Table of Contents

Foreign Affairs: A Primer on International Tax and Estate Planning

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I. INTRODUCTION

It should come as no surprise to tax practitioners that the world is becoming increasingly global. It has become commonplace for advisors to inquire, even in domestic practice, whether and to what extent a client may have foreign connections. Perhaps counterintuitively, many non-US persons now view the United States as a friendly tax jurisdiction, which has resulted in a boom in foreign investment.[2] Indeed, the European Parliament recently identified the United States as one of the primary emerging "tax havens."[3] Global families now look to the United States as a safe place to invest capital, viewing the United States as having well-regulated, secure and predictable investment markets backed by a modern and stable political system. Moreover, decades of global mobility have resulted in more and more international relationships, and many younger family members have traveled abroad to pursue educational or business opportunities, and have developed ties and broadened family footprints in the process.

As a result, there is an increasing need for domestic estate planning practitioners to have the ability to identify international planning opportunities and to cultivate an awareness of the various pitfalls that exist in the cross-border context. Many of the transfer tax and income tax rules that apply to global families can be thorny, unintuitive, and present traps for the unwary. Indeed, it is quite possible for unexpected tax consequences to occur in a situation in which one would think that a client representation involves purely domestic issues. Moreover, the push towards international financial transparency, with the introduction of the Foreign Account Tax Compliance Act ("FATCA") by the United States, and the Common Reporting Standard ("CRS") abroad, now requires practitioners to have a working knowledge of the information-exchange consequences and other compliance aspects of estate planning transactions.

This outline is intended to be a primer on international planning for domestic estate planners and tax practitioners to assist domestic advisors in identifying pitfalls that may unexpectedly arise during the course of a representation and in recognizing opportunities that can be leveraged to the benefit of the internationally-connected client. Particularly in the context of investment structures, savvy planners have considerable flexibility to control the incidence and timing of various taxes, and selecting the appropriate ownership structure can have a dramatic impact on the net economic result achieved.

II. INITIAL CONSIDERATIONS

The first portion of this outline will begin by providing a broad overview of the international tax paradigm, opening with the transfer tax regime, moving on to the individual income tax regime and, finally, addressing the taxation of trusts in cross-border transactions.

Although common elements exist between domestic and international representations, there are also a broader class of questions and concerns that need to be evaluated with a global client. A key consideration in this regard should be the jurisdiction of both the client and the client's assets, a factor that is less likely to inform the relevant tax analysis in the domestic context. For these purposes, the "residence" of a client will need to be analyzed for both

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[2] LISI Archive Message #905 (Apr. 22, 2017), *available at* http://leimbergservices.com ("In the real world last week, investment into the US from abroad surged to $53.4 billion").

[3] European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) ("The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners").

transfer tax and income tax purposes, based on very different rules and sometimes with unexpected results. Thus, the starting point in analyzing the global client's situation will involve taking into account the following:

- The client's residency status for US transfer tax purposes;
- The client's residency status for US income tax purposes;
- The nature and location of the client's primary assets;
- Where trusts are involved, the residency status of beneficiaries and the US tax classification of the trust; and
- Whether one or more bilateral tax treaties will inform the relevant tax analysis.

III. TRANSFER TAXES GENERALLY

Of course, when representing a US citizen client, US estate, gift and generation-skipping transfer ("GST") taxes (referred to broadly in this article as "transfer taxes") will generally be relevant to the client's worldwide assets, regardless of where they are situated and regardless of whether those assets are tangible or intangible. In contrast, non-US persons (sometimes referred to in this article as a nonresident aliens, or "NRAs"), are subject to a jurisdictionally sensitive form of transfer taxation, meaning that US transfer taxes will generally be applied only with respect to assets situated or deemed situated in the United States. Assets owned by an NRA and situated outside the United States will generally not be subject to US transfer taxes.[4]

Accordingly, the threshold determination a practitioner must make is whether a client is a US "resident" for US transfer tax purposes, as only US residents are subject to transfer taxation on their worldwide assets (i.e., in the same manner as a US citizen). Although the term "resident" is used for both transfer tax and income tax purposes, the detailed objective tests used to define this term for income tax purposes[5] are irrelevant in the transfer tax context. Rather, for transfer tax purposes, residency is the common law concept of "domicile," meaning: (i) living in the United States, even for a brief period of time, and (ii) having no definite present intention of leaving the United States.[6] This determination is based upon all relevant facts and circumstances, with the ultimate objective of determining the taxpayer's intent.[7] It should be noted that, while obtaining a green card is generally considered a strong indicia of one's intent, it is not conclusive evidence of being domiciled in the US. Generally speaking, a US resident will be similarly situated to a domestic client as far as US transfer tax planning is concerned. Interestingly, an NRA estate may sometimes find itself in the strange position of arguing in favor of US resident status in order to take advantage of the larger unified credit available to US residents.

IV. ESTATE TAXATION OF NRAS

The estate of a deceased NRA is generally subject to US estate tax only with respect to those assets of the NRA situated or deemed situated in the United States.[8] For these purposes, assets situated in the United States and included in a NRA's gross estate for US estate tax purposes may include both tangible and intangible assets owned by the NRA. Absent special circumstances, a NRA's assets situated outside the US will generally not be subject to US estate tax.

A. Tangible Property Included in Gross Estate.

Tangible property subject to US estate tax includes real property and tangible personal property physically located in the United States. With respect to tangible personal property, assets are generally deemed to be

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[4] Note that a special regime applies under IRC § 2801 to certain individuals who have relinquished their US citizenship. Those issues will be addressed in a subsequent edition of this series.

[5] *See* IRC § 7701(b).

[6] Treas. Reg. § 25.2501-1(b).

[7] *Estate of Niehaus*, 17 T.C. 1149 (1952) (influential Dutch resident unable to return to Netherlands due to WWII was not a US domiciliary because he retained an intent to return home); *Estate of Khan v. Commissioner*, TC Memo 1998-22 (green card holder who resided in the US for less than 2 years before returning to Pakistan for business was a US domiciliary because he had intended to return to the US, despite having died in Pakistan); *Estate of Jack v. United States*, 50 Fed. Cl. 590 (2002) (finding of domicile possible, although not certain, with respect to alien present in US on temporary non-immigrant visa).

[8] IRC §§ 2101(a), 2103.

situated in the place where they are physically located – this might include items like jewelry, artwork and other collectibles. Note that with respect to tangible personal property, certain exceptions exist for items that are "in transit," as well as for artwork and collectibles that are on loan or on exhibition for charitable purposes in the United States.[9]

B. Intangible Property Included in Gross Estate.

US estate tax is also imposed on intangible property situated within the United States. This includes stock of a domestic US corporation (but not a foreign corporation), and may also include certain interests in partnerships or LLCs.[10] With respect to the latter entities, an element of tension exists with respect to whether the place of organization of the partnership, the residence of the interest holder, or the location of the partnership's underlying assets should control in making this determination.[11] The situs of an individual's beneficial interest a trust or estate is generally determined by reference to the trust's underlying assets, rather than by place of administration or governing law of the trust.[12] Importantly, life insurance proceeds insuring the life of an NRA, no matter where the contract is issued, are not considered to be US situs property, and accordingly are not subject to US estate tax.[13]

Although the general rule for debt obligations is that a debt obligation is situated within the United States if the primary obligor is a US person, this rule is subject to many exceptions. Among these exceptions are certain interests relating to bank deposits held in US banks, foreign branches of US banks, or US branches of foreign banks; certain instruments subject to the OID rules; and, importantly, portfolio debt.[14] The rules relevant to determining whether a debt obligation qualifies as portfolio debt are discussed more fully in the income tax discussion, below.

C. Retained Interests Causing Gross Estate Inclusion.

A special note is in order with respect to the rules under Section 2104(b) that can cause otherwise non-US situated assets to be deemed US situated, and, consequently, included in the gross estate of a NRA. These rules incorporate the provisions of Sections 2035 through 2038, which should be familiar to the domestic planner, and provide that any property transferred by the decedent, and over which the decedent retained certain rights or powers, will be deemed to be situated in the United States (and thus subject to US estate tax) if the property was so situated either at the time of the original transfer or at the time of the NRA's death. Thus, if any transfer is made by an NRA that would otherwise subject the transferred property to inclusion in the NRA's gross estate under Section 2035 through 2038 (if the decedent were a U.S. resident), then the transferred property will be deemed to be situated in the United States at the NRA's death and, therefore, subject to US estate tax.[15] This is a little-known provision that can often catch unwary practitioners by surprise. Given the expansive application of Section 2036 as applied to family limited partnerships, practitioners need to be mindful of similar retained interest arguments under Section 2104(b).[16]

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[9] *Delaney v. Murchie*, 177 F 2d 444 (1st Cir. 1949).

[10] IRC § 2104(a). Stock in a foreign corporation is a non-US situs intangible and is therefore *not* subject to US estate tax.

[11] *Blodgett v. Silberman*, 277 US 1 (1928); Rev. Rul. 55-143, 1955-1 CB 465; GCM 18718, 1937-2 CB 476.

[12] Rev. Rule 82-193.

[13] IRC § 2105(a). Note that, because of some of the inherent uncertainties involving the estate taxation of entity structures, an NRA may prefer to simply purchase an insurance policy to mitigate the estate tax exposure attendant to ownership of US assets rather than engaging in a complex entity structuring exercise.

[14] IRC §§ 2104(c), 2105(b).

[15] IRC § 2104(b). *See also Estate of Swan*, 24 T.C. 829 (1955), *aff'd in part, rev'd in part*, 244 F.2d 144 (2d Cir. 1957) (holding that a transfer of assets from an NRA to Lichtenstein and Swiss stiftungs, which were amendable and revocable, were akin to transfers to a revocable trust and were therefore includible in the NRA's gross estate); PLR 9507044 (trust funded with US assets, and over which the grantor retained a general power of appointment, was included in gross estate notwithstanding the fact that it owned only non-US property at the decedent's death).

[16] *See* Edward J. Finley II, *Strangi's Stranglehold on Offshore Planning*, TRUSTS & ESTATES (Feb. 2004).

D. Basis Step-up at Death.

Interestingly, NRAs are generally eligible for one of the most generous benefits afforded to US citizen decedents – the basis step-up at death.[17] Property received directly from a NRA decedent will thus generally take a basis in the hands of a beneficiary equal to the fair market value of the property as of the date of the NRA decedent's death.[18] This rule applies without regard to whether or to what extent the property was included in the NRA decedent's US taxable estate.[19]

However, planners should be particularly sensitive to the basis step-up rules as they apply to assets that are not received *directly* from a NRA decedent at death, such as property held by the revocable trusts of NRAs. In the domestic context, the overarching rule of Section 1014(b)(9), which will ensure most assets included in a decedent's gross estate (including those held in a decedent's revocable trust) are eligible for a basis step-up; however, this rule does not apply to non-US property owned by a NRA.[20] Accordingly, cautious planners often ensure that a NRA's revocable trusts provide for the payment of income to or at the direction of the NRA during his or her life and that upon revocation, title will revest in the grantor, thereby ensuring the basis step-up will be available under Sections 1014(b)(2) and (3).[21]

E. Computing the Estate Tax.

Different rules apply in computing a NRA's federal estate tax liability, as compared to the estate tax liability of a US citizen. Estate tax deductions are generally available to a NRA's estate based only on the proportionate amount of US situated property versus worldwide property the NRA owned at death.[22] In order to claim the benefit of such deductions, a NRA's estate must disclose the NRA's worldwide assets on a timely filed federal estate tax return, IRS Form 706-NR.[23] In practice, a natural hesitation may develop for fiduciaries of a NRA's estate to disclose substantial worldwide assets to the IRS. As a result, some fiduciaries may opt to forego otherwise valuable deductions.

Although the estate of a NRA will generally be subject to the same US estate tax rates as the estate of a US citizen or resident, the generous exclusion against the estate tax for US citizens and residents is not available to the estate of a NRA.[24] Rather, the applicable exclusion amount available to the estate of a NRA is limited to $60,000.[25] While the applicable exclusion amount for US Citizens or residents has increased dramatically to $5,600,000 (for year 2018), this very modest exclusion for a NRA has remained constant since 1988. As noted above, in some cases the fiduciaries of a NRA's estate may wish to consider arguing in favor of US resident status in appropriate circumstances to achieve eligibility for the more generous exclusion available to US residents.

1. Administration Expenses.

Deductions for administration expenses are generally permitted, but are allocated on a proportionate basis based upon the ratio of the decedent's US assets to non-US assets.[26] Thus, for

[17] Rev. Rul. 84-139, 1984-2 C.B. 168; PLR 9246030.

[18] IRC § 1014(b).

[19] *Cinelli v. Comm'r*, 32 TCM 674 (1973); *Ujvari v. United States*, 212 F. Supp. 223 (SDNY 1963); Rev. Rul. 88-139. Note, however, that this will not be true in all circumstances. *See, e.g.,* Treas. Reg. § 1.1014-2; IRC § 1014(b)(9).

[20] Treas. Reg. § 1.1014-2(b)(2).

[21] These provisions generally require that trust income be payable to or at the direction of the decedent during life, and that the trust be revocable at all times before the decedent's death. Some planners take the position that the power to revoke or amend a trust encompasses the power to direct the payment of income, and should thus entitle property in a revocable trust to a basis step-up. There is no decisive authority supporting this view, however, and the uncertainty can be avoided by simply including a requirement to pay the income for life to or on the order or direction of the decedent in the trust agreement.

[22] IRC § 2106(a)(1).

[23] IRC § 2106(b).

[24] IRC § 2102(a). Note that special rules apply in the case of certain US possessions and that the terms of a bilateral estate tax treaty may inform the relevant analysis.

[25] IRC § 2102(b).

[26] Treas. Reg. § 20.2106-2(a)(2).

example, if the estate incurs an expense of $1,000, and the NRA's estate was comprised of $5M of US assets against total assets worldwide of $40M, then only $125 would be deductible ($1,000*($5,000,000/$40,000,000)). For these purposes, the deductibility of the expense is not impacted by whether the expense was incurred within or outside the United States.[27]

2. Debts.

Section 2106(a)(1) provides an estate tax deduction for debts of the decedent. For these purposes, the amount of the deduction may be affected by whether the debt is recourse or non-recourse as to the decedent. In the case of recourse debts, the amount of the deduction will be based on a proportionate allocation of US and non-US assets, similar to the deduction of administration expenses discussed above. In the case of non-recourse debts, on the other hand, a full deduction is permitted, meaning only the net equity of the asset will be included in the decedent's gross estate.[28]

3. Charitable Deduction.

The estate tax charitable deduction is available to the estate of a NRA, but on more restrictive terms than in the case of the estate of a US citizen or resident.[29] In order to be deductible, contributions must be made out of assets included in the NRA's US estate and must be made to a US domestic charity or to a trust that will make use of the donation only within the United States.[30] Because the deduction is permitted only for property otherwise included in the NRA's gross estate, no proportionate allocation of the charitable deduction is required.

4. Marital Deduction – Qualified Domestic Trusts.

Like US citizens and residents, NRAs are entitled to an unlimited estate tax deduction for US estate-taxable property transferred to a US citizen spouse.[31] From a policy perspective this is sensible, as a transfer to a US citizen spouse ensures that the property remains within the US estate tax net. In contrast, though, transfers of US estate-taxable property to a non-citizen spouse generally are not eligible for an estate tax marital deduction, and will therefore result in a first death estate tax. This treatment can be avoided if assets intended to benefit a non-citizen spouse are instead transferred to a "qualified domestic trust" ("QDOT"), which can achieve a limited deferral of US estate tax.[32]

In order to qualify as a QDOT, certain technical requirements must be satisfied. As is the case with a domestic QTIP trust, an election to treat a trust as a QDOT must be made on a timely filed US estate tax return, income from the trust must be paid the surviving spouse at least annually, and the surviving spouse must be the sole beneficiary of the trust during his or her lifetime.[33]

In addition, the QDOT must have at least one US trustee, who must be empowered to withhold any estate tax due on distribution. If the assets of the QDOT equal or exceed $2 million, the US trustee must be a qualified bank or an individual who has furnished to the Department of Treasury a bond or letter of credit to secure the payment of the estate tax.[34] Practically speaking, QDOTs that are large or are expected to become large will almost always appoint a US corporate trustee.

[27] Id.

[28] Treas. Reg. § 20.2053-7; *Estate of Johnstone v. Commissioner*, 19 T.C. 44, 46 (1952).

[29] IRC § 2106(a)(2)(A).

[30] These conditions should be explicitly stated in the decedent's estate planning documents. *See* PLR 9135003 (deduction disallowed where executor distributed assets to a US charity, but had discretion to make contributions to non-US charities as well).

[31] IRC §§ 2056(a), 2106(a)(3).

[32] Treas. Reg. § 20.2056A-2.

[33] IRC § 2056A(b)(3); Treas. Reg. § 20.2056A-5(c). For these purposes "income" generally means fiduciary accounting income under IRC § 643(b).

[34] Treas. Reg. § 20.2056A-2(d)(1). These requirements may be met in different combinations during administration, so long as one requirement is met at all times. Treas. Reg. § 2056A-2(d)(1)(i).

During the surviving spouse's life, annual distributions of income from a QDOT will not be subject to US estate tax; however, distributions of principal will be subject to a deferred estate tax upon distribution, subject only to an exception for instances of extreme hardship. If the tax due upon a principal distribution is paid by the QDOT trustee from QDOT assets, the tax paid is treated as an additional distribution to the beneficiary in that year, leading to a circular tax calculation.[35] As with a QTIP trust, at the surviving spouse's death, the remaining property in the QDOT will be subject to US estate tax. It is important to note that, unlike with QTIP trusts, it is not possible to create a lifetime QDOT to achieve a marital deduction for gratuitous lifetime transfers to a NRA spouse that would otherwise be subject to US gift tax.

V. <u>GIFT TAXATION OF NRAS</u>

Broadly speaking, as is the case with the estate tax, the imposition of US gift tax is based upon the "residency" of the donor, or in the case of donors who are not US residents, on the location in which transferred assets are situated for tax purposes. That is to say that although gifts made by US citizens and residents are subject to gift tax regardless of where property is located, NRAs are only subject to US gift tax on real or tangible property situated in the United States at the time of the transfer.[36]

In determining the situs of transferred property, general principles similar to those applied for estate tax purposes are applied for gift tax purposes, with a few exceptions. Notably, gifts of both US and non-US intangible property are not subject to the gift tax.[37] This exclusion from the gift tax includes items like stock of a US corporation and nonqualified debt obligations of a US person, which would otherwise be subject to US estate tax if owned by a NRA at death.[38] Thus, to avoid the imposition of US gift tax, a NRA simply needs to ensure that gifted assets consist of non-US situated real estate, non-US situated tangible personal property, or intangible assets, wherever situated.[39]

A. <u>Calculating Gift Tax Liability</u>.

Taxable gifts made by NRAs are taxed at the same rates as gifts made by US residents. However, NRAs and US residents are not treated similarly insofar as credits and exclusions against the gift tax are concerned.[40] For example, there is no unified lifetime gift tax credit available to NRAs (although NRAs are permitted to make annual exclusion gifts), and NRAs are not able to take advantage of gift splitting with a spouse.[41] Importantly, gifts to charity by a NRA consisting of real or tangible property situated in the US will also be subject to the gift tax unless made to US domestic charities or for exclusive use in the United States.[42]

As noted above, although US persons are entitled to an unlimited marital deduction for gifts to US citizen spouses, no such deduction is permitted for gifts to non-citizen spouses. Thus, tax-free gifts to non-citizen spouses are generally limited to "present interest" gifts falling beneath the annual exclusion amount ($152,000 in 2018).[43] As in the estate tax context, however, these rules apply only with respect to

[35] IRC § 2056A(b)(1)(A); Treas. Reg. § 20.2056A-5(b). Treas. Reg. § 20.2056A-5(b)(1). Hardship distributions are not subject to the deferred estate tax, but must be reported on IRS Form 706-QDT. IRC § 2056A(b)(3)(B); Treas. Reg. § 20.2056A-5(c)(1).

[36] IRC §§ 2501(a)(2), 2511.

[37] *Id.* Practitioners sometimes attempt to morph the characterization of otherwise tangible property into intangible form by utilizing entities like partnerships or limited liability companies. In considering such measures, practitioners should be mindful of recharacterization arguments that have been raised by the IRS under a step transaction type of analysis. N. Todd Angkatavanich & Edward A. Vergara, *Gift Tax Cost Depends on Form and Substance*, 150 TR. & EST. 20 (2011).

[38] PLR 7737063; PLR 8342106.

[39] IRC § 2501(a)(2); Treas Reg. § 25.2511-3(b)(1). Commentators and the IRS continue to disagree as to whether cash constitutes tangible property for these purposes. Cautious practitioners will often try to avoid this issue altogether by advising clients to make gratuitous transfers of cash exclusively from non-US accounts. *See* PLR 200748008; PLR 200340015; PLR 7737063. *Cf.* PLR 8120030; PLR 9427025; PLR 8210055.

[40] IRC § 2505(a).

[41] IRC § 2513(a)(1) requires that both spouses be US citizens to take advantage of gift splitting.

[42] IRC § 2522(b).

[43] IRC § 2523(i); Treas. Reg. § 25.2523(i)-1(a)(c)(2). The amount is indexed for inflation.

"outbound" gifts. Direct gifts from a NRA to a US citizen spouse will typically qualify for the unlimited gift tax marital deduction.

B. Joint Property.

A special note is in order with respect to property jointly owned by a US resident and his or her NRA spouse. For estate tax purposes, the full value of jointly owned property will be included in the taxable estate of a US resident, unless and only to the extent the estate can establish that consideration for the joint property was furnished by a NRA spouse.[44] In other words, the tax law imposes a burden of proof on the estate of a US resident to substantiate contributions to joint accounts or consideration furnished for jointly owned property.

For gift tax purposes, however, the rules for jointly owned property are somewhat more permissive. With respect to jointly owned real estate, no deemed gift will typically arise upon the creation of joint ownership; however, a gift may occur upon the sale or partition of property if proceeds are divided between spouses. With respect to jointly held financial accounts, a gift will generally occur immediately only if local law permits the non-contributing spouse to unilaterally discontinue joint ownership. As these implications are heavily dependent on local law, it may be important to consult with local counsel where substantial joint property is held by US resident and NRA spouses.

VI. GST TAXATION OF NRAS

As a general proposition, the GST tax applies only to generation-skipping transfers made by NRAs where transferred property is situated or deemed situated in the United States for gift or estate tax purposes at the time of transfer.[45] This means that, with respect to direct skips, transfers are subject to GST tax only to the extent the transferor is otherwise presently subject to US gift or estate tax. With respect to taxable terminations or taxable distributions, this means that GST tax will be imposed to the extent that the initial transfer in trust by the NRA was subject to US estate or gift tax.[46]

It is important to note that, unlike in the gift and estate tax context, NRAs are eligible for the same exemption amount from GST tax as US residents (currently $5,600,000 for year 2018). In addition to the generous exemption amount available to NRAs, planners should also remember that NRAs are essentially entitled to an unlimited exemption from GST tax for property that is not situated in the United States at the time of transfer, even if such assets are later brought into the United States.[47]

VII. TRANSFER TAX TREATIES

Practitioners confronted with international issues should also consider whether the general rules described above might be altered by an applicable bilateral estate and/or gift tax treaty. To date, the US has such treaties with seventeen countries.[48] The provisions of a treaty will generally override contrary US tax law and, in many cases, provide more favorable tax treatment for an eligible NRA.

These treaties are generally aimed at addressing instances of double taxation that may arise as the result of mismatches existing between the basis of taxation in two jurisdictions (for example, where one jurisdiction claims a right of taxation to worldwide assets based upon the domicile of a decedent and another claims a right of taxation

[44] IRC § 2040(a).

[45] *See generally* Treas. Reg. § 26.2663-2.

[46] PLR 200123045 (trust funded by NRA with non-US assets not subject to GST tax upon death of last non-skip person beneficiary).

[47] Planners should be not be too cavalier, however, as the provisions of IRC § 2014(b) (discussed above) could result in otherwise non-US assets being drawn back into a NRAs gross estate. Treas. Reg. § 26.2663-2(d), Ex. 6.

[48] The US has entered into combined estate and gift tax treaties with Austria, Denmark, France, Germany, Japan and the United Kingdom. The US has entered into separate estate tax treaties with Australia, Belgium, Finland, Greece, Ireland, Italy, the Netherlands, Norway, South Africa and Switzerland. The US has entered into a separate gift tax treaty with Australia. The US-Canada income tax treaty also addresses the transfer taxation of certain dispositions at death.

based upon the situs of assets owned at death).[49] These treaties contain many similar elements, but can be broadly be divided into two conceptual frameworks: the first attempts to address double taxation by giving primary taxing authority to the jurisdiction in which assets are situated or deemed situated; the second attempts to address double taxation by giving primary taxing authority to the jurisdiction in which an individual maintains a "fiscal domicile" (essentially a nuanced tie-breaking procedure that attempts to ascertain an individual's appropriate residency for transfer tax purposes).

Two notes of caution are in order when treaty protection may be available. First, taxpayers wishing to avail themselves of treaty benefits must disclose on a US return any position contrary to the general US tax rules. Second, one cannot selectively apply the provisions of an estate or gift tax treaty; rather, if treaty protections are desired, they must be applied globally to all relevant tax items for a given year.[50]

VIII. INCOME TAXATION OF INTERNATIONAL TAXPAYERS

An individual's status as a US "resident" for income tax purposes will significantly impact the manner and extent to which he or she is subject to US income tax. Although US residents are subject to federal income tax at graduated rates on their worldwide income, NRAs are subject to federal income tax only on income from US sources. The following is a general description of the federal income tax rules applicable to NRAs.

It should be noted that special tax and reporting regimes generally apply to “cross-border” interests and transactions with US tax relevance. Thus, for example, where US residents own interests in foreign business entities, special tax rules and reporting obligations apply. Similarly, where US residents establish or receive benefit from foreign trusts, special tax and reporting obligations apply. Conversely, NRAs owning interests in or receiving benefit from US entities can also be subject to special US tax and reporting obligations. Many of these special rules will be discussed in greater detail in subsequent installments of this series.

A. Income Tax Residency.

Compared to the somewhat amorphous transfer tax rules used to determine residency, the standards for determining residency for US income tax purposes are comparatively mechanical. As mentioned earlier, the term "residency" is used in both the transfer tax and income tax context, but has dramatically different meanings under each regime. For US income tax purposes, a non-US citizen will be treated as a US resident (and will therefore be subject to US income tax on a worldwide basis) if he or she: (i) is a lawful permanent resident (i.e., a green card holder),[51] (ii) satisfies the "substantial presence test,"[52] or (iii) makes an affirmative election either to be treated as a US resident in the year prior to which he or she satisfies the substantial presence or to file a joint return with his or her US resident spouse for the relevant tax year.[53]

1. Lawful Permanent Residents.

Being admitted to the United States as a lawful permanent resident and holding a US green card is generally determinative of tax status for US income tax purposes.[54] This is a departure from the transfer tax rules discussed above, under which holding a green card is a strong indicium of residency, but is not determinative. Thus, a green card holder will generally be subject to US income tax in the same manner as a US citizen, and this status will generally apply regardless of the amount of time the individual spends in the United States. In order to terminate this tax status,

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[49] In the US context, it should be noted that deductions and credits may be available to offset such double taxation, even where treaty benefits are not available. For example, IRC § 2014 provides for a unilateral foreign tax credit to offset double taxation.

[50] Rev. Rul. 84-17.

[51] IRC § 7701(b)(1)(A)(i)

[52] IRC § 7701(b)(1)(A)(ii).

[53] IRC §§ 7701(b)(1)(A)(iii), 6013(g).

[54] IRC § 7701(b)(1)(A)(i). Technically, a lawful permanent resident can cease to be treated as a US resident under the terms of an income tax treaty with another country. As discussed in later installments of this series, however, electing such treatment could result in a “deemed expatriation” in certain circumstances.

a green card holder must generally follow through with the administrative steps required to formally relinquish their status as a lawful permanent resident.

2. Substantial Presence Test.

The substantial presence test is an objective test based on day counting that is used to determine whether an individual has spent enough time in the United States to qualify as a US income tax resident. An individual will meet the substantial presence test if: (i) the individual is present in the United States for 183 days or more during a calendar year, or (ii) if the individual is present in the United States for 31 days or more during a calendar year, and a weighted average of the individual's time spent in the United States for the current year and the two prior years equals at least 183 days.[55] For purposes of calculating this weighted average, each day of presence in the United States in the current year counts for one day, each day of presence in the United States in the immediately preceding calendar year counts for 1/3 of a day, and each day of presence in the United States in the second preceding calendar year counts as 1/6 of a day.[56] In practice, if an individual is present in the United States for at least 121 days per year over a three year period, the individual will satisfy the substantial presence test.

Generally speaking, any portion of a day spent in the United States counts as a full day for purposes of the substantial presence test.[57] However, certain exceptions can apply to exclude periods of time spent in the United States from an individual's day count. One such exception exists for an individual in the United States as an "exempt individual." Exempt individuals include certain individuals associated with foreign governments, teachers or teachers in training, students, and professional athletes participating in charitable sporting events.[58] Other regulatory exceptions exist for individuals receiving treatment for medical conditions arising while in the United States and individuals regularly commuting into the United States from Canada or Mexico.[59]

In light of the mechanical nature of these tests, clients for whom the substantial presence test might present an issue should be encouraged to maintain contemporaneous records detailing time spent in the United States and the activities carried out during each trip. Records of this sort can be invaluable to a practitioner attempting to determine or advise with respect to an individual's residency status, or for practitioners defending a client in connection with an income tax residency audit.

3. Closer Connection Exception.

Notwithstanding the rules described above, an individual who would otherwise satisfy the substantial presence test (but who is not a lawful permanent resident) may still avoid classification as a US income tax resident by establishing that they have "closer connection" to a another jurisdiction. The closer connection exception is available if the taxpayer spends fewer than 183 days in the United States in the current year, maintains a "tax home" in a foreign country, and has a closer connection to the country that is the individual's tax home.[60] A tax home is generally an individual's regular or principal place of business, or, if no regular or principal place of business, the regular place of abode in a real and substantial sense. The determination is based on all relevant facts and circumstances. Claiming protection under the closer connection exception is accomplished by filing IRS Form 8840 with a timely filed US income tax return.

[55] Treas. Reg. §§ 301.7701(b)-1(b), 1(c)(1).

[56] Treas. Reg. § 301.7701(b)-1(b)(i)(C)(1).

[57] In determining days of presence, both the day of entry and the day of departure are included. *Jose Angel Lujan*, 80 TCM 780 (2000).

[58] As a general matter, therefore, individuals temporarily admitted to the United States under F, M, J or Q visas who substantially comply with the terms of their visas will be considered exempt individuals.

[59] IRC § 7701(b)(3)(D), (b)(5); Treas. Reg. § 301.7701(b)-3.

[60] IRC § 7701(b)(3)(B); Treas. Reg. § 301.7701(b)-2.

4. Treaty Tie-Breaker Exception.

An additional layer of protection may be provided to individuals under a bilateral income tax treaty. Under the residency "tie-breaker" provisions of most US income tax treaties, an individual who might otherwise be classified as a US tax resident can be classified as a NRA if the individual also qualifies as a tax resident of the other treaty country and the treaty's residency tie-breaker provisions resolve in the other country's favor.[61] As with the closer connection exception, treaty benefits are claimed by filing IRS Form 8833.[62]

It should be noted that in the case of a lawful permanent resident, claiming residency in a foreign country under a treaty's tie-breaker provisions could potentially trigger a deemed expatriation from the United States for purposes of Section 877A. Therefore, careful consideration should be given to the implications of making such a filing.

B. General Treatment of Income of NRAs.

An NRA is subject to US income tax only with respect to two broad categories of income. First, a flat 30% withholding tax is imposed on a gross basis with respect to certain categories of US source investment income, including dividends, rents, royalties, dividends, annuities, and similar items. In technical parlance, these are referred to as fixed, determinable, annual or periodical income items or "FDAP."[63] Note that capital gains realized by a NRA are not considered FDAP and are thus not generally subject to US tax. However, if a NRA is present in the United States for 183 days or more during the year, capital gains are subject to US income tax on the same basis as FDAP (notwithstanding the fact that in such case, such person may not necessarily be treated as a US income tax resident).[64]

A special note is in order with respect to interest items, which are generally subject to the 30% withholding tax imposed on FDAP, but are eligible for numerous exceptions from US income taxation. These exceptions include certain deposit interest, interest on certain short-term obligations and, importantly, portfolio interest.[65] Favorable treatment for portfolio interest is generally available with respect to obligations issued by US borrowers, with respect to whom NRA lenders are mere portfolio investors who are not making loans in the ordinary course of a US trade or business.[66] In order to be eligible for this treatment, an obligation must be in registered form, must not be issued by certain parties related to the borrower and must bear interest at a fixed rate that does not fluctuate with the borrower's profits.[67]

Second, NRAs are subject to US income tax on income that is, or is deemed to be, effectively connected with the conduct of a US trade or business. This income is often referred to simply as "effectively connected income" or "ECI." ECI is generally subject to US income tax at the same graduated rates applicable to US citizens and residents.[68] Unlike FDAP income, ECI is taxed on a net basis. However, deductions are generally limited to those items associated with the ECI.[69]

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[61] A typical treaty tie-breaker provision (for instance, the US-Switzerland treaty) might apply the following tests to determine an individual's tax residence: (i) the place of the individual's permanent home, (ii) if an individual has a home in both countries, then his or her center of vital interests; (iii) if this is not determinative, the individual's place of habitual abode; (iv) if the individual has an abode in both countries, the individual's nationality; and (v) if all of the foregoing are inconclusive, the agreement of the competent authorities.

[62] of IRC § 877A.

[63] IRC § 871(a).

[64] IRC § 871(a)(2).

[65] IRC § 871(g)(1)(B).

[66] IRC § 871(h)(2).

[67] Note that the related party restrictions for portfolio interest have limited applicability vis-à-vis trusts and, therefore, can provide a powerful advantage in the estate planning context.

[68] IRC § 871(b).

[69] IRC § 873(a). Note that the charitable deduction, personal exemption, and deductions associated with certain US-source losses are subject to less stringent restrictions.

The rules of Sections 861 through 865 are generally applied in determining whether an item of income is properly sourced to the US and thus potentially subject to US income tax in accordance with the rules described above. These rules generally apply in the following manner, subject to numerous exceptions:

- Interest is generally sourced to the United States if it is interest on an obligation issued by a US person or entity;[70]

- Dividends are generally sourced to the United States if from a domestic corporation;[71]

- Rents and royalties are generally sourced to the United States if the property giving rise to the income is located or used in the United States;[72]

- Compensation for services rendered is generally sourced to the place the services are performed;[73]

- Income from the sale of inventory is generally sourced to the place in which the inventory is sold, although this general rule will be impacted by whether or not the inventory in question was produced by the taxpayer;[74] and

- Income from the sale of personal property other than inventory is generally sourced to the United States if the seller is a US resident or if the property is depreciable property.[75]

As noted above, the US income tax regime for NRAs may apply differently based on the application of certain anti-abuse and enforcement regimes, including special rules applicable to gains associated with interests in US real estate. Those rules will be discussed in a subsequent edition of this series.

C. International Income Tax Treatment of US Taxpayers.

In an attempt to avoid or offset the incidence of double taxation on taxpayers living and working in multiple countries, the US income tax law provides certain preferences to US taxpayers living, working or otherwise engaged in income producing activities outside the United States. These preferences include a credit for income taxes paid in foreign jurisdictions, as well as exclusions for certain amounts of income earned and housing expenses incurred by US citizens living and working abroad.

1. Foreign Tax Credit.

Section 901 provides that a US taxpayer may elect to take a credit (as opposed to a deduction) against his or her annual US federal income tax liability for foreign income taxes paid or accrued by the taxpayer.[76] In principle, this foreign tax credit ("FTC") is intended to protect US taxpayers from exposure to double-taxation by allowing them to offset US tax liability by the amount of foreign taxes paid, on a dollar-for-dollar basis. However, Section 904 limits the amount of foreign income taxes that may be credited in a given tax year to the amount of US income tax that would have been imposed on the taxpayer's foreign income without application of the credit. Under Section 904, FTCs for a given year are limited to a taxpayer's tentative US federal income tax liability for the tax year multiplied by a fraction which is (i) the taxpayer's net foreign source

[70] IRC §861(a)(1).

[71] IRC §861(a)(2).

[72] IRC §861(a)(4).

[73] IRC §861(a)(3).

[74] IRC §861(a)(6).

[75] IRC §861(a)( ).

[76] To be creditable, a foreign tax must have the "predominant character" of "an income tax in the US sense." Treas. Reg. 1.901-2(a)(3). This means that a creditable foreign tax must generally attempt to reach net gain in normal circumstances, rather than having the character of a "soak-up" tax. Note also that Section 901(j) also denies the foreign tax credit for taxes paid to certain countries identified as bad actors, including Afghanistan, Cuba, Iran, North Korea and Syria. *See* Rev. Rul. 2005-3, 2005-1 C.B. 334.

income for the tax year over (ii) the taxpayer's net worldwide income for the tax year. Section 909 imposes an additional limitation, and attempts to avoid timing distortions by deferring the creditability of foreign taxes until the associated income has been taken into account for US income tax purposes. Excess FTCs not used in the current year may be carried back one year and carried forward for the ten succeeding years.[77]

The annual limitation under Section 904 is calculated separately for two different categories of net foreign source income, referred to as "general category income" and "passive category income." In general terms, passive income includes all portfolio investment income,[78] and general category income is everything else. As a result of the separate limitations for general and passive category income, FTCs in the general category income basket can only reduce US federal income tax liability to the extent there is sufficient net foreign source general category income, and FTCs in the passive category income basket can only reduce US federal income tax liability to the extent there is sufficient net foreign source passive category income.

2. Foreign Earned Income and Housing Exclusions.

While US citizens and lawful permanent residents are generally subject to US income tax on their worldwide income, Section 911 allows US taxpayers to exclude from income limited amounts (currently up to $102,100) attributable to services performed abroad if certain qualifications are met.[79] To qualify for the foreign earned income exclusion, a US taxpayer must be a "qualified individual," which means that one of two tests must be satisfied: (1) the taxpayer was a bona fide resident of a foreign country or countries for an uninterrupted period including an entire tax year (sometimes referred to as the "bona fide residence test"); or (2) the taxpayer was present in a foreign country or countries for at least 330 full days during twelve consecutive months and has a tax home in a foreign country (sometimes referred to as the "330-day test").[80] An individual's tax home is generally his or her regular or principal place of business, or if none, his or her regular place of abode in a real and substantial sense.[81]

An individual who is a "qualified individual" may elect to exclude up to $102,100 of his or her foreign earned income from gross income for US income tax purposes. Foreign earned income is generally all income attributable to services performed outside the United States during the relevant period (excluding items of deferred compensation), regardless of where and when the taxpayer receives payment.[82] The dollar ceiling for the exclusion is pro-rated if the taxpayer qualifies for the exclusion for only a portion of the year, such that the resulting exclusion amount is reduced proportionately.[83] Note that the foreign earned income exclusion is claimed in lieu of, rather than in addition to, any other credits or deductions that might be related to the foreign income in question (including the FTC).[84]

Qualified individuals may also elect to exclude a portion of foreign housing costs from gross income if certain qualifications are met.[85] The availability of this exclusion reflects a policy recognition that US taxpayers living abroad are often subject to additional housing costs, and often receive additional compensation to offset these costs. The excludable amount is determined using

[77] IRC § 904(c).

[78] Passive category income is defined as foreign personal holding company income as defined in IRC § 954(c). IRC § 904(d)(2)(B)(i).

[79] IRC § 911(a)(1). Note that the exclusion amount is indexed to inflation and adjusted annually. For purposes of the foreign earned income exclusion, foreign earned income includes wages, salaries, professional fees and other income items attributable to the provision of services by a US taxpayer (other than pension and related payments).

[80] IRC § 911(d); Treas. Reg. § 1.911-2(c).

[81] Treas. Reg. § 1.911-2(b).

[82] IRC § 911(b)(1)(B); Treas. Reg. § 1.911-3(a).

[83] Treas. Reg. § 1.911-3(d)(2).

[84] IRC § 911(d)(8).

[85] IRC § 911(a)(2).

a mechanical calculation that generally captures a taxpayer's housing costs attributable to living in a foreign country to the extent that: (i) the costs exceed a floor equal to 16% of a set exclusion amount, and (ii) the costs do not exceed a ceiling equal to 30% of a set exclusion amount.[86] To be eligible for the exclusion, housing costs must be reasonable and may not be "lavish or extravagant."[87] Both the foreign earned income and foreign housing exclusions are claimed by filing IRS Form 2555.

D. Effect of US Income Tax Treaties.

As in the transfer tax context, the tax result determined under the general rules described above may be altered in a particular circumstance by a bilateral income tax treaty, which can operate to modify certain provisions of US income tax law. The United States has entered into over 60 such treaties pursuant to which residents of one country may be eligible for tax exemptions or reduced rates with respect to income derived from activities in the other country.[88]

Treaty provisions can be particularly beneficial for NRAs, as they may act to exempt or reduce the rate of taxation imposed on certain items of US source income, or to reduce or eliminate withholding taxes on FDAP income. Moreover, income tax treaties are generally designed with an express goal of precluding the incidence of double taxation, and include procedures for addressing such issues as they may arise. This is generally accomplished by way of an exemption or by providing a uniform set of sourcing rules as between two countries to ensure that an offsetting credit or exemption is always available.

Although a full review of the detailed provisions of US income tax treaties is beyond the scope of this article, it is advisable for practitioners representing international clients to account for the existence of an applicable treaty in analyzing a client's circumstances and proactively seek out opportunities that might improve the net tax result achieved by a client residing or conducting activities in a treaty jurisdiction.

IX. INCOME TAXATION OF FOREIGN TRUSTS

In the domestic context, the income tax treatment of a trust is broadly dependent on whether the trust is treated as a grantor trust or a non-grantor trust. If a trust is a grantor trust, it will essentially be disregarded for income tax purposes, and its income, gains and losses will be taxable to the grantor. Of course, in the domestic estate planning context this provides many planning advantages from a transfer tax standpoint, as the requirement that the grantor pay the income tax liability attributed to the trust allows the grantor to reduce his or her otherwise estate taxable assets while allowing the grantor trust to effectively grow on a tax free basis.[89] A domestic non-grantor trust, on the other hand, is treated as a separate taxable entity and is obligated to pay the tax associated with its undistributed income.

An additional layer of complexity exists in the case of taxation of foreign trusts. In addition to the classification of a trust as grantor or non-grantor, the practitioner must determine whether a trust is a foreign trust or domestic trust. Thus, it is possible for a trust to have four different classifications for US income tax purposes, the status of which is determined on an annual basis, which are as follows:

- US grantor trust;
- US non-grantor trust;
- Foreign grantor trust; or
- Foreign non-grantor trust.

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[86] IRC § 911(c).

[87] IRC § 911(c)(3)(A). Note that the total amount excluded under the foreign earned income and foreign housing exclusions may not exceed the taxpayer's foreign earned income for the year.

[88] *See https://www.irs.gov/businesses/international-businesses/united-states-income-tax-treaties-a-to-z.*

[89] See [ARTICLES]

The practitioner's determination of the appropriate classification for a trust will have a significant impact on the relevant tax rules. Moreover, it is quite possible for the status of a trust to change periodically based on certain mechanical rules, and the change of status can result in income tax triggers that can have unexpected results. For instance, the simple change in residency status of a trust fiduciary might result in a change of status, regardless of whether the change is intended. Lastly, planners should be aware that the requirements for creation of a grantor trust by a NRA are radically different from the requirements for the creation of a grantor trust by a US person. Accordingly, these special rules must be considered as this planning is undertaken with foreign trusts.

A. <u>Foreign or Domestic Trust?</u>

The Code classifies a foreign trust in the negative, providing that a trust will default to being treated as a foreign trust unless it qualifies as a US trust, meaning it satisfies both the "court test" and the "control test".[90] Expressed another way, if a trust fails either of these two tests, it will be considered a foreign trust. Only if a trust meets both of these two tests will it be considered a domestic trust.

1. <u>Court Test</u>.

The court test requires that a US court be able to exercise primary supervision over the administration of the trust.[91] This test will be deemed to have been met if the three criteria of a safe harbor are satisfied: (i) the trust instrument does not direct that the trust be administered outside the United States, (ii) the trust is actually administered in the United States, and (iii) the trust does not include an automatic migration, or "flee," provision.[92] The court test is also deemed satisfied by trusts registered with a US court, testamentary trusts with trustees qualified by a US court, and by trusts actively supervised by a US court.[93]

2. <u>Control Test</u>.

The second test (and indeed, the one more likely to result in a non-intuitive foreign trust status), is the "control test." The control test essentially provides that if a foreign person, or a group consisting of a majority of foreign persons, has authority with respect to any substantial decision of the trust, the trust will fail the control test and will be a foreign trust.[94] The following are considered "substantial decisions" of a trust: (i) whether and when to make distributions; (ii) the amount of distributions; (iii) selecting beneficiaries; (iv) allocating receipts to income or principal; (v) revoking or terminating the trust; (vi) compromising, arbitrating or abandoning claims to the trust; (vii) suing on behalf of or defending suits against the trust, (viii) removing, adding or replacing trustees or appointing successor trustees, and (ix) making investment decisions.[95] These powers will typically be held by a trustee, protector, veto holder or investment advisor, and the residency status of these individuals should be verified during the planning process in order to minimize the risk that the control test might be inadvertently failed.

3. <u>Relief for Accidental Foreign Trusts</u>.

As mentioned above, because these are mechanical rules that can be triggered without intent or even awareness, it is quite possible to trigger an unexpected change in classification. The regulations recognize this possibility and provide that an unintended loss in status as a domestic trust that is corrected by taking remedial steps within twelve months to give control over all

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[90] Treas. Reg. § 301.7701-7(a)(2).

[91] Treas. Reg. § 301.7701-7(a)(1).

[92] Treas. Reg. § 301.7701-7(c)(3).

[93] Treas. Reg. § 301.7701-7(c)(4).

[94] Treas. Reg. § 301.7701-7(d)(1)(ii).

[95] Treas. Reg. § 301.7701-7(a)(2).

substantial decisions to US persons.[96] If the trust can establish reasonable cause for this process taking longer than twelve months, the IRS has the authority to extend the time period.[97]

B. Grantor or Non-Grantor Trust?

Special rules apply to NRA grantors in determining whether a trust is properly classified as a grantor trust or non-grantor trust. To address certain perceived abuses with respect to foreign grantor trusts, Congress enacted rules in 1996 to narrow the circumstances under which a NRA may create a grantor trust. Under these rules, a trust will be treated as a grantor trust with respect to a NRA grantor only if: (i) the trust is revocable by the grantor, or (ii) distributions from the trust during the grantor's lifetime may only be made to the grantor or the grantor's spouse.[98] A revocation power will be effective to create a foreign grantor trust ("FGT") even if subject to the consent of another person, as long as that other person is a related or subordinate party who is subservient to the grantor. A foreign trust that does not qualify as a foreign grantor trust will be classified as a foreign non-grantor trust ("FNGT").

C. Foreign Grantor Trusts.

As is the case with a domestic grantor trust, a foreign grantor trust is essentially disregarded for US income tax purposes, meaning the grantor will be liable to pay the US income tax, if any, attributable to the trust's assets. Because a FGT will be taxed to the NRA grantor, and therefore will only be subject to US income tax on certain US source income, and because distributions from FGTs are not subject to the throwback tax (discussed below), a FGT can provide a very income tax-efficient means to hold assets for the benefit US taxpayers.

1. Anti-Conduit Rules.

Care should be taken to ensure that certain "anti-conduit rules" are not triggered with respect to a FGT.[99] These rules can have the effect of treating a US beneficiary as the grantor of a purported FGT where the US beneficiary previously made a transfer of assets to the nominal NRA grantor. For example, if A transfers assets to G, a NRA, before becoming a US person and G subsequently creates a trust for the benefit of A that would otherwise be treated as a FGT as to the Grantor, A may be treated as the owner of the trust for US income tax purposes once he becomes a US person. It should be noted that this rule applies without regard to whether the beneficiary was a US person at the time of the initial transfer of assets to the NRA.[100]

2. Accidental Grantor Trusts.

Under Section 679, a US person who directly or indirectly makes a gratuitous transfer of property to a foreign trust with one or more US beneficiaries will be treated as the owner of the trust for income tax purposes to the extent of the transfer. For these purposes, a trust is treated as having a US beneficiary unless: (i) the trust prohibits distributions to US persons, or (ii) no US person could benefit from a current termination of the trust.[101] This determination must be made on an annual basis, taking into consideration not only the trust instrument itself, but also things such as letters of wishes and even implied understandings.[102]

[96] Treas. Reg. § 301.7701-7(d)(2)(i).

[97] Treas. Reg. § 301.7701-7(d)(2)(ii).

[98] IRC § 672(f).

[99] IRC § 672(f)(5).

[100] Treas. Reg. § 1.672(f)-5(a).

[101] IRC § 679(c); Treas. Reg. § 1.679-2(a).

[102] Treas. Reg. 1.679-2(a)(4)(i). If the trustee has the power to add a US person as a beneficiary, the trust will also be deemed to have a US beneficiary. Treas. Reg. § 1.679-2(a)(4)(ii)(A).

Section 679 applies not only to direct transfers in trust, but also to indirect or constructive transfers. This might include a transfer made by a US person to an NRA friend who subsequently funds a trust for the benefit of the US person's US family members. If it cannot be established that the transfer to the NRA friend was unrelated to the funding of the trust, Section 679 would result in the trust being treated as a grantor trust with respect to the US person. Section 679 will also apply to any loan made to a foreign trust unless the loan constitutes a qualified obligation.[103]

The policy rationale behind these rules was to prevent the abuse of so called "drop off" trusts – foreign trusts in which a US grantor, or a NRA grantor who planned to become a US income tax resident in the foreseeable future, would "park" assets in an attempt to shelter the trust's non-US source income from US taxation (because, in the absence of Section 679, the trust would be a FNGT that would be subject to US income tax only on its US source income), while enabling US beneficiaries to receive distributions. The rule avoids this perceived abuse by causing a US grantor, or NRA grantor who becomes a US income tax resident within 5 years of trust funding, to be treated as the owner of the trust assets for income tax purposes.

Although the rule seems sensible on its face, it can create unanticipated complications where a NRA transfers property to a foreign trust and subsequently becomes a US resident within a 5 year period. In such case, the trust will be characterized as a grantor trust to the extent of the contribution.[104] Of course, because of the 5 year look-back, if the timing of the grantor's plans are flexible, this "drop-off" planning can still be achieved by creating the trust more than 5 years before the NRA grantor becomes a US resident. If the NRA grantor becomes a US income tax resident within the 5 year look-back period, he or she will be treated as the owner of the trust beginning on his or her US residency starting date, regardless of whether the trust in question might or might not qualify as a grantor trust under the general grantor trust rules.

3. Death of Grantor.

Practitioners should keep in mind that a grantor trust will necessarily become a non-grantor trust upon the death of the grantor, and should plan for this eventuality. For income tax purposes, the death of the grantor of a grantor trust is treated as a transfer of the trust property by the grantor.[105] Absent effective planning, this could result in gain recognition on assets within the trust, either with respect to assets with liabilities in excess of basis, or under the special deemed disposition rules of Section 684 (discussed in greater detail below) if the grantor is a US person. An exception to the latter provision will prevent gain recognition with respect to certain assets included in the grantor's gross estate for estate tax purposes.[106]

An additional consideration is whether to migrate or domesticate a foreign trust after the grantor's death. This could produce income tax efficiencies as to US beneficiaries by avoiding the imposition of the throwback tax, but would necessarily subject all trust income to current US taxation. This may, however, limit some ongoing flexibility for future planning, particularly if it is anticipated that current US beneficiaries may not remain US tax residents. Practitioners should undertake a holistic analysis of the trust and its beneficiaries prior to any change in status.

D. Foreign Non-Grantor Trusts.

A foreign non-grantor trust ("FNGT") is generally subject to US income taxation in the same manner as a NRA, subject to certain modifications. Thus, a FNGT will only be subject to US income tax on certain US sourced income, namely: (i) FDAP, which is subject to a 30% gross withholding tax, and (ii) ECI, which is subject to tax at marginal rates on a net basis.

[103] IRC § 679(a)(3).

[104] IRC § 679(a)(4).

[105] Treas. Reg. § 1.1001-2(c), Ex. 5.

[106] Treas. Reg. § 1.684-3(c).

1. Foreign Trust Accounting.

Development of a thorough understanding of the special tax rules applicable to foreign trusts and their beneficiaries requires a basic facility with three separate accounting concepts: fiduciary accounting income ("FAI"), distributable net income ("DNI") and undistributed net income ("UNI"). FAI is effectively a property law concept that defines the character of a trust's receipts as either income or principal for purposes of the trust instrument. FAI is determined under local law and, in most cases, will not include realized capital gains. DNI is a tax concept that generally amounts to the trust's net taxable income under US principles.[107] UNI is defined in broad terms as any net, after-tax DNI that has not been distributed.

These concepts become important because FNGTs are subject in certain circumstances to draconian tax consequences when making distributions to US beneficiaries that are deemed to come from trust UNI. Distributions subject to these tax rules are referred to in the Code as "accumulation distributions" and they are subject to a tax regime commonly referred to as the "throwback tax."

2. Distributions from FNGTs.

As is the case with a domestic non-grantor trust, distributions of DNI from a FNGT will generally carry out taxable income, and the trust beneficiary will inherit tax attributes corresponding to the beneficiary's proportionate share of trust income. Accumulation distributions, on the other hand, are subject to the punitive throwback tax regime, which is intended to discourage the deferral of taxable income through the use of foreign trusts.

The receipt of an accumulation distribution by a beneficiary has two practical effects for income tax purposes: first, the entire distribution is subject to income tax at the highest marginal rate, regardless of whether the distribution would otherwise have been eligible for preferential treatment; and second, a punitive interest charge is imposed that relates back to the years in which the distributed UNI was first accumulated, on a worst in, first out basis. In the worst case scenario, the throwback tax can essentially become confiscatory and reach 100% of the distribution.

Accumulation distributions can occur not only upon outright transfers from a trust to a US beneficiary, but also by way of a trust making loans, permitting rent-free use of trust property or making distributions indirectly through intermediaries.[108] These special provisions are designed to prevent creative maneuvers that might otherwise avoid the imposition of the throwback tax.

3. Deemed Distributions from FNGTs.

Section 643(h) was designed to prevent maneuvers whereby distributions are made indirectly from a FNGT to a US beneficiary through a nominee. The effect of this rule is to deem such payments to be distributions directly from the FNGT. For example, if a FNGT makes a distribution of $100 to X, a foreign beneficiary, and X subsequently pays such amounts to A, a US beneficiary, Section 643(h) will treat the transaction as a distribution from the trust to A.[109]

Section 643(i) provides that if a foreign trust permits the use of trust property by any grantor or US beneficiary of the trust (or a related person), such use will be treated for tax purposes as a deemed distribution by the foreign trust in amount equal to the fair market value of such use. Section 643(i) further provides that if a foreign trust directly or indirectly makes a loan to or by any grantor or US beneficiary of the trust (or a related person), the amount of such loan will be treated

[107] It should be noted that the DNI of a FNGT generally includes realized capital gains. IRC §643(a)(6)(C).

[108] IRC § 643(h) & (i).

[109] For additional examples of the application of these rules, *see* Treas. Reg. § 1.643(h)-1(g).

for tax purposes as a deemed distribution unless the loan meets the specific requirements of a "qualified obligation."[110]

4. Distribution Planning for FNGTs.

As one might imagine, a cautious trustee will often desire to avoid making accumulation distributions to US beneficiaries altogether, as the tax consequences could be quite harsh. Fortunately, there are four common strategies trustees can rely on to avoid triggering the throwback tax. Distributions made in accordance with one of the following will generally escape the imposition of the throwback tax:

a) Distributions not in Excess of DNI / 65-Day Election.

Distributions from a FNGT are deemed to initially carry out current year DNI and, thus, are necessarily not considered accumulation distributions. To avoid the uncertainties that may arise in attempting to make such calculations before the end of a taxable year, a trustee may make a special tax election to treat amounts distributed to beneficiaries within the first 65 days of a tax year as having been distributed on the last day of the preceding tax year.[111] Note that amounts to which the election applies cannot exceed the greater of the FNGT's FAI and DNI for the year with respect to which the election is made.

b) Distributions not in Excess of FAI

Distributions from a FNGT that do not exceed current year FAI will likewise not be considered accumulation distributions.[112] Thus, for example, if a FNGT has $1000 of FAI in a particular year, but only $900 of DNI, a distribution of $1000 would still not be treated as an accumulation distribution and would not be subject to the throwback tax, as it would not exceed the $1,000 of FAI.

c) Specific Distributions

A distribution from a FNGT will not be considered an accumulation distribution to the extent the distribution is in satisfaction of a gift of a specific sum of money or of specific property.[113] Distributions of this sort may be made in installments, but will nonetheless be considered accumulation distributions if made in more than three installments.

d) Default Distributions

As one might imagine, the information needed to calculate the throwback tax will very often not be available and, thus, the calculation of the throwback tax can pose an accounting and administrative nightmare. IRS Notice 97-34 and the instructions for IRS Form 3520 acknowledge this difficulty by providing for a "default method" to determine whether an accumulation distribution has been made.[114]

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[110] A qualified obligation is a debt instrument that meets the following requirements: (i) must be in writing, (ii) must not have a term exceeding 5 years, (iii) must provide for payments denominated in US dollars, (iv) must bear interest at a rate between 100-130% of the applicable federal rate, (iv) the US beneficiary must extend the period for assessment of tax to a least 3 years following the maturity of the obligation, and (v) the US beneficiary must report the loan on IRS Form 3520 for each year the obligation is outstanding. IRS Notice 93-34.

[111] IRC § 663(b).

[112] IRC § 665(b) ("If the amounts properly paid, credited or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year").

[113] Treas. Reg. § 1.665-1A(c)(1).

[114] Beneficiaries are required to apply the default method if the trustee does not provide a foreign non-grantor trust beneficiary statement. Once the default method has been applied in a year, it is required to be applied in all subsequent years.

This methodology amounts to a safe harbor, allowing a beneficiary of a FNGT to avoid treating a distribution as an accumulation distribution. The safe harbor provides that, to the extent a current year's distribution does not exceed 125% of the average distributions from the trust over the prior three years, the distribution will not be considered an accumulation distribution.[115] For example, if in the prior three years, distributions from a FNGT were $100, $110 and $150, the total distributions over the prior three years would be $360, 125% of which is equal to $450. Therefore, in year 4, the FNGT could make a distribution of up to $150 ($450/3) without having made an accumulation distribution.

The default method can provide a planning opportunity over time, in that increasingly larger distributions in prior years, although potentially attracting some level of throwback tax initially, can increase the default distribution threshold in future years. In other words, gradually increasing year-over-year distributions from a FNGT can have the practical effect of continually raising the ceiling under which tax favored distributions can be made.

This type of distribution planning could perhaps be combined with investment strategies intended to ensure high levels of gain recognition, and thus high levels of DNI, each year, thereby further increasing the base upon which distributions may be calculated. However, the benefits provided by the default method from the perspective of a trust's UNI account must be balanced with the acknowledgment that all distributions received by US beneficiaries will be treated as ordinary income, even if consisting of otherwise tax-favored items.

e) Gain Recognition on Contribution to a FNGT

Although a US person is generally able to contribute property to a domestic trust on an income tax neutral basis, a special rule can trigger gain recognition when a US person contributes appreciated property to a foreign trust, or in some cases when a US non-grantor trust becomes a FNGT.[116] In essence, this rule treats the US person as though he or she had sold the contributed property to the trust in exchange for an amount equal to the property's fair market value.[117] Note that although this provision can result in gain recognition, it will not allow for recognition of loss.

Because of an exception to the application of this special rule for transfers to grantor trusts, a practitioner's sensitivity to gain recognition upon funding of a foreign trust should be most acute in the relatively rare circumstance of a FNGT funded by a US person that does not include US beneficiaries.[118] These rules could also be triggered by the change in status of a domestic trust. For example, if a domestic non-grantor trust were to become a FNGT, perhaps by change in status of a fiduciary or decanting, gain recognition could potentially be triggered.[119] Lastly, gain could also potentially be triggered by virtue of a domestic grantor trust becoming a FNGT upon the death of the grantor. However, this situation would not generally arise with respect to a trust eligible for a step-up in basis under Section 1014(a) (e.g., a decedent's revocable trust).[120]

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[115] Note that if the trust has been a FNGT for less than three years, total distributions are instead divided by the number of years in which the trust has been a FNGT.

[116] This rule is not applicable to transfers to grantor trusts, regardless of whether the transferor is the deemed owner of the trust for income tax purposes.

[117] IRC § 684(a).

[118] Treas. Reg. § 1.684-3(a). This is particularly the case because of the broad sweep of IRC § 679, discussed above.

[119] Treas. Reg. § 1.684-4(a). Note that inadvertent migrations within the meaning of Treas. Reg. § 1.7701-7(d)(2) may avoid the application of these rules by complying with the relevant remedial procedures.

[120] Treas. Reg. § 1.684-3(c).

f) Reporting Distributions from Foreign Trusts

A US beneficiary receiving a distribution from a foreign trust (whether from a FGT or a FNGT) must report certain information regarding the distribution to the IRS on IRS Form 3520. US tax law contemplates that the trustee of a foreign trust will provide certain statements to trust beneficiaries to inform them of the amount and character of trust income distributed. If a beneficiary does not receive such a statement, the beneficiary is automatically subject to US taxation based on the default calculation specified on Schedule A of IRS Form 3520. Failure to report distributions to the IRS carries a penalty equal to 35% of the amount distributed.

X. PLANNING STRATEGIES FOR FOREIGN NON-GRANTOR TRUSTS

A. Domestication

Where a foreign non-grantor trust has primarily US beneficiaries and has not yet accumulated a substantial pool of UNI, it may be worthwhile to consider "domesticating" the trust to a US jurisdiction so as to preclude the further accumulation of UNI and, thus, limit the extent of future application of the throwback tax. In so doing, however, a planner must be mindful that a distribution in further trust could, in some instances, itself be considered an accumulation distribution and subject to immediate throwback tax.[121]

As an alternative to decanting a FNGT, for example, where a substantial pool of UNI makes the possible risk of an accumulation distribution too substantial, the FNGT could instead migrate to the United States by changing its situs, governing law and fiduciaries such that it satisfies both the court test and control test.[122] However, planners should be aware that the domestication of a FNGT in this manner will not altogether avoid the future imposition of the throwback tax; rather, the domesticated trust will maintain its existing pool of UNI, potentially triggering a throwback tax upon future distribution; nonetheless, the domestication of the trust will prevent further build-up of the UNI pool thus containing the issue.

Prior to domesticating a FNGT, planners should undertake a balancing of the relative merits of such a strategy. In so doing, planners should take into account not only the benefits of domestication as it relates to a trust's UNI pool, but also the fact that the domesticated trust will be subject to US income taxation on its worldwide assets on a going forward basis. Although a reduction in the potential for accumulation distributions can be advantageous, the throwback tax is relevant only to the extent a FNGT will benefit US persons – to the extent a FNGT might primarily benefit non-US persons, FNGT status may perhaps be manageable.

B. Segregating Trust Income

For a FNGT with no existing UNI pool and US beneficiaries, one idea might be for the trustees to make annual distributions either directly to the US beneficiaries or to a domestic trust for their benefit. This will have the practical effect of carving off the trust's income, thus leaving a pool of "clean capital" in the original FNGT. If substantial distributions into the US are not desirable, different income tax efficient investment applications, including insurance products, might be available to reduce or eliminate the realization of income for a period of time.

This strategy could also be adapted to work with a FNGT that has accumulated a substantial pool of UNI. In this application, the trustee of the FNGT would make a substantial distribution, consisting of all current year income and all prior accumulations, to foreign beneficiaries or to an unrelated foreign entity, thereby leaving only a pool of clean capital untainted by UNI. In the following tax year, the trustee could either domesticate the trust, thereby permitting future accumulations of income without fear of the throwback tax,

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121 Treas. Reg. § 1.665(b)-1A(b)(1) ("a distribution from one trust to another trust is generally an accumulation distribution"). Note that a distribution in further trust may also affect the GST-exempt status of the trust assets, although this conclusion is being studied by the IRS. Rev. Proc. 2015-3, 2015-1 I.R.B. 129.

122 PLR 7917063, PLR 7917037. Domestication by these means should not generate an accumulation distribution, and should not affect the trust's GST-exempt status.

or could implement the annual distribution procedure described in the preceding paragraph to manage future income accumulations. The timing is extremely important in this application, as distributions to US and non-US beneficiaries in a single tax year will carry out proportionate amounts of UNI, which is undesirable from a tax efficiency standpoint.

C. Managing DNI and FAI Through Entity Planning

As discussed above, Section 655(b) provides that an accumulation distribution occurs when a trust makes a distribution that exceeds both current year DNI and current year FAI. In other words, if a trust distribution is less than either DNI or FAI for a current year, no accumulation distribution will have occurred. Notably, a trust's FAI is determined under the terms of the trust's governing instrument and local law, and will often differ in some regards from the determination of the trust's DNI.[123] The laws of many jurisdictions provide that certain non-liquidating distributions from a business entity will be treated as fiduciary accounting income of the trust, rather than as a return of capital.[124] In some circumstances, a situation may arise in which a substantial disparity exists between trust FAI and DNI for a particular year, and attentive and proactive planners can sometimes structure trust distributions for such years to pass significant value to US beneficiaries while mitigating the impact of the throwback tax.

D. Preferred and Reverse Preferred Partnerships

One interesting technique to consider as a means to address the accumulation of UNI in a FNGT is through the use of a preferred partnership. Preferred partnerships are vehicles with multiple classes of equity, which provide the preferred class a priority annual coupon payment, and the common class access to all asset growth in excess of the preferred coupon. It should be noted that, in most cases involving trusts and family members, it is critical that any preferred partnership planning implemented comply with the sometimes draconian provisions of Section 2701, a detailed review of which is outside the scope of this article, but which should be familiar to the domestic estate planner.[125]

1. FNGT Holding Preferred Interest.

A preferred interest in a preferred partnership can function as a ceiling under which distributions may be made without triggering the throwback tax. This is because, under the laws of many jurisdictions, non-liquidating distributions received from a partnership are included in FAI. Because an accumulation distribution is only deemed to occur to the extent a trust distribution exceeds both DNI and FAI, a FNGT should be able to make a distribution up to the amount received in respect of the preferred coupon without fear of triggering the throwback tax. Moreover, proactive planners can substantially impact how large or small the required preferred coupon should be by properly structuring the preferred interest, thereby permitting significant flexibility in determining the size of the annual distributions.[126]

2. FNGT Holding Common Interest

In the so called "reverse" preferred partnership, a FNGT would hold the common interest, such that it would only be entitled to distributions of income to the extent that the partnership's income exceeded the amount required to be paid to the preferred partner (perhaps a domestic trust).

[123] Treas. Reg. § 1.643(b)-1. Note that the terms of a trust's governing instrument will only be respected for purposes of determining FAI to the extent they do not "depart fundamentally from traditional principles of income and principal."

[124] *See, e.g.*, Uniform Principal and Income Act §§ 401(c)(3), 401(d)(2) (distributions of less than 20% of an entity's gross assets treated as income).

[125] The authors would like to acknowledge the contribution of James R. Brockway, Esq. and Richard Cassell, Esq. in connection with the idea of the Throwback Preferred Partnership. The discussion included in this section is also derivative of a discussion contained in N. Todd Angkatavanich & Edward A. Vergara, *Preferred Partnership Freezes: They Come in Different "Flavors" and Provide a Menu of Creative Planning Solutions,* TR. & EST. (May 2011).

[126] Rev. Rul. 83-120. Notably, factors such as the strength (or weakness) of the partnership's "coverage" of the preferred coupon and liquidation preference can significantly affect the required coupon. In the case of a preferred partnership that is heavily capitalized with preferred interests, and therefore has much less common interest to help support the required coupon payments, the partnership would have weaker coverage and would likely result in a much higher required coupon.

Particularly in the situation in which the preferred coupon is structured to be a higher, the practical result would be less (or no) excess income allocated to the FNGT and, therefore, less (or no) annual realization of DNI by the FNGT, thereby containing the accumulation of income on a going forward basis.

In circumstances in which the required coupon were to exceed the partnership's investment performance, the preferred partnership strategy would also have the effect of eventually depleting the FNGT's asset base simply by virtue of its underperforming investment in the preferred partnership. An ancillary benefit of this technique vis-à-vis making regular trust distributions is the absence of the requirement to file IRS Form 3520, which would otherwise be required upon distribution from a foreign trust to a US person.

XI. SPECIALIZED TAX REGIMES APPLICABLE TO CROSS-BOARDER TRANSACTIONS

This section is intended to provide an overview of various specialized tax regimes that apply to cross-border transactions. These regimes – the special taxes imposed on US expatriates, the corporate anti-deferral regimes for controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") and the withholding tax regime applicable to foreign investment in US real estate, are intended to address certain historical transactions and structures perceived as abusive or potentially abusive. Perhaps unsurprisingly, the manner in which these regimes address those perceived abuses is not always intuitive (or effective), and practitioners should proceed deliberately in planning scenarios that implicate these issues.

As important as it is to be aware of potential pitfalls, practitioners should also be aware of the value that can be added by skillfully and proactively navigating the application of these regimes. Particularly in the context of international investment, it is often the case that, absent effective structuring at the outset, foreign investors are at a competitive disadvantage to their domestic counterparts insofar as taxation is concerned. Skillful and creative planning can have the effect of placing international investors entangled with the US tax system in a place of parity as compared to their domestic counterparts and, in some circumstances, can place them in an even more favorable position. Although an exhaustive discussion of the myriad structuring alternatives available to international investors is beyond the scope of this outline, this discussion attempts to provide some context as to why these rules exist and how they function, and to identify some of the opportunities available in cross-border transactions.

XII. THE EXPATRIATION REGIME

US expatriation is becoming an increasingly attractive option for US citizens living abroad who can enjoy lower tax rates outside the United States and are confronted by an ever increasingly complex set of US reporting requirements with regard to their non-US holdings. In particular, the challenges presented by compliance with the Foreign Account Tax Compliance Act ("FATCA") have made international banking by US citizens incredibility difficult, if at all possible.[127] As a result, the past half-decade has seen record numbers of expatriations, with over 3,000 in 2013 (almost three times the number of 2012 expatriations), over 4,000 in each of 2014 and 2015 and a record total of 5,411 in 2016.[128]

A common misconception about US expatriation is that expatriates somehow magically escape US income and transfer taxation by surrendering their US passports. While this would certainly simplify the decision making process for high-net-worth individuals, the reality is that, since 2008, high-net-worth citizens and long-term residents who relinquish their US citizenship or long-term resident status, known as "covered expatriates," are subject to a special tax regime that can result in both an immediate income tax and continued exposure to the US transfer tax system. This special regime includes: (i) a mark-to-market "exit tax" under Section 877A, which applies on expatriation (or, for certain assets, even after the individual's expatriation date), and (ii) a special succession tax under Section 2801 (the "2801 tax").[129] These rules require careful consideration as they may present significant obstacles to the potential US expatriate.

[127] The third installment of this series, forthcoming, will address FATCA, CRS and other reporting obligations applicable to international taxpayers.

[128] IRC § 6039G requires the IRS to publish the full name of every expatriate in the Federal Register no more than 30 days after the close of the calendar quarter in which they expatriate.

[129] References in this article to a "Section" refer to the relevant section of the Internal Revenue Code of 1986, as amended.

A. Non-Tax Issues to Consider

Potential expatriates also face a host of non-tax issues, which include selecting a new country of citizenship, deciding whether family members will also expatriate, managing the formal expatriation process and determining whether the expatriate will (or will be able to) come back into the US for business or pleasure. Although beyond the scope of this article, advisors should be proactive in ensuring potential expatriates have thoroughly considered these non-tax issues prior to taking steps to relinquish their citizenship or long-term resident status.

Notable among these is a provision of immigration law known as the "Reed Amendment."[130] Invocation of the Reed Amendment can render a former US citizen ineligible for admission to the US if the Attorney General determines that the former US citizen surrendered his or her citizenship for tax avoidance purposes. Although regulations were never issued to implement the Reed Amendment and significant legal barriers to its enforcement have not been addressed, government reports indicate that the Reed Amendment has been invoked twice to deny entry to US expatriates.[131] What this provision makes clear is that any individuals considering expatriating should retain immigration counsel in addition to (or prior to) tax counsel, so as to ensure that one does not "win the battle" from a tax standpoint but "lose the war" from a practical, non-tax standpoint.

B. Application of the Expatriation Taxes

The current regime governing the taxation of US expatriates has been in place since the 2008 enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "HEART Act").[132] Under the HEART Act, certain high-net-worth citizens and long term residents relinquishing their US status are designated "covered expatriates" and subjected to special tax regimes under Sections 877A and 2801. A practitioner's first task in advising a client considering expatriation is to determine whether the individual will be considered a "covered expatriate," and then to determine whether planning is available to avoid such status. The answers to these questions will inform the US income tax treatment of the soon-to-be expatriate and the potential application of the 2801 tax to beneficiaries under his or her estate plan.

1. Definition of "Expatriate"

For purposes of the expatriation regime, "expatriates" include both individuals who relinquish their US citizenship and, perhaps surprisingly, certain lawful permanent residents of the United States who terminate such status.[133] In the case of a US citizen, the act of expatriation is most often accomplished by renouncing US nationality before a diplomatic or consular officer.[134]

Lawful permanent residents (*i.e.,* green card holders) are considered "long-term residents" (and thus potential expatriates) if they have held lawful permanent resident status in at least eight of the fifteen tax years preceding their expatriation date.[135] It is important to note that holding a green card for any portion of a calendar year counts as a full year of lawful permanent residence for

[130] 8 USC § 1182(a)(10)(E).

[131] US DEPARTMENT OF HOMELAND SECURITY, *Fiscal Year 2015 Report to Congress, Inadmissibility of Tax-Based Citizenship Renunciants* (2015) ("Since 2002, two individuals who have admitted to having renounced for tax avoidance purposes were found to be inadmissible under [the Reed Amendment]"). The most significant barrier to more widespread enforcement of the Reed Amendment is the confidentiality provisions of IRC § 6103, which prohibit the IRS from providing individual tax information to the US Attorney General absent a court order or other exigent circumstances.

[132] Pub. L. No. 110-245 (2008). Individuals expatriating prior to June 17, 2008 were subject to a different expatriation income tax regime under IRC § 877 and special gift tax situs rules under IRC § 2107 & 2501. As IRC §§ 877, 2107 and 2501 apply only to certain pre-2008 expatriates, and thus have limited applicability, they are not addressed in this article.

[133] IRC § 877A(g)(2). Status as a lawful permanent resident is determined under the rules of IRC § 7701(b)(6).

[134] The act of expatriation can also be accomplished by the individual furnishing the US Department of State a signed statement of voluntary relinquishment of nationality, the issuance by the US Department of State of a certificate of loss of nationality or a US court's cancellation of an individual's certificate of naturalization. IRC § 877A(g)(4).

[135] IRC § 877A(g)(5).

purposes of the expatriation regime; thus, a person could theoretically hold a green card for as little as six years and two days and be considered a long-term resident.[136]

Termination of long-term resident status is most often achieved through the official abandonment of a US green card. Notably, this does not include the mere expiration of a US green card. A green card holder is also treated as having abandoned long-term resident status if he or she claims treatment as a resident of a foreign country under the provisions of a bilateral income tax treaty or otherwise fails to waive the benefits of the treaty applicable to residents of the foreign country.[137]

Because timing is an important factor in the application of the exit tax and the expatriation regime generally, the statue provides detailed rules for determining an individual's "expatriation date."[138] In the case of a US citizen, the expatriation date is the date the US citizen relinquishes his or her citizenship. In the case of a long-term resident, the expatriation date is generally the date the individual abandons his or her green card; however, in the case of a green card holder invoking the residency tiebreaker provision of a bilateral tax treaty, the date may be retroactive to the date the green card holder's foreign residency commences under the treaty.[139]

2. <u>Definition of "Covered Expatriate"</u>

An expatriate is considered a covered expatriate if he or she meets either or both of the "tax liability test" or the "net worth test," or fails the "tax certification test."[140] Covered expatriates are subject to the special expatriation tax regime described below unless one of two exceptions apply.

Tax Liability Test. The tax liability test is met if the expatriate's average annual net US income tax liability over the five taxable years preceding expatriation exceeds $162,000 (for calendar year 2017, adjusted annually for inflation).[141] An expatriate who files joint income tax returns with his or her spouse is required to take into account the net income tax liability reflected on the joint return, regardless of whether the tax would be attributable to the expatriate had he or she filed separately.[142]

Net Worth Test. The net worth test is met if the expatriate's net worth equals or exceeds $2 million on the expatriation date.[143] For purposes of computing the expatriate's net worth, he or she is treated as owning property if a transfer of that property would constitute a taxable gift for US gift tax purposes, made without regard to exclusions from taxable gifts such as the gift tax annual exclusion or transfers for educational or medical expenses, and without regard to gift splitting, the gift tax charitable deduction or the gift tax marital deduction.[144] Gift tax valuation principles apply in ascribing value to an expatriate's property. Expatriates are permitted to use good faith estimates in reporting their net worth. Formal appraisals are not technically required, though best practice may be to obtain them.[145]

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[136] In other words, issuance of a green card on December 31st of year one, continuation of such status in years two through seven and relinquishment of such status on January 1st of year eight would result in possible exposure to the expatriation regime. *See* IRC § 877A(g)(5); IRC § 877(e)(2).

[137] IRC § 7701(b)(6).

[138] IRC § 877A(g)(3).

[139] *See* Notice 2009-85, 2009-45 IRB 598 (cessation of lawful permanent resident status occurs when an individual's foreign residence commences for treaty purposes, and not on the date notice is provided to the IRS).

[140] IRC § 877A(g)(1)(A).

[141] IRC § 877A(g)(1)(A); IRC § 877(a)(2)(A).

[142] *See* Notice 97-19, 1997-1 C.B. 394.

[143] IRC § 877A(g)(1)(A); IRC § 877(a)(2)(B).

[144] *See* Notice 97-19, 1997-1 C.B. 394.

[145] *Id.*

A covered expatriate's beneficial interest in a trust is included in the net worth test computation and is valued using a two-step process. First, property held by the trust is allocated to trust beneficiaries based on all relevant facts and circumstances, including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust fiduciary or advisor. Trust property that cannot be allocated based on these factors is allocated to trust beneficiaries under the principles of intestate succession.[146] Second, trust property allocable to the expatriate is valued using US gift tax principles. This is a somewhat imprecise process that requires exercising a degree of judgment, and may provide some flexibility for creative practitioners planning for a potential future expatriation.

Tax Certification Test. Even an individual who does not meet the tax liability test or the net worth test will be treated as a covered expatriate if he or she fails to certify under penalties of perjury or, if requested, fails to substantiate that he or she has satisfied all outstanding US tax obligations for the five taxable years preceding expatriation. This certification should be made by every expatriate by filing IRS Form 8854 by the due date of the expatriate's US income tax return for the taxable year that includes the day before his or her expatriation date.[147] Given that the IRS Form 8854 is filed under penalties of perjury, some individuals may need to complete a voluntary disclosure process to remedy historical tax filing irregularities or omissions prior to expatriating and filing the tax certification.

Exceptions. An expatriate who meets one of the tests above can nonetheless avoid status as a covered expatriate under one of two exceptions.[148] The first exception applies to an expatriate who (i) became at birth a citizen of the United States and another country (*i.e.*, a dual citizen), (ii) at the time of expatriation is taxed as a resident of such other country and (iii) has been a US resident for not more than ten of the fifteen taxable years ending on the expatriation date. The second exception applies to an expatriate who relinquishes US citizenship before attaining age 18½ and who has been a US resident for not more than ten years before the date of relinquishment.[149]

C. The Exit Tax

Covered expatriates are subject to a mark-to-market exit tax under Section 877A that treats the covered expatriate as having sold his or her property for fair market value as of the day before his or her expatriation date.[150] The only exclusions from the exit tax are certain deferred compensation items, specified deferred accounts and interests in "non-grantor trusts",[151] which are subject to special tax rules described below.[152] Net gain or loss that would be realized on the hypothetical sale is required to be recognized, notwithstanding the non-recognition provisions of the Code, and a corresponding adjustment to the US tax basis of such property results. To the extent the net gain recognized exceeds an exclusion amount ($699,000 for 2017, adjusted annually for inflation), the covered expatriate is required to pay tax at generally-applicable marginal rates based on the applicable character and holding period.

1. The Exit Tax Base

[146] *Id.* The intestacy rules applied are those contained in the Uniform Probate Code, and they are applied by reference to the trust settlor's hypothetical intestacy.

[147] IRC § 877A(g)(1)(A); IRC § 877(a)(2)(B).

[148] IRC § 877A(g)(1)(B).

[149] For purposes of both exceptions, US residence is determined under IRC § 7701(b)(1)(a)(ii) (i.e., the substantial presence test). The tests for US residence are described in detail in the first installment of this series.

[150] IRC § 877A(a)(1).

[151] The term "non-grantor" trust in this context is a bit of a misnomer, as further explained below.

[152] IRC § 877A(c).

Although the Code notes only that "all property" of a covered expatriate is subject to the exit tax, guidance from the IRS clarifies that a covered expatriate is treated as owning (and is thus subject to the exit tax on) any interest in property that would be includible in his or her gross estate had he or she died the day before his or her expatriation date.[153] Practitioners should keep in mind that determinations with respect to the exit tax are made under US *estate tax* rules, and will not always align with the determinations made for purposes of the net worth test, which requires the application of US *gift tax* principles.

The IRS considers a covered expatriate's beneficial interest in certain trusts to be subject to the exit tax, even if such interest would not otherwise be includible in the covered expatriate's gross estate.[154] Exposure to the exit tax base is generally limited to trusts with respect to which the covered expatriate is treated as the owner under the grantor trust rules.[155] All other trusts, including trusts treated for US income tax purposes as owned by someone other than the expatriate under the grantor trust rules, are deceptively called "non-grantor trusts" for purposes of Section 877A. Non-grantor trusts are excluded from the exit tax base but are subject to a special withholding tax, described below.

The exit tax contemplates coordination with other provisions of the Code that may require gain to be recognized on expatriation, and generally gives priority to these other provisions over the exit tax. For example, Section 684(a) requires the recognition of gain (but not loss) where the grantor of a grantor trust expatriates and causes the trust to become a foreign non-grantor trust.[156] This may occur because Section 672(f) limits the circumstances in which a trust may be treated as a grantor trust as to a foreign individual.[157] In such a case, gain recognized under Section 684 will be taken into account prior to the application of the exit tax, so the gain is only taxed once.[158] Practitioners presented with this situation should consider whether any unrealized losses in the trust (which are triggered by Section 684(a)) can be taken into account in determining the net tax due under Section 877A(a)(2)(B).

2. Computing the Exit Tax

As noted above, assets are valued for purposes of the exit tax using general estate tax valuation rules, including the special valuation rules of Sections 2701 through 2704 (which are applied as though all of the covered expatriate's property is transferred to family members), but excluding the deductions provided under Sections 2055, 2056, 2056A and 2057.[159] Accordingly, traditional valuation discounts should be permitted in computing the exit tax, including discounts for lack of marketability, lack of control and fractional interests. Valuation planning typically undertaken in the domestic context for estate tax purposes may thus be effective in reducing the exit tax of a covered expatriate.

Once values are determined, net gain on the hypothetical sale is reduced (but not below zero) by an exclusion amount ($699,000 for 2017, adjusted annually for inflation).[160] The exclusion

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[153] *See* Notice 2009-85, 2009-45 IRB 598. Note that this determination does not include the application of any credits provided under IRC §§ 2010 through 2016, inclusive.

[154] *Id.*

[155] The IRS's position is clear as to the inclusion of grantor trusts in which the covered expatriate has retained a beneficial interest. The status of grantor trusts in which the covered expatriate has not retained a beneficial interest is less clear. As the exit tax is in the nature of an income tax, it would seem to follow that such trusts should be included in their entirety. *See* Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 6081*, JCX-44-08 (May 20, 2008). However, this reasoning is called into question by the IRS's administrative mandate that estate tax valuation and inclusion rules be applied. *See* Notice 2009-85, 2009-45 IRB 598.

[156] *See* Notice 2009-85, 2009-45 IRB 598.

[157] Generally, Section 672(f) provides that a trust will not be treated as owned by a foreign individual unless the individual retains the power to revoke the trust or distributions from the trust during the individual's lifetime are limited to the individual and his or her spouse.

[158] IRC § 877A(h)(3).

[159] Notice 2009-85, 2009-45 IRB 598.

[160] IRC § 877A(a)(3).

amount must be allocated ratably among each of the covered expatriate's assets on the basis of the amount of gain recognized.[161] This allocation is intended to prevent the covered expatriate from allocating the exclusion amount to ordinary income assets and other assets taxed at higher rates, such as collectibles. Note that the exclusion amount is a lifetime exclusion similar to that provided against the US estate tax.[162] Accordingly, a second expatriation by the same individual could result in some or all of the exemption being unavailable.

3. Exit Tax Deferral and Timing Issues

Because the deemed gain triggered by the exit tax will not have corresponding liquidity, the expatriation regime permits deferral of the tax payment, subject to an interest charge.[163] If the covered expatriate so elects, the exit tax can be deferred on an asset-by-asset basis until the asset's actual disposition. As part of the election, the covered expatriate is required to provide "adequate security" for the payment of the tax, which generally means a bond or letter of credit conditioned on the payment of tax.[164] Interest on the deferred tax accrues daily at the federal underpayment rate, and the covered expatriate must irrevocably waive any treaty rights that might preclude collection of the deferred tax. In light of these somewhat burdensome requirements, many covered expatriates prefer to pay the tax and cut ties cleanly rather than elect to defer the exit tax.

In addition to liquidity, the timing of the gain recognition may pose a significant obstacle to expatriation. The exit tax causes an acceleration of gain, offending the maxim that tax later is always better than tax now. The time value of money calculations force consideration of the potential holding period in the expatriate’s assets, the anticipated rate of return in those assets, and the potential tax rate that might apply if the expatriate remains in the US and sells the assets at a later date. This is further complicated by market fluctuations that may prove unfavorable for the potential expatriate. Because the tax is triggered using values as of the day prior to expatriation, the actual day of expatriation may have a significant impact on the amount of tax, and this date (often that of a visit to a diplomatic or consular office) is challenging to control with any level of precision. This creates tax risk for potential expatriates holding volatile assets.

Timing must also be taken into consideration with foreign tax credits. The deemed US tax recognition event may not correspond with a taxable event in a foreign jurisdiction where the potential expatriate may reside. If that is the case, there may be US tax liability without a corresponding foreign liability giving rise to a foreign tax credit, resulting in the covered expatriate paying tax twice on the same gain without the benefit of foreign tax credit or treaty relief. Coordination with a potential expatriate's foreign tax counsel may be beneficial to determine whether recognition events can be accelerated or otherwise harmonized in a manner that mitigates double taxation.

4. Withholding on Non-Grantor Trust Distributions

Although excluded from the exit tax base, the assets of any non-grantor trust (which, recall, includes for these purposes any trust not treated as owned by the covered expatriate for US income tax purposes) in which a covered expatriate has a beneficial interest are subject to special treatment under the expatriation regime. Under Section 877A(f), the trustee of any such non-grantor trust is required to withhold 30% from the "taxable portion" of any direct or indirect distribution to the covered expatriate. The "taxable portion" of the distribution is that portion that would be includible in the covered expatriate gross income had he or she continued to be a US

[161] Notice 2009-85, 2009-45 IRB 598. In other words, the value of each item is multiplied by a fraction, the numerator of which is the gain recognized with respect to the item and the denominator of which is all gain recognized under Section 877A. If the gain recognized is less than the exclusion amount, the allocation is limited to the gain recognized.

[162] *Id*.

[163] IRC § 877A(b)(1).

[164] IRC § 877A(b)(4). Notice 2009-85, 2009-45 IRB 598 provides that other forms of security may also be accepted, but does not specify what forms are acceptable. This is meaningful because a covered expatriate lacking liquidity to cover the exit tax likely also lacks sufficient liquidity to support a bond or letter of credit.

citizen or resident.[165] When property is distributed to the covered expatriate in kind, the trust is deemed to have recognized any unrealized gain as if the property had been sold to the covered expatriate.[166]

Although covered expatriates are deemed to have waived treaty rights with respect to non-grantor trust withholding under Section 877A(b)(4)(B), the IRS has developed a procedure for trust beneficiaries wishing to limit the trust's exposure to future US tax obligations.[167] This is accomplished by the covered expatriate making an election on IRS Form 8854 to be treated as having received the value of his or her interest in the trust as of the day before his or her expatriation date. The value of the covered expatriate's interest in the trust is thus included in his or her exit tax base and subject to immediate tax. Upon receipt of a letter ruling from the IRS that the interest in trust is susceptible to valuation, the tax will be considered fully satisfied and no withholding will be required on future distributions to the covered expatriate. Treaty benefits would thereafter be available to the covered expatriate with respect to any such distribution.

5. Deferred Compensation and Tax-Deferred Accounts

Special rules apply to "eligible deferred compensation items" and "tax-deferred accounts." Relevant items of deferred compensation include those with respect to which the payor is a US person or a foreign person who has elected to be treated as a US person for purposes of withholding, and with respect to which the covered expatriate has notified the payor of his or her status and irrevocably waived applicable treaty rights.[168] Rather than being subject to the exit tax, eligible deferred compensation items are subject to a 30% withholding at the source on future payment to the covered expatriate. The withholding tax applies to any payment that would have been includible in the gross income of the covered expatriate had he or she remained a US citizen or resident.

If the covered expatriate has an interest in a "tax-deferred account," meaning an individual retirement account, qualified tuition program, Coverdell education savings account, health savings account or Archer MSA, he or she is treated as having received his or her entire interest in the account on the day before his or her expatriation date.[169] Although this will result in the acceleration of tax with respect to such accounts, early distribution taxes will not apply.

D. The 2801 Tax

Under the existing expatriation regime, Section 2801 provides for the imposition of tax on a US person who is the recipient of a gift or bequest from a covered expatriate, referred to as a “covered gift” or “covered bequest”. As mentioned above, Section 2801, contained in Chapter 15 of the Code, was enacted with Section 877A as part of the HEART Act,[170] effective June 17, 2008. Before the introduction of these two new sections, expatriating US citizens and long-term residents were subject to a prior regime under Section 877, 2107 and 2501, under which they were subject to a 10-year post-expatriation tail period for the imposition of US income and transfer taxes. The prior regime under Section 877 continues to apply the ten year tail period with respect to those who expatriated prior to June 17, 2008.

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[165] IRC § 877A(f)(2). Note that this should exempt distributions from trusts that are non-grantor trusts for exit tax purposes but are treated as owned by a third party under the grantor trust rules, as a distribution from such a trust would not have been taxable to the covered expatriate had he or she remained a US citizen or resident.

[166] IRC § 877A(f)(1)(b).

[167] Notice 2009-85, 2009-45 IRB 598.

[168] IRC § 877A(d)(3).

[169] IRC § 877A(e)(1).

[170] Pub. Law 110–245 (122 Stat. 1624).

1. Imposition of the 2801 Tax

Unlike the case of the US estate and gift taxes, the 2801 tax is imposed on the US transferee.[171] Accordingly, the transferee must determine whether the transferor is a covered expatriate and whether the transfer is a covered gift or bequest subject to the 2801 tax.[172]

The tax is imposed at the highest estate or gift tax rate in effect for the year of transfer. The tax base includes the value of the covered gift or bequest, reduced by the annual gift tax exclusion for a given year (the Section 2801(c) amount is determined by reference to Section 2503(b)). The reference to 2503(b) is only for purposes of providing a dollar amount for the annual gift exclusion in order to determine the Section 2801 tax, but does not incorporate the substantive rules of Section 2503(b).[173] The calculated tax is reduced by any estate or gift tax paid to a foreign country with regard to those transfers.[174]

There are a number of exceptions to the imposition of the Section 2801 tax. These include: (i) taxable gifts reported on a covered expatriate's timely filed gift tax return, and property included in the covered expatriate's gross estate and reported on such expatriate's timely filed estate tax return, provided that the gift or estate tax due is timely paid; (ii) qualified disclaimers of property made by a covered expatriate; and (iii) charitable donations that would qualify for the estate or gift tax charitable deduction. In addition, a gift or bequest to a US citizen spouse of a covered expatriate is not considered a covered gift or bequest if it would otherwise qualify for the gift or estate tax marital deduction.[175]

On September 10, 2015, the IRS proposed regulations (further discussed below) under Section 2801, which have not yet been finalized. Once the regulations are finalized, the IRS will release IRS Form 708, *United States Return of Tax for Gifts and Bequests from Covered Expatriates* as the new form to provide information on any covered gift or bequest and to compute the 2801 tax. The 2801 tax continues to be deferred until the regulations are finalized. Once the regulations are finalized, transferees of covered gifts or bequests, including domestic trusts and electing foreign trusts (as described further below), will need to pay the 2801 tax relating back to the date of the transfer.

2. Transfers to Trusts

In the case of a covered gift or bequest to a US trust, the 2801 tax applies as if the trust were a US citizen, causing the trust itself to be the taxpayer. The proposed regulations under Section 2801 (further discussed below) provide that a transfer into trust is treated as a covered gift or bequest to the trust, ignoring beneficial interests or the existence of general powers of appointment or withdrawal powers.[176]

If a covered gift or bequest is made to a foreign trust, the tax is not imposed at the time of such transfer, but rather it is imposed on any distribution to a US beneficiary that is attributable to the covered gift or bequest. Because such distributions may be subject to both the 2801 tax and the normal income tax rules applicable to distributions from foreign trusts, a limited income tax deduction for 2801 tax paid is permitted to the extent the 2801 tax is attributable to amounts included in the gross income of the US beneficiary.[177]

[171] Prop. Treas. Reg. § 28.2801–(a)(1).

[172] Prop. Treas. Reg. § 28.2801–7(a).

[173] Prop. Treas. Reg. § 28.2801–4.

[174] Prop. Treas. Reg. § 28.2801–4(e). There is, for example, no present interest requirement for gifts in trust to qualify for the exclusion amount under IRC § 2801(c).

[175] Prop. Treas. Reg § 28.2801–3(c)(4).

[176] Prop. Treas. Reg. § 28.2801–3(d).

[177] Prop. Treas. Reg.§ 28.2801–4(a)(3)(ii).

A foreign trust may also elect to be treated as a domestic trust solely for purposes of the 2801 tax. In such case, the 2801 tax is imposed on the electing foreign trust on its receipt of a covered gift or bequest, and not on the distribution by the trust to US beneficiaries.[178] Because the election to be treated as an electing foreign trust is required to be made on IRS Form 708 (which the IRS does not intend to release until the promulgation of final regulations), and the trust must thereafter file IRS Form 708 on an annual basis, some uncertainty exists as to how current transfers to foreign trusts desiring to make the election should be handled.

With respect to distributions from foreign trusts, the proposed regulations provide for an allocation of the amount of the distribution attributable to covered gifts and bequests. This allocation is determined by multiplying the amount of the distribution by a ratio, referred to as the "Section 2801 ratio" determined at the time of the distribution, and which is redetermined after each contribution to the trust. The effect of this rule is that each distribution from the foreign trust consists of a ratable portion of the covered and non-covered portions of the trust.[179]

3. Proposed Regulations Under Section 2801

As mentioned above, on September 10, 2015, the IRS proposed regulations under Section 2801, which have not yet been finalized. Although the proposed regulations leave several issues unresolved, they provide significant guidance with respect to the following:

Direct and Indirect Transfers. As the 2801 tax applies to direct and indirect transfers, the proposed regulations clarify what may constitute an indirect transfer, including:

- Acquisitions by a business association owned by a US person;
- Acquisitions by an entity not subject to the 2801 tax on behalf of a US person;
- Transfers by a covered expatriate to satisfy the debts or liabilities of a US person;
- Transfers resulting from a non-covered expatriate's power of appointment granted by a covered expatriate over property not in trust; and
- "Other transfers" not made directly by the covered expatriate to a US person.

Protective Filings. The proposed regulations permit a protective filing of Form 708 once it becomes available. If the transferee reasonably concludes that a transfer is not subject to Section 2801, a protective Form 708 can be filed to start the period for the assessment tax.[180] This may be an attractive safeguard for clients who have trouble determining their tax liability.

Information Disclosure. Under certain circumstances the IRS may be permitted, upon request, to disclose to the US transferee information about the expatriate to assist the transferee in determining whether the transfer is a covered gift or bequest. The proposed regulations also provide for the issuance of further guidance and procedures for making such a request. The proposed regulations leave the process uncertain, however, and various privacy issues may inhibit the release of the information.[181]

Rebuttable Presumption of Donor's Status. In the case of a gift, the proposed regulations create a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift unless the donor authorizes the disclosure of his return or relevant information to the recipient.

Powers of Appointment. The proposed regulations apply traditional estate tax treatment of general powers of appointment when the covered expatriate is the power holder. This means an exercise or release of the general power of appointment of in favor of a US beneficiary is a covered gift or

[178] IRC § 2801(e)(4)(B)(iii).

[179] Prop. Treas. Reg. § 28.2801–5(c).

[180] Prop. Treas. Reg. § 28.2801–7(b)(2). Protective filings would be made in accordance with Treas. Reg. § 28.6011–1(b).

[181] Prop. Treas. Reg. § 28.2801–7(b)(1).

bequest.[182] The regulation also includes as a covered gift or bequest the exercise of a power of appointment that violates the "Delaware tax trap".[183] The grant of a general power of appointment by a covered expatriate to a US beneficiary over non-trust property is also a covered gift or bequest.

Foreign Trusts.[184] The 2801 tax generally is imposed on a US beneficiary who receives distributions from a "non-electing foreign trust" to the extent such distributions are attributable to covered gifts or bequests to such trust. Because a foreign trust may be funded by covered and non-covered contributions, the proposed regulations create a "2801 ratio" to allocate the trust distribution between the covered and non-covered contributions to the trust.[185] If a non-electing foreign trust migrates and actually becomes a domestic trust, the now domestic trust must file Form 708 for the year of migration and pay any 2801 taxes due based on its 2801 ratio.

A foreign trust can also elect to be treated as a domestic trust.[186] Such a trust is referred to as an "electing foreign trust." The election results in the immediate imposition of the 2801 tax on (1) all covered gifts or bequests to the trust that year and future years in which the election remains effective and (2) the portion of the trust attributable to covered gifts and bequests in prior years. The election is made on a timely filed IRS Form 708 for the calendar year in which the election is to take effect.

E. Planning Strategies

If covered expatriate status cannot be avoided, there may be several planning options available to mitigate the consequences of the exit tax and the future imposition of the 2801 tax.

1. Pre-Expatriation Gift Planning[187]

Spousal Gifting. If one meets the net worth threshold for covered expatriate status but not the income tax liability threshold, one possible method of avoiding covered expatriate status would be to gift sufficient assets to a spouse (who must be a US citizen to qualify for a gift tax marital deduction) before expatriating to drop the expatriate's net worth below the $2 million threshold. This would leave the assets within the US worldwide income tax net in the hands of the US spouse, but, by avoiding covered expatriate status, the expatriate could avoid the exit tax and later provide for US family members without subjecting them to the 2801 tax.

Importantly, if gifts are made to a spouse, the spouse would not be able to gift assets to the now expatriate without making a taxable gift, because only gifts to US citizen spouses are eligible for the gift tax marital deduction. Because expatriation ends US citizenship, transfers would be limited to the annual gift tax exemption for non-US spouses ($152,000 in 2018) before using some of the donor spouse's lifetime gift tax exemption, or to the extent that has been exhausted, resulting in gift tax.

Grantor Trusts. If the taxpayer has previously engaged in estate planning, he or she might have established one or more grantor trusts for the benefit of a spouse and descendants. Once the taxpayer expatriates, such trusts may continue to be treated as grantor trusts only if revocable by the grantor or for the sole benefit of the grantor and the grantor's spouse. A typical domestic estate planning trust established for purposes of lifetime transfer tax planning will almost certainly not

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[182] Prop. Treas. Reg. § 28.2801-3(e).

[183] *See* IRC §§ 2041(a)(3) & 2514(d).

[184] *See* Prop. Treas. Reg. § 28.2801-5.

[185] Prop. Treas. Reg. § 28.2801-5(c)(1).

[186] Prop. Treas. Reg. § 28.2801-5(d).

[187] This section on "Pre-Expatriation Gift Planning" was originally published in Angkatavanich, Stein & Haave, Bloomberg/BNA Tax Management Portfolio No. 875 *Wealth Planning with Hedge Fund and Private Equity Fund Interests* at A-49-50, and is reprinted (with some modifications) with the consent of the authors and Bloomberg/BNA Tax Management.

meet either of these requirements, as a revocable trust would be included in the grantor's gross estate (as likely would a trust of which the grantor is a beneficiary), and a trust only for the benefit of the grantor's spouse (but not his descendants) may not be consistent with the grantor's intentions.

Thus, in most cases, this means that on the expatriation by the grantor, the existing estate planning trust will become a non-grantor trust and, consequently, if any non-US person has any power that causes the trust to fail the control test under Section 7701(a)(31), the trust will become a foreign trust. This will trigger a mark-to-market tax under Section 684(a), resulting in deemed gain recognition on the trust's assets. In order to address this issue, the expatriate might wish to consider having any existing grantor trusts converted to non-grantor trusts prior to expatriation and relinquishing any powers that would cause the trust to fail the control test.[188]

Utilizing Unified Credit. As mentioned above, if a taxpayer is a covered expatriate, gifts and bequests to US recipients will attract the 2801 tax. Accordingly, a person contemplating expatriation who would meet the test for covered expatriate status, and who desires to provide for US children or other relatives, should consider using some or all of his or her remaining estate and gift tax exemption prior to expatriating. A later distribution from that trust to US beneficiaries will avoid the 2801 tax.

Basis Planning. With proper planning, there are various ways to lessen the impact of the exit tax. Because the tax imposed under Section 877A is a mark-to-market tax based on the difference between fair market value and tax basis, the exit tax can be reduced from two directions – first, with respect to fair market value, and second, with respect to tax basis.[189] Planning opportunities might be considered through the use of partnerships or limited liability companies, including basis stripping techniques that could have the effect of building up the tax basis of a covered expatriate's assets prior to his or her expatriation date. For instance, if the potential expatriate were to contribute appreciated property to a partnership and another partner were to contribute high-basis assets, a future redemption of the other partner using low-basis assets could result in a reallocation of outside basis to the benefit of the potential expatriate.[190] Upon expatriation, this higher outside basis, together with applicable valuation discounts, could have the effect of mitigating the covered expatriate's exit tax exposure.

2. <u>Post-Expatriation Planning</u>

After expatriation, there are more limited options for making tax-free gifts to US persons (other than gifts to a US spouse or annual exclusion gifts), because of the imposition of the 2801 tax. An exception to this tax is for gifts that are subject to gift tax and reported on a timely filed gift tax return. A possible technique for transferring assets from a covered expatriate to a US recipient would be for the covered expatriate to create a zeroed-out or nearly zeroed-out grantor retained annuity trust (a "GRAT"). Under general gift tax principles applicable to GRATs, if the GRAT is successful, later payments to US recipients should escape covered gift treatment, just as payments from a zeroed-out GRAT funded by a US person escape US gift tax on later payment from the GRAT. Other traditional freeze techniques, such as sales to irrevocable trusts and the use of life insurance, may also be attractive options for building up a pool of funds that would not be subject to the 2801 tax when left to a US beneficiary.

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[188] This assumes the change from grantor to non-grantor status would not itself trigger any gain, as in the case in which the trust owes an outstanding promissory note to the grantor on the sale of appreciated assets. Treas. Reg. § 1.1001-2(c), Ex. 5.

[189] *See* N. Todd Angkatavanich, James R. Brockway & Eric Fischer, *Mark-to-Market Freezes – Freeze Planning in an Estate Tax-Free Environment*, LISI Estate Planning Newsletter #2480 (Nov. 2016).

[190] This is a simplified version of what is a fairly complex transaction, requiring a thorough understanding of, among other rules, the partnership disguised sale rules.

XIII. THE CORPORATE ANTI-DEFERRAL REGIMES GENERALLY

Our first installment concluded with an overview of the rules relevant to foreign non-grantor trusts and planning strategies to minimize the associated negative tax impacts. The rules relating to foreign non-grantor trusts represent an effort to discourage the tax-free accumulation of income to or for the benefit of US taxpayers. Similarly, certain corporate anti-deferral regimes are designed to discourage the use of non-US corporate entities to defer US taxation, in particular with respect to passive income.

These corporate anti-deferral regimes follow two basic approaches. The controlled foreign corporation regime discourages the use of foreign corporations for tax deferral by imposing current taxation on certain types of income (in simplistic terms, the "bad" income subject to current taxation under this regime is anything other than active business income with unrelated parties), while the passive foreign investment company regime imposes a penalty charge on the realization of income from a foreign corporation owning primarily passive assets and/or generating primarily passive income.

XIV. CONTROLLED FOREIGN CORPORATIONS

Under the controlled foreign corporation, or "CFC," regime set forth in Sections 951 through 964, "United States shareholders" (defined below) of a CFC are required to include in gross income on a current basis their pro rata share of certain categories of income, referred to as "subpart F income," generated by the CFC.[191] In effect, the CFC regime eliminates a United States shareholder's ability to defer US taxation of passive or related party income generated in a foreign corporation controlled by the United States shareholder or other US taxpayers.

In analyzing a foreign corporation for CFC issues, a practitioner must make three determinations: (i) whether any shareholder of the corporation is a United States shareholder, (ii) whether ownership by United States shareholders is sufficient to classify the corporation as a CFC, and (iii) whether the CFC has derived certain types of tainted income that can give rise to current taxation.

A. "CFC" Defined

A foreign corporation is a CFC if more than 50% of the total combined voting power or the total value of its stock is owned, directly or indirectly by attribution, by United States shareholders on any day during the taxable year.[192] However, a United States shareholder will only be subject to income tax of the CFC's subpart F income to the extent that the foreign corporation is a CFC for an uninterrupted period of 30 days or more during the taxable year.[193] In addition, gross income inclusion will only apply with respect to United States shareholders who own stock of the CFC on the last day of the tax year in which it is a CFC.[194]

For these purposes, a "United States shareholder" means a US person who owns or is deemed to own 10% or more of the total combined voting power of all classes of voting stock.[195] Thus, in determining whether a foreign corporation is a CFC, shareholders who are US persons and own less than 10% of the corporation's total combined voting power will not be taken into account. For example, a foreign corporation with 11 equal shareholders will generally not be classified as a CFC absent related- party attribution. Voting power is not actually defined in the Code, but generally has been interpreted to mean the right to vote in connection with the election of directors.[196]

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[191] IRC § 951(a)(1).

[192] IRC § 957(a)(1)&(2).

[193] IRC § 951(a)(1).

[194] IRC § 951(a).

[195] IRC § 951(b); It should be noted that, under § 958(b), the constructive ownership rules under § 318(a), with certain modifications, generally apply in making this determination.

[196] *Hermes Consol., Inc. v. United States,* 14 Cl. Ct. 398 (1988); *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983); *Ach v. Comm'r.*, 358 F.2d 342 (6th Cir. 1966). Treas. Reg. § 1.957-(1)(b)(2) generally provides that if the IRS determines that voting power that has been nominally shifted from a US shareholder, but the US shareholder has in reality retained such voting power, such arrangement will not be given effect if entered into to avoid CFC status.

The CFC ownership rules take into account direct, indirect and constructive ownership of stock in a foreign corporation. Stock directly or indirectly owned by a foreign entity of which an individual is an owner is considered to be owned proportionally by its shareholders or partners.[197] In addition, stock constructively owned under the attribution rules of Section 318(a) is taken into account in determining whether a foreign corporation is a CFC.[198] Accordingly, in testing a foreign corporation, one must look not only to stock held directly by a US person, but also to stock held by other foreign corporations in which he or she is a shareholder, stock owned by certain family members, and stock owned by trusts and estate of which he or she is a beneficiary.

B. Consequences of CFC Status

The income taxation of United States shareholders of a CFC is determined under Sections 951 through 956. Essentially, these rules require the United States shareholder to include in his or her gross income a pro rata share of the CFC's "subpart F income" on an annual basis. For these purposes, subpart F income is generally income that is not derived from the active conduct of a trade or business with unrelated persons. Subpart F income is taxed currently, even if the CFC does not making any distributions to the United States shareholder during the taxable year (*i.e.*, subpart F income may be phantom income), and is required to be taken into account in the taxable year of the United States shareholder in which the CFC's taxable year ends.

1. Subpart F Income Generally

The Code defines subpart F income by reference to a number of categories, many of which are identified and expanded upon via cross-reference. In short, these categories are intended to capture certain types of income that are considered movable and were thus historically the subject of perceived abuses intended to defer the recognition of income through the use of entities in tax-favored jurisdictions. Section 952(a) identifies the following categories of subpart F income:

- insurance income;
- foreign base company income (the most relevant category for most estate planners);
- "international boycott income;"
- illegal bribes, kickbacks or other payments paid by or on behalf of the CFC, directly or indirectly, to government officials; and
- income derived from certain blacklisted countries.

2. Foreign Base Company Income

From a practical perspective, the primary type of subpart F income encountered in cross-border estate planning matters is "foreign base company income".[199] Foreign base company income includes:

- foreign base company sales income, which is essentially income derived from transactions in personal property with a related person, where the personal property is neither produced in nor sold for use in the country where the CFC is created;[200]

[197] IRC § 958(a)(2).

[198] IRC § 951(a)(1)&(2); IRC § 958(b).

[199] IRC § 954(a).

[200] IRC § 954(a)(2).

- foreign base company services income, which is essentially income derived from certain types of services performed on or behalf of a related person and outside the country where the CFC is created;[201]

- foreign base company oil-related income;[202] and

- foreign personal holding company income ("FPHCI"), which captures most passive-type income. More specifically, FPHCI includes:

  - dividends;
  - interest;
  - royalties that are not derived in the active trade or business;
  - rents that are not derived in the active trade or business;
  - annuities;
  - gains from property transactions (except business property or inventory);
  - gains from commodities transactions;
  - foreign currency gains; and
  - income equivalent to interest.[203]

In determining foreign base company income generally, such income is reduced by properly allocable deductions.[204] In making this computation, a "de minimus rule" applies so that no part of the gross income is treated as foreign base company income or insurance income if the sum of such income is less than the lesser of (1) 5% of the CFC's gross income, or (2) $1,000,000.[205] On the other hand, if a CFC's foreign base company income and insurance income exceeds 70% of the CFC's gross income, then the entire gross income for the year is treated as foreign base company income or insurance income.[206]

3. Exceptions to Subpart F Income

The Code also provides a number of exceptions to the broad and inclusive categories of subpart F income. Income falling into one of these exceptions will not be considered subpart F income and, thus, will not be includible in the gross income of United States shareholders on a current basis. These exceptions include the following:

- Items of income constituting income effectively connected with a US trade or business are not considered subpart F income;[207]

[201] IRC § 954(a)(3).

[202] IRC § 954(a)(5).

[203] IRC § 954(c)(1).

[204] IRC § 954(b)(5).

[205] IRC § 954(b)(3)(A).

[206] IRC § 954(b)(3)(B)

[207] IRC § 952(b).

- Subpart F income is limited to the amount of the CFC's current earnings and profits (this exception is intended to mirror the treatment of corporate distributions, which are generally treated as dividends to the extent of the corporation's undistributed earnings and profits);[208]

- Items of income taxed at more than 90% of the highest rate imposed under US law are not considered foreign base company income;[209] and

- A look-through rule excludes from subpart F income certain items of income attributable or properly allocable to a related corporation generating income that would not independently qualify as subpart F income.[210]

C. Post-Mortem Planning with CFCs

Where a foreign individual dies holding a significant interest in a foreign corporation, which interest is intended to pass to US taxpayers (or in some cases to a trust for their benefit), consideration should be given to whether to take steps to avoid the corporation's classification as a CFC. As noted above, a United States shareholder is only subject to taxation under subpart F to the extent he or she owns CFC shares for 30 days or more during the taxable year. Accordingly, either the executor of the foreign decedent's estate or the beneficiaries themselves may wish to take steps to quickly liquidate the corporation before the interest has been held for 30 days.

In the alternative, if the corporation is an eligible entity, it may wish to make a check-the-box election to be treated as a partnership or disregarded entity for US tax purposes. This election can typically be made retroactive within 75 days of filing. Accordingly, making such an election effective the day before the decedent's death may be an effective tool for achieving a basis step-up with respect to foreign situs assets.

However, care should be taken prior to filing such an election to ensure that the corporation does not own US situs assets, as these assets could potentially be subject to US estate tax if a retroactive election is made. If US situs assets are present, the election could perhaps be made retroactive as of the day after the decedent's death so as to protect the decedent's estate from US estate tax exposure while simultaneously managing CFC status, although this would also trigger a deemed liquidation of the corporation, potentially triggering gain on appreciated assets.[211]

XV. PASSIVE FOREIGN INVESTMENT COMPANIES

Of particular concern to portfolio investors is the second corporate anti-deferral regime, which applies to passive foreign investment companies ("PFICs"). When a foreign corporation invests primarily in passive assets, it may be categorized as a PFIC. US persons (or foreign persons becoming US persons during the relevant holding period) who own interests in the corporation are subject to a regime designed to discourage offshore income deferral through the imposition of draconian tax and reporting obligations. Because many foreign investment funds will qualify as PFICs, and because failure to account adequately for PFIC status can result in disastrous tax consequences, particular attention is required when advising international portfolio investors.

A. Identifying PFICs

As initial matter, one must identify whether an entity is a PFIC. The basic test for determining PFIC status is fairly simple – any foreign corporation that satisfies either of two disjunctive tests is classified as a PFIC:

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[208] IRC § 952(c).

[209] IRC § 954(b)(4).

[210] IRC § 954(c)(6).

[211] Treas. Reg. § 301.7701-3(g).

- The income test[212] – a foreign corporation is a PFIC if 75% or more of the gross income of such corporation for the taxable year is passive income, or
- The asset test[213] – a foreign corporation is a PFIC if at least 50% of the average value of its assets during the taxable year are of a type that ordinarily produce passive income.

For these purposes, passive income generally has the same meaning as "foreign personal holding company income," discussed above. In broad terms, this means passive investment returns – dividends, interest, royalties, rents and annuities, as well as gain from the sale of assets that produce these types of income, or do not produce income at all. One noteworthy consideration in applying these tests, even in a high-level review, is that a "look-through" rule applies in the case of corporations at least 25%-owned by the potential PFIC.[214] Thus, for purposes of PFIC test, you count a proportionate amount of the income and assets of any corporation that is at least 25%-owned by value.

As a practical matter, this means that virtually all non-US collective investment vehicles, such as foreign mutual funds and foreign investment funds, will be PFICs. This can be a trap for the unwary, as even some publicly-traded mutual funds qualify as PFICs for US tax purposes. Unlike the CFC rules, the PFIC rules are indifferent to the size of a shareholder's interest in the corporation, meaning that even investors with small interests in foreign mutual funds and investment funds can be subject to the PFIC regime.

In addition, the definition of passive income and passive assets for these purposes can produce surprising results. For example, the rules do not provide an exception for working capital. As a result, even genuine operating businesses can be classified as PFICs in certain circumstances, particularly with respect to service businesses and businesses in the start-up phase.[215] As another example, businesses in the real estate industry can be particularly susceptible to classification as PFICs, because rent is classified as passive unless it is associated with an exceptionally high level of services.[216] Effectively, short of running a hotel-like property, a real-estate focused business is highly susceptible to classification as a PFIC.

Although the PFIC rules contain a number of traps for the unwary, in the sense that the literal application of the PFIC rules can produce a result that is contrary to their apparent policy objective, there are also some industry-specific exceptions whereby a foreign corporation that might otherwise satisfy the technical qualifications of being a PFIC nonetheless will not be treated as such. In effect, these exceptions acknowledge that in certain industries, such as banking and insurance, passive assets are a necessary component to the activities of the operating business.

B. Passive vs. Active Income

For purposes of the asset and income tests, passive income is defined by reference to Section 954(c) as foreign personal holding company income ("FPHCI"). This includes dividends, interest, royalties that are not derived in active business, rents that are not derived in active business, annuities, gains from sale of property, gains from commodities transactions, foreign currency gains, and income equivalent to interest.[217] Certain exceptions to FPHCI exist with respect to rents and royalties derived in the active conduct of a trade or business, and which are received from a person other than a related person.[218]

In particular, uncertainty may often arise with respect to rental income, and whether or not such income is considered to be derived from an active business. Rents are considered to be derived in the active conduct

[212] IRC § 1297(a)(1).

[213] IRC § 1297(a)(2).

[214] IRC §1297(c).

[215] In this regard it should be noted that an exception exists for PFIC start-ups under IRC § 1298(b)(2), provided that the corporation can demonstrate that it is not likely to be a PFIC for either of the next two years.

[216] Treas. Reg. § 1.954-2(c) generally provides that rents are considered passive unless the lessor, through its officers or employees, regularly performs active and substantial management and operational functions while the property is leased.

[217] IRC § 954(c).

[218] IRC § 954(c)(2)(A).

of a trade or business only if they fall within one of four categories, the most common of which relates to rents arising from the "active and substantial management and operational functions" of the corporation's officers or employees.[219] Although there is no quantitative test to determine what constitutes "active and substantial management and operational functions," guidance from the IRS and case law indicate that a landlord who acts as rental agent and employs a staff to perform maintenance functions with respect to rental property qualifies for the exception.[220] Conversely, an "absentee landlord" who merely selects tenants, pays for taxes and insurance, and collects rent, or a landlord who delegates <u>all</u> leasing and management functions to a third-party management company, would not qualify for the exception.[221]

In addition to the Regulations, courts have developed what has been called the "*Rafferty* approach," based on the approach taken by the First Circuit Court of Appeals decision in *Rafferty v. Commissioner*.[222] In *Rafferty*, the First Circuit determined that the appropriate test was whether a company's entrepreneurial activities qualitatively and quantitatively distinguish its corporate operations from a passive investment. Stated simply, the *Rafferty* approach looks to whether a taxpayer's activity is "almost indistinguishable" from an investment in securities. In the rental real estate context, the court noted that a passive investment in rental real estate involves "merely collecting rent, paying taxes, and keeping separate books." A greater level of activity constitutes the active and substantial management of leased property. This approach is in accord with the analysis in IRS Revenue Rulings.[223] Despite its age, the Rafferty approach remains good law and has been cited in several more recent Tax Court cases.[224]

C. <u>Consequences of PFIC Classification</u>

PFIC shareholders are subject to a special tax and reporting regime. While PFIC status is technically determined one a year-over-year basis, a rule known as the "once a PFIC, always a PFIC" rule provides that, if a foreign corporation is a PFIC at any time during the holding period of a shareholder, the corporation will always be treated as a PFIC with respect to that shareholder, even if it subsequently ceases to meet either the income test or the asset test.[225] This PFIC taint will generally continue until the shareholder disposes of his or her stock or until he or she makes one of several elections available to purge the PFIC taint.

From a reporting perspective, a US person is generally required to file IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, in any year that the taxpayer is a direct or indirect shareholder of a PFIC. From a tax perspective, the consequences of owning a direct or indirect interest in a PFIC depend primarily on whether the taxpayer accepts the

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[219] Treas. Reg. § 1.954-2(c) states the following four situations for rents to be derived in the active conduct of a trade or business from leasing: (1) property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind; (2) real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased; (3) personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or (4) property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

[220] *See* Treas. Reg. § 4.954-2(c)(3), Ex. 4.

[221] PLR 8305036; Rev. Rul. 73-236. The Service has noted in PLRs 8406059 and 8509042 that it is "not inconsistent" to apply the tests under IRC §§ 954(c)(2)(A), 355(b), and 367(a) (all of which use the language "active and substantial management and operational functions") interchangeably.

[222] 452 F.2d 767 (1st Cir. 1971). In GCM 37968, the Service noted that "355(b) issues will be resolved in accordance with the *Rafferty* approach."

[223] *See, e.g.*, Rev. Rul 73-237 (corporate employees who submitted bids, entered into contracts, purchased equipment, and supervised the work of independent contractors were engaged in the performance of active and substantial management functions); Rev. Rul 92-17 (a corporation that was responsible for substantial decisions relating to rental real estate, regularly participated in the supervision of rental properties, and directed and controlled third parties in the day-to-day operation of its rental business was engaged in substantial management functions. The IRS considered whether the activities of a company were considered to be active. There, the company (i) was responsible for substantial decisions regarding capital improvements to its rental real estate, (ii) regularly participated in the supervision of rental properties, and (iii) oversaw the work of third parties performing routine maintenance and repairs to the property. In that Revenue Ruling, it was decided that the company <u>was</u> regularly performing active and substantial management and operational functions).

[224] *See, e.g., Pulliam v. Commissioner*, T.C. Memo 1997-274; *Bowater Inc. v. Commissioner*, T.C. Memo 1995-164.

[225] IRC § 1298(b)(1).

"default" regime for PFIC taxation, or whether the taxpayer makes one of the special elections that are available for PFIC shareholders.

1. Default Method

The default method for PFIC taxation is conceptually similar to the foreign non-grantor trust regime, and indeed was modelled on the same rules. These rules apply when a US taxpayer recognizes income from a PFIC holding, either through a PFIC distribution or through the sale or disposition of PFIC stock. Whenever such income is recognized, a punitive tax regime applies under Section 1291, which is intended to punish the deferral of taxation on accumulated investment returns. Note that this approach stands in direct contrast to the CFC rules, which seek to curb offshore deferral by simply taxing phantom income on a current basis.

Under the default method, a punitive tax regime applies to that portion of income from a PFIC distribution or disposition identified as an "excess distribution." An excess distribution is the sum of (i) that portion of dividends received by a US shareholder that exceeds (determined on a per-share basis) 125% of the average dividends received during the preceding three years, and (ii) any gain realized on the sale or other disposition of PFIC stock.[226] For these purposes, an excess distribution does not include dividends received in the first year of the US shareholder's holding period because, by definition, this cannot be an excess distribution.[227] A regular or non-excess distribution is simply included in the US shareholder's income for that year.

Excess distributions generally are subject to tax as ordinary income and, in addition, are subject to a punitive interest charge. The taxation of an excess distribution is calculated according to the following procedure: (i) the excess distribution is prorated evenly over the taxpayer's post-1986 PFIC holding period;[228](ii) the portion of the excess distribution allocated to prior years is subject to US income tax at the highest ordinary rate for such years;[229] and (iii) amounts allocated to years within the post-1986 PFIC holding period are taxed as ordinary income and are subjected to an interest charge, applying the compounded statutory rate under Section 6621, calculated as if the tax had been imposed in such years and assuming that the taxpayer had failed to pay the tax until the year in which the excess distribution or sale occurs.[230] The sum of the tax on the portion of the excess distribution allocated to prior years, and the interest thereon, is referred to as a "deferred tax amount," and represents the total additional tax owed by the US shareholder for the year in which the excess distribution was received.[231]

2. Elimination of Basis Step-Up at Death

Under the PFIC rules, on the death of a US shareholder of a PFIC, the stepped-up basis that would typically be obtained under Section 1014 is effectively eliminated, unless the decedent was a nonresident alien at all times during the his or her PFIC holding period.[232] This rule is of obvious import in the estate planning context. Note, however, that the basis step-up generally is lost only to PFIC shareholders using the default method, and not to shareholders of PFICs that have made an election to be treated as a qualified electing fund.

3. Qualified Electing Fund Election

[226] IRC § 1291(a)(2), (b)(2).

[227] IRC § 1291(b)(2)(B).

[228] IRC § 1291(a)(1)(A). Note that the taxpayer's holding period for these purposes includes only years after 1986, when the PFIC regime was enacted. The portion of the excess distribution allocated to the current year, or to pre-1987 years, is included in the US shareholder's income for such year under "normal" tax rules.

[229] IRC § 1291(a)(1)(B).

[230] IRC § 1291(a)(1)(C).

[231] IRC § 1291(c).

[232] IRC § 1291(e).

A US shareholder of a PFIC can avoid the application of the excess distribution regime by making an election to treat the PFIC as a "qualified electing fund" (a "QEF"), which effectively treats the PFIC as tax transparent and subjects the shareholder to current taxation on his or her share of PFIC earnings.[233] The benefit of making a QEF election is that, although the PFIC shareholder will be subject to current income taxation on his or her share of PFIC earnings, the election enables long-term capital gains to retain their character and avoids the draconian interest charge imposed under the default method.[234]

A QEF election applies only with respect to the PFIC shareholder making the election, and it is possible that it may apply with respect to some shareholders but not others. Importantly, such an election can be made only if the PFIC agrees to provide its shareholder with the information needed to determine his or her pro rata share of the PFIC's ordinary earnings and net capital gain.[235] It should be noted that many foreign investment funds will refuse to take on the obligation to provide such information and, as a result, a QEF election is not possible in some circumstances.

While the effect of a QEF election is to tax the QEF shareholder on a current basis, without regard to whether the QEF makes distributions, further election can be made whereby the electing shareholder can defer the time for payment of income tax liability on undistributed QEF earnings.[236] As one might anticipate, the election to defer QEF taxes carries a cost, and the deferring shareholder must pay interest on the deferred amount at the time the tax is paid. The deferral election occurs until the occurrence of a terminating event, which can include the receipt of QEF distributions, a transfer of QEF stock or termination of QEF status.

A final election available to QEF shareholders is a so-called "purging election." Because exposure to the excess distribution regime is determined on a year-over-year basis, a PFIC shareholder that makes a QEF election several years into his or her holding period may nonetheless still be subject to the default method with respect to non-QEF years (such a QEF is sometimes called an "unpedigreed QEF"). The effect of the purging election is to trigger a deemed sale or deemed dividend with respect to the unpedigreed portion of the PFIC stock and, accordingly, to pay tax and interest under the default method for years preceding the QEF election.[237] A QEF for which an election has been made, or a QEF that has been a QEF since inception, is sometimes called a "pedigreed QEF".

4. Mark-to-Market Election

The second alternative to avoid the potentially harsh consequences of the default method is to make a so-called mark-to-market election under Section 1296. The mark-to-market election is available only if the stock of a PFIC is marketable.[238] In such a case, the US shareholder can elect to mark the stock to market at the end of each taxable year, and the US shareholder is require to recognize as ordinary income the gains for the taxable year.[239] Because there is no income deferral achieved, an electing shareholder is not subject to the interest charge imposed under the default method. Upon the disposition of PFIC stock for which a mark-to-market election has been made, any gain on the disposition is taxed as ordinary income, and any loss on such disposition is treated as an ordinary loss.[240]

233 IRC § 1295(b).

234 IRC § 1293(a)(1).

235 IRC §§ 1295(a)(2), 1293.

236 IRC § 1294(a).

237 IRC § 1291(d)(2).

238 The term "marketable stock" generally refers to any stock which is regularly traded on a national securities exchange and is registered with the SEC, or any other exchange which has similar rules. IRC § 1296(e)(1).

239 IRC § 1296(a).

240 IRC § 1296(c)(1)(A)&(B).

5. Attribution Rules

Ownership of PFIC stock by one or more layers of partnerships, trusts, estates and other PFIC's is attributed successively and proportionately to their partners, beneficiaries and shareholders. Such ownership of a PFIC by a non-PFIC corporation is attributed proportionately only if such corporation is at least fifty percent (50%) in value owned by any shareholder and only to such shareholder.

D. PFIC/CFC Overlap

A US taxpayer's interest in a foreign corporation may be simultaneously classified as an interest in a PFIC and as an interest in a CFC. In such cases, the CFC rules essentially "trump" the PFIC rules, such that a foreign corporation will not be considered a PFIC with respect to any United States shareholders of a CFC.[241]

In effect, the tax attributes of the stock will be determined under the CFC rules with respect to the "qualified portion" of such person's holding period of the stock in the foreign corporation – essentially the US shareholder's post-December 31, 1997 holding period.[242] Of course, because a foreign corporation is only considered a CFC with respect to a US shareholder, to the extent that the US person owns less than 10% of the voting shares of the corporation, the CFC-PFIC trumping rule will not apply.[243]

XVI. INBOUND INVESTMENTS IN US REAL ESTATE

As discussed above, NRAs are generally subject to US federal income tax only on specified categories of US-source income and gains: first, income that is (or is deemed to be) effectively connected with the conduct of a US trade or business ("ECI"); and second, certain US-source investment income, including dividends, royalties, rents, and similar property ("FDAP"). ECI is taxed on a net basis at the same graduated rates applicable to a resident US taxpayer. FDAP is generally subject to a flat 30% withholding at the source on a gross basis, subject to reduction by treaty.

The source of income from capital gains is generally determined under a residence-of-the-seller rule. Under this rule, capital gains recognized by a US resident have US source, and capital gains recognized by a NRA have foreign source. Thus, capital gains recognized by a NRA generally are not subject to US federal income tax.[244] However, the application of this exclusion to foreign investment in US real estate was viewed by many as an end-run around the US tax system.[245]

Accordingly, in 1980, Congress enacted a special set of rules under the Foreign Investment in Real Property Tax Act ("FIRPTA"), which added Sections 897, 1445 and 6039C to the Internal Revenue Code.[246] Under these rules, any gain directly or indirectly derived from the sale or other disposition of a "US real property interest" (a "USRPI") by a NRA is taxable in the same manner as if derived by the NRA in the active conduct of a US trade or business, and is therefore subject to US federal income tax regardless of whether a US trade or business actually exists.[247]

Enforcement of this rule is supported by a withholding obligation on the purchaser of a USRPI from a NRA.[248] The purchaser of a USRPI is required to withhold and remit to the IRS an amount equal to 15% of the gross sale

[241] IRC § 1297(d)(1).

[242] IRC § 1297(d)(2).

[243] A new holding period begins when a US shareholder of a CFC ceases to own at least 10% of the foreign corporation's voting power. IRC § 1297(d)(3).

[244] Different rules apply in certain circumstances, such as for depreciable personal property, intangibles and capital gains derived in the conduct of a US trade or business. In addition, in certain cases sales by an NRA are treated as having a source in the United States. IRC § 871(a)(2).

[245] H.R. Rep. No. 1167 (96th Cong.).

[246] For a more exhaustive discussion of the various facets of tax planning for inbound real estate investment, *see* Caballero, Feese & Plowgian, 912-2nd T.M., *US Taxation of Foreign Investment in US Real Estate*.

[247] IRC § 897(a)(1).

[248] IRC § 1445(a).

proceeds, subject to certain exemptions.[249] Any amount withheld is credited on the NRA seller's US income tax return and may be refunded if the withholding exceeds the NRA's net tax liability.

In determining whether the FIRPTA withholding rule applies to a particular transaction, a two-part analysis must be undertaken: first, one must determine whether an NRA owns a USRPI; and, second, one must determine whether a "disposition" of the USRPI has occurred.

A. What is a USRPI?

A USRPI is generally a direct interest in real property located in the United States or the US Virgin Islands, an interest in a US corporation classified as a "United States Real Property Holding Company" ("USRPHC"), or an interest in a partnership, the assets of which consist primarily of US real property.[250] For these purposes, relevant ownership interests in US real property include traditional fee interests, leases, time-sharing interests, life estates, remainders, reversions and certain mineral and mining rights.[251] More exotic interests connected with US real property may also be considered USRPIs depending on the facts and circumstances, including deferred payment obligations, commissions, derivative instruments, options, rights of first refusal and stock appreciation rights.[252] Note that interests held solely as a creditor (*i.e.*, "straight debt" interests) are generally not considered interests in US real property for FIRPTA purposes.[253]

1. United States Real Property Holding Corporations

Stock in a USRPHC is generally considered an interest in US real property and, as such, the disposition of such stock is generally subject to US federal income tax and FIRPTA withholding. A US corporation is a USRPHC if the value of its interests in US real property equal or exceed 50% of the sum of the fair market value of the corporation's interests in US and non-US real property and any other assets held by the corporation for use in a trade or business.[254] To prevent corporations from shifting assets in anticipation of a foreign shareholder's sale of stock so as to preclude USRPHC status, the testing period used to determine such status is the shorter of the holding period of a foreign person's stock, and the five years immediately preceding the foreign person's sale of such stock.[255]

Even if a domestic corporation satisfies the test above, it may nonetheless escape USRPHC status through one of three exceptions. First, under the so-called "purge exception," a US corporation can escape USRPHC status if it has disposed of all of its USRPIs in taxable transactions and has not subsequently reacquired USRPIs.[256] Next, a domestic corporation that is regularly traded on an established securities market is not considered a USRPHC provided that a NRA does not own more than 5% of all such stock during the testing period. Finally, a domestic corporation will not be considered a USRPHC if (i) a NRA owns some or all of a non-regularly traded class of stock in the corporation, and (ii) the NRA's interest in such stock does not exceed 5% of the value of a class of stock in the same corporation that is regularly traded on an established securities market.

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[249] *Id.* Note that, for dispositions made on or before February 16, 2016, the applicable FIRPTA withholding rate was 10%. This rate was adjusted upward from 10% to 15% for dispositions after February 16, 2016 pursuant to the Protecting Americans from Tax Hikes Act of 2015, Pub. Law No. 114-113 (114th Cong.).

[250] IRC § 897(c)(1)(A)(i); IRC § 897(g).

[251] Treas. Reg. § 1.897-1(d)(2)(ii).

[252] Treas. Reg. § 1.897-1(d)(2) & (3).

[253] Treas. Reg. § 1.897-1(c)(i). Interests held solely as a creditor may include, for example, mortgage interests with respect to US real estate or security interests on the stock of a USRPHC. Treas. Reg. § 1.897-1(d)(2)(ii) & (iii). Interests are not considered straight debt, and may thus be considered USRPIs, if they include rights "to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property." Treas. Reg. § 1.897-1(d)(2).

[254] IRC § 897(c)(2). In applying the 50% test, assets are valued at fair market value. This presumably permits the application of available valuation discounts, and corporations near the 50% limit could potentially avoid status as a USRPHC with creative valuation planning. Treas. Reg. § 1.897-1(o)(2).

[255] IRC § 897(c)(1)(A)(ii).

[256] IRC § 897(c)(1)(B).

2. Partnership Interests

FIRPTA generally adopts the entity theory of partnerships and, accordingly, an interest in a partnership may also be considered a USRPI.[257] A NRA's partnership interest is considered a USRPI if: (i) 50% or more of the partnership's gross assets, whether held directly or indirectly, are USRPIs; and (ii) 90% or more of the partnership's gross assets, whether held directly or indirectly, consist of USRPIs, cash, or cash equivalents.[258] This is commonly known as the "50/90 test."

Under Section 897(g), a NRA's disposition of an interest in a partnership satisfying the 50/90 test will be treated as a disposition of a USRPI only to the extent the gain on disposition is attributable to US real estate, and not to the extent the gain on disposition is attributable to other assets. However, FIRPTA withholding may nonetheless be required on the full amount realized.[259]

B. What is a Disposition of a USRPI?

Assuming the interest in question is a USRPI under one of the tests above, the transferee of such an interest is obligated to withhold and remit to the IRS a portion of the gross proceeds of the transaction if the transferor is a foreign person. Accordingly, the next step in determining whether the FIRPTA withholding obligation applies involves determining whether a sale or other disposition by a foreign person has occurred. This analysis is straightforward in the case of a direct sale of US real estate, but is more complicated in the case of a real estate holding structure involving one or more entities.

1. Dispositions Generally

The regulations under Section 897 define the term "disposition" broadly. Generally speaking, any transfer that would be considered a disposition for any tax purpose (including, in certain circumstances, non-recognition transactions) could be considered a disposition for FIRPTA purposes. Thus, FIRPTA may be triggered in connection with actions like foreclosures, involuntary conversions, corporate mergers and liquidations, transfers or shifts in interests in trusts, estate or partnerships, and gifts of property with liabilities in excess of basis.[260] As noted above, a disposition can occur not only with respect to direct interests in US real property, but also with respect to interests in USRPHCs and partnerships satisfying the 50/90 test.

The broad definition of a "disposition" means that a transaction could potentially trigger a FIRPTA withholding obligation without a corresponding liquidity event. Because FIRPTA withholding is calculated on the basis of gross proceeds (rather than net gain), the amount due can be quite substantial. Particularly in the context of related-party transactions, care must be taken to carefully monitor the technical aspects of a transaction to ensure that an unintended and unexpected tax and withholding obligation does not arise. In short, any "restructuring" of an NRA's US real estate holding structure should not be undertaken without careful consideration of the FIRPTA implications.

2. Dispositions by Domestic Corporations

Corporations are subject to special and sometimes counter-intuitive rules under FIRPTA. These rules will generally supersede the terms of a bilateral income tax treaty, and will sometimes contradict the general non-recognition rules of the Code.

For a domestic corporation classified as a USRPHC, certain distributions to an NRA shareholder may be considered dispositions of a USRPI, whether or not consisting of interests in US real

[257] Treas. Reg. § 1.897-9T(c). Note that this also means that a foreign partnership is treated as a NRA for FIRPTA purposes and, thus, its disposition of a USRPI may give rise to a FIRPTA withholding obligation.

[258] Treas. Reg. § 1.897-7T.

[259] *See* IRC § 1445(e)(5); Treas. Reg. § 1.1445-11T.

[260] Treas. Reg. § 1.897-1(g).

property or other corporate assets. Relevant distributions include redemptions of stock from an NRA, liquidating distributions to an NRA, and certain returns of capital to an NRA.[261] Note, however, that dividends from a USRPHC to an NRA shareholder, though likely subject to tax under other provisions of the Code, are generally not treated as FIRPTA dispositions.

3. Foreign Corporations

The transfer of a USRPI to a foreign corporation is generally treated as a disposition under FIRPTA, requiring a foreign transferor to recognize gain.[262] This rule runs contrary to the general rule of non-recognition on corporate formation under Section 351(a), and the NRA will be required to recognize gain equal to the excess of the USRPI's fair market value over the NRA's adjusted basis in the USRPI. Similarly, FIRPTA treats the distribution of a USRPI to a shareholder as a disposition, reasoning that because sales of stock in a foreign corporation are never subject to tax under FIRPTA, taxing the corporation on distribution is the only way to prevent tax avoidance via non-recognition.[263]

The FIRPTA rules prescribe somewhat harsh treatment for foreign corporations owning US real property. To preclude potential challenges to FIRPTA under the nondiscrimination provisions of bilateral income tax treaties, Congress included in FIRPTA an election allowing a foreign corporation to be treated as a domestic corporation if it holds a USRPI and is otherwise entitled to treaty benefits.[264] An electing foreign corporation is treated as a domestic corporation solely for FIRPTA purposes, and is therefore subject to tax on any gain or loss on the disposition of a USRPI in the same manner as a domestic corporation.[265] Assets of the foreign corporation other than USRPIs are subject to US tax under the normal rules applicable to foreign corporations.

4. Special Rule for Non-Recognition Exchanges

As noted above, in enacting FIRPTA, Congress was particularly concerned with the potential to circumvent the withholding obligation through creative use of the various non-recognition provisions of the Code. For example, absent an anti-avoidance rule, a foreign person’s capital contribution of an appreciated USRPI to a domestic corporation would be eligible for tax-free treatment under Section 351(a) and, so long as the domestic corporation was not classified as a USRPHC, the foreign person’s subsequent disposition of the corporate stock could potentially escape taxation.

To avoid this result, Section 897(e)(1) provides that a non-recognition rule can apply with respect to a foreign person’s USRPI only if the transaction is an exchange in which the foreign person receives property that will be subject to US tax on subsequent disposition. Thus, in the example above, the foreign person’s capital contribution would be eligible for non-recognition only if the stock received in exchange was stock in a USRPHC. Other situations in which this rule might apply include involuntary conversions in which a USRPI is replaced with foreign property and corporate reorganizations in which a NRA exchanges shares in a USRPHC for shares in a corporation other than a USRPHC.[266] If a transaction satisfies Section 897(e)(1), no disposition will have occurred for FIRPTA purposes and, thus, no withholding will be required.[267]

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[261] *See* Treas. Reg. § 1.897-5T(b).

[262] IRC § 897(e)(1); IRC § 897(j)

[263] Treas. Reg. § 1.897-5T(c); Notice 2006-46, 2006-24 IRB 1044.

[264] IRC § 897(i).

[265] Treas. Reg. § 1.897-3(f).

[266] Note that this rule will not apply in circumstances in which a recapitalization or reincorporation occurs if the shares received are "substantially identical to the shares exchanged." *See* Notice 99-43, 1999-2 CB 344.

[267] *See* Treas. Reg. § 1.445-5(b)(ii).

C. The FIRPTA Withholding Obligation

As noted above, the FIRPTA tax regime is supported with a withholding at the source.[268] Thus, in the case of a disposition of a USRPI by a NRA, the transferee is obligated to withhold 15% of the gross proceeds on the transaction. This obligation applies to the purchaser of a USRPI, as well as corporations and other entities subject to the special rules described above. The obligation to withhold is a personal obligation of the transferee and amounts withheld must generally be turned over to the IRS, along with IRS Forms 8288 and 8288-A, within 20 days of the transaction closing.[269] Although the transferee will be relieved of liability if the NRA files a tax return and pays the tax due, he or she can still be held liable for penalties for failure to file IRS Forms 8288 and 8288-A, and failure to pay the withholding tax.[270]

It is important to note that FIRPTA withholding is not the exclusive method of taxation for gains derived from a NRA's investment in US real estate. Rather, the amount withheld is credited to the NRA's US income tax return for the taxable year of the disposition and is used to offset the net tax that would otherwise be due. In many circumstances, this will result in the NRA being entitled to a refund. However, particularly in cases in which an investment has been fully or partially depreciated, any tax due in excess of the withholding amount will remain his or her liability. Importantly, because FIRPTA gains are treated as ECI, the NRA will be required to obtain a tax identification number and file a US tax return to report and pay tax on the gain.

1. Exceptions to Withholding

The FIRPTA withholding obligation is, without doubt, a blunt instrument. Although it is intended to secure the ultimate payment of tax, it can lead to distorted results that do not align with economic reality. In many cases, a gross 15% withholding will exceed the gross profit margin an investor intends to realize on a particular investment. In other cases, the NRA will have sufficiently close ties to the United States that withholding to secure the payment of tax is unnecessary. In an effort to provide relief in such situations, the FIRPTA rules provide a number of exceptions to the FIRTPA withholding obligation.

Non-Foreign Certification. Withholding under FIRPTA is not required if the transferor is not a foreign person. Accordingly, a transferee is relieved of the obligation to withhold if he or she obtains from the transferor a certificate of non-foreign status signed under penalties of perjury.[271] This procedure is not strictly necessary, as sales between US persons do not implicate the FIRPTA rules, but is a common part of commercial transactions because a transferee obtaining a certificate of non-foreign status is entitled to rely on it unless he or she has reason to believe it is false.

A foreign corporation that has made an election under Section 897(i) to be treated as a domestic corporation may also provide a certificate of non-foreign status, as no withholding is required on the disposition of a USRPI by an electing foreign corporation.[272] Note, however, that the disposition of the actual stock in an electing foreign corporation is itself treated as a disposition of a USRPI and is thus subject to the FIRPTA withholding requirement.[273]

Affidavit of Non-Recognition. A transferee is not required to withhold where the transferor furnishes an affidavit attesting that a non-recognition provision of the Code applies to the entire transaction.[274] The affidavit must be mailed to the IRS by the transferee within 20 days of the

[268] IRC § 1445(a).

[269] Treas. Reg. § 1.1445-1(c). The transferee need not withhold on the transaction if the NRA has filed for a withholding certificate. Treas. Reg. § 1.1445-1(c)(2). In commercial transactions, the transferee may wish to hold an appropriate amount in escrow pending the issuance or rejection of a withholding certificate.

[270] IRC § 1463.

[271] Treas. Reg. § 1.1445-2(b)(2).

[272] Treas. Reg. § 1.1445-7(b)(1).

[273] Treas. Reg. § 1.1445-7(b)(2).

[274] Treas. Reg. § 1.1445-2(d)(2).

transaction closing. As above, the transferee is entitled to rely on such an affidavit unless he or she has reason to believe all or a portion of the transaction is not entitled to non-recognition treatment.

Residential Real Estate. FIRPTA withholding is not required where the USRPI is acquired for use as a personal residence and the gross amount realized on the disposition is US$300,000 or less. To qualify for this exception, the transferee must intend to reside in the property for at least 50% of the number of days the property is used over the following 24 months.[275] A transferee can be held liable for withholding if he or she fails to utilize the property as a personal residence, absent exigent circumstances.

Transfers on an Established Securities Market. No withholding is required on the sale of shares in a USRPHC, or of interests in a partnership satisfying the 50/90 test, if the interests are regularly traded on an established securities market.[276]

2. The FIRPTA Withholding Certificate

For situations that do not fall within one of the exceptions described above, the FIRPTA withholding obligation may nonetheless be avoided or reduced by obtaining a withholding certificate from the IRS.[277] A transferee is not required to withhold, or is permitted to withhold at a reduced rate, if, as of the date of the transaction closing, the transferor has applied to the IRS for the issuance of a qualifying statement that reduced or eliminated withholding is appropriate.

Withholding certificates are often issued where, for example, the transferor can provide a tentative calculation of the tax due showing that reduced or eliminated withholding is appropriate, where the transferor is otherwise exempt from US income tax, where the transferor has made adequate arrangements for the payment or security of the tax, or where an installment sale or foreclosure is occurring. A NRA may also want to apply for a withholding certificate on a protective basis when a non-recognition transaction is entered into.

An application for a withholding certificate is made on IRS Form 8288-B. Although this is a simple, one-page form, a number of supporting documents and attestations must accompany the form, and close attention to detail is required to ensure the smooth and timely issuance of the withholding certificate. Notably, both the transferor and transferee must have US taxpayer identification numbers prior to the issuance of a withholding certificate. For NRA individuals without other ties to the United States, this may require obtaining an individual taxpayer identification number ("ITIN") by filing IRS Form W-7. This form must be processed and an ITIN assigned prior to issuance of the withholding certificate. Once issued, the withholding certificate provides the transferee protection against the future assessment of tax, penalties and interest in relation to the FIRPTA withholding requirement.

XVII. INFORMATION REPORTING REGIMES

This section will focus on the ever expanding class of information reporting regimes imposed on taxpayers with ties to the United States.

We live in an era that necessitates an unprecedented level of disclosure of personal and financial information to both governments and private institutions. In this age of financial transparency and global information exchange, internationally connected clients, many of whom have spent decades seeking enhanced privacy protections, must now accept that compliance with tax reporting requirements demands a level of transparency that may feel uncomfortable, offensive or even dangerous. These requirements are complex and require clients to seek the

[275] IRC § 1445(b)(5); Treas. Reg. § 1.1445-2(d)(1).

[276] IRC § 1445(b)(6). Note, however, that if a NRA owns more than 5% of the stock in a USRPHC traded on an established securities market, he or she may still have a substantive FIRPTA tax liability under IRC § 897(c)(3).

[277] IRC § 1445(b)(4).

counsel of knowledgeable advisors who can help them establish structures that accomplish their economic goals while controlling their reporting obligations to the greatest extent possible. After vetting the available international options, clients and advisors alike may be surprised to reach the conclusion that, for some structures, the United States is now the "offshore" jurisdiction of choice for tax, reporting and regulatory reasons.[278]

XVIII. THE FOREIGN ACCOUNT TAX COMPLIANCE ACT

As noted in prior installments of this series, US persons are taxable on their worldwide income. Tax enforcement and compliance for US persons maintaining accounts at US financial institutions historically has been centralized and straightforward, in large part due to the fact that US institutions are subject to the jurisdiction of US tax authorities and are thus obligated to provide relevant information to both the IRS and the account holders themselves. By contrast, foreign institutions historically have been less concerned with the tax obligations of their US account holders and have instead focused on applicable local regimes. This presented a challenge for even the most compliant US taxpayers, who could not simply request that a foreign bank issue the equivalent of IRS Form 1099. This dynamic also resulted in a significant level of non-compliance, both intentional and unintentional, on the part of US taxpayers with foreign financial accounts.

The Foreign Account Tax Compliance Act ("FATCA") was enacted in 2010 as a legislative response to these ongoing challenges.[279] These challenges were viewed most publicly through the investigation of non-US financial institutions, including UBS AG, by the United States Department of Justice, and the staggering number of taxpayers coming forward in response to the IRS's Offshore Voluntary Disclosure Initiative, which allowed US taxpayers to correct historical tax and reporting irregularities in a relatively predictable manner. The basic effect of FATCA is to strong arm foreign institutions into cooperating with a newly-established information reporting regime by imposing a substantial US tax withholding on payments to institutions that fail to undertake due diligence procedures to identify, document, and report information with respect to their direct and indirect US account holders.

Although the intent of FATCA was regulation of "traditional" financial institutions, as is often the case, the resulting legislation applied much more broadly and has created a ripple of unintended compliance issues for individuals, trusts and estate planning structures. The inherent complexity of the FATCA regime has been compounded by the response of foreign institutions, many of which have taken extremely conservative views of their compliance obligations, to the extent that many such institutions now impose requirements beyond those strictly required under FATCA. Although this response presumably reflects the aggressive enforcement posture of the US authorities, it has nonetheless resulted in a certain element of unpredictability in implementing and maintaining even basic cross-border estate planning structures.

A. Basic Rules and Classifications

FATCA created a new Chapter 4 of the Code, consisting of Sections 1471 through 1474, and hundreds of pages of associated regulations and other pieces of administrative guidance. In broad form, Section 1471 imposes a 30 percent withholding tax on any "withholdable payment" to a "foreign financial institution" (a "FFI") that fails to meet certain reporting requirements applicable to FFIs, and Section 1472 imposes a 30 percent withholding tax on any "withholdable payment" to a "non-financial foreign entity" (a "NFFE") that fails to meet certain reporting requirements applicable to NFFEs. FFIs are also required to withhold on certain "pass-thru payments" to non-compliant FFIs and to "recalcitrant account holders."

Where an FFI or NFFE is required to withhold, it is personally liable for payment of the tax, essentially forcing the FFI or NFFE to either act as the tax collector or pay the tax from its own funds. The withholding obligation under FATCA is unlike other US tax withholding regimes, which are intended to serve as a rough proxy for an individual's ultimate US tax liability. FATCA withholding, on the other hand, is punitive in nature and is intended as a means by which to induce compliance.

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[278] *See* European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) ("The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners"). *See also*, Richard LeVine, Aaron Schumacher & Shudan Zhou, *A Comparison: FATCA and the Common Reporting Standard*, J. INT. TAX 43 (Mar. 2016) (arguing that "the United States is becoming the big black hole in the global transparency network that it pioneered in building").

[279] Pub. L. No. 111-147, Section 501-541 (2010). FATCA was enacted as part of the Hiring Incentives to Restore Employment Act.

Administration of the FATCA requirements is accomplished through the issuance of the Global Intermediary Identification Numbers ("GIINs") and IRS Form W-8BEN-E. Withholding is not required for payments to entities possessing a GIIN. The withholding requirements are intended to implement the provisions of various bilateral intergovernmental agreements ("IGAs"). These are largely based off of two model IGAs (a "Model 1 IGA" and a "Model 2 IGA") developed by the Treasury Department. The provisions of the IGAs generally simplify and supersede the FATCA withholding regulations and are described further below.

It perhaps goes without saying that the definitions and categories established under the FATCA regulations are critical in establishing the nature and extent of applicable reporting obligations. What follows is a high-level overview of some the more important defined terms present in the FATCA regulations.

Foreign Financial Institution. FATCA classifies every non-US entity as either an FFI or an NFFE. An FFI is any "financial institution" that is a foreign entity.[280] A financial institution is defined as any entity that falls into one of three categories: (i) a "depository institution,"[281] meaning an entity that accepts deposits in the ordinary course of a banking or similar business, (ii) a "custodial institution,"[282] meaning an entity that holds financial assets of others as a substantial portion of its business, or (iii) an "investment entity,"[283] meaning an entity that is engaged primarily in the business of investing, reinvesting or trading in passive investment assets.

The term "investment entity" can be further broken down into three sub-categories: (i) a "manager investment entity," meaning an entity whose business revolves around providing trading, investing and similar services with respect to the financial assets of third parties, (ii) a "managed investment entity," meaning an entity whose gross income is primarily attributable to investment activities and which is managed by a depository institution, a custodial institution or a manager investment entity, or (iii) a "fund investment entity," which is an entity that functions or holds itself out as a collective investment vehicle, investment fund or similar entity primarily engaged in the trading of financial assets.[284] Any entity meeting one or more of these definitions will be classified as an FFI for FATCA purposes. An FFI can also include certain holding companies, insurance companies and treasury centers.[285]

Non-Financial Foreign Entity. The only other category of entity in the FATCA lexicon, the NFFE, is defined under the FATCA regulations simply as a foreign entity that is not a financial institution or is otherwise categorized as an NFFE under an applicable Model 1 IGA or Model 2 IGA (the application of IGAs is discussed below).[286] NFFEs are further categorized as either "active NFFEs" or "passive NFFEs." Active NFFEs are generally those deriving less than 50% of their gross income from passive sources and having less than 50% passive assets.[287] Passive NFFEs are those that do not qualify as active NFFEs.

Withholdable Payment. The FATCA withholding obligation applies to "withholdable payments." A withholdable payment generally includes any US source payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensation or other fixed or determinable annual or periodical gains, profits or income.[288] The phrase also includes gross proceeds from the sale or other disposition of any property of

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[280] IRC § 1471(d)(4).

[281] IRC § 1471(d)(5)(A); Treas. Reg. § 1.1471-5(e)(1)(i).

[282] IRC § 1471(d)(5)(B); Treas. Reg. § 1.1471-5(e)(1)(ii). Generally, an entity meets this definition if the entity's gross income attributable to holding financial assets and related financial services equals or exceeds 20% of the entity's gross income during the prior 3 years. Treas. Reg. § 1.1471-5(e)(3).

[283] IRC § 1471(d)(5)(C); Treas. Reg. § 1.1471-5(e)(4)(iii) and (iv). Generally, an entity meets this definition if 50% or more of the entity's gross income during the prior 3 years is attributable to such activities.

[284] Treas. Reg. § 1.1471-5(e)(4)(i).

[285] Treas. Reg. § 1.1471-5(e)(1)(iv) and (v).

[286] Treas. Reg. § 1.1471-1(b)(80).

[287] Treas. Reg. § 1.1472-1(c)(1)(iv). Passive income includes investment income like dividends, interest, rents and royalties, annuities, etc., but does not include such income received from a related person or earned by a dealer entity.

[288] IRC § 1473(1)(A)(i).

a type that can produce US source interest or dividends, but, importantly, does not include most income taxable in the United States as income effectively connected with the conduct of a US trade or business.[289]

Withholding Agent. Individuals or entities subject to the FATCA withholding obligation are known as "withholding agents." A withholding agent is defined as any person with custody or control of any withholdable payment or pass-thru payment. A pass-thru payment is any withholdable payment or any other payment attributable to a withholdable payment.[290] If multiple persons qualify as withholding agents with respect to a payment, tax need not be withheld twice.[291]

B. Application to Common Foreign Estate Planning Structures

The general rules described above are relatively straightforward on their face. Applying them to common international estate planning structures, though, can present both conceptual and technical difficulties. Although the concepts behind FATCA and its 30% percent withholding regime are easy to understand in the abstract, complexities arise in their application due to the expansive nature of the regime and, indeed, its inconsistencies in interpretation. Moreover, practitioners may find that the interpretation of FATCA requirements varies from financial institution to financial institution. In the case of the application of FATCA to foreign trusts, this dynamic certainly exists.

As a starting point for any FATCA analysis, a practitioner should be armed with answers to a number of fact-specific questions. What type of entity is the subject of the analysis? What is the entity's ownerships structure? Is the entity foreign or domestic? How and by whom is the entity managed? What are the entity's assets and investments? The answers to these questions will serve as the basis for applying the relevant rules and definitions.

1. Foreign Trusts

One of the primary characteristics of an FFI is that it is a foreign entity engaged in some type of business. As such, the natural conclusion might be that a trust could never be an FFI, since its overriding purpose is to vest the management of certain property in trustees, who hold the property for the benefit of beneficiaries, and are not generally considered to be associates in a joint enterprise for profit.[292] Nonetheless, the FATCA regulations take the position that a trust can be engaged primarily in the business of investing or trading in passive assets and can be classified as an investment entity and, thus, an FFI.

In order for a trust to come within the scope of FATCA, either as an FFI or an NFFE, the trust must be a foreign trust. As discussed in Part 1 of this series, Section 7701(a)(30) defines a "domestic trust" as a trust that meets both the “court test” and the “control test.” Section 7701(a)(31) defines a "foreign trust" in the negative – namely, a foreign trust is a trust that is not a domestic trust.[293] Accordingly, a trust will be subject to FATCA only if no US court is able to exercise primary supervision over its administration or if one or more foreign persons are able to control substantial decisions regarding its administration.

The underlying investments of a foreign trust are a key component of its FATCA classification, regardless of whether an institution, individual or closely-held entity acts as its trustee. If a trust holds only non-financial assets (*e.g.*, real estate, artwork, etc.), the gross income of the trust will not be primarily attributable to financial assets and, thus, the trust should be classified as an NFFE. Moreover, if a foreign trust holds stock in a foreign entity that is classified as a corporation for US

[289] IRC § 1473(1)(A)(i); Treas. Reg. § 1.1473-1(a).

[290] IRC § 1471(d)(7).

[291] IRC § 1473(4); Treas. Reg. § 1.1473-1(d).

[292] *See* Treas. Reg. § 301.7701-4(a).

[293] *See also* Treas. Reg. § 301.7701-7.

tax purposes, the trust may not have any taxable income unless the foreign entity makes distributions. In those circumstances, the trust arguably should also be classified as an NFFE.[294]

Foreign Trusts with Institutional Trustees. As noted above, an entity (including a foreign trust) will be treated as an FFI if it falls into one of three broad categories: depository institutions, custodial institutions and investment entities. Trusts will almost never qualify as depository or custodial institutions, and thus generally will be FFIs only to the extent they qualify as investment entities. Accordingly, if a foreign trust derives 50% or more of its gross income from investment activities and has an institutional trustee, it will likely be treated as an FFI.[295]

Foreign Trusts with Individual Trustees. Because an individual is not an "entity" for FATCA purposes, a foreign trust with an individual trustee generally will not be treated as being "managed by a financial institution," and thus will not be treated as an FFI even if 50% or more of its gross income is derived from investment activities.[296] Instead, foreign trusts with individual trustees generally will be treated as NFFEs. Note that if an individual trustee, or an entity owned by a foreign trust with an individual trustee, hires a financial institution to provide investment management services for the trust, the trust may be treated as an FFI.[297]

Foreign Trusts and Private Trust Companies. Where a private trust company is trustee of a foreign trust, the key determinant of whether the trust will be treated as an FFI is whether the private trust company is a financial institution. Ordinarily, a private trust company does not actually custody the financial assets of its trust and is thus not a custodial institution. Similarly, a private trust company generally is not engaged in a banking or similar business and is thus not a depository institution. However, in certain circumstances, a private trust company that receives fiduciary or management fees may be considered an investment entity by virtue of having 50% or more of its gross income attributable to managing financial assets. In such a case, the private trust company would be treated as a financial institution and, accordingly, the trusts for which it acts as trustee likewise would be treated as FFIs. Where no management or fiduciary fees are paid to a private trust company, the trusts for which it acts as trustee likely would be treated as NFFEs.

2. Foreign Partnerships and Corporations

It is not uncommon for foreign estate planning structures to include one or more foreign partnerships or foreign corporations. Such entities may be utilized for the purpose of consolidating related investments, segregating liabilities, providing enhanced asset protection or serving as "blockers" for US or foreign tax purposes. In addition, foreign corporations may be established for the purpose of serving as private trust companies or other service provider entities in estate planning structures.

The classification of holding companies under the FATCA regulations will be determined primarily by the nature of the company's assets and the manner in which it is managed. As noted above, where a foreign holding company holds only non-financial assets such as artwork or real estate, it will be considered an NFFE because its gross income will not be primarily attributable to investing in financial assets. On the other hand, if a foreign holding company holds financial

[294] *See* Harris & Sanna, *FATCA and Non-US Trusts: An Overview*, TRUSTS & ESTATES (May 2013).

[295] *See* Reg. 1.1471-5(e)(4)(v), Example 6. Even though Example 6 refers to a trust company that is an FFI, it appears that a US financial institution acting as trustee will also cause a foreign trust to be an FFI. This is because the definition of a managed investment entity refers to management by an entity that is a financial institution, not to an entity that is an FFI. *See* Reg. 1.1471-5(e)(4)(i)(B). This may have sweeping implication for certain “foreign domestic trusts” that are governed by US law but fail one or both of the court and control tests. These trusts are often structured in Delaware as foreign grantor trusts during the grantor’s lifetime, with the intent that the trust will automatically become a US trust upon the grantor’s death.

[296] Treas. Reg. § 1.1471-5(e)(4)(v), Example 5.

[297] Treas. Reg. § 1.1471-5(e)(4)(i)(B).

assets and is professionally managed by an FFI, the company itself will be consider an FFI, provided its gross income is primarily attributable to investment activities.[298]

As discussed above, where a foreign private trust company is established, the FATCA classification of a foreign trust will often turn on the classification of the foreign private trust company itself. Depending on the facts and circumstances, it may be possible to classify a private trust company as an investment entity, provided it charges fiduciary or management fees such that 50% or more of its gross income is attributable to managing financial assets held by a trust for which it acts as trustee. In such a case, the private trust company likely will be characterized as an FFI. If these circumstances are not present, the private trust company, and thus the trusts for which it acts as trustee, likely will be classified as NFFEs.

C. FATCA Compliance for NFFEs

A NFFE generally will be excluded from FATCA withholding if it is a so-called "active NFFE," or if it provides withholding agents a written certification that either confirms that the NFFE does not have any substantial US owners, or includes the name, address and taxpayer identification number of each of its substantial US owners.[299] An NFFE is a passive NFFE if less than 50% of its gross income in the prior calendar year is passive income and less than 50% of its assets are held for the production of passive income.[300] Thus, appropriate compliance for NFFEs is driven in large part by understanding who qualifies as a "substantial US owner."

"Substantial US owners" are US persons who: (i) own, directly or indirectly, more than 10% (by vote or value) of the stock in a corporation, (ii) own, directly or indirectly, more than 10% of the profits interests or capital interests in a partnerships, (iii) own, directly or indirectly, more than 10% of the beneficial interests in a trust, or (iv) are treated as owning the assets of a grantor trust.[301] Attribution rules apply to aggregate the ownership interests of related persons (relying on definitions under Section 267).[302]

With respect to interests in trust, a beneficiary is treated as holding a beneficial interest if the beneficiary has the right to receive, directly or indirectly, a mandatory distribution from the trust, or if the beneficiary may receive, directly or indirectly, a discretionary distribution from the trust.[303] In applying the percentage thresholds described above, a discretionary beneficiary who receives no distributions from the trust should not be treated as an owner.[304] Rather, a discretionary beneficiary is treated as owning a beneficial interest in a trust based on the proportionate value of distributions received.[305] Beneficiaries entitled to receive mandatory distributions are treated as owning a portion of the trust based on the value of their distribution rights under the principles of Section 7520.[306]

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[298] The more challenging classification is where the foreign holding entity owns lower-tier subsidiaries which may be professionally managed resulting in classification as FFIs. However, the upper level holding company may have no actual "management." Nonetheless, the upper level holding entity may be swept into FFI classification as part of an "expanded affiliated group" that does not qualify for an exclusion. *See* Treas. Reg. § 1.1471-5(e)(5)(i).

[299] Treas. Reg. § 1.1471-3(d)(12)(iii)(A). If an NFFE is erroneously subject to withholding, it is entitled to apply for a refund. Treas. Reg. § 1.1474-2(a)(3).

[300] Treas. Reg. § 1.1472-1(c)(1)(iv).

[301] IRC § 1473(2)(A); Treas. Reg. § 1.1473-1(b)(1)(i).

[302] Reg. 1.1473-1(b)(2)(v).

[303] Treas. Reg. § 1.1473-1(b)(3). It should be noted that, for these purposes, a discretionary distribution can result from either the discretionary act of a trustee <u>or</u> the exercise of a limited power of appointment by any person. Note also that a de minimus rule provides that a discretionary beneficiary is not a substantial US owner of a trust if the beneficiary receives distributions of $5,000 or less in the relevant year. Treas. Reg. § 1.1473-1(v)(4)(i).

[304] Treas. Reg. § 1.1471-1(b)(83). Note that a de minimus rule provides that a beneficiary is not a substantial US owner of a trust if the beneficiary is entitled to receive mandatory distributions of $50,000 or less. Treas. Reg. § 1.1473-1(b)(4)(i).

[305] A discretionary beneficiary is treated as owning a requisite interest in trust to the extent: (i) the fair market value of the property distributed, directly or indirectly, from the trust to such beneficiary, divided by the fair market value of all distributions made by the trust in the prior calendar year exceeds the threshold, or (ii) the fair market value of the property distributed, directly or indirectly, from the trust to such beneficiary, divided by the fair market value of all assets held by the trust at the end of the calendar year exceeds the threshold. Treas. Reg. § 1.1473-1(b)(3)(ii)(A).

[306] Treas. Reg. § 1.1473.-1(b)(3)(ii)(B).

Lastly, it should be noted that a grantor or beneficiary of a trust also may be treated as the owner of the trust's underlying entities for FATCA purposes. A person treated as owning a trust under the grantor trust rules is treated as owning all the interests owned by the trust. In the case of a non-grantor trust, beneficial interests are determined based on all relevant facts and circumstances.[307]

D. FATCA Compliance for FFIs

A FFI generally will be excluded from FATCA withholding if it is either a "participating FFI" or a "deemed-compliant FFI."[308] A participating FFI is one that agrees to enter into a FATCA agreement that obligates the FFI to: (i) undertake sufficient due diligence to determine whether its accounts are US accounts, (ii) comply with IRS information requests, (iii) obtain waivers of banking secrecy laws or close accounts for which waivers cannot be obtained, (iv) withhold 30% on pass-thru payments to recalcitrant account holders or non-compliant FFIs, and (v) report certain information to the IRS on an annual basis.[309] For this purpose, US accounts consist of financial accounts held by foreign entities with one or more substantial US owners (as defined above, but substituting 0% for 10% in determining the relevant ownership thresholds for substantial US owners), and financial accounts held directly by US persons, excluding publicly traded companies, tax-exempt organizations and charitable trusts, banks, REITs, RICs and common trust funds.[310] Participating FFIs must register through the IRS's online portal and obtain a GIIN, which must be provided to all applicable withholding agents.

A note should be made with respect to so-called "recalcitrant account holders." A recalcitrant account holder with respect to an FFI is an account holder that is not itself an FFI and which fails to comply with FATCA information requests or waive banking secrecy.[311] Where a participating FFI is responsible for an account, it is required to deduct and withhold a 30% tax on any withholdable payment to an account held by a recalcitrant account holder or to a non-compliant FFI.[312]

Deemed-compliant FFIs can be divided into three categories: "registered deemed-compliant FFIs," "certified deemed-compliant FFIs" and "owner documented FFIs."[313] Registered deemed-compliant FFIs include two further sub-categories that are common in estate planning structures – Local FFIs and sponsored investment entities. Local FFIs are those licensed and regulated as financial institutions in their country of incorporation, and may be an option for certain private trust companies. In addition to other requirements, Local FFIs must not have a place of business outside their country of incorporation and 98% of their accounts by value must be maintained by residents of their country of incorporation.[314] Sponsored investment entities are FFIs that enter into a sponsorship arrangement with another FFI.[315] This is often an attractive option for trusts with institutional trustees, as the trust can rely on the trustee's compliance infrastructure to optimize efficiency.

Certified deemed-compliant FFIs are seen less frequently in estate planning structures, with one notable exception known as the "sponsored closely held investment vehicle." The requirements for a sponsored

[307] Treas. Reg. § 1.1473-1(b)(2).

[308] Importantly, trusts classified as deemed-compliant FFIs are not entitled to apply for a refund of withholding unless a treaty requires it or the trust is not the beneficial owner of the income subject to the withholding. Treas. Reg. §§ 1.1473-1(d), 1.1474-2(a)(1), 1.1471-5(a)(1). Accordingly, the trustee of a trust that is not a participating FFI should be sensitive as to trust distributions so that the beneficiary, as the beneficial owner, is entitled to claim the refund if necessary. *See* Harrison, *The Foreign Account Tax Compliance Act – Withholding Rules for Trusts and Estates*, STEP JOURNAL (Apr. 2013).

[309] Treas. Reg. § 1471-1(b)(85). A draft FFI agreement was published on October 22, 2013 in IRS Notice 2013-69. Reporting for participating FFIs is completed on IRS Form 8966.

[310] IRC §§ 1471(d), 1473(3). Note that a US account does not include an account maintained by an FFI if the account holder is an individual and the aggregate value of all depository accounts held by such individual at the FFI does not exceed $50,000.

[311] IRC § 1471(d)(6); Treas. Reg. § 1.1471-5(g)(2).

[312] Treas. Reg. §§ 1.1471-4(b), 4(d)(6).

[313] Registered deemed-compliant FFIs include: a class of FFIs defined in the Regulations, FFIs that comply with the registration requirements of a Model 1 IGA, and FFIs that are treated as registered-deemed compliant FFIs under a Model 2 IGA. Treas. Reg. § 1.1471-5(f)(1).

[314] Treas. Reg. § 1.1471-5(f)(1)(A).

[315] Treas. Reg. § 1.1471-5(f)(1)(F). The sponsoring FFI must be authorized to manage the sponsored FFI and enter into contracts on its behalf, must register with the IRS as a sponsoring FFI and must agree to perform certain due diligence, withholding and reporting tasks.

closely held investment vehicle are very similar to those of a sponsored investment entity and may provide a suitable classification for foreign holding entities in a trust structure.[316] Certified deemed-compliant FFIs generally are not required to register with the IRS; rather, they simply provide withholding agents with certain required information and documentation.[317]

The final category of deemed-compliant FFIs not subject to FATCA withholding are owner-document FFIs, which are unique insofar as they must qualify as FFIs solely because they are investment entities.[318] Owner-documented FFIs are required to provide withholding agents with detailed information on the reporting status of every individual (including non-US individuals) and specified US person that owns a direct or indirect interest in the FFI.[319] Because the 0% ownership threshold for specified US persons is significantly lower for FFIs than for NFFEs, trust distributions could affect an FFIs reporting requirements from year to year and active trust structures should therefore be monitored closely. It is also important to note that this status is effective only with respect to payments received from accounts held with US financial institutions, participating FFIs or certain FFIs in compliance with Model 1 IGA registration requirements.[320]

E. Impact of Intergovernmental Agreements

As noted above, if an applicable IGA is in place, the terms of the IGA generally control an entity's FATCA compliance, even if the terms of the IGA conflict with the provisions of the FATCA regulations. Thus, if an entity is resident in a jurisdiction with an IGA, payments made to such entity are not subject to withholding as long as the entity is in compliance with its reporting requirements under the IGA. Compliance requirements differ depending on whether the country of residence has negotiated a Model 1 IGA or a Model 2 IGA. When an estate planning structure includes entities in multiple FATCA partner jurisdictions, each entity in the structure must comply with the IGA relevant to its jurisdiction of residence.

1. Model 1 IGA

Model 1 IGAs are the more common IGAs, and are structured to be either "reciprocal" or "non-reciprocal." A reciprocal IGA requires US financial institutions to report information about accounts held by residents of the FATCA partner jurisdiction. Non-reciprocal IGAs contain no such requirement and apply only to financial institutions in the FATCA partner jurisdiction. The key feature of both reciprocal and non-reciprocal Model 1 IGAs is the requirement that the FATCA partner jurisdiction enact legislation requiring FFIs to report directly to local tax authorities, who then exchange information with the US.

Under the Model 1 IGA, an FFI is treated as compliant, and is thus not subject to FATCA withholding, if it identifies US accounts and reports them to the relevant authority in the FATCA partner jurisdiction.[321] The FFI need not comply with the other requirements in the FATCA regulations – it is not obligated to withhold on payments to non-compliant FFIs or recalcitrant account holders, nor is it required to close the accounts of recalcitrant account holders.[322]

If the account is owned by a US owned entity, only information about US persons who are "controlling persons" is required to be reported.[323] In the case of a corporation or partnership, a controlling person means any individuals who exercise control over the entity. In the case of a trust, a controlling person means the settlor, trustee, beneficiary, protector, holder of a power of

[316] The requirements for a sponsored closely held investment vehicle can be found in Treas. Reg. § 1.1471-5(f)(2)(iii).

[317] Treas. Reg. § 1.1471-5(f)(2).

[318] Treas. Reg. § 1.1471-5(f)(3)(ii)(A).

[319] Treas. Reg. § 1.1471-3(d)(6)(iv).

[320] Treas. Reg. § 1.1471-5(f)(3)(i).

[321] Model 1 IGA, Article 4(1).

[322] Note that some Model 1 IGAs allow FFIs to elect to apply the FATCA regulations instead of the IGA, if desired.

[323] Model 1 IGA, Article 2(2).

appointment, or any other individual exercising ultimate effective control over the trust. An account is a US account, and is thus reportable under the Model 1 IGA, if it has any controlling person who is a US person.

2. Model 2 IGA

Under the Model 2 IGA, a reporting FFI is required to report information directly to the IRS, rather than to the taxing authority in the FATCA partner jurisdiction. Accordingly, participating FFIs under the Model 2 IGA must register with the IRS and enter in to an FFI agreement. The FFI agreement imposes obligations on the participating FFI with respect to due diligence, reporting and withholding on US accounts. As with the Model 1 IGA, an account is a US account if it has any controlling person who is a US person. Model 2 FATCA partner jurisdictions are required to waive their bank secrecy laws and to provide the US with information on recalcitrant account holders.[324] Unlike the Model 1 IGA, the Model 2 IGA requires an FFI to withhold on payments to FFIs that do not qualify as participating FFIs.

F. Compliance Challenges for Withholding Agents

Implementation with the FATCA regulations has been ongoing for several years, but strict compliance remains burdensome and, in some circumstances, nearly impossible. Acknowledging some of the practical challenges presented to withholding agents obligated to obtain and report required information, in particular foreign tax identification numbers and dates of birth, on September 25, 2017, the IRS issued Notice 2017-46, in which it relaxed certain rules under Section 1471 and announced its intention to amend the existing temporary regulations thereunder. In the Notice, the IRS indicated its intention to carve back the circumstances in which such information is required to be provided by a withholding agent, enumerate certain exceptions for the provision of the foreign taxpayer identification numbers for certain account holders and provide for a period of time for such rules to apply, and provide for a grandfathering rule for the provision of date of birth information for withholding certificates signed prior to 2018.

G. Implications for Future International Tax Planning

The continued implementation of FATCA will further shape the landscape of international tax planning in the years to come. FATCA has made life abroad, as well as cross-border business and investing, significantly more challenging for US persons. Although many institutions have adapted to FATCA compliance obligations, others remain wholly unwilling to service US persons. From a broader policy perspective, FATCA represents the cornerstone of a new and unprecedented era of international cooperation in financial transparency and tax information sharing, requiring internationally mobile clients to recalibrate their expectations for privacy in financial matters. Complete transparency also brings with it onerous reporting obligations that increase the cost and risk associated with international planning transactions and require practitioners to integrate an additional layer of complexity into the planning process.

XIX. THE COMMON REPORTING STANDARD

The umbrage expressed on the introduction of FACTA quickly gave way to imitation as the sincerest form of flattery. Having spent years trying to combat cross-border tax evasion with the common understanding that "countries have a shared interest in maintaining the integrity of their tax systems," OECD member countries quickly concluded that FATCA could be an effective blueprint to establish a multi-lateral information exchange regime.[325]

[324] As with the Model 1 IGA, an FFI is not required to withhold on payments to recalcitrant account holders or close their accounts. However, the FFI is required to report payments to accounts of recalcitrant account holders and FFIs other than participating FFIs that refuse to allow information to be provided to the IRS. The IRS then must apply to the FATCA partner jurisdiction under procedures governing the exchange of information. *See* Model 2 IGA Article 2(1).

[325] *Standard for Automatic Exchange of Financial Information in Tax Matters: Implementation Handbook*, Organization for Economic Cooperation and Development, available at http://www.oecd.org/ctp/exchange-of-tax-information/implementation-handbook-standard-for-automatic-exchange-of-financial-account-information-in-tax-matters.htm [hereinafter "OECD CRS Handbook"].

The result of this revelation came in the form of the OECD's Common Reporting Standards, or "CRS."[326] CRS takes its cues from FATCA's reciprocal Model 1 IGA, in which taxpayers report certain information to local authorities, who then coordinate information exchange on an inter-governmental basis.[327]

This structure was driven in part by the ability of OECD member countries to leverage the investments made in the implementation of FATCA IGAs by utilizing similar infrastructure to facilitate broader information exchange relationships.[328] However, the OECD model also sought to improve upon the Model 1 IGA in ways it hoped would optimize efficiency and reduce the compliance costs borne by financial institutions, including by tailoring CRS more closely to concepts applicable in the global tax paradigm, such as territorial taxation.[329] The ultimate goal of these modifications was to ensure financial institutions were producing a consistent quantity and quality of information so as to enhance compliance across signatory countries through the use of data analytics and other modern tools.

CRS envisions the implementation of its provisions through bilateral agreements among signatory countries. In other words, it is intended that each CRS signatory will enter in to an agreement with each other signatory to implement the automatic exchange of information pursuant to CRS. These agreements generally are based on the OECD's model competent authority agreement (subject to jurisdiction-specific modifications). Each jurisdiction is responsible for establishing a legal basis for information exchange and for implementing sufficient internal procedures to address privacy and data protection laws and other potential impediments.

As of the time of this writing, 102 countries have committed to participating in CRS, and over 2,000 bilateral relationships have been established among CRS signatory countries.[330] 49 such countries (the so-called "early adopters") committed to an initial exchange of information in September 2017, with the remaining 53 such countries (the so-called "late adopters") committing to an initial exchange of information by September 2018.

A. Conceptual Approaches

Although FATCA served as a catalyst for the creation of CRS, and there are certainly overlapping concepts, the two regimes take different approaches in several key respects. Perhaps the most important is in enforcement. The stick wielded by FATCA is a mandatory 30% withholding tax. CRS, by contrast, does not call for a uniform enforcement mechanism. Rather, it leaves participating jurisdictions to impose appropriate consequences for non-compliance through the enactment of local laws.

Another fundamental difference between the two regimes is the approach taken in identifying tax non-compliance. FATCA's aim is to identify underlying US beneficial ownership of passive assets held in non-US accounts. This is sensible from a US perspective, as US persons are subject to tax on a worldwide basis. CRS, by contrast, seeks to identify "controlling persons" with respect to assets held in participating jurisdictions. This is because of a policy choice on the part of the OECD to target widespread sources of systematic tax non-compliance, which the OECD believed would be better accomplished by identifying control nodes rather than beneficial owners.

It should be noted that, to date, the US has not become a signatory to CRS, which has drawn widespread criticism from the international community. This has resulted in speculation that, despite the various reporting regimes described in this article, the US may be on the path to becoming a hub for international

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[326] *Standard for Automatic Exchange of Financial Account Information in Tax Matters,* Organization for Economic Cooperation and Development, available at http://dx.doi.org/10.1787/9789264216525-en [hereinafter "OECD Common Reporting Standard"].

[327] *See* M. Read Moore, *A New World Order for Estate Planners or Why Is It So Difficult to Open a Bank Account?*, 50th Annual Heckerling Institute on Estate Planning (Jan. 2016). *See also*, OECD CRS Handbook, at 5 ("Many jurisdictions have opted to implement FATCA on an intergovernmental basis and, more specifically, to collect and exchange the information required to be reported under FATCA on the basis of a Model 1 FATCA Intergovernmental Agreement").

[328] *Id.*

[329] OECD CRS Handbook, at 22.

[330] *AEOI: Status of Commitments*, Organization for Economic Cooperation and Development (Aug. 2017), available at https://www.oecd.org/tax/transparency/AEOI-commitments.pdf .

financial privacy, which has resulted in a recent influx of trusts and other entities migrating to the United States to avoid the expansion of reporting and disclosure regimes in foreign jurisdictions.[331]

B. Basic Rules and Application of CRS

In broad form, the objective of CRS is to implement a system of automatic exchange of financial information between signatory countries. This is accomplished through the requirement that financial institutions ("FIs") resident or having a branch in a participating jurisdiction engage in due diligence and report certain information regarding their "financial accounts" to local authorities, which then transfer that information to other signatory countries. As noted above, CRS does not provide a specified penalty for non-compliance.

As in the case of FATCA, the mechanics of CRS rely on the application of various defined terms, and the CRS lexicon divides every entity in the world into one of two categories – "financial institutions" ("FIs") and "non-financial entities" ("NFEs"). Reporting FIs are required to review their financial accounts, undertake certain due diligence activities to identify reportable accounts and report relevant information to local authorities.

1. Financial Institutions and Non-Financial Entities

The category of FIs, which are subject to CRS reporting and due diligence rules, embraces a broad class of entities, and shares some common traits with the definition of an FFI under FATCA. More specifically, the following entities are classified as FIs under CRS: (i) entities accepting deposits in the ordinary course of a banking or similar business (referred to as "depository institutions"), (ii) entities deriving 20% or more of their gross income from holding financial assets for others or providing related financial services (referred to as "custodial institutions"), (iii) entities deriving 50% or more of their gross income from providing certain investment services to customers, or entities managed by an FI that derive 50% or more of their gross income from investment activities (referred to as "investment entities"), (iv) certain insurance companies.[332]

Any entity that is not classified as an FI is labeled an NFE. Borrowing from the categories in FATCA, NFEs are deemed to be either "active NFEs" or "passive NFEs". Active NFEs are those that own primarily active assets and derive primarily active income, certain publicly traded entities, holding companies that are members of a non-financial group, start-up companies and other specified categories.[333] Passive NFEs are defined in the negative to include all NFEs other than active NFEs, as well as professionally managed investment entities that would otherwise be classified as FIs but for their residence in a non-participating jurisdiction.

2. Treatment of Trusts

Generally speaking, a trust is treated as resident in any country in which one or more of its trustees is resident, meaning a trust with trustees in multiple jurisdictions could theoretically be subject to duplicative reporting. However, if a trust is itself resident for tax purposes in a participating country, then all CRS information reporting with respect to the trust is accomplished in the participating country in which the trust has its tax residence.

Trusts are most commonly classified for CRS purposes as either reporting FIs or passive NFEs. If a trust is a reporting FI, its trustees will be obliged to report certain information directly to the relevant local authorities. If the trust is a passive NFE, its trustees will be obliged to disclose certain information to FI's with which the trust maintains reportable accounts.

[331] European Parliamentary Research Service, *EU-US trade and investment relations: effects on tax evasion, money laundering and tax transparency*, PE 598.602 (Mar. 2017) ("The United States of America is seen as an emerging leading tax and secrecy haven for rich foreigners").

[332] OECD Common Reporting Standard, at 15. Note that certain entities are considered to present a low risk of being used for evading tax and are thus excluded from reporting.

[333] *Id. at 59.*

As with FATCA, a trust will be treated as an FI if its gross income is primarily attributable to investments in financial assets and if it is managed by another FI. A trust is treated as being managed by another FI if its trustee itself is classified as an FI (for example, an institutional trustee or certain private trust companies), or if its trustees (or the managers of an underlying holding entity) have delegated certain asset management authority to one or more FIs.[334]

Trusts that do not meet these criteria generally will be treated as passive NFEs. It is important to note that CRS includes as passive NFEs investment entities that are resident in non-participating jurisdictions. This means that even a trust that would otherwise qualify as an FI under the test described above could nonetheless be treated as a passive NFE if the trust is resident in a non-participating jurisdiction.

3. CRS Reporting Obligations

As noted above, FIs are required to undertake due diligence procedures and to report certain information to local authorities regarding "financial accounts" held by persons or entities resident in a participating jurisdiction. For these purposes, "financial accounts" include depository and custodial accounts, equity and debt interests in certain investment entities (including certain trusts), cash value insurance contracts and annuity contracts. Where trusts are concerned, an equity interest is considered to be held by any settlor or beneficiary of the trust, or by any other natural person exercising ultimate effective control over the trust, and a debt interest is treated as being held by any person who has made a loan to the trust.[335] Discretionary beneficiaries of a trust should not be treated as holding an equity interest in the trust's financial accounts unless they have received a distribution in a particular reporting period.

FIs are required to furnish the following information in respect of their reportable financial accounts: (1) account numbers, if any; (2) the name and identifying number of the reporting FI; (3) the account balance or value and the gross amount of income, including interest, dividends and redemption proceeds paid or credited to the account on an annual basis; and (4) the name, address, taxpayer identification number, jurisdiction of residence, and, in the case of an individual, date and place of birth of each account holder resident in a participating jurisdiction.

Passive NFEs are subject to similar reporting, which is carried out by the FIs with which they maintain accounts, with respect to "controlling persons" resident in participating jurisdictions. "Controlling persons" are generally natural persons who exercise control over the entity. Where companies are involved, this is typically determined by reference to ownership, which may itself vary depending on the ownership structure of the company, or if no natural person exercises control through ownership, by reference to managerial control. In the case of a trust, controlling persons include the settlor, trustees, protector, beneficiaries and "any other natural person exercising ultimate effective control over the trust."[336] The inclusion of protectors in the class of reportable persons with respect to a trust account is one key difference between the treatment of trusts under FATCA and the treatment of trusts under CRS.

The categories of reportable persons under CRS are, like FATCA, incredibly broad and have the potential to produce counter-intuitive results. For example, individuals involved in a fiduciary or managerial capacity in a client's estate planning structure may be subject to CRS reporting even if the client's structure is established in a non-participating jurisdiction, but maintains accounts in a participating jurisdiction. For this reason, where controlling reporting exposure is a factor, careful attention should be paid to the location of the individuals, entities and financial institutions involved.

[334] *Id.* at 152 (noting that an entity is "managed by" another entity if the other entity performs certain services "either directly or through another service provider").

[335] *Id. at 51.*

[336] *Id. at 57.*

C. Impact on International Estate Planning

The initial shockwave of FATCA, which reshaped the landscape of international tax planning in the US context, has taken on global proportions with the enactment of CRS. Many CRS signatory countries established themselves as market leaders in fiduciary services, investment services and other industries relevant to international estate planning due to strong local protections and favorable taxation. With this new wave of cross-border compliance and disclosure activity, the looming question is whether offshore structures will now find a reason to come back ashore or to migrate to places like the United States. Despite the existence of FATCA, the United States' unwillingness to participate in CRS could result in a net privacy gain for particular clients.

XX. SELECTED REPORTING REQUIREMENTS

In addition to the disclosure requirements imposed under FATCA and CRS, taxpayers with ties to the United States are also subject to a number of other information reporting and disclosure obligations. These requirements are aimed primarily at providing US tax authorities access to sufficient information regarding US ownership of foreign entities and assets to allow them to effectively enforce the worldwide tax obligations of US citizens and residents. While an exhaustive discussion of these information reporting requirements is beyond the scope of this series, what follows is a brief description of the most common types encountered in the international estate planning context.

A. Form 3520 – Transactions with Foreign Trusts and Receipt of Foreign Gifts

Form 3520 is an information return that is required to be filed by US persons who enter into certain transactions with foreign trusts, or who receive certain gifts from foreign persons. More particularly, the form applies to any US person who: (i) received a gift of more than $100,000 from a nonresident alien or foreign estate; (ii) received a gift of more than $15,797 (for 2017) from a foreign corporation or partnership; (iii) received a distribution from any foreign trust or estate; (iv) created or funded a foreign trust; (iv) is treated as the owner of any foreign trust under Sections 671 through 679; or (v) dies as the owner of a foreign trust or with assets of the foreign trust includible in his estate.[337] Note that loans to foreign trusts other than those constituting qualified obligations can also trigger a reporting obligation on Form 3520.

Where transactions with foreign trusts are concerned, the trustee may wish to consider appointing a US agent to provide relevant information to the IRS. This will prevent the need to provide additional information and documentation regarding the trust on Form 3520, which would be required in the absence of such an appointment. Suggested language for an appointment of a US agent, as well as other information regarding Form 3520 reporting, can be found in Notice 97-34.

Form 3520 is due on the same date as the filing of the US person's income tax return (including extensions).[338] Although no tax is due in connection with the filing of Form 3520, there are, nonetheless, potentially harsh penalties for the failure to file the form, or for the filing of a form with incomplete or incorrect information.[339] The initial penalty is the greater of $10,000 or: (i) 35% of the gross value of property transferred to, or of distributions received from, a foreign trust, or (ii) 5% of the gross value of the assets of a foreign grantor trust.[340] Where gifts are concerned, a penalty of 5% of the amount of unreported foreign gifts applies for each month that non-compliance continues, subject to a maximum of 25%.[341] Furthermore, penalties may be imposed under Section 6662(j) for undisclosed foreign financial asset understatements. The statute of limitations for the assessment of any tax imposed with respect to any tax

[337] Gifts receive from related parties must be aggregated for purposes of determining whether the applicable reporting threshold has been met.

[338] In the case of a US decedent, Form 3520 is due on the date that Form 706 is due (including extensions), or the date that Form 706 would be due if such a return were required.

[339] IRC § 6677. A reasonable cause exception can apply if the taxpayer can establish that the failure to file or include required information was not due to willful neglect. However, a foreign fiduciary's failure to provide required information or reliance on a provision in the trust instrument prohibiting disclosure is not considered to be reasonable cause.

[340] Gross value for these purposes is determined using the principles of IRC § 2512.

[341] IRC § 6039F.

event, return or period reportable on Form 3520 (as well as most other forms described in this section) is tolled until three years after the date on which the return is filed.[342]

B. Form 3520-A – Annual Reporting of Foreign Trusts with US Grantors

Form 3520-A must be filed by the trustee of any foreign trust that has at least one US owner under the grantor trust rules so as to enable the US grantor to comply with his or her individual reporting obligations. Each US grantor is responsible for ensuring that the foreign trustee timely files Form 3520-A and provides annual statements to its US grantors and US beneficiaries. Form 3520-A must be filed by the 15th day of the third month following the end of the trust's tax year, and the trustee must provide copies of the component "foreign grantor trust owner statement" and "foreign grantor trust beneficiary statement" to any US grantor or US beneficiary by the same day.[343]

The initial penalty for the foreign trust's failure to file, incorrect filing or failure to furnish required information is the greater of $10,000 or 5% of the gross value of the portion of the trust treated as owned by a US grantor. US grantors themselves are also subject to the penalties described above for their failure to timely file Form 3520. Further penalties may apply for continued non-compliance more than 90 days after issuance by the IRS of notice of failure to comply. In addition, possible criminal penalties may be imposed for willful failure to file on time or for filing a fraudulent return.[344] As with Form 3520, reasonable cause exception may apply and the taxpayer may avoid imposition of such penalties upon showing that the failure to comply was due to reasonable cause and not willful neglect.[345]

C. Form 8621 – PFIC or QEF Shareholders

Form 8621 must be filed by a US person who is a direct or indirect shareholder of a PFIC, if such person: (i) receives distributions from a PFIC, (ii) recognizes gain on a disposition of PFIC stock, (iii) is reporting information with respect to a QEF election under Section 1295 or a mark-to-market election under Section 1296, (iv) is making certain elections for annual reporting with respect to PFIC stock, or (v) is required to file an annual report pursuant to Section 1298(f). A separate Form 8621 must be filed for each PFIC in which the US person holds stock and for each PFIC in the chain of ownership. The extent of the percentage of ownership in the PFIC by the US person is not a factor in filing Form 8621.

Form 8621 must be attached to the shareholder's US federal income tax return, or if no return is required, it may be filed directly. There are no explicit penalties for a failure to file Form 8621, but such a failure could prevent the statute of limitations from running with respect to the shareholder's entire federal income tax return. Nevertheless, it is often to the advantage of a US taxpayer to file Form 8621 to make a QEF election to pay taxes on the current income of the PFIC. If no QEF election is made, future distributions may be re-characterized as ordinary income and subjected to the punitive tax on excess distributions, as described in part 2 of this series.

D. Form 5471 – Certain Foreign Corporations

Form 5471 must be filed by certain US citizens and residents who are officers, directors, or shareholders of certain foreign corporations. The individuals required to file the form are divided into four separate categories, each with distinct information reporting obligations, based on whether the filer is a shareholder, officer or director of the foreign corporation. Generally speaking, Form 5471 requires the disclosure of detailed information regarding the corporation, its shareholders, its assets and its financial performance in

[342] IRC § 6501(c)(8).

[343] Extensions may be sought by filing Form 7004 (filing an extension for the trust's income tax return will not be sufficient).

[344] IRC §§ 7203, 7206, 7207.

[345] Again, a foreign fiduciary's failure to provide required information or reliance on a provision in the trust instrument prohibiting such disclosure is not considered to be reasonable cause

the previous tax year. In addition to filing Form 5471, a US shareholder of a CFC is required to disclose any reportable transactions[346] by filing Form 8886.

As with Form 8621, a separate Form 5471 must be filed for each foreign corporation by attaching same to the income tax return of the filer. A $10,000 penalty is imposed for failure to timely file.[347] An additional $10,000 penalty per foreign corporation is charged after 90 days of the IRS's issuance of a notice of failure, and for each 30 day period thereafter, subject to a maximum of $50,000. Moreover, the foreign corporation itself is subject to a reduction of 10% of the foreign taxes available for credit.[348] As above, penalties can be avoided to the extent the taxpayer can establish that the failure was due to reasonable cause and not willful neglect.

E. Form 5472 –Foreign-Owned US Corporations and Foreign Corporation Engaged in a US Trade or Business

Form 5472 is generally required with respect to US corporations with at least 25% non-US ownership and foreign corporations engaged in a trade or business in the United States, to the extent the corporation engages in a "reportable transaction" with a related party. For these purposes, "reportable transactions" are defined broadly to include not only monetary transactions, but also less direct transactions like the use of corporate assets or the provision of services.[349] Various exceptions, including exceptions for certain small corporations and *de minimus* transactions with related parties, may apply and forestall a filing obligation.

Form 5472 is filed by attaching same to the income tax return of the reporting corporation and is due on the same date as the corporation's income tax return (including extensions). A separate Form 5472 is required for each foreign or domestic related party with which the reporting corporation had a reportable transaction. In addition to the filing of Form 5472, a reporting corporation must maintain the permanent books of account or records sufficient to establish the correctness of its income tax return.[350]

A reporting corporation is subject to a penalty of $10,000 if it fails to timely file a complete Form 5472 or fails to maintain records as required. An additional $10,000 penalty is charged after 90 days of the IRS's issuance of a notice of failure, and for each 30 day period thereafter. Furthermore, criminal penalties may be imposed for willful failure to file or for filing false or fraudulent information.

For tax years beginning on or after January 1, 2017, new regulations require Form 5472 to be filed with respect to any domestic disregarded entity that is wholly owned by a foreign person and engages in any reportable transaction with a related party. Under the new regulations, the generally applicable exceptions to the requirements of Section 6038A do not apply to a domestic disregarded entity that is wholly owned by a foreign person, meaning (among other things) that there is no *de minimus* exception for small transactions with related parties. At the time of writing this article, there remains some uncertainty as to the timing and manner in which Form 5472 should be filed when the foreign owner of a domestic disregarded entity is not required to file a US tax return. Neither Form 5472 nor the instructions thereto have been updated to reflect the new regulations.

F. Form 8938 – Foreign Financial Assets

US persons are required to disclose on Form 8938 any interests they own in "specified foreign financial assets" if the value of such assets exceeds an applicable reporting threshold. The applicable reporting thresholds are different for taxpayers living inside the United States and outside the United States, and for married taxpayers and single taxpayers. "Specified foreign financial assets" are defined broadly to include items like non-US bank accounts, stocks, mutual funds, interests in trusts or other entities, financial instruments and contracts. Importantly, foreign real estate generally is excluded from the reporting

[346] IRC § 6011; Treas. Reg. § 1.6011-4(c)(3)(i)(G).

[347] As with Form 8621, failure to file Form 5471 will result in the statute of limitations failing to run with respect to the taxpayer's entire return.

[348] An additional 5% reduction is made after 90 days of the issuance by the IRS of a notice of failure; for each 30 day period thereafter, it continues, subject to a maximum of the greater of $10,000 and the annual income of the foreign corporation per failure.

[349] Treas. Reg. §§ 1.6038A-2(b)(3), 1.482-1(i)(7).

[350] *See* Treas. Reg. § 1.6038A-3.

obligation. Information to be reported on Form 8938 includes an asset's date of acquisition, cost basis, income or gains, maximum value and foreign currency denomination.

Form 8938 must be filed by attaching same to the taxpayer's annual income return and is due on the same date as the filing of that return (including extensions). Form 8938 need not be filed if the specified person does not have to file an income tax return, even if the value of such persons' specified foreign financial assets exceeds the applicable reporting threshold. A partial reporting exemption does apply if the taxpayer's interest in a specified foreign financial assets was already required to be reported on another IRS form (*e.g.*, Form 8621, Form 5471, etc.).

A penalty of $10,000 is imposed for failure to timely file a complete and correct Form 8938. An additional $10,000 penalty is charged after 90 days of the IRS's issuance of a notice of failure, and for each 30-day period thereafter, up to a maximum of $50,000. The penalty may be avoided if the taxpayer can establish that such failure was due to reasonable cause and not willful neglect. An underpayment due to transactions involving an undisclosed specified foreign financial asset may result in an additional penalty equal to 40 percent of such underpayment. If the underpayment is due to fraud, the penalty is increased to 75 percent of the underpayment. In addition, criminal penalties may be imposed for willful failure to file or to report an asset.

G. <u>FinCEN Form 114 – FBAR</u>

A US person that has financial interest in or signature authority over one or more financial accounts outside of the US must file a FinCEN Form 114 (previously known as the "foreign bank account report", or "FBAR"), if the aggregate maximum value of such foreign financial accounts exceeds $10,000 at any time during the calendar year. Financial account includes bank accounts, securities accounts, commodity futures or options accounts, insurance policies with a cash value, mutual funds or similar pooled funds, and any other accounts maintained by a foreign financial institution.

FBARs are required under a Bank Secrecy Act, not under the Internal Revenue Code, and are administered by the Department of Treasury's Financial Crimes Enforcement Network ("FinCEN"). FBARs must be filed electronically through FinCEN's BSA E-Filing System on or before April 15 of the year following the calendar year being reported. However, an automatic six-month extension is granted to those who fail to meet the due date.

Broadly speaking, the failure to file an FBAR may subject a taxpayer to one of two civil penalties: (i) where the failure is non-willful, a penalty of up to $10,000 per violation, or (ii) where the failure is willful, a penalty equal to the greater of $100,000 or 50% of the balance of each unreported account, per violation. Criminal penalties may also apply to willful violations, and may result in fines of up to $500,000 and imprisonment for up to 10 years, depending on the circumstances.

H. <u>Pending Form 708 – Covered Gifts and Bequests</u>

In 2015, the Internal Revenue Service published proposed regulations regarding Section 2801, which imposes a tax on US citizens and residents (including certain trusts) who receive certain gifts or bequests from covered expatriates. The tax applies regardless of the situs of the property and regardless of whether the transferred property was acquired by the covered expatriate before or after his or her expatriation date. The Section 2801 tax is imposed at the highest applicable gift and estate tax rate in effect at the time of the transfer, and is supposed to be payable with a timely filed Form 708. While the filing and tax payment requirements have been stayed pending the issuance of final regulations, the proposed regulations provide that certain elections (including elections by foreign trusts wishing to be treated as US trusts) are to be made on Form 708. This requirement notwithstanding, the IRS has not, as of the time of writing this outline, issued Form 708, even in draft form.

XXI. REMEDIAL COMPLIANCE PROGRAMS

The authors have endeavored in this outline to identify the many US tax rules that apply to international taxpayers in unintuitive or unexpected ways. The natural result of this complexity is that even the most diligent taxpayers, in the absence of expert counsel, can run afoul of their US tax or reporting obligations. As such, it is not uncommon for internationally mobile clients to seek advice on the ways in which they can come back into compliance. A number of remedial compliance programs are available to such taxpayers, and the ones they choose to participate (or not participate) in will be driven in large part by the facts and circumstances of a particular case. A full discussion of this specialized field is beyond the scope of this series, but what follows is a brief description of four common avenues for compliance: (i) a so-called "quiet" disclosure, (ii) formal participation in the IRS's offshore voluntary disclosure program (the "OVDP"), (iii) utilization of the IRS's streamlined filing compliance procedures, and (iv) utilization of the IRS's delinquent international information return submission procedures.

A. "Quiet" Disclosure

A quiet disclosure generally involves simply submitting all required historical filings and paying any past-due tax, with interest, for the past six years (the statute of limitations for FBAR penalties is generally six years from the filing deadline). While this option comes with the advantage of deferring (or potentially avoiding) any substantial asset-based penalty, it also comes with several disadvantages: (i) it does not provide any cap on the amount of additional liabilities the IRS might impose for failure to comply with, for example, information filing obligations, (ii) it provides no protection from possible criminal prosecution for willful reporting failures, and (iii) if audited, the IRS may require additional back filings, as the statute of limitations on a tax return generally does not begin to run if the original return was not filed or contains substantial omissions. The IRS has also made public statements that it takes a negative view of quiet disclosures due to its establishment of formal compliance programs.

B. Offshore Voluntary Disclosure Program

Participation in the IRS's offshore voluntary disclosure program, or the "OVDP," allows US taxpayers to make necessary information filings with respect to their non-US assets, file past-due tax returns for the previous eight years, and pay any back taxes, together with interest, penalties and a "miscellaneous offshore penalty." In return, the IRS will issue a closing agreement certifying compliance and will not pursue criminal prosecution or revisit past filings unless it uncovers information that the taxpayer failed to disclose relevant information or took fraudulent positions during the OVDP process. The "miscellaneous offshore penalty" is generally 27.5% of the highest aggregate value of all off the taxpayer's offshore assets that are related in any way to tax non-compliance. The penalty can increase to 50% for assets held with foreign financial institutions that are under investigation by the IRS or are cooperating with the IRS. The current OVDP is open for an indefinite period, although the IRS makes periodic modifications to the terms of the program by amending its "frequently asked questions" webpage.

C. Streamlined Filing Compliance Procedures

The IRS's streamlined filing compliance procedures (the "Streamlined Program") are aimed at taxpayers who are able to certify that their tax compliance in relation to non-US assets was not the result of willful conduct. For non-US residents, the Streamlined Program requires filing amended US federal income tax and information returns for the most recent three tax years, filing FBARs for the six most recent years and submitting a detailed statement describing the basis for a non-willful determination. Payment of all back taxes is required, with interest, but participation in the Streamlined Program for non-US residents generally does not subject participants to further penalties. For US residents, the Streamlined Program is available on similar terms; however, US residents must also pay a miscellaneous offshore penalty equal to 5% of the highest aggregate balance of the taxpayer's unreported non-US assets during the disclosure period. Because no formal closing agreement is entered into in connection with the Streamlined Program, this process is best suited for taxpayers who can readily substantiate the reasons for their non-willful failure to comply with applicable US tax and reporting obligations.

D. Delinquent International Information Return Submission Procedures

Where a taxpayer's non-compliance extends only to FBARs or other information returns, the IRS has provided a less burdensome alternative to the OVDP and Streamlined Program. These procedures are generally available to US taxpayers who do not need to use the OVDP or Streamlined Program to pay back taxes, have not filed required FBARs or information returns, are not under examination by the IRS and have not been contacted by the IRS regarding their delinquent FBARs or information returns. If eligible, simply filing the missing returns or FBARs along with a statement setting forth a reasonable cause for the failure to file completes the process. Delinquent FBARs or information returns are not automatically subject to audit according to the IRS, but may be examined in the course of the ordinary audit selection process.

XXII. CONCLUSION

The authors have endeavored in this outline to provide an overview of the general tax landscape for international estate planning, to discuss some of the specialized regimes that apply to internationally mobile clients and to address the increasingly complex field of international tax reporting, disclosure and compliance. As the world becomes increasingly global, there is no doubt that a working knowledge of these rules will become a necessity for US estate planners and tax practitioners. A holistic awareness of the structure of these regimes and the potential pitfalls present in international planning can allow practitioners to skillfully and proactively navigate the rules in a way that can provide an incredible benefit to clients engaged in cross-border transactions.

TABLE OF CONTENTS

U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*

by
Ellen K. Harrison, Elyse G. Kirschner and Carlyn S. McCaffrey

The Small Business Job Protection Act of 1996 (the "1996 Act")[1] made significant changes to the rules applicable to foreign trusts and trusts established by non-U.S. persons. The new rules were intended to prevent tax avoidance through the use of foreign trusts and the exploitation of the grantor trust rules. The 1996 Act imposes an array of reporting requirements, imposes harsh penalties on failures to comply with these requirements, increases the interest charge imposed on taxes paid on distributions of accumulated income from foreign trusts, treats loans of cash from foreign trusts as distributions, expands the kinds of gifts that can be treated as indirect transfers from foreign trusts, limits the circumstances in which a non-U.S. person will be treated as the owner of a trust under the grantor trust rules and allows certain gifts to be recharacterized as taxable distributions from corporations, partnerships or trusts. Curiously, the 1996 Act encourages the creation of foreign trusts by its adoption of a set of criteria for foreignness that is both more objective than the criteria formerly used and biased in favor of foreign status.

The Foreign Account Tax Compliance Act ("FATCA"), enacted as part of the Hiring Incentive to Restore Employment Act of 2010 (the "2010 HIRE Act"), increased compliance responsibilities with respect to foreign trusts and other foreign assets.[2] FATCA imposes new information reporting requirements on foreign trusts. Trusts that fail to comply with FATCA will have 30% of U.S. source payments withheld. The reporting and withholding rules under FATCA have been significantly modified by inter-governmental agreements negotiated between the United States and other countries.[3] FATCA is intended to prevent U.S. persons from hiding assets and income in offshore accounts and offshore structures. The 2010 HIRE Act also increases the reporting obligations and penalties applicable to U.S. persons who fail to timely file information returns reporting their interests in foreign trusts and other foreign entities and their gratuitous transfers to and receipt of assets from foreign trusts or other entities. The 2010 HIRE Act also treats the uncompensated use of assets owned by a trust as a deemed distribution.

This outline discusses how to create foreign trusts, examines their exposure and the exposure of their U.S. beneficiaries to U.S. income tax and describes the reporting requirements imposed on their creators, their beneficiaries and the trusts themselves, explains the grantor trust rules applicable to non-U.S. persons and immigrants and covers anti-avoidance provisions that require reporting of foreign gifts, redefines who is the grantor and recharacterizes purported gifts from "intermediaries" and from partnerships, foreign corporations and certain trusts. In addition to explaining the rules, it also considers the extent to which foreign trusts continue to be useful planning tools for U.S. persons.

I. HOW TO CREATE A FOREIGN TRUST

A. How to Determine Whether a Trust is a Foreign Trust

1. Before the 1996 Act

Before the 1996 Act there was no clear standard for determining a trust's nationality. The former statutory definition consisted only of a statement that a foreign trust is a trust

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1 The Small Business Job Protection Act of 1996 was enacted on August 20, 1996. P.L. 104-188, 110 Stat. 1755 (1996).

2 The Hiring Incentives to Restore Employment Act was enacted on March 18, 2010, Pub. Law 111-147.

3 The form of these agreements varies depending upon whether the United States has a Double Tax Convention or Tax Information Exchange Agreement with the other country.

> "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A."[4]

This statement is merely descriptive of the consequences of foreign trust status and gives no guidance as to how to determine its existence.[5]

Judicial and administrative authority partially filled the definitional void by establishing a test that required weighing of a trust's foreign contacts against its U.S. contacts.[6] The guidance these authorities provided was of little help in determining the foreign or domestic status of trusts with both foreign and domestic contacts.

2. After the 1996 Act

Code § 7701(a)(30)(E) and (31)(B) attempt to provide clarity, but do so in a way that creates a strong statutory bias in favor of foreignness.

Under Code § 7701(a)(30)(E) and (31)(B), a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[7]

Under this test, a trust may be a foreign trust even if it was created by a U.S. person, all of its assets are located in the U.S., and all of its beneficiaries are U.S. persons. All it takes is one foreign person who has control over one "substantial" type of trust decision. Consider the following example:

> **Example 1:** Jenny, a U.S. citizen and resident of New York, created a trust for the benefit of her children, all of whom are U.S. citizens and residents. She named the Gotham Trust Company, a New York corporation, and her brother Pat, a citizen and resident of Ireland, as co-trustees. The trust instrument gave Pat the right to determine the ages at which each of the children would receive his or her share of the trust

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4 Code § 7701(a)(31) before amendment by the 1996 Act. References in this outline to "Code §" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. §" are to sections of the Treasury regulations promulgated thereunder.

5 Curiously, the domestic or foreign status of an estate continues to be governed by the same provision. Code § 7701(a)(31)(A).

6 *See, e.g., B. W. Jones Trust v. Commissioner*, 132 F.2d 914 (4th Cir., 1943); *First National City Bank v. Internal Revenue Service*, 271 F.2d 616 (2d Cir., 1959), *cert. denied*, 361 U.S. 948 (1960); Rev. Rul. 60-181, 1960-1 C.B. 257.

7 The Administration's explanation of this rule issued in connection with its original proposal offered some protection from this harsh rule by expressing an intention that the Service would allow a trust "a reasonable period of time to adjust for inadvertent changes in fiduciaries (*e.g.*, a U.S. trustee dies or abruptly resigns when a trust has two U.S. fiduciaries and one foreign fiduciary)." Treasury Department, "General Explanations of the Administration's Revenue Proposals" 25 (February 7, 1995). The Joint Committee Explanation offers similar comfort. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 274. The Administration's intention is reflected in Treas. Reg. § 301.7701-7(d)(2). The Act's version of the definition referred to "fiduciaries" rather than persons. Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 changed the word "fiduciaries" to "persons."

fund. It directed that the trust funds be maintained in the U.S. in the custody of Gotham and that the laws of the State of New York were to govern the trust's administration.

Despite its significant U.S. contacts, the new law will treat Jenny's trust as a foreign trust since an obviously substantial decision is controlled by a foreign fiduciary.[8] The new definition fulfills the Treasury Department's goal, to

> "increase the flexibility of settlors and trust administrators to decide where to locate and in what assets to invest. For example, if the location of the administration of the trust were no longer a relevant criterion, settlors of foreign trusts would be able to choose whether to administer the trusts in the United States or abroad based on non-tax considerations."[9]

It is understood that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level the competitive playing field for trust business between U.S. and foreign institutions. Under the former definition, a foreign person who might have preferred to use a U.S. financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a U.S. domestic trust. Under the new law a foreign person can easily use a U.S. financial institution without creating a domestic trust.[10]

Although Code § 7701(a)(30)(E) and (31)(B) establishes a more objective method for determining whether a trust is domestic or foreign, it falls short of establishing the bright line test that was intended.

a. The Treasury Regulations

Some clarity is provided by Treas. Reg. § 301.7701-7, which is applicable to trusts for taxable years ending after February 2, 1999.[11] The regulations provide that a trust is a U.S. person on any day that the trust meets both the "court test" and the "control test."

b. The Court Test

The "court test" is the regulatory interpretation of the statutory requirement that "a court or courts within the United States is able to exercise primary supervision over administration of the trust." The final Treasury regulations provide a safe harbor for the court test. The safe harbor provides that a trust satisfies the court test if the following three requirements are met:

(1) The trust instrument does not direct that the trust be administered outside the U.S.;

(2) The trust in fact is administered exclusively in the U.S.; and

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8 A trust that is treated as a foreign trust for federal tax purposes under the new rule may continue to be a local trust for state income tax purposes. Jenny's trust, for example, although it may pay no federal income tax, will continue to be subject to New York State income tax because it was created by a resident of New York and has a New York trustee. N.Y. Tax Law § 605(b)(3).

9 Treasury Department, "General Explanation of the Administration's Fiscal Year 1996 Revenue Proposals" 25 (February 7, 1995).

10 This understanding is based on conversations with David K. Sutherland, former Associate International Tax Counsel and a principal draftsperson of the new statutory definition.

11 Treas. Reg. § 301.7701-7 may be relied on by trusts for taxable years beginning after December 31, 1996 and by trusts whose trustees have elected under Code § 1907(a)(3)(B) of the 1996 Act to apply Code §§ 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996.

(3) The trust is not subject to an automatic migration provision described in Treas. Reg. § 301.7701-7(c)(4)(ii).

According to the preamble to the regulations, the Internal Revenue Service (the "IRS") included the court test safe harbor in the final regulations because it recognized the difficulty in determining whether the courts of a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before any court in that state.

Treas. Reg. § 301.7701-7(c)(3) provides the following definitions critical to the application of the court test:

(1) "Court" includes federal as well as state and local courts.

(2) "United States" means the fifty states and the District of Columbia.

(3) "Is able to exercise" means "that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust."

(4) "Primary supervision" means the judicial "authority to determine substantially all issues regarding the administration of the entire trust . . . notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property."

(5) "Administration" means "the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions."

Treas. Reg. § 301.7701-7(c)(4) describes four types of trusts that satisfy the court test and one that does not. The four types of trusts which satisfy the court test are:

(1) Trusts that are registered in a court within the U.S. by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.[12]

(2) Testamentary trusts if all fiduciaries of the trust have been qualified as trustees by a court within the U.S.

(3) Intervivos trusts if the fiduciaries and/or beneficiaries take steps with a court in the U.S. to cause the administration of the trust to be subject to the primary supervision of such court.

(4) Trusts that are subject to primary supervision with respect to their administration by a U.S. court and a foreign court.

This list of trusts that satisfy the court test is not intended to be an exclusive list. Thus, other types of trust may also satisfy the test.

A trust whose trust instrument contains a provision that would cause the trust to migrate from the U.S. if a U.S. court attempted to assert jurisdiction over it or otherwise attempted to supervise its administration, either directly or indirectly, does not satisfy the court test. However, a trust will not fail the court test solely because "the trust instrument provides that the trust

[12] § 7-201 of the Uniform Probate Code gives exclusive jurisdiction over the internal affairs of a trust to the courts of a state in which a trust is registered. Seventeen states have adopted the Uniform Probate Code in its entirety (in some cases with significant modifications). They are Alaska, Arizona, Colorado, Hawaii, Idaho, Maine, Massachusetts, Michigan, Minnesota, Montana, Nebraska, New Jersey, New Mexico, North Dakota, South Carolina, South Dakota and Utah. 8 Uniform Laws Annotated 1 (West Supp. 1998).

will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States."[13]

c. The Control Test

The "control test" is the regulatory explanation of the statutory requirement that "one or more United States persons have the authority to control all substantial decisions of the trust." Treas. Reg. § 301.7701-7(d)(1)(ii) provides the following critical definitions.

(1) "United States person" means a U.S. person within the meaning of Code § 7701(a)(30).

(2) "Substantial decisions" means all decisions other than ministerial decisions that any person, whether acting in a fiduciary capacity or not, is authorized or required to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:

(a) The timing and amount of distributions;

(b) The selection of beneficiaries;

(c) The power to determine whether receipts are allocable to income or principal;

(d) The power to terminate the trust;

(e) The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust;

(f) The power to remove, add or replace a trustee;

(g) The power to appoint a successor trustee (even if such power is not accompanied by an unrestricted power to remove a trustee) unless the appointment power is limited in such a way that it cannot be exercised in a manner that would alter the trust's residency; and

(h) The power to make investment decisions.[14]

(3) Ministerial decisions "include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions" made by the fiduciaries.

(4) "Control" means "the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions."

Certain employee benefit trusts will be deemed to satisfy the control test as long as U.S. *fiduciaries* control all of the substantial decisions to be made by trust fiduciaries.[15]

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[13] Treas. Reg. § 301.7701-7(c)(4)(ii).

[14] If a U.S. person hires an investment advisor on behalf of the trust and can terminate at will such advisor's power to make investment decisions, the U.S. person will be treated as retaining control over the investment decisions made by the investment advisor. Treas. Reg. § 301.7701-7(d)(1)(ii)(J).

Applicable regulations clarify that a domestic corporation is a "U.S. person" even if the shareholders are foreign persons.[16] Domestic partnerships also are "U.S. persons." By analogy, this should be true whether or not the partners are foreign persons. Therefore, a grantor who wishes to give foreign individuals control over trust decisions but also wishes the trust to be a domestic trust can accomplish this result if the powers are given to a U.S. corporation, such as a private trust company, which is owned and controlled by such foreign individuals. The same result should obtain if the grantor gives the powers to a domestic partnership. This rule makes sense from a policy perspective because a U.S. court will have jurisdiction over the domestic corporation or partnership, but it makes classification of trusts as domestic or foreign in substance elective. It would make better sense from a policy perspective to instead make classification entirely elective.

d. Reversing an Unintended Loss of U.S. Status

If a trustee whose U.S. status caused a trust to be treated as a U.S. trust ceases to be a trustee because of resignation, disability or death (but not removal) or because such trustee ceases to be a U.S. person, the regulations give the trust twelve months from the date of such cessation to make whatever changes are necessary to give control over all substantial decisions of the trust to U.S. persons.[17] If corrective changes are made within 12 months, the trust will be treated as having maintained its U.S. status even during the time when one or more substantial decisions were not controlled by U.S. persons. If the change is not made within this time period, the trust will be treated as having lost its U.S. status on the date the trustee lost her U.S. status or ceased to serve as trustee. The appropriate district director has the power to extend this time period for reasonable cause.

B. Creation of and Transfer of Property to a Foreign Trust by a U.S. Person

1. Tax Consequences of Creation and Transfer

No tax consequences are imposed on a U.S. person on account of her creation of a foreign trust, but, under some circumstances, income tax may be imposed on her transfer of property to a foreign trust, whether that trust was created by her or by another. Code § 684[18] treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of the property transferred and requires that the transferor recognize gain (but not loss) on the excess of such fair market value over her basis in the transferred property. This rule does not apply to the extent that any person (including the transferor) is treated as the owner of such trust under Code § 671.

2. Tax Treatment During the Life of a U.S. Creator or Transferor

a) **Grantor Trust Treatment Under § 679.**

Footnote continued from previous page

[15] Such employee benefit trusts include qualified trusts described in Code § 401(a); trusts described in Code § 457(g); trusts that are individual retirement accounts described in Code § 408(a); trusts that are individual retirement accounts described in §§ 408(k) or (p); trusts that are Roth IRAs described in Code § 408A; trusts that are educational retirement accounts described in Code § 530; trusts that are voluntary employees' beneficiary associations described in Code § 501(c)(9); and such additional categories of trusts designated by the Service.

[16] Treas. Reg. §301.7701-7(d)(1).

[17] Treas. Reg. §301.7701-7(d)(2). The same rule is not applicable if there is a change of trustees that is not inadvertent. A change is inadvertent if it is due to resignation, disability, death or change of residency of a trustee. A change of trustee due to removal and appointment is not inadvertent.

[18] Code § 684 was added to the Code by the Tax Reform Act of 1997, P.L. 105-34, 111 Stat. 788 (1997) ("the 1997 Act").

If a foreign trust to which a U.S. person has made any direct or indirect gratuitous transfers has one or more U.S. beneficiaries, Code § 679 treats the trust as a so-called "grantor trust" owned by the U.S. person within the meaning of Code § 671 to the extent of her transfer.[19]

A transfer is not a gratuitous transfer if it was made for full fair market value. For purposes of determining whether full fair market value has been received, if the transferor is the grantor or a beneficiary of the trust (or a person related within the meaning of Code § 643(i)(2)(B) to any grantor or beneficiary of the trust), any obligation issued by the trust (or by certain related persons) is disregarded, except as provided in the regulations.[20] Treasury regulations provide that certain "qualified obligations" will be recognized as consideration.[21] An obligation is a qualified obligation only if:

> "(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. transferor extends the period for assessment of any income tax or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter; and (vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for each year that the loan is outstanding."[22]

Section 679 applies to both direct and indirect transfers to foreign trusts. If a U.S. person transfers property to another person and that person transfers property to a foreign trust, the second transfer will be treated as an indirect transfer by the U.S. person to the foreign trust if the transfers were part of a plan the principal purposes of which is to avoid U.S. income tax. The regulations deem the principal purpose of tax avoidance to exist if the U.S. person is related to a beneficiary of the foreign trust (or has another relationship with a beneficiary that establishes a reasonable basis for the transferor making a gratuitous transfer to the foreign trust) and the U.S. person cannot demonstrate that (i) the other person (the "intermediary") has a relationship with a beneficiary that establishes a reasonable basis for the intermediary making a gratuitous transfer to the trust; (ii) the intermediary acted independently of the U.S. person; (iii) the intermediary is not an agent of the U.S. person; and (iv) the intermediary timely complied with the reporting requirements of § 6048 of the Code.[23] According to the regulations, if

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[19] Code § 679(a)(1). This section does not apply to trusts that are described in Code § 6048(a)(3)(ii). Trusts that are described in Code § 6048(a)(3)(ii) are either trusts that are described in Code § 402(b), 404(a)(4) or 404A (relating to deferred compensation trusts) or trusts determined by the Treasury to be described in section 501(a)(3) (relating to charitable trusts). The regulations under Code § 679 have expanded the protection for transfers to charitable trusts to apply to any foreign trust described in section 501(c)(3) determined without regard to whether the Treasury has determined it is so described and determined without regard to Code § 508(a). Treas. Reg. § 1.679-4(a)(3).

[20] Code § 679(a)(3)(A)(i).

[21] Treas. Reg. § 1.679-4(d).

[22] *Id.*

[23] Treas. Reg. § 1.679-3(c)(2)(i). *See also* IV.G.1.c, *infra*.

a bank loans money to a foreign trust and the loan would not have been made unless the U.S. person had deposited funds with the bank, the bank is an intermediary.[24]

Section 679 applies if a U.S. person makes a constructive transfer to a foreign trust.[25] A constructive transfer includes an assumption or satisfaction of a foreign trust's obligation to a third party. A U.S. person who is related to a beneficiary of a foreign trust and who guarantees a loan to the trust is treated as making a transfer to the foreign trust equal to the portion of the obligation guaranteed.[26] A guarantee includes any arrangement under which a person, directly or indirectly, assures on a conditional or unconditional basis the payment of another person's obligation. A commitment to contribute capital to the debtor, or otherwise maintain its financial viability, is a guarantee even if the arrangement is not a legally binding obligation or is subject to a contingency that has not yet occurred.[27]

Transfers by U.S. persons to entities owned by a foreign trust are treated as transfers to the foreign trust followed by a transfer by the trust to the entity unless the U.S. person is not related to a trust beneficiary or the U.S. person demonstrates that the transfer is attributable to the U.S. person's ownership interest in the entity.[28] For example, if a foreign trust and a U.S. person jointly fund a corporation, each taking back stock proportionate to their transfers, Code § 679 is not applicable.

It may be possible to use this exception to defer U.S. taxable income by capitalizing a corporation, partnership or LLC with preferred and common interests. If the preferred interest is held by a foreign non-grantor trust and the common interest is held by U.S. taxpayers, the U.S. taxpayers will be able to reduce their shares of current income (and tax on that income) until after the preferred interest holder has been paid. If the assets appreciate and a return is paid to the common interest holders, they will owe tax on that income. The arrangement is functioning to some degree like a loan, but tax is deferred and the loan need not be a qualified obligation even if the person providing the capital is a related party.

A trust is treated as having a U.S. beneficiary in any year in which income or corpus may be paid to or for the benefit of, or accumulated for future distribution to or for the benefit of, a U.S. person, or in any year in which, if the trust terminated, any part of the income or corpus could be paid to or for the benefit of a U.S. person.[29] According to the regulations Code § 679 applies even if no distribution may be made to a U.S. person until after the grantor's death or to a person who is a U.S. person until he or she ceases to be a U.S. person.[30] If the terms of the trust permit the trust to be amended to make a U.S. person a beneficiary, the trust will be treated as having a U.S. beneficiary.[31] For this purpose the term "U.S. person" includes a

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24 Treas. Reg. § 1.679-3(c)(5), *Example 3*.

25 Treas. Reg. § 1.679-3(d). *See also* IV.G.1.c, *infra*.

26 Treas. Reg. § 1.679-3(e)(4).

27 *Id*.

28 Treas. Reg. § 1.679-3(f).

29 Code § 679(c)(1). CCA 200445025 demonstrates how broadly the IRS construes the reach of this section. In that ruling, the IRS treated a U.S. grantor as the owner of a foreign trust under Code §679 even though the trust prohibited distributions to U.S. beneficiaries. The trust was considered to have a U.S. beneficiary because distributions could be made to beneficiary of the trust which was a foreign charity and the foreign charity was not prohibited from making distributions to U.S. persons.

30 Treas. Reg. § 1.679-2(a)(2), *Examples 4 and 13*.

31 Treas. Reg. § 1.679-2(a)(4)(ii)(A).

controlled foreign corporation as defined in Code § 957(a), a foreign partnership with one or more U.S. partners, and a trust or estate, one or more beneficiaries of which are U.S. persons.[32]

A beneficiary who first became a U.S. person more than five years after a gratuitous transfer to a trust will not be treated as a U.S. person for purposes of that transfer.[33] The exception is not applicable if the person at any previous time had been a U.S. person.[34]

The test for determining whether a foreign trust has a U.S. beneficiary is done on a year by year basis. If a foreign trust has no U.S. beneficiaries in one year and acquires one in a subsequent year, the U.S. gratuitous transferor will be required to include in her gross income in such year an amount equal to all the undistributed net income of the trust at the end of the prior year that is attributed to her transfer or transfers to the trust.[35] Code § 679 will cease to apply on January 1 of the year following the year when it no longer has U.S. beneficiaries. The grantor will be treated as transferring assets to the foreign trust on January 1 and Code § 684 will require the transferor to realize income and gain as if the assets had been sold.[36]

b) **Hiring Incentives to Restore Employment Act of 2010**

The 2010 HIRE Act contains the following amendments to § 679, most of which seem to do nothing more than codify certain regulatory provisions designed to increase the likelihood that a trust created by a U.S. person will be treated as having a U.S. beneficiary in any particular taxable year.

(1) Section 531(a) of the 2010 HIRE Act amends § 679(c)(1) to provide that income will be treated as accumulated for the benefit of a U.S. person in a particular year even if the U.S. person's interest in the trust is contingent on a future event. The section replicates the provision in Treas. Reg. § 1.679-2(a)(2)(i) which provides that the determination of whether income or corpus may be paid or accumulated to or for the benefit of a U.S. person is made ". . . without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event." The regulation also contains an exception for contingent interests that are so remote as to be negligible.[37] It is unclear whether this exception will apply to the new Code provision.

(2) Section 531(b) amends § 679(c) to provide that if any person has the discretion to make a distribution from the trust to or for the benefit of any person, the trust will be treated as having a U.S. beneficiary unless the class in whose favor the power can be exercised is specifically identified and no member of the class is a U.S. person in such year. This provision states the rule that is illustrated by an example in the regulations. The example concludes that a trust will be treated as having a U.S. beneficiary when the trustee has the discretion to distribute income to any person who is studying ancient Greek because it is possible that a U.S. person will receive trust income.[38]

(3) Section 531(c) amends § 679(c) to provide that a trust will be treated as having a U.S. beneficiary if any U.S. transferor to the trust is involved in any agreement, written, oral or otherwise, that may result in trust income or corpus being paid or accumulated to or for the benefit of a U.S. person. Because this provision requires the involvement of the transferor in the agreement, it appears to be a narrower application of the rule of Treas. Reg. § 1.679-2(a)(4), which states that

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32 Code § 679(c)(2).

33 Code § 679(c)(3).

34 Treas. Reg. § 1.679-2(a)(3), *Example 2*.

35 Code § 679(b).

36 Treas. Reg. § 1.679-2(c)(2).

37 Treas. Reg. § 1.679-2(a)(2)(ii).

38 Treas. Reg. § 1.679-2(a)(2)(iii) Example 10.

all written and oral agreements and understandings relating to the trust are to be taken into account in determining whether a trust has a U.S. beneficiary. The technical explanation of the HIRE Act issued by the Joint Committee on Taxation, however, broadens the provision by stating that it is assumed "that a transferor of property to the trust is generally directly or indirectly involved with agreements regarding the accumulation or disposition of the income and corpus of the trust."[39]

(4) Section 532 of the 2010 HIRE Act amends § 679 to permit the IRS to treat a foreign trust to which a U.S. person has made a transfer as having a U.S. beneficiary unless the transferor submits to the IRS such information as it requires and demonstrates to Treasury's satisfaction that the trust has no U.S. beneficiary.[40]

(5) Section 533 of the 2010 HIRE Act amends § 679 to provide that a loan of cash or marketable securities or the use of any other property from a foreign trust to a U.S. person "shall be treated as paid or accumulated for the benefit of a United States person", whether or not the person to whom the loan is made is a trust beneficiary unless the U.S. borrower pays market value interest or rent. Presumably this means that the trust would be treated as having a U.S. beneficiary. If such a loan is made to a person who is not a beneficiary, the loan would contravene the trust terms. This new rule is similar to Treas. Reg. § 1.679-2(a)(4)(ii)(C), which provides that, "[if] the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account."

3. Tax Treatment at the Death of U.S. "Owner" of a Foreign Trust

The death of a U.S. person who was treated as the owner of a foreign trust during her lifetime may be a gain recognition event under Code § 684. Until the U.S. person's death, she was the owner of the property for U.S. income tax purposes under Code § 671. Her death terminates the trust's grantor trust status. Treas. Reg. § 1.1001-2(c), Example 5, treats the termination of grantor trust status as a transfer of the trust property by the grantor.[41] If this regulation is applied to Code § 684, and if it applies to terminations caused by death, the deceased U.S. person will be treated as having made a transfer to a foreign trust at the moment of her death. Treasury Regulations under Code § 684 confirm this tax treatment for the U.S. owner, except that the regulations provide that the transfer to the foreign trust will be treated as having occurred *immediately before* the U.S. owner's death.[42] Treasury Regulations § 1.684-3(c) provides an exception to this gain recognition rule if the trust property is included in the U.S. owner's gross estate for U.S. estate tax purposes and the basis of the property in the hands of the foreign trust is determined under Code § 1014(a).

It may be possible to avoid the risk that gain will be recognized upon the death of a foreign trust's U.S. owner by giving a U.S. person, perhaps a U.S. trust, the right to withdraw the foreign trust's property immediately before the death of the U.S. person.[43] The withdrawal power would give the deceased U.S. person the protection of Code § 684(b).[44] Code § 684(b)

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[39] Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the "Hiring Incentives to Restore Employment Ac*t," *Under Consideration by the Senate,* (JCX-4-10) February 23, 2010, at 72. This document is referred to in this outline as the "Joint Committee's HIRE Act Explanation."

[40] This new provision appears to supersede the normal rule of § 7491 that puts the burden of proof as to factual issues on the Internal Revenue Service when a taxpayer introduces credible evidence with respect to a factual issue and satisfies certain record keeping requirements.

[41] *See, also, Madorin v. Commissioner,* 84 T.C. 667 (1985) and Rev. Rul. 77-402, 1977-2 C.B. 222.

[42] Treas. Reg. § 1.684-2(e), *Example 2*.

[43] A trust will be treated as an owner of another trust to the extent it has the power to withdraw that trust's assets. Treas. Reg. § 1.671-2(e)(6), *Example 8*.

excepts transfers to trusts to the extent such trusts are owned by any person (other than a foreign nongrantor trust) under Code § 671.

A transfer by the will of a U.S. decedent of property to a foreign nongrantor trust generally will not be subject to Code § 684 if Code §1014 applies in the year of the decedent's death. This is so because the estate will receive the property from the decedent with a basis adjustment under Code § 1014. If the estate transfers the property before any post-death appreciation occurs, there will be no gain to which Code § 684 can apply. Even if there were gain, to the extent the distribution carries out the gain to a foreign beneficiary, the gain should avoid U.S. tax.

4. Tax Treatment After Death of U.S. Person

After the death of the U.S. person who has made transfers to a foreign trust, the trust will no longer be subject to Code § 679 and will be treated as a foreign nongrantor trust.

5. Reporting Requirements

a. Contributions

A U.S. person who creates a foreign trust or who transfers property to a foreign trust, other than a transfer in exchange for consideration equal to the full value of the transferred property, is required to report the creation or transfer on Form 3520.[45] For purposes of determining whether full consideration has been received, notes issued by the trust or related persons are to be disregarded to the same extent they are disregarded for purposes of Code § 679 (a)(3) as discussed above. Qualified obligations, as defined in Treas. Reg. § 1.679-4(d), will be treated as consideration, but an obligation will be treated as qualified only if reported.[46] Failure to file Form 3520 may subject a transferor to a penalty equal to 35% of the amount transferred.[47] For reports required to be filed after December 31, 2009, the 2010 HIRE Act requires a minimum penalty of $10,000, not to exceed the gross reportable amount.[48]

b. Foreign Trusts Owned by U.S. Person

A U.S. person who is treated as the owner, within the meaning of Code § 671, of a foreign trust is required to ensure that the trust files an annual return that sets forth a full accounting of all trust activities and operations for each year that she is treated as owner.[49] The 2010 HIRE Act added, for years beginning after March 18, 2010, a separate requirement that the U.S. owner of the foreign trust supply such information as the Treasury prescribes with respect to such trust.[50] The U.S. "owner" is required to disclose on Form 3520 the existence of the trust, its taxpayer identification number, the names of other persons who are considered "owners" of the trust, the code section which causes the trust to be treated as owned by the U.S. person and others who are treated as owners, the country in which the trust was created and the date of creation. The information required

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44 See Treas. Reg. § 1.684.2(e) *Example 2*, which implies that the death of a U.S. grantor will not trigger Code § 684 if, as of the date of death, another person is treated as the owner of the trust.

45 Code § 6048(a); Notice 97-34, 1997-2 C.B. 422.

46 Treas. Reg. § 1.679-4(d)(1)(vi).

47 Code § 6677(a).

48 Code § 6677(a).

49 Code § 6048(b).

50 Code § 6048(b).

to be furnished by the trust must be disclosed on Form 3520A, which is due on each March 15th following the year for which reporting is required. If Form 3520A is not filed, the U.S. person who is treated as the owner may be liable for a penalty equal to 5% of the value of the trust assets that are treated as owned by her.[51]

c. Reporting by Executors

The executor of the estate of a U.S. person who transfers property to a foreign trust at her death, who was treated as the owner of a foreign trust during her lifetime or whose estate includes, for estate tax purposes any portion of a foreign trust, must report the death and the transfers on Form 3520.[52] Failure to file may subject the executor to a penalty equal to 35% of the amount transferred.[53]

d. Due Date for Form 3520

For calendar year 2015 and all prior calendar years, Form 3520 is (or was) due at the same time as the U.S. person's income tax return is (or was) due, including extensions, for the year in which such creation or transfer took place.[54] Section 2006(b) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015,[55] enacted on July 31, 2015, directs the Treasury to modify appropriate regulations to change the due date of Form 3520. After the regulations are modified, the due date for Form 3520 will be April 15th, with a maximum extension for a 6-month period ending on October 15th. Notably, it appears that for calendar years 2016 and later, an extension of time to file an individual's income tax return will not provide an extension of time to file Form 3520, and that a separate extension request will need to be filed. IRS may develop a form for requesting an extension of time to file Form 3520, or may modify Form 4868 or Form 7004 for this purpose.

In the case of a Form 3520 required to be filed with respect to a U.S. decedent, Form 3520 is due on the date that Form 706 is due, or would be due if the estate were required to file Form 706.[56]

6. Treatment of Trusts That Become Foreign Trusts

a. In General

If a U.S. grantor made a gratuitous contribution to a U.S. trust which later becomes a foreign trust during the lifetime of such grantor, the U.S. grantor will be treated for purposes of Code §§ 679 and 6048 as if she had transferred assets equal to the portion of the trust attributable to her contribution directly to a foreign trust on the date the trust became a foreign trust.[57]

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51 Code § 6677(b).

52 Code § 6048(a).

53 Code § 6677(a).

54 *See* 2015 instructions for Form 3520 (August 24, 2015).

55 P.L. 114-41 (July 31, 2015).

56 Section 2006(b) of the Surface Transportation and Veterans Health Care Choice Improvement Act of 2015 directs the Treasury to modify applicable regulations to change the due date of Form 3520 only for calendar year filers, so it appears that the due date may be unaffected in the case of Forms 3520 required to be filed with respect to a U.S. decedent.

57 Code § 679(a)(5).

If a U.S. trust that was funded by a U.S. grantor becomes a foreign trust (1) at a time when there is no living U.S. person who ever made a gratuitous transfer to it or if it has no U.S. beneficiaries, and (2) if it is not treated as owned by another person within the meaning of Code § 671, the trust will be treated as having transferred all of its assets to a foreign trust immediately before becoming a foreign trust.[58] As a result, Code § 684(a) will treat it as having sold all of its assets for an amount equal to their fair market value. Gain is recognized on an asset by asset basis, but losses are not deductible.[59]

b. Reporting Requirements

A U.S. trust that becomes a foreign trust is required to report its change of status on Form 3520.[60] For a discussion of the due date for Form 3520, see I.B.5.d, *supra*. Failure to file may subject a trust to a penalty equal to 35% of the amount transferred.[61]

c. Treatment of Distributions by U.S. Trusts to Foreign Trusts

When a U.S. trust transfers property to a foreign trust, unless the foreign trust is treated as owned by another person within the meaning of Code § 671, the transfer will be treated in the same manner as a transfer by an individual to a foreign trust. This means that the transfer will be treated as a sale or exchange and that the trust will be treated as having recognized gain equal to the excess of the fair market value of the property transferred over the trust's adjusted basis in the transferred property.

If, however, the transferee foreign trust is a beneficiary of the U.S. trust and the transfer is treated as a distribution to a beneficiary within the meaning of Code §661(a), the application of Code §684 will result in no income tax liability if the U.S. trust's capital gains are included in its distributable net income in the year of the distribution. This would be so because the U.S. trust would receive a distribution deduction equal to the amount of income recognized on the distribution.[62] Treas. Reg.

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58 Code § 684(c); Treas. Reg. §1.684-4(a).

59 Treas. Reg. § 1.684-1(a)(2).

60 Code § 6048(a).

61 Code § 6677(a).

62 It is possible that the IRS would take the position that a U.S. trust that makes a distribution to a foreign trust that has one or more U.S. beneficiaries and that is not terminated by the distribution becomes the deemed owner of the foreign trust under Code §679. A literal application of Code §679 appears to compel this result. The following consequences would flow from a successful assertion of this position: (1) no distribution deduction would be available because the trust would be treated as having made a distribution to itself; (2) Code §684 would not apply because the foreign trust would be treated as owned by another person (the distributing U.S. trust); and (3) the foreign trust's income attributable to that distribution would be treated for U.S. income tax purposes as the income of the U.S. trust. While the foreign trust is treated as owned by the U.S. trust, its income distributed to U.S. beneficiaries would not be taxed to them unless the distribution is treated as made by the domestic trust to the beneficiaries via the foreign trust. (Compare, for example, (i) the treatment of a distribution to a beneficiary that is made from a grantor trust as a transfer by the grantor to the beneficiary, which, in the case of the grantor who is an individual is treated for income tax purposes as a gift, and (ii) a distribution to a beneficiary that is made from a trust to which an entity has made a gratuitous contribution, which may be treated and taxed as a distribution from the entity directly to the beneficiary under Treas. Reg. §1.672(f)-4(c).) If the distribution from the foreign trust is treated as made from the domestic trust, then income of the domestic trust should carry out to the beneficiaries under the normal rules of Code § § 661 and 662. However, if the domestic trust was never a foreign trust, the throwback tax should not be applicable

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§1.643(a)(3) describes the rules for determining when a trust's capital gains are included in its distributable net income. Inclusion in distributable net income of all of the capital gains recognized by a trust in the year of its termination will always be required because all of the trust's remaining assets (including its capital gains) will be distributed in that year.[63]

C. Creation of a Foreign Trust by a Non-U.S. Person

Neither Code § 684(a) nor Code § 679 applies to a transfer to a foreign trust by a non-U.S. person. As a result, no U.S. income tax will be imposed on such transfer. The trust's income will be treated for U.S. income tax purposes as if earned by a foreign nongrantor trust unless Code § 672(f) applies to the trust. Prior to the 1996 Act, trusts created by non-U.S. persons were subject to the so-called "grantor trust" rules set forth in Code §§ 671 through 679 to the same extent as trusts created by U.S. persons. The application of the grantor trust rules shifted the trust's income, for virtually all U.S. income tax purposes, from the trust to its grantor.

As discussed more fully below, Code § 672(f), which was added by the 1996 Act, denies grantor trust status to trusts with non-U.S. grantors unless (1) the grantor retains the right, exercisable either unilaterally or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; or (2) the only amounts permitted to be distributed from the trust during the grantor's life are amounts distributable to the grantor or her spouse.[64]

II. TAX TREATMENT OF FOREIGN NONGRANTOR TRUSTS

A. In General

Nongrantor trusts calculate their taxable incomes in the same manner as individuals with certain modifications set forth in Code §§ 642, 643, 651, and 661. For this purpose, foreign nongrantor trusts are treated as nonresident individuals who are not present in the U.S. at any time.[65]

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to a distribution attributed to the domestic trust because a distribution from such a trust is not subject to the throwback rules and interest charges. On the other hand, if the distribution is treated as being made from the foreign trust (and not indirectly made from the domestic trust), to the extent that the income of the foreign trust is "owned by" the domestic trust as a result of the application of Code § 679, the throwback tax will not apply because the foreign trust will not have any UNI. As a practical matter, treating the domestic trust as the owner of a foreign trust under §679 does not seem to be a good position for the IRS to take because, if the U.S. trust lacked sufficient assets to pay the income tax on the foreign trust's income, the IRS seems to have no available way under the Code of collecting the tax. If Code §679 does not apply, then Code §684 will apply, which may produce a better result.

63 Treas. Reg. §1.643(a)-(3)(e) Example 7.

64 Code § 672(f). Trusts with foreign grantors that were in existence on September 19, 1995 and that were treated as grantor trusts under Code § 676 (relating to trusts, the property of which may be returned to the grantor) or Code § 677 (relating to trusts the income from which may be paid to the grantor or her spouse) other than Code § 677(c) (relating to trusts the income from which may be used to pay life insurance premiums on the life of the grantor or her spouse) will continue to be treated as grantor trusts except to the extent transfers were made to such trusts after September 19, 1995. P.L. 104-188 § 1904(d)(2).

65 Code § 641(b). Code § 871(a)(2) provides that a nonresident alien individual who is present in the United States for a period of 183 days or more in a taxable year is subject to a 30 percent tax on her net capital gains allocable to sources within the United States. Under Code § 865(a)(1) income from the sale of personal

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B. Gross Income

The gross income of a foreign nongrantor trust consists only of (1) gross income derived from sources within the U.S. that is not effectively connected with the conduct of a trade or business within the U.S., and (2) gross income that is effectively connected with the conduct of a trade or business within the U.S.[66]

Gross income from sources within the U.S. includes:

- interest from the U.S. (or any of its agencies), the District of Columbia, from noncorporate residents of the U.S. and from domestic corporations;[67]
- dividends from domestic corporations;[68]
- rentals and royalties from property located in the U.S. including rentals or royalties for the use in the U.S. of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and the like; and[69]
- gains from the disposition of U.S. real estate.[70]

C. Imposition of U.S. Income Tax

Foreign nongrantor trusts are subject to U.S. income tax on the types of income described below:

1. Income Effectively Connected With U.S. Trade or Business

Foreign nongrantor trusts are taxable on taxable income which is effectively connected with the conduct of a trade or business within the U.S.[71]

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property is generally sourced according to the residence of the seller. But, under Code § 865(e)(2)(A), a nonresident alien who maintains an office in the United States has United States source income to the extent she sells personal property attributable to that office. Prior to the 1997 Act, it was unclear whether a trust that was a foreign trust within the meaning of new Code § 7701(a)(31) but that had a United States trustee with an office in the United States would be treated as having United States source income to the extent that trustee directed the sale of personal property. *See* Schwab and Davies, Tax Risks When U.S. Fiduciary Acts as Trustee of Foreign Trust, New York Law Journal (January 7, 1997). Section 641(b) was amended by the 1997 Act to provide that, in determining the income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the United States at any time.

66 Code § 872(a).

67 Code § 861(a)(1).

68 Code § 861(a)(2).

69 Code § 861(a)(4).

70 Code § 861(a)(5).

71 Code § 871(b).

Although it is unlikely that a foreign nongrantor trust would be engaged directly in a trade or business, some foreign trusts may have this type of income as a result of investments in partnerships that engage in U.S. trades or businesses. A foreign nongrantor trust that is a general or limited partner in a partnership engaged in a U.S. trade or business is deemed to be engaged in that trade or business.[72] When a limited partnership conducts a business activity in the U.S. through a fixed place of business in the U.S., each limited partner is deemed to have a place of business in the U.S.[73]

In Revenue Ruling 91-32, the government held that this rule applied not only to income from the business carried out by the partnership, but also to gain realized on the disposition of such partnership interest.[74] However, the Tax Court has rejected the holding in Revenue Ruling 91-32. The Tax Court found that because gain from the redemption or sale of a partnership interest by a foreign person is a capital transaction, the gain is foreign source income unless the gain is attributable to a U.S. place of business.[75] Even though the partnership had a fixed place of business in the U.S., the gain was not attributed to the U.S. place of business of the partnership because that office was not involved in the sale, the sale was not made in the ordinary course of the partnership's business carried on in that office. However, the parties agreed that the portion of the gain attributable to a U.S. real property interest owned by the partnership was taxable.[76]

2. Election With Respect to Income From Real Property

In addition, a foreign nongrantor trust that receives income from real property located in the U.S. may make an election to treat all such income as income effectively connected with a U.S. trade or business if the property is held for the production of income.[77] In the absence of such an election, such income would be taxed on the basis of gross receipts unreduced by any deductions.

3. Disposition of U.S. Real Property Interests

A foreign nongrantor trust's gains from the disposition of "United States real property interests" are treated as income that is effectively connected with a U.S. trade or business.[78] For this purpose, a "United States real property interest" is "any interest, other than an interest solely as a creditor, in either:

i) real property located in the United States or the Virgin Islands, or

ii) a domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii)."[79]

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72 Code § 875(1); Treas. Reg. § 1.864-2(c)(2)(ii) excepts partnerships that trade in securities for their own accounts unless they are dealers.

73 Rev. Rul. 85-60, 1985-1 C.B. 187; *Donroy, Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962).

74 Rev. Rul. 91-32, 1991-1 C.B. 107.

75 *Grecian Magnesite Mining v. Com'r*., 149 T.C. No. 3 (7/13/20017).

76 Code §897(g).

77 Code § 871(d)(1).

78 Code § 897(a). PLR 9152014 confirms that no taxable disposition occurs when U.S. real property is distributed from a trust to a beneficiary unless gain would otherwise be recognized as a result of such distribution. Gain is ordinarily not recognized on the distribution of property from a trust to a beneficiary. See Code § 643(e)(3).

79 Treas. Reg. § 1.897-1(c)(1); *see* Code § 897(c)(1).

The term "interests in real property" includes fee ownership and co-ownership of and leaseholds of land, improvements thereon, personal property associated with the use of real estate, and options to acquire such land, improvements, leaseholds and personal property.[80]

A U.S. real property holding corporation is any corporation unless the value of its U.S. real property interests is less than 50% of the sum of the value of all of its real property interests plus the value of all of its assets that are used or held for use in its trade or business.[81]

A foreign nongrantor trust's receipt of consideration for the disposition of a partnership interest in a partnership that holds any U.S. real property interests is treated as consideration received for the disposition of a U.S. real property interest to the extent attributable to U.S. real property interests.[82]

4. Fixed or Determinable Annual or Periodic Income

Foreign nongrantor trusts are taxed on their U.S. source fixed or determinable annual or periodic income such as interest, dividends, rents, annuities and the like.[83] They are also taxed on their U.S. source gains from certain timber, coal and iron ore transactions,[84] on their U.S. source gains from the sale or exchange of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises and similar property to the extent the gains are from payments which are contingent on the use of the transferred interest,[85] and, subject to the important exceptions described below, on their original issue discount from U.S. sources.[86] These types of income are all subject to the same type of taxation, except to the extent they are effectively connected with a U.S. trade or business. For convenience they are referred to in this outline as "fixed or determinable annual or periodic income."

5. Other Gains

Nonresident aliens who are present within the U.S. for 183 days or more in a particular taxable year are normally subject to tax on gains derived from sources within the U.S. from the sale of capital assets.[87] As discussed above, Code § 641(b) prevents this rule from applying to foreign nongrantor trusts. It provides that, for purposes of calculating the taxable income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the U.S. at any time. Thus, even though the trustees of a foreign nongrantor trust reside permanently in the U.S., the trust will be treated for U.S. income tax purposes as if the trustees had never been present in the U.S.

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[80] Code § 897(c)(6).

[81] Code § 897(c)(2). Shares of any class of securities that are regularly traded on an established securities market will not be treated as a United States real property interest except as to a person who holds more than 5% of the stock. Code § 897(c)(3).

[82] Code § 897(g); Notice 88-72, 1988-2 C.B. 383.

[83] Code § 871(a)(1)(A).

[84] Code § 871(a)(1)(B).

[85] Code § 871(a)(1)(D).

[86] Code § 871(a)(1)(C).

[87] Code § 871(a)(2). Income from the sale of personal property (other than inventory property) attributable to an office or other fixed place of business in the U.S. that is maintained by a nonresident in the U.S. is sourced in the U.S. Code § 865(e)(2).

6. Exceptions

a. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of so-called "portfolio interest" unless such income is effectively connected with the conduct of a U.S. trade or business.[88] For this purpose, portfolio interest is interest (including original issue discount) which is paid on certain obligations of U.S. persons issued after July 18, 1984.[89] If issued in proper form, interest paid by a U.S. person in a debt instrument issued to reflect that person's borrowings from a foreign trust should qualify for the exception.

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[88] Code § 871(h).

[89] With certain exceptions, interest payable on two types of obligations is eligible for the portfolio debt exception: bearer debt, but only if it is described in Code § 163(f)(2)(B) and the regulations under that section, and debt issued in registered form if the payee has provided the obligor with a statement that the owner of the obligation is not a U.S. person for U.S. income tax purposes. These requirements are intended to decrease the possibility that U.S. persons will acquire and fail to pay tax on such obligations. The portfolio debt exception is not available for interest on obligations issued by a corporation if the nonresident alien and certain related parties own 10% or more of the voting stock or for interest on obligations issued by a partnership if the nonresident alien and certain related parties own 10% or more of the capital or profits interest. The portfolio debt exception is also not available for contingent interest, *i.e.*, interest that is determined with reference to receipts, cash flow, income profits and the like of the obligor.

Foreign targeted bearer debt is eligible for the portfolio debt exception. Foreign targeted bearer debt is debt that meets the following requirements:

(1) There are arrangements reasonably designed to ensure that the obligation will be sold (or resold in connection with the original issue) only to a person who is not a U.S. person;

(2) Interest on the obligation is payable only outside the United States and its possessions; and

(3) The face of the obligation bears the legend that "[a]ny United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in section 165(j) and 1287(a) of the Internal Revenue Code." Treas. Reg. § 1.163-5(c).

Section 502 of the 2010 HIRE Act repeals the foreign targeted bearer debt exception for debt issued after March 18, 2012.

Debt is considered to be issued in registered form if:

(1) The obligation is registered as to principal and interest with the issuer or its agent and transfer of the obligation may be accomplished only by surrender of the old instrument and reissuance to the new holder;

(2) The right to principal and interest may be transferred only through a book entry system maintained by the issuer or its agent that identifies the owner of an interest in the obligation; or

(3) It is registered as to principal and interest with the issuer or its agent and may be transferred by either of the methods described in (1) or (2). Treas. Reg. § 5f.103-1(c).

b. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of interest from a U.S. bank, savings and loan association, insurance company or similar institution unless such income is effectively connected with the conduct of a U.S. trade or business.[90]

c. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of original issue discount income on obligations that mature in 183 days or less from the date of original issue unless such income is effectively connected with the conduct of a U.S. trade or business.[91]

d. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of any interest-related dividend or short-term capital gain dividend from a regulated investment company.[92]

D. Deductions

1. Income Effectively Connected With U.S. Trade or Business

In computing a foreign nongrantor trust's taxable income that is effectively connected with the conduct of a trade or business within the U.S., the trust is entitled to reduce its gross income so connected (or treated as so connected) by the deductions that are "connected" with such income.[93] The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treas. Reg. § 1.873-1. In addition, it is also entitled to deduct against its effectively connected income the following:

a. the deduction for losses allowed by Code § 165(c)(3) if the loss occurred with respect to property located in the U.S.;

b. the deduction for charitable contributions allowed by Code § 170; and

c. the deduction for personal exemptions allowed by Code § 151.[94]

Nothing in the Code or the regulations indicates whether the distributions made to beneficiaries by a foreign nongrantor trust with income effectively connected with the conduct of a trade or business within the U.S. are connected with such income and, are therefore, deductible under Code §§ 651 and 661.

It is appropriate to permit a foreign nongrantor trust to deduct that portion of its distributions to beneficiaries that consist of effectively connected income. In determining the portion of a distribution that consists of effectively connected

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[90] Code § 871(i).

[91] Code §§ 871(a)(1)(C), 871(g)(1).

[92] Code § 871(k). The exceptions for interest-related dividends and short-term capital gain dividends is not applicable to dividends with respect to a taxable year of a regulated investment company that begins after December 31, 2013. The termination date has been extended a number of times. Bills are pending to extend this expiration date and to make the provision permanent but neither has passed to date.

[93] Code § 873(a).

[94] Code § 873(b).

income, the distribution should be treated as consisting of the same portion of effectively connected income as the total of the trust's effectively connected income bears to the trust's total income. The IRS seems to take this approach.[95]

2. Other Income

No deductions are permitted against U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business.

3. Foreign Tax Credit

A foreign nongrantor trust engaged in a trade or business within the U.S. (either directly or through investments in partnerships that are so engaged) that pays foreign income, war profits or excess profits taxes on income that is effectively connected with such trade or business may, subject to certain limitations, credit the foreign tax against its U.S. income tax liability.[96] Alternatively, it may deduct such taxes.[97]

The total amount of the credit:

a. is limited to the proportion of the U.S. tax against which such credit is taken as the trust's taxable income from foreign sources bears to its entire taxable income effectively connected with its U.S. trade or business;[98]

b. may not be used against any income tax imposed on income not effectively connected with such business;[99] and

c. is not allowed to the extent it is properly allocable under Code § 901(b)(5) to the trust's beneficiaries.[100]

In some cases foreign income, war profits or excess profits taxes will be imposed on the foreign grantor of a foreign nongrantor trust rather than on the trust itself. This would occur, for example, if the trust were treated as "owned" by its grantor under foreign tax rules similar to the so-called grantor trust rules set forth in Code §§ 671 through 679. There is no mechanism in the Code that permits the foreign nongrantor trust to credit the taxes paid by the grantor against the trust's U.S. income tax.[101]

Until the 1996 Act's imposition of significant limitations on the availability of grantor trust status for trusts created by non-U.S. persons, the absence of a credit mechanism was unlikely to be a problem. This was so because the U.S. grantor trust system is so broad that any trust treated as owned by its grantor under foreign tax law was also likely to be treated as owned by

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95 *See, e.g.*, Rev. Rul. 85-60, 1985-1 C.B. 187.

96 Code §§ 901(b)(4), 906(a).

97 Code § 164(a)(3). If the trust claims the credit, the deduction is not permitted. Code § 275(a)(4).

98 Code §§ 904(a) and 906(b)(2).

99 Code § 906(b)(3).

100 Code § 642(a).

101 Code § 901(b)(5). *See* III.B.2.d.

its grantor under U.S. tax law. Under current U.S. law, the absence of a credit mechanism can result in serious foreign tax credit misallocations.[102]

E. Tax Rates

1. Income Effectively Connected to a U.S. Trade or Business

This type of income is subject to the normal tax rates applicable to trusts under Code § 1 or Code § 55.[103] Code § 1(e) imposes a maximum tax rate of 39.6%; Code §1(h) imposes maximum tax rates between 15% and 28% on long term capital gains and between 15% and 20% on qualified dividend income.

2. Other Income

U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business, is subject to tax at a flat rate of 30%.[104] The reduced maximum tax rates applicable to dividend income of 15%[105] to 20% do not apply to income received by a foreign trust or any other nonresident alien.

F. Withholding

1. Income Effectively Connected With U.S. Trade or Business

Withholding is generally not required for income (including fixed or determinable annual or periodic income) to the extent it is effectively connected with a U.S. trade or business. Withholding obligations are, however, imposed on partnerships that have taxable income that is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business if such income is allocable under Code § 704 to a foreign partner.[106] The withholding rate applicable to foreign nongrantor trusts that are partners in such partnerships is the highest rate of tax specified in Code § 1.[107]

2. U.S. Real Property Interests

The transferee of a disposition by a foreign person of a U.S. real property interest is required to withhold. The Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"), P.L. 114-113, enacted on December 18, 2015, increased the applicable withholding rate from 10% to 15% of the amount realized for dispositions occurring after February 16, 2016.[108]

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[102] *See* discussion at III.B.2.d of credit that may be allowed to a foreign trust by regulation for foreign taxes imposed on its foreign grantor in certain circumstances.

[103] Code § 871(b)(1).

[104] Code § 871(a).

[105] § 302 of The Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law No. 108-27) added paragraph (11) to § 1(h) of the Code. This paragraph provides that the term "net capital gain" means "net capital gain . . . increased by qualified dividend income."

[106] Code § 1446(a). Such a partnership is required to file Form 8804 and to send Form 8805 to each such foreign partner.

[107] Code § 1446(b).

[108] Code § 1445(a).

The prior 10% withholding rate remains effective where the transferee acquires a personal residence and the purchase price does not exceed $1,000,000,[109] and for dispositions occurring on or before February 16, 2016.[110]

3. Fixed or Determinable Annual or Periodic Income

Code § 1441(a) requires any person paying any of the items of income listed in Code § 1441(b) to withhold a 30% tax (or lower treaty rate) to the extent such income constitutes gross income from U.S. sources of any nonresident alien individual or of any foreign partnership[111] unless such income is effectively connected with the conduct of a U.S. trade or business.[112] The income items listed in Code § 1441(b) are the various kinds of fixed or determinable annual or periodic income. Code § 1442 imposes a similar requirement with respect to the income of foreign corporations. Curiously, neither section refers to withholding with respect to the income of trusts. Nevertheless, the regulations state that income paid to a foreign trust is subject to the withholding requirements of Code § 1441. In general, withholding will be required unless the person paying any of the items listed in Code §1441(b) has received appropriate documentation indicating that withholding is not required (or that a lower rate of withholding applies) and the person does not have any reason to believe that the documentation is inaccurate.[113]

4. Effect of Tax Treaties

The principles described above may apply differently to foreign nongrantor trusts that are residents of countries with which the U.S. has an income tax treaty. For example, most income tax treaties to which the U.S. is a party reduce the tax imposed on dividends not effectively connected to a U.S. trade or business to 15% from 30%.

5. FATCA Withholding

Sections 1471 and 1472 of the Code, enacted as part of the Foreign Account Tax Compliance Act ("FATCA") provisions of the HIRE Act, require withholding of 30% of the amount of "withholdable payments"[114] made to foreign entities, which includes foreign trusts, unless the payee qualifies for an exemption from withholding.[115] Withholdable payments are U.S. source income including gross proceeds from the sale of property that produces U.S. source fixed or determinable annual or periodic income and certain "passthru payments."[116] Except for gains, withholding began June 30, 2014. Withholding for gains began January 1, 2017.[117] Passthru payments are not yet defined by applicable regulations. The subject is "reserved,"

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[109] Code § 1445(c)(4).

[110] Treas. Reg. § 1-1445(1)(h).

[111] The person withholding is required to file Form 1042 and to furnish Form 1042-S to the person from whom tax is withheld.

[112] Code § 1441(c)(1).

[113] Treas. Reg. § 1.1441-5(e).

[114] Treas. Reg. §1.1473-1(a) defines withholdable payments.

[115] Treas. Reg. §1.1471-2(a)(1) as modified by Notice 2013-43, 2013-31 I.R.B. 1. However, for trusts resident in a jurisdiction governed by a Model 1 Intergovernmental Agreement, withholding did not begin until January 1, 2015.

[116] A foreign passthru payment is one designed to avoid U.S. withholding by making indirect U.S. investments through foreign "blocker corporations" For example payments on debt instruments issued by a foreign blocker corporation would be a passthru payment to the extent the blocker corporation has U.S. assets.

[117] Treas. Reg. §1.1473-1(a)(1)(ii).

but the term has generally been described to mean foreign source payments to the extent they represent U.S. source income.[118] Withholding for passthru payments will not begin earlier than 6 months after regulations are issued defining passthru payments.[119]

Payments to accounts owned by estates are not subject to the new withholding rules.[120]

Eligible foreign entities will be issued identifying numbers called Global Intermediary Identification Numbers ("GIINs").[121] Eligible entities include participating foreign financial institutions ("FFIs"), registered deemed-compliant FFIs (discussed below) and FFIs resident in a country with which the U.S. has an agreement concerning FATCA. These numbers will be published to make it easier for payors to determine whether payments to a particular entity are subject to withholding. New W-8 BENE–E forms require foreign entities to identify their classification under FATCA. A FFI that doesn't have a GIIN will be subject to withholding unless an exemption applies.[122]

A trust will qualify for an exemption from withholding under different rules depending upon whether it is an FFI or a nonfinancial foreign entity (an "NFFE"). If the trust is an FFI, the trust can avoid withholding if it enters into an agreement with the IRS to become a "participating FFI" or it is either an exempt person[123] or a registered deemed-compliant FFI.[124] A trust that has primarily investment income and is professionally managed by an entity will be classified as an FFI.[125] A trust is "professionally managed" if the trustee is a trust company that provides fiduciary services to customers or the trustee hires a professional investment management company to manage investments. A trust managed by an individual trustee is not an FFI.

A trust will be a participating FFI if it enters into an agreement with the IRS to identify its beneficiaries and owners who are U.S. persons, specify their interests in the trust, withhold on distributions of withholdable payments to payees who are subject to withholding and file annual FATCA Reports (Form 8966).[126] FATCA reports for each year are due on March 31 of the following year.[127] The first FATCA Report was not due until March 31, 2015, and it reported information for 2014 but not earlier years.[128] In the case of a person whose beneficial interest is wholly discretionary, an FFI will report such person's beneficial interest for a particular year based on actual distributions made to the beneficiary during such year.[129]

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118 Treas. Reg. § 1.1471-5(h).

119 Treas. Reg. §1.1471-4(b)(4).

120 Treas. Reg. § 1.1471-5(b)(2)(iii).

121 Treas. Reg. § 1.1471-1(b)(57).

122 However, a sponsored FFI (described below) may use its sponsor's GIIN until January 1, 2016.

123 Some exemptions are described in Treas. Reg. §1.1471-5(e)(5).

124 Deemed-compliant FFIs are defined in Treas. Reg. § 1.1471-5(f).

125 Treas. Reg. §1.1471-5(e)(4)(i)(B); 1.1471-5(e)(4)(v) Examples 5 and 6.

126 Treas. Reg. §1.1471-4. The FFI agreement appears in Section 5 of Revenue Procedure 2014-38, 2014-3 I.R.B. 150 (June 27, 2014).

127 Treas. Reg. §1.1471-4(d)(3)(vi).

128 Notice 2013-43.

129 Treas. Reg. §1.1473-1(b)(3).

A trust may become a registered deemed-compliant FFI if an eligible sponsor registers as a sponsor with the IRS and agrees to "sponsor" the trust.[130] The sponsoring FFI handles reporting for the sponsored FFI. The same information is required as if the sponsored trust itself were a participating FFI. The sponsored FFI is a registered deemed-compliant FFI and should obtain its own GIIN.

A trust that is an FFI also can avoid withholding without becoming a participating FFI or a registered deemed-compliant FFI by becoming a certified deemed-compliant FFI. Categories of certified deemed compliant FFIs that are relevant to trusts include an "owner-documented FFI"[131] and a sponsored closely-held investment vehicle.[132]

An owner-documented trust would identify both U.S. and foreign beneficiaries to the "designated withholding agent" who then reports information about U.S. beneficiaries to the IRS.[133] Instead of filing an owners' report for all owners, both U.S. and foreign, the owner-documented FFI can obtain an auditor's letter from an auditor or attorney licensed in in the U.S. signed no more than 4 years prior to the date of payment that certifies that the trust is eligible to be an owner-documented FFI and provide to the withholding agent an owner reporting statement and Form W-9 for each U.S. beneficiary that owns an interest in the trust. A discretionary beneficiary who does not receive a payment is not an owner.[134] An owner-documented FFI is exempt from withholding only on payments made through the designated withholding agent who must be either a participating FFI, a U.S. institution or a reporting FFI under an IGA Model 1 agreement. An owner-documented FFI cannot obtain a GIIN.

A sponsored closely-held investment vehicle is an FFI that is sponsored by another FFI. The sponsored "investment vehicle" must enter into a contractual arrangement with a sponsoring person who must be a participating FFI, a reporting Model 1 IGA FFI or a U.S. financial institution under which the sponsor agrees to assume FATCA reporting responsibilities. The sponsored investment vehicle may not hold itself out as an investment vehicle for unrelated parties and 20 or fewer individuals must own all of the debt and equity interests, excluding debt held by participating FFIs, registered deemed-compliant FFIs and certified deemed-compliant FFIs, and equity interests owned by an entity if that entity owns 100 percent of the equity in the FFI and is itself a sponsored FFI.[135] Thus, this description would appear to include the underlying holding company of a trust and the sponsor may be the trustee of the trust if it is a participating FFI, a Model 1 IGA FFI or a U.S. financial institution. The sponsor must register with the IRS. The sponsoring entity provides all of the information on behalf of the sponsored FFI that the sponsored entity would have provided if it had been a participating FFI.

It is important for a trust that is an FFI to avoid FATCA withholding because the overwithheld tax generally is not refundable.[136] It can be refunded only if a treaty requires it and even then any refund is paid without interest. A foreign trust would not normally actually owe tax on gross proceeds, for example, but could not obtain a refund of the overpaid tax. Theoretically, a trust could avoid withholding by not investing in the United States so that no withholdable payments would be made to it. As a practical matter, however, it may be difficult for nonparticipating FFIs to open accounts with participating FFIs who may not want the added compliance burden imposed on them by having nonparticipating FFIs as account holders.

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[130] Treas. Reg. §1.1471-5(f)(1)(i)(F).

[131] Treas. Reg. §1.1471-5(f)(3).

[132] Treas. Reg. §1.1471-5(f)(2)(iii).

[133] Treas. Reg. §1.1471-3(d)(6)(iv).

[134] Treas. Reg. §1.1471-1(b)(89) defining "owner" to include a discretionary beneficiary who receives a distribution during the relevant year.

[135] Treas. Reg. §1.1471-5(f)(2)(iii).

[136] Treas. Reg. §1.1474-5(a)(2).

A trust that is not professionally managed (*i.e.*, has only individuals serving as trustees and investment managers) and that has primarily investment income will be classified as a passive nonfinancial foreign entity ("NFFE"). Most trusts classified as NFFEs will be able to avoid withholding either by certifying to the withholding agent that no U.S. beneficiary owns or is deemed to own as much as 10 percent of the beneficial interests in the trust or by disclosing the names of any such U.S. beneficiaries.[137] However, for purposes of the 10 percent test, beneficial interests of related persons are aggregated.[138] An NFFE, unlike an FFI, is not barred from obtaining a refund of overwithheld tax. Thus, the treatment of an NFFE is much more favorable than the treatment of an FFI.

An NFFE may elect to become a "direct reporting NFFE".[139] A direct reporting NFFE registers with the IRS, files annual FATCA reports but does not enter into a FFI Agreement.[140] A direct reporting NFFE also can be sponsored in the same manner as a trust that is an FFI may be sponsored.

6. Intergovernmental Agreements

The U.S. has entered into intergovernmental agreements ("IGAs") with 101 countries (85 of those agreements are in force, and 16 are signed but not yet in force) and has reached agreement in substance with 12 more.[141] Under previous guidance, Treasury has treated countries as having entered into an agreement if an agreement has been reached in substance even if it has not been signed or entered into force.[142] On July 29, 2016, Treasury announced that it will begin updating the IGA list to provide that certain jurisdictions that have not brought their IGA into force will no longer be treated as if they have an IGA in effect.[143] Under the IGAs, an alternative method of reporting is allowed in order to avoid withholding. An FFI in a FATCA Partner jurisdiction – a country which has entered into an IGA with the U.S. – generally is not required to withhold on withholdable payments made to nonparticipating FFIs or recalcitrant account holders or to close accounts of recalcitrant account holders if they report the information as required under the IGA.

FFIs in a FATCA Partner jurisdiction are not subject to the rule that prohibits a participating FFI from having affiliates that are nonparticipating FFIs. A FATCA Partner can have affiliates that are nonparticipating provided certain rules are followed to prevent abuse. A similar rule applies to FFIs in nonpartner jurisdictions but only until December 31, 2015.

There are two types of IGAs – Model 1 and Model 2. To date all but four of the IGAs in force are Model 1 IGAs. The only Model 2 IGAs are with Switzerland, Japan, Bermuda, Hong Kong and San Marino. Seven more pending IGAs are Model 2 IGAs. Under a Model 1 IGA, a trust resident in a FATCA Partner jurisdiction is deemed-compliant and eligible to obtain a GIIN. FFIs in Model 1 jurisdictions report to tax authorities in the FATCA Partner jurisdiction. The tax authorities in

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137 Treas. Reg. §1.1472-1.

138 Treas. Reg. §1.1473-1(b)(2)(v).

139 Treas. Reg. §1.1472-1T(c)(4).

140 Treas. Reg. §1.1472-1T(c)(3).

141 A list of jurisdictions is found at https://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx.

142 Announcement 2014-17.

143 Announcement 2016-27. Jurisdictions that wish to continue to be treated as having an IGA in effect must provide to Treasury by December 31, 2016 a detailed explanation of why it has not yet brought the IGA into force and a step-by-step plan that it intends to follow in order to sign the IGA (if not yet signed) and bring it into force, including expected dates for achieving each step. In deciding whether to treat a jurisdiction as having an IGA in effect, Treasury will consider whether the jurisdiction has submitted a plan and whether the jurisdiction's entire course of conduct demonstrates "firm resolve" to bring the IGA into force.

the FATCA Partner jurisdiction share that information with the IRS.[144] A trust resident in the FATCA Partner jurisdiction, unlike a participating FFI, is not obligated to assume withholding responsibilities on withholdable payments made to nonparticipating FFIs or recalcitrant account holders.[145] FFIs that are exempt from reporting to local tax authorities under the Model 1 IGA (such as retirement plans and small local banks) are deemed to be FATCA compliant.[146]

Trusts resident in a Model 2 IGA, if the trusts are FFIs, have the same obligations as trusts resident in jurisdictions that don't have an IGA except to the extent modified in the IGA. Thus they register with the IRS as participating FFIs but the FFI agreement they enter into with the IRS is modified. One modification is that the Model 2 FFI need not withhold on payments to recalcitrant account holders if the FFI complies with the IGA, and recalcitrant accounts need not be closed if the FFI reports required information to the IRS.[147] Under a Model 2 IGA, a reporting Model 2 FFI is required to report on Form 8966 certain aggregate information regarding accounts treated as non-consenting U.S. accounts. The IRS then will make government-to-government exchange of information requests to obtain information about the accounts. FFIs must ask account owners to waive restrictions on providing information about their accounts and cannot continue to open new accounts whose owners do not consent to waive restrictions on exchange of information concerning the accounts.

A trust that is resident in a FATCA Partner jurisdiction is deemed-compliant if the trust complies with the requirements of the IGA.

The reporting rules under IGAs are different from those under Treasury regulations in a number of respects. Under the IGA, a trust that is not an FFI must identify all "controlling persons" who are U.S. persons.[148] In the case of a trust, controlling person means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. Despite the adjective "controlling," it appears that the settlor and beneficiary must be identified even if they have no control. A trust that is an FFI must identify U.S. persons who are deemed to have equity interests in the trust. This includes the settlor, the beneficiaries and any other natural person exercising ultimate effective control over the trust.[149] A beneficiary includes a person who is eligible to receive distributions as well as a person who is entitled to mandatory distributions. The IGA is silent as to whether holders of future interests must be disclosed. However, Guidance Notes for some IGAs imply that a person who has a future interest may have to be disclosed, but a person who is a wholly discretionary beneficiary of a trust who has not received a distribution in the relevant period may not have to be disclosed.[150]

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144 IGA Article 4 paragraph 1.

145 IGA Article 4 paragraph 1 e) (unless the entity is a qualified intermediary, withholding partnership or withholding trust) but the entity is required to provide information to the 'immediate payor' of the US source withholdable payment required for withholding to occur.

146 Annex II of the IGA contains the relevant exemptions.

147 IGA Article 3 paragraph 2.

148 IGA Article I paragraph 1 mm) defines controlling persons and Article 2 paragraph 2 a) 1) requires identification and reporting.

149 IGA Article I paragraph t. The only difference between this definition and the definition of "controlling person" is the absence of a specific reference to trustee and protector in the list of U.S. persons who must be reported, although, if a trustee or protector is an individual, such individual would seem to fall within the category of "natural persons exercising ultimate effective control." Possibly this definition extends to require reporting of U.S. individuals who control a trustee or protector that is an entity.

150 Section 6.8 of the Guidance Notes (Cayman Islands, issued 7/22/2014) provides that the value of a settlor's interest is the value of the entire trust if the trust is revocable, if the settlor is a beneficiary or the settlor has a

Footnote continued on next page

Another significant change is to create a new category for trusts – "trustee-documented trusts" – which allows an eligible trustee to report on behalf of the trusts it administers, obviating the need for the trusts themselves to register with the IRS (or to have a sponsor register on their behalf). Annex II provides the following definition of trustee-documented trust:

> A trust established under the laws of [a FATCA Partner] to the extent that the trustee of the trust is a Reporting U.S. Financial Institution, Reporting Model 1 FFI, or Participating FFI and reports all information required to be reported pursuant to the Agreement with respect to all U.S. Accounts of the trust. Such a trust is a Non-Reporting [FATCA Partner] Financial Institution treated as a certified deemed-compliant FFI for purposes of section 1471 of the U.S. Internal Revenue Code.

Notice 2013-43 gave Model 1 FFIs additional time to comply with FATCA. A Model 1 FFI was not subject to withholding until January 1, 2015 and did not need to obtain a GIIN before that date.

G. Taxable Year; Reporting

1. Taxable Year and Estimated Tax Payments

Foreign nongrantor trusts must adopt a calendar taxable year and are required to make estimated income tax payments in the same manner as U.S. trusts.[151]

2. U.S. Nonresident Alien Income Tax Return – Form 1040NR

The trustee of a foreign nongrantor trust is required to file Form 1040NR for a particular year if:

a. the trust was engaged in trade or business in the U.S. during such year even if no income was derived from such trade or business; or

b. the trust had income in such year that is subject to tax in the U.S. unless the trust's liability for such tax is fully satisfied by withholding.[152]

c. The trust was a U.S. trust for a portion of the year and a foreign trust at the end of the same year.[153]

Footnote continued from previous page

power of appointment. If none apply, the settlor's interest is reportable at nil value. The value of a mandatory beneficiary's trust interest is the net present value of amounts payable in the future. The value of a discretionary beneficiary's interest is the amount paid in the relevant reporting period. The Guidance Notes are silent about whether a discretionary beneficiary's interest is reportable at nil value if no distributions are made, or is not reportable at all. Section 12.20 says that no due diligence *or reporting* is required if the beneficiaries have not been identified or cannot be determined. Similarly, section 3.8 of the U.K. Guidance Notes (August 29, 2014) provides that a U.S. person is a beneficiary whose interest is reportable if distributions are required to be made to such person or if he or she is a discretionary beneficiary if such person received a distribution. The Guidance Notes don't specify whether the distribution must be made during the relevant reporting period.

[151] Code §§ 6654(a) and 6654(l); Notice 87-32, 1987-1 C.B. 477.

[152] Treas. Reg. § 1.6012-1(b).

[153] CCA 201432022 (8/8/2014); Treas. Reg. § 1.6012-1(b)(2)(ii). If the trust was a foreign trust during a portion of the year and a U.S. trust at the end of the year, the trust must file Form 1041 reporting the income from the

Footnote continued on next page

If a foreign nongrantor trust is required to file Form 1040NR for a particular year, the return must be filed by the 15th day of the 6th month following the close of the year if the trust does not have an office or place of business in the U.S. If the trust does have an office or place of business in the U.S., its Form 1040NR must be filed by the 15th day of the 4th month following the close of the year.[154]

3. Report of Foreign Bank and Financial Accounts – Fin CEN Form 114

A U.S. trustee of a foreign nongrantor trust must file Fin CEN Form 114 if she has a financial interest in or signature authority or other authority over any financial accounts, including bank, securities, or other types of financial accounts in a foreign country if the value of such accounts exceeds $10,000. A person has a financial interest in any such account if she has legal title to it. Trustees generally have legal title to accounts in which trust funds are invested. In addition, if legal title to an account is held by a corporation or partnership and the trustee owns more than 50% of the corporation or partnership, the trustee will be treated as having a financial interest in such account. A person has signature authority over an account if she can control the disposition of account property by the delivery of a document signed by her and one or more other persons. A person has other authority over an account if she can control such disposition by direct communication to the person with whom the account is maintained.

Fin CEN Form 114 must be filed by April 15th of the year following the year in which the U.S. person had such financial interest or signature or other authority. An automatic six-month extension of time to file is allowed and no request for an extension is necessary.[155] Forms 114 are required to be filed electronically.[156]

4. Taxpayer Identification Numbers

Code § 6109 requires persons to obtain a U.S. identifying number to the extent required by regulations. Treas. Reg. § 301.6109-1(b) requires a foreign nongrantor trust (or any other nonresident alien) to obtain a U.S. taxpayer identification number if:

a. it has income effectively connected with a U.S. trade or business;

b. it has a U.S. office or place of business;

c. it files a U.S. income tax return or refund claim; or,

d. after December 31, 1998, it furnishes a withholding certificate claiming a reduced tax rate under a treaty (other than for dividends and interest from stocks and debt that are actively traded and certain other

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portion of the year it was a U.S. trust, enter "Dual-Status Return" across the top and attach a statement showing the income from the portion of the year it was a foreign trust. If the trust was a U.S. trust during a portion of the year and a foreign trust at the end of the year, the trust must file Form 1040NR, enter "Dual-Status Return" across the top and attach a statement (usually Form 1040) as a schedule showing income for the part of the year that the trust was a U.S trust.

[154] Treas. Reg. § 1.6072-1; T.D. 7426.

[155] https://www.fincen.gov/news/news-releases/new-due-date-fbars-0

[156] FR Doc. 2012-4756, 77 Fed. Reg. 12367 (2012); Fin CEN Mandatory E-Filing FAQs, www.Fincen.gov/forms/e-filing_FAQs.html.

securities), or an exemption from withholding from income that is effectively connected with a U.S. trade or business.

The PATH Act amended Code § 6109 to add Code § 6109(i), which modifies certain rules relating to taxpayer identification number ("TIN") procedures and provides that a TIN not used on a federal tax return for three consecutive years, either as the TIN of an individual who files the return or as a TIN of a dependent on the return of another taxpayer, will expire on December 31st of the third consecutive year of nonuse. Notice 2016-48[157] explains those changes, how the IRS will implement them, and the potential consequences to taxpayers who do not renew a TIN when required by Code § 6109(i).

III. TAX TREATMENT OF U.S. BENEFICIARIES OF FOREIGN NONGRANTOR TRUSTS

A. In General

U.S. taxpayers who are beneficiaries of foreign nongrantor trusts may be subject to U.S. income taxes on distributions of cash or other property received from such trusts. In some cases, loans made to them or to persons related to them from such trusts will be treated as distributions.

The determination of the U.S. tax liability of a U.S. beneficiary with respect to distributions and loans depends on a number of factors, including whether the distribution was made during a year in which the foreign nongrantor trust earned income and the relationship between the size of that income and the value of the distributions made in that year to the U.S. beneficiary and to other trust beneficiaries, whether, if the amount of the trust's distributions exceeded the amount of its income for the year of distribution, the trust had undistributed income accumulated from prior years, and whether the trust previously paid U.S. income tax or foreign income tax.

U.S. beneficiaries of foreign trusts may also be subject to tax on income earned by certain corporations whose shares are owned by the trust. The types of corporations that are the source of such potential liability are controlled foreign corporations and passive foreign investment companies. This subject is discussed more fully below.

B. Distributions of Income in the Year Earned

1. General Rules

a. Distributable Net Income

A U.S. beneficiary of a foreign nongrantor trust is required to include in her gross income for any particular year:

(1) the amount of any trust income in such year required to be distributed to her from a so-called "simple trust" (whether or not actually distributed to her) to the extent of her share of the trust's distributable net income ("DNI") for the year;[158]

(2) the amount of any trust income required to be distributed to her in such year from any other foreign nongrantor trust, a "complex trust" (whether or not actually distributed to her), to the extent of her share of the trust's DNI for the year;[159] and

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[157] 2016-33 I.R.B. 235, August 4, 2016.

[158] Code § 652(a). The term "simple trust" refers to a nongrantor trust that is required to distribute income, is not permitted to make payments to charity and that, in the year for which the characterization is made, makes no principal distributions.

(3) any other amount required to be distributed to her (whether or not actually distributed to her) or properly and actually distributed to her from a foreign complex trust in a such year to the extent of her share of the trust's DNI for such year.[160]

b. Determining a Beneficiary's Share of DNI

In the case of a simple trust, if the amount of income distributions required to be made exceeds the trust's DNI, each beneficiary shares in the trust's DNI in the proportion that the amount of income required to be distributed to her bears to the amount of income required to be distributed to all beneficiaries.[161] The same rule applies to income distributions from complex trusts.[162]

If a complex trust's DNI exceeds the amount of income required to be distributed to its beneficiaries and if there are other amounts either required to be distributed or properly distributed to a beneficiary, that beneficiary will share in the trust's remaining DNI in the proportion that the amount of the trust's distribution (or required distribution) to her bears to the amount of all such distributions (or required distributions) to all beneficiaries.[163]

Consider the following example:

> **Example 2:** Kate is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). Under the terms of the trust all income is (and always has been) required to be distributed currently to Kate's mother, M, a nonresident alien. The trustees are permitted to make principal distributions to Kate. In 2010, the trust's income (and its DNI) consisted of $100,000 of dividends from foreign corporations, all of which were distributed to M. FNT has never had any income from capital gains. The trustees made a principal distribution of $100,000 to Kate. Kate is not required to include any portion of the $100,000 distribution in her gross income.

c. Meaning of "Income"

For purposes of these rules, the term "income" (unless part of the phrase "taxable income," "distributable net income," "undistributed net income," or "gross income") means the amount of income for the taxable year of the trust determined under the terms of the governing instrument and applicable local law.[164] To avoid confusion, this outline refers to "income" as "trust accounting income." The term "income" or "trust accounting income" is generally used to describe for local law purposes the amount required or permitted to be distributed to current trust beneficiaries when the terms of the trust instrument require or permit trust income, but not trust principal, to be distributed to such beneficiaries. The items that are included in the term "income" or "trust accounting income" vary from jurisdiction to jurisdiction. There is no standard federal definition. The term generally includes items such as dividends and similar distributions made with respect to investments in business or investment

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[159] Code § 662(a)(1). The term "complex trust" refers to a nongrantor trust other than a simple trust.

[160] Code § 662(a)(2).

[161] Code § 652(a).

[162] Code § 662(a)(1).

[163] Code § 662(a)(2).

[164] Code § 643(b).

entities, interest, and rent. It generally excludes gains from the disposition of property. Trust provisions that define income in a manner that departs fundamentally from local law are not recognized for purposes of this definition.[165]

d. Sixty-Five Day Election

At the trustee's election, an amount that is properly paid to a beneficiary within 65 days after the end of a taxable year will be treated as having been paid to her within such taxable year.[166] The amount to which the election applies may not exceed the amount of income of the trust for the prior taxable year or the DNI for such year, if greater, reduced by amounts paid, credited or required to be distributed in such year calculated without regard to the election.[167] For example, a distribution made within 65 days after the close of a year cannot be treated as a distribution of UNI made in the earlier year.

e. Specific Gifts

An amount that the trust instrument requires to be paid to a beneficiary as a gift of a specific sum of money or of specific property and which is actually paid to her all at once or in no more than three installments is not treated as a distribution and, therefore, is not included in the gross income of the U.S. beneficiary. This exception does not apply to amounts that can be paid only from trust income.[168]

Consider the following example:

> **Example 3:** Pat is a U.S. beneficiary of FNT, a foreign nongrantor trust. The terms of the trust document require the trustees of FNT to pay Pat $1,000,000 on his 30th birthday. Pat reached age 30 during 2010, a year in which FNT's income and DNI exceeded $1,000,000. FNT's principal in that year was worth $10,000,000. Pat is not required to include the $1,000,000 paid to him by FNT in his gross income.

f. Distributions of Property Other Than Cash

The amount of any distribution to a beneficiary of property other than cash (other than a required distribution of trust accounting income or other fixed amount[169]) is the lesser of the trust's basis in the property or its value at the time of distribution unless the trustee makes an election to recognize gain on the distribution. If the trustee makes such an election, the amount of the distribution will be the value of the property. The trust will recognize gain equal to the excess of the value of the property over its basis. If the trustee does not make the election, the beneficiary's basis will be the same as the trust's basis.[170]

Consider the following example:

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[165] Treas. Reg. § 1.643(b)-1.

[166] Code § 663(b).

[167] Treas. Reg. § 1.663(b)-1(a)(2).

[168] Code § 663(a)(1). If the fixed amount exceeds the value of property contributed to the trust, such amount necessarily has to be paid partly from income.

[169] The distribution of appreciated property by a trustee to a beneficiary in satisfaction of the beneficiary's right to receive trust accounting income or other fixed amount is a recognition event. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton,* 15 F.Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936). Cf. Treas. Reg.§ 1.664-1(d)(5).

[170] Code § 643(e).

> **Example 4:** Jenny is a U.S. beneficiary of FNT, a foreign nongrantor trust. During 2010, the trustees of FNT distributed 100 shares of X corporation stock to her. The shares were worth $1,000,000 at the time of distribution. The trust's basis in the shares was $1,000. FNT's income and DNI in 2010 exceeded $1,000,000. The trustees did not make the election described above to recognize gain on the distribution. Jenny will not be required to include any amount in excess of $1,000 in her gross income on account of the distribution. Her basis in the X shares will be $1,000.

These general rules are no different than the rules that apply to U.S. beneficiaries of U.S. nongrantor trusts.

However, a trust must recognize gain on the distribution of appreciated property to a "covered expatriate" who is subject to tax under § 877A in an amount equal to the excess of the property's then fair market value over basis.[171]

2. Special Rules Applicable to Nongrantor Trusts That Are Foreign

a. Different Definition of Distributable Net Income

Generally, the DNI of a U.S. nongrantor trust for a particular year is equal to its taxable income for that year adjusted by adding to taxable income the amount deducted as a personal exemption, the amount of its tax exempt income, and the amount of the trust's deduction for distributions to beneficiaries and by subtracting from taxable income the trust's capital gains except to the extent such capital gains are "paid, credited or required to be distributed to any beneficiary during the taxable year."[172]

The DNI of a foreign nongrantor trust includes its capital gains.[173] In addition, a foreign nongrantor trust's DNI includes the amount of its income from non-U.S. sources reduced by amounts which would be deductible in connection with such income in the absence of Code § 265[174] and the amount that was excluded from its gross income by treaty under Code § 894.[175]

Consider the following example:

> **Example 5:** John is a U.S. beneficiary of FNT, a foreign nongrantor trust. During 2010 the trust had foreign source dividend income of $10,000 and long term capital gain from the sale of securities of $10,000. Its U.S. gross income and taxable income is zero. The trust distributed $15,000 to John. It neither made nor was required to make distributions to any other beneficiary. The trust's DNI was $20,000. John's gross income from the trust, therefore, is $15,000. If FNT had been a U.S. trust, its DNI would have been only $10,000, and John's gross income on account of his distribution from the trust would have been $10,000.

The special calculation of DNI applicable to foreign trusts is not applicable to foreign estates. Capital gains and foreign source income are not included in the calculation of the DNI of a foreign estate. This rule should apply to a trust that

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171 Code § 877A(f)(1)(B). The trustee is required to withhold 30% of the taxable portion of the distribution. In the case of a U.S. trust, the "taxable portion" would not ordinarily include the amount of gain triggered by the distribution. Code § 877A applies to certain persons who expatriate on or after June 17, 2008.

172 Code § 643(a)(3).

173 Code § 643(a)(6)(C).

174 Code § 643(a)(6)(A).

175 Code § 643(a)(6)(B).

elects to be treated and taxed as part of an estate.[176] In some cases the election to recognize gain permitted by § 643(e) on a distribution of appreciated property could produce a tax-free basis adjustment for the beneficiary.

b. Tax Character of Distributions

The tax character of distributions received by a beneficiary in a particular year reflects the character of the trust's income for that year proportionately.[177]

> **Example 6:** John, the U.S. taxpayer in the above example, who received a $15,000 distribution from FNT, which had dividend income of $5,000, interest income of $5,000 and long term capital gains of $10,000, will be treated as having received dividend income of $3,750, interest income of $3,750, and long term capital gains of $7,500. The dividend income may be eligible for the 15% maximum rate of tax on dividend income.

If the trust document or local law requires that particular types of trust income be allocated to particular beneficiaries and if such requirement has economic significance independent of the tax consequences, the character of the amounts received by the beneficiaries will reflect such required allocation.[178]

> **Example 7:** The terms of FNT, the foreign nongrantor trust described in the example above, required that all of FNT's dividend and interest income be distributed annually to F, John's nonresident alien father. F will be treated as having received all of the ordinary income included in the trust's DNI. John's $15,000 distribution, therefore, will consist of $10,000 of long term capital gains. The balance of $5,000 will not be included in his gross income.

c. Credit for U.S. Withholding Tax

As discussed above, if the foreign nongrantor trust had fixed or determinable annual or periodic income or income from the disposition of U.S. real property interests, it is likely that the trust paid U.S. income tax on such income through withholding under Code § 1441 or Code § 1445. The IRS takes the position that a U.S. beneficiary who receives a distribution from a foreign nongrantor trust that includes U.S. source income from which U.S. tax has been withheld must include in her gross income not only the amount she actually receives but also the amount of the withheld tax. She may then credit the withheld tax against her personal income tax liability.[179]

> **Example 8:** FNT, the foreign nongrantor trust described in the above example, had, in addition to its $10,000 of foreign source dividend income and $10,000 of long term capital gains, $10,000 of dividends on U.S. securities from which $3,000 of tax was withheld. FNT distributed $13,500 to John. John will be treated as having received a distribution of $15,000 consisting of foreign source dividend income of $5,000, long term capital gains of $5,000, and U.S. dividend income of $5,000. The U.S. dividend income has been "grossed-up" by his $1,500 share of the taxes withheld from it. The $1,500 will be credited against his U.S. income tax.

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[176] Code §645.

[177] Code §§ 652(b) and 662(b).

[178] Code §§ 652(b) and 662(b); Treas. Reg. §§ 1.652(b)-2(a) and 662(b)-1.

[179] Treas. Reg. §§ 1.1441-3(f) and 1.1462-1(b); Rev. Rul. 56-30, 1956-1 C.B. 646; Rev. Rul. 55-414, 1955-1 C.B. 385.

d. Credit for Foreign Income Taxes Paid by Trust

A U.S. person who pays income, war profits or excess profits tax to a foreign country may credit the amount of such taxes against her U.S. income tax liability or may claim such taxes as an itemized deduction.[180] The total amount of the credit is limited to the proportion of the tax against which such credit is taken as her taxable income from foreign sources bears to her entire taxable income.[181]

If a foreign nongrantor trust pays such foreign taxes, its U.S. beneficiaries who receive distributions of income on which such taxes have been paid may elect to take a credit for the share of foreign taxes attributable to their share of the income or a deduction.[182] The credit is subject to the limits described above.

Neither the Code nor the regulations explain whether the beneficiary must include in her gross income the amount of foreign taxes paid with respect to the income distributed to her if she elects to take the credit. The IRS's internal position seems to require such inclusion. The current edition of the IRS's foreign trust training manual provides the following guidance for its agents:

> "While many foreign trusts are established in countries having no income taxes, such as Bermuda or the Bahamas, some are established in countries with income taxes. Some also pay taxes to other countries where they have investments.
>
> In either case, a U.S. citizen or resident taxed on the income of such a trust may claim credit for his/her allocable share of foreign income taxes paid by the trust. If the credit is claimed, the amount of income reported should be grossed up to include the foreign taxes paid.
>
> The taxpayer may deduct the taxes instead if he/she chooses. Failure to gross up trust income should be regarded as an election to take a deduction."[183]

If foreign income, war profits or excess profits taxes are imposed on a foreign nongrantor trust's non-U.S. grantor or on another non-U.S. person rather than on the trust itself and if the trust would have been treated as owned by the grantor or such other person under subpart E of the Code but for Code § 672(f), Code § 901(b)(5) may permit these taxes to be treated for foreign tax credit purposes as if they had been imposed on the trust.[184] Unfortunately, the implementation of this portion of Code § 901(b)(5) appears to require regulatory action, which has not yet occurred.

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180 Code §§ 901(a) and 164(a)(3). An election to take the credit precludes the deduction. Code § 275(a)(4). The election may affect the calculation of state income taxes where the state allows a deduction for foreign taxes but not a credit.

181 Code § 904(a).

182 Code § 901(b)(5).

183 "Foreign Trusts and the IRS," 1997 Training 3325-002 (05-97), 98 TNI 149-44. The manual cites no authority for this conclusion. Its discussion of the issue is quite similar to Howard Zaritsky's speculation as to how the issue should be resolved in Zaritsky, U.S. Taxation of Foreign Estates, Trusts and Beneficiaries, 854 T.M. A-32.

184 *cf* p. 23.

C. Distribution of Income Accumulated in a Prior Year – the "Throwback Rules"

1. In General

If a foreign nongrantor trust makes distributions in excess of its DNI for a particular year, the U.S. beneficiaries who receive such distributions are likely to be required to include such distributions in their gross incomes, may be required to calculate their U.S. income tax on such distributions under a complex rule generally referred to as the "throwback rule" and may be subject to interest on these taxes.

2. Accumulation Distributions

a. In General

The throwback rule and its accompanying interest charge apply only if the foreign nongrantor trust has made an "accumulation distribution." An accumulation distribution is a distribution under Code § 661(a)(2) (dealing with amounts properly paid or credited or required to be distributed other than trust accounting income required to be distributed currently) to the extent such distribution exceeds the trust's DNI for the year reduced (but not below zero) by trust accounting income required to be distributed currently.[185]

The following two important exceptions to this definition may be applicable to distributions from foreign nongrantor trusts:

b. Exceptions

(1) Specific Gifts

A distribution in satisfaction of a gift of a specific sum of money or of specific property described in Code § 663(a)(1) (described above) is not an accumulation distribution.[186]

> **Example 9:** FNT, the foreign nongrantor trust described above of which Pat is a beneficiary had no DNI in the year in which Pat reached age 30. The trustees distributed the sum of $1,000,000 to Pat as they were required to do under the terms of the trust instrument. The distribution to Pat is not an accumulation distribution.

(2) Distributions Not in Excess of Trust Accounting Income

Distributions that do not exceed trust accounting income in the year in which made are not accumulation distributions. The Code establishes this exception with the following text:

> "If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year, there shall be no accumulation distribution for such year."[187]

This principle is illustrated by the following example:

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[185] Code § 665(b).

[186] Treas. Reg. § 1.665(b)-1A(c)(1).

[187] Code § 665(b). The word "income" in this quotation refers to "trust accounting income."

Example 10: Isaac is a U.S. beneficiary of FNT, a foreign nongrantor trust. The terms of the trust permit the trustees to distribute income and principal to any one or more beneficiaries at such times and in such amounts that they believe appropriate. In 2010, FNT received $100,000 in dividends from foreign corporations. It paid trustee commissions of $60,000, $40,000 of which was allocable to principal and $20,000 of which was allocable to income. Its trust accounting income for the year was $80,000, $100,000 reduced by the $20,000 of expenses chargeable to income. Its DNI was $40,000, $100,000 reduced by the total amount of the trustee commissions. The trustee distributed $80,000 to Isaac. The distribution is not an accumulation distribution because it is not in excess of trust accounting income.

c. Default Method of Calculating an Accumulation Distribution

In some cases the U.S. beneficiary of a foreign nongrantor trust will not have received sufficient information about her distribution and the trust to enable her to determine whether or not she has received an accumulation distribution. Notice 97-34[188] and the current version of IRS Form 3520 (2015) gives her a so-called "default" method of making this determination. A beneficiary is required to use this method if the trust did not provide her with a Foreign Nongrantor Trust Beneficiary Statement.[189] Even if the trust did provide her with such a statement, she nevertheless may elect to use the default method.

The required steps of the default method are as follows:

Step 1 -- Calculate the total amount of distributions the beneficiary has received from the foreign nongrantor trust during the three prior years.

Step 2 -- Multiply the total by 1.25.

Step 3 -- Divide the product determined in Step 2 by the lesser of 3 or the number of years the trust has been in existence (other than those years in which it was treated as a grantor trust).

The amount treated as a distribution of current income will be the smaller of the actual distribution or the amount determined in Step 3. The balance of the distribution will be treated as an accumulation distribution. If the default method is used, the number of years used for purposes of calculating the interest charge under Code § 688, as discussed below, will be one-half of the number of years the trust has been in existence.[190]

Consider the following example:

Example 11: Joshua is the beneficiary of FNT, a foreign nongrantor trust that has been in existence since 1998. At the end of 2006 the FNT had assets worth $20,000,000. In each of the

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188 1997-1 C.B. 422.

189 IRS Form 3520, Line 30 (2013). Presumably the IRS's authority for enforcing this requirement is found in Code § 6048(c)(2)(A), which provides,

> "If adequate records are not provided to the Secretary to determine the proper treatment of any distribution from a foreign trust, such distribution shall be treated as an accumulation distribution includible in the gross income of the distributee under chapter 1."

The information that must be furnished in a Foreign Grantor Trust Beneficiary Statement is described below.

190 Code § 6048(c)(2)(B).

years 1998 through 2006, FNT earned $1,000,000. Assume FNT has no income in 2007, 2008, 2009 and 2010 and that FNT distributes $2,000,000 to Joshua in each such year. The amount of Joshua's accumulation distribution in each year would be $2,000,000 under Code § 665(b). His situation would be improved considerably by using the default method.

In 2007, the accumulation distribution under the default method would be the full $2,000,000 because there were no distributions in any of the prior three years.

In 2008, the amount of the accumulation distribution is reduced to $1,166,667 ($2,000,000 - ($2,000,000 X 1.25/3)).

In 2009, the amount of the accumulation distribution is reduced to $333,333 ($2,000,000 - ($4,000,000 X 1.25/3)).

In 2010, the amount of the accumulation distribution is reduced to 0 ($2,000,000 - (6,000,000 X 1.25/3).

Because the default method of calculating the amount of an accumulation distribution can have the effect of significantly reducing that amount, the use of this method can significantly reduce the interest imposed on the taxes paid on accumulation distributions.

d. Undistributed Net Income

(1) In General

"Undistributed net income" ("UNI") limits the amount of an accumulation distribution that will be subject to tax. If a foreign nongrantor trust has no UNI, no tax will be imposed on its accumulation distributions. A trust's UNI for any particular year is equal to the amount by which its DNI for such year exceeds the sum of:

(i) the amount of trust accounting income required to be distributed in such year;

(ii) the amount of any other amount properly paid or credited or required to be distributed for such year; and

(iii) the amount of any taxes imposed on the trust that are attributable to its DNI for the year.[191]

(2) Addition of Taxes

The taxes taken into account in the UNI calculation include U.S. income taxes and foreign income, war profits and excess profits taxes that are imposed on the trust and that are allocable to the undistributed portion of the trust's DNI.[192] In addition, if any such taxes are imposed on a foreign nongrantor trust's non-U.S. grantor or any other non-U.S. person and if that person would have been treated as the owner of the trust under the normal grantor trust rules but is prevented from being treated as the owner by Code § 672(f), these taxes may also reduce the trust's UNI.[193] Unfortunately, the effectiveness of the portion of the Code that permits such reduction appears to require regulatory action, which has not yet occurred.

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191 Code § 665(a).

192 Code § 665(d).

193 Code § 665(d)(2).

(3) Reduction of UNI

The original UNI for a particular year of a trust will be reduced by accumulation distributions made in later years to the extent that such distributions are deemed to have been made in such year under Code § 666(a).[194] A distribution paid or used for charitable purposes within the meaning of Code § 642(c) is not treated as an accumulation distribution.[195] As a result, such distributions do not reduce UNI.

If distributions are made under the default method which in fact exceed DNI, do those distributions reduce UNI for purposes of determining whether there is an accumulation distribution in the final year of the trust if the trust then switches to the actual method? Consider the following example:

> **Example 12:** Trust worth $2,000X has $60x of UNI at the beginning of 2010. In 2010, the trust has gain of $100x which is distributed to beneficiaries. The trust has no DNI in any subsequent year, but distributes $41.67 in 2011 and $18.33 in 2012 using the default method so that there is no accumulation distribution. The trust terminates in 2013 and distributes the balance of the assets. If the distributions made under the default method carry out UNI (which the distributions would have had the default method not been used), then there is no accumulation distribution in 2013. This seems to be the correct result and the logical consequence of allowing trusts to revert to the actual method in the final year of the trust.

(4) Default Method of Calculating UNI

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, the instructions to Internal Revenue Service Form 3520, in effect, require her to assume that the trust's UNI is at least equal to the amount of the accumulation distribution.

e. Calculation of Throwback Tax on an Accumulation Distribution

(1) In General

If a beneficiary has received an accumulation distribution from a foreign nongrantor trust, the "throwback tax" on the distribution can be calculated by following the complex series of steps outlined below. The steps are intended to produce a rough approximation of the tax the beneficiary would have been required to pay if the foreign nongrantor trust had paid income to her in the year earned instead of accumulating it and paying it to her in a later year.

(2) The Steps

Step 1 -- Allocate the accumulation distribution among the preceding years of the trust for which there is any remaining UNI, starting with the earliest such year.[196] If the amount of the accumulation distribution exceeds the UNI for the earliest year, the excess is allocated to the next year for which there is any remaining UNI. The process continues in the same manner until all of the accumulation distribution has been allocated to a preceding year. Each portion of an accumulation distribution allocated to a particular preceding year is deemed to have been distributed on the last day of such year.

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[194] Treas. Reg. § 1.665(a)-1A(c).

[195] Treas. Reg. § 1.665(b)-1A(c)(2).

[196] Code § 666(a). If the trust's records are not sufficient to establish which years have UNI, the accumulation distribution will be allocated to the earliest year that the trust was in existence. Code § 666(d).

Example 13: Michael is a U.S. beneficiary of FNT, a foreign nongrantor trust. FNT was created in 1997 by Michael's non-U.S. mother. FNT distributed $100,000 to Michael in 2004, a year in which FNT's DNI and trust accounting income was $20,000. Therefore, $80,000 of the distribution is treated as an accumulation distribution. FNT's DNI, none of which was distributed, in each of its preceding years was as follows:

1997 - $4,000

1998 - $20,000

1999 - $30,000

2000 through 2003 - $40,000

Michael's $80,000 accumulation distribution is deemed to have been made $4,000 on the last day of 1997, $20,000 on the last day of 1998, $30,000 on the last day of 1999, and $26,000 on the last day of 2000.

Step 2 -- Add to the amount deemed, under Step 1, to have been distributed on the last day of a preceding year the taxes that were imposed on such amounts in such year.[197] Such taxes include U.S. income taxes and foreign income, war profits and excess profits taxes.[198]

Example 14: Assume that FNT, the trust described in the preceding example, paid taxes in each of its preceding taxable years equal to 40% of its DNI. The total amount deemed to have been distributed to Michael on the last day of each of 1997, 1998, 1999 and 2000 will be $5,600, $28,000, $42,000 and $36,400, respectively. The total amount deemed distributed or "thrown back" will be $112,000.

Step 3 -- Determine the number of preceding taxable years in which a distribution is deemed to have been made.[199] For purposes of this calculation, if any year's deemed distribution is less than 25% of the total amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated, that year will not be included.[200]

Example 15: In the above example the number of preceding taxable years in which a distribution is deemed to have been made will be 3. The year 1997 is disregarded because the amount of the accumulation distribution allocated to that year ($4,000) is less than 25% of the total

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197 Code § 666(b) and (c).

198 Code § 665(d). If the beneficiary has received distributions from more than two trusts that are deemed to have been distributed to her on the last day of the same preceding taxable year, the taxes that were imposed on the third trust and any additional trusts on account of such amounts are not deemed to have been distributed to the beneficiary. Code § 667(c). This is detrimental to the beneficiary rather than beneficial because the consequence of the failure to treat taxes as having been distributed is the loss of the ability to use the taxes as a credit against the tax on the accumulation distribution. Code §§ 667(b) and 667(d). For purposes of this rule, a distribution from a trust deemed to have been distributed on the last day of a particular preceding year will be disregarded unless it, when added to any previous distributions for such year, equals or exceeds $1,000. Code § 667(c)(2).

199 Code § 667(b)(1)(A).

200 Code § 667(b)(3).

accumulation distribution ($80,000) divided by the number of years to which the distribution is deemed allocated (4).

Step 4 -- Identify the beneficiary's computation years. The computation years are those three of the beneficiary's five immediately preceding taxable years left after eliminating the year in which her income was the highest and the year in which her income was the lowest.[201]

Example 16: Assume in the above example that Michael's taxable income in 1999 was $50,000, in 2000 was $100,000, in 2001 was $200,000, in 2002 was $150,000 and in 2003 was $175,000. The year of the highest taxable income, 2001, and the year of the lowest taxable income, 1999, are eliminated. Michael's three computation years are the remaining years, 2000, 2002 and 2003.

Step 5 -- Determine the average annual distribution amount by dividing the amount deemed distributed (the amount of the accumulation distribution plus the amount of taxes deemed distributed) by the number of preceding years in which the distribution is deemed to have been made as determined under Step 3.[202]

Example 17: In the above example, the amount deemed distributed is $112,000 and the number of preceding years in which the distribution is deemed to have been made is 3. The average annual distribution amount is $37,333.

Step 6 -- Determine the amount by which the beneficiary's income tax would have increased in each of the three computation years if the annual distribution amount had been added to her taxable income in each of such years.[203] In making this calculation, no differentiation is made among the various types of income that were included in the foreign nongrantor trust's UNI (other than tax-exempt income). Thus, for example, if a portion of the trust's UNI was long term capital gain, the beneficiary will not receive the advantage of the lower rate that generally applies to such gains. If any foreign income, war profits or excess profits taxes were added in Step 2 to the amount deemed to have been distributed, the amount of such taxes may be allowed as a credit against the increase in tax calculated in this step.[204]

Example 18: Assume that Michael's income tax would have been increased by $15,200, $16,500 and $16,600 in each of the three computation years.

Step 7 -- Determine the average tax increase by dividing the sum of the three increases by three.[205]

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[201] Code § 667(b)(1)(B).

[202] Code § 667(b)(1)(C).

[203] Code § 667(b)(1)(D). Code §1411, which was added to the Code by the 2010 Health Care Act as Amended by the 2010 Health Care Reconciliation Act, imposes an extra tax equal to 3.8 % of an individual's net investment income to the extent her modified adjusted gross income exceeds a threshold amount of $250,000 in the case of married individuals filing joint returns and $200,000 in the case of unmarried individuals. This new tax is effective for taxable years beginning after 2012. Because Code §667(b) calculates the throwback tax with reference to an individual's "taxable income," Code §1411 does not seem to apply to accumulation distributions. Treasury announced in the preamble to the final Code §1411 regulations that it is studying how the 3.8% tax should apply to accumulation distributions taken from foreign trusts. Until guidance on the subject is issued the 3.8% tax will not be applied to the accumulation distributions.

[204] Code § 667(d).

[205] *Id.*

Example 19: Michael's average tax increase is $16,100 ($48,300 divided by three).

Step 8 -- Multiply the average tax increase by the number of preceding taxable years in which the distribution is deemed to have been made as determined under Step 3.[206]

Example 20: Michael's average tax increase, $16,100, is multiplied by 3. The product is $48,300.

Step 9 -- Subtract from the product obtained in Step 8 the amount of any U.S. income taxes that were added, in Step 2, to the amount deemed distributed to the beneficiary.[207] The result is the amount of the beneficiary's throwback tax.

Example 21: Assume that $25,000 of the total taxes added to Michael's deemed distribution were U.S. income taxes. The $25,000 is subtracted from $48,300, leaving a throwback tax of $23,300.

(3) Use of the Steps with the Default Method

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, it is unclear how she would calculate her throwback tax using these 9 steps. The difficulty is that the default method contains no instructions for determining the number of years to which the distribution is to be thrown back. In the absence of detailed information, the appropriate approach might be to treat the distribution as having been thrown back in equal shares to one-half the total number of years the trust has been in existence. This approach would be consistent with the method used to calculate the interest charge when the default method is used.

f. Calculation of the Interest Charge

(1) In General

If a foreign nongrantor trust makes a distribution to a U.S. beneficiary that is subject to a throwback tax, the tax is increased by an interest charge determined under Code § 668.[208]

(2) Before the 1996 Act

Before the 1996 Act, the throwback tax imposed on distributions from foreign trusts was subject to a 6% simple interest charge.[209] For purposes of the interest calculation, an accumulation distribution was deemed to have been made from the earliest period or periods with respect to which the trust had UNI. For example, if a foreign nongrantor trust made an accumulation distribution in 1992 of $25,000 and if its UNI for 1990 (after adjustment for any prior accumulation distributions) was $50,000, for purposes of the interest calculation, the distribution would be deemed to have been made entirely from the income accumulated in 1990 and four years' worth of interest would be charged. If the tax on the distribution was $10,000, the interest charge would have been $2,400. Code § 668(b) limited the total interest charge to the excess of the amount of the taxed distribution over the tax charged on such distribution. Thus, in this example, the interest charge could not exceed $15,000 ($25,000, the amount of the distribution), reduced by $10,000, the amount of the tax on the distribution.

(3) After the 1996 Act

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206 Code § 667(b)(1).

207 Code § 667(b).

208 Code § 667(a)(3).

209 Prior Code § 668.

Code § 668, as amended by the 1996 Act, modified the interest rate charged on the tax imposed on distributions of accumulated income by foreign trusts and completely changed the calculation method. The interest rate will be the floating rates applied under Code § 6621 to underpayments of tax. In addition, interest will be compounded daily and will be calculated over a specially calculated number of years rather than with reference to the length of time between the year of the earliest undistributed accumulations and the year of distribution.[210] The number of years over which interest is calculated is determined by the following rather complicated process designed to produce a "dollar-weighted" number of years.

Step 1 -- the UNI for each year must be multiplied by the number of years between such year and the year of the distribution (counting the year of the accumulation but not the year of distribution).

Step 2 -- all products calculated in the first step must be added together.

Step 3 -- the sum of such products calculated in the second step must be divided by the aggregate amount of the trust's undistributed income. The quotient is to be rounded to the nearest half-year.[211]

For purposes of this calculation, an accumulation distribution is treated as having come proportionately from each year with respect to which there is UNI (other than a year during which the beneficiary was not a U.S. person) rather than from the earliest accumulation years. This change has the effect of reducing the interest charge on earlier distributions but will prevent the trustees from arranging for distributions from earlier years to be made to beneficiaries who are likely to pay less tax and, therefore, less interest.

The process may be illustrated by the following example:

Example 22: FNT, a foreign trust created in 1996, made no distributions before 2002. It had income of $0 in 2001, $60 in 2000, $124 in 1999, $87 in 1998, $54 in 1997, and $25 in 1996. Its total UNI in 2002 was the sum of these amounts or $350. It had no income in 2002 and distributed $286 in that year to its U.S. beneficiary, Tyler. FNT's weighted UNI is $1,260, as shown in the chart below:

[1]	[2]	[3]	[4]
Year	# of Years Since That Year	UNI From Each Year	Weighted UNI
			[2] x [3]
2001	1	$ -	$ -
2000	2	$ 60.00	$ 120.00
1999	3	$ 124.00	$ 372.00
1998	4	$ 87.00	$ 348.00
1997	5	$ 54.00	$ 270.00
1996	6	$ 25.00	$ 150.00
Totals		$ 350.00	$1,260.00

210 Code § 668(a).

211 Line 50, Internal Revenue Service Form 3520 (2005).

To determine the weighted number of years, the weighted UNI figure is divided by the total UNI figure, producing, in this example, a weighted number of years of 3.6, which is to be rounded to the nearest half year, or 3.5.[212]

Tyler's income tax on his accumulation distribution was $100. He will calculate his interest over a 3.5 year period ending on the applicable date. The applicable date, according to the instructions to Form 3520, is June 30th of the year in which the distribution was made.[213] Total interest is calculated in the manner illustrated by the chart below:

From	To	Rate	# of Days	Interest	Interest
					+
					Principal
					$ 100.00
1-Jan-99	31-Mar-99	7.0%	90.00	$ 1.74	$ 101.74
1-Apr-99	31-Mar-00	8.0%	366.00	$ 8.50	$ 110.24
1-Apr-00	31-Mar-01	9.0%	365.00	$ 10.38	$ 120.62
1-Apr-01	30-Jun-01	8.0%	91.00	$ 2.43	$ 123.05
1-Jul-01	31-Dec-01	7.0%	184.00	$ 4.42	$ 127.47
1-Jan-02	30-Jun-02	6.0%	181.00	$ 3.85	$ 131.32
Total			1,277.00	$ 31.32	

Alternatively, Tyler may use a chart contained in the instructions to Form 3520 to calculate his interest. The chart produces total interest of only 29.998% rather than 31.32%.

The chart below shows the various Code § 6621 rates in effect from January 1, 1996 through September 30, 2017:[214]

From	Through	Rate
January 1, 1996	March 31, 1996	9%
April 1, 1996	June 30, 1996	8%
July 1, 1996	March 31, 1998	9%
April 1, 1998	December 31, 1998	8%
January 1, 1999	March 31, 1999	7%
April 1, 1999	March 31, 2000	8%
April 1, 2000	March 31, 2001	9%
April 1, 2001	June 30, 2001	8%
July 1, 2001	December 31, 2001	7%
January 1, 2002	December 31, 2002	6%
January 1, 2003	September 30, 2003	5%
October 1, 2003	March 31, 2004	4%
April 1, 2004	June 30, 2004	5%
July 1, 2004	September 30, 2004	4%
October 1, 2004	March 31, 2005	5%

212 The figures in this example are derived from the instructions to Form 3520 (2002).

213 Alternatively, if the taxpayer received only one accumulation distribution during the year, she may use the date of the distribution as the applicable date.

214 Rev. Rul. 2017-13, 2017-26 I.R.B. 1011 (June 9, 2017).

April 1, 2005	September 30, 2005	6%
October 1, 2005	June 30, 2006	7%
July 1, 2006	December 31, 2007	8%
January 1, 2008	March 31, 2008	7%
April 1, 2008	June 30, 2008	6%
July 1, 2008	September 30, 2008	5%
October 1, 2008	December 31, 2008	6%
January 1, 2009	March 31, 2009	5%
April 1, 2009	December 31, 2010	4%
January 1, 2011	March 31, 2011	3%
April 1, 2011	September 30, 2011	4%
October 1, 2011	March 31, 2016	3%
April 1, 2016	December 31, 2017	4%

Code § 668(b) remains unchanged. Thus, total interest charges can never exceed the amount of the accumulation distribution reduced by the tax imposed on it.

If the interest calculation period includes any years before 1996, a possibility that will become increasingly unlikely given the peculiar method of determining the calculation period, the interest rate applicable to that period will be 6%. The interest will not be compounded except as to that portion of the interest calculation period after 1995.[215]

(4) The Default Method

If the U.S. beneficiary uses the default method of calculating her accumulation distribution, the period over which interest is calculated is one-half the number of years the trust has been in existence as a foreign nongrantor trust.[216]

The application of the new default interest rule can be draconian. If, for example, the interest rate on underpayments is 5% and if the U.S. beneficiary's tax rate is 40%, almost the entire amount of the distribution from a trust that has been in existence for 36 or more years will be consumed by taxes and interest.[217] Interest charges, however, can be reduced by spreading distributions over a number of years and using the default method rather than the exact method of calculating the amount of the accumulation distributions. As illustrated by Example 11, use of the default method will, with a pattern of equal annual distributions, eliminate accumulation distributions after a period of three years.

(5) Observation

215 Code § 668(a)(6).

216 Internal Revenue Service Form 3520, Line 38 (2015). A similar rule exists under Code § 666(d). It provides that, if adequate records are not available to determine the years within which income was accumulated, a distribution of accumulated income shall be deemed to have come from income accumulated in the first year of the trust's existence. Presumably, the new rule in Code § 6048(c)(2)(B) supersedes Code § 666(d) for foreign trusts.

217 A 36-year trust requires that interest be calculated over an 18 year period. Interest calculated at a rate of 5% compounded daily on a tax of $40 (the assumed tax on a hypothetical distribution of $100) over an 18-year period will be approximately $98.

For families who view their trusts as semi-perpetual arrangements, the interest charge is not likely to be significant. Their trustees are likely to be able to arrange investment and distribution patterns in order to avoid accumulation distributions. No matter how many years a foreign nongrantor trust is permitted to accumulate income free of U.S. income tax, its U.S. beneficiaries will never be subject to an interest charge unless they receive an accumulation distribution. Distributions that do not exceed the greater of the trust's trust accounting income or DNI in the year of distribution will not be treated as accumulation distributions and, therefore, the income tax they attract will not be subject to an interest charge.

g. Distributions of Income Accumulated Before Beneficiary Became a U.S. Resident

If a U.S. person receives an accumulation distribution that is attributable to periods before she became a U.S. resident, the interest charge on the accumulation distribution is computed by excluding the years in which she was a foreign person. Code § 668(a)(4). For example, if a trust accumulated $25,000 of income each year from 2000 to 2005, and a foreign person moved to the U.S. in 2004, and in 2006 received an accumulation distribution of $125,000, the interest charge would apply only for 2004 and 2005.

However, a question arises as to whether the person who moved to the U.S. in 2004 should be taxed at all on the income accumulated prior to 2004, assuming it is not U.S. source income.[218] Code § 667(a) establishes the general rule that an accumulation distribution allocated to a particular preceding taxable year is to be taxed, when distributed, to the extent that the such amounts "would have been included in the income of such beneficiary under section 662(a)(2) (and, with respect to any tax exempt interest to which section 103 applies, under section 662(b)) if such total had been paid to such beneficiary on the last day of such preceding taxable year." This rule abandons the usual rule in Code § 662(b) that the character (and presumably the source) of income taxable to a beneficiary is determined by the source and character of the income of the trust, with the limited exception for tax exempt interest. If the character of the non-U.S. source income were preserved for purposes of computing the tax on an accumulation distribution made to a U.S. person, then the person who received an accumulation distribution attributable to non-U.S. source income accumulated in a year in which such person was not a U.S. person would not be subject to tax. Unfortunately, Code § 667 does not expressly so provide, although it should as a matter of tax policy. Note that Code § 667(d) and (e) preserve the character rule for other purposes, namely, calculation of the allowable foreign tax credit and distributions from a foreign trust to a nonresident alien. Code § 667(e) appears to apply only if the person is a nonresident alien at the time of the distribution. Unless Code § 667(e) can be broadly interpreted to preserve the character rule for distributions to a U.S. person that are attributable to income accumulated in the foreign trust in years in which the U.S. taxpayer was a nonresident alien, then the U.S. immigrant is unfairly penalized for tax avoidance that did not occur.[219] The provisions of Code § 668(a)(2) (waiving the interest charge for distributions allocable to a year in which the beneficiary was not a U.S. person) would not be necessary if the accumulated income in the year were not subject to U.S. tax.

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[218] *See* Jose L. Nunez and Andrea L. Mirabito, *Just Off the Boat, Trust Fund in Hand*, Trusts & Estates, December 2005; *See also,* Norman H. Lane and Howard M. Zaritsky, *Federal Income Taxation of Trusts and Estates* (1993), Section 6.06(6)(b) (regarding the application of the throwback rules with respect to a beneficiary who was not taxable in some of the base period years).

[219] The unfair application of the accumulation distribution rules is not limited to this situation. For example, suppose a typical Canadian marital trust pays all income to a Canadian widow and accumulates capital gain. Upon the widow's death, the trust terminates and distributes to U.S. children. The children will be taxed under the accumulation distribution rules on gains that were accumulated in the trust. Gains were not accumulated in the trust to avoid U.S. tax. Gains were accumulated to preserve principal and because distributions to anyone other than the spouse is prohibited in order to qualify under Canadian law to defer capital gains at death. Had the assets passed outright to the widow rather than to the marital trust, the children would not be taxed on the gains (realized or unrealized) that accrued as of the date of their mother's death.

D. Loans Treated as Distributions

1. In General

Code § 643(i), which was added to the Code by the 1996 Act, treats, except as provided in regulations, a foreign trust's loans of cash (including foreign currencies and cash equivalents) or marketable securities to any U.S. grantor or beneficiary of the trust or to any other U.S. person who is related to such a grantor or beneficiary as a distribution.[220] For this purpose, a person is related to another person if the relationship between them would result in loss disallowance under Code § 267 or Code § 707(b).

If the loan is made to a person who is not the grantor or a beneficiary, it is not treated as a distribution to the borrower, but, instead, is treated as a distribution to the grantor or beneficiary to whom the borrower is related.[221] The logic of this provision is difficult to see. It has the effect of separating the tax consequences from the economic enjoyment of the deemed distribution.

Congress apparently intended that Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.[222] Although such regulations have yet to be issued, the IRS signaled its thinking on this subject in Notice 97-34.[223] The Notice states that the regulations will provide that a loan to a U.S. beneficiary (or a U.S. person related to a beneficiary) will be treated as a distribution unless it is a "qualified obligation." An obligation is a qualified obligation only if:

> "(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. person extends the period for assessment of any income tax attributable to the loan and any consequential income

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[220] Code § 643(i). This provision did not apply to the loan of tangible property, such as vacation homes, automobiles, and boats until the enactment of the 2010 HIRE Act on March 18, 2010. An earlier version of the foreign trust legislation that was passed in 1996 would have treated the loan of such property as a distribution of its use value. H.R. 981 § 207(d)(104th Congress, 1st Session). There is no existing authority holding that a beneficiary's rent-free use of a residence or other asset owned by a trust is a constructive distribution to the beneficiary. *See, e.g., Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1935) (trust income expended for maintenance of property in which beneficiary resided held not income taxable to beneficiary); *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976) *affirmed per curiam*, 574 F.2d 1332 (5th Cir. 1978) (same); *Sparrow v. Commissioner*, 18 B.T.A. 1 (1929) (on similar facts, allowing income tax deductions by trustees for cost of repairs to property on grounds that widow's right to occupy did not amount to a legal life estate). *See also*, IRS Notice 97-34 (discussing constructive distributions from foreign trusts to U.S. beneficiaries, but silent regarding the rent-free use of trust-owned assets).

[221] A person is related to a grantor or beneficiary if their relationship would result, under Code § 267, in a disallowance of losses for transactions between them. For this purpose, Code § 267(c)(4) is to be applied as if the family of an individual includes the spouses of her family members. Code § 643(i)(2)(B).

[222] H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 334 (1996).

[223] 1997-1 C.B. 422.

> tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation issued in consideration for the loan (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period); when properly executed and filed, such an agreement will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d); and (vi) The U.S. person reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding."

Section 533 of the 2010 HIRE Act, effective March 19, 2010, extended the reach of Code § 643(i).[224] The section now treats loans of any property by a foreign trust to the grantor, beneficiary or a U.S. person related to the grantor or a beneficiary as a distribution. In the case of loans of property other than cash or marketable securities, the provision does not apply "to the extent that the trust is paid the fair market value of such use within a reasonable period of time of such use."[225]

2. Repayment of Loans

When a loan that has been treated as a distribution under Code § 643(i) is repaid, Code § 643(i)(3) disregards the repayment for all purposes of "this title." More precisely,

> "any subsequent transaction between the trust and the original borrower regarding the principal of the loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) shall be disregarded for purposes of this title."[226]

This is a curious provision. The "title" referred to includes not only the income tax provisions, but the estate, gift and generation-skipping transfer tax provisions as well. A literal application of this Code § 643(i)(3) would permit a foreign trust created by a U.S. person to make a loan to a grandchild beneficiary of the trust's creator and to subsequently cancel that loan without any generation-skipping transfer tax consequences. The loan itself would not be treated as a taxable distribution for generation-skipping transfer tax purposes because it is offset by a corresponding obligation running from the grandchild to the trust. The trust's subsequent cancellation would not be treated as a taxable distribution because Code § 643(i)(3) requires that it be ignored. This provision should be amended to change its reference to "title" to "subtitle."

3. Amount of the Distribution

In gauging the impact of the loan provision as it applies to loans of marketable securities, it is important to keep in mind how Code § 643(e) treats the distribution of property in kind. Under Code § 643(e), unless the trustee elects otherwise, the amount of a distribution other than cash is the lesser of the trust's basis in the distributed property or its fair market value. The new rule does not seem to change this result. Thus, if a foreign trust lends marketable securities with a basis of 10 and a fair market value of 100 to a U.S. beneficiary, the amount treated as a distribution under Code § 643(i) would be 10, not 100,

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[224] The tax-free use of tangible personal property or real estate owned by a foreign trust was identified as an abuse. "Loans that are treated as trust distributions under U.S. tax law should be expanded to include, not just cash and securities as under present law, but also loans of real estate and personal property of any kind, including artwork, furnishings and jewelry." "Tax Haven Abuses: The Enablers, the Tools and Secrecy," Minority & Majority Staff Report of the Permanent Subcommittee on Investigations, August 1, 2006 at page 10.

[225] Code § 643(i)(2)(E).

[226] Code § 643(i)(3).

unless the trustee elects to recognize gain on the distribution (or is required to recognize gain in the case of a distribution to a covered expatriate).[227]

E. Indirect Transfers From Foreign Trusts

1. Distributions Through "Intermediaries"

Code § 643(h), which was added by the 1996 Act, treats a U.S. person who receives property from a person as having received the property directly from a foreign trust if the property she received was derived directly or indirectly from a foreign trust. This provision does not apply if the person from whom she received the property was the grantor of the trust. The intent of this provision is to prevent U.S. persons from avoiding income tax on their share of trust distributions by arranging for the distributions to be routed to them through another person.

Since 1962 the Code has contained a rule intended to prevent the use of intermediaries as a means of circumventing the general rules which tax U.S. persons on distributions from foreign trusts created by U.S. persons. Former Code § 665(c) provided that:

> "For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust."

The language of former Code § 665(c) was broader than needed to accomplish the statutory objective. The Treasury, however, perhaps in recognition of the unnecessary breadth of the provisions, brought it within reasonable boundaries by regulation. Treasury Regulation § 1.665(c)-1A(b) provided that the section would not apply

> "if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 . . . was enacted."

New Code § 643(h) extends the scope of the old rule (1) to amounts derived from trusts created by non-U.S. persons (other than amounts received from the grantor of certain foreign trusts that would have been so-called "grantor trusts" prior to the 1996 Act) and (2) to payments received from U.S. persons.

It provides as follows that:

> "For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person."

The expansion of the rule to trusts created by non-U.S. persons was presumably necessary to prevent what would otherwise have been a means of circumventing other provisions of the 1996 Act which enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts which are not taxed as grantor trusts under Code § 679 or otherwise.[228]

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[227] Code § 877A(F)(1)(B).

[228] *See* Code § 668.

The reason for extending the rule to payments received from U.S. persons is less urgent. Foreign trust payments channeled through U.S. persons would, in the absence of new Code § 643(h), already have been exposed to U.S. taxation, and in the case of accumulation distributions, to the 1996 Act's additional costs imposed on the receipt of such distributions.

Treasury has issued regulations under Code § 643(h).[229] The regulations treat distributions from trusts as made through intermediaries only if the transaction has a principal purpose of avoiding U.S. tax. The regulations create a presumption of tax avoidance if all of the following factors are present:

(a) The U.S. person who received property from the intermediary is related to the grantor of the foreign trust or has another relationship with the grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person. For example, if the U.S. person is a child of the grantor of the foreign trust, this factor would be satisfied.

(b) An intermediary received a distribution from a foreign trust and within a four year period beginning two years before the distribution, transferred to a U.S. person: the same property; proceeds from the disposition of such property; or property "in substitution for" such property.

  (i) Example 5 of Treas. Reg. § 1.643(h)-1(g) illustrates a transfer of property to a U.S. person in substitution for property distributed to an intermediary. The substitute property was shares of stock of equivalent value to shares distributed from the trust, but in different companies.

  (ii) Example 6 of Treas. Reg. § 1.643(h)-1(g) demonstrates that a bank is viewed as an intermediary if it lends money to a U.S. person and the loan is secured by the trust's deposit of funds in the bank if it can be shown that the bank would not have loaned funds to the U.S. person without the security interest in the trust's deposit. Note that the bank has not received a "distribution" from a foreign trust, but rather a deposit. However, the loan is deemed made from the trust.

(c) The U.S. person cannot demonstrate to the satisfaction of the IRS that:

  (i) The intermediary has a relationship with the U.S. person that establishes a reasonable basis for concluding that the intermediary would also make a gratuitous transfer to the U.S. person;

  (ii) The intermediary acted independently of the grantor and the trustee of the foreign trust;

  (iii) The intermediary was not the agent of the U.S. person; and

  (iv) The U.S. person properly reported the gift under Code § 6049F (required if the gift was made by a foreign person).

Examples in the regulations indicate that a U.S. person who receives property from a nonresident alien parent who received a distribution from a foreign trust funded by a grandparent will have to demonstrate more than a family relationship to the intermediary to avoid the nonresident alien parent being treated as an intermediary. If there is a pattern of giving and if the intermediary has other sources of income from which the transfer may have derived, that, plus the family relationship,

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[229] Treas. Reg. § 1.643(h)-1.

apparently will be sufficient to avoid the parent being treated as an intermediary.[230] Less evidence is required to show that a resident alien parent did not act as an intermediary.[231]

Example 2 of Treas. Reg. § 1.643(h)-1(g) demonstrates that a U.S. person who is treated as having received a distribution from a foreign trust through an intermediary need not be a beneficiary of the foreign trust. In that example, GM created a trust for her children. A distribution was made to the child, who was a non-resident alien. The beneficiary made a gift to her daughter who was a U.S. resident. The grantor's granddaughter was treated as having received a distribution from the foreign trust even though she was not a beneficiary.

Although none of the examples of intermediaries involve a second trust as an intermediary, nothing precludes a trust from being treated as an intermediary for another trust. For example, if a trust makes a distribution to a nonresident alien beneficiary who funds a revocable trust, and the revocable trust makes a distribution to a U.S. person, the nonresident alien beneficiary/settlor and the revocable trust could be considered to be intermediaries. The intermediary rule would seem also to apply if the second trust distributed funds back to the grantor of that trust; the grantor exception should not apply because the grantor of the second trust was not also the grantor of the first trust.

2. The Grantor Is Not an "Intermediary"

Under the Code, a grantor is never an intermediary. Treas. Reg. § 1.643(h)-1(b)(2) limits the exception to instances in which "the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived." The regulations do not discuss how the portion rules are to be applied in this context.

The portion rules apply to determine what portion of a trust a grantor is deemed to own for income tax purposes. The rules do not explain how one determines who is the grantor of a portion of a trust. Consider, for example, a trust created by gift of community property. If a distribution is made to just one of the spouses, will the distribution qualify in full for the exception to the intermediary rule? If the trustee separately accounts for trust shares, presumably the answer is yes.

If a person creates or nominally funds a trust on behalf of another person, both are considered "grantors" but the nominal grantor is not treated as the owner of any portion of the trust.[232] Although the intermediary regulations use the term "grantor" and not the term "owner", if nominal grantors were able to serve as intermediaries, the intermediary rule would be simple to circumvent.

It is not clear whether the grantor must actively participate in the transfer of funds in order for the exception to the intermediary rule to apply. For example, if the trust makes a distribution to an account in the joint names of the grantor and a beneficiary and the beneficiary withdraws funds, it would be reasonable to treat the distribution as made through the grantor because the bank should not be treated as an intermediary in this situation.

Similarly, it is unclear whether the grantor's estate is treated as the grantor for purposes of the exception to the intermediary rule. For example, suppose that a trust either directs or authorizes distributions to the grantor's estate and the estate makes a distribution to a U.S. beneficiary. If the distribution to the grantor's estate does not carry out U.S. source income (other than capital gain income) then the estate will have no DNI.[233] If the intermediary rule is not applicable, then the U.S. beneficiary who receives the distribution will not owe income tax. Some precedent exists for treating the estate as the

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230 *See* Treas. Reg. § 1.643(h)-1(g), *Example 3*.

231 *See* Treas. Reg. § 1.643(h)-1(g), *Example 7*.

232 Treas. Reg. § 1.671-2(e)(5).

233 Code §643(a) excludes foreign source income and capital gains in computing the DNI of a foreign estate.

grantor.[234] There are other grounds for advocating that the intermediary rule is not applicable where the payment to the estate either is not discretionary or the person who benefits from the estate is not a beneficiary of the trust. In such cases, it can be persuasively argued that the distribution is being made for reasons independent of avoiding income tax.

3. Agency Principles Control Issue of Timing and Amount of Income

Under the regulations, if a distribution is treated as made through an intermediary, the intermediary is considered to be the agent of the trust unless the facts show that the intermediary was the agent of the U.S. person. Where the intermediary is considered to be the agent of the trust, the U.S. person includes the cash or property he or she receives from the intermediary in income in the year in which the U.S. person receives the cash or property, even if the distribution was made to an intermediary in an earlier taxable year. If the property distributed from the foreign trust is worth more by the time the U.S. person receives it, the increased amount is included in income. If the property has declined in value, the U.S. person reports the lower value. If the intermediary has paid foreign taxes with respect to the cash or property distributed from the foreign trust, the U.S. person treats such taxes as if imposed on the trust for purposes of Code § 665(d)(2).[235]

If the intermediary is the agent of the U.S. person, the U.S. person includes the cash or property distributed to the intermediary in the U.S. person's income when her agent receives the distribution. Any income accruing on such cash or property between the time the intermediary receives it and the time the U.S. person receives it is also taxable to the U.S. person. If any foreign taxes were owed by the intermediary with respect to such cash or property, the taxes are creditable by the U.S. person as if the taxes were imposed on the U.S. person. Usual agency principles are applied to determine whether the intermediary is the agent of the U.S. person.[236]

If a person who receives a distribution from a foreign trust is deemed to be an intermediary, the intermediary may exclude the distribution from gross income.[237] The regulations fail to exclude from the intermediary's gross income any income accruing on the property distributed from the foreign trust before it is transferred to the U.S. person, although presumably this was intended.

A *de minimis* exception applies where the aggregate amount of distributions to a U.S. person in one taxable year that are made from foreign trusts, either directly or through one or more intermediaries, does not exceed $10,000.[238]

F. Treatment of Income of Controlled Foreign Corporations and Passive Foreign Investment Companies

1. In General

The U.S. beneficiaries of a foreign nongrantor trust may be subject to tax on income earned by controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") whose shares are held by the trust.[239] The CFC

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[234] *Walton v. Commissioner*, 115 T.C. 41 (2000). In this case, the Tax Court held that an annuity retained for a term of years and payable to the grantor for life and, following her death during the term, payable to her estate should be valued as an annuity for a fixed term, and not, as advocated by then-applicable regulations, as a retained annuity payable for the shorter of a term of years or the grantor's life. The theory of the tax court was not that the estate is the same as the grantor but rather that the grantor cannot be treated as making a taxable gift to her own estate.

[235] Treas. Reg. § 1.643(h)-1(c)(1).

[236] Treas. Reg. § 1.643(h)-1(c)(2).

[237] Treas. Reg. § 1.643(h)-1(c)(3).

[238] Treas. Reg. § 1.643(h)-1(d).

and PFIC rules, also called the "anti-deferral regimes," eliminate the deferral of U.S. income tax that generally exists for U.S. shareholders of domestic corporations (*i.e.*, shareholders are not subject to income tax on corporate income until dividends are paid to them). These anti-deferral regimes require that certain types of passive income of CFCs or PFICs be taxed to their U.S. shareholders currently, whether or not distributions are made to them.

Without such provision, or some revision to the rules of subchapter J, deferral of tax would be possible without subjecting income to the throwback tax by postponing distributions from a corporation owned by a trust until such time as the trustee intended to make a distribution to a U.S. beneficiary, or by the trustee selling shares before taking a distribution from the corporation. The throwback tax would not apply if the income is received or gain is realized by the trust in the same year the distribution is made to the U.S. beneficiary. In addition, a distribution to a U.S. beneficiary would not carry out income in excess of DNI and UNI, and because the portion of an excess distribution that is allocated to prior years is excluded from income, it is neither DNI nor UNI.[240] The deferred tax and interest charge on certain PFIC distributions is not part of the subchapter J scheme of taxation.

However, the anti-deferral regimes are not well suited to trusts, especially discretionary trusts. To date, the Treasury and the IRS have provided only limited guidance regarding the application of the anti-deferral regimes to determine indirect ownership by trust beneficiaries and the information reporting obligations of such indirect owners.[241] No guidance has been provided as to how to coordinate the anti-deferral regimes with subchapter J so that the same income is not taxed more than once. In the preamble to proposed and temporary regulations published December 31, 2013, Treasury stated that no guidance was being given on how Code §1291 is to be applied when an estate or nongrantor trust, or a beneficiary thereof, receives or is treated as receiving an excess distribution subject to tax and interest charges under Code §1291, but that §1291 and the principles of subchapter J must be applied in a "reasonable manner" to preserve or trigger the tax and interest charge rules under Code §1291 consistent with the general operating rules of subchapter J.[242] Although the regulations were published as final on December 28, 2016, the final regulations are silent on this subject.

Both the CFC and PFIC rules provide adjustments to avoid imposing tax on previously taxed income.[243] Income that was previously taxed is not again subject to tax when actually distributed to a U.S. shareholder.[244] Amounts included in

Footnote continued from previous page

239 Code §958(a)(2) and 1298(a)(3). The American Jobs Creation Act of 2004, which was enacted on October 22, 2004 (P.L. No. 108-357, 118 Stat. 1418) (the "2004 Act"), repealed similar anti--deferral rules - the foreign personal holding company rules - under Code §§ 551 – 558. The repeal is effective for taxable years of foreign corporations beginning after December 31, 2004.

240 Code §1291 excludes from income excess distributions allocated to prior years beginning after December 31, 1986, and instead imposes a deferred tax amount under Code §1291(c). Since DNI and UNI begin with gross income, the exclusion prevents that portion of the excess distribution from being DNI, and UNI is accumulated DNI.

241 Prop. Reg. §1.1291-2((f)(2) and 1.1291-3(e)(5)(ii) "reserve" on the issue of explaining how excess distributions apply to estates and trusts.

242 Curiously, the regulation seeks to preserve the interest charge under §1291 and omits mention of the interest charge under §668. Logically, the regulation should have required preservation of the interest charge under either of such sections. Imposition of the charge under §668 clearly would be more consistent with the "general operating rules of subchapter J" because, with the exception of §643(i), such rules defer tax until a beneficiary receives a distribution, which makes dealing with uncertain imputed ownership rules unnecessary.

243 Code §959, 961 and 1298(b)(5)(A); Prop. Reg. §1.1291-3(4)(iv).

income but not distributed increase a U.S. shareholder's basis in the shares of a CFC so that her gain is reduced if the shares are sold prior to receiving the previously taxed income.[245] It is very unclear how these rules should be applied where the shareholder owns the shares indirectly through a trust.

For example, suppose a foreign nongrantor trust directs that all income be paid to H for life and, upon H's death, the income is payable to such of A, B and C who are living on the date of each distribution, in equal shares, until the death of the last survivor of them. Principal is distributable to D upon the death of the last survivor of A, B and C. H is deemed to indirectly own PFIC shares owned by the trust and is taxed on $100,000 of gain deemed realized when the trustee disposes of ½ of the PFIC shares. In accordance with the governing instrument, all of the amount realized is accumulated and added to principal. One year after H's death, the trust sells the other half of the shares for $150. The amount realized is added to principal. The shares had a cost basis to the trust of $50. One-third of the gain is imputed to each of A, B, and C, all of whom are U.S. persons. No distributions are made until 5 years after H's death when the last survivor of A, B and C dies. Five years after H's death, the proceeds of both sales are distributed to D.

What is the trust's basis in the shares sold after H's death? Applicable regulations provide that when gain is realized by the trust, and taxed to a beneficiary who is treated as the indirect owner, ***the beneficiary's basis in the trust is increased***.[246] Therefore, H's basis in the trust was increased by $100,000 attributable to the first sale, and each of A, B. and C's basis in the trust was increased by $33.33 attributable to the second sale. However, ***the increase to each beneficiary's basis in the trust has no effect on D's tax liability***. A recognizes income on the distribution of accumulated income under the rules of subchapter J. There is no apparent adjustment to the basis of the shares held by the trust for the fact that $100,000 of gain was taxed to H and $100,000 of gain was taxed equally to A, B and C.

2. The Anti-Deferral Regimes

a. Controlled Foreign Corporations ("CFCs")

A foreign corporation is a CFC if over 50% (by vote or value) of its stock is owned by "United States shareholders."[247] However, a CFC's United States shareholders will not be taxed under the CFC rules unless the CFC ownership test is met "for an uninterrupted period of 30 days or more during any taxable year.[248] For purposes of this definition, a "United States shareholder" is a United States person[249] who owns either directly, indirectly through one or more foreign entities,[250]or through the application of certain constructive ownership rules,[251]at least 10% of the total combined

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Footnote continued from previous page

[244] Code §959(a).

[245] Code §961.

[246] Code §1298(b)(5)(B); Prop. Reg. §1.1291-3(e)(4)(iv); Reg. §1.961-1(b)(1).

[247] Code § 957(a).

[248] Code § 951(a).

[249] The term "United States person" generally has the same meaning assigned to it by Code § 7701(a)(30). It includes individuals who are citizens or residents of the U.S., domestic partnerships, domestic corporations, and estates or trusts other than foreign estates and trusts.

[250] Code § 958(a).

[251] Code § 958(b).

voting power of all classes of stock entitled to vote.[252] Since trust beneficiaries rarely have any voting rights, it is questionable whether beneficiaries who lack voting rights should be treated as indirect U.S. shareholders. For purposes of determining whether a United States shareholder meets the 10% test, the constructive ownership rules of Code § 318, as modified by Code § 958(b), apply. Under the constructive ownership rules, a shareholder will be deemed to own stock owned directly or indirectly by members of her family who are also U.S. persons, and will be deemed to own her proportionate share of any stock owned directly or indirectly by a partnership, estate or trust in which she has an interest, or by a corporation if she owned, directly or indirectly, 10% or more of the value of its stock.[253] A corporation will be treated as constructively owning shares owned by a shareholder who owns 50% or more of the stock.[254] For purposes of Code § 318, the members of a shareholder's family include only her spouse, children, grandchildren and parents.[255]

A U.S. person who owns directly or through a foreign entity shares of a foreign corporation that is a CFC for an uninterrupted period of more than 30 days during any taxable year and who owns shares in such corporation on the last day in such year on which the corporation is a CFC must include in gross income for each year her pro rata share of the CFC's "subpart F" income.[256] A shareholder's pro rata share of a CFC's subpart F income is that amount which would have been distributed with respect to the stock which such shareholder directly or indirectly (but not constructively) owns if, on the last day of the taxable year, the CFC had distributed all of its subpart F income pro rata to its shareholders.[257] Subpart F income includes insurance income, foreign base company income, international boycott income and foreign bribe-produced income.[258] Generally, foreign base company income includes foreign personal holding company income ("FPHCI") which includes among other things, dividends, interest, royalties, rents, annuities, gains from the sale or exchange of certain types of property, gains from commodities, foreign currency gains, profits from the certain purchases and sales of certain types of personal

[252] Code § 951(b). For taxable years of foreign corporations beginning before January 1, 2005, an alternate, anti-deferral regime known as the foreign personal holding company ("FPHC") regime could apply to tax a shareholder who owned shares of a foreign corporation that was not reached by the CFC rules. Code §551-558, repealed by the 2004 Act. The FPHC rules potentially applied to a smaller group of foreign corporations because they applied to a corporation only if at least 50% of its gross income was FPHCI. But, corporations that satisfied the gross income test were more likely to satisfy the U.S. ownership test of the FPHC regime than the U.S. ownership test of the CFC regime because of the FPHC's more expansive constructive ownership rules. Under the FPHC rules, a U.S. person was deemed to own all shares of a foreign corporation owned by her spouse, ancestors, descendants and siblings, whether or not such family members were U.S. persons, as well as all shares owned by any partner of hers, no matter how large the partnership nor how small her interest in it. Additionally, the FPHC rules applied to tax a U.S. person with shares in an FPHC on her share of the corporation's income for a particular year no matter how many days in the taxable year the corporation was an FPHC. In contrast, the CFC rules operate to tax a U.S. person in a particular year only if the corporation is a CFC for at least 30 continuous days in such year.

[253] Code §958(b)(3). A shareholder is attributed ownership of shares owned by a corporation that is not a PFIC only if she owns 50% or more of the value of the stock, but if the corporation is a PFIC, she will be treated as owning her proportionate share of the stock owned by the PFIC regardless of the percentage she owns in the PFIC. Code §1298(a).

[254] Reg. §1.958-2(d).

[255] Code § 318(a)(1).

[256] Code § 951(a).

[257] Code § 951(a)(2).

[258] Code § 952(a).

property, and income from the performance of certain services for or on behalf of a related person outside the CFC's country of incorporation.[259]

b. Passive Foreign Investment Companies ("PFICs")

A U.S. shareholder who is not subject to current tax under the CFC regime may still be subject to the PFIC regime. A foreign corporation is a PFIC if (1) 75% or more of its gross income for the taxable year is passive income or (2) the average percentage of assets (by value) held by the corporation for the production of passive income is at least 50%.[260] Passive income generally means income which would be FPHCI under subpart F.[261] Generally, a U.S. person who owns any interest in a PFIC will be subject to ordinary income tax on "excess distributions." Excess distributions means distributions in excess of 125% of the average distributions to such shareholder made by the PFIC for the prior three years and gains from disposing of PFIC stock. Tax on excess distributions is computed by allocating an equal share of the excess distribution to each year in the shareholder's holding period. Current year income includes the excess distribution allocated to the current year and to years beginning prior to December 31, 1986. A tax and interest charge on the amount of excess distributions allocated to other years is calculated.[262] This tax regime is the same as the default method for computing throwback tax discussed above at III. C except that there is no statutory ceiling on the aggregate amount of tax and interest that may be assessed.[263]

A disposition of shares in a PFIC by a foreign nongrantor trust will be treated as a disposition of PFIC stock by the trust's U.S. beneficiaries who are deemed to indirectly own the shares. Similarly, a distribution of property from a PFIC to the foreign nongrantor trust will be treated as a distribution to its U.S. beneficiaries who are deemed to indirectly own the shares.[264] Amounts subsequently distributed from the PFIC and gains realized from the disposition of shares in such PFIC representing previously taxed income is not supposed to be taxed again.[265] However, as discussed above, it is not clear how the exclusions will be effectuated in the trust context.

The tax on excess distributions described above generally does not apply to a U.S. shareholder of a PFIC who has made a "qualified electing fund" ("QEF") election,[266] or a mark to market ("MTM") election.[267] A shareholder who makes a QEF election is taxed on her share of PFIC income whether or not distributed. A shareholder who makes a MTM election,

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[259] Code § 954(a) and (c). A de minimis rule provides that if, in any particular year, a CFC's foreign base company income and its gross insurance income is less than the lesser of (i) 5% of its gross income or (ii) $1,000,000, no part of its income will be treated as foreign base company income or insurance income. Code § 954(b)(3). Special rules are provided for CFCs that have more than one class of stock with different dividend rights.

[260] Code § 1297(a).

[261] Code § 1297(b).

[262] Code § 1291(a) and (c).

[263] *Cf.*, §668(b) providing that the interest charge imposed by that section cannot, when added to the tax imposed by §667(b), exceed the amount received from the trust.

[264] Code § 1298(b)(5) provides that "under regulations" a beneficiary will be taxed but the IRS takes the view that tax may be imposed on beneficiaries even though regulations have not yet been issued. TAM 200733024.

[265] Code §1298(b)(5).

[266] Code §§ 1293 -1295. The tax on excess distributions may continue to apply if the shares were not subject to a QEF election for every year in the shareholder's holding period. A shareholder also may elect to defer payment of tax, with interest. Code §1294.

[267] Code §1296. A mark to market election may be required under other provisions of the Code.

which is only available for marketable stock, is taxed as if income or loss was realized at the end of each year based on changes in the market value of the shares. However, until Treasury clarifies the rules coordinating the anti-deferral and subchapter J regimes, such elections are not likely as a practical matter.

Under the Voluntary Disclosure initiative (discussed in VII. B.), a taxpayer may calculate tax on a basis that is consistent with a MTM election but without the need to reconstruct historical data.[268] Instead, the PFIC tax is computed as of the end of 2003, or the end of the first year PFIC shares were owned, if later, assuming a basis that is negotiated between the taxpayer and the IRS, if records are not available. Gains are taxed at 20% instead of the rate called for under Code § 1291, and interest on the deferred tax is calculated at 7% for the first year instead of the rate under Code § 1291(c).

3. The Attribution, Indirect and Constructive Ownership Rules

The CFC regime contains indirect and constructive ownership rules that are used to determine both whether a corporation is a CFC and the extent to which U.S. persons will be taxed on its income.[269] Similarly, the PFIC regime contains attribution rules that are used to determine the extent to which U.S. persons will be taxed on distributions and dispositions.[270] In both cases, these rules provide that stock in a foreign corporation owned by a grantor trust would be treated as owned by the grantor,[271] and stock in a foreign corporation owned by a nongrantor trust will be considered as owned proportionately by its beneficiaries.[272] However, in the case of the CFC rules, attribution stops with the first U.S. owner. By contrast, attribution of PFIC shares can be from U.S. as well as foreign trusts.[273]

When the beneficiaries of a foreign nongrantor trust have fixed interests in the trust, applying the constructive ownership rules is simple.

> **Example 23:** FNT, a foreign nongrantor trust established in 2004, has three beneficiaries, Michael, Isaac and Tyler. Each beneficiary is entitled to 1/3 of FNT's income each year. At the end of FNT's ten-year term, the trust fund will be distributed equally among the three beneficiaries. Michael and Tyler are U.S. persons; Isaac is not. The FNT holds 100% of the stock of a foreign corporation (FC). In 2005, eighty (80%) percent of FC's gross income is FPHCI.[274] Under the attribution rules discussed above, Michael, Isaac and Tyler will each be considered as owning 33-1/3% of the shares of FC.[275] As a result, in 2005 FC will be classified as a CFC.[276] FC

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[268] FAQ 10 on IRS webpage on voluntary disclosure. https://www.irs.gov/individuals/international-taxpayers/offshore-voluntary-disclosure-program-frequently-asked-questions-and-answers-2012-revised

[269] Code § 958(a) and (b).

[270] Code § 1298(a).

[271] Treas. Reg. §§1.958-1(b) ; 1.1291-1(b)(iii)(8)(D). However, a U.S. person treated as the owner of a tax-exempt account (such as an IRA) is not treated as the indirect owner of PFIC shares. Reg. 1.1291-1(e)(2).

[272] Code § 958(a)(2); Reg. §1.958-1(b) (CFC attribution rules); Code § 1298(a)(3); Reg. §1.1291-1(b)(8)(iii)(C) (PFIC attribution rules).

[273] Code §1298(a)(i) provides that except as provided in regulations, attribution of ownership to a U.S. person shall not apply to treat stock owned by a U.S. person as owned by any other person. However, Reg. §1.1291-1(b)(8)(i) provides that attribution from a domestic entity to a U.S. person can apply for limited purposes.

[274] FPHCI is defined in Code §954(c) as passive type income.

[275] Code §958(a)(2); Treas. Reg. §1.958-1(d), *Example (3).*

[276] Code §957.

will also be a PFIC because of its percentage of passive income.[277] Michael and Tyler, however, will be taxed only under the CFC regime, which takes precedence over the PFIC regime.[278]

Matters are more complicated when beneficial interests are divided temporally. Suppose, for example, that in Example 23, on the death of the first of Michael, Isaac and Tyler to die, the FNT was to terminate and all of its property was to be distributed to Cathlyn, a non-U.S. person. Suppose further that the actuarial value of the income interests in the trust were equal to 30% of the value of the trust and the actuarial value of the remainder interest, 70%. Do each of Michael and Isaac, the two U.S. persons, now indirectly own only 10% of FC?

The regulations under the former FPHC rules in now repealed Code §554 deal only with trusts the beneficiaries of which own both present and future interests in equal shares.[279] The IRS has ruled, however, that for purposes of the FPHC rules, shares held by a trust are considered to be owned by the present or future beneficiaries in proportion to their actuarial interest in the trust.[280]

The CFC regulations establish two different approaches. The first construes Code § 958(a) which defines direct and indirect ownership. This subsection determines whether the beneficiary will be subject to tax on a CFC's income as an indirect owner. It states that the determination of a person's proportionate interest in a foreign trust will be made on the basis of all of the facts and circumstances.[281] The second construes Code § 958(b), which defines constructive ownership. This subsection applies both for purposes of determining whether a corporation whose shares are owned by a trust is a CFC and a particular person has a sufficient interest to qualify as a "U.S. shareholder" within the meaning of Code §951(b). It states that stock owned directly or indirectly by a nongrantor trust will be considered as owned constructively by its beneficiaries in proportion to the actuarial interests of such beneficiaries in the trust.[282] However, a person is taxable only on shares owned directly or indirectly and is not taxed on shares owned constructively.

The IRS provided some guidance on this issue in Field Service Advice 199952014.[283] Without stating whether the actuarial allocation rule might simultaneously apply for purposes of Code § 958(b),[284] it determined that, for purposes of Code § 958(a)(2), the trust beneficiaries who were entitled to receive all current income should be treated as indirectly owning all of the stock owned by the trust. The remainder beneficiaries were treated as owning no stock. The FSA defended its conclusion:

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[277] Code §1297.

[278] Code §1297(d).

[279] Treas. Reg. § 1.554-1; Treas. Reg. § 1.552-3; Treas. Reg. § 1.544-2.

[280] Rev. Rul. 62-155, 1962-2 C.B. 132.

[281] Treas. Reg. § 1.958-1(c)(2). The regulation does not provide much guidance in making this determination other than to say that in determining a person's proportionate interest, the purpose for which the rules of §958(a) are being applied should be taken into account. "Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation." For example, if the issue is whether a trust beneficiary who has the right to trust income should be taxed on current personal holding company income of a CFC, the income beneficiary is the appropriate person to tax.

[282] Treas. Reg. § 1.958-2(c)(1)(ii)(a).

[283] FSA 199952014 (September 23, 1999).

[284] Treas. Reg. §1.958-2(f)(2). Because the FSA concluded that the income beneficiaries' indirect ownership made them U.S. Shareholders as defined in §951(b), it was not necessary to apply the constructive ownership rules.

"Our conclusion supports the purpose of subpart F, which is to avoid the deferral of certain classes of income earned by CFCs by requiring such amounts to be annually included in income by the United States shareholders thereof."

This rationale is flawed. If the remainder beneficiaries are U.S. persons, attributing ownership to them based on the actuarial value of their interests would not avoid U.S. tax. In fact, if the income beneficiaries are foreign, attributing ownership to remainder beneficiaries would increase tax. However, there are practical difficulties in attributing income to a person who has no current right to distributions. If the remainder interest is contingent or subject to divestiture, attribution of ownership to remainder beneficiaries may fail.

Applying the attribution rules in the context of a foreign nongrantor trust becomes more difficult when the trust is a discretionary trust. The trustees of such a trust have complete discretion to distribute income and/or principal among the beneficiaries. The beneficiaries do not have fixed interests in the trusts that can be easily calculated.

In Private Letter Ruling 9024076,[285] the IRS described several relevant facts and circumstances to be considered in determining the actuarial interest of a beneficiary in a discretionary trust for purposes of Code § 544 (concerning personal holding companies). These facts include (1) the pattern of past distributions, (2) appropriate mortality assumptions, (3) the trustee's fiduciary duties and (4) the relationships among the trustees and beneficiaries. According to the IRS, if it is possible to discern a pattern of past distributions, each beneficiary receiving distributions under such pattern will be deemed to own an income interest in the trust in the same proportion that the amount of distributions she receives bears to the total amount of the distribution. Each beneficiary's income interest can then be determined on an actuarial basis with reference to the mortality tables as if the trustees were required to distribute the income to such beneficiary over the remainder of her life.

In Technical Advice Memorandum 200733024, the IRS applied the facts and circumstances test to treat beneficiaries of a foreign trust as indirectly owning shares of a PFIC owned by the trust in the same proportion as the historic patterns of distributions. When the trust liquidated its interest in the PFIC, the beneficiaries were treated and taxed as if they had disposed of the PFIC shares of which they were the indirect beneficial owners.

Similar to the CFC regulations, the PFIC regulations provide that a person's indirect ownership is determined based on all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purposes of §§1291 through 1298.[286] In the case of a trust or an estate, whether domestic or foreign, each beneficiary of an estate or nongrantor trust, is treated as owning a "proportionate amount of such stock."[287] There is no further explanation of how to determine proportionate ownership.

Although the PFIC attribution rules are similar to the CFC rules there are some important differences. In the case of the CFC rules, attribution stops with the first U.S. owner.[288]By contrast, attribution from entities occurs even if the PFIC shares are owned through a U.S. entity.[289] A domestic partnership or S corporation is not treated as a PFIC shareholder except for purposes of information reporting.[290] However, PFIC shares directly or indirectly owned by a U.S. corporation that is not a subchapter S corporation are not considered to be owned by a shareholder of the U.S. corporation except for purposes of determining whether a person satisfies the 50% ownership test necessary for shares owned by a corporation to be attributed to a shareholder.

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[285] PLR 9024076 (March 21, 1990).

[286] Reg. §1.1291-1(b)(8)(i).

[287] Reg. § 1.1291-1(b)(8)(iii)(C).

[288] Code §958(a)(2).

[289] Reg. §1.1291-1(b)(8)(i).

[290] Reg. §1.1291-1(b)(7).

Example 1 of Reg. §1.1291-1(b)(8)(iv) illustrates this rule. A, a U.S. person, owns 49% of the stock of FC1, a foreign corporation that is not a PFIC and separately owns all of the stock of DC, a domestic corporation that is not an S corporation. DC owns the remaining 51% of the stock of FC1. FC1 owns 100 shares of a PFIC. A is treated as owning all of the stock of FC1 that DC owns so that A can be attributed ownership of of PFIC shares owned by FC1. However, A is treated as indirectly owning only 49 shares of the PFIC and DC is treated as owning 51 shares of the PFIC.

4. Information Reporting by Indirect Owners

If the beneficiaries are treated as the indirect owners of CFC or PFIC shares held in a trust or estate, the beneficiaries may be obligated to file information returns required of CFC shareholders (Form 5471) and PFIC shareholders (Form 8621).[291] The reporting rules for PFICs are more complicated because indirect ownership of PFIC, shares, unlike CFC shares, does not cease with the first tier of U.S. owners.

A U.S. person is required to file information returns if she directly owns CFC or PFIC shares, indirectly owns shares through one or more entities each of which is foreign or is treated as the owner of a trust under §§671-679 that owns CFC or PFIC shares, directly or indirectly.[292] A U.S. person will not be attributed ownership of CFC shares owned indirectly through a U.S. entity. However, a U.S. person who indirectly owns PFIC shares through a U.S. entity has to file Form 8621 only if the indirect shareholder is (i) treated as receiving an excess distribution; (ii) treated as recognizing gain that is taxable as an excess distribution; (iii) required to include an amount in income under a QEF election; (iv) required to include an amount in income under a MTM election; or (v) required to report the status of a §1294 election. However, the U.S. person need not file Form 8621 by reason of (iii) or (iv) if the domestic entity through which the PFIC shares are held filed Form 8621.[293] In the case of a domestic partnership or S corporation, this exception only applies if the partnership or S corporation made the QEF election.[294]

This filing rule is not clear because the regulations do not tell us how to determine whether the beneficiary or the domestic trust through which she is attributed ownership is taxable on an excess distribution. U.S. tax is not avoided regardless of whether the domestic trust or the beneficiary is taxable because both are U.S. taxpayers. Do the rules of subchapter J apply so that the U.S. beneficiary is taxable on excess distributions only if she receives a distribution from the U.S. trust? Under the rules of subchapter J, only the portion of the excess distribution allocated to the current year is include in DNI and, if distributed, taxable to the U.S. beneficiary, and that amount is not subject to the PFIC tax and interest charge, so that there seems to be no purpose for a beneficiary to file Form 8621. The regular K-1 issued by the domestic trust would provide the information necessary to correctly compute tax. The domestic trust would be responsible for the tax and interest charge imposed on excess distributions and it would be required to file Form 8621.

Other filing exceptions include the following:[295]

1. A U.S. person who is treated as the owner of a domestic liquidating trust under §301.7701-4(d) or a widely-held fixed investment trust under §1.671-5 is not required to file Form 8621. The trust itself is treated as the shareholder and files the form instead.

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291 The expanded filing requirement imposed by Code §1298(f) is waived for years ending prior to December 31, 2013. Reg. §1.1298-1(c)(3).

292 Reg. §1.1298-1(b)(1).

293 Reg. §1.1298-1(b)(2).

294 In most cases, the QEF election would have to have been made by the upper tier domestic entity. Reg. §1.1295-1(d)(1).

295 Reg. §1.1298-1(b)(3) and -1(c).

2. A beneficiary of a foreign estate or trust is not required to file if she has not made a QEF or MTM election, and is not treated as receiving an excess distribution or gain taxable as an excess distribution.

3. Tax exempt entities described in §§501(c), 501(d), 401(a), 511(a)(2)(B), 403(b), 457(b), 7701(a)(37), 529, 529A or 530 are not required to file Form 8621.

4. A U.S. person is not required to file if the aggregate value of her PFIC shares owned directly or indirectly is $25,000 or less or the value of her indirect PFIC shares is $5,000 or less, in each case valued as of the end of the year, unless the shareholder has an excess distribution or there is a QEF election in effect. For purposes of this calculation, certain shares are disregarded - shares owned through a domestic entity or another PFIC and shares marked to market under a provision other than §1296. The thresholds are doubled for taxpayers filing jointly.

5. A shareholder is not required to report shares marked to market under under a provision other than Code §1296 unless gain must be realized under Reg. §1.1291-1(c)(4) for the first year the shares are marked to market.

6. A shareholder is not required to report shares held through certain foreign pension funds.

7. Dual resident taxpayers who elect to be taxed as nonresidents under a treaty are not required to file if they file Form 8833 to report their treaty-based position. This rule is a significant departure from past practice which requires such dual residents to file information returns and to be considered U.S. shareholders for purposes of the CFC rules.[296] Thus, for example, such a person would be required to file Forms 3520, 8938 and 5471 but not Form 8621.

8. A domestic partnership need not file if all its partners are non-U.S. shareholders, tax exempt entities, dual residents described in 7 above or another domestic partnership excused from filing.

9. A shareholder is not required to file if she acquires PFIC shares taxable as a §1291 fund[297] in the taxable year or the immediately preceding taxable year and is a shareholder for a total of 30 days or less during the period beginning 29 days before the first day of the year and ending 29 days after the close of the year and is not treated as receiving an excess distribution or gain treated as an excess distribution.

10. A bona fide resident of Guam, the Northern Mariana Islands or the U.S. Virgin Islands if she is not required to file an income tax return with the IRS.

11. A return is not required to be filed under Code §1298(f) for taxable years ending before December 31, 2013.[298]

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[296] Reg. §301.7701(b)-7(a)(3).

[297] Reg. §1.1291-1(b)(2)(v) defines a 1291 fund as a PFIC that has not had a QEF election in effect for all years in the shareholder's holding period or has not made a MTM election, so that the tax regime imposed by Code §1291 applies.

[298] The 2010 HIRE Act enacted Code § 1298(f) to expand the annual filing obligations of PFIC shareholders (which previously only required filing if a QEF or MTM election was applicable or a shareholder received an excess distribution (or realized gain treated as an excess distribution), but the expanded filing requirements were suspended for taxable years ending prior to December 31, 2013.

5. Planning Techniques

If U.S. beneficiaries receive shares of CFCs on the death of a nonresident alien, their retention of the shares will subject them to current income tax at ordinary income tax rates on their pro rata shares of certain corporate income whether or not the income is distributed to them. If, in order to avoid this result, they liquidate the corporation, they will be taxed on their shares of the unrealized appreciation in the corporation's assets on liquidation and, if their shares of the value of the assets received on liquidation exceeds their basis in the stock of the corporation, on that gain as well.[299]

The tax on the unrealized appreciation in the corporation's assets can be avoided by liquidating the corporation within 30 days of the death of the non-U.S. person. The liquidation will be timely if it prevents the corporation from having been a CFC for 30 days or more during the year of death of the non-U.S. person.[300] For purposes of counting the 30 days, the date of death of the non-U.S. person is excluded and the date of the liquidation is included. For example, if a nonresident alien dies on September 1 and her will bequeaths her 100% ownership in a foreign corporation to her U.S. daughter, a liquidation of the corporation on or before September 30 would be timely, but liquidation on or after October 1 would not be.[301]

The 30 day time limit can effectively be extended by using a corporation that would be classified as a partnership or disregarded entity for U.S. income tax purposes, if an appropriate election is made.[302] Within 75 days after the death of the nonresident alien, the foreign corporation would file an election to be classified as a partnership for U.S. income tax purposes effective two days after the death of the nonresident alien. The effect of the election will be to treat the corporation as having distributed all of its assets and liabilities to its U.S. shareholder in complete liquidation of the corporation on the day before the effective date of the election.[303] The corporation will be treated as recognizing gain to the extent the fair market value of its assets exceeds its basis in those assets, but will not pay U.S. income tax on this gain because it is not subject to U.S. income tax.[304] The basis of the corporation's assets in the hands of its U.S. shareholder will be the fair market value of the assets on the day before the effective day of the election.[305] The deemed receipt by the shareholder of the corporation's assets will be

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[299] If the liquidation takes place shortly after the death of the nonresident alien, the basis adjustment normally applicable under Code § 1014 will often eliminate the tax on the unrealized gain with respect to the shares of stock. *See* discussion at IV.E. below.

[300] Code §951(a)(1).

[301] Treas. Reg. § 1.951-1(a) and (f).

[302] Treas. Reg. § 301.7701-2 classifies, for U.S. income tax purposes, a foreign business entity, other than an entity that is automatically classified as a corporation under Treas. Reg. § 301.7701-2(b), as a partnership if it has more than one member at least one of which does not have limited liability, or as an association taxable as a corporation if all of its members have limited liability. If the entity has only one member and that member does not have limited liability, the entity is disregarded as an entity separate from its owner. A business entity is, generally, any entity other than an entity properly classified as a trust. Foreign entities that are automatically classified as corporations include the Societe Anonyme in Belgium, France, and Switzerland, the Aktiengellschaft in Austria, Germany and Switzerland, the Sociedad Anonima in Mexico and Spain, and the Public Limited Company in the United Kingdom. If a foreign entity is not automatically classified as a corporation, but is classified as an association taxable as a corporation because all of its members have limited liability, it may elect to be classified as a partnership by filing Form 8832 with the appropriate IRS service center. The election made on Form 8832 will be effective on the date specified on the form, provided that the effective date may not be more than 75 days prior to or more than 12 months after the form is filed.

[303] Treas. Reg. § 301.7701-3(g)(1)(iii).

[304] Code § 311(b).

[305] Code § 334(a).

treated as amounts received in exchange for her stock.[306] Any gain recognized, however, should be minimal if the basis of the stock of the corporation was adjusted under Code § 1014 to the value as of the date of death of the nonresident alien.[307]

U.S. income tax could be imposed, however, if the corporation owns U.S. real estate. Similarly, U.S. tax could be imposed if the corporation directly or indirectly owns shares of PFICs and beneficiaries are considered to indirectly own the shares. In that case, the deemed disposition of the PFIC shares as a result of the liquidation of the foreign corporation would be taxable to a U.S. shareholder/beneficiary who was treated as the indirect owner of the PFIC shares. If the foreign corporation owns PFIC shares, it would be preferable if the effective date of the check-the-box election was immediately before the death of the grantor/owner of the trust, rather than effective immediately after her death. That conclusion is correct because only the grantor is treated as indirectly owning shares held by a grantor trust, so the U.S. beneficiaries will not be considered to indirectly own the shares during the lifetime of the grantor.[308]

However, an election effective immediately before death may expose U.S. situs assets to U.S. estate tax if the grantor held any interests or powers that would cause inclusion in her gross estate. To avoid gain recognition on U.S. real estate and to allow a check-the-box election to be made effective immediately before death without exposing such assets to U.S. estate tax, U.S. real estate and shares of PFICs should be segregated in separate foreign holding companies so that different choices can be made for each regarding check-the-box elections. Alternatively, a tiered structure could be used.

For example, suppose that a FGT whose grantor is a NRA owns 100% of two foreign corporations: #1 and #2. The two foreign corporations own a third foreign corporation, #3, that has U.S. and foreign portfolio investments, some of which are PFICs. If corporation #3 makes a check-the-box election the day before the grantor dies, assuming that the classification of #3 was relevant for U.S. tax purposes,[309] the basis of assets held by #3 is stepped up to fair market value on the date of the deemed liquidation because the assets are deemed to have been acquired by #1 and #2 in full payment in exchange for their shares of stock of #3.[310] If the shares of corporations #1 and #2 that are directly owned by the trust are stepped up under Code §1014, and corporations #1 and #2 make check-the-box elections effective immediately after death, the estate tax shelter of corporations #1 and #2 is retained because at the time of the grantor's death they continued to be foreign corporations. The U.S. beneficiaries of the trust should not incur gain because the basis in the shares of #1 and #2 should equal the value of the assets owned by each. For the same reason, there is little risk of the U.S. beneficiaries realizing gain on the deemed disposition of the PFICs that, after the grantor's death, may be treated as indirectly owned by the U.S. beneficiaries.

This plan may reduce U.S. tax even if the foreign trust is not a grantor trust. If a nonresident alien individual has a general power of appointment which she exercises by will, the basis in the shares of corporations #1 and #2 is stepped up at the death of the holder of the general power.[311] Assume that the trust had no UNI because all accumulated income was retained in

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[306] Code § 331(a).

[307] Code § 1014. In the case of decedents dying before January 1, 2005, the Code § 1014 basis adjustment was not available for shares of FPHC's. This rule continues to apply to PFIC shares held by a U.S. decedent but does not apply to shares owned by a decedent who was a nonresident alien. Code §1291(e); Prop. Reg. §§1.1291-1(b); 1.1291-1(h)(2).

[308] Treas. Reg. §1.1291-1(b)(8)(iii)(D).

[309] Treas. Reg. §301.7701-3(d) and (g).

[310] Code §332(a) should not apply to the liquidation of corporation #3 because there is no common parent as described in Code §1504(a). If Code §332 is not applicable, then the assets of Corporation #3 are received by shareholders (corporations #1 and #2) in exchange for stock. Although corporations #1 and #2 may have gain on the liquidation, the gain is not U.S. source income because the corporations are foreign.

[311] Code §1014(b)(4). Note that a power exercisable with the consent of an independent person is still a general power. Code §2041(b)(1)(C).

the corporations and there were no U.S. beneficiaries to whom ownership could be attributed. The assets of corporation #3 get a basis adjustment when the pre death check-the-box election is made. The post death check-the-box elections for #1 and #2 results in the trust owning assets with a fair market value basis and no UNI. The gain realized on the pre-death election as to corporation #3 did not create DNI or UNI; it created corporate income for corporations #1 and #2 which did not pass through to the trust because no dividends were paid and neither corporation was a CFC for as long as 30 days.

IV. TAX TREATMENT OF U.S. BENEFICIARIES OF GRANTOR TRUSTS WITH FOREIGN GRANTORS

A. Background

The 1996 Act limited the circumstances in which a person who is not a U.S. citizen or resident ("foreign person") will be treated as the owner of a trust under the grantor trust rules.

Under prior law, a foreign person was treated as the owner of a trust under Code §§ 673 through 678 of the Code to the same extent as a U.S. person, whether the trust was foreign or domestic. Only Code § 679 was limited to U.S. grantors. If a foreign person were treated as the owner of the income, then (i) the foreign grantor-owner was taxed on such income only under the limited rules for taxing nonresident alien individuals and foreign corporations; and (ii) distributions from the trust to U.S. beneficiaries were treated as gifts from the foreign grantor-owner. Such gifts generally were not taxable to the U.S. beneficiary as income.[312] Gift tax would not be imposed so long as the subject matter of the gift was either intangible property or situated outside the U.S.

B. Limitation on Grantor Trusts

Code § 672(f) prevents avoidance of U.S. income tax by limiting the circumstances in which foreign persons will be treated as the owner of trust assets under the grantor trust rules. Generally, the grantor trust rules will apply only to the extent the rules result in an amount (if the trust has any income) being currently taken into account in computing the income of a U.S. person.

C. Definition of "Grantor"

Treasury regulations define the term "grantor" as a person (which may include both an individual and a non-natural person) to the extent such person either creates a trust or directly or indirectly makes a "gratuitous transfer" of property to a trust. [313] Prior to the issuance of regulations on July 5, 2000, there was no clear definition of "grantor," which led to abuses.[314]

1. Accommodation Grantor

If a person creates or funds a trust on behalf of another person, both persons are treated as grantors, but only the person making gratuitous transfers may be treated as the owner of the trust. A person who is reimbursed for a gratuitous transfer is not treated as an owner of any portion of the trust. For example, if an attorney settles a trust for the benefit of a client's children, funds the trust with $5,000 and later receives reimbursement for such contribution, the attorney is a grantor who may have an obligation to report the creation of the foreign trust and the transfer of funds to the trust for purposes of Code § 6048, but the attorney is not treated as the owner of any portion of the trust.[315] If an accommodation grantor, such as the attorney in the above example, were treated as the grantor for purposes of the exception to the intermediary rule, the

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312 Rev. Rul. 69-70, 1969-1 C.B. 182.

313 Treas. Reg. § 1.671-2(e).

314 T.D. 8890 (7/5/2000).

315 Treas. Reg. §§ 1.671-2(e)(1) and 1.679-3(c); *Example 3* of Treas. Reg. §1.671-2(e)(6).

intermediary rule would be easily circumvented.[316] Distributions could be made from foreign trusts through accommodation grantors and such transfers would be tax-free gifts to the U.S. donees. Applicable regulations seek to prevent this by limiting the exception to distributions from the "portion of the trust" of which the intermediary is the grantor.[317]

2. "Gratuitous Transfer"

A gratuitous transfer means a transfer other than a transfer made for fair market value or a distribution made by an entity, such as a corporation or partnership, in respect of an interest in such entity owned by a trust. For example, dividends received from a corporation in which a trust owns stock are not gratuitous transfers. A transfer for fair market value means a transfer in consideration for and equal to the value of (i) property received from the trust (other than an interest in the trust); (ii) services rendered by the trust; or (iii) the right to use property owned by the trust. A transfer may be gratuitous without regard to whether it is a gift for gift tax purposes and without regard to whether gain is recognized on the transfer.

3. "Grantor" Includes Purchasers

A grantor includes a person who acquires a beneficial interest in a trust from the grantor if the trust is one of the following: a fixed investment trust described in Treas. Reg. § 301.7701-4(c), a liquidating trust described in Treas. Reg. § 301.7701-4(d) or an environmental remediation trust described in Treas. Reg. § 301.7701-4(e).

4. Grantors Who Are Corporations or Partnerships

A corporation or partnership will be treated as the grantor of a trust established for a business purpose, such as to secure a legal obligation to an unrelated third party. However, if a corporation or partnership establishes a trust for a purpose other than a business purpose, the shareholder or partner on whose behalf the trust was deemed to have been established will be treated as constructively receiving the property and contributing it to the trust.[318]

5. Trusts Established by Other Trusts

If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust *unless* a person with a general power of appointment over the transferor trust exercises the power in favor of another trust. When this occurs, the power holder is treated as the grantor of the transferee trust.[319] This rule applies even if the grantor of the transferor trust is treated as the owner of the transferor trust. This rule creates significant planning opportunities.

A power of appointment exercisable with the consent of a person who is not the grantor or an adverse party may be a general power. For example, suppose that A creates a foreign trust which is treated as owned by A. Further suppose that B, who is a nonresident alien individual, has a general power of appointment over the trust exercisable with the consent of a protector who is related to A but who has no beneficial interest in the trust. If B exercises the power to appoint the trust assets to a new trust, B is treated as the grantor of the trust to which the assets have been appointed. Although B will not qualify as the owner of the trust unless the requirements of Code § 672(f)(2) are met, distributions through B may satisfy the exception to the intermediary rule in Code § 643(h) even if B is not treated as the owner of the trust.

Code § 672(f)(5) does not apply to make A the owner of the trust (even assuming that A were a beneficiary of the transferee trust) unless B would otherwise be treated as the owner of the trust.

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[316] Code § 643(h) excludes a grantor from the class of persons who are treated as intermediaries.

[317] Treas. Reg. § 1.643(h)-1(b)(2).

[318] Treas. Reg. § 1.671-2(e)(4).

[319] Treas. Reg. § 1.671-2(e)(5).

Code § 679 treats A as the owner of the foreign transferee trust if A has transferred property to the trust, directly or indirectly, and the trust has a U.S. beneficiary, unless the transfer was for value. Has A indirectly transferred property to the trust established by B's exercise of B's power of appointment? Does Treas. Reg. § 1.671-2(e)(5) affect the analysis? That regulation makes B, and not A, the grantor of the transferee trust. Does this regulation preclude A from being treated as the transferor of the transferee trust for purposes of Code § 679?

If B's power were a limited power of appointment, A would continue to be treated as the grantor of the trust to which the assets were appointed.

6. Code § 678 Powers

The regulations clarify that a person who has the right to withdraw assets from the trust is not a "grantor." Although such a person would be treated as the owner of the trust under Code § 678 if he or she were a U.S. person, a foreign person who has an *unexercised* Code § 678 power will not be treated as the owner of a trust.[320]

If the person who has the Code § 678 power exercises the power to create a new trust, then he or she will qualify as the grantor. Even if he or she will not qualify as the owner of the trust, distributions may be made through the new grantor. The grantor is never treated as the intermediary.

Reg. § 1.671-2(e)(5) provides that a person who funds a trust by exercising a general power of appointment is the grantor. The general power of appointment, but not the Code § 678 power, can be subject to limitations on exercise. Therefore, a power of appointment may be more useful for changing the grantor.

However, there is a risk that a nominal grantor will not be treated as the grantor for purposes of the intermediary rule. In some cases, the more conservative course may be to give the grantor control over assets before they are resettled in a new trust so that there is less argument for challenging her status as a real grantor.

7. Trust as Owner of Another Trust

A trust can be treated as the owner of another trust under the grantor trust rules. For example, if Trust-1 funds Trust-2 pursuant to the exercise of the trustee's discretion, but the trustee of Trust-1 retains a power to revoke Trust-2 and revest the assets in Trust-1, Trust-1 will be treated as the owner of Trust-2 under Code § 678.[321]

D. Foreign Persons Not Treated as Owners

1. General Rule

Code § 672(f)(1) provides:

> Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

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[320] Treas. Reg. § 1.671-2(e)(6), *Example 4.*

[321] Treas. Reg. § 1.671-2(e)(6), *Example 8.*

2. Exceptions to General Rule

Code § 672(f)(2) provides three exceptions to the general rule of Code § 672(f) - certain revocable trusts, trusts that benefit only the grantor and the grantor's spouse and compensatory trusts. In addition, certain trusts in existence on September 19, 1995 are grandfathered from the new rules.

a. Revocable Trust

A trust is exempt from Code § 672(f)(1) if it is revocable by the grantor alone or with the consent of a "related or subordinate party" as defined in Code § 672(c) who is subservient to the grantor.[322] In the event of the grantor's incapacity, the trust will continue to qualify as revocable if a guardian or other person has the power to revoke the trust on behalf of the grantor without the consent of any other person.

A related or subordinate party is a "nonadverse party" who is the grantor's parent, issue, sibling, employee, a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. A nonadverse party is a person who does not have a sufficient beneficial interest in the trust to be adverse to the exercise of the power of revocation. Therefore, the exception in Code § 672(f)(1) may not apply where the grantor needs a beneficiary's consent to revoke the trust, even if, without regard to the "nonadverse party" requirement, the beneficiary is a related or subordinate party. However, if the beneficiary whose consent is required is the grantor's spouse, the spouse's adverse interest should be disregarded because any power or interest held by the grantor's spouse is treated as if held by the grantor.[323] However, it is not clear whether Code § 672(f) overrides Code § 672(e).

Persons within the category of related or subordinate are presumed to be subservient to the grantor unless shown by a preponderance of the evidence to be not subservient.[324]

De facto control over the person who holds the consent power is not sufficient. Example 3 of Treas. Reg. § 1.672(f)-3(a)(4) provides that where an independent trustee has the power to revest assets in the grantor and the grantor has the power to replace an independent bank with a related or subordinate trustee, the nonresident alien grantor will not be treated as the owner of the trust. Example 1 reaches the opposite conclusion where the bank serving as trustee is owned and controlled by the grantor's brother. The regulations are not consistent with the IRS rulings concerning when trustee powers are imputed to the grantor.[325] If the grantor has the power to remove the independent bank and appoint himself as trustee, the powers of the trustee should be imputed to the grantor, but the regulations suggest that the IRS would not agree.

Treas. Reg. § 1.672(f)-3(a)(2) requires that the revocation power must be exercisable for a period aggregating 183 days or more during the taxable year of the trust. If the year is less than 183 days, the 183 day requirement is met if the trust is revocable for each day of the short year.

Treas. Reg. § 1.672(f)-3(a)(1) provides that if a trust does not qualify for the limited exception for certain revocable trusts for a particular year, the trust will not qualify for the exception in any subsequent year even if the trust is later revocable by the grantor. To avoid this result, the grantor could exercise the power and resettle the trust.

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[322] The trust need not expressly state that it is "revocable" as long as the grantor has the power to "revest absolutely in the grantor title to the trust property."

[323] Code § 672(e). If this subsection applies, then the trust would qualify as a grantor trust where the power of revocation was held by the grantor's spouse rather than by the grantor.

[324] Treas. Reg. § 1.672(f)-3.

[325] *See*, for example, Rev. Rul. 79-353, 1979-2 C.B. 325; as modified by Rev. Rul. 95-58, 1995-2 C.B. 191.

A beneficiary who has a withdrawal right is not treated as the de facto grantor. For example, a beneficiary who can withdraw all of the assets of a trust at any time is not defined as the grantor, and thus cannot be treated as the owner of the trust under Code § 672(f)(2)(A)(i). If the beneficiary actually withdrew trust assets and funded a new trust, the beneficiary would be treated as the grantor-owner if she retained the same right to withdraw the assets from the trust.

b. Trust for the Benefit of Grantor or Spouse

A trust that benefits *only* the grantor or the grantor's spouse during the lifetime of the grantor is exempt from Code § 672(f)(1). If any amount is distributable to another person, even temporarily, the trust will not be a grantor trust under this exception. For example, if a trust benefits only the grantor except that distributions may be made to the grantor's child during the period the child attends graduate school, the trust will not be a grantor trust even after the child graduates.[326]

This exception does not require that the grantor be a beneficiary of the trust. For example, a trust that authorized distributions to the grantor's spouse and nobody else would qualify. However, if the grantor survives her spouse, distributions could not be made during the grantor's lifetime to anyone else. Similarly, a trust that directed all income be accumulated and no principal distributions be made during the lifetime of the grantor would qualify for this exception.

The regulations treat certain amounts that are distributable to discharge a legal obligation of the grantor or the grantor's spouse as distributable to the grantor or the grantor's spouse for purposes of determining the applicability of this exception.[327] If the obligation is owed to a person not related to the grantor or the grantor's spouse, the exception is applicable so long as it is enforceable under the local law of the jurisdiction where the grantor or the grantor's spouse resides. If, however, the obligee is a related person (other than a spouse who is legally separated from the grantor under a decree of divorce or separate maintenance), the exception will not apply unless "it was contracted, bona fide and for adequate and full consideration in money or money's worth"[328] or unless the related person is an individual who would be treated as a dependent of the grantor or the grantor's spouse under Code § 152(a)(1) through (9) if the grantor or the grantor's spouse provided more than half of her support and that individual is either permanently disabled or younger than 19 years of age.

For this purpose, a person is related to the grantor or the grantor's spouse if the relationship between them would result in a disallowance of losses under Code § 267 or § 707(b) with the following expansions of the relationships described in those provisions:

- For purposes of applying the family relationship rules of Code § 267, the family of an individual includes the individual's spouse; and

- For purposes of applying Code § 267 (other than Code § 267(f)) and Code § 707(b)(1), a 10%, rather than a 50% interest, is required.

The regulations do not address the consequences of divorce except to say that distributions pursuant to a decree of divorce or separate maintenance are deemed to satisfy the legal obligations of the grantor. Therefore, it is uncertain whether a trust which fails to terminate the beneficial interest of the grantor's spouse upon divorce will qualify for this exception to Code § 672(f)(1).

The exception in Code § 672(f)(2)(A)(ii) also applies to certain business trusts established by a corporation or other business entity. For example, a trust established by a corporation to secure a loan to finance an airplane will be a grantor trust

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326 Treas. Reg. § 1.672(f)-3(b)(4), *Example 3*.

327 Treas. Reg. § 1.672(f)-(3)(b)(2)(i).

328 Treas. Reg. § 1.672(f)-(3)(b)(2)(ii).

under this exception if distributions may only be made to satisfy the legal obligations of the corporate grantor arising out of its loan and upon satisfaction of the loan, the balance reverts to the corporate grantor.[329]

c. Certain Compensatory Trusts

Compensatory trusts are exempt from Code § 672(f)(1). The final regulations clarify that compensatory trusts include those for self-employed persons (independent contractors) as well as employees.[330]

d. Limited Grandfathering for Trusts Funded as of September 19, 1995

Code § 672(f)(1) does not apply to trusts that are grandfathered. Grandfathered trusts are trusts to the extent funded as of September 19, 1995 that were either:

(1) Treated as owned by the grantor because distributions could be made to the grantor or the grantor's spouse without the consent of an adverse party; or

(2) Treated as owned by the grantor because the trusts were revocable by the grantor without the consent of an adverse party. Unlike the exception in Code § 672(f)(2), the person whose consent is required to revoke can be independent and need not be related or subordinate.

According to a literal reading of the statute, grantor trust status continues as long as the trust otherwise would continue to be so treated under any of the basic grantor trust rules except as to any portion of the trust that is attributable to transfers to the trust that are made after September 19, 1995. However, applicable regulations add some additional requirements.

According to Treas. Reg. § 1.672(f)-3(d), if any additions are made to a grandfathered trust, and the additions are not separately accounted for, the *entire* trust ceases to be grandfathered. There is no basis for this in the statute. However, the regulations clarify that physical separation is not required to satisfy the separate accounting requirement. In addition, the regulations give an extension of time to satisfy the separate accounting requirement. Separate accounting is satisfied if completed by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999. If the trust is not required to file a return, this regulation could be construed to suspend the separate accounting requirement until a return is required.

The statute says that Code § 672(f) does not apply to grandfathered trusts, with no requirement that the grandfathered trusts continue to satisfy the requirements for which grandfathered status was allowed. However, Treas. Reg. § 1.672(f)-3(a)(3) provides that a trust which was treated as owned by the grantor under Code § 676 on September 19, 1995 will no longer be grandfathered if it thereafter ceases to satisfy Code § 676. For example, suppose that A, a nonresident alien, was the grantor of a revocable trust in existence on September 19, 1995. No subsequent additions were made to the trust after September 19, 1995, but A released her power to revoke the trust on January 1, 2000.[331] A retained a power of substitution described in Code § 675(4) which would cause the trust to be a grantor trust if Code § 672(f) did not apply. According to the regulations, the trust would cease to be grandfathered as of January 1, 2000.

Similarly, Treas. Reg. § 1.672(f)-3(b)(3) provides that a trust that was treated as owned by the grantor under § 677(a)(1) or (2) on September 19, 1995 will no longer be grandfathered if it thereafter ceases to satisfy § 677(a)(1) or (2).

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329 Treas. Reg. § 1.672(f)-3(b)(4), *Example 6.*

330 Treas. Reg. § 1.672(f)-3(c).

331 To avoid the release of a power of revocation from being treated as a transfer to the trust, it would be prudent to continue to have a power of revocation exercisable with the consent of another person, who need not be a related or subordinate party who is subservient to the grantor.

For example, if A, a nonresident alien, was a beneficiary of a foreign trust that was in existence on September 19, 1995 and A released A's beneficial interest on January 1, 2000, but retained a testamentary power of appointment, according to the regulations, the trust would cease to be grandfathered as of January 1, 2000.

3. Trusts Created by Certain Foreign Corporations

Code § 672(f)(3) provides that the rules of Code § 672(f)(1) do not apply to a CFC or a PFIC. This prevents such corporations from using foreign trusts to avoid U.S. tax.[332]

CFCs, and PFICs are treated as domestic corporations for purposes of the grantor trust rules but are treated as foreign corporations for purposes of Code § 672(f)(4). Code § 674(f)(4) gives the IRS the authority to recharacterize purported gifts to U.S. persons that are made directly or indirectly from foreign corporations. The regulations treat gifts to U.S. persons that are made from a trust funded by a foreign corporation as if made indirectly by such corporation if that incurs more U.S. tax.

The regulations further provide that the rules of Code § 672(f)(4) also will apply if the CFC or PFIC is not the grantor of a foreign trust but is treated as the owner of such trust under Code § 678. Purported gifts to U.S. persons from the foreign trust over which a CFC or PFIC has a Code § 678 power will be treated as indirectly made by such CFC or PFIC.[333]

For purposes of determining whether the character of income and assets of a corporation qualifies it to be classified as a PFIC, the rules of Code § 672(f) are ignored. That is, the assets held in the trust are treated as held directly by the PFIC.[334]

E. Qualifying for a Basis Adjustment at the Grantor's Death

Under some circumstances, assets transferred by a nonresident alien to a trust will qualify for an adjustment to basis under Code § 1014 even though the assets are not subject to U.S. estate tax at the grantor's death.[335]

> Property transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent, with the right reserved to the decedent at all times before his death to revoke the trust;[336] and
>
> …[P]roperty transferred by the decedent during his lifetime in trust to pay the income for life to or on the order or direction of the decedent with the right reserved to the decedent at all times before his death to make any change in the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust.[337]

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[332] Treas. Reg. § 1.672(f)-2(a) extends these rules to FPHC's. Because the rules relating to FPHC's have been repealed by the 2004 Act, presumably this regulatory provision is no longer effective.

[333] Treas. Reg. § 1.672(f)-2(b)(2).

[334] Treas. Reg. § 1.672(f)-2(c).

[335] Rev. Rul. 84-139, 1984-2 C.B. 168; PLRs 8904046 and 201245006. In Rev. Proc. 2015-37 the IRS revised the list of areas of the Internal Revenue Code relating to matters on which it will not issue letter rulings or determination letters, adding whether the assets in a grantor trust will receive an adjustment to basis under Code § 1014 at the death of the deemed owner for income tax purposes when those assets are not includible in the gross estate of the owner at death. The no-rule position applies to requests for guidance received after June 15, 2015. Rev. Proc. 2015-37, 2015-26 I.R.B. 1196 (June 15, 2015). Paragraph (9) of §1014(b), requires that assets be included in the gross estate of the decedent to obtain a basis adjustment, but this paragraph is expressly made inapplicable to property described in any other paragraph of that subsection.

[336] Code § 1014(b)(2).

Property passing without full and adequate consideration under a general power of appointment exercised by the decedent's will.[338]

The requirements of Code § 1014(b)(2) and (3) are different from the requirements to qualify a trust as a grantor trust under Code § 672(f). First, it is not clear that an irrevocable trust payable to or on the order or direction of the grantor will qualify for the exception for a trust that is payable only to the grantor or the grantor's spouse. As a matter of tax policy, this should not be a problem. Second, the grantor's retained power to alter, amend or terminate a trust should not be exercisable to allow payment to anyone other than the grantor or the grantor's spouse during the grantor's lifetime. Code § 1014(b)(3) should be satisfied even where the grantor's power to alter, amend or terminate the trust applies to distributions made after the grantor's death.[339]

If a basis adjustment is not possible under Code § 1014(b)(2), (3) or (4), another possible way to adjust the basis of assets is to invest trust assets through a foreign entity that is eligible to make a check the box election under Treas. Reg. § 301.7701-3. If the election is treated as a deemed liquidation, the assets will acquire a new basis equal to the fair market value of such assets on the deemed liquidation date.[340] An election may be made following the grantor's death to be effective before death provided the election is filed within 75 days of the effective date.[341] However, the results of this would be disastrous for U.S. beneficiaries of the trust if they were taxable as constructive owners of the shares held by the foreign trust on the date of the deemed liquidation. U.S. beneficiaries should not be treated as constructive owners during the period that the trust was a grantor trust.[342]

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[337] Code § 1014(b)(3).

[338] Code §1014(b)(4).

[339] PLRs 8904046 and 201245006. PLR 201245006 is often cited as support for the proposition that any assets deemed owned by the grantor under Subpart E of Subchapter J of the Code qualify for a basis step adjustment under Code § 1014 at the grantor's death even if such assets are not includable in the grantor's gross estate. The wording of the PLR lends credibility to this proposition. However, in fact, the trust involved in that ruling satisfied the requirements of Code § 1014(b)(3) for a basis adjustment and the ruling does not support allowing a basis adjustment when neither Code § 1014(b)(2) nor (b)(3) is applicable.

[340] Treas. Reg. § 301.7701-3(g). However, if the U.S. classification of the foreign entity as a corporation or disregarded entity was never relevant for U.S. tax purposes, the filing of the election could be treated as establishing the *initial* classification of the entity rather than as a liquidation, so that a basis adjustment would not be allowed. Treas. Reg. § 301.7701-3(d)(2).

[341] An election may be filed with an effective date up to 75 days prior to the date of filing. Treas. Reg. § 301.7701-3(c)(1)(iii). Thus, an election can be made after the grantor's death that is effective prior to the grantor's death. However, in this case, the consent of the grantor's executor may be necessary; each person who was an owner between the effective date of the election who is not an owner at the filing date must sign the election. Treas. Reg. §301.7701-3(c)(2)(ii). Presumably this means "tax owner" rather than legal owner. If the election is treated as a deemed liquidation, the election would cause assets to acquire a new basis as of the effective date of liquidation. The election is made on Form 8832, and a taxpayer identification number is required in order the make the election.

[342] A grantor is treated as actually owning the assets held by the grantor trust. Rev. Rul. 85-13, 1985-1 C.B. 184. Treas. Reg. § 1.958-1(b) attributes to the grantor ownership of shares in a CFC that are held by a grantor trust. The same rule applies to shares of the PFIC. Treas. Reg. §1.1291-1((b)(iii)(8)(D). Stock in a CFC owned or

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F. Consequences of Expatriation

Unless the foreign trust is a grantor trust under the rules of § 672(f), a U.S. person who expatriates at a time when she is treated as the owner of a foreign trust will cease to be treated as the owner of the trust under the grantor trust rules when she expatriates. If the grantor ceases to be treated as the owner of the foreign trust, Code § 684 will treat the grantor as having sold all of the assets of the trust immediately before the trust ceases to be a grantor trust and will be required to recognize gain but not loss.[343]

> **Example 24:** Joshua moved to the U.S. in 2000 for temporary employment. Joshua had established a foreign trust before becoming a U.S. resident. On the date of Joshua's immigration to the U.S., the trust owned securities worth $1 million that had a basis of $700,000 and that had had a value of $900,000 when he first became a U. S. resident. The trust is an irrevocable discretionary trust for the benefit of Joshua and his family and thus is not a grantor trust under § 672(f) while Joshua is not a U.S. person. However, while he is a U.S. person, the trust is a grantor trust. After two years, Joshua returns to his home in the U.K. The trust assets have appreciated to $1.2 million. Joshua will recognize at least $500,000 of gain immediately before he is no longer treated as the owner of the trust, that is, immediately before he ceases to be treated as a U.S. person. Depending upon the circumstances, this may occur when he departs or on January 1 of the year following his departure. Joshua's gain includes appreciation that accrued before Joshua moved to the U.S. Because the gain accrues immediately before Joshua ceases to be a U.S. person, he cannot avoid tax on non-U.S. source gains.

Joshua could avoid gain if the trust continued to qualify as a grantor trust after his residency terminated.

Joshua could avoid gain if the trust terminated immediately before he expatriated or if the trust became a U.S. trust prior to his expatriation. As discussed above at section I.B.6.c of this paper, the tax imposed by Code §684 may be reduced or eliminated by a timely distribution by the trust to a nonresident alien beneficiary which is deductible by the trust under Code § 661.

A person who expatriates may also be subject to tax under Code § 877A. That section applies only to a person who is a "covered expatriate." A "covered expatriate," with certain exceptions including some exceptions based on income and net worth, is a U.S. citizen who gives up her citizenship or a long-term permanent resident of the U.S. who gives up her residency. A long-term permanent resident is a person who has been a permanent resident of the U.S. for all or a portion of 8 years in the 15-year period prior to relinquishing residency. Code §877A applies to expatriations that occur after June 17, 2008.

When a covered expatriate expatriates, Code §877A treats her as having sold all her property, including certain property held in a trust treated as owned by her under the grantor trust rules, for its fair market value. The following are some differences between the recognition rules imposed by Code §877A and those imposed by Code §684.

1. Code § 684 is applicable only to transfers to foreign trusts; Code § 684 is not applicable to transfers to domestic trusts. If both Code §§ 684 and 877A apply, then Code § 684 applies first.[344] This is unfortunate for the expatriate since the Code § 684 rules are harsher.

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treated as owned by a nonresident alien individual is not treated as constructively owned by a U.S. individual. Treas. Reg. § 1.958-2(b)(3).

[343] Treas. Reg. § 1.684-2(e).

[344] Code § 877A(h)(3).

2. The property owned by the trust that is treated as owned by the expatriate for purposes of the mark-to-market tax is limited to property that would have been includable in her gross estate had she died at the time of expatriation and property that she is treated as beneficially owning under a facts and circumstances test (so that the expatriate would not be treated as owning any portion of the grantor trust in which she had no beneficial interest).[345]

3. The sale is deemed to have taken place on the day before the expatriation rather than immediately before the expatriation.

4. Code §877A permits the covered expatriate to offset her gains with her deductible losses; Code §684 does not.

5. Code §877A reduces the amount subject to tax by $693,000;[346] Code §684 does not.

6. Code §877A allows the payment of the expatriation tax to be deferred, with interest, if adequate security is provided, but no deferral is permitted by Code §684.

7. Code §877A permits the covered expatriate to use the fair market value of an asset on the date she became a U.S. resident as the basis for purposes of calculating gain if such fair market value is higher than the expatriate's basis.

If the trust is and remains a U.S. trust, Code § 684 will not apply.

G. Consequences of Immigration

1. Pre-immigration Trusts under Code § 679(a)(4)

Code § 679(a)(4) provides that if a foreign person becomes a U.S. resident within five years of directly or indirectly transferring property to a foreign trust, for purposes of Code §§ 679 and 6048, the grantor will be treated as if he or she funded the trust on the date her residency commenced. Code § 679(a) provides that a U.S. person who transfers property to a foreign trust shall be treated as the owner for a particular taxable year of the portion of the trust attributable to such property for such year if there is a U.S. beneficiary of any portion of such trust in such year.

Grantor trust status under Code § 679 may be avoided, of course, by the trust migrating to the U.S. since the statute only applies to foreign trusts.[347] However, as discussed below, Code § 679 is not the only basis upon which the new immigrant may be treated as the owner of the trust.

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[345] See Notice 2009-85, 2009-45 I.R.B. 598 Section 3.A and Instructions to Form 8854 (2013). Assets in the grantor trust are treated as owned by the grantor for purposes of calculating the net worth test for determining whether the person is a covered expatriate but are not counted for purposes of the mark-to-market tax calculation except to the extent the assets would be included in the expatriate's gross estate had she died at the time of expatriation and assets she is treated as beneficially owning under a broadly applied facts and circumstances test in Section III of Notice 97-19.

[346] The reduction amount is adjusted yearly for inflation. The $699,000 figure is the amount applicable to expatriations that take place in 2017. Rev. Proc. 2016-55, 2016-45 I.R.B., Section 3.33 (October 25, 2016).

[347] In PLR 200338015, a foreign pre-immigration trust was domesticated and thus ceased to be a grantor trust under Code § 679. The grantor retained no other power that would cause the trust to be a grantor trust. The IRS confirmed that the conversion of the trust from a grantor trust to a nongrantor trust did not trigger gain under

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a. Determination of whether a trust has a U.S. beneficiary.

As discussed at section I.B.2 of this paper, the Code and regulations take an expansive view of when a trust has a U.S. beneficiary.

However, a beneficiary who *first* became a U.S. person more than five years after a transfer to a foreign trust will not be treated as a U.S. person for purposes of that transfer.[348]

For purposes of Code §679, the term "U.S. person" includes a controlled foreign corporation, as defined in Code §957(a) ("CFC"), a foreign partnership with one or more U.S. partners, and a trust or estate, one or more beneficiaries of which are U.S. persons.[349]

b. The test for determining whether a foreign trust has a U.S. beneficiary is done annually.

If a foreign trust that has no U.S. beneficiary in one year acquires a U.S. beneficiary in a subsequent year, the U.S. grantor will be treated as receiving additional income in the year the trust acquires a U.S. beneficiary. The amount of additional income is equal to the UNI of the trust at the end of the preceding year. Such additional income is subject to the throwback tax, discussed above.[350]

If a foreign trust that has a U.S. beneficiary in one year ceases to have a U.S. beneficiary in a subsequent year, Code § 679 will cease to apply on January 1 of the subsequent year. The grantor will be treated as transferring all of the assets then in the foreign trust to the foreign trust on January 1 and Code § 684(a) will require the grantor to realize income and gain as if the trust assets had been sold.[351]

c. Indirect and constructive transfers

As discussed at section I.B.2 of this paper, Code §679 applies to indirect and constructive transfers to a foreign trust. The regulations under Code § 679 take an expansive view of indirect and constructive transfers.[352]

Transfers by a U.S. person to an entity owned by a foreign trust are treated as transfers to the foreign trust followed by a transfer by the foreign trust to the entity. This rule is not applicable, however, if the U.S. person is not related to a trust beneficiary or if the U.S. person demonstrates that the transfer is attributable to the U.S. person's ownership interest in the

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Code §684 because the trust was a U.S. trust at the time it became a nongrantor trust. The IRS also ruled that the funding of the trust before the grantor became a U.S. resident was a completed gift so that there were no gift or generation-skipping transfer tax consequences to the domestication. The ruling did not address the more pertinent question – whether the deemed transfer following immigration that occurs under Code §679(a)(4) has gift or generation-skipping tax consequences. However, the statute is clear by its terms that the deemed transfer is solely for purposes of Code §§ 679 and 6048.

348 Code § 679(c)(3); Treas. Reg. § 1.679-2(a)(3).

349 Code § 679(c)(2).

350 Code § 679(b); Treas. Reg. § 1.679-2(c)(1).

351 Treas. Reg. § 1.679-2(c (2).

352 Treas. Reg. § 1.679-3.

entity.[353] For example, if a foreign trust and a U.S. person jointly fund a corporation, each taking back stock proportionate to their transfers, Code § 679 is not applicable.

Transfers to a trust that are made by a corporation or partnership are treated as made by its shareholders or partners unless the trust serves a business purpose. For example, a corporation that funds a trust to secure a debt obligation serves a business purpose.[354]

If a person is treated as the owner of a trust (a "transferor trust") which makes a transfer to a foreign trust (a "transferee trust"), the person who is treated as the owner of the transferor trust is treated under Code § 679 as making the transfer to the foreign transferee trust.[355] This result is slightly different from the portion of the § 671 regulations that defines the term "grantor." The § 671 regulations provide that the grantor of a trust that makes a gratuitous transfer to another trust is the grantor of the receiving trust to the extent of such transfer unless the transferee trust is funded by the exercise of a general power of appointment held by another person.[356] In the latter case, the power holder, rather than the grantor of the transferor trust, is treated as the grantor of the transferee trust.

The § 671 regulations do not treat a person as the grantor of a transferee trust if the only reason that person was treated as the owner of the transferor trust was his, her or its possession of a Code § 678 power. The power holder becomes the grantor of a transferee trust only if the transferee trust is funded as a result of the power holder's exercise of her general power of appointment. This portion of the § 671 regulations is inconsistent with the § 679 regulations. Regulations under Code § 679 treat the beneficiary as the owner of the foreign transferee trust whether or not the beneficiary exercised her general power of appointment to fund the transferee trust. Of course, if the beneficiary exercises her general power of appointment, the same result occurs under both sets of regulations – the beneficiary is treated as the owner.

> **Example 25:** Suppose that FP creates a trust (Trust #1) that gives a U.S. beneficiary a withdrawal right that makes the U.S. beneficiary the owner of the Trust #1 under Code § 678. The trustee exercises a decanting power to appoint the assets of Trust #1 to Trust #2, a foreign trust that terminates the beneficiary's withdrawal right. Under Code § 679, the U.S. beneficiary will be deemed to own the assets of Trust #2 even though she has no withdrawal right. However, the beneficiary is not the grantor of either trust.

d. Deemed transfer date for pre-immigration trusts

If a nonresident alien grantor transfers property to a foreign grantor trust more than five years before becoming a U.S. person and within five years of becoming a U.S. person the trust is amended so that the trust ceases to be a grantor trust, the transfer to the trust is deemed to have been made within five years of immigrating to the U.S. and Code § 679(a)(4) applies.[357] For example, if the trust was a revocable trust, and the grantor released the power to revoke, the trust is deemed funded on the date the power of revocation is released.[358]

Because Code § 672(f) limits the circumstances in which a nonresident alien will be treated as the owner of a trust under the grantor trust rules, it also limits the circumstances in which an amendment to a trust will cause the trust to be subject

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353 Treas. Reg. § 1.679-3(f).

354 Treas. Reg. § 1.671-2(e)(4).

355 Treas. Reg. § 1.679-3(b).

356 Treas. Reg. § 1.671-2(e).

357 Treas. Reg. § 1.679-5(b)(1).

358 See Example 2 of Treas. Reg. § 1.679-5(c).

to Code § 679(a)(4). For example, assume that a nonresident alien grantor and her husband and children are beneficiaries of a foreign nongrantor trust created more than five years prior to the family immigrating to the U.S. If the grantor and her husband remain beneficiaries after the family immigrates, the trust will become a grantor trust under Code § 677. This is because Code § 672(f) will cease to apply to the grantor who has become a U.S. taxpayer. However, if prior to becoming U.S. taxpayers, the grantor and her spouse renounce their beneficial interests in the trust, so that Code § 677 will not apply, the trust may continue as a nongrantor trust after the family immigrates to the United States so long as the trust instrument contains no other provisions that would cause the grantor to be treated as owner. Code § 679 will not apply because the trust was created more than five years prior to immigration.

e. Treatment of undistributed income

If Code § 679(a)(4) applies, for purposes of Code §§ 679 and 6048, all UNI for periods prior to immigration to the United States is deemed contributed to the trust on the residency start date.[359] The statute provides that UNI that accrued before immigration is taken into account in determining the portion of the trust which is attributable to property transferred by such individual but "shall not otherwise be taken into account." The scope of the phrase "shall not otherwise be taken into account" is not entirely clear nor is it explained by regulations.

It seems clear that the grantor will not be taxed on the undistributed income or the deemed transfer of the assets to the foreign trust on the date U.S. residency commences. It remains unclear, however, whether the UNI of the trust prior to immigration remains subject to the throwback tax upon later distribution to a U.S. beneficiary. Consider the following examples:

> **Example 26**: Sally, who is not a citizen or resident of the United States, contributed $100x to a foreign trust in 2008. Sally and her husband and children are discretionary beneficiaries of the trust. On January 1, 2010, Sally and her husband became U.S. residents. At that time, the value of the trust was $125x of which $25x was UNI for 2008 and 2009. Suppose that a distribution was made to Sally of $15x on June 30, 2010, and that 2010 income of the trust was $5x.
>
> Sally is treated as contributing $125x on January 1, 2010. Sally is treated as the owner of the trust and is taxable on 2010 income. However, Sally is not taxable on the $25x of UNI she is deemed to have conveyed to the trust on January 1, 2010. The distribution made to Sally in June, 2010 should not be subject to the throwback tax because, Code § 671, subpart D of subchapter J, the subpart that contains the throwback tax, applies to a trust only to the extent that the grantor trust rules of subpart E do not apply. Although Code § 679 does not explicitly address this question, it would be inconsistent to tax Sally on the receipt of property from the trust which she is deemed to own for income tax purposes under Revenue Ruling 85-13.
>
> **Example 27**: Assume the same facts described in Example 26 except assume that Sally is no longer living on June 30, 2010 when a distribution of $15x is made to Sally's daughter, Betty. Code § 679 is not applicable to the trust after Sally's death. In this case, it is unclear whether the throwback tax will apply to Betty's distribution. The distribution exceeds current income but all prior UNI was deemed contributed by Sally on January 2010. The provision in Code § 679 (a)(4)(B) that pre-immigration income shall not be taken into account for any purpose other than determining which portion of the trust the grantor will be treated as owning post-immigration lends some support to an argument that the throwback tax should not apply.

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[359] Code § 679(a)(4)(B).

2. Treatment of trusts that become grantor trusts when the grantor or beneficiary immigrates.

a. Grantor trust rules applicable to U.S. persons will commence to apply.

Even if Code §679(a)(4) is not applicable, all of the other grantor trust rules would become applicable to trusts of which the immigrant is the grantor or a beneficiary after the immigrant becomes a U.S. person. Code § 672(f) will cease to apply to limit application of the grantor trust rules. Thus, the broad reach of Code §§ 673-678 will apply to potentially make the immigrant the owner of the trust. For example, the immigrant will be treated as the owner of the trust after becoming a U.S. person if she was the grantor of the trust and the immigrant or her spouse is a beneficiary or if the immigrant is has a withdrawal right described in Code § 678 even if the trust was funded more than five years before immigration occurred.

b. Treatment of pre-immigration UNI when the trust becomes a grantor trust.

It is not clear whether the UNI of a foreign trust which becomes a grantor trust under Code §§ 673-678 as a result of the immigration of a grantor or beneficiary is deemed added to the trust in a tax-free transaction as may occur in the case of trusts subject to Code §679(a)(4). There are two other possibilities. One possibility is that the UNI remains in the trust and may be subject to throwback tax when distributed to a U.S. beneficiary. This result would be inconsistent with the principle of Revenue Ruling 85-13 – that the grantor is treated as actually owning the assets in a grantor trust. If so, it would be strange to tax a grantor-owner on the receipt of property that she is deemed to own, or to treat another beneficiary as taxable on the receipt of assets deemed owned by the grantor rather than by the trust. In addition, it would also be inconsistent with Code § 671, which provides that subpart D of subchapter J applies only to the extent that subpart E does not apply.

Another possibility is that there is a deemed distribution from the nongrantor trust to the grantor when the grantor becomes a U.S. person and therefore is treated as acquiring tax ownership of the trust assets under the grantor trust rules. A grantor is treated as actually owning the assets held in a grantor trust.[360] Therefore, one could take the position that when a nongrantor trust becomes a grantor trust, a deemed distribution occurs. It is well settled that a deemed transfer occurs when a grantor trust becomes a non-grantor trust.[361] To be consistent, arguably the reverse should also be true, but there seems no authority for this proposition. If there were a deemed distribution, would the grantor have taxable income? Code § 679(a)(4) seems to preclude this possibility in the case of pre-immigration trusts because the deemed transfer to the trust is solely for purposes of §§ 679 and 6048. Why should older trusts be treated more harshly?

Notwithstanding the fact that a transfer is deemed to occur when a grantor trust becomes a nongrantor trust, which transfer can be a taxable event, apart from Code § 679(b), there is no authority for the reverse – that a deemed transfer to the grantor occurs when a nongrantor trust becomes a grantor trust or, even if it does, that this deemed transfer constitutes a taxable event. In Chief Counsel Advice 200923024, the taxpayer sold a partnership interest to a nongrantor trust in exchange for an annuity. Gain on the sale would be recognized as annuity payments were made. The trust received a cost basis in the partnership interest it purchased in exchange for the annuity even though recognition of gain to the seller was deferred and reported as the annuity payments were made. The partnership elected under Code § 754 to adjust the basis of partnership assets. The partnership owned appreciated securities which it then sold. The stepped up basis on partnership assets avoided tax on the sale. In order to avoid the taxpayer having to recognize gain as annuity payments were made, the taxpayer arranged for the trusts to become grantor trusts. The IRS argued that in order to ensure that taxable income is recognized from the sale of the appreciated stock owned by the partnership, the conversion of the trust from nongrantor to grantor trust should be treated as a taxable transaction. The grantor should be treated as realizing income on the receipt of assets from the nongrantor trust. Even though the Chief Counsel viewed the transaction as abusive, the government's argument was rejected.

> "Assuming the transaction in the present case is abusive, asserting that the conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor would have an impact on non-abusive situations.

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360 Rev. Rul. 85-13; 1985-1 C.B. 189.

361 E.g., *Madorin v. Commissioner*, 84 T.C.667 (1985); Treas. Reg. §1.1001-2(c) Example (5).

> A nongrantor trust may become a grantor trust in several situations: examples include the appointment of a related or subordinate trustee to replace an independent trustee as in the present case (§674); a borrowing of the trust corpus under §675(3) …; or the payment of the grantor's legal support obligations under §677(b). No prior guidance dealing with these events has indicated that they result in taxable income to the deemed transferee (the owner of the grantor trust). Rev. Rul. 85-13 concluded that the grantor became the owner of the trust corpus which he had indirectly borrowed and thus was taxable on the trust's income and, as the deemed owner of the trust assets, could not engage in a transaction with the trust that would be respected for income tax purposes. It did not conclude that the grantor realized the amount of the indirect borrowing or any portion of that amount as income under §61 or any other section. Therefore, while we agree that this appears to be an abusive transaction, the Service should not take the position that the mere conversion of a nongrantor trust to a grantor trust results in taxable income to the grantor."

Because a conversion of a trust from nongrantor to grantor trust status can occur for a variety of common reasons, if the conversion were a taxable event it is reasonable to expect that there would have been some authority supporting it. The absence of authority supports the proposition that such conversion has no immediate tax consequences.

In addition, Code § 679(b) supports the proposition that conversions to grantor trust status for any reason other than that subsection are not taxable distributions to the grantor. Code § 679(b) specifically provides that when a foreign trust that is not a grantor trust under Code § 679 because it has no U.S. beneficiary subsequently acquires a U.S. beneficiary, the trust becomes a grantor trust and the grantor is taxable on all of the undistributed net income of the trust.[362] If all conversions of nongrantor trusts to grantor trusts were deemed to be taxable distributions to the grantor, Code § 679(b) would be superfluous.

3. Pre-immigration amendments to obtain grantor trust status

Post-immigration grantor trust status may be advantageous to U.S. beneficiaries. Suppose that a grantor created a trust more than five years before immigrating to the United States. The trust had substantial UNI when the grantor became a U.S. resident. If the trust remains a nongrantor trust, a distribution to a U.S. beneficiary that is deemed to carry out that UNI would be subject to throwback tax, as discussed below. However, if the trust becomes a grantor trust when the grantor becomes a U.S. resident and if the conversion is not treated as a taxable distribution to the grantor, a subsequent distribution from the grantor trust to a U.S. beneficiary should not be taxable. If the grantor is treated as owning trust assets, then the beneficiary is treated as if she received a gift from the grantor rather than a distribution from a trust.[363] Thus, the change from nongrantor trust classification to grantor trust classification may avoid throwback tax on UNI that accrued before U.S. residency started. This result arguably is inconsistent with the purposes of Code § 672(f), which was intended to limit the use of the grantor trust rules to shield U.S. beneficiaries from income tax on trust distributions.

4. Pre-immigration amendments to prevent grantor trust status

Suppose that a grantor fully funded a trust more than five years before becoming a U.S. resident, is not treated as the owner of the trust due to the limitations in Code § 672(f) but would start to be treated as the owner after the grantor becomes a U.S. person and Code § 672(f) no longer applies. If, before becoming a U.S. person, all of the interests or powers that would make the trust a grantor trust after U.S. residency commences are released, then the trust will continue as a foreign nongrantor trust.

For example, suppose that *prior* to becoming a U.S. resident, the trust is modified to require the consent of an adverse party prior to making distributions to the grantor and the grantor's spouse (and the trust was not otherwise a grantor trust). In that case, the trust would remain a foreign nongrantor trust even after the grantor became a U.S. resident. Form 3520 would

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[362] See also Treas. Reg. § 1.679-2(c).

[363] Rev. Rul. 69-70, 1969-1 C.B. 182.

not have to be filed except when distributions were made to U.S. persons. In effect, the income of the trust would be taxed in the United States only on a remittance basis.

Suppose instead that the modification to require the consent of an adverse party occurs *after* the grantor becomes a U.S. resident. Code § 679 would apply when the trust is modified because the cessation of the U.S. grantor's treatment as the owner of the foreign trust should be treated as a deemed transfer to a foreign trust by the U.S. grantor.[364]

5. Treatment of pre-immigration UNI if trust remains a nongrantor trust

As discussed above in section III. C. 2. g, the UNI of a foreign nongrantor trust is subject to throwback tax if and when distributed to U.S beneficiaries, including UNI attributable to periods prior to the grantor's immigration to the U.S. This is true because the character of the income distributed to a U.S. beneficiary is disregarded (except for tax-exempt income). However, the interest charge on the throwback tax would not apply to tax on income attributed to a year in which the recipient was not a U.S. resident.[365] Thus, the use of a nongrantor trust for U.S. beneficiaries works best when the trust will not be distributing its UNI.

H. Shifting the Identity of the Grantor – Code § 672(f)(5)

Code § 672(f)(5) provides that if a foreign person funds a trust which would be a grantor trust and a U.S. person who is a beneficiary made gratuitous transfers to such foreign person, the U.S. beneficiary will be treated as the grantor-owner of the trust.[366] The rule applies whether or not the beneficiary was a U.S. person at the time of the transfer to the foreign person, but only if the U.S. person making the gratuitous transfer to the foreign person is a beneficiary. For example, if A transfers assets to her brother, B, who is a nonresident alien, before becoming a U.S. person and B establishes a revocable trust for A and A's family, A will be treated as the grantor after she becomes a U.S. person.

Code § 672(f)(5) would not apply if A were not a beneficiary. For this purpose, however, the IRS views a person who may be added as a beneficiary as a "beneficiary."[367]

Code § 672(f)(5) does not by its terms contain any time constraints on applying this rule. However, if the U.S. beneficiary can demonstrate that the transfer to the foreign person was wholly unrelated to the funding of the trust, Code § 672(f)(5) will not apply.[368]

Transfers not in excess of the amount not treated as taxable gifts under Code § 2503(b) are disregarded.[369]

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364 Cf, Treas. Reg. § 1.679-3(b); *Madorin v. Commissioner*, 84 T.C. 667 (1978).

365 Code § 668(a)(2).

366 The U.S. person will be considered the grantor under this section only to the extent that her transfers to the foreign person exceeded transfers from the foreign person to the U.S. person.

367 Treas. Reg. § 1.672(f)-5(a) refers to Code § 679 for the definition of "beneficiary." Code § 679 defines "beneficiary" very broadly to include, for example, persons who may be added as beneficiaries through the exercise of a power of appointment or power of amendment. *See*, Treas. Reg. § 1.679-2(a)(2) *Example 11;* Treas. Reg. § 1.679679-2(a)(4)(ii)(A).

368 Treas. Reg. § 1.672(f)-5(a).

369 *Id.*

I. Comparison of Code §§ 672(f)(5) and 679(a)(4)

Code § 679(a)(4) applies whether or not the purported nonresident alien grantor for any other reason would be treated as the owner of the trust and whether or not the U.S. person is a beneficiary of the trust. For example, if A transfers assets to her brother, B, who is a nonresident alien, B funds a trust for the benefit of A's descendants, and A becomes a U.S. person within five years of making the transfer to B, Code § 679(a)(4) will apply because A will be treated as indirectly funding the trust. Code § 672(f)(5) would not apply if B is not otherwise treated as the owner of the trust. (If the trust is irrevocable and benefits B's sister's descendants, the trust would not qualify as a grantor trust while B remained a nonresident alien.) Code § 672(f)(5) also would not apply if A were not a beneficiary of the trust. If A transferred the funds to B and B funded the trust more than five years before A became a U.S. person, Code § 679(a)(4) would not apply -- § 679(a)(4) does not apply if the trust is funded more than five years before immigration to the U.S.[370] It is not clear whether Code § 679(a)(4) applies if the U.S. person made a transfer to a nonresident alien person more than five years before immigration to the U.S. but the trust was funded within the five-year period before U.S. residency commenced.

Code § 672(f)(5) has an exception for transfers within the annual gift tax exclusion, but there is no dollar limitation for purposes of Code § 679(a)(4).

Code § 672(f)(5) has no time limit. Thus, if A transferred funds to B six years before moving to the U.S., B created a revocable trust for A, Code § 672(f)(5) may apply to treat A as the owner of the trust.

V. RECHARACTERIZATION OF PURPORTED GIFTS

A. "Purported Gift"

A "purported gift or bequest" is any transfer, other than a transfer for fair market value, made from a corporation or a partnership to a person who is not a shareholder or a partner. If the purported donee is a shareholder or partner, a purported gift includes a distribution not consistent with the donee's interest in the partnership or corporation.[371]

B. Purported Gifts From Partnerships

When a U.S. person receives a purported gift from a partnership (directly or indirectly), the entire amount must be included in the U.S. donee's gross income as ordinary income without regard to the amount of partnership income.[372]

C. Purported Gifts From Corporations

When a U.S. person receives a purported gift from a foreign corporation (directly or indirectly), the amount must be included in the U.S. donee's income as if it were a distribution from the foreign corporation. The distribution will be taxed as a dividend to the extent of earnings and profits and as a sale or exchange to the extent the amount exceeds earnings and profits. If the corporation is a PFIC, an interest charge may apply. If the distribution is taxed as a sale or exchange, the donee's basis will be deemed to be zero. The donee's holding period for determining whether any gain is short or long term is equal to the weighted average of the holding periods of the actual shareholders (excluding the holding period of shareholders who treat the purported gift attributable to their interest as if received by and taxable to them). If the purported donee is a corporation, no "deemed paid" foreign tax credit will be allowed under Code § 902 to offset U.S. tax.

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[370] Even if Code § 679(a)(4) is not applicable, the usual "intermediary" rules of Code § 679 are applicable. *See* Treas. Reg. § 1.679-3(c).

[371] Treas. Reg. § 1.672(f)-4(d).

[372] Treas. Reg. § 1.672(f)-4.

D. Exceptions

There are the following exceptions to the above rules:

1. Donee Has No Relationship to Partners or Shareholders

The purported gift rules do not apply if the U.S. person receiving the purported gift has no family or other relationship to a partner or shareholder that establishes a reasonable basis for concluding that the partnership or foreign corporation would make a gratuitous transfer to the U.S. donee.[373]

2. Domestic Partnership Wholly Owned by U.S. Citizens or Residents or Domestic Corporations

If all beneficial owners of a domestic partnership are U.S. citizens or residents or domestic corporations, the purported gift rules do not apply.[374] This exception does not apply to foreign partnerships. For this purpose, a "domestic partnership" is a partnership created or organized under the laws of the U.S. or any state of the U.S.[375]

3. A U.S. Citizen or Resident Individual Owning the Shares or Interests Reports the Distribution and Gift

If a U.S. citizen or resident individual who directly or indirectly holds an interest in the partnership or foreign corporation treated the gift as a distribution to the U.S. partner or shareholder and as a subsequent gift by such partner or shareholder to the U.S. donee, then the gift will not be taxable to the donee. There is no similar exception where the owner of the interest is a non-natural person, such as a trust.[376]

4. Foreign Individual Owning the Shares or Interests Reports the Distribution and Gift and U.S. Donee Reports the Gift

If a nonresident alien individual partner or shareholder reported the distribution from the entity and the gift for purposes of the tax laws of such individual's country of residence and the U.S. donee timely reported the gift in accordance with Code § 6039F, then the gift will not be taxable to the donee.[377] Example 1 of Treas. Reg. § 1.672(f)-4(g) suggests that if reporting in the foreign country is "not applicable" under the laws of such country, the exception may still be available.

5. Capital Contributions

The purported gift rules do not apply to contributions to the capital of a U.S. corporation described in Code § 118.[378]

6. Charities

The rule does not apply to payments made for an exempt purpose by donors who are charities and who have received determination letters of tax exempt status or to donees that are charities described in Code § 170(c).[379]

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[373] Treas. Reg. § 1.672(f)-4(d)(2)(ii).

[374] Treas. Reg. § 1.672(f)-4(b)(2).

[375] Treas. Reg. § 301.7701-5.

[376] Treas. Reg. § 1.672(f)-4(b)(1)(i).

[377] Treas. Reg. § 1.672(f)-4(b)(1)(ii).

[378] Treas. Reg. § 1.672(f)-4(b)(3).

E. Gifts Through Trusts Funded by Gratuitous Transfers from Partnerships or Foreign Corporations

If a partnership or foreign corporation creates and funds a trust, whether or not it is the entity or the partners or shareholders who are treated as the grantors of the trust (see Treas. Reg. § 1.671-2(e)(4) treating entities as the grantor of trusts established for business purposes and partners and shareholders as the grantor of trusts established for nonbusiness purposes), and then the trust makes a distribution to a U.S. person --

(a) The distribution is deemed made by the partnership or foreign corporation unless the rule in (b) applies.

(b) The distribution will be taxed as if it were made by the trust if the tax as so computed would be greater than the tax that would be imposed if it were treated as a distribution directly from the partnership or foreign corporation.[380]

(c) A distribution to a U.S. person from a trust funded by a foreign corporation or partnership will not be taxed as a purported gift by the entity or as a trust distribution if a U.S. donee demonstrates that the transfer has been taken into account for U.S. tax purposes by a U.S. citizen or resident or domestic corporation. No similar exception applies where a nonresident alien has reported the income. In Example 3 of Treas. Reg. § 1.672(f)-4(g), a purported gift to a U.S. person from a foreign trust funded by a foreign corporation is treated as subject to the accumulation distribution rules. The example does not mention whether a foreign shareholder reported the distribution and the gift. An inference can be drawn that the IRS considered this fact immaterial, since this information was mentioned in Example 1, where the distribution was made directly from the foreign corporation.

F. Affirmative Use

Treas. Reg. § 1.672(f)-4(e) provides that a taxpayer may not use the rules under Code § 672(f)(4) affirmatively to reduce the taxpayer's tax liability. The regulation purports to give the IRS authority to "depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance."

G. De Minimis Rule

The purported gift rules do not apply if during the taxable year of a U.S. donee, the aggregate amount of gifts and bequests received directly or indirectly (such as from trusts) from all partnerships or foreign corporations that are related does not exceed $10,000.[381] The amount must include gifts or bequests from persons that the U.S. donee knows or has reason to know are related to the partnership or foreign corporation within the definition of "related" in Code § 643(i).

Footnote continued from previous page

379 Treas. Reg. § 1.672(f)-4(b)(4).

380 Treas. Reg. § 1.672(f)-4(c)(2).

381 Treas. Reg. § 1.672(f)-4(f). Although this regulation does not index the de minimis amount, Form 3520 does index the reporting threshold for purported gifts from partnerships and foreign corporations. The indexed amount for 2017 is $15,797. Rev. Proc. 2016-55, 2016-45 I.R.B., Section 3.42 (October 25, 2016).

H. Anti-Avoidance Rule - Check the Box

The purported gift rules cannot be avoided by electing pass-through treatment for a single member entity. A single member entity that elects to be taxed as a sole proprietorship under the check the box regulations will be treated as a corporation for purposes of Treas. Reg. § 1.672(f)-4.[382] This rule gives the IRS latitude to recharacterize purported gifts made by such entities.

VI. REPORTING OF DISTRIBUTIONS FROM FOREIGN TRUSTS AND GIFTS FROM FOREIGN PERSONS

A. Reporting by U.S. Beneficiaries of Foreign Trusts Who Receive Distributions

A U.S. person (including a grantor) who receives, directly or indirectly, or is treated as receiving, any distribution from a foreign trust must report to the IRS information regarding the name of the trust, the amount of distributions received from the trust, and such other information as the IRS may require.[383] Form 3520 is used to report distributions from foreign trusts.

In Notice 97-34,[384] the IRS describes the additional required information. Such information is to be set forth in either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement.

1. Nontaxable Distributions Are Reportable

Reporting is required even if the foreign trust is a grantor trust and whether or not Code § 663(a) applies to the distribution.

2. Only Gratuitous Transfers Are Reportable

All gratuitous transfers are reportable. Trustee fees, for example, are not reportable. However, if the trustee fees paid to a beneficiary/trustee are excessive, the distribution is reportable. The reporting obligation is waived if the payee reports the amount as taxable compensation for services rendered.

3. Constructive Distributions

Indirect and constructive distributions are reportable. For example, if a beneficiary uses a credit card and the trust guarantees or pays the invoice, the amount charged on the card is treated as a distribution. A beneficiary who draws a check on a trust account is in receipt of a distribution. A beneficiary who receives a payment for services or property in excess of the value of such services or property is deemed to have received a distribution.

4. Knowledge that Trust Is Foreign

Reporting is required only if the U.S. beneficiary knows or has reason to know that the trust is a foreign trust.

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382 Treas. Reg. § 1.672(f)-5(b).

383 Code § 6048(c).

384 1997-1 C.B. 422.

5. Information Required

a. IRS Discretion to Determine Tax

Code § 6048(c) provides that if adequate records are not provided (by the beneficiary or some other person) to enable the IRS to determine the proper tax treatment of any distribution received from a foreign trust, then the distribution will be treated as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax. For purposes of determining the interest charge on the throwback tax, the deemed accumulation period will be one-half of the years the trust has been in existence.

b. Appointment of Agent

To the extent provided in regulations, this rule will not apply if the foreign trust has appointed a U.S. agent for the purpose of responding to IRS inquiries. Any U.S. person may serve as the agent of the trust, including a grantor or a beneficiary. While the appointment of a U.S. agent is not required, if an agent is not appointed the IRS will have broad discretion to determine the amount of taxable income derived by the U.S. beneficiary from the trust. According to the "Blue Book" prepared by the staff of the Joint Committee on Taxation, Congress intended that the IRS's exercise of this authority will be subject to judicial review under an "arbitrary and capricious" standard, which provides a high degree of deference to the IRS.[385] A foreign trust which appoints such an agent will not be considered to have an office or permanent establishment in the United States, or to be engaged in a U.S. trade or business, solely because of the activities of the agent under Code § 6048. Notice 97-34 provides a form for the appointment of an agent.

c. Beneficiary Statements

A U.S. beneficiary may avoid the presumption that a distribution is taxable as an accumulation distribution from a foreign nongrantor trust, and therefore subject to the throwback tax, if with respect to the distribution, the beneficiary obtains from the foreign trust either (i) a Foreign Grantor Trust Beneficiary Statement to be attached to Form 3520, which would allow the beneficiary to treat the distribution as a nontaxable gift, (ii) a Foreign Nongrantor Trust Beneficiary Statement to be attached to Form 3520, or (iii) information regarding actual distributions from the trust for the prior three years ("default treatment"). Under the default treatment, a U.S. beneficiary will be allowed to treat a portion of the distribution as current income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution subject to the throwback tax. This rule is an adaptation of the rule for determining the interest charge on distributions from a passive foreign investment company.[386]

d. Exceptions

Beneficiaries need not report (i) distributions from trusts taxable as compensation for services rendered that are reported as such on the recipient's federal income tax return, or (ii) distributions from foreign trusts received by a U.S. charitable organization, provided that such organization has a determination letter from the IRS (that has not been revoked) recognizing its tax-exempt status.

It is not clear whether loans from grantor trust are reportable. Notice 97-34 provides:

> If a trust makes a loan to a grantor that causes the grantor to be treated as the owner of a portion of the trust under section 675(3), the loan will not be treated as a distribution under section 643(i) and will not be reportable under section 6048(c).

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[385] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 276.

[386] *See* Code § 1291(b).

Code 643(i) treats loans and the uncompensated use of trust assets as distributions for purposes of Subparts B, C and D. These Subparts do not apply to grantor trusts. Consequently, loans to a beneficiary from a grantor trust may not be reportable. Similarly, the uncompensated use by any beneficiary of trust assets owned by a grantor trust may not be reportable. However, Form 3520 does not "prompt" this result, and it is not clear why, as a matter of policy, an exception to the reporting requirements would be made for these transactions with grantor trusts when other distributions from grantor trusts are reportable.

e. Penalties for Nonreporting

A U.S. beneficiary who fails to report distributions from a foreign trust under Code § 6048(c) will be subject to a penalty equal to the greater of $10,000 or 35 percent of the amount distributed.[387] Additional penalties can be imposed for continuing noncompliance. Although the total penalties may not exceed the reportable amount, the IRS may assess the penalties before the reportable amount is determined and when the reportable amount is determined, the excess must be refunded. The IRS is authorized to assess and collect these penalties without prior judicial review.

The IRS is permitted to waive any penalty if the failure to file was due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on any person for disclosing the required information will not be considered a reasonable cause for failure to file. Notice 97-34 clarifies that "reasonable cause" does not include refusal on the part of a foreign trustee to provide information. This is true whatever the reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of information.

These penalties generally apply to distributions received after August 20, 1996. The minimum penalty applies to returns required to be filed after March 18, 2010.

Under the second voluntary disclosure initiative announced February 8, 2011, no penalty was imposed for failure to file information returns, including Form 3520, if all income was reported and the Form was filed by August 31, 2011.[388] A third voluntary disclosure initiative was announced on January 9, 2012 which is similar to the 2011 initiative but it has no time limit.[389]

f. Statute of Limitations

The statute of limitations does not begin to run until a return required by Code § 6048 is filed for an event or a period related to information required to be reported.[390] Section 512 of the 2010 HIRE Act increases the negligence penalty imposed by Code § 6662 from 20 percent to 40 percent for deficiencies attributable to an unreported foreign financial asset, which is defined as "any asset with respect to which information was required to be provided under section 6038, 6038B, 6038D, 6046A or 6048 for such taxable year but was not provided by the taxpayer as required under the provisions of those sections." Section 512 is applicable to taxable years beginning after March 18, 2010.

If penalties for nonreporting could apply under both Code §§ 6677 and 6039F, then the Code § 6677 penalty will be assessed and will reduce any penalty otherwise imposed under Code § 6039F.[391]

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[387] Code § 6677 as amended by section 535 of the 2010 HIRE Act.

[388] FAQ 17 and 18 on IRS webpage.

[389] I.R. 2012-5. The announcement cautions, however, that the IRS may terminate the initiative at any time.

[390] Code § 6501(c)(8).

[391] Notice 97-34.

B. Reporting Gifts from Foreign Persons

Code § 6039F imposes information reporting requirements on any U.S. person (other than certain tax-exempt organizations) who after August 20, 1996 receives, in the aggregate, gifts from foreign persons in excess of $10,000 in any taxable year.[392] A "gift" includes a bequest.[393] A foreign gift does not include an amount that is a "qualified transfer" under Code §2503(e)(2)(a) payment of tuition or medical expenses to a service provider) or any distribution from a foreign trust properly reported under Code § 6048. The $10,000 threshold is indexed for inflation after 1996. The threshold for 2017 is $15,797.[394]

1. Form 3520

Part IV of Form 3520 requires only a brief description of the property received, the fair market value of the property and the date of the gift where the donor is an individual or an estate. Form 3520 does not ask for the name and address of the donor except where the foreign donor is a corporation or a partnership. The identity of a foreign donor who is a corporation or a partnership must be disclosed. The form also asks whether the filer has any reason to believe that the foreign donor is acting as a nominee or intermediary for another person. Form 3520 does not indicate that a gift from a grantor should not be treated as gifts by an intermediary. Even though the identity of donors is not required in the case of donors who are individuals, it is important to note that upon request, the U.S. person may be required to provide additional information, including the identity of the donor.

2. Exceptions

Qualified tuition and medical payments are not taxable gifts under Code § 2503(e) and will not have to be reported. Distributions made from a foreign trust to a U.S. beneficiary, and which are reported by the U.S. beneficiary under Code § 6048(c), do not have to be reported again by the U.S. beneficiary under Code § 6039F.

3. Interaction of Code §§ 6039F and 6048

U.S. beneficiaries who receive distributions from foreign trusts should report the amounts under the trust reporting rules Code § 6048(c) rather than the gift reporting rules of Code § 6039F.[395] This is true even if the trust is grantor trust and the distribution is treated as a gift under principles of substantive law.

4. Gifts to Trusts

U.S. beneficiaries are not required to report contributions by foreign persons to trusts in which the U.S. beneficiaries have an interest, unless the U.S. beneficiaries are treated as receiving the contribution in the year of transfer (*i.e.*, a U.S. beneficiary has a Code § 678 power). A domestic trust that receives a contribution from a foreign person must report the gift unless the trust is treated as owned by a foreign person (*e.g.*, a foreign person creates a U.S. revocable trust). According to Notice 97-34 and the instructions to Form 3520, a U.S. beneficiary who receives a distribution from a domestic grantor trust owned by a foreign grantor must report it under Code § 6039F as a gift from a foreign person (*i.e.*, the deemed foreign owner of the domestic trust).

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[392] Code § 6039F.

[393] Code § 6039F(b).

[394] Rev. Proc. 2016-55, 2016-45 I.R.B., Section 3.42 (October 25, 2016).

[395] IRS Notice 97-34, Part VI. A.

5. Reporting Thresholds

a. Individuals and Estates

Notice 97-34 increases the statutory threshold for reporting gifts received from foreign individuals and foreign estates. The annual reporting threshold for the aggregate amount of gifts from a foreign individual or foreign estate is $100,000 with respect to that individual or estate. Once the $100,000 threshold is met, Form 3520 requires the U.S. donee to separately identify each gift in excess of $5,000; however, the U.S. donee is not required to identify the donor unless the IRS requests this information.

b. Corporations and Partnerships

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of gifts from all such entities exceeds $10,000 (as adjusted for the cost of living under Code § 6039F(d)) in the taxable year. Once the $10,000 threshold is met, Form 3520 requires the U.S. donee to separately report all purported gifts from such entities, including the identity of the donor entity. Such purported gifts are subject to recharacterization under Code § 672(f)(4).

c. Aggregation Rules

In calculating the threshold amounts with respect to a particular foreign person, a U.S. donee must aggregate gifts from foreign persons that he or she knows, or should know, are related (under Code § 643(i)(2)(B)). If the relevant reporting threshold is exceeded, the donee must (i) separately report each aggregated gift in excess of $5,000 from a foreign individual or foreign estate without identifying the donor, and (ii) separately report each aggregated purported gift from a foreign corporation or foreign partnership, including the identity of the donor.

d. **Examples**

Notice 97-34 provides two examples:

<u>Example 14</u>. If a U.S. person, A, receives $90,000 from his or her nonresident alien spouse, B, and the following amounts from the spouse's siblings:

Sibling C	$40,000
Sibling D	2 gifts, $4,000 & $3,000
Sibling E	$4,000

The total of gifts from related foreign individuals is $141,000. Reporting is required because the total exceeds $100,000. A must separately identify the gifts from B and C. A must identify the receipt of $7,000 from D but is not required to separately list information about each transaction. A is not required to separately identify information about E's gift. None of the donors need be identified.

<u>Example 15</u>. If U.S. citizen, A, receives a gift of $6,000 from his or her nonresident alien spouse, B, and a purported gift of $8,000 from a foreign corporation wholly owned by B, A must report the gifts because A has reason to know that the donors are related and the aggregate amount, $14,000, exceeds the $10,000 threshold for gifts from foreign corporations. A must separately identify each gift.

6. Penalties for Nonreporting

A U.S. person who fails to report such foreign gifts will be subject to penalties equal to five percent of each gift for each month of noncompliance (not to exceed 25 percent of the aggregate foreign gifts). The IRS is also authorized to determine the tax consequences of any unreported gift based on the information available to it. The Conference Report to the 1996 Act states that the IRS's exercise of this authority will be subject to review under an "arbitrary and capricious" standard. These sanctions will not apply if the failure to file was due to reasonable cause and not due to willful neglect.

C. Unified Reporting Forms

Form 3520 ("Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") allows U.S. persons generally to use a single form to comply with all the foreign trust and foreign gift reporting requirements. Form 3520-A is to be filed by or on behalf of U.S. grantor-owners of foreign trusts to report trust income.[396]

Generally, to avoid the penalties for nonreporting under Code §§ 6039F or 6677, taxpayers must file Form 3520 with the IRS Service Center in Ogden, Utah. For a discussion of the due date for Form 3520, see I.B.5.d, *supra*. Spouses may file jointly.[397]

Form 3520-A must be filed in the IRS Service Center in Ogden, Utah by the fifteenth day of the third month following the end of the taxpayer's taxable year (*i.e.*, by March 15, in the case of a calendar year taxpayer) or later if an extension is granted. An extension of time to file Form 3520-A is made on Form 7004; an extension of time to file Form 1040 does not extend the time to file Form 3520-A. A separate form is required for each trust, but spouses may file jointly.[398] Reporting must be done on a calendar year basis even if the foreign trust uses a different fiscal year.

D. Gifts from Covered Expatriates

A U.S. person (including a domestic trust) who directly or indirectly receives a gift or bequest from a covered expatriate (as defined in Code § 877A(g)(1)) whose expatriation date is on or after June 17, 2008 is subject to tax under Code § 2801. The tax is imposed at the highest rate under Code § 2001(c). The tax does not apply to gifts not in excess of the dollar amount of the annual exclusion allowed under Code § 2503(b) in the year of the gift, gifts or bequests that would qualify for the marital or charitable deduction if the donor or decedent were a U.S. taxpayer, and gifts or bequests that are otherwise subject to U.S. gift or estate tax provided that such gifts or bequests are reported on timely filed returns. The tax does not apply to gifts or bequests to foreign trusts (unless the trust elects to be treated as a domestic trust and pay the tax), but applies to distributions from foreign trusts to U.S. beneficiaries which are attributable to gifts or bequests from a covered expatriate. A credit is allowed for foreign gift or estate tax paid with respect to the same gift or bequest. A deduction is allowed under Code § 164 for income tax paid by the recipient of a distribution from a foreign trust which is includable in income.

Form 3520 asks whether the filer has received a gift or bequest from a covered expatriate. If the answer is "yes," Form 3520 directs the filer to also file Form 708 "U.S. Return of Tax for Gifts and Bequests Received from Expatriates" when

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396 Section 534 of the 2010 HIRE Act amends Code § 6048(b) to provide that a U.S. person who is treated as the owner of a foreign trust shall submit such information concerning the trust as the Secretary may require. This requirement is in addition to such person's obligation under Code § 6048(b) to ensure that the trust makes a return for the relevant year which fully accounts for all trust activities.

397 Treas. Reg. § 1.16.3(d)(2).

398 Treas. Reg. § 404.6048-1(a)(2).

the form becomes available. As of the date of this writing, no such form has been issued. The IRS announced that no tax payment would be due until further guidance was issued.[399]

Proposed regulations were issued on September 20, 2015 to implement Code § 2801.[400] Although legislative history indicates that the purpose of Code § 2801 was to make expatriation "tax neutral" by eliminating opportunities for avoidance of gift and estate tax that otherwise would result from expatriation, neither the statute nor the proposed regulations achieve tax neutrality. A number of comments on the proposed regulations have been submitted to address perceived problems. We expect that significant changes will be made before the regulations are issued in final form. However, it is likely that the regulations will impose new record-keeping obligations on trustees of foreign trusts so that trustees of foreign trusts will be able to provide U.S. beneficiaries with information necessary to determine whether the distributions they receive are indirect gifts from covered expatriates. The proposed regulations continue to defer the date for reporting and payment of the § 2801 tax until a reasonable period of time after final regulations are issued. The proposed regulations confirm that retroactive reporting for covered gifts and bequests made after June 17, 2008 will be required, but that no interest for late payment of tax will be due because payment of the § 2801 tax will not be due until the date fixed in the final regulations.[401]

VII. REPORTING FOREIGN FINANCIAL ASSETS AND FOREIGN ACCOUNTS

A. Bank Secrecy Act Reporting Requirements for Trust Beneficiaries

Section 5314 of Title 31 (the Bank Secrecy Act) of the United States Code requires a U.S. person to file Fin CEN Form 114 – Report of Foreign Bank Account ("FBAR") to report all foreign bank accounts and foreign financial accounts in which he or she has a financial interest or signature authority if the aggregate value of the accounts exceeded $10,000 at any time during the year.[402] A financial account includes a bank account, a securities account, a mutual fund or other pooled investment fund.

The instructions to the FBAR state that a U.S. person has an indirect financial interest in an account owned by the trust and is therefore required to file an FBAR report for foreign accounts held by the trust if he or she is the grantor and is treated as the owner of the trust under Code §§ 671-679 or he or she has a present beneficial interest in more than 50% of the assets of the trust or receives more than 50% of the income of the trust.[403] Regulations issued by the Financial Crimes Enforcement Network ("Fin CEN"), a bureau of the Treasury,[404] lighten trust beneficiaries' reporting obligations by providing that trust beneficiaries (other than those treated as owners under the grantor trust rules) do not have to file an FBAR report for

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[399] Notice 2009-85, 2009-45 I.R.B. 598 issued 10/15/2009 and Announcement 2009-57, 2009-29 I.R.B. 158.

[400] 80 Fed. Reg. 54,447 (September 10, 2015).

[401] The last sentence of the preamble to the proposed regulations provides "[i]nterest will not accrue on the section 2801 tax liability for any taxable years until the due date for payment, as specified in the final regulations, has passed."

[402] 31 U.S.C. § 5314. Form 114 replaces Form TD 90-F 90.22.

[403] The preamble to the final FBAR regulations at Federal Register Vol 76, No. 37 at 10234 (February 16, 2011) makes it clear that a discretionary beneficiary and a remainder beneficiary are not required to file FBARs. The regulations do not specifically address a beneficiary-owned trust under Section 678. There appears to be no rule requiring aggregation of interests held by related persons to determine whether the more than 50% test is met.

[404] Treasury has delegated its authority to administer the Bank Secrecy Act to the director of Fin CEN. By a Memorandum of Agreement between Fin CEN and the Commissioner of the IRS, the authority to enforce the FBAR reporting requirements of the Bank Secrecy Act was re-delegated to the IRS.

financial assets held by trusts of which he or she is a beneficiary if the trust, trustee of the trust or agent of the trust is a U.S. person and files an FBAR report disclosing the trust's foreign financial accounts.[405] Participants and beneficiaries of retirement plans under sections 401(a), 403(a) and 403(b) and individual retirement plan accounts under 408A will not be required to file an FBAR with respect to a foreign financial account held by or on behalf of the retirement plan or IRA.

For calendar years 2015 and earlier, the FBAR was required to be received by June 30th of the year following the year in which the person possessed the interest obligating him or her to file an FBAR (timely mailing is not timely filing). No extensions of time to file were available. For calendar years 2016 and later, the FBAR due date is April 15th and there is an automatic 6-month extension to file ending on October 15th.[406]

The penalty for failure to file is $10,000. If the failure is willful, the penalty is the greater of $100,000 or 50% of the value of the account. Criminal penalties are up to $250,000 and 5 years in prison and if the failure to file is part of a pattern of illegal activity, the penalty increases to up to $500,000 and up to 10 years in prison. To avoid the penalty where the filer lacks adequate information, the IRS website suggests filing an incomplete return and an amended returned filed later when missing information becomes available. Answers to frequently asked questions ("FAQs") about FBAR issues can be obtained from an IRS website. The address is FBARquestions@irs.gov.

B. Offshore Voluntary Disclosure Programs and Streamlined Filing Compliance Procedures

Beginning on March 23, 2009, the IRS announced a series of offshore voluntary disclosure programs ("OVDP"). In the first program, a penalty for failing to file all information returns, not just the FBAR, was capped at 20% of the highest account balance during the six-year disclosure period. In the second program, the penalty increased to 25% and in the third to 27.5% and the disclosure period increased to eight years.[407] However, lower penalties applied in certain circumstances and the taxpayer could opt out of the program if the taxpayer believed that lower penalties would be applicable outside of the program. Income tax on unreported income, interest and an accuracy penalty for the disclosure period also would be owed. At the closure of the case, a closing agreement on Form 906 was used to resolve all tax issues during the disclosure period. FAQs on the IRS website provide useful details about the OVDP, including circumstances in which the penalty would be lower.

The OVDP currently in effect, the 2014 OVDP, has some significant revisions. One is that the tax, interest and all penalties are due when the taxpayer makes his or her OVDP submission rather than after the closing agreement is signed. Certain reduced penalties are eliminated. Instead, a taxpayer who qualifies for reduced penalties may apply for them under the streamlined procedure. A 50% penalty applies to a taxpayer who has an account in a financial institution that is under investigation. A taxpayer may use a pre-clearance procedure explained in FAQ 23 to determine whether he or she is already under criminal investigation (and therefore ineligible for the OVDP) before submitting his or her submission for acceptance into the OVDP so as to avoid incriminating himself or herself by making the submission.

FAQ 52, which applied to those filing for the OVDP prior to July 1, 2014, but has since been deleted, provided relief for U.S. citizens living abroad who have complied with the tax laws of the country of residence and have U.S. source income of $10,000 or less per year; the penalty for failure to file information returns would be only 5% of the highest financial account

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[405] Section 103.24(g)(5) of 31 CFR Part 103, Federal Register Vol. 76, No. 37, at 10234 (February 16, 2011.)

[406] https://www.fincen.gov/news/news-releases/new-due-date-fbars-0.

[407] The first voluntary disclosure program, 2009 OVDP, opened March 23 and closed October 15, 2009; the second, 2011 OVDP, was announced on February 8, 2011 and closed on August 31, 2011 but could be extended to September 9, 2011 in many cases, the third program, 2012 OVDP, commenced on January 9, 2012 (IR -2012-5) without a fixed termination date but was substantially modified effective July 1, 2014 and now is referred to by the IRS as the "2014 OVDP." See Offshore Voluntary Disclosure Program Frequently Asked Questions and Answers" on the IRS website.

balance. Such nonresident taxpayers could file for "streamlined procedures" to resolve their case -- filing tax returns for the past three years and FBARs for the past six years.

On June 26, 2012, the IRS announced a streamlined procedure separate from the OVDP for U.S. citizens living abroad whose unreported tax liability did not exceed $1,500 for each of the prior three years.[408] Taxpayers participating in the streamlined program, unlike those in the OVDP, were given no assurances that the IRS would not recommend criminal prosecution in appropriate cases.

On June 18, 2014, the IRS announced that the streamlined procedure would be greatly expanded.[409] The procedure would apply to persons living in the U.S. as well as to those living abroad and would apply to nonresidents without regard to the amount of their unreported income or tax deficiency. In addition, the aggregate penalty for failure to file FBARs was reduced from 5% to zero for certain U.S. citizens living abroad and would be 5% for U.S. residents participating in the procedure. The streamlined procedure would be available to persons already participating in the voluntary disclosure program provided they had not yet signed Form 906, without the need to opt out of the voluntary disclosure program. However, the procedure would not be available to persons who filed for participation in a voluntary disclosure program on or after July 1, 2014. On and after July 1, 2014, a taxpayer has to elect between participating in the voluntary disclosure program or the streamlined procedure, and therefore must be very certain of sustaining his or her position that the failure to file was not willful since participation in the streamlined procedure affords no protection against prosecution for criminal penalties.

C. Internal Revenue Code Reporting Requirements for Foreign Financial Assets

Section 511 of the 2010 HIRE Act added new Code § 6038D to the Code, effective for taxable years beginning after December 31, 2010.[410] Section 6038D(a) requires any individual who holds any interest in a specified foreign financial asset during any taxable year to attach to his or her income tax return for that year the information described in § 6038D(c) if the aggregate value of all such assets exceeds $50,000 (or such higher amount as the Secretary may prescribe). The definition of an interest in a specified foreign financial asset includes not only financial accounts maintained in foreign financial institutions, but also, unless held in an account maintained by a domestic financial institution, any stock or security issued by a non-U.S. person, any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. person and any interest in a foreign entity. The term "foreign entity" includes foreign trusts. A person who is treated as the owner of a trust under the grantor trust rules is treated as having an interest in any foreign financial assets held by the trust.[411] The value of a beneficiary's interest in a trust equals the sum of the amounts actually received in the taxable year plus the present value of a mandatory right to receive a distribution.[412] This valuation rule applies even if the trust is deemed to be owned by another person under the grantor trust rules. If the taxpayer cannot determine the value of his or her interest in a foreign estate, the value is the amount actually received. A foreign financial asset is subject to reporting even if the asset does not have a positive value.[413] If a Form 3520, 3520A, 5471, 8621 or 8865 is filed, Form 8938 need only disclose the identity of the taxpayer and

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[408] IR-2012-65.

[409] IR-2014-73.

[410] Notice 2011-55 postponed the filing due date until a final Form 8938 "Statement of Specified Foreign Financial Assets" was issued, which occurred on December 19, 2013. According to Notice 2011-55, individuals for which the filing of Form 8938 was suspended under that notice for a taxable year are required to attach Form 8938 for the suspended taxable year to their next income tax or information returned required to be filed with the IRS, and any Form 8938 so filed for a suspended taxable year will be treated as having been filed on the date that the income or information return for the suspended year was filed.

[411] Treas. Reg. § 1.6038D-2T(b)(3).

[412] Treas. Reg. § 1.6038D-5J(f)(3).

[413] Treas. Reg. § 1.6038D-2(a)(5).

indicate that the information is on the other form. However, an FBAR and Form 8938 both have to be filed in full; there is no relief from duplicative filing of these forms, which are filed with different agencies. In addition, the instructions to Form 8938 clarify the filing threshold (filing is required if the value at the end of the year is at least $50,000 or if the value was at least $75,000 at any time during the year), create higher filing thresholds for persons living abroad ($200,000 at the end of the year or $300,000 at any time during the year) and double filing thresholds for married taxpayers. The statute creates a presumption that the filing threshold is exceeded.

The penalty for failure to file is $10,000. Additional penalties apply if the failure to file continues after notice is given to the taxpayer. If the failure to file continues 90 days after notice is given to the taxpayer, the additional penalty is $10,000 per 30-day period beginning after expiration of the 90-day period. However, the penalty cannot exceed $50,000. The penalty may be waived if the failure was due to reasonable cause and not willful neglect.

The statute applies only to interests held directly by U.S. individuals or by individuals indirectly through disregarded entities. However, the statute gives the IRS authority to issue rules applying the statute to other U.S. entities that are formed or availed of to avoid the reporting requirements for foreign financial assets. Regulations issued in 2016[414] extend the reporting obligation to certain "Specified Domestic Entities" beginning in 2016.[415] Such entities are presumed to be formed or availed of to avoid reporting.

Subject to limited exceptions, a Specified Domestic Entity is (i) a U.S. corporation or partnership if it is: (a) closely-held, meaning that it is 80% owned by a U.S. citizen or resident (determined by applying attribution rules of §267); and (b) produces a significant amount of passive income (meaning 50% of the income is passive or 50% of the assets produce passive income),[416] and (ii) a U.S. trust formed or availed of for the purpose of holding specified foreign financial assets if the trust has a current beneficiary who is a U.S. citizen or resident.[417] Beneficiary means a person who may receive a distribution currently (other than a potential appointee under a power of appointment that has not been exercised) or who has a general power of appointment that is exercisable during the year (not including a testamentary power). Certain domestic entities are not included in the definition: an estate, a publicly traded company or its affiliate, a charity, a nonexempt charitable trust, a governmental entity, an IRA, a grantor trust owned by a U.S. person or any other trust whose trustee is a bank or financial institution if the trustee timely files annual returns and information returns on behalf of the trust.[418]

A Specified Domestic Entity is required to file Form 8938 if it holds specified foreign financial assets, defined the same way as for individuals, exceeding the reporting threshold for single individuals residing in the United States,[419] but excluding for this purpose assets that were reported on Forms 3520, 5471, 8621, or 8865 (referred to as "information returns").[420] As is the case for individuals, Form 8938 must be filed even if one of the information returns was filed, but the information reported on one of those information returns need not appear on Form 8938.

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[414] Treas. Reg. §1.6038D-6, TD 9751, 81 Fed. Reg. 8835 (February 23, 2016).

[415] Treas. Reg. §1.6038D-2(g).

[416] Treas. Reg. §1.6038D-6(b).

[417] Treas. Reg. §1.6038D-6(c).

[418] Treas. Reg. §1.6038D-6(d).

[419] $50,000 at the end of the year or $75,000 at any time during the year.

[420] Treas. Reg. §1.6038D-2(a)(6)(ii).

Effective for taxable years beginning after March 18, 2010, the negligence penalty imposed by Code § 6662 is increased from 20 percent to 40 percent if the deficiency is attributable to an unreported foreign financial asset.[421]

In addition, the statute of limitations will not commence to run until the return required by new Code § 6038D is filed for events and periods related to the information required on the return.[422] This statute is effective for all open years as of March 18, 2010. Section 513 of the 2010 HIRE Act also amended Code § 6501(e) to provide that the statute of limitations on assessment of a return is extended from three to six years if the taxpayer omitted more than $5,000 from gross income and the omission is attributable to assets with respect to which a return was required by Code § 6038D, whether or not the filing threshold for Code § 6038D is met.

D. The Common Reporting Standard ("CRS") and FATCA

Possibly as a consequence of FATCA, other countries began embracing the idea of adopting an automatic intergovernmental exchange of tax information system. Beginning in 2013, the Organization for Economic Co-operation and Development ("OECD"), working with G20 countries, developed the Common Reporting Standard ("CRS"). CRS, which was approved by the OECD Council on July 15, 2014, is a set of due diligence and reporting model rules, similar to FATCA. The rules provide a single standard for the automatic exchange of financial account information among participating jurisdictions in accordance with their exchange of information treaties. The objectives of CRS are to promote transparency and ensure tax compliance. CRS will apply to certain trusts.

A number of "Early Adopter" jurisdictions have pledged to work towards launching their first information exchanges by September, 2017. Although the United States is not a CRS signatory, on March 14, 2016, BNA reported that IRS Commissioner John Koskinen indicated at a Tax Executives Institute, Inc. conference that, in his view, the U.S. should adopt the CRS in lieu of FATCA so that the U.S. would be operating on a common exchange of information platform with the rest of the world. The reason the U.S. has not yet signed on, Koskinen explained, is that "we don't have the legal authority to provide – on a reciprocal basis – the range of information the other countries are prepared to share with each other and with us." He warned "[i]t's going to be critical and in the interest of the United States to pass the necessary legislation to allow us to participate in the common reporting standard."[423]

Because the U.S. is not a signatory to CRS, the U.S. may become a tax haven for nonresident aliens seeking to avoid CRS reporting. However, an individual resident in a CRS jurisdiction will avoid CRS reporting by funding a U.S. trust or other U.S. entity if and only if the trust or other entity has no foreign accounts or foreign structures in CRS jurisdictions. CRS reporting will be required by any foreign financial institutions where a U.S. trust or entity has an account if any "controlling person" of the trust or entity is resident in a CRS jurisdiction. For example if a nonresident establishes a U.S. trust that holds shares of a foreign holding company resident in a CRS jurisdiction, either the holding company or the financial institutions where the foreign holding company owns financial accounts will report the "Controlling Persons" of the foreign holding company and the trust that owns the foreign holding company. This term is defined in CRS the same way as it is defined in the Model 1 IGAs:

> The term "Controlling Persons" means the natural persons who exercise control over an Entity. In the case of a trust, such term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions.

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[421] Section 512 of the 2010 HIRE Act.

[422] Code § 6501(c)(8) as amended by Section 513 of the 2010 HIRE Act.

[423] Laura Davison, *Koskinen: U.S. at Disadvantage Without Common Reporting*, March 14, 2016, Bloomberg BNA Daily Tax Report.

The term “Controlling Persons” must be interpreted in a manner consisted with the Financial Action Task Force Recommendations.

Even if there are no foreign assets or foreign accounts, if the nonresident alien grantor of the trust is resident in a FATCA Partner jurisdiction with a Model 1 Reciprocal IGA, certain financial information must be provided by U.S. financial institutions to the IRS and the IRS will automatically provide this information to the FATCA Partner. However, the amount of information reporting and due diligence required of U.S. financial institutions by FATCA agreements is much more limited than CRS requirements. In general, only income subject to withholding by U.S. payors is reportable and only accounts held by an individual or an entity resident in the FATCA Partner jurisdiction must be reported. If the entity is not resident in the FATCA Partner jurisdiction, reporting is not required even if the Controlling Persons of the trust or entity are resident in the FATCA Partner jurisdiction. In the case of a FATCA Partner financial institution, it must report the interest of a non U.S. entity that has a Controlling Person who is a Specified U.S. person.[424]

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[424] See Article 2 of the reciprocal Model I IGA.