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Tax Cuts and Jobs Act: Impact on Chinese clients' wealth and business interest planning

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The 2017 U.S. tax reform has a disproportionate, significant impact on Chinese clients that have a nexus with the U.S. because of their unique wealth composition and cross-border economic activities. Among other things, Chinese clients' U.S. inbound investment structures and Asian business holdings should be reviewed and adjusted to minimize newly imposed U.S. tax and reporting obligations.

With the Tax Cuts and Jobs Act (P.L. 115-97, December 2, 2017) (TCJA), the U.S. tax law witnessed the most sweeping changes in the last three decades. While the TCJA has made major changes to individual taxation of U.S. residents, including tax brackets, marginal tax rates, deductions and exemptions, the modifications to the business and international tax rules will have an equally far-reaching impact. As a starting point, domestic U.S. business structures with U.S. owners, U.S. individuals and their overseas business and asset holding structures ("outbound structures"), and international clients' U.S. investment structures into the U.S. ("inbound structures") will all need to be reviewed and adjusted to achieve U.S. tax efficiency under the new tax rules.

This article will focus on the impact on Chinese clients having certain nexus with the U.S. All affected outbound and inbound structures will need to be reviewed for such impacts, including holding and investment structures consisting of direct ownership, trusts, and various business entities whether they are treated as pass-through and transparent or corporate and "opaque" (including variations in between) under relevant U.S. tax rules.

In fact, odd as it may seem, the new U.S. tax rules have a disproportionate impact on Chinese clients moving to or investing in the U.S., given the Chinese families' distinctive profiles, wealth composition, and economic activities. The discussion below reviews typical fact patterns applicable to Chinese clients, analyzes how holding and investment structures would be affected by the new tax rules, and discusses how residency planning will be even more important in such cross-border structuring.

Both outbound and inbound issues are significant to Chinese clients depending on how their nexus with the U.S. is created. In many respects, outbound concerns will have even more of an impact on Chinese private clients.

Below are a few general overview points, a couple of which may seem counter-intuitive at first:

(1) It is well publicized and has been discussed that corporate structures in general are marginally more cost-effective entities due to reduced corporate tax rates, expansion of the dividends-received deduction with respect to their holdings of non-U.S. companies, and repeal of various individual deductions and exemptions.

(2) Notwithstanding that various provisions were enacted as part of the TCJA to encourage "U.S. persons" **1** to use U.S. entities and maintain assets within the U.S., such provisions have in some respects encouraged the use of non-U.S. corporate entities. For example, itemized deductions for individuals, including many investment expenses, have been reduced greatly. In contrast, deemed income under Subpart F **2** is taxed on a net basis. As a result, the lower net income may offset the normal disincentives of earning Subpart F income through a controlled foreign corporation (CFC). **3** If an individual incurs $100,000 of nondeductible costs and $1 million of ordinary income, he could owe $370,000 of federal income tax if he holds the assets directly. As Subpart F income is taxed at the highest ordinary tax rates, income earned through a CFC would be subject to a similar tax rate but the income taxed would be lower resulting in a potential tax of $333,000. At some amount of expense, the net tax base of Subpart F income will offset any rate preferences otherwise available to individual investors holding investments directly.

(3) Due to changes in the rules governing the deductibility of interest, highly leveraged structures will view corporate borrowing alternatives as

marginally less appealing than under prior law, although debt remains preferable to equity for capitalization purposes. But U.S. corporations will have more taxable income from operations in early years as a larger portion of the interest deductions will be deferred.

(4) Residency planning is now even more important than it was before the enactment of the TCJA, and clients should use tax treaty protections (if available) and not rely solely on the crediting system available to U.S. persons. Also, considering how frequently Chinese families split residency (e.g., one spouse remains in China to continue managing a business while the other spouse moves to the U.S. to oversee their children's education), it is even more important to address the ownership of family assets including possible use of "foreign grantor trusts." **4**

(5) The U.S. created numerous tax incentives to encourage the use of U.S. corporations over foreign corporations. These provisions (including but not limited to global intangible low-tax income (GILTI), base erosion and anti-abuse tax (BEAT), and foreign-derived intangible income (FDII), discussed below) are complicated and, intentionally or not, they also incentivize substantially U.S. corporate ownership of foreign companies over individual or pass-through entity ownership.

(6) Counterintuitively and possibly not contemplated, the new rules (the GILTI provisions in particular) will increase the U.S. income tax due from active non-U.S. business operations that could previously generate no taxable income at all (this will substantially alter the calculus of not only operating structures but decisions as to how to make non-willful disclosures for prior years). In addition to increasing the tax due, this may increase penalties from inadvertent failures to report all foreign income and assets (many Chinese clients are unfamiliar with U.S. rules and are surprised by the extent and amount of deemed income and phantom income that is required to be reported). The IRS allows certain U.S. individuals who have failed nonwillfully to report income accurately to come forward under one of two streamlined disclosures processes, **5** and because much Chinese wealth is still in the first generation of creation, such procedures often would not trigger significant income tax liabilities, which will no longer be the case. **6**

This article is an overview of issues likely to arise. Many of the specific regimes and their interactions are complex enough to require significant discussion independently. Also, while interesting, more academic issues such as the constitutionality of deemed income **7** and potential World Trade Organization (WTO) claims are not discussed. Lastly, the transfer tax regime changes are relatively minor but are affected significantly to the extent that alternative structures are used for income tax efficiency reasons. These points are addressed where relevant.

Overview

Typical Chinese individual-profiles and wealth composition

In international wealth planning, some distinctive features clearly set Chinese clients apart from, for example, Latin American, European, Russian, and Middle Eastern clients. These differences have strong impacts on recommendations for appropriate investment structures and other planning advice.

China is creating an extraordinary amount of wealth at an astounding pace. As a result, and in view of the relatively recent relaxation of traditional communist views of asset ownership, Chinese high-net-worth individual clients are mostly active entrepreneurs (i.e., China has much less dynastic or inherited wealth). The following are frequent fact patterns for Chinese clients that the authors advise:

(1) Most Chinese high net worth individuals are the first generation (in recent times) to have significant wealth and most have substantial non-U.S. active business interests. For these clients, personal tax planning is almost always intertwined with international business interest planning.

(2) Wealthy Chinese families often send their children to "western" countries (e.g., the U.S., U.K., Europe) for education. Mothers move to be near the children while they are in school. Not infrequently, in a Chinese entrepreneur family, the husband and wife built the business empire together and have almost equal shares in the business and associated assets and interests. In this scenario, particularly when the U.S. is the country where the children are educated and where their mother lives, significant U.S. tax and reporting issues arise due to the family's business interests in China.

(3) Many of the Chinese families that the authors see contain a mix of individuals who would be treated as U.S. persons as a default matter under U.S. tax rules, and individuals who would not. This increasing global mobility represents a challenge and sometimes an opportunity. Use of prospective residency planning and appropriate asset transfers allow an international entrepreneurial family to arrange their global assets more efficiently from a U.S. tax perspective.

(4) Many Chinese clients with U.S. green cards maintain substantial ties with China and have the bulk of their assets (primarily in the form of corporate interests) in Asia. Chinese clients are increasingly considering a proactive "exit strategy" (i.e., how their immigration and tax issues should be managed when they cut ties with the U.S. in the future) at the outset.

(5) Since the first generation of wealth is still growing actively, compared with many international clients from other jurisdictions, Chinese clients' wealth is concentrated heavily on interests in operating companies that generate mostly active income from operations taking place outside the U.S.

(6) Conventional trust planning techniques used regularly for other international clients may not be available directly to Chinese clients, especially if the relevant assets are Chinese real properties or shares in Chinese public companies. **8** Chinese restrictions on outbound capital and ownership of Chinese assets by non-Chinese, combined with the way that Chinese law treats a common law trust and how the Chinese securities regulators approach public company shares held by a trust, raise special multi-jurisdictional issues that cannot be taken lightly.

The list can go on, but the above represents many of the most important recurring features that the authors see among Chinese clients that cause the new U.S. tax rules to affect them significantly.

Typical Chinese individual-U.S. nexus

From a U.S. income tax perspective, Chinese clients' nexus with the U.S. can usually be classified in one of two ways: (1) as potential acquisition of U.S. residency when key family members are in the U.S.(e.g., one or more family members either spend a significant number of days in the U.S., obtain a U.S. green card, marry a U.S. person, or have children in the U.S.); or (2) they invest in the U.S. either directly with family private wealth or indirectly through family-owned foreign companies.

The first category of nexus raises several outbound issues, which refers generally to rules applicable to U.S. persons owning non-U.S. assets such as the rules relating to CFCs and passive foreign investment companies (PFICs), as much of the family wealth often remains outside the U.S. and the TCJA altered substantially the tax regime governing these structures. **9** The second category implicates more directly inbound issues, referring to U.S. taxation of U.S. investments by non-U.S. persons, which were also affected substantially by changes in tax rates, **10** expensing and deduction provisions, **11** and the new pass-through entity tax regime. **12**

Importance of Residency Determinations

As with other international clients, Chinese clients always need to determine and control their U.S. tax residency carefully. For private clients, this determination is complicated slightly because the U.S. has two separate tax regimes on which the authors almost always advise together: (1) the U.S. income tax regime, and (2) the U.S. estate, gift, and generation skipping transfer tax regime (the latter is collectively referred to in this article as "transfer taxes" or the "transfer tax regime").

Residency is determined separately under the income tax and transfer tax regimes and the rules governing residency status are quite different under each regime. For U.S. citizens and residents, reporting and tax rules under both regimes apply on a worldwide basis. For nonresidents, these rules apply only with respect to certain U.S.-source income and U.S.-situs assets.

Generally, a Chinese individual client would be a U.S. income tax resident if he is (1) a U.S. citizen; (2) a green card holder (unless claiming a residency tiebreaker under the U.S.-China income tax treaty); **13** or (3) physically present in the U.S. for sufficient time (i.e., meets the "substantial presence test," which is also eligible for tiebreaker under the treaty as well as the Code). **14** In practice, many Chinese green card holders maintain strong ties with China while splitting time between the U.S. and China and so would qualify as non-U.S. residents for the treaty tiebreak position. **15** Unfortunately, many are not advised of the availability and practicality of taking such position and this will need to change going forward. Residency planning has always been the cornerstone for international clients.

A Chinese client would be a U.S. transfer tax resident (or domiciliary) if he has the intent to stay in the U.S. indefinitely. This is a fact-intensive and subjective test. **16**

A client's income tax residency and domicile status can occasionally be different. Also, possession of a green card is not definitive in determining whether a Chinese client is domiciled in the U.S., as many retain substantial ties to China. **17**

In light of certain deemed-income inclusion rules under the TCJA, the residency determination under both regimes is, if anything, even more important than it was previously. Residency (an income tax concept) and domicile (a transfer tax concept) are important because they determine whether Chinese clients would have relevant U.S. reporting and tax concerns with respect to non-U.S. assets on a worldwide basis. The new deemed-income rules of the TCJA, particularly the GILTI rules, mean that U.S. persons who own non-U.S. operating businesses would now have taxable phantom (albeit active) income from such operations,whereas under prior rules such active income was subject to reporting but not taxation obligations. This tax caused by the GILTI rules is imposed on the individual shareholder (who often owns shares indirectly through intermediate entities) and not on the Chinese (or other non-U.S.) company. This phantom income will be a major problem for many Chinese clients who may not have significant liquid assets outside their primary operating company in China (i.e., in certain instances they will not have the cash flow to satisfy associated tax liabilities).

Inbound Considerations

To the extent that a Chinese family's U.S. nexus is caused by investments in the U.S. (independent of any residency concerns), what is needed is typical "inbound planning." Following the flow of money, there are primarily two levels of analysis and planning that should be considered.

At the first level, funds should flow into the U.S. through a structure that will eliminate U.S. transfer tax (or minimize it when elimination is not possible due to the nature of U.S. assets) and will serve as an upper-tier structure to facilitate lower-tier income tax planning. At the second level, and dependent on the client's specific economic activities, investment structures should be devised properly and dovetail with the upper-tier holding structure. The specific investments that the authors see most frequently for our Chinese clients are (1) U.S. real estate (both passive investment holdings and active real estate development); (2) passive fund investments; (3) active joint venture investments; and (4) acquisition of operating companies' shares. Again, the new U.S. tax rules may have a significant impact on Chinese clients' inbound investments.

New income tax rules-impact on inbound investment

The two provisions of the TCJA having the most significant impact on Chinese clients' inbound capital flow structuring relate to reduced corporate tax rates and limits on interest deductibility. The headline item of the TCJA was of course the reduced corporate tax rates **18** and this obviously affects choice of entity and makes corporate form significantly more appealing. The second main item of interest in this area is the new limits on interest deductibility, which will affect capital structure, as the decision to fund with debt rather than equity will be marginally less appealing. **19**

That said, several of the new tax rules affect inbound investment (obviously, other provisions can have an "inbound" impact but those below cover the most significant provisions in this area): **20**

(1) Lower corporate tax rates- Section 11 .
(2) Creation of new pass-through business entity deduction-new Section 199A .
(3) Revisions to interest deductibility- Section 163(j) .
(4) New expensing allowances- Section 179 .
(5) New rules governing international payments to related corporations.

The the TCJA reduced the corporate tax rate from 35% to 21%. **21** This change very clearly makes the holding of investments and businesses in corporate form more efficient than was the case previously. That said, no changes were made to the rules on the taxation of dividends, liquidations, and redemptions so corporate form still carries the associated cost of two levels of taxation for U.S. persons and a cost on exit as distributions of appreciated property continue to attract a corporate level of tax. **22**

The overall effective tax rate on earnings that are subject to tax at the corporate level and that are then distributed via a qualified dividend or redemption or liquidation to or by a U.S. person is 36.8%. **23** The overall effective tax rate for non-U.S. person shareholders of course is quite different as dividends are subject to a flat 30% rate of withholding tax **24** unless reduced by an applicable treaty. Redemptions and liquidations will generally not trigger a tax at all unless a relevant U.S. corporation constitutes a U.S. real property interest under FIRPTA (Foreign Investment in Real Property Tax Act of 1980).

The end result is that the overall effective tax rate for non-U.S. shareholders of their interests in a U.S. corporation varies as follows:

(1) 44.7% for dividends distributions not affected by a treaty.
(2) 32.85% for dividend distributions subject to the most common reduction to a 15%withholding tax rate (under the U.S.-China income tax treaty, the rate is 10% for an effective combined rate of 28.9%).
(3) 21% for income generated on liquidation distributions (assuming that the underlying assets do not cause FIRPTA concerns).

Inbound U.S. real estate investment is subject to the above analysis. However, dispositions of U.S. corporations that are U.S. real property interests under FIRPTA remain subject to tax whereas sales by non-U.S. persons of interests in U.S. corporations are not otherwise taxed. **25**

While new Section 199A was created to better align pass-through entity taxation with reduced corporate rates, lowering effective rates to a maximum of 29.6% for qualifying income, use of such entities will remain less appealing to non-U.S. person investors due to the continuing existence of the branch profits tax, **26** even if such a reduced rate applies to the income being created. Even under prior rules, most inbound investment used corporate or trust structures to minimize the imposition of direct filing obligations on individual non-U.S. person investors. As the new rules decrease the tax burden on U.S. corporations, new Section 199A will be relevant primarily when evaluating noncorporate structures that would be made previously through trusts. **27** These rules apply more favorably to REITs and publicly traded partnerships. They also limit significantly interest deductions and include new generous expensing provisions. **28**

Minimizing transfer tax exposure

The the TCJA does not make extensive revisions to the transfer tax regime. For U.S. citizens and domiciliaries, the unified lifetime exemption amount is adjusted temporarily upward to $10 million from $5 million adjusted for inflation, which is $11,180,000 in 2018. **29** The increased exemption amount will sunset on January 1, 2026. **30** Vital for non-U.S. citizen and non-U.S. domciliaries is that the TCJA did not change the exemption amount for them, which remains $60,000, or the tax rate, which remains 40%(and may be increased by state death tax depending on where in the U.S. the asset is located).

Implications for Chinese clients

The new rules affect significantly choice of entity, capitalization decisions, and structuring related-party payments if relationships are maintained with existing Chinese business structures. What remains unchanged after the U.S. tax reform (and perhaps more so than before) is the importance of determining and managing U.S. domiciliary and U.S. residency status carefully.

Assuming for the moment that non-U.S. status is assured, investments in U.S. assets should be made through appropriately structured trusts, non-U.S. corporate structures, or some combination of the two to ensure that exposure to the U.S. transfer tax regime is minimized. **31** Once transfer tax planning is accounted for, a detailed review of the underlying income flows is needed to evaluate the various options available for structuring. That said, and subject to the proviso that a cash-flow analysis is needed for each investment, a few generalizations as to choice of entity can be made:

(1) The lower corporate rate of 21% makes corporate form appealing for enterprises producing substantial annual income flows that need not be distributed. Trusts and individuals remain taxable at higher marginal rates on ordinary income even when new **Section 199A** applies and in all events the spread between the corporate rate and the highest marginal individual rate has increased from 4.6% (i.e., 39.6% – 35%) to 16% (37% – 21%). **32** So for non-U.S. entities investing in annual income-generating businesses that can eventually realize exit gains through liquidation or sale, this spread will make corporate form even more preferable. As with any law, one should look to groups with good lobbyists, and these general rules are slightly tweaked and improved for REITs and publicly traded partnerships, making investments in these entities marginally more appealing. In the international space, the new rules reduce the tax burdens for U.S. real estate-related investments made through REITs that are subject to FIRPTA, making REITs more appealing.

(2) The choice is not as clear when little income is expected until exit in which case noncorporate taxpayers can realize long-term capital gains. Under the new rules, corporate rates may now be less than long-term capital gain transactions realized by individuals or trusts due to the additional imposition of the 3.8% net investment income tax, which remains in effect.

(3) The new limits for interest deductions will make interest substitutes (whether imbedded in other instruments such as derivatives or replaced through other structures such as sales and leases) more appealing.

(4) The new rules restricting certain interest expenses for corporations and limiting corporate net operating losses (NOLs) strengthen the preexisting advantage of trust structures when leverage and income stripping is available. Corporations faced more related-party interest deduction limits than trusts under prior law and the new the TCJA rules on such limits also affect corporations more than trusts, so the new rules have, if anything, increased the benefits of trust structures when significant leverage may be used from outside the U.S.

(5) Many structures established to erode income to the U.S. via payments to foreign related parties need to be reviewed carefully to ensure the deductibility of such payments.

(6) The new rules provide opportunities for significant expensing of many items (including on the purchase of existing companies) and transactional advisors should take these into account when handling purchase transactions for their clients. **33**

As alluded to above, implications of the new tax rules are not always segregated into purely inbound or outbound considerations. A good example is the new rule taxing U.S. shareholders of CFCs if the test for such status is satisfied for even one day (whereas previously a continuous 30-day period was required). **34** If a family has U.S. heirs or beneficiaries, this risk should be addressed while the asset is owned by a Chinese person that is not a U.S. person as there is no longer a 30-day adjustment period following such individual's death. **35** This rule also has implications with respect to certain basis "step-up" planning as deemed liquidations of foreign entities are now more likely to create Subpart F income even if such a liquidation (or deemed liquidation) occurs within the first 30 days of U.S. ownership.

Outbound Considerations

To the extent that a Chinese family's U.S. nexus is caused by certain family members being present in the U.S., even if no significant wealth is brought into or created in the U.S., the major U.S. tax concerns arise as a result of an affected individual's U.S. person status. U.S. status implicates the worldwide reporting and tax regime that the U.S. imposes on such persons (under both the income tax and transfer tax regimes).

The new rules are a sea change in this area. Historically, there was often little to no U.S. income tax imposed on active business income generated outside the U.S. within a non-U.S. corporation. Under the prior rules, tax charges for such income under the CFC and PFIC tax regimes were minimal. The new U.S. tax rules have the very basic effect of imposing what could be considered a form of an alternative minimum tax on non-U.S. corporate income. **36**

With respect to transfer taxes, the new rules have changed little other than the threshold at which point U.S. citizens and U.S. domiciliaries become subject to such taxes. The key is to determine carefully when the client will become domiciled in the U.S. This requires a close examination of all of the facts and circumstances. Pre-immigration trust planning is typically conducted prior to a client becoming domiciled in the U.S. so that the client's non-U.S. assets will be excluded from the U.S. transfer tax net.

New income tax rules-outbound effects generally

The new tax rules affect outbound holdings in a transformative manner. A few of the most significant impactful changes are the following:

(1) A minimum "phantom" GILTI tax imposed on non-U.S. income at a rate determinable with respect to the underlying annual income of a CFC reduced by an amount equal to a deemed 10% annual return on tangible assets (**Section 951A** , imposing what is essentially a minimum income tax on U.S. shareholders of CFCs in most instances when a business is not primarily tangible asset-based).

(2) A new deduction available to U.S. corporations with respect to their ownership of intangibles for use abroad (foreign-derived intangible income), which is intended to encourage domestication of intangible assets and bring the effective tax rate of U.S. corporations realizing such income down to 13.125% on that income (**Section 250** FDII).

(3) Increased breadth to the definition of a U.S. shareholder of a CFC (*Section 951*(b) expanding the definition to include U.S. shareholders who own 10% of the vote or value of such CFC where the prior definition was limited to vote only.

(4) Revisions to CFC ownership attribution rules (repeal of **Section 958(b)(4)** , imposing new "downward attribution" to CFC ownership; may apply with the end result being that additional non-U.S. ownership of a CFC will be attributed to U.S. owners).

(5) New minimum phantom tax charges imposed on certain related parties in large enterprises (more than $500 million in revenues) (**Section 59A** BEAT).

(6) Availability of a dividends received deduction for U.S. corporations is greatly expanded as compared with prior law (**Section 245A**).

(7) Changing the definition of Subpart F income to include income from a CFC that was a CFC for one day (**Section 951(a)** amendment removing the prior requirement that an entity be a CFC for an uninterrupted 30-day period in a tax year). The new rules represent an enormous departure from the prior tax regime applicable to income realized through non-U.S. corporations. While a number of the new provisions operate to impose a new alternative minimum tax on certain CFC income, the new rules do not in fact change the overall incentive to use non-U.S. corporations in many instances. The fact remains that the 10.5% to 13.125%effective tax rate applicable under the GILTI rules is less than the new 21% rate imposed on U.S. corporations (or even the 13.125%/16.4% applied to FDII-which may be challenged as an improper export subsidy under WTO rules) so foreign entities will retain their appeal in certain instances.

As this article addresses mainly private client issues, the taxpayers generally described will be less affected by the BEAT provisions, which apply to large affiliated groups with annual gross receipts of at least $500 million. **37**

GILTI and FDII-a push and a pull

On an ongoing basis, U.S. shareholders of active CFCs will generally need to cope with an increased tax annual tax burden. Under the new rules, a CFC's GILTI will be included currently in a U.S. shareholder's U.S. income.

The computation of GILTI is based on a complex formula, with the net effect of including currently in a U.S. shareholder's U.S. taxable income all income from the relevant CFC reduced by any (1) effectively connected income or Subpart F income of such CFC (both of which are otherwise taxable by the U.S. under other rules); (2) income subject to an effective foreign tax rate of approximately 18.9% (formally 90% of the corporation's tax rate); (3) dividends received from related persons; and (4) certain oil and gas income. This amount is further reduced by an amount calculated as a deemed 10% return on the tangible assets of the CFC.

The new GILTI rules are alleviated substantially for certain U.S. corporations classified as U.S. shareholders as they will be eligible for a new deduction **38** under these rules and relief for foreign taxes paid. **39** However, if the U.S. shareholder is not a corporation, the deduction and foreign tax credit provisions of GILTI are not available.

This result encourages the use of U.S. corporations in many instances as the reduced GILTI charges are likely in certain situations to offset the double taxation regime applicable to U.S. corporations generally, particularly after considering the new lower corporate tax rate. That said, when considering U.S. corporate form, taxpayers need to consider exit strategies concurrently as appreciated assets distributed out of corporate form are generally subject to tax. **40**

Whereas GILTI is intended to impose a U.S. tax cost on income realized in foreign corporations (in addition to the tax costs already imposed under the prior tax regimes governing, e.g., CFCs and PFICs), the new deduction for FDII is intended to make holding intangible assets in U.S. corporations for use abroad more appealing. The FDII regime can, therefore, be viewed as a counterpart to GILTI that attempts to reduce the tax cost of using U.S. corporations while GILTI increases the corresponding tax cost of using foreign corporations. That said, the push and pull of these provisions do not happen in a vacuum for (1) using U.S. corporations still imposes a potential additional tax on appreciated assets in a liquidation, as stated above; (2) the income available for a deduction under the FDII rules is narrower than the income taxed under GILTI; and (3) of course, non-U.S. tax and other legal concerns must be reviewed in any non-U.S. business operation.

In sum, the choice-of-entity question has become even trickier under the new rules. In each case, devising a proper structure will require careful, quantitative analysis of the capitalization structure, the projected cash-flow situation, and the proposed exit strategy.

Expansion of CFC reach

In addition to the GILTI and BEAT provisions, which essentially impose new alternative minimum tax regime(s) on U.S. corporations and individuals that realize income through non-U.S. corporations, the definitions of what constitutes a CFC and U.S. shareholder are broadened as well (thereby increasing the number of taxpayers subject to these rules). **41** As a starting point, any entity that qualifies as a CFC for one day in a tax year will face related reporting and tax consequences. Prior law required CFC status to exist for at least 30 days before the tax and reporting rules were triggered. In the private client practice, this has substantial implications for post-death planning when a family has U.S. heirs. One important technique used under prior law to obtain post-death basis stepup relied on the existence of the 30-day window. Under the new rules, it is still possible to obtain basis step-up in a similar fashion, but the mechanics and means to achieve the goal will be different and less flexible or effective. **42**

Under the new rules, stock of a foreign corporation owned by a foreign person can be attributed to a U.S. entity that is owned by the same foreign person ("downward attribution"). This did not exist under prior law. Such U.S. entity can be a U.S. corporation in which the foreign person owns 10% of the value of the stock; a U.S. partnership in which the foreign person is a partner; or a U.S. trust in which the foreign person is a beneficiary or in some cases a grantor. **43**

This new downward attribution has two primary results: (1) more foreign corporations will now be treated as CFCs; and (2) more U.S. persons (individuals and entities) will face the tax reporting and filing (Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations)) and payment obligations imposed on U.S. shareholders of CFCs (such payment obligations, as discussed above, were themselves increased substantially under the TCJA). The IRS intends to amend the instructions for IRS Form 5471 to exempt the form's filing obligations if a U.S. person becomes a U.S. shareholder with respect to a CFC only because of such downward attribution (i.e., if such person would otherwise not own or constructively own any shares in such would-be CFC). **44**

Under the new rules, the definition of a U.S. shareholder is expanded to include any U.S. person who owns 10% of the voting power or the value of the non-U.S. corporation's stock. **45** A non-U.S. corporation would constitute a CFC if more than 50% of its value or voting power is owned, directly, indirectly, or constructively, by U.S. shareholders. Under the old rules, a "U.S. shareholder" was limited to a U.S. person who owns, directly, indirectly, or constructively, 10% or more of the voting power of the non-U.S. corporation's stock.

Implications for Chinese clients

For Chinese clients, the downward attribution rule and other new rules expanding the reach of the CFC tax regime would warrant two key considerations given that Chinese clients generally own substantial portions of shares in their Chinese companies while concurrently engaging in business or making investments in the U.S. The consequence of these new rules is that more Chinese clients who become U.S. income tax residents will constitute U.S. shareholders of CFCs. Also, the opportunity to defer the payment of U.S. income taxes through CFCs is diminished greatly due to GILTI.

In addition, the extent of information required to complete Form 5471 provides added incentive to avoid having U.S. persons (whether family members, trusts, or U.S. affiliates) own or be deemed to own *any* interest in their foreign business operations (other than through such downward attribution). This means that de minimis transfers of interests to U.S. entities or family members should be avoided whenever possible. Existing structures, whether in trust, partnership, or corporate form should, therefore, be revisited.

For example, it is typical for the children of a Chinese family to become U.S. income tax residents whereas the parents, who created the wealth and hold substantial shares in the Chinese operating companies, remain non-U.S. income tax residents. As a result, the family should be careful to avoid having the children own even a small portion (e.g., 1%) of the shares in the Chinese companies (this position is slightly broader than strictly necessary as "upward attribution" remains limited in some circumstances).

Additional final takeaways regarding outbound planning include the following:

(1) Pay more attention to U.S. residency considerations, reviewing the status of different family members separately to minimize the rules applicable to U.S. persons as much as possible.

(2) If such U.S. status is not avoidable, consider using U.S. corporations to own CFCs so as to reduce GILTI tax charges, while planning an exit strategy concurrently.

(3) Consider elections for pass-through tax status if income tax will be due in any event if favorable deductions could pass onto U.S. returns.

(4) As Chinese clients are becoming more sophisticated, weigh exit strategies, particularly the costs of exiting new beneficial U.S. corporations before one is set up.

Final Thoughts

the TCJA's unintended disproportionate impact on Chinese clients with nexus with the U.S. is caused partially by these clients' unique wealth composition, cross-border economic activities, and global mobility. With China's private wealth continuing to grow and Chinese clients' ever-increasing nexus with the U.S., wealth planning and tax practitioners should follow clarifying authorities to be issued in months and years to come and should use the new rules effectively to help prevent pitfalls for clients.

FOOTNOTES

1 Generally, "U.S. persons" include U.S. citizens; most green card holders unless treaty positions are claimed to the contrary; individuals that spend sufficient time in the U.S. during an applicable year meeting the "substantial presence test" unless the "closer connection" exception is claimed; entities organized in the U.S.; and qualifying trusts. See **Section 7701(a)(30)**. The substantial presence test is satisfied if both (1) an individual is present in the U.S. for at least 31 days during the calendar year; and (ii) the sum of all days present in the U.S. in the current year, plus 1/3 of the days present in the U.S. in the first preceding year, plus 1/6 of the days present in the U.S. in the second preceding year, equals or exceeds 183 days. See **Section 7701(b)(3)**.

2 **Section 951** *et seq.*

3 **Section 957(a)** .

4 Trusts for which the assets are treated as owned by the non-U.S. spouse under **Section 671** *et seq.*

5 If the nonwillful taxpayer has omitted income in relevant prior years due to failure to file certain international information returns, the Streamlined Filing Compliance Procedures ("Streamlined") are available. See www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures. In contrast, if the nonwillful taxpayer has no omitted income in prior years despite the failure to file certain international information returns, the Delinquent International Information Return Submission Procedures ("Information Only Filing") can be used. See www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures. As a matter of actual consequences to clients, the major difference between these two procedures is that Streamlined would require payment of back taxes, interest, and certain penalties, whereas Information Only Filing would not.

6 As discussed herein, many Chinese clients are eligible to "treaty tie-break" out of the U.S. and thus qualify as a non-U.S. person even if they have green cards or otherwise spend substantial time in the U.S. These individuals arguably should still have the residual obligation to file certain international information returns such as Form 5471 (Information Return of U.S. Persons With Respect to Certain Foreign Corporations) with respect to the CFCs when they are 10% U.S. shareholders. Most of the Chinese clients' Chinese companies, to the extent that they constitute CFCs, generate active operating income. As discussed later in this article, prior to the enactment of the TCJA, these clients' CFCs' active business income would not cause current inclusion for their U.S. tax. Therefore, failing to file Form 5471 would not have resulted in omitted income, which would qualify the client for Information Only Filing. By contrast, the new GILTI rules likely will cause the current inclusion of such active business income to some extent, meaning that if a client fails to file Form 5471, he might not be able to use Information Only Filing and would have to pay back taxes, interest, and certain penalties under Streamlined or, if a client otherwise would be using Streamlined anyway, the cost is now much higher if certain active business income becomes includable in the computation of back tax. The difference is that the client previously may have been able to rectify a historical filing error free of U.S. tax and penalties or at a lower cost, but under the current rules, correcting a historical filing error may become much more costly. This is significant because a large number of Chinese clients will be affected due to their typical mobility pattern and wealth composition.

7 See *Eisner v. McComber*, 252 U.S. 189 (1920).

8 Certain Chinese assets implicate change-of-title issues, particularly Chinese real estate and public company shares regulated by the Chinese regulatory authorities (China Securities Regulatory Commission or CSRC). Planning with these assets will require working with local Chinese advisors and certain flexibility and creativity on both sides.

9 These rules include **Sections 318** and **958** ("downward attribution" rule discussed below), 951(b) (expanded definition of 10% U.S. shareholder), 951(a)(1) (elimination of the 30-day CFC holding period requirement), 78 and 960 (deemed-paid foreign tax credit), and new 951A (GILTI) and 250 (FDII), all as amended or added by the TCJA.

10 See **Section 1** for individual rate changes, and **Sections 11** and **243** for corporate rate changes, all as amended by the TCJA.

11 See **Section 163(j)** regarding interest expense deductibility limitation and **Section 172** regarding net operating loss deduction limitation, both as amended by the TCJA.

12 See new **Section 199A** , as added by the TCJA.

13 See Article 4 of the U.S.-China income tax treaty. Most U.S. bilateral income tax treaties provide a "waterfall" treaty tie-break rule in Article 4, whereby a taxpayer, if resident in both treaty countries under their respective domestic laws, may tie-break to the country where he has, for example, a permanent home, center of vital interests, or habitual abode. Article 4 of the U.S.-China treaty does not provide such a rule expressly but rather the U.S. Treasury Technical Explanation directs the Chinese and U.S. competent authorities to consider a similar rule through consultation when determining which country has the primary taxing authority.

14 If the relevant Chinese individual maintains his permanent home and center of vital interests (i.e., his business, professional, and social ties) primarily in China, he could qualify for the "closer connection exception" under **Section 7701(b)(3)** if he is not a U.S. green card holde and if he spends less than 183 days in the U.S. during the current year, or he could treaty tie-break out of the U.S. under the U.S.-China treaty if he is a U.S. green card holder or otherwise spends slightly over 183 days in the U.S. during the current year (there are no hard anc fast rules as to how many more days above 183 would still give a practitioner the level of comfort needed to recommend a treaty position and one should always review the totality of facts for that matter). Both the closer-connection exception and treaty position can result in the Chinese individual's non-U.S. person status for income tax purposes. The differences are: (1) clients' facts may qualify for the treaty position but not the closer-connection exception; and (2) the closer-connection exception, being statutory, can provide more certainty as a legal position to the extent available.

15 One should always consult an immigration lawyer when taking such a treaty position and find the right balance between the nexus requirements under U.S. tax law and U.S. immigration law, respectively. The tension here is that U.S. immigration law requires sufficient nexus with the U.S. for the green card to continue to be valid, whereas taking the treaty position for tax law purposes requires a diminished degree of nexus with the U.S. To the extent that a right balance can be found, taking a treaty position from the beginning will solve another problem for the client (i.e., a potential exit tax) when they consider giving up their green cards down the road. Chinese clients are looking increasingly to exit as well as enter, so it is a disservice if one does not consider how to help them get out of the U.S. as well as how to get in.

16 The facts required to show that a client does not have such intent for domicile are quite similar to those that allow an individual to treaty tie-break for residency purposes under the treaty.

17 While possession of a green card does create a presumption of domicile, many Chinese individuals retain their Chinese businesses and homes in China and spend more time in China than they do in the U.S. Also, as noted above, Chinese clients often split time between China and the U.S. and have residences in both countries, while leaving most of their family members (even including members of the nuclear family in many instances) back in China, a fact pattern that provides much support to overcome the presumption of U.S. domicile.

18 See **Section 11** as amended by the TCJA.

19 See **Section 163(j)** as amended by the TCJA.

20 the TCJA drastically revises some of the bedrock principles of Code as it existed prior to its enactment, particularly in the internationa area, many of the new provisions could serve as the basis of an article as long or longer than this one.

21 **Section 11** as amended by the TCJA.

22 **Section 311(b)** repealing the General Utilities doctrine.

23 21% + (20% * (100% – 21%)) = 36.8%. With potentially an additional 3.8% net investment income tax (NIIT) cost.

24 **Section 1441** .

25 **Section 865(a)(2) .**

26 **Section 884 .**

27 Although new **Section 199A** is limited to business operations of a certain size, there is no such limitation on similar relief to real estate investment trusts (REITs) and certain publicly traded partnerships, providing a fresh example of how the U.S. legislative system works.

28 **See Sections 163(j)** and **179** .

29 **Sections 2010©(3)** and **2001(g)** as amended by the TCJA.

30 It is clear that the increased exemption will apply to the estates of U.S. domiciled decedents between 2018 and the end of 2025. It is much less clear whether gifts in excess of $5 million (adjusted for information) during the same period will be subject to certain "clawback" rules if the donors die after 2026 when their estates would be subject to the lower exemption amount. Practitioners may have different views over a potential claw-back. In practice, an attempt to claw back by the government may raise interesting questions including a collection issue if the gifts have been made to non-U.S. domiciliaries, which frequently can be the case in the international context.

31 Given the relatively small exemption amount ($60,000) that continues to apply for non-U.S. citizen non-U.S. domiciliaries with respect to U.S.-situs assets, and the relatively high tax rate applicable to the value of assets under the U.S. transfer tax regime, this planning remains as important as it was previously. There are other planning options to control situs that are not germane to this discussion, which are subject to various costs and risks. For example, there remains some ambiguity as to the situs status of noncorporate entities.

32 NIIT makes individual and trust rates even higher.

33 This will increase the appeal of elections to treat stock sales as asset sales under **Sections 336(e)** and **338** .

34 Section 951(a)(1) .

*35*_ Id._

36 This is an interesting way to view the GILTI, FDII, and BEAT rules considering that the corporate alternative minimum tax was repeale domestically.

37 Section 965 . At a high level, BEAT increases the income of an applicable taxpayer by adding back deductible payments or payments fc depreciable property to a related foreign person to arrive at "modified taxable income," which is used to calculate a minimum tax. See Villano and Leeds, "Can't Find the BEAT: The Interaction of the New Base Erosion Rules With a Foreign Bank's Branch Interest Deductions," **29 JOIT 30 (March 2018)** .

38 Section 250(a) .

39 Section 960(d) . Relief under both the deduction and credit provisions of GILTI is subject to mathematical limitations not covered herein.

40 While there are potential planning alternatives to address this exposure, they are not simple or indeed always available.

41 See Sections 951(a) and **(b)**.

42 While some issues are clerical (e.g., check-the-box elections still exist), the new rules do present issues with post-death basis step-up planning using trust structures. Such planning still exists but the mechanics and means available to get to the same end are now more involved and less flexible as liquidations effective after death can now create Subpart F income.

43 Sections 958(b) and **318(a)(3)** .

44 Notice 2018-13 , 2018-6 IRB 341. See PwC, " IRS 'Toll Tax' Guidance," 29 JOIT 48 (April 2018).

45 Section 951(b) .

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