How does the TCJA affect trusts and estates having foreign business:

- Emerging Start Ups
- Update of Existing Structures
- Exit Strategies
- Migration or Death of Grantor or Beneficiary
GRANTOR TRUSTS: §§671-679

U.S. Grantor

- U.S. grantor is subject to U.S. income tax on worldwide income including passthrough income, Subpart F and GILTI inclusions, and PFIC dispositions or QEF.
- U.S. grantor must report contribution to foreign trust on Form 3520. Unless testamentary or sale for FMV, the foreign trust is a grantor trust. §679.

Foreign Grantor

- Foreign grantor is subject to U.S. income tax on U.S. source income and ECI.
- Also consider U.S. gift tax on contributions or U.S. estate tax on death of U.S. situs assets.

U.S. Beneficiary

- Because the grantor pays all U.S. income tax distribution to beneficiary is generally free of tax.
- U.S. beneficiary must report receipt of distribution from foreign trust on Form 3520.
- Other than trust assets includible in grantor’s estate, authorities are inconsistent regarding income tax basis of trust assets after grantor’s death.

U.S. Beneficiary

- IRS has taken the audit approach that there is no step up on death of a US person (citizen or domiciliary) as grantor, unless the grantor trust assets are includible in his estate. CCA 200937028
- However, death of a foreign person as grantor has been found to result in basis step-up for foreign situs assets not included in his estate. See PLR 201245006, PLR 201544002, Rev. Rul 84-139.
Nongrantor Trusts: IRC 641-668

U.S. or Foreign Grantor

- Nongrantor trust is subject to U.S. income tax on worldwide income, and is allowed deduction up to DNI, for FAI distributed to beneficiary. §661.

- DNI means taxable income, adding back distributions but excluding net gains unless paid or credited to beneficiary. §643(a). Capital gain may be included in DNI if, under trust and local law, or impartial exercise of trustee’s discretion, allocated to income; or allocated to corpus and treated consistently, or actually distributed. FAI is determined under the trust and local law. §643(b).

- A domestic nongrantor trust pays U.S. tax on DNI. A foreign nongrantor trust pays U.S. tax only on US source and ECI.

- Also consider U.S. gift tax on contributions or U.S. estate tax on death of U.S. situs assets.

Beneficiary

- Beneficiary include distributions in gross income and is taxable on DNI. The character of DNI is the same for trust as for beneficiary. §652(a), §662(a).

- Basis of in-kind property received by beneficiary is the trust’s basis prior to distribution, adjusted for gain or loss recognized by the trust. §643(e)(1). In-kind distributions carry out DNI equal to lesser of fair market value of basis. §643(e)(2).

U.S. Beneficiary of Foreign Trust

- U.S. beneficiary of foreign trust must report receipt of distribution on Form 3520.

- U.S. beneficiary is subject to income tax on accumulation distributions (known as the throwback tax), at ordinary income rates. §667. Interest is charged at the rate applicable to underpayments. §668. U.S. beneficiary’s free use of foreign trust property, or certain borrowings, are treated as distributions. §643(i)
DEFINITIONS: Controlled Foreign Corporation (“CFC”), Passive Foreign Investment Company (“PFIC”), Pass-Through

**Controlled Foreign Corporation**
- CFC is more than 50% owned by US shareholders, counted only if such US shareholder actually or constructively owns 10% or more of vote or value (pre-tax reform, only vote). §951
- Indirect ownership results in income inclusion. §958(a). Constructive ownership results in CFC classification. §958(b).
- If a foreign corporation is a CFC, the PFIC rules do not apply §1297(d)
- US shareholders of CFC are subject to income inclusion on Subpart F (i.e., most types of passive income) and on GILTI (the remaining active income, under a complex formula). §954, §951A, §250.

**Foreign Pass-Through**
- Entity classification election for eligible entities, not available for “per se” corporations. Regs 301.7701.
- Anti-hybrid proposed regulations. §267A, 245A(e), 1503(d).
- Direct foreign tax credit §901.

**Passive Foreign Investment Company**
- PFIC shareholder is any US person (excluding US shareholder of CFC) directly or indirectly owning stock of a foreign corporation if 75% or more of its gross income is passive, or at least 50% of its assets produce passive income. §1297. Caveat: tax reform causes certain foreign insurance companies to be PFICs. Also see recent proposed regulations.
- “Once a PFIC, always a PFIC,” cannot cleanse the taint in future years.
- PFIC shareholder is subject to US income tax and a draconian interest charge upon any distribution from, or disposition of, PFIC interest beginning after December 31, 1986.
- PFIC shareholder can make a qualified electing fund (“QEF”) election to include income currently; and/or a mark to market election. § § 1293, 1295, 1296.

**Common Problems**
- Business entity or trust: unit trust, civil foundation, privately funded retirement plan, purpose trust, nominee arrangement, escrow agreement.
- Death of foreign grantor of foreign grantor trust.
- Pre-immigration foreign beneficiary.
Domestic income:

- Given the disparity between the U.S. corporate tax rate (21%) and the U.S. individual tax rate (37%), U.S. individual investors have incorporated U.S. operating businesses previously operated through pass-throughs.
- Exception if the principal income to be derived is capital gain (e.g., on a sale), qualified dividend income (“QDI”), eligible for the §199A deduction, or will principally be distributed currently.
Foreign income:

- In the past, foreign investments in many cases held directly or through pass-throughs so that investor received foreign tax credit (“FTC”). In other situations, investors took advantage of deferral and held through CFCs.

- Now it is penal for individual investors to own CFCs directly because limited deferral under GILTI and no FTC and because the tax rate disparity of holding CFC directly (37% on GILTI) or through a U.S. corporation (10.5% less a FTC for 80% of foreign taxes) is even more severe than the 21% vs. 37% tax rate disparity for domestic income.

- Consider the impact of the §962 election for an individual investor in a CFC.
- If high effective foreign tax rate, life hasn’t changed—individual investor may decide to hold directly to get FTC.

- May also decide to hold directly if expect principally capital gains or QDI.
- If low effective foreign tax rate, individual investors may decide to own through a CFC that is owned by a U.S. corporation or make a §962 election—foreign income can get to the U.S. corporation at 10.5% less a FTC for 80% of foreign taxes.
Gain/QDI Assets: Investments (U.S. or foreign) that generate capital gains or dividends that, if held directly by U.S. individual investors, would be subject to 20% capital gains/QDI rate plus 3.8% net investment income (“NII”) surtax should be held directly by U.S. individual investors or through pass-through entities.

Operating Assets: Other investments are expected to generate operating income that, if held directly by U.S. Individual Investors or through pass-through entities, would be subject to 37% U.S. tax (although operating businesses have historically generated losses).

- **High-taxed foreign operating assets**: Should be held directly or through pass-through entities so that investors receive a foreign tax credit against 37% U.S. tax.
- **Low-taxed foreign operating assets**: Should be held through a CFC that is owned by a U.S. C-corporation that is owned by Investors. C-corporation would be subject to GILTI tax at max 10.5% (subject to an 80% FTC).
- **Domestic operating assets**: Consider holding through C-corporation that is owned by Investors, unless income is eligible for 199A deduction or operating income is principally distributed currently. C-corporation would be subject to 21% tax, and distributions from C-corporation would be subject to 20% QDI rate plus 3.8% NII surtax.
SOLUTIONS: US Individual or Domestic Trust Uses Pass-Through or Domestic Holding Company

Unfavorable Results for US Individual or Domestic Trust as US Shareholder of CFC:

The following undesirable results may result for a domestic trust or other US shareholder of a CFC that is not a C corporation, absent a domestic parent or equivalent §962 election:

• No participation exemption for dividends received §245A.
• No foreign tax credit for foreign corporate taxes paid. §901 et seq.
• Inclusion of Subpart F foreign base company sales and services income, foreign personal holding company income (generally passive) subject to high tax kickout and other exceptions. §954 et seq, Subpart F inclusions do not receive qualified dividend rates. Rodriguez v. Commr, 2013-2 USTC 50,420 (5th Cir. 2013) aff’g 137 TC 174 (2011).
• Inclusion of GILTI on active income (subject to high tax kickout, per recent proposed regulations), without any 50% deduction, and without any 80% FTC.

BETTER OPTION: US Individual or Domestic Trust Holds Pass-Through

• Single level of US tax; direct tax reporting and payment liability.
• Access to direct foreign tax credit.

BETTER OPTION: US Individual or Domestic Trust Holds Domestic “C” Corporation as Parent of CFC:

• Participation exemption under §245A for dividends received.
• Subpart F inclusions and GILTI inclusions at 21% corporate income tax rate
• Potentially lower corporate income tax rates for “foreign derived intangible income” under §250 through 2025 or unless Congress changes the law.
• GILTI inclusions receive 50% deduction, and 80% FTC.
• US shareholder may elect to be treated as a domestic corporation under §962 and receive these benefits, but at cost of second level of tax. However, US shareholder does not receive qualified dividend treatment from the deemed US corporation. Barry M. Smith v. Commr, 151 TC 5 (2018)
• Disadvantages: double tax, inflexibility, may be subject to greater vulnerability to future changes of tax law. Consider foreign laws, and state (non)conformity.

ABA Fall Tax Meeting (2019)
Questions worth asking in deciding whether to incorporate

- Will some or all of the income qualify as QDI, qualified business income ("QBI") or long-term capital gain?
- Will the differential between corporate and individual rates remain as large?
- Will the tax rate on long-term capital gain and qualified dividend income (QDI) change?
Questions worth asking in deciding whether to incorporate (cont’d)

• Is it a new business or existing business?

• Will the business generate taxable income or taxable loss in the near term?

• If it is an existing business, do the business’s liabilities exceed the basis of its assets?

• Is the business conducted by a partnership with multiple owners with different tax bases?

• Will the corporation be subject to the accumulated earnings tax (AET) or be treated as a personal holding company (PHC)?
Questions worth asking in deciding whether to incorporate (cont’d)

• Will the owners outlive the investment?

• What are the state & local tax consequences at both the corporate level and the individual level?

• To what extent is the income of the business from foreign operations (as described above)?

• Other considerations:
  • Accounting method (cash v. accrual)
  • Effect on section 163(j) limitation
Deduction Eligible Income means gross income minus:

- Subpart F income determined under §951;
- GILTI;
- Financial services income defined in §904(d)(2)(D);
- Dividends from CFCs;
- Domestic oil and gas extraction income;
- Foreign branch income defined in §904(d)(2)(J); and

then subtracting deductions (including taxes) properly allocable to such gross income.

Foreign-Derived Intangible Income (“FDII”)

FDII = Deemed Intangible Income \times \frac{\text{Foreign-Derived Deduction Eligible Income}}{\text{Deduction Eligible Income}}

For domestic C-corporations that are not RICs or REITs, New Code §250, in addition to providing a deduction for GILTI of CFCs, also provides a deduction for foreign-derived intangible income (“FDII”). The deduction for FDII is 37.5% from January 1, 2018 through December 31, 2025, and thereafter 21.875%. Based on a 21% corporate income tax rate, and after application of this deduction, the effective tax rate on FDII is 13.125% through December 31, 2025, and thereafter 16.406%.

- “Deemed Intangible Income” means the excess, if any, of the domestic corporation’s deduction eligible income, over its deemed tangible income return expressed as 10% of qualified business asset investment:
  \[
  \text{Deduction Eligible Income} - (10\% \times \text{QBAI})
  \]
  QBAI is based on the average aggregate adjusted bases determined quarterly in specified tangible property described in §167, determined using alternative depreciation using §168(g).

- “Foreign Derived Deduction Eligible Income” is any deduction eligible income derived in connection with:
  - Property sold, leased, licensed, exchanged or otherwise disposed to any person that is not a US person for use, consumption or disposition not within the US; or
  - Services provided to any person, or with respect to any property, not located within the US

Special rules for determining foreign use apply to transactions involving property or services to domestic intermediaries or related parties.

- “Deduction Eligible Income” means gross income minus:
  - Subpart F income determined under §951;
  - GILTI;
  - Financial services income defined in §904(d)(2)(D);
  - Dividends from CFCs;
  - Domestic oil and gas extraction income;
  - Foreign branch income defined in §904(d)(2)(J); and

then subtracting deductions (including taxes) properly allocable to such gross income.
Foreign-Derived Intangible Income (“FDII”)

Amount of Deduction

- Deduction equal to 37.5% of FDII (plus 50% of GILTI, if any) for taxable years beginning after December 31, 2017, and before January 1, 2026. For a domestic “C” corporation:

  13.125% effective federal income tax rate on FDII through December 31, 2025
  (assumes corporate income tax rate of 21%).

- Deduction equal to 21.875% of FDII (plus 37.5% of GILTI, if any) for taxable years beginning after December 31, 2025. For a domestic C-corporation:

  16.406% effective federal income tax rate on FDII after January 1, 2026
  (assumes corporate income tax rate of 21%)

- The Joint Explanatory Statement of the Conference Committee, footnote 1524, provides that deductions for FDII and GILTI are not available to S corporations, RICs or REITs.
Foreign-Derived Deduction Eligible Income (“FDII”)

“Foreign Derived”

- property that is sold (including leased, licensed, exchanged or disposed) to any person who is not a United States person and that the taxpayer establishes is for a foreign use; or

- services provided by the taxpayer that the taxpayer establishes are provided to any person, or with respect to property, not located within the United States.