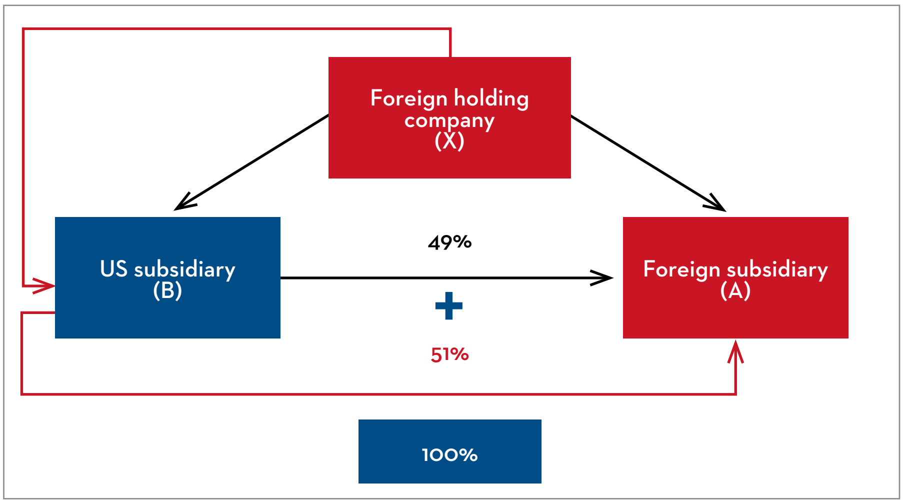
It's time to review CFCs

MARISA STERN AND **PETER HARPER** EXPLAIN HOW THE US *TAX CUTS AND JOBS ACT OF 2017*'S DOWNWARD ATTRIBUTION RULES AFFECT GLOBAL FAMILY OFFICE STRUCTURING

THE US *Tax Cuts and Jobs Act of 2017* (the Act) drastically expanded the reach of US tax laws with regard to non-US citizens and residents. This expansion was primarily achieved through a broadening of the rules on constructive ownership for the purposes of determining whether a non-US corporation is deemed to be a controlled foreign corporation (CFC).

This particular impact of the Act is an issue that has come to the forefront of tax and trust planning, as global persons and family offices can lose a significant amount of their wealth solely by failing to amend their corporate structure in light of the new requirements.



CFC DEFINITION

As per s.957 of the *Internal Revenue Code of 1986* (the Code), a non-US corporation will be classified as a CFC if it is owned by US shareholders who hold, on any day of the corporation's tax year, more than 50 per cent of the company's total voting stock or total value. Under this definition, however, a US shareholder means a US person[1] who owns, directly, indirectly or constructively, 10 per cent or more of a foreign corporation's total value or voting stock.[2]

The Act expanded this definition by removing the ban on downward attribution,[3] a method by which a person can 'constructively own' shares in a non-US company.

DOWNWARD ATTRIBUTION

Downward attribution causes a US person to constructively own shares in a non-US entity (which itself must hold at least 51 per cent of the stock in another non-US corporation)[4] that the US person has an ownership interest in.

EXAMPLE

Prior to the Act's implementation of this rule, a non-US company (Company X) could own 51 per cent of its non-US subsidiary (Company A), and own 100 per cent of its US subsidiary (Company B). Company B could own 49 per cent of Company A without the latter being classified as a CFC for US tax purposes.

Under this scenario, even though Company B is a US shareholder of Company A, the total amount of Company A owned by US shareholder(s) would be less than the 50 per cent threshold to make it a CFC.

Now, however, to determine the amount of Company A that is owned by US shareholders, the Act uses the downward attribution rules to hypothetically assign Company X's interest in Company A to Company B for determining Company A's CFC status (see the diagram above). Company X's 51 per cent interest in Company A is thus attributed downward to Company B.

Now Company B is treated as directly owning 49 per cent and constructively owning 51 per cent of Company A; consequently, Company B, a US shareholder, owns 100 per cent of Company A, making Company A a CFC for US tax purposes.

TAX IMPLICATIONS

A US shareholder of a CFC must pay taxes on the CFC's income in the year that the income is derived, regardless of whether the CFC makes any distributions.[5] The purpose of this rule is to prevent US persons from using non-US corporations to avoid paying tax on income that would otherwise be classified as taxable income had they utilised a US corporation instead.

While on the surface this rule only appears to be primarily applicable to US shareholders, it largely affects global families with companies in various countries. For example, where a family office owns a German holding company with an Australian subsidiary, an Indian subsidiary and a US subsidiary, the Australian and Indian subsidiaries may be classified as CFCs for the purpose of US tax, and the US subsidiary will be subject to tax on its current year earnings.

This increases the family office's tax exposure solely because of its structure. As such, it is imperative for trust and estate practitioners and tax practitioners, both based in the US or with connections to US persons and companies, to be mindful of the cross-border implications of including a US company in their asset structure plans.

1 As per s.951(b) of the Code, a 'US person' is defined as a citizen or resident of the US, a domestic partnership, a domestic corporation, any estate other than a foreign estate without effectively connected income, and any trust over which a US court has primary jurisdiction and that is controlled by one or more US citizens or residents. **2** s.951(b) the Code **3** s.958(b)(4) the Code (repealed in 2017 by the Act) **4** Treas. Reg. 1.958-2(c)(1)(iii) **5** ss.951–965 the Code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