Historic Planning Must Now Change

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Impact of New US Tax Legislation to Family Structures

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Planning Under Old Law

- **Trust for Benefit of Non-US/US Persons Structured to be "Foreign Grantor Trust"**
  - Because of this planning, trust income during life of the Non-US Grantor is deemed realized by Non-US Grantor and *not* the Trust
    - That means that ***trust income distributed to US Beneficiary is non-taxable*** and considered a "gift" from grantor to beneficiary
    - There is no "build-up" of accumulated income (and thus no "throwback tax")
- **Revocable Trust aspect requires planning to "block" US Estate Tax for Grantor**

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Benefits of Election under IRC Sec. 645

- Given current plan, the benefits of tax-free income to US Beneficiaries could be extended for up to 2 years following the death of the Grantor, by making an election under IRC Section 645 which treats the Trust as part of the "estate" of the decedent

- Benefits of the Section 645 election: "Distributable net income" of a foreign estate does not include gains or non-US source income, and therefore:

  - There is a basis step-up for trust assets owned at death, and thereafter through churning of trust assets during the Section 645 election period

  - Throwback rules inapplicable to accumulated non-DNI during period

  - 2-year period also allows for ample time to do additional personal / wealth planning for the Family

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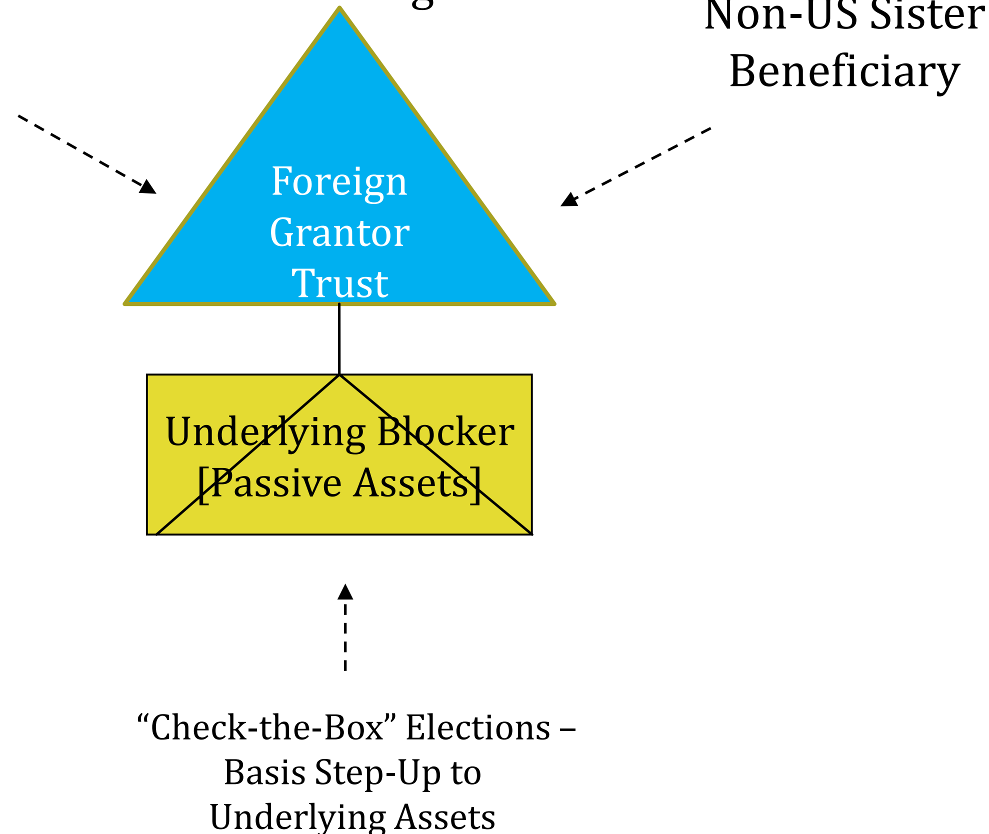
Section 645/Underlying Blocker: Old Law

- Blocker "blocks" US Estate Tax Exposure for Foreign Grantor
- Post-Death "Check-The-Box" Election eliminated Corporate Status (and thus CFC Risk) to US beneficiary if made w/in 30 days of death:
  - Income deemed realized within "estate"
  - Income = Foreign source gains excluded from DNI/UNI



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Trump Tax Bill Changes When a CFC Exists and Who Owns its Shares

When does a CFC Exist:

- **Old Law:** A foreign corporation that was owned by "US shareholders" was deemed a CFC only if it was classified as a CFC for 30 consecutive days in the relevant tax year. This gave us ample time to make the appropriate tax elections to avoid CFC status
- **New Law:** Does not provide for a 30-day grace period. No time will be available

- **Attribution of Foreign Ownership**:
  - **Old Law**: Generally, stock owned by a foreign person was *not attributed* to a US person when determining whether the company was a controlled foreign corporation.
  - **New Law**: The constructive ownership rules were amended so that certain stock of a foreign corporation owned by a foreign person is attributed to a related US persons (corporations, parents, children, siblings) for purposes of figuring CFC status.

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Old Planning Upended Due to Changes to CFC Rules under Trump

- **What is the consequence of CFC changes?**
- **Income may be deemed Attributed to "US Shareholders" of a CFC:**
  - US beneficiaries (relatives of non-US Grantor/settlor who are beneficiaries of the Foreign Grantor Trust) may be considered "owners" of the underlying "foreign blocker", thereby making it a CFC for US tax purposes
  - CFC status imputes Subpart F income to all US shareholders (i.e. the US beneficiaries) on an annual basis even if the income is not distributed
- **When US Beneficiaries have deemed income from a CFC, they owe tax thereon at the highest marginal rates (i.e., 37% + state)**

Impact on Structure with Underlying Blocker

- Now any foreign company (i.e. "blocker") that is owned by the Foreign Grantor Trust could be deemed owned by the Grantor's "US" related parties/beneficiaries and may be classified as a CFC *from the instant of the Grantor's death*.
  - No longer have 30-day grace period to eliminate the CFC by making special tax election
  - Moreover, shares owned by foreign related parties are now attributable to US beneficiaries/family members.
  - While election may be made "retroactive" to date prior to death, that retroactivity may expose non-US Grantor to US estate tax for that portion of blocker assets which would be subject to estate tax *if held directly at death*
    - Generally, the estate tax exposure applies to US equities and real estate.

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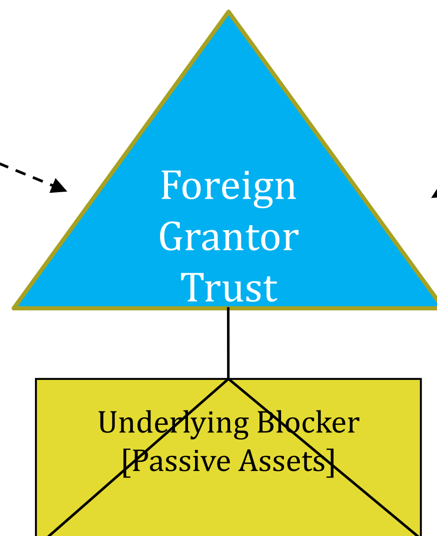
Section 645 Basis-Step Up: Now Subpart F Inclusion?

United States Brother Beneficiary

Non-US Sister Beneficiary

- Recall: No more 30 day "grace" period for "CTB" elections
- Instead, immediately @ death, there is attribution of ownership from the trust to the US beneficiaries
- Issues:
  - The blocker would immediately become a CFC
  - I.e., there is attribution from "Sister" to "Brother"
- If the foreign blocker is a CFC, then is there Subpart F inclusion for income allocable to the US Brother



"Check-the-Box" Elections – Basis Step-Up to Underlying Assets

Election Retroactive Prior to Grantor's Death Exposes Him to Estate Tax

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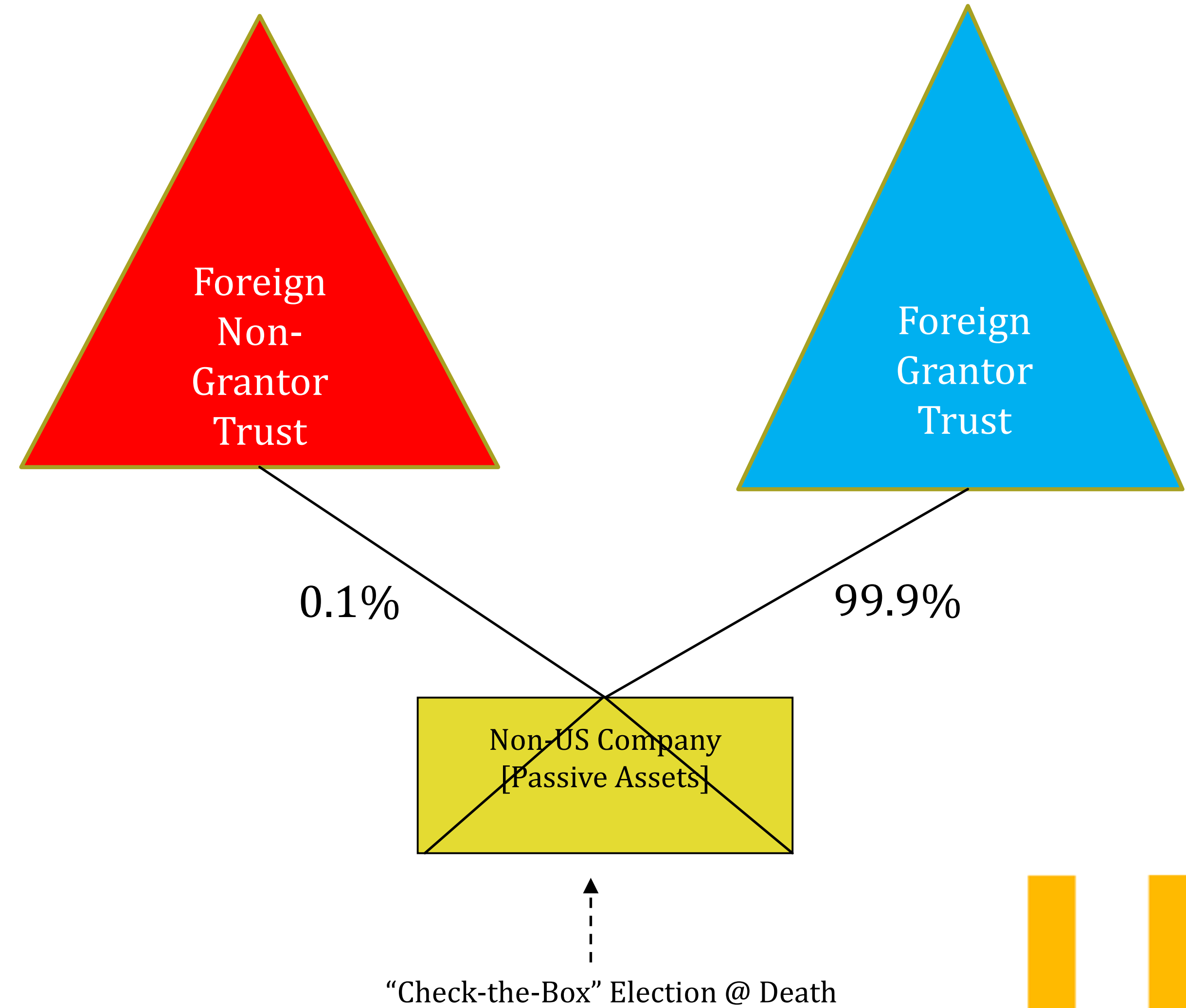
How to Solve the CFC Issue?

- Usually there is a single-member foreign "blocker" in the structure, owned by 1 trust.
- One plan is to modify the structure entirely before the date of the Grantor's death by:
  1. Admitting a second member to the "blocker" (i.e., Family Investments LLC), and
  2. Making a "check the box election" effective as of the date immediately prior Grantor's death (to be done post-death, but made retroactive to the day before death)
- Result: Blocker LLC should be treated as a foreign "partnership" for US tax purposes – and still continues to act as a blocker for the estate tax exposure.
- "Partnership" status avoid classification as CFC because only foreign "corporations" can be CFCs – so can avoid annual deemed Subpart F inclusion for US beneficiaries.
- Who is the 2nd member: Any third party other than the Foreign Grantor, including a newly-formed trust (i.e., a trust very similar to the existing one but which is a "nongrantor trust").

One Solution: Restructuring With Second Trust

- Admit new Member prior to grantor's death & make check-the-box election retroactive to the day prior to grantor's death
- Result? Now foreign blocker is a Multi-Member Non-US Flow-thru (partnership) Entity and continues to "block" out estate tax
- 0.1% Portion attributable to foreign non-grantor trust will risk DNI/UNI build-up (very small portion of trust income, and can be managed post-death during Section 645 2-year restructuring period.



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Impact of CFC Changes to Corporate/Business Structures

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Downward Attribution Impacting Other Structures

- **Old Law**: Generally, stock owned by a foreign person was *not attributed* to a US person; foreign parent shares in brother/sister sub not attributed to US person

- **New Law**: Now, shares foreign parent holds attributed down chain to US corporations in group

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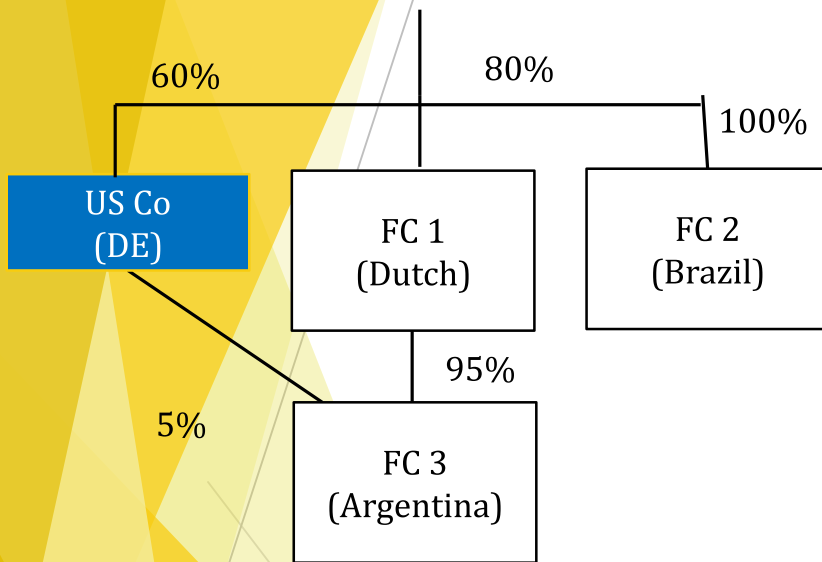
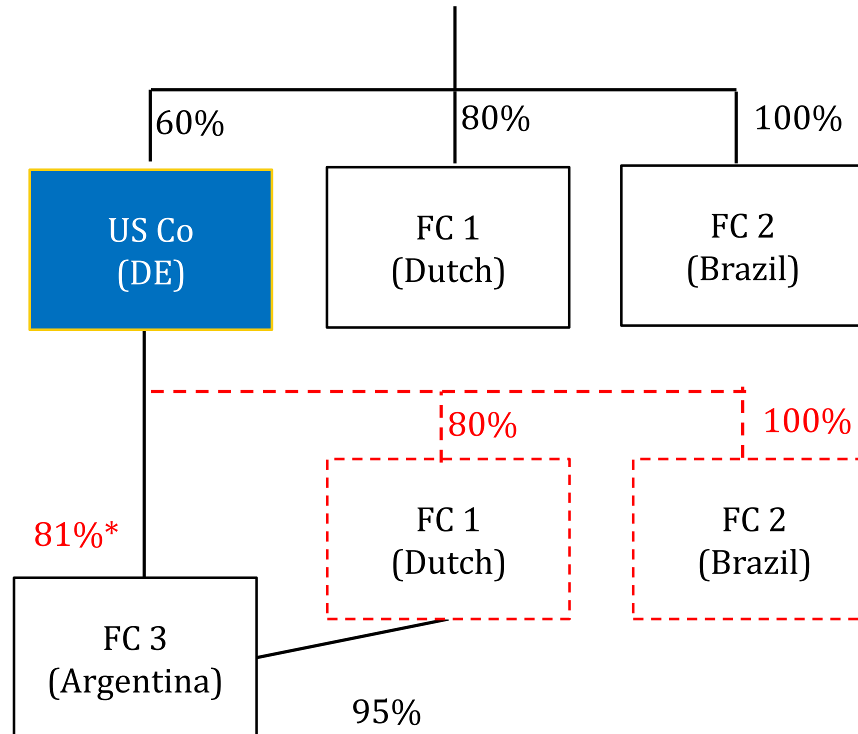
Repeal of IRC Section 958(b)(4)

Prior Law



*All foreign companies generate either Subpart F or GILTI type income

Current Law



(1) Are FC 1, FC 2, and FC 3 CFCs?
(2) Does US Co. have a Subpart F inclusion on earnings of foreign companies?
(3) Does US Co. have reporting obligations?

Effective retroactively for 2017 tax year!

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Consequence of CFC Status

- Certain categories of income – Subpart F income – are deemed distributed to the US shareholders of the CFC when earned rather than when actually distributed.
- CFC income inclusions are taxed currently
  - As ordinary income and not eligible for qualified dividend tax rates for individuals; and
  - In case of corporate entities, taxed at regular corporate rates
  - ***Subpart F inclusions, however, remain based upon ownership w/o regard to "downward" attribution***
- Actual distributions of "previously taxed income" are tax-exempt.
- All capital gain on sale of property and all rent, royalties, interest, dividends may (likely) be considered Subpart F; related party transactions – payments for services rendered between companies in structure – are (likely) considered Subpart F and thus taxable currently.

Even if No Subpart F income, GILTI applies

- GILTI = New category of income
  - Ends deferral of taxation on significant portion of foreign earnings, requiring inclusion in manner similar to Subpart F
- GILTI income = generally income earned by foreign corporations, minus specified “tangible property return”
- US domestic corporate shareholder generally able to take a deduction on the GILTI amount and is entitled to a reduced foreign tax credit
  - Deduction = 50% of tax rate – i.e., 10.5%
  - Foreign tax credits (80%) reduce US liability
    - If foreign taxes paid = 13.125% of GILTI income, no additional US liability

Other Changes to Inbound Business Structures

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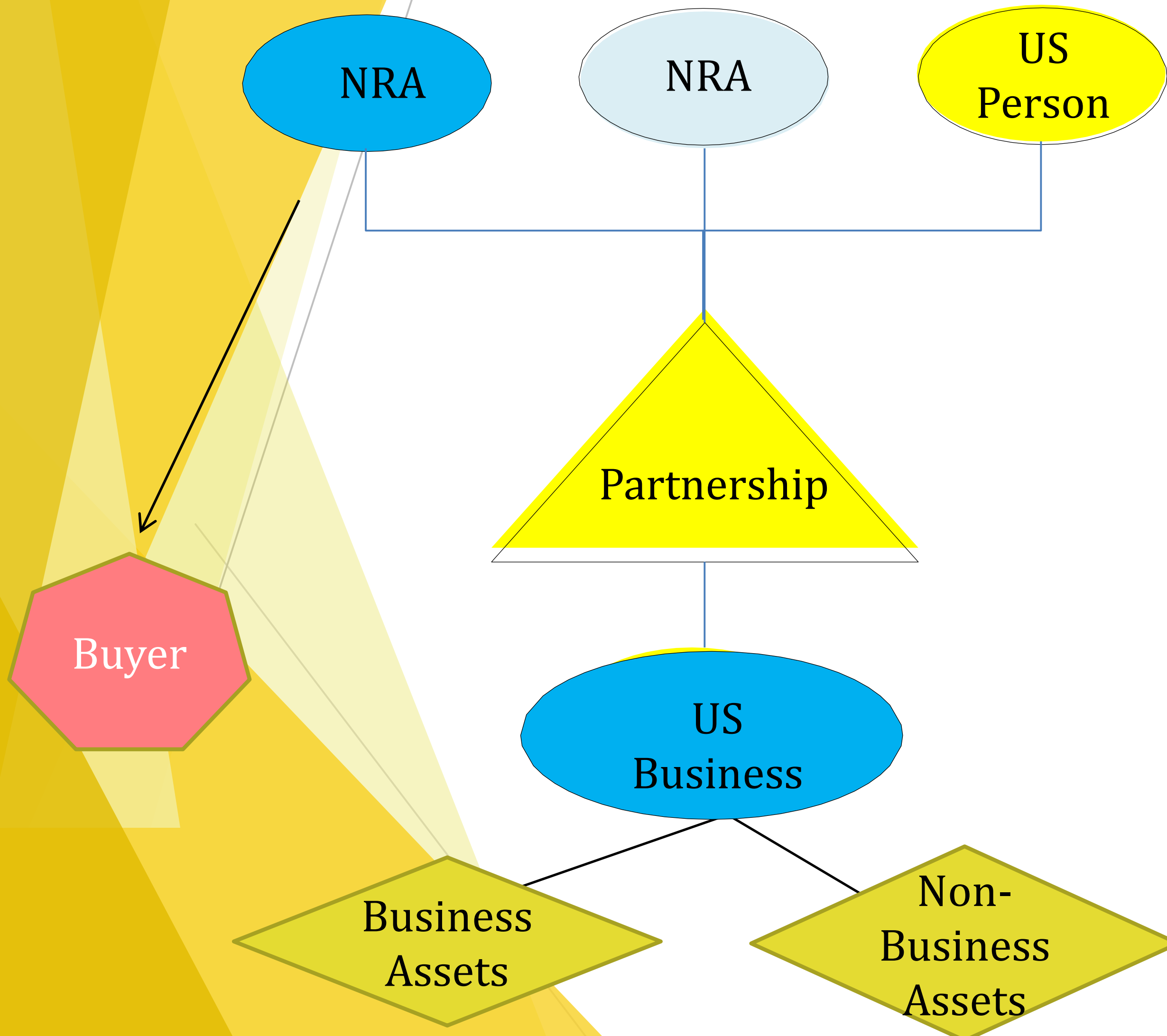
New IRC Section 864(c)(8)

- **Sale of Partnership Interest with Underlying US Business**
  - **Old Law**: Generally, except for real estate partnerships/LLCs, gain would be tax-free when sold by non-US person. *Confirmed by Tax Court's recent (2017) Grecian Magnesite decision; upheld on appeal*
  - **New Law:** Foreign partner gain from disposition of a partnership interest is "effectively connected income" (ECI) and now taxable to the extent disposition of partnership assets would generate ECI

Foreign Partners' Sale of Partnership Interest



- Look-through rule for such gain, using a constructive sale of partnership assets to determine source; and
- Buyer required to withhold 10% of sale price; if fails, partnership required to withhold from new partner/ buyer;
- Ultimate tax may be higher and seller must file U.S. tax return to pay balance or claim refund.

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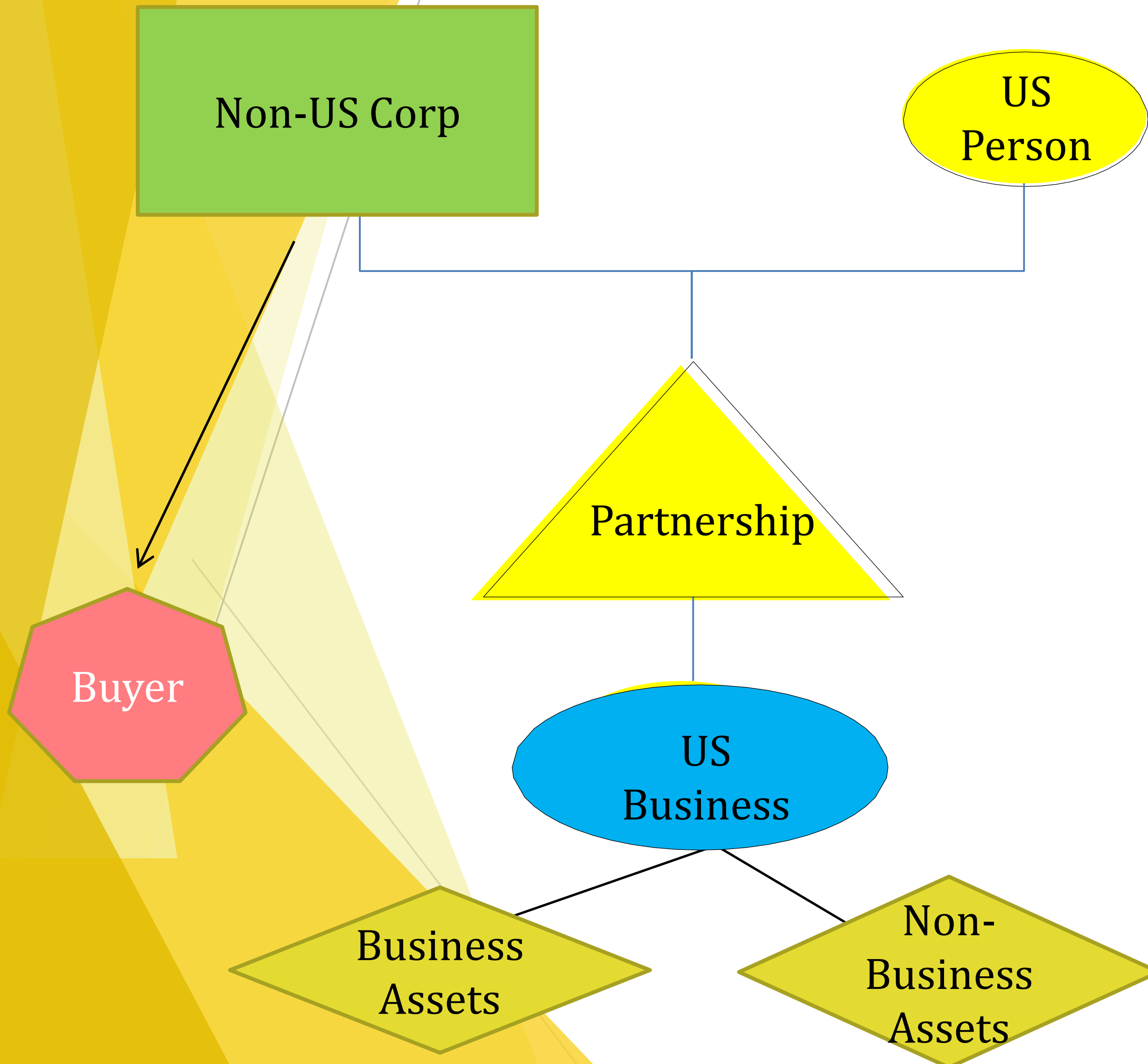
Foreign Corporate Partners' Gain?



Non-US Corp subject to tax on gain at rate of 21% plus "branch profits tax"

- Branch profits tax = 30%
- Treaty may reduce, even eliminate (e.g., UK), branch profits tax

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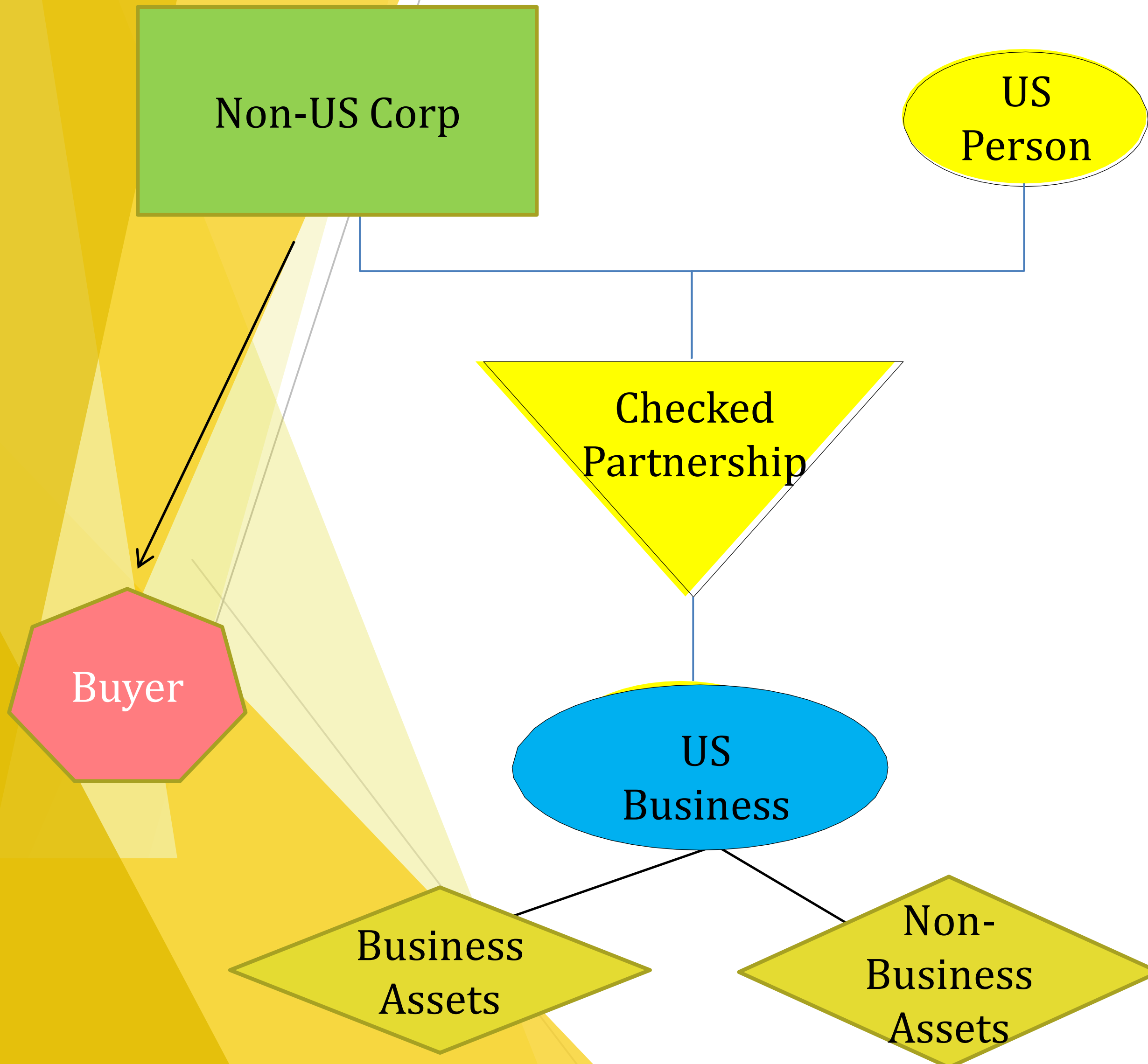
Now What?



Elect to treat partnership as domestic corporation?

- Partnership taxed at 21% rate:
  - Operating income taxed to US person at 37% – i.e., possibly better @ 21% (with accumulating partnership).
  - No branch profits tax; dividend WHT
- No Gain on Sale of interest in Checked Partnership by Non-US "partner"

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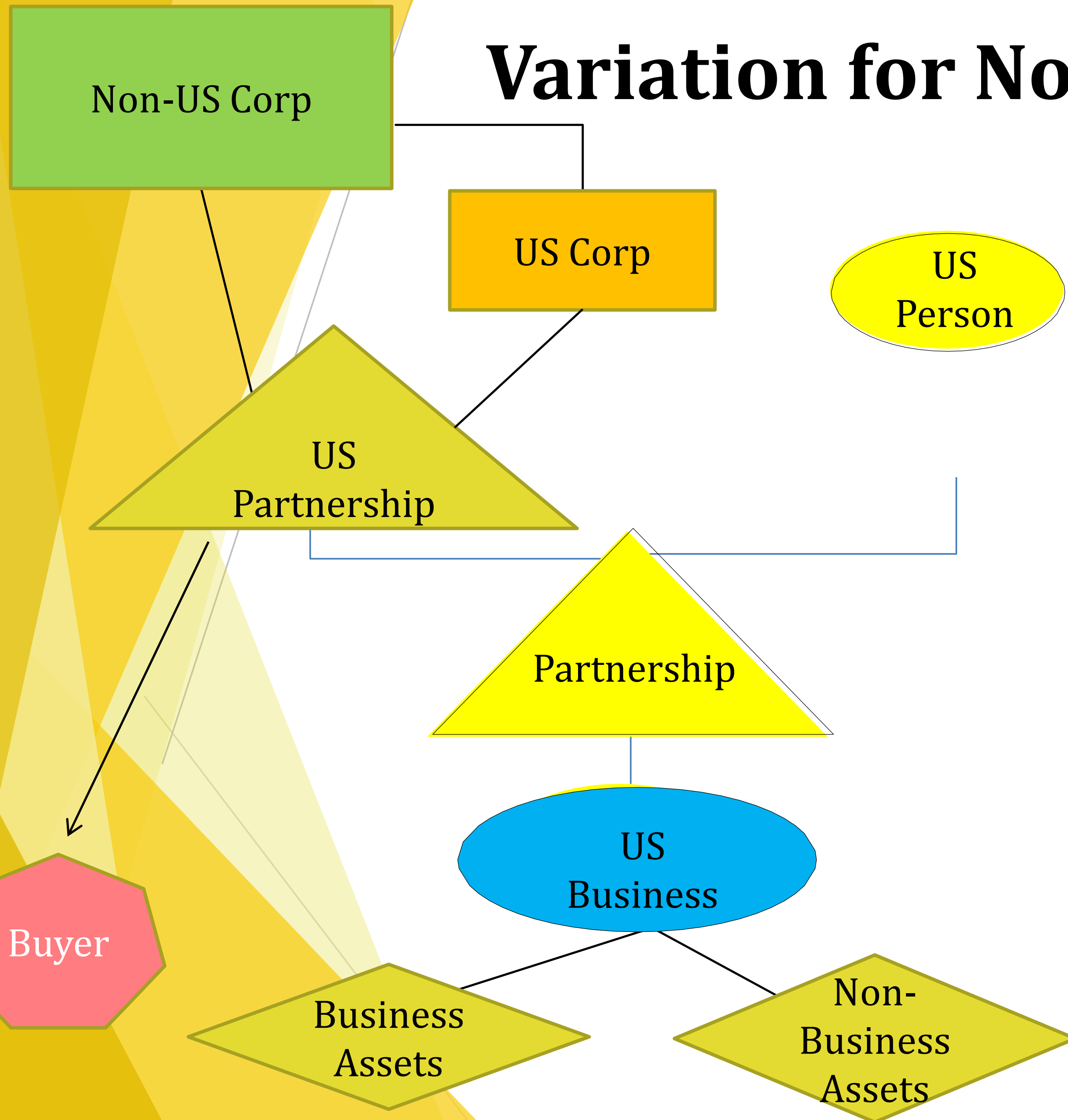
Variation for Non-US Investor



Form "own" domestic partnership?

- No withholding when US Partnership/LLC sells interest
- Gain remains taxable to extent of business assets in underlying partnership
  - US partnership (subject to rules requiring that allocations have "substantial economic effect") may attempt to allocate ECI to US Corp
    - Taxed at 21%
    - Liquidate US Corp tax-free (no branch profits tax)