Hot Topics Related to Foreign Trusts with US Beneficiaries

Hal J. Webb
Abraham W. Smith
Erika Litvak
Leslie A. Share
COMMUNITY PROPERTY ISSUES
Who owns the property?

- Starting point in any analysis should be determining ownership, as determined under local law
- Marital Property Rights
Basic Concepts

- Different approach between common law and civil law.
- There is no one system of community property.
- England, Canada, Australia and 41 U.S. States (Common Law).
  - No Community of Property (separate property)
- Latin America, Europe and 9 U.S. States (Civil Law).
  - Community of Property
Community Property

- Each spouse has a vested \( \frac{1}{2} \) ownership.
Determining which law applies

- Marital Domicile
  - Where did couple get married?
  - Where have they lived?
  - Where do they currently live?
Identifying the relevant community property regime

- **Estate of Charania**, 608 F.3d 67 (1st Cir. 2010).
  - Married: Uganda (UK)
  - Citizens: UK
  - Moved to Belgium
  - Husband Acquired Citigroup stock while living in Belgium
  - Husband dies in Belgium (after 30 years living there)
  - Citigroup stock worth $12 million. Shares in Husband’s name alone.
  - No prenup or other agreement
Identifying the relevant community property regime (cont.)

- Marital Property Rights in Belgium – Community
- Marital Property Rights in UK – Separate

1. Belgium permits married couple to modify or change the matrimonial regime governing their property. No change was made.
2. Belgium looks to the law of the country of the spouses common nationality (UK).
3. Question was whether UK adhered to the doctrine of mutability or immutability.
Identifying the relevant community property regime (cont.)

- **Mutability**
  - The marital property regime of the jurisdiction in which the spouses were domiciled when the property was acquired governs questions of ownership. (United States)

- **Immutability**
  - The marital property regime of the jurisdiction in which the spouses were domiciled at the time of their marriage. (Many European countries)
Understanding the community property regime

- What property does the community attach to?
- Does non-earning spouse have an interest in income?
- When does the community crystallize?
- Can we change the community?
Lesson of the Day

- Understand full nature of any applicable community property regime.
JOINTLY SETTLED TRUSTS
Joint Settlors
Case Study

-Juan and Ana Maria come to your office for advice. They are both citizens and residents of Argentina. They have been married for 20 years under community property law and have two children, Diego and Paula, both living on a permanent basis in Miami.

- Juan and Ana Maria explain that they hold shares in a non-U.S. company that holds passive investments outside of the United States (“Non-US Invest. Co.”). They funded such company with savings they were able to set aside from their operating business in Argentina.

- They ask you to advise how to transfer the shares of Non-US Invest. Co. in an efficient way to their U.S. children. They heard they could do a non-U.S. trust and want to know your opinion. They have retained Argentinean counsel, who will advise on any Argentinean law issue related to the planning.
Joint Settlors

• How to settle the trust?
  • Given that Juan and Ana Maria own the shares of Non-US Invest Co. jointly, you advise them to jointly settle the trust.
  • But, how will the trust be taxed?
• How to achieve grantor trust status with a nonresident settlor?
  • IRC Section 672(f) -- 2 alternatives:

(a) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor; or

(b) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.
Joint Settlors

Why grantor trust status is tax efficient for Juan and Ana Maria?

- Trust is disregarded and trust owners (Juan and Maria) are taxed directly with respect to any trust income.
- As non-resident aliens of the United States, they would generally only be taxed on U.S. source income that is considered FDAP (passive) or with respect to income that is effectively connected with a U.S. trade or business.
- If the trust solely earns non-U.S. source passive income, they would not be subject to U.S. income tax on the trust income during the period the trust is a grantor.
- Their U.S. children could receive trust distributions during that period without being subject to tax (but would have to report the distributions).
Joint Settlors

• What happens if Juan dies?
  • Service could argue that a portion of the trust (50%) became non-grantor:
    • The pertinent portion would become a separate taxpayer;
    • Throwback rules would apply
  - Unless a person other than Juan can be treated as a trust owner.

• How can someone other than Juan be treated as a trust owner?
  • Reg. 1.671-2(e)(5): If a person with a general power of appointment over the trust exercises that power in favor of another trust, then such person will be treated as the grantor of the second trust, even if the grantor of the first trust is treated as the owner of the first trust.
  • This scenario provides a useful estate planning tool that can be incorporated in Juan and Ana Maria’s trust deed.
So, how does the general power of appointment work?

- The trust deed would provide that each Juan and Ana Maria hold a general power of appointment.

- Upon the death of one of them (i.e., Juan), Ana Maria would effectively exercise her general power of appointment and would settle the trust assets into a new trust.

- Ana Maria would then be deemed under the regulations the owner of the second trust, even if half of the assets were treated as owned by Juan in the first trust.

- The new trust would have to incorporate the provisions discussed before (672(f) language) to make it a grantor trust with respect to Ana Maria.

- This tool permits the grantor trust status to continue with respect to the entire trust fund until the death of Ana Maria.
CHECK-THE-BOX ELECTIONS
Check the Box Elections for Foreign Holding Companies—In General - Part I

• See Reg. §§ 301.7701-2 and 301.7701-3, which define for U.S. tax purposes whether a "business entity" is one of the following: (1) single-owner disregarded entity; (2) corporation; or (3) partnership, and provide specific rules to determine such status by default or election

• Compare Reg. § 301.7701-4 for definition of a "trust"—trusts are not a CTB election alternative

• What is a "foundation," "stiftung" or "fideicomiso" for U.S. tax purposes?
The CTB election is made on Form 8832, Entity Classification Form (rev. 1/11)

"Foreign eligible entities" with a single owner may elect to be treated as either: (1) an association taxable as a corporation; (2) a partnership; or (3) a disregarded entity

"Foreign eligible entities" with multiple owners may elect to be treated as either: (1) an association taxable as a corporation; or (2) a partnership
Check the Box Elections for Foreign Holding Companies—In General - Part III

- "Per se" entities MUST be treated as "corporations"—see Reg. § 301.7701-2(b)(8)
- Common "per se" holding companies—Panama S.A., Dutch N.V.,
- U.S. corporations require "corporation" treatment
- Common "CTB eligible" entities—British Virgin Islands corporations, Cayman Islands corporations, limitadas, other limited liability companies, partnerships
- CTB pass-through election for a "corporation" is a taxable liquidation for U.S. income tax purposes
Check the Box Elections for Foreign Holding Companies—Timing—Part I

- "Timing the election" can be very tricky—you want to preserve U.S. estate tax protection through foreign corporations (or for the intrepid, partnerships), while at the same time obtaining the best possible overall U.S. income tax result by avoiding PFICs and CFCs.
- CTB election may be effective up to 75 days prior to the filing date, which (hopefully) provides sufficient time to make post-mortem elections.
- Form 8832 now includes a box to check (and explanation section) for late classification elections under Rev. Proc. 2009-41.
Check the Box Elections for Foreign Holding Companies—Timing—Part II

- If the foreign entity in question holds U.S. situs assets, a CTB election effective before death will potentially result in U.S. estate tax.
- If the foreign entity in question does not hold U.S. situs assets, with no U.S. estate tax concerns, consider a pre-death CTB election date to obtain a "free" U.S. income tax basis step-up, purge the company’s accumulated income, and avoid potential post-death CFC/PFIC issues.
- 2010 deaths may provide alternate planning opportunities due to U.S. estate tax avoidance.
Check the Box Elections for Foreign Holding Companies
Timing - Part III

- A post-death CTB election for a potential CFC should be made effective fewer than 30 days after death to avoid potential Subpart F income inclusion issues.
- To avoid potential post-death PFIC issues to the greatest possible extent, consider making the post-death CTB election effective the day after death.
- Consider possible application of IRC §1291(b)(2)(B) for avoiding PFIC "excess distributions" for "first-year PFICs".
- For a "per se" foreign entity, perhaps convert to a non-"per se entity" (e.g., Panama S.A. to Panama S.R.L.) as soon as possible after death, which would be deemed a constructive liquidation of the entity for U.S. income tax purposes.
Effective October 22, 2003, the CTB Regulations were revised to include the following paragraph relating to foreign eligible business entities the U.S. tax classification of which has never been relevant:

"If the classification of a foreign eligible entity has never been relevant...then the entity’s classification will initially be determined pursuant to the provisions of paragraph (b)(2) of this section when the classification of the entity first becomes relevant ..." [see Reg. §301.7701-3(d)(2)
Check the Box Elections for Foreign Holding Companies—Relevance - Part II

- A foreign eligible business entity’s U.S. tax classification is relevant [as defined in Reg. §301.7701-3(d)(1)(i)] when such entity’s classification "affects the liability of any person for federal tax or information purposes"...
- The date that the classification of a foreign eligible entity is "relevant" is the date an event occurs that creates an obligation to file a federal tax return, information return, or statement for which the classification of the entity must be determined
Check the Box Elections for Foreign Holding Companies—Relevance - Part III

- **Example 1**—a foreign entity’s classification is relevant if U.S. income is paid to the entity and the determination by a withholding agent of the amount to be withheld varies depending upon whether the entity is classified as a partnership or as an association, because such classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared.

- **Example 2**—the classification of a foreign entity is relevant on the date that an interest in the entity is acquired where as a result a U.S. person becomes obligated to file Form 5471, 8858 or 8865.
Check the Box Elections for Foreign Holding Companies—Relevance - Part IV

- **Example 1**—a foreign entity’s classification would be relevant if U.S. income was paid to the entity and the determination by a withholding agent of the amount to be withheld varies depending upon whether the entity is classified as a partnership or as an association, because such classification might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file, or how the return must be prepared.

- **Example 2**—the classification of a foreign entity is relevant on the date that an interest in the entity is acquired where as a result a U.S. person becomes obligated to file Form 5471, 8858 or 8865.
Check the Box Elections for Foreign Holding Companies—Relevance - Part V

• It may be possible to form an eligible foreign business entity (e.g., a British Virgin Islands or Cayman Islands corporation), have it purchase a USRPI and avoid U.S. tax classification.

• If the USRPI is sold, the "newly relevant foreign eligible business entity" could file an "initial election" to be classified for U.S. tax purposes as a partnership or disregarded entity (as applicable) effective immediately prior to the sale.

• This election, where applicable, would arguably allow for the beneficial 15% U.S. long-term capital gains rate to apply.
Check the Box Elections for Foreign Holding Companies—Relevance - Part VI

• If a foreign trust holds a USRPI when the settlor dies, the "newly relevant foreign eligible business entity" could either elect its U.S. tax classification or allow the default classification rules to apply.

• If there are multiple foreign owners, a foreign partnership classification could be elected for U.S. tax purposes and, as a result, make a non-U.S. situs asset partnership interest argument.

• On the other hand, foreign corporation U.S. tax classification could be then applicable or elected to avoid U.S. estate tax.
Check the Box Elections for Foreign Holding Companies—Relevance - Part VII

- How can "relevance" be avoided?
  1. The mere holding of a non-income producing U.S. situs asset should not create relevance; however, EMISC 2007-006 seems to disagree
  2. Check the date when the foreign entity was formed to see if the applicable Regulation applies
  3. Check applicable laws and local practice to see if a TIN is required to purchase real estate, make tax filings, or open a bank or financial account
  4. Consider if any applicable treaty benefits will need to be claimed, as Form 8833 may be required
  5. Avoid U.S. person (i.e., U.S. income tax resident or U.S. citizen) ownership in the foreign entity
Check the Box Elections for Foreign Holding Companies—Relevance - Part VIII

- How can "relevance" be obtained?
  1. Open a U.S. bank or financial account and provide Form W-8BEN
  2. Acquire U.S. income producing property—e.g., a USRPI, stock of a U.S. corporation, or a U.S. limited partnership interest
  3. Have a U.S. person (i.e., U.S. income tax resident or U.S. citizen) own 1% or more of the foreign entity
Check the Box Elections for Foreign Holding Companies—Relevance - Part IX

- When is relevance "initially determined"—is the U.S. tax classification of the "newly relevant foreign eligible business entity" "initially determined" as effective from:
  1. the inception of the entity (i.e., the classification is merely clarifying what the entity has always been for U.S. tax purposes); or
  2. the date the entity becomes relevant—but if this date applies, then what was the entity before it was classified for U.S. tax purposes? Could this mean that the "initial determination" is effectively a change in the U.S. tax classification of the entity with related U.S. income tax consequences?
NOMINEE/SHAM COMPANIES
Foreign Holding Company
Nominee/Agent Issues - Part I

• A foreign holding company may be deemed a separate and distinct legal entity for non-U.S. tax purposes, but still not be treated as a separate U.S. taxpayer

• In very limited circumstances, "nominee" or "agent" status may apply (for example) to avoid CFC/PFIC treatment where a CTB election was improperly made or is otherwise unavailable

• Similar concept to Reg. § 1.643(h)-1(a)(1) for "agency" treatment of an "intermediary" receiving a distribution from a foreign trust that is then paid to to a U.S. person

• "After the fact" "nominee" planning probably won’t work

• A different argument than a "sham" entity

• In general, only the IRS can "sham" a taxpayer or a transaction—taxpayers can’t do so
Foreign Holding Company
Nominee/Agent Issues - Part II

• **Unequivocal evidence** is required to prove the existence of a corporate agency agreement—see, e.g., Commissioner v. Bollinger, 88-1 USTC ¶ 9233 (S.Ct. 1988) and Private Letter Ruling 199947006

• Written documentation provides the most preferable means of supportive proof of the alleged facts and circumstances

• An oral agreement *may* be sufficient to establish a nominee arrangement under certain circumstances—Advance Homes, Inc. v. Commissioner, 59 TCM 906 (1990)
Six factors exist to determine if a corporation is acting as an agent for a principal:

1. whether the corporation operates in the name and account for the principal;
2. whether the principal was bound by the actions of the alleged corporate agent;
3. whether the corporate agent transmitted money received to the principal;
4. whether the receipt of income was attributable to assets or employees of the principal;
5. whether the relationship of the corporate agent was dependent on the fact that it was owned and controlled by the principal; and
6. whether the activities of the corporate agent were consistent with the normal duties of an agent.

See, e.g., National Carbide Corp., 49-1 USTC ¶ 9223 (S.Ct.)
The fifth National Carbide Corp. factor requires that an additional three-part test be applied to determine if a controlled corporation will be treated as an agent:

1. whether a written agreement set forth that the corporation acted as agent for its shareholders with respect to a particular asset;
2. the corporation functioned as agent and not as the principal with respect to the asset for all purposes; and
3. the corporation was held out as the agent and not the principal in all dealings with third parties relating to the asset.
Foreign Holding Company
Nominee/Agent Issues - Part V

- Personal holding company status apparently may be avoided by demonstrating that an entity is acting as an agent for a principal—see, e.g., Advance Homes
- Reporting of any and all income by the beneficial owner supports the testimony of a nominee holder of stock that he is not the "real" owner—see, e.g., Berthold v. Commissioner, 12 BTA 1306 (1928)
- Income received by an agent is taxable to a principal at the time of receipt by the agent, rather than at the time of payment by the agent to the principal—Gerling International Insurance Co., 87 T.C. 679 (1986)
- A principal-agent relationship must not merely be an attempt at an assignment of income—see, e.g., National Carbide Corp., and Mone v. Commissioner, 774 F.2d 570 (2 Cir. 1985)
Nominee/Agent Issues - Part VI

• The relationship of the parties in question (e.g. as principal and agent) should be determined under applicable local law. See, e.g., Matut v. Commissioner, 88 T.C. 1250 (1987), Estate of Robert L. Allen, 56 TCM 1494 (1989), and Estate of Larch M. Cummins, 66 TCM 1232 (1993)—therefore, an opinion of local counsel will likely be crucial to support claimed nominee status.

• A purported agency relationship was considered to be a "sham" where the written document was never effective, the actions of the parties were inconsistent, the testimony of the parties was unreliable, and "supportive" documents were created currently to document prior actions only after the IRS had requested copies of them (after previously being told by the taxpayer that they did not exist)—see Ghidoni v. Commissioner, 61 TCM 2993 (1991).
Nominee/Agent Issues - Part VII

- See also:
  
  **New York Guangdong Finance, Inc. v. Commissioner**, 588 F.3d 889 (5th Cir. 2009)

  **Canterbury Holdings LLC v. Commissioner**, T.C. Memo 2009-175


Nominee/Agent Issues - Part VIII

- Failure to follow corporate formalities may help in making a nominee/agent claim, but is generally not sound planning under any circumstances, and can be especially bad in asset protection related situations.
- Written "Declaration of Trust Ownership" and "Nominee Agreement" documents are the best means of proof if the parties actually follow them.
- IRS may claim that even a "nominee" is still subject to reporting on Form 5471 and other U.S. information forms.
UNCOMPENSATED USE OF TRUST PROPERTY
HIRE Act—Uncompensated Use of Trust Property—Part I

• § 643(i)(1) treats a loan of cash or marketable securities by a foreign trust to a grantor, beneficiary, or related person who is a U.S. person as a distribution for non-grantor trust purposes.

• Under §§ 643(i)(1) and 643(i)(2)(E), the same distribution treatment applies to the use of any property of a foreign trust by such a U.S. person to the extent the trust is paid less than fair market value compensation for such use within a reasonable period of time.
HIRE Act—Uncompensated Use of Trust Property—Part II

- For purposes of determining whether a foreign trust has a U.S. beneficiary under § 679, § 679(c)(6) treats a loan of cash or marketable securities or use of any other trust property by a U.S. person as payment from the trust to the U.S. person to the extent such person pays less than market interest on a loan or less than fair market value for the use of trust property within a reasonable period of time.

- Effective for loans made and uses of property after March 18, 2010 (date of enactment)
Form 3520, Part III now requires reporting for uncompensated use of trust property as a "loan" from a foreign trust

"Uncompensated use of trust property. If you, a U.S. beneficiary, or a U.S. person related to you or the U.S. beneficiary, directly or indirectly, received the use of any property of a foreign trust, the FMV of such use will be treated as a distribution to you or the U.S. beneficiary, unless you, the U.S. beneficiary, or the U.S. person related to you or the U.S. beneficiary compensate(s) the trust at FMV for the use of such property within a reasonable period of time..."

- Consider written leases, charters, etc. for use of trust assets, with fair market value payments by the lessee
- Such payments may also be helpful for asset protection purposes to support the "integrity" of the foreign trust
WHAT TO DO IF A US PERSON REFUSES TO COMPLY WITH US TAX PAYMENT OR REPORTING OBLIGATIONS
Typical Situations

• US Settlor
• US Beneficiary
• Stand-alone company
• Personal bank account
Options for Trustees

- Do nothing (not recommended)
- Convince US person to comply
- Resign or otherwise change trustee
- Terminate trust
Section 371 of Title 18 of the United States Code

“If two or more persons conspire either to commit any offense against the United States, or to defraud the United States, or any agency thereof in any manner or for any purpose, and one or more of such persons do any act to effect the object of the conspiracy, each shall be fined under this title or imprisoned not more than five years, or both.”
Contact Information

**Hal J. Webb**  
Cantor & Webb, P.A.  
1001 Brickell Bay Drive Suite 3112  
Miami, FL 33131  
Phone: (305) 374-3886  
Fax: (305) 371-4564  
Email: hal@cantowebb.com  
Website: www.cantorwebb.com

**Abrahm W. Smith**  
Baker & McKenzie LLP  
Mellon Financial Center  
1111 Brickell Avenue, Suite 1700  
Miami, Florida 33131  
Phone: (305) 789-8972  
Fax: (305) 789-8953  
Email: abrahm.smith@bakermckenzie.com  
Website: www.bakermckenzie.com

**Erika Litvak**  
Greenberg Traurig, P.A.  
333 S.E. 2nd Avenue  
Miami, FL 33131  
Phone: (305) 579-0744  
Fax: (305) 961-5744  
Email: litvake@gtlaw.com  
Website: www.gtlaw.com

**Leslie A. Share**  
Packman Neuwahl & Rosenberg  
1500 San Remo Avenue Suite 125  
Coral Gables, Florida 33146  
Phone: (305) 665-3311  
Fax: (305) 665-1244  
E-mail: las@pnrlaw.com  
Website: www.pnrlaw.com
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