New Tax Law Eliminates 30-Day Safe Harbor Against CFC Status

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The recent tax law changes have focused primarily on corporate income tax, and in the international context, mostly on outbound tax matters. However, certain less publicized changes to the Code's controlled foreign corporations (CFC) provisions will have significant impact on inbound planning issues as well. This article focuses on one change that will greatly impact a traditional planning strategy used by wealthy non-residents who own U.S. equities they wish to leave, on their death, to one or more U.S. relatives. Generally, a foreign corporation is a "controlled foreign corporation" if U.S. shareholders (i.e., U.S. taxpayers who directly or indirectly own 10 percent or more of the foreign corporation's stock) collectively own more than 50 percent of the foreign corporation's stock. Prior law provided a safe harbor against CFC status if the U.S. shareholders owned the requisite amount of stock for less than 30 continuous days during the year. In other words, if the U.S. ownership group owned more than 50 percent of the foreign corporation for less than 30 consecutive days during the year, they could avoid CFC status for the foreign subsidiary. The new tax act eliminates this 30-day exception rule so that CFC status is tested from day one, and tested every day of the year. This change will have a large impact on a very common inbound inheritance planning strategy used by wealthy, senior generation non-residents who wish to leave their U.S. equity portfolio to their U.S. descendants. During the non-resident's lifetime, the U.S. equity portfolio would be owned by a foreign corporation, which would be solely owned by a foreign trust treated as a grantor trust owned by, and therefore taxable to, the non-resident. Upon the non-resident's death, the trust would convert into an irrevocable non-grantor trust of which the U.S. descendants would be the sole beneficiaries. Under prior law, as long as the trust could make a check-the-box election within 30 days of the non-resident's death to treat the foreign corporation as a disregarded entity, U.S. beneficiaries could avoid CFC status. Further, the trust would be able to step up the basis of the U.S. equities as of the date of the election. Then, the trust could either liquidate the portfolio without recognizing significant gain, if any, and distribute the cash to the U.S. descendants, or simply distribute the portfolio to the U.S. descendants and let them sell or hold as they wished. Now that the 30-day safe harbor rule has been eliminated, CFC status is tested immediately upon the non-resident's death. Accordingly, because of the ownership attribution rules, the U.S. descendants are treated as if they own the foreign corporation's stock held by the foreign trust. This means that a constructive liquidation through a check-the-box election (or an actual dissolution) after the non-resident's death leads to a CFC gain to the U.S. descendants, as does a distribution of the portfolio to them. **Possible Solutions in This Changed Landscape** One option is to avoid the problem by simply changing the investment portfolio from taxable U.S. equities to non-taxable items such as U.S. treasury bills. If you've eliminated the U.S. estate tax problem by changing the asset class, then you may not need the expensive offshore structure. Another option is to do the math and compare the tax costs in both scenarios, choosing the bullet you would rather bite. Ask yourself two questions: (1) How much estate tax is due if I check the box on the entity on the day before Foreign Grandma's death? (2) How much Subpart F tax is due if I check the box on the entity the day after Foreign Grandma's death? Then pay the lower of these taxes. It would, of course, be preferable to pay the minimum tax possible, which brings us to your third option: build a better structure before Foreign Grandma dies. Generally, the idea is to introduce a second layer of foreign corporation ownership into the chain between the foreign trust and the portfolio holding company so you can control the timing of multiple check-the-box elections timed around both sides of the settlor's date of death. Generally, you'll want to have two new foreign corporations introduced, each with lower than 80 percent ownership of the underlying portfolio holding company so you can avoid the basis carryover resulting from a Section 332 subsidiary liquidation, and achieve a step-up in basis upon making the check-the-box election on the lower-tier portfolio holding company. But remember, you'll only have a 75-day retroactive window in which to get it right. So, to summarize, the potential solutions in this changed landscape caused by elimination of the 30-day safe harbor from CFC rules fall into three categories: (1) change the premise, meaning change your asset class to non-U.S. situs assets; (2) bite one bullet, meaning pay the lesser of the two taxes which could apply; or (3) rearrange the deck chairs so you can control the timing again, meaning introduce a second layer of foreign corporate holding companies to make multiple check-the-box elections within 75 days of the day before Foreign Grandma's death.

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