Impact of US Tax Reform on Cross-Border Estate Planning

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The U.S. tax act enacted in December 2017 includes a number of provisions that impact high net worth families with U.S. connections. For families with U.S. members, changes to the estate, gift and generation-skipping transfer taxes offer gift planning opportunities. For those with U.S. inbound investments, changes to the income taxation of corporations and partnerships may impact how investments are structured. Additionally, families holding business and investment assets through foreign corporations need to consider new taxes that may be imposed on U.S. shareholders.

New Gift Planning Opportunities (For Some)

US Individuals

The act temporarily doubles the amount that a U.S. citizen or domiciliary can transfer free of U.S. federal estate, gift and genera-tion-skipping transfer taxes (collectively, transfer taxes). Effective January 1, 2018, the exemption available to offset these taxes increased to $11.18 million per person from $5.49 million. The higher exemption amounts are scheduled to return to their lower pre-act levels after December 31, 2025.

This temporary increase creates a window for high net worth U.S. citizens and domiciliaries to make gifts to family members or trusts free of transfer taxes. Because any appreciation in gifted assets should be protected from future transfer taxes, a gift of property in 2018 may be a better use of an individual's exemption than a gift in 2025.

Non-US Individuals

The act did not change the transfer tax exemptions available to non-U.S. individuals. Non-U.S. decedents with U.S. situs assets con-tinue to have an exemption of only $60,000 from the U.S. estate tax and a small per-donee annual exclusion from the gift tax, currently $15,000 per donee per year. The act also leaves in place the special succession tax applicable to former U.S. citizens and green card holders known as "covered expatriates." This tax continues to apply to most gifts and bequests from covered expatriates to U.S. persons.

Rethinking Inbound US Investments of Non-US Persons

Inbound Investments Through Corporations

The act significantly reduces the U.S. corporate income tax rate to 21 percent, down from a prior top rate of 35 percent. In addition, corporations generally retain important income tax deductions, such as the deduction for state and local taxes, that the act eliminates for individuals and trusts.

As a result of these changes, one asset that may now make particular sense for non-U.S. individuals to consider holding through a foreign corporation is U.S. real estate. Prior to the act, non-U.S. individuals sometimes preferred to hold U.S. real estate through trusts or partnerships, due to relatively high rates of U.S. income tax imposed on the disposition of U.S. real estate held by corporations. However, at least in certain cases, holding U.S. real estate through a foreign corporation may now result in lower overall federal, state and local income taxes than alternate forms of ownership. In addition, holding U.S. real estate through a foreign corporation may protect non-U.S. persons from the imposition of U.S. estate tax on the value of the real estate.

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The act also changed a rule related to the indirect ownership of so-called “S corporations” by non-U.S. persons. S corporations gener-ally are closely held corporations that, like partnerships, are subject to only one level of U.S. income tax rather than to both an entity level tax and a shareholder level tax. Historically, S corporations have been precluded from having any non-U.S. persons as share-holders, either directly or indirectly through trusts. Certain trusts called “electing small business trusts” that own S corporation shares now are permitted to have non-U.S. individuals as potential current beneficiaries.

Inbound Investments Through Partnerships

The act impacts the sale by non-U.S. persons of interests in partnerships that do business in the U.S., overturning the taxpay-er-favorable decision of the U.S. Tax Court in *Grecian Magnesite*. Under the act, gain recognized by a non-U.S. person on the sale of a partnership interest will be subject to U.S. income tax if a hypothetical sale of the partnership’s assets would give rise to income effectively connected with a U.S. trade or business. The tax is enforced through an initial 10 percent withholding tax on the amount realized on the sale of the non-U.S. person’s partnership interest.

Planning for Foreign Corporations With US Shareholders

The act makes a number of changes to the controlled foreign corporation (CFC) regime. Historically, this regime has required certain U.S. shareholders of foreign corporations to pay tax on passive income that the corporation earns, whether or not the corporation makes distributions.

US Shareholders Subject to CFC Regime

Previously, only those U.S. shareholders owning 10 percent or more of the voting stock in a CFC were subject to the CFC regime. Following the act, U.S. shareholders with 10 percent or more of either the vote or the value of the CFC are subject to the regime.

Elimination of 30-Day Grace Period for CFCs

Prior to the act, a foreign corporation would not be treated as a CFC unless the corporation met certain U.S. ownership thresh-olds for an uninterrupted 30-day period. This grace period was helpful in planning for the ownership transition of a foreign company from a non-U.S. individual to his or her U.S. heirs. Following the death of a non-U.S. owner of a foreign company, the U.S. heirs could be protected from the harsh CFC regime as long as a so-called “check the box” election was made within 30 days of the owner’s death.

The act eliminated this 30-day grace period, effective for tax years beginning after December 31, 2017. Because a check-the-box election generally may have an effective date up to 75 days prior to its filing, it still may be possible to avoid CFC consequences when U.S. heirs inherit stock of a foreign corporation from a non-U.S. decedent. However, the elimination of the 30-day grace period makes testamentary planning for foreign corporations with U.S. shareholders more difficult.

Global Intangible Low-Taxed Income

The act significantly expands the scope of the CFC regime, imposing a new tax on certain U.S. shareholders of CFCs that earn global intangible low-taxed income (GILTI). Although, as the name suggests, the tax is meant to cover intangible income (such as licensing income), GILTI is defined broadly to include many forms of income. As a result, U.S. shareholders of a CFC may now be taxed not only on their share of the corporation’s passive investment income but also on their share of the corpora-tion’s active business income.

The GILTI tax may be particularly onerous for U.S. individuals and trusts that are shareholders of a CFC. While the act permits U.S. corporate shareholders of a CFC to reduce their GILTI inclusions by 50 percent and claim a credit for up to 80 percent of the foreign taxes paid or accrued by a CFC, these benefits generally are not available to noncorporate shareholders. Although these shareholders may be able to elect to be treated as corporations for purposes of the CFC regime, these elections may provide incomplete relief in mitigating the GILTI tax burden to individuals and trusts.

Transition Tax

The act moved the U.S. closer to a “territorial” corporate tax system by providing a 100 percent deduction for dividends received by U.S. corporations from foreign subsidiaries in which the U.S. corporations hold at least a 10 percent stake. To transition to this new system, Congress imposed a one-time transition tax on certain U.S. shareholders of CFCs and other foreign corpora-tions. The transi-tion tax is imposed on certain previously untaxed earnings of the foreign corporation at a rate of 15.5 percent for earnings attributable to cash positions and 8 percent for earnings attributable to other assets. Affected U.S. shareholders may elect to defer the tax and pay it over an eight-year period. While U.S. individuals and trusts owning stock in a CFC will not be eligible for the new deduction for dividends received, they may nonethe-less be subject to the transition tax.