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- Law360's MVPs
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- Global 20
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- Diversity Snapshot
- Practice Groups of the Year
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Expert Analysis

Looking For A GILT(I)-Free Structure? Try Estonia

By Jeffrey Rubinger and Summer Ayers LePree

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Law360 (April 4, 2019, 3:36 PM EDT) -- Estonia, the small Baltic country of just 1.3 million people situated halfway between Sweden and Russia, was named "the most advanced digital society in the world" by Wired magazine. According to recent figures, Estonian residents complete their taxes online in under five minutes, 99% of Estonia's public services are available on the internet 24 hours a day and nearly one-third of its citizens vote via the internet. With these advanced technological features, it is not surprising that its government boasts that Estonia is home to more tech unicorns (i.e., private companies valued at more than $1 billion) per capita than any other small country in the world.

Jeffrey Rubinger

As a result of the high number of technology companies that call Estonia home, one might think that the U.S.' new global intangible low-taxed income, or GILTI, tax was enacted specifically to go after U.S. taxpayers doing business in countries such as Estonia, where intangible assets presumably make up a significant portion of the value of these tech companies. The new GILTI regime, enacted as part of 2017 tax reform, generally triggers immediate U.S. tax on active income earned by a controlled foreign

corporation, or CFC, other than an annual carve-out for 10% of the CFC's adjusted basis in its tangible depreciable assets used in its trade or business.

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In essence, all active income above this assumed return is deemed to be from intangibles (regardless of any actual relationship to intangible assets), and is thus subject to the GILTI provisions, which now reach most offshore income that was previously possible to defer from U.S. taxation. There is no high-tax exception to GILTI, although income that would otherwise be Subpart F income but for the Section 954(b)(4) high-tax exception is excluded from GILTI.

Despite GILTI's apparent reach and intended impact of requiring immediate U.S. federal income tax recognition for almost all income earned by a CFC (specifically a CFC without sufficient high-basis tangible assets), Estonia's tax system, coupled with a few key provisions in the U.S. tax rules, may afford U.S. taxpayers a unique opportunity to avoid immediate taxation under both the Subpart F income and GILTI rules, without paying any current foreign tax.

Estonian Corporate Tax System

The Estonian corporate tax system, which is no longer unique,[1] generally functions as follows. All undistributed corporate profits are exempt from taxation. This exemption covers both active (e.g., trading) and passive (e.g., dividends, interest, royalties) types of income, and also covers capital gains from the sale of any and all assets, including shares, securities, and immovable property. The taxation of corporate profits is postponed, typically until the profits are distributed as dividends. At the time of distribution, the 20% corporate income tax applies.

For example, a company that has profits of €100 (approximately $112) available for distribution may distribute dividends of €80, with the remaining €20 being used to satisfy the Estonian corporation income tax of 20%. From the Estonian perspective, this tax is considered a corporate income tax and not a withholding tax, so the tax rate is not affected by applicable tax treaties. The tax system makes sense in the context of Estonia's active start-up culture. It allows young, growing companies to maximize the use of cash to grow the business, requiring them to pay into the tax system only when they proceed to actually distribute profits to ownership.

Although the Estonian corporate tax is not payable until a distribution is made from the corporation, according to relevant Estonian tax principles, the corporate income tax arising from the payment of dividends is recognized as a liability and an income tax expense in the period the dividends are declared, regardless of the period for which the dividends are paid or the actual payment date.

Accrual of Foreign Taxes for Relevant U.S. Purposes

For purposes of the high-tax exception to Subpart F income under Section 954(b)(4), the amount of foreign income taxes paid with respect to an item of income generally is the amount a taxpayer would be deemed to have paid under Section 960.[2] In order to determine the deemed-paid tax amount under Section 960, as a starting point, only foreign taxes that would be creditable are taken into account.[3]

For this purpose, Section 905(a) allows the accrual of foreign income taxes by an electing U.S. taxpayer, even if the taxpayer generally uses the cash method of accounting. A taxpayer exercising this election must usually continue to use this method for all subsequent years. A foreign income tax accrues under U.S. standards when the "all-events" test is met, which is the tax year in which all the events have occurred that establish the fact of the liability and permit the amount of the liability to be determined with reasonable accuracy. The economic performance test is not required to be met with respect to the accrual of foreign taxes. Therefore, actual payment is not required in order for a creditable foreign tax liability to accrue for U.S. tax purposes.[4]

Generally, the accrual date is the end of the foreign taxable period in which the relevant income is computed. (Until the end of that year, the existence of a tax liability is uncertain).[5] This is the case if no further event after

the close of the foreign computation year could remove the liability.[6]

In analogous cases involving taxpayers that were liable for determinable, aggregate amounts, but where the identity of the eventual recipients remained unknown, courts allowed the determinable amounts to be accrued for U.S. tax purposes as of the year the taxes became fixed.

For example, in United States v. Hughes Properties Inc., the United States Supreme Court allowed a casino to deduct guaranteed jackpots on progressive slot machines, even though the jackpots had not yet been won, because the machines were operated under state regulations requiring that each machine pay guaranteed jackpots equal to a fixed percentage of the amounts wagered, subject to a dollar ceiling.[7] According to the court, an amount accrues under the all events test when a "fixed and absolute" liability arises, and this liability was created by the state gambling regulation.[8] It was not relevant that the particular winner of the jackpot was not identified until later or that payment of the jackpot might be prevented altogether by the taxpayer's bankruptcy or loss of its gambling license.[9]

Based on the all events test and related guidance, the Estonian corporate taxes should be considered to accrue for U.S. foreign tax credit purposes (and thus also for Section 954(b)(4) purposes) in the year that an Estonian CFC declares a dividend. This is because Estonian law causes the amount of domestic tax to be fixed and determinable at that time, notwithstanding that the exact time of payment of the tax is not yet known.

More specifically, where an Estonian CFC earns Subpart F income from the U.S. perspective, the declaration of a dividend with respect to the same income in Estonia should cause the accrual of a 20% Estonian tax to occur for purposes of Section 954(b)(4). The threshold effective rate of foreign tax for purposes of the exception under Section 954(b)(4) is now 18.9%,[10] and thus the 20% Estonian tax meets the relevant test, permitting U.S. shareholders of the CFC to elect deferral of U.S. tax on the Subpart F income under Section 954(b)(4).

Relevance of Foreign Tax Credit Redetermination Rules?

It appears that the ability of the taxpayer to claim the Section 954(b)(4) high-tax exception on the basis of an accrued foreign tax should not be altered by the Section 905(c) foreign tax credit redetermination rules, even if the dividend, and thus the resulting Estonian tax, is not paid within two years.

Pursuant to Section 905(c), certain U.S. adjustments are made to previously accrued amounts for foreign tax credit purposes in the case of a "foreign tax redetermination." For this purpose, a foreign tax redetermination is "a change in the foreign tax liability that may affect a taxpayer's foreign tax credit ... [and] ... includes ... accrued taxes that are not paid before the date two years after the close of the taxable year to which such taxes relate[.]"[11]

Based on the Section 905(c) rules, if an accrued tax is not paid within two years after the close of the taxable year for which it accrues, this triggers a foreign tax redetermination of the amount that the taxpayer previously claimed as a foreign tax credit. This rule was illustrated by the staff of the Joint Committee on Taxation as follows:

> [A]ssume that in year 1 a taxpayer accrues 1,000 units of foreign tax that relate to year 1 and that the currency involved is not inflationary. Further assume that as of the end of year 1 the tax is unpaid ... If the 1,000 units of tax are paid by the taxpayer in either year 2 or year 3, no redetermination of foreign tax is required. If any portion of the tax so accrued remains unpaid as of the end of year 3, however, the taxpayer is required to redetermine its foreign tax accrued in year 1 to eliminate the accrued but unpaid tax, thereby reducing its foreign tax credit for such year. If the taxpayer pays the disallowed taxes in year 4, the taxpayer again redetermines its foreign taxes (and foreign tax credit) for year 1[.][12]

Unlike the above examples, in the case of the Estonian corporate income tax for purposes of Section 954(b)(4), the taxpayers are not seeking to claim a foreign tax credit for the Estonian taxes under Section 960. In fact, they are not claiming any foreign tax credits as to the relevant income during the year the dividend is declared in

Estonia. Rather, they are claiming the high-tax exception under Section 954(b)(4) as to the income, which references the Section 960 rules for certain relevant calculations. For purposes of the Section 954(b)(4) exception, as contrasted with the foreign tax credit rules, however, the failure to pay accrued taxes within two years does not seem to be relevant.

Rather, as Regulation Section 1.904-4(c)(6) illustrates, the high-tax exception to Subpart F is calculated on a snapshot basis, in the year of the inclusion.[13] The cited regulation provides relevant rules for categorizing items for foreign tax credit purposes. This regulation clarifies that the high-tax exception to Subpart F under Section 954(b)(4) is calculated in the year of the inclusion, not the year of distribution.[14] Thus, additional taxes withheld on a later distribution of previously taxed income would not cause otherwise low-taxed income to qualify for the exception. Similarly, subsequent reductions in foreign tax should not cause an item to fall out of the high-taxed exception.[15] In the same way, a failure to pay the accrued taxes within two years should not change the result under Section 954(b)(4). The timing of the subsequent payment simply is not relevant for this purpose.

U.S. Foreign Tax Credit for Estonian Corporate Tax

When an individual owns the stock of a CFC, the individual generally is not entitled to an indirect foreign tax credit for any foreign corporate income taxes paid by the CFC (unless the shareholder makes an election under Section 962 to be taxed as a corporation for certain purposes). Thus, if an individual U.S. shareholder owns a CFC, he or she may have the opportunity to claim the Section 954(b)(4) exception from Subpart F income for income of an Estonian CFC where a dividend is declared in Estonia in the same amount.

However, if and when that Estonian CFC makes an actual distribution of profits to the U.S. individual shareholder, any Estonian tax imposed on the CFC will not typically be creditable by the individual against his or her 23.8% U.S. qualified dividend tax. This inability to credit the foreign tax against U.S. tax would result in a relatively high effective global tax rate on the CFC's profits. It may be possible, however, to trigger a deemed liquidation of such a CFC into an S corporation shareholder, avoid realizing and recognizing any corporate level gain on the deemed liquidation for U.S. purposes, and then claim a credit in the U.S. for any Estonian taxes imposed after the CFC has been deemed to liquidate from the U.S. perspective. This ordering of steps would in turn cause the global effective tax rate on the income to be capped at 23.8% (generally, 20% in Estonia, with residual U.S. taxation of the remaining 3.8% after crediting the foreign taxes).

When the assets of a foreign corporation are acquired by a domestic corporation in an inbound Section 332 liquidation (including a deemed liquidation triggered by a check-the-box election of the CFC), Section 332 and 337 benefits generally are available, but pursuant to Section 367(b), the foreign corporation’s U.S. shareholders must recognize deemed dividend income equal to their ratable shares of the foreign corporation’s all earnings and profits amount.[16] Specifically, each exchanging U.S. shareholder subject to this rule must report a deemed dividend equal to the "all earnings and profits amount" attributable to the shareholder’s stock, which is the stock’s ratable share of the foreign corporation’s net positive earnings and profits.[17]

Where the CFC is resident in Estonia, with which the U.S. has a comprehensive income tax treaty, the resulting dividend is a qualified dividend taxable at 23.8%. As long as the Estonian tax is imposed subsequent to this deemed liquidation, but is still imposed during the same tax year, the Estonian tax should be viewed as imposed on the U.S. shareholder, and thus creditable by such shareholder under Section 901, assuming the income and credits are placed in the same basket for Section 904 purposes.

Under Section 904(d), the U.S. foreign tax credit limitation must be computed separately for foreign taxes on each of four separate limitation categories ("baskets"). For 2018 and subsequent tax years, there are four baskets among which income and taxes must be allocated: GILTI, foreign branch income, passive category income and general category income. Passive income generally is the same as FPHC income for Subpart F purposes.[18] Also, for 2018 and following years, foreign branch income and taxes allocable to that income comprise a separate basket.

"Foreign branch income" is business profits attributable to "separate and clearly identified unit of a trade or business located in a foreign country for which the taxpayer maintains separate books and records." Notably, however, foreign branch income does not include any item of passive category income. In addition to allocating income among the baskets, foreign taxes also must be placed into the same baskets. A foreign income tax imposed on a base consisting of income within only one basket is assigned to that basket. For example, credit for a foreign withholding tax on a dividend classified as passive income is subject to the separate limitation for the passive basket.[19] A foreign tax imposed on a base including income within two or more baskets is allocated among the baskets based on net income.

The Section 954(b)(4) income of the Estonian CFC generally would fall into the passive basket where dividends, capital gains and other passive Subpart F income is earned by the CFC. Likewise, the taxes imposed on that income in Estonia should be considered to fall into the same passive basket, and the Estonian taxes should therefore be creditable against the corresponding U.S. taxes imposed on the deemed dividend.

Example — Using High-Tax Exception to Avoid Subpart F Income

Assume a U.S. shareholder (or group of U.S. shareholders) forms a U.S. S corporation, which in turn forms an Estonian subsidiary — the CFC. The CFC engages in trading activities on the U.S. markets for its own account and is not considered to be engaged in a U.S. trade or business under the trading safe harbor of Section 864(b)(2). As a result of its trading activities, in Year 1 the CFC earns substantial short-term capital gain income, non-qualified dividends, and other Subpart F income totaling $10 million. The CFC declares a dividend in Estonia at the end of Year 1 in an amount equal to the Subpart F income of the CFC, i.e., $10 million, triggering the accrual of a $2 million Estonian corporate tax liability, which will be due on distribution of the profits by the CFC to its owner. The U.S. shareholders elect the high-tax exception under Section 954(b)(4), thus deferring any U.S. recognition of the CFC's income. The CFC realize income of $10 million in each of years 2 and 3, and again the U.S. shareholders claim the benefits of Section 954(b)(4) in those years.

In year 4, the CFC wishes to distribute its profits of $30 million to its S corporation owner. At that time, the CFC continues to hold a small portfolio of substantially-appreciated securities. If the CFC simply distributed the $30 million cash as a dividend, Estonian corporate tax would first apply to require payment of $6 million of Estonian tax. Additionally, the U.S. shareholder owners of the S corporation would receive $24 million, which would be taxable at 23.8% in the U.S., resulting in $5,712,000 U.S. qualified dividend taxes. The Estonian corporate taxes would not be creditable against this U.S. dividend tax imposed on the U.S. shareholders.

On the other hand, if the CFC filed a check-the-box election, electing to be treated as a disregarded entity for U.S. tax purposes as of Dec. 15 of Year 4, the S corporation parent would inherit the appreciated stock with a carryover basis, so that no gain would be triggered on the deemed liquidation. In addition, the CFC's "all earnings and profits amount", i.e., $30 million, would be treated as a deemed dividend to the U.S. shareholders, taxable at 23.8% in the U.S. As long as the CFC then made an actual distribution of the same $30 million on or before Dec. 31 of Year 4 and paid to the Estonian tax authorities the resulting Estonia corporate tax of 20% tax (i.e., $6 million), the Estonian tax should be creditable in the United States.

Because at the time the Estonian tax is paid, the CFC is treated as a branch of the S corporation parent, the taxes are treated for U.S. purposes as being paid by the S corporation. These taxes in turn flow up to the U.S. individual shareholders, who can utilize that Estonian tax as a credit against their related U.S. tax liability. In this way, a global effective tax rate of 23.8% is imposed on the income at the time it is actually distributed.[20] As a result, any short-term capital gain or other ordinary income not only is deferred from U.S. taxation until distribution, but also effectively is converted into lower-taxed qualified dividends for U.S. purposes.

Planning for GILTI Income

Because the high-tax exception of Section 954(b)(4) is available only for Subpart F income, and no similar high-tax exception exists for GILTI, it may make sense to consider restructuring certain streams of income so that they are classified as Subpart F income and may thus be available to benefit from the above Estonian structure.

For example, if a British Virgin Islands CFC, utilizing a staff of its own employees in the British Virgin Islands, is providing support services to related persons, the resulting income of the CFC would be GILTI income, rather than Subpart F income, because the services are performed in the country of incorporation. However, if the U.S. shareholders of that British Virgin Islands CFC form a new sister CFC in Estonia, and then the British Virgin Islands CFC subcontracts its activities to the Estonian CFC, which provides the services from outside Estonia (e.g., the British Virgin Islands), the resulting income is Subpart F income to the Estonian CFC and the high-tax exception may be claimed. Alternatively, the Estonian CFC could enter into the services contract directly with the related persons, and the resulting income should be Subpart F income because the services of the CFC are not provided in Estonia.

Conclusion

As noted above, despite GILTI's apparent reach, with the use of Estonia's rather unique corporate income tax system, coupled with the U.S. tax rules relating to the accrual of foreign taxes, U.S. taxpayers may be afforded an interesting planning opportunity to avoid immediate taxation under both the Subpart F income and GILTI rules, without paying any current foreign tax.

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[1] Latvia, Georgia and Ukraine recently enacted tax systems mirrored after Estonia's tax regime.

[2] Treas. Reg. Section 1.954-1(d)(2).

[3] The 20% Estonian tax is an income tax, clearly calculated on the basis of the corporation's income, and is a tax imposed on the Estonian corporation, rather than on its shareholders or other persons.

[4] Treas. Reg. Sections 1.446-1(c)(1)(ii) and 1.461-4(g)(6)(iii)(B).

[5] See A.M. 2008-005 (citing Rev. Rul. 61-93).

[6] See Universal Winding Co. v. Commissioner, 39 BTA 962 (1939).

[7] United States v. Hughes Properties, Inc. , 476 U.S. 593 (1986). See Gold Coast Hotel & Casino v. United States , 158 F.3d 484 (9th Cir. 1998) (casino allowed to deduct cash value of "slot club points" accumulated by players of its slot machines and redeemable for prizes, even though some players would never redeem).

[8] Hughes Properties at p. 600.

[9] Note that the result of Hughes Properties would be different assuming the same facts under current law, which now requires jackpots to be paid before economic performance is considered complete.

[10] I.e., Ninety percent of the Section 11 rate of 21%. See Section 954(b)(4).

[11] Regulation Section 1.905-3T(c).

[12] Staff of Joint Comm. on Tax'n, 105th Cong., 1st Sess., General Explanation of Tax Legislation Enacted in 1997 at 298 (Comm. Print 1997).

[13] See also Bittker & Lokken at Para. 72.7, footnote 45, stating as follows: "Generally, whether passive subpart F income is highly taxed is determined when it is included in the shareholder's gross income, not when it is distributed. Treas. Reg. Section 1.904-4(c)(6). But see Treas. Reg. Section 1.904-4(c)(7) (special rules for where foreign tax on CFC's passive income is refunded or otherwise reduced on income's distribution)."

[14] See Treas. Reg. Section 1.904-4(c)(6)(i).

[15] See, e.g., Foreign Tax Redeterminations under § 905(c) and Other Procedural Issues in Claiming the Foreign Tax Credit, William Skinner, Fenwick & West (2015).

[16] Treas. Reg. Section 1.367(b)-3(a).

[17] Treas. Reg. Sections 1.367(b)-3(b)(3)(i), -2(d)(1).

[18] Note that while there is a high-tax "kickout" provision under Section 904(d)(2)(B)(iii)(II) that would cause passive income to be moved to the general category basket, this exception only applies where the rate of foreign tax imposed is greater than the maximum rate of tax imposed under U.S. law on the same taxpayer (in the case of a corporate taxpayer, the Section 11 rate of 21 percent). The Estonian corporate tax rate of 20% thus does not trigger this high-tax kickout as to income for which the Section 954(b)(4) exception is claimed.

[19] Treas. Reg. Section 1.904-6(a)(1)(i).

[20] Note that there also are methods that would allow for tax-free access to the cash of the CFC without the necessity of liquidating the CFC (whether by way of a check-the-box election or an actual liquidation).

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