

# Foreign Trusts, the CFC Rules and the new GILTI tax

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# Controlled Foreign Corporations – Basics

- Controlled Foreign Corporation (CFC) = foreign corporation that is more than 50% owned by “United States Shareholders.” Section 957(a)
  - 50% ownership measured by vote or value.
- “United States Shareholders” (U.S. shareholder) = U.S. person who owns directly, indirectly, or constructively 10% or more of a foreign corporation. Section 951(b).
  - 10% ownership measured by vote or value.
- Three major consequences of owning a CFC
  - CFC’s “Subpart F income” and “GILTI” taxed to U.S. shareholders every year
  - CFC’s other income taxed to U.S. shareholders when:
    - Income is distributed as a dividend
    - U.S. shareholders sell the shares
    - CFC invests in US assets – especially by lending to its US shareholders
  - CFC tax compliance (e.g. Form 5471)

# Foreign Trust Ownership of CFCs

- Why do we care in the context of a foreign corporation wholly owned by a foreign trust?
- While foreign trusts are generally treated as NRAs, beneficiaries who are U.S. persons may be deemed to own the foreign corporation.

## CFC – Foreign Trust Indirect Ownership

- For purposes of determining stock ownership (both for measuring CFC status and U.S. shareholder status), we consider direct, indirect and constructive ownership of a foreign corporation.
- Indirect ownership (Section 958(a)):
  - Stock owned, directly or indirectly, by or for a foreign trust or foreign estate shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

# CFC – Foreign Trust Indirect Ownership; Measuring Proportionate Interest

- Treasury Regulation Section 1.958-1(c)(2):
  - The determination of a person's proportionate interest in a foreign trust will be made on the basis of all the facts and circumstances in each case.
  - Example 3:
    - Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation X. By the application of this section, each of D, E, and F is considered to own 30 percent (1/3 of 90 percent) of the stock in X Corporation.

# CFC – Foreign Trust Indirect Ownership; Measuring Proportionate Interest (cont'd)

- FSA 199952014
  - Addresses situation where one or two beneficiaries was to receive all net income.
  - Primary issue was whether actuarial value was an appropriate fact and circumstance in determining indirect ownership of shares.
  - The FSA concludes that the actuarial value of a beneficiary's interest is not a relevant fact or circumstance for purposes of applying the indirect ownership rules.
- Example 3 of Treasury Regulation Section 1.958-1(c)(2) and FSA 199952014 offer little practical guidance given the prevalence of discretionary trusts.

# CFC – Foreign Trust Constructive Ownership

- Constructive ownership (Section 958(b)):
  - Apply constructive ownership rules of Section 318(a) with certain modifications:
    - Stock owned, directly or indirectly, by or for a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.
    - In applying subparagraphs (A), (B), and (C) of section 318(a)(2), if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.

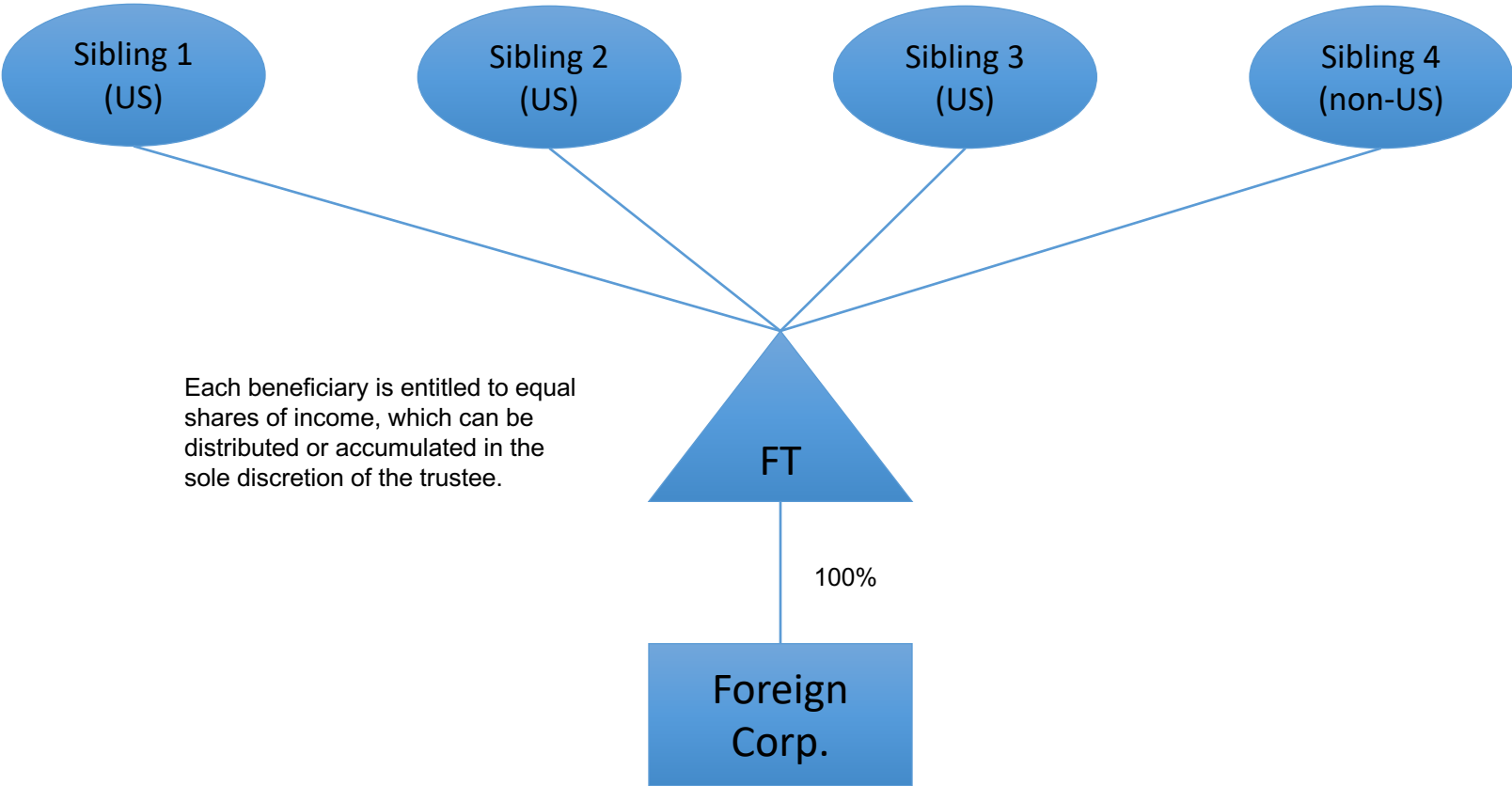
# CFC – Foreign Trust Constructive Ownership; Measuring Actuarial Interest

- Treasury Regulation Section 1.958-2(c)(1)(ii)(a):
  - Stock owned, directly or indirectly, by or for a trust shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust.
- Treasury Regulation Section 1.958-2(d)(1)(ii)(a):
  - Stock owned, directly or indirectly, by or for a beneficiary of a trust shall be considered as owned by the trust, unless such beneficiary's interest in the trust is a remote contingent interest. For purposes of the preceding sentence, a contingent interest of a beneficiary in a trust shall be considered remote if, under the maximum exercise of discretion by the trustee in favor of such beneficiary, the value of such interest, computed actuarially, is 5 percent or less of the value of the trust property.

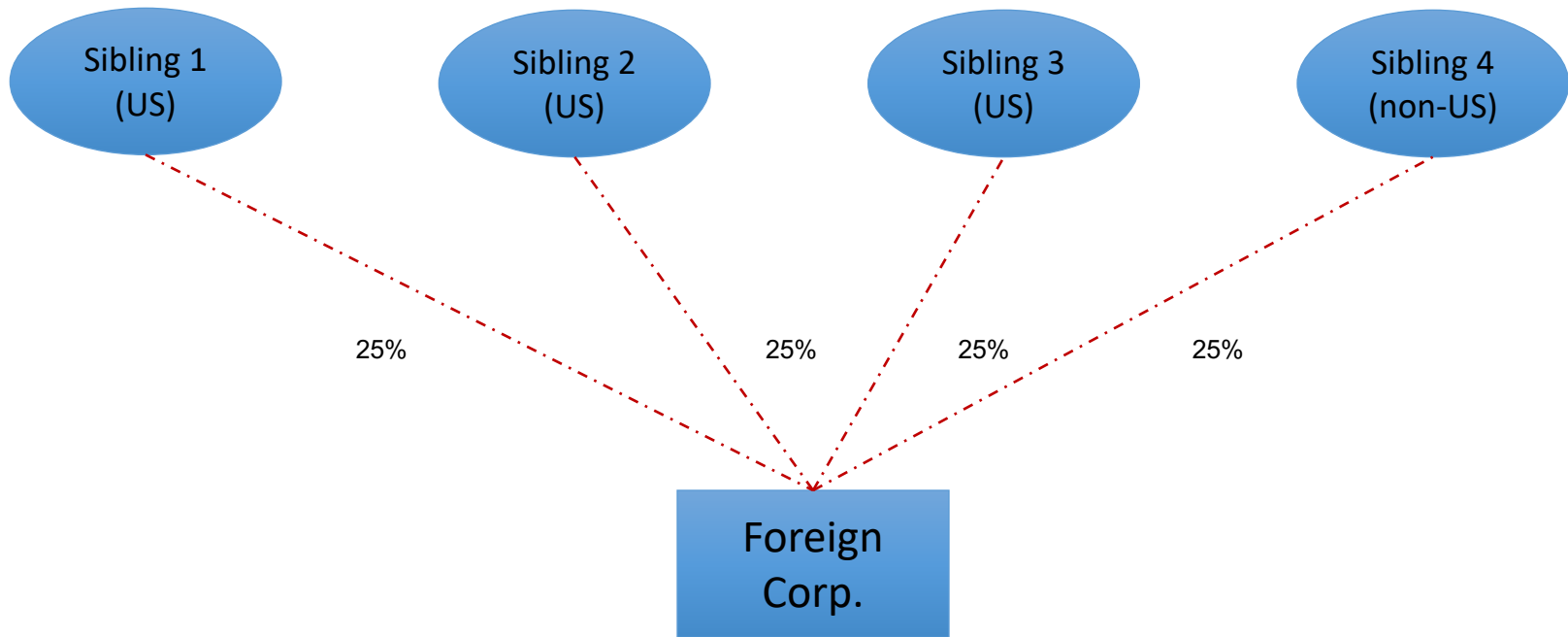


## CFC – Foreign Trust Constructive Ownership; Measuring Actuarial Interest (cont'd)

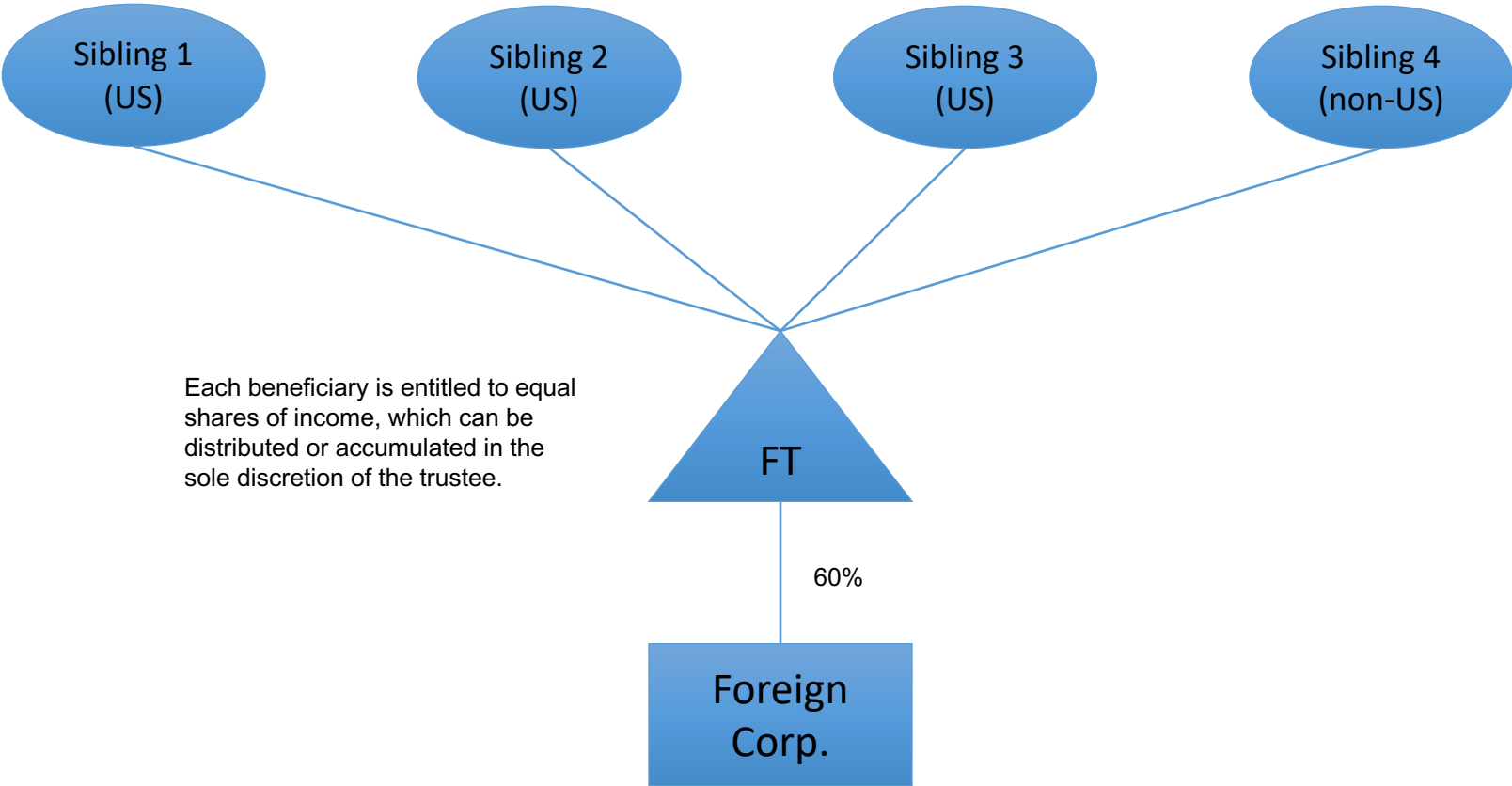
- Treasury Regulation Section 1.958-2(f)(1)(iii):
  - Stock constructively owned by a trust by reason of the application of paragraph (d) of this section shall not be considered as owned by it for purposes of applying paragraph (c) of this section in order to make another the constructive owner of such stock.
- For these purposes, actuarial interests are to be computed using the estate tax rules for valuing such interests. See Treas. Reg. § 20.2031-7 and Treas. Reg. § 1.318-3(b).
- Note: constructive ownership rules only apply with respect to determining CFC and U.S. shareholder status. Those deemed to constructively own CFC shares are not subject to Subpart F inclusions.

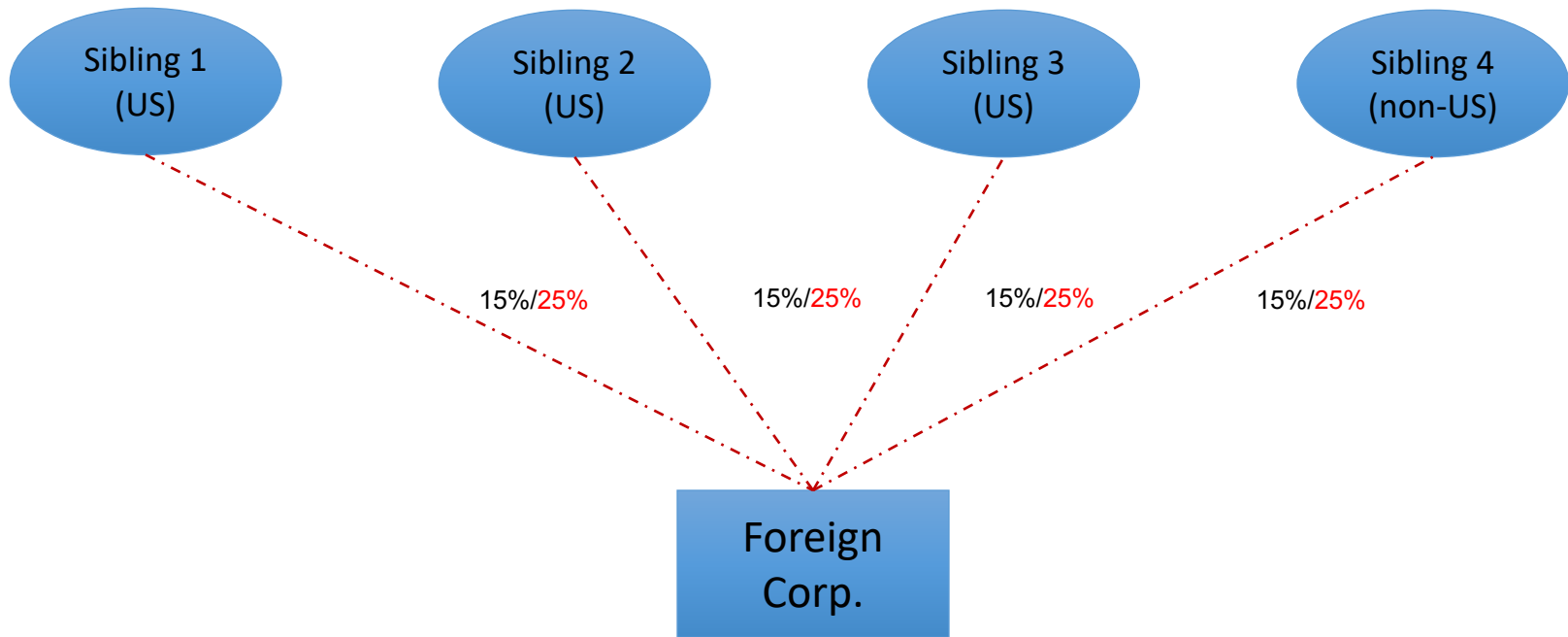


Each beneficiary is entitled to equal shares of income, which can be distributed or accumulated in the sole discretion of the trustee.

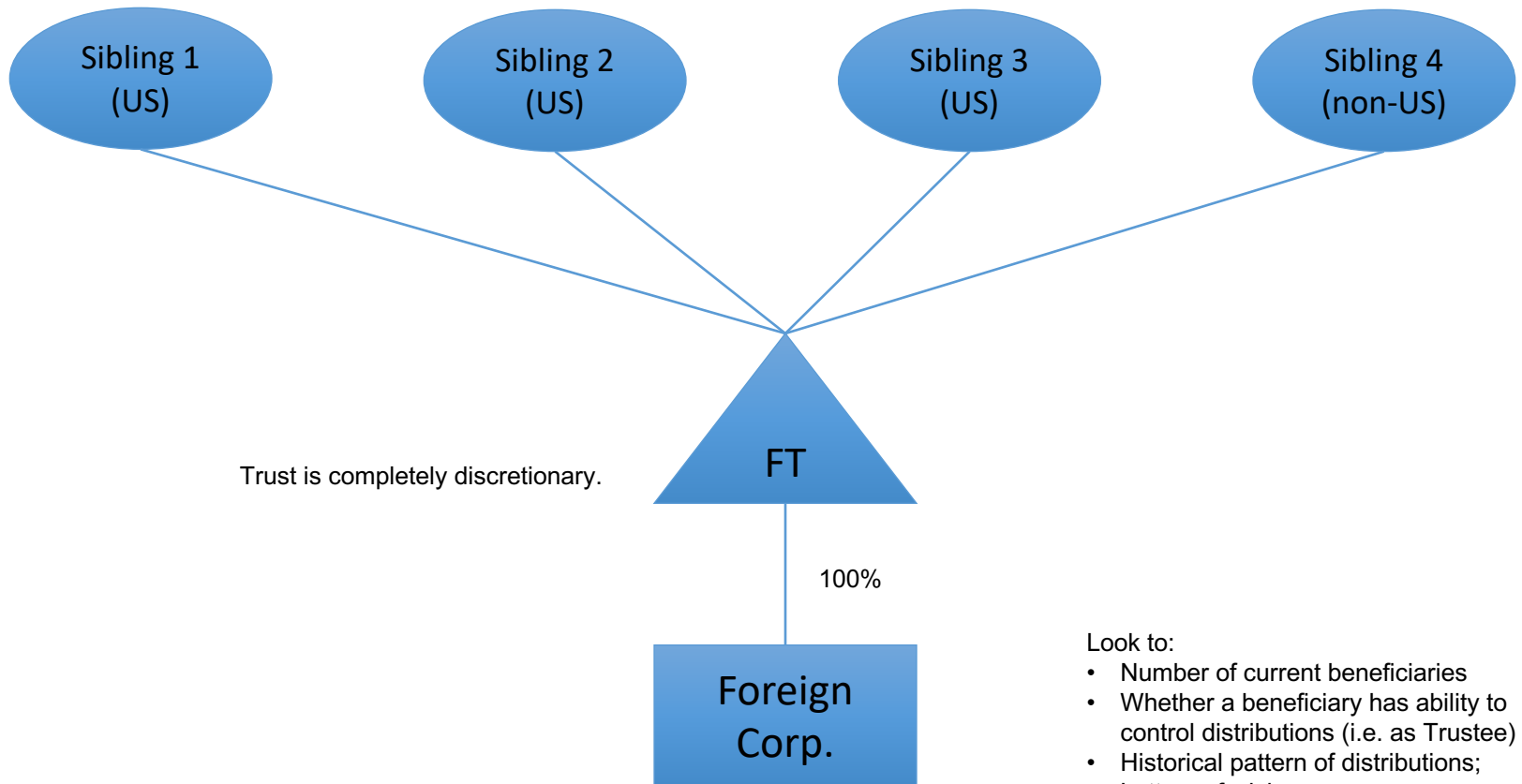


US Persons	Indirect Percent	US Shareholder	Pro Rata Share
Sibling 1	25%	Yes	25%
Sibling 2	25%	Yes	25%
Sibling 3	<u>25%</u>	Yes	25%
	75% = CFC		



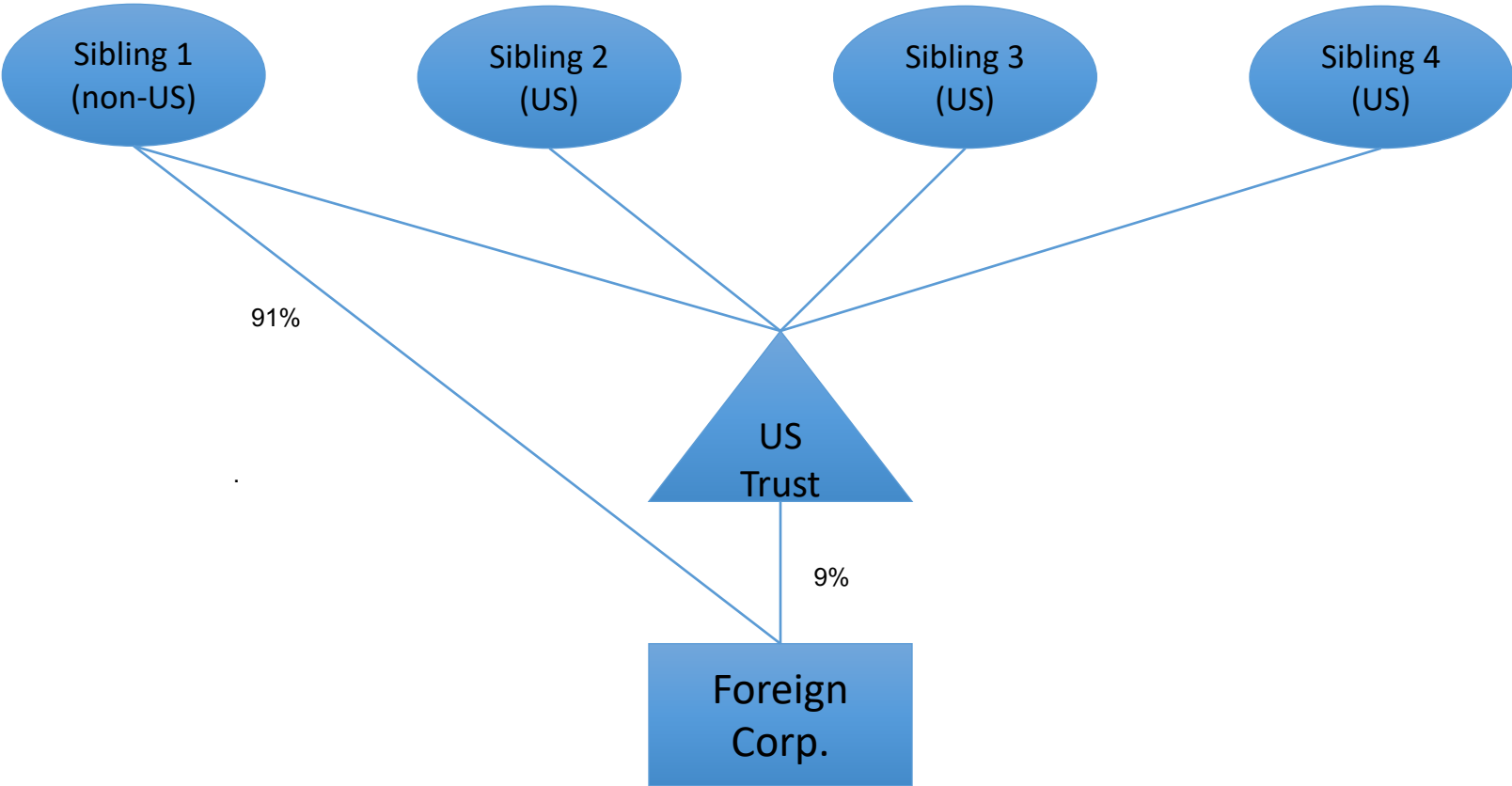


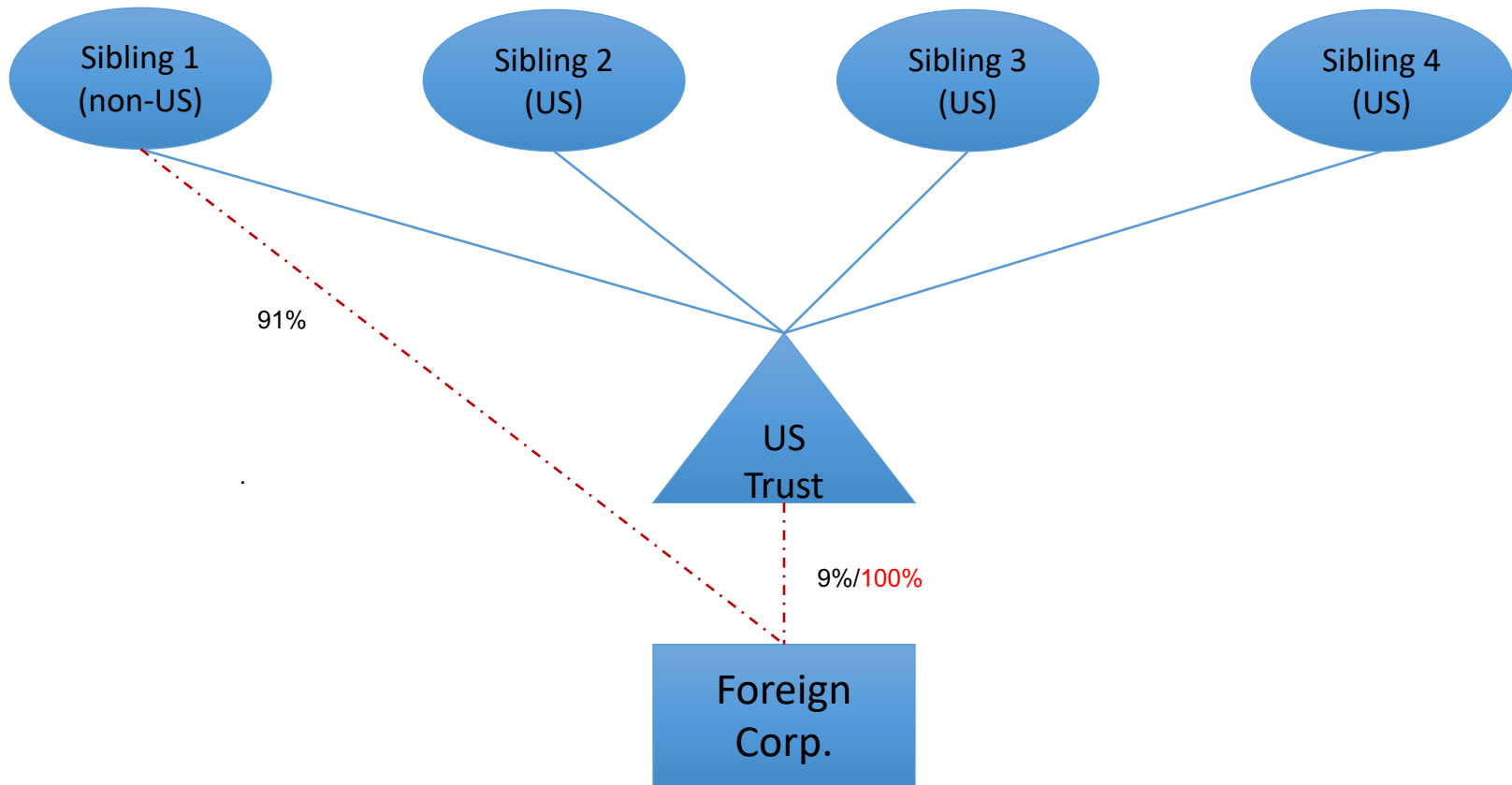
US Persons	Indirect Percent	Constructive Percent	US Shareholder	Pro Rata Share
Sibling 1	15%	25%	Yes	15%
Sibling 2	15%	25%	Yes	15%
Sibling 3	<u>15%</u>	<u>25%</u>	Yes	15%
	45%	75% = CFC		



Look to:

- Number of current beneficiaries
- Whether a beneficiary has ability to control distributions (i.e. as Trustee)
- Historical pattern of distributions;
- Letters of wishes
- Foreign trust law and entitlements of beneficiaries





US Persons	Indirect Percent	Constructive Percent	US Shareholder	Pro Rata Share
US Trust	9%	100%	Yes	9%
	9%	100% = CFC		



# Foreign Trust Ownership of CFCs Open Questions

- Subpart F rules are aimed at U.S. persons with control over a foreign corporation. Do the beneficiaries of the foreign trust above really have control?
  - For the purpose of determining CFC status
  - For the purpose of determining U.S. shareholder status
  - Does the 2017 Act indirectly impact this analysis?
- Is the U.S. beneficiary entitled to vote the shares of the foreign corporation as a trustee or other capacity? Does the U.S. beneficiary have any control over the identity of the fiduciary voting such shares?

## GILTI – Basics

- 2017 Act added new Section 951A, which subjects to income tax a U.S. shareholder's proportion share of a CFC's global intangible low-taxed income (GILTI).
- What is GILTI?
  - CFC net tested income (computed on a consolidated or aggregate basis)
  - Less net deemed tangible income return
- GILTI is not limited to income derived from intangible property and not necessarily low-taxed income either.

## GILTI – Basics (cont'd)

- What is tested income? CFC gross income less:
  - ECI
  - Subpart F income
  - Income that would be Subpart F but for the “high tax” exception (Section 954(b)(4))
  - Dividends received from a related person
  - Foreign oil and gas extraction income
  - Deductions (including foreign taxes) allocated to such income
- What is net deemed intangible return?
  - A CFC’s depreciable tangible personal property (qualified business asset investment) used in a trade or business x 10% (representing a deemed return)
  - Less interest expense

## GILTI – Basics (cont'd)

- U.S. shareholder's proportionate share of GILTI is included in gross income as a Subpart F inclusion.
- U.S. shareholders that are C corporations are entitled to:
  - Deduct 50% (37.5% after 2025) of their attributable GILTI. Section 250(a)(1)(B).
  - An 80% credit for foreign taxes imposed on the CFC's GILTI. Section 960(d).
    - Subject to applicable limitations
    - Section 78 "gross-up" for foreign taxes deemed paid
- All other U.S. shareholders, including U.S. individuals or trusts:
  - Are subject to tax on 100% of their attributable GILTI.
  - No "deemed paid" foreign tax credit is available.

# GILTI – Planning Alternatives and Considerations

- Electing Section 962 treatment.
  - Non-C corporation U.S. shareholders may elect to be taxed on amounts included in income at corporate rates.
  - This permits the U.S. shareholder to take advantage of the foreign tax credit under Section 960(d).
  - The 50% deduction under Section 250 remains unavailable.
  - For foreign trust, this election would be made at the beneficiary level.
- Ownership of CFC through a U.S. C corporation holding company
  - The holding company may take advantage of Section 250 deduction and Section 960(d) credit -- allowing for the deferral of U.S. taxation assuming that foreign taxes eliminated U.S. tax.
  - Other considerations including withholding tax and compliance.
- Structuring new foreign operations in pass-through entities.

# Passive Foreign Investment Companies – Basics

- PFIC taxation was supposed to level the playing field between domestic and offshore mutual funds
- However, definition of PFIC (Section 1297(a)) far broader than a foreign fund:
  - Any company if 75% or more of annual income is passive or average assets in any year are at least 50% passive
  - Once a foreign corporation is treated as a PFIC with respect to a U.S. shareholder, it stays a PFIC even if it later ceases to meet the definition.
  - Tax on PFIC distributions in excess of 125% of rolling 3-year average and gains on sale of PFIC subject to potentially punitive interest charge
  - PFIC dividends are not eligible for qualifying dividend treatment
  - “Qualified electing fund” allows pass-through taxation of PFIC earnings but requires cooperation and information from PFIC

## PFICs – Indirect Ownership

- For purposes of determining stock ownership:
  - Stock owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries. Section 1298(a)(3).
- Under regulations, in any case in which a U.S. person is treated as owning stock in a PFIC by reason of:
  - (i) any disposition by the U.S. person or the person owning such stock which results in the U.S. person being treated as no longer owning such stock, or
  - (ii) any distribution of property in respect of such stock to the person holding such stock,
  - shall be treated as a disposition by, or distribution to the U.S. person with respect to the stock in the passive foreign investment company.

# PFICs – Indirect Ownership; Measuring Proportionate Interest

- TAM 200733024:
  - In the absence of temporary or final regulations under section, apply the facts and circumstances analysis provided under the Subpart F (CFC) regulations.
    - Look to pattern of distributions
    - Letters of wishes or other expressions of Settlor's intent
    - What happens to proceeds from disposition giving rise to excess distribution



# PFICs – Foreign Trust Ownership

- Taxation of excess distributions
  - Excess distributions are spread over prior, pre-PFIC years. If there are pre-PFIC years in the foreign trust's holding period, how are these allocations to prior years treated?
  - Since they are not included in the foreign trust's notional DNI, presumably it can not become DNI. Section 665(a).