TABLE OF CONTENTS

Two Systems Separated by a Common Language: U.S. Tax Law Meets Non-U.S. Trust Law: Factual Scenarios

Scenario 1

Your client Victoria's family is originally from Sweden, where her parents ran a very successful company. Victoria is one of two children and now lives in the United States and has become a U.S. citizen. Victoria and her husband Paul, who is also a U.S. citizen, have three children, all of whom are U.S. citizens. Victoria's parents left Sweden long ago and are now resident but not domiciled in the United Kingdom for U.K. income tax, capital gains tax, and inheritance tax purposes. You recommend that as part of Victoria's parents' estate planning that they establish a trust to hold assets that Victoria would receive by inheritance. Victoria's parents are not comfortable establishing such a trust in the United States but would consider doing so in Bermuda or another English-speaking offshore financial center.

Scenario 2

Fast forward ten years. Victoria and her family are now the beneficiaries of an irrevocable trust with substantial assets administered by a professional trustee company in Bermuda. The trustee decided to hold all of the trust assets in a Bermuda limited company rather than at the trust level. The trustee from time to time makes distributions to Victoria and her family members. The trustee has also suggested that instead of making distributions to Victoria, the trustee would consider making a loan of trust assets to her. Victoria's accountant understands that Victoria and her family members need to report the receipt of distributions and loans from the trust to the IRS on her individual income tax return and asks you for assistance in understanding how to do so.

Scenario 3

Your client Paul is originally from South Africa but has lived in the United States for the last 30 years, having married a U.S. citizen and subsequently becoming a naturalized U.S. citizen himself. Paul has two siblings, Douglas and Sarah. Douglas lives in Sydney, Australia, and Sarah lives in Vancouver, British Columbia. In the 1970s Paul's parents established a trust in Bermuda for the benefit of all of their descendants, giving the trustee broad discretion to distribute income and principal among Paul, his siblings, and their respective descendants. As was customary at the time, the trust had a perpetuities period of 80 years. The current trustee is a trust company in Bermuda. The trust's investments consist mostly of listed securities held in an investment company, though the company also owns a residence in England which had been Paul's parents' vacation residence.

Because the three siblings live in three different countries, they agreed that it would make sense to divide the trust along family lines so that instead of a single trust for the entire family, they would like to have three trusts, one for each family line. They would also like to modernize the trust agreement, and, if possible, extend the term of the trust. Paul asks you for your advice whether this is possible and to describe the U.S. tax implications of the potential changes.

Scenario 4

Michael and his family, who live in Los Angeles, are beneficiaries of a long-term trust administered in Bermuda by a professional trustee that was established by Michael's parents many years ago. The trust was never particularly large, and the trustee has suggested that it would be willing to terminate the trust and distribute the remaining assets to Michael. Michael seeks your advice on the tax and legal implications of the termination and asks you if there are any alternatives that may be more tax efficient from a U.S. tax perspective.

Don't Block the Box: U.S. Federal Income Tax Issues for Trusts and Estates That Own Shares in Foreign Corporations

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I. Introduction

A. When a U.S. citizen or resident client owns shares in a foreign corporation, that client will face a number of U.S. federal income tax issues. The most obvious situation is when a U.S. client directly owns shares in a foreign corporation. Numerous complex issues, however, can also arise when the client is a beneficiary of an estate or trust that owns shares in a foreign corporation. In particular, certain indirect ownership rules and constructive ownership rules appear to subject the beneficiary to the controlled foreign corporation and passive foreign investment company rules regardless of whether the corporation or the trust makes a distribution to him or her.

B. Trustees of nonresident trusts often hold their investments through non-U.S. companies.

C. This outline describes some of the basic income tax issues that arise for clients who own shares in foreign corporations, with a focus on when clients have beneficial interests in trusts and estates that own shares in foreign corporations. The outline also addresses how trustees of foreign trusts can use the pass-through entity rules of U.S. tax law to potentially avoid the consequences of owning shares in foreign corporations.

II. General Issues for U.S. Owners of Shares in Foreign Corporations

A. *Tax Rate on Dividends*

1. If a foreign corporation is a "qualified foreign corporation," dividends paid by the corporation to a U.S. shareholder will qualify for the 15% federal income tax rate on dividends. A corporation will be a qualified foreign corporation if its shares are readily tradable on an established U.S. securities market. IRC § 1(h)(11)(C)(ii). A corporation will qualify if ADRs in its shares or the shares themselves are readily tradable. The markets that qualify are the Nasdaq, NYSE, AMEX, Boston Stock Exchange, Chicago Stock Exchange, Philadelphia Stock Exchange, Cincinnati Stock Exchange, and the Pacific Exchange, Inc. IRS Notice 2003-71, 2003-43 I.R.B. 922. The IRS stated in Notice 2003-71 that the OTC Bulletin Board and the pink sheets did not meet the definition of an established U.S. securities market, although the IRS said it would consider expanding the definition of such a market in the future.

2. A corporation will be a "qualified foreign corporation" if the corporation is eligible for the benefits of a comprehensive income tax treaty with the United States. IRC § 1(h)(11)(C)(i)(II). The treaty must also have an information exchange provision. The IRS originally listed the U.S. income tax treaties that are "comprehensive" for purposes of IRC § 1(h)(11)(C) in IRS Notice 2003-69, 2003-42 I.R.B. 851. The IRS updated the list in 2011 in IRS Notice 2011-64, 2011-37 I.R.B. 231. Even if the corporation is incorporated within one of these countries, it must still qualify for benefits under the treaty, which is a separate inquiry.

B. *Reporting the Acquisition of Shares*

1. Under IRC § 6046(a)(1)(B), a U.S. taxpayer must report the acquisition of shares in a foreign corporation to the IRS on Form 5471 in two situations:

a. When the taxpayer acquires shares in a foreign corporation which, when added to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total

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combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(i), 6046(a)(2).

b. When the taxpayer acquires shares in a foreign corporation which, without regard to the shares the taxpayer already owns, results in the taxpayer owning 10% or more of the total combined voting power of all classes of stock of the corporation entitled to vote or 10% or more of the total value of the corporation. IRC §§ 6046(a)(1)(B)(ii), 6046(a)(2).

2. The reporting requirement of IRC § 6046(a) applies if the U.S. taxpayer owns stock directly or indirectly. Under IRC § 6046(c), an individual will be deemed to indirectly own shares owned by members of his or her family. "Family" for this purpose means "only brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants." IRC § 6046(c). This is the only instance in the Code in which there is sibling-to-sibling attribution, and it is to no particular purpose; neither the CFC constructive ownership nor the PFIC indirect ownership rules have sibling-to-sibling attribution. To this extent, the constructive ownership rules do not really help the government monitor the proper application of the CFC or PFIC rules. This family attribution rule does not apply to treat a U.S. person as indirectly owning shares deemed to be indirectly owned by another U.S. member of that person's family. Treas. Reg. § 1.6046-1(i)(2).

3. The reporting requirements apparently do not apply if a U.S. person becomes a beneficiary of a foreign trust or foreign estate that owns shares in a foreign corporation. Any reporting requirements related to the acquisition of shares are postponed until the U.S. taxpayer receives a distribution of shares from such a trust or estate. *See* Treas. Reg. § 1.6046-1(i)(1)(only shares owned by a corporation or partnership will be deemed to be indirectly owned by shareholders or partners; no reference to estates or trusts).

4. A U.S. taxpayer subject to the reporting requirements is a "Category 3" filer for IRS Form 5471 purposes. The Instructions to Form 5471 provide that a putative Category 3 filer does not have to file Form 5471 if all the following apply:

a. The U.S. taxpayer does not directly own any shares in the foreign corporation.

b. The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

c. The U.S. person through whom the putative Category 3 filer owns shares files an IRS Form 5471 with all of the required information.

See Treas. Reg. § 1.6046-1(e)(4)(iii).

C. *Information Filing for "Control" Shareholders*

1. Any U.S. person who "controls" a foreign corporation for an uninterrupted period of at least 30 days during the annual accounting period of the corporation must file an IRS Form 5471. *See* IRC § 6038(a)(1); Treas. Reg. § 1.6038-2(a)(2). Such a person is a "Category 4" filer for Form 5471 purposes.

2. "Control" for IRC § 6038 purposes means ownership of stock that possesses more than 50% of the total combined voting power of all classes of stock entitled to vote or more than 50% of the value of shares of all classes of stock in the corporation. IRC § 6038(e)(2); Treas. Reg. § 1.6038-2(b). Note that the corporation in question does not need to be a controlled foreign corporation or "CFC" for U.S. tax purposes. A foreign corporation for which a U.S. person meets the "control" test of IRC § 6038(e)(2) will be a CFC only if there are one or more U.S. shareholders who control 10% or more of the vote of the corporation. *See* IRC § 951(b). Under IRC § 6038(e)(2), it is possible that a U.S. person could be deemed to "control" a foreign corporation by owning more than 50% of the value of the shares of the corporation. Unless another U.S. person controls 10% or more of the vote, however, the corporation will not be a CFC.

3. In determining whether a U.S. taxpayer "controls" a corporation for IRC § 6038 purposes, the constructive ownership rules of IRC § 318(a) apply. Treas. Reg. § 1.6038-2(c).

4. A putative Category 4 filer is not required to file an IRS Form 5471 if the person is deemed to control a foreign corporation only because he or she is deemed to constructively own shares owned by a nonresident alien. This exception does not apply if the U.S. shareholder directly or indirectly owns any shares of the foreign corporation. Treas. Reg. § 1.6038-2(l).

5. In addition, a putative Category 4 filer does not have to file Form 5471 if all the following apply:

   a. The U.S. taxpayer does not directly own any shares in the foreign corporation.

   b. The filing requirement arises solely because the U.S. taxpayer constructively owns shares owned by another U.S. taxpayer.

   c. The U.S. person through whom the putative Category 4 filer owns shares files an IRS Form 5471 with all of the required information.

   See Treas. Reg. § 1.6038-2(j)(2).

D. *Reporting Requirements under FATCA*

1. In 2010 Congress added a new section, 6038D, to the Internal Revenue Code that has implications for U.S. citizen and resident shareholders in foreign corporations who are not required to file reports related to their shares under IRC § 6046 or IRC § 6038.

   a. Under IRC § 6038D, a U.S. citizen or resident taxpayer who holds "specified foreign assets" with a collective value of more than $50,000 must disclose those assets to the IRS on an annual basis. For almost all taxpayers, the filing requirement applies for 2011 and future years.

   b. The legislation defines "specified foreign assets" as accounts held at a foreign financial institution and assets held outside of a foreign financial institution, which include stock or securities issued by a non-U.S. person, a financial instrument or contract (if the contracting party is a non-U.S. person), or any interest in a foreign entity. Though the nature of the information requested is similar to that required on a Report of Foreign Bank and Financial Accounts (FBAR), this requirement does not eliminate the need for a foreign account holder to file an FBAR. This new requirement is supplementary, and broadens the disclosure requirements by applying to certain persons who may not meet the current levels of ownership to require an FBAR filing. Because the reporting threshold under this rule is value-based, there will be instances in which a U.S. person may be required to file both a disclosure statement and an FBAR, and other instances in which a U.S. person's interest may not meet the FBAR reporting threshold but may be great enough so as to require disclosure under the HIRE Act.

   c. The legislation applies to interests in foreign financial assets that a U.S. taxpayer "holds," though it does not include the usual modifier "directly or indirectly." The Treasury Regulations under IRC § 6038D take the position that a taxpayer need disclose only directly owned foreign financial assets. Treas. Reg. § 1.6038D-2(b)(3). For this reason, a taxpayer need not separately disclose shares in a non-U.S. company held in a U.S. or a foreign financial account. Similarly, a beneficiary of a foreign trust or estate must disclose his or her interest in the trust or estate, rather than its assets. *See* Treas. Reg. § 1.6038D-3(b)(1)(iii).

2. Taxpayer can comply with IRC § 6038D by filing IRS Form 8938. The Form 8938 Instructions provide that if a taxpayer must file a Form 5471, 8865, 8858, or 8621 related to his or her interests in a foreign company, the taxpayer is not required to include very much information related his or

her interest in the corporation on the Form 8938. Rather, the principal reporting will be done on the other forms. The principal implication for shareholders in foreign corporations that are not PFICs is that they must disclose to the IRS their ownership interests in foreign corporations that are not CFCs or that are CFCs but for which the shareholder is not a 10% shareholder.

3. A $10,000 penalty will apply to a taxpayer who fails to timely file an IRS Form 8938. An additional $10,000 penalty is due for every 30 days the failure to file persists longer than 90 days after the taxpayer is informed of such failure, up to a maximum penalty of $50,000.

4. Another new section of the Code, 1298(f), requires shareholders in passive foreign investment companies ("PFICs") to disclose their ownership of PFIC shares. The outline discusses IRC § 1298(f) below at pages 32 - 34. Although IRC § 1298(f) appears to overlap with IRC § 6038D, the IRS has indicated that if a shareholder must comply with IRC § 1298(f), that compliance will be deemed to satisfy the compliance requirements of IRC § 6038D.

III. Controlled Foreign Corporations and Foreign Trusts and Foreign Estates

A. *CFC Basics*

1. If a US taxpayer owns shares in a controlled foreign corporation or "CFC," the taxpayer will have special compliance obligations and substantive tax issues as a result of the ownership of those shares. These tax issues may arise when a U.S. taxpayer is the beneficiary of a foreign estate or a foreign trust that owns shares in a foreign corporation.

2. A foreign corporation is a CFC if on any day during its tax year one or more United States shareholders directly, indirectly, or constructively own more than 50% of the total combined voting power of all classes of the foreign corporation's voting stock or more than 50% of the total value of the foreign corporation's stock. IRC § 957(a); Treas. Reg. § 1.957-1(a). For purposes of the CFC rules, a United States shareholder is a "United States person" who "owns . . . or is considered as owning" 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

3. For a foreign corporation to be a CFC, the following facts must be present:

   a. One or more U.S. taxpayers must own 10% or more of the total combined voting power of all classes of stock entitled to vote. IRC § 951(b).

   b. The 10% U.S. shareholders must collectively own more than 50% of the total combined voting power of the corporation's outstanding stock or more than 50% of the total value of the stock of the corporation. IRC § 957(a).

   If both facts exist, the corporation is a CFC. If either one of the facts is not true, the corporation is not a CFC.

4. If the corporation is a CFC, the next step is to determine the extent to which the CFC's U.S. shareholders are currently subject to U.S. income tax on the corporation's Subpart F income.

   a. Each 10% U.S. shareholder of a CFC is subject to U.S. income tax on the shareholder's proportionate share of the CFC's "Subpart F" income, which, broadly speaking, is income from the CFC's non-operating or passive assets. IRC § 951(a). *See generally* IRC § 952(a).

   b. For this purpose, the shareholder's "proportionate share" of the CFC includes not only the shareholder's voting shares but also the shareholder's nonvoting shares. A U.S. shareholder who owns less than 10% of the voting power of a CFC is not subject to tax on his or her pro rata share of the CFC's Subpart F income even if the shareholder owns more than 10% of the value of the CFC's shares due to his or her ownership of nonvoting shares. *See* IRC §§ 951(a), 951(b).

5. Income tax consequences of CFC share ownership.

   a. Any U.S. taxpayer who is a 10% shareholder of a CFC must include a pro-rata share of the CFC's Subpart F income in his or her income whether or not the CFC distributes that income. Subpart F income is effectively taxed as dividend income that does not qualify for the 15% federal rate on qualified dividends. This characterization applies regardless of the source of the Subpart F income, including realized gains. A U.S. taxpayer will have Subpart F income only if the corporation has earnings and profits in the relevant calendar year, computed using U.S. tax principles.

   b. A CFC's non-Subpart F income is not taxed to a shareholder until the CFC distributes that income to a shareholder. The shareholder will pay tax on that distributed income under normal U.S. principles. Most importantly, the distribution will be taxed as a dividend to the shareholder if the corporation has earnings and profits in the year of distribution, but taking any previously taxed Subpart F Income into account. Such a distribution is eligible for the 15% rate on dividends provided that the corporation is a "qualified foreign corporation" under IRC § 1(h)(11)(C). IRS Notice 2004-70, 2004-44 I.R.B. 724, 726.

   c. If a U.S. shareholder of a CFC sells his or her shares, the gain on the sale will be treated as ordinary income to the extent of the CFC's earnings and profits over the shareholder's holding period. *See generally* IRC § 1248. Recall that in this context a "U.S. shareholder" is a person who owns 10% or more of the shares of the company either directly or indirectly. *See* IRC § 1248(a)(2)(referring to the direct and indirect ownership rules of IRC § 958(a)). The previous allocation of Subpart F income to the shareholder, however, will have increased his or her basis in the shares, resulting only in the taxation of earnings and profits only once. Furthermore, amounts treated as dividends under IRC § 1248(a) are eligible for the 15% rate on dividends, assuming that the CFC is a "qualified foreign corporation" under IRC § 1(h)(11)(C). *See* IRS Notice 2004-70, 2004-44 I.R.B. 724, 726. The special tax treatment of sales proceeds under IRC § 1248 does not apply to a redemption of shares taxed under IRC § 303. IRC § 1248(g)(1).

6. A U.S. taxpayer can own shares in a CFC directly, indirectly, or constructively.

   a. Direct ownership by an individual is when the individual owns shares in his or her individual name. IRC § 958(a)(1).

   b. If a U.S. taxpayer has an interest in a foreign corporation, foreign partnership, foreign estate, or foreign trust that owns shares in a foreign corporation, the taxpayer will be deemed to "indirectly" own a proportionate share of the foreign entity's shares in the foreign corporation. IRC § 958(a)(2).

   c. A U.S. taxpayer will also be deemed to constructively own shares owned by other persons under the constructive ownership rules of IRC § 318(a). IRC § 958(b).

   d. The indirect and constructive ownership rules can result in a U.S. beneficiary of a foreign estate or foreign trust being deemed to own shares of a foreign corporation owned by that foreign estate or foreign trust. If so, the U.S. beneficiary may have extra compliance obligations and possibly extra tax obligations.

B. *Introduction to Indirect Ownership*

1. In IRC § 958(a)(2) Congress provided that U.S. taxpayers who have interests in certain foreign entities that own shares in foreign corporations will be deemed to indirectly own the foreign entity's shares for purposes of determining whether the foreign corporation is a CFC:

> For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.

2. The Treasury Regulations provide that the determination of a beneficiary's "proportionate interest" in a foreign entity, including a foreign trust, depends on the facts and circumstances of the situation:

> The determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account.

Treas. Reg. § 1.958-1(c)(2).

C. *Indirect Ownership Through Foreign Estates*

1. Under the indirect ownership rule of IRC § 958(a)(2), the determination of a beneficiary's "proportionate interest" in a foreign estate depends on the facts and circumstances of the situation. Treas. Reg. § 1.958-1(c)(2).

2. The CFC indirect ownership regulations have one example that addresses beneficiaries of a foreign estate:

> Example 4. Among the assets of foreign estate W are Blackacre and a block of stock, consisting of 75 percent of the one class of stock of foreign corporation T. Under the terms of the will governing estate W, Blackacre is left to G, a nonresident alien, for life, remainder to H, a nonresident alien, and the block of stock is left to United States person K. By the application of this section, K is considered to own the 75 percent of the stock of T Corporation, and G and H are not considered to own any of such stock.

Treas. Reg. § 1.958-1(d), Example 4.

3. Applying these principles to determine the indirect ownership of a foreign estate's U.S. beneficiaries in shares of a foreign corporation should be relatively straightforward because the facts and circumstances of an estate and its beneficiaries are usually fairly simple. On the death of a decedent, the beneficiaries' interests in the decedent's estate will vest, which would appear to permit the easy application of the indirect ownership test. Thus, if a beneficiary receives a specific gift of CFC shares, he or she should be treated as indirectly owning those shares until the estate distributes the shares to him or her. *See* Treas. Reg. § 1.958-1(d), Example 4. The beneficiaries of the residue of the decedent's estate should similarly be deemed to own the estate's shares in a foreign corporation based on their proportionate interests in the residue. *Id.* Unlike trusts, estates do not raise difficult issues related to apportionment of trust property between income and remainder beneficiaries and the quantification of beneficiaries' rights in discretionary trusts.

4. Attributing ownership of a foreign estate's CFC shares to an estate's beneficiaries will be more difficult when the beneficiaries are entitled to a formula pecuniary gift or a fractional share of the estate. Unlike a specific gift of CFC shares or a fixed portion of the residue of an estate, the proportion of an estate attributable to a beneficiary of pecuniary gift or fractional gift may not be determinable until well into the administration of the estate. A pecuniary gift, for example, might abate or might be subject to the payment of estate taxes. Similarly, a gift of a fraction of the residue of an estate may be subject to the payment of specific gifts, pecuniary gifts, and some taxes and expenses. The uncertainties as to amounts, and uncertainties as to funding, at first glance appear to make the application of the indirect ownership rule to a foreign estate a problematic task. In this case, an analogy to the separate share rule of IRC § 663(c) may be the best way to proceed, although applying that rule is not necessarily easy.

D. *Indirect Ownership Through Foreign Trusts*

1. Congress did not provide any rules in the Code for determining when a U.S. beneficiary of a foreign trust would be deemed to indirectly own the trust's shares of a foreign corporation under IRC § 958(a)(2).

2. The Treasury Regulations under IRC § 958(a)(2) have one example of how to apply this facts and circumstances test in the context of a foreign trust and its beneficiaries:

> Example 3. Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

Treas. Reg. § 1.958-1(d), Example 3.

3. This example is confusing because it does not specify whether it relates to the determination of whether U.S. beneficiaries indirectly own 10% of the voting power of the corporation, indirectly own more than 50% of the voting power of the corporation, indirectly own more than 50% of the voting value of the stock, or are subject to tax on the corporation's Subpart F income as a result of their indirect share ownership.

4. The only statement from the IRS on how to apply the facts and circumstances test of IRC § 958(a)(2) to trusts other than Example (3) is FSA 199952014 (September 23, 1999). In the FSA, the IRS National Office addressed the application of the indirect ownership rules to a trust that provided that all net income was to be paid to one of two beneficiaries during the primary beneficiary's lifetime. The principal issue was whether the actuarial values of the trust beneficiaries' interests were appropriate "facts and circumstances" under which to determine whether the trust's income beneficiaries were indirect shareholders. The National Office concluded that the actuarial values of the trust beneficiaries' interests were not relevant facts and circumstances for purposes of applying the indirect ownership rules. Instead, the National Office advised the field that it should treat the income beneficiaries as the owners of the trust's shares.

5. Example (3) and the FSA overlook the issue that is at the heart of the CFC rules: does a U.S. beneficiary control any voting power over with respect to the trust's shares in the foreign corporation?

    a. Under IRC § 957(a), which defines a "controlled foreign corporation," the threshold question in determining whether a foreign corporation is a CFC is whether one or more U.S. taxpayers control "10% or more of the total combined voting power of all classes of stock entitled to vote." *See* IRC § 951(b (defining "United States Shareholder")). Without at least one such U.S. shareholder, a foreign corporation cannot be a CFC. Furthermore, only a 10% shareholder is subject to tax on a CFC's Subpart F income.

b. Example (3) and FSA 199952014 focus on who receives the current benefit of a trust's investments as the facts relevant to determining indirect ownership in the trust context. But who receives the economic benefit of the trust's investments does not tell you whether any U.S. person controls 10% or more of the voting power of a foreign corporation in which the trust owns shares.

c. By overlooking whether a beneficiary possesses voting power over a trust's shares, Example (3) and FSA 199952014 ignore the plain language of IRC § 951(a)'s definition of a U.S. shareholder. Thus, Example (3) and the FSA are not faithful to the Congressional purpose of subjecting only those U.S. taxpayers who have some influence over or control of the corporation in which a foreign trust owns shares.

d. The Tax Court has recognized the importance of determining whether U.S. shareholders actually exercise control in applying statutes such as the CFC rules. In *Estate of Miller v. Commissioner*, 43 T.C. 760 (1965), the Tax Court rejected an IRS attempt to classify a foreign corporation as a personal holding company when no U.S. persons actually controlled how the corporation was managed even though the corporation technically met the definition of a foreign personal holding company:

> Respondent's interpretation can, as in the instant case, cause the U.S. stockholders to be subject to the tax because the corporation will not distribute, when they do not control the corporation, and they are not related to the foreign controlling stockholders or to their U.S. relative. *It is unreasonable and absurd to try to force corporate action without being able to bring pressure on those who control the corporation's actions*. *Alvord* v. *Commissioner, supra*. When there is an interpretation that accords with the purpose of the act then the statute should not be interpreted to produce absurd consequences even though such an interpretation might be within the literal language of the act. *United States* v. *Amer. Trucking Ass'ns*, 310 U.S. 534. This rule of statutory construction has been applied directly to the foreign personal holding company statute. *Alvord* v. *Commissioner, supra; Marsman* v. *Commissioner, supra*. In the last cited case the court held that only that portion of the foreign personal holding company income earned by the company after the taxpayer became a U.S. resident was taxable, the opinion stating: "We do not think * * * that the statute should be applied literally and without reference to the purpose for which it was admittedly enacted." (emphasis added).

e. Consistent with the purposes of the CFC rules and the common sense approach used by the Tax Court in *Estate of Miller*, the test of whether a trust beneficiary indirectly owns a trust's shares in a foreign corporation should focus first on the extent to which the beneficiary can control or influence the voting of the shares. *See* Treas. Reg. § 1.958-1(c)(2). Factors the IRS could consider include:

(i) Is the beneficiary acting as trustee or in another capacity in which she has the ability to vote the shares?

(ii) If the beneficiary can vote the shares, is she acting in a fiduciary capacity when she votes the shares or does the trust instrument limit her discretion in voting the shares?

(iii) If the beneficiary cannot vote the shares, can she control the identity of the fiduciary that votes the shares in such a way as to justify the IRS treating the beneficiary as if she can vote the shares?

f. If the trust is the only owner of the shares and the U.S. beneficiaries do not have any ability to control or influence the voting of the trust's shares, then the corporation should not be a CFC. If the corporation is not a CFC, whether or not those beneficiaries receive some benefit from the trust's use of the foreign corporation is irrelevant to the CFC rules. The beneficiaries, however, may be subject to the PFIC rules, discussed below, if the corporation is not a CFC.

g. If a foreign trust owns more than 10% of the shares of a foreign corporation and a U.S. beneficiary has the ability to vote the shares or influence the voting of the shares, then several additional inquiries must be made to determine whether that U.S. beneficiary is in fact a 10% shareholder.

(i) Is the beneficiary an income beneficiary or a remainder beneficiary? If the beneficiary is only a remainder beneficiary, Example (3) and FSA 199952014 suggest that the beneficiary should not be treated as an indirect owner of the shares because he or she cannot presently benefit from the shares.

(ii) If the beneficiary is an income beneficiary, what percentage of the income is he or she entitled to receive? If the trust is a 25% shareholder in a foreign corporation but the beneficiary is one of five income beneficiaries, he or she should not be a 10% shareholder because he or she is entitled to only 5% of the income. On the other hand, if the trust owns 100% of the shares, the beneficiary would be a 20% shareholder. Keep in mind that the shareholder will be deemed to constructively own any shares directly or indirectly owned by a parent, spouse, or descendant under the constructive ownership rules (of which more later).

(iii) If the trust is a discretionary trust, does the beneficiary have any ability to control the amount of distributions the trustee makes to him or her? If the beneficiary has no ability to control the distribution of income from the trust, he or she should not be treated as an indirect owner of the shares because he or she cannot control whether he or she receives any benefit from the shares. The inquiry here would be similar to the inquiry as to whether the beneficiary can control the voting of the shares.

(iv) It may be appropriate to deem a U.S. person to indirectly own shares in a discretionary trust if the shares held by the trust would includable in the U.S. person's gross estate. The IRS relies on this approach in the indirect ownership rules that apply to trusts under IRC § 2701. *See* Treas. Reg. § 25.2701-1(b)(2)(C)(2).

6. If a foreign corporation has at least one 10% U.S. shareholder, then the next inquiry is whether that shareholder and the other 10% shareholders, if any, collectively control more than 50% of the voting power of the foreign corporation or collectively own more than 50% of the value of the foreign corporation. If the answer is yes, then the corporation is a CFC.

a. In the trust context, you will get to this question only if you have concluded that a U.S. trust beneficiary controls 10% or more of the voting power of the foreign corporation.

b. The question then becomes whether the beneficiary and any other 10% shareholders collectively own more than 50% of the voting power or 50% of the value of the foreign corporation directly, indirectly, or constructively.

c. If the trust in question has other beneficiaries who are related to the voting beneficiary, the voting beneficiary may be deemed to constructively own those other beneficiaries' shares, which could push ownership above the 50% level.

7. If the foreign corporation is a CFC, then the next step is to determine the extent to which trust beneficiaries are subject to current income tax on the CFC's Subpart F income.

a. Only the 10% beneficiary-owner will be subject to tax on the CFC's Subpart F income. Any shares he or she constructively owns are not counted for purposes of determining the beneficiary-owner's share of Subpart F income.

b. As noted above, the scant authority from the government on these questions focuses on the beneficiary's share of the trust income, which makes sense.

(i) The purpose of the CFC rules is to currently tax the Subpart F income of a controlled foreign corporation to those U.S. taxpayers who are shareholders and who can influence the corporation's distribution policy. Just as the CFC rules follow dividends to determine indirect ownership through a corporation, the CFC rules should follow trust distributions to determine who the indirect owners of the trust's shares are. *See* Treas. Reg. § 1.958-1(c)(2).

(ii) As is the case with corporations, trusts confer their present economic benefits through distributions. In the case of corporations, the distributions are made to the shareholders – the owners of the company. In the case of trusts, the distributions of corporate dividends are made to income beneficiaries – the equitable owners of the trust property.

(iii) The government's eschewal of actuarial factors in determining trust beneficiaries' stock indirect ownership for Subpart F inclusion purposes is consistent with the government's focus on the income beneficiaries in Example (3) in the regulations and in FSA 199952014. Using actuarial factors would lead to remainder beneficiaries being deemed to own some of the economic benefits of the CFC. That conclusion, however, is inconsistent with the principle that Subpart F inclusion should follow the trust beneficiaries' interests in the income of the CFC, at least when the trust has a mandatory income interest.

c. The determination of who receives the economic benefits of a trust for Subpart F inclusion purposes is relatively straightforward in the case of a trust with mandatory income distributions to U.S. beneficiaries. In this situation, it is easy to determine who is receiving the economic benefits of the trust, as is the case in Example (3). Those beneficiaries would then be deemed to be the indirect owners of the CFC's shares for Subpart F income inclusion purposes.

d. It may appear inconsistent with Subchapter J to subject a trust's income beneficiary to tax on a trust-owned CFC's income when the beneficiary did not receive a distribution of any of that income. Recall, however, that you will only get to this point if you have determined that the U.S. beneficiary in question exercises some degree of control over the voting of the CFC shares If so, the imposition of tax seems less unfair. Furthermore, under the CFC rules only an income or unitrust beneficiary with an indirect interest in more than 10% of the CFC will be subject to this tax. Thus, if the foreign trust owns 25% of the CFC but the income beneficiary is only beneficiary of one-fourth of the income of the trust, then he or she will own only 6.25% of the income, making him or her a less than 10% shareholder.

8. The IRS's focus on the income beneficiaries of a trust in the application of IRC § 958(a)(2), while easy to understand, is usually unrealistic in the foreign trust context.

a. As discussed above, the IRS relies on the identity of the income beneficiaries to determine indirect ownership percentages for purposes of the CFC definitional test and the allocation of Subpart F income. The IRS appears also to rely on the identity of the income beneficiaries for 10% owner identification purposes, but as discussed above, the IRS's reasoning misses the point about control.

b. The IRS's focus on income beneficiaries assumes that every trust will have identifiable income beneficiaries. This may be true for certain foreign trusts, such as a trust in which a beneficiary has an interest in possession (a U.K. tax law concept) or a spousal rollover trust under Canadian tax law. Most foreign trusts, however, are discretionary trusts that give the trustee wide discretion over when and to whom to distribute trust income. This is particularly true of trusts settled and administered in tax havens. If a trustee has discretion to determine to whom to distribute trust income, then how do you determine who the income beneficiaries are from time to time for purposes of applying the indirect ownership rules?

c. The IRS has not issued any public or private guidance on how to apply the facts and circumstances test of IRC § 958(a)(2) to determine the proportionate ownership of beneficiaries of a discretionary trust. Attempting to determine what facts and circumstances are relevant in this situation is usually an academic exercise because a foreign discretionary trust will probably not have any U.S. shareholders who can vote 10% or more of the trust's shares in a foreign corporation, making the analysis of the trust beneficiaries' indirect ownership interests in the trust irrelevant. Most foreign trusts have non-U.S. fiduciaries who can control the voting of the trust's shares and the distributions to the beneficiaries.

d. But for the sake of argument, are there any analogous areas of the tax law in which there is authority on how to apply the proportionate ownership test of IRC § 958(a)(2)?

(i) One possibility is the rules for determining the net worth of an expatriate under IRC § 877, which applies to individuals who expatriated before June 17, 2008 (other rules apply to individuals who expatriate after June 16, 2008).

(a) Under IRC § 877, if a U.S. citizen who had a net worth of $2 million or more expatriated before June 17, 2008, he or she would have been subject to a special expatriate tax regime for the 10 years following expatriation. *See* IRC § 877(a)(2)(B) ($2 million threshold). The special tax regime also applied to certain former long term residents who gave up their green cards. *See generally* IRC § 877(e).

(b) For purposes of computing the individual's net worth, the IRS in Notice 97-19, 1997-1 C.B. 394, came up with the following method for computing the value of the individual's interest in trusts:

> The value of an individual's beneficial interest in a trust will be determined using a two-step process. First, all interests in property held by the trust must be allocated to beneficiaries (or potential beneficiaries) of the trust 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 protector or similar advisor. Interests in property held by the trust that cannot be allocated based on the factors described in the previous sentence shall be allocated to the beneficiaries of the trust under the principles of intestate succession (determined by reference to the settlor's intestacy) as contained in the Uniform Probate Code, as amended. Second, interests in property held by a trust that are allocated to the expatriate must be valued under the principles of section 2512 and the regulations

thereunder without regard to any prohibitions or restrictions on such interest.

(c) This approach to valuing trust interests is not relevant to IRC § 958(a)(2) because the approach computes the value of all beneficial interests, including remainder interests. As discussed above, however, the IRS has taken the view that only the current beneficiaries of a trust should be considered to proportionately own shares of foreign corporations owned by the trust. Using the Notice 97-19 approach would be inconsistent with this view. The purpose of the net worth test of IRC § 877 was to determine which expatriates should be subject to the special expatriation tax regime. Whether the beneficiary has a present interest or a future interest in a trust is irrelevant for purposes of IRC § 877; Congress was concerned with persons with a certain level of wealth. With IRC § 958(a)(2), on the other hand, the government tries to determine which of the current beneficiaries should be deemed to be the owners of the trust's shares because they are receiving the benefits of the deferral afforded through the use of the foreign corporation.

(ii) Another possible approach is the "maximum exercise of discretion" standard used in the indirect ownership rules under IRC § 2701.

(a) Under IRC § 2701(e)(3), for purposes of the special valuation rules of IRC § 2701, an individual will be deemed to indirectly own an interest in a corporation or partnership that is owned by a trust.

(b) In the regulations interpreting the indirect ownership rule, the IRS adopted a "maximum exercise of discretion" standard in determining when an individual indirectly owns an interest in a trust for purposes of IRC § 2701:

> A person is considered to hold an equity interest held by or for an estate or trust to the extent the person's beneficial interest therein may be satisfied by the equity interest held by the estate or trust, or the income or proceeds thereof, assuming the maximum exercise of discretion in favor of the person. A beneficiary of an estate or trust who cannot receive any distribution with respect to an equity interest held by the estate or trust, including the income therefrom or the proceeds from the disposition thereof, is not considered the holder of the equity interest. Thus, if stock held by a decedent's estate has been specifically bequeathed to one beneficiary and the residue of the estate has been bequeathed to other beneficiaries, the stock is considered held only by the beneficiary to whom it was specifically bequeathed. However, any person who may receive distributions from a trust is considered to hold an equity interest held by the trust if the distributions may be made from current or accumulated income from or the proceeds from the disposition of the equity interest, even though under the terms of the trust the interest can never be distributed to that person. This paragraph applies to any entity that is not classified as a corporation, an association taxable as a corporation, or a partnership for federal income tax purposes.

Treas. Reg. § 25.2701-6(a)(4)(i).

(c) The Treasury Regulations, however, provide that the government will apply the indirect ownership rule to value transactions under IRC § 2701 only when the trust beneficiary is either the owner of the trust's income and gains under the grantor trust rules or if the trust assets would be includable in the individual's gross estate. This effectively limits the application of the indirect ownership rules to situations in which a trust beneficiary has some level of control over the trust assets. The government will not apply the indirect ownership rules to cause a beneficiary to be subject to the special valuation rules if the beneficiary is not a grantor of the trust or does not have sufficient powers over the trust to cause the inclusion of its assets in the beneficiary's estate. *See* Treas. Reg. § 25.2701-1(b)(i)(C). For this reason, the "maximum exercise of discretion" test in the regulations under IRC § 2701 is not particularly helpful for determining indirect *economic* ownership, which is the key task under IRC § 958(a)(2) with respect to determining a U.S. shareholder's percentage of the value of a foreign corporation. Rather, the IRC § 2701 indirect ownership rules focus on control.

(d) Apart from the fact that the IRC § 2701 indirect ownership regulations have a fairly limited application, the maximum exercise of discretion test articulated in those regulations would not be appropriate for IRC § 958(a)(2) purposes. The purpose of the CFC indirect ownership rules is to prevent a U.S. taxpayer from deferring U.S. federal income tax on assets he or she controls and enjoys. The maximum exercise of discretion test, however, does not address whether a trust beneficiary actually benefits from a trust's ownership of shares in a foreign corporation. The government should apply the indirect ownership rules only if it prevents a deferral of tax that would otherwise be paid absent the trust and foreign corporate structure.

(iii) Another possible analogy is to the rules of IRC § 267(c).

(a) Under IRC § 267(c)(1), an interest owned by an estate or trust will be considered as owned proportionately by its beneficiaries. The IRS, however, has not issued any regulations under IRC § 267(c)(1) that explain how to apply the proportionate ownership rule.

(b) Court decisions and rulings under IRC § 267(c) do not provide any guidance on how to apply the proportionate ownership rule. In PLR 9015055, for instance, the IRS ruled that an individual and her children, who were beneficiaries of a trust that owned shares, were deemed to own the shares under IRC § 267(c)(1). The IRS, however, did not discuss how to apportion the shares among the trust beneficiaries. *See also Liflans Corp. v. United States*, 390 F.2d 695 (Ct. Claims 1968) (court concludes that beneficiaries of a trust deemed to own trust's shares under IRC § 267(c) without any discussion of the basis on which the proportionate ownership rules were to be applied); PLR 8128073. About the most we can tell from the cases and rulings is that even contingent interests do count for purposes of IRC § 267(c) but we do not know how to count them. *E.g.*, *Wyly v. United States*, 662 F.2d 397 (5th Cir. 1981); *Widener Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983). To this extent, the cases and rulings are not helpful in figuring out how to apply IRC § 958(a)(2) to interests in discretionary trusts.

(c) In *Hickman v. Commissioner*, T.C. Memo. 72-208, 31 T.C.M. 1030 (1972), the Tax Court held that actuarial values cannot be used to apply the proportionate ownership rules for trust beneficiaries under IRC §

267(c)(1). So far, so good; this conclusion is consistent with the IRS's views expressed in FSA 199952014. In *Hickman*, the taxpayer challenged the IRS's method of computing proportionate ownership, but failed to convince the court that the IRS was incorrect. The taxpayers first suggested that actuarial values should be used to determine their proportionate interests in the trust's shares, but the court found no support for this approach in the legislation and its history. The court also rejected the taxpayers' suggestion that the value of their interests in the shares owned by the trust was zero because they could not assign their interests in the trust. The court, however, did not describe how the IRS applied the proportionate ownership test other than referring to an IRS conclusion that the taxpayers owned more than 50% of the value of the shares because the taxpayers were the only present beneficiaries of the trust and because the trust had no specifically named remainder beneficiaries. Once again, the lack of discussion of how to apply the proportionate ownership test makes this decision useless to the indirect ownership rules.

(iv) Yet another possibility is the approach the IRS took in temporary regulations under IRC § 6038D.

(a) Under IRC § 6038D, a U.S. taxpayer must disclose the existence of and value of certain specified foreign financial assets to the IRS on Form 8938. An interest in a foreign trust is a reportable asset. Treas. Reg. § 1.6038D-3(b)(iii)

(b) A taxpayer must know the value of his or her interest in a foreign discretionary trust in order to determine whether he or she meets the filing threshold, and if he or she does meet the filing threshold, what the value of his or her interest in such a trust is.

(c) The regulations take a practical approach to the question of the value of an interest in a foreign discretionary trust by essentially providing that the maximum value of an interest in such a trust for a given year is the sum of the distributions from the trust to the beneficiary for that year. Treas. Reg. § 1.6038D-5(f)(2)(i)(A). Therefore, if the beneficiary received no distributions from a discretionary trust, his or her beneficial interest in the trust has no value for purposes of the reporting requirements of IRC § 6038D. The regulations take the appropriate position that if a beneficiary does not know about a discretionary trust or that he or she has an interest in the trust, he or she is not required to disclose the existence of that interest on Form 8938. Treas. Reg. 1.6038D-3(c)(an interest in a foreign trust is not a reportable foreign financial asset unless the person "knows or has reason to know based on readily accessible information of the interest").

(d) The IRS took a realistic and sensible approach to the valuation of and accounting for interests in foreign discretionary trusts in the regulations under IRC § 6038D, and this approach would be appropriate to apply in determining indirect ownership through a foreign trust under IRC § 958(a)(2). Unlike the maximum exercise of discretion standard, an approach based on actual distributions is much fairer and reflects the economics of the situation as well as, potentially, the beneficiary's lack of control over the trustee. Putting aside the question of control for the moment, such an approach to indirect ownership, which implicates both knowledge and actual benefit, is a fair way to approach the indirect ownership question.

E. *Constructive Ownership of CFC Shares by Beneficiaries of Foreign Trusts*

1. If the IRS cannot rely on the indirect ownership rules of IRC § 958(a)(2) to determine that the U.S. beneficiaries of a foreign trust indirectly own the trust's shares of a foreign corporation, the IRS may instead be able to determine that the beneficiaries constructively own some or all of the trust's shares under IRC § 958(b). These constructive ownership rules apply to determine whether a U.S. beneficiary is a 10% shareholder for purposes of determining whether a foreign corporation is a CFC. In this way, the constructive ownership rules are an alternate way to identify 10% shareholders and, therefore, to determine whether a corporation is a CFC.

2. It is important to understand, however, that if a person constructively owns shares in a CFC but does not own the shares directly or indirectly, that U.S. taxpayer will not be subject to tax on any part of the CFC's Subpart F income. The only purpose of the constructive ownership rules is to determine whether a corporation is a CFC – i.e. do 10% U.S. shareholders hold more than 50% of the shares of the CFC by vote or value? The only consequence to being a constructive owner, as opposed to being a direct or indirect owner, is reporting requirements.

3. Section 958(b) incorporates the constructive ownership rules of IRC § 318(a) to determine when a trust beneficiary will be deemed to constructively own shares of a corporation owned by a trust. Under IRC § 318(a)(2)(B)(i), stock owned by a trust will be considered to be owned by its beneficiaries in proportion to the beneficiaries' actuarial interests in the trust.

4. The principal difference between the indirect ownership rules of IRC § 958(a)(2) and the constructive ownership rules of IRC § 958(b) is that the constructive ownership rules rely on actuarial values rather than "facts and circumstances" to determine a beneficiary's proportionate ownership of a trust's shares. Thus, a U.S. beneficiary can be deemed to constructively own a foreign trust's shares without regard to whether the beneficiary can vote the trust's shares or control the voting of the trust's shares.

5. The constructive ownership rules' reliance on actuarial values makes those rules simple to apply to foreign trusts with mandatory income interests and fixed remainder interests. *See, e.g.*, Treas. Reg. § 1.318-3(b). The regulations direct the use of actuarial factors and methods described in Treas. Reg. § 20.2031-7, which are estate tax valuation regulations, to compute the actuarial interests of trust beneficiaries. *Id.* Treasury Regulation § 20.2031-7 generally directs a taxpayer to use the IRC § 7520 actuarial factors to determine the value of annuities, life estates, and remainder interests. Treas. Reg. § 20.2031-7(d)(1)(for valuations after April 1, 1999). The tables provide an easy way to determine a beneficiary's pro rata ownership of trust-owned shares when the beneficiary has an interest capable of actuarial valuation.

6. The constructive ownership rules cannot, however, be applied when the beneficiaries' interests in the trust are discretionary, as is the case with most foreign trusts.

   a. The IRC § 958(b) constructive ownership rules rely on IRC § 318(a) to determine a beneficiary's proportionate ownership of trust owned stock. Section 318(a) in turn relies on IRC § 7520 and its actuarial factors to determine beneficiaries' proportionate interests in trusts. The regulations under IRC § 7520, however, do not permit the use of actuarial factors to determine the value of "restricted beneficial interests" in trusts:

   > A restricted beneficial interest is an annuity, income, remainder, or reversionary interest that is subject to any contingency, power, or other restriction, whether the restriction is provided for by the terms of the trust, will, or other governing instrument or is caused by other circumstances. In general, a standard section 7520 annuity, income, or remainder factor may not be used to value a restricted beneficial interest.

   Treas. Reg. § 20.7520-3(b)(1)(ii).

b. For example, if a trustee has discretion to divert or withhold income or principal distributions, actuarial factors cannot be used to compute the value of interests in the trust. *See* Treas. Reg. § 20.7520-3(b)(2)(ii)(B), (C).

c. When the IRC § 7520 factors are not applicable in determining the value of an interest in a trust, the taxpayer cannot rely on IRC § 7520 to value the interest. Rather, the taxpayer must determine the value of his or her trust interest based on "all of the facts and circumstances if and to the extent provided by the Internal Revenue Code provision applicable to the property interest." Treas. Reg. § 20.7520-3(b)(1)(iii).

d. The regulations under IRC § 318(a) provide that factors and methods described in Treas. Reg. § 20.2031-7 "shall be used" to compute actuarial values. Treas. Reg. § 1.318-3(b). That regulation and its related regulation, Treas. Reg. § 20.7520-3(b), however, effectively provide that the actuarial value of an interest in a discretionary trust cannot be computed. As a result, an interest in a discretionary trust should have no value for purposes of applying the constructive ownership rules of IRC § 958(b).

7. The IRS has confirmed the impossibility of determining the actuarial value of an interest in a discretionary trust.

a. An analysis of the Treasury Regulations under IRC § 367, for example, demonstrates that the IRS knows that valuing an interest in a discretionary trust under IRC § 318(a) is not possible.

(i) The regulations under IRC § 367 provide that stock owned by or for a trust shall be considered to be owned "proportionately by the persons who would be treated as owning such stock . . . under sections 318(a)(2)(A) and (B)." Treas. Reg. § 1.367(e)-1.

(ii) The regulations have an additional rule, however, for discretionary trusts:

> In applying section 318(a)(2)(B), if a trust includes interests that are not actuarially ascertainable, all such interests shall be considered to be owned by foreign persons.

Treas. Reg. § 1.367(e)-1(b)(2).

(iii) By coming up with a special rule to deal with interests that are not "actuarially ascertainable," the regulation tacitly acknowledges that IRC § 318(a)(2)(B) is of no use in situations involving discretionary trusts. Interestingly, the preamble to the temporary regulations, which preceded the permanent regulations, provides that the IRS "is studying the determination of a beneficiary's actuarial interest in a trust, and may issue further guidance on this subject at a future date." T.D. 8472, 1993-1 C.B. 51, 52. The IRS did not address the issue when it issued the permanent regulations in 1999. *See* T.D. 8834, 1999-2 C.B. 251. Apparently the IRS is still studying this question.

b. The IRS demonstrated a similar view in regulations under the shipping income tax rules of IRC § 883 and the branch profits tax rules of IRC § 884.

(i) Both sections have rules that condition the availability of certain benefits to foreign corporations on the ownership by certain individuals of more than 50% of the value of the shares of the corporation. *See* IRC §§ 883(c)(1), 884(e)(4).

(ii) For purposes of both sections, shares owned by a trust are deemed to be owned proportionately by the trust beneficiaries. *See* IRC § 883(c)(4); Treas. Reg. § 1.884-5(b)(2)(iii).

(iii) Treasury Regulations under both sections address how to compute a beneficiary's proportionate ownership of a trust's shares. Treas. Reg. §§ 1.883-4(c)(3); 1.884-5(b)(2)(iii)(A). The regulations under IRC § 883, which came after the regulations under IRC § 884, use the same rules as the IRC § 884 regulations, so I will discuss only the IRC § 884 regulations. *See* 2000-8 I.R.B. 654, 662.

(iv) The Treasury Regulations under IRC § 884 generally provide for the determination of a beneficiary's constructive ownership of a trust's shares by reference to IRC § 318(a)(2). Treas. Reg. § 1.884-5(b)(2)(iii)(A).

(v) In the regulations, however, the IRS appears to have recognized that the actuarial approach in IRC § 318(a)(2) would not work when the trust was a discretionary trust:

> In general, a person shall be treated as having an interest in stock of a foreign corporation owned by a trust or estate in proportion to the person's actuarial interest in the trust or estate, as provided in section 318(a)(2)(B)(i), except that an income beneficiary's actuarial interest in the trust will be determined as if the trust's only asset were the stock. The interest of a remainder beneficiary in stock will be equal to 100 percent minus the sum of the percentages of any interest in the stock held by income beneficiaries. The ownership of an interest in stock owned by a trust shall not be attributed to any beneficiary whose interest cannot be determined under the preceding sentence, and any such interest, to the extent not attributed by reason of this paragraph (b)(2)(iii)(A), shall not be considered owned by a beneficiary unless all potential beneficiaries with respect to the stock are qualifying shareholders.

Id.

(vi) Stated another way, the IRS views a beneficial interest that cannot be determined by reference to actuarial tables to have no value. The IRS's use of this approach is understandable given that the IRS was attempting to limit a benefit under the branch profits tax rule to situations in which certain taxpayers were sure to receive benefits from the trust. To this extent, the regulation reflects the realistic view that you cannot determine the actuarial value of a beneficiary's interest in a discretionary trust. Taking this approach, of course, was to the government's benefit under IRC § 884 because it made it harder for a corporation to qualify for benefits.

(vii) The IRS should take a similar approach in attempting to determine the actuarial value of an individual's interest in a discretionary trust under IRC § 958(b). The IRS should be consistent in applying IRC § 958(b) even though the approach disfavors the government.

c. Commentators sometimes refer to cases and rulings under the personal holding company rules as providing a method for determining the actuarial value of beneficial interests in discretionary trusts.

(i) IRC § 544(a)(1) provides that for purposes of determining whether a corporation is a personal holding company, shares owned by an estate or trust are considered to be owned proportionately by the estate or trust beneficiaries.

(ii) The IRS has not issued any regulations under IRC § 544(a)(1) that describe how to apply the proportionate ownership test. As a result, courts and the IRS have had to develop the rules for applying the proportionality test in decisions and rulings. Those decisions and rulings have generally based proportionate ownership on actuarial values, though without reference to any particular way of computing actuarial values. This ad hoc approach has left the IRS to struggle with how to determine the actuarial value of an interest in a discretionary trust for purposes of IRC § 544(a)(i).

(iii) In PLR 9024076 the IRS attempted to come up with an actuarial value of an interest in a discretionary trust for IRC § 544(a)(1) purposes. In that ruling the IRS considered these facts and circumstances:

(a) Patterns of past distributions;

(b) Appropriate mortality assumptions;

(c) The trustee's fiduciary duties; and

(d) The relationships among the trustees and beneficiaries.

(iv) A close reading of PLR 9024076 shows that the IRS was not really computing actuarial values of beneficial interests in the trust within the common meaning of that term. Rather, the IRS was using qualitative factors to determine the value of a beneficiary's interest in a discretionary trust.

(v) The IRS appears to have recognized the disingenuousness of the multifactor approach to determining actuarial values of interests in discretionary trusts in a 1994 Field Service Advisory Memorandum.

(a) In FSA 1644 (July 14, 1994), the IRS National Office considered how the proportionate ownership rules of IRC § 544(a)(1) should apply to a discretionary trust held for the benefit of a single beneficiary for purposes of applying certain of the passive loss rules. The trustee of the trust had discretion to make or not make distributions of income to the beneficiary, and the beneficiary was not entitled to receive principal distributions.

(b) Although the IRS could have used the multi-factor approach of PLR 9024076 to deem the beneficiary to own the trust's stock, the National Office instead took the view that court decisions and Revenue Ruling 62-155 required the use of a strict actuarial approach in applying the indirect ownership rules of IRC § 544(a)(1).

(c) The National Office advised the field that "because of the discretionary nature of [the trust], particularly the trustee's power to completely withhold income and the uncertainty of the identity of the remaindermen, [the beneficiary] has no *actuarially determinable interest* in the trust. Accordingly, the National Office advised that the beneficiary could not be deemed to own the trust's stock in the corporation under IRC § 544(a)(1). This result contradicts the result in PLR 9024076.

d. The IRS might suggest that it could determine the actuarial value of an interest in a discretionary trust by considering the maximum extent of the trustee's discretion to make a distribution to that beneficiary. The IRC § 7520 regulations, however, preclude the government from making such an argument.

(i) For example, under IRC § 1563(e)(3)(A):

> stock owned, directly or indirectly, by or for a . . . trust shall be considered as owned by any beneficiary who has an *actuarial* interest of 5 percent or more in such stock, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the *maximum exercise of discretion* by the fiduciary in favor of such beneficiary and the maximum use of such stock to satisfy his rights as a beneficiary." (emphasis added).

(ii) The treasury regulations under IRC § 1563 provide further that "a beneficiary of a . . . trust who cannot under any circumstances receive any interest in stock held by the . . . trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him." Treas. Reg. § 1.1563-3(b)(3)(i). Thus, to the extent the trust provides expressly that a beneficiary may have no interest in either the income or the disposition proceeds of stock owned by a trust, ownership of the stock will not be attributed to the beneficiary.

(iii) The "maximum exercise of discretion" rules in the consolidated return regulations are not relevant to the determination of actuarial values under IRC § 7520. As noted above, those regulations provide that the value of a restricted beneficial interest cannot be determined by reference to the actuarial tables. The IRC § 7520 regulations do not have a "maximum exercise of discretion" assumption in them; the IRS would have to revise the regulations to bring such a standard into the regulations. Thus, the plain language of the IRC § 7520 regulations cut off the ability of the government to make a "maximum exercise of discretion" argument in applying the constructive ownership rules of IRC § 958(b).

F. *Compliance Issues for Shareholders of CFCs*

1. A U.S. taxpayer who owns more than 10% of the total combined voting power of a CFC must file a Form 5471 if he or she owned that 10% or more of the shares for an uninterrupted period of more than 30 days during the tax year of the CFC or owned that 10% or more of the shares on the last day of the CFC's tax year. *See* IRC § 6038(a)(4)(giving the IRS authority to require a 10% shareholder to file an informational return).

2. The IRS used the authority given to it by Congress to require a 10% shareholder to file a Form 5471 simply by instructing a shareholder to do so on Form 5471. The IRS did not promulgate regulations requiring such a filing. A 10% shareholder of a CFC is a Category 5 filer.

3. A U.S. taxpayer is required to file a Form 5471 as a Category 5 filer if he or she directly, indirectly, or constructively owns 10% or more of the total combined voting power of all classes of stock of a CFC entitled to vote. *See* IRC § 951(b)(defining a "U.S." shareholder for purposes of Subpart F). If, however, the U.S. person does not directly or indirectly own any shares of the CFC, but only constructively owns shares through a nonresident alien, that U.S. person is not required to file a Form 5471.

4. Just because a U.S. taxpayer must file a Form 5471 does not mean that he or she will be taxable on a share of the CFC's Subpart F income. If the U.S. person does not own any shares directly or indirectly, but only constructively, he or she will not be liable for a pro rata share of the CFC's

Subpart F income. *See* Instructions to IRS Form 5471 at 3. *See also* Treas. Reg. § 1.6038-2(l)(similar rule for a Category 4 filer). *See generally* IRC § 951.

IV. Passive Foreign Investment Company Shares Owned by Trusts and Estates

A. *What is a PFIC?*

1. A PFIC is a foreign corporation that meets one of these tests:

   a. 75% or more of the gross income of the corporation is "passive" income. IRC § 1297(a)(1).

   b. The average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50%. IRC § 1297(a)(2).

2. Subject to certain limited exceptions, "passive income" is foreign personal holding company income within the meaning of IRC § 954(c). *See generally* IRC § 1297(b).

3. In determining whether a foreign corporation is a PFIC, if a foreign corporation owns at least 25% of the stock of another corporation, then the first corporation will be deemed to own a pro-rata share of the assets of the other corporation and directly received a pro-rata share of the other corporation's income. IRC § 1297(c). This rule effectively permits the use of a holding company to own a foreign operating business without that holding company being classified as a PFIC.

4. The PFIC regime does not apply to a U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation. IRC § 1297(e). *See also* PLR 200943004. Because such a shareholder is currently taxable on her share of the CFC's Subpart F income, it is unnecessary to subject him or her to the PFIC tax regime; the CFC rules accomplish Congress's anti-deferral objectives.

B. *Taxation of Distributions From a PFIC*

1. A special tax regime applies when a U.S. shareholder receives a distribution from a PFIC. Unlike the normal rules of U.S. federal corporate income taxation, a PFIC's earnings and profits are often not relevant to the taxation of a PFIC distribution. Rather, the taxation of a PFIC distribution depends on the relative size of the distribution as compared to the PFIC's distributions in prior years, including the years before the corporation became a PFIC.

2. Distributions from a PFIC fall into two categories, "excess" and "nonexcess" distributions. An excess distribution is the portion of a distribution from a PFIC that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years included in the shareholder's holding period or, if the shareholder's holding period is less than three years, the holding period. IRC § 1291(b)(2)(A). A nonexcess distribution is the part of a distribution that is not an excess distribution.

3. The portion of a PFIC distribution that is a nonexcess distribution is taxed to the shareholder based on the general rules of U.S. corporate income taxation, which will usually result in dividend treatment. Prop. Treas. Reg. § 1.1291-2(e)(1). The nonexcess distribution from a PFIC will not qualify for the 15% rate on qualified foreign dividends because a PFIC by definition is not a "qualified foreign corporation." IRC § 1(h)(11)(C)(iii).

4. The portion of a PFIC distribution that is an excess distribution is subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares. IRC § 1291(a)(1)(A). Whether the PFIC had earnings and profits in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years is included in the taxpayer's income for the year of receipt as ordinary income. IRC §

1291(a)(1)(B)(i), (ii). Those amounts of the excess distribution are not qualified dividends for federal income tax purposes. *See* IRC § 1(h)(11)(C)(iii) (a foreign corporation that is a PFIC is not a "qualified foreign corporation").

5. The portion of the excess distribution allocated to other years in the taxpayer's holding period (the "PFIC years") is not included in the shareholder's income. Rather, this portion is subject to a special "deferred tax" that the taxpayer must add to her tax that is otherwise due. *See* IRC § 1291(c). To compute the deferred tax the shareholder must first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year. IRC § 1291(c)(1). The shareholder then aggregates all the "unpaid" tax amounts for the PFIC years. IRC § 1291(c)(2). The shareholder must then compute interest on those increased tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable federal underpayment rate. IRC § 1291(c)(3). The taxpayer includes the deferred tax and interest as separate line items on his or her individual income tax return. *See* IRC § 1291(a)(1)(C). The effect of the deferred tax and the interest charge is similar to the throwback rule that applies to accumulation distributions from foreign trusts.

6. Tax law treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the PFIC shares. IRC § 1291(a)(2). The effect of these rules is to treat the gain as ordinary income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

C. *Alternate Tax Regimes*

1. Instead of subjecting himself or herself to the excess distribution regime, a U.S. shareholder of a PFIC may make a "qualified electing fund" or "QEF" election for his or her shares. If the shareholder makes this election, he or she must include in his or her gross income a pro rata share of the PFIC's ordinary income and net capital gain for a taxable year. *See generally* IRC § 1293(a). Thus, instead of waiting until the PFIC makes a distribution, the shareholder elects to be taxed currently on the PFIC's earnings and profits. If a shareholder makes this election, however, he or she must have access to the PFIC's books and records so that he or she can determine how to compute their allocable share of the PFIC's income and gains.

2. If a U.S. taxpayer acquires shares in a PFIC which are "marketable," the shareholder may make a "mark to market" or "MTM" election for the shares. *See generally* IRC 1296. A PFIC's shares are marketable when the shares are regularly traded (as defined in Treas. Reg. § 1.1296-2(b)) on:

   a. A national securities exchange that is registered with the Securities and Exchange Commission (SEC);

   b. The national market system established under section 11A of the Securities and Exchange Act of 1934; or

   c. A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and has the characteristics described in Regulations section 1.1296-2(c)(1)(ii).

   Instructions to IRS Form 8621 (Rev. December 2016) at 3. Under the mark to market regime, the shareholder includes the excess of fair market value of the PFIC shares over his or her adjusted basis in the shares in gross income on an annual basis. The shareholder may adjust his or her basis in the shares for the amount of income subject to inclusion under the mark to market regime.

D. *Compliance Obligations*

1. Before the 2013 tax year, a direct or indirect U.S. shareholder in a PFIC who had not made a QEF election or an MTM election was required to file an IRS Form 8621 for a year in which the taxpayer received a distribution from the PFIC or recognized gain on the disposition of shares in

the PFIC. If a shareholder of such a PFIC did not receive a distribution from the PFIC in a given year, the shareholder was not required to file Form 8621 for the year. On the other hand, a U.S. shareholder of a PFIC who had made a QEF election or an MTM election with respect to the PFIC was required to file a Form 8621 for each year in which the election was in place.

2. In March 2010 Congress enacted a new statute, IRC § 1298(f), which requires every shareholder in a PFIC to file an informational return with the IRS in a form and with information that the IRS decides is appropriate. The IRS, however, suspended the filing requirement for a number of years. *See* IRS Notice 2011-55, 2011-29 I.R.B. 53. In that notice, the IRS indicated that once it revised Form 8621 to pick up the legislative change to IRC § 1298(f), taxpayers would have to file the form for the years in which the filing requirement had been suspended.

3. In 2012 the IRS issued a revised Form 8621 that picked up the legislative change, and issued a draft Form 8621 for 2013 that retained the revisions. The 2012 Instructions to the Form 8621 provided that until the government issued regulations, however, taxpayers did not have to complete that particular part of the form.

4. In December 2013 the IRS issued temporary regulations under IRC § 1298(f) that implemented the requirement that taxpayers who own shares in PFICs report that ownership on Form 8621 even if a taxable event does not occur with respect to the shares. The filing requirements apply for the 2013 tax year and future years. Temp. Treas. Reg. § 1.1298-1T(d). Happily for taxpayers, the IRS eliminated the requirement that taxpayers file Form 8621 for the tax years in which the IRS had previously suspended the filing requirement in IRS Notice 2011-55. Temp. Treas. Reg. § 1.1298-1T(c)(3).

5. The IRS withdrew the temporary regulations and issued final regulations under IRC § 1298 on December 28, 2016. TD 9806, 81 Fed. Reg. No. 249, 95459. Under the final regulations, a taxpayer who directly or indirectly owns shares in a PFIC must disclose the ownership of those shares to the IRS on a timely filed Form 8621 even if a taxable event has not occurred with respect to the taxpayer's PFIC shares. *See* Treas. Reg. § 1.1298-1(b)(1). If, however, the value of the taxpayer's shares in a particular PFIC is less than $25,000 and the shareholder did not receive an excess distribution, the taxpayer need not file the form with respect to that PFIC. Treas. Reg. § 1.1298-1(c)(2)(i)(A). If the taxpayer is married and files a joint return, the filing threshold increases to $50,000 in value per qualifying PFIC. Treas. Reg. § 1.1298-1(c)(2)(iii).

6. The filing requirements generally apply to domestic estates and nongrantor trusts as well as to U.S. taxpayers who own the income of trusts under the grantor trust rules. A U.S. citizen or resident beneficiary of a domestic or foreign trust or estate must file Form 8621 for years in which the beneficiary is deemed to have received an excess distribution. Treas. Reg. § 1.1298-1(b)(3)(i).

7. A shareholder must file a separate Form 8621 for each PFIC in which he or she owns shares. Treas. Reg. § 1.1298-1(e). Form 8621 is due at the same time a taxpayer's individual income tax return is due and must be filed with the taxpayer's individual income tax return. Temp. Treas. Reg. § 1.1298-1(d).

E. *Estate Planning Issues for Individuals Who Own PFIC Shares*

1. Death as a Disposition?

a. The death of an owner of PFIC shares may result in a deemed disposition of his or her PFIC shares. By way of background, the Internal Revenue Code usually treats transfers of assets by reason of death as a nonrecognition event for income tax purposes. Under the PFIC rules, however, any transfer by a U.S. owner of PFIC shares that would normally be a nonrecognition transaction is generally deemed to be a taxable disposition of the PFIC shares. IRC § 1291(f).

b. The transfer of assets at death is not a recognition event for federal income tax purposes. Thus, the death of a U.S. owner of PFIC shares appears to be a taxable disposition of those shares under IRC § 1291(f). If, however, the effect of the death of a U.S. taxpayer who owns PFIC shares is a transfer of the shares to a domestic estate or directly to another U.S. taxpayer, then the shareholder's death is not a taxable event. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A). The transfer of PFIC shares by a U.S. taxpayer on death to a testamentary trust or to a foreign person, however, is a taxable disposition. *See* Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B). The proposed PFIC regulations treat a death-related disposition as a transfer by the shareholder immediately before his or her death, making the transfer taxable to the shareholder during his or her last taxable year. Prop. Treas. Reg. § 1.1291-6(d)(2).

c. If a U.S. taxpayer owns shares of a PFIC through a grantor trust, the taxpayer's death would be a taxable disposition of the shares unless one of the exceptions applies. *See* Prop. Treas. Reg. § 1.1291-6(c)(3)(iv). These rules apply to a trust that is a grantor trust by reason of the settlor's retained powers as well as a trust that is a grantor trust by reason of IRC § 678. If a U.S. beneficiary holds a testamentary general power of appointment, however, the trust will not be a grantor trust and, therefore, the grantor trust disposition rules will not apply.

2. Basis Issues

a. IRC § 1014 generally provides that a taxpayer who receives property from a decedent will receive a new basis in the property equal to the value of the property on the decedent's date of this death.

b. The step-up in basis nominally applies to PFIC shares. Under IRC § 1291(e)(1), however, a shareholder's basis in PFIC shares received from a decedent is reduced by the difference between the new basis awarded under IRC § 1014 and the decedent's adjusted basis in the PFIC shares immediately before the decedent's death. Thus, there is effectively no new basis in PFIC shares received from a decedent. The statute is not a model of clarity because it refers to rules similar in effect to rules that were part of IRC § 1246 before its repeal by the American Jobs Creation Act of 2004.

c. The basis reduction rule does not apply to PFIC shares received by a U.S. shareholder by reason of the death of a nonresident alien decedent if the decedent was a nonresident alien during her entire holding period. IRC § 1291(e)(2).

F. *Issues for Domestic Trusts that Own PFIC Shares*

1. Introduction

a. The income tax rules related to PFICs are fairly easy to apply individual U.S. taxpayers. The rules, however, are much more difficult to apply to domestic trusts that own PFIC shares and the trust's beneficiaries because the concepts used by Congress in the PFIC rules conflict with many of the principles of Subchapter J.

b. In the proposed PFIC regulations the IRS acknowledged that application of the PFIC rules to trusts and their beneficiaries presented complicated issues. The IRS, however, did not give any guidance on how to apply to these rules to a trust that owns shares in a PFIC and its beneficiaries. In sections of the 1992 proposed regulations where the IRS had in mind to address trusts and their beneficiaries, the IRS simply wrote "reserved." Prop. Treas. Reg. §§ 1.1291-2(f)(2)(i), 1.1291-2(f)(2)(ii)(B), 1.1291-3(e)(5)(ii).

c. In 2013 the IRS again issued temporary and proposed regulations related to PFICs but again did not address how the PFIC rules apply to nongrantor trusts:

> These temporary regulations do not provide guidance on the application of section 1291 when an estate or nongrantor trust, or beneficiary thereof, receives, or is treated as receiving, an excess distribution (including an amount of gain treated as an excess distribution).

T.D. 9650, 2014-3, I.R.B. 394, 396.

d. In light of the lack of any rules on the subject, the preamble to the 2013 temporary regulations simply directs the "shareholder" – which could be the trust or the beneficiary – to apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge:

> Section 1291 and the principles of subchapter J must, however, be applied in a reasonable manner with respect to estates and trusts, and beneficiaries thereof, to preserve or trigger the tax and interest charge rules under section 1291. Accordingly, until further guidance is issued, the estate or trust, or the beneficiary thereof, must take excess distributions into account under section 1291 in a reasonable manner, consistent with the general operating rules of subchapter J.

Id.

2. Effect of a PFIC Distribution to a Domestic Trust

a. If a domestic trust receives a distribution from a PFIC, the nonexcess portion of the distribution will be included in the trust's DNI to the extent that the nonexcess portion constitutes taxable income. *See* IRC § 643(a); Prop. Treas. Reg. § 1.1291-2(e)(1).

b. The trust's DNI will also include the excess portion of the distribution attributable to the current year and to pre-PFIC years. *See* IRC § 643(a); IRC § 1291(a)(1)(B). If, however, the trust is a simple trust or a complex trust with Tier 2 beneficiaries, applying the PFIC rules in a manner consistent with the principles of Subchapter J is very difficult because the two regimes are so different.

c. It might seem like the PFIC rules would be easy to apply to a simple trust because unlike the CFC rules, the PFIC rules focus on the receipt of a distribution from a corporation rather than on imputing income. Nevertheless, applying the PFIC rules to a simple trust raises a number of issues.

(i) Under general tax principles, the current year portion of the excess distribution will be included in the trust's DNI. The trust will receive a deduction for the amount of the DNI and the beneficiary will include the DNI in his or her income. *See* IRC §§ 651, 652.

(ii) The excess distribution allocated to prior tax years, however, is not included in DNI, so the trust would not receive a deduction for that amount. *See* IRC § 651(b) (distribution deduction limited to DNI, and DNI does not include items of accounting income not included in taxable income). That part of the excess distribution, however, would be includable in the trust's accounting income, which would require the trustee to distribute that amount to the beneficiary. Doing so, however, could leave the trustee with the deferred tax and interest obligation on the amount of the excess distribution allocated to prior years without any cash to pay the tax and interest.

(iii) The trustee could treat the deferred tax and interest as income related expenses for accounting purposes and reduce the accounting income accordingly. This should work all right as long as the deferred tax and interest do not exceed the gross amount of the excess distribution allocated to prior years. Alternatively, the trustee could make an adjustment to income by not allocating the excess distribution amount to income if state law permits such an adjustment. Such an approach should be appropriate under the PFIC rules because it preserves the deferred tax and the interest charge.

d. Applying the distribution tax rules to a domestic complex trust is easier.

(i) The trustee of a complex trust will include the current year portion of an excess distribution in the trust's DNI. If the trustee makes a distribution, the distribution will carry out some or all of the current year excess portion and the tax associated with it. *See* IRC §661(a).

(ii) The trustee presumably would not distribute the excess portion allocated to prior years but rather retain that portion as a source of funds to pay the deferred tax and interest. This is a reasonable way to approach the PFIC rules in connection with trusts and preserves the deferred tax and interest charge.

3. Sales of PFIC Shares by a Domestic Trust

a. Tax law treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the shares. IRC § 1291(a)(2). The effect of these rules is to treat the gain as ordinary income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

b. The tax effects of a sale of PFIC shares by a domestic trust are fairly straightforward. If a domestic trust sells PFIC shares, the proceeds of sale will be capital gain and, therefore principal, for fiduciary accounting purposes. Although the PFIC rules treat the gain as an excess distribution, turning the current portion of the gain into ordinary income, the gain should not be includable in the trust's DNI. *See* IRC § 643(e)(3) (a domestic trust's DNI does not ordinary include the trust's capital gains).

c. Although the PFIC rules treat the "gain" as ordinary income, the treatment of the gain as an excess distribution under the PFIC rules should not change the character of the gain for fiduciary income tax purposes. *See* IRC § 1291(a)(2)(when a taxpayer disposes of stock in a PFIC, the excess distribution rules will apply to any "gain" recognized as if the "gain" was an excess distribution); Prop. Treas. Reg. § 1.1291-3(a)(referring to a "gain" from the sale of PFIC shares being taxed as an excess distribution); Prop. Treas. Reg. § 1.1291-3(c)(a direct shareholder of an interest in a PFIC "recognizes all gain that it realizes on the disposition" of the interest). Because the gain will not be includable in DNI, the trustee will pay the tax on the gain (as recharacterized). The trustee will also pay the deferred tax and interest.

4. Distributing PFIC Shares From a Domestic Trust

a. The distribution of PFIC shares from a domestic trust may result in a taxable disposition of the shares.

b. The distribution of property from a trust usually is a nonrecognition event for federal income tax purposes unless the trustee elects to treat the disposition as a taxable transaction under IRC § 643(e). The general nonrecognition rules of the Code, however, do not apply to dispositions of PFIC shares. IRC § 1291(d). Thus, a distribution of PFIC shares from a domestic trust or estate will be treated as taxable disposition of the shares. Prop. Treas. Reg. § 1.1291-6(a)(2).

c. The proposed regulations, however, effectively provide that a distribution from a domestic trust or estate to a U.S. taxpayer beneficiary is not taxable as long as the trustee does not make an IRC § 643(e) election. *See* Prop. Treas. Reg. § 1.1291-6(c)(2). Thus, taxation is likely to be a risk only when a domestic trust makes a distribution to a non-U.S. beneficiary. Such a beneficiary will receive a basis adjustment to reflect the taxation of the distribution, although the basis will not be relevant to that beneficiary. *See* Prop. Treas. Reg. § 1.1291-6(b)(4).

d. If a trust makes a distribution to a charitable organization that qualifies for an IRC § 642(c) deduction, the trust may reduce an excess distribution. *See generally* Prop. Treas. Reg. § 1.1291-2(d)(5)(implementing regulatory authority granted by IRC § 1291(b)(3)(G)). In general, the trust can reduce the excess distribution by some or all of the charitable deduction amount, depending on how much other property the trust has besides the PFIC shares.

G. *Subchapter J Issues When a Foreign Trust Owns PFIC Shares*

1. Taxation of Distributions in the Hands of U.S. Beneficiaries

a. If a foreign complex trust receives an excess distribution from what would be a PFIC under U.S. rules, that distribution will have excess and nonexcess portions. The nonexcess portion will be included in the trust's DNI for that year. *See* IRC § 643(a)(6)(A). The portion of the excess distribution allocated to the current year and pre-PFIC years will also be allocated to DNI. *Id.*

b. If the trust makes a distribution to a U.S. beneficiary in the year of receipt of the PFIC distribution, that beneficiary will pick up some or all of the PFIC distribution included in DNI in his or her income in accordance with the character rule. *See* IRC § 662(b). If the trust does not make any distributions during the year, the portions of the distribution included in DNI will become undistributed net income ("UNI"). *See* IRC § 665(a). In this way, a later distribution of the income would be subject to a penalty tax and interest through the throwback rule rather than through the PFIC rules.

c. The treatment of the portion of the excess distribution to a foreign complex trust that is allocated to prior years under the PFIC rule is unclear. Because the portion of the excess distribution allocated to prior years is not included in the trust's notional U.S. taxable income, the excess portion is not included in the trust's DNI. *See* IRC § 643(a)(1). The allocation of the excess portion to prior years cannot convert that income to UNI for those prior years because the excess portion is not DNI. *See* IRC § 665(a)(defining UNI by reference to DNI).

d. This issue will arise when a foreign complex trust makes a distribution to a U.S. beneficiary that exceeds the amount of the PFIC distribution that was included in DNI. The distribution from the PFIC to the foreign trust should be fiduciary accounting income. The distribution of that accounting income to the beneficiary will not in and of itself be an accumulation distribution that draws out UNI from the trust. *See* IRC § 665(b). Thus, even if the IRS took the position that the excess distribution allocated to prior years was UNI, the distribution of accounting income to a U.S. beneficiary would not pull out that UNI.

e. Taking such a position, however, would effectively defeat the purposes of the deferred tax and the interest charge. In fact, taking this position would allow the avoidance of U.S. income tax on the noncurrent portion of an excess distribution. In this situation, the foreign trust could distribute the full amount of the excess distribution to a U.S. beneficiary but the U.S. beneficiary would pay tax only on the current portion of the excess distribution. The U.S. beneficiary would receive the balance of the excess distribution without any tax consequences because that portion of the distribution did not constitute current DNI of the trust and because the distribution would not attract UNI. If the trust retained the excess distribution, the noncurrent portion of the excess distribution would not be UNI because the noncurrent portion was not DNI.

f. These apparent results reflect the Congressional tax writers' and the PFIC regulation writers' lack of understanding of the Subchapter J rules. The IRS in its 2013 temporary regulations related to PFICs, however, took the view that it was not reasonable to interpret the PFIC rules in a way that eliminates the excess distribution tax and penalty charge:

> It would be unreasonable for the shareholders of [a] section 1291 fund to take the position that neither the beneficiaries nor the estate or trust are subject to the tax and interest charge rules under section 1291.

T.D. 9650, 2014-3 I.R.B. 394, 396.

Based on the way Congress drafted the PFIC rules and the way the Subchapter J works, however, it is unclear how those rules can be reconciled without legislation.

g. The IRS could perhaps issue regulations under IRC § 643(a)(7) to define a foreign trust's DNI to include any distribution from a PFIC in the year of receipt. Doing so, however, would forgo the deferred income tax and interest on the excess part of the PFIC distribution. In order to capture the deferred income tax from a trust beneficiary who receives a distribution that includes an excess distribution, Congress would have to change the fiduciary income tax rules.

h. Although the government might not be able to collect the deferred income tax and interest under the direct ownership rules, it may be able to do so under the indirect ownership rules of IRC § 1298(a)(3). As discussed below, those rules may allow the IRS to treat the beneficiary as having indirectly received a portion of the excess distribution allocated to prior years of the foreign trust.

2. Effect of Sale of PFIC Shares by a Foreign Trust

a. The effect of a complex foreign trust's sale of PFIC shares is also difficult to square with Subchapter J. Because a foreign trust is not a U.S. taxpayer, its sales of PFIC shares do not have an immediate tax consequence. U.S. tax consequences, however, arise if the foreign trust makes a distribution to a U.S. beneficiary.

b. Under IRC § 643(a)(6) a foreign trust's DNI includes "amounts of gross income" from non-U.S. sources. In addition, a foreign trust's DNI includes realized capital gains. If a foreign trust sold PFIC shares, U.S. tax law would treat the gain from the sale as an excess distribution. IRC § 1291(a)(2). Thus, to compute its notional U.S. income, the trust would have to allocate the gain across its holding period on a daily basis. *See* IRC § 1291(a)(1)(A). Under IRC § 1291(a)(1)(B), a foreign trust's gross income for the year of the disposition would include only the current amount of the excess distribution and the pre-PFIC portion of the excess distribution. The balance of the gain would not be includable in gross income and, therefore, not includable in the foreign trust's DNI. For the reasons discussed above with respect to PFIC distributions, the "untaxed" portion of the gain could avoid U.S. income taxation whether the trust distributes the gain or retains the gain.

c. The application of the PFIC rules and Subchapter J rules in this manner would have the effect of avoiding the deferred tax and the interest charge on the gain from the sale of PFIC shares. The proposed regulations, however, under IRC § 1291 do not address the application of the deemed disposition rules to trusts, estates, and their beneficiaries. *See* Prop. Treas. Reg. § 1.1291-3(e)(5)(ii)(proposed regulations on the application of the indirect disposition rules to trusts, estates, and their beneficiaries are "[Reserved]").

Without any authority we are simply left to guess at how to apply the Code rules in a reasonable manner consistent with Subchapter J in a way that preserves the deferred tax and the interest charge.

3. Effect of Distribution of PFIC Shares From a Foreign Trust

a. The distribution of PFIC shares from a foreign trust to a U.S. beneficiary will not trigger a gain because the trust will not be subject to U.S. income tax. The beneficiary, however, will not receive a new basis in the PFIC shares, even if the foreign trust makes an IRC § 643(e) election. Prop. Treas. Reg. § 1.1291-6(d)(3). *See generally* IRC § 643(e)(trust beneficiary does not receive a new basis in trust property distributed in kind from a trust or estate).

b. If the foreign trust satisfies a pecuniary distribution or bequest with appreciated PFIC shares, the U.S. beneficiary should receive a new basis in the shares because the distribution from the trust would have been a taxable disposition if the trust was not foreign. In this situation, however, the IRS might treat the beneficiary as the indirect owner of the PFIC shares distributed to her and tax her on the deemed gain.

4. Effect of Domestication of a Foreign Trust That Owns PFIC Shares

a. If a foreign trust becomes a domestic trust and the domestication does not otherwise result in a deemed disposition of the trust's PFIC shares, the domestication should not trigger any PFIC-related taxes to the trust. The PFIC regulations provide that in effect when a nonresident alien becomes a U.S. taxpayer, the PFIC rules will apply from the residency start date. *See* Treas. Reg. § 1.1291-9(j)(1)(i); Prop. Treas. Reg. § 1.1291-1(b)(1)(i) (a corporation is not treated as a PFIC for those years in those years during the owner's holding period when the owner was not a United States person).

b. Thus, while a domesticated trust's holding period for excess distribution purposes will include its entire holding period, including the pre-immigration period, the deferred tax and interest will be computed based only on those days in the holding period in which the trust was a domestic trust.

H. *Indirect Ownership of PFIC Shares Through Estates and Trusts*

1. Introduction

a. The PFIC tax regime applies to U.S. taxpayers who directly or indirectly own shares of a PFIC. The direct and indirect ownership rules work together to "find" the first U.S. taxpayer in the ownership chain and subject him or her to the PFIC tax regime on excess distributions. *See* IRC § 1298(a). If a U.S. citizen or resident directly owns shares in a PFIC, he or she will be directly subject to the PFIC tax regime.

b. Indirect ownership rules apply when an estate or trust owns PFIC shares. *See* IRC § 1298(a)(3) (shares in a PFIC owned by an estate or trust will be considered as owned "proportionately" by its beneficiaries). In 1992 the IRS issued proposed regulations under what was then IRC § 1297(a)(3). 1992-1 C.B. 1124.

c. The 1992 proposed regulations did not address how to apply the proportionate ownership rule to trusts and estates and their beneficiaries. In the preamble to the proposed regulations the IRS solicited comments as to "whether different attribution rules, such as the indirect ownership rules in section 25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC." 1992-1 C.B. 1124, 1125. At least one law firm submitted comments on the attribution rules in the proposed regulations.

d. In 2013 the IRS withdrew the 1992 proposed regulations related to indirect ownership. REG. 113350-13, 2014-3 I.R.B. 440. At the same time the IRS issued a temporary regulation related to indirect ownership with a vague rule that provided that beneficiaries of nongrantor trusts will be deemed to own trust-owned PFIC shares in proportion to their beneficial interests in the trust:

> If a foreign or domestic estate or nongrantor trust (other than an employees' trust described in section 401(a) that is exempt from tax under section 501(a)) directly or indirectly owns stock, each beneficiary of the estate or trust is considered to own a proportionate amount of such stock.

Temp. Treas. Reg. § 1.1291-IT(b)(8)(iii)(c).

e. In the simultaneously released preamble to the 2013 proposed regulations, the IRS asked for comments on how to determine proportionate ownership of trust-owned PFIC shares by trust beneficiaries. REG-140974-11, 2014-3 I.R.B. 438, 439. In the meantime, until the IRS issues guidance, the taxpayers are to use a "reasonable method" to determine beneficiaries' proportionate interests in trust-owned PFIC shares. T.D. 9650, 2014-3 IRB 394, 396.

f. The IRS issued final regulations in 2016 that turned the temporary regulations into final regulations without any changes the wording of the temporary regulations. The now final regulations provide that a trust beneficiary will be deemed to own a proportionate amount of the stock owned by the trust. Treas. Reg. § 1.1291-1(b)(8)(iii)(C). The regulations provide that indirect ownership depends on the facts and circumstances in each case, with the substance rather than the form of ownership controlling, taking the purposes of the PFIC rules into account. Treas. Reg. § 1.1291-1(b)(8)(i). The IRS did not include any guidance in the 2016 final on how taxpayers should apply the proportionate ownership interest rules for PFIC shares indirectly owned by trust beneficiaries despite the request for input from the professional community in the preamble to the 2013 proposed regulations.

g. Apart from the foregoing statements, the IRS has not issued any public or private rulings on this subject. The outline discusses the possible application of "maximum exercise of discretion" indirect ownership rule of Treas. Reg. § 25.2701-6 above at pages 18-20, concluding that the approach would not be appropriate to determine indirect ownership of shares through a trust for CFC purposes. Apply the maximum exercise of discretion approach for PFIC purposes would be inappropriate for the same reason it is inappropriate for CFC purposes: the approach does not focus on who actually receives the benefit of deferring U.S. income tax through investing in a foreign corporation.

h. As discussed in detail below, however, in 2007 the IRS National Office took on this issue in a technical advice memorandum, relying on the CFC rules.

2. Indirect Ownership Through Domestic Trusts and Estates

a. IRC § 1298(a)(1) generally provides that once you find a U.S. shareholder of PFIC shares under the direct or indirect PFIC share ownership rules, no other person will be deemed to own the shares for U.S. income tax purposes. The Secretary of the Treasury, however, can provide in regulations that PFIC shares owned by a U.S. person may be deemed to be owned by another person. IRC § 1298(a)(1)(B).

b. The IRS could use this authority to deem beneficiaries of domestic trusts and estates to indirectly own PFIC shares owned by a trust or estate. *See* Heller, "Structuring Hedge Fund Investments for Charitable Remainder Trusts to Avoid UBTI and PFIC Concerns," 109 J. Taxn. 344, 346 (Dec. 2008)(suggesting that noncharitable beneficiaries of a charitable remainder trust may be deemed to indirectly own PFIC shares owned by the trustee of a charitable remainder trust). In fact, the recently released temporary proposed PFIC regulations have a general rule that PFIC shares owned by an estate or trust will be deemed to be owned proportionately by the beneficiaries of the estate or trust. Temp. Treas. Reg. § 1.1291-1T(b)(8)(iii)(C). These proposed regulations do not differentiate between foreign estates and trust and domestic estates or trusts. You might think, therefore, that the IRS is attempting to generally apply the indirect ownership rules to domestic trusts and estates that own PFIC interests. As discussed below, the indirect ownership rules may provide a tempting way to overcome the difficulties associated with the coordination of the excess distribution rules and Subchapter J.

c. The proposed regulations, however, are just that: proposed. They are not final regulations or even temporary regulations. Absent final or temporary regulations, the general rule of IRC § 1298(a)(2) should control: Once you find a U.S. owner of PFIC shares, the inquiry stops. IRC § 1298(a)(1).

3. Indirect Ownership Through Foreign Estates.

a. There are no proposed regulations under IRC § 1298(a)(3) with respect to foreign estates with U.S. beneficiaries. The CFC indirect ownership rules are probably the closest in spirit to the PFIC rules because both sets of rules seek to discourage and punish U.S. investors' deferral of U.S. income tax by investing in foreign corporations. In fact, in the 1992 proposed regulations, IRS referred to the CFC rules in the proposed PFIC regulations in connection with the facts and circumstances test of indirect ownership. Prop. Treas. Reg. § 1.1291-1(b)(8)(i) ("In applying this paragraph (b)(8), the determination of a person's indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291. *Cf. section 1.958-1(c)(2)*") (emphasis added). In the 2016 final regulations, however, the IRS did not make reference to the CFC rules. *See* Treas. Reg. § 1.1291-1(b)(8)(i). Nevertheless, the facts and circumstances on which the government relies to apply the CFC indirect ownership rules under IRC § 958(a)(2) are probably the most useful ones to look to in predicting how the IRS would interpret IRC § 1298(a)(3).

b. The application of the CFC indirect ownership rules to estates is discussed above on pages 9 and 10. You could take the approach used in the CFC indirect ownership rules with respect to the indirect ownership of PFIC shares of a foreign estate.

4. Indirect Ownership of PFIC Shares Through Foreign Trusts

a. Because there are no proposed regulations under the PFIC indirect ownership rules with respect to trusts and their beneficiaries, again the logical place to look for inspiration is the CFC indirect ownership rules for trusts and their beneficiaries.

b. The CFC trust-beneficiary indirect ownership rules are fairly easy to apply to trusts with mandatory income interests. *See* Treas. Reg. § 1.958-(d), Example (3).

c. As discussed above, however, the CFC rules have no clear guidelines on when a U.S. beneficiary of a foreign discretionary trust will be deemed to own a proportionate share of such a trust's shares in a foreign corporation.

5. TAM 200733024

a. In 2007 National Office Technical Advice Memorandum, TAM 200733024, the IRS used a "facts and circumstances" test in applying IRC § 1298(a)(3) to trusts and their beneficiaries:

> Section 1298(a)(3) states that "[s]tock owned, directly or indirectly, by or for a partnership, estate or trust shall be considered as being owned proportionately by its partners or beneficiaries. No temporary or final regulations have been promulgated under section 1298(a)(3). However, unlike section 1298(b)(5), section 1298(a)(3) contains no language contemplating the promulgation of regulations and there is therefore no ambiguity with regard to its applicability.
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> * * *
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> Regulations have been issued under subpart F, another anti-deferral regime, that provide a method of allocating subpart F income to the beneficiaries of a trust that holds an interest in a controlled foreign corporation.
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> * * *
>
> In the absence of temporary or final regulations under section 1298(a)(3), the Service proposes to determine the beneficiaries' proportionate share of the stock of Corp J by applying a facts and circumstances analysis, following the method imposed under the subpart F regulations.

b. The TAM involved the application of the indirect ownership rules to a foreign discretionary trust that liquidated a PFIC. The IRS's reliance on the CFC indirect ownership rules is not surprising, given that the PFIC rules and the CFC rules have a similar purpose: to discourage U.S. taxpayers from deferring U.S. income tax on passive investments by using foreign corporations to hold those investments. The IRS's application of the CFC indirect rules to the facts presented in TAM 200733024, however, raises a number of questions, particularly in the context of dispositions of PFIC interests by foreign trusts.

c. To the extent the IRS applies the CFC facts and circumstances approach suggested in TAM 200733024 when a foreign trust receives a PFIC dividend that was an excess distribution, the IRS should focus on the trust's distributions in the year in which the trust receives the dividend and treat those beneficiaries as indirect owners of the PFIC shares, at least for that year. *See generally* F.S.A. 199952014 (Sept. 23, 1999) (rejecting the use of actuarial values to determine a trust beneficiary's proportionate ownership of shares owned by a trust for CFC purposes).

d. Such an approach should dovetail with the general Subchapter J rules. Under those rules, the current portion and pre-PFIC portion of an excess distribution would be included in DNI and carried out to the income beneficiaries. *See* IRC § 661(b). The portion of the excess distribution allocated to previous years, however, will not be included in DNI for the reasons discussed above. That portion will be accounting income, so to the extent that accounting income is distributed to U.S. beneficiaries, those beneficiaries should receive some of that portion of the excess distribution under the character rule of IRC § 661(b). Thus, it makes sense to treat those beneficiaries as indirectly picking up a pro-rata share of the noncurrent portion of the excess distribution. This result would be consistent with the general principles of Subchapter J because the beneficiaries did in fact receive the PFIC dividend and, therefore, enjoyed the benefit of the deferral of U.S. income tax made possible by the trust's investment in the PFIC.

e. The relevance of the CFC indirect ownership rules to the PFIC indirect ownership rules, however, breaks down when a foreign trust sells or otherwise disposes of PFIC shares.

The PFIC rules generally treat a disposition of PFIC shares as an excess distribution to the extent the taxpayer realizes a gain on the disposition. IRC § 1291(a)(2). If a U.S. person indirectly owns PFIC shares, IRC § 1298(b)(5) provides that "under regulations" the U.S. person will be deemed to have disposed of the shares. Putting aside the fact that there are no regulations applying IRC § 1298(b)(5) to trust beneficiaries, an attempt to apply the principles of the CFC indirect ownership rules in the case of a trust's disposition of PFIC shares does not work well.

f. The indirect ownership facts and circumstances test of Treas. Reg. § 1.958-1(c)(2) focuses on who receives the income from a foreign trust to determine indirect ownership. *See generally* Treas. Reg. § 1.958-1(c)(2). If a foreign trust disposes of PFIC shares and makes a distribution that would otherwise carry out the gain, then the analogy to the CFC indirect ownership rules works; the beneficiaries effectively received the benefit of the deferral when they received a cash distribution from the trust.

g. If, however, the trustee does not distribute the gain realized on the disposition of the PFIC shares, the application of the PFIC indirect ownership rules using the facts and circumstances described in Treas. Reg. § 1.958-1(c)(2) becomes much more difficult. The receipt from the disposition of the PFIC shares will be trust accounting principal. In the case of a discretionary trust, treating the trust's beneficiaries as owning the PFIC shares for purposes of imposing the excess distribution tax on the disposition seems unfair because those beneficiaries would have no legal right to receive the principal. Putting aside that inconvenience, how would such a beneficiary determine his or her deemed holding period for purposes of computing the deferred tax and interest charge? Using the trust's holding period might be a way to do this, but that does not take account of the fact that the trust may have never made distributions to the beneficiary in previous years, the fact that the beneficiary may not have been born during the trust's holding period, or the fact that the beneficiary may have been added as a beneficiary during the trust's holding period. By contrast, if a U.S. taxpayer indirectly owned PFIC shares through a foreign partnership or foreign corporation, his or her holding period would be relatively easy to determine; it would be the taxpayer's holding period for the shares of the foreign corporation or the partnership.

h. TAM 200733024 illustrates the difficulties of applying the indirect ownership rules based on the CFC facts and circumstances test when a trust disposes of PFIC shares but does not distribute the proceeds of sale to the trust beneficiaries. In TAM 200733024, a foreign trust, referred to in the TAM as "Fund B," liquidated a PFIC, which meant that the trust had a notional excess distribution for purposes of the PFIC rules. Fund B's beneficiaries were the five children of one of the children of the settlor; none of the children were U.S. citizens or residents. Only two of the children, Child H and Child I, themselves had children during the years involved in the TAM, and only Child I's children were U.S. citizens or residents. Although Fund B benefited five grandchildren and their families, the TAM indicates that the trustees had made distributions during the years in question only to the children of Child H and Child I; apparently the trustees did not make any distributions to the three other trust beneficiaries. According to the IRS, the trustees "historically" had made distributions in equal amounts between the children of Child H and the children of Child I.

i. Although the facts of the TAM are not entirely clear, it appears that two of the beneficiaries of Fund B who had not previously received distributions but were likely to have children (apparently the fifth beneficiary was not likely to have children) renounced their interests and their potential children's interests in Fund B. Child I and Child H also apparently renounced their interests in Fund B, leaving only the children of Child I and the children of Child H as the beneficiaries of Fund B. Following this series of renunciations, the trustees of Fund B liquidated the PFIC and in the same year distributed the accrued income of Fund B and a portion of the principal of Fund B to a separate non-U.S. trust established for the benefit of children of Child H, none of whom were U.S. citizens or residents. The total amount distributed to this trust was about 50% of Fund

B's total assets (accrued income and principal). In the following year the trustees distributed the balance of the property of Fund B to a U.S. domestic trust administered for the benefit of the children of Child I, all of whom were U.S. citizens or tax residents. The trustees of this new trust did not make any distributions to the children of Child I, so no individual U.S. citizen or resident received a distribution of income or principal of Trust B following the PFIC liquidation.

j. Among other things, the taxpayers argued that the distribution to the non-U.S. trust for the children of Child H, who were not U.S. citizens or residents, in the year of the PFIC disposition event carried out the DNI of Fund B along with the notional excess distribution to the non-U.S. trust, leaving only principal in Fund B. The taxpayers took the position that the distribution in that year to the non-U.S. trust "cleansed" Fund B of the notional excess distribution, leaving only principal to be distributed to the U.S. trust for the benefit of the children of Child I in the succeeding year. According to the taxpayers, no excess distribution remained in Fund B in the succeeding year because of the distribution to the trust for the benefit of the children of Child H in the preceding year. Because of the timing of the distributions, the taxpayers argued that the non-U.S. trust ended up with the excess distribution and the U.S. trust ended up with principal. The TAM indicates that there was a disagreement between the taxpayers and the IRS as to whether Fund B was a grantor trust. This disagreement was very fact-specific, and a discussion of the issues is beyond the scope of this outline's focus on indirect ownership rules. If the trust had been a grantor trust as to a nonresident alien, the PFIC issues should not have arisen.

k. The taxpayers pointed out to the IRS that this result was consistent with the general rules of Subchapter J and its DNI principles:

> Taxpayers argue that their adopted method of applying the trust distributable net income ("DNI") rules to preserve the PFIC excess distribution at the trust level and carry it out upon a subsequent distribution from the trust to the foreign beneficiaries is one such reasonable manner. Under Taxpayers' DNI method, the entire amount of the excess distribution resulting from the gain on the liquidating distribution from Corp J would have been carried out to the beneficiaries of Trust 5, along with all of the DNI of Fund B, on Date 28 when Fund B advanced half of its assets to Trust 5. Since Trust 5 has no U.S. beneficiaries, the excess distribution would result in the imposition of no PFIC tax. The distribution of the other half of the assets from Fund B to Trust 4 in the following year, on Date 32, would correspondingly result in no PFIC tax as there would be no excess distribution amount remaining in that year.
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> Taxpayers point specifically to the reference to subchapter J in the preamble to the proposed section 1291 regulations. Taxpayers argue that, since DNI is an integral part of the taxation of trusts and beneficiaries under subchapter J and since the utilization of the DNI rules results in the preservation of tax at the trust level in the form of DNI, their method is a reasonable manner of applying section 1298(b)(5).

l. The IRS, however, thought that the taxpayers' approach was unreasonable because it did not preserve the excess distribution tax scheme and the interest charge:

> It is the Service's position that Taxpayers' DNI approach is unreasonable because it fails to actually preserve any of the PFIC interest charge. To the contrary, it facilitates the avoidance of the interest charge altogether by allowing the entire excess distribution amount to be carried out to foreign beneficiaries who are not subject to the PFIC regime. The purpose of section 1298(a)(3) and (b)(5) is to insure that the PFIC tax is not circumvented by the imposition of a foreign pass-through entity such as a partnership or trust in an ownership chain between a U.S. person and a PFIC. Taxpayers' method of applying section

> 1298(b)(5) would make a trust with both U.S. and foreign beneficiaries an effective vehicle for circumvention of the PFIC regime because the PFIC tax and interest charge could be carried out to the foreign beneficiaries by manipulating the time of distributions from the trust, as Taxpayers have done here. Taxpayers' method represents neither a reasonable nor a good faith attempt to implement the statute in light of its language and purpose.

m. Probably realizing the strength of the taxpayers' Subchapter J argument, the IRS decided to take a back-door approach by deeming the children of Child I to have indirectly owned 50% of the assets of Fund B at the time of the PFIC liquidation, thereby allowing the IRS to tax those children of Child I on one-half of the deemed excess distribution under IRC § 1298(b)(5). The IRS pointed out that in the years preceding the PFIC liquidation, the trustees of Fund B had historically made distributions to the children of Child H and Child I in equal amounts and that certain documents described the settlor's intention that the benefits of Fund B be split between those two branches of the family on a 50-50 basis. In its analysis of the distributions from Fund B the IRS did not mention the fact that for most of the years in question there were actually three other beneficiaries of Fund B; the IRS focused only on the distributions the trustees made to the children of Child H and the children of Child I. According to the IRS, these facts and circumstances meant that the children of Child H and the children of Child I should each be deemed to own 50% of the trust-owned PFIC under the indirect ownership rules of IRC § 1298(a)(3). Although the IRS acknowledged that the trustees of Fund B made a distribution to a trust for the benefit of the U.S. beneficiaries ("Trust 4"), the IRS treated the beneficiaries themselves, and not Trust 4, as the indirect owner of the PFIC shares. Because of the deletion of the dates, it is unclear from the TAM whether Trust 4 was in existence on the date of the PFIC liquidation. If Trust 4 was in existence on the date of the PFIC liquidation, it, rather than the children of Child I, should have been treated as the indirect owner of the PFIC shares if the indirect ownership rules applied at all.

n. From an academic perspective, the IRS's reliance on of the facts and circumstances approach used in the CFC indirect rules to the PFIC indirect ownership rules is sensible because both sets of rules have the same purpose: to penalize tax deferral through the use of foreign corporations. In TAM 200733024, however, the IRS did not apply the CFC-based facts and circumstances test in a reasonable manner. The CFC indirect ownership rules follow trust distributions to identify proportions in which the beneficiaries of a foreign trust should be deemed to indirectly own the trust's shares. *See* Treas. Reg. § 1.958-1(c)(2). To the extent the IRS wants to rely on the facts and circumstances test used in the CFC indirect ownership rules for PFIC purposes, the IRS should similarly focus on who receives distributions from a trust to determine the indirect owners of the trust's PFIC shares, if any.

o. If the facts in TAM 200733024 had involved a dividend paid by the PFIC that was an excess distribution, the CFC indirect ownership rules would suggest that the beneficiaries who received a distribution from the trust in the year the trust received the dividend should be treated as indirectly having received an excess distribution. The TAM, however, involved the liquidation of the PFIC, the proceeds of which were presumably allocable to principal for fiduciary accounting purposes. It was unreasonable for the IRS to say that the children of Child I should be deemed to own one-half of the entire trust principal when principal had not distributed to them and would not necessarily ever be distributed to them. In fact, the distribution from Fund B was made to Trust 4, not the children of Child I. The children of Child I had never received substantial principal distributions from Fund B, and there was no suggestion that the trustees would or could distribute one-half of the entire principal of Trust 4 to the children. In fact, it appeared there were three other grandchildren of the settlor who were beneficiaries of Fund B for most of the years in question. The trustees of Fund B could have distributed income and principal to any of the beneficiaries, including the non-U.S. beneficiaries and the grandchildren who did not yet have any children, in any portions the trustees wished. The trustees apparently chose not to make any distributions to these beneficiaries, which indicates the discretionary nature of Fund B. The children of Child I apparently had no vested right to receive principal from Fund B, and had no ability to compel the trustees to distribute principal to them. Furthermore, the proceeds of the liquidation were distributed to Trust 4, not to the children of Child I. In light of these facts, deeming those beneficiaries to own and control one-half of proceeds of the liquidation of the PFIC was unreasonable.

p. One way to test the reasonableness of the IRS's application of the facts and circumstances test in TAM 200733024 is to determine whether the tax result to the U.S. beneficiaries would be the same if the trustees of Fund B had invested the trust assets in the trust's name rather than through a holding company. Assume, for example, that instead of making passive investments through a PFIC, the trustees of Fund B purchased and sold investment assets in the trust's name but never distributed any of the realized capital gain to the trust beneficiaries. Under Subchapter J, the realized gains would be part of DNI in the year in which the trustees realized the gain. To the extent that the trustees did not distribute the gain in that year, the gain would become part of UNI. *See* IRC § 665(a).

q. If the trustees later distributed trust principal to Fund B's nonresident alien beneficiaries, the distribution would carry out that UNI and any DNI from the year of the distribution to those beneficiaries as long as the separate share rule of IRC § 663(c) did not apply. If the separate rule applied, then 50% of the realized gains would be allocated to the children of Child H and 50% to the children of Child I. *See generally* IRC § 663(c); Treas. Reg. § 1.663(c)-1(a). Under the separate share rule of IRC § 663(c), a trustee of a trust with more than one beneficiary must allocate DNI pro rata among the trust beneficiaries to the extent that the trust instrument provides for substantially independent and separate shares for the beneficiaries. For example, if a trust instrument provides for the payment of the trust income in equal shares to three beneficiaries, those beneficiaries have separate and independent shares. In that situation, the separate share rule requires the trustee to effectively treat the shares as separate trusts for purposes of allocating DNI, even though the trustee files only one income tax return. If, however, the trustees did not make any distributions to the children of Child I, they would not be currently taxed on that realized gain. Instead, the gain would have become UNI, and a later distribution to those beneficiaries or a U.S. trust for their benefit could have carried out the UNI as an accumulation distribution. *See* IRC § 665(b) (defining an accumulation distribution). The taxpayers in the TAM argued that IRC § 667(b) would have achieved the same result as the application of the excess distribution regime because the PFIC distribution would have lost its character once it became UNI and would have been subject to the accumulation distribution tax and interest charge when later distributed to a U.S. taxpayer, whether a trust or an individual. Thus, the application of the Subchapter J rules would have been roughly consistent with the PFIC rules. As discussed above, however, it is unclear whether the prior years' portion of a PFIC excess distribution can ever be part of UNI given the fact that the prior years' portion is not technically includable in DNI. Whether or not the separate share rule applied, however, the U.S. beneficiaries would not pay any tax unless the trustees made a distribution to them.

r. For example, if the trustees of Fund B had a $1 million gain in 2006 and distributed $1 million to the children of Child H or a foreign trust for their benefit and the separate share rule did not apply, the distribution would carry out all the gain to those beneficiaries. If in 2007 the trustees distributed $1 million to a the children of Child I or a U.S. trust for their benefit, there would be no basis on which the IRS could argue that the children of Child I or the trust should be taxed on half of the gain from 2006 unless the separate share rule applied to Fund B. If, however, the separate share rule applied, then the 2006 distribution would have carried out only $500,000 of the gain to the children of Child H, leaving $500,000 of the gain to be allocated to the share of DNI allocable to the children of Child I, where it would have become UNI, thereby attracting a throwback tax and interest charge on the distribution in the next year. The U.S. beneficiaries or a trust for their benefit, however, would not be taxable in 2006 on 50% of the realized gain.

s. The TAM indicates that the taxpayer and the IRS disagreed about the potential application of the separate share rule to Fund B, which would have been an issue if the PFIC indirect ownership rules did not apply. The taxpayers argued that because Fund B was a discretionary trust, the separate share rule did not apply to Fund B. The separate share rule, however, does not apply to a discretionary trust under which the trustee can select among a class of beneficiaries to whom to distribute income and principal. The taxpayers provided evidence of the law of the country in which the trust was organized, including an opinion of counsel, to support its position. The IRS, however, stated that the taxpayers and their counsel were wrong in their interpretation of the trust agreement and of the applicable foreign law. According to the IRS, Fund B was not a discretionary trust within the context of the separate share rule, and that there were two separate and independent shares, one for the children of Child H and one for the children of Child I.

t. Whether or not the separate share rule applied to Trust B in the year of the PFIC liquidation is not particularly important to answering the question of whether the tax result in the TAM would have been the same under Subchapter J if the trustees of Fund B directly invested the trust assets instead of through a company. The application of the PFIC indirect ownership rules would cause a tax whether or not the trustees of Fund B made a distribution to the children of Child I or a trust for their benefit. If the trustees of Fund B had made the trust investments directly, the taxability of the children of Child I or the U.S. trust for their benefit on the gain would depend on whether and when the trustees of Fund B distribution made a distribution to the children or the trust. If the trustees of Fund B did not make such a distribution, no U.S. tax would be owed, which is the critical difference between the PFIC indirect ownership rules and Subchapter J. Because the PFIC indirect ownership rules would result in taxation without any distributions in this situation, the application of those rules would conflict with Subchapter J and produce an unreasonable result.

u. The legislative history of the PFIC rules shows the importance of applying the PFIC rules in a way that reaches the same result as the Subchapter J rules. An important purpose of the PFIC rules was to discourage U.S. investors from obtaining advantages through the investment in a foreign passive investment company that was not a CFC:

> The committee is concerned that U.S. persons who invest in passive assets through a foreign investment company obtain a substantial tax advantage vis-à-vis U.S. investors in domestic investment companies because they avoid current taxation and are able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income. The committee does not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. In the committee's view, U.S. persons who invest in passive assets should not be able to achieve tax deferral just because they invest in those assets indirectly through a foreign corporation.

Senate Finance Committee Rep. No. 99-313 on the Tax Reform Act of 1986 (H.R. 3838) at 393-94 (reprinted at 1986-3 C.B. 393-94). The PFIC rules, accordingly, attempt to roughly mimic the tax results that a U.S. investor would have if he or she directly invested in assets rather than through a foreign corporation. In TAM 200733024, however, the IRS applied the PFIC indirect ownership rules in a way that would result in considerably different – and worse – treatment than would have occurred had the trustees of Fund B invested directly in the trust's name. If the trustees of Fund B had owned the investment assets directly, there would be no question that the children of Child I or a trust for their benefit would not have been taxable on 50% of the notional gain incurred in the liquidation of the company in the year in which the company was liquidated. It is possible that the children of Child I or the trust for their benefit would be required to pay a throwback tax on a distribution from Fund B in a later year, but such a distribution would be a prerequisite to U.S. taxation. The IRS's approach in the TAM produced much more onerous tax results than a direct investment by Fund B, which is an unreasonable result.

v. Tax advisers and their clients should keep in mind that the IRS's position in the TAM is nothing more than an articulation of its likely position in litigation. Under IRC § 6110(k)(3), the TAM is not citable as authority. Rather, like a proposed regulation, the TAM is nothing more than a statement of a frequent litigant and is not entitled to any judicial deference. *See, e.g., Lagia v. Commissioner*, 88 T.C. 894, 897 (proposed regulations carry no more weight in court than a position advanced on brief). Taxpayers should not concede the application of the PFIC indirect ownership rules in the manner suggested by the IRS in TAM 200733024.

V. Using Pass-Through Entities in Lieu of Corporations in Cross Border Private Wealth Situations

A. *Introduction*

1. Unlike many other countries, the United States has a parallel system of taxation of the earnings of companies: the "pass-through" rules. Under the pass-through rules, which generally apply to business entities that are classified as partnerships for U.S. income tax purposes, each member of the company is deemed to own a proportionate share of the company's items of income, gain, loss, and credit for U.S. tax purposes. In the case of certain entities that have only one owner, the IRS will "disregard" the entity for U.S. tax purposes and treat the single owner of the company as the owner of all the company's items of income, gain, loss, and credit.

2. Because the pass-through system of taxation treats the members of a company as owning all of the company's items of income, gain, loss, and credit, antideferral rules such as the CFC and PFIC regimes do not apply to pass-through entities. If a U.S. taxpayer is a shareholder in or member of a foreign pass-through entity, he or she will be currently taxable on his or her pro rata share of the company's income as a matter of law. For this reason, there is no need for an antideferral regime for U.S. owners of interests in foreign pass-through entities.

3. Unlike the CFC and PFIC rules, there are no indirect or constructive ownership rules for foreign pass-through entities that result in U.S. beneficiaries of foreign trusts and foreign estates being deemed to own the income of a foreign pass-through entity. For this reason, the trustee of a foreign trust can often improve the tax situation of the trust's U.S. resident beneficiaries by using pass-through entities as holding companies or operating companies all the way through the trust's holding company and operating company structure. In some situations it may not be possible to use pass-through entities for operating companies, but simply making the election for holding companies in the structure should at a minimum avoid PFIC issues.

4. This section of the outline addresses ways in which trustees of foreign trusts can use foreign pass-through entities in lieu of companies classified as corporations for U.S. income tax purposes.

B. *Using Entities "Default Classified" as Partnerships for U.S. Income Tax Purposes*

1. Under U.S. income tax classification rules, some kinds of foreign entities are automatically classified as pass-through entities, which means they will be treated as partnerships for U.S. income tax purposes if they have more than one owner or disregarded entities if they have only one owner. If a trustee of a foreign trust can use an entity of this kind from the outset or convert an entity classified as a corporation into a pass-through entity, the trustee may be able to avoid the problems that arise when a foreign trust owns shares in an entity classified as a corporation.

2. The U.S. entity classification rules provide that as long as one member of a foreign entity with more than one member has unlimited liability for the entity's obligations, the entity will be classified as a partnership. Treas. Reg. § 301.7701-3(b)(2)(i)(A). If a foreign entity has a single owner and that owner does not have limited liability for the company's obligations, the entity will

be classified as a disregarded entity. Treas. Reg. § 301.7701-3(b)(2)(i)(C). Commonly used companies that meet this description include the following:

a. Nova Scotia and Alberta unlimited liability corporations.

b. A Netherlands *Commanditaire Vennootschap* (a "CV").

c. A German *Kommanditgesellschaft* (a "KG").

3. Trustees of foreign trusts can often fairly easily effect a conversion of a foreign entity classified as a corporation to a company classified as a partnership or disregarded entity for U.S. purposes. For example, a Canadian limited company can be "migrated" to an Alberta or Nova Scotia unlimited liability company with no Canadian income tax or capital gains tax consequences. Of course, in tax havens tax is not an issue; only company related fees will be payable. Such a conversion, however, may give rise to a notional capital gain for U.S. income tax purposes, which would create DNI and therefore possibly UNI.

4. The classification of an entity as a partnership or disregarded entity for U.S. income tax purposes will, of course, not affect the way the country in which the entity is organized will tax the entity or its owners. Some countries, such as a Germany, also treat these entities as pass-throughs or the equivalent for purposes of their income tax. Other countries, such as Canada, do not treat these entities as pass-throughs and tax the entities as if they were corporations (in the U.S. way of thinking of things).

C. *Check the Box Elections for Entities Default Classified as Associations Taxable as Corporations for U.S. Tax Purposes*

1. If no member of a company has unlimited liability for the company's obligation, the United States will generally classify that company as an association taxable as a corporation, which means that the CFC and PFIC rules may come into play for the company. *See* Treas. Reg. § 301.7701-3(b)(2)(i)(B).

2. Most forms of limited companies used in offshore financial centers and in industrialized countries used by trustees as holding companies are subject to this default classification, including the following kinds of companies:

a. British Virgin Islands limited companies and limited companies in other offshore financial centers.

b. U.K., South African, Australian, and Singapore private or proprietary limited companies.

c. A Swiss or German *Gesellschaft mit beschränkter Haftung* (GmbH).

d. A Luxembourg *Société à responsabilité limitée* (S.A.R.L.).

3. In some situations, however, it is possible for such a company to make an election to be classified as a pass-through entity for U.S. purposes, resulting in the company being treated as a partnership or a disregarded entity for U.S. income tax purposes. *See* Treas. Reg. § 301.7701-3(a). If a holding company can make such a "check the box" election for itself and effects elections for all lower-tier eligible entities in the structure, the trustee of the trust that owns the interests in the company may be able to improve the U.S. beneficiaries' substantive and compliance position for U.S. income tax purposes.

4. Not all foreign limited companies are eligible to make a check the box election ("per se companies"). The IRS publishes a list of per se companies that are not eligible to make the election and routinely updates the list. The Treasury Regulations contain the basic list of

companies that cannot make a check the box election. *See* Treas. Reg. § 301.7701-2(b)(8). Among the companies that cannot make the election are Canadian limited companies, U.K. public limited companies, a Swiss *Aktiengesellschaft*, a French *Societe Anonyme*, and Panamanian *Sociedad Anonima*.

5. Notwithstanding the per se list, many kinds of foreign limited companies that trustees of foreign trusts routinely use as holding companies are eligible to make a check the box elections.

    a. Most limited companies in offshore financial centers are eligible to make the election, including Bermuda limited companies, British Virgin Islands limited companies, and Cayman Islands limited companies.

    b. Many of the former British colonies, though not Canada, maintain a distinction between widely held limited companies, which are usually called "public limited companies," and closely held limited companies, which are usually called "private limited companies." Public limited companies are generally on the per se list, including U.K. public limited companies, Singapore public limited companies, Australian public limited companies, and South African public limited companies. Private limited companies, however, are not usually on the per se list, which means that such a company is eligible to make a check the box election even though no member of the company has unlimited liability for the company's obligation.

6. Under U.S. tax law, a check the box election for a non-U.S. company must be "relevant" for U.S. tax purposes. Treas. Reg. § 301.7701-3(d)(1). An election is relevant if the company will have U.S. source income, has one or more U.S. shareholders, or the income of the company will be taken into account in computing the income of a U.S. shareholder. *Id.* If a nonresident trust with U.S. resident beneficiaries owns shares in a company such as a Swiss GmbH that is eligible to make the election, even company that has no U.S. source income, an election will be "relevant" because how the company is classified has an effect on how the U.S. beneficiaries may be taxed on the company's income on a direct, indirect, constructive, current, or future basis.

7. The managers of the company must first apply for a U.S. taxpayer identification number by filing an IRS Form SS-4 with the IRS. After the IRS issues the company's taxpayer identification number, the managers of the company must file an IRS Form 8832 with the IRS to make the election. The election may have an effective date in the future or in the past, though no more than 75 days in the past. A newly formed company therefore has 75 days from its date of organization to file the Form 8832. If for some reason the election ceases to be relevant for 60 months, the company must renew its election or else it will again be subject to default classification. *See* Treas. Reg. § 301.7701-3(d)(2).

D. *Substantive Tax Issues Raised by Foreign Trust's Use of Foreign Pass-Through Entities*

1. As noted above, the principal advantage of the trustee of a foreign trust using a foreign pass-through entity as a holding company is the avoidance of the indirect and constructive ownership rules that could result in a U.S. beneficiary being deemed to own a foreign company's shares under the CFC and PFIC rules. At the present time, there are no U.S. tax rules that deem a U.S. beneficiary of a foreign trust to indirectly or constructively own shares of a foreign pass-through entity that would result in the taxation of the pass-through entity's income to the U.S. beneficiary without a distribution from the trust.

2. If the trustee uses a pass-through entity as a holding company, the trustee, rather than the company, would be deemed to have earned the company's income and realized gains on an annual basis; the company would be treated as transparent for U.S. tax accounting purposes. In other words, the income of the company would be included in the trust's distributable net income or DNI. If the trustee made a distribution to a U.S. resident beneficiary during that year, the distribution would carry out a portion of the DNI to the beneficiary. In this way, a U.S. resident beneficiary would be taxable on a share of the holding company's income but the beneficiary will

have received the cash with which to pay the tax. For example, assume a holding company wholly owned by a trustee has interest income of $1 million and dividend income of $1 million. The trust's DNI will be $2 million. If the trustee causes the company to distribute $1 million to the trustee, which the trustee then distributes to a U.S. resident beneficiary, the beneficiary will be deemed to have received $500,000 of interest income and $500,000 of dividend income.

3. If the trustee does not distribute an amount equal to the holding company's income included in the trust's DNI, the undistributed income would become "undistributed net income" or UNI. The trustee, of course, would not pay any current U.S. income tax on the DNI attributable to the entity's earnings and profits that do not have a source in the United States. Thus, one effect of using a pass-through entity may be to build up UNI in the trust beyond what it would have been had the entity not made the election and the income and realized gains were effectively accumulated in the entity.

4. For example, if a holding company wholly owned by the trustee of a foreign trust had $1 million of interest, $1 million of dividends, and $1 million of capital gains, the trust's DNI would be $3 million if the company made a check the box election. If the trustee did not make any distributions to the beneficiaries during the year, that DNI would become UNI. By contrast, without a check the box election the trust would have DNI only if the company paid a dividend or made some other form of distribution. For example, if the company in this example was not a disregarded entity and paid only a $1 million dividend, the trust would have $1 million of DNI, not $3 million.

5. This comparison, however, is potentially misleading because absent a check the box election any holding company in a trust where there are U.S. resident beneficiaries structure could be a CFC or a PFIC, which means that the beneficiaries may be directly or indirectly subject to tax on the company's income or a tax on an excess distribution and interest when the company paid a dividend or liquidated. These taxes and interest could be payable whether or not the trustee made a distribution to the beneficiaries. The beneficiaries would also have significant tax reporting obligations.

6. Therefore, the proper comparison is the potential application of the throwback tax against the application of the CFC or PFIC rules: which antideferral regime will apply to the trust? The throwback tax regime, which is a consequence of a check the box election, is the lesser evil for several reasons. Among these reasons is that the throwback tax regime may preserve the benefits of foreign tax credits in situations in which the CFC and PFIC regimes do not.

7. In addition, the trustees may have opportunities to reduce the impact of the throwback tax on distributions. In particular, the presence of the company, even though it has checked the box, may allow the trustee to distribute dividends paid by the company to the beneficiaries on a current basis without the imposition of the throwback tax even if the dividend exceeds the company's current year earnings and profits. *See* IRC §665(b) (flush language).

8. While the use of a pass-through entity may appear to benefit the U.S. beneficiaries of a foreign trust, from time to time the tax laws of the country in which the company is organized may not mesh well with the U.S. fiduciary income tax system, resulting in some inefficiencies. This is not a problem, of course, for companies organized in offshore financial centers that do not tax the earnings of companies organized there. But it can be an issue if the company is organized in a country with a robust system of taxation.

   a. Assume, for example, that a trustee of a trust administered in Switzerland uses a Swiss GmbH as a holding company and that the GmbH has made a check the box election so it is treated as a disregarded entity for U.S. income tax purposes.

      (i) If the trustee receives a distribution from the GmbH, it will be subject to a Swiss federal withholding tax at a rate of 35% of the amount distributed under general principles of Swiss tax law. If the trustee makes a distribution to a U.S.

beneficiary in the same year, the sum of the withheld tax and the net distribution from the GmbH will be included in the trust's DNI.

(ii) The U.S. beneficiary will be deemed to have received a pro-rata share of the pre-tax distribution but will also be deemed to have paid a pro-rata share of the Swiss tax. As a result, the U.S. beneficiary will be able to take a credit for the Swiss tax paid, subject to certain limitations under U.S. law. The principal limitation is that the tax credit cannot exceed the deemed U.S. tax on the GmbH distribution, which is 15% for dividends paid by Swiss companies, which are generally qualified foreign dividends under IRC § 1(h)(ii). Therefore, a considerable amount of the withheld Swiss tax cannot be credited against the U.S. tax, resulting in an effective tax rate on the dividend of 35%. If the United States – Switzerland Income Tax Treaty applies, the beneficiary could obtain a refund of the 20% difference.

(iii) If the trustee does not make a current distribution and the company's income becomes part of the trust's UNI, the 35% Swiss withholding tax and any Swiss corporate income taxes paid by the GmbH will help reduce the throwback tax, but only to the extent that the combined amount of Swiss taxes do not exceed the notional U.S. tax rate used to compute the throwback tax. That tax rate is likely to be about 35%. The effective combined rate of the Swiss entity level tax and withholding tax, however, may be higher than the notional U.S. tax rate.

b. Another scenario that illustrates the mismatch of tax systems is when the trustee of an Australian resident trust with U.S. resident beneficiaries uses an Australian proprietary limited company as a holding company.

(i) In general, under Australian law a limited company is subject to a 30% tax on its income at the company level. If the company later makes a distribution of previously taxed income, that distribution is called a "franked" dividend. If a shareholder is resident in Australia and receives a franked dividend, the shareholder will pay an extra "top up" tax of about 15%, which reflects the top Australian income tax rate of 45%. The franked dividend concept is the basis on which Australia has integrated its corporate income tax and its individual income tax.

(ii) If an Australian proprietary limited company makes a distribution of a franked dividend to a nonresident shareholder, the company is not required to withhold any further Australian income tax; the tax has already been paid at the corporate level. Similarly, if the trustee of an Australian resident trust receives a franked dividend and distributes the dividend to a nonresident beneficiary, such as a beneficiary who resides in the United States, the trustee need not withhold any Australian income tax on the cash distributed. If the shareholder is an individual resident of the United States or the trustee of a trust resident in the United States, or a U.S. resident beneficiary of an Australian resident trust, the shareholder or beneficiary will pay a 15% tax on the franked dividend, but with no credit for the Australian tax paid by the company. *See* IRC § 1(h)(11) (a dividend paid by an Australian proprietary limited company is a "qualified dividend."). Therefore, the effective tax rate is 40.5% (30% plus 15% of 70%). This is a tax inefficiency in United States – Australian investment situations.

(iii) The inefficiency can be alleviated if the Australian company makes a check the box election because it allows the U.S. shareholder to take a foreign tax credit for the Australian income tax paid by the corporation on its Australian source income. If the company has non-Australian source income on which it has paid foreign tax, the U.S. shareholder should also receive a credit for those other foreign taxes. If the company has non-Australian sourced income on which it pays Australian tax but no other tax, the U.S. taxpayer can nevertheless take a credit for the Australian tax paid on that income. The U.S. taxpayer, however, will still pay a higher rate of tax on the company's income than 30% because the top marginal U.S. rate is 35%. Because the company is not a pass-through in Australia, it may choose not to pay any dividends, which may leave the taxpayer short of cash to pay the remaining U.S. tax.

(iv) If an Australian resident trust with U.S. beneficiaries uses a proprietary limited company as a holding company and makes a check the box election for the company, the trust's DNI will include a ratable share of the company's earnings and profits. This means that each year the company's earnings and profits would become UNI to the extent the trustee does not make a distribution to the trust beneficiaries. The trustee, of course, would not pay any current U.S. income tax on the company's earnings and profits that do not have a source in the United States. Rather, the U.S. tax on those earnings and profits would be deferred until the trustee makes a distribution to the U.S. beneficiaries, but such a distribution could be subject to the throwback tax.

(v) For example, if a proprietary limited company had $1 million of interest, $1 million of dividends, and $1 million of capital gains in a particular year, the trust's notional DNI would be $3 million if the company made a check the box election. If the trustee did not make any distributions to the beneficiaries during the year, that DNI would become UNI. By contrast, without a check the box election the trust would have DNI only if the company paid a dividend or made some other form of distributions (assuming the company is not a CFC or a PFIC to which indirect ownership rules apply). For example, if the company in this example paid only a $1 million dividend, the trust would have $1 million of DNI, not $3 million. If the trustee did not distribute $1 million, the $1 million of DNI would become UNI.

9. Another issue that concerns some practitioners in this area is that the use of a foreign company that would be classified for U.S. tax purposes as a disregarded entity either under the entity classification rules or a check the box election might be looked through for U.S. estate tax purposes. *See generally* Karlin, et al, "U.S. Estate Planning for Nonresident Aliens Who Own Partnership Interests," 99 Tax Notes 1683, notes 49 to 50 and accompanying text.

a. If the government did look through the holding company and the company held U.S. situs assets that would otherwise be includable in the decedent's gross estate, then the use of the holding company would be problematic.

b. Other provisions of U.S. tax law, however, suggest that the check the box rules would not affect the situs of the interest of the foreign corporation for tax purposes. For example, IRC § 2104(a) provides an estate tax situs rule for "shares of stock" whereas the check the box rules address the classification of a business entity as a corporation or a partnership for income tax purposes. The check the box rules do not define "shares of stock . . . issued by a domestic corporation," which is the basis of taxation under IRC § 2104(a).

c. In 2009 the Tax Court, in a reviewed opinion, determined that the check the box rules relate only to the income tax classification of business entities and do not apply to characterize interests in property for gift tax purposes as something different than what those property interests really are. *Pierre v. Commissioner*, 133 T.C. No. 2 (2009). The *Pierre* decision should apply with equal force to situs questions under estate tax law, which should allow clients to use checked foreign eligible entities as "blockers" for U.S. estate tax situs purposes.

E. *Planning by a Foreign Trustee to Use Foreign Pass-Through Entities*

1. Ideally the trustee of a foreign trust with U.S. beneficiaries would organize the trust's holding companies as entities that are default classified as pass-through entities. Alternatively, the trustee could convert entities classified as associations taxable as corporations to default classified pass-through entities or entities eligible for a check the box election. If the trustee of a foreign nongrantor trust is using a foreign eligible entity as a holding company, the trustee may make a check the box election at any time.

2. A check the box election or a conversion of a entity classified as an association taxable as a corporation to an entity with a default classification as a pass-through entity, however, may give rise to a number of U.S. tax issue for a foreign nongrantor trust.

   a. The election or conversion will be deemed to be a liquidation of the foreign entity, which will trigger a notional capital gain for U.S. tax accounting purposes. Because the trust is a foreign trust, that notional gain will be included in its DNI and could become UNI. The election or conversion will give the assets that were held in the entity a new basis for U.S. tax purposes, which will be important going forward for the trustee when it computes pass-through gain or loss.

   b. If at the time of the election or conversion the company meets the definition of a PFIC, the deemed liquidation of the company is notionally an excess distribution. Because the trust will have been a foreign trust during its entire holding period, however, the fact that the entity might meet the definition of a PFIC is of no particular consequence because the excess distribution regime will not apply to the disposition. *See* Prop. Treas. Reg. 1.1291-1(b)(1)(i) (a corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period before the shareholder became a United States person within the meaning of IRC 7701(a)(30)). Instead, the gain is ordinary income. *See* IRC § 1291(a)(1)(B) (under the excess distribution rules, a taxpayer's gross income for the current year includes (as ordinary income) the amounts allocated under IRC § 1291(a)(1)(A) to any years in which the company was not a PFIC).

   c. The gain will be included in the trust's DNI, and if the trustee makes a distribution to U.S. resident beneficiaries in the year in which the trustee makes the election, some or all of the gain will pass out to the U.S. beneficiaries. Those beneficiaries should have a reasonable basis to report the gains as ordinary income and not as excess distributions from a PFIC, though the beneficiaries should disclose the liquidation on a Form 8621. If the trustee does not make any distributions in the year of the election, the deemed gain on liquidation will become UNI. Despite these general rules, it is possible that the IRS may treat the U.S. beneficiaries as the indirect owners of the PFIC shares under IRC § 1298(a)(3) as they did in TAM 200733024 and deem those beneficiaries to have recognized a part of the deemed excess distribution.

3. If, on the other hand, the trust in question is a foreign grantor trust, the check the box election or change in form of an entity will have no U.S. tax effects because a nonresident alien will be treated as the owner of all of the trust's items of income, gain, and loss. *But see* IRC § 672(f)(2) (limiting the circumstances in which a nonresident alien will be treated as owning items of a trust's income, gain, or loss for U.S. income tax purposes).

   a. The timing of an election or conversion for a foreign grantor trust is important because the election results in a new basis for the assets the trustee holds through the now-disregarded entity. Ideally the trustee would wait to effect a check the box election or conversion until very near the time in which the trust will cease to be a grantor trust, such as by reason of the grantor's death, so as to maximize the basis of the trust assets. The higher the trust's basis in the assets held in the now-disregarded entity, the smaller the gain on the disposition of the assets when the trust is a nongrantor trust, thereby leading to a smaller amount of DNI or UNI.

b. A trustee of a foreign grantor trust, however, may not be able to predict when the trust will cease to be a grantor trust. Because the trustee may make a check the box election that is effective up to 75 days before the trustee files the election, the trustee should be able to make the election, and the notional gain realized on the election, effective on a date when the trust was a grantor trust.

c. A trustee, however, may be concerned that the IRS could treat the now-deceased grantor as the owner of U.S. situs assets held in the disregarded entity for U.S. estate tax purposes (despite the authority to the contrary, discussed above). In this instance, the trustee could make an election that is effective after the grantor's date of death. The trustee should make such an election within 30 days of the grantor's death, however, to avoid the potential classification of the entity as a controlled foreign corporation as well as to limit the possibility that the IRS will treat the U.S. resident beneficiaries of the now-nongrantor trust as indirect shareholders of what would be a PFIC. The trustee, for example, could make the election effective the day after the decedent's date of death (and would have 75 days from the decedent's date of death to make the election).

d. An election that is effective after the decedent's date of death, however, means that the election is made when the trust is foreign nongrantor trust, which would result in the inclusion of the gain deemed realized on the election in the trust's DNI. If the trust assets received a new basis on the decedent's date of death, however, this should not be a substantial concern.

(i) As long as the trust owned all the shares in the company, the fair market value of the shares should be the value of the company's assets without any discounts. As a result, the outside basis of the shares should equal the value of the company's assets as of the decedent's date of death as long as IRC § 1041(b)(2) applies (discussed below). As a result of the election the trust will be deemed to have received assets with a value equal to the trust's basis in the shares, which should result in no gain.

(ii) Assume, for example, a revocable trust owns 100% of the shares of a holding company that owns assets with a value of $100 million on the settlor's death. The date of death value of the shares in the holding company should be $100 million, which should be the new outside basis of the shares on the settlor's death. The check the box election is a deemed distribution from the holding company of assets with a value of $100 million to the trustee in exchange for its shares with a $100 million basis, so there should be no notional gain includable in the trust's DNI as a result of the election. The company, of course, is not taxable on the deemed liquidation of the company because the company is not a U.S. taxpayer.

e. The key to this strategy is for the trustee's outside basis in the company's shares to be equal to the value of the company's assets on the settlor's date of death. Assuming none of the trust assets were includable in the grantor's gross estate for U.S. estate tax purposes, the trust assets will receive a new basis on the grantor's death if:

> [The assets were] 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

IRC § 1014(b)(2). Thus, although a nonresident alien may be treated as the owner of a trust's income, gain, and loss because he or she or his or her spouse had a beneficial interest in the trust, the presence of such an interest absent a power of revocation will not result in a new basis for the trust assets. Similarly, even if the trust in question was revocable, it assets will not receive a new basis on the grantor's death if the decedent may not have had an income interest in the trust or had the power to direct the distribution of the income.

f. For a foreign grantor trust to which IRC § 1014(b)(2) does not apply but that was a revocable trust, the equivalent of a new basis may be available if the trustee can make an election under IRC § 645 to treat the trust as an estate for U.S. income tax purposes.

(i) The benefit of having the trust treated as an estate for U.S. federal income tax purposes is that its gains will not be included in the trust's DNI.

(a) Section 643(a) generally provides that the DNI or an estate or trust is the trust's taxable income computed with certain modifications. A foreign estate's taxable income for U.S. purposes is only its U.S. source income. Foreign source income, including gains realized on the sale of U.S. intangible assets, would not be part of a foreign estate's taxable income. *E.g.*, PLR 8317020. *See generally* IRC § 872(a). Although IRC § 643(a)(6) provides that a foreign *trust's* gross income includes non-U.S. source income and capital gains, the modification of that section does not apply to foreign estates. Accordingly, a foreign estate's DNI does not include foreign source income, including gains realized from the sale of U.S. intangible assets.

(b) As a result, any gain deemed realized on a post-death check the box election by a foreign estate will not be included in DNI, thereby apparently solving the trustee's dilemma. Assume, for example, that a trustee of a revocable trust owns shares in a holding company with $100 million of assets but does not receive a new outside basis in the holding company shares on the grantor's date of death. Instead, the basis in the shares is $50 million. If the trustee makes a check the box election with a post-death effective date, the trust will be deemed to have realized a $50 million capital gain. If, however, the trust is treated as an estate for federal income tax purposes, that $50 million of gain will not enter into the trust's DNI. The trustee will be deemed to have a $100 million basis in the assets of the now-disregarded entity. If the trustee makes distributions to U.S. beneficiaries while the election is in effect, the distributions will not carry out any foreign source income to those beneficiaries. Furthermore, because the deemed gains are not includable in the trust's DNI, that income cannot become UNI, which could give rise to a throwback tax if the trustee later makes an accumulation distribution after the election period expires (beneficiaries of foreign estates are not subject to the throwback tax on distributions of income accumulated in the estate).

(ii) The regulations under IRC § 645 do not limit the election to domestic revocable trusts and estates. In fact, the IRS acknowledged in the preamble to the regulations that a foreign trust could make the election as long as the trust was a "qualified revocable trust" or "QRT" within the meaning of IRC § 645(b)(1):

> The proposed regulations also provide that a QRT must be a domestic trust under section 7701(a)(30)(E) and that a section 645 election for a QRT must result in a domestic estate under section 7701(a)(30)(D). Several commentators suggested that the section 645 election should also be available in situations in which either the QRT or the related estate, or both, are foreign. According to the commentators, U.S. citizens living abroad frequently use revocable trusts to avoid jurisdictional

> disputes concerning the decedent's assets, as well as the cumbersome probate and forced heirship rules of several foreign countries. Many of the trusts will be foreign trusts upon the grantor's death and, if a section 645 election is permitted to be made, will become part of a foreign estate. The commentators questioned the authority for the domestic restriction provided in the proposed regulations given that the statute and the legislative history do not explicitly limit the applicability of a section 645 election to domestic trusts and domestic estates. Upon consideration of these comments, the requirements that a QRT be a domestic trust and that the election result in a domestic estate are removed from the final regulations. The IRS and the Treasury Department note, however, that a trust for which a section 645 election is made is treated as an estate for purposes of Subtitle A of the Code, but not for purposes of Subtitle F. Accordingly, information reporting under section 6048 will continue to apply with respect to a foreign trust even though a section 645 election has been made to allow the foreign trust to be taxed as part of an estate for purposes of Subtitle A of the Code.

T.D. 9032, 2003-7 I.R.B. 471. Consistent with the preamble, IRS Form 8855, by which the IRC § 645 election is made, allows a foreign estate or foreign trust to make the election.

(iii) To make the election, a revocable trust established by a nonresident alien must have been treated as the owner of the assets of the trust for income tax purposes during his or her lifetime under IRC § 676 by reason of the decedent's retention of a power to revoke the trust. IRC § 645(b)(1).

(iv) To make the IRC § 645 election, the executor of the decedent's estate, if any, otherwise the trustee of the revocable trust, must file the appropriate forms with the IRS. *See generally* Treas. Reg. § 1.645-1(c). A foreign executor or trustee may be reluctant to file the necessary forms with the IRS if the trust will not have any U.S. source income.

(v) The length of the election will be two years after the date of the decedent's death unless the decedent's estate files an IRS Form 706, in which case the election will continue until six months after the final determination of the federal estate tax in the decedent's estate. If the six-month period concludes sooner than two years after the decedent's date of death, the two-year period applies. *See generally* Treas. Reg. § 1.645-1(f).

(vi) One risk of this approach is that when a revocable trust becomes an estate, it may be easier for the government to treat the U.S. resident beneficiaries as the indirect owners of the shares in the entity for CFC purposes. The outline discusses the application of the indirect ownership rules to foreign estates above at pages 9 and 10. As long as the post-death election is effective within the first 30 days after the decedent's death, however, the trustee can minimize this risk.

(vii) There is also, of course, a risk that the holding company is a passive foreign investment company, which means that the post-death liquidation could notionally be treated as an excess distribution that the government may deem the beneficiaries to indirectly own under IRC § 1298(a)(3).

g. If the formerly foreign grantor trust's assets do not receive a new basis, the trustee's only realistic option is to make the election effective the day before the decedent's date of death and take the position that the election does not result in the inclusion of the U.S. assets in the decedent's gross estate.

VI. Compliance Issues for U.S. Owners of Interests in Foreign Partnerships

A. *Introduction*

1. Extra compliance rules apply to U.S. citizens and residents who "control" foreign partnerships or who own interests in foreign partnerships and disregarded entities. The applicable form for interests in foreign partnerships is IRS Form 8865 and the form to report an interest in a foreign disregarded entity is IRS Form 8858.

2. New IRC § 6038D requires a U.S. citizen or resident taxpayer to disclose ownership of interests in a foreign pass-through entity that are not reportable under IRC § 6038 and 6046A. The outline discusses IRC § 6038D and its general provisions above at pages 4 to 5. If a taxpayer must file an IRS Form 8858 or 8865 with respect to an interest in a foreign pass-through entity, he or she will probably not be required to make a separate disclosure under IRC § 6038D with respect to that entity.

B. *IRC § 6038 Reporting*

1. A U.S. person will be deemed to "control" a foreign partnership if he or she directly or indirectly owns more than a 50% interest in the partnership. Code § 6038(e)(3)(B) describes a 50% interest as either an interest equal to 50% of the capital of the partnership, an interest in 50% of the partnership's profits, or, as provided in regulations, an interest to which 50% of the partnership's deductions or losses are allocated.

2. Even if a U.S. person does not "control" a foreign partnership, he or she may be subject to extra compliance obligations if he or she holds a 10% or greater interest in a foreign partnership that is controlled by U.S. persons who own 10% of greater interests. *See* IRC § 6038(a)(5)(giving the IRS authority to require 10% partners to file an informational return); Treas. Reg. § 1.6038-3(a)(2)(implementing reporting requirements). For purposes of this reporting requirement, "control" by 10% partners means that the 10% partners together own more than a 50% interest in the partnership. *See* IRC § 6038(e)(3)(C)(referring to IRC § 6038(e)(3)(B)); Treas. Reg. § 1.6038-3(b)(1).

3. For purposes of the 10% reporting rules, a 10% interest is an interest equal to 10% of the capital interest in the partnership, an interest equal to 10% of the profits of the partnership, or an interest to which 10% of the partnership's deductions and losses are allocated. Treas. Reg. § 1.6038-3(b)(3).

4. Unlike the CFC and PFIC rules, the controlled foreign partnership reporting rules are not substantive tax rules; they are only compliance rules. Under the general principles of Subchapter K, a U.S. citizen or resident owner of an interest in a foreign partnership must already include his or her share of the foreign partnership's income, gain, loss, and deductions in his or her income.

5. The constructive ownership rules of IRC § 267(c), other than IRC § 267(c)(3), apply to determine when U.S. citizens and residents are deemed to own interests in partnerships for purposes of the IRC § 6038 reporting requirements. Treas. Reg. § 1.6038-3(b)(4).

    a. The effect of the constructive ownership rules means that an individual will be deemed to own interests in a foreign partnership owned by members of his or her "family." IRC § 267(c)(2). A member of an individual's "family" for purposes of IRC § 267(c)(2) is the individual's spouse, siblings, ancestors, and descendants. IRC § 267(c)(4).

    b. The regulations, however, provide that an interest of a nonresident alien in a foreign partnership will not be attributed to a U.S. member of that alien's family unless that U.S.

family member directly or indirectly owns an interest in that partnership. Treas. Reg. § 1.6038-3(b)(4). In other words, a U.S. taxpayer will not be subject to the reporting requirements simply because a nonresident alien member of the taxpayer's family owns an interest in a foreign partnership.

c. A U.S. beneficiary of a foreign trust or foreign estate may be deemed to own a proportionate share of the trust's or estate's interest in a foreign partnership.

(i) Under IRC § 267(c)(1), an interest owned by an estate or trust will be considered as owned proportionately by its beneficiaries. The IRS, however, has not issued any regulations under IRC § 267(c)(1) that explain how to apply the proportionate ownership rule.

(ii) Applying the proportionate ownership rule to an estate should be fairly straightforward as it is in the CFC and PFIC indirect ownership rules, i.e. based on the beneficiaries' proportionate interests in the decedent's estate.

(iii) Applying the proportionate ownership rule to trusts, however, is more difficult due to a lack of guidance from the courts and the IRS. In PLR 9015055, for instance, the IRS ruled that an individual and her children, who were beneficiaries of a trust that owned shares, were deemed to own the shares under IRC § 267(c)(1). The IRS, however, did not discuss how to apportion the shares among the trust beneficiaries. *See also Liflans Corp. v. United States*, 390 F.2d 695 (Ct. Claims 1968) (court concludes that beneficiaries of a trust deemed to own trust's shares under IRC § 267(c) without any discussion of the basis on which the proportionate ownership rules were to be applied); PLR 8128073. About the most we can tell from the cases and rulings is that even contingent interests do count for purposes of IRC § 267(c) but we do not know how to count them. *E.g.*, *Wyly v. United States*, 662 F.2d 397 (5th Cir. 1981); *Widener Trust No. 5 v. Commissioner*, 80 T.C. 304 (1983).

(iv) In *Hickman v. Commissioner*, T.C. Memo. 72-208, 31 T.C.M. 1030 (1972), the Tax Court held that actuarial values cannot be used to apply the proportionate ownership rules for trust beneficiaries under IRC § 267(c)(1). In *Hickman*, the taxpayer challenged the IRS's method of computing proportionate ownership, but failed to convince the court that the IRS was incorrect. The taxpayers first suggested that actuarial values should be used to determine their proportionate interests in the trust's shares, but the court found no support for this approach in the legislation and its history. The court also rejected the taxpayers' suggestion that the value of their interests in the shares owned by the trust was zero because they could not assign their interests in the trust. The court, however, did not describe how the IRS applied the proportionate ownership test other than referring to an IRS conclusion that the taxpayers owned more than 50% of the value of the shares because the taxpayers were the only present beneficiaries of the trust and because the trust had no specifically named remainder beneficiaries.

C. *IRC § 6046A Reporting*

1. Under IRC § 6046A a U.S. taxpayer must file an informational return when:

a. The U.S. person acquires or disposes of an interest in a foreign partnership if the U.S. person owns at least a 10% interest in the partnership either before or after the acquisition or disposition. IRC §§ 6046A(a)(1), 6046A(a)(2).

b. The U.S. person's proportionate interest in a foreign partnership changes "substantially." This reporting requirement applies only if a change is equivalent to at least a 10% interest in the partnership. IRC § 6046A(a)(3). Under the regulations, a partner's proportional interest in a foreign partnership may change for a number of reasons:

> [F]or example, the change may be caused by changes in other partners' interests resulting from a partner withdrawing from the partnership. A proportional change may also occur by operation of the partnership agreement, for example, if the partnership agreement provides that a partner's interest in profits will change on a set date or when the partnership has earned a specified amount of profits and one of those events occurs.

Treas. Reg. § 1.6046A-1(b)(3).

2. Section 6046A relies on the definition of a 10% partnership interest used in IRC § 6038(e)(3)(C).

3. Under IRC § 6046A, reporting of an event is required only when it changes a *direct* interest that the U.S. taxpayer has in a foreign partnership. Even though IRC § 6046A suggests its rules apply to U.S. taxpayers who indirectly own interests in foreign partnerships, the regulations provide that the reporting requirements do not apply to transactions that involve interests in partnerships that the U.S. person might indirectly own under the principles of IRC § 6038(e)(3)(C). *See* Treas. Reg. § 1.6046A-1(b)(1); Treas. Reg. § 1.6046A-1(b)(7), Example 1.

D. *Compliance Obligations*

1. A U.S. citizen or resident who is required to report information about a controlled foreign partnership does so on IRS Form 8865 or IRS Form 8858 in the case of a foreign disregarded entity.

2. A U.S. taxpayer who "controls" a foreign partnership under the 50% test is a Category 1 filer for Form 8865 purposes. A U.S. taxpayer who owns a 10% interest in a controlled foreign partnership is a Category 2 filer. A Category 3 filer is a U.S. person who made a capital contribution to a foreign partnership in a particular year with the result that he or she owned directly or constructively at least a 10% interest in the partnership immediately after the contribution. Category 3 also includes U.S. taxpayers who contributed property with a value of more than $100,000 in a 12-month period, without regard to that taxpayer's proportionate ownership. Finally, a Category 4 filer is a U.S. taxpayer who had an event with respect to the partnership that must be reported under IRC § 6046A.

3. In general, any U.S. citizen or resident who owns more than a 10% "controlling" interest in a foreign partnership must file an IRS Form 8865. If, however, the foreign partnership has a U.S. citizen or resident who is a 50% controlling partner, then the 10% partners are not required to file Form 8865. Instead, the government will rely on the Form 8865 filed by the 50% partner to collect the information the government needs.

4. A Category 1 or 2 filer is not required to file a Form 8865 if the partnership itself files an IRS Form 1065 or 1065-B for its tax year. Instead, the Category 1 or 2 filer can use a copy of the partnership's return in lieu of the Form 8865.

Statutory Hastings-Bass Enacted in Bermuda

The Bermuda Government recently approved an amendment to Bermuda's trust legislation giving the court a new statutory jurisdiction to remedy the negative effects or consequences of acts or omissions made by settlors, trustees or other fiduciaries, otherwise known as the 'Rule in Hastings-Bass'.

Operative on the 29 July 2014, the *Trustee Amendment Act, 2014* ("TAA") expressly recognises the availability of the rule in Hastings-Bass as it was understood and applied in England (and other common law jurisdictions) prior to 2011 (the "traditional Hastings-Bass rule"). The TAA, which has retroactive application, amends the *Trustee Act, 1975* (the "TA") in order to place the traditional Hastings-Bass rule on a statutory footing in Bermuda law.

Jurisdiction of court to set aside flawed exercise of fiduciary power

The TAA inserts a new Section 47A into the TA. Subsection 47A(1) of the TA is the key provision conferring the Hastings-Bass jurisdiction on the court in relation to the exercise of fiduciary powers. There are two parts to the exercise of the court's jurisdiction:

a) First, the threshold test: two conditions must be met before the jurisdiction can be invoked (see below);
b) Second, if the jurisdiction is engaged, the court then has a discretion to set aside the exercise of the fiduciary power in whole or in part, and either unconditionally or on such terms and subject to such conditions as it thinks fit, and to make such order consequent on the setting aside of the exercise of the power as it thinks fit.

Meaning of "fiduciary power"

The Section 47A jurisdiction of the court can be invoked in relation to any fiduciary power which is defined as any power that, when exercised, must be exercised for the benefit of or taking into account the interests of at least one person other than the power holder. "Power" is defined as including a discretion as to how an obligation is performed. This definition is not intended to be comprehensive, and the common law meaning of the term 'power' is retained.

Conditions for setting aside the flawed exercise of a fiduciary power

The conditions that engage the court's jurisdiction reflect the standard requirements of the traditional Hastings-Bass rule, as derived from the leading authorities, and are as follows:

The first condition
The first condition is that the "power-holder" (defined as including any person on whom a power has been conferred, whether or not that power is exercisable by that person alone, and any person to whom the exercise of a power has been delegated) has:

- failed to take into account a 'relevant consideration'; or

- has taken into account an ‘irrelevant consideration’.

What constitutes a ‘relevant’ or an ‘irrelevant’ consideration is not defined so as to give the court maximum flexibility.

The second condition
The second condition is a causation test; in order to justify intervention by the court, the exercise of the power must be so flawed that but for that flaw, the power-holder:

- would not have exercised the power;
- would have exercised it but on a different occasion to that on which it was exercised; or
- would have exercised the power, but in a different manner to that in which it was exercised.

The test is a test of causation in fact (i.e. the ‘but for’ test) and is subjective; in other words, what would the power-holder have done under the circumstances?

Effect of the order

The TAA states that if the exercise of a power is set aside, the exercise of the power shall be treated as never having occurred. The key purpose of this provision is to make it clear that, if the exercise of the power is set aside, the effect is that the exercise is void and treated as if the power was never exercised in the first place.

No need for breach

The TAA makes it clear that it is not necessary for the fiduciaries or their advisors to be shown to have been in breach of trust or in breach of duty in order for the court to exercise its jurisdiction.

Who can make the application?

The TAA restricts who can invoke the court’s jurisdiction. These people include the power holder, the trustees and beneficiaries, the Attorney General (where there is a charitable element), and any other person - with the leave of the court.

Conclusion

The codification of the traditional Hastings-Bass rule demonstrates Bermuda’s commitment to maintaining its position as a leading and competitive jurisdiction for trust business. The new law offers fiduciaries and beneficiaries of Bermuda trusts an attractive alternative to otherwise costly, time-consuming and uncertain litigation based on negligence or breach of duty claims.

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