Practical Solutions to Deal with the Inconvenience of Having a Family Member Who is a U.S. Person

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The Most Basic Question: Are You Sure The Client is a U.S. Person?

**Income Tax Definition of “U.S. Person”:**
- U.S. Citizen
- Green Card
- Substantial Presence Test

**Estate Tax Definition of “U.S. Person”:**
- U.S. Citizen
- Domicile
Practical Solutions to: “OMG, I am a U.S. Person!”

 Exceptions Applicable to SPT Residents:

- Be certain that the days count for the SPT!
  - Student Visa?
  - Diplomats?
  - Medical Condition?
  - NOTE: Watch out for the special source rules that may cause certain NRAs to be subject to tax on capital gains!
- Closer Connection Tax Home Exception.
- Treaty country residency claim.
  - Consider Section 7701(b)(6) issues!

 Move out of the United States!

- Watch out for Section 7701(b)(10) if you “come back to the U.S. too soon!”
Practical Solutions to: “OMG, I am a U.S. Person!”

 Exceptions Applicable to Green Card Residents:
  - Treaty country residency claim.
    - Consider Section 7701(b)(6) issues!

 Do Treaties work for U.S. citizens?
  - Generally not. The U.S. generally retains the right to tax its citizens as if the treaty were not in force.

 Move out of the United States!
  - This does not result in a loss of RA status, but may allow for a change of domicile!
    - A client must be careful to not have the Green Card revoked!
    - Careful planning to return to the U.S. “enough” for immigration purposes should be considered.

 Expatriate!
  - Have the Client relinquish his or her Green Card.
  - Watch out for Section 877A and Section 2801!
Practical Solutions to: “OMG, I am a U.S. Person!”

◆ Does RA status equate to Domicile for estate tax purposes?
  ▪ If the Client is not a U.S. citizen, Domicile is always a facts and circumstances test!
  ▪ Having a Green Card is only one factor!
  ▪ Try to document non-U.S. domicile as long as possible!

◆ Exceptions to Domicile:
  ▪ Use a Treaty where applicable!

◆ Move Outside of the United States!

◆ Expatriate!
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

I am moving to or already live in the U.S., my NRA/NRAD parents are wealthy, what should I tell them?

Basic considerations:

- An NRA and NRAD is subject to a limited scope of U.S. income, estate and gift taxation.
- An RA is subject to worldwide income tax and a variety of U.S. information reporting.
- An RAD is subject to worldwide estate and gift taxation.
- Thus, when such NRAD has U.S. citizen or RA / RAD children, grandchildren or other U.S. Person family he or she must consider the impact of the U.S. tax laws on his or her estate planning.
Basic Planning Considerations for: “I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

Why is it important to plan for U.S. Person family members?

- Simply put, this planning is necessary so as to avoid unnecessary taxes applying to the U.S. Person beneficiaries, including:
  - Estate Tax;
  - Gift Tax, and
  - Income Tax.

- It is also important so as to help the U.S. Person beneficiaries avoid penalties for failing to meet various U.S. tax and information reporting requirements.
My Family Member is a U.S. Person, Do They Have To File Anything? Consider Community Property.

- Where a client was married and/or the laws of which govern their marriage may determine this to some extent.
- For couples subject to the community property rules of another state or as may be more common in this area, from a foreign country, the practitioner will also need to consider the application of the community property rules for all U.S. tax purposes.
- In very general terms, community property income is allocated to each spouse in equal shares with certain important exceptions. These rules are quite relevant in the event that only one of the spouses is considered an RA while the other of can avoid such status.
- Similarly, for estate tax purposes, the community property rules can also result in a co-ownership of every “marital asset” regardless of how the property may be titled and this may have unintended U.S. estate tax consequences unless such rules are carefully considered and provided for.
  - In addition to considering the community property rules of the “local” jurisdiction, the practitioner must also consider the community property rules (if any) of the “host” jurisdiction.
  - For example, many states like Florida which are not a community property states but separate property states recognize that couples from a community property state or country may acquire property in such separate property state or could even move from a community property state to a separate property state.
My Family Member is a U.S. Person, Do They Have To File Anything? Consider Community Property.

“Community property” is allocated between the spouses as follows:

- Earned income (wages, salary, etc.) is taxed as separate income of the spouse performing the services.
- Community income from a trade or business (other than one carried on by a partnership) and related deductions are income and deductions of the spouse carrying on the trade or business.
- A distributive share of partnership income or loss, if community income, is income or loss of the spouse who is the partner.
- Community income from separate property (other than partnership interests and assets of a trade or business) is income of the spouse who owns the property.
- All other community income is treated as provided under applicable community property laws (typically resulting in a 50/50 split between spouses).
My Family Member is a U.S. Person, Do They Have To File Anything? Forms to be Considered.

- Form 926 applies to certain transfers to FCs.
- Form 5471 applies to U.S. Persons that own interests in certain FCs, and has 4 Categories of people to which it can apply.
- Form 8621 is for PFICs and QEFs.
- Form 5472 is used to report certain information about: (i) a domestic corporation that is 25% foreign owned (as defined below); and (ii) a foreign corporation that is 25% foreign owned (as defined below) and is doing business in the United States.
- Form 8865 applies to U.S. Persons that own interests in certain foreign partnership, and has 4 Categories of people to which it can apply.
- FINCEN 114 (Formerly TD F 90-22.1) is required to be filed by each U.S. Person who has a “financial interest in or signature authority or other authority over a bank, securities, or other financial account in a foreign country, which exceeded $10,000 in aggregate value at any time during the calendar year.” See the IRS FAQ for good overview of the issues relating to this form.
- Form 8938, which is used to report “specified foreign financial assets”
- Consider the specific questions on Form 1040, Schedule B, Part III.
- Form 8858 is required to be filed with respect to certain disregarded entities.
- Form 3520 and Form 3520-A, relating to foreign trust formation and distributions and gifts from foreign people and entities.
- IMPORTANT: Civil and Criminal penalties may be imposed for the failure to file the above mentioned forms!
My Family Member is a U.S. Person, Do They Have To File Anything? Other Considerations.

- Yes, U.S. person children must file tax returns and information forms.
- Community property ownership result in requirements to file forms and pay taxes!
  - Community Property rights do not require filing an FBAR (FINCEN 114)! See the IRS FAQs on this point!
- Joint returns are not allowed for a U.S. Person married to an NRA.
  - This can cause surprise consequences, possibly arising in the AMT computation.
  - Special elections exist to allow for a joint filing, but this needs to be carefully considered.
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

◆ The use of a revocable / grantor trust is a classic example of a planning structure for an NRA/NRAD with U.S. person family.

◆ By having grantor trust status during the lifetime of the settlor:
  ▪ All U.S. income tax consequences, if any, fall on the settlor (this can be structured to be minimized or avoided), and thus no U.S. income tax will apply to distributions to any U.S. Person beneficiary during the lifetime of the settlor;
  ▪ Accumulations of income and capital gains during the lifetime of the settlor can be insulated from U.S. income tax (the “Accumulation Throwback Tax”); and
  ▪ “Family companies” owned by the trust should not be considered to be “owned” by the U.S. Person beneficiaries during the settlor’s lifetime.
Basic Planning Considerations for: “I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- There are several tax benefits to using a trust structure for U.S. Person beneficiaries, and these include:
  - Property can be passed down the generations for extended periods of time free of U.S. gift and estate taxes (hundreds of years in some jurisdictions and indefinitely in jurisdictions allowing “dynasty trusts”). This can be true even if the U.S. Person beneficiary:
    - has the right to all of the income;
    - can invade principal under an ascertainable standard;
    - can change the beneficiaries after his or her death via a special power of appointment; and
    - can receive other distributions in the discretion of the trustee (even to the whole of the trust assets).
  - **WATCH OUT** for §2801, which imposes an “inheritance tax” on U.S. Persons inheriting from a so-called “covered expatriate.” See generally, §§877A and 2801; and
  - Trusts can be structured to avoid U.S. income tax during the lifetime of the settlor and to minimize U.S. income tax issues after the death of the settlor.
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

◆ There are several non-tax benefits to using a trust structure, these include:
  ▪ Avoidance of U.S. (and other jurisdiction) probate!
  ▪ Properly drafted trusts protect the trust property from U.S. Person beneficiaries’ creditors; and
  ▪ Properly drafted trusts protect the trust property from claims by heirs.

◆ Consideration should be given to the non-tax benefits of non-U.S. based trusts
  ▪ Possibly better asset protection.
  ▪ Possible investment benefits (but watch out for PFICs!).
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

• At the death of the NRA/NRAD settlor, it is often recommended that a foreign trust be “domesticated” where there are U.S. Person beneficiaries.
  • Why should a foreign trust become a domestic trust upon the death of the non-U.S. grantor?
    ◆ The short answer is that potential significant adverse U.S. income tax rules (the Accumulation Throwback Tax) may apply.
    ◆ If retaining a foreign trust is desired after the death of the settlor, careful consideration of the relevant U.S. tax rules must be undertaken with the trustee.
  • Does making the trust a domestic trust undo the estate tax benefits?
    ◆ The simple answer is NO.
    ◆ Although income tax benefits of grantor trust status will be lost, the potential application of the Accumulation Throwback Tax, will be avoided.
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- I am a U.S. Person, my NRA spouse is establishing a foreign trust, do I have to worry?
  - Yes, you could be seen as the settlor of the trust to the extent of 50% of the asset contributed.
  - This raises numerous issues (e.g., Form 3520, possible gain on the transfer of the assets, etc.).
  - This also raises issues associated with a joint trust that, without planning, raises concerns that is half grantor / half non-grantor at the death of the first spouse.

- Is there ever a time where one might want to leave the trust offshore?
  - The short answer is yes.
  - Consideration should be given to non-tax reasons for maintaining a trust outside of the U.S., such as asset protection.
  - When this is done, consideration must be given to how to avoid or minimize the Accumulation Throwback Tax issues (discussed herein).
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- Isn’t it getting even harder to have trust and accounts outside of the U.S. where there is a U.S. person involved (even if the NRA / NRAD settlor is still alive)?
  - The short answer is yes.
  - Between offshore banks being petrified over the U.S. OVDP information collection issues and the implementation of FATCA, many banks are turning away U.S. account holders, even where they are just beneficiaries.
  - Also, some NRA / NRAD clients are being very cautious in drafting trusts in order to avoid there being a U.S. Person directly mentioned in documents so as to “try” to avoid FATCA disclosures.
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- Once irrevocable, is there a difference between domesticating a foreign trust by having it change the law and trustee versus it distributing its all of its assets (decanting) to a new domestic trust (possibly a sub-trust)?
  - From an income tax perspective, possibly.
  - **Decanting:**
    - If the IRS views this as a mere restructuring of the trust (like an “F reorganization”) the DNI and UNI of the trust carries over to the domestic trust; however,
    - The IRS could view the decanting of the entire corpus of a foreign trust as the transfer of its assets to a new beneficiary, the domestic trust.
      - This would result in the domestic trust being subject part or all of the distribution to U.S. income tax (to the extent of DNI). The taxation of any UNI would be a more complex issue).
      - Consider if this is the right result if the dispositive provisions have changed.
  - **Change of Situs.**
    - The domestication of a trust in this manner should not create a distribution and the DNI and UNI of the trust should carry over to the domestic trust.
  - There is an argument that the change in law / trustee is not a distribution for any purpose, including having to report under the Form 3520.
Basic Planning Considerations for: “I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- I am an NRA and I have U.S. Person and NRA family members. For various reasons, possibly due to my local laws, I want to establish an irrevocable trust for the benefit of my family from the beginning and not wait for my death. This is easier than this revocable trust planning, right?
  - Wrong! This is actually more complex.
  - Not being revocable limits the ability for us to plan for grantor trust status due to statutory limitations.
    - Grantor trust status is only achieved if distributions during the grantor’s lifetime are to the grantor or the grantor’s spouse.
  - Assuming that grantor trust status is achieved, how are gifts made to children and/or grandchildren during the lifetime of the settlor if the settlor / settlor’s spouse become(s) disabled and is unable to make gifts?
    - Watch out for indirect gifts from foreign entities!
  - No step up in basis at death!
    - Creative use of entities and check-the-box elections may help!
    - Enter into a program of “cleansing” income and assets while grantor trust status is achieved.
Basic Planning Considerations for:
“I have a family member who is a U.S. Person and they aren’t leaving the U.S.!”

- I am from a country that is unfamiliar with the trust concept, what about using a Foundation and not a trust?
The Accumulation Throwback Rules in an Inheritance Context.

- I am U.S. person, my NRA/NRAD parents just passed away and there is a foreign trust for my benefit. How is a foreign trust taxed?
- Distributable Net Income ("DNI") is a key concept!
- DNI serves three functions:
  - It limits the amount of the entity’s distribution deduction;
  - It limits the amount on which beneficiaries are subject to taxation; and
  - It determines the character of amount the entity retains or distributes to its beneficiaries.
- Because DNI measures both the amount and the character of income retained or distributed, it includes income subject to taxation as well as tax-free items and receipts subject to special treatment.
The Accumulation Throwback Rules in an Inheritance Context.

- DNI is defined in §643(a).
  - With respect to any taxable year, the taxable income of the estate or trust computed with modifications, including in the case of a foreign trust (but not a foreign estate):
    - Amounts of gross income from sources without the United States, reduced by any amounts which would be deductible in respect of disbursements allocable to such income but for the provisions of §265(a)(1) (relating to disallowance of certain deductions);
    - Gross income from sources within the United States shall be determined without regard to §894 (relating to income exempt under treaty); and
    - Gains from the sale or exchange of capital assets, reduced by losses from such sales or exchanges to the extent such losses do not exceed gains from such sales or exchanges.
  - Presumably, the DNI of a foreign estate is simply the taxable income of the foreign estate as NONE of the modifications listed in §643(a)(1) through (5) will cause the calculation of DNI to greatly differ from the taxable income of the foreign estate.
The Accumulation Throwback Rules in an Inheritance Context.

- The Accumulation Throwback Rules are contained in §§665 through 668.
- These rules generally apply to the extent a distribution to a U.S. Person beneficiary is made up of Undistributed Net Income (“UNI”) (effectively DNI that is accumulated).
- The Throwback Rules include a “Throwback Tax” (§667) and an interest charge (§668).
- Policy: Limits the potential tax savings of foreign accumulation trusts by subjecting distributions of accumulated income to taxation at the rates which would have applied to the U.S. person beneficiary had the trust distributed such income in the year in which the trust initially received such income.
- Calculation of the Throwback tax and the interest charge is a very complex process and it is conceivable that the Throwback tax, together with the interest charge, could consume a very substantial portion of any Accumulation Distribution received.

♦ If it is determined that the client wants to keep the foreign trust, what planning can be implemented in order to minimize the issues relating to the Accumulation Throwback Rules?

♦ Consider:
  ♦ Carefully managing and choosing investments to find non-income producing assets or income that is not included in DNI (certain tax exempt income);
  ♦ Use of the Three Payment Rule in trust drafting (which does not carry out DNI or UNI);
  ♦ Use of a domestic subtrust (discussed hereafter);
  ♦ A Section 645 election (discussed hereafter); and
  ♦ The use of the Fiduciary Accounting Income limitation (discussed hereafter).

- Assuming that the document allows the creation of a subtrust, the creation of a domestic subtrust may help avoid the Accumulation Throwback Rules.

- In short, the foreign trust would annually distribute its DNI to the domestic subtrust. This would achieve:
  - The domestic subtrust would be the income tax on the DNI so there is no UNI at the foreign trust level.
  - The domestic subtrust could allow for accumulation of income and thus provide additional tax and non-tax benefits.

♦ Can you have an Accumulation Throwback problem if you don’t have a trust for tax purposes?
♦ An election made under §645 will allow a foreign trust to be treated and taxed as part of the foreign estate for all of the tax years of the foreign estate ending after the date of the decedent’s death and before the date that is two years after the date of the decedent’s death or until six months after the final determination of estate tax liability (if an estate tax return is required).
  • Only a foreign trust that is a “qualified revocable trust” may make the §645 election.
  • The §645 election is made on IRS Form 8855, no later than the time for filing the income tax return for the first tax year of the estate (including any extensions). Once the election is made, it is irrevocable.
U.S. beneficiaries to whom a foreign estate distributes its foreign source income are taxed on that income, up to their share of the foreign estate’s DNI. The computation of a foreign estate’s DNI begins with a foreign estate’s taxable income; however, §643(a)(6) does not apply to foreign estates. Therefore, foreign source income is not included in the DNI of a foreign estate. Also, the U.S. Beneficiaries of a foreign estate are NOT taxed on accumulation distributions and, therefore, are NOT subject to the Throwback Rules.

If a foreign estate does not distribute all its DNI (or, for that matter, its taxable income) in a taxable year, the foreign estate alone is taxed on that income. In a subsequent taxable year, when the foreign estate distributes its accumulated income, such accumulated income would not be taxable to the U.S. Beneficiaries.

Furthermore, if a foreign estate makes a distribution of its current taxable income when such taxable income is not included in the foreign estate’s DNI, presumably, such distribution would also be income received tax-free to the U.S. Beneficiary or, at least only be subject to U.S. income tax to the extent of the foreign estate’s DNI for that year.
One potential mechanism to avoid the effect of the Throwback Rules is based on Fiduciary Accounting Income limitation.

- The relevant rule provides that there can be no Accumulation Distribution if the sum of all “amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the income of the trust for such year.”

- For this purpose, the term “income” is interpreted to mean income determined under the terms of the governing instrument (e.g., a trust document) or local law. In other words, the term “income” in the context of a trust or estate generally means “Fiduciary Accounting Income” or “FAI”.

- This rule generally prevents an Accumulation Distribution, even where a trust has UNI, as long as the distributions during a particular year do not exceed the trust’s FAI for that year. It, therefore, provides relief in a year in which FAI exceeds DNI; as a distribution in this circumstance can exceed DNI, to the extent of FAI, without being subject to the Throwback Rules.
Consider the use of a hybrid entity (i.e., a pass-through entity for U.S. tax purposes but a corporation for local law purposes).

- In a structure like this the income earned by the pass-through entity would be taxable income each year to the trust from a U.S. tax perspective, and thus be considered DNI; however,

- it may be that, under local accounting rules and the principles, the income earned by the hybrid entity will not be considered FAI to the trust until the year in which it is actually distributed to such trust.

This planning may be helpful from inception or can possibly be utilized to help take money out of a trust with existing UNI without triggering the Accumulation Throwback Rules.
The Accumulation Throwback Rules in a Pre-immigration Context.

- I am moving to the U.S., my NRA/NRAD parents established an irrevocable trust for my benefit many years ago. Do I have a problem?
- As mentioned above, the Throwback Rules are contained in §§665 through 668.
- For purposes of calculating the Throwback tax, §667(a) seems to direct that one should look at the income tax consequences of a distribution to a beneficiary, not at the time when the beneficiary actually receives such distribution, but when such distribution was deemed made to the beneficiary under §666.
- In essence this sentence states that the beneficiary will be subject to the Throwback tax with respect to an Accumulation Distribution only if the beneficiary would have had to include such distribution in his income had he received the accumulated income in the year in which it was earned by the trust. This conclusion would be quite beneficial to a U.S. person beneficiary who was not a U.S. person during all or part of the “accumulation” period.
- Query: what does this mean if a U.S. Person expatriates? How does it coordinate (if at all) with the “Exit Tax”?
The “CFC” Problem.

- I am U.S. person, my NRA/NRAD parents just passed away and I am inheriting the offshore family investment entities (directly or through a trust). Do I have a problem?
- A detailed discussion of the CFC rules is beyond the scope of this presentation; however, a CFC is any foreign corporation where United States shareholders own more than fifty percent (50%) of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of such corporation.
  - A U.S. shareholder is defined as a U.S. person who owns ten percent (10%) or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation.
The “CFC” Problem.

- In determining ownership, the constructive ownership rules of §318 are applicable with certain modifications.
- Applying these rules, stock owned by a foreign trust is considered as proportionately owned by the beneficiaries of the trust.
- The Subpart F rules are highly complex and a detailed summary is beyond the scope of this presentation; however, Subpart F income generally includes foreign base company income (“FBCI”). FBCI includes, among other types of income, foreign personal holding company income (“FPHCI”). FPHCI includes passive type income such as dividends, interest, royalties, rents, and annuities. FPHCI can also include certain net gains from property, commodities and foreign currency transactions.
The “CFC Problem”: A Case Study.

- Assume that A, an NRA/NRAD, settles a trust ("FT") for the benefit of his U.S. person son, B.
- Further assume that A initially funded a foreign corporation ("FC") (through FT) with $1 million of cash on 1/1/YEAR 1.
- Then, for the next 10 years, FC has income and realized gains of $200,000 per year.
- In addition, certain passive assets in FC have appreciated by $1 million so that at the end of year 10, the FC’s fair market value ("FMV") is $4 million.
- A dies 1/1/YEAR 11.
A’s pre-death basis in FC (via FT) is $1 Million.

At A’s death, assuming the §1014 basis step up applies, FC’s basis in the hands of FT is $4 Million.

FC’s basis in the hands of FT - Basis Calculation:
- Initial contribution ($1 million) + realized income and gain ($2 million) + the appreciation in FC’s passive assets ($1 million).
Further assume that subsequent to A’s death, FC liquidates into FT. The FMV of the assets of FC at the time of liquidation is $4 million.

FC has internal liquidation gain of $1 million.

Such gain would constitute E&P of FC and would be taxable to B as Subpart F income under the CFC rules. B would have to report $1 million of Subpart F income as a result of the internal gain upon liquidation.

B’s Basis in the Assets of FC:
- Subpart F income inclusion ($1 million) + adjusted basis of FC’s assets at the time of liquidation ($4 million)

Note: The FMV of the assets of FC is only $4 million. Thus, B arguably realizes a capital loss of $1 million.
To eliminate the Subpart F income to the maximum extent possible, the settlor and the trustee should continuously monitor the assets of any foreign corporations owned by the trust.

Although appreciation is generally welcomed, excessive unrealized appreciation at the time of the settlor’s death could create problems to any U.S. person beneficiaries.

The cleansing of the trust’s income and the underlying income and unrealized appreciation of any corporation held by the trust is important with regard to increasing the basis of such corporation and the assets held by it.
The “CFC Problem”: Minimizing the Problem: “Cleansing”.

- For example, if the foreign corporation has unrealized appreciation in some of its assets, such assets could be sold and repurchased. Such sales would generate accumulated earnings and profits, and if such earnings and profits are actually or constructively distributed to the trust while the trust is a grantor trust, the settlor will be deemed to have received the income from the trust. While the settlor is an NRA and receives the income from the trust (e.g., dividends from the foreign corporation), the settlor will receive such income free from U.S. income tax. The settlor can then re-contribute such income to the trust as an additional contribution and the trust can then re-contribute such funds to the foreign corporation as additional capital contributions. The trust could thereafter repurchase additional assets (possibly even the same assets). The overriding effect of this “cleansing procedure” is that the settlor’s basis in the assets held by the trust will thus be increased and the appreciation inside the foreign corporation will be controlled. Of course, each situation and in particular the assets of the foreign corporation must be analyzed in order. Although appreciation is generally welcomed, excessive unrealized appreciation at the time of the settlor’s death could create problems to any U.S. person beneficiaries.
The “CFC Problem”: Minimizing the Problem: The “30 Day Rule”.

- As illustrated, the unrealized appreciation that stays within the foreign corporation may result in Subpart F income for purposes of the CFC rules and this income will have to be recognized by any U.S. person beneficiaries.

- On the other hand, this result can be avoided if the foreign corporation is liquidated in a timely fashion following the settlor’s death (i.e., within 29 days of the settlor’s death, assuming the settlor still had NRA status at the time of death). This is because the taxing power of the CFC rules is limited, once the ownership requirement is met, to taxing any U.S. person shareholder who owns stock of the CFC on the last day of the taxable year in which the foreign corporation is a CFC for 30 days or more during such taxable year.
The “CFC Problem”: Minimizing the Problem: The “30 Day Rule”.

- In this regard, we normally suggest that any foreign corporation owned by the trust not formally liquidate (as this often “takes too long”) but instead liquidate for U.S. tax purposes by making the so-called “check-the-box” election if appropriate by timely filing the Form 8832. As a general matter, this allows for an additional 75 days (as a “check-the-box” election can be made retroactively 75 days) to consider the issues (including the “PFIC problem” mentioned below) and make a determination as to the “best date” for the election to be effective.

- In a “perfect world”, a “check-the-box” election could be made effective prior to the date of death of the settlor; however (and assuming the trust was revocable by the settlor for other reasons discussed in this presentation) this would require there to be no (or very nominal) U.S. situs assets held by the entity in order to avoid U.S. estate taxation.

- If a post-death date is chosen, consideration should be given to choosing a date that results in the highest basis to the U.S. person beneficiaries so as to minimize any U.S. income tax gains to them.
On the other hand, it may not be possible to utilize the “30-day rule” effectively in situations where the so-called “check-the-box” election is not available.

However, there may be some alternatives (e.g., consider domesticating the entity and/or the trust to take advantage of “S” corporation status or possibly considering the viability of using the “30 day rule” in the next taxable year).

As a bottom line, this is why planning in advance to utilize entities that are eligible for the so-called “check-the-box” election is important.

Caution: some Congressional proposals would remove the “30 day rule”.
The “PFIC Problem”.

- I am U.S. person, my NRA/NRAD parents just passed away and I am inheriting the offshore family investment entities (directly or through a trust), and that investment entity has investments in offshore mutual funds. Do I have a problem?

- A detailed discussion of the PFIC rules is beyond the scope of this presentation; however, a PFIC is a foreign corporation that meets either a gross income test or an asset test. §1297(a).
  - The gross income test is met if seventy-five percent (75%) or more of the gross income of the foreign corporation for the taxable year is passive, generally defined as any income that would be passive under the CFC rules.
  - The asset test is met if fifty percent (50%) or more of the average value of the foreign corporation’s assets comprise assets that produce passive income or are held for the production of passive income.
The “PFIC Problem”.

- The PFIC provisions apply to actual or constructive distributions made to a U.S. person shareholder (e.g., certain constructive distributions from a CFC).
  - A U.S. person shareholder, for purposes of the PFIC rules, is any U.S. person (e.g., a U.S. citizen) who directly or indirectly (through corporations, partnerships, trusts, and other entities, but not through other family members) owns the stock of a PFIC.
  - Such U.S. person shareholder may be subject to additional tax on the amount of the distribution that constitutes an “excess distribution.”
    - An excess distribution is the excess of the amount of the distributions received by the U.S. person shareholder during the taxable year over 125% of the average amount received in respect of such stock by the U.S. person shareholder during the 3 preceding taxable years.
    - Furthermore, if a U.S. person shareholder in a PFIC disposes of stock in a PFIC, then the PFIC rules of taxation apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution.
  - Complicating this rule even further, the PFIC rules apply to “indirect distributions” and “indirect dispositions” (e.g., a disposition of a PFIC by an actual owner (such as a trust) can result in the indirect owners (e.g., U.S. person beneficiaries of such trust) being subjected to taxation under the PFIC rules).
The “PFIC Problem”.

- TAM 200733024 reflects the Service’s position with respect to a U.S. taxpayer’s “indirect disposition” of a PFIC. As a bottom line, the TAM applied the PFIC rules to a situation where: (1) the “direct owner” (in the TAM, a foreign trust) disposed of PFIC stock; and (2) the ultimate beneficial or “indirect owners” were U.S. taxpayers (in the TAM, certain U.S. taxpayer beneficiaries of the foreign trust). Of primary importance, the Service concluded (among other things) in the TAM that §1298(b)(5), which starts out “Under regulations,” does not require Regulations in order to be applied.

- With the above being said, the TAM demonstrated the Service’s dedication to applying the onerous and burdensome PFIC rules to situations where: (1) the stock of a PFIC is disposed of by its “direct owner”; and (2) the ultimate beneficial or “indirect owners” are U.S. persons. Although we would argue against the Service’s interpretation of several of the PFIC rules (as discussed herein), the TAM has made the Service’s position clear. Thus, advanced planning should be considered so as to avoid adverse consequences to U.S. taxpayer persons that inherit PFICs.
In this regard, an example of how the problem can arise may help. Assume the following:

- Individual X, an NRA and NRAD, has held:
  - Stock of an offshore mutual fund, which X purchased for $1,000,000 and has a fair market value of $1,500,000 on April 1, 2009 (“FUND 1”);
  - an FC holding company (“HoldCo”) that was formed in the British Virgin Islands (where we will assume there is no taxation) funded with $2,000,000.

- HoldCo then subsequently purchased:
  - stock of an offshore mutual fund for $1,000,000, and such stock has a fair market value of $1,500,000 on April 1, 2009 (“FUND 2”);
  - and (b) stock of IBM for $1,000,000, and such stock has a fair market value of $1,500,000 on April 1, 2009.

- X’s three children (C1, a U.S. citizen, C2 a U.S. Green Card holder and C3 an NRA) inherit X’s assets equally and outright upon his death (whether under X’s Will or local law).
- X dies on April 1, 2010.

The following slides summarize this fact pattern.
The “PFIC Problem”: A Case Study.

Basic Fact Pattern

X

HoldCo

FUND 1

$1,000,000 Cost
$1,500,000 FMV

FUND 2

$1,000,000 Cost
$1,500,000 FMV

IBM

$2,000,000 Cost
$3,000,000 FMV

$1,000,000 Cost
$1,500,000 FMV
The “PFIC Problem”: A Case Study.

The diagram illustrates the case study of HoldCo and its investments in FUND 1, FUND 2, and IBM.

- **HoldCo**: $3,000,000 Basis, $3,000,000 FMV, no gain on deemed liquidation. There should be a capital loss if §§1291 and 1298(b)(5) apply.

- **FUND 1**: $1,500,000 Basis, $1,500,000 FMV, no gain on sale.

- **FUND 2**: $1,000,000 Cost, $1,500,000 FMV, $500,000 gain – taxable under §§1291 and 1298(b)(5)?

- **IBM**: $1,000,000 Cost, $1,500,000 FMV, $500,000 gain – not taxable via avoiding CFC status.

**Deemed liquidating distribution resulting from a Check-the-Box Election**:

- **Sale**

**Deemed asset sale resulting from a Check-the-Box Election**: $1,000,000 Cost, $1,500,000 FMV, $500,000 gain – not taxable via avoiding CFC status.
The “PFIC Problem”: Avoiding or Minimizing the Problem.

There are several arguments to help avoid or minimize this result. None of these arguments have been officially approved by the IRS. Consider:

- Does Section 1298(b)(5) require regulations to be issues?
- Interpretation of the attribution rules and the possible accumulation of income inside of a trust (where one is involved), preserving the PFIC tax for when ultimately distributed.
- Use of “indirect owner’s basis” and not the basis of the “actual owner” in an inheritance situation from an NRA. This would be contrary to the Proposed Regulations but would not seem inconsistent with the Congressional intent of the PFIC rules.
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