International Tax Issues for the Domestic Estate Planner

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The World is Getting Smaller – And Clients Are Getting More Global

• Increasing investment by foreign persons in U.S. investments
• International families with cross-border connections, including spouses, children and businesses
• Non-resident non-citizens (otherwise known as “non-resident aliens” or “NRAs”) increasingly look to the U.S.
  • Correct U.S. structuring can minimize tax and provide legitimacy
• Increased international financial transparency mandates correct U.S. and non-U.S. structuring
• Knowledge of the rules can avoid traps for the unwary
Topics

• Jurisdictional Principles
• Transfer Taxation of Non-Domiciliaries
• Income Taxation of Non-Residents
• Taxation of Foreign Trusts
• Taxation of Foreign Corporations
• Foreign Investment in U.S. Real Property
• U.S. Expatriation
• FATCA and CRS
• U.S. Tax Reporting
Preliminary Issue Spotting

• Three preliminary questions:
  • Who is subject to the U.S. Federal estate, gift, GST, and income taxes?
  • Which assets and income are subject to these taxes?
  • Is there an overriding treaty?
Jurisdictional Principles
Who is Subject to the U.S. Estate, Gift, and GST Taxes ("Transfer Taxes")?

• These three types of taxes can be imposed on gratuitous transfers of property

• But they only apply if the testator or donor:
  • Is a U.S. citizen
  • Is a U.S. domiciliary for estate, gift, and GST tax purposes (different than “residency” for Federal income tax purposes); OR
  • Is a non-citizen/non-domiciliary who has certain assets that are situated in the U.S.
Domiciliaries – Subject to U.S. Transfer Taxes

• “Residency” for transfer tax purposes means “Domicile”
• Two requirements for domicile, Treas. Reg. 20.0-1(b) and 25.2501-1(b):
  • Living in a place, even for a brief period of time
  • No definite present intention of leaving the place
• Difficulty in determining intent – Not a black and white test.
Domiciliaries – Subject to U.S. Transfer Taxes (continued)

• Courts look to many factors (highly subjective):
  • Location of residences, other dwelling places, expensive possessions and investments
  • Relative amount of time spent at claimed domicile and other countries
  • Location of family and friends
  • Location of church, business activities and club memberships
  • Jurisdiction of voter’s registration and driver’s license
  • Declarations or statements of residence or intent (visa applications, Wills, trusts, letters, oral statements, tax returns, etc.)
Domiciliaries – Subject to U.S. Transfer Taxes (continued)

- Effect of a green card on intent
  - Green card application requires a statement of the applicant’s intention to stay in the U.S.
  - Case law indicates that holding a green card is not determinative
    - Estate of Nienhuys, 17 T.C. 1149 (1952)
    - Estate of Kahn, T.C. Memo 1998-22
    - Estate of Jack, U.S. Court of Federal Claims, No. 01-410T, filed November 27, 2002
Who is Subject to U.S. Income Taxes?

• Three types of persons are subject to U.S. income tax:
  • U.S. *citizens*
  • U.S. *residents*
  • An NRA, but only on *U.S. source income* or *effectively connected income*
Citizens – Subject to U.S. Transfer Taxes and Income Tax

• Typical ways to obtain U.S. citizenship (*no passport needed*):
  • Birth within the U.S.
  • Birth outside of the U.S. to at least one U.S. parent (subject to certain additional requirements depending on DOB)
  • Naturalization

• Important to ask clients about their citizenship and the citizenship of their family members
“Resident”
Subject to U.S. Income Taxes

• Different meaning than “resident” for transfer tax purposes.

• Ways to be a resident:
  • Satisfaction of the “Substantial Presence Test”
  • Green card holder (determinative)
  • First year election to be treated as a resident under § 7701(b)(4)
  • Spousal election under § 6013(g)
Residents –
Subject to U.S. Income Taxes

• Substantial Presence Test, § 7701(b)(3)
  • (1) Presence in the U.S. for at least 31 days in the test year, and
  • (2) Day count: current year days + 1/3 of prior year days + 1/6 of second prior year days \(\geq 183\) days
  • Green card holder (determinative)

• Certain days do not count (ex. Medical treatment arising while in U.S. and certain visas)

• “Closer Connection” exception under § 7701(b)(3)(B)
Closer Connection Exception

- Even if satisfy substantial presence, if establish:
  - (1) §7761(b)(3)(B) taxpayer spent fewer than 183 days in U.S.
  - (2) Treas. Reg. §301.7701(b)-2 Maintains “tax home” in foreign country where regular place of business, or if none regular place of abode
     AND
  - (3) Has closer connection to another jurisdiction
- Form 8840 if timely U.S. Income Tax to claim closer connection
Closer Connection Exception

- Under residency “tie breaker” provisions of most U.S. income tax treaties, a “U.S. resident” can still be classified as NRA if also “resident” of other country AND treaty tie breaks in other country’s favor.
- Form 8833 – treaty exception claimed by filing.
  - Caveat – could trigger deemed expatriation under §877A.
Transfer Taxation of Non-Domiciliaries
Estate Taxation of NRAs – Overview

• Gross Estate
• Situs Rules
• Deductions
• Credits
Estate Taxation of NRAs – Gross Estate

- Gross estate of an NRA includes only assets “situated” in the U.S., § 2103
- Transfers where §§ 2035 – 2038 is applicable will trigger inclusion in the NRA’s gross estate if the assets are U.S. situs assets at the time of the transfer or at the NRA’s death
  - Planning note: Do not mix U.S. situs assets with non-U.S. situs assets, and consider carefully retaining “strings” in trusts
  - Note § 2104(b) deemed “U.S. Situs” assets.
- Jointly Owned Property – based on contribution
§ 2104(b) – Deemed U.S. Situs

- **Estate of Swan** – 29 TC 829 (1955) – Transfer by NRA to Lichenstein & Swiss Stiftungs – amendable and revocable – were akin to Revocable Trusts
  - Transferred assets includible in NRA’s GE
- **PLR 9507044** –
  - NRA transferred assets to trust – over which NRA retained GPOA.
  - Assets includible in NRAs GE under 2104(b) – despite the fact that trust only owned non-U.S. assets at death.
- FLP 2036 considerations for NRA.
Estate Taxation of NRAs – Situs Rules

- Real Property
- Real Property Interests (leaseholds?, mortgages?)
- Tangible Personal Property – Generally deemed to be situated where located
  - Includes currency, jewelry, furnishings, clothing, collectibles
- § 2105 not U.S. sitused
  - Exceptions for certain artwork on loan, on exhibition or in transit to or from an exhibition
  - Exceptions – Artwork on loan, exhibition or in transit
    - For exhibition purposes – §2105(c)(1)
    - Loaned to pub gallery or museum - §2105(c)(2)
    - “en route” on exhibition - §2105(c)(3)
  - Exception for “in transit” tangibles, Delaney v. Murchie 177 F.2d 444 (1st Cir. 1949)
Treaty Protections

- U.S. has a small number of bilateral estate tax treaties with foreign countries (17 to date)
- Treaty provisions in general override U.S. tax and generally can provide more favorable tax result for eligible NRA
- Intended to avoid double taxation due to mismatches
- Bilateral transfer tax treaties generally allow taxation of intangibles only to country of transferor’s residence
- Bilateral transfer tax treaties generally allow tax credit to transferor in host country for taxes payable to country where property transfer is taxed to non-domiciliaries
Treaty Protections (continued)

• Taxpayer availing of treaty benefits must disclose on U.S. return any position to the contrary under general U.S. tax rules.

• Cannot selectively apply provisions – must apply Treaty provisions globally to all relevant tax items in a year.
Estate Taxation of NRAs – Situs Rules (continued)

• Intangible Personal Property
  • Corporate stock
  • Partnership interests
  • LLC interests
  • Interests in trusts
  • Life insurance proceeds
  • Debt obligations
  • Mutual funds
Estate Taxation of NRAs – Situs Rules – Debt Obligations

- Debt Obligations Generally, §2104(c)
  - Debt obligations are U.S. situs if the primary obligor is a U.S. person under § 7701(a)(30)

- §2105(b) Many exceptions swallow the rule – Not considered U.S. situs if:
  - Certain bank deposits
    - Bank Deposits and CDs with a U.S. bank
    - §2105(b)(2) Deposits held with a foreign branch of a U.S. commercial bank
    - Deposits in a U.S. branch of a foreign commercial bank
  - §2105(b)(4) Certain instruments subjects to OID rules
  - Portfolio Debt (important exception)
Estate Taxation of NRAs – Deductions

• Deduction for Expenses, §2106(a)(1)
  • §2106(a)(1) Deductions are allocated *pro rata*, based on ratio of U.S. assets to non-U.S. assets
  • Generally requires disclosure of worldwide assets on Form 706-NA, otherwise lose the deduction
  • §2106(b) No deductions for debts or expenses associated with property not situated in the U.S.
• Ex. $1,000 estate expense.
  NRAs U.S. Estate = $5M; worldwide Estate = $40M
  Amount deductible: $5M (U.S.) / $40M (worldwide) = .125 x $1,000 = $125
Estate Taxation of NRAs – Deductions (continued)

• Deduction for Debts, §2106(a)(1)
  • Recourse debt – allocated *pro rata*, based on ratio of U.S. assets to non-U.S. assets
  • Non-Recourse debt – full offset so only *net equity* is included in the NRA’s gross estate

• Example: NRA’s only U.S. property is an apartment in NY worth $5 million, subject to a recourse mortgage of $4 million. NRA has $15 million of non-U.S. property. Value includible in NRA’s estate is $5 million gross minus $1 million allocation of the recourse mortgage, or $4 million. This $4 million is **$3 million more** than the net equity in the NY residence. The $1 million allocation of recourse mortgage is calculated as follows:

  \[
  \text{\$4 million} \times \frac{\$5 \text{ million}}{\$20 \text{ million}} = \$1 \text{ million}
  \]

  Gross estate situated in U.S. = $1 million

  $20 million worldwide gross estate
Estate Taxation of NRAs – Deductions (continued)

- Marital Deduction, §2106(a)(3)
  - Only allowed for the *proportion* of U.S. situs assets passing to the surviving spouse (disclosure required)
  - If surviving spouse is a U.S. citizen, there is an unlimited marital deduction
  - If surviving spouse is not a U.S. citizen, property must pass to a Qualified Domestic Trust (QDT) or surviving spouse must be or become a citizen or form a self-settled QDOT before the filing of Form 706-NA. §2106(d)(2)
Estate Taxation of NRAs – Deductions (continued)

• Charitable Deduction, § 2106(a)(2)
  • Generally requires disclosure of worldwide assets on Form 706-NA
  • Contribution must be of property that is included in the NRA’s gross estate
  • Contribution must be made to a domestic charity or a trust (domestic or foreign) that will use the donation within the U.S.
  • No pro rata allocation of the deduction required
Estate Taxation of NRAs – Credits or Exemptions

• §2102(b) True credit of $13,000 (equivalent of ~$60,000 exemption) OR possible treaty option for pro rata amount of unified credit available to U.S. citizens and residents (based on proportion of U.S. situs assets)
  • If they have the option, Execut or’s of estate of NRAs often choose the $13,000 credit to avoid disclosure
  • If no treaty option, consider arguing that the decedent was a U.S. domiciliary (with resulting higher exemption around $11.18M) if assets are mostly U.S. situs (Estate of Kahn) and worldwide assets below applicable exclusion amount
U.S. Estate Tax Exposure
Non-U.S. Citizen Spouse – Transfers at Death

• Transfers to non-U.S. citizen spouse estate taxable unless transfer into Qualified Domestic Trust (“QDOT”) (§2056A)
  • Timely election made
  • Income automatically payable only to surviving spouse
  • Principal payable only to surviving spouse during lifetime
  • Pay-out of principal attracts U.S. estate tax charge
  • Principal remaining at spouse’s death subject to U.S. estate tax
  • Must have one “U.S. Trustee” with the power to withhold the tax imposed on distributions from a QDOT – if assets > $2 million must be a bank or must furnish bond or letter of credit
  • Surviving non-U.S. citizen spouse can “self-settle” a QDOT before the filing date of the decedent U.S. estate tax return (§2056(d)(2)(B))
  • Taxed as part of decedent spouse’s estate
U.S. Estate and Gift Tax Exposure
Non-U.S. Citizen Spouse

• Jointly Owned Property – Trap for the Unwary
  • “Consideration Provided Rule” (§2040(a)) - Full value of property included in the U.S. decedent's estate, except to the extent that estate proves consideration was provided by surviving non-U.S. citizen spouse

• Depends on Type of Property
  • Real Estate – No deemed gift on creation of joint tenancy. May have estate tax consequences. Gift upon sale or severance if divide proceeds
  • Joint Accounts – Deemed gift on purchase of joint property (If non-contributing spouse can “sever” the joint tenancy) under applicable law
Gift Taxation on Transfers by NRAs - Overview

- Situs Rules
- Credits and exclusions
- Deductions
Gift Taxation on Transfers by NRAs - Situs Rules

• Property subject to gift tax
  • Real and tangible personal property **situated in the U.S.**
  • Gift by check? PLR 8210055

• Gifts of U.S. **intangible property** are **not** subject to gift tax under § 2501(a)(2)
  • Debt obligations of a U.S. person
  • Stock of U.S. corporations

• Planning Point - Better to gift U.S. intangibles during life (gift tax-free) because if held until death they will be included in the estate of a non-domiciliary
Gift Taxation on Transfers by NRAs – Credits and Exclusions

• No unified credit available
• § 2513(a)(i) – No gift splitting unless both spouses are U.S. citizens or residents
• § 2522(b) Charitable deduction allowed for U.S. charities or trust using assets in the U.S.
• Limited marital deduction for gifts to non-citizen spouses § 2523(i)
  • No lifetime QDOT available
  • Increased annual exclusion allowed ($152,000 for 2018) to non-citizen spouse
GST Tax on Transfers by NRAs

- **Direct Skips** – Subject to GST tax only to the extent that the transfer is subject to estate or gift tax. Reg § 26.2663-2(b)(1)
- **Taxable Distribution or Taxable Termination** – Subject to GST tax only to the extent that the initial transfer by the NRA to the trust was subject to estate or gift tax. Reg § 26.2663-2(b)(2) See: PLR 200123045
- **GST Exemption** – Same as for U.S. citizens and residents (approximately $11.18 million for 2018)
- Automatic exemption allocation rules apply
- Tax is imposed at the highest rate in effect at the time of the transfer (i.e. no marginal rates)
Which assets are subject to the GST tax?

- Situs rules at time of transfer control
  - A transfer by a non-domiciliary transferor is a “Direct Skip” subject to GST Tax only to the extent that the transfer is subject to federal estate or gift tax (Treas. Reg. §26.2663-2(b)(1))
  - The GST Tax applies to a “Taxable Distribution” or a “Taxable Termination” to the extent that transfers of property to the trust was subject to U.S. federal estate or gift tax (Treas. Reg. §26.2663-2(a)(2))
- Planning Opportunities / “Remaining Out of the Net”
  - Gifts of U.S. intangibles avoid GST Tax in addition to Gift Tax and Estate Tax
  - Generally, as long as there is no estate or gift tax on the transfers into the trust, there is no GST Tax on transfers out of the trust
Income Taxation of Non-Residents
Income Taxation of NRAs

• U.S. source Fixed or Determinable, Annual or Periodical ("FDAP") income
  • Includes U.S. source interest, dividends, rents, salaries, wages, annuities and debts
  • Generally does not include portfolio debt
  • 30% withholding on FDAP, subject to treaty benefits

• Income “effectively connected” to a U.S. trade or business ("ECI")
  • Income derived from a U.S. trade or business
  • Generally taxed on a net basis, at regular graduated rates
  • Treaty benefits may be available
Income Taxation of NRAs (continued)

• FIRPTA
• Generally not subject to tax on capital gains unless effectively connected with a U.S. trade or business or unless sale takes place in a year in which NRA is physically present in U.S. for 183 days or more.
FDAP

- Subject to a **flat 30% gross** tax unless reduced by treaty
- **No deductions**
- Typically satisfied through **withholding at source**
- Includes dividends, rents, royalties and other investment income
  - **Note**: virtually all capital gains are excluded and interest income is rarely taxed as FDAP (due to portfolio and bank interest exceptions as well as relevant treaty provisions).
  - **However**: an additional withholding tax may apply to FDAP income or the gross proceeds upon the sale or disposition of FDAP producing assets unless certain additional reporting requirements are met under FATCA.
Effectively Connected Income

- ECI – Net tax at graduated rates applicable to individuals or corporations
- Requires a foreign person to have a U.S. trade or business (USTB) or an investment in a pass-through entity that has a USTB
- Only income effectively connected to the USTB is taxed
- Deductions and credits against available ECI only if a tax return is timely filed (subject to a good faith exception)
Effectively Connected Income (continued)

• Under §864(c)(8) as added by the 2017 Tax Act, a NRA who sells an interest in a pass-through entity which engaged in a USTB must treat a portion of the gain as ECI. The portion treated as ECI is that portion of the gain the NRA should have been taxed on if the pass-through entity had sold all of its assets at fair market value on the date of the NRA’s sale.
FIRPTA – Foreign Investment in Real Property Tax Act

• Enacted in 1980 to eliminate the perceived tax advantage of foreigners purchasing U.S. real property
• FIRPTA applies to U.S. real property interests, other than interests solely as a creditor (“USRPI”)
  • Also applies to U.S. real property holding corporations (“USRPHC”) if more than 50% of the FMV of the corporation over five years is USRPI
  • Certain exceptions to USRPHC: publicly traded companies, certain REITs, etc.
FIRPTA – Foreign Investment in Real Property Tax Act (continued)

- Gain on the disposition of USRPI is treated as ECI
  - Must file a U.S. income tax return and pay tax on a net basis at graduated rates
  - Transferee must withhold 15% of gross sale proceeds (not on the gain), unless an exception applies

**Exceptions:**
1. Sale of Residence $300k or less = 0% (if purchase to use as residence)
2. Sale of Residence over $300k but less than $1M – 10%
   *Can apply for lower rate
Taxation of Foreign Trusts
Trust Status – Four Quadrants to Classify Trusts

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<th>Domestic</th>
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<td>Grantor</td>
<td>Non-Grantor</td>
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- Four resulting types of trusts:
  - Foreign Grantor Trust (with Foreign Grantors; with U.S. Grantors)
  - Foreign Non-Grantor Trust
  - Domestic Grantor Trust
  - Domestic Non-Grantor Trust
“Foreign Trust”

- A trust is a “Foreign Trust” (§7701(a)(31)) unless:
  - A Court within U.S. exercises **primary supervision** over administration of the trust (the “Court Test”); **and**
  - One or more U.S. persons have authority to control **all substantial decisions** of the trust (the “Control Test”)
  - If a trust fails **either** test the trust is a Foreign Trust
Taxation of Foreign Non-Grantor Trusts

- Income taxation of the trust
  - Taxed as if the trust were an NRA under income tax rules (so only taxed on FDAP or ECI)
  - Difference in treatment of capital gains – for purposes of the 183 day rule, foreign trusts are treated as not present in the U.S. at any time.
- Income taxation of NRA beneficiaries
  - Trust is a conduit, so all items of income are carried out with the same character to each beneficiary, pro rata
- Income taxation of U.S. beneficiaries
  - Distributions carry out DNI; DNI includes capital gains
  - Distributions in excess of DNI are subject to the “throwback rules”
  - Accumulated long-term capital gain income and dividend income are taxed at ordinary rates
Taxation of Non-Grantor Trusts and U.S. Beneficiaries

- U.S. taxation of foreign trusts is limited to U.S. source income.
- DNI of a foreign trust includes worldwide income and gains.
- Trust is allowed to deduct amounts paid to beneficiaries.
- U.S. beneficiary is taxed on amount paid to the extent of DNI and UNI, but, in the case of UNI, only to the extent the trust distributions for the year exceed FAI.
- The character of income is a proportion of the character of the income included in current DNI and any UNI deemed distributed is taxed as ordinary income.
Accumulation Distributions

- Accumulation distributions are distributions that exceed the greater of DNI and fiduciary accounting income.
- A payment that is not a “distribution” (e.g. a payment to a charity or a gift of a specific sum) is not an accumulation distribution.
- Separate share rule applies.
- An accumulation distribution is taxed as ordinary income; the character of the income (except for tax-exempt income) does not affect the character of an accumulation distribution (subject to an exception for accumulation distributions to a NRA).
Example

- Foreign non-grantor trust requires payment of 75% of income to Bruce for life. Balance of income is accumulated. On Bruce’s death, 50% of the trust is payable to Bruce’s U.S. children and 50% is payable to a Bruce’s foreign charitable foundation that has not filed for tax-exempt status in the U.S.

- On Bruce’s death, the amount paid to the foundation may qualify for a deduction under section 642(c), but even if it does, the deduction only offsets income for the year of payment and the prior year, but all of the UNI is allocable to Bruce’s children even though they only receive 50% of the remainder unless 50% of the trust is treated as a “separate share.” Consider actually dividing the trust.
Foreign Non-Grantor Trusts – Distributions to U.S. Beneficiaries

• Indirect Distributions
  • Distributions to a U.S. person made through an intermediary are treated as if they were made directly from the foreign trust to the U.S. beneficiary, if for the *principal purpose of tax avoidance*

• Use of Property
  • Use of personal property (residences, jewelry, artwork) is deemed to be a distribution unless rented for fair market value

• Loans to a U.S. Person
  • Loans of *cash or securities* to a U.S. beneficiary, U.S. grantor or U.S. persons related or subordinate to the beneficiary or grantor are treated as *distributions*
  • Exception for loans satisfying certain requirements of IRS Notice 97-34
Taxation of Non-Grantor Trusts and U.S. Beneficiaries - Exceptions

- Beneficiary is not taxed on amounts distributed in satisfaction of a gift of a specific sum or specific property.
- Distributions of property carry out income only to the extent of basis unless the trustee elects under section 643(e) to recognize gain.
- Separate shares of a trust are treated as separate trusts and carry out only DNI and/or UNI allocable to the separate share.
- Distributions to a charity are deductible only as provided in section 642(c).
- Divisions of a trust are not distributions.
Throwback Rules

• Throwback rules apply whenever a distribution of accumulated income from a prior year is made in excess of the greater of current year’s DNI or the current year’s trust accounting income.

• Draconian rules aimed to recapture tax that was deferred offshore
  • Prior accumulations treated as income
  • Capital gains and dividends are taxed as ordinary income
  • Interest charge based on accumulated income from past years
Exact and Default Methods of Calculating Throwback Tax

• Exact Method
• Default Method
  • Protects beneficiary from throwback tax if amount of her distribution in a particular year is no more than 125% of the average distributions she received over the previous three years.
  • Advantages
  • Disadvantages
  • Why UNI should be segregated before making default election
Example

• Foreign non-grantor trust has assets worth $20m including a valuable residence that will be sold in 2018. Trust is for the life of Cathy, a NRA, for life and remainder to 2 U.S. children. Trust has UNI of $5 m.
• Upon realization of gain of $3m, trust will distribute amount equal to gain to a U.S. trust in a state that has no income tax. U.S. trust elects default method in 2019. It receives distributions of $1,250,000 in 2019, $1,770,833 in 2020, and $2,508,680 in 2021. These distributions will be classified as current income and will exhaust UNI (including DNI generated in years 2019 through 2021). The trust continues to make distributions equal to each year’s DNI to other beneficiaries. In year of Cathy’s death, trust distributes remaining assets to U.S. trust. U.S. trust will convert to exact method and take the position that there is no UNI.
Limitations on Reach of these Rules

- Grantor is not an intermediary
- If a trust migrates into the U.S. the rules cease to apply
- Note that the throwback tax will continue to apply to a migrated trust.
Section 645 Election

- A section 645 election may allow the same consequences as a basis step up because gain is not necessarily included in the DNI of an estate and, if the estate is foreign, U.S. tax will not be imposed on gains in most cases. Even if assets are not sold, a section 643(e) election can be made.

- However, the usual rules apply concerning when gain is included in DNI, e.g. in the year of termination.

- Termination of the 645 election is deemed to trigger a deemed distribution to the trust, and the election terminates 24 months from date of death.

- Estates can elect fiscal years to make sure that gain is not incurred in the final year of the estate.
Example

- NRA dies March 1, 2011 and foreign trust elects to be taxed as a foreign estate under section 645. Estate elects a July 1 FYE. On July 1, 2011, DNI is $100. On June 1, estate distributes $50,000 of assets to Alice that have a basis of $5 and elects to treat it as a sale. Gain of $45,000 is not taxed to estate. Alice is taxed on $100.

- Is estate foreign?

- If one of the assets was stock of a foreign company that was a CFC or a PFIC, if Alice is treated as the indirect owner, gain is taxed to Alice and not to the estate.

- If Alice receives stock of FC X and FC X owns shares of FC Y, the shares of FC Y are not adjusted.
Converting Complex Trust to a Grantor Trust

• If the grantor is alive:
  • resettlement;
  • decanting to a new grantor trust;
  • serial decanting.

• If the grantor is deceased: consider granting a general power of appointment to a NRA beneficiary who will exercise the power (possibly with consents of an independent party) to fund a new grantor trust.
Other Strategies

- Isolate UNI in a separate “accumulation trust.”
  - Is it a distribution or a division?
  - Is the accumulation trust part of the distributing trust (section 643(f), the multiple trust rule)?

  “For purposes of this subchapter, under regulations prescribed by the Secretary, 2 or more trusts shall be treated as 1 trust if –
  
  - (1) such trusts have substantially the same grantor or grantors and substantially the same primary beneficiary or beneficiaries, and
  
  - (2) a principal purpose of such trusts is the avoidance of the tax imposed by this chapter.

For purposes of the preceding sentence, a husband and wife shall be treated as 1 person.
Example

Trust A was funded by Albert, who is deceased, for the primary benefit of Beth, who is a NRA. Beth has 5 children, two of whom are U.S. taxpayers. Trust A has a value of $100m and UNI of $20m. Trustee decants $20m to accumulation trust (Trust B). Future income of Trust A that is not distributed in the year earned is payable to Trust B. Upon Beth’s death, assets of both trusts are distributable to Beth’s children in such shares as Beth appoints. Beth directs that 1/5 of the combined trusts be paid to each child but that U.S. children’s shares be paid first from Trust A.

- Consider varying terms of Trust B. For example, its beneficiaries could be limited to Beth’s NRA children.
FNGT Accumulation Distributions

• Avoid throwback rules by:
  • Distribute DNI currently
  • Structure Trust to qualify for “3 gift rule”
  • Using Total Return Trust – Manipulate FAI vs. DNI
  • Using offshore Private Placement Variable Universal Life (“PPVUL”)
  • “Carve-off” undistributed net income (“UNI”) to a new foreign trust and the remainder of the trust can make distributions to U.S. beneficiaries
  • “Default Method” three-year rolling average
  • Migrate Trust to U.S.
  • Preferred Partnership
Other Methods of Avoiding Throwback Tax

- Use grantor as an intermediary
- Use the fiduciary income exception
- Make stripping distributions
- Isolate UNI in a separate accumulation trust.
- In-kind distributions
- Gifts of specific sum or specific property
- Bunch income and switch to default method
- Migrate to the U.S.
- Trust to trust loans and purchase of life insurance as an accumulation vehicle.
Grantor Trust Solution

• If a NRA is treated as the owner of a trust under the grantor trust rules, distributions to U.S. beneficiaries are not taxed because the trust’s income is treated as owned by the grantor.

• A NRA is taxed as the owner if the trust is
  • Revocable
  • Solely for grantor and/or spouse
  • Compensatory
  • Grandfathered (9/19/95)
Grantor Trust Status for Foreign Grantors

- Section 672(f) - special grantor trust rules apply to trusts with non-U.S. grantors
- For non-U.S. grantors, there are generally two ways to create “Grantor Trust” status:
  - The grantor has the power to revest the property in himself – can require the consent of a related or subordinate party (power of revocation), or
  - Distribution of income or principal can only be made during the grantor’s lifetime to the grantor or the grantor’s spouse
Foreign Grantor Trust Planning

- If Section 672(f) requirements are satisfied, substantial opportunities for efficient tax planning for U.S. beneficiaries.
- As all income is taxable income of foreign grantor – U.S. beneficiaries can receive distributions free of tax.
- Foreign grantor only taxed on ECI or U.S. source FDAP, so trust can invest in the U.S. and generate capital gains (excluding FIRPTA gains) and interest income, as well as non-U.S. income, without incurring an income tax burden in the U.S.
- Can be U.S. transfer tax free if properly structured.
- Planning necessary with respect to estate and income tax consequences following grantor’s death.
Foreign Grantor Trust Planning (continued)

• May not be obvious: grantor can revest by exercising powers held in a fiduciary capacity; or grantor could have been added as a beneficiary to a pre-’95 trust; or contributions after ’95 (much) later separately accounted for.

• Regulations further narrow circumstances in which NRA will be treated as the owner: amendment of an irrevocable trust to make it revocable, or to exclude a beneficiary other than the grantor and/or the grantor’s spouse will not cause a trust to become a grantor trust.

• Section 678 is not applicable to a NRA, unless, perhaps, the NRA created the trust.
Planning when Foreign Grantor Dies

• Benefits of Foreign Grantor Trust cease when Grantor Dies; trust becomes a Foreign non-Grantor Trust.
• Consider leaving trust in place as Foreign non-Grantor Trust to take advantage of U.S. tax deferral
  -or-
• Plan to avoid the Throwback Rules and reporting requirements
  • Consider purging DNI each year (outright or to a “mirror” U.S. trust)
  • Consider domesticating the foreign trust
Estate Tax Exposure of Grantor Trusts

- Section 2104(b) imposes estate tax on trusts that are includable in the estate of a NRA as a consequence of a retained interest or power.
- Tax is limited to “U.S. situs” assets.
- Use of foreign corporations as a “shield” against U.S. estate tax; as discussed below, CTB elections may be made to eliminate the foreign corporation after death of NRA grantor.
Step-up in Basis

- Section 1014(b)(2) and (3) allow a basis step-up for a trust that gives grantor the right to income and the power to revoke or alter beneficial enjoyment.
- Such trusts will not necessarily qualify as grantor trusts for NRA grantors.
- Revocable trusts should qualify under both rules
- Irrevocable trusts designed to qualify under section 1014(b)(3) should limit income payments to the grantor and the power to alter beneficial enjoyment to testamentary powers of appointment.
Check–the-Box Elections and Basis Adjustments

• What is a CTB?
• Is a CTB allowed? Who makes the election?
• How is the election made?
• What is the effective date?
• Estate and income tax consequences of the election to a grantor trust owned by an NRA.
• Estate and income tax consequences if the trust is not a grantor trust.
Example of CTB Election Used to Increase Basis

- Mary is NRA. Her foreign trust is revocable and owns low-basis U.S. securities. She would like to protect securities from U.S. estate tax and arrange for a basis step-up at her death.
  - Immediately after Mary’s death, a check-the-box election is made for Corp. C, effective the day before her death.
  - Within 75 days after Mary’s death, a check-the-box election is made for Corp. A and Corp. B, effective the day after her death.
Overview of Tax Hurdles

- Historic Deferral Opportunities
  - Foreign holding companies
  - Foreign trusts
- Section 679 for U.S. grantors of certain foreign trusts
- Section 684 for transfers by U.S. persons to foreign non-grantor trusts
- Anti-Deferral for foreign holding companies – CFCs and PFICs
Section 679 – Foreign Grantor Trusts - U.S. Grantor

• **U.S. person** who transfers property to a **foreign trust** will be treated as the owner of the portion of the trust attributable to that property if:
  
  • (i) the trust is an inter vivos trust; and
  • (ii) there is a current, future or contingent **U.S. beneficiary** of any portion of the trust
    • Trust agreement should specifically identify class of persons who can receive distributions
    • Presumption of a U.S. beneficiary for new trusts unless information is submitted to the IRS
  
• Five-year look-back period for transfers in trust by a foreign grantor who became a U.S. person
Section 679 –
Foreign Grantor Trusts - U.S. Grantor (continued)

• Section 679 creates a potential trap for the unwary
  • **Loans** of cash or securities by a U.S. person to a foreign trust with U.S. beneficiaries is treated as a **contribution**, triggering grantor trust status
  • Loss of grantor trust status (e.g. no more U.S. beneficiaries) under Section 679 would trigger Section 684
Section 684 – Transfers by U.S. Persons to Foreign Non-Grantor Trusts

- A U.S. person will recognize gain (**but not loss**) on transferring property to a foreign trust or estate unless the transferor is treated as owner of the trust for grantor trust purposes.
  - **Indirect transfers** through certain third parties
  - **Constructive transfers** – paying or assuming an obligation of the trust, or certain guarantees of an obligation of the trust
- Applies only if another person is not treated as the owner of the foreign trust
- Does not apply to assets passing at death that are includible in the transferor’s estate
Taxation of Foreign Corporations
Foreign Holding Companies

• **Common Scenarios:**
  • Estate tax “blocker” for foreigners with U.S. assets
  • Investment holding vehicle in offshore structures
  • Local tax planning
  • Foreign operating business
Foreign Holding Companies (continued)

• **Key Considerations:**
  - Entity classification and effect on:
    - U.S. estate tax exposure
    - U.S. income tax efficiency
    - Reporting requirements
  - Potentially onerous reporting requirements generally
  - Application of complex tax rules under the “controlled foreign corporations” (CFCs) or “passive foreign investment companies” (PFICs) regimes
  - Potentially punitive taxes
Entity Classification Generally

- **Classification as a corporation for U.S. tax purposes:**
  - On an inbound basis:
    - Should function as “blocker” of U.S. situs assets for U.S. estate tax purposes
    - Functions as “blocker” of ECI
    - Can help to manage “Branch-Profits Tax” (“BPT”) and FIRPTA withholding
  - On an outbound basis:
    - Baseline rule is that U.S. persons are subject to tax only when foreign corporation makes a distribution or is sold, but CFC or PFIC rules may apply
    - Generally only permits for deduction of foreign taxes paid within corporate solution
Entity Classification Generally (continued)

- **Classification as a pass-through entity for U.S. tax purposes:**
  - On an inbound basis:
    - Probably not an effective “blocker” of U.S. situs assets for U.S. estate tax purposes
    - Can allow for LTCG rates if owned by individual(s)
    - Generally treats individual owners as direct participants in underlying activity – can result in significant U.S. tax and reporting obligations for individual owner if entity owns FIRPTA or ECI assets
  - On an outbound basis:
    - Pass-through taxation
    - Generally allows for crediting of foreign taxes paid within pass-through solution
Entity Classification – Deduction versus Crediting of Foreign Taxes – Hypothetical

**CORPORATE TAXATION**
1) $100 profit generally not subject to current U.S. taxation (unless special rules apply)
2) $30 corporate tax reduces taxable income
3) $70 treated as dividend income
4) $5 dividend withholding tax generally creditable by U.S. individual
   - In sum:
     - $70 taxable income
     - $5 creditable foreign taxes
     - Assuming marginal tax rate of 37%, total taxes on profits is 44% (if QDI) or 55.9% (if not QDI)
     - Possibility of deferral

**PASS-THROUGH TAXATION**
1) $100 profit generally treated as income item of U.S. individual
2) $30 corporate tax generally creditable by U.S. individual
3) $70 distribution generally not tax-relevant to U.S. individual unless distribution exceeds basis
4) $5 dividend withholding tax generally creditable by U.S. individual
   - In sum:
     - $100 taxable income
     - $35 creditable foreign taxes
     - Assuming marginal tax rate of 37%, total taxes on profits is $37
     - No deferral

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**Diagram**

- **Foreign Income**
  - $100 profits
  - $70 distribution
  - $5 dividend withholding
  - $30 corporate tax

- **Foreign Company**
  - $100 profits
  - $30 corporate tax

- **U.S. individual**
  - $65 cash
  - $5 dividend withholding

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Controlled Foreign Corporations
Identification and Consequences

• Controlled Foreign Corporations

  • **CFC Test**: A CFC is a foreign corporation that is greater than 50% owned in the aggregate by U.S. persons each owning at least 10% of the vote or value (i.e., a “United States shareholder”)

    • The test for being treated as a “United States shareholder” was broadened under the TCJA from U.S. persons owning at least 10% vote to U.S. persons owning at least 10% of vote or value.

    • Prior to TCJA, no CFC income inclusion unless foreign corporation was a CFC for an uninterrupted period of 30 days or more during the taxable year and the U.S. Shareholder owned stock in the foreign corporation on the last day of such taxable year. TCJA eliminated this requirement.
Controlled Foreign Corporations (continued)

Identification and Consequences

- **CFC Consequences**: United States shareholders are subject to current taxation at ordinary income tax rates on their proportionate share of certain categories of income generated by the CFC, even if not distributed from the CFC to the shareholder.
  - TCJA expanded the categories of CFC income subject to current taxation
  - Onerous reporting requirements also apply
Controlled Foreign Corporations (continued)
Identifying United States Shareholders

- Important questions:
  - Identify United States shareholders, if any
  - Do these shareholders own greater than 50% of the vote or value?

- Identifying value should be straightforward

- Identifying “voting power”
  - Generally measured by proportion of board directors (or similar persons) that can be elected by shareholder

- Direct, indirect and constructive stock ownership rules apply
  - Foreign stock owned by an entity generally is treated as owned proportionately by the equity holders.
Controlled Foreign Corporations (continued)
Identifying United States Shareholders

• Section 318(a) attribution rules, with some modifications, apply to determine constructive ownership

• Generally no attribution from foreign persons to U.S. Persons, but TCJA expanded attribution rules to allow for downward attribution from foreign persons to U.S. Persons
Controlled Foreign Corporations (continued)
Subpart F Income

• Subpart F income defined by reference to different categories of income. Generally either (i) passive income or (ii) active income generated from related party transactions.

• Key categories of Subpart F income include, among other things:
  • Foreign personal holding company income (FPHCI) – Passive income, such as interest, dividends, rents, royalties, certain capital gain, etc.
  • Foreign base company sales income - Income derived from personal property transactions with related parties, when property not produced or sold for use in CFC’s country
  • Foreign base company services income - Income from certain services performed for or on behalf of related person outside CFC’s country

• De minimis exception applies
Controlled Foreign Corporations (continued)
Exceptions and Limitations to Subpart F Income

- Subpart F income limited to CFC’s current year E&P
- Effectively connected income (to a U.S. trade or business)
- “Same country” exceptions for product sales and services
- Income subject to foreign tax at a rate greater than 90% of highest U.S. corporate tax rate (i.e. > 18.9% currently because corporate rate reduced to 21%)
- “Look-through” rule excludes from Subpart F Income certain income received from a related CFC that itself is not generating Subpart F income (e.g. rental income paid by related CFC that itself does not generate Subpart F income)
Controlled Foreign Corporations (continued)

Global Intangible Low-Taxed Income (GILTI)

- New category of income established by the TCJA that is currently includable in the income of a United States shareholder of a CFC, similar to Subpart F income.
- GILTI generally is equal to:
  - Net CFC income (excluding Subpart F income, certain income excepted from Subpart F and ECI) reduced by
  - A specified return (10%) on the CFC’s adjusted basis in depreciable assets generating the income at issue.
- Expansion of historical CFC rules because a portion of active income and unrelated party income is now subject to current income taxation.
TCJA – One-Time Deemed Repatriation

• The TCJA establishes a 100% Dividends-Received-Deduction ("DRD") for the foreign-source portion of dividends from non-U.S. corporations with 10%-U.S. corporate owners (not just CFCs) to a U.S. corporation.

• In connection with this rule, TCJA established a one-time repatriation of post-1986 E&P of CFCs and non-U.S. corporations with a 10%-U.S. corporate owner.

• E&P is taxed at 15.5% - 17.54% for E&P invested in cash and cash equivalents, 8% - 9.05% for all other E&P.
  • Election available to pay over eight year period
TCJA – One-Time Deemed Repatriation (continued)

• Applies to all United States shareholders (under the pre-TCJA test), both corporations and individuals.
• Applies for the last taxable year of the non-U.S. corporation beginning before January 1, 2018
Controlled Foreign Corporations (continued)
Inheritance Planning

• Upon death of NRA, it is important to consider whether shares in a foreign corporation that will pass to U.S. beneficiaries will cause such corporation be a CFC.

• If the foreign corporation is an “eligible entity” one must consider whether a “check-the-box” election is advisable to treat the foreign corporation as a pass-through entity for U.S. tax purposes.

• “Check-the-box” election is treated as a deemed liquidation of the entity.
Controlled Foreign Corporations (continued)
Inheritance Planning (continued)

• Election can be retroactive within 75 days of filing.
  • Procedural questions regarding required signatories to election – estate representative probably required signatory
  • Election effective before death should achieve basis step-up, but risks loss of estate tax “blocker” status
  • Election effective after death should achieve basis step-up, but risks taxation under CFC rules
Passive Foreign Investment Companies

• Passive Foreign Investment Companies (PFICs)
  • a foreign corporation is a PFIC in a year where (i) 75% or more of its gross income for a taxable year is “passive income,” or (ii) at least 50% of its assets (on a quarterly average) produce or are held for production of “passive income”
  
• Taxation occurs only on actual distributions or dispositions, absent an election to be treated as “Qualified Electing Fund”
  
• Draconian rules on “excess distributions” and upon disposition of PFIC shares: (i) subject to an interest charge on tax deferral and (ii) deferred income taxable at highest tax rates, regardless of underlying character in a manner similar to foreign non-grantor trust distributions
Passive Foreign Investment Companies (continued)

- Yearly reporting requirements
- CFC rules take precedence over PFIC rules with respect to a specific shareholder.
- “Passive Income” defined with reference to “foreign personal holding company income” of a CFC.
  - dividends, rents, royalties, rents and annuities and gains on sale of assets producing such income
- No threshold percentage ownership requirement for PFIC treatment (ex. 1 percent owner still subject to PFIC rules).
Passive Foreign Investment Companies (continued)

• Stock held by a non-U.S. corporation generally is a passive asset, but “look-through” rule applies where that entity owns (directly or indirectly) at least 25% of the corporation. In such case, the entity is treated as owning a proportionate share of the 25%-owned corporation’s assets, which may be active or passive assets.

• Exceptions to FPHCI and passive income for rents and royalties from active conduct of a trade or business received from non-related person.
Passive Foreign Investment Companies (continued)

• Gray area for rents:
  • Considered derived in the active conduct of a trade or business if, in most cases, arise from “active and substantial management and operational functions”
  • Passive collection of rents and finding tenants is not “active and substantial management”
  • “Rafferty approach” - inquiry is whether corporation’s activities qualitatively and quantitatively distinguishable from holding a passive asset.
  • need more than “merely collecting rents, paying taxes, and keeping separate books.”
Passive Foreign Investment Companies (continued)

• Tax Regime
  • The term “excess distribution” means the excess (if any) of
    • the amount of the distributions in respect of the stock received by
      the taxpayer during the taxable year, over
    • 125 percent of the average amount received in respect of such
      stock by the taxpayer during the 3 preceding taxable years (or, if
      shorter, the portion of the taxpayer’s holding period before the
      taxable year).
  • In general terms, the “excess distribution” is allocated ratably to
    all days in U.S. person’s holding period; any portion allocated to
    prior years is subject to taxation at the highest marginal rate plus
    a punitive interest charge.
  • PFICs inherited by U.S. Persons from U.S. Persons generally
    “tack” holding period and basis.
Passive Foreign Investment Companies (continued)

• PFICs inherited by U.S. Persons from NRAs should be eligible for basis step-up and fresh holding period.

• “Once a PFIC always a PFIC” – If an entity satisfies the PFIC test for one year, it is a PFIC for all subsequent years, even if it doesn't meet the PFIC test thereafter.

• If a Qualified Electing Fund (QEF) election is in place, the U.S. person owner is taxable annually on its proportionate share of the ordinary income and capital gains of the PFIC (similar to a partnership). Income taxed under QEF regime is not subject to tax again when actually distributed.

• PFIC “taint” remains unless QEF election is in place for all years, however, “purging elections” are available to make a late QEF election.
Foreign Investment in U.S. Real Property
FIRPTA – Overview

• Enacted in 1980 to eliminate the perceived tax advantage of foreigners purchasing U.S. real property over U.S. taxpayers
• FIRPTA’s main effect is to treat gain on the disposition of any USRPI as ECI
  • Expansive view of “disposition” includes but is not limited to a sale or exchange, liquidation, redemption, gift, transfer, etc., and generally eliminates application of “nonrecognition” provisions
• USRPI:
  • Direct ownership interest in U.S. real estate;
  • Ownership in a U.S. corporation unless taxpayer can establish that U.S. corporation was not classified as a “U.S. Real Property Holding Corporation” (“USRPHC”) during the preceding five years
• A USRPHC is any U.S. corporation if more than 50% of the FMV of the corporation consists of USRPIs

• Exceptions:
  • An interest as a “pure” creditor does not qualify as a USRPI;
  • Certain U.S. corporations that have been “cleansed” of USRPIs in fully taxable transactions;
  • Publicly traded companies;
  • Certain REITs

• Must file a U.S. income tax return and pay tax on a net basis at graduated rates

• Transferee must withhold a portion of gross sale proceeds (including transferred liabilities), unless an exception applies
FIRPTA – Overview (continued)

• Persons purchasing U.S. real property interests from foreign persons (as well as certain purchasers’ agents, and settlement officers) are required to withhold 15% of the amount realized on the disposition (special rules for foreign corporations).

• In most cases, the transferee/buyer is the withholding agent.
  • For cases in which a U.S. business entity such as a corporation or partnership disposes of a U.S. real property interest, the business entity itself is the withholding agent.
FIRPTA – Overview (continued)

• If the transferee is a foreign person and fails to withhold, transferor may be held liable for the tax.
• A foreign corporation that distributes a U.S. real property interest must withhold a tax equal to 35% of the gain it recognizes on the distribution to its shareholders.
FIRPTA - U.S. Real Property Interest (USRPI)

• Direct –
  • U.S. land, buildings and related permanent structures.
  • Unsevered minerals and natural deposits
  • Personal property associated with real property (fixtures)

• Indirect –
  • Stock in U.S. Real Property Holding Corporation (USRPHC)
  • Interests in trusts or partnership holding USRPIs
What is an “Interest?”

• **Interest** in real property, is any interest other than an interest solely as a creditor.

• **Interest solely as creditor**
  • No right to directly or indirectly share in the appreciation in value of, or the gross/net profits generated by a USRPI
  • Mortgage at 8% = interest solely as creditor
  • Mortgage at 8% plus 10% of gain from sale of U.S. real estate ≠ interest solely as a creditor.
What is an “Interest?” (continued)

• The TCJA established a new rule that limits the annual deduction of business interest expense generally to the sum of (1) business interest income and (2) 30% of “adjusted taxable income” defined as similar to EBITDA for 2018 through 2021 and EBIT thereafter.

• Real property trades or businesses may elect out of this interest limitation but then they must use the ADS method of depreciation.
What is an “Interest?” (continued)

- “Interest” includes
  - co-ownership,
  - leaseholds,
  - timeshares,
  - life estates,
  - remainders,
  - options to acquire,
  - installment sales of USRPI,
  - mortgages if rights are not limited to an “interest solely as a creditor,” and
  - rights in a USRPHC if rights are not limited to an “interest solely as a creditor”
USRPHC

• A U.S. corporation is a USRPHC if it holds USRPIs having an aggregate FMV that comprises at least 50% of the FMV of the following items held by the tested corporation:
  • USRPIs;
  • Interests in real property outside of the U.S.; and
  • Assets used or held for use in a trade or business.
• Look through rules apply (for controlling interests)
• If the look through rule does not apply for stock held by the tested corporation, USRPHC test applied to see if that stock itself is a stock of a USRPHC
• A USRPC is any corporation that was a USRPHC in last 5 years, unless sold all its USRPIs in a taxable transaction (the FIRPTA Cleansing Exception)
FIRPTA - Partnerships

- Interests in partnerships technically not a USRPI
- Purchaser of partnership interest must withhold if
  - 50% or more of the gross value of partnership consists of USRPIs
  - 90% or more of gross value of the partnership’s assets consist of USRPIs, cash and cash equivalents.
FIRPTA - Withholding Certificates

- The amount that must be withheld from the disposition of a U.S. real property interest can be adjusted pursuant to a withholding certificate issued by the IRS.
- The transferee, the transferee’s agent, or the transferor may request a withholding certificate.
- The IRS will generally act on these requests within 90 days after receipt of a complete application.
- A withholding certificate may be issued due to:
  - A determination by the IRS that reduced withholding is appropriate because either:
    - A determination by the IRS that reduced withholding is appropriate because either:
FIRPTA - Withholding Certificates
(continued)

• The amount that must be withheld would be more than the transferor’s maximum tax liability, or
  • Withholding of the reduced amount would not jeopardize collection of the tax

• The exemption from U.S. tax of all gain realized by the transferor, or

• An agreement for the payment of tax providing security for the tax liability, entered into by the transferee or transferor.
FIRPTA - Withholding Certificates (continued)

• All applications for withholding certificates are divided into six basic categories. This categorizing provides for specific information that is needed to process the applications. The six categories are:
  1. Applications based on a claim that the transfer is entitled to nonrecognition treatment or is exempt from tax,
  2. Applications based solely on a calculation of the transferor's maximum tax liability,
  3. Applications under special installment sale rules,
  4. Applications based on an agreement for the payment of tax with conforming security,
  5. Applications for blanket withholding certificates, and
  6. Applications on any other basis.
FIRPTA Dispositions

• “Dispositions” – not defined in Section 897
• Broadly defined to include
  • Sales and exchanges
  • Capital contributions
  • Entity distributions
  • Transfers in connection with mergers
  • Gifts... But only if there is boot or liabilities in excess of basis
FIRPTA Dispositions/Non-recognition

- General framework is that dispositions generally include non-recognition transactions unless:
  - Non-U.S. person receives USRPI in exchange for USRPI (“hot for hot” exception)
    - USRPI received in exchange would be subject to U.S. tax upon disposition and
    - Reporting requirements satisfied
  - Certain foreign corporations eligible for treaty benefits may elect to be treated as U.S. corporation for these purposes (Section 897(i))
FIRPTA Non-Recognition Rules

• Applicable regulations (temp. reg. section 1.897-5T and 1.897-6T) have been modified or supplemented by seven different notices (some of which modify other notices in the series):
  1. Notice 2006-46 (providing rules relating to inbound merger transactions, foreign-to-foreign nonrecognition transactions, and the FIRPTA toll charge);
  2. Notice 99-43 (providing rules relating to single-entity reorganization transactions involving a “former” USRPHC);
  3. Notice 89-85 (providing rules relating to certain distributions of USRPHC interests by foreign corporations and section 897(i) elections);
FIRPTA Non-Recognition Rules (continued)

4. Notice 89-64 (providing rules relating to the application of Article XIII(9) of the Canada-U.S. Income Tax Convention to certain nonrecognition exchanges involving USRPIs);

5. Notice 89-57 (providing rules relating to the filing requirements that must be satisfied by a foreign person that transfers a USRPI in a nonrecognition transaction);

6. Notice 88-72 (providing rules applicable to the disposition of interests in partnerships that own USRPIs);

7. Notice 88-50 (announcing the IRS’s intention to treat a domestication of a foreign corporation as an inbound F reorganization that involves a deemed transfer of assets (including USRPIs) owned by the foreign corporation).
Some parting thoughts on the reorg provisions...

• “Nothing in FIRPTA is clear.”

• “In the end, significant portions of the original regulatory language are no longer applicable, and many of the other rules set forth in the regulations come with exceptions and with exceptions to exceptions that appear only in the notices or notices that modify other notices.”

  • David F. Levy in “Nonrecognition Transactions Involving FIRPTA Companies”
Some parting thoughts on the reorg provisions... (continued)

• “more often than not, when the tax advisor consults the regulations and notices for an answer to a FIRPTA question, she finds no answer, finds a partial answer that cannot be clearly applied to the facts at hand, or finds an answer that is clearly ridiculous under the circumstances.”

• Kimberly Blanchard in “FIRPTA in the 21st Century — Installment One: A Closer Look at Reg. § 1.897-5T(c),”
U.S. Expatriation
Introduction

Generally

• U.S. expatriation is becoming an increasingly attractive option for U.S. citizens living abroad who face lower tax rates in their countries of residence and must confront an ever increasingly complex set of U.S. reporting requirements with regard to their non-U.S. holdings.

• In particular, the challenges presented by compliance with the Foreign Account Tax Compliance Act (“FATCA”) have made international banking by U.S. citizens incrediably difficult, if at all possible.

• As a result, annual expatriations continue to increase at significant rates (2012 = 972; 2013 = 2,999; 2014 = 3,415; 2015 = 4,279; 2016 = 5,411; 2017 = 5,954 (annualized based on Q1-3 figures)).
Introduction
Tax Issues

- Certain U.S. expatriates, known as “covered expatriates,” are subject to tax under a complex tax regime, which includes:
  - A mark-to-market “exit tax” upon expatriation.
  - A special succession tax imposed upon any U.S. person who receives a gift or bequest from a covered expatriate.
- These tax ramifications require careful consideration as they may cause significant obstacles for the potential U.S. expatriate.
Introduction
Non-Tax Issues

• Potential expatriates also face a host of non-tax issues, which often include:
  • Selecting a new country of citizenship.
  • Deciding which family members will expatriate.
  • Managing the formal expatriation process.
  • Determining whether the expatriate will (or will be able to) come back into the U.S.

• Although beyond the scope of this presentation, caution should be exercised in navigating these non-tax issues as well.

• Notable among these are a provision of immigration law known as the “Reed Amendment” and the previously proposed “Ex-PATRIOT Act.”
Definition of “Covered Expatriate”
Generally

- The current regime governing the taxation of U.S. expatriates was introduced in 2008 under the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act).
- The HEART Act created a category of expatriates dubbed “covered expatriates” who are subject to a tax regime provided by §§ 877A and 2801.
- As such, it is critical first to determine whether a potential expatriate will be a covered expatriate in order to determine the tax implications for the expatriate and the potential beneficiaries under his or her estate plan.
Definition of “Covered Expatriate”

Definition of “Expatriate”

- For purposes of the U.S. expatriation regime, an “expatriate” generally means an individual who relinquishes U.S. citizenship.
- Relinquishing U.S. citizenship is typically done by renouncing U.S. nationality before a U.S. diplomatic or consular officer.
- Additionally, and somewhat surprisingly, long-term green card holders may fall within the definition of an “expatriate.”
  - If a non-U.S. citizen held a green card in eight or more of the last 15 tax years and ceases to be a U.S. resident, the green card holder will be treated as an expatriate for U.S. tax purposes.
  - As the statute implies, holding a green card in any portion of a calendar year counts as a full year for purposes of this test.
Definition of “Covered Expatriate”
Definition of “Covered”

• A covered expatriate is an expatriate who meets one or both of the “tax liability test” and the “net worth test,” or who fails the “tax certification test.”

• The tax liability test is satisfied if:
  • The expatriate’s average annual net income tax liability for the five taxable years preceding the expatriation date is greater than $165,000 (for calendar year 2018, adjusted annually for inflation).
  • This includes the total income tax liability shown on the individual’s return, even if filing jointly.
Definition of “Covered Expatriate”
Definition of “Covered” (continued)

• The net worth test is satisfied if:
  • The expatriate’s net worth exceeds $2 million on the expatriation date.
  • For purposes of this computation, the individual is treated as owning any property if a transfer of that property would constitute a taxable gift for gift tax purposes.
• This determination is made without regard to exclusions from taxable gifts, such as the gift tax annual exclusion or transfers for education or medical expenses, and without regard to gift splitting and the charitable and marital deductions.
• Additionally, a covered expatriate’s beneficial interest in a trust is included in this computation. The value of the beneficial interest is determined under a two-step process.
Definition of “Covered Expatriate”
Definition of “Covered” (continued)

• 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 these factors must 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.

• Second, interests in property held by a trust that are allocated to the expatriate must be valued under basic gift tax principles without regard to any prohibitions or restrictions on such interest.
Definition of “Covered Expatriate”
Definition of “Covered” (continued)

• Even if the expatriate does not otherwise qualify as a covered expatriate under the tax liability test or the net worth test, to avoid being treated as a covered expatriate, an expatriate must satisfy the tax certification test.

• Under the tax certification test, the expatriate must certify under penalties of perjury that the expatriate has satisfied all U.S. tax obligations for the five preceding taxable years and must provide any requested evidence of such compliance.

• This certification is provided by completing Form 8854.

• Any expatriate who fails to satisfy this obligation will be treated as a covered expatriate.
Definition of “Covered Expatriate”

Exceptions

• A dual citizen who relinquishes U.S. citizenship is excepted if, at birth, the individual became a citizen of the United States and another country, as of the expatriation date the individual continues to be a citizen taxed as a resident of the other country, and the individual has been a U.S. resident (under the § 7701(b)(3) “substantial presence test”) for 10 or fewer years during the 15-year period ending with the taxable year during which the expatriation date occurs.
Definition of “Covered Expatriate”
Exceptions (continued)

• Alternatively, a dual citizen who relinquishes U.S. citizenship is excepted if the individual’s relinquishment of U.S. citizenship occurs before the individual attains age 18½ and the individual has been a U.S. resident (under the substantial presence test) for 10 or fewer years before the date of relinquishment.

• An expatriate is also excepted during any period after the expatriation date during which the expatriate is subject to tax as a U.S. citizen or resident.
The Exit Tax
Generally

- Expatriates who qualify as “covered expatriates” are subject to the exit tax.
- The exit tax treats expatriation as a deemed sale of all of a covered expatriate’s property.
- The sale is deemed to take place on the day before the expatriation date.
- All gain or loss realized from the sale is required to be recognized, notwithstanding any nonrecognition provisions of the Code.
- The recognized gain or loss results in an adjustment to bases in the covered expatriate’s property.
The Exit Tax
Exit Tax Base

• Guidance from the IRS provides that the exit tax base includes any property that would be includible in the expatriate’s gross estate if the expatriate died on the day before the expatriation date.

• This determination is made under the basic estate tax includibility provisions of the Code.
The Exit Tax
Exit Tax Base (continued)

- IRS guidance also indicates that a covered expatriate’s beneficial interest in any trust is subject to the exit tax, even if such interest would not be estate tax includible. The application of the exit tax to trusts can be divided into two types of trusts: trusts of which the covered expatriate is treated as the owner under the grantor trust rules and all others (irrespective of whether another individual may be treated as the owner under the grantor trust rules). The Code deceptively uses the term “nongrantor trust” to describe the latter.
The Exit Tax
Grantor Trusts

• All of the assets of a grantor trust of which the covered expatriate is treated as the owner are subject to the exit tax.
• Although this requirement is far from clear based on the statutory language, which refers to “all property of a covered expatriate,” the Joint Committee on Taxation’s commentary to the HEART Act expressly states this rule.
• Notwithstanding this rule, the exit tax as applied to grantor trusts also must be coordinated in many instances with the possible “outbound migration” of the trust, which may result in gain recognition.
• Under § 684, the outbound migration of a U.S. trust triggers gain (but not loss) recognition in the trust’s assets, if the trust is not a grantor trust subsequent to the migration.
The Exit Tax
Grantor Trusts (continued)

• Because grantor trust status is limited in application to non-U.S. persons, in many circumstances trusts other than revocable trusts will cease to be grantor trusts upon the grantor’s expatriation.

• If gain is recognized as a result of the outbound migration, that gain is taken into consideration prior to the application of the exit tax, so the gain is only taxed once.
The Exit Tax
“Nongrantor” Trusts

• Second, the assets of a “nongrantor” trust, though excluded from the exit tax base, are subject to special provisions under the expatriation regime.

• In the case of a distribution (directly or indirectly) of any property from a “nongrantor” trust to a covered expatriate, the trustee is required to deduct and withhold from such distribution an amount equal to 30 percent of the “taxable portion” of the distribution.

  • The “taxable portion” of a distribution is the portion of the distribution that would be includible in the gross income of the covered expatriate if the covered expatriate were to continue to be subject to tax as a U.S. citizen or resident.

  • The taxable portion is also subject to tax provisions that apply generally to the taxation of non-U.S. residents.
The Exit Tax
“Nongrantor” Trusts (continued)

- If the fair market value of the property distributed in kind exceeds the trust’s basis in the property, the trust is required to recognize gain as if the property were sold to the covered expatriate.
- The covered expatriate is also treated as having waived any right to claim a reduction in withholding under any U.S. tax treaty unless otherwise agreed by the IRS.
- Even though a trust of which someone other than the covered expatriate is treated as the owner would be a “nongrantor” trust under the exit tax definition, a distribution from such a trust should not be subject to the 30 percent withholding tax because, if the expatriate were subject to tax as a U.S. citizen or resident, such a distribution would not result in taxable income.
The Exit Tax
Computation of Tax

• For purposes of computing the exit tax, assets are valued under general *transfer* tax valuation rules.
• IRS guidance also provides that the transfer tax special valuation rules (§§ 2701 through 2704) apply as if the covered expatriate were transferring property to family members.
• There is no authority disallowing valuation discounts such as lack of marketability discounts, lack of control discounts, or fractional interest discounts.
• A covered expatriate is permitted to exclude up to $713,000 of gain (for calendar year 2018, adjusted annually for inflation).
The Exit Tax
Computation of Tax (continued)

• The exclusion is allocated pro rata among the expatriate’s assets subject to the exit tax on the basis of the amount of gain recognized with respect to each asset.

• This pro rata allocation is intended to prevent the covered expatriate from allocating the exclusion amount to ordinary income assets and other assets taxed at higher rates, such as collectibles.
The Exit Tax

Exceptions

• There are two exceptions for “eligible deferred compensation items” and for certain “tax-deferred accounts.”

• Rather than being subject to the exit tax, “eligible deferred compensation items” are subject to 30 percent withholding at the source of payment.

• The withholding is imposed on the “taxable payment,” meaning any payment to the extent it would be includible in the gross income of the covered expatriate if such expatriate continued to be subject to tax as a U.S. citizen or resident.
The Exit Tax

Exceptions (continued)

- The exit tax also provides that “tax-deferred accounts,” such as individual retirement accounts and tax-preferred education and medical savings accounts, are treated as being distributed in their entirety to the covered expatriate on the expatriation date. No early distribution taxes apply.
The Exit Tax
Deferral of Exit Tax

• Because the deemed gain triggered by the exit tax will not have corresponding liquidity, the expatriation regime permits deferral of the tax payment, subject to an interest charge.

• If the covered expatriate so elects, the pro rata portion of the exit tax associated with a particular asset can be deferred until its actual disposition.

• As part of the election, the covered expatriate is required to provide “adequate security” for the payment of the tax, which generally means a bond conditioned on the payment of tax.

• Any covered expatriate making the election must also irrevocably waive any rights under any U.S. income tax treaty with respect to the collection of the exit tax.

• Most expatriates would rather “cut ties” than elect the tax deferral.
The Exit Tax
Timing Challenges

• In addition to liquidity, the timing of the gain recognition may pose a significant obstacle to expatriation.

• The exit tax causes an acceleration of gain, offending the maxim that tax later is always better than tax now.

• The time value of money calculations force consideration of the potential holding period in the expatriate’s assets, the anticipated rate of return in those assets, and the potential tax rate that might apply if the expatriate remains in the U.S. and sells assets at a later date.

• This is further complicated by market fluctuations that may prove unfavorable for the potential expatriate.
The Exit Tax
Timing Challenges (continued)

• Because the tax is triggered at expatriation date values, the actual day of expatriation may have a significant impact on the amount of tax.
• Thus, the timing of this gain recognition is often simply a function of the date of the visit to the U.S. diplomatic or consular office, which is something that cannot be controlled with precision.
• This creates tax risk for potential expatriates holding volatile assets.
• It also highlights another risk — that assets may actually decrease in value after expatriation.
• The result is that not only does the tax become due immediately, the total tax liability may be greater than had the covered expatriate remained in the U.S.
The Exit Tax
Timing Challenges (continued)

• Timing must also be taken into consideration with foreign tax credits.
• The deemed U.S. tax recognition event may not correspond with a taxable event in a non-U.S. jurisdiction where the potential expatriate may reside.
• If that is the case, there may be U.S. tax liability without a corresponding non-U.S. liability against which the credit can be used.
• So, the covered expatriate may pay tax twice on the same gain without the benefit of foreign tax credit or treaty relief.
The § 2801 Tax

Generally

• Under the U.S. expatriation regime, a U.S. person who receives a gift or bequest from a covered expatriate (referred to as “covered gift or bequest”) is generally subject to a special succession tax known as the § 2801 tax.

• The tax is equal to the value of the covered gift or bequest multiplied by the highest marginal estate tax rate in effect on the date of the receipt.

• Notably, the tax is imposed on the recipient instead of the covered expatriate.

• Certain exclusions apply from treatment as a covered gift or bequest, and an annual exclusion is available.
The § 2801 Tax
Transfers to Trusts

• When a covered gift or bequest is made to a U.S. trust, the § 2801 tax applies as if the trust were a U.S. citizen, and the trust is liable.
• When a covered gift or bequest is made to a non-U.S. trust, the § 2801 tax is imposed on any distribution attributable to the covered gift or bequest, whether from income or principal, made to any U.S. citizen or resident.
• If any amount of the distribution is included in the recipient’s gross income, which may be the case under standard rules of trust taxation or under the “throwback rules,” then the transferee is entitled to an income tax deduction for the § 2801 tax.
• A non-U.S. trust may elect to be treated as a U.S. trust solely for purposes of the § 2801 tax.
The § 2801 Tax
Proposed Regulations

- Form 708: *United States Return of Tax for Gifts and Bequests from Covered Expatriates* is a new form that will be released after final regulations are issued to provide information on any covered gift or bequest, and to compute the § 2801 tax.

- The § 2801 tax continues to be deferred until final regulations are issued, but practitioners should prepare clients who have received covered gifts or bequests on the scope of the forthcoming tax liability.
The § 2801 Tax
Proposed Regulations (continued)

• Non-U.S. citizens are subject to the § 2801 tax only if they are domiciled in the U.S. under estate and gift tax rules. This means a recipient’s income tax status (under substantial presence test or green card status) is not determinative.

• Consequently, for a non-U.S. citizen recipient a domicile analysis will be needed, and in limited circumstances may afford a planning opportunity where the non-U.S. citizen recipient can relinquish his or her domicile before the gift/bequest.
The § 2801 Tax
Proposed Regulations (continued)

• Practitioners will need to ask clients whether a gift or bequest may have come from a covered expatriate.

• Although the IRS will provide a mechanism for taxpayers to request tax return information on the donor or decedent to evaluate whether a covered transfer occurred, the proposed regulations leave the process uncertain, various privacy issues may inhibit the release of insightful information, and the IRS is not required to provide the information.

• Since the inception of the § 2801 tax, a challenging issue has been how a taxpayer can determine his or her tax liability, which is ultimately based upon the private information of another individual, without the taxpayer encountering an onerous or even impossible information gathering burden.
The § 2801 Tax
Proposed Regulations (continued)

• The proposed regulations identify five exceptions to covered gifts and bequests.
  • Taxable gifts that are timely reported and paid on a gift tax return (Form 709).
  • Gross estate property that is timely reported and paid (including QDOT distributions) on an estate tax return (Form 706).
  • Normally deductible charitable transfers.
  • Normally deductible marital transfers including QTIP and QDOT assets if valid elections are made.
  • Qualified disclaimers.
The § 2801 Tax
Proposed Regulations (continued)

• Upon receipt of a covered transfer, a domestic trust or foreign trust that elects to be treated as a domestic trust (“electing foreign trust”) is not “looked through” to assess the status of the beneficiaries, and it is the trust rather than the beneficiaries that is liable for the § 2801 tax.

• Once the proposed regulations become final, existing domestic trusts and electing foreign trusts that received a covered transfer on or after June 17, 2008, will need to pay the § 2801 tax, attributable back to the date of the transfer.
The § 2801 Tax
Proposed Regulations (continued)

• For foreign trusts that do not elect domestic status (“nonelecting foreign trust”) there is a process to allocate distributions between the portion of the trust that is attributable to covered transfers and any portion that is not attributable to a covered transfers; the beneficiary will pay the § 2801 tax on the portion of the distribution attributable to the covered transfers.
The § 2801 Tax
Proposed Regulations (continued)

• The preamble to the proposed regulations requests practitioner comments, especially on issues related to non-electing foreign trusts.
  • How to address the situation where a foreign trust’s record keeping is not sufficient to determine portions attributable to covered transfers.
  • How to minimize the administrative burden of a foreign trust electing domestic trust status, while ensuring all tax is paid.
  • How to address what appears as a real downside of the proposed regulations that distributions from a foreign trust to a U.S. citizen spouse are not covered by the marital deduction, and § 2801 tax is imposed on the U.S. citizen spouse.
Planning Opportunities
Generally

• Several traditional planning techniques may be available to minimize the tax exposure facing a potential covered expatriate.

• Of course, these should be considered only after thoroughly evaluating whether the expatriate can avoid being “covered” altogether.

• This sometimes can be achieved through gifting, thereby reducing net worth for the net worth test, or by postponing gain recognition for several years, thereby reducing income tax liability for the tax liability test.

• Assuming covered expatriate status cannot be avoided, the following techniques can be considered.
Planning Opportunities
Valuation Discounts

• Because the exit tax is based on the fair market value of the property, traditional estate planning techniques designed to create valuation discounts will reduce the amount of gain recognized upon expatriation.

• Accordingly, the formation of a family limited partnership (or similar entity) to hold assets may be an attractive option.

• Claiming valuation discounts for exit tax purposes may be susceptible to some of the same arguments levied against valuation discounts for transfer tax purposes, especially because of the incorporation of § 2031 valuation principles into the exit tax computation.
Planning Opportunities
Valuation Discounts (continued)

• A “well-seasoned” family limited partnership is, thus, advisable in order to produce the intended results.

• Additionally, the use of fractional interest discounts, most often achieved by splitting real property among several trusts, can produce significant discounting.
Planning Opportunities
Pre-expatriation Trusts

• Potential covered expatriates should also be advised to use all of their remaining unified credit before expatriating.

• Once a covered expatriate becomes a non-U.S. citizen and non-U.S. domiciliary, the unified credit is no longer available, either for § 2801 tax purposes or for standard estate and gift taxation (except for the possibility of a $13,000 estate tax credit).

• The most efficient use of this credit is likely to be through transfers to a “pre-expatriation” trust, which can be structured as a standard irrevocable gifting trust.
Planning Opportunities
Pre-expatriation Trusts (continued)

• Careful consideration should be given as to whether the trust should be structured as a grantor trust or nongrantor trust and also whether expatriation will cause the trust to become a non-U.S. trust, thereby triggering § 684 gain and potential throwback tax in future years.
Planning Opportunities
Crummey Planning

• If standard *Crummey* provisions are included in the pre-expatriation trust, the covered expatriate can make annual exclusion gifts that are not subject to the § 2801 tax.
• Additionally, there should be no need to allocate GST exemption to the transfer (as in a traditional life insurance trust).
• The transfer by the covered expatriate is not a transfer subject to the estate or gift tax, thereby taking it outside the scope of the GST tax.
• These annual exclusion gifts can then be utilized to purchase life insurance on the covered expatriate as in a traditional life insurance trust, with the result that the death benefits payable upon the covered expatriate’s death pass into trust for the U.S. beneficiaries without incurring § 2801 tax.
Planning Opportunities
Sales to Trusts

• The pre-expatriation trust also can be used in a manner similar to a traditional gift-sale technique.
• Although the pre-expatriation trust would most likely not qualify as a grantor trust subsequent to the grantor’s expatriation, the technique can still be beneficial.
• If the covered expatriate sells appreciated property to the pre-expatriation trust, there may be gain recognition in the covered expatriate’s place of residence.
• However, the covered expatriate is likely to have chosen a no- or low-tax jurisdiction, so the gain recognition may be irrelevant.
Planning Opportunities
Sales to Trusts (continued)

• The pre-expatriation trust can purchase the property from the covered expatriate using a traditional promissory note with interest payable at the applicable federal rate.

• If structured properly, the interest payable on the note will qualify as “portfolio interest” and the covered expatriate will not have U.S. taxable interest income.

• The only significant inefficiency in comparison to a traditional gift-sale is that the covered expatriate would not be able to pay the trust’s income taxes without such payment being subject to the § 2801 tax.
FATCA and CRS
What is FATCA?

• The Foreign Account Tax Compliance Act (FATCA) was enacted in 2010 in response to ongoing challenges in combating U.S. tax evasion through the use of foreign financial accounts.

• These challenges were particularly highlighted by the investigation of several non-U.S. financial institutions, including UBS AG, and the overwhelming responses to the IRS “Offshore Voluntary Disclosure Initiative.”

• The intent of FATCA is to enlist financial institutions into cooperating with U.S. tax authorities through a vast and complex reporting regime, or face significant ramifications in the form of U.S. tax withholding.
What is FATCA? (continued)

• Unfortunately, the breadth of the legislation (and the Service’s reluctance to narrow its scope) have resulted in a ripple of unintended compliance issues for individuals and their estate planning structures, especially trusts.
What is FATCA? (continued)

- FATCA created a new Chapter 4 of the Code consisting of:
  - Section 1471. Withholdable Payments to Foreign Financial Institutions.
  - Section 1472. Withholdable Payments to Other Foreign Entities.
  - Section 1473. Definitions.
  - Section 1474. Special Rules.
What is FATCA? (continued)

• Importantly, FATCA substantially broadens, but does not supersede, the provisions under Chapter 3 of the Code imposing withholding on nonresidents aliens and foreign corporations (e.g., withholding on items of “fixed, determinable, annual or periodical” (FDAP) income or dispositions of U.S. real property interests).

• Under Section 1471, a 30 percent withholding tax is imposed on any “withholdable payment” to a “foreign financial institution” (FFI) that does not meet the FATCA reporting requirements applicable to FFIs.
What is FATCA? (continued)

• Under Section 1472, a 30 percent withholding tax is imposed on any “withholdable payment” to a “non-financial foreign entity” (NFFE) that does not meet the FATCA reporting requirements applicable to NFFEs.

• FFIs are also required to withhold on “pass-thru payments” to non-compliant FFIs and “recalcitrant account holders.”

• If required to withhold, the FFI or NFFE is liable for the tax, essentially forcing the FFI or NFFE to be the tax collector or pay the tax itself.
What is FATCA? (continued)

• Withholding will be simplified through provision of Global Intermediary Identification Numbers (GIINs) and a new W-8 BENE-E.
  • Withholding not required for payment to entities with a GIIN.
  • W-8 BENE-E will identify FATCA classification of foreign entities.
• These withholding requirements are also conditioned by efforts to enter into “Intergovernmental Agreements” (IGAs).
• Over 100 IGAs negotiated.
Definitions

• An “FFI” is any entity that:
  • Accepts deposits in the ordinary course of a banking or similar business;
  • As a substantial portion of its business, holds financial assets for the accounts of others; or
  • Is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities.
    • Manager Investment Entities
    • Managed Investment Entities
    • Fund Investment Entities
• An “NFFE” is any foreign entity that is not an FFI.
Definitions (continued)

- A “withholdable payment” is generally:
  - Any payment of interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, and other fixed or determinable annual or periodical gains, profits and income, if such payment is U.S. source income (same definition as FDAP, except withholdable payment includes original issue discount); and
  - Any gross proceeds from the sale or other disposition of any property of a type which can produce U.S. source interest or dividends.
  - It does not include income effectively connected with a U.S. trade or business (ECI) unless the ECI is exempt from U.S. tax under a tax treaty that exempts income not associated with U.S. permanent establishment.
Definitions (continued)

• A “withholding agent” means any person, in whatever capacity, having the control, receipt, custody, disposal, or payment of any withholdable payment.

• A “pass-thru payment” means any withholdable payment or other payment to the extent attributable to a withholdable payment (further definition reserved in final regulations).
Definitions (continued)

- A “U.S. account” means any financial account held by one or more specified U.S. persons or U.S. owned foreign entities.
  - $50,000 minimum for natural persons
- A “substantial U.S. owner” means
  - Any specified U.S. person which owns, directly or indirectly, more than 10 percent (by vote or value) of the stock in a corporation.
  - Any specified U.S. person which owns, directly or indirectly, more than 10 percent of the profits interests or capital interests in a partnership.
  - Any U.S. person treated as owning a “grantor” trust.
  - Any specified U.S. person which holds, directly or indirectly, more than 10 percent of the beneficial interests of a trust.
Definitions (continued)

• A “specified U.S. person” generally means any U.S. person other than publicly traded companies, tax exempt organizations and charitable trusts, banks, REITs, RICs, and common trust funds.

• A “recalcitrant account holder” means any account holder who fails to comply with FATCA information requests or to waive banking secrecy.
How to categorize

- Is the entity domestic or foreign?
- What are the entity’s investments?
- How is the entity managed?
Corporations and Partnerships: Investments

• An entity is engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities if 50 percent or more of its gross income during the prior three years if derived from such activities.

• Certain corporations that function as private companies or family offices that receive a management fee may also be classified as FFIs because they primarily conduct business on behalf of a customer (again, a 50 percent gross income test).
Trusts: Investments

- At first glance, it would appear that a trust could not be an FFI because any qualification as an FFI requires that the foreign entity be engaged in a business. For tax purposes, a trust by definition is not engaged in a business. So to think of a trust as an FFI seems to be nonsense.
- However, Treasury took the position under the FATCA proposed regulations that a trust could be engaged primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, and therefore could be classified as an FFI (an “investment entity”).
- Notwithstanding widespread commentary that this result was inappropriate and counter to the intent of FATCA, Treasury confirmed this position in the FATCA final regulations.
Trusts:
Investments (continued)

• Note that estates should not be viewed as FFIs and do not trigger FATCA reporting obligations, provided that the estate provides a copy of the decedent's will or death certificate to the financial institution.
Corporations and Partnerships: Management

• If corporation or partnership is a passive holding company, it will not be managed by a financial institution and therefore may qualify as an NFFE.

• However, if entity is managed by a financial institution (including family office), then it will be classified as an FFI.
Trusts: Management

- Under the FATCA final regulations, a foreign trust that is, in essence, managed by a professional trustee will be treated as an FFI.
- Examples provide that a trust managed by a professional trust company is an FFI; whereas, a trust with an individual trustee is not an FFI.
- The final regulations are silent on the treatment of a private trust company or of a professional individual trustee; however, a private trust company that receives a fee will be a financial institution, rendering the trust an FFI.
How do private client structures comply with FATCA?

• Identify substantial U.S. owners
• Compliance for NFFEs
• Compliance for FFIs
  • Participating FFI
  • Deemed Compliant FFI
• IGAs
Identify Substantial U.S. Owners

• A “substantial U.S. owner” means
  • Any specified U.S. person which owns, directly or indirectly, more than 10 percent (by vote or value) of the stock in a corporation.
  • Any specified U.S. person which owns, directly or indirectly, more than 10 percent of the profits interests or capital interests in a partnership.
  • Any U.S. person treated as owning a “grantor” trust.
  • Any specified U.S. person which holds, directly or indirectly, more than 10 percent of the beneficial interests of a trust.
Trusts
Substantial U.S. Owners

- There are three ways a person can be an owner of a trust for FATCA:
  - A person treated as the owner under the grantor trust rules;
  - A beneficiary who is entitled to a mandatory distribution from the trust; or
  - A beneficiary who may receive a discretionary distribution, but only if such person receives a distribution in the calendar year.

- An FFI is treated as having substantial U.S. owners if:
  - Any specified U.S. person is treated as the owner of the trust under the grantor trust rules; or
  - Any specified U.S. person holds, directly or indirectly, more than a “zero percent” beneficial interest in the trust.
Trusts
Substantial U.S. Owners (continued)

• An NFFE is treated as having substantial U.S. owners if:
  • Any specified U.S. person is treated as the owner of the trust under the grantor trust rules; or
  • Any specified U.S. person holds, directly or indirectly, more than a ten percent beneficial interest in the trust.
• For U.S. grantors, grantor trust rules treat the grantor as the owner of the entire trust for FATCA; however, this rule does not apply to foreign grantors and “foreign grantor trusts.”
• Attribution rules apply to aggregate the ownership interests of related persons (relying on definitions under Section 267).
Trusts
Beneficial Interests

• A person will be treated as holding more than 10 percent of the beneficial interest in a foreign trust if:
  • The beneficiary receives only discretionary distributions and the fair market value exceeds ten percent of the value of all distributions or all the assets;
  • The beneficiary is entitled to mandatory distributions and the value of the distributions determined under Section 7520 exceed ten percent of the value of all assets of the trust; or
  • The sum of the beneficiary’s discretionary distributions and value of mandatory distributions together exceed ten percent of the value of all distributions or ten percent of the value of all assets of the trust.
• A de minimis rule excludes distributions of less than $5,000 annually and mandatory distribution rights worth less than $50,000.
Trusts
Indirect Ownership Through Trusts

• A person treated as owning a trust under the grantor trust rules is treated as owning all the interests owned by the trust.

• In a nongrantor trust, beneficial interests are determined based on all relevant facts and circumstances. So, while the foreign trust itself might not be treated as having substantial U.S. owners (for example, in a year when no distributions are made), the U.S. beneficiaries may still be considered substantial U.S. owners of underlying foreign entities.

• If indirect ownership cannot be determined, then substantial U.S. ownership is presumed.

• The indirect ownership rules do not apply if the trust is a participating FFI or a deemed-compliant FFI (other than an owner-documented FFI).
Compliance for NFFEs
Generally

- If the trust is an NFFE it simply needs to certify it has no substantial U.S. owners or identify its substantial U.S. owners.
- NFFEs that are publicly traded or are otherwise “Active NFFEs” are exempt from withholding.
  - An Active NFFE is an NFFE with less than fifty percent of its gross income as passive and less than fifty percent of its assets producing passive income.
  - Limited application to trusts practically.
Compliance for NFFEs
Generally (continued)

• NFFEs will be compliant if the beneficial owner or payee provides the withholding agent:
  • A certification that the beneficial owner does not have any substantial U.S. owners; or
  • The name, address, and TIN of each substantial U.S. owner of the beneficial owner.

• The withholding agent must not know, or have reason to know, that any information provided is incorrect.

• The withholding agent must report information to Treasury.
Compliance for FFIs
Generally

• Generally, if the trust is an FFI it can avoid withholding if:
  • It is a participating FFI
  • It is a deemed-compliant FFI

• Deemed-compliant FFIs include:
  • Sponsored FFIs
  • Owner Documented FFIs
  • IGAs
Compliance for FFIs

Participating FFI

• A trust is a participating FFI if it enters into an agreement with the IRS to be a participating FFI.

• This requires the FFI to enter into an agreement with Treasury under which the FFI agrees to:
  • Obtain information regarding each of the FFI’s account holders in order to determine whether such accounts are “U.S. Accounts;”
  • Comply with verification and due diligence procedures as Treasury may require with respect to the identification of U.S. accounts;
  • Report required information regarding each U.S. account;
  • Deduct 30 percent of any “passthru payment” to a “recalcitrant account holder” or non-compliant FFI;
Compliance for FFIs
Participating FFI (continued)

- Comply with requests from Treasury for additional information regarding the FFI’s U.S. accounts; and
- Obtain waivers of foreign law restrictions on account disclosure or close accounts for which waivers cannot be obtained.

- Compliance completed on Form 8966

- Information required regarding each U.S. account includes:
  - The name, address, and taxpayer identification number of each account holder that is a specified U.S. person;
  - The account number;
  - The account balance or value; and
  - The gross receipts and gross withdrawals or payments from the account.
Compliance for FFIs
Sponsored FFIs

• A trust can become a sponsored FFI and be deemed compliant as either a “registered deemed-compliant” FFI (as a “sponsored investment entity”) or a “certified-deemed compliant” FFI (as a “sponsored closely held investment vehicle”).

• Under this arrangement the sponsoring FFI agrees to take on the FATCA compliance on behalf of the sponsored FFI.
Compliance for FFIs
Sponsored FFIs (continued)

• Sponsoring FFI must:
  • Be authorized to manage the sponsored FFI and enter into contracts on its behalf (i.e. as trustee) or agree to fulfill all due diligence, withholding, and reporting responsibilities that the FFI would have assumed if it were a participating FFI;
  • Register with Treasury as a sponsoring entity;
  • Register the sponsored FFI with Treasury;
  • Agree to perform, on behalf of the FFI, all due diligence, withholding, reporting, and other requirements that the FFI would have been required to perform if it were a participating FFI;
  • Identify the sponsored FFI in all reporting completed on behalf of the sponsored FFI; and
  • Not have had its status as a sponsoring FFI revoked.
Compliance for FFIs
Owner Documented

• Requirements
  • Must identify U.S. and foreign beneficiaries to the withholding agent on reports filed every three years;
  • Withholding agent reports the information about the U.S. beneficiaries;
  • May alternatively provide “auditor’s letter”; and
  • Note that reporting is only of owners, so amount of trust distributions from year to year may condition the reporting requirements.

• While a useful alternative, owner documentation only provides exemption from withholding for payments from U.S. financial institutions, participating FFIs, or FFIs reporting under a Model 1 IGA.
FATCA: Alternative Approaches under IGAs

• Where the U.S. Treasury Department has entered into an IGA, the FATCA requirements imposed by the Regulations are supplanted, in whole or in part, with the information reporting procedures provided for under the IGA.

• Overview of IGAs
  • FFIs under an IGA are still required to register with the IRS and obtain a GIIN.
  • Under most IGAs, a FFI’s reporting obligations with respect to its “U.S. accounts” (which include certain accounts held by non-U.S. entities that have “U.S. Controlling Persons”) is to the FFI’s local government. The local government, in turn, is required to transfer the information to the U.S. government.
IGAs

• If an entity is resident in a jurisdiction with an IGA, payments made to such trust are not subject to withholding as long as the entity is in compliance with its reporting requirements under the IGA.

• Compliance requirements differ depending on whether the country of residence has negotiated a Model 1 IGA or a Model 2 IGA.
IGAs (continued)

• Model 1 IGA
  • FATCA partner jurisdiction enacts legislation requiring FFIs to report directly to home tax authorities, who then exchange information with the U.S.
  • May be reciprocal or non-reciprocal.
  • FFI not obligated to withhold on payments to non-participating FFIs or recalcitrant account holders.
  • FFI not obligated to close accounts of recalcitrant account holders.
IGAs (continued)

- Model 2 IGA
  - Waives bank secrecy laws in FATCA partner jurisdiction, which also agrees to provide U.S. with information on recalcitrant account holders.
  - FFI enters agreement directly with the U.S. to become a participating FFI.
  - FFI not obligated to withhold on payments to recalcitrant account holders or close their accounts.
  - However, FFI is obligated to withhold on payments to nonparticipating FFIs.
IGAs (continued)

• Definitions
  • Definitions under IGAs are very similar to those under FATCA.
  • Main difference is focus on “controlling persons”
    • “Controlling Persons” means the natural persons who exercise control over an entity. In the case of a trust, such term means the settlor, the trustees, the protector (if any), the beneficiaries or class of beneficiaries, and any other natural person exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions. The term “Controlling Persons” shall be interpreted in a manner consistent with the Financial Action Task Force Recommendations.
CRS

- CRS is the international equivalent of FATCA.
  - FATCA is a “wheel” with U.S. as hub (i.e. a series of bilateral treaties).
  - CRS is a web with each signatory getting (roughly) equal dignities (i.e. a single multilateral treaty)
- Very similar definitions and concepts to FATCA and Model 1 IGAs
- No withholding mechanism
CRS: What is an FI?

- An FI encompasses a broad range of entities including:
- Banks and brokers
- Certain entities managed by a professional investment manager and certain trusts with a professional corporate trustee (collectively, “Investment Entities”)
- Certain insurance companies
- Any entity that is not an FI is labeled a “Non-Financial Entity” (an “NFE”)
CRS: What is a Financial Account?

- A “Financial Account” is an account maintained by an FI and generally includes:
  - Depository and Custodial Accounts
  - Equity and debt interests in certain Investment Entities
  - Cash Value Insurance Contracts
  - Annuity Contracts
CRS: What Information is Required to be Exchanged between CRS-Participating Jurisdictions?

- With respect to any “Financial Account”:
  - Account number;
  - Name and identifying number of the reporting FI;
  - Account balance or value and the gross amount of income, including interest, dividends and redemption proceeds paid or credited to the account on an annual basis;
  - The name, address, TIN(s), jurisdiction of residence, and, in the case of an individual, the date and place of birth of each “Reportable Person” that is an account holder; and
• In the case of an account holder that is a Passive NFE (regardless of whether it is a “Reportable Person”) with one or more “Controlling Persons” that is a “Reportable Person,” the name, address, TIN(s), and jurisdiction of residence of the Passive NFE and the name, address, TIN(s), jurisdiction of residence, and date and place of birth of each Reportable Person.
CRS: Controlling Persons

• “Controlling Persons” are:
  • The *natural persons* who exercise control over an Entity
  • In the case of a company or partnership, such term generally means the relevant persons exercising control of the company through ownership
    • Though this can vary depending on the ownership structure of the company or partnership, it may be any person owning more than a certain percentage of the company or partnership (e.g. 25%)
    • If no natural persons exercises control through ownership, such term means the natural persons who exercise control of the Entity through other means, and where no such person is identified, the relevant persons having a senior management position (e.g. company directors or the general partner of a partnership).
In the case of a trust, such term means “the settlor(s), the trustee(s), the protector(s) (if any), the beneficiary(ies) or class(es) of beneficiaries, and any other natural person(s) exercising ultimate effective control over the trust, and in the case of a legal arrangement other than a trust, such term means persons in equivalent or similar positions.”
CRS: Reportable Person

- A “Reportable Person” is:
  - Any individual identified as a resident for tax purposes in a CRS reportable country
  - Entities resident in a CRS reportable country, not including FIs and certain other specified entities
U.S. Tax Reporting
Reporting Requirements

- Form 3520 – Transfers involving foreign persons and foreign trusts
- Form 3520-A – Foreign trust annual reporting
- Form 8621 – PFIC
- Form 5471 – CFC
- Form 8865 – Controlled Foreign Partnership
- Form 8858 – Disregarded Entities
- Form 8938 – Foreign Financial Assets
- FinCEN Form 114 (“FBAR”)
Form 3520 – Foreign Gifts and Trusts

- Required to be filed by any U.S. person (or the estate of a U.S. person) who:
  
  (i) Received a gift of more than $100,000 from an NRA (and related persons);

  (ii) Received more than $16,111 (in 2018) of gifts from foreign corporations and partnerships;

  (iii) Received a distribution from any foreign trust or estate;

  (iv) Created or funded a foreign trust;

  (v) Is treated as the owner of any foreign trust under Sections 671 through 679; or

  (vi) Dies as the owner of a foreign trust or with assets of the foreign trust includible in his estate.
Form 3520 – Foreign Gifts and Trusts (continued)

- Due on the same due date as income tax return, with extensions
- Minimum $10,000 penalty for the failure to file or incorrect filing
  - If greater, the penalty will be 35% of the property transferred to trust, 35% of the value of distributions received from a foreign trust, or 5% of any trust owned by the U.S. person
Form 3520-A – Annual Reporting of Foreign Trusts with U.S. Grantors

• Required to be filed by the **trustee** of a **foreign trust** that has a U.S. owner for grantor trust purposes
• Disclosure of trust income during the year
• Due date of **March 15** for calendar year trusts
• Penalty for failure to file or an incorrect filing is the greater of $10,000 or 5% of the gross value of the portion treated as owned by the U.S. person
Form 8621 - PFIC

- Required to be filed by a U.S. person who is a direct or indirect shareholder of a PFIC in each tax year
- Very limited exceptions to filing obligation
- Due on the same due date as income tax return, with extensions
Form 5471 - CFC

- This Form must be filed by certain U.S. persons who are shareholders of a non-U.S. corporation, including, but not limited to:
  - A U.S. person who during such year acquires stock in a non-U.S. corporation and, as a result, owns 10% or more of the total value or voting power of all stock of the corporation (presumably will be expanded to include 10% value);
  - A U.S. person who disposes of stock in a non-U.S. corporation thus reducing his stock ownership to less than 10% of the total value or voting power of all stock of the corporation;
  - A U.S. person who owns more than 50% of the total value or voting power of all stock of a non-U.S. corporation for an uninterrupted period of 30 days (presumably will be expanded to eliminate 30-day requirement);
  - A U.S. person who directly, indirectly or constructively owns 10% or more of the total voting power of all classes of stock of a corporation that is a controlled foreign corporation for an uninterrupted period of 30 days (presumably will be expanded to eliminate 30-day requirement).
Form 8865 - CFP

- This Form must be filed by certain U.S. persons who hold an interests in a non-U.S. partnership, including, but not limited to:
  - A U.S. person who during such year acquires membership interests in a non-U.S. partnership and, as a result, owns 10% or more of the total membership interests of the partnership;
  - A U.S. person who disposes of membership interests in a non-U.S. partnership thus reducing its membership interest ownership to less than 10% of the total membership interests; and
  - A U.S. person owns more than 50% of the partnership interests of a non-U.S. partnership.
Form 8858 – Disregarded Entities

• This Form must be filed by:
  • U.S. persons who are tax owners of a foreign disregarded entity; and
  • Certain U.S. persons who are required to file Form 5471 or Form 8865 with respect to a CFC or CFP that owns a foreign disregarded entity.
Form 8938 – Foreign Financial Assets

• Certain U.S. persons with an interest in “specified foreign financial assets” must file, if the value of those assets exceed a certain threshold
  • Broad definition of foreign financial assets, including interests in foreign trusts
  • Threshold varies from $75,000 to $600,000 depending on residence and filing status
  • Requirements applies to individuals, domestic trusts and closely-held domestic corporations and partnerships with at least 50% passive assets
Form 8938 – Foreign Financial Assets (continued)

- Due on the same due date as income tax return, with extensions
- Minimum $10,000 penalty for each failure to file or late filing
- No duplicative reporting is required if information is reported on Form 3520, Form 8621, Form 5471 or Form 8865
FinCEN Form 114 – FBAR (Report of Foreign Bank and Financial Accounts)

• U.S. owners, beneficial interests in, or signature authority over foreign bank accounts must file an FBAR if aggregate value of the accounts exceeds $10,000 at any time in the calendar year
  • FBAR requires disclosure of the highest balance in the year
• Due on same date as income tax return, with extensions