Gary S. Wolfe, Esq.
Ryan Losi, CPA
Mark Ivener, Esq.

EB-5 Visas:
International Investors
&
U.S. Taxes

By

Gary S. Wolfe, Esq
Ryan Losi, CPA
Mark Ivener, Esq

Other Books by Gary S. Wolfe:

Offshore Tax Evasion: IRS Offshore Voluntary Disclosure Program

Offshore Tax Evasion: IRS Tax Compliance FATCA/FBAR

Offshore Tax Evasion: U.S. Tax & Foreign Entities

International Tax Evasion & Money Laundering

Tax Planning for U.S. and State Exports: IC-DISC

Asset Protection 2013: The Gathering Storm

U.S. Pre-Immigration Tax Planning

For more information please see website: www.gswlaw.com

Published by BG Digital Publishing

All Rights Reserved © 2014 Gary S. Wolfe

Table of Contents

Chapter 1 - EB-5 Investor Visa and U.S. Tax Issues

Chapter 2 - Estate & Gift Tax Planning

Chapter 3 - EB-5 Visas: U.S. Estate and Gift Tax

Chapter 4 - Domicile Law

Chapter 5 – Grantor Trust (Income Tax Rules)

Chapter 6 – FATCA/FBAR

Chapter 7 - 2014: U.S. Income, Estate & Gift Tax

Chapter 8 - International Tax Planning for U.S. Exports: IC-DISC

About the Authors

Chapter 1 - EB-5 Investor Visa and U.S. Tax Issues

By Gary S. Wolfe, Esq. and Mark Ivener, Esq.

Introduction

On September 3, 2011, the Los Angeles Times published an article "In U.S. Visa Program, Money Talks." On September 6, 2012 the New York Times published an article "Visas-For Dollars Program a Boon to Hotel Developers." On March 18, 2013, The Wall Street Journal published an article "Foreign Cash For U.S. Green Cards." Over the past few years, EB-5 Investor Visas have gained in popularity and have received recognition as an excellent opportunity for foreign investors looking for freedom and flexibility to live and work in the United States.

U.S. Nonimmigrant and Immigrant Investor Visa Options

Under current U.S. Immigration Laws there are 2 different investment visa options for foreign nationals wishing to invest in enterprises in the U.S. in exchange for the right to live and work in the US. Generally, a citizen of a foreign country who wishes to enter the United States must first obtain a visa, either a nonimmigrant visa for temporary stay, or an immigrant visa for permanent residence.

The Immigrant Investor (EB-5) Program

The Immigrant Investor (EB-5) Program was established as a pilot program in 1990 and is administered by the U.S. Citizenship & Immigration Services ("USCIS"). The EB-5 program encourages foreign investors to invest their way to living in the U.S.A. and allows investors and their families to become permanent residents (green card holders) in usually 1-2 years.
On September 28, 2012, President Obama signed S.3245, extending the EB-5 Regional Center Program for an additional three years until 9/30/15.

There are 10,000 EB-5 green cards available every year, and historically the program has been underutilized. In 2011 only 3,463 were issued and in 2012, 6,200 immigrants got their green cards via EB-5. In 2013, 8,567 visas were issued and based on the predicted increase for FY2014, Charles Oppenheim, Chief of the Visa Control and Reporting Division at the US Department of State has predicted a potential backlog for the first time in 2014 for Chinese nationals.

There are two EB-5 programs, i.e. the Direct Investment (Direct) program and the Regional Center program

The Direct Program and History of EB-5

In order for an applicant to qualify under the initial or Direct program, the following three basic requirements must be met:

1. Investment in a new commercial enterprise;
2. Investment of at least $1 million (or $500,000 in certain cases) into the business; and

3. Creation of employment for at least 10 full-time U.S. workers.

For the first two years, the program was only set up for those who were willing to invest and create their own business that would produce at least ten jobs. However, in 1993, the government began to designate certain businesses as regional centers: they were primarily businesses that were started or expanded in a Targeted Employment Area (TEA), an area where the unemployment rate exceeded the national average by 150% or a rural area where the population is less than 20,000, fit within the $500,000 investment designation, and were duly approved by the USCIS (formerly the INS).

Regional Centers

The second program within the EB-5 category, i.e. the Regional Center program, is ideal for the retiree or inactive investor due in large part to the “indirect employment” feature of this program. The Regional Center program advantageously removes the 10 full-time employee requirement of the Direct program and substitutes the less-restrictive “indirect employment creation,” which allows the investor to qualify by proving 10 direct and/or indirect employees who are new to the Regional Center.

The EB-5 policy management requirement is minimal in that the investor can be a limited partner and still qualify as long as the limited partners have a policy making role. Thus, for those who are not interested in day-to-day management or running an active business, Regional Center programs offer a more acceptable

inactive form of investment, than do most Direct program investments. Another advantage of Regional Center programs that adds to the flexibility of this Green Card category is that the investor is not required to live in the place of investment; rather, he or she can live wherever he/she wishes in the United States.

Procedures and Timelines for Filing EB-5 Investor Green Card Petition

Each Regional Center program must be pre-approved by USCIS in order to be eligible to qualify for EB-5 Green Cards. The investor must present evidence that documents the lawful source of funds and traces the funds through bank transfers and other documentation, from the investor directly to the enterprise. The money can be the investors' own funds or in the form of a loan or gift, which would allow a parent to gift a son or daughter.

After the investor completes a thorough business and financial due diligence analysis of the viability of the Regional Center business opportunity, the investment is made and an I-526 petition is filed by the foreign investor with USCIS, requiring the agency to approve that the applicant (source of funds) and the investment are eligible for EB-5 status, which takes an average of 6 months for Direct and 18-24 months for Regional Center cases.

If the investor is already in the U.S., generally in valid work status, he or she then applies for a Green Card through USCIS. No interview customarily is required, and approval for most cases is currently taking approximately 6-12 months. If the investor resides abroad, an application for the Green Card is generally made at the U.S. Embassy or Consulate in the investor's home country, where an interview is necessary. Approval of the Green Card in this case takes on average about 6-8 months. Thus, the entire immigration process generally takes about 12-24+ months, depending on where the Green Card processing occurs. Once USCIS or a U.S. Consulate approves the investor's Green Card, it is conditional for a period of two years. Conditional Green Card status confers the same rights as the permanent Green Card. Between 21-24 months after the conditional Green Card has been approved, the investor must reconfirm that the investment has been made and that the employment requirement has been fulfilled. An I-829 application to remove the conditional Green Card status is then filed with USCIS, which takes about 12 months for processing. Once the condition has been removed, a full Green Card is granted for permanent resident status. From the

filing of the I-526 application until approval of the Removal of Conditions usually takes about 4-5 years. Thereafter, in an approved EB-5 case, even if the investment is sold, the investor will still maintain the permanent Green Card.

E-2 Treaty Investor Nonimmigrant Visa

The E-2 Treaty Investor visa is a nonimmigrant visa for citizens of countries with which the United States maintains treaties of commerce and navigation.

(Please see gswlaw.com website, EB-5 Visa button for complete list of E-2 Treaty Countries.)

The E-2 visa allows a foreign national from a treaty country the right to live and work in the U.S. for a business that either they have invested in or in which nationals from their country have invested for a temporary period of time. Initial visas may last for up to five years, with unlimited extensions. The length of the visa depends upon the visa "reciprocity" agreement between the U.S. and the foreign country and upon the viability of the business (new companies may receive shorter validity periods). Each time E-2 visa holders (workers or family members) enter the U.S., they receive a period of stay of up to two years. They also may extend their stay while remaining in the U.S. E-2 visas are available for an accompanying spouse and unmarried children under the age of 21, and the spouse, but not children, may apply for a work permit once physically present in the U.S.

The following are the criteria to qualify for an E-2 Treaty Investor Visa:

• The applicant must be a citizen of a country that has a relevant treaty with the United States. (See attached list of eligible countries);

• The applicant must be coming to work in the U.S. for a company that he or she either owns or that is at a minimum 50% owned by other nationals of the treaty country of origin;

• The applicant must be either the owner who will develop and direct the operations or a key employee (executive or supervisor, or someone with essential skills) of the U.S. business;

• The applicant or the company must have made a substantial investment in the U.S. business (there’s no legal minimum, but the applicant or company must be putting capital or assets at risk, be trying to make a profit, and the amount must be substantial relative to the type of business).

• The U.S. company must be actively engaged in commercial activities and meet the applicable legal requirements for doing business in its state or region. It also cannot be merely a means to support the investor. The underlying goal of the treaty investor visa is to create jobs for U.S. workers.

• The applicant must intend to leave the U.S. when his or her business in the U.S. is completed, although the person is not required to maintain a foreign residence abroad. With the exception of E-2 applicants from the United Kingdom, the applicant need not be presently residing in the country of citizenship in order to qualify for an E-2 visa.

In determining which investor program is best suited, there are several factors to consider. With EB-5, once the Green Card is issued, the foreign national is authorized to work for any employer or enterprise, while with an E-2, the treaty investor or employee is restricted to working only for the employer or self-owned business that acted as the E-2 visa sponsor. The EB-5 allows for passive or inactive investment, whereas the E-2 visa requires that the treaty investor develop and direct the operations of the investment enterprise. However, the EB-5 requires a minimum investment of $500,000 and with the E-2 visa, there’s no legal minimum provided the amount must be substantial relative to the type of business. Also, there are no annual limits on the number of E-2 visas that can be issued to qualified applicants.

In summary, freedom to live anywhere in the United States, a passive form of investment with no required direct management responsibilities, no employer sponsor required within the Immigration process, and an accelerated path to Green Card procurement – all are important factors which make the EB-5 Green Card Regional Center category an ideal vehicle for the inactive investor or retiree who wishes to live and/or work in the United States. As with other U.S. Immigration visas, applicants also need to take into account U.S. and foreign tax and other business and personal planning considerations, which are covered below.

EB-5 Investor/U.S. Tax Issues

Once an EB-5 investor enters the U.S., he becomes a U.S. income tax resident, i.e. a conditional permanent resident immediately subject to tax on worldwide income: income from inside the United States and income earned outside the United States.

Upon entry into the U.S. from the date entered, the EB-5 Investor is subject to U.S. Income Tax compliance annually, which includes filing the following:

1. <u>Form 1040</u>: report worldwide income;

2. <u>Foreign Financial accounts over $10,000</u> file Form TDF 90-22.1, Report of Foreign Bank and Financial Accounts, "FBAR Filing," due June 30th following tax year (separate tax filing);

3. <u>Foreign Financial Assets valued in excess of $50,000</u> file Form 8938, "Specified Foreign Financial Assets" attached to Form 1040 (Foreign Account Tax Compliance Act: "FACTA Filing").

Note: Filing Form 8938 (with Form 1040) does *not* relieve U.S. taxable residents of the requirement to file "FBAR," Form TDF 90-22.1 if FBAR filing is otherwise due.

For willful failure to report the foreign bank and financial account (under Form 1040/Schedule B (Part III, Foreign Accounts and Trusts) and TDF 90-22.1, the taxpayer faces criminal penalties of up to 10 years in jail, a $500,000 fine and civil penalties of 50% of the account balance computed annually. So, for example, if the FBAR is not filed for 4 years, the civil penalty is 200% of the account balance.

Until such time as the investor receives the EB-5 visa, they are classified as a non-resident alien and are subject to a flat 30% tax on U.S. source income that is not effectively connected with the conduct of a U.S. trade or business.

A tax withholding agent must withhold 30% of the gross amount paid to a foreign taxpayer, who is subject to tax; unless the withholding agent obtains valid documentation (IRS Form W-8) that the U.S. payee (Foreign National) is a "beneficial owner", and subject to a tax exemption, or a reduction of tax.

U.S. Estate and Gift Tax

Once an EB-5 investor becomes a "conditional permanent resident", it may be considered an indicia of U.S. domicile (i.e., the investor intends to permanently reside in the U.S.). If the investor is audited by the IRS, and is determined to have a U.S. domicile, they will be subject to U.S. Estate & Gift Tax.

Domicile is defined "A person acquires a domicile in a location by living there, even for a brief period, with "no definite present intention" of later removing from that location (Treas. Reg. Sec. 20.0-1(b)(1)(b)(2), Estate of Edouard H. Paquette v. Commr. (T.C. Memo, Par. 83,571 (1983)

EB-5 Investors (2012) U.S. Estate & Gift Tax Planning
U.S. citizens and U.S. domiciles are subject to U.S. Estate and Gift tax on their world-wide assets. Non-U.S. domiciles are subject to U.S. Estate and Gift Tax on U.S. assets.

EB-5 Investors (Non-Citizens Who Reside in the U.S.)

A non-citizen who holds a green card is a "permanent resident" of the United States subject to U.S. income tax on their world-wide income (IRC§7701(a)(30)(A); Treas. Reg. Sec. 301-7701(b)-1(b)(1). The immigration laws do not require a green card holder to intend to remain permanently in the U.S. since the definition of a U.S. tax resident, for U.S. estate and gift tax purposes, focuses on intent, a green card holder may be a U.S. income tax resident, but under the residency "intent" test, may not be a U.S. tax resident for estate and gift tax purposes. The EB-5 investor, who is present in the U.S. under an EB-5 visa (Immigrant Investor Visa), and intends to permanently remain in the U.S. can be classified as a U.S. resident for U.S. Estate & Gift tax purposes and will be subject to U.S. Estate & Gift Tax.

EB-5 Investors before they immigrate to the U.S. may be classified as non-resident aliens ("NRA") with no U.S. domiciles, not subject to U.S. estate and Gift tax except for specified assets: (i.e. U.S. real estate, tangible personal property). EB-5 investors who immigrate to the U.S. may be classified as either a U.S. estate & gift tax resident, or non-resident.

EB-5 Investors: U.S. Estate & Gift Tax Rates - (NRA: No U.S. Domicile)

An EB-5 Investor who is a non-citizen, and is not domiciled in the U.S., is a non-resident alien (NRA) for U.S. Estate & Gift Tax purposes.

U.S. Gift Tax (NRA)
An NRA is subject to U.S. gift tax only on gifts of interests in U.S. real estate and tangible personal property located in the U.S. (e.g. cash, art, jewelry). An NRA is not subject to U.S. gift tax on gifts of intangible personal property (including stock in U.S. corporations) even if that property has a connection to the U.S. (See IRC§2501).

U.S. Estate Tax (NRA)
Under IRC§2103, the federal estate tax applies more broadly (than gift tax rules) to NRA estates.

An NRA estate is subject to U. S. estate tax on property located in the U.S. including: real property, tangible personal property, stock in U.S. corporations, debt obligations of U.S. persons. Property located in the U.S. may include: interests in U.S. partnerships and limited liability companies but the law is not definitive.

An NRA's U.S. estate will not include proceeds of insurance on the decedent's life, certain bank accounts, and portfolio debt, the income from which is exempt from U.S. income tax (IRC§2105). The portfolio debt exception exempts U.S. Company publicly traded debt securities and U.S. government obligations.
Under IRC§2103, the value of an NRA's "gross estate", which at the time of his death is "situated in the US" is subject to US estate tax (Treas. Reg. 20.2103-1).

NRA estates receive a credit against the U.S. estate tax of $13,000 which shelters $60,000 of property from transfer tax (IRC§2102(c)). Tax rates are the same as for U.S. citizens and resident aliens (IRC§2001(c)).

A marital deduction is allowed for property in the U.S. under IRC§2056, and if applicable, IRC§2056A (assets passing to a decedent's non-citizen spouse, thru a Qualified Domestic Trust, IRC§2056(d)(2)(A)). There is no gift tax marital deduction for otherwise taxable gifts to non-citizen spouses (IRC§2523, Treas.

Reg. Sec 25.2523 (1)-1(a)). However, under IRC§2523(i)(2) the annual exclusion amount for gifts to non-citizen spouses is $139,000.

An estate tax of an NRA must file a federal estate tax return if the decedent's gross estate exceeds $30,000 (Treas. Reg. §20.6018-1(b)).

Resident Aliens

An EB-5 Investor who is a resident alien, and is classified as a U.S. Estate & Gift tax resident, based on having a U.S. domicile, is subject to U.S. gift tax on lifetime transfer of assets, wherever located, and is subject to U.S. estate tax on their world-wide assets (IRC§2001(a), 2031(a)).

A resident alien has the same applicable credit and GST exemption as a U.S. citizen (IRC§2010(a), 2505(a), 2631). The same annual gift tax exclusions (IRC§2503), and the same spousal "gift-tax splitting" rights as long as that spouse is a U.S. citizen or resident alien (IRC§2513).

Reporting Gifts from Foreign Person

IRC§6039F imposes annual information reporting requirements on any U.S. person who:

1. Receives a foreign gift (i.e. a gift from a foreign corporation or partnerships) in excess of $14,723 (2012) (Rev. Proc. 2011-52);

2. Receives a gift of $100,000 from a foreign individual or estate (IRS Notice 97-34);

The gift must be reported on IRS Form 3520 (Part IV) describing the property received, the FMV of the property and the gift date when the donor is an individual, an estate, Form 3520 does not require the donor name and address except where the foreign donor is a partnership or corporation.

U.S. beneficiaries who receive distributions from foreign trusts should report the amounts under the trust reporting rules IRC§6048(c), rather than gift reporting rules of IRC §6039F.

U.S. beneficiaries are not required to report contributions by foreign persons to trusts in which the U.S. beneficiaries have an interest, unless the U.S. beneficiaries are treated as receiving the contribution on the year of transfer (the U.S. beneficiary has an IRC§678 power). A domestic trust that receives a contribution from a foreign person must report the gift unless the trust is treated as owned by a foreign person (e.g. a foreign person creates a U.S. revocable trust).

According to IRS Notice 97-34 (and Form 3520 instructions), a U.S. beneficiary who receives a distribution from a domestic grantor trust, owned by a foreign grantor, must report it under IRC §6039F as a gift from a foreign person (i.e. the deemed foreign owner of the domestic trust).

A U.S. person who fails to report such foreign gifts will be subject to penalties equal to 5% of each gift for each month of non-compliance (not to exceed 25% of the aggregate foreign gifts).

In 2014, U.S. Estate & Gift Tax Rates for U.S. citizens and domiciles are as follows:

1. Estate Tax Exemption is $5,340,000 ($10,680,000 husband and wife) excess assets taxed at 40% (2014);

2. Lifetime Gift Tax Exemption is $5,340,000 ($10,680,000 husband and wife) excess assets taxed at 40% (2014);

3. Generation Skipping Tax (”GST”) exception, assets over taxed at 40% (2014);

4. Marital deduction gifts up to $139,000 (2013); $143,000 (2014) in annual gifts to an alien spouse (non-citizen) are exempt from tax (Rev. Proc. 2011-52, IRS§2503(b), 2523(i); (2012)

5. Annual gifts received from foreign persons (i.e. foreign corporations and partnerships) are reportable if they exceed $14,723 for the year (Rev. Proc. 2011-52, Sec 3.35, 2011-45 I.R. B.); (2012)

6. Annual gifts received from foreign individuals and estates are reportable once they reach the annual reporting threshold of $100,000 (IRS Notice 97-34)(2012)

7. Annual Gift Tax Exclusion is $14,000 ($28,000 husband and wife). Gifts in excess of the annual exclusion amount must be reported on Form 709. Taxpayers who fail to attach Form 709, past gift tax returns, to Form 706: Estate Tax Return may trigger an audit. The IRS is aggressively pursuing this tax issue. (2013)

8. “Succession Tax” Under IRC§2801, gift tax at the highest applicable gift or estate tax rates is imposed on the gift recipient, who receives a “covered gift” (i.e. a direct or indirect bequest) from a “covered expatriate” (under IRC§877A). The Succession Tax (gift tax) does not apply to annual exclusion gifts (IRC§2503(b)), in 2013: $14,000 per year, or gifts entitled to a marital or charitable deduction.

Chapter 2 – Estate & Gift Tax Planning

1. Non-Domicile international investors may gift unlimited non-U.S. situs assets with no U.S. Gift Tax.

2. U.S. Domicile international investors are subject to estate and gift tax on transfers of world–wide assets that in 2012 exceed the following exemptions:

a. $5,340,000 Estate Tax and Lifetime Gift Tax exception ($10,680,000 husband and wife).

b. $14,000 annual gift tax exemption ($28,000 husband and wife)(2013).

Domicile Test

Domicile is determined by the facts (there is no bright line test). A foreigner living in the U.S. will be treated as domiciled in the U.S. if:

1. They reside in the U.S. (the "Presence Test") and

2. They intent to reside in the U.S. indefinitely (The "Intent Test")

The Intent Test

Under the intent test, a foreigner briefly living in the U.S., with no intention of later leaving the U.S., can lead to a determination of U.S. domicile.

If the foreigner has no intention to reside in the U.S. indefinitely, the foreigner can never become domiciled in the U.S. even if they lived in the U.S. for many years.

The Presence Test

Under the presence test, the IRS examines facts and circumstances to determine whether foreigners plan to stay in the U.S.

The Presence Test (facts and circumstances) includes:

1. Residences location, value and size and the amount of time spent on each residence

2. Location of Family and friends

3. Location of personal possessions

4. Location of their businesses

5. Where they are licensed to drive

6. Where they are registered to vote

7. Location of their religious organization

8. Location of their social organization

9. Location of any burial plots

10. Terms of immigration status

11. Whether they have a green card or visa

12. Whether they have a U.S. Social Security number

13. Where they declared their residence to be in a will or trust

14. Where they declare their residence in an application for a visa or "green card".

Non-Domicile Status

A foreigner who wants to establish non-domicile status should do the following in their home country:

1. Purchase a principal residence and spend as much time there as possible

2. Purchase Burial plots

3. Join clubs and religious organizations

4. Engage in business activities

5. Register to vote

6. Obtain a driver's license

For U.S. gift tax purposes a foreigner who lives in the U.S. and intends to leave is better advised to seek a visa instead of a "green card" (since the green card is an indicia of domicile)

If the IRS accepts a foreigner as a non-domicile, they may gift (U.S. gift tax-free) unlimited non-U.S. situs assets (including stock in U.S. Corporations).

If the foreigner is treated as a U.S. domicile, they will be subject to gift tax on transfer of worldwide assets that exceed applicable exceptions (eg. $14,000 annually, $5,340,000 lifetime gift tax exemption).

U.S Estate Tax Planning (Non-Domicile)
Non-domicile should reduce possible U.S. estate tax exposure:

1. Make unlimited gifts of non-U.S. situs tangible personal property (e.g. shares of stock in non-U.S. corporations, tangible property located outside of the U.S. at the time of the gift (i.e. art, jewelry, cash);

2. Make unlimited gifts of shares of stock in U.S. corporations (not subject to U.S. gift tax, would be subject to U.S. estate tax);

3. Make unlimited gifts of real property located outside the U.S.

If the transfers are within the $5,340,000 gift/estate tax exemption they will remain tax-free in the event of an adverse domicile determination under an IRS Tax Audit.

U.S. Gift Tax Planning

U.S. gift tax is imposed on;

1. U.S. Real Property;

2. U.S. tangible property (e.g. Cash, art, jewelry) physically located in the U.S.; Stock in U.S. corporations is not U.S. situs property for gift tax purposes (but is U.S. situs property for U.S. estate tax purposes.)

U.S Gift Tax: Non-U.S. Situs Property

For U.S. Gift Tax purposes, assets that are deemed outside of the U.S. (non-U.S. situs include:

1. Real, and personal property located outside the U.S.;

2. Shares of stock issued by a foreign corporation;

3. Life insurance proceeds on a non-resident individual's life;

4. Deposits with a foreign branch of a domestic corporation (or partnership) engaged in the commercial banking business;

5. Deposits with U.S. commercial or foreign commercial banks;

6. Many types of Bonds or notes.

Tax treaties between the U.S. and a foreigner's home country may provide further exceptions which qualify assets as non-U.S. situs for U.S. estate and gift tax purposes.

Spousal Gifts

Spouses, who are non-domiciles, can make unlimited gifts to each other, outside the U.S., gift-tax free.

Non-U.S. citizen foreigner spouses, who are considered to have a U.S. domicile may each only gift the other $139,000 (2013), $143,000 (2014) without using up the $5,340,000 exemption (2014) to which they will be subject.

If domicile status is unclear, in order to avoid U.S. gift tax exposure the foreigner spouse should:

1. Establish an offshore trust (irrevocable trust);

2. Establish an offshore account in their name;

3. Transfer $5,340,000 to the offshore account in their name;

4. Gift $5,340,000 from the offshore account in their name, to the offshore trust account.

In the event of an IRS Gift Tax Audit using the gift tax exemption, there would be no U.S. gift tax exposure on the $5,340,000 gift. For the non-domicile, there would be no U.S. gift tax. For the domicile, the $5,340,000 gift would be U.S. gift-tax free, using the $5,340,000 lifetime gift tax exemption.

Wealthy non-domicile may gift non-U.S. property, beyond the $5,340,000 exemption which will be U.S. gift tax-free. This gift would be subject to classification as a non-domicile, since if the IRS determines domicile the foreigner will owe gift tax, interest and penalty on the transferred amount that exceeds the $5,340,000 exemption.

Cash Gifts (Non-Domicile)

In order to avoid U.S. gift tax, non-domiciles should make cash gifts outside of the U.S. as follows:

1. Establish a non-U.S. account in the non-domicile’s name and transfer funds to it;

2. Have the U.S. donee (whether an individual or trust) set up a non-U.S. account in donee’s name;

3. Gift from the non-domicile non-U.S. account to the U.S donee’s non-U.S. account;

4. The U.S. donee may then wire transfer funds from the non-U.S. account to the U.S. donee's account.

Stock: U.S. Corporation (Non-Domicile)

1. A non-domicile, who owns stock in a U.S. corporation, should gift the stock while alive (so no U.S. estate tax on death). The non-domicile gift of U.S. stock is U.S. gift-tax-free.

2. A non-domicile, who is concerned that they may be deemed domiciled in the U.S., under an IRS gift tax audit, should gift the stock (under the gift tax exemption i.e. $5,340,000). If the gift is made while alive, it will either be not subject to IRS gift tax audit (with no tax imposed) or if subject to IRS gift tax audit, exempt from U.S. gift tax, up to $5,340,000 in value (if U.S. domicile is deemed established by the IRS, under the audit).

Chapter 3 – EB-5 Visas: U.S. Estate and Gift Tax
By Mark Ivener, Esq. & Gary S. Wolfe, Esq.

EB-5 Investors who receive both conditional and permanent Green Cards subject themselves to classification as US domiciles subject to US estate and gift tax on their world-wide estates. A US domicile is a non-US citizen who relocates to the US with the intention to permanently reside in the US. Under the Estate of Paquette (T.C. Memo,Par. 83,571(1983), a person acquires a US domicile, by living in the US, even for a brief period, with no definite present intention of later removing from that location (See: Treas Reg. Sec. 20.0(b)(1),(b)(2). If an EB-5 Investor receives a Green Card, under IRS audit it may be construed as evidence of a permanent intention to reside in the US subjecting them to US estate and gift tax on their World-wide assets taxed at 40% over $5.34m in assets ($10.68m husband and wife), 2014 US Estate and Gift tax rates.

The issue of domicile may prove to be an expensive IRS audit trap since if the investor is not a US Estate and Gift tax resident (i.e. a non-US domicile), they are only subject to US Gift Tax on: gifts of interests in US real estate and tangible personal property located in the US (e.g. cash, art and jewelry), and US estate tax on property located in the US, including: real property, tangible personal property, stock in US corporations, debt obligations of US persons and potentially: interests in US Partnerships and Limited Liability Companies (there is no US gift tax on gifts of intangible personal property including stock in US corporations even if that property has a connection to the US (IRC Code Sec. 2501). In contrast, a non-US domicile would not have a US estate and gift tax on non-US assets (i.e. World- wide assets). In addition, the non-US domicile would not be subject to US estate tax on life insurance proceeds, and certain bank accounts and portfolio debt.

The question arises: what does the investor do to protect themselves from this tax conundrum? The first issue is recognizing the tax audit trap i.e. the IRS wants their money. The EB-5 program was established in 1990, suspended in 1998, and resumed in 2003. It is a new program. US Estate and Gift Tax law has not definitively addressed these tax issues, yet. However, given the US governments huge deficits and need for new sources of revenue, it is likely this issue will be addressed as more foreign investors pour funds into US real estate, companies and investment portfolios. So what is the investor's risk? Simply put, the EB-5 Visa specifically designates their intention to permanently reside in the US first by

declaration to the USCIS under their 2 year conditional Green Card, then prima facie under their "permanent Green Card". If they receive their conditional Green Card within 2 years after initial filing, their permanent Green Card in about 3 years later and then continue to reside in the US, what evidence could they present to support their case that they are not a US domicile and not subject to world-wide US Estate and Gift Tax on their total World-wide assets? Which evidence would the IRS believe as credible under an IRS audit? As an IRS audit expert(I have successfully handled numerous IRS audits for 30 plus years), I would be hard pressed to make a convincing case that an EB-5 Investor residing in the US does not have an intention to permanently reside in the US especially since that testimony is generally given to support their Green Card (i.e. conditional Green Card), and is prima facie evidence once they receive their permanent Green Card (the word permanent is not helpful to establish a case for non-US domicile). Or, in other words:"If they were a horse, I would not bet on them".

The second issue is a bi-lateral tax treaty issue. Is the investor a citizen or estate/gift tax resident of another country? Does that country have a tax treaty with the US? If so, what about the investor who is a citizen of a foreign country, but is also a US domicile? Under the treaty rules, both governments would look at the investor's family, social and business connections to each country: i.e. where is their permanent home, where is their center of vital interests, where is their habitual abode, where is their citizenship and apply the treaty tie-breaker rules which determines which country gets to impose the estate and gift tax (and are there tax credits available for taxes paid in one country if the second country has a higher tax rate).

The third and most important issue does the investor do US pre-immigration tax planning? If the investor is tax conscious, the answer is absolutely. What can the investor do to protect against US estate and gift tax? First, establish an offshore trust in a reputable jurisdiction with an established banking system, infrastructure, "secrecy laws" and favorable asset protection legislation. The trust should be irrevocable and non-amendable so the trust assets would not be subject to US estate tax (i.e. the trust assets would not be included in the US estate for estate and gift tax purposes). Second, establish non-US accounts in the non-domiciliary's name, transfer funds to it, have the US donee set up a non-US account in the donee's name, make gifts from the non-domiciliary's non-US account to the US donee's non-US account, the US donee may then wire transfer funds from the non-US account to the US donee's account. A non-domiciliary who

owns stock in a US corporation should gift the stock while alive so there will be US estate tax on death. The non-domiciliary's gift of US stock is US gift tax free.

For the wealthiest of investors (i.e. over $10.68m), use the funds in the offshore trust to purchase a US life insurance policy (after they get their Green Card). The offshore trust is the owner and beneficiary of the US life insurance policy. If they purchase the policy before they get the Green Card, there is a 30% US/NRA withholding tax on the life insurance policy proceeds paid on the death of the insured (see IRS Pub. 515,p.15). If they establish the "pre-immigration trust" and fund it before they move to the US, they hit the "tax trifecta": no US gift tax on funding the trust, and no US estate or income tax on the life insurance death benefit proceeds. As we used to say in NY, "What's not to like?" For all those investors who prefer to "do nothing" or "do it themselves" i.e. read a manual, consult with an non-expert advisor, always remember, "It is not the ship so much, as the skillful sailing that assures the prosperous voyage."

Chapter 4 – Domicile Law

1. Definition of Residence for California Income Tax Purposes

2. Treasury Regulation Section 20.0-1 – Domicile

3. Domicile (Generally)

4. Domicile of Choice

5. Domicile – Defining Resident Status For U.S. Estate Tax Purposes

6. Domicile – Definition Under U.S. Estate Tax Treaties

7. For Estate And Gift Tax Purposes Residence Means Domicile

8. Determination of Federal Estate and Gift Tax Residence Domicile

9. Domicile: Non–U.S. Citizen Residency for Estate, Gift, and Generation-Skipping Transfer Taxes

10. Domicile and Residence – The Same and Different

11. Domicile v. Residency

12. Property of Non-resident Alien Treated as Located in the United States

13. Identifying Property Economically Owned by the Nonresident Alien Decedent

14. Joint ownership of property

15. Double Taxation (Domicile) - Tax Treaties

16. U.S. Gift Tax

17. Applicability of U.S. Transfer Tax to Nonresident Aliens

18. U.S. Estate, Gift, and Generation Skipping Transfer Taxation of Non-Resident Aliens

19. Property Subject to Tax

20. Rate and Calculation of Tax

Definition of Residence for California Income Tax Purposes

A. Taxation of California Residents and Nonresidents

1. California residents are subject to California income taxation on their worldwide business and non-business income. The California tax on taxable income is a graduated tax ranging from 0% to 10.3% (imposed on income in excess of $1 million).

2. Nonresidents are only subject to California income taxation on their California source business and non-business income.

The California income tax for each nonresident is computed by multiplying (i) the California income tax which would be owed if the nonresident were a California resident by (ii) a fraction the numerator of which is the nonresident's adjusted gross income from California sources and the denominator of which is the nonresident's worldwide adjusted gross income.

B. Determination of Residence for California Income Tax Purposes

1. California has not adopted the federal income tax rules (IRC § 7701(b)) for determining resident status for California income tax purposes.

2. Under the California Revenue and Taxation Code ("R&T") and the regulations there under, an individual is a resident of California for California income tax purposes if such individual is:

a. present in California for other than a "transitory or temporary purpose"; or

b. domiciled in California and leaves California for a "temporary or transitory purpose." See R&T Code § 17014(a); and Reg. 17014(a).

3. Temporary or transitory purpose test is satisfied if an individual is present in California:
a. For a brief rest or vacation (i.e. definite short stay). See R&T Reg. § 17014(a);

i. Not a California resident if (i) here not more than six months and while here person is only on vacation to rest, or as a guest, but does not conduct any

business and (ii) maintains a permanent abode at place of domicile. See R&T Reg. 17014(b);

ii. Presumption. Individual is a resident if here more than nine months. See R&T Reg. 17016;

b. Or, to perform a contract or engagement (i.e., complete a particular transaction or engagement with a short duration). See R&T Reg. § 17014(a).

4. Temporary or transitory purpose is not satisfied if an individual is present in California:

a. To improve such person's health and person has an illness which requires long recuperation;
b. To retire;

c. For business purpose which will last for a long or indefinite period.

C. Factors which are relevant in determining residence: (close connection or contacts)

1. Length of physical presence in California.

a. Physical presence in California is the most persuasive indicator of residence. The longer the taxpayer remains in California, the more likely that the taxpayer will be found to be a California resident for tax purposes.

b. A taxpayer is presumed to be California resident if the taxpayer is present in California for at least nine months. The presumption is a statutory presumption which is rebutted by satisfactory evidence that the taxpayer is present in California for temporary or transitory purposes.

2. Employment in California.

a. Employment in California is a very important determining residency in California. A presence in California to complete a particular transaction, complete a particular contract or fulfill a particular engagement constitutes presence for a temporary or transitory purpose. On the hand, indefinite employment in

California, or employment for a long period of time constitutes presence which is not for a temporary or transitory purpose.

3. Contacts with California.

a. A taxpayer’s contacts with California are very important in determining residency. A taxpayer with significant contacts in California is considered a California resident. Under these circumstances, the magnitude of the taxpayer’s contacts indicates that the taxpayer’s presence in California is not temporary or transitory.

b. The taxpayer’s contacts in California are compared with the taxpayer’s contracts in other states or countries to determine which place the taxpayer has the closest connections to.

c. Factors which indicate that the taxpayer is a California resident are:

i. He actively seeks and acquires a business in California;

ii. He is present in California for a business project requiring a long period to complete; or

iii. He incorporates a business in California even though the business is transacted outside of California;

iv. Maintenance of home in California;

v. Banking and checking accounts in California;

vi. Social clubs and other activities in California;

vii. Business in California;

viii. Family relationships in California including spouse and children.

d. Place where person votes, files tax returns or donates to charity are relevant for determining domicile not residence.

D. Proof of Nonresidence. R&T Reg. § 17014(d).

Proof of Nonresidence can be established through testimony or affidavits from individual, friends, employer, etc. that individual is in California for permissive purpose described in IIB above and for short duration.

Treasury Regulation Section 20.0-1 – Domicile

Under Treasury Reg. Section 20.0-1(a)(b), U.S. Estate Tax is imposed on either a citizen of the U.S. or an Estate Tax Resident (i.e., a "resident" decedent is a decedent who at the time of his death, had his domicile in the U.S.)

Treasury Regulations Section 20.0-1

(b) SCOPE OF REGULATIONS

(1) ESTATES OF CITIZENS OR RESIDENTS. Subchapter A of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a citizen or a resident of the United States at the time of his death. A "resident" decedent is a decedent who, at the time of his death, had his domicile in the United States. The term "United States", as used in the estate tax regulations, includes only the States and the District of Columbia. The term also includes the Territories of Alaska and Hawaii prior to their admission as States. See section 7701(a)(9). A person acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of later removing therefrom. Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, nor will intention to change domicile effect such a change unless accompanied by actual removal. For the meaning of the term "citizen of the United States" as applied in a case where the decedent was a resident of a possession of the United States, see Section 20.2208-1. The regulations pursuant to subchapter A are set forth in Sections 20.2001-1 to 20.2056(d)-1.

(2) ESTATES OF NONRESIDENTS NOT CITIZENS. Subchapter B of Chapter 11 of the Code pertains to the taxation of the estate of a person who was a nonresident not a citizen of the United States at the time of his death. A "nonresident" decedent is a decedent who, at the time of his death, had his domicile outside the United States under the principles set forth in subparagraph (1) of this paragraph. (See, however, section 2202 with respect to missionaries in foreign service.) The regulations pursuant to Subchapter B are set forth in Sections 20.2101-1 to 20.2107-1.

Domicile (Generally)

Domicile is a legal construct that describes the relationship the law creates between an individual and a particular locality or country.

Income tax rules do not apply for estate, gift, or generation-skipping tax purposes. Whether the transfer is subject to taxation generally depends on the domicile of the donor, or decedent, at the time of the gift or death. Reg. Section 20.0-1(b)(1), Reg. Section 25.2501-1(b).

Domicile is defined as the combination of physical presence in a place and the intent to remain there indefinitely.

Domicile is a function of a person's intent to remain in a particular residence indefinitely and even an illegal alien can establish a U.S. domicile. Estate of Jack v. United States, 54 Fed. Cl. 590 (Fed. Cl. 2002).

An individual can be both a non-resident alien and a resident alien during the same year. This generally occurs in the year the individual arrives in or departs from the United States.

The IRS will not rule on whether an alien individual is a non-resident of the United States, including whether the individual has met the requirements of the substantial presence test or exceptions to it. However, the IRS may rule regarding the legal interpretation of the definition of resident. Rev. Proc. 2007-7, 2007-1 I.R.B. 227, Section 3.01(7).

Domicile is the place where a person has his/her permanent principal home to which, whenever he/she is absent, he/she returns or intends to return. Domicile is important because it is used in determining in what state a probate of a dead person's estate is filed, what state can assess income or inheritance taxes, where a party can begin divorce proceedings, or whether there is "diversity of citizenship" between two parties which may give federal courts jurisdiction over a lawsuit. Where a person has several "residences" evidence may need to be examined to determine which is the state of domicile. A person may have only one domicile at a single point in time. A business has its domicile in the state where its headquarters is located. For tax purposes, a business' domicile is often a principal place of business.

Each State of the United States is considered a separate sovereign within the U.S. federal system, and each therefore has its own laws on questions of marriage, inheritance, and liability for tort and contract actions. Persons who reside in the U.S. must have a state domicile for various purposes. For example, an individual can always be sued in their state of domicile. Furthermore, in order for parties to invoke the diversity jurisdiction of a United States Federal Court, the plaintiffs may not have the same domicile as any defendant.

Domicile of Choice

One who is legally capable of changing his domicile may attain a domicile of choice by simultaneously being physically present in the new location while possessing the requisite attitude of mind. (RESTATEMENT (SECOND) OF CONFLICT OF LAWS §15 (1971). See Bell v. Bell, 326 Pa. Super. 237, 473 A.2d 1069 (1984). The court held that a husband had established domicile in Nevada even though he moved to that state for the purpose of obtaining a divorce.)

The requisite attitude of mind is the present intent to make a principal home in the place, with no present intent to move elsewhere. (RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 15 comment a (1971).)

Intent is usually determined by the person's conduct and surrounding circumstances. A person's own declaration of domicile is admissible as evidence, but is not very persuasive because of its self-serving nature. (See Kjarstad v. State, 703 P2d 1167 (Alaska 1985); In re Esser's Will, 38 Misc. 2d 963, 239 N.YS.2d 585 (Sur. Ct. 1963); Meltzer & Weisberg v. Commonwealth Unemployment Comp. Bd. of Review, 80 Pa. Commw. 178, 471 A.2d 157 (1984).)

Courts concentrate on such factors as substantial business and social contacts, type of home, membership in church or other organizations, registration to vote, place of driver's license and car registration, and similar elements demonstrating that a particular locality has the most significant relationship to the person.

Domicile – Defining Resident Status For U.S. Estate Tax Purposes

The alien must also be a nonresident to avoid global U.S. estate taxation. For U.S. estate tax purposes, the term “nonresident decedent” means a person who, at the time of death, had his domicile outside the United States. (Reg. § 20.0-1(b)(2). This regulation specifies that domicile is determined by application of the principles prescribed in Reg. § 20.0- l(b)(1).) The statutory term utilized is “resident,” but the import of this term really contemplates domicile, often a very different concept. (Even an illegal alien, though subject to deportation if discovered by immigration authorities, may be domiciled in the United States for estate tax purposes if the facts indicate an intention to remain in the United States ‘indefinitely. Rev. Rul. 80-209, 1980-2 CB 248. The ruling involved an illegal alien living in the United States for nineteen years, who owned property in the United States, was a member of social clubs, and participated in community activities.)

A person acquires a domicile in a location by living there, even for a brief period, with “no definite present intention” of later removing from that location. (Reg. § 20.0-1(b)(1). Physical presence is an important factor but is not controlling. See Estate of Paquette, 46 TCM 1400 (1983), where a Canadian citizen who had spent the winter months in Florida for twenty-five years and had purchased a home in Florida that was his sole residence was held to be a nondomiciliary of the United States. He had filed with the State of Florida a “Revocation of Declaration of Domicile and Citizenship.”)

Residence without the requisite intention to remain indefinitely will not suffice to constitute domicile, however. (Because this is a question of fact, the Service will not rule on the status of residency or domicile. See Rev. Proc. 95-3, 1995-1 IRB 85, § 4.02(1). Revenue Procedure 95-7, 1995-1 IRB 185.) If domicile exists in the United States, an intention to change domicile does not actually effect such a change unless accompanied by an actual removal from the United States. (See Rev. Rul. 58-70, 1958-1 CB 341, where an alien was planning to terminate domicile in a foreign country and establish domicile in the United States but did not accomplish this objective prior to death and was not treated as a resident for U.S. estate tax purposes.)

The Section 7701(b) definition of “resident alien” applies only for purposes of the income tax provisions. These rules do not apply for purposes of the U.S. estate

tax, gift tax, and generation- skipping transfer (GST) tax provisions. Consequently, an alien holding a “green card” is a resident for U.S. income tax purposes, but this status is not determinative for U.S. estate tax purposes if his domicile is actually outside the United States.

Domicile – Definition Under U.S. Estate Tax Treaties

In a situation where a U.S. estate tax treaty may be applicable, the same inquiry will arise with respect to the location of the decedent's domicile. The U.S. bilateral estate tax treaties have their own rules to determine whether a foreign individual is a resident in the United States at the time of death. These same rules apply bilaterally, of course, to determine whether a U.S. individual is domiciled in the foreign tax treaty jurisdiction at the time of death.

Recognizing that dual domiciliary status may exist, estate tax treaties often prescribe tie-breaker rules to determine domicile, based on the following priorities:

1. Location of the permanent home

2. Location of the closest personal and economic interests (i.e., the "center of vital interests")

3. The individual's habitual abode

4. Citizenship - The benefits of a U.S. estate tax treaty available to a foreign client are ordinarily available only if the foreign client is a domiciliary of that country and not if he is actually domiciled in a third country.

For Estate And Gift Tax Purposes Residence Means Domicile

If an alien individual is not domiciled in the United States at the time he makes a gift, he is nonresident for gift tax pur-poses. (Treas. Reg. § 25.2501 -1 (b); F. Giacomo Fara Forni v. Commissioner, 22 T.C.M. 975 (1954).) If he is domiciled outside the United States at the time of his death, he is nonresident for estate tax purposes. (Treas. Reg. § 20.0-1(b) (1); Estate of Julius Bloch-Sulzberger v. Commissioner, 6 T.C.M. 1201 (1947).)

Every individual must have a domicile. (See Restatements (Second) of Conflicts of Laws § 11(2) (1971).) At birth, a child normally acquires the same domicile as his father. If his father changes his domi-cile while the child is a minor, the child's domicile will normally fol-low that of the father. Once he is an adult, the individual is free to choose his own domicile.

To effect a change of domicile, there must be physical presence in a new jurisdiction with the intent to make that place his home and with no present intention of departing. A married woman traditionally takes the domicile of her husband but she is capa-ble of changing her domicile (i.e., Domicile of Choice).

Determination of Federal Estate and Gift Tax Residence Domicile

A. An alien is a resident for federal gift and estate tax purposes (whether or not he is a resident for federal income tax purposes) if the alien is domiciled in the U.S. at the time of his death.

B. Declaration of Domicile. An alien acquires domicile in the U.S. if he is physically present in the U.S. with the intention of permanently residing in the U.S.

1. The issue of the alien's intent as to residency is determined by examining all of the facts and circumstances of the alien's case.

2. The following factors are significant in determining the issue of domicile:

a. The intent of the alien as evidenced by the objective acts of the alien;

b. The duration of the alien's stay in the U.S. and in other countries, and the frequency of travel by the alien between the U.S. and other countries, and between places abroad;

c. The size, cost and nature of the alien's house(s) or other dwelling place(s) in the U.S. and abroad, and whether those places were owned or rented;

d. The location of clothing and cherished personal possessions of the alien and his family;

e. The marital status of the alien and the residence of the alien's family and close friends;

f. The place where the alien maintains religious affiliation;

g. The extent the alien and his family participate in community activities in the U.S. and abroad;

h. The location of the alien's business interests;

i. Statements made by the alien in a declaration of will, deed, trust, divorce petition, contract, hotel registry or other legal document;

j. The alien’s reasons and motivation for leaving his foreign home, such as health, pleasure, business, or avoiding of war or political oppression; and

k. The alien’s U.S. visa classification.

Domicile: Non-U.S. Citizen Residency for Estate, Gift, and Generation-Skipping Transfer Taxes

A non-U.S. citizen is a U.S. resident for estate, gift, and GST tax purposes if he or she is domiciled in the United States at the time of the asset transfer in question. (Regs. §§ 20.0-1(b)(1), 25.2501-1(b); see also Farmers' Loan & Trust Co. v. United States, 60 F2d 618 (SDNY 1932); Rodiek v. Comm'r, 33 BTA 1020 (1936), affd, 87 F2d 328 (2d Cir. 1937).) "Domicile" is defined, for this purpose, as that combination of physical presence (even for a very brief period) and no present intention of departing. (Regs. §§ 20.0-1(b)(1), 25.2501-1(b).) Proof of the requisite intent to remain depends on all of the relevant facts and circumstances, including:

1. The length of the individual's stay;

2. The size, nature, and expense of the individual's dwelling within the United States and of any dwellings outside the United States;

3. The location of personal possessions;

4. The existence of social and church contacts; and

5. Club memberships, business accounts, driver's licenses, and such other indicia of permanence. (See Cooper v. Reynolds, 24 F2d 150 (D. Wyo. 1927); Estate of Fokker v. Comm'r, 10 TC 1225 (1948), acq. 1948-2 CB 2; Rodiek v. Comm'r, 33 BTA 1020 (1936), aff'd, 87 F2d 328 (2d Cir. 1937); Bank of New York & Trust Co. v. Comm'r, 21 BTA 197 (1930), acq. 1 CB 4.)

Domicile and Residence – The Same and Different

Another concept that closely resembles and is often confused with domicile is "residence." Residence does not, however, generally involve the requisite attitude of mind – the intent to remain permanently or indefinitely in a locality. Primarily, residence requires only physical presence in a particular locality, or an actual place of abode there. (See Stacher v. United States, 258 F.2d 112 (9th Cir.), cert. denied, 358 U.S. 907 (1958); Weible v. United States, 244 E2d 158 (9th Cir. 1957).)

Residence is a necessary component of domicile, but the converse is not true. A person can have numerous residences, but only the place most significantly related to him, around which he organizes his life, is his domicile.

In other statutes, when the term "residence" is used, it is not always synonymous with "domicile." For example, in construing the Immigration and Nationality Act (Immigration and Nationality Act §§ 310(a), 340(a), 8 U.S.C. §§ 1421(a), 1451(a)), the U.S. Court of Appeals for the Ninth Circuit said: "There is an essential difference between 'domicile,' which generally involves intent, and 'residence,' which generally involves an actual place of abode." (Stacher v. United States, 258 E2d 112, 116 (9th Cir.), cert. denied, 358 U.S. 907 (1958).) The court found that residence, for purposes of that statute, did not involve intent. Therefore the interpretation of "residence" will depend on the purpose of the statute and the context in which it is used.

Domicile v. Residency

1. An Individual can have more than one place of residency

2. An Individual can have only a single domicile at one time

3. In Elkins v. Moreno (435 U.S. 647 (1978)) the IRS revoked its prior ruling and held that a non-immigrant alien who entered the United States with a G-4 Visa, formed the intent to remain indefinitely, died 13 years later, was domiciled in the U.S. (Rev. Rul. 80-363, 1980-2 C.B. 249, revoking Rev. Rul. 74-364, 1974-2 C.B. 321)

4. A non-domiciled resident alien:

a. Interest Income from U.S. Bank Accounts subject to U.S. income tax because he is resident (IRC § 871(i)(3))

b. U.S. Bank Account subject to U.S. estate tax (IRC § 2105 (b)(1))

c. Foreign Bank Accounts interest income subject to U.S. income tax but not estate tax (i.e., deposits foreign-situs property for estate tax)

Property of Nonresident Alien Treated as Located in the United States

Property Situs Rules - U.S. Estate Tax Treatment

For U.S. estate tax purposes, the gross estate of a deceased nonresident alien is that part of his estate that at the time of death is deemed located in the United States. (IRC § 2103.) The primary rules for determining the situs of specific assets are included in the Internal Revenue Code (the Code). (See particularly IRC §§ 2103-2105.) Tax jurisdictional rules might be moderated by U.S. estate tax treaties.

An executor for a nonresident alien decedent is permitted to choose to apply either the Code provisions or the estate tax treaty situs rules, depending on which rules are more deemed to be more favorable. The choice must ordinarily be for the exclusive application of the Code provisions, or the tax treaty provisions, rather than picking and choosing the best rules from either the Code or the tax treaty.

Property situated in the United States generally includes U.S.-based real property and debt obligations of U.S. persons. (IRC § 2104(c).) Special exemptions are available, however, for bank deposits and portfolio obligations (including U.S. government obligations), the interest on which would be exempt from U.S. income tax. (IRC § 2105(b).) For foreign individuals, this U.S. income tax exemption arises under IRC § 871(i).)

Stock owned and held by a nonresident alien is treated as property situated in the United States if that stock has been issued by a domestic corporation. (IRC § 2104(a); Reg. § 20.2104-1(a)(5).) A non-resident alien may hold U.S. property indirectly through a foreign corporation, however, thereby generally avoiding any application of U.S. estate taxation.

Estate Tax Treaty Treatment

An estate tax treaty to which the United States is a party may alter these statutory rules concerning the primary situs of property for U.S. estate tax purposes. (Reg. § 20.2104-1(c), entitled "Death tax convention," indicates that the situs rules described in IRC § 2104 "may be modified for various purposes under the provisions of an applicable death tax convention with a foreign country.") The

objective under many U.S. estate tax treaties is to shift the taxing jurisdiction from the property situs to the domicile of the decedent. The underlying premise is that the jurisdiction where the control of the wealth ultimately resides should have the primary right to tax the transfer of this wealth.

For determining whether taxation based on situs is applicable, a U.S. estate tax treaty ordinarily divides the U.S.-based assets of a foreign client into three groups:

1. Assets having a business connection with a “permanent establishment” in the United States

2. Tangible property, particularly real property and, in some situations, personal property
3. All remaining assets

The most recent U.S. estate tax treaties provide that only two classes of property (immovable or real property and business assets connected with a permanent establishment), and in some cases a third class (tangible personal property), are subject to estate tax in the non-domicile country.

Identifying Property Economically Owned by the Nonresident Alien Decedent

Nominal but not substantive ownership. The foreign client may be only the nominal owner and may hold the property on behalf of some other person. For example, the foreign client could hold the U.S. property as an agent for other parties, including for a corporation, or the foreign client could hold the property in some other fiduciary capacity. (See Estate of Banac v. Comm'r, 17 TC 748 (1951), acq. 1952-1 CB 1, where the Tax Court held that monies of a Yugoslav corporation deposited in the United States in the name of a nonresident alien under a power of attorney for the corporation were not includible in the nonresident alien's estate.)

The determination of actual ownership may necessitate reference to the laws of both the domicile and property situs jurisdictions to determine whether substantive ownership rights are held in that property. The process of real ownership determination may, in turn, require reference to conflict-of-laws rules to determine which jurisdiction's laws will enable the resolution of this inquiry.

Joint Ownership of Property

Joint ownership of property. Property held in the United States may have been acquired with the proceeds of joint funds, but the technical property ownership may only be reflected in the name of an individual foreign client. For example, property held in the United States may have been acquired with foreign-source funds that really constitute the community property resources of two spouses. That ownership of community property funds may be determinable under the laws of a foreign jurisdiction. (In Revenue Ruling 72-443, 1972-2 CB 531, the Service ruled that one half of the value of real property situated in the United States that was acquired in the name of the decedent, who was a citizen and a resident of Norway, was included in his gross estate for the purpose of U.S. estate taxes. The state in which the property was located recognized the vested rights of the spouse in the funds used to purchase the property. Therefore, under Norwegian community property law, the decedent was treated as owning at the time of his death only a one-half interest in the property.) In this type of situation, each spouse may own, therefore, only a one-half interest in the property even though it is nominally held entirely in the name of one of the spouses.

Similarly, the property may be held in a tenancy in common or in a joint tenancy with the right of survivorship. In each instance, ascertain the precise source of the funds for the investment in and ownership of these properties.

Property rights of a decedent may cease to exist at the time of death. For example, as determined by reference to foreign law concepts (as mandated under applicable conflict-of-laws principles) the decedent may really own a life estate in certain property, with successors holding the remainder interest. These rules might apply even though the property has a U.S. situs because, under applicable conflict-of-laws principles, the property rights are to be determined under the laws of the domicile.

Double Taxation (Domicile) — Tax Treaties

In many instances the adverse tax consequences of a determination of double domicile have been alleviated by tax treaties between the contending jurisdictions. U.S. estate tax treaties vary. They generally provide that in the event the contracting parties both claim the decedent as a domiciliary for estate tax purposes, a credit will be given against each country's tax for tax on property situated in the other country. The amount of the credit cannot exceed the portion of the tax imposed by the country granting the credit attributable to such property.

The Internal Revenue Code (the Code) provides for a death tax credit for a citizen or resident of the United States with respect to property situated and taxed in a foreign country. (I.R.C. § 2014.)

If there is a treaty in force with a particular foreign country, the taxpayer may elect the provisions of the treaty or the Code, whichever is more favorable. (S. REP. No. 82-781, at 89-90 (1951); Treas. Reg. § 20.2014-4 (1973).)

The treaties also include "deemed to be situated" clauses. These clauses, varying from treaty to treaty, describe where assets are considered to be located for purposes of taxation. For example, under a former treaty with the United Kingdom, a corporate bond was deemed to have its situs at the decedent's domicile, and negotiable instruments were deemed situated where they were physically located. (Estate Tax Treaty with the United Kingdom, Apr. 16, 1945, U.S. United Kingdom, 60 Star. 1391, TI.A.S. No. 1547, superseded by Estate Tax Treaty with the United Kingdom and Northern Ireland, Oct. 19, 1978, 30 U.S.T. 7225, T.I.A.S. No. 9580.)

Under a former estate tax treaty with Canada, corporate debt was deemed to have its situs at the place of incorporation and negotiable instruments at the residence of the maker. (Estate Tax Treaty with Canada, Feb. 17, 1961, U.S.-Canada, 13 U.S.T. 382, T.I.A.S. No. 4995. See Borne v. United States, 577 E Supp. 115 (N.D. Ind. 1983).

The court held that the U.S.-Canada Estate Tax Treaty only applied to taxes levied by the governments themselves and not those imposed by the countries' political subdivisions. The court noted, however, that the treaty allows "each respective

country to receive a credit from the other country for the entire amount of tax charged by the national government even though that government allowed a credit on its own tax for taxes paid to political subdivisions of the country." Id. at 117.)

Under California law, domicile is described as that place where one has his permanent home (Barnett, California Inheritance and Gift Taxes, A Summary, 43 Cal. L. Rev. 51 (1959)).
Domicile of Origin is the domicile the law assigns to each person at birth (Restatement [Second] of Conflict of Laws 14 (1971)). The domicile of origin is assigned unless domicile of choice is attained. U.S. jurisdictions generally will not find a domicile abandoned until a new one has been adopted.
In most U.S. jurisdictions, the rule is stated as a rebuttable presumption that the wife's domicile is the same as her husband's.

Under IRS Publication 555, Community Property, Revised May 2007, the IRS Publication states:

"You have only one domicile even if you have more than one home. Your domicile is a permanent legal home that you intend to use for an indefinite or unlimited period, and to which, when absent, you intend to return. The question of your domicile is mainly a matter of your intention as indicated by your actions. You must be able to show with facts that you intend a given place or state to be your permanent home. If you move into or out of a community property state during the year, you may or may not have community income.

Factors considered in determining domicile include:

• Where you pay state income tax,
• Where you vote,
• Location of property you own,
• Your citizenship,
• Length of residence, and
• Business and social ties to the community.

Amount of time spent. The amount of time spent in one place does not always explain the difference between home and domicile. A temporary home or residence may continue for months or years while a domicile may be established

the first moment you occupy the property. Your intent is the determining factor in proving where you have your domicile.

U.S. Gift Tax

1. U.S. citizens and residents are subject to gift tax on all direct or indirect transfers of property, wherever located, for less than full and adequate consideration.

2. Non-resident aliens are subject to gift tax only on gifts of tangible personal property and real property located in the United States. IRC § 2511(a).

3. Gifts of intangible property made outside the United States are not subject to gift tax. IRC § 2501(a)(2).

4. Rules and Calculation of Tax:

a) Since TAMRA, the same gift tax rates apply to non-resident aliens as U.S. citizens and residents.

b) Non-resident alien donors are not entitled to the unified credit against gift tax.

c) Non-resident aliens do qualify for the $13,000 per year donee exception for gifts to persons other than spouses. (IRC § 2503) In 2012, $139,000 annual exclusion for gifts to a spouse who is not a U.S. citizen. (§ 2523(i)(2))

d) Non-resident aliens are not entitled to the gift tax marital deduction, unless the gift is to a U.S. citizen (IRC § 2523(i)).

e) The charitable deduction is limited to gifts to certain charities (IRC § 2522(b)).

f) A non-resident alien may not split gifts with a spouse (IRC § 2513(a)(1)).

5. Gift tax treaties may change these rules.

a) Some of these treaties allow a marital deduction for gifts to non-citizen spouses and expand the availability of the charitable deduction.

b) For example, the Australian and Japanese treaties may give a donor domiciled in those countries the right to use a portion of the unified credit for gift tax purposes.

Applicability of U.S. Transfer Tax to Nonresident Aliens

Scope of U.S. Estate Taxation

U.S. estate and gift taxation applies to non-resident alien transferors who have property located in the United States (referred to here as foreign clients) in addition to citizens and residents of the United States. For nonresident aliens, the gross amount subject to U.S. estate tax can be determined by reference only to property situated in the United States. (IRC § 2103. Any imposition of a transfer tax on nonresident aliens with respect to their transfers of non-U.S. assets would be both unenforceable and contrary to norms of international law.) In contrast, for U.S. citizens and residents any U.S. estate and gift tax exposure is determined by reference to personal status and not the specific location of assets. (IRC §§ 2031(a), 2511(a).)

U.S. Estate, Gift, and Generation Skipping Transfer Taxation of Non-Resident Aliens

1. Taxation based on citizenship and residence.

1.1 U.S. citizens and residents are subject to estate tax on all interests in property wherever located owned or controlled at death.

1.2 Individuals who are neither U.S. residents nor U.S. citizens ("non-resident aliens") are only subject to U.S. estate tax on:

(a) Interests in "property deemed located in the United States" ("U.S. Property") at the decedent's death; or

(b) "U.S.-Property" transferred prior to death, but includable under IRC § 2035 (transfers within three years of death), § 2036 (transfers with a retained life estate), § 2037 (transfer taking effect at death), and § 2038 (revocable transfers). IRC §§ 2103-2105.

1.3 Citizenship.

(a) An individual's status as a citizen is determined by the Immigration and Naturalization Act (8 U.S.C. § 1101 et seq.), except that persons who are U.S. citizens solely by reason of having been a citizen of a U.S. possession either by birth or residence within the possession are treated as nonresident aliens for estate and gift tax purposes.

(b) Persons who gave up U.S. citizenship are subject to special estate and gift tax rules. See IRC §§ 2107, 2501.

1.4 Residence/Domicile.

(a) For U.S. estate and gift tax purposes, a resident is one who, at the time of his death or at the time of gift, is domiciled in the United States. An individual is a U.S. domiciliary if he lives in the United States, even for a brief period of time, with the intention to remain indefinitely. Treas. Reg. §§ 20.0-1(b)(1), 25.2501-1(b).

(b) Note: This concept is different from the income tax rules regarding residency. See IRC § 7701(b).

(1) For income tax purposes, an alien is considered a U.S. resident for a calendar year if: (i) the alien is a lawful permanent resident of the United States at any time during the calendar year, (ii) the alien meets the substantial presence test, or (iii) the alien makes a first-year election under IRC § 7701(b)(4).

(c) A non-resident alien could be domiciled in the United States and in one or several other countries. Treaties address in various ways the potential for double taxation of estates that may result.

(d) A number of treaties either leave the question of domicile to be determined under the local laws of the two countries or have no provision regarding domicile. Under such treaties, an estate may be subject to taxation of worldwide assets by two countries, but the tax authorities of the signatories all allow tax credits for taxes on property situated in the other country.

Property Subject to Tax

U.S. Property for estate tax purposes includes:

a. Real property located in the United States;

b. Tangible personal property located in the United States (except works of art on loan for an exhibition);

c. Stock of domestic corporations;

d. Debt obligations of U.S. persons except obligations which qualify as “portfolio interest” obligations under § 871(h)(4).

In addition, a general power of appointment over U.S. Property will be subject to U.S. estate tax.

U.S. Property can also be subject to estate tax at death if it was transferred during lifetime in a manner which would render it includable under IRC §§ 2035 through 2038 IRC § 2104(b);

a. So, for example, U.S. real property or stock of a domestic corporation in a trust which is deemed to be a grantor trust for income tax purposes because the non-resident alien had a right to revoke or amend the trust during lifetime would be subject to estate tax at the non-resident alien settlor’s death.

b. Also, U.S. Property transferred to a trust which was not a “grantor” trust for income tax purposes, but over which the decedent-settlor retained control or an interest sufficient to make the assets includable under §§ 2036, 2037, or 2038 (such as a power to sprinkle income and principal) would be subject to estate tax at the death of the non-resident alien decedent.

U.S. property does not include any of the assets listed below unless they are held in connection with a U.S. trade or business of the decedent:

a. Life insurance proceeds on the life of a non-resident alien (IRC § 2105(a));

b. Real and tangible personal property located outside the U.S.;

c. Stock of a foreign corporation;

d. Bank deposits;

e. “Portfolio interest” obligations (IRC §2105(b)); and
f. U.S. Property owned by a foreign partnership if, under foreign law, the partnership is regarded as an entity separate from its partners and if the death of the decedent did not terminate the partnership.

Rate and Calculation of Tax

For nonresident alien decedents dying after November 10, 1988 (the date of enactment of the Technical and Miscellaneous Revenue Act of 1988 ("TAMRA") the estate tax rates are the same as for U.S. citizens.

Credits available to offset the tax include:
a. IRC § 2102(b): Unified credit of $13,000 is equal to an exemption for $60,000 of property. The unified credit amount is increased under some treaties.
(versus $1 million for U.S. Citizens and residents)

b. A credit for state death taxes paid.

c. A credit for federal estate tax paid on prior transfers of property included in the gross estate.

d. No credit for foreign death taxes paid.

Deductions available to offset the estate tax include:
a. Marital deduction.

1. Since the enactment of TAMRA, the marital deduction is available to non-resident alien decedents for gifts to (or in a QTIP trust for) a spouse who is a U.S. citizen.

2. The opposite is also true – gifts to or for the benefit of a spouse who is not a U.S. citizen (even if they are a U.S. resident) no longer qualify for the marital deduction. IRC § 2056(d). The estate tax can be postponed, but only if property is placed in a trust which qualifies as a Qualified Domestic Trust.

3. Qualified Domestic Trust (IRC § 2056A) must provide:

i. One of the trustees must be a U.S. citizen or a domestic corporation who has a right to withhold estate tax on financial distributions;

ii. The surviving spouse must be entitled to all the income from the trust, payable annually or more frequently;

iii. The executor must make an election; and

iv. The trust must comply with regulations applying to qualified domestic trusts to be issued in the future.

4. The estate tax is only postponed until there is a distribution of principal, either upon termination of trust, or earlier (except for lifetime distributions on account of “hardship”). The estate tax is imposed at highest rates applicable to the estate of the first spouse to die.
5. A credit for prior transfers will be available to the estate of the second spouse to die if the property is also taxable in his/her estate. IRC § 2056(d)(3).

b. The charitable deduction is available for gifts to certain qualified charities (IRC § 2106 (a)(2)(A)).

c. The estates of nonresident aliens are entitled to deduct a portion of debts and expenses of administration. See IRC § 2106(a)(i); Treas. Regs. §§ 20.2106-1 and -2. The deductible portion of such items is determined by a fraction; the numerator of which is the value of the gross estate situated in the United States, and the denominator of which is the value of all property included in the gross estate. Treas. Reg. § 20.2106-2(a)(2). The deductible amounts may have been incurred or expended within or without the United States. As a condition to allowance of any such deductions, the estate tax return must disclose the decedent’s gross estate situated outside the United States. Treas. Reg. § 20.2106-2(a)(2).

Only a proportional part of a recourse note secured by a mortgage on U.S. Property is deductible, while the mortgaged property is includable in full. Thus in some circumstances, the tax could exceed the decedent’s equity interest in the property. However, where property is subject to a non-recourse mortgage, only the value of the equity of redemption is included, thus in effect giving a 100% deduction on the mortgage.

Chapter 5 - Grantor Trust (Income Tax Rules)

(Subpart E of Subchapter J of Chapter 1 of Subtitle A IRC 1954)

IRC Sec. 671-679 determines whether a trust is a “grantor trust” for U.S. federal income tax purposes. If a trust is a grantor trust, all items of income, deduction and credit in respect of the trust property will be reported on the grantor’s U.S. federal income tax return, and any income tax liability will be paid by the grantor and not from the trust (Treas. Reg. 1.671-3 (a)(1).

IRC Sec. 673-679 identify persons as “owners” of portions of trusts with which they have relationships. IRC Sec. 671 specifies the consequences of being treated as the owner [IRC Sec. 671: The neck of the funnel through which Sec. 673-678 passes].

Tres. Reg. 1.671-2(e)(1)

“A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.” (A Settlor is the person who intentionally causes the trust to come into existence.)

IRC Sec. 671 identifies a grantor as owner of any “portion” of a trust; items of income, deductions and credits attributable to that portion of the trust are taken into account in computing the grantor’s taxable income and credits.

A “Portion” includes:

- Ordinary income;
- Income allocable to corpus;
- An entire trust;
- An undivided fractional interest in the trust;
- An interest represented by a dollar amount;
- Specific trust property.

IRC Sec. 671: Grantor Trust Status

The person designated by Subpart E as “owner” of a portion of a trust must take into account in computing their tax liability the items of income, deductions and

credits attributable to that portion of the trust (that would otherwise be reportable by the trust itself).

Tax Compliance

IRC Sec. 6012(a)(4) requires an income tax return from “every trust having for the taxable year any taxable income, or having gross income of $600 or over, regardless of the amount of taxable income. Subpart E may attribute part or all of a trust’s income to the grantor.

IRC Sec. 6501 statute of limitations protects a taxpayer against assessments occurring later than three years after the filing of the relevant tax return. For the statute of limitations, in the case of a grantor trust the statute begins to run only on the filing of the grantor’s return (not the filing of any trust tax return). (See: Lardas v. Commr., 99 T.C. 490 (1992); Olson v. Commr., 64 T.C.M. 1524 (1992), Bartol v. Commr., 63 T.C.M.2324 (1992), Field Serv. adv. 200207007 (Nov. 6 2001).

Under Treas. Reg. 1.671-4(a), items attributed to a grantor are not to be reported by the trust on Form 1041; instead such items should be “shown on a separate statement attached to Form 1041, and reported by the grantor”.

Grantor Trust

If the trust is a grantor trust for income tax purposes, a sale of assets to the trust by the grantor is disregarded. (See Rev. Rul. 85-13, 1985-1 C.B. 184).
If the non-contributing spouse has a discretionary interest as to both income and principal, the trust is a grantor trust under IRC Sec. 677(a)(1) to the contributing spouse. No income tax realization event occurs and the policy proceeds are excluded from both estates (Ltr. Rul. 9413045).

Intentionally Defective Grantor Trust

An “Intentionally Defective Grantor Trust” (“IDGT”) takes advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042, and the grantor trust income tax rules of IRC Sec. 671-678. An IDGT is an irrevocable trust that effectively removes assets from the grantor’s estate. As a result, a sale

of assets to an IDGT can freeze an individual's estate by converting appreciating assets into a non-appreciating asset with a fixed yield.
For income tax purposes, the trust is "defective" and the grantor is taxed on the trust's income. Accordingly, sale of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself eliminating capital gain tax on sale.

(Additionally, interest payments by the IDGT to the grantor are not income.)
Since the IDGT is "defective" for income tax purposes, all of the trust's income is taxed to the grantor, which produces an additional "tax-free gift" to the IDGT (Rev. Rul. 2004-64, 2004-2(C.B. 7).

As a grantor trust, the IDGT:
- Can be the owner of S-corporation stock (it is a permitted shareholder);
- Can purchase an existing life insurance policy on the grantor's life, without subjecting the policy to taxation under the transfer for value rule;

The sale of the policy is a sale to the grantor-insured and the transfer for value exception under IRC Sec. 101 (a)(2)(B) should apply.
If the IDGT is structured as a "Crummey Trust", the contribution will qualify for the IRC Sec. 2503(b) gift tax annual exclusion. Under IRC Sec. 678(b), a grantor will be treated as the owner of the trust, rather than the beneficiary with respect to power over income (and corpus), which are subject to "Crummey Withdrawal" rights (See IRS PLR 200606006, 200603040, 200729005, 200942020).

Under an IDGT, Grantor Trust Status:

1. Power of Substitution: The Grantor (or spouse) has the power to reacquire trust assets in a non-fiduciary capacity (IRC Sec. 675(4); Treas. Reg. Sec. 1.675-1(b)(4). In Rev. Rul 2008-22, 2008-1 CB 796, the IRS ruled that a grantor's retained power, exercisable in a non-fiduciary capacity, to acquire trust property by substituting property of equivalent value will not by itself cause estate tax inclusion under IRC Sec. 2036 or 2038.

2. Swapping Assets: If the grantor sells assets to the IDGT, the trust assets are excluded from the grantor's estate at death, but the IDGT assets would not receive a tax basis step-up under IRC Sec. 1014. If the assets sold to an IDGT have a low basis, the lack of basis step-up is an income tax disadvantage which may be

ameliorated by the grantor exchanging high-basis outside of the IDGT, with low-basis assets inside of the IDGT, achieving a "basis step-up". The swap of assets with an IDGT should not be treated as a gift for purposes of IRC Sec. 1014(e).

3. Power to Make Loans without Adequate Security: The power exercisable by a grantor or a non-adverse party that permits the grantor or the grantor's spouse to borrow trust property without adequate security (IRC Sec. 675(2). Grantor trust status is achieved if the grantor's spouse holds such power under IRC Sec. 672(e). Unlike Sec. 675(3), which requires an actual borrowing by the grantor, the existence of a power under IRC Sec. 675(2) may cause grantor trust status.

Even if the loan provides for adequate interest, grantor trust status is secured if the trustee has the power to lend unsecured. To avoid estate tax inclusion, the lending power should not include the authority to make loans without adequate interest. In order to minimize the risk of estate tax inclusion, the power to lend without security should be held by a non-adverse party and not the grantor (e.g. a trust protector).

4. Power to Add Beneficiaries: The power to add to the class of beneficiaries (other than the grantor's after-born or after-adopted children) to receive the trust's income or corpus held by the grantor, or a non-adverse party will cause grantor trust status. To avoid estate tax inclusion, the grantor should not hold such a power, but the power could be held by the grantor's spouse without inclusion if the spouse did not contribute to the trust and is not controlled by the grantor. A marital agreement should be entered into in advance of the transfer to ensure that the spouse did not make a contribution to the IDGT. The IRS has privately ruled that the power to add beneficiaries held by a trustee triggers grantor trust status (IRS PLR 199936031; 9709001; 9010065).

5. Payment of Life Insurance Premiums: A grantor is treated as the owner of any portion of the trust whose income may be applied to the payment of premiums of life insurance policies on the grantor or the grantor's spouse (IRC Sec. 677(a)(3). IRS Field Attorney Advice 20062701 F indicates that the power to purchase life insurance on the grantor's life results in grantor trust status. Treasury Regulations establish that the grantor is taxed on any trust income actively used to pay premiums. Under PLR 8852003, the IRS has privately ruled that the power to pay premiums is sufficient.

Income Tax - Transfer for Value (IRC Sec. 101(a)(2)

If insurance policy transferred for valuable consideration, unless exception applies, general rule that policy proceeds are not includable in gross income does not apply.

Not Income Tax Realization Event

- Rev. Rul. 85-13 (1985-1 CB 184): Transfer between grantor and his grantor trust, not an income tax realization event;

- IRC Sec. 1041: Transfers between spouses (if no NRA spouse), no income tax realization, transferee spouse “carry-over” income tax basis.
Exceptions from application of the transfer for value include transfers where the transferee takes a carry-over basis (IRC Sec. 101(a)(2)(A), transfers to the insured, a partner of the insured, a partnership in which the insured is a partner and a corporation in which the insured is a shareholder or officer (IRC Sec. 101(a)(2)(B).

Under Rev. Rul. 2007-13, 2007-11 IRB 684, a transfer to a grantor trust with respect to the insured qualifies as a transfer “to the insured” for purposes of the transfer for value rule. Under this Revenue Ruling, a grantor who is treated for federal income tax purposes as the owner of a trust (that owns a life insurance contract on the grantor’s life) is treated as the owner of the contract for purposes of applying the transfer for value limitations under IRC Sec. 101(a)(2).

Grantor Trust - Avoids Application of Transfer for Value Rules

Treas. Reg. 1.671-2 (e)(1): A grantor includes any person to the extent such person either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust.

Under IRC Sec. 671-677, only a person who makes a gratuitous transfer to a trust can be treated as an “owner”, necessary to engage in disregarded transactions with the trust. The Trust Donor is treated as the owner for grantor trust purposes.

Grantor Trust Status
IRC Sec. 677 (a)(3): Trust is a grantor trust to the extent trust income may be used to pay premiums on insurance policies on the grantor’s life, or the grantor’s

spouse. However, grantor trust status may apply only to the portion of the trust the income from which is currently used to pay premiums (See: Weil, 3TC 579 (1944); Iverson, 3 TC 756 (1944).

Settlor power, held in a non-fiduciary capacity, to substitute property of equivalent value under IRC Sec. 675(4)(C), causes a trust to be a grantor trust.

Estate Tax

Where trust assets consist of an insurance policy on the grantor's life, a power to substitute assets may not result in estate tax inclusion under IRC Sec. 2042(2), if the grantor held the power in a fiduciary capacity (See: Estate of Jordahl, 65 TC 92 (1975); Aug. 1977-1, (CB 1) (See: Ltr. Rul. 200603040).

IRS

Trust property may not be includable in the gross estate under IRC Sec. 2035, 2036, 2048 or 2039 if the power of substitution is held in a fiduciary capacity.

Grantor Trust Rules - IRC Sec. 672(e)

Spousal Unity Rule; i.e., grantor is treated as holding any power or interest held by the grantor's spouse.

Gift Tax

Creation of an irrevocable trust may subject the grantor to the gift tax: Treas. Reg. 25.2511-2(d).

Grantor Trust Status (ILIT)

A related and subordinate party could be named as trustee with the power to make discretionary distributions, not on an ascertainable standard, in order to make the ILIT a grantor trust. If the grantor cannot remove and replace the trustee, the initial appointment of a related and subordinate party trustee may not cause the powers of the trustee to be attributed back to the grantor for estate tax purposes (Ltr. Rul. 9636033).

Grantor trust status confirmed if a person who is not a contributor to, or beneficiary of, the trust, has the power to add to the class of beneficiaries (e.g. charity or other descendants (IRC Sec. 674(b)(5), 674(b)(6). See: Madorin, 84 TC 667 (1985)).

Grantor Trust - (Ownership of Assets)

Under Rev. Rul. 85-13, and Proposed Treas. Reg. Sec. 1.671-2(f) "a person that is treated as the owner of any portion of a trust under subpart E is considered to own the trust assets attributable to that portion of the trust [See: REG- 209826-96, 1996-2 (C.B. 498)].

Termination Grantor Trust Status

A grantor trust loses its status as a grantor trust on the death of its grantor (D.G. McDonald Trust, 19 TC 672 (1953), acq. 1953-2 C.B.3 (Chase Nat'l Bank v. Commr., 225 F.2d 621 (8th Cir. 1955)); Proposed Treas. Reg. Sec. 1.671-4(h)(2)).

Adverse Party

IRC Sec. 672(a) defines an "adverse party" as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or non-exercise of the power which he possesses respecting the trust."

A trustee may be an adverse party if the trustee has the power to distribute all of the trust income and property to himself but is not an adverse party if the trust terms fix all the beneficial interests even if the trustee is a beneficiary (See: Johnson v. Commr., 108 TC 448 (1957), Floyd G. Paxton, 57 TC 627 (1972).

Beneficiaries can be adverse parties if they have a power the exercise or non-exercise of which would adversely affect the beneficiary's own beneficial interest. IRC Sec. 672(b) defines a "nonadverse party" as "any person who is not an adverse party".

A trust is classified as a grantor trust if more than half of the trustees are related or subordinate to the grantor.

IRC Sec. 674(a) provides that the grantor of a trust is to be treated as the owner of any portion of such trust, in respect of which the beneficial enjoyment of such portion is subject to a power of disposition, exercisable by the grantor or a non-adverse party, or both, without the approval or consent of any adverse party.

IRC Sec. 674(c) provides an exception to the general rule of IRC Sec. 674(a) for distribution powers of the "independent trustee", none of whom is the grantor, and no more than half of whom are related or subordinate to the grantor or are subservient to the wishes of the grantor (IRC Sec. 672(c) defines: "related or subordinate party".)

Related or Subordinate Party

IRC Sec. 672(c) defines a "related or subordinate party" as any "non-adverse party" which includes:

1. IRC Sec. 672(c)(1): The grantor's spouse (only if they are living together);
2. IRC Sec. 672(c)(2): Grantor's father, mother, children, brother, sister (including half-brothers/sisters). See: Rev. Rul. 58-19, 1958-1, CB 251);

3. IRC Sec. 672(c)(2): An employee of the grantor, or the grantor's corporation.

Not Related or Subordinate Party

Under IRC Sec. 672(c) the following are not related or subordinate parties:
1. Nieces, nephews, grandparents, spouses of children, spouses of grandchildren, spouses of brothers and sisters;

2. Partners of the grantor;
3. Director of a corporate grantor (i.e. stock holdings of the grantor and the trust are significant, re voting control). See: Rev. Rul. 66-160, 1966-1, CB 164;

4. The grantor's lawyer, accountant or trust company (See: Zand v. Commr., 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998); Estate of Hilton W. Goodwyn, 35 TCM 1026, 1038 (1976) re lawyers-trustees not "related or subordinate parties" and lawyer-trustees were independent trustees under IRC Sec. 674(c).

Power Subject to Condition Precedent

IRC Sec. 672(d) states that a person is deemed to have a power described in subpart E "even though the exercise of the power is subject to a precedent giving of notice or takes effect only on the expiration of a certain period after the exercise of the power".

Grantor's Spouse

The Tax Reform Act of 1986 added IRC Sec. 672(e), which treats the grantor as holding any power or interest held by the grantor's spouse if the grantor's spouse was living with the grantor at the time of the creation of the power or interest (i.e., if the spouse and the grantor are eligible to file a joint return with respect to the period in question).

Grantor as Foreign Person - ("Inbound Trusts")

If a foreign person is an "owner" of any portion of a trust, and the trust has as a beneficiary a U.S. person who has made one or more gifts to that foreign person, IRC Sec. 672(f)(5) designates the U.S. beneficiary, not the foreign grantor-donee, as the owner of the trust to the extent of the gifts (with an exception for gifts that qualify for the annual exclusion under IRC Sec. 2503(b)).

IRC Sec. 672(f)(5) precludes foreigners immigrating to the U.S. from giving property to another foreigner, who agrees to use the property to fund a U.S. trust for the benefit of the immigrating foreigner, who then denies he was the grantor of the trust. Under IRC Sec. 672(f)(5), the immigrating foreigner receives the same treatment he would have received had he created the trust directly (Treas. Reg. Sec. 1.672(f)-5(a)(1)).

In the Small Business Job Protection Act of 1996, Congress expanded IRC Sec. 672(f) so that subpart E now generally applies only when its effect is to designate as owner of part or all of a trust a U.S. citizen, resident or domestic corporation (IRC Sec. 672(f)(1), a "controlled foreign corporation", defined in IRC Sec. 957 is treated as a domestic corporation. IRC Sec. 672(f)(3)(A).

IRC Sec. 672(f) reverses prior law under which subpart E designated non-resident aliens as owners of trusts, thereby allowing U.S. beneficiaries to receive the income from such trusts tax-free.

Grantor Trust: Co-ownership and Reversionary Interest

IRC Sec. 673(a) now treats the grantor who retains any reversionary interest as owner of the entire trust (Treas. Reg. 1.671-3(b)(3)); Priv. Ltr. Rul. 9519029 (Feb. 10, 1995). IRC Sec. 672(e) treats the grantor as owner of any interest their spouse owns. Unless the value of the reversionary interest at inception is less than 5% of the value of the property transferred. (IRC Sec. 673(b) excepts from the general rule any reversionary interest that follows the death before attaining age 21 of a lineal descendant of a grantor.)

A grantor who has retained a reversionary interest in the corpus of a trust is treated as owner of the corpus portion of that trust (Treas. Reg. Sec. 1.673(a)-1(a), 1.677(a)-1(g) Ex. (2).

IRC Sec. 674: Powers over Beneficial Enjoyment

IRC Sec. 674(a) treat any grantor as owner of any portion of any trust "in respect of which the beneficial enjoyment of the corpus or income is subject to a power of disposition, exercisable by a grantor or non-adverse party, or both, without the approval or consent of any adverse party."

IRC Sec. 674, 677: Power to Apply Income to Support of a Dependent

A grantor is not subject to tax under neither IRC Sec. 677(b) nor Sec. 674(a) merely because in the discretion of another person, the trustee or the grantor (or the grantor's spouse, IRC Sec. 672(e)), acting as trustee, income may be applied or distributed for the support or maintenance of a beneficiary (other than the grantor's spouse) whom the grantor is legally obligated to support or maintain. Under IRC Sec. 677(a), the grantor is treated as the owner of the income portion, to the extent of the grantor's obligation of support.

Grantor Trust - Power to Distribute Corpus

IRC Sec. 674(b)(5) provides two exceptions (to IRC Sec. 674) for powers to distribute corpus:

1. Power to distribute corpus to or for one or more beneficiaries if the power is limited by a reasonably definite standard in the trust instructions (IRC Sec. 673(b)(5)(A), i.e. a “clearly measurable standard under which the holder of a power is legally accountable (Treas. Reg. Sec. 1.674(b)-1(b)(5)(i)). Examples of reasonably definite standards are standards relating to a beneficiary’s “education, support, maintenance or health”, “reasonable support or comfort”, to enable a beneficiary to maintain an “accustomed standard of living”, to allow a beneficiary to “meet an emergency”, or to pay a beneficiary’s “medical expenses” (Treas. Reg. Sec. 1.674(b)-1(b)5(iii), Ex. (1)).

2. Power to distribute corpus to or for any “current income beneficiary”, whether subject to a standard or not, if the distribution must be chargeable against the proportionate share of corpus held in trust for payment of income to the beneficiary “as if the corpus constituted a separate trust” (IRC Sec. 674(b)(5)(B).

Grantor Trust - Exception: (Independent Trustee)

Exceptions to the general rule of IRC Sec. 674(a) are contained in IRC Sec. 674(c), which provides exceptions if the powerholder is an “independent trustee”; i.e. not the grantor, grantor’s spouse, no more than half of whom are related or subordinate parties who are subservient to the grantor’s wishes.

The exceptions:
1. The power of a trustee to distribute, apportion or accumulate income to or for one or more beneficiaries (IRC Sec. 674(c)(1).

2. The power of a trustee to sprinkle corpus to or among one or more beneficiaries, regardless of whether they are income beneficiaries (IRC Sec. 674(c)(2).

Grantor Trust/Exception: (Powerholder is a Trustee, other than the Grantor or the Grantor’s Spouse)

IRC Sec. 674(d) protects a power to distribute, apportion or accumulate income to or for the beneficiaries if the power is limited by a “reasonably definite external standard” (Treas. Reg. 1.674(d)(1), 1.674(b)-1(b)(5) which “defines a reasonably definite standard”). The “standard” must be set forth in the trust instrument.

Grantor Trust - Power to Remove Trustee

Under Treas. Reg. Sec. 1.674(d)-2(a), W. Clarke Swanson, Jr. 1950 Trust, 33 TCM 296, 302 (1974), aff'd 518 F.2d 59 (8th Cir. 1975), if the grantor or the grantor's spouse has the power to remove the trustee and make either of them the trustee, neither the exception under IRC Sec. 674(c) or IRC Sec. 674(d) applies.

Grantor Trust - Power to Add Beneficiaries
A power to add beneficiaries does not qualify under IRC Sec. 674 exceptions if any person has the power to add to the group of beneficiaries, other than providing for after-born or after-adopted children. A power in a non-adverse party to add charitable beneficiaries or trigger IRC Sec. 674 (See: Madorin v. Commr., 84 TC 667 (1985). Priv. Ltr. Rul. 9838017 (6/19/98), Priv. Ltr. Rul. 9710006 (11/8/96), Priv. Ltr. 97090001 (11/8/96)).

IRC Sec. 675 - Grantor Administrative Powers

IRC Sec. 675 contains provisions designed to prevent a grantor from maintaining dominion and control over a trust through certain types of administrative powers vested in either the grantor or others.

1. Power to Deal with Trust Property for Less Than Adequate and Full Consideration.

IRC Sec. 675(1) describes a power exercisable by the grantor or any non-adverse party to enable the grantor or any person to "purchase, exchange or otherwise deal with or dispose of the corpus or the income there from for less than an adequate consideration in money or money's worth."

2. Grantor Borrowing. IRC Sec. 675(2) relates to a power enabling a grantor to borrow without adequate interest or security. IRC Sec. 675(3) relates to actual borrowing.

Power to Borrow without Adequate Interest or Security

IRC Sec. 675(2) describes a power exercisable by the grantor or any non-adverse party to enable the grantor to borrow either principal or income "directly or indirectly, without adequate interest or adequate security". If so, grantor is

treated as the owner of some portion of the trust. If the trustee (who is not the grantor or the grantee's spouse) has the power to lend on such terms to anyone, the power is disregarded for purposes of IRC Sec. 675(2). In addition, there are no other restrictions on the trustee's identity; even a related or subordinate party may serve as trustee.

Actual Borrowing

IRC Sec. 675(3) states that actual borrowing by the grantor causes grantor trust status, if the grantor has "directly or indirectly borrowed the corpus or income and has not completely repaid the loan, including any interest, before the beginning of the taxable year." IRC Sec. 675(3) does not apply to a loan to a grantor that provides for adequate interest and adequate security if made by a trustee "other than the grantor and other than a related or subordinate trustee subservient to the grantor". If a loan to a grantor provides for adequate interest and adequate security, and is made by a non-captive trustee, there are no grantor trust consequences.

In Zand v. Commr., 71 TCM 1758 (1996), 143 F.3d 1393 (11th Cir. 1998), the court held that certain loans qualified under the exception of IRC Sec. 675(3) because they provided for adequate interest and security and a majority of the trustees who made them were neither related nor subordinate to the grantor under IRC Sec. 672(c), despite the fact these two trustees were also the grantor's lawyers.

General Powers of Administration

IRC Sec. 675(4) describes three powers of administration and treats the grantor as owner of a portion of the trust if any of these powers is exercisable in a "non-fiduciary capacity" by any person without the approval or consent of any person in a fiduciary capacity. Treas. Reg. Sec. 1.675-1(b)(4) limits the applicability of the provision to powers held by a "non-adverse party". If a power is exercisable by a trustee, it is presumed to be exercisable in a fiduciary capacity.

The three powers:
1. The power to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are "significant from the viewpoint of voting control."

2. The power to control the investment of the trust funds either by directing investments or by retaining proposed investments “to the extent that the trust funds consist of stocks or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control”.

3. The power to reacquire trust property by substituting other property of an equivalent value.

Revocable Trusts

If a trust is wholly revocable by the grantors, IRC Sec. 676 treats the grantor as owner of the entire trust because the grantor has the power to revest in himself all of the trust property.

IRC Sec. 677

Income for Benefit of Grantor or Grantor’s Spouse

1. Income Distributable to the Grantor or Grantor’s Spouse.
If a grantor retains a mandatory income interest, or creates a mandatory income interest in the grantor’s spouse, IRC Sec. 677 treats the grantor as owner of the income portion of the trust, under IRC Sec. 677(a)(1), the “income is distributed to the grantor or the grantor’s spouse.” IRC Sec. 677(a) requires that the income be distributed “without the approval or consent of any adverse party.”

2. Income Accumulated for the Grantor or Grantor’s Spouse
IRC Sec. 677(a)(2) applies if income may be accumulated without the consent of an adverse party for future distribution to the grantor or the grantor’s spouse.
3. Income Applicable to Payment of Life Insurance Premiums
IRC Sec. 677(a)(3) applies if income is or may be applied without the consent of an adverse party to the payment of premiums on policies of insurance on the life of the grantor or the grantor’s spouse. The grantor is treated as the owner of some portion of any trust required or permitted to pay premiums on policies of life insurance on the life of either the grantor or the grantor’s spouse. The courts have limited the amount of income on which a grantor is subject to taxation to that which the trustee actually uses to pay premiums on specified policies (Joseph Weil, 3 TC 579 (1944)).

4. Income Applicable to Discharge of Indebtedness

IRC Sec. 677(a) treats the grantor as owner of a portion of a trust if its income can be used to pay off debts of the grantor such as rent, household expenses or mortgage debt (See: Treas. Reg. Sec. 1.677(b)-1(d); Jack Wiles, 59 TC 289 (1972), Jenn v. U.S. 70-1 USTC Para. 9264 (S.D. Ind. 1970).

5. Income Applicable to Discharge of Support Obligations IRC Sec. 677(b) is an exception to the general rule of IRC Sec. 677(a). According to IRC Sec. 677(b), IRC Sec. 677(a) does not apply if trust income may be “applied or distributed for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support”.

Under Treas. Reg. Sec. 1.677(b)-1(f), if income must be applied in discharge of a support obligation of the grantor, IRC Sec. 677(b) does not apply; instead IRC Sec. 677(a) applies. For IRC Sec. 677(b) to apply, the power to use trust income to discharge the grantor’s support obligations must be that of “another person, the trustee, or the grantor acting as trustee or co-trustee”. Under Treas. Reg. Sec. 1.677(b)-1(e), if the power is that of the grantor acting in a non-fiduciary capacity, the grantor is treated as owner of the trust’s income, to the extent of his or her dischargeable obligations, regardless of whether the trust discharges them.

Under IRC Sec. 677(b), for trust distributions in discharge of a grantor’s support obligations:

- If a distribution comes out of current income, the grantor is treated as owner of the trust, but only to the extent of the obligation discharged (Brooke v. U.S., 300 F.Supp. 465 (D. Mont. 1969), aff’d 468 F.2d 1155 (9th Cir. 1972).

- If the distribution comes out of either principal or accumulated income, IRC Sec. 677(b) treats the amount distributed as deductible by the trust under IRC Sec. 661(a)(2) and taxable to the grantor under IRC Sec. 662, (Rev. Rul. 74-94, 1974-1 C.B. 26); Treas. Reg. Sec. 1.677(b)-1(c).

IRC Sec. 678 - Non-Grantors Treated as Grantors
Under IRC Sec. 678, one other than the grantor is treated as owner of any portion of a trust that he can by exercise of a power exercisable by himself, vest in himself a portion of a trust.

Released or Modified Power

IRC Sec. 678(a)(2), applies if a person other than the grantor has "previously partially released or otherwise modified" a power described in IRC Sec. 678(a)(1), and "retains such control as would subject a grantor of a trust to treatment as the owner thereof", IRC Sec. 678(a)(2) treats anyone who has released or modified an IRC Sec. 678 power as though he created a continuing trust.

Obligations of Support

IRC Sec. 678(a), if a powerholder can direct a trust to expend either its income or its principal to discharge a legal obligation, he is treated as the powerholder, if principal or accumulated income is used to discharge the powerholder's support obligation, the powerholder is treated as a beneficiary who receives a taxable distribution under IRC Sec. 661 and 662.

IRC Sec. 679 - Foreign Trusts with U.S. Beneficiaries ("Outbound Trusts")

If a U.S. person transfers property to a foreign trust that has one or more U.S. beneficiaries, IRC Sec. 679 treats the transferor as owner of the portion of the trust attributable to the property transferred (IRC Sec. 679(a)(1)). There are exceptions:

A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));
A transfer "in exchange for consideration of at least the fair market value of the transferred property" (IRC Sec. 679(a)(2)(B).

If a foreign trust accumulates income during a year in which it has no U.S. beneficiary, if the trust acquires a U.S. beneficiary in a later year, a U.S. transferor (who would have been treated as owner of a portion of the trust during the prior year, but for the fact that it had no U.S. beneficiary) is taxable in the first year IRC Sec. 679 applies, on additional income equal to the trust's undistributed net income for all prior taxable years (to the extent such undistributed net income remains in the trust at the end of the taxable year immediately prior to applicability of IRC Sec. 679) attributable to the portion to which IRC Sec. 679 applies (IRC Sec. 679(b).

Direct/Indirect Transfers

Under the IRC Sec. 679(a)(1) a U.S. person's transfer to a foreign trust includes both indirect and direct transfers, either of which classifies the U.S. person as the owner of the trust attributable to the property transferred if the foreign trust has one or more U.S. beneficiaries.

Indirect transfers include:
1. A transfer by either a foreign or domestic entity in which a U.S. person has an interest "may be regarded as an indirect transfer to the foreign trust by the U.S. person if the entity merely serves as a conduit for the transfer by the U.S. person or if the U.S. person has sufficient control over the entity to direct the transfer by the entity rather than himself." (S. Rep. 938, 94th Cong., 2d Sess. 219 (1976)).

2. If a foreign trust borrows money or property and a U.S. person guarantees the loan, the U.S. person is making an indirect transfer to the trust.

3. An intermediate transfer to either another person or an entity that makes the actual transfer to the foreign trust is to be disregarded "unless it can be shown that the ultimate transfer of property to the trust was unrelated to the intermediate transfer. In such a case, the person making the intermediate transfer would be treated as having made the ultimate transfer directly." See: Haeri v. Commr., 56 TCM 1061 (1989) (transfer by agent). Treas. Reg. Sec. 1.679-3 provides elaborate guidance with respect to indirect transfers.

IRC Sec. 679: U.S. Persons

IRC Sec. 679 applies only to a "U.S. person" which IRC Sec. 7701 (a) (30) defines as "a citizen or resident of the U.S.", including a resident alien (See: Treas. Reg. Sec. 1.679-1(d); Haeri v. Commr., 56 TCM 1061 (1989); Rev. Rul. 90-106, 1990-2 (B162)). A "U.S. person" includes: a U.S. partnership or corporation, any estate other than a foreign estate (defined in IRC Sec. 7701(a)(31)(A). A U.S. person includes a "U.S. Trust" (i.e. a domestic trust) which is a trust if "a court within the U.S. is able to exercise primary supervision over the administration of the trust", and "one or more U.S. persons have the authority to control all substantial decisions of the trust". (Treas. Reg. Sec. 301.7701-7(a)(1).

IRC Sec. 679 only applies to transfer to a "foreign trust" (i.e. not a domestic trust) only if a trust has a U.S. beneficiary. (IRC Sec. 7701(a) (31)(B) defines a foreign trust as any trust that does not qualify as a U.S. person.

U.S. Beneficiary

Under IRC Sec. 679(c), a foreign trust always has a U.S. beneficiary unless "under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a U.S. person (IRC Sec. 679(c)(1)(A). Under Treas. Reg. Sec. 1.679-2(a)(2)(i), this determination is independent of whether there is an actual distribution of income or corpus to a U.S. person during the year. If the trust authorizes accumulations for possible distributions to any U.S. person in the future, the trust has a U.S. beneficiary throughout the intervening period. Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 2). Even if the only interest a U.S. person has a right to receive is corpus upon termination, the trust has a U.S. beneficiary. Treas. Reg. 1.679-2 (a)(2)(iii), Ex (3).

In addition, a foreign trust always has a U.S. beneficiary if "no part of the income or corpus" of the trust could be paid to or for the benefit of a U.S. person "if the trust were terminated at any time during the taxable year". (IRC Sec. 679(c)(1)(B).

If any person has the authority to distribute trust income or corpus to unnamed persons generally or to any class of persons which include "U.S. persons", the trust has U.S. beneficiaries (Treas. Reg. 1.679-2(a)(2)(i), this determination is independent of whether a U.S. person's trust interest is contingent).

If any person has a power of appointment pursuant to which income or corpus may pass to a U.S. person, the trust has U.S. beneficiaries (Treas. Reg. Sec. 1.679-2(a)(2)(iii), (Ex 11).

If any person has the power to amend the trust so as to include U.S. persons as beneficiaries, the trust has U.S. beneficiaries (S. Rep 938, 94th Cong., 2d Sess. 219 (1976)).

Under Treas. Reg. 1.679-2(a)(4), the determination of whether income or corpus may be paid to or for the benefit of a U.S. person, the IRC consults "writings, oral agreements between the trustee and persons transferring property to the trust, local law, and the trust instrument".

IRC Sec. 679(c)(2) provides attribution rules that can cause income paid to or accumulated for a foreign corporation, partnership, trust or estate to be treated as though it were paid to or accumulated for the benefit of a U.S. beneficiary: these attribution rules apply if a corporation is a controlled foreign corporation, as defined in IRC Sec. 957(a) (See: IRC Sec. 679(c) (2)(A).

If a U.S. person is a partner of a foreign partnership (IRC Sec. 679(c) (2) (B), or if a U.S. person is a beneficiary of a foreign estate or trust (IRC Sec. 679(c)(2)(C). See: Treas. Reg. Sec. 1.679-2(b)(2) and (3), (Ex. 4 & 5).

A foreign trust has U.S. beneficiaries the day after the trust beneficiaries move to the U.S. (Treas. Reg. Sec. 1.679-2(a)(3)(ii), (Ex 1). Under IRC Sec. 679(c)(3), a beneficiary who first becomes a U.S. person more than 5 years after the date of a transfer to a foreign trust is not a U.S. person with respect to that transfer (See: Treas. Reg. Sec. 1.675-2(d)(3)(ii), (Ex 2).
The determination whether a trust has a U.S. beneficiary for purposes of IRC Sec. 679 occurs on an annual basis (Treas. Reg. 1.679-2(a)(1).

If a foreign beneficiary becomes a U.S. person, IRC Sec. 679 begins to apply with the transferor's first taxable year in which the foreign beneficiary is a U.S. person. The U.S. transferor has "additional income" pursuant to IRC Sec. 679(b) in the taxable year in which the trust acquires a U.S. beneficiary. Treas. Reg. 1.679-2(c)(1)(3), (Ex 1).

When a trust ceases to have any U.S. beneficiaries, the U.S. transferor continues to be treated as owner until the beginning of the following taxable year (Treas. Reg. Sec. 1.679-2(c)(2)(3), (Ex 2).

Under IRC Sec. 679, with respect to a foreign trust, to which no U.S. resident has ever transferred anything, if a non-resident alien becomes a U.S. resident within 5 years of an actual transfer (Treas. Reg. 1.679-5), it is a U.S. grantor trust.

If a non-resident alien transfers property to a foreign trust and during the succeeding 5 years becomes a U.S. resident, IRC Sec. 679 applies as though the transferor had, on that later date, transferred "an amount equal to the portion of such trust attributable to the property actually transferred". (IRC Sec.

679(a)(4)(A), which includes undistributed net income of the trust for periods before the transferor became a U.S. resident (IRC Sec. 679(a)(4)(B).

If a U.S. trust becomes a foreign trust, under IRC Sec. 679 the trust becomes a foreign grantor trust (Treas. Reg. 1.679-6) and IRC Sec. 679 applies as though the grantor had on that date transferred "an amount equal to the portion of such trust attributable to the property previously transferred (IRC Sec. 679(a)(5), including undistributed net income of the trust for periods before the trust became a foreign trust." (IRC Sec. 679(a)(5)).

Chapter 6 – FATCA/FBAR

Summary of HIRE and Foreign Account Tax Compliance Act

On March 18, 2010, President Obama signed the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. 111-147) (The "Act"), which included the Foreign Account Tax Compliance Act containing new foreign account tax compliance rules.

Under the Act, new reporting and disclosure requirements for foreign assets will be phased in between 2010 – 2014:

1. Foreign Institutional Reporting: Foreign Institutions have new reporting and withholding obligations for accounts held by U.S. Persons (generally effective after 12/31/12, commencing 1/1/13).

2. Foreign Financial Assets ($50,000): Individuals with an interest in a "Foreign Financial Asset" have new disclosure requirements. If foreign financial assets are valued in excess of $50,000, the U.S. Taxpayer must attach certain information to their income tax returns for tax years beginning after March 18, 2010. (U.S. Taxpayers are not required to disclose interests that are held in a custodial account with a U.S. financial institution).

The penalty is substantial ($10,000, plus additional amounts for continued failures, up to a maximum of $50,000 for each applicable tax period). The penalty may be waived if the individual can establish that the failure was due to reasonable cause and not willful neglect.

3. 40% Penalty: A 40% accuracy-related penalty is imposed for underpayment of tax that is attributable to an undisclosed foreign financial asset understatement. Applicable assets are those subject to mandatory information reporting when the disclosure requirements were not met. The penalties are effective for tax years beginning after March 18, 2010.

4. 6 Year Statute of Limitations: Statute of limitations re: omission of income in connection with foreign assets: The statute of limitations for assessments of tax is extended to six (6) years if there is an omission of gross income in excess of $5,000 attributable to the foreign financial asset. The six-year statute of limitations is effective for tax returns filed after March 18, 2010, as well as for any

other tax return for which the assessment period has not yet expired as of March 18, 2010.

5. Passive Foreign Investment Companies: The Act imposes an information disclosure requirement on U.S. Persons who are PFIC shareholders. A PFIC is any foreign corporation if:

a. 75% or more of the gross income of the corporation for the taxable year is passive income; or

b. The average percentage of assets held by such corporation during a taxable year which produce passive income or which are held for the production of passive income are at least 50%.

6. Foreign Trusts with U.S. Beneficiaries: The Act clarifies if a foreign trust is treated as having a U.S. Beneficiary; an amount accumulated is treated as accumulated for the U.S. Person's benefit even if that Person's trust interest is contingent.

The Act clarifies that the discretion to identify beneficiaries may cause the trust to be treated as having a U.S. Beneficiary. This provision is effective after March 18, 2010.

7. Rebuttable Presumption/Foreign Trust – U.S. Beneficiary: The Act creates a rebuttable presumption that a foreign trust has a U.S. Beneficiary if a U.S. Person directly or indirectly transfers property to a foreign trust (unless the transferor provides satisfactory information to the contrary to the IRS). This provision is effective for property transfers after March 18, 2010.

8. Uncompensated Use of the Foreign Trust Property: The Act provides that the uncompensated use of the foreign trust property by a U.S. Grantor, a U.S. Beneficiary (or a U.S. Person, related to either of them), is treated as a distribution by the trust. The use of the trust property is treated as a distribution to the extent of the fair market value of the property's use to the U.S. Grantor/U.S. Beneficiary, unless the fair market value of that use is paid to the trust.

The loan of cash or marketable securities by a foreign trust, or the use of any other property of the trust, to or by any U.S. Person is also treated as paid or accumulated for the benefit of the U.S. Person. This provision applies to loans made and uses of property after March 18, 2010.

9. Reporting Requirements, U.S. Owners of Foreign Trusts: This provision requires any U.S. Person treated as the owner of any portion of a foreign trust to submit IRS-required information and insure that the trust files a return on its activities and provides such information to its owners and distributees.

This new requirement imposed on U.S. Persons treated as owners is in addition to the current requirement that such U.S. Persons are responsible for insuring that the foreign trust complies with its own reporting obligations. This provision is effective for taxable years beginning after March 18, 2010.

10. Minimum Penalty re: Failure to Report Certain Foreign Trusts: This provision increases the minimum penalty for failure to provide timely and complete disclosure on foreign trusts to the greater of $10,000 or 35% of the amount that should have been reported.

In the case of failure to properly disclose by the U.S. Owner of a foreign trust of the year-end value, the minimum penalty would be the greater of $10,000 or 5% of the amount that should have been reported. This provision is effective for notices and returns required to be filed after December 31, 2009.

Foreign Financial Assets

U.S. Taxpayers who hold any interests in specified foreign financial assets during the tax year must attach their tax returns for the year certain information with respect to each asset if the aggregate value of all assets exceeds $50,000. An individual who fails to furnish the required information is subject to a penalty of $10,000. An additional penalty may apply if the failure continues for more than 90 days after a notification by the IRS to a maximum of $50,000. The penalty may be avoided if the Taxpayer shows a reasonable cause for the failure to comply.

The Joint Committee on Taxation, Technical Explanation of the Hiring Incentives to Restore Employment Act (JCX-4-10) clarifies that although the nature of the information required to be disclosed is similar to the information disclosed on an FBAR, it is not identical.

For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50%, may still be required to disclose the interest with his tax return if the $50,000 value threshold is met. In addition, this provision is not intended as a substitute for compliance with the FBAR reporting requirements, which remain unchanged.

For purposes of IRC Code §6038(D) as added by the HIRE Act, a specified foreign financial asset includes:

1. Any depository, custodial, or other financial account maintained by a foreign financial institution, and

2. Any of the following assets that are not held in an account maintained by a financial institution:

a. Any stock or security issued by a person other than a U.S. Person

b. Any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. Person, and

c. Any interest in a foreign entity (IRC §6038(D)(b) as added by the 2010 HIRE Act).

The information required to be disclosed with respect to any asset must include the maximum value of the asset during the tax year (IRC §6038(D)(c) as added by the 2010 HIRE Act).

For a financial account, the Taxpayer must disclose the name and address of the financial institution in which the account is maintained and the number of the account.

In the case of any stock or security, the disclosed information must include the name and address of the issuer and such other information as is necessary to identify the class or issue of which the stock or security is a part.
In the case of any instrument, contract, or interest, a Taxpayer must provide any information necessary to identify the instrument, contract, or interest along with the names and addresses of all issuers and counterparties with respect to the instrument, contract, or interest.

Under these rules, a U.S. Taxpayer is not required to disclose interests held in a custodial account with a U.S. financial institution. In addition, the U.S. Taxpayer is not required to identify separately any stock, security instrument, contract, or interest in a disclosed foreign financial account.

An individual who fails to furnish the required information with respect to any tax year at the prescribed time and in the prescribed manner is subject to a penalty of $10,000 (IRC §6038(D)(d) as added by the 2010 HIRE Act). If the failure to disclose the required information continues for more than 90 days after the day on which the notice was mailed (from the Secretary of Treasury), the individual is subject to an additional penalty of $10,000 for each 30-day period (or a fraction thereof) with the maximum penalty not to exceed $50,000.

In addition to the $10,000 penalty (up to $50,000) under IRC §6038(D) a 40% accuracy-related penalty is imposed on any understatement of tax attributable to a transaction involving an undisclosed foreign financial asset.

The statute of limitations for omission of gross income attributable to foreign financial assets (omission of gross income in excess of $5,000 attributable to a foreign financial asset), is extended to six years.

The IRC §6038(D) penalties are not imposed on any individual who can show that the failure is due to reasonable cause and not willful neglect. (IRC §6038D(g), as added by the 2010 HIRE Act.)

The information disclosure with respect to foreign financial assets supplements the FBAR reporting regime. The HIRE Act broadens reporting requirements and extends the rules to ownership of foreign assets such as foreign stocks, securities, interests in foreign companies not covered by the FBAR reporting. The threshold reporting requirement amount for FBARs ($10,000) is increased to $50,000. While the FBAR reporting covers those having signatory or other authority, the new reporting regime focuses on ownership.

IRS Form 8938: Statement of Specified Foreign Financial Assets

“FATCA” Tax Reporting

Under the Foreign Account Tax Compliance Act ("FATCA") for tax years beginning after March, 18, 2010, specified persons (i.e. U.S. Citizens, resident aliens), who have an ownership interest in specified foreign financial assets (i.e. foreign financial accounts, foreign stock, any interest in a foreign entity) must file Form 8938 (attached to their form 1040 tax return) if the value of the foreign financial assets exceeds applicable "reporting threshold".

The value of a specified foreign financial asset, for Form 8938 reporting purposes is the asset's fair market value.

For Individuals: more than $50,000 on the last day of the tax year, more than $75,000 at any time during the tax year. If living abroad; $200,000 on the last day of the tax year or more than $300,000 at any time during the tax year.

For Married Taxpayers: more than $100,000 on the last day of the tax year, more than $150,000 at any time during the tax year, if living abroad: $400,000 on the last day of the tax year, or more than $600,000 at any time during the tax year.

The IRS anticipates issuing regulations that will require domestic entity to file Form 8938, if it holds specified foreign financial assets whose value exceeds the applicable reporting threshold. Until the IRS issues such regulation, only individuals must file Form 8938.

Foreign Trusts

The value of an interest in a foreign trust, during the tax year, (if taxpayer doesn't know its fair market value is the Maximum Value of the interest in the foreign trust calculated as the sum of the following amounts:

1. The value of all of the cash (or other property) distributed during the tax year from the trust to the beneficiary, plus

2. The value (using the IRC§7520 Valuation Tables) to receive mandatory distributions as of the last day of the tax year;

Foreign Grantor Trusts

A U.S. Taxpayer, who is the owner of a foreign grantor trust, does not have to report specified financial assets, held by the trust if:

1. The US Taxpayer reports the trust on a timely filed form 3520 for the same tax year;

2. The trust timely files Form 3520-A (Annual Information Return of Foreign Trust with a U.S. owner) for the same tax year;

3. Taxpayer identified on form 8938 how many of these forms they filed.

Specified Foreign Financial Assets

Foreign financial accounts include any depository (or custodial) account maintained by a foreign financial institution, any equity or debt interest in a foreign financial institution including any financial account maintained by a financial institution organized under the laws of a U.S. possession (America Samoa, Guam, The Northern Mariana Islands, Puerto Rico or the U.S. Virgin Islands)
A foreign financial institution is any financial institution that is not a U.S. entity, and satisfies one of the following conditions:

1. It accepts deposits;

2. It holds financial assets for the account of others;

3. It is engaged in the business of investing or trading in securities, partnership interests, or commodities;

4. It includes investment vehicles such as foreign mutual funds, hedge fund and private equity funds.

Interests in Specified Foreign Financial Assets

A U.S. Taxpayer:

1. has an interest in a specified financial asset if any income, gains, losses, deductions, credits, gross proceeds, or distribution from asset dispositions is required to be reported on U.S. income tax returns;

2. who is the owner of a disregarded entity, has an interest in any specified foreign financial assets owned by the disregarded entity;

3. who has an interest in a financial account that holds specified foreign financial assets, do not have to report the assets held in the account;

4. does not own an interest in any specified foreign financial asset held by a partnership, corporation or estate, as a result of their status as a partner, shareholder or beneficiary;

5. who is the owner, under the grantor trust rules of any part of a trust, has an interest in any specified foreign financial asset held by that part of the trust;

6. does not have an interest in a foreign trust or a foreign estate specified foreign financial asset, unless they know (or have reason to know) of the interest. If they receive a distribution from the foreign trust or foreign estate, they are considered to know of the interest.

Exceptions to Tax Reporting (Form 8938)

U.S. Taxpayers do not have to report a specified foreign financial asset on Form 8938:

1. If the financial account is maintained by a U.S. payer which includes: a U.S. financial institution, a domestic branch of a foreign bank or insurance company, a foreign branch or subsidiary of a U.S. financial institution;
2. If the U.S. Taxpayer reports the specified foreign financial asset on timely filed IRS forms:

a. Form 3520: Annual Return to Report Transactions with Foreign Trusts and Receipt of certain foreign Gifts

b. Form 5471: Information Return of U.S. Persons with Respect to Certain Foreign Corporations

c. Form 8865: Return of U.S. Persons with Respect to Certain Foreign Partnerships

Civil Penalties (Form 8938)

1. Failure to File Penalty: A penalty of $10,000 for each 30 day period not filed, (within 90 days after the IRS notifies of the failure to file) after the 90 day period has expired, up to $50,000 maximum penalty.

2. Accuracy-Related Penalty: A 40% penalty on a tax underpayment as a result of an undisclosed, specified foreign financial asset.

3. Fraud: A 75% penalty on a tax underpayment, due to fraud.

Criminal Penalties (Form 8938)

Criminal penalties may be imposed for:

1. Failure to file Form 8938;

2. Underpayment of tax;

3. Failure to report asset.

Statute of Limitations

1. For failure to file Form 8938, failure to report a specified foreign financial asset, the statute of limitations remains open until 3 year after the date Form 8938 is filed.

2. For failure to include in gross income, an amount relating to one or more specified foreign financial assets, and the amount omitted in more than $5,000, any tax owed for the tax year, can be assessed at any time within 6 years after the tax return is filed.

U.S. Taxpayer Tax Compliance Issues

FBAR rules are not found in the Code. Rather, they are set forth in the Bank Secrecy Act, first enacted by Congress in 1970. Since 2003, however, the IRS bears responsibility for enforcing these rules.
The FBAR rules require that every U.S. Person report (i) any financial interest or authority over a (ii) financial account in a foreign country with (iii) an aggregate value over $ 10,000 at any time during the taxable year. The report must be filed on a Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts (hence the acronym "FBAR"). U.S. Persons must also disclose the existence of the account on their Form 1040, Schedule B, Part III. This is commonly referred to as "checking the 'B' box."

Taxpayers who fail to disclose the account on their Form 1040 could be subject to criminal sanctions for filing a false tax return.

The FBAR report is due on June 30th. This due date is not subject to extensions. The FBAR report must be filed separately from the U.S. Person's tax return.

Financial Interest Or Authority

A U.S. Person has a financial interest in a foreign account if he or she is the legal or beneficial owner. Attribution rules apply in making this determination. A person serving as a shareholder, partner, and trustee may also be deemed to hold a financial interest if the owner of the account is (i) a person acting as an agent on behalf of the U.S. Person, (ii) a corporation where the U.S. Person owns, directly or indirectly, more than 50 percent of the outstanding stock, (iii) a partnership in which the U.S. Person owns more than 50 percent of the profits, or (iv) a trust in which a U.S. Person has either a present interest in more than 50 percent of the assets or from which the U.S. Person receives more than 50 percent of the income. If these thresholds are met, the U.S. Person has an FBAR reporting obligation, regardless of whether he or she has any authority over the account.

Non-owners with authority over a foreign account are also subject to the FBAR reporting rules. Authority means the U.S. Person has the ability to order a distribution or disbursement of funds or other property held in the account. This is not limited to signature authority, but includes the ability to order distributions by verbal commands or other communication. Authority does not include persons who have the right to invest, but not distribute, the foreign account funds.

There is no limitation for taxpayers who have authority over a foreign account, but only in an official capacity. (For example, the president of a corporation, the general partner of a partnership, or the manager of an LLC may be subject to these rules.)

Both the entity, as beneficial owner, and the representative, who has control over the account, may be required to file an FBAR report. Similarly, when more than one U.S. Person has authority over an account, i.e., president and vice president, both persons may have an FBAR reporting obligation.

Even when the account is subject to joint control, and the signature of someone other than the taxpayer is required to cause a distribution, the taxpayer is still considered to have authority over the account for FBAR reporting purposes.

Financial Account In A Foreign Country

The term financial account is broadly defined as any asset account and encompasses simple bank accounts (checking or savings), as well as securities or custodial accounts. It also includes a life insurance policy or other type of policy with an investment value (i.e., surrender value).

Foreign country naturally refers to any country other than the United States. Puerto Rico, U.S. possessions and territories are included as part of the United States (as they should) for these purposes. Accounts held by U.S. Persons in these areas are not foreign accounts subject to FBAR reporting.

The IRS has indicated that a traditional credit card with a foreign bank is not a foreign account. However, use of a credit card as a debit or check card could trigger foreign account status and thus an FBAR reporting obligation.

$10,000 Threshold

To be reportable, the account must have assets the value of which during the year, exceeds $10,000.

The Instructions to the FBAR report state that if the aggregate value of all financial accounts exceeds $10,000 at any time during the year, the U.S. Person must file an FBAR report. A U.S. Person who possesses multiple foreign accounts,

all of which have less than $10,000, but which collectively exceed $10,000, may have an FBAR reporting obligation.

Taxpayers may transfer an appreciating asset to a foreign account, such as stock or securities. As these assets increase in value, they may trigger an FBAR reporting requirement.
Whether the account generates any income is not relevant.

Penalties

In an attempt to improve compliance, Congress enhanced the FBAR penalties in 2004. Under pre-2004 law, civil penalties applied only to willful violations. In 2009, civil penalties up to $10,000 may be imposed on non-willful violations. **This penalty may be avoided if there was reasonable cause and the U.S. Person reported the income earned on the account. 31 U.S. C. §5321(a)(5).**

Although reasonable cause is not defined, the IRS will likely apply the reasonable cause standard for late-payment/late-filing penalties.

The penalty for willful violations is far more severe. It is equal to the greater of $100,000 or 50 per-cent of the balance of the account at the time of the FBAR violation. No reasonable cause exception exists for a willful violation. 31 U. S. C. §5321(a)(5)(c).

The IRS has six years to assess a civil penalty against a taxpayer that violates the FBAR reporting rules. (See: 31 U. S. C. §5321(b)(1), IRS OVDP (FAQ) 6/26/12 #42)

Amended Tax Returns (Voluntary Disclosure)

U.S. Taxpayers who fail to report offshore accounts by filing FBAR (TD F 90.22-1) face criminal and civil penalties:

1. Failure to Report Income
(3 Felonies and 1 Misdemeanor) up to 14 years in jail, plus 75% Civil Tax Fraud Penalty, 25% Failure to Pay Tax Penalty.

2. Failure to File FBAR’s

(a maximum annual penalty of 50% of the account balance, up to 10 years in jail a $500,000 fine).

3. Perjury
Taxpayers Form 1040/Schedule B must declare whether Taxpayers have any authority over, or interest in foreign accounts with a total of more than $10,000.

In the IRS 6/24/09 FAQ update the IRS stated:
What is the distinction between filing amended returns to correct errors and filing a voluntary disclosure?

An amended return is the proper vehicle to correct an error on a filed return, whether a taxpayer receives a refund or owes additional tax. A voluntary disclosure is a truthful, timely and complete communication to the IRS in which a taxpayer shows a willingness to cooperate (and does in fact cooperate) with the IRS in determining the taxpayer's correct tax liability and makes arrangements in good faith to fully pay that liability. Filing correct amended returns is normally a part of the process of making a voluntary disclosure under IRM 9.5.11.9. Taxpayers and practitioners trying to decide whether to simply file an amended return with a Service Center or to make a formal voluntary disclosure under the process described in IRM 9.5.11.9 and the March 23, 2009 memoranda should consider the nature of the error they are trying to correct.

Taxpayers with undisclosed foreign accounts or entities should consider making a voluntary disclosure because it enables them to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution. Making a voluntary disclosure also provides the opportunity to calculate, with a reasonable degree of certainty, the total cost of resolving all offshore tax issues. It is anticipated that the voluntary disclosure process is appropriate for most taxpayers who have underreported their income with respect to offshore accounts and assets. However, there will be some cases, such as where a taxpayer has reported all income but failed to file the FBAR (FAQ 9), or only failed to file information returns (FAQ 42), where it remains appropriate for the taxpayer to simply file amended returns with the applicable Service Center (with copies to the Philadelphia office listed in FAQ 9).
The IRS stated position is that a Taxpayer's voluntary disclosure entitles the Taxpayer to become compliant, avoid substantial civil penalties and generally eliminate the risk of criminal prosecution.

In reality, a taxpayer who makes a voluntary disclosure may:

1. Spotlight their “tax crimes”

2. If the voluntary disclosure is not accepted, jeopardize them and subject them to criminal prosecution

The IRS SBSE 3/23/09 memorandum, Subject: Routing of Voluntary Disclosure Cases, which addresses a change in the processing of voluntary disclosure requests containing offshore issues.

1. Such requests will continue to be initially screened by Criminal Investigation to determine eligibility for voluntary disclosure, and, if involving only domestic issues will be forwarded to Area Planning and Special Programs for Civil Processing;

2. Voluntary disclosure eligibility for offshore issues will be initially screened by Criminal Investigation and forwarded to the Philadelphia Offshore Identification Unit (POIU) for processing.

Voluntary Disclosure risks include:

1. Heightened risk of criminal prosecution (since initial screening is by the IRS Criminal Investigation Division);

2. A voluntary disclosure may be used as an evidentiary admission of Taxpayer’s unreported income;

3. A voluntary disclosure may waive Taxpayer’s 5th Amendment right against self-incrimination;

4. While a voluntary disclosure is pending the IRS may request more information, commence an audit or initiate criminal prosecution.

As an alternative strategy to a voluntary disclosure, the “quiet filing” (for the Tax Years at issue) of an amended tax return (or original tax return) may instead:

1. Pre-empt criminal charges for the failure to file FBAR returns, Form 1040 tax returns and failure to pay tax;

2. Pre-empt a 75% civil tax fraud penalty, for failure to file or pay tax and a 25% failure to pay tax penalty;

3. If the income is properly reported (i.e., no substantial understatments which are subject to a 6 year statute of limitations), the tax filing will commence the 3-year statute of limitations (for each year) for IRS audit.

Statute of Limitations

*On 6/24/09, in FAQ #31, the IRS confirmed they will be able to assess taxes under a 6 year statute of limitations if the IRS can prove a substantial omission of gross income:
How can the IRS propose adjustments to tax for a six-year period without either an agreement from the taxpayer or a statutory exception to the normal three-year statute of limitations for making those adjustments?

Going back six years is part of the resolution offered by the IRS for resolving offshore voluntary disclosures. The taxpayer must agree to assessment of the liabilities for those years in order to get the benefit of the reduced penalty framework. If the taxpayer does not agree to the tax, interest and penalty proposed by the voluntary disclosure examiner, the case will be referred to the field for a complete examination. In that examination, normal statute of limitations rules will apply. If no exception to the normal three-year statute applies, the IRS will only be able to assess tax, penalty and interest for three years. However, if the period of limitations was open because, for example, the IRS can prove a substantial omission of gross income, six years of liability may be assessed. Similarly, if there was a failure to file certain information returns, such as Form 3520 or Form 5471, the statute of limitations will not have begun to run. If the IRS can prove fraud, there is no statute of limitations for assessing tax.

*See: 31 U. S. C. §5321(b)(1) re: 6 year statute.

Annual Filing Requirements and Reasonable Cause Exception

In April 2003, the Financial Crimes Enforcement Network delegated authority of the TD F 90-22.1 form (i.e., FBAR form) to the Internal Revenue Service (see IR 2003-48 (4/10/03); 31 CFR §103.5(6)(b)(8)). The IRS enforces all penalties associated with the FBAR with the same power it enforces tax reporting and payment compliance.

The IRS has been given the authority to enforce the filing rules and audit the reports as appropriate.

The FBAR filing is due by June 30th of the year following the year of the report with no provisions for extensions. The due date means the date it must be received by the US Treasury. Mailing it on the date it is due will result in a late filing. The FBAR form, filed separately from the income tax, must be mailed to US Department of Treasury, PO Box 32621, Detroit, Michigan 48232-0621.

If there is an emergency, the form can be hand-delivered to a local IRS office for forwarding to the Treasury Department in Detroit.

An amended FBAR may be filed by completing a revised FBAR with the correct information writing the words “Amended” at the top of the revised FBAR and stapling it to a copy of the original FBAR. For Taxpayers amending a late-filed FBAR, they should include a statement explaining their reasons for a late filing (i.e., request a reasonable cause exception from penalty).

A failure to file a FBAR has civil and criminal penalties (which are in addition to any income tax penalties if the income is not reported). The IRS must assess the civil penalties within 6 years of the FBAR violation (31 USC 5321(b)(1)).

For a willful failure to file, the civil penalty increases from $10,000 (non-willful failure to file) to the greater of $100,000 or 50% of the account balance in the foreign account for the tax year.
The civil penalties for non-willful failure to file may be waived by the IRS if the Taxpayer can show reasonable cause. If the Taxpayer has a reasonable cause exception, the FBAR should be filed with an explanation (i.e., the reasonable cause, with an express request for waiver of penalties).

The waiver of civil penalties for a reasonable cause exception may include among other factors:

1. All the income from the foreign account was included on the US Taxpayer's return.

2. The Taxpayer was unaware of the requirement to file (for example, lack of understanding of what constitutes a financial interest).

3. Once the Taxpayer became aware of the filing requirements, he filed all delinquent reports (up to 6 years).

Civil and Criminal Penalties

Each U.S. Person who has a financial interest in, or signature or other authority over, one or more foreign financial accounts (value over $10,000, at any time during a calendar year) is required to report the account on Schedule B/Form 1040, and TD F 90-22.1 (Report of Foreign Bank and Financial Accounts (FBAR)), due by June 30 of the succeeding year (I.R.M. 5.21.6.1. (2/17/09)).

Failure to file the required report or maintain adequate records (for 5 years) is a violation of Title 31 with civil and criminal penalties (or both). For each violation a separate penalty may be asserted.

(I) Non-Willful Violation
Civil Penalty – Up to $10,000 for each violation. 31 U.S.C.§ 5321(a)(5)(A)

(II) Negligent Violation

Civil Penalty – Up to the greater of $100,000, or 35 percent of the greatest amount in the account. 31 U.S.C.

(III) Intentional Violations

1. Willful – Failure to File FBAR or retain records of account

Civil Penalty -Up to the greater of $100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty -Up to $250,000 or 5 years or both

31 U.S.C. §5321(a)(5)(C), 31 U.S.C. § 5322(a) and 31 C.F.R. §103.59(b) for criminal

2. Knowingly and Willfully Filing False FBAR

Civil Penalty – Up to the greater of $100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty – $10,000 or 5 years or both

18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal

3. Willful – Failure to File FBAR or retain records of account while violating certain other laws

Civil Penalty – Up to the greater of $100,000, or 50 percent of the greatest amount in the account.

Criminal Penalty – Up to $500,000 or 10 years or both

31 U.S.C. § 5322(b) and 31 C.F.R. §103.59(c) for criminal

Criminal Penalties: Willful Failure to File (Defenses)

Under IRS Form 1040, at the bottom of Schedule B, Part III, on Page 2, Question 7(a) states: "at any time during the previous year, did you have any interest in or signatory or other authority over a financial account in a foreign country, such as a bank account, a security account, or other financial account? The answer is either yes or no. If yes, Question 7(b) requires the name of the foreign country (with the account). Question 8 requires confirmation of receipt of distribution from the account, or if the Taxpayer was a grantor of, or transferor to a foreign trust (which requires filing Form 3520).

A willful failure to file a FBAR can lead to a felony of up to 10 years in jail and a $500,000 fine. The IRS must prove willfulness in order to assert the $500,000 monetary penalty and the imprisonment for up to 10 years (see 31 USC 5321(a)(5)(B); CCA 200603026; Eisenstein, 731 F.2d 1540 (CA – 11, 1984)).

Willfulness must be proven by the IRS under the standard of clear and convincing evidence. If the Taxpayer knew about the requirement to file, it would affect his defense. If the Taxpayer failed to report the foreign account interest or other income on his income tax return, it would affect his defense.

If a failure to file is deemed to be part of a criminal activity involving more than $100,000 in a 12-month period, the penalty limit increases to $500,000 with up to 10 years in jail. The issue of whether a failure to file is willful or non-willful is based on the facts of each case. Willfulness has been defined as the voluntary, intentional violation of a known legal duty, see Cheek 498 US 192, 67 AFTR 2d 91-344 (Supreme Court 1991).

A Taxpayer's good faith belief that he does not have to file (or even his negligent failure to file) can be a defense to the charge of willful failure to file (i.e., a defense to criminal charges).

A defense may include that the Taxpayer was advised by his advisor that no FBAR was required.

Failure to maintain adequate records of the foreign account for the years the FBAR filing is due may result in additional civil and criminal penalties.

Chapter 7 - 2014: U.S. Income, Estate & Gift Tax

Estate & Gift Tax

1. Estate and Gift Tax Exemption increases from $5,250,000 to $5,340,000, tax rate: 40% (excess over $5,340,000)

2. Gift Tax Exclusion: $14,000 per donee

3. Up to $1,090,000 of farm or business realty can receive discount estate valuation

4. Estate Tax Deferral (Installments)

If one or more closely-held businesses make up greater than 35% of an estate, as much as $580,000 of tax can be deferred, and the IRS will charge 2% interest (15 year tax deferral)

Pensions/Retirement Plans (2014)

1. Pay-in limitation for defined contribution plans increase to $52,000 (based on up to $260,000 in salary), which is a $1,000 increase (for profit-sharing plans, KEOGH plans, et al)

2. Benefit limit for Defined Pension Benefit Plans is $210,000.

3. 401(K) limit remains $17,500

Social Security

Social Security wage base increases in 2014 to $117,000 (up $3300 from 2013 cap). The tax rate imposed on employers and employees remains 6.2% and the employer share of Medicare tax stays at 1.45%. The employee’s share is 1.45%, but the 0.9% Medicare surtax kicks in for singles with wages exceeding $200,000 and couples earning over $250,000.

Income Taxes

US Taxpayers working abroad have a larger exclusion $99,200 (2014).

<u>2014 Top Tax Rates</u>
Taxable Income / Over / Tax Rate
1. Married / $457,600 / 39.6%
2. Singles / $406,750 / 39.6%

Standard Deductions
1. Married: $12,400
with one spouse over 65: $13,600
with both spouses over 65: $14,800

2. Singles: $6,200
over 65: $7,750

Itemized Deductions
High Income Earners have phase-out of itemized deductions 3% of the excess of AGI over:
1. Singles: $254,200
2. Married: $305,050

Total deduction can't exceed 80% of itemizations. Medicals, investment interest, casualty loss, are exempted.

Dividends/Capital Gains
20% top tax rate on dividends and long-term gains 2014; on taxable income in excess:
1. Singles: $406,750
2. Married: $457,600
3.8% Medicare surtax boosts the rate to 23.8%

AMT
AMT exemptions increase for 2014
1. Singles: $52,800
2. Marrieds: $82,100

AMT phase-outs start at income levels
1. Singles: $117,300

2. Couples: $156,500

28% AMT tax bracket begins above $182,500.

2014 U.S./California Income Tax

In 2014, the highest income tax rate is 51.7% (Federal tax rate: 44.3%, California tax rate: 13.3%). The 51.7% tax rate applies to wage earners)

For investors the top rate on net investment income is 50.92% (Federal tax rate: 43.4%, California tax rate: 13.3%).

The top tax rates apply to U.S. taxpayers who earn income over certain levels, see below. These top tax rates apply to international investors who are classified as U.S. tax residents under either the "Green Card Test" or the "Substantial Presence Test".

2014 Income Taxes (U.S./California)
California Income Tax

Income over $250,000 is taxed at 12.3%. Income over $1m is taxed at 13.3% (additional 1% mental health tax). These tax rates apply through 2018.

2014 Highest California Tax Rate: 13.3%

U.S. Income Tax (2014): Income/Medicare Tax

1. Income Tax
Individuals (over $406,750); Married (over $457,000) Tax: 39.6%

2. Medicare Surtax
Net Investment Income

Individuals/Heads of Household

(Modified Adjusted Gross Income ("AGI") over $200,000)

Married Taxpayers (over $250,000)

Married filing separately (over $125,000) Tax: 3.8%

The 3.8% Medicare surtax on net investment income is levied on the lesser of:
1. Taxpayer's net investment income; or

2. The excess of modified adjusted gross income over the applicable dollar threshold (modified AGI is AGI plus any tax-free foreign earned income). Investment income includes: interest, dividends, capital gains, annuities, royalties and passive rental income. Tax-free interest is exempted, along with pay-outs from retirement plans such as 401(k)s, IRAs, deferred pay plans and pension plans.

<u>Earned Income</u>
(Wages and Self-Employment Income)
Individuals/Heads of Household
(Total Earnings over $200,000)

Married Couples
Joint Returns/Earnings over $250,000

Filing Separately/Earnings over $125,000; Tax: 0.9%

This surtax applies only to the employee's share of Medicare tax.

Employers don't owe it. Employers will withhold the surtax once an employee's wages exceed $200,000. Employees will then calculate the actual tax due on their Form 1040 tax returns.
2014 Highest U.S. Tax Rate (44.3%)

(Includes Medicare Surtaxes on Net Investment Income and Earned Income)

Summary 2014/Combined U.S./California Tax (Top Rates: 57.6%)

"Blended" U.S./California Tax (Top Rates: 51.7%)

For taxpayers (individual) who have income over $406,750, including net investment income over $200,000 (modified adjusted gross income), and earned

income over $200,000 (wages and self-employment income), the combined top tax rate is 57.6%, the “blended” top tax rate is 51.7%.

For investors (who do not have wages and self-employment income) the combined top tax rate is 56.7%; the “blended” top tax rate is 50.92%.

Chapter 8 – International Tax Planning for U.S. Exports: IC-DISC
By Ryan L. Losi and Gary S. Wolfe

In 2013, after a five-year (plus) “Great Recession”, America needs jobs (since 2007, millions of U.S. jobs have been lost). One solution is to propagate international export of U.S.-made products, which may both accelerate new U.S. hiring and increase U.S. jobs.

Under the Internal Revenue Code, a special type of U.S. Corporation, an “IC-DISC” provides significant tax benefits for closely held, small and mid-size U.S. corporations who export U.S.-made products. By use of an IC-DISC, U.S. manufacturers who internationally export U.S.-made products may annually, indefinitely defer tax on between $400,000-$2.5 million of foreign sales revenues.

Under the IC-DISC tax rules, up to $10 million in annual foreign sales is subject to a formula, which limits the tax deferral (i.e. the greater of: four percent of foreign sales (up to $10 million; i.e. $400,000), or 50 percent of net income (on $10 million in foreign sales), which is computed: $10 million less expenses (e.g. $5 million) = $5 million net income x .50 percent = $2.5 million (or more if net income is higher than 50 percent).

Under the IC-DISC tax rules:

- No corporate income tax (for IC-DISC);
- Indefinite tax deferral (subject to a less than 1 percent interest charge, annually; i.e. in 2013, 16 basis points (.0016%), which on $2.5 million is $4,000 per year);
- Reduced tax on distributions (20 percent not 39.6 percent);
- No tax on distributions (with international tax planning).

In addition, the U.S. manufacturer, who exports the U.S.-made products, receives a corporate income tax deduction for the annual IC-DISC “sales commission” paid, (up to $2.5 million per year or more, subject to the 50 percent net income test) which may be worth nearly $1 million annually in tax savings. For example, if the IC-DISC is paid $2.5 million and the U.S. manufacturer pays the top corporate income tax rate (38 percent) = $950,000 corporate tax savings, with no

corresponding income declared by the IC-DISC (since their income is indefinitely tax-deferred).

The proposed international tax planning strategy includes an IC-DISC which receives $2.5M yearly as “tax-free” income from the export of U.S. made products and with the IC-DISC shares are owned and held by a Puerto Rico-issued private placement variable life insurance policy. This policy contains two component parts:

1. A “MEC frozen cash value” and a “non-MEC”. The annual $2.5 million shareholder distributes trust fund non-MEC (which has tax-free withdrawals of both basis and earnings) and then funds a MEC (which has tax-free withdrawals of basis, with earnings applied to increase the policy death benefit);

2. If the IC-DISC distributes $2.5 million per year (over 15 years), total: $37.5 million, the IC-DISC annual distribution requirement will be satisfied and a $37.5 million shareholder dividend may be paid tax-free, plus a tax-free distribution (by loan) of any non-MEC earnings.

In summary, $37.5 million plus tax-free withdrawal of basis, plus investment earnings (tax-free for the non-MEC, MEC earnings apply to insurance policy death benefit (tax-free).
Judge Learned Hand, dissenting in Commissioner v. Newman, 159 F.2d 848, 850-851 (2d Cir. 1947), stated: “Over and over again the courts have said there is nothing sinister in arranging affairs to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands...”

Companies who export U.S produced goods may significantly reduce their U.S. taxes by establishing an Interest Charge Domestic International Sales Corporation (“IC-DISC”). Congress encourages the export of U.S produced goods via an export incentive under IRC Sec. 991, an “arcane provision” of the Internal Revenue Code. IRC Sec. 991 provides a powerful tax incentive to promote the export of U.S produced goods through a Domestic International Sales Corporation, including:

1. Lower Income Tax Rate. A 19.6 percent tax rate savings, IC-DISC income is taxed at 20 percent not 39.6 percent (a favorable “tax arbitrage”), IRC Sec. 1(h)11.

2. Tax Deferral. For a miniscule annual interest charge of less than 1 percent (computed on the base period T-Bill rate for the period ending September 30, 2012, i.e., 0.16%), IC-DISC corporate commission income on the first $10 million of export sales shall not be taxed until an actual distribution is made to shareholders. Based on experience IC-DISC corporate commission income will usually range anywhere from $400K to $2.5 million on the first $10 million of export sales. Until an actual shareholder distribution, the IC-DISC commission income compounds almost "tax free" (i.e., subject to 0.16 percent annual interest charge). The tax deferral is indefinite (i.e., no tax until an actual shareholder distribution). IRC Sec. 995(f).

3. No Corporate Income Tax. An IC-DISC pays no corporate income tax, IRC Sec. 991.

Since 95 percent of global consumers are international (i.e., outside the U.S.), U.S. exports have a "wide International audience" (See: Bloomberg Business Week 4/1/13). Leading U.S. experts include:

- Information Products. Films, sound recordings (i.e., music), software.

- Entertainment Products. Toys, videogames, DVDs, posters, watches, clocks, jewelry.

- Clothing. Fashion apparel, celebrity merchandising; e.g., T-shirts, jeans, et al.

For exporters of U.S produced goods, the world is a big market.

History of the IC-DISC

The Domestic International Sales Corporation ("DISC") regime was enacted by Congress to stimulate exports in 1971. U.S. exporters were allowed to avoid U.S. tax on a portion of their profits by allocating those profits to a DISC subsidiary. U.S. trading partners filed complaints with the provisional organization of General Agreement on Tariffs and Trade ("GATT"), now know as WTO, that the DISC regime was an "illegal export subsidy".

Under pressure from GATT, the U.S. Congress then passed the Foreign Sale Corporation ("FSC") regime in 1984, which replaced the DISC regime. The DISC regime was not repealed entirely; it was altered and became the IC-DISC regime.

The IC-DISC regime was unattractive compared to the FSC regime because it provided only a temporary tax benefit (i.e., tax deferral) versus a permanent tax benefit provided under the FSC regime. The FSC regime responded to controversy about the subsidy claims by U.S. trading partners by requiring a U.S. exporter to establish a foreign corporation and that foreign corporation had to perform certain foreign economic processes and activities to obtain the U.S. tax benefit. U.S. trading partners objected to the FSCs as being conduits having no substantial economic substance or purpose other than to subsidize U.S. exporters, and the FSC regime was an "illegal export subsidy".

In response, Congress passed the Extraterritorial Income ("ETI") regime, which replaced the FSC regime and repealed the FSC regime. The ETI regime did not require a separate legal entity but rather excluded a portion of an exporter's income from taxation.

After complaints from the World Trade Organization ("WTO"), Congress then repealed the ETI regime in 2004 over a three year period (2004-2006).

At this time, the IC-DISC became an attractive tax planning vehicle when the 2003 Tax Act ("Jobs and Growth Tax Relief Reconciliation Act of 2003") was enacted and the IC-DISC income was classified under very favorable dividend tax rules (i.e., the IC-DISC income was taxed at the new qualified dividend tax rate (in 2004—15 percent, in 2013—20 percent).

The result of the 2003 Tax Act was that by creating an IC-DISC, exporters of U.S produced goods may obtain a permanent tax savings of up to 50 percent on U.S. income from foreign exports (based on net export income). The tax benefits are also available for companies when products are exported by another party (i.e., reseller/distributor), or "ultimately used" outside the U.S.

IC-DISC Tax Strategy

Permanent tax savings start with the U.S. exporting company declaring a tax deduction on the commission it pays to the IC-DISC from its ordinary income, which is taxed at a maximum tax rate of 39.6 percent.

Federal tax law (IRC Sec. 994) establishes the commission rate, which is based on export sales revenue (maximum $10 million in annual export sales; i.e., qualified export receipts). The commission rate, which is based on up to $10 million (export sales revenue) is the greater of: 50 percent of net export income, or 4 percent of export sales revenue Since the IC-DISC is tax-exempt (i.e., no corporate income tax), tax is only paid on distributions to shareholders. The tax is imposed at the tax rate of 20 percent (2013) (i.e., the qualified dividend tax rate), not the current ordinary income tax rate (maximum) of 39.6 percent (2013).

The commission income is tax-deferred while held in the IC-DISC, until distributed to the shareholders. The deferral of U.S. tax on the commission income (for up to $10 million in annual export sales; i.e., qualified export receipts), can be indefinite, is only subject to a minimum interest charge (as previously referenced 0.16 percent (2013), on the deferred tax liability (IRC Sec. 995(f)).

The ultimate tax benefits:

1. The 19.6 percent differential between the qualified dividend tax rates and the ordinary income tax rates;

2. An income tax deduction for the exporting company, on the commission paid to the IC-DISC;

3. No corporate income tax for the IC-DISC;

4. For U.S. exporters who operate their business via a sole proprietorship or pass-through entity (e.g., limited liability company (LLC), S-Corporation or limited partnership (LLP)), the IC-DISC benefit is the difference between the qualified dividend tax rates and the ordinary income tax rates;

5. Exporters who operate their business via a C-Corporation can benefit by using the IC-DISC to eliminate double taxation on a majority of their export income, as well as to reduce additional payroll taxes on income paid to their shareholders/officers.

IC-DISC Qualification

To qualify an IC-DISC, a domestic corporation must pass two main tests:

- The qualified export receipts test; and

- The qualified export assets test.

Qualified export receipts include gross receipts from the sales or exchange of export property, rents for the use of export property outside the U.S., services related to export sales or rents, engineering or architectural services for projects located outside the U.S. and commissions thereon. (IRC Sec. 993(a)). The qualified export assets test requires that 95% of the assets of the IC-DISC be qualified export assets (IRC Sec. 992(a)(1)(B), which include: accounts receivable, temporary investments, export property and loans to producers (IRC Sec. 993(b).

The export property must:

- Be manufactured, produced, grown or extracted in the U.S. by a person other than the IC-DISC;

- Be held primarily for sale, lease or rental for use, consumption or disposition outside the U.S;

- Have a maximum of 50% foreign content (IRC Sec. 993(b).

IC-DISC Structure

The IC-DISC is a domestic corporation which is a “paper” entity used as a tax-savings vehicle. The IC-DISC does not require office space, employees or tangible assets; instead it is a “conduit” for “export tax savings”. IC-DISC shareholders may be: corporations, individuals, limited liability companies, limited partnerships, trusts or estates.

The IC-DISC structure is as follows:

1. The owners of the U.S. exporting company form a special U.S. corporation that elects to be an IC- DISC. The IC-DISC election is made on IRS Form 4876-A. The IRS Form 4876-A must be filed within 90 days after the beginning of the tax year. For any tax year that is not the corporation’s first tax year, the election must be made during the 90-day period immediately preceding the first day of that tax year.

2. The U.S. exporting company pays the IC-DISC a commission.

3. The U.S. exporting company deducts the commission from ordinary income taxed at up to 38% (top federal tax rate-- $15M-$18.33M).

4. IC-DISC pays no tax on the commission as long as the qualification standards are met: the 95% qualified export assets, and the 95% qualified export receipts (IRC Sec. 992(a)(1).
The U.S. exporter qualified export receipts in excess of $10M per year are not eligible for deferral of tax (IRC Sec. 995(b)(1)(E).

5. IC-DISC shareholders are not taxed until the earnings are distributed as dividends. The shareholders must pay annual interest on the tax deferred (IRC Sec. 995(f)(1)). The interest charge is computed on IRS Form 8404. Shareholders that are individuals (or pass-through entities) pay income tax on qualified dividends at the capital gains rate of 20%. Corporate shareholders are automatically considered to have received 1/17th of the IC-DISC's taxable income even if no distributions are made.

6. Foreign Persons may receive a larger benefit than U.S. persons if their country of tax residence has a tax treaty with the U.S. that was ratified after 1984.

Additionally, three tests must be passed:

1. Content Test. Qualifying Foreign Trading Gross Receipts (i.e. export sale) includes property: manufactured or produced within the U.S.; held for use or disposition outside the U.S. Foreign content (i.e. cost based on import value) cannot exceed 50 percent of Fair Market Value (i.e. sales price); Content can include related and subsidiary services as well as engineering and architectural services;

2. Production Test. Property is considered manufactured or produced if it is "physically manufactured," that is, it is substantially transformed prior to the sale, or the process to convert is substantial in nature and considered within the industry to be manufacturing or production, or if conversion costs (i.e. direct labor and factory burden) account for 20 percent or more of the total cost of goods sold.

3. Destination Test. The property's use or disposition must be outside the U.S., delivery must be made by a seller in the U.S. to a carrier or freight forwarder for ultimate delivery outside the U.S. Delivery must be made to a purchaser in the U.S. if the property is ultimately delivered outside the U.S. within one year of sale ("One Year Rule"). Delivery can also be to another U.S. entity that incorporates product into product used/sold outside the U.S.

Investment Tax Planning

If the U.S. taxpayer's shares in the IC-DISC are owned and held by a Puerto Rico-issued private placement variable life insurance policy then:

1. Under IRC Sec. 72(e)(5), income from assets (i.e. IC-DISC) are not subject to income tax, nor is there tax reporting. Effectively, the IC-DISC taxable income received by the U.S. taxpayer shareholder is not subject to U.S. income tax or tax reporting.

2. Policy lifetime withdrawals may be tax-free and not subject to tax reporting (as either a return of premium/basis or a loan). The MEC rules may or may not apply depending on policy design. IRS Private Letter Ruling 200244001 (May 2, 2002). IRS audit risks are minimized since assets held under a qualifying life insurance policy are neither subject to investor income tax, nor is there any required income tax reporting (IRC Sec. 72(e)(5), reference: Rev. Rul. 81-225 (Situation #5), Rev. Rul. 82-54, 1982-1, C.B.11.

3. For IRS audit purposes, there would be no presumed IRS tax avoidance, due to the fact that life insurance has been granted an "angel exception" (i.e. is an IRS approved transaction) (IRS Revenue Procedures 2007-20, 2013-11, 2004-67, 2004-68).

4. As a U.S. territory, Puerto Rico life insurance policies do not require filing of "FBAR" Form TDF 90-22.1 (Report of Foreign Bank and Financial Accounts), for accounts over $10,000).

Regarding IRS Form 8938, Statement of Specified Foreign Financial Assets for specified foreign financial assets (over $50,000), if the policy is owned by a U.S. limited liability company, Form 8938 is not required to be filed (only applies to individuals), (See IRS Form 8938 instructions, p. 2).

Effectively, all IC-DISC shareholder distributions may be U.S. income tax free, not subject to tax reporting, if the U.S. taxpayer's IC-DISC shares are owed by the U.S. taxpayer's Puerto Rico life insurance policy.

Asset Protection

Under Puerto Rico law, the cash value benefits of a life insurance policy are expressly exempt from seizure by creditors (absent fraudulent conveyance funding of the policy). Act No. 399 of September 22, 2004, as amended by Act No. 98 of June 20, 2011. Under Act No. 98 (June 20, 2011), which amended Act. No. 399 (September 22, 2004), the policy owner and policy beneficiary are statutorily protected from seizure.

Conclusion

The tax strategy for export of U.S-made products includes an IC-DISC owned by a Puerto Rico private placement life insurance policy. The tax planning strategy:

1. Reduced Tax/Tax Arbitrage. A lower tax rate on income (in 2013, income is taxed at 20 percent, not 39.6 percent);

2. Tax Deferral. For an annual interest charge of 0.16 percent (as of 9/30/12) between $400,000-$2.5 million of IC-DISC, corporate income is not taxed until distributed to shareholders, until then income annually compounds "tax free" (subject to 0.16% interest charge).

3. No corporate income tax on IC-DISC earnings.

4. For IC-DISC shares held by U.S. taxpayers, Puerto Rico Life Insurance Policy, IC-DISC income distributed to shareholders is not subject to U.S. income tax or tax reporting, minimizing IRS tax audit risks.

5. In addition, the tax strategy includes asset protection planning for the IC-DISC shares, which are held by the Puerto Rico Life Insurance Policy "cash value" (premiums paid plus earnings) are expressly exempt from creditors, and the policy owner and beneficiary(s) are statutorily protected from seizure.

Based on Ryan Losi CPA's IC-DISC tax projections, the tax planning strategy has significant income tax benefits:

1. The $37.5 million distributions to the Puerto Rico Private Placement Life Insurance Policy (15 years) if invested may grow in value, and with compounded annual tax-free earnings, may be worth (in 15 years) $83,310,954 (if invested in a S&P 500 index fund; the S&P 500 has averaged an annual 10.6 percent return with cumulative dividend, over the last 30 years) or $118,951,027 (if invested in a hedge fund whose annual return are 15 percent, which is the hedge fund annual yearly projected yield).

2. U.S. Exporter ("ABC, Inc."): No IC-DISC, $5million [Annual Net Export Income],

3. $2,637,800 [Combined Federal Tax, All Income], $2,362,200 [Net Annual After-Tax Income] x 15 years = $35,433,000 [Net Aggregate After-Tax Return];

4. U.S. Exporter ("ABC, Inc."): IC-DISC, $5M [Annual Net Export Income], $1,913,900 [Combined Federal Tax on All Income], $3,086,100 [Net Annual After-Tax Income] x 15 years = $46,291,500 (Net Aggregate After-Tax Return);

5. U.S. Exporter ("ABC, Inc."): IC-DISC Owned by PPLI, $5 million [Annual Net Export Income], $1,318,900 [Combined Federal Tax on All Income], $3,681,100 [Net Annual After-Tax Income] x 15 years = $55,216,500 [Net Aggregate After-Tax Return];

6. The proposed tax planning strategy may save the U.S. client $19,783,500 in income taxes over 15 years (i.e. $55,216,500- $35,433,000].

7. If the U.S. client only uses the IC-DISC planning (without the PPLI), they may save $10,858,500 in income taxes over 15 years (i.e. $46,291,500-$35,433,000]. The PPLI saves additional income taxes of up to $8,925,000.

About the Author – Ryan Losi, CPA

Ryan Losi is a shareholder and Executive Vice President of PIASCIK, in Glen Allen, Virginia, and leads the firm's international tax practice and business development efforts. He is a nationally published author and has presented at numerous organizations and universities, including Virginia Society of CPAs, Virginia International Business Council, Virginia Leaders of Export Trade, VirginiaBio, U.S. Export-Import Bank, Virginia Conference on World Trade, South Carolina International Trade Conference, Virginia General Assembly, Council for International Tax Executives, Medical Society of Virginia, Ohio State university, Virginia Commonwealth University, University of Richmond, James Madison

University, Virginia State University, Virginia Economic Development Partnership and many others.

Ryan has vast domestic and international work experience in the technology and manufacturing sectors after tenures at PricewaterhouseCoopers, as an International Manager in their National Tax Practice out of their New York, New York office and at KPMG in the Richmond, Virginia office where he served in both their International and Domestic Tax Practices. Ryan has and currently serves as a Board member for a number of international business organizations focusing on international trade. For more information please visit: PIASCIK.COM and ICDISC.US

About the Author – Mark Ivener, Esq.

Mark Ivener is a nationally renowned EB-5 immigration attorney and a founding partner of Ivener & Fullmer, a global immigration law firm based out of Los Angeles with offices in Tokyo, Vancouver, and New York. Attorney Ivener has focused his practice on immigration law for over 35 years. He has participated in over 15 seminars on EB-5 immigration topics throughout the United States and overseas.

Attorney Ivener is a leader in the immigration world and a founder of the Alliance of Business Immigration Lawyers and the National Consortium of Immigration Law Firms. He has been selected for inclusion in Chambers Global, Chambers U.S.A.,

the International Who's Who of Corporate Immigration Lawyers, and the Bar Register of Preeminent Lawyers for Immigration and Naturalization by Martindale-Hubbell Bar Register. Attorney Ivener was also named by Citywealth Magazine as one of the Top 100 Wealth Advisers and Managers, where he was the only immigration attorney to be listed.

Staff members of the Ivener & Fullmer law firm are fluent in Chinese, Farsi, Japanese, French, and Spanish. The firm represents both international and domestic individuals and companies, from celebrities to Fortune 500 corporations. They assist with all business-related immigration matters including the representation of foreign investors, executives, entertainers, managers, and professionals for permanent and temporary visa types.

A prolific author, Attorney Ivener has published numerous immigration law books including Get the Right Visa, the Handbook of Immigration Law, and Doing Business in the USA under Free Trade. He has also published numerous articles for publications such as Business and the Law, the Canadian-American Bar Association Newsletter, and the International Law Journal.

In addition to his publications, attorney Ivener has lectured on EB-5 topics for organizations such as ILW.com in Los Angeles, the American Immigration Lawyers Association, and the Thai Appraisal Foundation. He has been a speaker at conferences across the nation and overseas.

Attorney Ivener earned his undergraduate degree from the University of Illinois in 1964 and his law degree from the University of California, Los Angeles School of Law in 1967. He is a member of the State Bar of California and the American Immigration Lawyers Association.

About the Author – Gary Wolfe, Esq.

Gary S. Wolfe received his Juris Doctorate from Loyola Law School in 1982, where he was President of the Tax Law Society.

From 1982 through the present, Gary has been in private practice in Beverly Hills and Los Angeles.

Gary is an international tax attorney representing clients for IRS audits, international tax planning, and asset protection.

Previously, Gary was the managing partner of a tax and business law firm, which represented Fortune 500 companies (IBM, ITT) and financial institutions (Sterling Bank, First Charter Bank.) Gary now provides case management for international litigation.

In 1997, Gary completed the Team Beverly Hills civic leadership training.

From 1997-1999 Gary was Vice-President and Member of the Board of Trustees of The Greystone Foundation, Beverly Hills, California.

From 1995-2001, Gary was the Chief Financial Officer and a Member of the Board of Directors of the Le Faubourg Honore Homeowners Association, Beverly Hills, California.

Since 2004, Gary has been conducting private seminars throughout California on the IRS, International Tax and Asset Protection.

Gary is an international tax expert and a nationally published tax author. In 2013 he published articles in the ABA (ALI-CLE) publication: The Practical Tax Lawyer (Winter, 2013 Edition), "U.S. Tax Planning for Passive Investments," (Spring 2013 Edition), "Why U.S. Tax Evasion is a Bad Idea (UBS/Wegelin Bank)," and in the Summer 2013 Edition he published 2 articles:

1) "International Tax Planning for U.S. Exports (IC-DISC)" (with Ryan Losi, CPA)

2) "International Tax Evasion, Money Laundering, and Other Crimes"

In the Autumn 2013 Edition of the ABA/The Practical Tax Lawyer he published 2 articles:

1) "EB-5 Visas (Immigrant Investor Visas)" (with Mark Ivener, Esq.)

2) "Offshore Hedge Funds and Reinsurance" (with Allen Walburn, Esq.)

For the February 2014 edition of EB-5 Investor Magazine, he published: "EB-5 Investors and the Perils of U.S. Estate and Gift Taxes (with Mark Ivener, Esq.)

Books by Gary S. Wolfe:

Asset Protection 2013: The Gathering Storm

Offshore Tax Evasion: IRS Offshore Voluntary Disclosure Program

Offshore Tax Evasion: IRS Tax Compliance FATCA/FBAR

Offshore Tax Evasion: U.S. Tax & Foreign Entities

International Tax Evasion & Money Laundering

Tax Planning for U.S. Exports: IC-DISC

U.S. Pre-Immigration Tax Planning

For more information please see website: gswlaw.com