The US Tax Reform's GILTI Provision: Full Transcript

Our panellists are:

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- Dr. Karen Alpert, Finance Lecturer, University of Queensland Business School, Australia

Introductory Remarks

John: Before we get started, we will introduce ourselves. So I think back to the Taxlinked conference in November in Cyprus. It was incredibly interesting and largely focused on the OECD response to base profit erosion, which in people talk means the concern that the multinationals are not in fact keeping the profits where the profits are actually made but are finding ways to put them in other different jurisdictions and that sort of stuff. In a very general sense, the OECD response seems to be to enforce conditions pursuant at which profits are taxed, where they are actually made in terms of end use of products, etc.

I was on a panel discussing and in the end we spoke a bit about the US situation. And the US has taken quite a different approach. Rather than attempting to tax profit where they are made, what the US has done is taken the position that profits made by any US corporation, regardless of where they are made in the world, regardless of whether they are made through a company owned by an individual US citizen anywhere in the world, believe it or not, the USA has the primary taxing rights over. They wouldn't put it that way but certainly the GILTI provisions that we are talking about today I think are clear proof of that. Certainly, the earlier 965 Transition Tax—Karen and I did one webinar on that—is proof of that. And what these things are, are essentially fictitious tax events where US law now says that a taxable transaction has taken place and, using Karen's language, front running the tax systems of other countries. So, in other words, imposing taxation on this stuff prior to what would be the tax event in the other country to kind of scoop that money out first.

The trend of fictitious tax is also manifested in the section 877A Exit Tax rules, which some of you may have heard in the webinar I did in December. So the theme today is GILTI which, whereas the Transition Tax was punishing the individuals for their past, for having committed the crime against America of having run a business through a foreign corporation even if they're living abroad, GILTI is about destroying their future. It's effectively making it impossible for any US citizen living abroad to effectively run a business through non-US corporations.

Now these provisions are tremendously complex, they are primarily aimed at the Apple's and Google's and multinational corporations of the world. Karen and I will be discussing this, though, from the point of view of how they impact the individuals, and I think how they impact the US individuals or perhaps the Green Card holders abroad under the current tax system.

As you know, my name is John Richardson, I'm a Toronto, Canada-based lawyer with a very narrow practice of helping US citizens and Green Card holders through all the problems inflicted on them through their US citizenship or immigration status. And Karen, perhaps before we get started, you could introduce yourself.

Karen: My name is Karen, I am a former US citizen, I am a lecturer in finance in the University of Queensland and I'm talking to you from Brisbane, Australia, where it's late at night right now. So my background: I came into this because I have a Master's degree in tax that I got years ago, and my research in finance area is looking at incorporating the effects of tax on the financial decisions that individuals make. And the effects of these US tax laws on the financial decisions of US expatriates particularly. It's interesting but also it's amazing that they're getting away with this because they're front-running the other countries and basically the US is saying, "We get to police the world by making sure that everybody is paying enough tax, if you have any connection to the US, we're going to make sure you pay enough tax," and that's essentially what GILTI does.

JOHN: And the last point before we delve into the presentation, I think it's extremely important for this one, and it's that number one: this is absolutely not accounting or legal advice, this is a general discussion and anybody who feels that they are impacted by this has got to go out and find a confident advisor, preferably in your own country because there is definitely an interplay between US tax rules and rules where you live.

And number two: under no circumstances should this presentation be construed as something that would help an individual actually file their tax returns. This stuff is very complex. But now onto the show so to speak.

So we are looking at the section 951A of the Internal Revenue Code, which is part of the infamous sub-part F provisions, which have been dragged up and reinvented for the modern world, I suppose. Karen, tell us a little bit about GILTI. What does that stand for? What does that really mean?

What is GILTI?

KAREN: So GILTI stands for the Global Intangible Low-Taxed Income. But that's really a misnomer because it's not really measuring intangible income at all. There's no identification. Let's look at this dollar and see how you earned it, did you earn it by selling intangible assets, licencing software that was developed in the US or anything like that, there's no tracing. They just generally say, "Ok, 10% of your fixed assets is tangible income and everything else must be intangible," which is an overly broad definition of intangible income because it ignores a lot of tangible assets that generate income such as inventory and land. So it's not intangible.

Then the low-taxed part of the name. Well, it doesn't exclude high-taxed income, there's no high tax exclusion here, so the way they get at the headline 13,125% minimum tax that they are imposing on the worldwide income of US-related corporations is through this combination of a 50% deduction and disallowance of a portion but less than 50% of the foreign tax credits. But if you're an individual, you're going to find that it could be worse if there's some kind of allocated expenses, etc., but in the best case, vanilla case, an individual with a corporation that pays anything less than 26.25% in foreign taxes is going to end up having a US tax liability through GILTI. And that's higher than the US corporate tax rate of 21% so I don't know where low-taxed comes into it. So basically, when you take out what's not really there, GILTI is a way for the US to tax the global active business income of the corporations that are affiliated with the US in any way, essentially.

JOHN: So in other words, the title's a lie. Actually, it's an out-and-out lie. It should simply be called the Global Tax Act. If there's any connection to the US, we get to tax it first.

KAREN: Right. You know, with regard to the intangible stuff, that 10% that you get for your fixed assets, there are a lot of people in Congress who are saying, “Oh, that’s a loophole, we need to close that one, let’s get rid of that and just tax all the active business income.”

JOHN: What’s interesting on the corporate side is the theory of creating huge incentives through the interaction of all these complex rules for people who actually run their businesses outside the United States.

KAREN: Basically, the incentive is, if you’ve got fixed assets, you want to be running the business outside the US, you want to put as many fixed assets outside of the US as possible, to increase that deemed tangible return.

JOHN: Absolutely, and that’s one way of making America great. So GILTI. The US can’t, at least publically, tax anything they want, they have to claim a connection to the United States, right?

KAREN: Yes, so it has to be a company that has some relationship to the US, either it’s a US corporation, then they can tax that, that’s easy. Or if it’s a foreign corporation, it has to be owned by US persons.

JOHN: Ok so let’s just pause here for a minute, just to set the context of what we’re talking about here. So foreign corporation is what it sounds, it would be a corporation incorporated outside of the US. So we have to be dealing with a foreign corporation, so whether it’s a CFC or whether it’s an individual’s GILTI, it depends on their relationship to that foreign corporation, correct? Can you help us by describing the relationship? In fact, let’s move away from the corporate and let’s move right into the individuals. What kinds of individuals need to fear that they might be accused of being GILTI?

What kinds of individuals need to fear that they might be accused of being "GILTI"?

KAREN: First of all, you have to be a US shareholder of a controlled foreign corporation. So you need to know whether you are a US shareholder. And if you are a US shareholder, if you are some sort of a US person and that's a US citizen, Green Card holder, or other US entity, and you own more than 10% of a foreign corporation.

JOHN: Ok, so pausing on that for a minute. You may have seen a common question tax preparers give Americans abroad is: Do you own more than 10% of a foreign corporation? Because if the answer is no, you can never be GILTI, correct?

KAREN: Yes, but you must really be careful about whether you own that 10% because there's attribution rules to attribute to you ownership of shares owned by related parties.

JOHN: Oh my god, you're absolutely right. So you don't only have to worry about your direct ownership but you have to worry about your indirect ownership and the attribution. We're going to give you this whether you like it or not, yes?

KAREN: Yes, exactly. So just owning 10% is not enough. Then, once you take those US shareholders, which are the US persons that own more than 10%, if you add all those US shareholders up and you get more than 50% of the corporation, then you have a controlled foreign corporation.

JOHN: Ok, alright. So that's the answer to the question: Does every US citizen who owns more than 10% of a foreign corporation fall under GILTI? But as you can see, even determining whether you are potentially GILTI could be a major inquiry.

KAREN: So if you own a 10% of a corporation, you now have to go and ask all the rest of the shareholders: Are you a US person? Is there a US person that is related to you that constructively owns your shares?

JOHN: That's right. We now not only have to have a family meeting, but a town meeting and perhaps get the State Department involved, to check the records. What do you think?

KAREN: Yes, it gets messy. But I think that the most of these that you're going to see are either wholly owned or possibly with a small number of owners.

JOHN: For all practical purposes, at least in my experience, what we're dealing with is individual Americans abroad who happen to be running their business through corporations, because that's just how it's done where they live, in, for example, Canada, where there's so many of them. And very often, as far as the US person, as far as the percentage of ownership, I think we need to add voting control, doesn't voting control count in this too?

OK, so then, there is the potential of somebody being potentially GILTI, and I think it's important to realise that where we're going with this is that the income earned by the company will also be taxed to the individual shareholder. So if you are or you think you might be a US citizen, maybe it's a good idea to figure out how not to be a US citizen.

KAREN: You can avoid being a US shareholder by not owning 10% so you can give away some of your shares to someone who's not related.

JOHN: But, Karen, wait a second, giving away. Every time I hear that, it makes me nervous because I live in Canada, because we have to consider whether just giving stuff away is a taxable transaction.

KAREN: That's right. You have to very careful and consider the impact on your local tax situation. Or you can stop being a US person by giving up your citizenship or Green Card. The other thing that is really important to consider is that just because it's called a corporation where you live, it doesn't necessarily mean that the US will tax it as a corporation.

JOHN: Yeah, this is really important. What Karen is saying here is that it might be called a corporation in Australia, that doesn't make it a corporation in the USA for US tax rules.

KAREN: You may have the opportunity when forming a business to organize it as something that will be taxed as a partnership or sole proprietorship in your US return and taxed locally as a corporation.

JOHN: If it's going to be taxed as a partnership or corporation, which is going to make it a disregarded entity. If it's going to be taxed in that way, then there is no deferral of income.

KAREN: Not on the US side, but if you can get the deferral locally, possibly. But it's going to require a lot of planning to make sure it all works for both sets.

JOHN: A lot of expensive tax advice. In fact, I think for Americans abroad long-term if you want to keep your American citizenship and be tax compliant and live outside the US, then you have to send one of your kids to become a CPA, the other one a lawyer, because no family can survive without an in-house lawyer.

KAREN: Either that or you never make any money. If you're a wage earner on a low wage, it's not so bad. But if you want to start a business, run a business, save for your retirement, then you'll need a lot of advice to be compliant.

JOHN: There's no question, the US hates its entrepreneurs. Absolutely hates them, it's part of US tax law.

Ok, so we've talked here about: Who has to worry about being GILTI? What is a CFC? Now let's move the topic to what exactly does the section 951 do?

What exactly does Section 951A (GILTI) do?

KAREN: 951A GILTI is a major change in how the US is taxing active business income. Before, under the old rules, everyone planned by creating a corporation where they lived, they could defer their active business income and retain it inside, use the retained earnings to grow the business or save for retirement, or both at the same time. But now that deferral is severely limited or almost impossible. It's also a problem. They have really complicated the foreign tax credit computation by making a separate basket for GILTI, as well as foreign branches. But that won't affect individuals. But GILTI is a separate basket so you have to get the foreign taxes paid into that basket to be able to use them to offset US tax.

JOHN: Ok, let's break this down a little bit. Let's begin first with, so taxation of GILTI, the creation of GILTI, is conceptually different from foreign tax credit issues. So can you explain what the US is exactly doing with that active business income earned inside the corporation in relation to that unlucky US shareholder. What happens?

KAREN: What they are doing is they are saying that they are going to take your income, everything the company has earned that has not already been taxed by the US, and call that tested income. And then subtract from that what we're going to deem your tangible income to be 10% of your net appreciable assets and that's your GILTI to start with. And we measure that for each CFC and most US individuals are going to have just one CFC so they will avoid the really complex parts of these regulations that have been coming out. Most of them are about complex aggregation rules. If you're a corporation, you get to deduct 50% of that and, if you're a corporation, you also get to say that that CFC of mine already paid tax on that income and I will use that as foreign tax credit.

JOHN: Ok, the first thing they're doing is they are saying that that money that was made by the CFC, we're actually going to pretend that was made by you personally. We're going to make you put that money on your tax return. So you're a US citizen abroad trying to make ends meet, small corporation, so you need an extra 30, 40, 50 thousand dollars of profit a year to invest in that business to keep it current. Now all of a sudden what the US is saying, "You might think that your company made a 50 thousand dollar profit, we're going to make you put that profit right now on your tax return and have you pay full tax." Agree?

KAREN: Yes, basically. If you're an individual, there are ways to plan around it that we will get to.

JOHN: They are forcing you to pay tax on income you never got, right?

KAREN: Right, they are basically breaking the distinction between you and the corporation.

JOHN: Right, as somebody who went to law school in Canada, the British Commonwealth, the distinction between the individual and the corporation is respected, corporation is a legal entity, etc., etc., for tax purposes as well. But the US doesn't see it that way.

KAREN: It does if your corporation is a US corporation. It doesn't see it that way if you control a foreign corporation.

JOHN: So it's more a hatred or distrust of foreignness?

KAREN: It's more looking at foreign corporations as a way of avoiding the US tax system.

JOHN: Ok, now let's look at it from the point of view of an individual. So that income goes on the tax return of the individual. Clearly, you don't want to pay tax on that income so you'd want to be able to find tax credits to offset that tax where available.

KAREN: Where do those foreign tax credits come from? So we're taxing the income that's paid by that CFC, so we'd like to be able to take the tax that that corporation paid. So you're an individual, you didn't pay the tax. So as an individual absent in an election, you cannot use that. When you do get the income out of that corporation, it comes out as a dividend. And as an individual shareholder, you're going to pay tax on that dividend when you receive it.

JOHN: Now, let's break this down. We have a very small business with 100 thousand dollars of profits. Let's say you're in a country where the country imposed a 25% tax so 25 thousand dollars on that. So the first thing that happens is that the US is saying the individual would have to pay tax on 75 thousand dollars.

KAREN: 75 thousand net. You look at your net income after the taxes, so essentially you get a deduction for those foreign taxes.

JOHN: Then what happens is, when you actually take the money out, you'd have to pay tax on the US side or not?

KAREN: If we paid US tax on the 75 thousand of net income in year one and distributed it out in year two, we would have a foreign tax credit in year two for the foreign tax paid on the dividend, but because we already paid US tax on that 75 thousand, it doesn't get taxed again.

JOHN: We have to keep a clear distinction between the income that's attributed to the person and how that is actually taxed.

KAREN: Attributed income from inside the CFC, which is only available if the shareholder is a corporation or if the shareholder is an individual, they can get at that tax by making a section 962 election but then there's also the tax paid by the individual on the dividends that come out of the CFC. That becomes really complex.

JOHN: Ok, obviously we don't want to pay the tax directly. We're looking for foreign tax credits. The first place we're going to look is why should you be able to get credit for taxes actually paid by the corporation. The second source of credit would be taxes paid by the individual shareholder when dividends were to come out.

KAREN: Right. Moving on. We talked about how it works when you have tax paid by the CFC, that's only available if you're an American corporation or you've made that section 962 election. Everything paid by that CFC are taxes paid by that GILTI income, that's why it's coming out of that CFC. Those taxes definitely end up in that separate basket for GILTI, foreign tax credits. What's happening here with the baskets is the US is saying, "Oh, you might be paying foreign taxes on many types of income, we're going to divide it into 5 baskets. There's the general basket, which is everything that doesn't go anywhere else, there's passive income, there's GILTI, there's foreign branches and reclassified by tax treaty."

JOHN: So I think it's important to reinforce that the purposes of that is to make sure… the US is generally very hostile to foreign tax credits and the principal under the Internal Revenue Code seems to be make sure that it only allows a credit with respect to the kind of income being taxed, correct?

KAREN: Right. They don't want you to use taxes paid on your salary to offset taxes paid on dividends received from investments or offset GILTI.

JOHN: GILTI is a separate basket. So maybe help us with this: what is the purpose of the GILTI income, what are they trying to achieve with it?

What is the purpose of the GILTI income and what is the US trying to achieve with it?

KAREN: They were looking at companies like Apple, Google, Facebook, they had all of this income, taking patents and other IP and putting those assets in the CFCs that were in very low-tax jurisdictions. Apple could say that all of the income earned from this patent, all the income earned I earned in Ireland. And Ireland is going to charge me a very low tax rate, so I'm not going to be paying tax on that anywhere because I moved it to a tax haven. So the US is saying, "Wait a minute, all of those patents you're transferring to Ireland are things that were made in the US, so we should get a bite of that income. Number two, we want to make sure that you're paying a minimum rate of 13.8% tax on your worldwide income and GILTI is supposed to take care of that." Somewhere in the world, total worldwide minimum tax is essentially one way of looking at this.

The problem is that they are casting way to wide, so they're catching in GILTI a lot of stuff that is not patents put in low tax jurisdictions. And number two, when they looked at this in Congress, someone asked the question, "Do you mean individuals?" They put a footnote that said, "Yeah, we mean individuals." Individuals can use the 962 election but they didn't realize all the complications with this election and that it wouldn't make the tax on individual shareholders the same as it is on CFCs.

JOHN: This also explains why tax credits and GILTI can neither be carried forward nor backwards.

KAREN: Right, because they want to make sure you pay that 13.8% for corporations on your GILTI income. There are no carryovers or carry-backs in the GILTI basket.

JOHN: The only way that an individual can get foreign tax credits for tax paid by the corporation is through this Section 962 election?

KAREN: Certainly the easiest way, I would not say the only way. But it would be very difficult to use anything else to get foreign tax credit.

JOHN: Focusing only on the 962 election. We have 100 dollars and have 75 dollars left. Explain to us how the 962 election would work here.

KAREN: You have 100 thousand in income; you paid 25 thousand in tax and have 75 thousand net. So you have fixed assets or anything, no deemed tangible return, you have 75 thousand of GILTI. If you make the 962 election, you add back that foreign tax, the 25 thousand, so GILTI becomes the 100 thousand that the corporation earned. But you get to use 80% of that 25 thousand that you paid in foreign tax, 20 thousand of it, as a credit against your US tax.

If you're a corporation, there's another step in there. The other step for a corporation is, we're at 100 thousand of GILTI, we get a 50% deduction and we're only going to tax 50 thousand but we're still going to give you 80% of the tax you paid on the 100 thousand.

JOHN: Don't the tax treaties require the US to give tax credits for foreign taxes paid?

KAREN: Yes, the tax treaties require parties to allow an offset for foreign taxes paid so there's no double taxation.

JOHN: This case for individuals, there would be double taxation?

KAREN: There would be double taxation because they are paying tax on 100% of the income, not 50%, but they are only getting 80% of the taxes paid. So there's double taxation on that remaining 20%.

JOHN: Would you say that's a potential treaty violation?

KAREN: I'd say that's a potential treaty violation. If they don't make the 962 election, the other way to get some foreign tax paid into the GILTI basket is by paying out dividends. Let's talk about the foreign tax credit from dividends, because here it's where it gets really complex.

JOHN: To be clear, the 962 election, we're looking at the tax paid directly by the foreign corporation. This time, we're looking for tax paid by individual shareholder for credit.

KAREN: Exactly. When a shareholder pays a dividend, that will be taxed where they live. So that's going to generate some foreign tax paid and we have to allocate that foreign tax paid in one of the baskets. How do we figure out what basket that foreign tax paid goes to? There's a look-through rule. In order to pay the dividend, you have to have retained earnings. If you have zero retained earnings and you make a distribution, you have retained capital, not a dividend. You must have earnings and profits, generally these are retained earnings calculated with other tax rules. Some of those earnings and profits might have been taxed already by the US. We call that previously taxed earnings and profits, or PTEP.

JOHN: Once something is deemed to be GILTI by the US and it's treated as GILTI by the individual shareholders for the corporate or individual, it will not be taxed again by the US. That correct?

KAREN: We'll talk a bit about how that works. Basically, if you've paid US tax already on some of your earnings and profits, that would happen because you had subpart F income in the past that was passive income, if you paid the Transition Tax, GILTI from prior years, if you got US effectively-connected income, which is not going to be a major problem, and there are other arcane code sections that might cause you to have PTEP. You have to track PTEP. When was it generated and under what section did the US tax it before? You keep this big matrix of PTEP so that you can figure out, when you pay a dividend, from which band did that dividend come out of. So the ordering becomes crucial because if it all comes out of your Transition Tax, then it goes into the general basket and it's subject to the haircut that we have for the Transition Tax foreign tax credit. The Transition Tax didn't tax 100% of the earnings and profits at the corporate tax rate, they gave you a deduction for some of it to get the tax rate down to 15.5% or 8% depending on how you were holding your earnings and profits and whatever percentage they allowed you to deduct to get that tax rate down, that percentage of foreign tax paid.

JOHN: The tax made available was a credit reduced by the same percentage.

KAREN: If it's from the Transition Tax, it goes to the general basket. If from GILTI, it goes into the GILTI basket. As an individual that's not making the 962 election, you only get foreign tax into the basket for GILTI when you pay dividends out of E&P that was previously taxed as GILTI. Ordering matters. Generally, the ordering is last in, first out. Which is all right for GILTI because the GILTI income will be fairly recent so you can distribute it out in the first year.

JOHN: GILTI income comes after Transition Tax income.

KAREN: Transition Tax would have been at the end of 2017 and GILTI doesn't start until 2018. So GILTI PETP would have come in later, so if you do last in, first out, GILTI would come out first. But the IRS came out with this notice that they distributed in December, notice 201901, “We want to simplify things for you by getting rid of the 965 band of PTEP first.” I don't see that they have the right to force it. For corporations, it might just be easier. Remember corporations are getting to pull through income from the CFC and use that tax to offset GILTI so they don’t need foreign tax credits in the GILTI basket. And getting rid of the 965 first simplifies things for them. But for individuals, specially if they are not making the 962 election, they cannot get anything into that GILTI basket unless they can allocate their dividends as coming out of PTEP that was taxed under GILTI provisions.

JOHN: In other words, if somebody paid a Transition Tax, there’s no way they could ever get a foreign tax credit against GILTI until they’ve liquidated their company. This is another indignity against individual Americans abroad.

KAREN: So this notice is just a notice that they are writing to propose regulations, they are asking for comments. Comments were due last week and as far as I can tell there haven’t been many comments. But it’s something to keep in mind because this seems how the IRS is thinking about PTEPs.

JOHN: It means they are not thinking about individual shareholders.

KAREN: Absolutely not. So if we move on, if we’re not using the 962 election, we do not get the 50% deduction that corporations get, we do not get to use the tax paid inside the CFC, so, if that notice is binding, it becomes very difficult and we have guaranteed double taxation. So what about the 962 election?

JOHN: The 962 election means that we’re shifting being able to make use of the tax being paid inside the corporation to offset the GILTI.

KAREN: We elect to be taxed as if the shareholder were a corporation. You might think, “Oh well, corporations get that 50% deduction.” But, no, it’s only in computing tax not in computing taxable income. You cannot use deductions, 962 applies to income that’s from broadly subpart F where they threw in the GILTI provision. So you can take the income from subpart F or GILTI but you cannot take any deductions from anywhere else in the code. The 50% deduction is in section 250, it’s not in subpart F.

JOHN: So what you’re telling me, in simple terms, is that a corporation gets to avoid GILTI in part by deducting 50% of profits that’d be subject to GILTI that the individual doesn't.

KAREN: Right. So that loss of the 50% deduction basically doubles the minimum tax, so essentially what the US is saying is the worldwide minimum tax on CFCs earned by individuals is 26.25 percent.

JOHN: Hold on, isn’t the US corporate tax 21%? So you’re telling me that Congress is saying that in order to avoid this tax an individual outside the US has to be paying a higher tax than the US corporate tax?

KAREN: I don't think Congress understood this bit about the deduction not being allowed. I think it’s a technical error.

JOHN: If it’s a technical error, it ought to be able to be fixed more easily.

KAREN: I see no interest in making any fixes to this bill.

JOHN: They probably have no idea what they’re even fixing.

What are some of the planning options available to individuals vis-à-vis GILTI?

KAREN: Let’s talk a bit about planning options. So with all of these you need to be really careful about what are the tax implications where you live. Because too many US tax advisors have no idea what the tax implications are where you live. And this comes back to John’s point at the beginning that you need a tax advisor locally that understands US tax. You need someone who can navigate between both tax systems.

JOHN: We cannot overemphasize this. The situation is so bad that I have the impression that some tax advisors in the US don’t even know that other countries have taxation, they think taxation is some sort of American invention.

KAREN: I wouldn’t go that far but they are constantly trying to fit square pegs into round holes. Trying to get foreign structures to fit into US tax law. But they don't event think about the things that I would do to plan for US tax, how does that impact my foreign tax liability.

If the CFC has no profit, there is no GILTI. You start with tested income, which is your net profit. So you can zero out your tested income. Pay your profits out of salary or other deductible expenses. Not only do you not have any money inside the corporation, you're accelerating your local tax.

JOHN: Which means that in countries like Canada, where small business corporations are in effect private pension plans, it means you lose the only option being able to do business as a private pension plan as well.

KAREN: Yeah, but if you're running it as an active business in Australia, where the corporate tax rate on a small business it's now 27.5% scheduled to go down to 25%, but if you draw out all that income as salary you're paying 45% on it. So you're accelerating your Australian taxes if you're trying to pull it out as a salary.

JOHN: All financial retirement planning seems to be based on the concept of tax deferral, and the whole point of this is to obliterate tax deferral, therefore, the whole point of this is to obliterate long-term investment, retirement financial planning.

KAREN: Pretty much, if it's outside the US.

JOHN: Yeah, Americans abroad shouldn't be able to have a plan for retirement; they should be back in the US. Question: Do you agree that all these problems would go away if the US just stopped this citizenship-based taxation nonsense?

KAREN: Yeah, all the problems would go away.

JOHN: Or get rid of US citizenship. One of the two has to go. Either the US rules have to change or you have to get outside the US rules.

KAREN: You can make that 962 election. One thing we didn't mention earlier, if I do not do the 962 election and pay the tax on GILTI, even if I get some foreign tax credit to offset it somehow, all of that GILTI income becomes PTEP.

JOHN: Meaning that the US will never tax it again.

KAREN: Whereas if I make the 962 election, then the amount of GILTI that becomes PTEP is equal to whatever US tax I paid and no more than the net US tax after your foreign tax credits.

How do we make a CFC a disregarded entity?

KAREN: Compliance is not a DYI project. In that regard, we have a question here. How do we make a CFC a disregarded entity? This is a compliance questions really. There are these entity classification elections that can be made when the business is created so it’s going to require some reorganization and some real competent tax advisors.

JOHN: And they can be made retroactively without a cost, right?

KAREN: There might be a cost like reorganization.

JOHN: I think that practically speaking the answer to the question is this: You stop using the existing corporation and set up a new one. I think that’s what you have to do.

I live in Toronto, Canada, and this is a compliment to the many people I know here. Where the availability of top US tax advisors is second to none. And I was listening to a presentation a couple of weeks ago and he was talking like very large amounts of money to comply with this sort of thing. My personal recommendation to get out of this is to simply stop using that corporation and create another one. Does that make sense to you?

KAREN: Yeah, the way to get out of it is to leave it there as an inactive corporation that has E&P that you could distribute later.

JOHN: Or another possibility is if it has investment assets, maybe you can stop using it for active business income, you use it to hold the investments because the reduction in the US corporate tax rate has diminished the amount of subpart F income as well.

KAREN: That’s become a big planning thing for large corporations. How can we turn what we were previously calling active business income into subpart F income where there is actually a high tax kick out and if I am paying more than 90% of the US tax rate, I don’t have to worry about US taxes.

JOHN: It’s a complete reversal of the old order where subpart F income, what was traditionally subpart F income, meaning the attribution of passive income, is no longer the real risk, because the reduction of the US tax rate is out. So I mean it occurs to me the thing to do might be to have two corporations. Actually, the best thing is to not be an American.

KAREN: What this illustrates is that compliance is not something you can do yourself. You’re going to need expensive, competent advice. Perfect compliance is not possible because even the IRS does not really understand these rules. They’ve thrown together some regulations, but I don't think they understand exactly how individuals are using small businesses overseas.

JOHN: Not only does the IRS, but there are very few people in the legal and tax industries who understand these rules as well. I think this has created specialty advisor, which I would call the general subpart F advisor, which includes GILTI, Transition Tax, subpart F and incredibly high fees. Even the tax people I know who are generally on top of this, it’s still pretty much a learning curve and a work in progress. Final thoughts, Karen?

Concluding Remarks

KAREN: Life's too short. This is really complex stuff. If you want to be an entrepreneur and grow a business, if you're a US citizen, you do it in the US or you do not do it at all.

JOHN: On that point, you do it in the US. From the point of view of Americans abroad, I know there has been discussion of maybe the thing you do is you run your business via a C-Corporation and then onto your foreign corporation. But you have to remember that other countries also have CFC-type rules. You do not go to the US and set up any kind of entity without seeing what the impact of that would be where you live. For example, S-Corporations are taxed differently, etc. Caution, caution.

KAREN: We've got a question about which countries are best equipped to help US citizens with this provision and I'd say none of them. And the reason I'd say that is because in every country, they look at these problems and they say, "Well, the US has the right to tax however they want," you're a US citizen, now you may be a dual citizen, you may not even think of yourself as an American, but once you have that document, the US passport, you're suddenly not the problem of whatever country you're living in.

JOHN: I put out a Tweet on that a few days ago. Helen Burggraf at American Expat Finance has written some interesting articles on that. My view of it is, and this in the context of the UK and what the UK government or Canada has done, is essentially they have stripped British and Canadian citizens of their British and Canadian citizenship. They've thrown them out to the dogs through this whole FATCA thing. Until these countries understand how these tax rules are and I believe are designed to be a pre-emptive tax strike against the tax base of other countries, I don't think there's going to be much relief at all. Renounce, renounce, best long-term investment you'll ever make.