The Good, the Bad, and the GILTI - Ten Takeaways from US Tax Reform for High Net Worth Individuals

The Tax Cuts and Jobs Act (the "Act") introduced significant changes to the taxation of high net worth individuals. The changes affect globally mobile clients and multi-jurisdictional families with US connections. This alert outlines the Act's key takeaways for international high net worth individuals

The Good

(1) Consider planning opportunities for overseas dividends. Qualified dividends of a US individual are generally taxed at a maximum 20% rate while other dividends are taxed at a maximum 37% rate. Dividends from non-US corporations qualify for the reduced 20% rate only if the payor is organized in a country that has an income tax treaty with the United States. In Latin America, only Mexico and Venezuela have income tax treaties with the United States. Therefore, dividends paid to US individuals from companies organized in most Latin American jurisdictions (except Mexico and Venezuela) generally are taxed at the higher ordinary income rates. The Act's modified participation exemption regime and the reduced corporate tax rate of 21% create opportunities for individuals to restructure ownership of non-US corporations to benefit from reduced tax rates. The participation exemption exempts dividends paid by foreign corporations to US C corporate shareholders from US federal tax, which was not the case before the Act.

(2) The lower corporate tax rate is driving new thinking on choice of entity. The Act reduces the US federal corporate tax rate from a top marginal rate of 35% to a flat rate of 21% effective January 1, 2018. The Act also introduced a deduction of up to 20% for qualified business income earned through pass-through entities, which could reduce the top ordinary rate to 29.6%. The pass-through deduction is subject to significant limitations under the tax law and is set to expire in 2026. There are many factors in deciding to invest or operate through a corporate or pass-through entity. For instance, will the business accumulate, reinvest, or distribute earnings? In some cases, a corporation may be subject to punitive tax if it accumulates earnings or does not properly reinvest the earnings in the business. It is important to consider the type of income earned, duration of the business, the tax treatment on exit and liquidity events, and non-US taxes (where applicable). The disparity between the corporate rate (21%) and the maximum individual rate (37%) require clients to consider alternative structures for holding US real estate and other investments.

(3) Increased gift and estate tax exclusion for US individuals. The Act provides immediate relief from estate tax, gift tax, and generation-skipping transfer tax by doubling the exclusion to US$ 11.2 million (expected, as the figure is indexed for inflation) beginning in 2018. By doubling the exclusion, married couples who use portability can shield up to US$ 22.4 million (as indexed for inflation) from estate, gift, and generation-skipping transfer tax. The increased exemption is set to decrease to pre-Act levels in 2026; however, the exclusion may also be reduced before 2026 by future legislation so clients should consider strategic gifting early to ensure that they can utilize the increased exclusion. Non-citizens not domiciled in the US have only a US$ 60,000 exclusion from estate tax and no exemption from gift tax.

(4) New tax incentive for US Exporters. US corporations that exports goods or services may benefit from a special deduction on income earned from non-US markets. This effectively reduces the tax rate from 21% to 13.125%, on qualifying income.

The Bad

(5) US shareholders of non-US corporations face a one-time deemed repatriation tax due this year. The Act imposes a one-time tax, ranging from approximately 8% to 27%, on US persons that own shares of non-US corporations that have non-US earnings and profits that were not previously taxed in the United States. This tax applies to (i) US individual shareholders of a controlled foreign corporation ("CFC"), and (ii) US domestic corporations that own at least 10% of a non-US corporation. A CFC is a non-US corporation that is owned more than 50% (by vote or value) by US persons who each own more than 10% of the corporation (by vote or value). Proper planning can defer the payment of the tax over an eight-year period and in some cases indefinitely. Because this tax applies based on a deemed repatriation, the tax is based on "phantom income" which may not be accompanied by liquidity to pay the tax. US individuals that own CFCs or interests in US domestic corporations that own more than 10% of a non-US corporation should consider this new one-time tax as part of their planning.

(6) There are new rules for determining when a non-US corporation is a CFC. Before the Act, a non-US corporation was a CFC if US persons owned 10% or more of the corporation's voting stock. Under the Act, the corporation will be a CFC if US persons own 10% or more of the corporation by vote or value. Therefore, individuals that own non-voting shares in a foreign corporation can cause the corporation to become a CFC. In addition, the Act expanded the attribution of shares between related parties for purposes of determining whether a non-US corporation is a CFC. This expansion creates tax problems; for example, if a non-US individual owns both a US corporation and a non-US corporation, the non-US corporation may be considered a CFC owned by the US corporation. This would trigger new tax and burdensome reporting obligations for the US corporation. This new attribution rule applies retroactively to 2017 tax years; thus, it may even cause a US shareholder of a CFC to be unexpectedly subject to the repatriation tax.

(7) New challenges for non-US individuals with US beneficiaries. Before the Act, a US person was subject to adverse CFC rules only if the CFC was a CFC for at least 30 days. The Act eliminated this 30 day rule and with it eliminated a strategy of liquidating an inherited non-US corporation within 30 days of the decedent's death. This technique prevented non-US corporations holding US securities from being treated as a CFC in the hands of the US family members.

(8) New limitation on interest deductions. The Act introduced a new interest deduction limitation rules that can apply to limit the deduction of business interest on debt regardless of whether the lender is related or unrelated to the borrower. The Act's limitation on the deduction of interest will affect many leveraged businesses. These limits are considerably harsher than the limits on interest deductions under the prior law. However, there are exceptions under the new provision for small businesses, and certain real estate and other specified businesses.

(9) A non-US Partner's sale of a partnership interest may result in additional tax. A non-US partner's gain on the disposition of its partnership interest will be treated as income effectively connected with a US trade or business to the extent the non-US selling partner would have been allocated effectively connected income if the partnership sold its underlying assets in a hypothetical sale. Additionally, a 10% gross withholding tax applies to the transferee/buyer of the partnership interest, with the partnership subject to potential additional withholding obligations. The non-US partner will need to file a tax return to report and pay the tax, as well as to claim any applicable refund if the tax calculated is less than the tax withheld at the time of the sale.

The GILTI

(10) Feeling GILTI? US shareholders (including individuals) that own 10% or more of a CFC are subject to tax under a new regime designed to tax global intangible low-taxed income ("GILTI"). "Intangible income" is misleading because GILTI tax applies much more broadly. Specifically, GILTI tax applies to the excess of a CFC's income over a deemed return based on the CFC's tangible depreciable assets (e.g., buildings). Accordingly, the GILTI tax can apply to many non-US companies that do not have significant tangible assets, such as investment management, consulting accounting, financial advisory, engineering, distributors, internet-based, and IP-rich businesses. US shareholders of CFCs should evaluate their GILTI exposure and consider planning opportunities. An individual moving to the United States should consider GILTI as part of pre-immigration planning if he or she owns an interest in a corporation that will become subject to GILTI.

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