PROFITS AND CARRYOVER LOSSES IN A C.F.C. – CAN THOSE LOSSES OFFSET G.I.L.T.I. TAX ON GAIN

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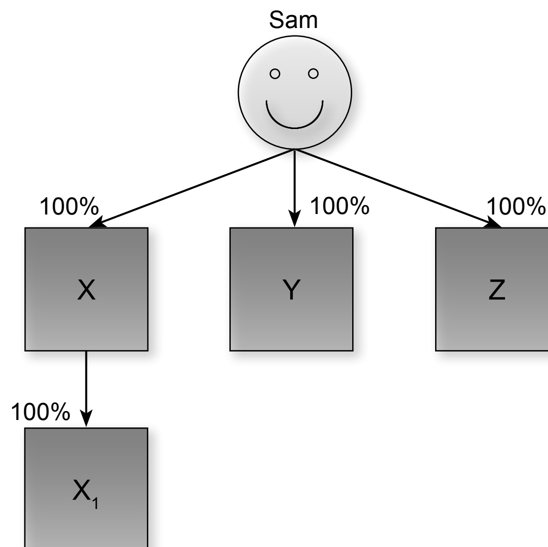
INTRODUCTION

This article addresses the G.I.L.T.I. rules that currently are in effect in the U.S. when a U.S. Shareholder of a C.F.C. engaged in an active business run at a loss sells its business assets at a gain. It also addresses certain reporting obligations on a U.S. Shareholder when a C.F.C. undergoes some form of tax-free merger or reorganization abroad.

BACKGROUND

Sam is a U.S. citizen who is the sole shareholder of three foreign corporations, X Co, Y Co, and Z Co, that are tax residents of country A. Sam is an indirect shareholder of X_1 Co, a tax resident of Country A, that is wholly owned by X Co.



All of the Country A corporations are C.F.C.'s. Both X Co and X_1 Co are engaged in the hospitality business, and each owns a fully operational multi-story hotel in Country A (Hotel X and Hotel X_1 respectively). Y Co and Z Co are also engaged in active trade or businesses in country A.

The annual financial and tax statements of each of the three C.F.C.'s have reported operating losses for several years. X Co and X_1 Co were merged under the corporate law of Country A in 2022, with X Co as the surviving company (the "Merger"). Post-Merger, X Co sold a portion of Hotel X, reporting a substantial gain for both U.S. and Country A purposes.

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The Merger was effected as a tax-free transaction in Country A. Further, the laws of Country A allow X Co to fully offset the gain arising from the sale with losses of Company X and Company X_1. As a result, no tax was paid in Country A in connection with the Merger and the sale.

As Sam narrated the transaction to his U.S. tax adviser as the U.S. tax filing due date approached, he was hopeful that similar tax results as in Country A can be achieved in the U.S. However, as he came to realize, he had manifested just the opposite of what he wanted. The tax adviser advised him of the following hurdles the transaction must overcome to achieve a tax-free treatment in the U.S. In principle, specific conditions must be satisfied in order for a merger involving a C.F.C. to be tax-free for a U.S. Shareholder. He also came to realize that the G.I.L.T.I. provisions of U.S. tax law that apply to U.S. Shareholders and C.F.C.'s may not provide the results that Sam anticipates.

Definitions

A foreign corporation is a C.F.C. for U.S. income tax purposes if more than 50% of the total voting rights of all classes of stock or the total value of the stock is directly or indirectly (through another corporation) owned by "U.S. Shareholders."[1] A U.S. Shareholder is a U.S. person that directly, indirectly, or constructively owns shares of the foreign corporation that represent 10% or more of the vote or value of all shares issued and outstanding.[2] A U.S. person includes a citizen or resident of the United States.

Indirect ownership includes ownership through foreign entities.[3] Constructive ownership in general includes ownership attributed to a person under Code §318(a)[4] with certain modifications.[5]

Based on the above, X Co and X_1 Co are C.F.C.'s for U.S. income tax purposes because more than 50% of the voting rights or value in each of the companies is either directly or indirectly held by Sam, a U.S. citizen. Also, Sam is a U.S. Shareholder of each C.F.C. since he owns directly or indirectly 10% or more of the voting stock or value of each company.

A STATUTORY MERGER

Merger Defined

Typically, a statutory merger of two or more corporations by operation of law is included in the term "reorganization," meaning a tax-free, nonrecognition transaction

1 Code §957(a).

2 Code §951(b).

3 Code §958(a)(2).

4 Relationships are as follows: (i) from members of family, (ii) from partnerships, estates, trusts, and corporations, (iii) to partnerships, estates, trusts, and corporations, and (iv) under options. Certain operating rules can affect how the attribution rules are applied.

5 Code §958(b).

for U.S. tax purposes.[6] One noted treatise describes a merger in the following language:

> Under § 368(a)(1)(A), a statutory (*i.e.*, under the controlling corporate law statute) merger or consolidation is the oldest of, and the prototype for, the various reorganization forms. In a merger, one corporation absorbs the corporate enterprise of another corporation, with the result that the acquiring company steps into the shoes of the disappearing corporation as to its assets and liabilities. * * *. In these transactions, shareholders and creditors of the disappearing transferor corporations automatically become shareholders and creditors of the transferee corporations by operation of law, assets move by operation of law, and transferor corporations can disappear as legal entities, resulting in a dissolution of the acquired corporations. [Footnotes omitted.][7]

In addition to the above, the Merger must meet the following non-statutory requirements to qualify as a tax-free merger for U.S. tax purposes.

Valid Business Purpose

There must be a valid business purpose other than tax avoidance. In other words, the purpose of the reorganization must be required by business exigencies, an ordinary and necessary incident of the conduct of the enterprise, and not a device or scheme to avoid tax.

Continuity of Interest

The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations. This requirement, in general, therefore, requires that the shareholders of the target corporation receive a substantial equity interest in the acquiring corporation. In the present case, the statutory merger involves a merger of the subsidiary with the parent, and therefore, the continuity of interest condition should be deemed satisfied since the parent acquired all of the assets and liabilities of the subsidiary.

Continuity of Business Enterprise

After the transaction, the acquiror must either continue the target's historic business or use a significant portion of the target's assets in an existing business. The policy underlying this general rule is to ensure that reorganizations are limited to readjustments of continuing interests in property under modified corporate form. The fact that X Co sold a portion of the first floor of Co X_1's hotel should not fail this requirement since X Co continues to own and operate a substantial portion of the property as a hotel after the Merger.

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6 Code §368(a)(1)(A).

7 Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders (WG&L), ¶ 12.21 Statutory Mergers and Consolidations (Type A Reorganization).

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SPECIAL REQUIREMENTS FOR FOREIGN REORGANIZATIONS

"A U.S. Shareholder of a foreign corporation surviving as a result of a merger is required to file a notice with the I.R.S. notifying it of the merger."

However, where a merger involves foreign corporations, the nonrecognition treatment is turned off in the event the transaction results in the loss of status of a U.S. person as a "Code §1248 Shareholder" in relation to a C.F.C. that is party to the merger.[8] A Code §1248 Shareholder is any U.S. person who directly, indirectly, or constructively owns 10% or more of the voting rights in a foreign corporation at any time during the prior five-year period, provided the foreign corporation was a C.F.C. at a time when the shareholder held 10% or more of its stock.[9] Nonrecognition treatment is turned off when the U.S. person no longer is a U.S. Shareholder and Subpart F and G.I.L.T.I. are no longer applicable, as a result.

As discussed above, Sam directly owned 100% of the voting rights in X Co and indirectly (through X Co) owned 100% of the voting rights in X_1 Co prior to the merger. Therefore, Sam meets the definition of a Code §1248 Shareholder with respect to both corporations as each was a C.F.C. during his holding period.

Under the present facts, Sam was a §1248 Shareholder with respect to both, X Co and X_1 Co. Pursuant to the Merger, X_1 Co disappeared, and X Co continued to survive with the earnings, assets, and liabilities of X_1 Co. X Co continues to be a C.F.C. and Sam continues to be a §1248 Shareholder in relation to X Co. Therefore, the §1248 Shareholder status of Sam does not cease to exist as a result of the Merger. As a result, the Merger should be given a tax-free treatment for U.S. tax purposes and Sam should not be subject to U.S. tax as a result of the Merger.

REPORTING REQUIREMENTS

Sam has certain reporting obligations that generally apply when a U.S. taxpayer exchanges shares as a result of a reorganization[10] and other reporting obligations that apply when C.F.C.'s are involved.[11]

Reporting Requirements Relevant to the Merger

A U.S. Shareholder of a foreign corporation surviving as a result of a merger is required to file a notice with the I.R.S. notifying it of the merger ("Code §367(b) Notice"). The §367(b) Notice must be filed even if no income is required to be recognized under Code §367(b).

The Code §367(b) Notice must be attached with Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, relevant to the surviving foreign corporation for the year in which the transaction occurs.[12] The §367(b) Notice generally must contain the following information:[13]

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[8] Treas. Reg. §1.367(b)-2(b).

[9] Code §§1248(a)(2), 1248(c)(2).

[10] See generally Treas. Reg § 1.368-3.

[11] See generally, Treas. Reg. §1.367(b)-4(c).

[12] Treas. Reg. §§1.367(b)-1(c)(3)(ii)(A); 1.367(b)-1(c)(2)(i)(v).

[13] Treas. Reg. §1.367(b)-1(c)(4).

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- The fact that the transfer is a §367(b) transfer
- A complete description of the transfer
- A description of any stock, securities, or other consideration transferred or received
- A statement that describes any amount(s) required under the Code §367(b) regulations to be taken into account as income or loss or as an adjustment to basis, E&P, or other tax attributes as a result of the transfer

Reporting Requirements Relevant to X Co

Sam is also required to file one last Form 5471 for 2022 in relation to X_1 Co. Accordingly, Line D on Page 1 of the form must be checked. Further, Schedule O, Organization or Reorganization of Foreign Corporation, and Acquisitions and Dispositions of its Stock, to Form 5471 must be prepared to include the details regarding the Merger, *e.g.*, the date and method of disposition, number of shares and class of stock disposed, and consideration received.

U.S. CHARACTERIZATION OF THE GAIN ARISING FROM THE SALE OF GROUND FLOOR

In General

Generally, a U.S. Shareholder of a C.F.C. is subject to U.S. tax on a current basis on his or her *pro rata* share of the income of the C.F.C.[14] Broadly speaking, the income of a C.F.C. is categorized as either Global Intangible Low Taxed Income ("G.I.L.T.I.") and Subpart F income.

G.I.L.T.I. income refers to the operating income (after several adjustments) of a C.F.C. if it is engaged in an active trade or business. One noteworthy adjustment that is relevant to Sam and the C.F.C.'s he owns relates to depreciable assets. Operating income of a C.F.C. is reduced by 10% of the average of the quarterly adjusted basis of depreciable and amortizable assets used by the C.F.C. in its business. If a C.F.C. incurs a loss, its U.S. Shareholder is allowed to use his or her *pro rata* share of the loss to offset the G.I.L.T.I. income generated by other C.F.C.'s. Any excess loss that remains unused is lost; it cannot be used to reduce G.I.L.T.I. in any other year.

On the other hand, Subpart F income refers principally to the passive income such as Foreign Personal Holding Company Income (after reducing passive losses but not below zero) and certain intercompany income of a C.F.C., such as Foreign Base Company Sales or Services Income.

Gain Arising From the Sale of a Portion of the Hotel Premises

The treatment of the gain from the sale of Hotel X depends on the nature of the gain for U.S. tax purposes. In other words, the gain will be taxed as G.I.L.T.I. if it is treated

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[14] Amounts specifically removed from G.I.L.T.I. categorization include Subpart F Income (even if excluded by reason of the high-tax exception), income effectively connected with a U.S. trade or business, certain dividends received from a related person, and certain foreign oil and gas income.

as income from X_1 Co's operating business activity. On the other hand, the gain will be taxed as Subpart F income if it is treated as passive income.

Generally, Subpart F income includes dividends, interest, royalties, rents, annuities, and any gains on the sale of assets that give rise to such income.[15] On the other hand, a gain on the sale of an asset (including real property and intangible property) used in the C.F.C.'s trade or business does not give rise to subpart F income.[16]

G.I.L.T.I. income is the excess of the gross tested income over deductions properly allocable to the gross tested income.[17] The gross tested income is the gross income of the C.F.C. However, it excludes, *inter alia*, income taxed as Subpart F income.[18] As discussed above, a gain arising from the sale of an operating asset used in the trade or business of a C.F.C. is excluded from Subpart F income. Therefore, by reason of its exclusion from Subpart F income, it is treated as gross income for the purposes of calculating the gross tested income for G.I.L.T.I. purposes.

Under the present facts, the asset sold is a portion of Hotel X. Because the portion consisted of premises regularly made available to the guests of Hotel X, the property sold was regularly used in the hospitality business that was carried on by X. As a result, the gain from the sale of a portion of Hotel X is not Subpart F Income, but is included for the purposes of calculating gross income, gross tested income, and G.I.L.T.I.

"G.I.L.T.I. income is the excess of the gross tested income over deductions properly allocable to the gross tested income."

G.I.L.T.I. CALCULATIONS

Shareholder-by-Shareholder Calculation

G.I.L.T.I. is calculated at the level of a U.S. shareholder. This implies that, in order to calculate a U.S. shareholder's G.I.L.T.I. inclusion amount for a relevant year, the tested income of all of the income-generating C.F.C.'s in the year and the tested losses of all of the loss-making C.F.C.'s for the same year are aggregated. This exercise is performed on Schedule A of Form 8992 (*U.S. Shareholder Calculation of Global Intangible Low-Taxed Income (GILTI)*). This has the effect of reducing the aggregate G.I.L.T.I. inclusion amount subject to U.S. tax in a year by the aggregate amount of tested losses from all of the loss-making C.F.C.'s.

As mentioned above, all corporations other than X Co incurred losses in 2022. X Co was profitable in 2022 due in large measure to the sale of a portion of the premises of Hotel X. Thus, the tested income of X Co can be offset against tested losses, if any, incurred by X_1 Co (through a day prior to the Merger), Y Co, and Z Co in 2022.

Ability to Offset the G.I.L.T.I. Gain by C.F.C. N.O.L.'s of Earlier Years

A U.S. Shareholder is not allowed to carry forward the net G.I.L.T.I. loss in one year to offset G.I.L.T.I. income in another year. In other words, the G.I.L.T.I. loss of a C.F.C. in a year is neither carried forward nor carried back. The tested loss of one

15 Code §954(c)(1)(B)(i).

16 Treas. Reg. §1.954-2(e)(3)(iii)-(iv).

17 Treas. Reg. §1.951A-2(b)(1).

18 Treas. Reg. §1.951A-2(c)(1)(i).

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C.F.C. owned by a U.S. Shareholder for a year is allowed to offset the tested income of another C.F.C. owned by that U.S. Shareholder for the same year.

X Co is a C.F.C. Therefore, any net operating loss incurred by X Co in a year will not be allowed to be carried forward to future years for purposes of computing Sam's share of G.I.L.T.I. income for any such future year. As a result, X Co's N.O.L.'s (or the N.O.L.'s of Y Co and Z Co from earlier years) cannot be utilized to reduce Sam's G.I.L.T.I. inclusion in 2022.

FACTORS TO KEEP IN MIND REGARDING THE SALE OF A PORTION OF HOTEL X

Computation of Taxable Gain

The gain from the sale of a portion of Hotel X must be reported in U.S. Dollars for U.S. tax purposes. Therefore, the sale proceeds denominated in the currency of country A must be converted into U.S. $ using the exchange rate on the date of the sale. Additionally, all costs incurred by X Co to facilitate the sale will be taken into account in determining the net taxable gain of X Co. Examples include expenses to advertise the property, attorneys' fees, brokers' fees, and registration fees regarding to the sale.

Tax Rate on G.I.L.T.I.

For an individual, the G.I.L.T.I. income is taxed at ordinary rates of up to 37%, plus state and local tax in the state where Sam resides. A subsequent distribution by X Co to Sam of the G.I.L.T.I. income will not be subject to U.S. tax. However, if an election is made to characterize Sam as if he were a corporation for the sole purposes of computing U.S. tax on G.I.L.T.I. ("Code §962 election"), the effective rate of the G.I.L.T.I. tax can be reduced to 10.5%, reflecting the 21% rate of Federal income tax for corporations that is applied to a tax base reflecting a deduction of 50% of G.I.L.T.I. allowed to corporations. Individuals are not entitled to that deduction.

Once the net G.I.L.T.I. tax is computed after a Code §962 Election is made, an individual taxpayer may claim a credit equal to 80% of the foreign taxes paid by the C.F.C. on the G.I.L.T.I. income. For Sam, the foreign tax credit likely provides little or no benefit due to X Co's N.O.L., which eliminated corporate tax in Country A.

At some point when Sam receives a dividend from X Co, additional U.S. income tax will be due. If an income tax treaty is in effect with Country A, the U.S. Federal income tax will be imposed at a rate that does not exceed 20% assuming the dividend is a qualified dividend. In the absence of a tax treaty between the U.S. and Country A, the dividend will be subject to U.S. tax at ordinary rates of up to 37%. Net Investment Income tax of 3.8% will be imposed. State and local tax may also be imposed. However, Sam will be eligible to claim a credit for any dividend withholding tax that may arise in Country A on the dividend distribution.

In view of the above, making a Code §962 election will offer the following benefits:

- It will likely result in an overall lower tax liability (10.5% x 100% of G.I.L.T.I.) plus (20% of 89.5% of G.I.L.T.I.) plus (3.8% x 100% of G.I.L.T.I.) or 32.26%. In the absence of an election, the U.S. tax would be (37.5% x 100% of G.I.L.T.I.)

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plus (3.8% of 100% of G.I.L.T.I.) or 40.8%.

- The election will allow deferral of the 20% tax liability plus the 3.8% N.I.I.T. to the year of an actual distribution.
- The election will allow Sam to claim a credit of the tax paid in Country A on actual distributions against his U.S. tax liability of 20%. In the absence of the election, the foreign tax may remain unused in the absence of any other source of foreign passive income.

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