

New US International Tax Provisions– Paradigmatic Shift in Planning for Inbound Structures

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New International Tax Paradigm: Upends Planning of Past 50 or more years

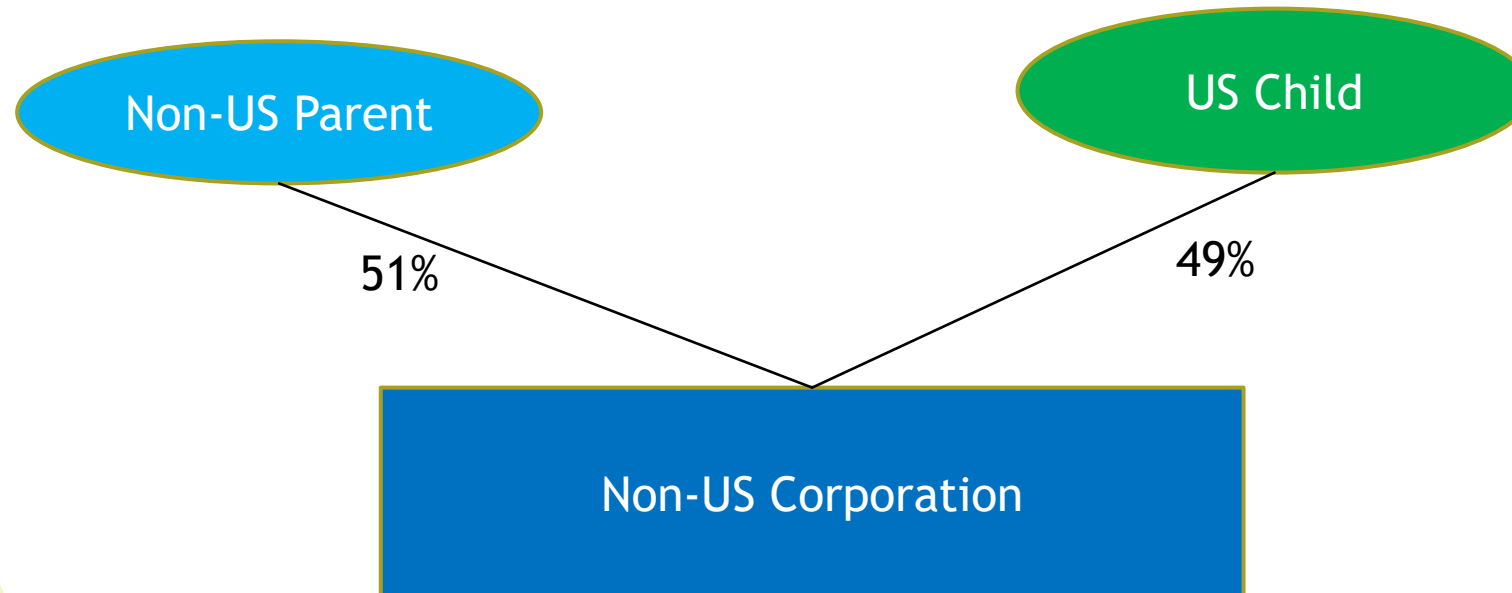
- ▶ Outbound Blocker Structures No Longer Block
 - ▶ All income abroad must bear minimum tax rate
- ▶ Everything is a CFC
 - ▶ No 30 day “grace” period
 - ▶ Foreign to Domestic Attribution of Ownership of Shares
- ▶ Large Margin of rates between C corporation and Flow-through Entities (21% v. 37%)
- ▶ Limitations of Deductibility for Business Interest and Payments Involving Related Hybrid Entities or Hybrid Transactions

Everything is a CFC?

- ▶ CFC = Controlled Foreign Corporation in which US Shareholders own more than 50% of vote or value
 - ▶ US Shareholder now defined as one owning at least 10% of vote or value
 - ▶ Old Law set test at 10% of vote:
 - ▶ That led to planning with non-voting shares held by US persons in non-US corporations
 - ▶ Concentration of value in non-voting shares meant no status as “US Shareholder”
- ▶ Now, Holding Shares worth at least 10% of Value of Company means that “US Shareholder” and Company More Likely CFC

Everything is a CFC?

- ▶ Old Law: No attribution of share ownership from Non-US Person to US Person for Testing Status as CFC
 - ▶ In other words, if a related foreign shareholder held shares, those shares were deemed non-owned by the related US person



New Law: Now Attribution between Related Persons ⁴

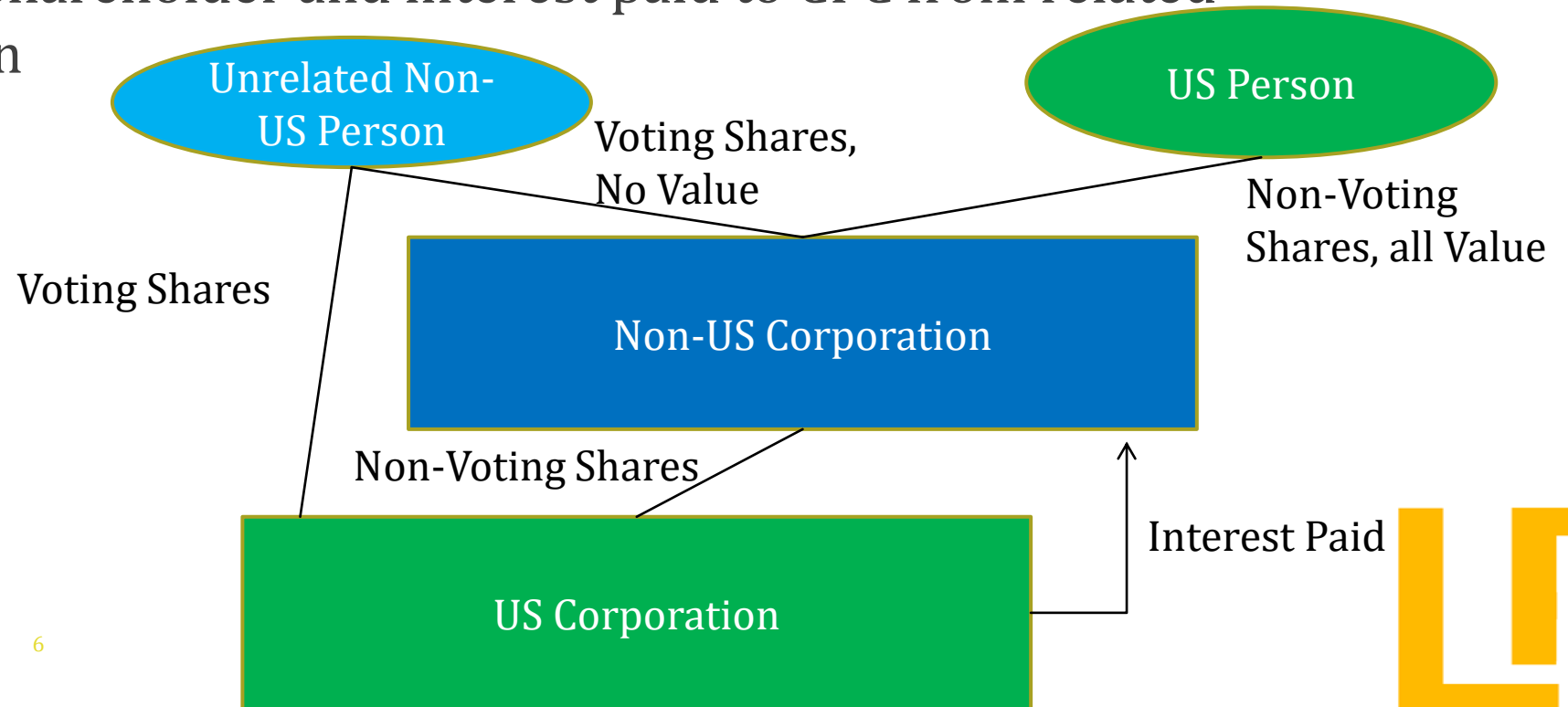
Everything is a CFC?

- ▶ CFC Status Results in Deemed Inclusion of “Subpart F income” of CFC
 - ▶ Generally passive income
 - ▶ Subpart F income also includes many related party transactions
- ▶ Old Law: Income inclusion only if US Shareholder owns stock in the foreign company for “an uninterrupted period of 30 days or more during the year”
 - ▶ If held less than 30 days in any year, could liquidate company (etc.) without income inclusion
- ▶ New Law: Income inclusion for any part of year in which person is a US Shareholder of a CFC

Everything a CFC: Traditional Inbound Financing Models Must Change

- ▶ “Portfolio Interest” Not Subject to US Withholding or Tax
- ▶ Portfolio interest defined to exclude both interest paid to 10% Shareholder and interest paid to CFC from related person

- 10% Shareholder status based on voting power
- Since Non-US Co is now CFC, interest is taxable & subject to withholding



“Everything a CFC”: Historic Planning for “Global Families” Much Less Certain

- ▶ Trust for Benefit of Non-US/US Persons Structured to be “Foreign Grantor Trust”
 - ▶ Trust income during life of the Non-US Grantor deemed realized by Non-US Grantor and not Trust
 - ▶ Thus trust income distributed to US Beneficiary is non-taxable and considered a “gift” from grantor to beneficiary
 - ▶ No “build-up” for accumulated income (and thus no “throwback tax”)
- ▶ Where Grantor Trust qualifies as “Revocable” under US Law, Benefits of Non-US Taxation to US Beneficiaries often extended – Election under IRC Section 645
- ▶ Revocable Trust aspect translates to need to “block” US Estate Tax for Grantor

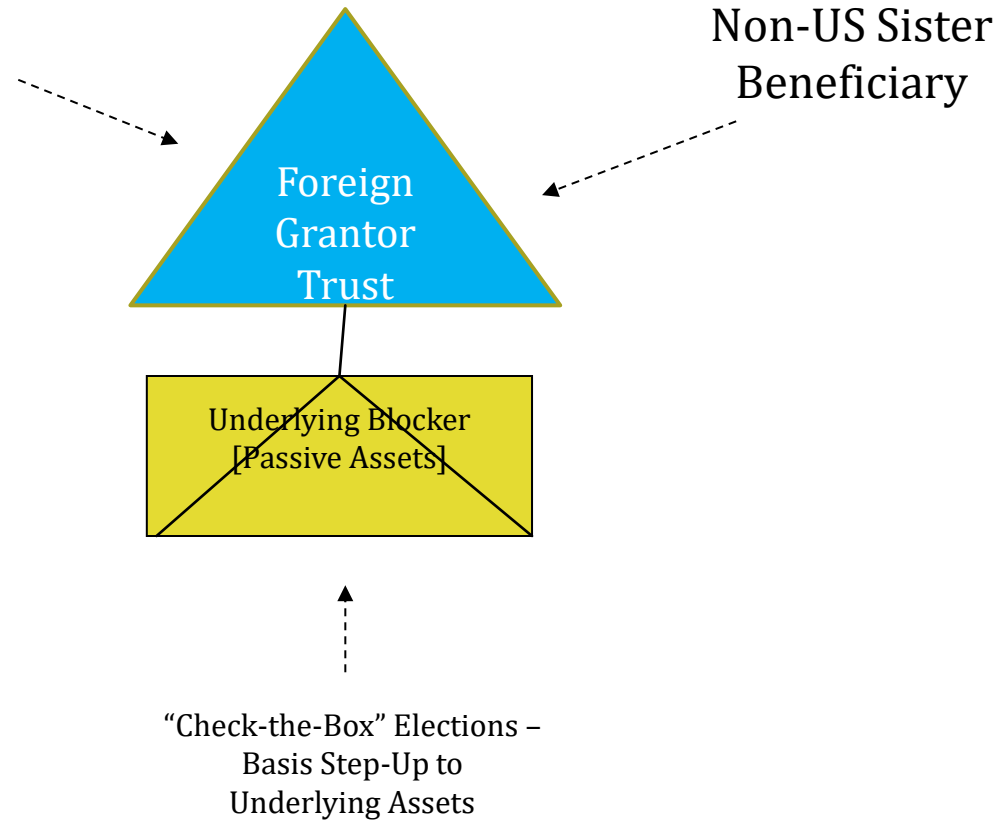
Election under IRC Sec. 645

- ▶ Permits trustee of “qualified revocable trust” and – if any – executor of related estate to make election to treat the “qualified revocable trust” as part of “estate” of decedent
 - ▶ Status continues for at least 2 years (maybe more)
- ▶ Benefit is that “DNI” of foreign estate does not include gains or non-US source income
 - ▶ Basis-step up for trust assets at death, and thereafter through churning of trust assets during Section 645 election period = free from US tax
 - ▶ Throwback rules inapplicable to accumulated non-DNI during period

Section 645 Basis-Step Up

@ Death of Grantor: Elect to Treat Trust as Part of Grantor's Foreign Estate

- United States Brother Beneficiary
- Non-US Sister Beneficiary
- Blocker "blocks" US Estate Tax Exposure for Foreign Grantor
- Post-Death 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

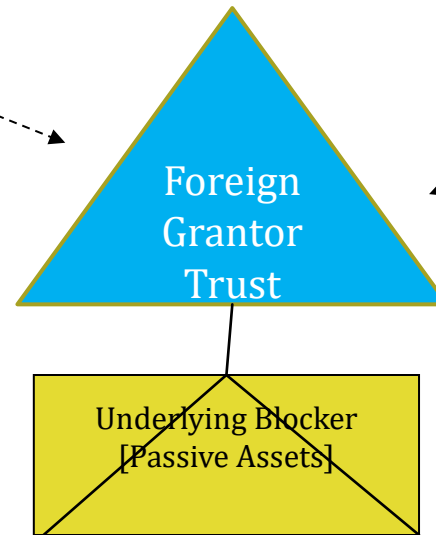


Section 645 Basis-Step Up: Now Subpart F Inclusion?

- No more 30 day “grace” period
- Immediately @ death, attribution from trust to beneficiaries
 - Is blocker a CFC?
 - Downward attribution from Sister to Brother
 - How treat “discretionary” trust/estate?
- If CFC, Subpart F inclusion for Brother attributable to Check-the-Box

United States
Brother Beneficiary

Non-US Sister
Beneficiary

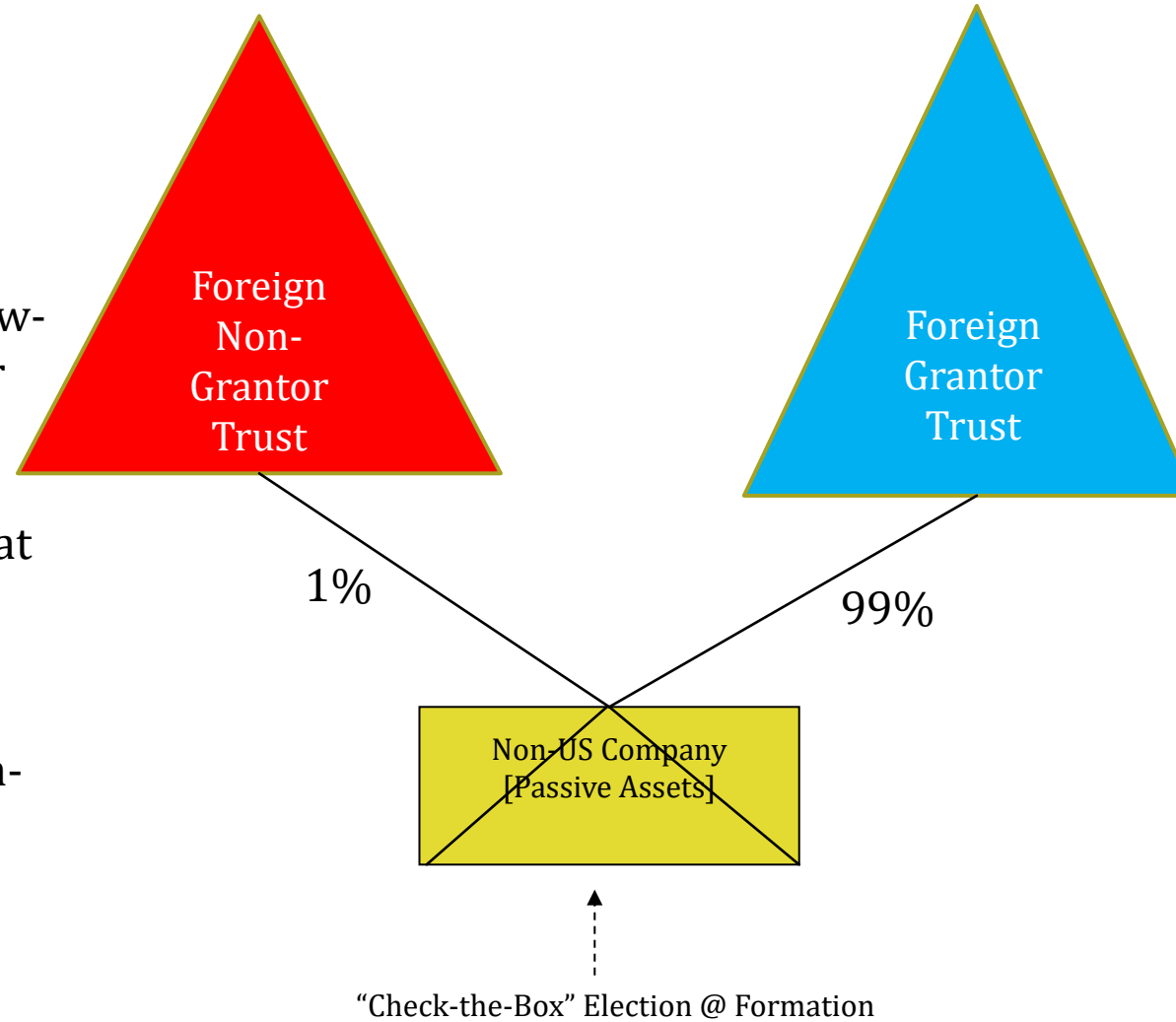


***Election Retroactive
Prior to Grantor's
Death Exposes Him to
Estate Tax***

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

Now What?

- Multi-Member Non-US Flow-thru Entity as “blocker” for estate tax
 - No risk of CFC if elect non-corporate status at formation
 - Less certainty of US estate tax conclusion
- Portion attributable to non-grantor trust will risk DNI/UNI build-up



New Tax Law incentivizes move to C Corporation

- ▶ Flow-through structures no longer as economically efficient in comparison
 - ▶ If “pass-through deduction” available, effective tax rates in the 30-35% range (depending); If not, 37%
 - ▶ State and local tax imposed at individual level, such that non-deductible
- ▶ C corporations taxed at 21%
 - ▶ State and local taxes fully deductible
 - ▶ “Shareholder Level” dividend taxed at 20%
 - ▶ “Combined” rate approximately 38.8%, assuming regular distribution

C Corporation Benefits for Investment Income

- ▶ Flow-Through Effective Rates on Investment Income range from 20% to 37%, Without State Tax Deductibility
- ▶ Corporate Rate = 21% Plus State Tax Deductibility
- ▶ Keeping “assets in corporate solution” viable strategy again
 - ▶ Personal Holding Company Excise Tax Generally Manageable
 - ▶ Accumulated Earnings Excise Tax Generally Manageable

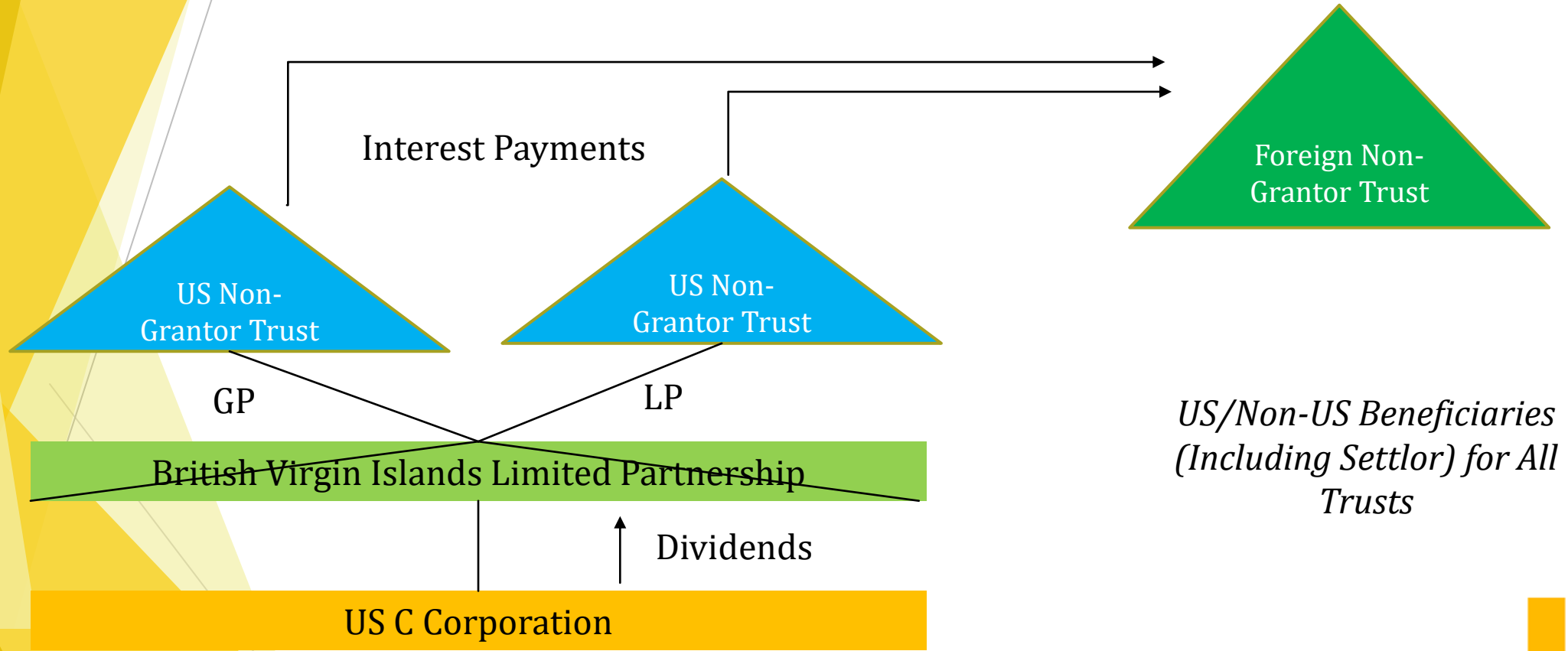
New Limitations on Deductibility of Business Interest

- ▶ New IRC Section 163(j) limits deductibility of “business interest” expenses to an amount not exceeding the sum of taxpayer’s business interest income and 30 percent of adjusted taxable income
- ▶ Business interest defined to mean all interest other than “investment interest” and real-estate-related interest for which special (irrevocable) election can be made.
- ▶ Interest expense exceeding this limit is not deductible in the current tax year but may be carried forward to subsequent years.
- ▶ An “electing real property trade or business” may elect to be excluded from these limitations. The election will require the business to change its cost recovery periods under the ADS.
- ▶ To be eligible for the election, taxpayer must be in a “real property trade or business” which includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business. Does not include mortgage debt.

New Limitations on Deductibility of Payments Involving Hybrids

- ▶ New IRC Section 267A disallows interest deductions for disqualified related-party amounts paid under a hybrid transaction or by or to a hybrid entity.
- ▶ Policy is to deny a deduction in the United States when a related non-U.S. recipient is not subject to tax on the item in its home country (I.e., Lux Preferred Equity Certificate Structures)
- ▶ The payment of interest/royalties = disqualified (nondeductible) if made between related parties where one of those parties is transparent in one jurisdiction but not in the other –a “hybrid entity”
 - ▶ Term “hybrid entity” would thus likely include a foreign grantor trust, but not non-grantor trust
 - ▶ Grantor trust is transparent for US tax but not likely transparent in jurisdiction of trust
 - ▶ Non-Grantor Trust is (likely) non-transparent in both jurisdictions

Revisions to Financing Models for Inbound Planning



*US/Non-US Beneficiaries
(Including Settlor) for All
Trusts*

Deductibility of Investment Interest

- ▶ Unlike “business interest” which is now subject to limitations under IRC Section 163(j), “investment interest” remains deductible
- ▶ Limitation on deductibility = aggregate amount of “investment income”; carryforward for any excess
- ▶ Where dividends/gains on sale of US corporation shares considered “investment income”, interest is deductible against net
 - ▶ Special election [IRS Form 4952] required to treat dividend income/gains as investment income
 - ▶ May apply to all or any portion of dividends or gains
 - ▶ Election, once made, revocable solely with consent of IRS

No Tax/Withholding for Interest Paid by Trust to Foreign Related Party

- ▶ IRC Section 871(h) generally imposes tax on interest paid to a foreign person unless interest is “portfolio interest”
 - ▶ Withholding by US payor required under IRC Section 1441
- ▶ Portfolio interest does not include interest paid by corporations or partnerships to a “10% Shareholder/Partner”
 - ▶ Attribution of ownership of shares/partnership interests between related parties
 - ▶ If interest were payable by US C Corporation or by Foreign Partnership, tax would be owing and withheld
- ▶ IRC Section 871(h) does not apply to obligations issued by trusts
 - ▶ Such interest paid is outside scope of statute

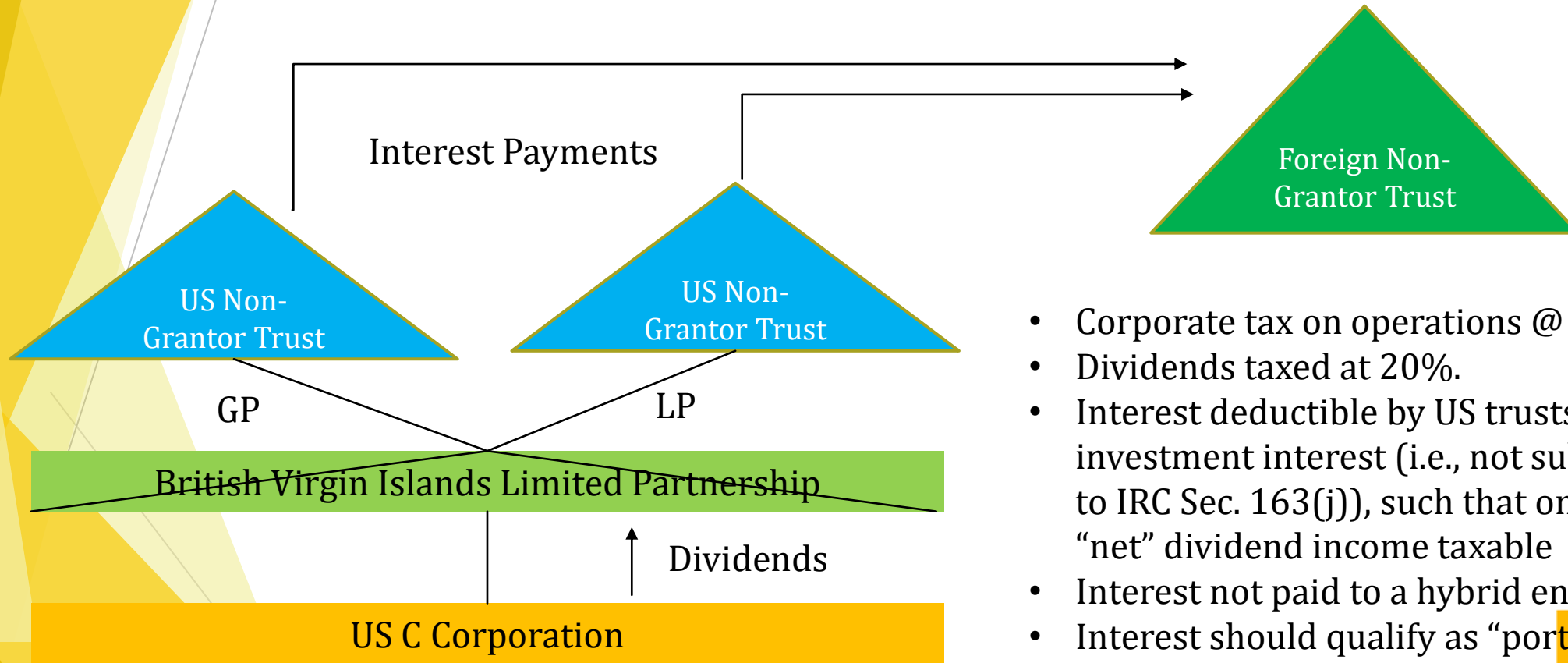
Non-US Beneficiaries Should Find Domestic Trust Structure Efficient

- ▶ Domestic US Non-Grantor Trust is subject to tax on “distributable net income” retained in trust
 - ▶ Where investment interest is deductible against dividends/gains, reduction in DNI to zero is possible
 - ▶ Gains not included in DNI absent language to that effect in trust instrument or “reasonable application” of fiduciary discretion
 - ▶ DNI is deductible if actually paid to beneficiaries – i.e., not retained
- ▶ Distributions to beneficiaries “carry out” character of trust income so that beneficiaries pay tax (or not) depending on what income is included in DNI
 - ▶ If no “net” dividend income in trust but only gains, distribution of cash to non-US beneficiary may carry out gains to beneficiary
 - ▶ Since gains on sale of non-US shares is exempt from income, beneficiary avoids tax

Estate Tax Inclusion Problem for Non-US Settlor Benefitting from Trusts

- ▶ Non-US Persons subject to US Estate Tax if “own” at least \$60,000 of “US Situs assets” at death
- ▶ US Situs assets include shares in US Corporations
- ▶ All persons (foreign or domestic) deemed to own assets held in trust for their benefit if they settle those trusts and hold that beneficial entitlement at death (but nuances exist)
- ▶ Absent planning, non-US person settling US nongrantor trust for own benefit considered to own all US situs assets owned by trust – i.e., subject to US estate tax at death
- ▶ Thus need a “non-US blocker” to block out US estate tax – such a foreign partnership (not as ideal as historic planning)

Revised Financing Model



- Corporate tax on operations @ 21%
- Dividends taxed at 20%.
- Interest deductible by US trusts as investment interest (i.e., not subject to IRC Sec. 163(j)), such that only “net” dividend income taxable
- Interest not paid to a hybrid entity
- Interest should qualify as “portfolio interest” not subject to withholding
- BVI Partnership = Estate Tax Blocker

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US Business Operations