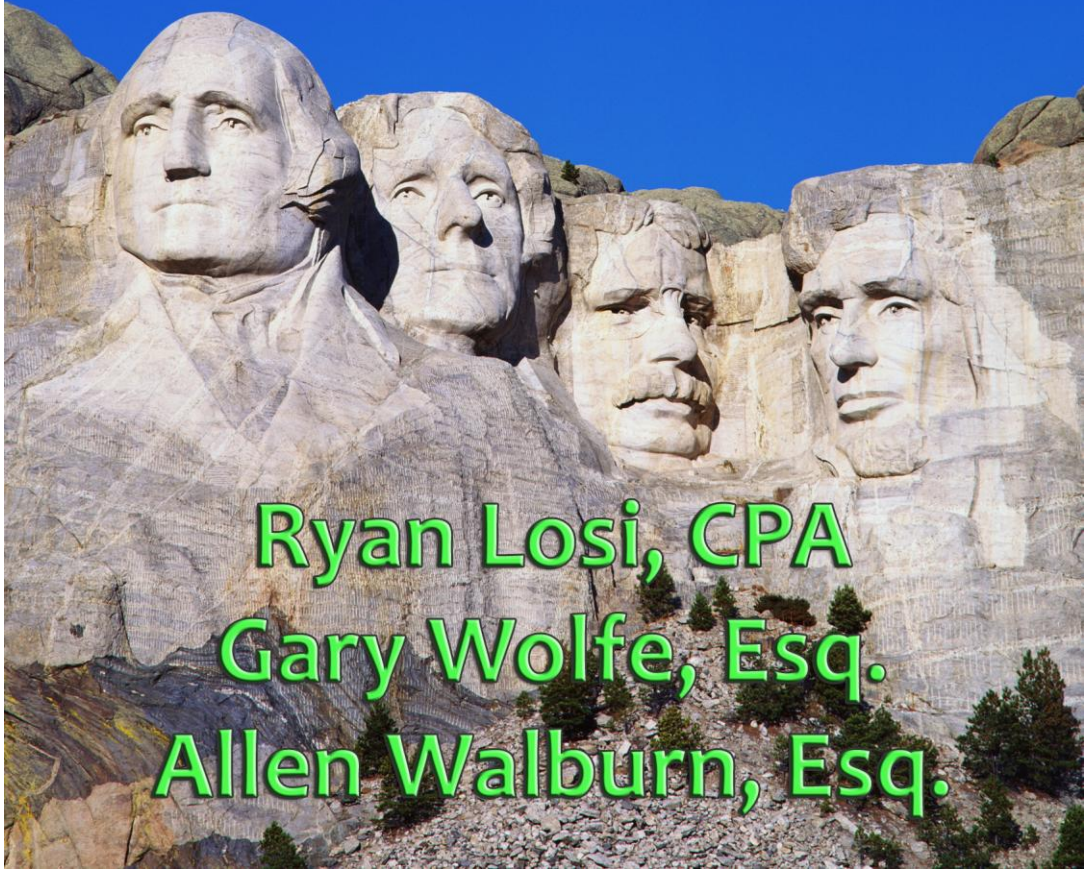
Tax Planning for U.S. & State Exports: IC-DISC



Ryan Losi, CPA
Gary Wolfe, Esq.
Allen Walburn, Esq.

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

By

Ryan Losi, CPA

Gary Wolfe, Esq.

Allen Walburn, Esq.

Other 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

For more information please see website:
gswlaw.com

BG Digital Publishing

Table of Contents

Chapter 1 – Introduction

U.S. and California exports are resurgent. For those U.S. manufacturers who export U.S.-made goods to foreign countries they may realize significant tax breaks through the use of an Interest Charge – Domestic International Sale Corporation (IC-DISC). An IC-DISC may either reduce tax, defer tax or with tax planning, eliminate tax.

1. For the first time, U.S. copyright industries in 2012 sold over $1Trillion in product sales ($1.01Trillion up from $885Billion in 2009 (a 14% increase) up from $965Billion in 2011 (a 4.5% increase)

2. Copyright Sales, including movies, TV, and music creation and distribution accounted for $142Billion in foreign sales in 2012 (and became the U.S. leading export).

California exports are booming. In November 2013, California shipped merchandise worth $15.2 billion, a 14% jump over November 2012, more than twice the national rate for US exports (5.9%). 2013 was the best year since 2007.

For those California manufacturers who use a special type of US Corporation known as an IC-DISC, the DISC owner may, through sophisticated tax planning, receive significant tax benefits.

California manufacturers who receive 50% of their net income from foreign sales (e.g. on $10 million in sales, net income $5 million, 50% of net income = $2.5 million) may be subject to a significantly reduced US income tax rate.

1. DISC income tax rate is fixed at approximately 50% less tax rate (i.e. 20% not 39.6%).

2. Up to $2.5 million of the annual net export income (or in some cases a greater amount) may be subject to indefinite annual income tax deferral, by paying a 16 basis point interest charge (i.e. less than 1%). The deferred income must be "loaned back" to the manufacturer which effectively becomes (almost) "tax-free" annual financing of $2.5 million per year. (See IRC § 993 (d))

3. Under tax planning strategy developed with my colleague Ryan Losi, CPA (PIASCIK) who is a national "IC-DISC expert," the annual $2.5 net export income (or greater) may be income tax free (see our article, "Tax Planning for US Exports: IC-DISC").

In addition, the California manufacturer gets an immediate federal income tax deduction for their payment to the DISC, which may be $1 million+ (e.g. maximum federal income tax rate 39.6%), for pass-through payments to S-Corp, LLC plus 3.8% Medicare Tax on net investment income, and additional 3-4% tax for phase-outs of personal exemptions, itemized deductions.

So if the tax planning strategy is effective a double tax benefit based on $2.5 million in net export income, paid to the DISC as a sales commission (up to $1 million+ in immediate tax savings), deferred tax or no tax at all on the $2.5 million received by the DISC.

For Sept-Nov 2013 California's biggest export markets:

1. Mexico $6.25 billion

2. Canada $5.21 billion

3. China $4.08 billion

4. Japan $3.34 billion

5. Hong Kong $2.32 billion

California manufacturing exports for 11 months in 2013 (Jan - Nov) was $153.5 billion, well ahead of 12 months total for 2012 ($148 billion), which was characterized by Jack O'Connell, trade specialist: "Unusually Huge Export Growth."

For more information see LA Times article, "California exports jump to pre-recession levels."

Chapter 2 - Fate of Va. Exports Rests with General Assembly
By Ryan Losi, CPA

Inside Business – The Hampton Roads Business Journal, Posted: January 31, 2014
http://insidebiz.com/news/export-incentives-fate-va-exports-rests-general-assembly

In the 2014 Virginia General Assembly session that convened earlier this year, a promising bill is being introduced that, if signed into law, will allow small and mid-sized Virginia businesses to receive full advantage of a vitally important export tax incentive known as a Domestic International Sales Corporation or DISC.

DISCs are U.S. corporations that meet the special criteria of U.S. Internal Revenue Code Sections 991-997, where a U.S. exporter can exclude a portion of its qualifying "export" income from federal taxation. Under the federal DISC rules, exporters pay their affiliated DISCs commissions from export income and deduct those commissions from income. Qualifying commissions are not taxable to a DISC, and are instead taxed when paid to the DISCs' shareholders as a dividend. That dividend is then taxed federally at a maximum rate of 20 percent, resulting in permanent federal tax savings for U.S. exporters and their owners (avoiding the 39.6 percent maximum rate that applies to ordinary income).

This exclusion has created an incentive for small and mid-sized manufacturers and exporters to grow exports. If HB 480 and SB 515 are passed and made law, Virginia taxpayers will be able to take advantage of this vitally important export tax incentive, both with federal and state tax exemptions promising to keep (and increase) jobs and capital investment in the commonwealth.

During the recent five-year "Great Recession," businesses throughout Tidewater benefited from taking their Virginia-made products and services overseas, to foreign countries with better economies, and bringing that money back to help expand their businesses and create new jobs. In 2012, the Tidewater region had exports valued at $6.2 billion, growing by 4.6 percent annually from 2009-2012 and supporting more than 40,000 local jobs in industries including transportation equipment, machinery and tourism.

The DISC regime was first enacted by Congress in the early 1970s as a means to stimulate exports. It has since evolved through the years; today, it is the last remaining export incentive providing permanent tax savings. In 1995, § 58.1-401 of the Code of Virginia was amended to conform to the IRC's other export regime, the Foreign Sales Corporate regime, which was similar to the DISC regime although at the time provided a much larger benefit to large companies, in addition to those small and medium-sized. However, in the early 2000s, Congress repealed the FSC regime, leaving only the DISC regime. Virginia has yet to update its books to reflect this change. Thus, Virginia has not authorized DISCs incorporated in Virginia to take advantage of the favorable tax treatment at the state level. Virginia taxpayers have been denied the DISC incentive originally intended by the General Assembly.

Virginia companies today are at a significant disadvantage for creating qualifying DISCs in Virginia. They instead are turning to competing tax-favorable states, such as Delaware, taking business and investments out of Virginia.

Local legislators, including Del. Ron Villanueva, R-Virginia Beach, and Sen. Frank Wagner, R-Virginia Beach, who are sponsoring HB 480 and SB 514, understand the advantages that this export tax incentive can bring to businesses throughout Tidewater.

Exporters will benefit from a nearly 20 percent reduction in federal taxes, and Virginia will continue receiving the same amount of state income tax.

Additionally, capital that would otherwise flow to accounts in neighboring states and corporate charter and other fees paid to establish and operate DISCs would remain in Virginia's banking system and within the Virginia economy.

By restoring this vitally important export program, the fiscal impacts would be felt both locally, and throughout the commonwealth. The Virginia State Corporation Commission would see an increase in fee revenue from incorporation fees and annual corporate maintenance fees, which are now going to other states that recognize DISCs. Exporters, who have been required to pay fees to out-of-state professionals and support services (registered agents for instance), could now pay Virginia-based professionals for these same services, creating more local jobs.

Passage of this legislation will benefit countless small and mid-sized businesses throughout Tidewater. Eligible industries cover a wide segment of the Virginia economy, including agricultural products (soy, tobacco, timber, etc.), a wide range of manufactured goods, software and other information technology products, biomedical products, minerals and mining products and many sectors of the recycling industry (such as scrap metals, used computers and cellular phones).

For Virginia exporters, the world awaits. DISC is the last remaining export incentive. It's permanent and it's here to stay. I hope that you, as business executives, will see the economic impact this legislation can have on Virginia and support its passage.

Ryan L. Losi, CPA, is a shareholder and executive vice president of accounting and tax firm PIASCIK. He leads the firm's international tax practice. He can be contacted by phone at (877) 527-2046 or email rlosi@piascik.com.

Chapter 3 – International Tax Planning For US Exports (IC-DISC)
Co-Authors: Ryan Losi & Gary 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:

- 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);

- 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:

- 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.

- 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).

- 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:

- The 19.6 percent differential between the qualified dividend tax rates and the ordinary income tax rates;
- An income tax deduction for the exporting company, on the commission paid to the IC-DISC;
- No corporate income tax for the IC-DISC;
- 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;
- 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:

- 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;

- 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.

- 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:

- 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).

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

- 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);

- 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];

- 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].

- 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.

Chapter 4 - Tax Planning Strategy

Client transfers $5.34 million to irrevocable trust (husband and wife, $10.68 million/2014 estate and gift tax exclusion). The transfer triggers a gift tax, the Form 709 (Gift Tax Return) is filed, the appreciation escapes gift tax and IRS audit risk (i.e. gift tax returns audit risk/2011: 1.42%, Estate tax returns audit risk/2011 29.9%, estates $5m-$10m 60% audit rate, estates over $10m 100% audit rate).

The assets in the irrevocable trust are not subject to creditor attachment unless prior lien or fraudulent conveyance. Trust assets upstreamed to California LLC (which holds investment portfolio), these assets not subject to creditor attachment, creditor sole remedy in California is “charging order.”

In addition attaching creditor may be set-up for a “tax problem” (ie. “phantom income” a tax liability re: LLC/K-1 “income” distribution with no cash distribution from LLC to pay tax).

The attaching creditor is subject to California “spendthrift” trust provisions, i.e. creditor cannot attach trust assets only trust distributions (which if made as either a loan or to 3rd party nominee entity are not subject to attachment).

For assets over $5.34m ($10.68m h&w), assets may be sold to the trust for a note (self-cancelling on death, so not includable in estate, not subject to estate tax), which sale is not subject to capital gains. The sale is to an intentionally defective grantor trust, which has no capital gains tax on transactions between grantor and the trust (the trust assets excluded from grantor’s estate after gift tax return is filed).

For additional investment tax planning/asset protection, client may purchase a Puerto Rico Private Placement Life Insurance Policy (PR/PPLI). The Trust is owner and beneficiary (client or designated party is insured) which is funded by conditional premium either in one lump sum (frozen cash value) or as a non-mec (over 5 years, so basis and earnings may be withdrawn tax free as a loan repaid by life insurance proceeds re: death benefit).

The PR/PPLI owns IC-DISC shares (along with other investments) so the DISC annual income is tax free. Assets held in the PPLI, which is a “tax-free wrapper” (i.e. earnings compound tax free), no IRS tax reporting (cash value earnings not subject to tax reporting, minimize audit risk), “bullet proof” asset protection (i.e. PR/PPLI cash value exempt from creditors, CA LLC charging order protection, California spendthrift trust provision.)

Chapter 5 – Grantor Trust (Income Tax Rules)

Under Chapter 4, tax planning strategy a Grantor Trust is required.

(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 identifies 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. <u>Income Distributable to the Grantor or Grantor's Spouse.</u>
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

<u>Foreign Trusts with U.S. Beneficiaries ("Outbound Trusts</u>")
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:

1. A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));
2. 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 – CFC/PFIC: U.S. Tax Compliance
Co- Authors: Allen Walburn & Gary Wolfe

There are two primary anti-tax deferral regimes: Controlled Foreign Corporation ("CFC") and Passive Foreign Investment Company ("PFIC")

The Internal Revenue Code limits tax-deferral on foreign-based income realized by U.S. shareholders of foreign corporations. Undistributed foreign corporation income is taxed either annually, or upon investment sale.

U.S. Manufacturers who export products internationally often establish foreign, offshore companies for their foreign sales. The foreign, offshore companies do not qualify for the IC-DISC tax benefits (only domestic corporations). In addition, under the CFC/PFIC tax rules the U.S. shareholders of foreign corporations are taxed annually and must report the foreign company income on their Form 1040/U.S. Tax Returns. A U.S. taxpayer failure to report the tax subjects them to civil and/or criminal penalties and suspends the statute of limitations for IRS tax audits**.**

The Internal Revenue Code limits tax-deferral on foreign-based income realized by U.S. shareholders of foreign corporations. Undistributed foreign corporation income is taxed either annually, or upon investment sale.

Controlled Foreign Corporation ("CFC") Annual Tax

U.S. shareholder pays annual income tax on pro-rata share of CFC's income, and files IRS Form 5471.

A U.S. shareholder of a foreign corporation, that is a "controlled foreign corporation" (CFC) for an uninterrupted period of 30 days or more during the tax year, and is a shareholder on the last day of the CFC's tax year, must include in gross income its proportionate share of the CFC's "Subpart F income" (whether distributed or not) (IRC Sec. 951).

A CFC's Subpart F income is limited for any tax year to its total earnings and profits for that year. The income is treated as a deemed dividend.

A foreign corporation is a CFC if more than 50 percent of its total voting power or value is owned by U.S. shareholders (IRC Sec. 957). A "U.S. shareholder" is any U.S. person (citizen, resident, domestic corporation, partnership, estate or trust) that owns 10 percent or more of the total combined voting power of the foreign corporation. Ownership may be direct, indirect, or constructive with certain exceptions (IRC Sec. 958).

The U.S. shareholders of a CFC are taxed on earnings, which are undistributed, if the CFC earns "tainted income", (i.e., Subpart F Foreign Base Company Income). CFC Subpart F income is the sum of the corporation's insurance income, foreign base

company income, boycott income, illegal payments and income from countries not diplomatically recognized by the U.S. government (IRC Sec. 952).

CFC income does not include income from sources within the U.S. that is effectively connected with the conduct of a trade or business by the corporation in the United States, unless that income is exempt from tax or taxed at a reduced rate pursuant to a treaty.

Subpart F income is limited to the CFC's total earnings and profits for that year, and may be reduced in certain circumstances to accumulated deficits of earnings and profits.

Foreign Base income of a CFC is made up of income from foreign personal holding company (FPHC) and foreign base company sales, services and oil-related income (IRC Sec. 954).

FPHC income is the major component of foreign base income. FPHC income includes: dividends, interest (including otherwise tax-exempt interest), rents, royalties and annuities.

FPHC income does not include rents and royalties from an active trade or business.

Tainted CFC Income attributed to U.S. shareholders includes:

1. Foreign Personal Holding Company Income (IRC Sec. 954(c)): dividends, interest, royalties and other types of passive income, including gains from stock and commodity sale.

2. Foreign Base Company Sales Income: (IRC Sec. 954(d)(3)); i.e. sale of personal property sold for use outside the CFC's country of incorporation.

3. Foreign Base Company Services Income: (IRC Sec. 954(c)): income from the performance of technical, managerial, engineering or commercial services performed outside the CFC's country of incorporation for a related person.

4. Foreign Base Company Income includes: shipping and oil-related income.

5. Increase in Earnings Invested in U.S. Property: Excess of CFC earnings invested in U.S. property at year end, over earnings so invested at the beginning of the year (IRC Sec. 956).

Regarding FHPC Income, the sale of a partnership interest by a CFC is treated as a sale of the proportionate share of partnership assets attributable to that interest (including subpart F income).

U.S. shareholders of a CFC are taxed on their pro-rata share of the CFC's earnings which are invested in U.S. property during the tax year and which are not distributed or otherwise taxed (IRC Sec. 956). The amount of earnings invested in U.S. property is a "dividend deemed paid" to the corporation's U.S. shareholder. U.S. property includes: tangible real or personal property located in the U.S., stock of domestic corporations, obligations of U.S. persons, and the right to use a patent, copyright or invention in the U.S.

If a U.S. shareholder sells CFC stock, recognized gain will be included in taxpayer's gross income as an ordinary dividend to the extent of the foreign corporation's earnings and profits allocable to the stock (IRC Sec. 1248). Any gain exceeding the CFC's earnings and profits is treated as capital gain. The shareholder may claim a foreign tax credit for the taxes the CFC paid on the income.

Every U.S. person (i.e. taxpayer) who is a U.S. shareholder of a CFC must file an annual Form 5471 (IRC Sec. 6038) or be subject to penalties and a reduced foreign tax credit.

CFC investments in U.S. property include: tangible property, stock of a domestic corporation an obligation of a U.S. person.

Investments not included: U.S. bonds, U.S. bank deposits, debts arising in the ordinary course of business from the sale of property.

"Repatriated" earnings of offshore corporation will be deemed taxable subpart F income.

To prevent double taxation, the basis of the U.S. shareholder's CFC stock, (and basis in property the shareholder is considered owning through the CFC), is increased by the amount of subpart F income required to be included in income and decreased by any distribution that is excluded from income (IRC Sec. 961).

A U.S. shareholder of a CFC that is a domestic corporation is allowed a foreign tax credit for any foreign taxes paid (or deemed paid) by the CFC for income that is attributed or distributed to it as a U.S. shareholder (IRC Sec. 960).

Effective for tax years beginning after December 31, 2010, the credit is limited to taxes that would have been deemed paid if the foreign corporation had made an actual distribution to the domestic corporation.

A "deemed-paid' credit is available to any individual U.S. shareholder who elects to be taxed at domestic corporate rates on amounts included in gross income (IRC Sec. 962).

Passive Foreign Investment Company ("PFIC")

U.S. shareholder of a PFIC pays income tax plus interest (based on value of tax deferral):

a. Upon sale of PFIC investment
b. Upon receipt of PFIC “excess distribution” (i.e. distribution which is greater than 125% of the average distribution received by the shareholder during the preceding 3 tax years).

A PFIC is any foreign corporation who has:
c. At least 75% of its gross income from passive investments or
d. At least 50% of its assets produce passive income (IRC Sec. 1297)

A Special tax regime applies when a U.S. shareholder receives a PFIC distribution (unlike the normal rules of U.S. federal corporation income taxation, a PFIC’s earnings and profits are not relevant to the taxation of a PFIC distribution).

PFIC distributions fall into 2 categories: “excess” and “non-excess” distributions. An excess distribution is the PFIC distribution that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder’s shares within the 3 preceding years or if held for less than 3 years the shareholders holding period. (IRC§1291(b)(2)(A)).

A non-excess distribution is a PFIC distribution that is not an excess distribution (i.e. does not exceed 125% of the average PFIC distributions). A non-excess distribution is taxed to the U.S. shareholder under the rules of U.S. corporate income taxation, which is taxed as a dividend (Prop. Treas. Reg. §1.291-2(e)(1)). A PFIC non-excess distribution will not qualify for the 15% tax rate on qualified foreign dividends because a PFIC is not a “qualified foreign corporation” (IRC§1(h)(11)(C)(iii)).

A PFIC excess distribution is subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder’s holding period for the shares (IRC§1291(a)(1)(A)). Whether the PFIC had earnings and profits in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years (prior 3 years) is included in the taxpayer’s income for the year of receipt as ordinary income (IRC§1291(a)(1)(B)(i)(ii)). These PFIC excess distributions are not qualified foreign dividends subject to the 15% tax rate.

The portion of the excess distribution allocated to the other years in the taxpayers holding period (the “PFIC years”) is not included in the taxpayer’s current income. Rather, this portion is subject to a special “deferred tax” that the taxpayer must add to his tax that is otherwise due (IRC§1291(c)).

To compute the deferred tax, the shareholder first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year (IRC§1291(C)(1)). The shareholder then aggregates all “unpaid tax amount” for the PFIC years (IRC§1291(c)(2).

The shareholder must then compute interest on those increased tax amounts as if the shareholder had not paid the tax for the PFIC years when due using the applicable

federal tax underpayment rate (IRC§1291(c)(3)). The taxpayer includes the deferred tax and interest as separate line items on their Form 1040 individual tax returns (IRC§1291(a)(1)(C)).

A U.S. taxpayer's sale of PFIC shares is an "excess PFIC distribution" to the extent the sole proceeds exceed the seller's basis in the PFIC shares (IRC§1291(a)(2)).
The gain is treated as ordinary income realized rationally over the seller's holding period with deferred tax and interest on the amount allocated to prior years.

Passive Income (under the gross income test) includes: dividends, interest, royalties and other types of passive income.

There are no U.S. shareholder ownership requirements for the entity to be considered a PFIC.

If "Qualified Election Fund" status is elected, the shareholder is taxed currently on undistributed earnings. If the election is made, the shareholder must include in gross income each year as ordinary income its pro rata share of earnings of the corporation, and as long-term capital gain, its pro rata share of the net capital gain of the corporation. (IRC Sec. 1293 and Sec. 1295).

The inclusions are made for the stockholder's tax year in which the QEF's tax year ends. Once made, the QEF election is revocable only with the IRS's consent and is effective for the current tax year and all subsequent tax years. The U.S. shareholder can elect to defer payment of the tax on any undistributed earnings of the QEF (IRC Sec. 1294).

A U.S. shareholder of a PFIC who receives an "excess distribution" with respect to its stock, and disposes of its PFIC stock during the tax year, must allocate the income or gain ratably to each day they held the stock unless the shareholder elects to treat the PFIC as a "Qualifying Electing Fund" (QEF) or makes a mark-to-market election (IRC Sec. 1291).

Under the default method, the amount allocated to the current tax year, and to any prior tax year during the shareholder's holding period in which the corporation was not a PFIC, is taxed as ordinary income. The amount allocated to any other year in the shareholder's holding period is taxed at the highest rate applicable for that year, plus interest from the due date for the taxpayer's return for that year.

An excess distribution is any part of a distribution received from the PFIC which is greater than 125% of the average distribution received by the shareholder during the three preceding tax years, or, if shorter, during the period the shareholder held the stock.

Each U.S. shareholder of a PFIC must file an annual report on Form 8621, effective March 18, 2010. The requirement to file a report may also meet the requirements for disclosing information for specified foreign financial assets (Form 8938).
A U.S. shareholder of a PFIC may avoid the additional tax, or the deferral of income by making a mark-to-market election on their PFIC stock, and annually including in gross income, as ordinary income, an amount equal to the excess of the fair market value of the PFIC stock, as of the close of the tax year, over its adjusted basis. If the stock declines in value, an ordinary loss deduction is allowed, limited to the net amount of gain previously included in income.

The PFIC rules do not apply to a U.S. taxpayer who is also a 10% shareholder of a controlled foreign corporation IRC§1297(e); PLR200943004. Since the shareholder is currently taxable on their share of the CFC's subpart F income it is unnecessary to tax them under the PFIC tax regime. The CFC rules accomplish the anti-deferral tax objective.

Earnings of a foreign subsidiary of a US-based business are generally not subject to US Federal Income Tax until they are distributed, US tax deferral, on foreign subsidiary income, is limited by the CFC/PFIC rules. Even if share ownership can be structured to avoid CFC status, the foreign corporation may still be a PFIC subject to an interest charge on the tax attributable to PFIC gains or distributions, which eliminates the tax deferral benefits.

Chapter 7 - A Primer on Passive Foreign Investment Companies and Comparison to Controlled Foreign Corporations

Co-Authors: Allen B. Walburn & Gary Wolfe

Introduction

Generally, under the U.S. Internal Revenue Code (the "Code")1, the U.S. shareholders of a C corporation (including a foreign corporation) do not pay U.S. income taxes on the corporation's income unless the corporation makes distributions to its shareholders.2 A U.S. shareholder is also subject to U.S. income tax on the sale of corporate shares at a gain. A foreign corporation not engaged in a trade or business in the U.S. and not having any U.S.-source income is generally not subject to U.S. income tax on its income.3 The fact that U.S. shareholders of a foreign corporation and the foreign corporation itself generally do not pay U.S. income tax on the foreign corporation's undistributed foreign-source income is often referred to as "deferral."4

The United States generally taxes income under two principles: the residence of the taxpayer or the source of the taxpayer's income.5 Under U.S. federal income tax law, the residence of a corporation is considered to be its country of incorporation.6 Section

---

[1] Unless otherwise expressly stated, (i) all references in this article to the term "Code" refer to the U.S. Internal Revenue Code of 1986, as amended, and (ii) all references in this article to "Section" or "Sections" shall refer to the Code.

[2] See Section 11 (imposing corporate income taxes). In contrast to a C corporation, an S corporation generally does not pay U.S. federal income tax at the corporate level, but, rather, its shareholders are taxed directly on their respective shares of the S corporation's taxable income. See Sections 1361 through 1379 and the Treasury Regulations thereunder for the rules on the taxation of S corporations. Under Section 1361(b)(1), only a U.S. domestic corporation (and not a foreign corporation) may be an S corporation. The rules on eligibility to elect to be taxed as an S corporation are set forth in Section 1361 and the Treasury Regulations thereunder.

[3] Section 11(d) provides that U.S. income tax is imposed on a foreign corporation only as provided in Section 882. Sections 881 and 882 tax a foreign corporation on income effectively connected with the conduct of a U.S. trade or business and non-trade or business income from U.S. sources. See also Katz, Plambeck and Ring, 908-2nd T.M., *U.S. Income Taxation of Foreign Corporations*, at A-1.

[4] Deferral of U.S. income tax on undistributed foreign-source income of a foreign corporation is generally beneficial to a U.S. shareholder, particularly if the rate of foreign income tax in the foreign corporation's home country is less than the rate of tax that the U.S. would impose if the U.S. shareholder were taxed currently on the foreign corporation's undistributed income.

[5] See Katz, Plambeck and Ring, *supra* note 3 at A-1.

[6] *Id.*

7701(a)(4) of the Internal Revenue Code (the "Code") defines a U.S. domestic corporation as one organized under the laws of the U.S. or the laws of any U.S. state. A foreign corporation is any corporation that is not a U.S. domestic corporation.7

There are, however, two primary regimes under U.S. income tax law which impose tax on a U.S. shareholder's share of a foreign corporation's undistributed income under certain circumstances, thus eliminating the benefits of deferral. These are the controlled foreign corporation ("CFC")/subpart F income ("Subpart F") regime8 and the passive foreign investment company ("PFIC") regime.9 As explained in greater detail below, these regimes were enacted because Congress believed that unlimited deferral of U.S. income tax on a foreign corporation's undistributed income was inappropriate for the types of income covered by the Subpart F and PFIC rules (generally passive investment income and income from certain transactions between a foreign corporation and a related party).10

CFC/Subpart F Income Rules

This article focuses on the PFIC rules, but, first, a brief discussion of the Subpart F rules is appropriate because the objectives of both sets of rules are similar in many respects and there is overlap between the two sets of rules in some circumstances. 11

As explained in greater detail below, the Subpart F rules only apply if more than 50% of the voting power of the foreign corporation's stock is owned collectively by United States shareholders owning 10% or more of the voting power of the foreign corporation, while the PFIC rules apply to any U.S. person owning shares in a foreign corporation if that corporation's passive income or passive assets exceed certain thresholds (regardless of the percentage of a U.S. person's ownership of the foreign corporation or the aggregate percentage ownership of all U.S. shareholders). While both the Subpart F and PFIC rules impose U.S. income tax on U.S. persons owning shares in a foreign corporation with passive income (e.g., interest, dividends, rents, royalties and gain on sale of assets which produce such passive income), the Subpart F rules (but not the PFIC rules) also

---

[7] Section 7701(a)(5). Essentially, a foreign corporation is any corporation organized in a foreign country or other jurisdiction outside of the United States. Section 7701(a)(9) defines the United States to include only the fifty states and the District of Columbia.

[8] Sections 951 through 965.

[9] Sections 1291 through 1298.

[10] *See, e.g.*, Lee and Smiley, *Taxation of Passive Foreign Investment Companies: Current Rules, Problems, and Possible Solutions,* Journal of Corporate Taxation (Nov./Dec. 2011) at p. 39.

[11] See footnotes 44, 45, 56, 57, 62, 76, 77 and 78, *infra*, and accompanying text for discussion of certain areas of overlap.

impose tax on Untied States Shareholders (defined below) if the CFC has certain types of income from sales or services between the CFC and certain related persons.

Definition of Controlled Foreign Corporation

Section 951(a)(1) requires a United States Shareholder (as defined below) of a CFC to report as gross income its ratable share of (i) the CFC's Subpart F income and (ii) any increase in the CFC's investment of earnings in U.S. property as determined under Section 956.[12] Under Section 957(a), a foreign corporation is a CFC if more than 50% of the total combined voting power of all classes of stock of such corporation entitled to vote, or more than 50% of the total value of the stock of such corporation, is owned (including stock indirectly or constructively owned, as determined under Section 958), collectively by United States Shareholders on any day during the taxable year of such foreign corporation. A "United States Shareholder" with respect to any foreign corporation is a "United States person" as defined in Section 957(c)13 who owns ten percent or more of the total combined voting power of all classes of voting stock of a foreign corporation.[14] For this purpose, a United States person is considered to own such person's proportionate share of the stock actually owned by a foreign corporation, foreign partnership, foreign estate or foreign trust (see Section 958(a)) and the stock owned by certain related family members, trust, estates and entities (see Section 958(b)).

U.S. taxation of a United States Shareholder of a CFC under Section 951(a)(1) applies for a particular taxable year of a foreign corporation only if the foreign corporation is a CFC (under the tests described in the preceding paragraph) for an uninterrupted period during the year of at least 30 days. It applies to a particular shareholder of a CFC only if, on the last day of the year in which the foreign corporation is a CFC, the shareholder is a United States Shareholder and owns some of the CFC's stock, either directly or indirectly through foreign entities. A United States Shareholder is taxed under Section 951(a)(1) on a CFC's Subpart F income and earnings invested in U.S. property allocable to shares actually owned by the United States Shareholder and shares owned indirectly by the United States Shareholder through foreign entities, but not on amounts allocable to shares only owned constructively.[15] Under the indirect ownership rule of Section 958(a), stock owned by a foreign entity (but not stock owned by a U.S. domestic entity) is attributed ratably to the entity's shareholders, partners, or beneficiaries—

---

[12] Section 956 sets forth the rules concerning taxation of a CFC's investment in U.S. property. A discussion of Section 956 is beyond the scope of this article.

[13] A United States person is generally an individual who is a citizen or resident of the U.S., a U.S. domestic partnership, a U.S. domestic corporation, or a U.S. estate or trust, but not including certain individuals which are described in Sections 957(c)(1) and (2).

[14] Section 951(b).

[15] *See, e.g., Textron, Inc., v. CIR*, 117 TC 67 (2001).

successively through a chain of foreign entities until the stock reaches a U.S. person or a nonresident alien. 16

Subpart F Income

A CFC's Subpart F income generally consists of the sum of its insurance income and foreign base company (FBC) income.17 FBC income is the sum of four types of gross income—foreign personal holding company (FPHC) income, FBC sales income, FBC services income, and FBC oil-related income, less expenses and subject to various other adjustments.18 The concepts of FPHC income, FBC sales income and FBC services income are explained further below.

As defined in Section 954(c), FPHC income generally consists of a CFC's income in the form of dividends, interest, annuities, rents, royalties, net gains on dispositions of property producing any of the foregoing types of income, net gains from commodities transactions, net gains from foreign currency transactions, income from notional principal contracts, and amounts received under certain personal service contracts.19 The Senate Finance Committee explained the inclusion of FPHC income as follows: Your committee, while recognizing the need to maintain active American business operations abroad on an equal competitive footing with other operating businesses in the same countries, nevertheless sees no need to maintain the deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases there is no competitive problem justifying postponement of the tax until the income is repatriated. 20

FBC sales income21 is income from transactions in personal property where a person related to the CFC is either the buyer or seller, subject to certain exceptions.22 A

---

16 Section 958(a)(2).

17 Section 952(a).

18 Section 954(a).

19 The inclusion of certain of the foregoing types of income as FPHC income is subject to exceptions. *See, e.g.*, 954(c)(2) (excepting rents and royalties derived in the active conduct of a trade or business and received from a person other than a related person) and Section 954(c)(6) (excepting dividends, interests, rents and royalties received or accrued from a related CFC which is attributable to or properly allocable to income of the related CFC which is neither Subpart F income nor income effectively connected with a trade or business conducted in the United States).

20 S. Rep. No. 1881, 87th Cong., 2d Sess., reprinted at 1962-3 C.B. 703, 789.

21 FBC sales income is defined in Section 954(d).

22 *See, e.g.*, Section 954(d)(1) and Treas. Reg. § 1.954-3(a)(3) (same country

CFC's gross profit on a sale of personal property is usually FBC sales income if the CFC acquired the personal property by purchase and either bought the personal property from, or sold it to, a related person. FBC sales income is limited to income from transactions involving related persons because Congress was concerned with income of a selling affiliate that has been separated from manufacturing activities of a related corporation primarily to obtain a lower rate of tax for the sales income in a low tax jurisdiction.23

FBC services income consists of income from services transactions involving related persons,24 including "technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services."25 FBC services income may be compensation for the CFC's performance of services or a commission or fee received for arranging for a service to be performed by another party.26 Income is not FBC services income to the extent it is compensation for services performed in the foreign country under the laws of which the CFC is organized.27 Income that would otherwise be FBC services income of the CFC is excluded if the services are "directly related" to the CFC's sale of goods it manufactures, produces, grows, or extracts and are performed before the sale occurs or are directly related to an "offer or effort" to sell such goods.28

Section 1248

Section 1248 provides that gain recognized by a United States shareholder on the taxable sale or exchange of stock in a CFC is treated as a dividend (rather than gain on the sale of the stock) to the extent of the earnings and profits of the CFC attributable to the stock sold or exchanged.29 Section 1248 generally applies only to U.S. persons who owned 10% or more of the voting stock of a foreign corporation at any time during the previous five years when the foreign corporation was a CFC.30

---

exception) and Section 954(d)(1) and Treas. Reg. § 1.954-3(a)(2) (manufacturing exception).

23 S. Rep. No. 1881, 87th Congress, 2d Sess., reprinted at 1962-3 C.B. 703, 790.

24 See Sections 954(a)(3) and 954(e).

25 Section 954(e)(1).

26 Treas. Reg. § 1.954-4(a).

27 Section 954(e)(1)(B).

28 Section 954(e)(2).

29 Section 1248(a) and Treas. Reg. 1.1248-1(a)(1). The remaining portion of any capital gain is taxed under the general rules for taxing gain on the sale of property. This rule is designed to tax a United States shareholder at ordinary income rates on earnings of a CFC that it had not been previously subject to U.S. taxation under Subpart F. Section 1248, however, does not create income in excess of the amount of the gain recognized.

30 Section 1248(a)(2).

Currently, individuals are taxed at a 20% U.S. federal income tax rate on both qualified dividend income and long-term capital gain.31 Therefore, under current law, to the extent that the deemed Section 1248 dividend taxed as qualified dividend income at a 20% rate, the difference between characterization as a dividend under Section 1248 or long-term capital gain may make little difference to an individual shareholder.32 However, deemed dividend treatment can be beneficial to corporate shareholders, because deemed paid foreign tax credits can be used to reduce or eliminate U.S. tax on the portion of the gain recharacterized as dividend income which credits would not be available if the sale were treated as giving rise to capital gain rather than dividend income.33

PFIC Rules

The PFIC rules generally apply to U.S. persons owning shares of a foreign corporation at least 75% of the income of which is passive or at least 50% of the assets of which produce passive income or are held for the production of passive income.34 For this purpose, "passive income" means any income which is of a kind which would be FPHC income as defined in Section 954(c).35 However, certain types of income specified in Section 1297(b)(2) are specifically excluded from the definition of "passive income."36

---

31 See Section 1(h).

32 Amounts treated as dividends under Section 1248 are "qualified dividend income" provided that the CFC is otherwise a "qualified foreign corporation" under Section 1(h)(11)(C). See IRS Notice 2004-70, 2004-2, C.B. 724.

33 Yoder and Kemm, 930-2nd T.M., *CFCs-Sections 959-965 and 1248*, at A-58.

34 Section 1297(a). Under Section 1297(e)(1), the passive assets test is normally applied by reference to the fair market values of the corporation's assets if the corporation is "publicly-traded." A corporation is publicly-traded if its stock is regularly traded on a national securities exchange registered with the Securities and Exchange Commission, on a national market system established under Section 11A of the Securities and Exchange Act of 1934 (*e.g.*, NASDAQ), or any other exchange or market that the Treasury Department finds "adequate to carry out the purposes of this subsection." Section 1297(e)(3). However, if the corporation is (i) not publicly-traded and (ii) it is a CFC or it elects to use the adjusted basis of its assets in lieu of fair market value, then the corporation's assets are valued using the corporation's adjusted bases for purposes of determining earnings and profits. Section 1297(e)(2). For earnings and profits rules affecting adjusted basis, see Sections 312(k) and 312(n).

35 Section 1297(b). See text accompanying footnotes 19 and 20, *supra,* for a discussion of FPHC income.

36 These excluded types of income include income derived in the active conduct of certain banking or insurance businesses, income which is interest, dividends, rents or royalties received or accrued by the foreign corporation from a related person to the extent such amount is properly allocable to income of such related person which is not passive income, or income

Under a look-through rule, foreign corporations that own subsidiaries primarily engaged in active business operations are not treated as PFICs.37 Under this rule, if a foreign corporation owns 25% or more of another corporation (a "subsidiary"), the passive income and asset tests are applied by treating the foreign corporation's income and assets as including a pro-rata share of the subsidiary's income and assets.38 For example, if a foreign corporation's only assets are stock and debt instruments of subsidiaries primarily engaged in active business operations and the foreign corporation's income consists of dividends and interest from the subsidiaries, the corporation is not a PFIC because (i) its income is deemed to include the subsidiaries' non-passive business income, not the dividends and interest received from the subsidiaries and (ii) its assets are deemed to include the subsidiaries' operating assets, not the stock and debt of the subsidiaries that the foreign corporation owns.39

A newly-organized foreign corporation is given a one-year reprieve from classification as a PFIC if it meets the passive income or passive assets tests because of temporary investments in connection with the startup of its business.40 This reprieve applies to the first year that the foreign corporation has gross income, which is referred to as the "start-up year."41 To qualify, (i) the IRS must be satisfied that the foreign corporation will not be a PFIC for either of the two taxable years immediately following the start-up year, (ii) the foreign corporation must not in fact be a PFIC for either of those two years and (iii) the foreign corporation must not be a successor to another corporation that was a PFIC.42 Another exception is made for foreign corporations that hold passive assets as temporary investments while reinvesting the proceeds from the sale of one or more active trades or businesses.43

In addition, a foreign corporation is not a PFIC with respect to a shareholder for any period after 1997 during which the shareholder is a United States Shareholder and the corporation is a CFC.44 As a result of this exclusion, a United States Shareholder that is required to include Subpart F income in its U.S. gross income with respect to the

---

which is "export trade income" of an "export trade corporation" (as defined in Section 971).

37 Section 1297(c).

38 *Id*.

39 HR Rep. No. 841, 99th Cong., 2d Sess. II-644 (Conf. Rep. No. 99-841, 1986).

40 Section 1298(b)(2).

41 *Id.*

42 *Id.*

43 See Section 1298(b)(3) for the requirements to qualify for this exception.

44 See Section 1297(d). See text accompanying footnote 13, *supra*, for the definition of a United States Shareholder.

stock of a PFIC that is also a CFC generally is not also subject to income inclusion under the PFIC provisions with respect to the same stock. The PFIC provisions continue to apply, however, to shareholders of the PFIC that are not subject to Subpart F (i.e., to shareholders that are U.S. persons but are not United States Shareholders because they own directly, indirectly, or constructively, less than 10% of the foreign corporation's voting stock).45

The PFIC rules apply only to shareholders who are U.S. persons (i.e., individuals who are U.S. citizens or residents and U.S. domestic corporations, partnerships, trusts, and estates).46 However, unlike the CFC/Subpart F rules discussed above, no minimum share ownership by U.S. shareholders is required in order for the PFIC rules to apply to a U.S. shareholder.47 Thus, a U.S. person owning PFIC stock is subject to these rules even if the U.S. person holds only a very small percentage (e.g., less than 1%) of the foreign corporation's outstanding shares and all other shareholders are unrelated foreign persons.48 If a foreign corporation is a PFIC at any time while a U.S. person is a shareholder, the shareholder may be subject to
PFIC rules even after the corporation ceases to be a PFIC.49

The U.S. taxation of PFIC shareholders can fall under three possible alternative regimes. One regime defers U.S. tax until dividends are distributed by the PFIC or the U.S. shareholder sells the PFIC stock, but that regime often imposes interest on the tax when it is finally imposed.50 The other two regimes, which apply only when elected by the U.S. shareholder, either tax undistributed PFIC income to the U.S. shareholders as it is earned by the PFIC (the QEF election regime) or tax U.S. shareholders annually on

---

45 Staff of Joint Comm. on Tax'n, 105th Cong., 1st Sess., *General Explanation of Tax Legislation Enacted in 1997* at 310 (Dec. 17, 1997).

46 *See, e.g.*, Sections 1291(a)(1) and 1293(a) (PFIC excess distribution and QEF rules apply to U.S. persons owning PFIC stock).

47 As discussed above, the rules requiring inclusion of undistributed Subpart F income of a CFC in a U.S. shareholder's income apply only to United States Shareholders (*i.e.*, those U.S. persons directly, indirectly, and constructively owning 10% or more of the voting power or value of a foreign corporation's stock) and only if United States Shareholders collectively own more than 50% of the total combined voting power of all classes of stock of the foreign corporation or of the total value of the stock of the foreign corporation.

48 Bittker & Lokken: *Federal Taxation of Income, Estates, and Gifts* ¶ 70.1.1.

49 Section 1298(b)(i); Prop. Treas. Reg. § 1.1291-1(b)(1)(ii). This is sometimes referred to as the "once a PFIC, always a PFIC" rule.

50 Discussed *infra* in footnotes 52 through 59 and accompanying text.

appreciation or depreciation in the stock's value during the year (the mark-to-market regime).51

Under the first of these three regimes, a special tax computation and interest charge apply whenever a U.S. shareholder in a PFIC receives an "excess distribution" from the PFIC or recognizes gain on selling all or a portion of the U.S. shareholder's PFIC stock.52 In general, (i) an excess distribution or gain on sale is spread on a pro rata basis over all years after 1986 during which the U.S. shareholder held the PFIC stock, (ii) the U.S. shareholder is taxed on amounts allocated to years before the taxable year in which the excess distribution or sale occurred at the highest ordinary income rates in effect for those years, and (iii) the U.S. shareholder is required to pay interest (compounded daily) to the IRS as though these amounts had actually been taxed in such prior years and the U.S. shareholder had failed to pay the tax until the year in which the excess distribution or sale occurs.53

Pursuant to Section 1298(b)(1), these rules apply to an excess distribution or gain on sale if, at any time during the U.S. shareholder's holding period for the PFIC stock, the foreign corporation (or any predecessor to the foreign corporation) was a PFIC and no QEF election was in effect. Section 1291(b)(2)(A) defines an "excess distribution" as the amount by which (i) distributions received by the U.S. shareholder from the PFIC during the taxable year exceed (ii) 125% of the average of the distributions received by the U.S. shareholder from the PFIC over the preceding three taxable years (or, if shorter, the portion of the U.S. shareholder's holding period for the PFIC's shares before the taxable year in which the excess distribution occurred). For example, if a U.S. shareholder receives distributions from the PFIC during the year of $1,000 and received average annual distributions over the three preceding tax years of $500, the excess distribution is $375 ($1,000 less 125% of $500). Under Section 1291(b)(2)(B), distributions received by a U.S. shareholder during the year the PFIC stock is acquired are not excess distributions, regardless of the amount of the distributions. Generally, any "actual or constructive transfer of property or money by a [PFIC] with respect to its stock" is considered a distribution for purposes of the excess distribution rules unless the transfer is treated as received in exchange for stock (e.g., a stock redemption treated as a sale or exchange).54 A distribution is counted for this purpose even if it is not a dividend for federal income tax purposes due to a lack of earnings and profits.55 However, if the U.S. shareholder has been taxed on undistributed income of the PFIC under the Subpart F or QEF rules (see discussion of QEF rules below), some

---

51 Bitker & Lokken, *supra,* note 46 ¶ 70.1.1.

52 Section 1291(a). The tax and interest charge is calculated on IRS Form 8621.

53 See Bitker & Lokken *supra* note 48 ¶ 70.1.3.

54 Prop. Treas. Reg. § 1.1291-2(b)(1).

55 Prop. Treas. Reg. § 1.1291-2(c)(1).

of the distributions received during the current year or during the averaging period might be excluded from the U.S. shareholder's income as distributions of previously taxed income.56 Excess distributions are determined as though these excluded amounts have not been distributed.57

A non-excess distribution is a PFIC distribution that is not an excess distribution (i.e., does not exceed 125% of the average PFIC distributions). A non-excess distribution is taxed to a U.S. shareholder under the general rules of U.S. corporate income taxation.58 However, a PFIC non-excess distribution (as well as an excess distribution) will not qualify for the 20% tax rate on qualified foreign dividends because a PFIC is not a "qualified foreign corporation."59

Under one of the alternative regimes mentioned above, a U.S. shareholder may elect to treat a PFIC as a qualified elected fund ("QEF").60 A shareholder making a QEF election is required to include its pro rata share of the ordinary earnings and net capital gain of the PFIC in its U.S. gross income currently.61 Under Section 1295(b)(1), once a QEF election is made with respect to any foreign corporation, the election shall apply to all subsequent tax years of the U.S. shareholder making the election with respect to such foreign corporation unless revoked by the U.S. shareholder with IRS consent. If the QEF is also a CFC, exceptions to the pass-through of income by the QEF to U.S. shareholders under the QEF rules are provided for income of the QEF that is U.S. source effectively-connected income and income that is subject to a high foreign tax rate.62

The basis of a U.S. shareholder's QEF stock is increased by any amount included in the shareholder's income under Section 1293 with respect to that stock, and decreased by any amount distributed with respect to that stock that is excluded as previously taxed income.63 Thus, a shareholder who elects QEF treatment is not subject to any additional tax upon receipt of distributions out of earnings previously included in the

---

56 Sections 959(a) (Subpart F rules) and 1293(c) (PFIC rules).

57 Section 1291(b)(3)(F); Prop. Treas. Reg. § 1.1291-2(b)(2)(i).

58 Prop. Treas. Reg. §1.291-2(e)(1).

59 Section 1(h)(11)(C)(iii).

60 Section 1295; Treas. Reg. § 1.1295-1.

61 Section 1293(a).

62 Section 1293(g)(1).

63 Section 1293(d).

shareholder's income.[64] Gain on the sale of PFIC stock with respect to which a QEF election is in effect for all of the PFIC's post-1986 tax years is not subject to tax under the PFIC excess distribution rules under Section 1291, but instead is subject to the regular U.S. tax rules.[65]

If a PFIC is a QEF for some, but not all, tax years in a U.S. shareholder's holding period for the PFIC stock, the PFIC is treated as an "unpedigreed QEF."[66] In such case, the shareholder remains subject to the PFIC excess distribution/interest charge regime to the extent it receives any excess distributions from the PFIC or realizes gain on the disposition of the PFIC stock.[67] This PFIC taint may be purged, however, if the U.S. shareholder elects to include in income as an excess distribution (i) in the case of a U.S. shareholder holding stock of a PFIC that is also a CFC, its pro rata share of the PFIC's post-1986 undistributed earnings and profits as of the qualification date[68] or (ii) in all other cases, any built-in gain with respect to the PFIC shares as of the qualification date.[69] For this purpose, a U.S. shareholder's pro rata share of post-1986 undistributed earnings and profits does not include any amount that has previously been included in the U.S. shareholder's gross income pursuant to another provision of U.S. income tax law (e.g., Subpart F).[70]

The third alternative regime is one which allows a U.S. shareholder to elect to market-to-market such shareholder's PFIC stock. Under Section 1296, a mark-to-market election may be made by a U.S. person or CFC that owns marketable PFIC stock.[71] PFIC stock is considered "marketable" for this purpose if it is "regularly traded…on a qualified exchange or other market."[72] Stock may also be considered "marketable" for purposes of this rule if it meets all of the requirements set forth in Treas. Reg. § 1.1296-

---

[64] Section 1293(c).

[65] Staff of Joint Comm. on Tax'n., 99th Cong. *General Explanation of the Tax Reform Act of 1986* at 1030 (May 4, 1987).

[66] Prop. Treas. Reg. § 1.1291-1(b)(2)(iii).

[67] Section 1298(b)(1); Prop. Treas. Reg. §§ 1.1291-1(b)(2)(iii) and (c)(2).

[68] "Qualification date" is defined as the first day of the PFIC's first tax year as a QEF. Treas. Reg. §§ 1.1291-9(e) and 1.1291-10(e).

[69] Section 1291(d)(2).

[70] Treas. Reg. § 1.1291-9(a)(2)(ii)(B).

[71] Section 1296(a); Treas. Reg. § 1.1296-1(b)(1).

[72] Section 1296(e) and Treas. Reg. § 1.1296-2(a)(1). A qualified exchange or other market is a national securities exchange registered with the SEC, the national market system established under § 11A of the Securities Exchange Act, or a foreign securities exchange meeting all of the requirements set forth in Treas. Reg. 1.1296-2(c)(1). Treas. Reg. § 1.1296-2(c)(1).

2(d)(i). Mark-to-market gains and losses are reported as ordinary income or ordinary loss.73 In addition, gain on the sale or disposition of stock subject to a mark-to-market election is ordinary income, and loss on a sale or other disposition is deducible as an ordinary loss to the extent it does not exceed the unreversed inclusions attributable to the stock.74

If a taxpayer elects the mark-to-market regime after the year during which stock is acquired, the excess distribution regime under Section 1291 applies to distributions with respect to the stock and dispositions of the stock during year of the mark-to-market election and to the mark-to-market income for that year unless a QEF election was in effect during the taxpayer's entire holding period of the stock.75 Under Section 1296(k), once made, a mark-to-market election shall apply to the tax year for which the election is made and all subsequent tax years unless the stock ceases to be marketable stock or the IRS consents to the revocation of the election.

Additional Coordination Rules

Certain CFC/PFIC coordination rules are discussed supra in the text accompanying footnotes 44, 45, 56, 57 and 62. In addition, as explained below, the Code contains other coordinating rules designed to eliminate double taxation where both the PFIC rules and the Subpart F rules apply. Different rules apply where a U.S. shareholder has made a QEF election and where a QEF election is not made. If a U.S. shareholder that is a corporation has made a QEF election, Section 1293(f) provides that, for purposes of Section 960 (dealing with indirect foreign tax credits), if an item of income is includable in the gross income of a U.S. shareholder under both the Subpart F rules under Section 951(a)(1)(A)(i) and the QEF rules under Section 1293, the item is includable only under Section 951(a), thus allowing indirect foreign tax credits to the U.S. corporate shareholder if the shareholder would have been allowed indirect foreign tax credits on actual dividend distributions not paid out of Subpart F income.

If a QEF election has not been made for a PFIC that is also a CFC, for purposes of calculating "excess distributions" under the PFIC rules, distributions include deemed

---

73 Section 1296(c).

74 Section 1296(c)(1) and Treas. Reg. §§ 1.1296-1(c)(2) (concerning gains) and 1.1296-1(c)(4)(i) (concerning losses). Section 1296(d) defines "unreversed inclusions" as an amount, with respect to any stock in PFIC, equal to the excess, if any, of (i) the amount included in the gross income of the shareholder under the mark-to-market rules under Section 1296(a)(1) for prior taxable years, over (ii) the amount allowed as a deduction to such shareholder under the mark-to-market rules with respect to such stock for such prior taxable years under Section 1296(a)(2).

75 Section 1296(j)(1); Treas. Reg. §§ 1.1296-1(i)(1) and 1.1296-1(i)(2). The purpose of this rule is to ensure that the taxpayer does not avoid the interest charge under Section 1291 with respect to amounts attributable to periods before such mark-to-market election. *General Explanation of Tax Legislation Enacted in 1997, supra note 45 at 313.*

distributions under Section 956 (investments in U.S. property), which are includable in a United States Shareholder's income under Section 951(a)(1)(B).76 Income that is or has been included in the gross income of a United States Shareholder under both Subpart F rules under Section 951(a) (the Subpart F rules for CFCs) is treated as previously-taxed income under Section 959(a), and is disregarded for purposes of determining the amount of any "excess distribution" or gain that is subject to interest charges Section 1291.77

If the CFC is a PFIC but not a QEF, all gain on the sale or other disposition of the CFC stock is treated as ordinary income. Section 1248 (discussed above in this article) does not apply to a non-QEF PFIC.78

Conclusion

The PFIC rules are designed to ensure that U.S. shareholders of a foreign corporation cannot defer U.S. income taxes on the undistributed earnings of the foreign corporation where the foreign corporation's income consists primarily of passive investment income or its assets consist primarily of assets which produce passive investment income. In enacting the PFIC rules, Congress believed that deferral of U.S. income tax was not appropriate, as a policy matter, in those circumstances. The PFIC rules overlap, to some extent, with the rules on Subpart F income for U.S. Shareholders of CFCs. The Code and Treasury Regulations contain rules that coordinate the application of the two sets of rules where there is overlap.

---

[76] Section 1298(b)(8).

[77] Section 1291(b)(3)(F); Prop. Treas. Reg. § 1.1291-2(b)(2).

[78] Sections 1291(g)(2)(C) and 1248(g)(2); Prop. Treas. Reg. § 1.1291-3(i).

Chapter 8 – Conclusion

In the “U.S. Great Recession” millions of U.S. jobs have been lost. According to President Obama in his January 2014 State of the Union Address, 98% of U.S. exports are from small and medium-sized U.S. businesses.

The significant “tax breaks” offered these U.S. businesses under the IC-DISC tax rules (reduced tax and/or tax deferral) may be more compelling (i.e. no tax) if the PR/PPLI tax strategy described herein is implemented.

For the U.S. taxpayer it is the “Frank Sinatra Tax Question,” “All or Nothing at All,” (i.e. in other words, would the U.S. taxpayer prefer tax or no income tax at all?) Each U.S. exporter may answer that tax question for themselves but if no tax is the goal consider our tax strategy.

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 – Allen Walburn, Esq.

Allen B. Walburn is a partner in the law firm of Allen Matkins Leck Gamble Mallory & Natsis LLP in the San Diego office. His practice focuses on international tax and tax planning for mergers, acquisitions, restructurings, partnerships, real estate transactions, REITs and executive compensation.

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

For more information please see website: gswlaw.com