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

Gary S. Wolfe, Esq.
&
Allen B. Walburn, Esq.

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

By

Gary S. Wolfe, Esq.
&
Allen B. 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

International Tax Evasion & Money Laundering

For more information please see website:
gswlaw.com

BG Digital Publishing

Table of Contents

Introduction

U.S. Taxpayers, including: U.S. citizens, “green card holders,” foreign nationals who are in the U.S. for 183 days in one year or over 122 days per year, for three years, who establish:

1. Foreign Trusts (Grantor Trusts)
2. Controlled Foreign Corporations (“CFC”)
3. Passive Foreign International Companies (“PFIC”)

are subject to intricate, extensive U.S. tax compliance rules.

The tax compliance rules are discussed herein in detail.

Chapter 1
Foreign Grantor (Non-Grantor) Trusts

Due to changes made by the HIRE Act, effective after March 18, 2010 (for tax years beginning 1/1/11), foreign trusts may be classified as a foreign grantor trust or a foreign non-grantor trust.

A foreign trust is any trust other than a domestic trust. A domestic trust is any trust if:

1. A court within the U.S. is able to exercise primary supervision over the administration of the trust; and

2. One or more U.S. persons have the authority to control all substantial decisions of the trust.

Under the grantor trust rules:

1. A grantor includes any person who creates a trust or directly or indirectly makes a gratuitous transfer of cash or other property to a trust. A grantor includes any person treated as the owner of any part of a foreign trust's assets under IRC Sec. 671-679 (excluding IRC Sec. 678).

2. If a partnership or corporation makes a gratuitous transfer to a trust, the partners or shareholders are generally treated as the trust grantors, unless the partnership or corporation made the transfer for a business purpose of the partnership or corporation.

3. If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust, except that if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust.

4. An owner of a foreign trust is the person that is treated as owning any of the assets of a foreign trust under the rules of IRC Sec. 671-679.

5. Property distributed from the trust means any property, whether tangible or intangible, including cash.

Under the grantor trust rules, the foreign trust income reported under Form 3520-A is reported (and taxed) under the grantor's Form 1040 tax return (filed annually).

Under the grantor trust rules, the assets of the foreign trust are treated as owned by the grantor and are includable in the grantor's U.S. estate. However, any grantor distributions under Form 3520 foreign trust rules are reportable by the recipient of the distribution (whether or not the trust is a grantor trust or the recipient is designated as a beneficiary under the trust terms).

Due to changes to IRC Sec. 679(c) made by the HIRE Act, effective after 3/18/10, a loan of cash or marketable securities from a foreign trust with a U.S. grantor, directly or indirectly to a U.S. person, or the use of any other trust property, directly or indirectly by any U.S. person (whether or not a trust beneficiary under the trust terms), will cause a foreign trust to be treated as a grantor trust, unless the U.S. person repays the loan at a market rate of interest, or pays the fair market value of the use of such property within a reasonable period of time.

Additional Trust Distributions

Additional trust distributions include a guarantee. A guarantee:

1. Includes any arrangement under which a person directly or indirectly assumes on a conditional or unconditional basis, the payment of another's obligation;

2. Encompasses any form of credit support, and includes a commitment to make a capital contribution to the debtor, or otherwise maintains its financial viability;

3. Includes an arrangement, reflected in a "comfort letter", regardless of whether the arrangement gives rise to a legally enforceable obligation. If an arrangement is contingent upon the occurrence of an event in determining whether the arrangement is a guarantee, the taxpayer must assume that the event has occurred.

Foreign Non-Grantor Trusts

Under IRS Notice 97-34, 1997-25 I.R.B. 22 (Sec. V(A)), if a U.S. grantor, a U.S. beneficiary or a U.S. person related to the U.S. grantor or U.S. beneficiary, directly or indirectly receives a loan of cash or marketable securities from a foreign non-grantor trust, the amount of such loan will be treated as a distribution to the U.S. grantor or U.S. beneficiary, unless the obligation issued by the U.S. grantor, U.S. beneficiary or U.S. person related to the U.S. grantor or U.S. beneficiary in exchange for the loan, is a qualified obligation. A loan by an unrelated third party that is guaranteed by a foreign trust is generally treated as a loan from the trust.

After March 18, 2010, if a U.S. grantor, a U.S. beneficiary or any U.S. person related to the U.S. grantor or U.S. beneficiary directly or indirectly, uses any

property of a foreign non-grantor trust, and the U.S. grantor, U.S. beneficiary or U.S. person (related to the U.S. grantor or beneficiary) does not compensate the trust at fair market value for the use of the property within a reasonable period of time, the fair market value of such use will be treated as a distribution by the foreign non-grantor trust to the U.S. grantor or U.S. beneficiary.

A non-grantor trust is any trust to the extent that the assets of the trust are not treated as owned by a person other than the trust. A non-grantor trust is treated as a taxable entity. A trust may be treated as a non-grantor trust with respect to only a portion of trust assets.

U.S. Tax: Beneficiaries of Foreign Non-Grantor Trusts

U.S. taxpayers who are beneficiaries of foreign non-grantor trusts may be subject to U.S. income taxes on distributions of cash or other property (including trust loans) received from the trusts. The U.S. beneficiaries, U.S. income tax liability, with respect to foreign non-grantor trust distributions and loans depends on a number of factors, including:

1. Whether the distribution was made during a year in which the foreign non-grantor trust earned income and the relationship between the size of the income and the value of the distributions made in that year to the U.S. beneficiary and to other trust beneficiaries;

2. Whether, if the amount of the trust's distributions exceeded the amount of its income for the year of distribution;

3. Whether the trust had undistributed income accumulated from prior years; and

4. Whether the trust previously paid U.S. income tax or foreign income tax.

A U.S. beneficiary of a foreign non-grantor trust is required to include in their gross income for any particular year:

1. The amount of any trust income in each year required to be distributed to them from a "simple trust" (whether or not actually distributed) to the extent of their share of the trust's distributable net income for the year (IRC Sec. 652(a)).

A simple trust is a non-grantor trust that is required to distribute income, is not permitted to make payments to charity, and in that tax year makes no principal distribution.

2. The amount of any trust income required to be distributed to them in that tax year from a "complex" foreign non-grantor trust (whether or not actually distributed) to the extent of the trust's "DNI" (distributable net income) for the year

(IRC Sec. 662(a)(1). A “complex trust” is a non-grantor trust other than a simple trust.

3. The amount actually distributed to them from a foreign complex trust in the tax year, to the extent of their share of the trust’s DNI for such tax year (IRC Sec. 662(a)(2).

Specific gifts paid to a trust beneficiary are not treated as a distribution included in income of the beneficiary unless it is paid only from the trust income (IRC Sec. 663(a)(1).

If a U.S. beneficiary receives a distribution from a foreign grantor trust that includes U.S. source income from which U.S. tax has been withheld, they must include in their gross income the amount received but also the amount of the withheld tax and may then credit the withheld tax against their personal income tax liability (Treas. Reg. Sec. 1.1441-3(f) and 1.1462-1(b); Rev. Rul. 56-30, 1956-1 C.B. 646; Rev. Rul. 55-414, 1955-1 C.B. 385).

A U.S. taxpayer who pays income tax to a foreign country may credit the amount of such taxes against their U.S. income tax liability or may claim such taxes as an itemized deduction (IRC Sec. 901(a) and 164(a)(3). An election to take the credit precludes the deduction (IRC Sec. 275(a)(4). The total amount of the credit is limited to the proportion of the tax against which such credit is taken against their taxable income from foreign sources bears to their entire taxable income (IRC Sec. 904(a)).

If a foreign non-grantor trust makes distributions in excess of its DNI for a tax year, the U.S. beneficiaries who receive such distributions and include such distributions in their gross income may be required to calculate their U.S. income tax under the “throwback rule” and may be subject to interest on those taxes; the tax is increased by an interest charge determined under IRC Sec. 668 (See IRC Sec. 667(a)(3). The interest rate will be the floating rates applied under IRC Sec. 6621 to underpayments of tax.

Chapter 2
FATCA & FBAR: Foreign Trusts

Foreign Account Tax Compliance Act: ("FATCA")

Under FATCA, Section 511 of the 2010 HIRE Act, added new Sec. 6038D to the Code, effective for taxable years beginning with 12/31/10. IRC Sec. 6038D(a) requires any individual who holds any interest in a specified foreign financial asset during any taxable year to attach to their income tax return for that year the information described in IRC Sec. 6038(1)(c), if the aggregate value of all such assets exceeds $50,000, by filing IRS Form 8938.

Under Treas. Reg. Sec. 1.6038D-5J(f)(3), the value of a beneficiary's interest in a trust equals the sum of the amounts actually received in the taxable year plus the present value of the mandatory right to receive a distribution.

Under FATCA, IRC Sec. 6501(c)(8), as amended by Section 513 of the 2010 HIRE Act, provides that the statute of limitations will not commence to run until the tax return required by IRC Sec. 6038D is filed. Section 513 of the HIRE Act amended IRC Sec. 6501(c) to provide that the statute of limitations on assessment of a return is extended from three to six years if the taxpayer omitted more than $5,000 from gross income.

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

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

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

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

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

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

- Any stock or security issued by a person other than a U.S. Person
Any financial instrument or contract held for investment that has an issuer or counterparty other than a U.S. Person, and

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

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

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

In the case of any stock or security, the disclosed information must include the name and address of the issuer and such other information as is necessary to identify the class or issue of which the stock or security is a part.

In the case of any instrument, contract, or interest, a Taxpayer must provide any information necessary to identify the instrument, contract, or interest along with the names and addresses of all issuers and counterparties with respect to the instrument, contract, or interest.

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

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

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

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

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

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

FATCA: Foreign Trusts Treated as Having U.S. Beneficiaries

For purposes of treating a foreign trust as a grantor trust, there is a rebuttable presumption that the trust has a U.S. beneficiary if a U.S. Person transfers property to the trust. An amount is treated as accumulated for a U.S. Person even if that person has a contingent interest in the trust.

A foreign trust is treated as having a U.S. beneficiary if any person has discretion to make trust distributions, (unless none of the recipients are U.S. Persons). An amount will be treated as accumulated for the benefit of a U.S. Person even if that person's interest in the trust is contingent on a future event (IRC §679(c)(1) as amended by the 2010 HIRE Act).

If any person has the discretion (by authority given in the trust agreement, by a power of appointment or otherwise, of making a distribution from the trust to or for the benefit of any person), the trust will be treated as having a beneficiary who is a U.S. Person, unless the trust terms specifically identify the class of person to whom such distribution may be made and none of those persons are U.S. Persons during the tax year (IRC §679(c)(4) as added by the 2010 HIRE Act).

If any U.S. Person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding that may result in trust income or corpus being paid or accumulated to or for the benefit of a U.S. Person, that agreement or understanding will be treated as a term of the trust (IRC §679(c)(5) as added by the 2010 HIRE Act). The agreement or understanding may be written, oral or otherwise.

The provision creating a rebuttable presumption allowing the IRS to treat a foreign trust as having a U.S. beneficiary if a U.S. person directly or indirectly transfers property to the trust applies to transfers of property after March 18, 2010. (Act Section 532(b) 2010 HIRE Act.)

FATCA: Uncompensated Use of Foreign Trust Property

The uncompensated use of foreign trust property by a U.S. Grantor, a U.S. Beneficiary, or a U.S. Person related to either of them is treated as a distribution by the trust for non-grantor trust income tax purposes (which also includes the loan of cash or marketable securities by a foreign trust or the use of any other property of the trust).

The distribution treatment of foreign trust transaction has been expanded to include the uncompensated use of property by certain U.S. Persons. The treatment of foreign trusts as having U.S. beneficiaries for grantor trust purposes has been expanded to include loans of cash or marketable securities or the use of any other trust property to or by a U.S. Person.

If a foreign trust permits the use of any trust property by a U.S. Grantor, a U.S. Beneficiary, or any U.S. Person related to either of them, the fair market value of the use of such property is treated as a distribution by the trust to the Grantor or Beneficiary (IRC §643(i)(1), as amended by the 2010 HIRE Act).

This treatment does not apply to the extent that the trust is paid the fair market value of such use within a reasonable time (IRC §643(i)(2)(E), as added the 2010 HIRE Act). If distribution treatment does apply to the use of trust property, the subsequent return of such property is disregarded for federal tax purposes (IRC §643(i)(3), as amended by the 2010 HIRE Act).

Chapter 3
Foreign Grantor Trusts – Tax Compliance (U.S. Beneficiary)

A U.S. taxpayer who establishes a foreign trust is classified as the trust owner, under IRC Sec. 679, for those assets transferred to the trust, and must annually report foreign trust income (IRS Forms 3520-A/Form 1040), and asset transfers to the trust (Form 3520). U.S. beneficiaries must annually report distributions received from the foreign trust (Form 3520).

The U.S. grantor of the foreign trust must annually file Form TDF-90.22-1("FBAR") to report the trust foreign financial accounts over $10,000 (which accounts they either own or control (i.e. signatory authority) and IRS Form 8938, to report ownership of foreign assets over $50,000.

The U.S. grantor of the foreign trust's failure to file FBAR, Form 8938, report annual income on Forms 3520-A/Form/Form 1040, report trust transfers (Form 3520) and U.S. beneficiaries' failure to report trust distributions (Form 3520) have civil and criminal tax issues, including:

- Money Laundering (Disguise of the nature or the origin of funds (18 U.S.C. Sec. 1956 and 1957)

- FBAR Issues

- Unreported Income Issues

- FATCA Issues

- Perjury

IRS Penalties/Offshore Accounts

Criminal Penalties
6 Year Statute of Limitations

1. Tax Evasion (Willful Evasion of Tax)
(IRC Sec. 7201) up to five years in prison
Fine: $100,000 (individual)
$500,000 (corporation)

2. Obstruct (Impede Tax Collection)
(IRC Sec. 7212) up to three years in prison
Fine: $5,000

3. Conspiracy to Impede Tax Collection
(18 USC 371) separate charge of impeding

Up to five years in prison

4. Failure to File Tax Return
(IRC Sec. 7203) up to one year in prison
Fine: $25,000 (individual)
$100,000 (corporation)

5. File False Tax Return
(IRC Sec. 7206(1)), up to three years in prison
Fine: $250,000

6. "FBAR Violation"
(31 USC Sec. 5322(b), 31 CFR 103.59(c))
Willful violation: up to ten years in jail and
$500,000 fine

Additional Criminal Penalties:

1. Perjury (U.S. taxpayers who fail to disclose foreign accounts under Form 1040/Schedule B, Part III, question 7(a))

2. FATCA Filings (i.e. Failure to disclose foreign financial assets on $50,000/IRS Form 8938)

3. Money Laundering: Disguise of the nature or the origin of funds 18 USC Sec. 1956 and 1957)

U.S. Tax Compliance Issues

U.S. taxpayers who establish a foreign trust (i.e. a trust which either a U.S. court does not supervise trust administration, or a U.S. person does not control substantial trust decisions. See: IRC Sec. 7701(a)(30)(E)(31)(B), and funds the trust (i.e. transfers property to the trust), if the trust has a U.S. beneficiary, the trust will be treated as foreign “grantor trust” and the U.S. taxpayer will be treated as the owner “of that portion of the trust attributable to the property transferred” (IRC Sec. 678(b), 679).

Trust tax items of income, deduction or credit are for tax purposes treated as belonging to the trust grantor, and these tax items are reflected on the income tax return of the trust grantor; i.e. Form 1040 (originally declared on the Trust Tax Return, Form 3520-A: Annual Information Return of Foreign Trust with a U.S. Owner).

Based on a U.S. person funding the foreign trust, the IRS can presume that the trust has a U.S. beneficiary unless the U.S. person (i.e. transferor of trust assets)

submits to the IRS any information that the IRS requires regarding the transfer and demonstrates to the IRS's satisfaction that:

Under the trust terms, no part of the trust's income or corpus may be paid or accumulated during the tax year, to or for the benefit of a U.S. person, even if that person's interest is contingent on a future event; and

No part of the trust's income or corpus could be paid to or for the benefit of a U.S. person if the trust were terminated at any time during the tax year.

Generally:

The U.S. taxpayer who transfers assets to the trust must ensure that the trust satisfies tax reporting requirements, and submit any information the IRS may require regarding the foreign trust (IRC Sec. 6048(b), 6677(a);

The U.S. grantor trust rules will not apply to any portion of a trust that would otherwise be deemed to be owned by a foreign person (IRC Sec. 672(f).

Under Treas. Reg. Sec. 1.671-2(e) a trust grantor is a person (either an individual or a non-natural person) who either creates a trust, or indirectly makes a "gratuitous transfer" of property to a trust.

A gratuitous transfer means a transfer made, other than a transfer for fair market value.

A U.S. taxpayer who creates a foreign trust faces a myriad of U.S. tax-reporting compliance issues.

If the foreign trust is irrevocable, the U.S. taxpayer faces a U.S. gift tax on funding. The U.S. taxpayer must file Form 709 to report the gift, subject to the 2013: $5,250,000 gift tax exclusion. If the trust is revocable, the U.S. taxpayer must report any gifts (by filing Form 709) over $14,000 per donee;

File Form 3520 ("Annual Return to Report Transactions with Foreign Trusts) to report transfers to the trust and trust ownership (IRC Sec. 671-679).

Penalties for non-compliance:

- Thirty-five percent (35%) of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust, or

- On an annual basis, 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the

U.S. owner information.

Form 3520-A is the annual information return of a foreign trust with at least one U.S. owner, which provides annual information about trust income/expense, its U.S. beneficiaries and any person treated as an owner of any portion of the trust. Each U.S. person treated as an owner of any portion of a foreign trust is responsible for ensuring that the foreign trust files Form 3520-A and furnishes the required annual statements to its U.S. owners and U.S. beneficiaries.

Penalties for non-compliance:

- The U.S. owner is subject to an initial penalty equal to the greater of $10,000 or 5% of the gross value of the portion of the trust's assets treated as owned by the U.S. person at the close of that tax year, if the foreign trust either fails to timely file Form 3520-A or does not furnish all of the information required by IRC Sec. 6048(b) or includes incorrect information.

- Criminal penalties may be imposed under IRC Sections 7203, 7206 and 7207 for failure to file on time and for filing a false or fraudulent tax return.

For Both Forms 3520 and 3520-A:

- Additional penalties will be imposed if the non-compliance continues after the IRS mails a notice of failure to comply with the required reporting.

- Effective for taxable years beginning after 3/18/10, the IRC Sec. 6662 negligence penalty is increased from 20% to 40% if the deficiency is attributable to an unreported financial asset (See Sec. 512 of the 2010 HIRE Act).

U.S. Tax Reporting Foreign Financial Assets and Foreign Accounts ("FBAR")

USC Sec. 5314 of Title 31 (the Bank Secrecy Act) requires a U.S. person to file Form TDF 90-22.1- Report of Foreign Bank Account ("FBAR") to report all foreign bank and financial accounts in which they have a financial interest, or signatory authority, if the aggregate value of the accounts exceeded $10,000 at any time during the year (31 USC Sec. 5314). A financial account includes a bank or financial account, a securities account, mutual fund or pooled investment fund.

A U.S. person has an indirect financial interest in an account owned by the trust and is required to file an FBAR report for foreign accounts held by the trust if they are the trust grantor (IRC Sec. 671-679) or they have a present beneficial interest in more than 50% of the trust assets or receive more than 50% of the trust income.

The U.S. Treasury Dept., division "Financial Crimes Enforcement Network" ("FINCEN") issued regulations providing that trust beneficiaries (other than those treated as owners under the grantor trust rules) do not have to file an FBAR report for financial assets held by trusts of which they are the trust beneficiary if the trust, trustee of the trust or trust agent is a U.S. person and files an FBAR report disclosing the trust's foreign financial accounts (31 CFR part 103, Sec. 103.24(g)(5), Federal Register Vol. 76, No. 37 at 10234 (Feb. 16, 2011). FINCEN delegates the authority to enforce the FBAR reporting requirement of the Bank Secrecy Act to the IRS (by a memorandum of agreement).

A trust discretionary or remainder beneficiary are not required to file FBARs (Fed. Register Vol. 76, No. 37 at 10234 (Feb. 16, 2011).

Foreign Bank and Financial Account Report (FBAR)
(TD F 90-22.1), Civil & Criminal Penalties

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

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

	Civil Penalties	Criminal Penalties	Legal Authority
Non-Willful Violation	Up to $10,000 for each violation.	N/A	31 U.S.C.§ 5321(a)(5)(A)
Negligent Violation	Up to the greater of $100,000, or 35 percent of the greatest amount in the account.	N/A	31 U.S.C. §5321(a)(5)(C)
Intentional Violations Willful - Failure to File FBAR or retain records of account	Up to the greater of $100,000, or 50 percent of the greatest amount in the account.	Up to $250,000 or 5 years or both	31 U.S.C. § 5322(a) and 31 C.F.R. §103.59(b) for criminal
Knowingly and Willfully Filing False FBAR	Up to the greater of $100,000, or 50 percent of the greatest amount in the account.	$10,000 or 5 years or both	18 U.S.C. § 1001, 31 C.F.R. § 103.59(d) for criminal

Willful - Failure to File FBAR or retain records of account while violating certain other laws	Up to the greater of $100,000, or 50 percent of the greatest amount in the account.	Up to $500,000 or 10 years or both	31 U.S.C. § 5322(b) and 31 C.F.R. §103.59(c) for criminal

FATCA - IRC Reporting Requirements for Foreign Financial Assets

Section 511 of the 2010 HIRE Act added new Sec. 6038D to the Code, effective for taxable years beginning after 12/31/10.

Section 6038 D(a) requires any individual who holds any interest in a specified foreign financial asset during any taxable year to attach to his or her income tax return for that year the information described in Section 6038 D(c); i.e. Form 8938, if the aggregate value of all such assets exceeds $50,000.

Specified foreign financial assets include: financial accounts, stock or security issued by a non-U.S. person, financial instruments or contracts held for investment that has an issuer or counter-party other than a U.S. person, and any interest in a foreign entity (which includes foreign trusts).

A person who is treated as the owner of a trust under the grantor trust rules is treated as having an interest in any foreign financial assets held by the trust (Treas. Reg. Sec. 1.6038(D)-2T(b)(3).

The value of a beneficiary's interest in a trust equals the sum of the amounts actually received in the taxable year plus the present value of a mandatory right to receive a distribution (Treas. Reg. 1.6038D-5J(f)(3). This valuation rule applies even if the trust is deemed to be owned by another person under the grantor trust rules. A foreign financial asset is subject to reporting even if the asset does not have a positive value (Treas. Reg. Sec. 1.6038D-2T(a)(5).

An FBAR and Form 8938 both have to be filed in full, and filed with different agencies. The penalty for failing to file Form 8939 is $10,000 with additional penalties after notice is given to the taxpayer of $10,000 per 30 day period, after expiration of the 90 day notice period (after notice given to the taxpayer, the penalty cannot exceed $50,000).

The FATCA Form 8938 filing applies only to interests held directly by U.S. individuals (or indirectly through disregarded entities), but does not apply to U.S. entities.

For tax years beginning 1/1/11, the negligence penalty, if imposed by IRC Sec. 6662, is increased from 20% to 40% if the deficiency is attributable to an unreported foreign financial asset. (Sec. 512 of the 2010 HIRE Act.)

The statute of limitations will not commence to run until the return required (Form 8938) is filed, and is extended from three to six years if the taxpayer omitted more than $5,000 from gross income and the omission is attributable to assets with respect to which a return was required by IRC Sec. 6038 D (IRC Sec. 650(c)(8)), as amended by Sec. 513 of the 2010 HIRE Act).

Foreign Grantor Trust: U.S. Beneficiaries (U.S. Tax Compliance)

A U.S person who receives directly, or indirectly, a distribution from a foreign trust must report the gross amount of distributions received from a foreign trust on Form 3520 the information to the IRS regarding the trust name, date of distribution, description of property received, fair market value of property received, fair market value/description of property transferred, if any. (See Form 3520, Part III, line 24).

Under IRC Sec. 6677 (as amended by Sec. 535 of the 2010 HIRE Act) a penalty generally applies if Form 3520 is not timely filed or if the information is incomplete or incorrect. Generally, the initial penalty is equal to the greater of $10,000 or 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution (on Form 3520).

Additional penalties can be imposed by the IRS for continuing non-compliance. Although the total penalties may not exceed the reportable amount, the IRS may assess the penalties before the reportable amount is determined. When the reportable amount is determined, the excess must be refunded. The IRS is authorized to assess and collect those penalties without prior judicial review.

Form 3520: Trust Distributions

A distribution to a U.S. beneficiary is any gratuitous transfer of money or other property from a trust, whether or not the trust is treated as owned by another person under IRC Sec. 671-679, and without regard to whether the recipient is designated as a beneficiary by the terms of the trust. A distribution includes the receipt of trust corpus and the receipt of a gift or bequest described under IRC Sec. 663(a).

A distribution includes constructive transfers from a trust:

Personal charges made on a credit card paid by a foreign trust;

Personal charges (eg, credit card) guaranteed or secured by the assets of a foreign trust;

Personal checks written on a foreign trust’s bank account, the amount will be treated as a distribution.

In addition, a U.S. taxpayer who receives a payment from a foreign trust in exchange for property transferred to the trust, or services rendered to the trust, and the fair market value of the payment received exceeds the fair market value of the property transferred or services rendered, the excess will be treated as a distribution.

Chapter 4
IRS § 679: ("Outbound Trusts")

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

- A transfer by reason of the death of the transferor (IRC Sec. 679 (a)(2)(A));

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

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

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

Indirect transfers include:

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

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

3. An intermediate transfer to either another person or an entity that makes the actual transfer to the foreign trust is to be disregarded "unless it can be shown that the ultimate transfer of property to the trust was unrelated to the intermediate transfer. In such a case, the person making the intermediate transfer would be treated as having made the ultimate transfer directly." See: Haeri v. Commr., 56

TCM 1061 (1989) (transfer by agent). Treas. Reg. Sec. 1.679-3 provides elaborate guidance with respect to indirect transfers.

IRC Sec. 679: U.S. Persons

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

IRC Sec. 679 only applies to transfer to a "foreign trust" (i.e. not a domestic trust) only if a trust has a U.S. beneficiary. (IRC Sec. 7701(a) (31)(B) defines a foreign trust as any trust that does not gualify 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 IRS 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 5 – Grantor Trust (Income Tax Rules)

(Subpart E of Subchapter J of Chapter 1 of Subtitle A IRC 1954)
IRC Sec. 671-679 determines whether a trust is a "grantor trust" for U.S. federal income tax purposes. If a trust is a grantor trust, all items of income, deduction and credit in respect of the trust property will be reported on the grantor's U.S. federal income tax return, and any income tax liability will be paid by the grantor and not from the trust (Treas. Reg. 1.671-3 (a)(1).

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

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

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

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

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

IRC Sec. 671: Grantor Trust Status

The person designated by Subpart E as "owner" of a portion of a trust must take into account in computing their tax liability the items of income, deductions and credits attributable to that portion of the trust (that would otherwise be reportable by the trust itself).

Tax Compliance

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

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

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

Grantor Trust

If the trust is a grantor trust for income tax purposes, a sale of assets to the trust by the grantor is disregarded. (See Rev. Rul. 85-13, 1985-1 C.B. 184).

If the non-contributing spouse has a discretionary interest as to both income and principal, the trust is a grantor trust under IRC Sec. 677(a)(1) to the contributing spouse. No income tax realization event occurs and the policy proceeds are excluded from both estates (Ltr. Rul. 9413045).

Intentionally Defective Grantor Trust

An "Intentionally Defective Grantor Trust" ("IDGT") takes advantage of the differences between the estate tax inclusion rules of IRC Sections 2036-2042, and the grantor trust income tax rules of IRC Sec. 671-678. An IDGT is an irrevocable trust that effectively removes assets from the grantor's estate. As a result, a sale of assets to an IDGT can freeze an individual's estate by converting appreciating assets into a non-appreciating asset with a fixed yield.

For income tax purposes, the trust is "defective" and the grantor is taxed on the trust's income. Accordingly, sale of assets between the IDGT and the grantor are not taxable. The grantor is treated for income tax purposes to have made a sale to himself eliminating capital gain tax on sale. (Additionally, interest payments by the IDGT to the grantor are not income.)

Since the IDGT is "defective" for income tax purposes, all of the trust's income is taxed to the grantor, which produces an additional "tax-free gift" to the IDGT (Rev. Rul. 2004-64, 2004-2(C.B. 7).

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

The sale of the policy is a sale to the grantor-insured and the transfer for value exception under IRC Sec. 101 (a)(2)(B) should apply.

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

Under an IDGT, Grantor Trust Status:

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

2. Swapping Assets: If the grantor sells assets to the IDGT, the trust assets are excluded from the grantor's estate at death, but the IDGT assets would not receive a tax basis step-up under IRC Sec. 1014. If the assets sold to an IDGT have a low basis, the lack of basis step-up is an income tax disadvantage which may be ameliorated by the grantor exchanging high-basis outside of the IDGT, with low-basis assets inside of the IDGT, achieving a "basis step-up". The swap of assets with an IDGT should not be treated as a gift for purposes of IRC Sec. 1014(e).

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

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

4. Power to Add Beneficiaries: The power to add to the class of beneficiaries (other than the grantor's after-born or after-adopted children) to receive the trust's income or corpus held by the grantor, or a non-adverse party will cause grantor trust status. To avoid estate tax inclusion, the grantor should not hold such a power, but the power could be held by the grantor's spouse without

inclusion if the spouse did not contribute to the trust and is not controlled by the grantor. A marital agreement should be entered into in advance of the transfer to ensure that the spouse did not make a contribution to the IDGT. The IRS has privately ruled that the power to add beneficiaries held by a trustee triggers grantor trust status (IRS PLR 199936031; 9709001; 9010065).

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

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

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

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

- IRC Sec. 1041: Transfers between spouses (if no NRA spouse), no income tax realization, transferee spouse "carry-over" income tax basis.

Exceptions from application of the transfer for value include transfers where the transferee takes a carry-over basis (IRC Sec. 101(a)(2)(A), transfers to the insured, a partner of the insured, a partnership in which the insured is a partner and a corporation in which the insured is a shareholder or officer (IRC Sec. 101(a)(2)(B).

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

Grantor Trust - Avoids Application of Transfer for Value Rules

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

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

Grantor Trust Status

IRC Sec. 677 (a)(3): Trust is a grantor trust to the extent trust income may be used to pay premiums on insurance policies on the grantor’s life, or the grantor’s spouse. However, grantor trust status may apply only to the portion of the trust the income from which is currently used to pay premiums (See: Weil, 3TC 579 (1944); Iverson, 3 TC 756 (1944).

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

Estate Tax

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

IRS

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

Grantor Trust Rules - IRC Sec. 672(e)

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

Gift Tax

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

Grantor Trust Status (ILIT)

A related and subordinate party could be named as trustee with the power to make discretionary distributions, not on an ascertainable standard, in order to make the ILIT a grantor trust. If the grantor cannot remove and replace the trustee, the initial appointment of a related and subordinate party trustee may not

cause the powers of the trustee to be attributed back to the grantor for estate tax purposes (Ltr. Rul. 9636033).

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

Grantor Trust - (Ownership of Assets)

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

Termination Grantor Trust Status

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

Adverse Party

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

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

Beneficiaries can be adverse parties if they have a power the exercise or non-exercise of which would adversely affect the beneficiary's own beneficial interest.

IRC Sec. 672(b) defines a "nonadverse party" as "any person who is not an adverse party".

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

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

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

Related or Subordinate Party

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

1. IRC Sec. 672(c)(1): The grantor’s spouse (only if they are living together);

2. IRC Sec. 672(c)(2): Grantor’s father, mother, children, brother, sister (including half-brothers/sisters). See: Rev. Rul. 58-19, 1958-1, CB 251);

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

Not Related or Subordinate Party

Under IRC Sec. 672(c) the following are not related or subordinate parties:

1. Nieces, nephews, grandparents, spouses of children, spouses of grandchildren, spouses of brothers and sisters;

2. Partners of the grantor;

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

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

Power Subject to Condition Precedent

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

Grantor’s Spouse

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

Grantor as Foreign Person - ("Inbound Trusts")

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

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

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

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

Grantor Trust: Co-ownership and Reversionary Interest

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

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

IRC Sec. 674: Powers over Beneficial Enjoyment

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

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

Grantor Trust - Power to Distribute Corpus

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

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

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

Grantor Trust - Exception: (Independent Trustee)

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

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

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

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

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

Grantor Trust - Power to Remove Trustee

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

Grantor Trust - Power to Add Beneficiaries

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

IRC Sec. 675 - Grantor Administrative Powers

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

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

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

Power to Borrow without Adequate Interest or Security

IRC Sec. 675(2) describes a power exercisable by the grantor or any non-adverse party to enable the grantor to borrow either principal or income "directly or indirectly, without adequate interest or adequate security". If so, grantor is treated as the owner of some portion of the trust. If the trustee (who is not the grantor or the grantee's spouse) has the power to lend on such terms to anyone, the power is disregarded for purposes of IRC Sec. 675(2). In addition, there are no other restrictions on the trustee's identity; even a related or subordinate party may serve as trustee.

Actual Borrowing

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

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

General Powers of Administration

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

The three powers:

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

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

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

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

IRC Sec. 677
Income for Benefit of Grantor or Grantor's Spouse

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

2. Income Accumulated for the Grantor or Grantor's Spouse
IRC Sec. 677(a)(2) applies if income may be accumulated without the consent of an adverse party for future distribution to the grantor or the grantor's spouse.

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

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

5. Income Applicable to Discharge of Support Obligations
IRC Sec. 677(b) is an exception to the general rule of IRC Sec. 677(a). According to IRC Sec. 677(b), IRC Sec. 677(a) does not apply if trust income

may be “applied or distributed for the support or maintenance of a beneficiary (other than the grantor’s spouse) whom the grantor is legally obligated to support”.

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

Under IRC Sec. 677(b), for trust distributions in discharge of a grantor’s support obligations:
- If a distribution comes out of current income, the grantor is treated as owner of the trust, but only to the extent of the obligation discharged (Brooke v. U.S., 300 F.Supp. 465 (D. Mont. 1969), aff’d 468 F.2d 1155 (9th Cir. 1972).

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

IRC Sec. 678 - Non-Grantors Treated as Grantors

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

Released or Modified Power

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

Obligations of Support

IRC Sec. 678(a), if a powerholder can direct a trust to expend either its income or its principal to discharge a legal obligation, he is treated as the powerholder, if principal or accumulated income is used to discharge the powerholder’s support

obligation, the powerholder is treated as a beneficiary who receives a taxable distribution under IRC Sec. 661 and 662.

Chapter 6
A Primer on Passive Foreign Investment Companies and Comparison to Controlled Foreign Corporations

(Co-Author: Allen B. Walburn, Esq.)

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

---

[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.

tax law, the residence of a corporation is considered to be its country of incorporation.[6] Section 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") regime[8] 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

---

[6] *Id.*

[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.

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 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

---

[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).

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—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

---

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

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).

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 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

---

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 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).

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

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

---

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).

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

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

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

---

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 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).

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 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

---

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.

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

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 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

---

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.

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

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

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 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.

---

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).

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).

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 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

---

[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).

[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).

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. § 1.1296-2(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]

---

[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).

[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

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 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

---

(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.*

76 Section 1298(b)(8).

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.

Chapter 7 – U.S. Based Hedge Funds an Offshore Reinsurance

(Co-Author: Allen B. Walburn, Esq.)

Introduction

U.S.-based hedge funds are establishing offshore reinsurance companies to exempt their hedge fund earnings from annual U.S. income taxes. The hedge funds “ship” investment capital offshore to a newly-established reinsurance company, which is in the “business” of selling reinsurance (i.e. they sell insurance to insurance companies). Since there are no specific rules on how much insurance must be sold, the U.S. hedge fund may capitalize the offshore reinsurance company (e.g. $500M) and sell de minimis insurance (e.g. $8M in the case of John Paulson’s hedge fund), leaving almost 100% of the initial $500M in capital available to reinvest in the U.S. hedge fund (the $500M is sent on a “round-trip trip transfer”; i.e. from the U.S. to the “offshore reinsurance”, back to the U.S.). The hedge fund earnings, held in the offshore reinsurance company compound tax-free annually. The U.S. imposes no tax on those hedge fund earnings. The only U.S. taxes imposed is when the hedge funds sell their shares in the reinsurance company (taxed at capital gains tax rates on the sale of the shares).

Active or Passive Business

---

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).

For tax purposes, the “tax loophole” is whether the U.S.-owned offshore reinsurer is an “active” or “passive” business. If it is an active business, i.e. insurance, there is no tax due on annual earnings. If the business is a passive business (and the income is passive income, e.g. interest, dividends, rents, royalties, classified at foreign persons’ holding company income within the meaning of IRC Sec. 954(c), see IRC Sec. 1297(b)), the earnings are subject to annual tax due.

A passive foreign investment company (“PFIC”) is a foreign corporation that meets one of two tests:

- Seventy-five percent or more of the gross income of the corporation is “passive income” IRC Sec.1297(a)(1), or

- The average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50% (IRC Sec. 1297(a)(2).

The PFIC taxes do not apply to a U.S. taxpayer who is a 10% shareholder of a controlled foreign corporation (“CFC”) (IRC Sec. 1297(e), PLR 2009 43004). The CFC rules accomplish Congress’ anti-tax deferral objections. Since the CFC shareholder is currently taxable on their share of the CFC’s Subpart F income, it is not necessary to subject them to the PFIC tax regime.

Regarding taxation of distributions from a PFIC:

1. “Non-excess” distributions are taxed to the shareholder as a dividend taxable at ordinary income tax rates (the distribution does not qualify for the 15% tax rate on qualified foreign dividends because a PFIC is not a “qualified foreign corporation (IRC Sec. 1(h) (11)(C)(iii)).

2. “Excess distributions” are taxed at ordinary income rates (not subject to the favorable qualified foreign dividend tax rates), for the current tax year and pre-PFIC tax years, with the portion of the excess distribution allocated to other years in the taxpayer’s holding period (the “PFIC years”) subject to deferred tax and interest as separate line items on their individual income tax return (IRC Sec. 1291(a)(1)(c).

Current Tax Issues: U.S. Hedge Funds and Offshore Reinsurers

In Zachary Mider’s excellent article: “Hedge Fund Execs Beach their Tax Bills” (Bloomberg Business Week, Feb. 25-March 3, 2013 Pages: 36-37) he describes how U.S. hedge funds have launched Bermuda reinsurers to exempt hedge fund earnings from annual U.S. income taxes (no tax is paid until the hedge fund investors sell their shares in the reinsurer, creating in an indefinite tax deferral on hedge fund income, which compounds annually tax-free).

Since 2011, prominent U.S. hedge funds: Paulson & Co. (John Paulson), SAC Capital Advisors (Steve Cohen) and Third Point (Dan Loeb) have circulated billions of dollars of investment assets through Bermuda reinsurers to indefinitely defer U.S. tax on their hedge fund income. In 2012, these three hedge funds circulated a combined $1.7 billion through their Bermuda reinsurers to be reinvested through their U.S.-based hedge funds. (See Bloomberg Business Week, Feb. 25-March 3, 2013).

For example, in April 2012, top executives of billionaire hedge fund manager John Paulson's New York firm sent $450M to a reinsurance company called PaCRE they set up in a Bermuda reinsurer. By recycling this $450M through Bermuda, which has no corporate income tax, and reinvesting these funds in their U.S. hedge funds, they reduced their personal income taxes on their hedge fund earnings by indefinitely deferring their tax due.

In 2013, U.S. taxpayers who invest in hedge funds pay either: 39.6% tax rate for ordinary income on their profits, or 20% long-term capital gains rate (depending on whether the securities holding period is 12 months or less), plus an additional 3.8% tax surcharge (on net investment income) under the Affordable Care Act.

When investors circulate their money into a Bermuda-based reinsurer, which invests in the U.S. hedge funds, profits go to the reinsurer which does not owe U.S. tax on their earnings. U.S. investors defer taxes until they sell their stake in the reinsurer. Until then, the earnings compound tax-free and the tax savings increase the ultimate investment return.

Investing $100 million in a hedge fund that returns 10% annually for five years, and paying the top federal/California "blended" ordinary income tax rate (2013: 51%) on profits, creates a net after-tax return of $24,450,000 (i.e. $50M earnings less $25,500,000 tax). If a Bermuda reinsurer holds the same investment, the gain is $61,060,000 (which is the net after-tax compounded return). The projected tax savings is $36,610,000.

If the U.S. hedge fund was based in Bermuda there would be no tax advantage, since it would be taxed under the "Passive Foreign Investment Company" rules. However, for an insurance company (i.e. a reinsurer which provides insurance coverage for other insurers, not the general public) tax on these "same hedge fund earnings" would be tax-deferred.

Insurance company earnings are not subject to tax under the "PFIC" rules; instead they are not taxed, since the insurance company is an "active (not passive) business" (i.e. PFICs have "passive" not "active" income)

In a 2003 report, the IRS stated some "offshore reinsurance arrangements were shams, either because they were not selling enough insurance or because the insurance they reported selling was not insurance (i.e. it was illusory).

The IRS has apparently not challenged the claimed tax treatment for the offshore reinsurers. However, the extant issue is what qualifies an insurance company as exempt from tax as an "active" business. To qualify as an active business, the reinsurance companies can't have a pool of capital greater than what is required to capitalize the insurance they sell. The IRS has never specified the amount of capital reserve required (to sequester) to capitalize the insurance sold. The tax issue is whether the reinsurer is an actual business (i.e. an active business which sells reinsurance) or a "tax dodge" (i.e. sells nominal insurance and uses the investment capital to make "tax-deferred" hedge fund and other investments).

Whether these U.S.-hedge funds- Bermuda owned reinsurance- are an actual insurance company, or a "tax dodge" is a fact-dependent case-by-case basis. However, John Paulson's reinsurance company PaCRe is illustrative.

PaCRe [Bermuda]:

1. Has no employees;

2. Its listed legal address is actually the office of another reinsurance (to whom it outsources its underwriting);

3. From 4/12-12/12 PaCRe sold about $8M of reinsurance coverage (i.e. 1.6% of its $500 million startup capital).

4. PaCRe invested the entire $500 million in startup capital in four Paulson & Co. hedge funds. Through 12/31/12, those investments lost about $19 million in value. These losses were not passed through to their investors.

Please see the following summary of the anti-deferral tax rules:

Tax Compliance – CFC/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.

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

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.

Conclusion

For those U.S. Taxpayers who have established foreign entities, their failure to properly report income from these foreign entities, on an annual basis, or disclose their ownership of the foreign entities (or its assets) pose both civil tax fraud and criminal tax evasion penalties.

If required tax compliance filings are not timely made, the U.S. Taxpayer is in the unenviable tax position of the following risks:

1. For civil tax issues no statute of limitations for imposition of penalties, (i.e. the statute of limitations for IRS audit risk does not commence until the required tax compliance filings are reported).

2. For criminal tax issues, the failure to file the appropriate tax returns subjects the Taxpayer to multiple tax felonies for criminal tax evasion (and over 20 years in jail).

3. If the U.S. Taxpayer is found guilty of criminal tax evasion, and use the “tax cheating proceeds” (i.e. unpaid tax on foreign entity earnings) to purchase any asset (e.g. Real Estate, Stocks, Bonds, et al) accomplished by wire transfer, or mail, it may subject the U.S. Taxpayer to additional 20 year felonies (each) for: money laundering, mail fraud, and wire fraud (up to 60 years in jail total).

The U.S. Taxpayer’s predicament, committing civil tax fraud and criminal tax evasion is not excused by their “ignorance of the law” (i.e. ignorance of the law is not an excuse). Rather, they are in the position of the mythical “Mr. Jones” as expressed by Bob Dylan in his song, Ballad of a Thin Man, - “Something is happening, but you don’t know what it is, do you Mr. Jones?”

About the Author

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 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 will be publishing 2 articles:

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

2) “Offshore Hedge Funds and Reinsurance” (with 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

International Tax Evasion & Money Laundering

For more information please see website: gswlaw.com