income tax due even further. This is a significant reduction over the previous 35% corporate tax rate and still substantially lower than the new 21% corporate tax rate.

When earnings are distributed to shareholders as dividends, shareholders will pay taxes on those dividends. The qualified dividend tax rates remained unchanged at 0%, 15% and 20%, depending on your personal income tax bracket.

Thus owning shares in a CFC either directly or through a LLC or S corp exposes you to a higher tax rate than owning the same shares through a C corp.

There are three ways for a non-C corporation US shareholder to reduce or defer taxes on GILTI:

- Electing 962 treatment (see below
- Owning CFCs through a C corporation
- Qualifying for the FDII deduction (see below)

These steps reduce but do not eliminate the disparity between the GILTI taxation of C corporation US shareholders and non-C corporation US shareholders.

GILTI rules – How to qualify for the 10.5% GILTI tax rate

Of course there are requirements to qualify for the low 10.5% tax rate. Just as for the previous tax deferral, the lower GILTI tax rate only applies to international businesses that do not engage in US trade or business.

If you have operations, an office or warehouse in the US, or a "dependent agent" that works for you exclusively, you have a US presence and cannot take advantage of the 10.5% GILTI tax rate. Typically, Amazon resellers using direct shipping or businesses with only an online presence such as a membership website, would qualify for the low GILTI tax rate.

While you cannot defer taxes on foreign earnings anymore, you gain the flexibility to move the money as you see fit. You can now decide if you want to keep your taxed earnings overseas or bring it to the US, with no additional tax impact.

New FDII deduction for foreign-derived intangible income

If your business doesn't qualify for the low GILTI tax rate because you want to live in the US or have other US presence, you might still qualify for an unprecedented low tax rate of 13.125% by selling services or products to customers located outside of the US.

While GILTI applies to Controlled Foreign Corporations (CFC), FDII is for foreign-derived income of a US C corporation.

FDII stands for Foreign Derived Intangible Income, an income category that is taxed at a reduced rate meant to incentivize developing intangibles in the US rather than abroad.

Please note that any foreign derived intangible income is already included within the US taxable income of the corporation. The new FDII rules basically provide a deduction for eligible income.

FDII rules – How to qualify for the FDII deduction

The FDII deduction is only available to C corporations, including C corp subsidiaries of an offshore or multinational business. Foreign corporations with income effectively connected with a US trade or business, S corporations, regulated investment companies, real estate investment trusts, partnerships and individuals cannot claim a FDII deduction.

FDII rules to determine the foreign-derived income eligible for deduction are complex. The basic concept is that the income is earned for providing goods or services to persons outside the United States.

Very generally speaking, deduction eligible income is income derived in connection with:

- Property sold to any person who is not a US person for foreign use, or
- Service provided to any person not located within the US.

This means that even when you live in the US and have deemed effectively connected income in the US, you can still take advantage of a new low effective tax rate of 13.125% if you meet the above qualifications.

Tax reform impact on individually owned foreign companies

If you own your foreign company directly as an individual instead of through a US company, you can elect to be taxed as a corporation. Section 962 provides a special rule which allows US individual shareholders to elect to be taxed on amounts included in their gross income under Section 951(a) at corporate rates and to get the benefit of Section 960 foreign tax credits with respect to such income.

This election would lower your tax rate from your personal tax rate to the corporate rate of 21%. The low 10.5% GILTI rate that C corp US shareholders enjoy, however is not available for individuals, neither by a section 962 election.

While you would pay more as an individual owner than as a C corp with GILTI, you won't need to worry about dividend taxation. A distribution of income for which a 962 election was made will be subject to US tax (net of any income previously taxed both in the US and abroad).

Tax changes for pass-through entities

Currently, owners of a pass-thru entity, such as an LLC, partnership or S corp, are taxed at the individual rate, where the top individual tax bracket is 39.6%. The tax reform created a 20% deduction for pass-through income, but only for certain types of companies.

While some small business owners will benefit, others like some professional service providers would not qualify for that pass-through tax rate. Providers of legal and consulting services for example, do not benefit from the pass-through deduction, while engineers and architects do.

The new deduction applies to businesses operated and real estate located “inside” the United States. Taxpayers don’t get a deduction on pass-through income earned “outside” the United States. The current definition is gray, so if there is a partner or a US office, it can be deemed that there is business conducted in the US.

The new rules for pass-through taxation are quite complex and ultimately effect whether a US LLC would be a better structure vs a Foreign Corp. We strongly advise to obtain advice from a qualified tax preparer.

With the tax reform, owning a business as a pass through entity has become less appealing for entrepreneurs with foreign activities. The new pass through deductions focus on business conducted in the US, and the preferential tax rates for GILTI are available only for a C corp. Even entrepreneurs with a US presence may not qualify for the pass through deduction, but they may benefit from the new FDII deduction as a C corp.

Impact of the new tax law on offshore structuring

Previously, having an offshore business in a low or no tax jurisdiction which qualified for tax deferral allowed you to pay low or 0% tax on the income by leaving it in the foreign business. Now, you will have to pay GILTI tax on that income.

Although you can't completely avoid US tax with an offshore structure anymore, it still offers immense tax savings opportunities, as well as asset protection. A completely domestic business is taxed at 21%. The tax rate on earnings from a foreign subsidiary however can be as low as 10.5%, half of the domestic corporate tax rate and low by world standards.

Even better, you can still lower it down to single digits by other tax strategies such as deductions and setting up a solo 401k.

With those tax changes in mind, the new optimal structure for most entrepreneurs with business activities outside the US (especially those making over $200k in net income) would be a C corporation that owns a foreign company.

Every year the foreign corporation can pay its profits as dividends up to the C Corp, where the retained earnings (cash) can be held and invested in US real estate, stocks, bonds, etc, all subject to the 21% tax rate.

Previously, any US investments held by the foreign corporation was considered a deemed dividend, and any sales of stocks or bonds was taxed at higher ordinary income tax rates.

Furthermore, the retained earnings held in the C Corp can be paid to the shareholders as qualified dividend rates of 0%, 15%, and 20% depending on the tax rate of the shareholder, which is lower than non-qualified dividends coming from some foreign corporations.

In some aspects the new tax law allows for greater flexibility and tax planning than the old deferral scheme if the proper planning is done. It's all about following what the Googles and Apples of the world do with their structures, so we can do the same with our clients.

What company owners should do now

The changes in the tax legislation make for even more complexity and thus require in-depth scenario analysis. Taking into account the type of business, location and the long term plans for the shareholders will determine the best scenario.

One can choose to operate under the reduced GIILTI tax of 10.5%, elect to be taxed as a corporation at 21% or be a pass through S Corp with the 20% reduction. These scenarios ultimately depend on whether one wants to take the dividends out now, keep them in the company, or whether the operations of the company will remain onshore or offshore and the associated risk with that.

Elections and decisions should be made sooner rather than later on how to handle these new tax laws, including either making the 926 election or putting a C Corp holding company in place.

We recommend consulting an experienced tax advisor to analyze your business situation in light of the new tax law and to determine the next steps you should take.

We can help you to tax optimize your business structure and stay compliant with the new tax law. For advice on tax-optimized business structuring, contact us at Global Expat Advisors to set up a consultation.

Schedule your consultation with an expert in foreign structuring now!