ESTATE PLANNING CONSIDERATIONS FOR MULTINATIONAL FAMILIES AFTER THE 2017 TAX ACT

James A. Guadiana

Partner

Barton LLP

February 19, 2020

The Story of P and His Progeny

P is the patriarch of a Swiss family. Over the years P has developed various technologies and a number of processes some of which are the subject of patents obtained on behalf of his wholly-owned corporation (“SwissCo”). These patents, along with other protected technology have come to be known as the “Brand Business” and over the years have continued to be utilized in SwissCo’s businesses of manufacturing products for worldwide distribution as well as licensing such processes to third parties located throughout the world in exchange for royalties.

As a result of his success, P has accumulated great wealth and invested in traded securities (both equity and debt) as well as in private equity funds. Many of these publicly traded securities are issued by US corporations and US Treasury obligations. Other investments include private equity funds which own US portfolio companies. These investments are currently held in a Swiss AG (“InvestCo”) wholly-owned by P personally or by entities established by P for the benefit of his family with discretionary powers held by P.

P's Progeny

P has five children, most of whom attended schools at one point or another in the United States. Some of them met and married US citizens and themselves became US citizens.
Two of the five children are engaged in the Brand Business. One is a Swiss resident and the other is a US citizen. Of the remaining three children, one remained in Switzerland and two are citizens of the United States and reside here.

P, who is only 65 years old is now faced with how to manage the distribution of his assets to his heirs in a manner in which (i) each of his children receive roughly an equal share of his estate but with (ii) the Brand Business being maintained intact and (iii) all assets being distributed and held in the most tax efficient manner.

Brand Business

Obviously, the Brand Business needs to stay intact so that its value as a going concern is maintained. One consideration being weighed by P is the manner of distribution of interests in the Brand. One possibility is to distribute shares only to the children involved in the business. On the other hand, the brand business has developed its management to include some outsiders with the result that the shares themselves could be viewed as an investment that should pass to all the children in the same distribution pattern as other securities held by P. we have assumed herein that has adopted this approach in his estate plan. Also, for reasons beyond taxes, The Brand Business must remain in corporate form.

Thus, P has decided that following his death SwissCo will remain a Swiss holding company with at least two operating subsidiaries, one in Switzerland and the other in the United States. The manner in which profits will be allocated between the two companies turn on the transfer pricing requirements of the OECD's Transfer Pricing Guidelines of 2017 (issued as part of the BEPS initiative). An important consideration here is the location of talent (examining comparative compensation is a factor here). In the current tax environment, Swiss cantonal corporate taxes can be significantly lower than the combined federal, state and local tax rate of the United States. However, the placement of operations globally will be driven more by the location of talent pools and market advantages rather than by taxes.

Securities Investments (InvestCo)

The investment securities held in InvestCo are both equity securities and debt securities, some with foreign issuers but with a substantial portion having been issued by US corporations.

This fact requires us to deal with the tension between avoiding US estate tax for P's estate, while at the same time avoiding corporate (is contrasted to direct with single level taxation) ownership of the securities by the US beneficiaries.

If the US securities were held by a non-US corporation such as InvestCo, it is generally safe to say that no US estate tax would be imposed on such US situs assets. However, if ownership of InvestCo shares by the US children were to come about at P's death, gains and distributions to such heirs would be taxable for the most part as ordinary income under one of the US anti-deferral regimes such as Subpart F if InvestCo were to become a controlled foreign corporation ("CFC") or passive foreign investment company ("PFIC"). This would compare most unfavorably to ownership of such investments directly in asset management accounts or in some form of tax transparent vehicle so that dividends and gains from such investments could be subject to a single level of tax on of gains and dividends at capital gains rates. Even more onerous would be the change in ownership from corporate ownership to ownership by the US shareholders following P's death. Specifically, such conversion following P's death would result in a disposition of InvestCo's assets with the shares of the US heirs in all unrealized historic appreciation in those assets being taxable to the US beneficiaries at that time.

It may be possible for P to hold US debt (and not equity) securities directly at the time of his death as generally no US estate tax will be imposed on such assets. (An exception from US estate taxation is provided by section 2105 of the US Internal Revenue Code.) However, no such exception is provided for equity securities, whether traded or held through private equity funds.

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Repeal of 30-day Rule by 2017 Tax Act

As discussed below, if US Persons inherit more than 50% ofthe shares of a foreign corporation investing in securities, such corporation would become a "controlled foreign corporation" ("CFC") if this were to occur, the historic gains in such foreign corporation would be taxable to such shareholders as ordinary income upon its liquidation (liquidation is desirable so that such persons would then be taxable at capital gains rates with a single level of taxation).

Prior to the Tax Reform Act of 2017, a foreign corporation could avoid such status if it did not maintain that status for at least 30 days during a taxable year. It was then possible to have the US securities held by the foreign corporation at the date of P's death insulated from US estate tax and, at the same time, avoid CFC treatment for the US children so long as a "check the box" ("CBT") election made on Form 8832 be effective within 30 daysof the foreign shareholders death. With this election, the historic gains that would otherwise be taxable to the US shareholders upon liquidation (including by way of CBT) of the corporation would be avoided because the foreign corporation was not a CFC for 30 days in the taxable year.

Following the 2017 Tax Act, this is no longer the case and other alternative method must now be found to achieve a similar result. If P were to divide up the assets of InvestCo between the shares to pass to his US and non-US heirs, planning to avoid this dilemma could be better facilitated.

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Alternatives to Avoid CFC Status for InvestCo With Foreign Partnerships

Techniques using foreign partnerships have been considered by practitioners over the years with some basis in law (albeit less certain than other alternatives we discuss). The reasoning here is that a foreign partnership is still an entity and if respected as such, upon the death of a partner her/his estate would not own the underlying assets with US situs, but rather an intangible partnership interest with its situs at the deceased's domicile (rather than where the underlying assets are located).

For example, if a Cayman Islands limited partnership were formed with P as a 99% limited partner and a 1% partnership interest being held by a corporation he owned, this partnership could hold equity securities and upon P's death, P would arguably not own securities of US issuers but rather a 99% limited partnership interest in a Cayman Islands partnership. P would likely still be entitled to claim income tax treaty benefits on dividends paid by the US issuers since the entity is transparent for Swiss tax purposes. If this approach is followed, it is critical that the partnership take all steps to avoid being treated as engaged in a US trade or business. Assuming that the function of the partnership is principally managing portfolio investments, this should not be difficult to achieve.

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Other Alternatives to Avoid CFC Status for InvestCo

Other methods provide, perhaps, greater certainty than relying on foreign partnership's. However, in adipting one of these methods, isit would make sense to split the securities into 2 separate foreign corporations, one for the benefit of non-US children ("Forco 1") and the other for the US children ("Forco 2"). This will permit tax planning for the US heirs with less complication from the requirements of the non-US heirs. Two possibilities follow:

Churning Equity Portfolio (Simplest Solution). Have Forco 2 periodically churn gains in its portfolio (once or twice a year) so that gains were recognized by the foreign corporation and received a stepped-up basis even though such securities were not subject to US tax. This, of course, has some costs to it. Also, this technique doesn't work well with investments in private equity funds.

Multi Corp Structure. Another alternative is:

- P to contribute the shares of InvestCo to Forco 1 and Forco 2 according to the ratio of intended ownership for his non-US (Forco 1) and US (Forco 2) children. (Neither Forco 1 nor Forco 2l own 80% or more of InvestCo.).

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Other Alternatives to Avoid CFC Status for InvestCo (Cont'd)

- The US shareholders would inherit the shares of the Forco 2 upon the death of P, Forco 2 would file a CBT election with a retroactive effective date just preceding the date of P's death. This would have the effect of InvestCo having made tax-free liquidation distributions to the upper tier corporations which, because they are foreign corporations, would still insulate P's estate from US estate taxation of the securities.

- Due to this liquidation being a "taxable event" (albeit under US rules no tax would be due since the gains are not taxable (the assumption here is that none of the equities are in US real property holding companies) if recognized by a foreign person), the securities would now have a stepped-up fair market basis.

- P's estate and/or the US shareholders could then liquidate foreign corporations, thereby acquiring direct ownership of the securities while at the same time avoiding US tax on most, if not all, of the historical gains which disappeared by reason of the liquidation.

The following diagrams illustrate this alternative:

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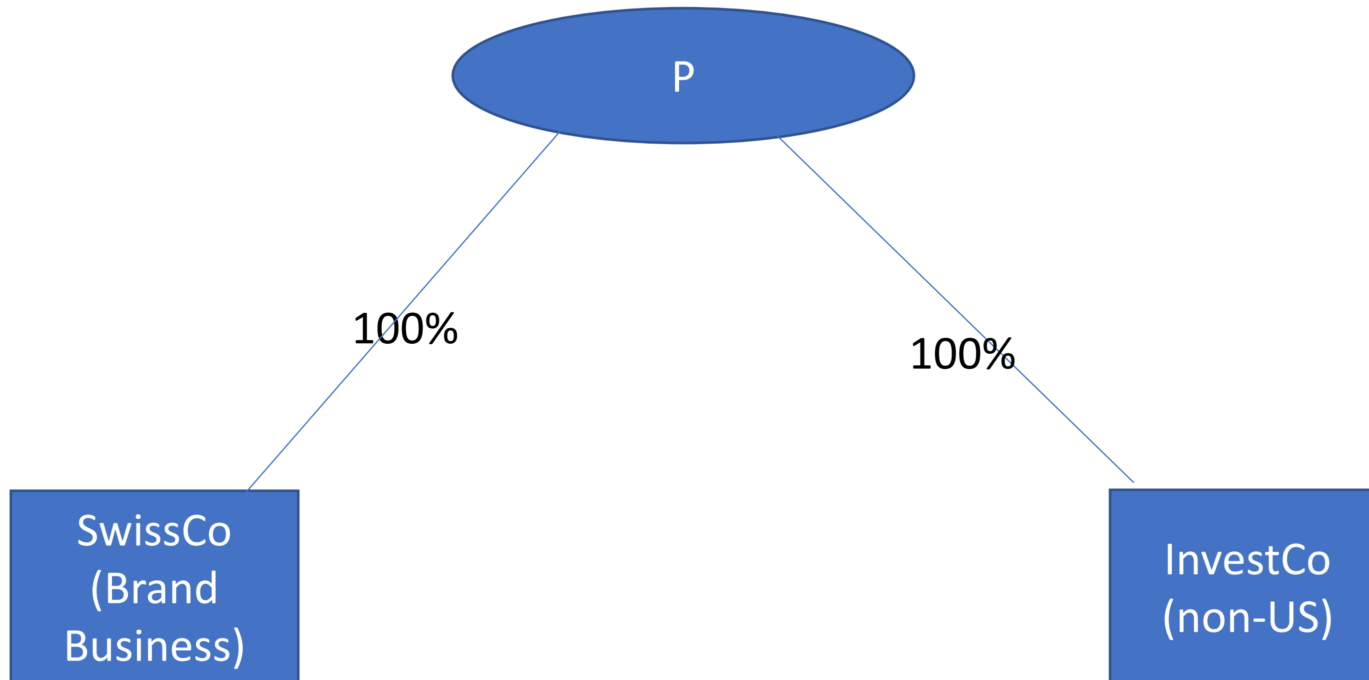
CURRENT STRUCTURE



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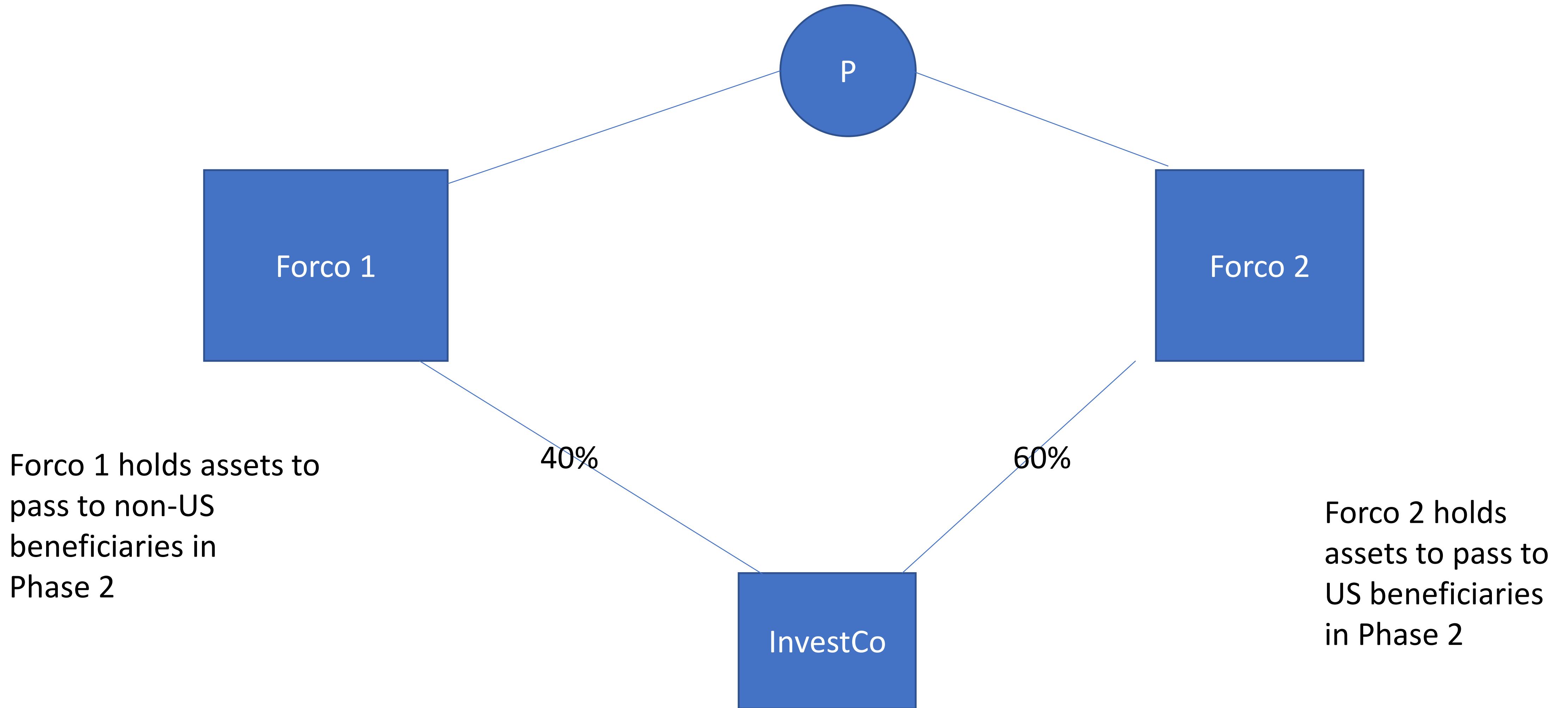
Proposed Structure-Phase 1



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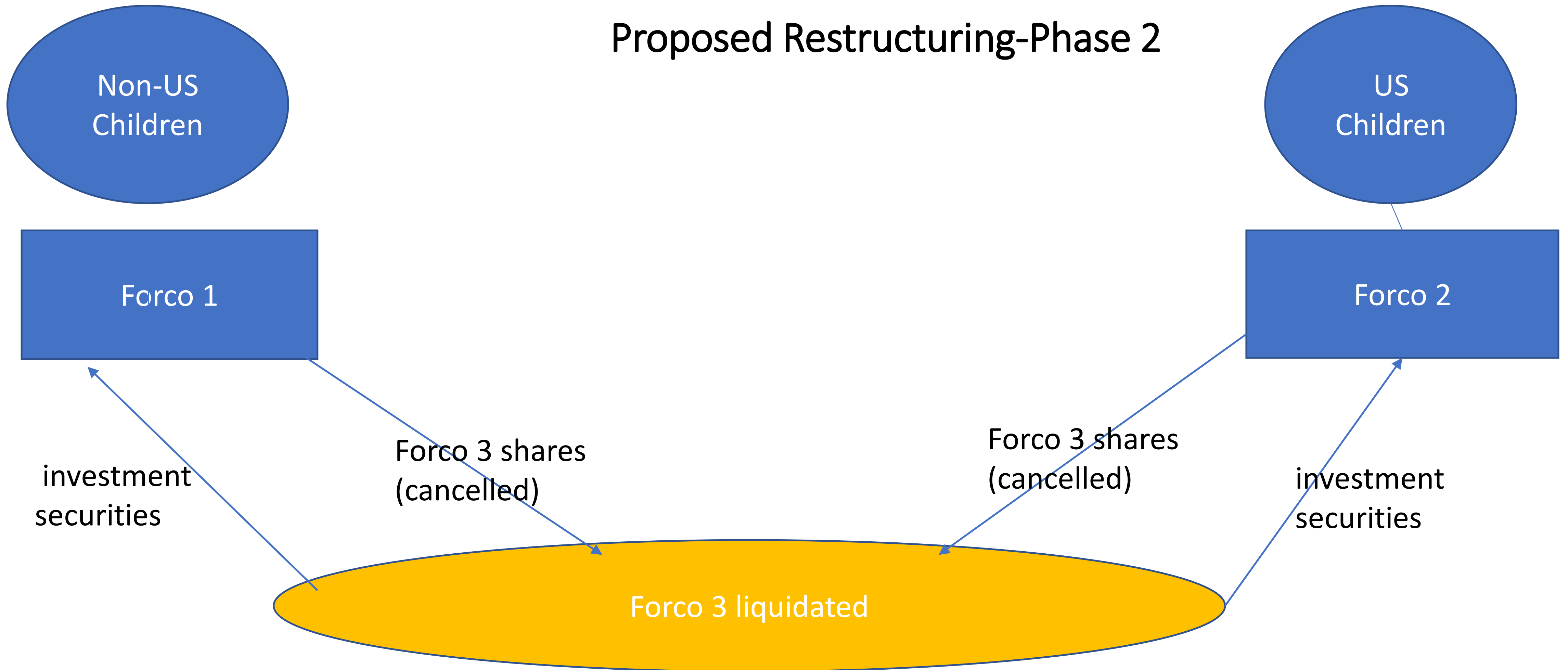
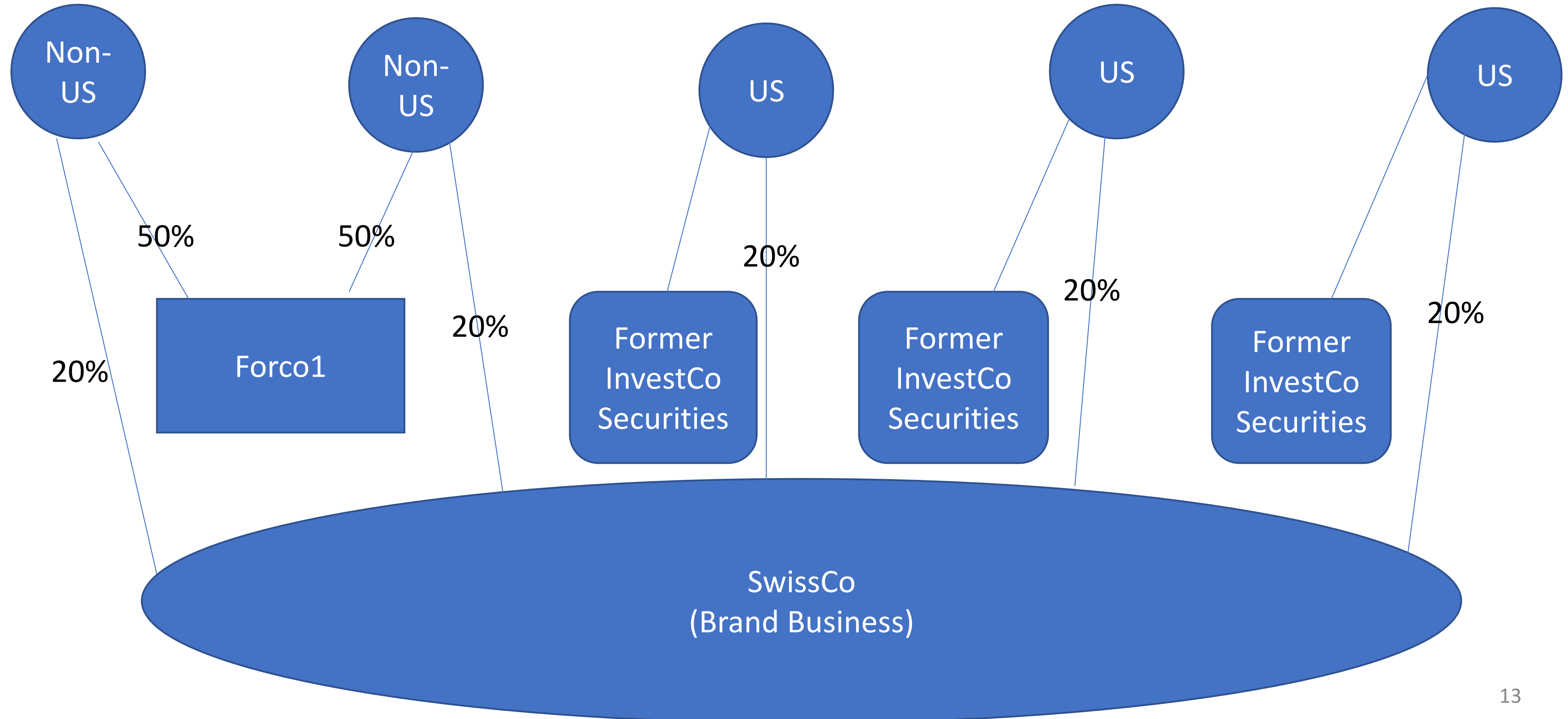
Proposed Restructuring-Phase 2



InvestCo checks the box (CBT) within 75 days of the day preceding P's death. This liquidation results in a deemed disposition of the securities previously held by InvestCo resulting in a newly acquired FMV basis in these securities. However, no US tax is payable because the securities were held by a non US person. Shortly after P's death, Investco CTBs and then dissolves under Swiss law. US children owning Forco 2 recognize no gain on this CBT/dissolution because the Forco shares received a stepped up basis on P's death.

Proposed restructuring- phase three



SwissCo Becomes a US Controlled Foreign Corporation (“CFC”)- GILTI Regime

Because more than 50% (in fact 60%) of SwissCo’s shares are owned by three shareholders , each of which is at least a 10% shareholder (in fact 20%), SwissCo has become a CFC. As a result,

Each US shareholder must include in income taxable as ordinary income his/her ratable share of Subpart F income.

Each US shareholder must now deal with the new GILTI regime introduced by the 2017 Act.

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Treatment of US Shareholders owning SwissCo (Brand Business) Shares:

- The 2017 Tax Act introduced the Global Intangibles Low Taxed Income ("GILTI") tax which will impact US shareholders having at least a 10% ownership interest in a controlled foreign corporation. This new tax was enacted to discourage placement of business operations abroad while taking advantage of the nontaxable dividend treatment under the new participation exemption introduced by the Act.
- Below we discuss three alternatives with respect to the ownership of the SwissCo shares US shareholders.
- Factual assumptions:
  - SwissCo's annual earnings before Swiss tax will be $1000. All earnings ($1,000) are treated as tested income.
  - Subpart F income is 0.
  - The return on SwissCo's net tangible assets is 0.
  - The combined cantonal and federal Swiss corporate rate is 16%.
  - Under the Swiss-US income tax treaty the Swiss withholding tax on dividends paid to a US shareholder which is a company owning 10% of the vote is 5%. Rate is 15% for any other shareholder (including individuals).
  - Remaining cash after Swiss corporate tax is paid out by SwissCo as dividend.

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GILTI-SwissCo Shares Held by Delcorp Owned by US Shareholders

- US shareholders form Delcorp which in turn holds the SwissCo shares. The Act has reduced the US federal corporate tax rate from 35% to 21 percent. In this case Delcorp, in computing its GILTI tax, would be entitled to a deduction equal to 50% of the GILTI amount and would be able to claim an indirect foreign tax credit with respect to 80% of the foreign taxes that SwissCo has incurred.

- Assume that Delcorp has no other US federal tax that would be payable (SwissCo has no subpart F income Also, Good luck youany dividends received by Delcorp from SwissCo would not be subject to the regular federal income tax under the new participation exemption introduced by the Act.

- The tentative GILTI tax before the foreign tax credit would be $105, being imposed at an effective rate of 10.5% (derived from 21% times 50%). However, Delcorp would be entitled to a credit of $118 (which is the lesser of the $160 Swiss tax paid and the tentative US tax of $118 under the foreign tax credit limitation rule), effectively avoiding paying any US GILTI tax. If SwissCo then distributes a dividend of $840 (all available cash) to Delcorp, there would be a 5% Swiss withholding tax which would result in net proceeds to Delcorp of $798 ($840 less $42), which could then be distributed on to its two shareholders. The 5% Swiss withholding tax would not produce a credit in this example because Delcorp has no other foreign source income. The US individual shareholders should be eligible for qualified dividend treatment (effectively taxed as capital gains). Thus, in this example the $798 of profit (after foreign taxes) in SwissCo could result in a qualified dividend which would be further subject to a maximum federal rate of 23.8% or $190. This would yield $608 after the US shareholders' personal federal income tax.

INDIVIDUAL OWNERSHIP WITH/WITHOUT SECTION 962 ELECTION

With Section 962 Election. Under section 962, the individual will generally pay GILTI tax on his or her pro rata share of GILTI as he or she were a U.S. corporation. Thus, the reduced corporate rate of 21% (effectively 10.5% with the 50% deduction) will apply and the individual may claim an indirect credit with respect to 80% of foreign taxes that SwissCo has incurred. As a result, the US shareholder should avoid incurring any GILTI tax. Since SwissCo should be a "qualified foreign corporation", the individual shareholder should be able to claim qualified dividend treatment with regard to the $840 dividend paid by SwissCo to the US shareholders. Since both Switzerland and the United States treat the dividend for regular income tax purposes as being paid directly to the US shareholder, US shareholder should able to claim a credit for the full 15% Swiss withholding tax with a net $705 after all Swiss and US federal taxes. This is slightly better than the above example due to the fact that the Swiss withholding tax was fully credited against any US tax liability.

Without 962 Election. In this case, the GILTI tax of $311 (37% times $840) and the receipt of a cash dividend (which is not subject to further federal tax at the shareholder level) but subject to a 15% Swiss withholding tax ($126), the US shareholders would retain a net after-tax amount of $403.

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Summary of GILTI on Mode of Ownership of Foreign Shares

Starting out with earnings of $1000, and after all Swiss and US taxes, the above examples yield the following after tax cash in the hands of the US shareholders:

US shareholders ownership of SwissCo through Delcorp: $608

Individual direct ownership of SwissCo by US shareholders and 962 Election: $705

Individual direct ownership of SwissCo by US shareholders and no 962 Election: $403

Obviously, these examples are based on specific assumptions which may not apply in all situations. Also, events can change year after year. Thus there is no substitute for careful tax planning.

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Inbound US Investments of Non-US Persons (Without US Heirs)

Before the Act, a foreign investor in US real estate had to consider the trade-off of insulation from US estate tax through corporate ownership in exchange for the significantly lower individual as compared to corporate income tax rates. Now that the corporate income tax rate has been reduced dramatically and is essentially the same as individual capital gains rates (in fact in many cases even lower due to the allowance of deductions to corporations that are denied to individuals), this trade-off is no longer necessary.

Typically, the ownership structure of US real estate by a foreign individual would be to organize a Delaware corporation which would be owned by in turn by a foreign corporation. The Delaware corporation would then acquire the US real estate interest. (The purpose of this to tier structure is to eliminate the compliance requirements of the US branch profits tax and reduce the exposure for the accumulated earnings tax).

If the property is held for rental, dividends could be subject to a 30% withholding tax unless the foreign Corporation and its shareholder are residents of a tax treaty jurisdiction. For example, if a Swiss individual were to own a Swiss Corporation, which in turn owned the Delaware Corporation, the dividends could probably be passed up to Switzerland at a US withholding tax of only 5%. Alternatively, if the real estate is acquired for development and sale, the final sales proceeds would now be subject to a federal income tax rate of only 21%, and so long as the proceeds are distributed as a liquidating distribution, there would be no US tax on the distribution.