A Double Taxation Nightmare Disguised as Tax Reform

by Jacqueline Bugnion


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In this article, Bugnion argues that the deemed repatriation tax and the global intangible low-taxed income tax unfairly burden U.S. citizens who operate businesses overseas through small corporations.

This article reflects the author's personal views only.

The Tax Cuts and Jobs Act is the first major tax reform since 1986 for both U.S. corporations and U.S. citizens.[1] Whatever the benefits for the U.S. economy and for domestic resident taxpayers, the law is a nightmare — with devastating consequences — for American citizens who reside abroad. This is particularly true for American entrepreneurs who operate through locally registered entities that the IRS deems to be controlled foreign corporations. They are subject to new confiscatory taxes going both backward and forward:

- the retroactive tax is the so-called deemed repatriation tax under section 965, also known as the transition tax; and
- the tax on future profits is the tax on global intangible low-taxed income under section 951A.

Both taxes, as applied to Americans abroad, are corollaries of citizenship-based taxation (CBT), the policy by which the United States taxes the worldwide income of its citizens who are residents outside the national borders.

Before fiscal 2017, an individual who owned 10 percent or more of a CFC[2] was subject only to a reporting requirement on Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." Complying with Form 5471 already represented a major reporting burden, but it is not a tax form.[3] After passage of the TCJA, a U.S. person that owns 10 percent or more of a CFC is subject not only to a significantly more complicated Form 5471[4] but also to the GILTI tax, regardless of whether the shareholder is a U.S.-based multinational corporation, a U.S. partnership, an S corporation, a domestic resident, or a citizen resident abroad. An American entrepreneur overseas who owns a company in the country of residence to carry out local business will generally control the CFC and be subject to U.S. laws on CFCs, as well as all local laws and taxes.

Thanks to the TCJA, CFCs have become a tax liability to individual owners. In theory, the liability affects all U.S. citizen taxpayers, whether they live within or outside the United States. In practice, the burden of the law falls disproportionately on overseas entrepreneurs

[1] For purposes of this article, the term "citizens" encompasses citizens and green card holders.

[2] A CFC is defined as a foreign corporation in which U.S. shareholders own 50 percent or more of the stock or control the voting power of the company.

[3] Form 5471 requires detailed information on the owners of the corporate stock, any transactions related to corporate stock, and details on section F income. It also requires the profit and loss statement and balance sheet to be translated into U.S. dollars, using generally accepted accounting principles and standards. The fine for failure to file Form 5471 is $10,000 per year per corporation. Delays in filing after notice by the IRS can lead to a fine of up to $50,000, plus restrictions on allowances for foreign tax credits.

[4] The instructions for Form 5471 went from 18 pages in 2017 to 29 pages in 2018, after passage of the TCJA. Reporting on the new Form 5471 has become a major burden for Americans abroad. *See* letter from American Citizens Abroad Inc. to Treasury and the IRS (Feb. 25, 2019).

who earn their livelihood through entities incorporated in their country of residence. The total number of CFCs owned by Americans resident abroad is anyone's guess, but based on the State Department estimate of 9 million Americans overseas, it is likely in the tens of thousands. The TCJA is no small matter to Americans abroad.

Corporate tax reform was the driving force behind the TCJA. The new law was developed in the interests of the large U.S. multinationals to lower tax rates, to shift the United States from worldwide corporate taxation toward territorial corporate taxation, to bring back to the United States trillions of retained earnings held in subsidiaries overseas, and to encourage investments in the United States. This makes sense for U.S.-based corporations.

In drafting the law, however, no consideration was given to the entirely different situation of Americans resident abroad who own foreign companies defined as CFCs under U.S. law. The heart of the problem is that the TCJA shifts to territorial taxation for U.S. multinationals but doesn't do so for individuals. CBT survived the TCJA. This inconsistency causes major distortions of law — and great inequity.

TCJA: The Straw That Breaks the Camel's Back

The deemed repatriation tax and the GILTI tax introduced by the TCJA add to a long list of fiscal abuses and instances of double taxation caused by the overseas extension of U.S. tax law.[5] CBT is based on the concept that all American citizens, irrespective of residence, should be taxed on the same basis. But it ignores a fundamental difference between domestic and overseas taxpayers: U.S. residents pay taxes only to the United States. Americans abroad first and foremost pay taxes in their country of residence but are also subject to U.S. taxation under CBT. Foreign tax structures are inherently different from U.S. practices, leading to incompatibilities and double taxation. Provisions of the Internal Revenue Code intended to mitigate those differences have positive but only limited effects. The new taxes imposed by the TCJA are off the charts in terms of fiscal absurdity.

Deemed Repatriation Tax — the Retroactive Tax

The term "deemed repatriation tax" says it all. The tax is a one-time hit on CFCs' retained earnings and profits accumulated from 1986 through 2017, even if there is no flow of funds back to the shareholder. It is a tax on a fictive repatriation to the United States. Because retained earnings are not equal to liquid assets, and only liquid assets can be used to pay taxes, the TCJA allows installment payments of the transition tax over eight years. The deemed repatriation tax is extremely retroactive, going back 31 years. Calculating the amount of the tax is highly complicated and may raise unsurmountable accounting issues, such as determining the amount of retained earnings taxable under the TCJA, translating foreign books into U.S. generally accepted accounting principles, and dealing with the 10-year statute of limitations applicable in many countries. Imagine the nightmare of trying to translate 31 years of retained earnings from local currency in a high-inflation country into the U.S. dollar.

For U.S.-based large multinational corporate owners of CFCs, the TCJA makes three tax changes. First, it shifts from a deferred taxation system under worldwide taxation to a territorial taxation system. Second, the cost of the shift is the deemed repatriation tax on all CFCs' retained earnings going back 31 years at a maximum rate of 15.5 percent.[6] Third, the benefit of the shift is a drop of the tax rate from 35 percent to 21 percent for all U.S. corporations.

Circumstances are fundamentally different for an American citizen resident abroad who owns a CFC. He has no corporate structure in the

[5] Since 1962, U.S. legislation has: (1) systematically increased taxes on Americans overseas, sometimes justifying the increases as compensating revenue for tax reductions for U.S. residents; (2) discriminated in the tax treatment of foreign pensions; (3) legislated double taxation by denying the application of FTCs on some income; (4) required duplicate reporting of foreign financial assets (with different rules) associated with massive penalties for insufficient reporting; (5) restricted the possibilities for making investments in the country of residence; (6) limited overseas employment possibilities; and (7) imposed taxation on fictive capital gains through the U.S. dollar functional currency requirement. Jacqueline Bugnion, "Concerns About the Taxation of Americans Resident Abroad," *Tax Notes*, Aug. 24, 2015, p. 861. *See also* American Citizens Abroad, "Taxation."

[6] The 15.5 percent rate applies to liquid assets, and a rate of 8 percent applies to illiquid assets.

United States; he has set up a company in his country of residence to carry out local business, not to trade with the United States. The company is not part of a multinational corporate network that can play sophisticated games to reduce tax liabilities by shifting profits to low-tax countries. The American abroad doesn't benefit from the tax break offered to U.S. multinationals but is instead subject to a new U.S. tax. The equity put into the company is generally foreign sourced from individual savings. The American citizen owner is most often a long-term overseas resident with no intention to ever repatriate dividends to the United States. He works and lives overseas. He either reinvests his earnings to build his business and an equity for his future retirement or he pays himself dividends. The company is basically a foreign company; only U.S.-citizenship-based tax law defines it as a CFC.

The American entrepreneur's business is most likely a small or medium-size company, often with just a few employees and limited revenue. The owner might have a plumbing business, a consulting business, a restaurant, a translation service, or a company that manufactures widgets, or he may be a doctor or dentist who operates his practice through a company. Establishing a corporate entity provides many practical advantages to hire employees, to develop a professional framework and image, to obtain bank financing, to bring in other investors, to ensure limited liability, and to carry out business. It is often a requirement of local law.

The deemed repatriation tax creates an impossible situation for American entrepreneurs abroad. Thirty-one years of past earnings are suddenly shoved onto one year's (2017) U.S. tax filing, creating an unanticipated tax liability. American entrepreneurs overseas suddenly see their life savings in the company substantially reduced by the deemed repatriation tax at a rate of up to 17.54 percent.[7] Not only is the tax rate higher for individuals than for U.S.-based multinationals, but the fictive dividend income is shifted to the individual's personal income tax, pushing the taxpayer into a higher tax bracket and probably subjecting him to the additional 3.8 percent net investment income tax. The individual taxpayer may not have the resources available to pay the retroactive tax. In extreme cases, some may be pushed into bankruptcy.

The deemed repatriation tax paid is a clear instance of double taxation because the retained earnings of the CFC have been subject to the taxes levied by the country of incorporation, and those foreign corporate taxes cannot be credited against the deemed repatriation tax. It could even lead to additional foreign taxation if, to pay the tax, the taxpayer has to instruct his company to pay out a dividend that may be subject to withholding of local tax at source or subject to local personal income tax. Under the TCJA rules, these foreign taxes may not be creditable against the business owner's deemed repatriation tax.[8]

GILTI — the New Annual Tax

Section 951A introduces the GILTI tax to prevent base erosion whereby multinationals shift profits to foreign subsidiaries beyond the IRS's reach.[9] The GILTI regime imposes a tax on CFC earnings starting in fiscal 2018.[10] Under the GILTI rules, profits of the CFC that exceed a 10 percent return on the company's qualified business asset investment — essentially, its depreciable fixed assets — are defined as GILTI and are subject to U.S. taxation of the shareholder.[11] Companies with low levels of fixed assets, such as service companies and technology companies, will be

[7]The 17.54 percent rate applies to liquid assets, and a rate exceeding 9 percent applies to illiquid assets.

[8]The taxpayer is allowed a tax credit for foreign taxes linked to the dividend income in his personal income only in 2017, the year of the deemed repatriation tax, or in 2018 as a result of the one-year carryback allowed. If the taxpayer is spreading his deemed repatriation tax over eight years, for years 3 through 8 he cannot apply FTCs on dividends paid from the corporation to him to cover the payment of the U.S. transition tax installment.

[9]As Lee A. Sheppard put it: "The legislative history of GILTI demonstrates that Congress did not believe that the offshore income it acted to claw back is really foreign or alien. In enacting GILTI, Congress believed that the companies had offshored their intangible assets and activities with the intent to deprive the United States of tax jurisdiction." Sheppard, "Is Taxing GILTI Constitutional?" *Tax Notes*, July 30, 2018, p. 603.

[10]Section 951A requires U.S. shareholders of CFCs to report the inclusion of GILTI for years they are shareholders. Form 8992, "U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)," must be completed to calculate the GILTI inclusion for the shareholder's annual Form 1040 filing. The GILTI amounts must also be recorded on Form 5471.

[11]For a detailed analysis of GILTI calculations, see Justin G. Crouse et al., "GILTI Rules Particularly Onerous for Non-C Corporation CFC Shareholders," McDermott Will & Emery (Jan. 30, 2018). *See also* Libin Zhang, "Direct Foreign Tax Credit and GILTI: The Curious Incidences of the Credit That Was Not Cut," 47 *Tax Mgmt. Int'l J.* 257 (2018).

particularly affected by the GILTI tax. Because earnings of the CFC are now taxed annually through the GILTI tax, the United States no longer imposes tax on dividend distributions of foreign subsidiaries to the U.S. parent corporation. This eliminates the distorted tax incentive under the 1986 law for U.S. multinational corporations to stash profits overseas.

Applying the same GILTI rules to citizens resident overseas who own a CFC creates a terrible distortion of law. Foreign governments would not tolerate the United States taxing companies incorporated in their countries. Consequently, the TCJA relies on U.S. law to tax its citizens resident abroad under CBT and shifts GILTI profits to the personal income of the shareholder. Phil Hodgen, a California-based U.S. lawyer who specializes in international tax affecting American citizens abroad, puts it this way:

> If you are a U.S. citizen and you own all of the shares of a French corporation, U.S. law creates a fiction: Let's pretend that all of the profit earned by your French corporation is somehow magically distributed to you, the U.S. citizen human, even if no money was in fact ever distributed to you. Guess what! You personally have taxable income and must pay U.S. income tax on that.[12]

This widespread interpretation of the law created panic and despair among overseas entrepreneurs, inspiring intensive grass-roots lobbying.

The TCJA allows a domestic resident taxpayer who own a CFC through a domestic passthrough entity (a partnership or an S corporation) to opt to make a section 962 election, which allows the GILTI income to be taxed as if the owner were a U.S. corporation. However, this option doesn't extend to overseas resident taxpayers. An American resident abroad who owns a local company would never have imagined a need to create a U.S.-based S corporation as the intermediary owner of his foreign company.

In the GILTI regulations proposed in March, Treasury finally recognized the need to resolve the incongruous tax dilemma of individuals who have direct ownership in CFCs.[13] The regulations allow individual shareholders who make a section 962 election to have the GILTI income from their foreign corporations taxed the same way as the foreign subsidiaries of domestic U.S. corporations, even though the calculation of that income and related deductions is reported on Form 1040.[14]

U.S. law aims to tax American citizens the same way, regardless of residence, domestic or overseas. Yet the GILTI rules are a perfect example of why the United States should not tax U.S. citizens abroad in the first place.

First, Congress passes a law designed for U.S. multinationals and specifies that the complicated rules to shift to territorial taxation relate only to U.S. corporations.

Second, Congress wants to maintain a taxing authority over income realized by foreign subsidiaries. Hence, the fictive GILTI tax is created. Through complex calculations, the U.S. corporation is taxed on the GILTI income at a maximum 10.5 percent rate (half of the 21 percent corporate tax rate). It is actually not taxed at all by the United States if the foreign corporate tax rate exceeds 13.125 percent because the United States allows the U.S. corporation to apply 80 percent of foreign tax credits related to the GILTI income. Most OECD countries have corporate tax rates higher than 13.125 percent. GILTI taxation allows future dividends paid to the U.S. parent corporation to be tax free.

Third, the law allows only individual shareholders who own a CFC through a U.S. domestic passthrough to make a section 962 election to benefit from the tax advantages in calculating GILTI taxes under rules granted to U.S. corporations.

Fourth, in a strange twist, the TCJA taxes the earnings of a CFC more heavily if the company is

[12] Phil Hodgen blog, "Minimultinationals Chapter 1 — Overview of the Series," Hodgenlaw PC (Jan. 28, 2019).

[13] REG-104464-18.

[14] *See id.* (explaining why the proposed regulations would give individuals the section 250 deduction for their GILTI if they make the section 962 election).

owned by an American resident overseas.[15] Individual citizens resident overseas are taxed on the full amount of the GILTI income, which is added to all other personal revenue on Form 1040. The U.S. citizen taxpayer can face a tax rate of up to 37 percent (the top personal income tax rate) on the GILTI income.

Fifth, more than a year after passage of the TCJA, Treasury seeks to correct and clarify Congress's statutory language by granting individual owners of CFCs, including Americans resident abroad, the right to make a section 962 election to benefit from the more favorable GILTI tax rules applicable to corporations.

Sixth, the fictive GILTI income based on the CFC operations must still be magically incorporated into the personal tax statement on the Form 1040. This measure implicitly turns the individual overseas into a passthrough under U.S. law even though the individual resides in a foreign country where the corporation is a separate entity.

Seventh, despite these twists and turns of Treasury to aim for equal treatment, the overseas American who owns a CFC to carry out a local business still suffers discrimination compared with a U.S. resident who owns shares in a comparable domestic business. The U.S. resident is taxed only on distributed dividends, not on the business's earnings or parts thereof; the corporate tax calculation remains separate. The American resident overseas, however, is taxed on his CFC earnings through the GILTI provisions, without any dividend distribution. Even if no U.S. tax is due on the GILTI income when making the section 962 election, the complicated calculations to determine GILTI income and related deductions substantially increase the compliance burden compared with that of U.S. residents.

Eighth, if a GILTI tax is due, the United States is imposing pure double taxation — possibly even triple taxation — on the American citizen overseas who owns a CFC. The company profits have already been taxed by the country of incorporation. To pay the GILTI tax, the U.S. citizen may be forced either to pay himself a higher salary or distribute a dividend from his corporation, thereby diminishing his capacity to develop the company and creating a taxable event in the country of residence, or to draw on other financial resources outside the corporation. This is an untenable situation.

The final outcome of GILTI tax imposed on overseas entrepreneurs will be negligible additional tax revenue for the United States but additional administrative work for the IRS and significant new accounting and return preparer costs for the entrepreneurs — including the cost of maintaining two sets of accounts: one for local tax purposes and the other for U.S. GAAP/GILTI rules in U.S. dollars. Consequently, profitability and competitiveness will be reduced. Through the GILTI regime and section 962, Congress and Treasury have created fictions as a solution to a problem that should never have existed. Of all U.S. income tax measures imposed by Congress on Americans abroad since 1962, the GILTI tax is by far the most pernicious. The TCJA crushes the law of foreign countries that separate foreign companies from their resident owners and imposes tax base erosion on foreign countries. No wonder Americans abroad are outraged.

All of the above implies that the U.S. citizen is the sole shareholder of the CFC. Imagine the added layer of complexity if, for example, the foreign corporation is owned 30 percent by the American overseas and the rest is owned by non-American shareholders. In fact, because of the well-known overreach of U.S. tax law, the Foreign Account Tax Compliance Act, and Form 5471 reporting requirements, foreigners generally refuse to enter into a joint venture with American citizens overseas. With GILTI, Americans overseas will definitely be excluded from joint ventures with foreigners.

Americans Abroad Plead for Changes to the TCJA

After passage of the TCJA and the publication of related proposed Treasury regulations, associations and tax lawyers representing Americans abroad pleaded with Congress and Treasury to resolve the dilemmas created for overseas entrepreneurs.

[15] For more detail on GILTI and related FTCs, see Amanda Varma and Greg Kidder, "Key Takeaways From the Proposed Foreign Tax Credit Regulations," *MNE Tax*, Dec. 19, 2018.

American Citizens Abroad Inc.,[16] a leading advocate for Americans abroad, recommended that a de minimis measure be added to the Treasury regulations to exclude U.S. citizens who own small corporations overseas from TCJA taxation.[17] Similarly, John Richardson, a Canada-based American lawyer, proposed that Americans living abroad be exempt from the repatriation and GILTI tax regimes for any given year if they are bona fide residents of a foreign country[18] and are individual U.S. shareholders rather than a corporation.[19]

Treasury received numerous comments from American entrepreneurs on the unreasonable compliance burden and unbearable taxes that the TCJA and the August 2018 proposed regulations[20] imposed on their small companies overseas. The American Bar Association Section of Taxation stated in its comments to Treasury that some rules under section 965(g) "add unneeded complexity to the calculation of credible foreign income taxes." The ABA tax section also said: "We are not aware of anything in the statute or legislation history, that mandates that foreign distribution taxes be subject to the section 965(g) reduction. This limitation is especially harsh on individual U.S. shareholders and those U.S. shareholders who reside outside the U.S."[21]

American Citizens Abroad ridiculed Treasury's estimate that the compliance burden for gathering information per taxpayer would be five hours. The organization said that a more realistic figure would be 50 hours — and that doesn't include the time to read the law and regulations and complete the filing requirements with a professional return preparer. "It will take months to figure out how these rules apply and to calculate the amount of tax owed," the group said.[22] The compliance complexity is illustrated in Treasury's mind-boggling guidance on FTCs under the TCJA, which totals 312 pages.[23]

Treasury Ignores Reality

In response to heavy lobbying by Americans abroad, Treasury finally did recognize the compliance difficulty and unfairness in the law. It delayed the due date for the first payment of the deemed repatriation tax, first from April 2018 to June 2018, and then to April 15, 2019.[24] And, as noted earlier, regulations published in March allow entrepreneurs overseas to opt to use section 962 to have their GILTI income taxed as though the owner were a U.S. corporation.

Notwithstanding its effort in defining guidelines,[25] Treasury has obviously not changed its fundamental position that U.S. law applies to Americans resident abroad who own a CFC, despite the unfair hardships that creates. In the February final regulations on the deemed repatriation tax, Treasury incredibly certifies that the regulations "will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act."[26] Treasury further states:

> As an initial consideration, foreign corporations are not considered small entities. Nor are U.S. taxpayers considered small entities to the extent that the taxpayers are natural persons or entities other than small entities. . . . Regardless of the number of small entities potentially affected by section 965 or the final regulations, the Treasury Department and the IRS have concluded that there is no significant economic impact on such entities as a result of the final regulations.[27]

[16] American Citizens Abroad is a qualified section 501(c)(4) nonprofit membership organization advocating for practical solutions to issues affecting U.S. citizens living and working abroad.

[17] Comments by American Citizens Abroad on proposed regulations under section 965, at 1-2 (Oct. 8, 2018).

[18] As defined in section 911.

[19] Richardson, "Part 11: Responding to the Sec. 965 'Transition Tax': Letter to the Senate Finance [Committee] Discussing the Effect of the Transition Tax on Americans Abroad," Citizenship Solutions blog (undated).

[20] REG-104226-18.

[21] ABA tax section, "Comments on Proposed Regulations Addressing Section 965," at 74-75 (Oct. 29, 2018).

[22] American Citizens Abroad comments, *supra* note 17, at 3.

[23] REG-105600-18.

[24] IR-2018-131.

[25] For a review of Treasury guidelines for sections 965 and 951A, see Baker Tilly Virchow Krause LLP, "2018 Year-End Tax Letter/ International Taxation" (Oct. 30, 2018).

[26] T.D. 9846.

[27] *Id.*

Treasury provides no evidence to back up these statements, which fly in the face of common sense and logic.

The final word on these issues will belong to the courts. In January an Israeli company owned by an American resident in Israel filed a lawsuit against the IRS and Treasury in the U.S. District Court for the District of Columbia.[28] At issue are the impenetrable regulations, the unreasonable burdens on a vast number of small businesses and small business owners, and the lack of a final regulatory analysis as required by law.[29]

Is Tax Reform Possible?

The TCJA has provoked unprecedented ire among the overseas American community because it directly threatens the survival of many entrepreneurs and their families. Prior tax increases on citizens abroad over the years had already created much irritation and frustration at the unfairness of U.S. tax law under CBT. FATCA legislation has locked Americans out of foreign financial institutions, leading to severe handicaps for daily living abroad. But the blatant overkill of the TCJA takes the cake. Either Congress will correct the injustice, or an increasing number of Americans overseas will be forced to renounce their U.S. citizenship. Others may simply go under the radar because compliance is impossible in practice.

Is tax reform possible? Fortunately, there appears to be a glimmer of hope. Washington has become increasingly aware of the serious tax issues facing Americans abroad, thanks to the continuing efforts of numerous advocacy groups, as well as American chambers of commerce throughout the world. Leaders of the House Ways and Means and Senate Finance committees have publicly recognized the need to look into the way Americans abroad are taxed.

Most encouraging is the legislation introduced in December 2018 by Rep. George Holding, R-N.C.: H.R. 7358, the Tax Fairness for Americans Abroad Act of 2018, would provide "an alternative exclusion for nonresident citizens of the United States living abroad." This bill represents a major step away from CBT toward residence-based taxation. Under H.R. 7358, only U.S.-source income of Americans abroad would be taxed by the United States. Foreign income would no longer be subject to U.S. taxation. This would automatically solve the problems posed by the GILTI tax, along with the multitude of other sources of double taxation under CBT. However, specific legislation is still needed to retroactively eliminate the damage imposed by the deemed repatriation tax.

Wake up, Washington! ■

[28] Complaint, *Silver v. IRS*, No. 1:19-cv-00247 (D.D.C. filed Jan. 30, 2019).

[29] *Id.* at 1-2. To gain more understanding of the framework of the lawsuit, see Richardson's interview of Monte Silver.