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Impact of International Tax Reform Provisions on International Estate Planning

By Henry P. Bubel, Esq., and Jenny L. Longman, Esq.[*]

The 2017 tax reform act,[1] signed into law on December 22, 2017 (the ''2017 tax act'') contains sweeping provisions that drastically change the international provisions of the Internal Revenue Code. This article examines one seemingly minor — but far-reaching — change to the Subpart F rules in the context of international estate planning: the change that eliminates the requirement that a foreign corporation be a controlled foreign corporation for an uninterrupted period of 30 days or more in order for U.S. shareholders of the corporation to be required to include certain income of the foreign corporation (even if not distributed). This change in law places increased pressure on pre-death planning for nonresident aliens with U.S. heirs, and may also provide for renewed attention to the effect of the check-the-box rules on the federal estate tax regime. This article first details the change in law under the 2017 tax act and its application to international estate planning. It then examines planning alternatives and provides an in-depth analysis of the interaction of the check-the-box rules and U.S. transfer taxes.

GENERAL OVERVIEW OF SUBPART F INCLUSION RULES

Subpart F (§951 through §965)[2] contains rules that are aimed at limiting the ability of U.S. taxpayers to defer income earned by certain foreign corporations. The Subpart F rules apply to certain shareholders of so-called ''controlled foreign corporations,'' and require such shareholders to include a proportionate share of certain income earned by those corporations annually, even if such income is not distributed to the shareholders.

Section 957(a) provides that a ''controlled foreign corporation'' (CFC) is any foreign corporation if more than 50% of the total combined voting power or more than 50% of the value is owned (applying special rules) by ''United States shareholders'' on any day during the taxable year of the foreign corporation. Special ownership rules apply to determine ownership through entities and apply constructive ownership principles. Those rules — some of which are changed by the 2017 tax act — are not the subject of this article. As provided in §951(b), a United States shareholder, **post tax reform**, is a United States person who owns, directly, indirectly, or constructively, 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10% or more of the total value of shares of all classes of stock of such foreign corporation. Prior to the 2017 tax act, a United States shareholder was required to meet the 10% voting stock requirement; the new vote **or value** requirement is a significant change in law, but beyond the scope of this article.

Section 951 generally requires United States shareholders who own CFC stock directly or indirectly to include their pro rata share of certain income earned by the CFC annually. Prior to the 2017 tax act, that section contained an important limitation: that such income inclusion is required only if the foreign corporation at issue had been a CFC ''for an uninter-

[*] Henry P. Bubel is of counsel and Jenny L. Longman is counsel with Patterson Belknap Webb & Tyler LLP in New York. The authors would like to thank their colleagues Dahlia Doumar and Rachel Meagher for their contributions.

[1] Formally known as ''An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,'' Pub. L. No. 115-97.

[2] All section references are to the Internal Revenue Code of 1986, as amended (the Code), and the regulations thereunder, unless otherwise specified.

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rupted period of 30 days or more during any taxable year.'' That 30-day limitation provided certain tax planning opportunities, and had been a target of tax reform under the Obama administration. Newly revised §951 contains no such limitation; the inclusion for United States shareholders is now required as long as the foreign corporation is a CFC ''at any time'' during any taxable year.

PRIOR INTERNATIONAL ESTATE PLANNING TECHNIQUE BASED ON 30-DAY LIMITATION

One common planning technique, used in the context of the death of a nonresident alien, relied on the 30-day limitation and is illustrated by the following fact pattern.

A, a nonresident alien individual, is a resident of a foreign country with no or minimal estate tax (causing A to be concerned about U.S. estate taxes, for which he would receive no home country tax credit). A has one daughter, B, who is a U.S. person for federal income tax purposes. A has substantial investment assets, which he holds through a British Virgin Islands company, ForeignCo (an ''eligible entity'' for purposes of the check-the-box rules of Reg. §301.7701-3). ForeignCo is classified as a corporation under the default classification rules because it provides A with limited liability. The investment assets of ForeignCo include U.S. and non-U.S. stocks and bonds. The investments are highly appreciated.

Upon A's death, B inherits the stock of ForeignCo. As a foreign corporation 100% owned by a U.S. person, ForeignCo is a CFC. Absent further planning, B would be subject to tax at ordinary rates on the passive income generated by the investment assets of ForeignCo by operation of Subpart F, whether or not B received distributions from ForeignCo. Further, if ForeignCo disposed of its assets, B would be taxed on the gain attributable to the historic appreciation in those assets, even though B would be eligible for a stepped-up outside basis in ForeignCo stock under §1014(b).

However, if B caused ForeignCo to elect to be treated as a disregarded entity under the check-the-box rules effective within 30 days of A's death, then **under prior law** B would have enjoyed several advantages: B could have avoided Subpart F inclusions going forward. B also could have avoided being taxed on the historic appreciation in the investment assets of ForeignCo upon its dissolution. Upon the deemed liquidation, B would have received (or have been treated as receiving) ForeignCo's investment assets with a fair market value basis.

The 2017 tax act's change to §951(a)(1) eliminates the ability to retroactively elect disregarded entity classification for ForeignCo effective shortly after A's death without consequences under §951(a). If there is little or no net appreciation in the assets of ForeignCo at the time of A's death, then a liquidation or deemed liquidation under the check-the-box rules may still be advisable, as the future income tax benefits are likely to outweigh a modest amount of Subpart F income in the year of the liquidation. If the appreciation is substantial, however, B could have a large Subpart F inclusion. This inclusion would increase her basis in the ForeignCo stock (over and above her already stepped-up date-of-death basis under §1014(b)), and she would wind up with a capital loss, which may or may not be usable — but which could not offset her Subpart F inclusion.

Retroactive Check-the-Box Election Effective Prior to Death

Depending on the composition of ForeignCo's assets, it may be beneficial for B to cause ForeignCo to check the box effective *shortly before A's death* on a retroactive basis. The deemed liquidation would step up the basis of the ''inside'' investment assets of ForeignCo, assuming the ''relevance'' rules under Reg. §301.7701-3(d) were met, and ForeignCo would never become a CFC. A pre-death deemed liquidation might also be preferable if, for some reason, a basis step-up under §1014(b) were not available for the ForeignCo stock. For example, if B's acquisition of ForeignCo did not squarely fall under §1014(b)(1), and thus was said to be acquired under the ''catch-all'' provision of §1014(b)(9), then B would not be eligible for a stepped-up basis in her ForeignCo stock.

We note that the making of a retroactive check-the-box election effective prior to death may raise questions regarding the appropriate signatories for Form 8832, Entity Classification Election. Although it is not entirely clear, in the case where a foreign grantor trust owns the foreign company stock, the trustee — as owner of the foreign corporation for all relevant periods — should have authority to sign the retroactive election. In the case where the decedent owned the shares directly and where there is no foreign executor who has the authority to make such an election, it can be challenging to determine who is the appropriate signatory with respect to the period before death, and it may require advice of foreign counsel.

However, the effect of a retroactive check-the-box election in the estate tax context is unsettled, and there is some risk (which we examine below) that the election could cause any U.S.-situs assets owned by ForeignCo to be includible in A's U.S. gross estate. Depending on the numbers, the income tax benefit of a stepped-up basis and the avoidance of the CFC rules could outweigh any risk of estate tax inclusion of

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U.S.-situs assets, particularly where the inside appreciation is significant, and the value of U.S.-situs assets is relatively insubstantial.

In situations where the income tax benefit does not clearly exceed the worst-case estate tax scenario, the question of the effect of a retroactive check-the-box election on inclusion rules applicable to nonresidents becomes the primary focus.

Check-the-Box Rules in The Estate Tax Context

The check-the-box regulations were issued pursuant to §7701, which defines various types of business entities for purposes of the Code. Those regulations were adopted in order to apply an objective set of rules for determining entity classifications, including elections available to certain ''eligible'' business entities, and apply for ''federal tax purposes.''[3] Importantly, §7701 contains a lead-in limiting the definitions where they would be ''manifestly incompatible'' with the intent of the Code.

In the situation where an eligible entity with a single owner, such as ForeignCo in the example above, checks the box to be treated as a disregarded entity (DRE), effective prior to death, it is treated as liquidating, and its sole owner is treated ''for federal tax purposes'' as owning its assets directly. Where ForeignCo holds U.S. stocks, which are U.S.-situs assets under §2104(a) and subject to U.S. estate tax when ''owned and held by a nonresident not a citizen of the United States,'' there is a question as to whether the check-the-box election causes those underlying assets to be treated as actually held by the nonresident alien owner.

It is clear that for U.S. federal **income** tax purposes, the owner of the DRE is treated as the tax owner of its assets, and federal income tax reporting is consistent with that fiction. However, despite the regulations' reference to ''federal tax purposes'' — as opposed to federal **income** tax purposes — there is considerable authority to support that a retroactive election under the check-the-box regulations does not extend that tax fiction to the estate tax rules.

For purposes of §2033, the value of the gross estate includes the value of all property ''to the extent of the interest therein of the decedent'' at the time of his death.[4] According to long-standing Supreme Court precedent, the determination of what a decedent owns at death — and hence, the extent of a decedent's interest — is typically determined by local law.[5] In general, state or local law determines what is owned by the decedent, and federal law determines how that property is taxed.[6]

One area where reliance on foreign law in determining a decedent's interest in property has surfaced is in the context of community property. As noted in *Estate of LePoutre*, which dealt with the application of French community property rules, ''[t]he legal interest of a decedent in property is determined by the law of the decedent's domicile and whether that interest is includable in the decedent's gross estate is determined by the Federal statute . . .''[7]

The first case to analyze the effect of the check-the-box rules on federal transfer taxation was *Pierre v. Commissioner*.[8] In that case, a taxpayer formed a single-member limited liability company under New York law and did **not** elect to treat the entity as a corporation under the check-the-box rules. Therefore, its default classification was a disregarded entity. The taxpayer created two trusts for the benefit of family members and transferred a portion of her interest in the LLC to each trust. The issue the Tax Court considered was whether the transfer of the LLC interests should be valued as a transfer of proportionate shares of the underlying assets of the LLC (cash and marketable securities) or whether the transfer should be valued as a transfer of interests in the LLC, and therefore, subject to discounts for lack of marketability and control.

The Tax Court outlined the significant Supreme Court jurisprudence analyzing the implementation of the federal gift and estate tax, including the ''fundamental premise of transfer taxation'' that ''State law creates property rights and interests, and Federal tax law then defines the tax treatment of those property rights.''[9]

The court reasoned that while the check-the-box regulations governed the federal taxation of the LLC, they did not apply to disregard the LLC in determining how a donor would be taxed under federal gift tax laws on a transfer of an ownership interest in the LLC.[10]

We note that while *Pierre* dealt with valuing LLC interests for gift tax purposes, the Tax Court's analy-

[3] *See* Reg. §301.7701-3(a).

[4] §2033.

[5] *See, e.g., Morgan v. Commissioner*, 309 U.S. 78 (1940).

[6] *See Aquilino v. United States*, 363 U.S. 509, 513 (1960) (''[I]n the application of a federal revenue act, state law controls in determining the nature of the legal interest which the taxpayer had in the property . . . sought to be reached by the statute,'' citing *Morgan*, 309 U.S. 78 (1940)).

[7] *Estate of LePoutre v. Commissioner*, 62 T.C. 84, 88 (1974).

[8] 133 T.C. 24 (2009).

[9] *Id.* at 29.

[10] *Id.* at 35 (''To conclude that because an entity elected the *classification* rules set forth in the check-the-box regulations, the

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sis necessarily first dealt with the question of **what** was transferred. This concept would also need to be addressed in the estate tax context, and indeed, the Tax Court specifically noted that the federal estate tax is interpreted *in pari materia* with the federal gift tax. Thus, we do not think the gift versus estate tax distinction would affect the analysis, nor do we believe *Pierre* should be narrowly interpreted as applicable only to the valuation of property being transferred.

Pierre continues to be followed in other contexts as well. In *RERI Holdings I, LLC v. Commissioner*, the Tax Court dealt with the valuation of an income tax deduction for a charitable contribution of an interest in a disregarded LLC.[11] The IRS had sought to limit the deduction claimed by treating the contribution as one of a remainder interest in the LLC, as opposed to an interest in the underlying property. The Tax Court cited the reasoning in *Pierre* that, under New York law, the taxpayer did not have a property interest in the underlying assets of the LLC and that federal law could not create a property right in those assets.[12]

Finally, in a recent California case involving an out-of-state corporation's liability for California franchise tax, the court noted that ''*Pierre* stands for the proposition that a taxation election may not control for all taxation purposes in all circumstances.''[13]

Based on the above, we believe there is good support for the argument that what a nonresident alien would be treated as owning at death would be determined under the law of the nonresident alien's domicile, and that a U.S. tax election with retroactive effect would not alter what that individual is considered to have owned at death for U.S. estate tax purposes.

CURRENT LANDSCAPE AND PLANNING STRATEGIES

Given the increased complication of post-death box-checking opportunities as a result of the 2017 tax act, increased pressure is likely to mount on the effect of the check-the-box rules on estate tax inclusion for nonresidents where pre-death planning was not undertaken. Whether such pressure results in guidance is anyone's guess.

In the meantime, several strategies are available where the nonresident alien is still alive that might reduce or eliminate the need to grapple with the question analyzed above. For example, portfolio managers of foreign corporations like ForeignCo in the example above should consider (a) selling investment assets, regardless of situs, thereby ''manually'' stepping up the basis in the inside assets, or (b) reallocating the portfolio in favor of non-U.S.-situs assets. In either case, foreign tax consequences would of course need to be considered. The first strategy would preserve the ability to keep substantial U.S.-situs assets in the portfolio without adverse U.S. tax consequences as long as the assets were sold somewhat routinely in order to avoid significant inside appreciation. The ''wash sale'' rules apply only to loss positions — so if gains were recognized, the same securities could be purchased immediately. As long as the appreciation were kept in check, a post-death check-the-box election could remain available without substantial U.S. income tax consequences, and the question of a pre-death check-the-box election's estate tax consequences wouldn't arise. The downside to this strategy would be increased brokerage fees. If the second strategy were chosen, the portfolio could retain its historic non-U.S.-situs assets, and dispose of most of the U.S.-situs assets, which would reduce the estate tax risk of a pre-death check-the-box election, while preserving the entity's ''relevance'' for purposes of the check-the-box rules. In employing these strategies, U.S. assets and non-U.S. assets might be segregated in different foreign corporations.

Where there are significant U.S.-situs assets, it may also be possible to structure in two tiers to mitigate the U.S. income tax consequences — whereby a lower-tier foreign corporation could own an investment portfolio, and that lower-tier entity would be owned by two upper-tier foreign corporations, 50/50. After the nonresident alien owner of the upper-tier corporations dies, an election could be made to cause the lower-tier company to be treated as a partnership, effective shortly before death. This election would cause the lower-tier entity to be treated as liquidating. As a liquidation of a corporation owned 50/50 by its members, the liquidation would be taxable, as opposed to a non-taxable liquidation under §332 if the lower-tier company had been wholly owned by one upper-tier corporation, and thus should allow for a basis step-up in the lower-tier corporation's assets. Then, the top-tier corporations could check the box effective after death. Although the top-tier corporations would be CFCs, there would be little, if any, appreciation in their assets that would trigger additional gain as Subpart F income upon liquidation. That said, depending on the timing of the decedent's death during the calendar year, there may be some amount of Subpart F income for the U.S. heir to include attributable to the lower-tier liquidation under the pro rata inclusion rules of §951(a)(2). It would be critical to closely ob-

long-established Federal tax valuation regime is overturned as to single-member LLCs would be 'manifestly incompatible' with the Federal estate and gift tax statutes a interpreted by the Supreme Court.'').

[11] 143 T.C. 41 (2014).

[12] *Id.*

[13] *Swart Enters., Inc. v. Franchise Tax Bd.*, 7 Cal. App. 5th 497 (App. 5th Dist. 2017).

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serve corporate formalities of the various entities so as to minimize the risk that the structure could be collapsed.

Another possible alternative that may be attractive, particularly where the nonresident alien's wholly owned entity is a ''per se'' corporation and thus not eligible for check-the-box planning, is to domesticate that entity into a Delaware corporation after death. There should be minimal tax upon the conversion, as there should not be much in the way of an ''all earnings and profits amount'' to attribute to the new U.S. shareholder. As a Delaware corporation owned by a U.S. person, the corporation could elect S corporation status. In order to avoid corporate-level taxation under §1374, the corporation could refrain from selling its assets for five years. Issues related to the excess passive investment income rules of §1375 would also need to be considered if the corporation had any E&P that carried over.

CONCLUSION

By eliminating what was once a relatively simple, post-death planning opportunity that could be used in a variety of circumstances, the 2017 tax act will force practitioners to give considerable thought to pre-death structuring and planning options for nonresident aliens with U.S. heirs, which will necessitate far more custom tailoring. Although the check-the-box rules still allow for some retroactive planning, they can only go so far in optimizing a structure. In the case where an nonresident alien has already passed away, the impact of retroactive check-the-box classification elections on estate tax inclusion may need to be wrestled with. Although we believe there is helpful authority arguing in favor for the principle that a post-death retroactive check-the-box election would not cause estate tax inclusion of U.S.-situs assets owned by a foreign decedent's foreign holding company, the subject is murky, and practitioners' views vary widely.

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