

Choice of Entity for Foreign Businesses Owned by American Entrepreneurs: Common Corporate Structures

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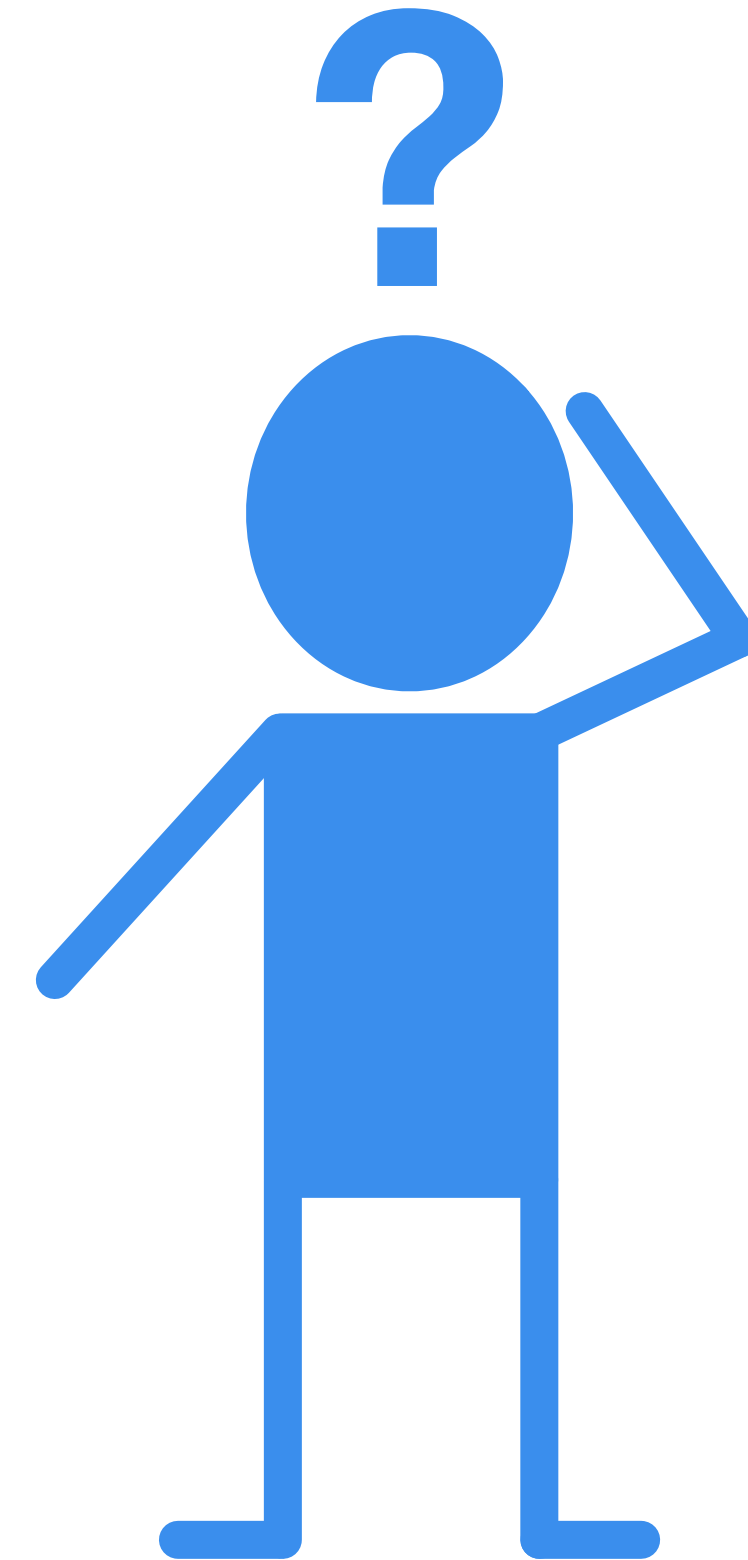
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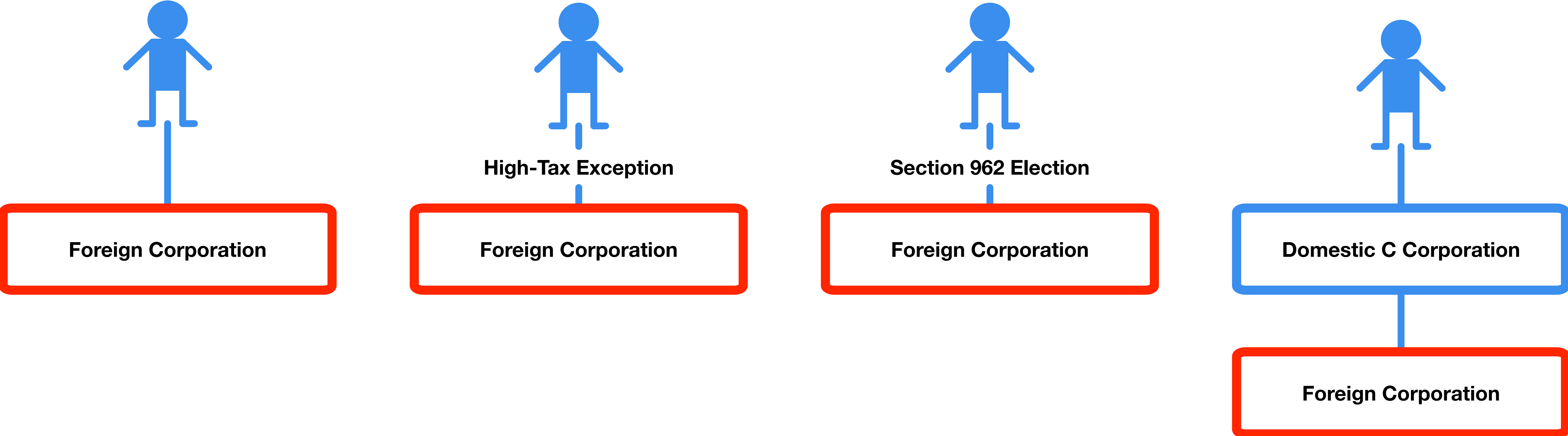
1. Introduction

“How do I structure my foreign business?”

- An American entrepreneur living abroad starts a business.
- Assume a local entity is necessary for business operations.
- What business entity type should the American entrepreneur choose for this new business?
- Why is this hard? The U.S. tax system’s insistence on worldwide taxation, and in particular IRC §§951, 951A.



We will compare the tax efficiency of these structures



Let's do some math! (The assumptions)

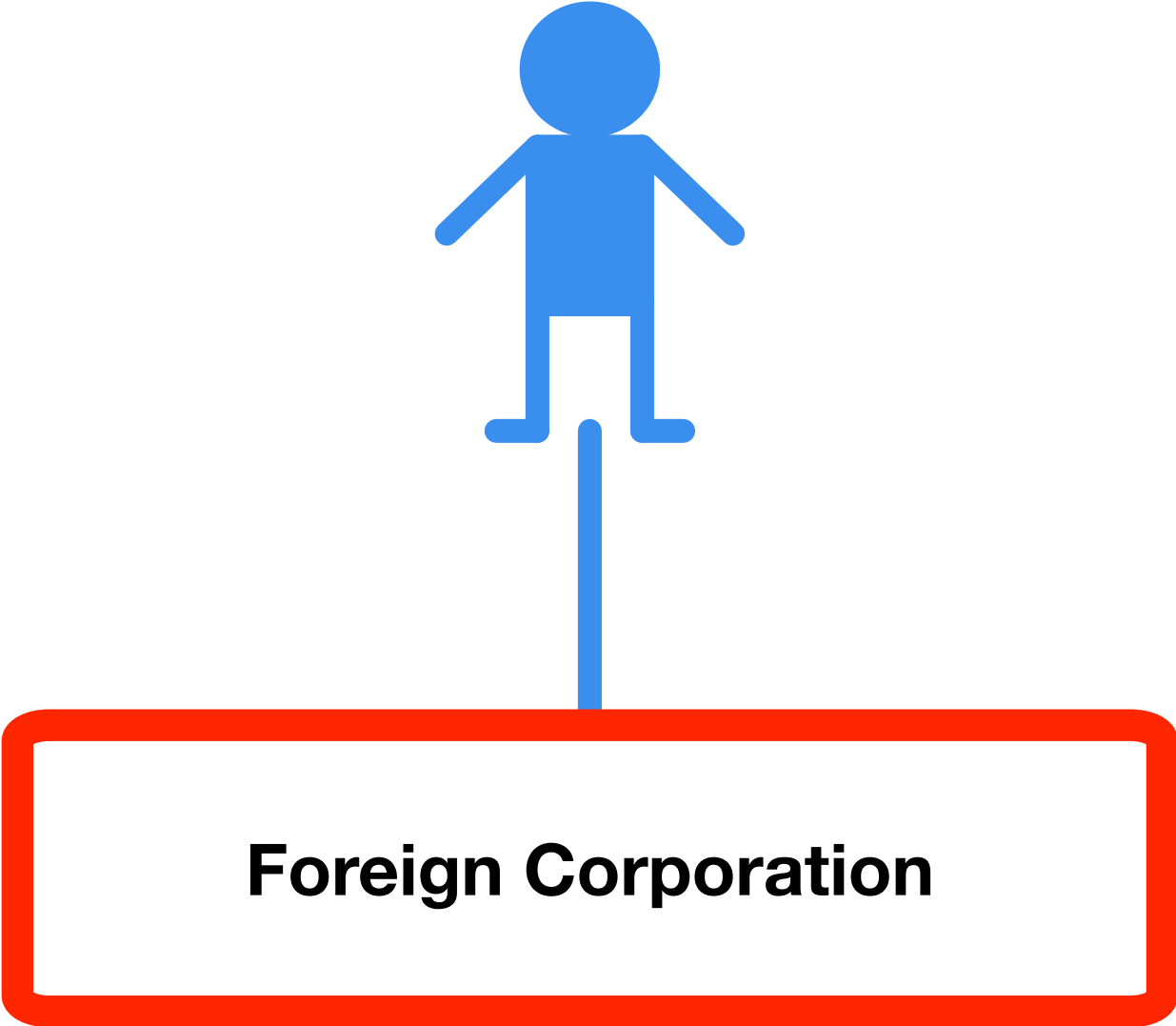
Item	Value
Foreign corporation gross revenue	600,000
Foreign corporation operating expenses (except salary to shareholder)	0
Foreign corporate income tax rate	30%
Foreign individual income tax rate	40%
U.S. individual income tax rate	37%
U.S. income tax rate (qualified dividends)	20%
U.S. net investment income tax rate (dividend income)	3.8%

All free cash distributed annually to the U.S. shareholder as a dividend

Here's the punchline, before I tell you the joke

Structure	Total Tax	Effective Tax Rate Worldwide
Foreign corporation	519,360	86.56%
Foreign corporation + high-tax exception	363,960	60.66%
Foreign corporation + Section 962 election	363,960	60.66%
Domestic parent/foreign subsidiary	348,000	58.00%

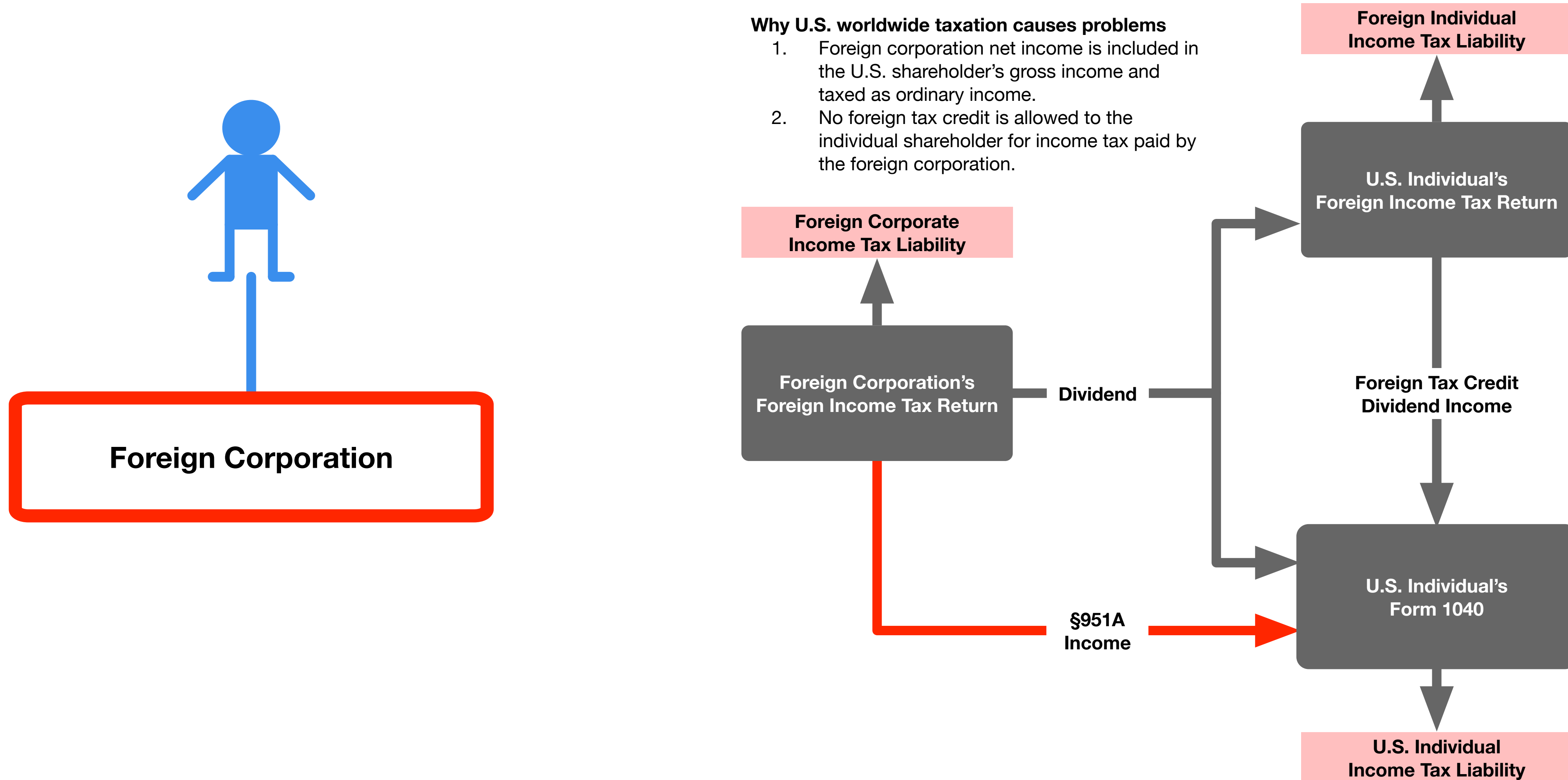
2. Foreign Corporation



How the United States taxes the shareholder

- **Corporation's operating profit:** included in the shareholder's gross income. IRC §951A(a). (**Subpart F income**, too. IRC §951(a)).
- **Foreign tax credit:** the individual shareholder is not allowed to claim a foreign tax credit for corporate income tax paid by the foreign corporation. IRC §960.
- **Dividends:** not included in the U.S. shareholder's U.S. gross income. IRC §959. No foreign tax credit permitted for the foreign individual income tax paid on the dividend income received, since U.S. tax on the dividend income is zero.

How the income items are taxed in two countries



Why U.S. worldwide taxation causes problems

1. Foreign corporation net income is included in the U.S. shareholder's gross income and taxed as ordinary income.
2. No foreign tax credit is allowed to the individual shareholder for income tax paid by the foreign corporation.

Foreign corporate income tax paid

Item	Value
Gross revenue	600,000
Less: deductible expenses	0
Taxable income	600,000
Foreign corporate tax rate	30%
Foreign corporate tax paid	180,000

Foreign income tax paid by shareholder (dividend income)

Item	Value
Foreign corporation taxable income	600,000
Less: foreign corporate income tax paid	(180,000)
Cash available for distribution	420,000
Dividend paid to shareholder by foreign corporation	420,000
Foreign individual income tax rate	40%
Foreign income tax paid by shareholder on dividend income	168,000

U.S. tax paid by shareholder (dividend income)

Item	Value
Dividend income received	420,000
Less: amount excluded from gross income (IRC §959)	(420,000)
Amount of dividend included in gross income	0
Shareholder's income tax on dividend income received	0
Dividend income included in net investment income	420,000
Net investment income tax rate	3.8%
Shareholder's net investment income tax on dividend received	15,960

Why no foreign tax credit on the dividend income?

- IRC §904 says the amount of foreign tax credit allowable is the lesser of foreign tax paid or the U.S. tax liability on the income item.
- IRC §959 says the shareholder's dividend income is zero because a distribution from previously taxed earnings and profits of a foreign corporation is not included in gross income.
- This makes U.S. income tax on dividend income equal zero. Therefore, the IRC §904 limitation makes the allowable foreign tax credit equal zero.
- Foreign tax credit rules doesn't apply to net investment income tax, which is its own special little tax, quite apart from the regular income tax. So you pay NIIT.

IRC §951A income: where it comes from

**SCHEDULE I-1
(Form 5471)**

(Rev. December 2021)

Department of the Treasury
Internal Revenue Service

Information for Global Intangible Low-Taxed Income

OMB No. 1545-0123

▶ Attach to Form 5471.

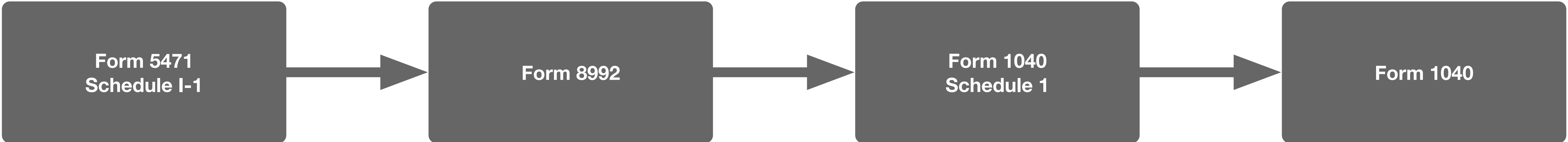
▶ Go to www.irs.gov/Form5471 for instructions and the latest information.

Name of person filing Form 5471		Identifying number
Name of foreign corporation	EIN (if any)	Reference ID number (see instructions)

Separate Category (Enter code—see instructions.) ▶

		Functional Currency	Conversion Rate	U.S. Dollars
1	Gross income (see instructions if cost of goods sold exceed gross receipts)	1	600,000	
2	Exclusions (see instructions if cost of goods sold exceed gross receipts)			
a	Effectively connected income	2a		
b	Subpart F income	2b		
c	High-tax exception income per section 954(b)(4)	2c		
d	Related party dividends	2d		
e	Foreign oil and gas extraction income	2e		
3	Total exclusions (combine lines 2a through 2e)	3	0	
4	Gross income less total exclusions (line 1 minus line 3) (see instructions)	4	600,000	
5	Deductions properly allocable to amount on line 4	5	180,000	
6	Tested income (loss) (line 4 minus line 5) (see instructions)	6	420,000	1 420,000

Gross income: from Form 5471 to the shareholder's Form 1040



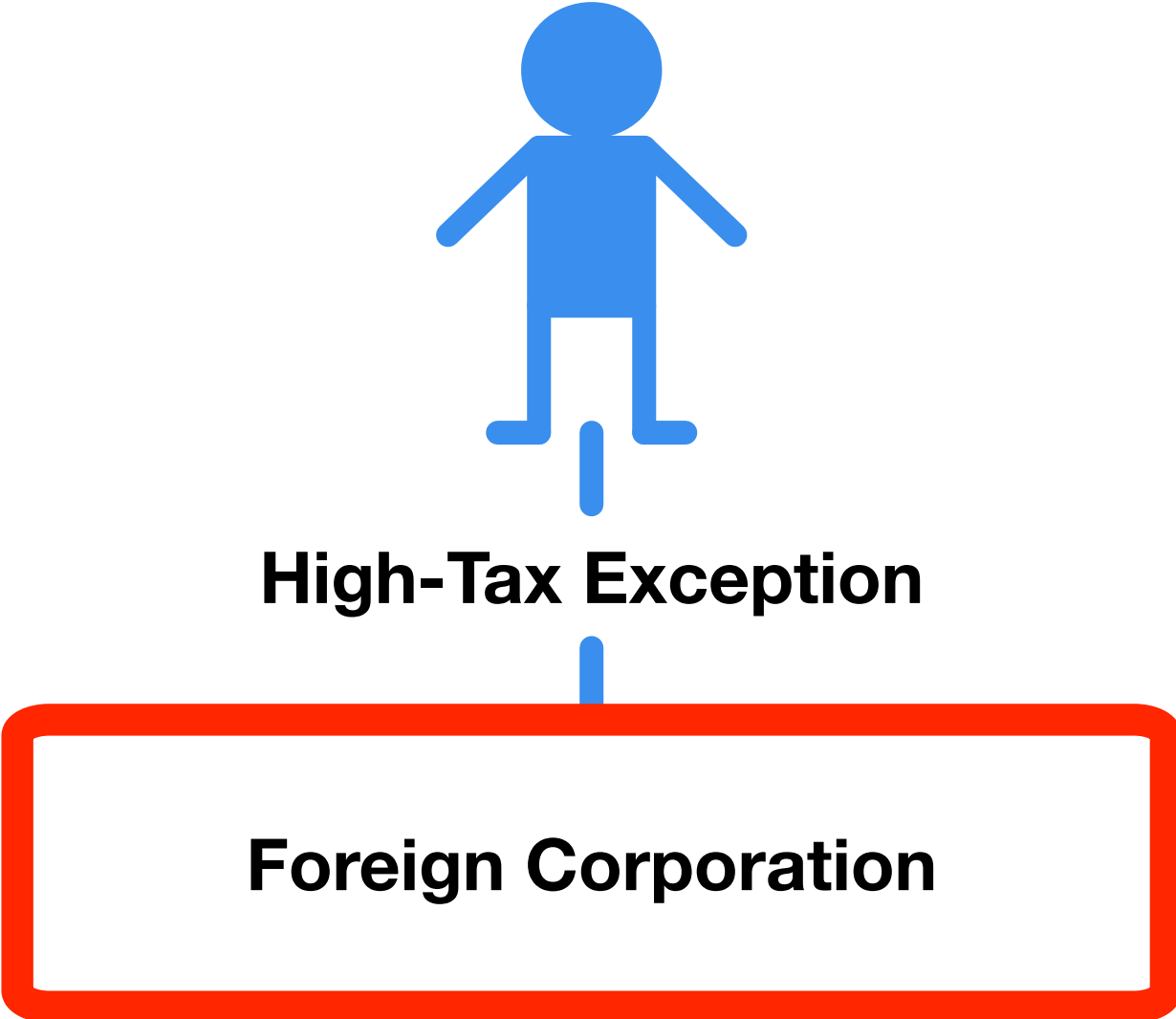
Shareholder's IRC §951A income tax

Item	Value
Foreign entity gross revenue	600,000
Less: specified categories of income	0
Less: allocable taxes	(180,000)
IRC §951A gross income inclusion (Form 8992 to Form 1040)	420,000
Less: standard deduction	Ignore
Shareholder's individual taxable income	420,000
Federal income tax rate	37%
Income tax liability on §951A gross income inclusion	155,400

Total tax paid by corporation and shareholder

Item	Value
Foreign corporate income tax on corporate net profit	180,000
Less: indirect foreign tax credit allowed to the individual shareholder	0
U.S. personal income tax (corporation's §951A income)	155,400
Foreign personal income tax (dividend)	168,000
U.S. personal income tax (dividend)	0
U.S. net investment income tax (dividend)	15,960
U.S. foreign tax credit (dividend)	0
Total tax paid worldwide	519,360
<i>Tax as % of corporation's \$600,000 taxable income</i>	<i>86.56%</i>

3. Foreign Corporation + High-Tax Exception



The High-Tax Exception

- The biggest problem with a foreign corporation structure is that corporate income is included in the individual shareholder's gross income as IRC §951A income (global intangible **low-taxed** income).
- If the corporation's income is subjected to a “high enough” corporate tax rate in a foreign country, then the corporation's income is NOT included in the individual shareholder's gross income—it is no longer low-taxed income.

Subtract high-tax income to make IRC §951A income = zero

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		Functional Currency	Conversion Rate	U.S. Dollars
1	Gross income (see instructions if cost of goods sold exceed gross receipts)	1	600,000	
2	Exclusions (see instructions if cost of goods sold exceed gross receipts)			
a	Effectively connected income	2a		
b	Subpart F income	2b		
c	High-tax exception income per section 954(b)(4)	2c	600,000	
d	Related party dividends	2d		
e	Foreign oil and gas extraction income	2e		
3	Total exclusions (combine lines 2a through 2e)	3	600,000	
4	Gross income less total exclusions (line 1 minus line 3) (see instructions)	4	0	
5	Deductions properly allocable to amount on line 4	5		
6	Tested income (loss) (line 4 minus line 5) (see instructions)	6		

High-tax exception: where it makes a difference

Item	Value
Foreign corporate income tax on corporate net profit	
Less: indirect foreign tax credit allowed to the individual shareholder	
U.S. personal income tax (corporation's §951A income)	
Foreign personal income tax (dividend)	
U.S. foreign tax credit (dividend)	
U.S. personal income tax (dividend)	
U.S. net investment income tax (dividend)	
Total tax paid worldwide	
<i>Tax as % of corporation's \$600,000 taxable income</i>	

A stylized explanation of how the high-tax exception affects Form 1040

Item	Value
Foreign entity gross revenue	600,000
<i>Less: high-tax exception income</i>	<i>(600,000)</i>
IRC §951A gross income inclusion	0
Less: standard deduction	Ignore
Shareholder's individual taxable income	0
Federal income tax rate	37%
Income tax liability on §951A gross income inclusion	0

Dividends received by the shareholder are taxable, but it doesn't matter

- IRC §959 says that distributions from previously-taxed earnings and profits will not be included in the gross income of the recipient U.S. shareholder.
- When the high-tax exception is used by the shareholder, the CFC's earnings and profits have not been taxed.
- This means that distributions from a CFC using the high-tax exclusion will be treated as dividend income to the shareholder to the extent of earnings and profits.
- Because we assume high tax rates in these examples, let's assume a tax treaty exists, and the qualified dividend rules apply.

U.S. tax paid by shareholder (dividend income)

Item	Value
Dividend income received	420,000
Less: amount excluded from gross income (IRC §959)	0
Shareholder's income tax on dividend income received	420,000
Qualified dividend tax rate	20%
Shareholder's income tax on dividend received	84,000
Dividend income included in net investment income	420,000
Net investment income tax rate	3.8%
Shareholder's net investment income tax on dividend received	15,960

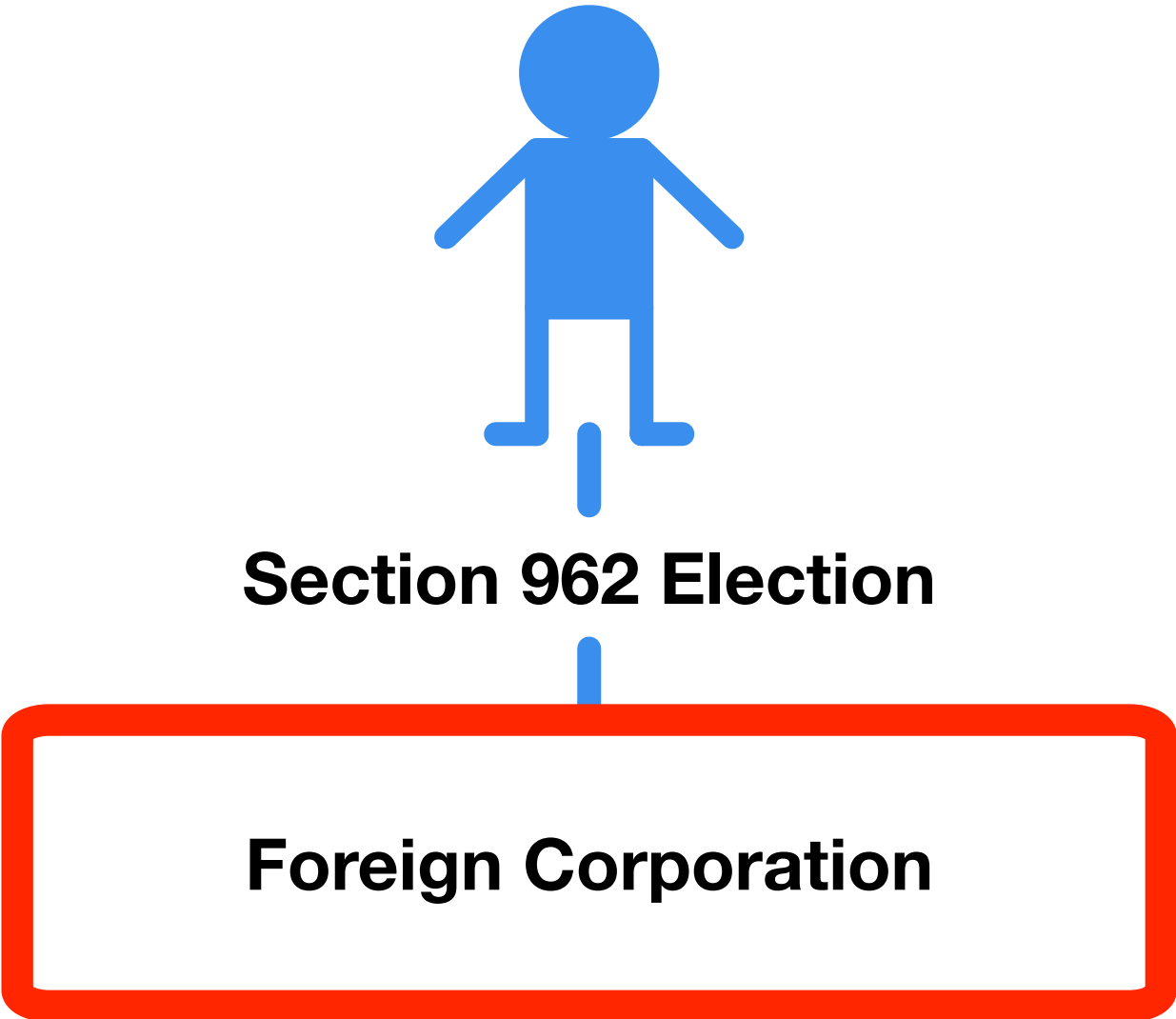
Tax credit allowed on dividend income (IRC §904 limitation)

Item	Value
Foreign income tax paid on dividend income	168,000
U.S. income tax liability on dividend income	84,000
IRC §904 limitation (lower of foreign tax, U.S. tax)	84,000
<i>Foreign tax credit allowable against dividend income</i>	<i>84,000</i>

High-tax exception: total tax paid by corporation and shareholder

Item	Value
Foreign corporate income tax on corporate net profit	180,000
Less: indirect foreign tax credit allowed to the individual shareholder	0
U.S. personal income tax (corporation's §951A income)	0
Foreign personal income tax (dividend)	168,000
U.S. foreign tax credit (dividend)	(84,000)
U.S. personal income tax (dividend)	84,000
U.S. net investment income tax (dividend)	15,960
Total tax paid worldwide	363,960
<i>Tax as % of corporation's \$600,000 taxable income</i>	<i>60.66%</i>

4. Foreign Corporation + Section 962 Election



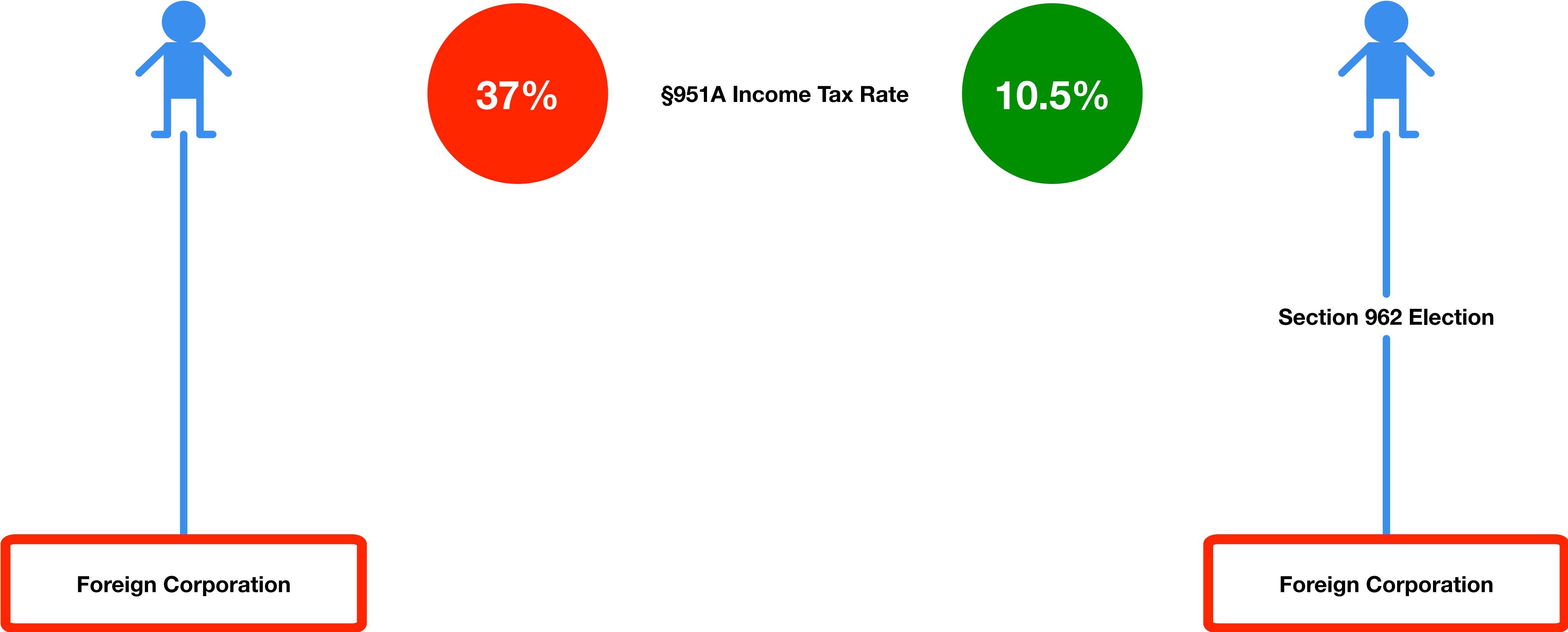
Different #1: take 50% off your gross income, and a lower tax rate

- **The foreign corporation's operating income** is included in gross income, as usual. IRC §951A.
- The amount included in the individual shareholder's gross income is **reduced by a 50% deduction**. IRC §250(a)(1), Reg. §1.962-1(b)(1)(i)(B)(3).
- **Nominal tax rate** on the inclusion: **21%**. Use the corporate tax rate (IRC §11) rather than individual tax rates (IRC §1) because IRC §951A income is taxed via IRC §951(a). IRC §§951A(f)(1)(A), 962(a)(1).
- The effect of the IRC §250 deduction is a **10.5% effective tax rate**.

Warning about Subpart F income and effective tax rates

- Subpart F income does not get the 50% deduction of IRC §250(a)(1) because that deduction only applies to IRC §951A inclusions - and Subpart F inclusions are caused by IRC §951(a).
- The effective tax rate on Subpart F income is **21%**. IRC §962(a)(1).

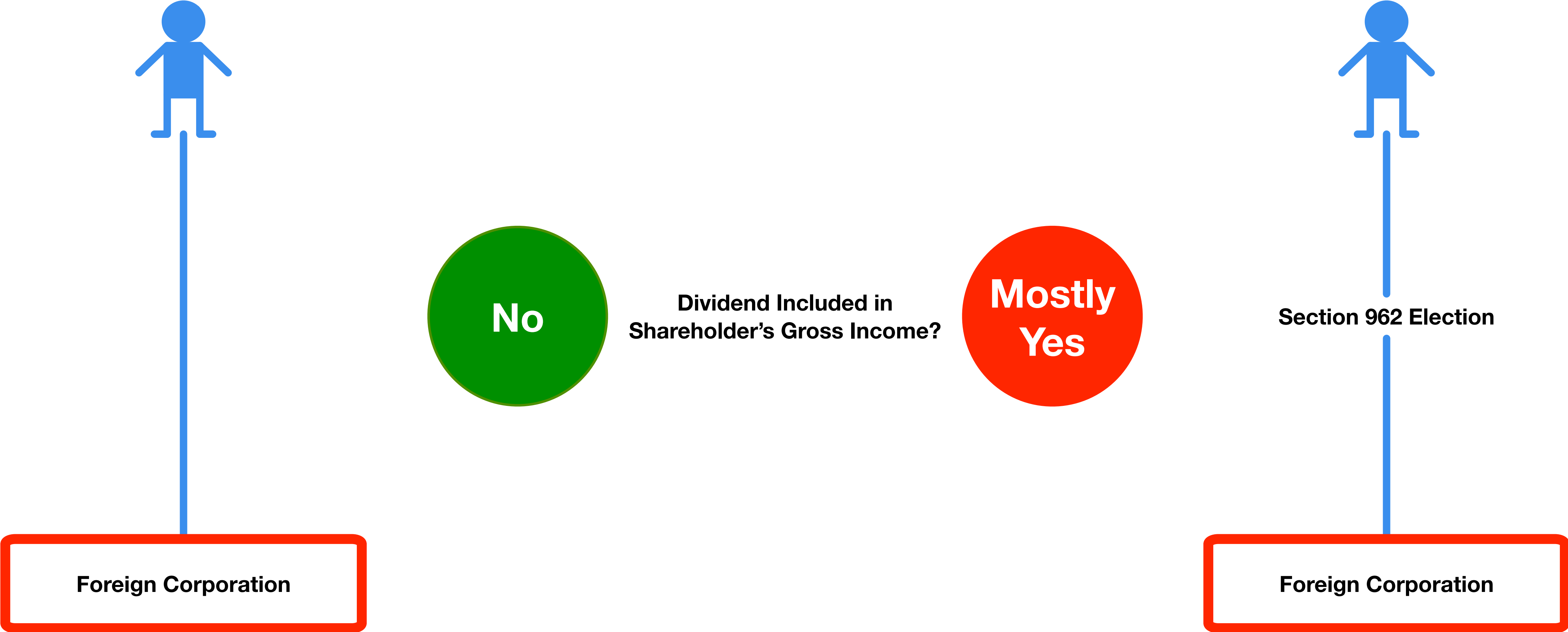
Tax rate on IRC §951A income inclusion



Different #2: dividends create gross income

- Remember that dividends paid to shareholders from a CFC's previously-taxed earnings and profits will not be treated as gross income to the recipient. IRC §959.
- Throw that exclusion out the window when you make a Section 962 election. Dividends are (mostly) included in the individual shareholder's gross income.
- Gross income to the shareholder = the dividend paid from previously-taxed earnings and profits minus the income tax actually paid on the previously-taxed earnings and profits. IRC §962(d).

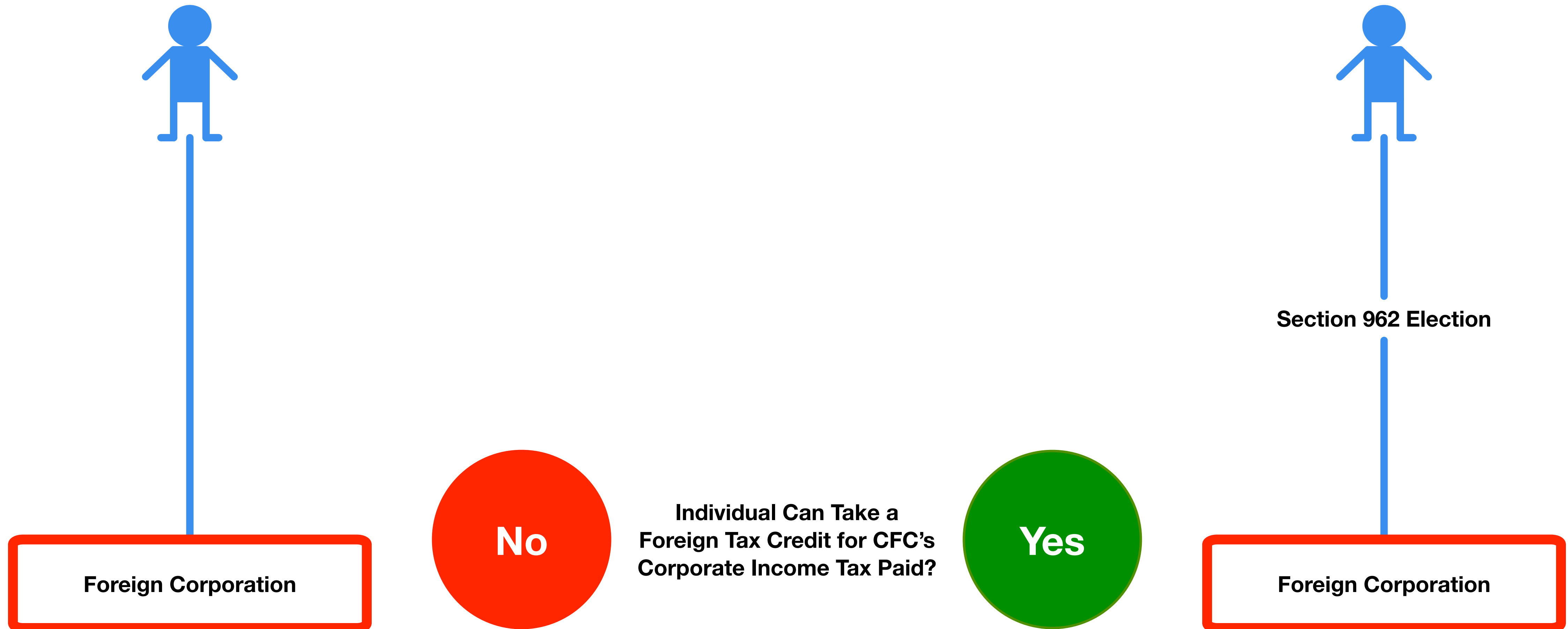
Are dividends included in gross income?



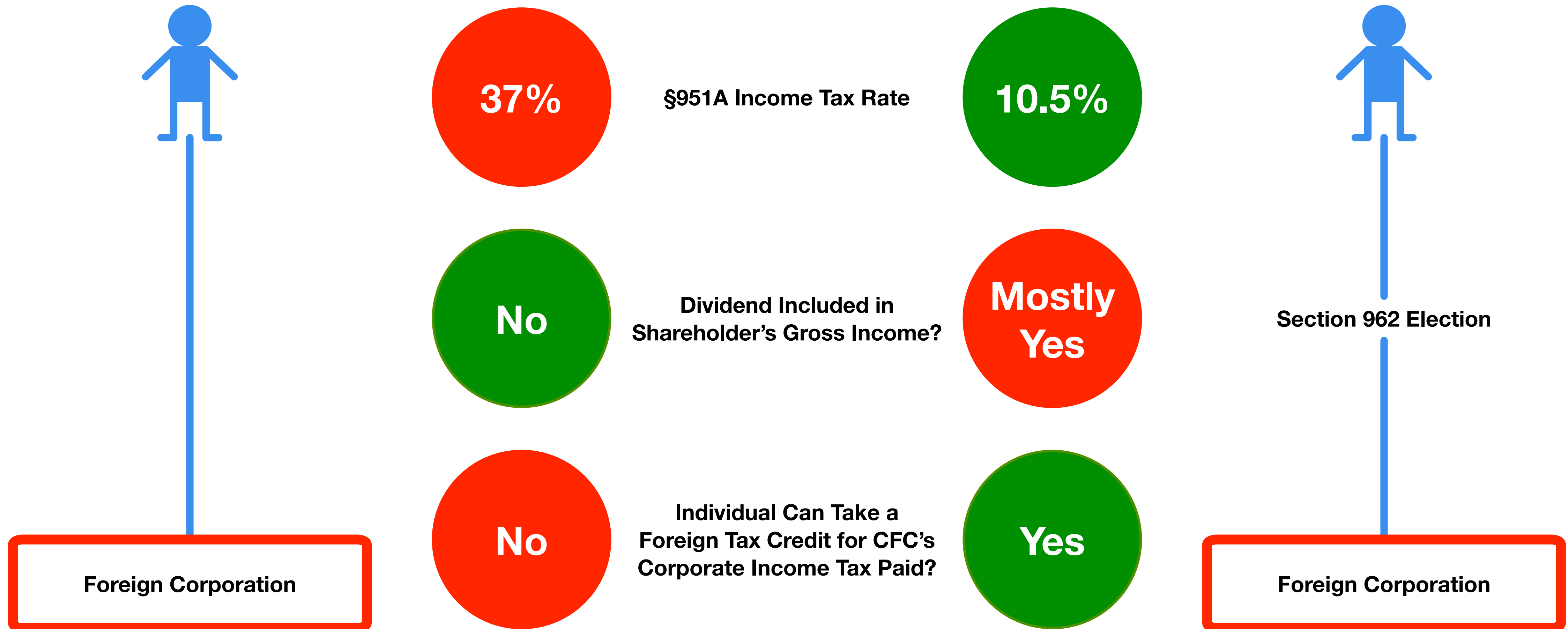
Different #3: use the indirect foreign tax credit

- The direct foreign tax credit (IRC §901) is not available because the CFC pays the foreign income tax, not the shareholder.
- Section 962 lets the individual shareholder take the indirect foreign tax credit (IRC §960) for amounts included in income because of IRC §951(a). IRC §962(a)(2).
- Operating profit (IRC §951A income) is treated as if it is included in gross income via IRC §951(a). IRC §951A(f)(1).
- Therefore, the Section 962 Election allows an individual shareholder to use the IRC §960 indirect tax credit for foreign income tax paid by a CFC on IRC §951A income.

Foreign tax credit allowable to shareholder



IRC §962 election: summary of the differences



Section 962 Election: shareholder's IRC §951A income

Item	Value
Foreign entity gross income	600,000
Less: statutory categories of income	0
Less: allocable taxes	(180,000)
Subtotal	420,000
Plus add back gross up for foreign tax (IRC §78)	180,000
IRC §951A and §78 gross income inclusion	600,000
Less: IRC §250 deduction	(300,000)
Shareholder's taxable income	300,000
Federal income tax rate	21%
Shareholder's income tax liability on IRC §951A income	63,000

Indirect foreign tax credit allowed on IRC §951A income

Item	Value
Foreign entity tax paid	180,000
IRC §960(d) limitation (80% of actual)	144,000
U.S. tax liability on IRC §951A income	63,000
IRC §904 limitation (lower of foreign tax or U.S. tax)	63,000
<i>Foreign tax credit allowable against IRC §951A income</i>	<i>63,000</i>

Section 962 election: U.S. tax paid by shareholder (dividend)

Item	Value
Dividend income received	420,000
Less: amount excluded from gross income (IRC §962(d))	0
Amount of dividend included in gross income	420,000
Federal income tax rate	20%
Income tax on dividend income received	84,000
Dividend income included in net investment income	420,000
Net investment income tax rate	3.8%
Net investment income tax on dividend received	15,960

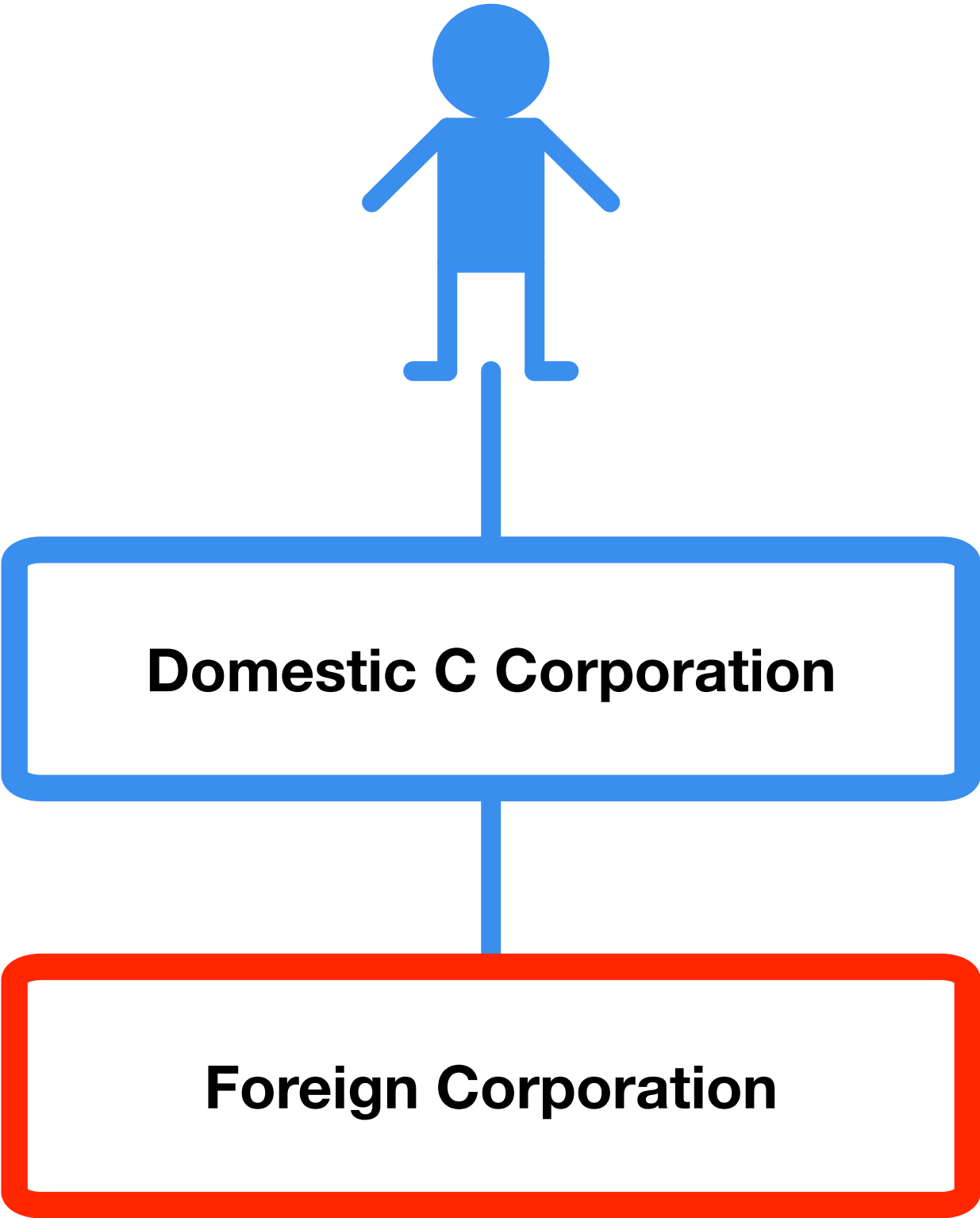
Tax credit allowed on dividend income (IRC §904 limitation)

Item	Value
Foreign tax paid on dividend income	168,000
U.S. income tax liability on dividend income	84,000
IRC §904 limitation (lower of foreign tax, U.S. tax)	84,000
<i>Foreign tax credit allowable against dividend income</i>	<i>84,000</i>

Total tax paid by everyone, everywhere

Item	Value
Foreign corporate income tax	180,000
Foreign personal income tax (dividend)	168,000
U.S. personal income tax (dividend)	84,000
Foreign tax credit against dividend income	-84,000
U.S. personal income tax (§951A income)	63,000
Foreign tax credit against §951A income	(63,000)
U.S. net investment income tax (dividend)	15,960
Total tax paid worldwide	363,960
<i>Tax as % of corporation's \$600,000 taxable income</i>	<i>60.66%</i>

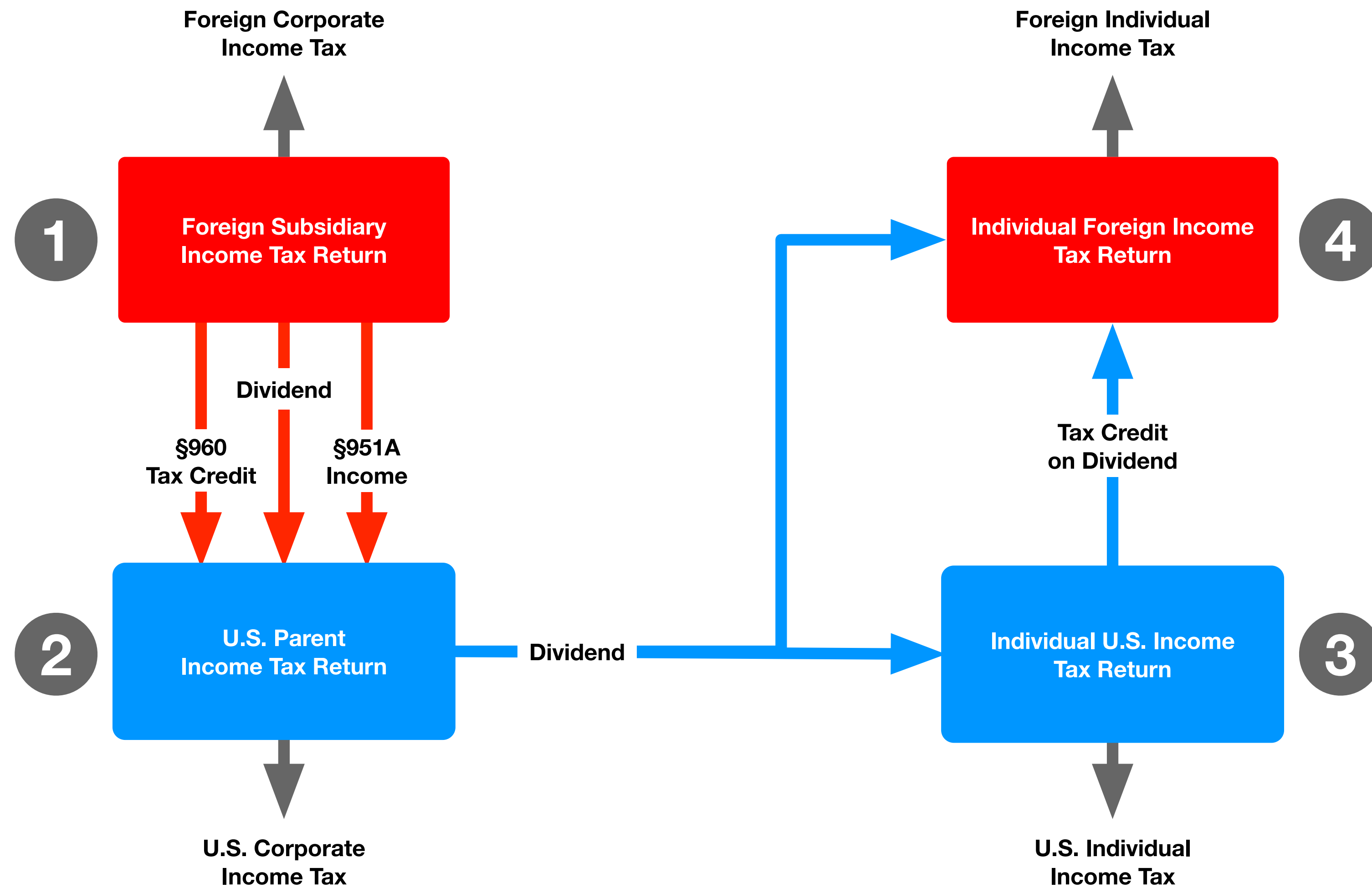
5. Domestic Parent/Foreign Subsidiary



Assumptions in the parent/subsidiary model

- The foreign subsidiary has \$600,000 of gross revenue, \$0 of operating expenses, and therefore has \$600,000 of taxable income.
- The foreign subsidiary distributes all after-tax cash to its shareholder (the domestic parent corporation) as a dividend.
- The domestic parent corporation distributes all of its after-tax cash tax to its shareholder, a U.S. individual living abroad.

Income, tax credit flows in a parent/subsidiary structure



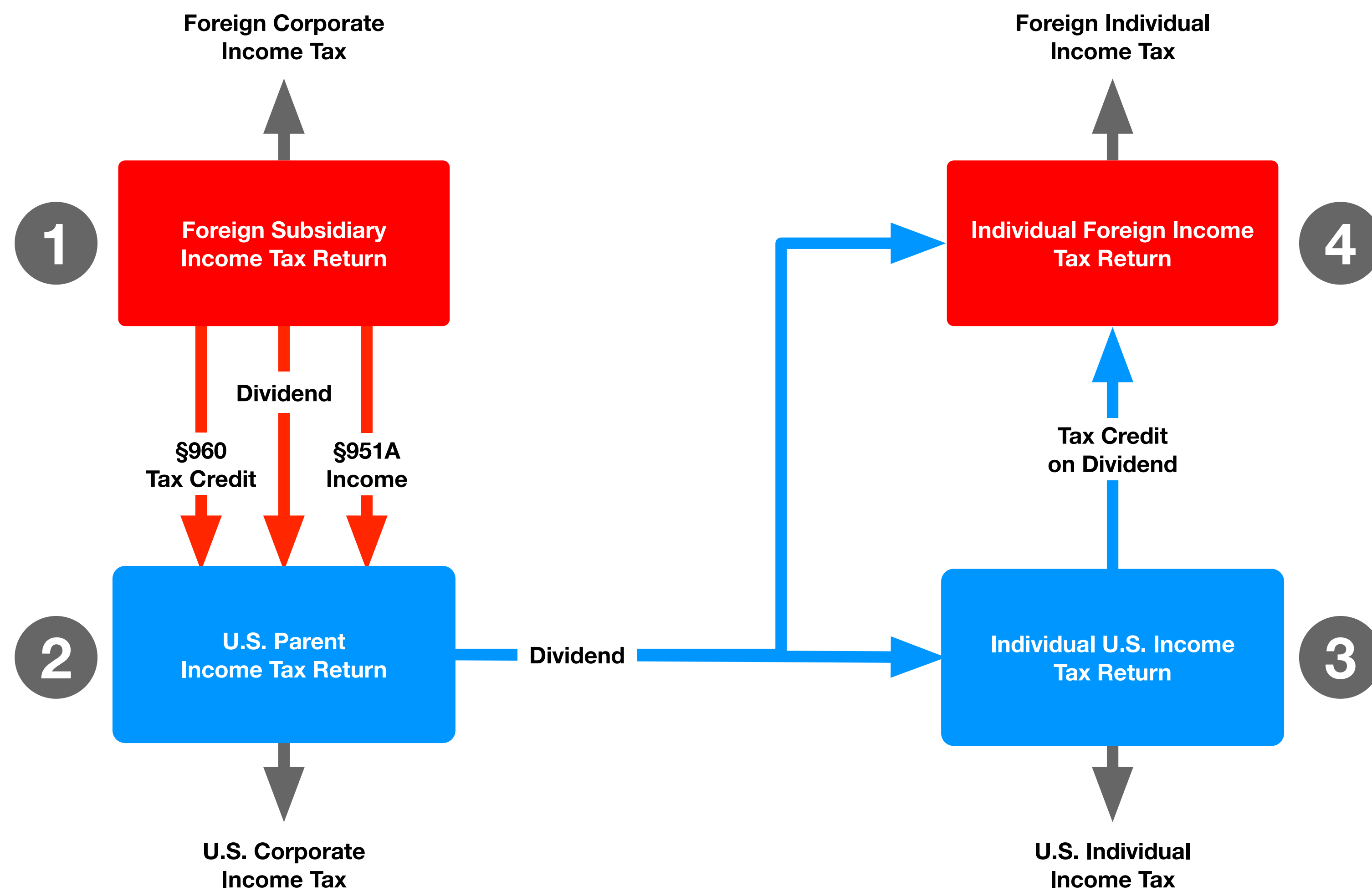
1 Foreign corporation income tax liability

Item	Value
Foreign corporation gross revenue	600,000
Less: deductible expenses	0
Foreign corporation taxable income	600,000
Foreign corporate income tax rate	30%
Foreign corporate income tax	180,000

2 Domestic parent: IRC §§78, 951A income

- The foreign corporation's net income is included in the gross income of the U.S. shareholder—the domestic parent corporation. IRC §951A.
- The foreign corporation's net income is grossed up by the amount of foreign corporate income tax paid. This is required in order for the shareholder to claim the indirect foreign tax credit (for corporate income tax paid by the foreign corporation). IRC §78.
- The IRC §250 deduction against both income items is allowed.

2 Domestic parent corporation



2 Domestic parent's income tax on IRC §951A income

Item	Value
Foreign entity gross income	600,000
Less: statutory categories of income	0
Less: allocable taxes	(180,000)
Subtotal	420,000
Plus add back gross up for foreign tax (IRC §78)	180,000
IRC §951A gross income inclusion	600,000
Less: IRC §250 deduction	(300,000)
Shareholder's taxable income	300,000
Federal income tax rate	21%
Domestic parent's income tax liability on IRC §951A income	63,000

2 Domestic parent: indirect foreign tax credit

- Domestic corporations can claim the indirect foreign tax credit for foreign income tax paid by their foreign subsidiaries. IRC §960(a).
- This means that the domestic corporation's income tax liability on IRC §951A income and IRC §78 deemed dividend can be offset by claiming the foreign tax credit.

2 Domestic parent: indirect foreign tax credit

Item	Value
Foreign entity tax paid	180,000
IRC §960(d) limitation (80% of actual tax paid)	144,000
U.S. actual tax liability on IRC §§951A, 78 income	63,000
IRC §904 limitation (lower of foreign tax, U.S. tax)	63,000
<i>Foreign tax credit allowable against IRC §951A income</i>	63,000

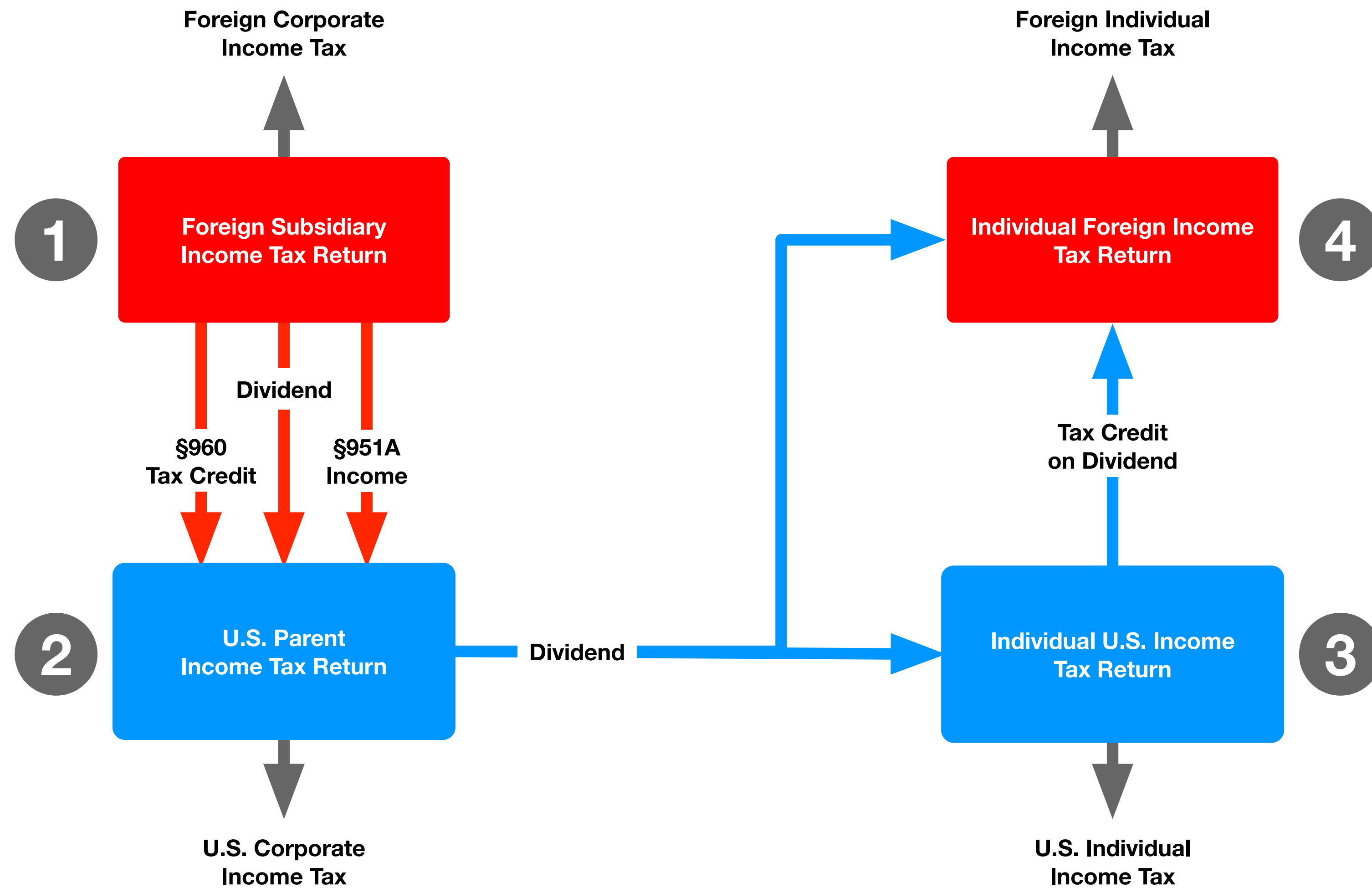
2 Domestic parent: dividend income

- There is a 100% dividends-received deduction for dividends paid to a domestic C corporation parent. IRC §245A.
- Result: cash distributions from a foreign subsidiary to domestic parent are received tax-free.

2 Domestic parent: dividend income

Item	Value
Dividend received from foreign subsidiary	420,000
Less: IRC §245A exclusion	(420,000)
Taxable dividend income	0

3 Individual U.S. shareholder



3 Individual's U.S. income tax, NIIT (dividend)

Item	Value
Dividend received from the domestic parent corporation	420,000
Income tax (20%)	84,000
Net investment income tax (3.8%)	15,960
U.S. income tax + NIIT on dividend income	99,960

4 Individual's foreign income tax

Item	Value
Dividend received from U.S. parent corporation	420,000
Income tax rate	40%
Foreign income tax on dividend	168,000
Less: credit for U.S. tax paid (dividend)	(99,960)
Net foreign income tax on dividend	68,040

Individual's foreign tax credit: assumptions

- This example assumes that the foreign country has a foreign tax credit system that works like the U.S. foreign tax credit system.
- The foreign country sees a “foreign” dividend (from the U.S. parent) received by one of its residents. So it taxes the dividend income normally, then grants a credit against the foreign income tax liability for U.S. income tax paid on the dividend income.
- You can't use the foreign tax credit on the U.S. income tax return. IRC §904(a) reduces the allowable foreign tax credit for foreign income taxes paid on U.S. source income to zero.

Total tax for the parent/subsidiary structure

Item	Value
Foreign subsidiary corporate income tax	180,000
U.S. parent corporation income tax (IRC §951A income)	63,000
U.S. parent corporation - foreign tax credit (IRC §951A income)	(63,000)
U.S. parent corporation - income tax on dividend income	0
Shareholder's U.S. income tax and NIIT on dividend from U.S. parent	99,960
Shareholder's foreign income tax on dividend from U.S. parent	168,000
Foreign country: foreign tax credit for U.S. tax paid on dividend from U.S. parent	(99,960)
Total tax paid by everyone, everywhere	348,000
<i>Tax as a % of \$600,000 corporate taxable income</i>	<i>58.00%</i>

6. Conclusion

One final idea: zero out the profit of the foreign corporation /1

Foreign corporation tax liability and IRC §951A income to shareholder	Amount
Foreign corporation gross revenue	600,000
Less: deductible expenses other than salary	0
Salary to shareholder	(600,000)
Foreign corporation net profit (IRC §951A income to shareholder)	0

One final idea: zero out the profit of the foreign corporation /2

Item	Tax
Salary income	600,000
Foreign personal income tax at 40%	240,000
U.S. personal income at at 37%	222,000
U.S. foreign tax credit (lower of foreign or U.S. tax liability)	(222,000)
Total individual income tax liability	240,000

Compare: total tax paid by everyone, everywhere

Structure	Total Tax	Effective Rate
Foreign corporation	519,360	86.56%
Foreign corporation + High-tax exception	363,960	60.66%
Foreign corporation + Section 962 election	363,960	60.66%
Domestic parent/foreign subsidiary	348,000	58.00%
Foreign corporation, zero out net profit with salary/bonus	240,000	40%

Disclaimer and all that

But of course there are obvious exceptions. Non-obvious ones, too. I just gave a superficial presentation of a technical topic. Spherical cow, etc.

This presentation is not legal or tax advice. You cannot use it to avoid penalties. Please hire someone to help you.

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