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Foreign Affairs: A Primer on International Tax and Estate Planning (Part 2)

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INTRODUCTION

This is the second in a series of articles providing a primer on international planning for domestic estate planners and tax practitioners. This series is intended to assist domestic advisors in identifying pitfalls that may unexpectedly arise during the course of a representation and in recognizing opportunities that can be leveraged for the internationally connected client. Our first installment addressed the international tax paradigm as it applies to individuals, in particular addressing the U.S. income, estate, and gift taxation of nonresident alien individuals (NRAs) and trusts established by them or for their benefit.[1]

This second installment is intended to provide an overview of various specialized tax regimes that apply to cross-border transactions. These regimes — the special taxes imposed on U.S. expatriates, the corporate anti-deferral regimes for controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs) and the withholding tax regime applicable to foreign investment in U.S. real estate — are intended to address certain historical transactions and structures perceived as abusive or potentially abusive. Perhaps unsurprisingly, the manner in which these regimes address those perceived abuses is not always intuitive (or effective), and practitioners should proceed deliberately in planning scenarios that implicate these issues.

As important as it is to be aware of potential pitfalls, practitioners should also be aware of the value that can be added by skillfully and proactively navigating the application of these regimes. Particularly in the context of international investment, it is often the case that, absent effective structuring at the outset, foreign investors are at a competitive disadvantage to their domestic counterparts insofar as taxation is concerned. Skillful and creative planning can have the effect of placing international investors entangled with the U.S. tax system in a place of parity as compared to their domestic counterparts and, in some circumstances, can place them in an even more favorable position. Although an exhaustive discussion of the myriad structuring alternatives available to international investors is beyond the scope of this article, this installment attempts to provide some context as to why these rules exist and how they function, and to identify some of the opportunities available in cross-border transactions.

THE EXPATRIATION REGIME

U.S. expatriation is becoming an increasingly attractive option for U.S. citizens living abroad who can enjoy lower tax rates outside the United States and are confronted with an ever increasingly complex set of U.S. reporting requirements with regard to their non-U.S. holdings. In particular, the challenges presented by compliance with the Foreign Account Tax Compliance Act (FATCA) have made international banking by U.S. citizens incredibly difficult, if possible at all.[2] As a result, the past half-decade has seen record num-

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[1] *See* 42 Tax Mgmt. Est., Gifts & Tr. J. 187 (July/Aug. 2017).

[2] The third installment of this series, forthcoming, will address FATCA, CRS, and other reporting obligations applicable to inter-

bers of expatriations, with over 3,000 in 2013 (almost three times the number of 2012 expatriations), over 4,000 in each of 2014 and 2015, and a record total of 5,411 in 2016.[3]

A common misconception about U.S. expatriation is that expatriates somehow magically escape U.S. income and transfer taxation by surrendering their U.S. passports. While this would certainly simplify the decision-making process for high net worth individuals, the reality is that, since 2008, high net worth citizens and long-term residents who relinquish their U.S. citizenship or long-term resident status, known as ''covered expatriates,'' are subject to a special tax regime that can result in both an immediate income tax and continued exposure to the U.S. transfer tax system. This special regime includes: (i) a mark-to-market ''exit tax'' under §877A, which applies on expatriation (or, for certain assets, even after the individual's expatriation date), and (ii) a special succession tax under §2801 (§2801 tax). These rules require careful consideration as they may present significant obstacles to the potential U.S. expatriate.

Non-Tax Issues to Consider

Potential expatriates also face a host of non-tax issues, which include selecting a new country of citizenship, deciding whether family members will also expatriate, managing the formal expatriation process, and determining whether the expatriate will (or will be able to) come back into the United States for business or pleasure. Although beyond the scope of this article, advisors should be proactive in ensuring potential expatriates have thoroughly considered these non-tax issues prior to taking steps to relinquish their citizenship or long-term resident status.

Notable among these is a provision of immigration law known as the ''Reed Amendment.''[4] Invocation of the Reed Amendment can render a former U.S. citizen ineligible for admission to the U.S. if the Attorney General determines that the former U.S. citizen surrendered his or her citizenship for tax avoidance purposes. Although regulations were never issued to implement the Reed Amendment and significant legal barriers to its enforcement have not been addressed, government reports indicate that the Reed Amendment has been invoked twice to deny entry to U.S. expatriates.[5] What this provision makes clear is that any individual considering expatriating should retain immigration counsel in addition to (or prior to) tax counsel, so as to ensure that the expatriate does not ''win the battle'' from a tax standpoint but ''lose the war'' from a practical, non-tax standpoint.

Application of the Expatriation Taxes

The current regime governing the taxation of U.S. expatriates has been in place since the 2008 enactment of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act).[6] Under the HEART Act, certain high net worth citizens and long-term residents relinquishing their U.S. status are designated ''covered expatriates'' and subjected to special tax regimes under §877A and §2801. A practitioner's first task in advising a client considering expatriation is to determine whether the individual will be considered a ''covered expatriate,'' and then to determine whether planning is available to avoid such status. The answers to these questions will inform the U.S. income tax treatment of the soon-to-be expatriate and the potential application of the §2801 tax to beneficiaries under his or her estate plan.

Definition of 'Expatriate'

For purposes of the expatriation regime, ''expatriates'' include both individuals who relinquish their U.S. citizenship and, perhaps surprisingly, certain lawful permanent residents of the United States who terminate such status.[7] In the case of a U.S. citizen, the act of expatriation is most often accomplished by renouncing U.S. nationality before a diplomatic or consular officer.[8]

Lawful permanent residents (i.e., green card holders) are considered ''long-term residents'' (and thus

national taxpayers.

[3] Section 6039G requires the IRS to publish the full name of every expatriate in the Federal Register no more than 30 days after the close of the calendar quarter in which they expatriate. All section references are to the Internal Revenue Code of 1986, as amended (Code), and the regulations thereunder, unless otherwise specified.

[4] 8 U.S.C. §1182(a)(10)(E).

[5] U.S. Department of Homeland Security, Fiscal Year 2015 Report to Congress, Inadmissibility of Tax-Based Citizenship Renunciants (2015) (''Since 2002, two individuals who have admitted to having renounced for tax avoidance purposes were found to be inadmissible under [the Reed Amendment]''). The most significant barrier to more widespread enforcement of the Reed Amendment is the confidentiality provisions of §6103, which prohibit the IRS from providing individual tax information to the U.S. Attorney General absent a court order or other exigent circumstances.

[6] Pub. L. No. 110-245 (2008). Individuals expatriating prior to June 17, 2008, were subject to a different expatriation income tax regime under §877 and special gift tax situs rules under §2107 and §2501. As §877, §2107, and §2501 apply only to certain pre-2008 expatriates, and thus have limited applicability, they are not addressed in this article.

[7] §877A(g)(2). Status as a lawful permanent resident is determined under the rules of §7701(b)(6).

[8] The act of expatriation can also be accomplished by the individual furnishing the U.S. Department of State a signed statement of voluntary relinquishment of nationality, the issuance by the U.S. Department of State of a certificate of loss of nationality, or a U.S. court's cancellation of an individual's certificate of natural-

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potential expatriates) if they have held lawful permanent resident status in at least 8 of the 15 tax years preceding their expatriation date.[9] It is important to note that holding a green card for any portion of a calendar year counts as a full year of lawful permanent residence for purposes of the expatriation regime; thus, a person could theoretically hold a green card for as little as six years and two days and be considered a long-term resident.[10]

Termination of long-term resident status is most often achieved through the official abandonment of a U.S. green card. Notably, this does not include the mere expiration of a U.S. green card. A green card holder is also treated as having abandoned long-term resident status if he or she claims treatment as a resident of a foreign country under the provisions of a bilateral income tax treaty or otherwise fails to waive the benefits of the treaty applicable to residents of the foreign country.[11]

Because timing is an important factor in the application of the exit tax and the expatriation regime generally, the statute provides detailed rules for determining an individual's "expatriation date."[12] In the case of a U.S. citizen, the expatriation date is the date the U.S. citizen relinquishes his or her citizenship. In the case of a long-term resident, the expatriation date is generally the date the individual abandons his or her green card; however, in the case of a green card holder invoking the residency tiebreaker provision of a bilateral tax treaty, the date may be retroactive to the date the green card holder's foreign residency commences under the treaty.[13]

Definition of 'Covered Expatriate'

An expatriate is considered a covered expatriate if he or she meets either or both of the "tax liability test" or the "net worth test," or fails the "tax certification test."[14] Covered expatriates are subject to the special expatriation tax regime described below unless one of two exceptions apply.

Tax Liability Test. The tax liability test is met if the expatriate's average annual net U.S. income tax liability over the five taxable years preceding expatriation exceeds $162,000 (for calendar year 2017, adjusted annually for inflation).[15] An expatriate who files joint income tax returns with his or her spouse is required to take into account the net income tax liability reflected on the joint return, regardless of whether the tax would be attributable to the expatriate had he or she filed separately.[16]

Net Worth Test. The net worth test is met if the expatriate's net worth equals or exceeds $2 million on the expatriation date.[17] For purposes of computing the expatriate's net worth, he or she is treated as owning property if a transfer of that property would constitute a taxable gift for U.S. gift tax purposes, made without regard to exclusions from taxable gifts such as the gift tax annual exclusion or transfers for educational or medical expenses, and without regard to gift splitting, the gift tax charitable deduction or the gift tax marital deduction.[18] Gift tax valuation principles apply in ascribing value to an expatriate's property. Expatriates are permitted to use good faith estimates in reporting their net worth. Formal appraisals are not technically required, though best practice may be to obtain them.[19]

A covered expatriate's beneficial interest in a trust is included in the net worth test computation and is valued using a two-step process. First, property held by the trust is allocated to trust beneficiaries based on all relevant facts and circumstances, including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust fiduciary or advisor. Trust property that cannot be allocated based on these factors is allocated to trust beneficiaries under the principles of intestate succession.[20] Second, trust property allocable to the expatriate is valued using U.S. gift tax principles. This is a somewhat imprecise process that requires exercising a degree of judgment, and may provide some flexibility for creative practitioners planning for a potential future expatriation.

Tax Certification Test. Even an individual who does not meet the tax liability test or the net worth test will be treated as a covered expatriate if he or she fails to certify under penalties of perjury and, if requested, substantiate that he or she has satisfied all outstanding

ization. §877A(g)(4).

[9] §877A(g)(5).

[10] In other words, issuance of a green card on December 31st of year one, continuation of such status in years two through seven, and relinquishment of such status on January 1st of year eight would result in possible exposure to the expatriation regime. *See* §877A(g)(5), §877(e)(2).

[11] §7701(b)(6).

[12] §877A(g)(3).

[13] *See* Notice 2009-85, 2009-45 I.R.B. 598 (cessation of lawful permanent resident status occurs when individual's foreign residence commences for treaty purposes, and not on date notice is provided to IRS).

[14] §877A(g)(1)(A).

[15] §877A(g)(1)(A), §877(a)(2)(A); Rev. Proc. 2016-55, 2016-45 I.R.B. 707 (providing adjusted amount for 2017).

[16] *See* Notice 97-19, 1997-1 C.B. 394.

[17] §877A(g)(1)(A), §877(a)(2)(B).

[18] *See* Notice 97-19.

[19] *Id.*

[20] *Id.* The intestacy rules applied are those contained in the Uniform Probate Code, and they are applied by reference to the trust settlor's hypothetical intestacy.

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U.S. tax obligations for the five taxable years preceding expatriation. This certification should be made by every expatriate by filing IRS Form 8854 by the due date of the expatriate's U.S. income tax return for the taxable year that includes the day before his or her expatriation date.[21] Given that the IRS Form 8854 is filed under penalties of perjury, some individuals may need to complete a voluntary disclosure process to remedy historical tax filing irregularities or omissions prior to expatriating and filing the tax certification.

Exceptions. An expatriate who meets one of the tests above can nonetheless avoid status as a covered expatriate under one of two exceptions.[22] The first exception applies to an expatriate who (i) became at birth a citizen of the United States and another country (i.e., a dual citizen), (ii) at the time of expatriation is taxed as a resident of such other country, and (iii) has been a U.S. resident for not more than 10 of the 15 taxable years ending on the expatriation date. The second exception applies to an expatriate who relinquishes U.S. citizenship before attaining age 18½ and who has been a U.S. resident for not more than 10 years before the date of relinquishment.[23]

The Exit Tax

Covered expatriates are subject to a mark-to-market exit tax under §877A that treats the covered expatriate as having sold his or her property for fair market value as of the day before his or her expatriation date.[24] The only exclusions from the exit tax are certain deferred compensation items, specified deferred accounts and interests in ''non-grantor trusts,''[25] which are subject to special tax rules described below.[26] Net gain or loss that would be realized on the hypothetical sale is required to be recognized, notwithstanding the non-recognition provisions of the Code, and a corresponding adjustment to the U.S. tax basis of such property results. To the extent the net gain recognized exceeds an exclusion amount ($699,000 for 2017, adjusted annually for inflation), the covered expatriate is required to pay tax at generally applicable marginal rates based on the applicable character and holding period.

The Exit Tax Base

Although the Code notes only that ''all property'' of a covered expatriate is subject to the exit tax, guidance from the IRS clarifies that a covered expatriate is treated as owning (and is thus subject to the exit tax on) any interest in property that would be includible in his or her gross estate had he or she died the day before his or her expatriation date.[27] Practitioners should keep in mind that determinations with respect to the exit tax are made under U.S. *estate tax* rules, and will not always align with the determinations made for purposes of the net worth test, which requires the application of U.S. *gift tax* principles.

The IRS considers a covered expatriate's beneficial interest in certain trusts to be subject to the exit tax, even if such interest would not otherwise be includible in the covered expatriate's gross estate.[28] Exposure to the exit tax base is generally limited to trusts with respect to which the covered expatriate is treated as the owner under the grantor trust rules.[29] All other trusts, including trusts treated for U.S. income tax purposes as owned by someone other than the expatriate under the grantor trust rules, are deceptively called ''non-grantor trusts'' for purposes of §877A. Non-grantor trusts are excluded from the exit tax base but are subject to a special withholding tax, described below.

The exit tax contemplates coordination with other provisions of the Code that may require gain to be recognized on expatriation, and generally gives priority to these other provisions over the exit tax. For example, §684(a) requires the recognition of gain (but not loss) where the grantor of a grantor trust expatriates and causes the trust to become a foreign non-grantor trust.[30] This may occur because §672(f) limits the circumstances in which a trust may be treated as a grantor trust as to a foreign individual.[31] In such a case, gain recognized under §684 will be taken into account prior to the application of the exit tax, so the

[21] §877A(g)(1)(A), §877(a)(2)(B).

[22] §877A(g)(1)(B).

[23] For purposes of both exceptions, U.S. residence is determined under §7701(b)(1)(a)(ii) (i.e., the substantial presence test). The tests for U.S. residence are described in detail in the first installment of this series.

[24] §877A(a)(1).

[25] The term ''non-grantor'' trust in this context is a bit of a misnomer, as further explained below.

[26] §877A(c).

[27] *See* Notice 2009-85. Note that this determination does not include the application of any credits provided under §2010–§2016, inclusive.

[28] Notice 2009-85.

[29] The IRS's position is clear as to the inclusion of grantor trusts in which the covered expatriate has retained a beneficial interest. The status of grantor trusts in which the covered expatriate has not retained a beneficial interest is less clear. As the exit tax is in the nature of an income tax, it would seem to follow that such trusts should be included in their entirety. *See* Staff of the Joint Comm. on Taxation, 110th Cong., Technical Explanation of H.R. 6081, JCX-44-08 (May 20, 2008). However, this reasoning is called into question by the IRS's administrative mandate that estate tax valuation and inclusion rules be applied. *See* Notice 2009-85.

[30] *See* Notice 2009-85.

[31] Generally, §672(f) provides that a trust will not be treated as owned by a foreign individual unless the individual retains the power to revoke the trust or distributions from the trust during the individual's lifetime are limited to the individual and his or her spouse.

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gain is only taxed once.[32] Practitioners presented with this situation should consider whether any unrealized losses in the trust (which are triggered by §684(a)) can be taken into account in determining the net tax due under §877A(a)(2)(B).

Computing the Exit Tax

As noted above, assets are valued for purposes of the exit tax using general estate tax valuation rules, including the special valuation rules of §2701 through §2704 (which are applied as though all of the covered expatriate's property is transferred to family members), but excluding the deductions provided under §2055, §2056, §2056A, and §2057.[33] Accordingly, traditional valuation discounts should be permitted in computing the exit tax, including discounts for lack of marketability, lack of control, and fractional interests. Valuation planning typically undertaken in the domestic context for estate tax purposes may thus be effective in reducing the exit tax of a covered expatriate.

Once values are determined, net gain on the hypothetical sale is reduced (but not below zero) by an exclusion amount ($699,000 for 2017, adjusted annually for inflation).[34] The exclusion amount must be allocated ratably among each of the covered expatriate's assets on the basis of the amount of gain recognized.[35] This allocation is intended to prevent the covered expatriate from allocating the exclusion amount to ordinary income assets and other assets taxed at higher rates, such as collectibles. Note that the exclusion amount is a lifetime exclusion similar to that provided against the U.S. estate tax.[36] Accordingly, a second expatriation by the same individual could result in some or all of the exemption being unavailable.

Exit Tax Deferral and Timing Issue

Because the deemed gain triggered by the exit tax will not have corresponding liquidity, the expatriation regime permits deferral of the tax payment, subject to an interest charge.[37] If the covered expatriate so elects, the exit tax can be deferred on an asset-by-asset basis until the asset's actual disposition. As part of the election, the covered expatriate is required to provide ''adequate security'' for the payment of the tax, which generally means a bond or letter of credit conditioned on the payment of tax.[38] Interest on the deferred tax accrues daily at the federal underpayment rate, and the covered expatriate must irrevocably waive any treaty rights that might preclude collection of the deferred tax. In light of these somewhat burdensome requirements, many covered expatriates prefer to pay the tax and cut ties cleanly rather than elect to defer the exit tax.

In addition to liquidity, the timing of the gain recognition may pose a significant obstacle to expatriation. The exit tax causes an acceleration of gain, offending the maxim that tax later is always better than tax now. The time value of money calculations force consideration of the potential holding period in the expatriate's assets, the anticipated rate of return in those assets, and the potential tax rate that might apply if the expatriate remains in the United States and sells the assets at a later date. This is further complicated by market fluctuations that may prove unfavorable for the potential expatriate. Because the tax is triggered using values as of the day prior to expatriation, the actual day of expatriation may have a significant impact on the amount of tax, and this date (often that of a visit to a diplomatic or consular office) is challenging to control with any level of precision. This creates tax risk for potential expatriates holding volatile assets.

Timing must also be taken into consideration with foreign tax credits. The deemed U.S. tax recognition event may not correspond with a taxable event in a foreign jurisdiction where the potential expatriate may reside. If that is the case, there may be U.S. tax liability without a corresponding foreign liability giving rise to a foreign tax credit, resulting in the covered expatriate paying tax twice on the same gain without the benefit of foreign tax credit or treaty relief. Coordination with a potential expatriate's foreign tax counsel may be beneficial to determine whether recognition events can be accelerated or otherwise harmonized in a manner that mitigates double taxation.

Withholding on Non-Grantor Trust Distributions

Although excluded from the exit tax base, the assets of any non-grantor trust (which, recall, includes for these purposes any trust not treated as owned by the covered expatriate for U.S. income tax purposes) in which a covered expatriate has a beneficial interest are subject to special treatment under the expatriation regime. Under §877A(f), the trustee of any such non-

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[32] §877A(h)(3).

[33] Notice 2009-85.

[34] §877A(a)(3); Rev. Proc. 2016-55 (providing the adjusted amount for 2017).

[35] Notice 2009-85. In other words, the value of each item is multiplied by a fraction, the numerator of which is the gain recognized with respect to the item and the denominator of which is all gain recognized under §877A. If the gain recognized is less than the exclusion amount, the allocation is limited to the gain recognized.

[36] Notice 2009-85.

[37] §877A(b)(1).

[38] §877A(b)(4). Notice 2009-85 provides that other forms of security may also be accepted, but does not specify what forms are acceptable. This is meaningful because a covered expatriate lacking liquidity to cover the exit tax likely also lacks sufficient liquidity to support a bond or letter of credit.

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grantor trust is required to withhold 30% from the "taxable portion" of any direct or indirect distribution to the covered expatriate. The "taxable portion" of the distribution is that portion that would be includible in the covered expatriate's gross income had he or she continued to be a U.S. citizen or resident.[39] When property is distributed to the covered expatriate in kind, the trust is deemed to have recognized any unrealized gain as if the property had been sold to the covered expatriate.[40]

Although covered expatriates are deemed to have waived treaty rights with respect to non-grantor trust withholding under §877A(b)(4)(B), the IRS has developed a procedure for trust beneficiaries wishing to limit the trust's exposure to future U.S. tax obligations.[41] This is accomplished by the covered expatriate making an election on IRS Form 8854 to be treated as having received the value of his or her interest in the trust as of the day before his or her expatriation date. The value of the covered expatriate's interest in the trust is thus included in his or her exit tax base and subject to immediate tax. Upon receipt of a letter ruling from the IRS that the interest in trust is susceptible to valuation, the tax will be considered fully satisfied and no withholding will be required on future distributions to the covered expatriate. Treaty benefits would thereafter be available to the covered expatriate with respect to any such distribution.

Deferred Compensation and Tax-Deferred Accounts

Special rules apply to "eligible deferred compensation items" and "tax-deferred accounts." Relevant items of deferred compensation include those with respect to which the payor is a U.S. person or a foreign person who has elected to be treated as a U.S. person for purposes of withholding, and with respect to which the covered expatriate has notified the payor of his or her status and irrevocably waived applicable treaty rights.[42] Rather than being subject to the exit tax, eligible deferred compensation items are subject to a 30% withholding at the source on future payment to the covered expatriate. The withholding tax applies to any payment that would have been includible in the gross income of the covered expatriate had he or she remained a U.S. citizen or resident.

If the covered expatriate has an interest in a "tax-deferred account," meaning an individual retirement account, qualified tuition program, Coverdell education savings account, health savings account, or Archer MSA, he or she is treated as having received his or her entire interest in the account on the day before his or her expatriation date.[43] Although this will result in the acceleration of tax with respect to such accounts, early distribution taxes will not apply.

The §2801 Tax

Under the existing expatriation regime, §2801 provides for the imposition of tax on a U.S. person who is the recipient of a gift or bequest from a covered expatriate, referred to as a "covered gift" or "covered bequest." As mentioned above, §2801, contained in Chapter 15 of the Code, was enacted with §877A as part of the HEART Act,[44] effective June 17, 2008. Before the introduction of these two new sections, expatriating U.S. citizens and long-term residents where subject to a prior regime under §877, §2107, and §2501, under which they were subject to a 10-year post-expatriation tail period for the imposition of U.S. income and transfer taxes. The prior regime under §877 continues to apply the 10-year tail period with respect to those who expatriated prior to June 17, 2008.

Imposition of the §2801 Tax

Unlike the case of the U.S. estate and gift taxes, the §2801 tax is imposed on the U.S. transferee.[45] Accordingly, the transferee must determine whether the transferor is a covered expatriate and whether the transfer is a covered gift or bequest subject to the §2801 tax.[46]

The tax is imposed at the highest estate or gift tax rate in effect for the year of transfer. The tax base includes the value of the covered gift or bequest, reduced by the annual gift tax exclusion for a given year (the §2801(c) amount is determined by reference to §2503(b)). The reference to §2503(b) is only for purposes of providing a dollar amount for the annual gift exclusion in order to determine the §2801 tax, but does not incorporate the substantive rules of §2503(b).[47] The calculated tax is reduced by any estate or gift tax paid to a foreign country with regard to those transfers.[48]

There are a number of exceptions to the imposition of the §2801 tax. These include: (i) taxable gifts re-

[39] §877A(f)(2). Note that this should exempt distributions from trusts that are non-grantor trusts for exit tax purposes but are treated as owned by a third party under the grantor trust rules, as a distribution from such a trust would not have been taxable to the covered expatriate had he or she remained a U.S. citizen or resident.

[40] §877A(f)(1)(b).

[41] Notice 2009-85.

[42] §877A(d)(3).

[43] §877A(e)(1).

[44] Pub. L. No. 110–245.

[45] Prop. Reg. §28.2801-4(a)(1).

[46] Prop. Reg. §28.2801-7(a).

[47] Prop. Reg. §28.2801-4.

[48] Prop. Reg. §28.2801-4(e). There is, for example, no present interest requirement for gifts in trust to qualify for the exclusion amount under §2801(c).

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ported on a covered expatriate's timely filed gift tax return, and property included in the covered expatriate's gross estate and reported on such expatriate's timely filed estate tax return, provided that the gift or estate tax due is timely paid; (ii) qualified disclaimers of property made by a covered expatriate; and (iii) charitable donations that would qualify for the estate or gift tax charitable deduction. In addition, a gift or bequest to a U.S. citizen spouse of a covered expatriate is not considered a covered gift or bequest if it would otherwise qualify for the gift or estate tax marital deduction.[49]

On September 10, 2015, the IRS proposed regulations (further discussed below) under §2801, which have not yet been finalized. Once the regulations are finalized, the IRS will release IRS Form 708, *United States Return of Tax for Gifts and Bequests from Covered Expatriates*, as the new form to provide information on any covered gift or bequest and to compute the §2801 tax. The §2801 tax continues to be deferred until the regulations are finalized. Once the regulations are finalized, transferees of covered gifts or bequests, including domestic trusts and electing foreign trusts (as described further below), will need to pay the §2801 tax relating back to the date of the transfer.

Transfers to Trusts

In the case of a covered gift or bequest to a U.S. trust, the §2801 tax applies as if the trust were a U.S. citizen, causing the trust itself to be the taxpayer. The proposed regulations under §2801 (further discussed below) provide that a transfer into trust is treated as a covered gift or bequest to the trust, ignoring beneficial interests or the existence of general powers of appointment or withdrawal powers.[50]

If a covered gift or bequest is made to a foreign trust, the tax is not imposed at the time of such transfer, but rather it is imposed on any distribution to a U.S. beneficiary that is attributable to the covered gift or bequest. Because such distributions may be subject to both the §2801 tax and the normal income tax rules applicable to distributions from foreign trusts, a limited income tax deduction for §2801 tax paid is permitted to the extent the §2801 tax is attributable to amounts included in the gross income of the U.S. beneficiary.[51]

A foreign trust may also elect to be treated as a domestic trust solely for purposes of the §2801 tax. In such case, the §2801 tax is imposed on the electing foreign trust on its receipt of a covered gift or bequest, and not on the distribution by the trust to U.S. beneficiaries.[52] Because the election to be treated as an electing foreign trust is required to be made on IRS Form 708 (which the IRS does not intend to release until the promulgation of final regulations), and the trust must thereafter file IRS Form 708 on an annual basis, some uncertainty exists as to how current transfers to foreign trusts desiring to make the election should be handled.

With respect to distributions from foreign trusts, the proposed regulations provide for an allocation of the amount of the distribution attributable to covered gifts and bequests. This allocation is determined by multiplying the amount of the distribution by a ratio, referred to as the "§2801 ratio" determined at the time of the distribution, and which is redetermined after each contribution to the trust. The effect of this rule is that each distribution from the foreign trust consists of a ratable portion of the covered and non-covered portions of the trust.[53]

Proposed Regulations Under §2801

As mentioned above, on September 10, 2015, the IRS proposed regulations under §2801, which have not yet been finalized.[54] Although the proposed regulations leave several issues unresolved, they provide significant guidance with respect to the following:

Direct and Indirect Transfers. As the §2801 tax applies to direct and indirect transfers, the proposed regulations clarify what may constitute an indirect transfer, including:

- Acquisitions by a business association owned by a U.S. person;
- Acquisitions by an entity not subject to the §2801 tax on behalf of U.S. person;
- Transfers by a covered expatriate to satisfy the debts or liabilities of a U.S. person;
- Transfers resulting from a non-covered expatriate's power of appointment granted by a covered expatriate over property not in trust; and
- "Other transfers" not made directly by the covered expatriate to a U.S. person.

Protective Filings. The proposed regulations permit a protective filing of Form 708 once it becomes available. If the transferee reasonably concludes that a transfer is not subject to §2801, a protective Form 708 can be filed to start the period for the assessment of tax.[55] This may be an attractive safeguard for clients who have trouble determining their tax liability.

[49] Prop. Reg. §28.2801-3(c)(4).

[50] Prop. Reg. §28.2801-3(d).

[51] Prop. Reg. §28.2801-4(a)(3)(ii).

[52] §2801(e)(4)(B)(iii).

[53] Prop. Reg. §28.2801-5(c).

[54] *See* REG-112997-10, 80 Fed. Reg. 54,447 (Sept. 10, 2015).

[55] Prop. Reg. §28.2801-7(b)(2). Protective filings would be

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Information Disclosure. Under certain circumstances the IRS may be permitted, upon request, to disclose to the U.S. transferee information about the expatriate to assist the transferee in determining whether the transfer is a covered gift or bequest. The proposed regulations also provide for the issuance of further guidance and procedures for making such a request. The proposed regulations leave the process uncertain, however, and various privacy issues may inhibit the release of the information.[56]

Rebuttable Presumption of Donor's Status. In the case of a gift, the proposed regulations create a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift unless the donor authorizes the disclosure of his return or relevant information to the recipient.

Powers of Appointment. The proposed regulations apply traditional estate tax treatment of general powers of appointment when the covered expatriate is the power holder. This means an exercise or release of the general power of appointment in favor of a U.S. beneficiary is a covered gift or bequest.[57] The regulation also includes as a covered gift or bequest the exercise of a power of appointment that violates the ''Delaware tax trap.''[58] The grant of a general power of appointment by a covered expatriate to a U.S. beneficiary over non-trust property is also a covered gift or bequest.

Foreign Trusts.[59] The §2801 tax generally is imposed on a U.S. beneficiary who receives distributions from a ''non-electing foreign trust'' to the extent such distributions are attributable to covered gifts or bequests to such trust. Because a foreign trust may be funded by covered and non-covered contributions, the proposed regulations create a ''§2801 ratio'' to allocate the trust distribution between the covered and non-covered contributions to the trust.[60] If a non-electing foreign trust migrates and actually becomes a domestic trust, the now domestic trust must file Form 708 for the year of migration and pay any §2801 taxes due based on its §2801 ratio.

A foreign trust can also elect to be treated as a domestic trust.[61] Such a trust is referred to as an ''electing foreign trust.'' The election results in the immediate imposition of the §2801 tax on (1) all covered gifts or bequests to the trust that year and in future years for which the election remains effective and (2) the portion of the trust attributable to covered gifts and bequests made in prior years. The election is made on a timely filed IRS Form 708 for the calendar year in which the election is to take effect.

made in accordance with Reg. §28.6011-1(b).

[56] Prop. Reg. §28.2801-7(b)(1).

[57] Prop. Reg. §28.2801-3(e).

[58] *See* §2041(a)(3), §2514(d).

[59] *See* Prop. Reg. §28.2801-5.

[60] Prop. Reg. §28.2801-5(c)(1).

[61] Prop. Reg. §28.2801-5(d).

Planning Strategies

If covered expatriate status cannot be avoided, there may be several planning options available to mitigate the consequences of the exit tax and the future imposition of the §2801 tax.

Pre-Expatriation Gift Planning

Spousal Gifting. If one meets the net worth threshold for covered expatriate status but not the income tax liability threshold, one possible method of avoiding covered expatriate status would be to gift sufficient assets to a spouse (who must be a U.S. citizen to qualify for a gift tax marital deduction) before expatriating to drop the expatriate's net worth below the $2 million threshold. This would leave the assets within the U.S. worldwide income tax net in the hands of the U.S. spouse, but, by avoiding covered expatriate status, the expatriate could avoid the exit tax and later provide for U.S. family members without subjecting them to the §2801 tax.[62]

Importantly, if gifts are made to a spouse, the spouse would not be able to gift assets to the now expatriate without making a taxable gift, because only gifts to U.S. citizen spouses are eligible for the gift tax marital deduction. Because expatriation ends U.S. citizenship, transfers would be limited to the annual gift tax exemption for non-U.S. spouses ($149,000 in 2017) before using some of the donor spouse's lifetime gift tax exemption, or to the extent that has been exhausted, resulting in gift tax.

Grantor Trusts. If the taxpayer has previously engaged in estate planning, he or she might have established one or more grantor trusts for the benefit of a spouse and descendants. Once the taxpayer expatriates, such trusts may continue to be treated as grantor trusts only if revocable by the grantor or for the sole benefit of the grantor and the grantor's spouse. A typical domestic estate planning trust established for purposes of lifetime transfer tax planning will almost certainly not meet either of these requirements, as a revocable trust would be included in the grantor's gross estate (as likely would a trust of which the grantor is a beneficiary), and a trust only for the benefit of the grantor's spouse (but not his descendants) may not be consistent with the grantor's intentions.

[62] This section on ''Pre-Expatriation Gift Planning'' was originally published (in slightly modified form) in Angkatavanich, Stein & Haave, 875 T.M., *Wealth Planning with Hedge Fund and Private Equity Fund Interests*, at A-49-50.

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Thus, in most cases, this means that on the expatriation by the grantor, the existing estate planning trust will become a non-grantor trust, and consequently, if any non-U.S. person has any power that causes the trust to fail the control test under §7701(a)(31), the trust will become a foreign trust. This will trigger a mark-to-market tax under §684(a), resulting in deemed gain recognition on the trust's assets. In order to address this issue, the expatriate might wish to consider having any existing grantor trusts converted to non-grantor trusts prior to expatriation and relinquishing any powers that would cause the trust to fail the control test.[63]

Utilizing Unified Credit. As mentioned above, if a taxpayer is a covered expatriate, gifts and bequests to U.S. recipients will attract the §2801 tax. Accordingly, a person contemplating expatriation who would meet the test for covered expatriate status, and who desires to provide for U.S. children or other relatives, should consider using some or all of his or her remaining estate and gift tax exemption prior to expatriating. A later distribution from that trust to U.S. beneficiaries will avoid the §2801 tax.

Basis Planning. With proper planning, there are various ways to lessen the impact of the exit tax. Because the tax imposed under §877A is a mark-to-market tax based on the difference between fair market value and tax basis, the exit tax can be reduced from two directions — first, with respect to fair market value, and second, with respect to tax basis.[64] Planning opportunities might be considered through the use of partnerships or limited liability companies, including basis stripping techniques that could have the effect of building up the tax basis of a covered expatriate's assets prior to his or her expatriation date. For instance, if the potential expatriate were to contribute appreciated property to a partnership and another partner were to contribute high basis assets, a future redemption of the other partner using low basis assets could result in a reallocation of outside basis to the benefit of the potential expatriate.[65] Upon expatriation, this higher outside basis, together with applicable valuation discounts, could have the effect of mitigating the covered expatriate's exit tax exposure.

Post-Expatriation Planning

After expatriation, there are more limited options for making tax-free gifts to U.S. persons (other than gifts to a U.S. spouse or annual exclusion gifts), because of the imposition of the §2801 tax. An exception to this tax is for gifts that are subject to gift tax and reported on a timely filed gift tax return. A possible technique for transferring assets from a covered expatriate to a U.S. recipient would be for the covered expatriate to create a zeroed-out, or nearly zeroed-out, grantor retained annuity trust (GRAT). Under general gift tax principles applicable to GRATs, if the GRAT is successful, later payments to U.S. recipients should escape covered gift treatment, just as payments from a zeroed-out GRAT funded by a U.S. person escape U.S. gift tax on later payment from the GRAT. Other traditional freeze techniques, such as sales to irrevocable trusts and the use of life insurance may also be attractive options for building up a pool of funds that would not be subject to the §2801 tax when left to a U.S. beneficiary.

THE CORPORATE ANTI-DEFERRAL REGIMES GENERALLY

Our first installment concluded with an overview of the rules relevant to foreign non-grantor trusts and planning strategies to minimize the associated negative tax impacts. The rules relating to foreign non-grantor trusts represent an effort to discourage the tax-free accumulation of income to or for the benefit of U.S. taxpayers. Similarly, certain corporate anti-deferral regimes are designed to discourage the use of non-U.S. corporate entities to defer U.S. taxation, in particular with respect to passive income.

These corporate anti-deferral regimes follow two basic approaches. The controlled foreign corporation regime discourages the use of foreign corporations for tax deferral by imposing current taxation on certain types of income (in simplistic terms, the ''bad'' income subject to current taxation under this regime is anything other than active business income with unrelated parties), while the passive foreign investment company regime imposes a penalty charge on the realization of income from a foreign corporation owning primarily passive assets and/or generating primarily passive income.

CONTROLLED FOREIGN CORPORATIONS

Under the controlled foreign corporation, or CFC, regime set forth in §951 through §964, ''United States shareholders'' (defined below) of a CFC are required to include in gross income on a current basis their pro rata share of certain categories of income, referred to

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[63] This assumes the change from grantor to non-grantor status would not itself trigger any gain, as in the case in which the trust owes an outstanding promissory note to the grantor on the sale of appreciated assets. Reg. §1.1001-2(c) *Ex.* 5.

[64] *See* N. Todd Angkatavanich, James R. Brockway & Eric Fischer, *Mark-to-Market Freezes — Freeze Planning in an Estate Tax-Free Environment*, LISI Estate Planning Newsletter #2480 (Nov. 2016).

[65] This is a simplified version of what is a fairly complex transaction, requiring a thorough understanding of, among other rules, the partnership disguised sale rules.

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as ''subpart F income,'' generated by the CFC.[66] In effect, the CFC regime eliminates a United States shareholder's ability to defer U.S. taxation of passive or related party income generated in a foreign corporation controlled by the United States shareholder or other U.S. taxpayers.

In analyzing a foreign corporation for CFC issues, a practitioner must make three determinations: (i) whether any shareholder of the corporation is a United States shareholder, (ii) whether ownership by United States shareholders is sufficient to classify the corporation as a CFC, and (iii) whether the CFC has derived certain types of tainted income that can give rise to current taxation.

CFC Defined

A foreign corporation is a CFC if more than 50% of the total combined voting power or the total value of its stock is owned, directly or indirectly by attribution, by United States shareholders on any day during the taxable year.[67] However, a United States shareholder will only be subject to income tax of the CFC's subpart F income to the extent that the foreign corporation is a CFC for an uninterrupted period of 30 days or more during the taxable year.[68] In addition, gross income inclusion will only apply with respect to United States shareholders who own stock of the CFC on the last day of the tax year in which it is a CFC.[69]

For these purposes, a ''United States shareholder'' means a U.S. person who owns or is deemed to own 10% or more of the total combined voting power of all classes of voting stock.[70] Thus, in determining whether a foreign corporation is a CFC, shareholders who are U.S. persons and own less than 10% of the corporation's total combined voting power will not be taken into account. For example, a foreign corporation with 11 equal shareholders will generally not be classified as a CFC absent related party attribution. Voting power is not actually defined in the Code, but generally has been interpreted to mean the right to vote in connection with the election of directors.[71]

The CFC ownership rules take into account direct, indirect and constructive ownership of stock in a foreign corporation. Stock directly or indirectly owned by a foreign entity of which an individual is an owner is considered to be owned proportionally by its shareholders or partners.[72] In addition, stock constructively owned under the attribution rules of §318(a) is taken into account in determining whether a foreign corporation is a CFC.[73] Accordingly, in testing a foreign corporation, one must look not only to stock held directly by a U.S. person, but also stock held by other foreign corporations in which he or she is a shareholder, stock owned by certain family members, and stock owned by trusts and estate of which he or she is a beneficiary.

Consequences of CFC Status

The income taxation of United States shareholders of a CFC is determined under §951 through §956. Essentially, these rules require the United States shareholder to include in his or her gross income a pro rata share of the CFC's ''subpart F income'' on an annual basis. For these purposes, subpart F income is generally income that is not derived from the active conduct of a trade or business with unrelated persons. Subpart F income is taxed currently, even if the CFC does not making any distributions to the United States shareholder during the taxable year (i.e., subpart F income may be phantom income), and is required to be taken into account in the taxable year of the United States shareholder in which the CFC's taxable year ends.

Subpart F Income Generally

The Code defines subpart F income by reference to a number of categories, many of which are identified and expanded upon via cross reference. In short, these categories are intended to capture certain types of income that are considered movable and were thus historically the subject of perceived abuses intended to defer the recognition of income through the use of entities in tax-favored jurisdictions. Section 952(a) identifies the following categories of subpart F income:

- insurance income;
- foreign base company income (the most relevant category for most estate planners);
- ''international boycott income'';
- illegal bribes, kickbacks, or other payments paid by or on behalf of the CFC, directly or indirectly, to government officials; and

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[66] §951(a)(1).

[67] §957(a)(1), §957(a)(2).

[68] §951(a)(1).

[69] §951(a).

[70] §951(b). It should be noted that, under §958(b), the constructive ownership rules under §318(a), with certain modifications, generally apply in making this determination.

[71] *Hermes Consol., Inc. v. United States*, 14 Cl. Ct. 398 (1988); *Ach v. Commissioner*, 358 F.2d 342 (6th Cir. 1966); *Jupiter Corp. v. United States*, 2 Cl. Ct. 58 (1983). Reg. §1.957-(1)(b)(2) generally provides that if the IRS determines that voting power that has been nominally shifted from a U.S. shareholder, but the U.S. shareholder has in reality retained such voting power, such arrangement will not be given effect if entered into to avoid CFC status.

[72] §958(a)(2).

[73] §951(a)(1), §951(a)(2), §958(b).

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- income derived from certain blacklisted countries.

Foreign Base Company Income

From a practical perspective, the primary type of subpart F income encountered in cross-border estate planning matters is "foreign base company income."[74] Foreign base company income includes:

- foreign base company sales income, which is essentially income derived from transactions in personal property with a related person, where the personal property is neither produced in nor sold for use in the country where the CFC is created;[75]
- foreign base company services income, which is essentially income derived from certain types of services performed on or behalf of a related person and outside the country where the CFC is created;[76]
- foreign base company oil-related income;[77] and
- foreign personal holding company income (FPHCI), which captures most passive-type income. More specifically, FPHCI includes:
  - dividends;
  - interest;
  - royalties that are not derived in the active trade or business;
  - rents that are not derived in the active trade or business;
  - annuities;
  - gains from property transactions (except business property or inventory);
  - gains from commodities transactions;
  - foreign currency gains; and
  - income equivalent to interest.[78]

In determining foreign base company income generally, such income is reduced by properly allocable deductions.[79] In making this computation, a "de minimis rule" applies so that no part of the gross income is treated as foreign base company income or insurance income if the sum of such income is less than the lesser of (1) 5% of the CFC's gross income, or (2) $1,000,000.[80] On the other hand, if a CFC's foreign base company income and insurance income exceeds 70% of the CFC's gross income, then the entire gross income for the year is treated as foreign base company income or insurance income.[81]

Exceptions to Subpart F Income

The Code also provides a number of exceptions to the broad and inclusive categories of subpart F income. Income falling into one of these exceptions will not be considered subpart F income and, thus, will not be includible in the gross income of United States shareholders on a current basis. These exceptions include the following:

- items of income constituting income effectively connected with a U.S. trade or business are not considered subpart F income;[82]
- subpart F income is limited to the amount of the CFC's current earnings and profits (this exception is intended to mirror the treatment of corporate distributions, which are generally treated as dividends to the extent of the corporation's undistributed earnings and profits);[83]
- items of income taxed at more than 90% of the highest rate imposed under U.S. law are not considered foreign base company income;[84] and
- a look-through rule excludes from subpart F income certain items of income attributable or properly allocable to a related corporation generating income that would not independently qualify as subpart F income.[85]

Post-Mortem Planning with CFCs

Where a foreign individual dies holding a significant interest in a foreign corporation, which interest is intended to pass to U.S. taxpayers (or in some cases to a trust for their benefit), consideration should be given to whether to take steps to avoid the corporation's classification as a CFC. As noted above, a United States shareholder is only subject to taxation under subpart F to the extent he or she owns CFC shares for 30 days or more during the taxable year. Accordingly, either the executor of the foreign decedent's estate or the beneficiaries themselves may wish to take steps to quickly liquidate the corporation before the interest has been held for 30 days.

In the alternative, if the corporation is an eligible entity, it may wish to make a check-the-box election to be treated as a partnership or disregarded entity for U.S. tax purposes. This election can typically be made

[74] §954(a).
[75] §954(a)(2).
[76] §954(a)(3).
[77] §954(a)(5).
[78] §954(c)(1).
[79] §954(b)(5).
[80] §954(b)(3)(A).
[81] §954(b)(3)(B).
[82] §952(b).
[83] §952(c).
[84] §954(b)(4).
[85] §954(c)(6).

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retroactive within 75 days of filing. Accordingly, making such an election effective the day before the decedent's death may be an effective tool for achieving a basis step-up with respect to foreign situs assets.

However, care should be taken prior to filing such an election to ensure that the corporation does not own U.S.-situs assets, as these assets could potentially be subject to U.S. estate tax if a retroactive election is made. If U.S.-situs assets are present, the election could perhaps be made retroactive as of the day after the decedent's death so as to protect the decedent's estate from U.S. estate tax exposure while simultaneously managing CFC status, although this would also trigger a deemed liquidation of the corporation, potentially triggering gain on appreciated assets.[86]

PASSIVE FOREIGN INVESTMENT COMPANIES

Of particular concern to portfolio investors is the second corporate anti-deferral regime, which applies to passive foreign investment companies (PFICs). When a foreign corporation invests primarily in passive assets, it may be categorized as a PFIC. U.S. persons (or foreign persons becoming U.S. persons during the relevant holding period) who own interests in the corporation are subject to a regime designed to discourage offshore income deferral through the imposition of draconian tax and reporting obligations. Because many foreign investment funds will qualify as PFICs, and because failure to account adequately for PFIC status can result in disastrous tax consequences, particular attention is required when advising international portfolio investors.

Identifying PFICs

As an initial matter, one must identify whether an entity is a PFIC. The basic test for determining PFIC status is fairly simple — any foreign corporation that satisfies either of two disjunctive tests is classified as a PFIC:

- the income test[87] — a foreign corporation is a PFIC if 75% or more of the gross income of such corporation for the taxable year is passive income, or
- the asset test[88] — a foreign corporation is a PFIC if at least 50% of the average value of its assets during the taxable year are of a type that ordinarily produce passive income.

[86] Reg. §301.7701-3(g).

[87] §1297(a)(1).

[88] §1297(a)(2).

For these purposes, passive income generally has the same meaning as ''foreign personal holding company income,'' discussed above. In broad terms, this means passive investment returns — dividends, interest, royalties, rents, and annuities, as well as gain from the sale of assets that produce these types of income, or do not produce income at all. One noteworthy consideration in applying these tests, even in a high-level review, is that a ''look-through'' rule applies in the case of corporations at least 25%-owned by the potential PFIC.[89] Thus, for purposes of the PFIC tests, you count a proportionate amount of the income and assets of any corporation that is at least 25%-owned by value.

As a practical matter, this means that virtually all non-U.S. collective investment vehicles, such as foreign mutual funds and foreign investment funds, will be PFICs. This can be a trap for the unwary, as even some publicly traded mutual funds qualify as PFICs for U.S. tax purposes. Unlike the CFC rules, the PFIC rules are indifferent to the size of a shareholder's interest in the corporation, meaning that even investors with small interests in foreign mutual funds and investment funds can be subject to the PFIC regime.

In addition, the definition of passive income and passive assets for these purposes can produce surprising results. For example, the rules do not provide an exception for working capital. As a result, even genuine operating businesses can be classified as PFICs in certain circumstances, particularly with respect to service businesses and businesses in the start-up phase.[90] As another example, businesses in the real estate industry can be particularly susceptible to classification as PFICs, because rent is classified as passive unless it is associated with an exceptionally high level of services.[91] Effectively, short of running a hotel-like property, a real-estate focused business is highly susceptible to classification as a PFIC.

Although the PFIC rules contain a number of traps for the unwary, in the sense that the literal application of the PFIC rules can produce a result that is contrary to their apparent policy objective, there are also some industry-specific exceptions whereby a foreign corporation that might otherwise satisfy the technical qualifications of being a PFIC nonetheless will not be treated as such. In effect, these exceptions acknowl-

[89] §1297(c).

[90] In this regard it should be noted that an exception exists for PFIC start-ups under §1298(b)(2), provided that the corporation can demonstrate that it is not likely to be a PFIC for either of the next two years.

[91] Reg. §1.954-2(c) generally provides that rents are considered passive unless the lessor, through its officers or employees, regularly performs active and substantial management and operational functions while the property is leased.

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edge that in certain industries, such as banking and insurance, passive assets are a necessary component to the activities of the operating business.

Passive vs. Active Income

For purposes of the asset and income tests, passive income is defined by reference to §954(c) as foreign personal holding company income (FPHCI). This includes dividends, interest, royalties that are not derived in active business, rents that are not derived in active business, annuities, gains from the sale of property, gains from commodities transactions, foreign currency gains, and income equivalent to interest.[92] Certain exceptions to FPHCI exist with respect to rents and royalties derived in the active conduct of a trade or business, and which are received from a person other than a related person.[93]

In particular, uncertainty may often arise with respect to rental income, and whether or not such income is considered to be derived from an active business. Rents are considered to be derived in the active conduct of a trade or business only if they fall within one of four categories, the most common of which relates to rents arising from the ''active and substantial management and operational functions'' of the corporation's officers or employees.[94] Although there is no quantitative test to determine what constitutes ''active and substantial management and operational functions,'' guidance from the IRS and case law indicate that a landlord who acts as rental agent and employs a staff to perform maintenance functions with respect to rental property qualifies for the exception.[95] Conversely, an ''absentee landlord'' who merely selects tenants, pays for taxes and insurance, and collects rent, or a landlord who delegates *all* leasing and management functions to a third-party management company, would not qualify for the exception.[96]

In addition to the regulations, courts have developed what has been called the ''Rafferty approach,'' based on the approach taken in the U.S. Court of Appeals for the First Circuit decision in *Rafferty v. Commissioner*.[97] In *Rafferty*, the First Circuit determined that the appropriate test was whether a company's entrepreneurial activities qualitatively and quantitatively distinguish its corporate operations from a passive investment. Stated simply, the Rafferty approach looks to whether a taxpayer's activity is ''almost indistinguishable'' from an investment in securities. In the rental real estate context, the court noted that a passive investment in rental real estate involves ''merely collecting rent, paying taxes, and keeping separate books.'' A greater level of activity constitutes the active and substantial management of leased property. This approach is in accord with the analysis in IRS revenue rulings.[98] Despite its age, the *Rafferty* approach remains good law and has been cited in several more recent Tax Court cases.[99]

Consequences of PFIC Classification

PFIC shareholders are subject to a special tax and reporting regime. While PFIC status is technically determined on a year-over-year basis, a rule known as the ''once a PFIC, always a PFIC'' rule provides that, if a foreign corporation is a PFIC at any time during

[92] §954(c).

[93] §954(c)(2)(A).

[94] Reg. §1.954-2(c) states the following four situations for rents to be derived in the active conduct of a trade or business of leasing: (1) property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind; (2) real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased; (3) personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or (4) property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

[95] *See* Reg. §4.954-2(c)(3) *Ex.* 4.

[96] PLR 8305036; Rev. Rul. 73-236. The IRS has noted in PLR 8406059 and PLR 8509042 that it is ''not inconsistent'' to apply the tests under §954(c)(2)(A), §355(b), and §367(a) (all of which use the language ''active and substantial management and operational functions'') interchangeably.

[97] 452 F.2d 767 (1st Cir. 1971). In GCM 37968, the IRS noted that ''355(b) issues will be resolved in accordance with the Rafferty approach.''

[98] *See, e.g.,* Rev. Rul 73-237, 1973-1 C.B. 184 (corporate employees who submitted bids, entered into contracts, purchased equipment, and supervised work of independent contractors were engaged in performance of active and substantial management functions); Rev. Rul. 92-17, 1992-1 C.B. 142 (corporation that was responsible for substantial decisions relating to rental real estate, regularly participated in supervision of rental properties, and directed and controlled third parties in day-to-day operation of its rental business was engaged in substantial management functions; IRS considered whether activities of company were considered to be active where company (i) was responsible for substantial decisions regarding capital improvements to its rental real estate, (ii) regularly participated in supervision of rental properties, and (iii) oversaw work of third parties performing routine maintenance and repairs to property; IRS decided company *was* regularly performing active and substantial management and operational functions.).

[99] *See, e.g., Pulliam v. Commissioner*, T.C. Memo 1997-274; *Bowater Inc. v. Commissioner*, T.C. Memo 1995-164.

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the holding period of a shareholder, the corporation will always be treated as a PFIC with respect to that shareholder, even if it subsequently ceases to meet either the income test or the asset test.[100] This PFIC taint will generally continue until the shareholder disposes of his or her stock or until he or she makes one of several elections available to purge the PFIC taint.

From a reporting perspective, a U.S. person is generally required to file IRS Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, in any year that the taxpayer is a direct or indirect shareholder of a PFIC. From a tax perspective, the consequences of owning a direct or indirect interest in a PFIC depend primarily on whether the taxpayer accepts the ''default'' regime for PFIC taxation, or whether the taxpayer makes one of the special elections that are available for PFIC shareholders.

Default Method

The default method for PFIC taxation is conceptually similar to the foreign non-grantor trust regime, and indeed was modelled on the same rules. These rules apply when a U.S. taxpayer recognizes income from a PFIC holding, either through a PFIC distribution or through the sale or disposition of PFIC stock. Whenever such income is recognized, a punitive tax regime applies under §1291, which is intended to punish the deferral of taxation on accumulated investment returns. Note that this approach stands in direct contrast to the CFC rules, which seek to curb offshore deferral by simply taxing phantom income on a current basis.

Under the default method, a punitive tax regime applies to that portion of income from a PFIC distribution or disposition identified as an ''excess distribution.'' An excess distribution is the sum of (i) that portion of dividends received by a U.S. shareholder that exceeds (determined on a per share basis) 125% of the average dividends received during the preceding three years, and (ii) any gain realized on the sale or other disposition of PFIC stock.[101] For these purposes, an excess distribution does not include dividends received in the first year of the U.S. shareholder's holding period because, by definition, this cannot be an excess distribution.[102] A regular or non-excess distribution is simply included in the U.S. shareholder's income for that year.

Excess distributions are generally subject to tax as ordinary income and, in addition, are subject to a punitive interest charge. The taxation of an excess distribution is calculated according to the following procedure: (i) the excess distribution is pro-rated evenly over the taxpayer's post-1986 PFIC holding period;[103] (ii) the portion of the excess distribution allocated to prior years is subject to U.S. income tax at the highest ordinary rate for such years;[104] and (iii) amounts allocated to years within the post-1986 PFIC holding period are taxed as ordinary income and are subjected to an interest charge, applying the compounded statutory rate under §6621, calculated as if the tax had been imposed in such years and assuming that the taxpayer had failed to pay the tax until the year in which the excess distribution or sale occurs.[105] The sum of the tax on the portion of the excess distribution allocated to prior years, and the interest thereon, is referred to as a ''deferred tax amount,'' and represents the total additional tax owed by the U.S. shareholder for the year in which the excess distribution was received.[106]

Elimination of Basis Step-Up at Death

Under the PFIC rules, on the death of a U.S. shareholder of a PFIC, the stepped up basis that would typically be obtained under §1014 is effectively eliminated, unless the decedent was a nonresident alien at all times during his or her PFIC holding period.[107] This rule is of obvious import in the estate planning context. Note, however, that the basis step-up generally is lost only to PFIC shareholders using the default method, and not to shareholders of PFICs that have made an election to be treated as a qualified electing fund.

Qualified Electing Fund Election

A U.S. shareholder of a PFIC can avoid the application of the excess distribution regime by making an election to treat the PFIC as a ''qualified electing fund'' (QEF), which effectively treats the PFIC as tax transparent and subjects the shareholder to current taxation on his or her share of PFIC earnings.[108] The benefit of making a QEF election is that, although the PFIC shareholder will be subject to current income taxation on his or her share of PFIC earnings, the election enables long-term capital gains to retain their

[100] §1298(b)(1).

[101] §1291(a)(2), §1291(b)(2).

[102] §1291(b)(2)(B).

[103] §1291(a)(1)(A). Note that the taxpayer's holding period for these purposes includes only years after 1986, when the PFIC regime was enacted. The portion of the excess distribution allocated to the current year, or to pre-1987 years, is included in the U.S. shareholder's income for such year under ''normal'' tax rules.

[104] §1291(a)(1)(B).

[105] §1291(a)(1)(C).

[106] §1291(c).

[107] §1291(e).

[108] §1295(b).

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character and avoids the draconian interest charge imposed under the default method.[109]

A QEF election applies only with respect to the PFIC shareholder making the election, and it is possible that it may apply with respect to some shareholders but not others. Importantly, such an election can only be made if the PFIC agrees to provide its shareholder with the information needed to determine his or her pro rata share of the PFICs ordinary earnings and net capital gain.[110] It should be noted that many foreign investment funds will refuse to take on the obligation to provide such information and, as a result, a QEF election is not possible in some circumstances.

While the effect of a QEF election is to tax the QEF shareholder on a current basis, without regard to whether the QEF makes distributions, further election can be made whereby the electing shareholder can defer the time for payment of income tax liability on undistributed QEF earnings.[111] As one might anticipate, the election to defer QEF taxes carries a cost, and the deferring shareholder must pay interest on the deferred amount at the time the tax is paid. The deferral election occurs until the occurrence of a terminating event, which can include the receipt of QEF distributions, a transfer of QEF stock or termination of QEF status.

A final election available to QEF shareholders is a so-called ''purging election.'' Because exposure to the excess distribution regime is determined on a year-over-year basis, a PFIC shareholder that makes a QEF election several years into his or her holding period may nonetheless still be subject to the default method with respect to non-QEF years (such a QEF is sometimes called an ''unpedigreed QEF''). The effect of the purging election is to trigger a deemed sale or deemed dividend with respect to the unpedigreed portion of the PFIC stock and, accordingly, to pay tax and interest under the default method for years preceding the QEF election.[112] A QEF for which an election has been made, or a QEF that has been a QEF since inception, is sometimes called a ''pedigreed QEF.''

Mark-to-Market Election

The second alternative to avoid the potentially harsh consequences of the default method is to make a so-called mark-to-market election under §1296. The mark-to-market election is only available if the stock of a PFIC is marketable.[113] In such a case, the U.S. shareholder can elect to mark the stock to market at the end of each taxable year, and the U.S. shareholder is required to recognize as ordinary income the gains for the taxable year.[114] Because there is no income deferral achieved, an electing shareholder is not subject to the interest charge imposed under the default method. Upon the disposition of PFIC stock for which a mark-to-market election has been made, any gain on the disposition is taxed as ordinary income, and any loss on such disposition is treated as an ordinary loss.[115]

Attribution Rules

Ownership of PFIC stock by one or more layers of partnerships, trusts, estates, and other PFICs is attributed successively and proportionately to their partners, beneficiaries, and shareholders. Such ownership of a PFIC by a nonPFIC corporation is attributed proportionately only if such corporation is at least 50% in value owned by any shareholder and only to such shareholder.

PFIC/CFC Overlap

A U.S. taxpayer's interest in a foreign corporation may be simultaneously classified as an interest in a PFIC and as an interest in a CFC. In such cases, the CFC rules essentially ''trump'' the PFIC rules, such that a foreign corporation will not be considered a PFIC with respect to any U.S. shareholders of a CFC.[116]

In effect, the tax attributes of the stock will be determined under the CFC rules with respect to the ''qualified portion'' of such person's holding period of the stock in the foreign corporation — essentially the U.S. shareholder's post-December 31, 1997, holding period.[117] Of course, because a foreign corporation is only considered a CFC with respect to a U.S. shareholder, to the extent that the U.S. person owns less than 10% of the voting shares of the corporation (including direct, indirect, and constructive ownership), the CFC-PFIC trumping rule will not apply.[118]

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[109] §1293(a)(1).

[110] §1295(a)(2), §1293.

[111] §1294(a).

[112] §1291(d)(2).

[113] The term ''marketable stock'' generally refers to any stock which is regularly traded on a national securities exchange and is registered with the SEC, or any other exchange which has similar rules. §1296(e)(1).

[114] §1296(a).

[115] §1296(c)(1)(A), §1296(c)(1)(B).

[116] §1297(d)(1).

[117] §1297(d)(2).

[118] A new holding period begins when a U.S. shareholder of a CFC ceases to own at least 10% of the foreign corporation's voting power. §1297(d)(3).

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INBOUND INVESTMENTS IN U.S. REAL ESTATE

As discussed in the first installment of this series, NRAs are generally subject to U.S. federal income tax only on specified categories of U.S.-source income and gains: First, income that is (or is deemed to be) effectively connected with the conduct of a U.S. trade or business (ECI); and second, certain U.S.-source investment income, including dividends, royalties, rents, and similar property (FDAP). ECI is taxed on a net basis at the same graduated rates applicable to a resident U.S. taxpayer. FDAP is generally subject to a flat 30% withholding at the source on a gross basis, subject to reduction by treaty.

The source of income from capital gains is generally determined under a residence-of-the-seller rule. Under this rule, capital gains recognized by a U.S. resident have U.S. source, and capital gains recognized by an NRA have foreign source. Thus, capital gains recognized by an NRA generally are not subject to U.S. federal income tax.[119] However, the application of this exclusion to foreign investment in U.S. real estate was viewed by many as an end-run around the U.S. tax system.[120]

Accordingly, in 1980, Congress enacted a special set of rules under the Foreign Investment in Real Property Tax Act (FIRPTA), which added §897, §1445, and §6039C to the Code.[121] Under these rules, any gain directly or indirectly derived from the sale or other disposition of a ''U.S. real property interest'' (USRPI) by an NRA is taxable in the same manner as if derived by the NRA in the active conduct of a U.S. trade or business, and is therefore subject to U.S. federal income tax regardless of whether a U.S. trade or business actually exists.[122]

Enforcement of this rule is supported by a withholding obligation on the purchaser of a USRPI from an NRA.[123] The purchaser of a USRPI is required to withhold and remit to the IRS an amount equal to 15% of the gross sale proceeds, subject to certain exemptions.[124] Any amount withheld is credited on the NRA seller's U.S. income tax return and may be refunded if the withholding exceeds the NRA's net tax liability.

In determining whether the FIRPTA withholding rule applies to a particular transaction, a two-part analysis must be undertaken: First, one must determine whether a NRA owns a USRPI; and, second, one must determine whether a ''disposition'' of the USRPI has occurred.

What Is a USRPI?

A USRPI is generally a direct interest in real property located in the United States or the U.S. Virgin Islands, an interest in a U.S. corporation classified as a ''United States Real Property Holding Company'' (USRPHC), or an interest in a partnership, the assets of which consist primarily of U.S. real property.[125] For these purposes, relevant ownership interests in U.S. real property include traditional fee interests, leases, time-sharing interests, life estates, remainders, reversions, and certain mineral and mining rights.[126] More exotic interests connected with U.S. real property may also be considered USRPIs depending on the facts and circumstances, including deferred payment obligations, commissions, derivative instruments, options, rights of first refusal, and stock appreciation rights.[127] Note that interests held solely as a creditor (i.e., ''straight debt'' interests) are generally not considered interests in U.S. real property for FIRPTA purposes.[128]

U.S. Real Property Holding Corporations

Stock in a USRPHC is generally considered an interest in U.S. real property and, as such, the disposition of such stock is generally subject to U.S. federal income tax and FIRPTA withholding. A U.S. corporation is a USRPHC if the value of its interests in U.S. real property equal or exceed 50% of the sum of the fair market value of the corporation's interests in U.S.

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[119] Different rules apply in certain circumstances, such as for depreciable personal property, intangibles, and capital gains derived in the conduct of a U.S. trade or business. In addition, in certain cases sales by a NRA are treated as having a source in the United States. §871(a)(2).

[120] H.R. Rep. No. 96-1167 (1980).

[121] *See* Pub. L. No. 96-499, tit. XI, subtit. C. For a more exhaustive discussion of the various facets of tax planning for inbound real estate investment, see Caballero, Feese & Plowgian, 912 T.M., *U.S. Taxation of Foreign Investment in U.S. Real Estate*.

[122] §897(a)(1).

[123] §1445(a).

[124] *Id.* Note that, for dispositions made on or before February 16, 2016, the applicable FIRPTA withholding rate was 10%. This rate was adjusted upwards from 10% to 15% for dispositions after February 16, 2016, pursuant to the Protecting Americans from Tax Hikes Act of 2015, Pub. L. No. 114-113.

[125] §897(c)(1)(A)(i), §897(g).

[126] Reg. §1.897-1(d)(2)(ii).

[127] Reg. §1.897-1(d)(2), §1.897-1(d)(3).

[128] Reg. §1.897-1(c)(i). Interests held solely as a creditor may include, for example, mortgage interests with respect to U.S. real estate or security interests on the stock of a USRPHC. Reg. §1.897-1(d)(2)(ii), §1.897-1(d)(2)(iii). Interests are not considered straight debt, and may thus be considered USRPIs, if they include rights ''to share in the appreciation in the value of, or in the gross or net proceeds or profits generated by, the real property.'' Reg. §1.897-1(d)(2).

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and non-U.S. real property and any other assets held by the corporation for use in a trade or business.[129] To prevent corporations from shifting assets in anticipation of a foreign shareholder's sale of stock so as to preclude USRPHC status, the testing period used to determine such status is the shorter of the holding period of a foreign person's stock, and the five years immediately preceding the foreign person's sale of such stock.[130]

Even if a domestic corporation satisfies the test above, it may nonetheless escape USRPHC status through one of three exceptions. First, under the so-called ''purge exception,'' a U.S. corporation can escape USRPHC status if it has disposed of all of its USRPIs in taxable transactions and has not subsequently reacquired USRPIs.[131] Next, a domestic corporation that is regularly traded on an established securities market is not considered a USRPHC provided that an NRA does not own more than 5% of all such stock during the testing period. Finally, a domestic corporation will not be considered a USRPHC if (i) an NRA owns some or all of a non-regularly traded class of stock in the corporation, and (ii) the NRA's interest in such stock does not exceed 5% of the value of a class of stock in the same corporation that is regularly traded on an established securities market.

Partnership Interests

FIRPTA generally adopts the entity theory of partnerships and, accordingly, an interest in a partnership may also be considered a USRPI.[132] An NRA's partnership interest is considered a USRPI if: (i) 50% or more of the partnership's gross assets, whether held directly or indirectly, are USRPIs; and (ii) 90% or more of the partnership's gross assets, whether held directly or indirectly, consist of USRPIs, cash, or cash equivalents.[133] This is commonly known as the ''50/90 test.''

Under §897(g), an NRA's disposition of an interest in a partnership satisfying the 50/90 test will be treated as a disposition of a USRPI only to the extent the gain on disposition is attributable to U.S. real estate, and not to the extent the gain on disposition is attributable to other assets. However, FIRPTA withholding may nonetheless be required on the full amount realized.[134]

What Is a Disposition of a USRPI?

Assuming the interest in question is a USRPI under one of the tests above, the transferee of such an interest is obligated to withhold and remit to the IRS a portion of the gross proceeds of the transaction if the transferor is a foreign person. Accordingly, the next step in determining whether the FIRPTA withholding obligation applies involves determining whether a sale or other disposition by a foreign person has occurred. This analysis is straightforward in the case of a direct sale of U.S. real estate, but is more complicated in the case of a real estate holding structure involving one or more entities.

Dispositions Generally

The regulations under §897 define the term ''disposition'' broadly. Generally speaking, any transfer that would be considered a disposition for any tax purpose (including, in certain circumstances, non-recognition transactions) could be considered a disposition for FIRPTA purposes. Thus, FIRPTA may be triggered in connection with actions like foreclosures, involuntary conversions, corporate mergers and liquidations, transfers or shifts in interests in trusts, estates or partnerships, and gifts of property with liabilities in excess of basis.[135] As noted above, a disposition can occur not only with respect to direct interests in U.S. real property, but also with respect to interests in USRPHCs and partnerships satisfying the 50/90 test.

The broad definition of a ''disposition'' means that a transaction could potentially trigger a FIRPTA withholding obligation without a corresponding liquidity event. Because FIRPTA withholding is calculated on the basis of gross proceeds (rather than net gain), the amount due can be quite substantial. Particularly in the context of related party transactions, care must be taken to carefully monitor the technical aspects of a transaction to ensure that an unintended and unexpected tax and withholding obligation does not arise. In short, any ''restructuring'' of a NRA's U.S. real estate holding structure should not be undertaken without careful consideration of the FIRPTA implications.

Dispositions by Domestic Corporations

Corporations are subject to special and sometimes counterintuitive rules under FIRPTA. These rules will generally supersede the terms of a bilateral income tax treaty, and will sometimes contradict the general non-recognition rules of the Code.

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[129] §897(c)(2). In applying the 50% test, assets are valued at fair market value. This presumably permits the application of available valuation discounts, and corporations near the 50% limit could potentially avoid status as a USRPHC with creative valuation planning. Reg. §1.897-1(o)(2).

[130] §897(c)(1)(A)(ii).

[131] §897(c)(1)(B).

[132] Reg. §1.897-9T(c). Note that this also means that a foreign partnership is treated as an NRA for FIRPTA purposes and, thus, its disposition of a USRPI may give rise to a FIRPTA withholding obligation.

[133] Reg. §1.897-7T.

[134] *See* §1445(e)(5); Reg. §1.1445-11T.

[135] Reg. §1.897-1(g).

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For a domestic corporation classified as a USRPHC, certain distributions to a NRA shareholder may be considered dispositions of a USRPI, whether or not consisting of interests in U.S. real property or other corporate assets. Relevant distributions include redemptions of stock from an NRA, liquidating distributions to an NRA and certain returns of capital to an NRA.[136] Note, however, that dividends from a USRPHC to an NRA shareholder, though likely subject to tax under other provisions of the Code, are generally not treated as FIRPTA dispositions.

Foreign Corporations

The transfer of a USRPI to a foreign corporation is generally treated as a disposition under FIRPTA, requiring a foreign transferor to recognize gain.[137] This rule runs contrary to the general rule of non-recognition on corporate formation under §351(a), and the NRA will be required to recognize gain equal to the excess of the USRPI's fair market value over the NRA's adjusted basis in the USRPI. Similarly, FIRPTA treats the distribution of a USRPI to a shareholder as a disposition, reasoning that because sales of stock in a foreign corporation are never subject to tax under FIRPTA, taxing the corporation on distribution is the only way to prevent tax avoidance via non-recognition.[138]

The FIRPTA rules prescribe somewhat harsh treatment for foreign corporations owning U.S. real property. To preclude potential challenges to FIRPTA under the nondiscrimination provisions of bilateral income tax treaties, Congress included in FIRPTA an election allowing a foreign corporation to be treated as a domestic corporation if it holds a USRPI and is otherwise entitled to treaty benefits.[139] An electing foreign corporation is treated as a domestic corporation solely for FIRPTA purposes, and is therefore subject to tax on any gain or loss on the disposition of a USRPI in the same manner as a domestic corporation.[140] Assets of the foreign corporation other than USRPIs are subject to U.S. tax under the normal rules applicable to foreign corporations.

Special Rule for Non-Recognition Exchanges

As noted above, in enacting FIRPTA, Congress was particularly concerned with the potential to circumvent the withholding obligation through creative use of the various non-recognition provisions of the Code. For example, absent an anti-avoidance rule, a foreign person's capital contribution of an appreciated USRPI to a domestic corporation would be eligible for tax-free treatment under §351(a) and, so long as the domestic corporation was not classified as a USRPHC, the foreign person's subsequent disposition of the corporate stock could potentially escape taxation.

To avoid this result, §897(e)(1) provides that a non-recognition rule can only apply with respect to a foreign person's USRPI if the transaction is an exchange in which the foreign person receives property that will be subject to U.S. tax on subsequent disposition. Thus, in the example above, the foreign person's capital contribution would only be eligible for non-recognition if the stock received in exchange was stock in a USRPHC. Other situations in which this rule might apply include involuntary conversions in which a USRPI is replaced with foreign property and corporate reorganizations in which an NRA exchanges shares in a USRPHC for shares in a corporation other than a USRPHC.[141] If a transaction satisfies §897(e)(1), no disposition will have occurred for FIRPTA purposes and, thus, no withholding will be required.[142]

The FIRPTA Withholding Obligation

As noted above, the FIRPTA tax regime is supported with a withholding at the source.[143] Thus, in the case of a disposition of a USRPI by an NRA, the transferee is obligated to withhold 15% of the gross proceeds on the transaction. This obligation applies to the purchaser of a USRPI, as well as corporations and other entities subject to the special rules described above. The obligation to withhold is a personal obligation of the transferee and amounts withheld must generally be turned over to the IRS, along with IRS Forms 8288 and 8288-A, within 20 days of the transaction closing.[144] Although the transferee will be relieved of liability if the NRA files a tax return and pays the tax due, he or she can still be held liable for penalties for failure to file IRS Forms 8288 and 8288-A, and failure to pay the withholding tax.[145]

It is important to note that FIRPTA withholding is not the exclusive method of taxation for gains derived from an NRA's investment in U.S. real estate. Rather,

[136] *See* Reg. §1.897-5T(b).

[137] §897(e)(1), §897(j)

[138] Reg. §1.897-5T(c); Notice 2006-46, 2006-24 I.R.B. 1044.

[139] §897(i).

[140] Reg. §1.897-3(f).

[141] Note that this rule will not apply in circumstances in which a recapitalization or reincorporation occurs if the shares received are "substantially identical to the shares exchanged." *See* Notice 99-43, 1999-2 C.B. 344.

[142] *See* Reg. §1.1445-5(b)(ii).

[143] §1445(a).

[144] Reg. §1.1445-1(c). The transferee need not withhold on the transaction if the NRA has filed for a withholding certificate. Reg. §1.1445-1(c)(2). In commercial transactions, the transferee may wish to hold an appropriate amount in escrow pending the issuance or rejection of a withholding certificate.

[145] §1463.

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the amount withheld is credited to the NRA's U.S. income tax return for the taxable year of the disposition and is used to offset the net tax that would otherwise be due. In many circumstances, this will result in the NRA being entitled to a refund. However, particularly in cases in which an investment has been fully or partially depreciated, any tax due in excess of the withholding amount will remain his or her liability. Importantly, because FIRPTA gains are treated as ECI, the NRA will be required to obtain a tax identification number and file a U.S. tax return to report and pay tax on the gain.

Exceptions to Withholding

The FIRPTA withholding obligation is, without doubt, a blunt instrument. Although it is intended to secure the ultimate payment of tax, it can lead to distorted results that do not align with economic reality. In many cases, a gross 15% withholding will exceed the gross profit margin an investor intends to realize on a particular investment. In other cases, the NRA will have sufficiently close ties to the United States that withholding to secure the payment of tax is unnecessary. In an effort to provide relief in such situations, the FIRPTA rules provide a number of exceptions to the FIRTPA withholding obligation.

Non-Foreign Certification. Withholding under FIRPTA is not required if the transferor is not a foreign person. Accordingly, a transferee is relieved of the obligation to withhold if he or she obtains from the transferor a certificate of non-foreign status signed under penalties of perjury.[146] This procedure is not strictly necessary, as sales between U.S. persons do not implicate the FIRPTA rules, but is a common part of commercial transactions because a transferee obtaining a certificate of non-foreign status is entitled to rely on it unless he or she has reason to believe it is false.

A foreign corporation that has made an election under §897(i) to be treated as a domestic corporation may also provide a certificate of non-foreign status, as no withholding is required on the disposition of a USRPI by an electing foreign corporation.[147] Note, however, that the disposition of the actual stock in an electing foreign corporation is itself treated as a disposition of a USRPI and is thus subject to the FIRPTA withholding requirement.[148]

Affidavit of Non-Recognition. A transferee is not required to withhold where the transferor furnishes an affidavit attesting that a non-recognition provision of the Code applies to the entire transaction.[149] The affidavit must be mailed to the IRS by the transferee within 20 days of the transaction closing. As above, the transferee is entitled to rely on such an affidavit unless he or she has reason to believe all or a portion of the transaction is not entitled to non-recognition treatment.

Residential Real Estate. FIRPTA withholding is not required where the USRPI is acquired for use as a personal residence and the gross amount realized on the disposition is $300,000 or less. To qualify for this exception, the transferee must intend to reside in the property for at least 50% of the number of days the property is used over the following 24 months.[150] A transferee can be held liable for withholding if he or she fails to utilize the property as a personal residence, absent exigent circumstances.

Transfers on an Established Securities Market. No withholding is required on the sale of shares in a USRPHC, or of interests in a partnership satisfying the 50/90 test, if the interests are regularly traded on an established securities market.[151]

The FIRPTA Withholding Certificate

For situations that do not fall within one of the exceptions described above, the FIRPTA withholding obligation may nonetheless be avoided or reduced by obtaining a withholding certificate from the IRS.[152] A transferee is not required to withhold, or is permitted to withhold at a reduced rate, if, as of the date of the transaction closing, the transferor has applied to the IRS for the issuance of a qualifying statement that reduced or eliminated withholding is appropriate.

Withholding certificates are often issued where, for example, the transferor can provide a tentative calculation of the tax due showing that reduced or eliminated withholding is appropriate, where the transferor is otherwise exempt from U.S. income tax, where the transferor has made adequate arrangements for the payment or security of the tax, or where an installment sale or foreclosure is occurring. An NRA may also want to apply for a withholding certificate on a protective basis when a non-recognition transaction is entered into.

An application for a withholding certificate is made on IRS Form 8288-A. Although this is a simple, one-page form, a number of supporting documents and attestations must accompany the form, and close atten-

[146] Reg. §1.1445-2(b)(2).

[147] Reg. §1.1445-7(b)(1).

[148] Reg. §1.1445-7(b)(2).

[149] Reg. §1.1445-2(d)(2).

[150] §1445(b)(5); Reg. §1.1445-2(d)(1).

[151] §1445(b)(6). Note, however, that if an NRA owns more than 5% of the stock in a USRPHC traded on an established securities market, he or she may still have a substantive FIRPTA tax liability under §897(c)(3).

[152] §1445(b)(4).

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tion to detail is required to ensure the smooth and timely issuance of the withholding certificate. Notably, both the transferor and transferee must have U.S. taxpayer identification numbers prior to the issuance of a withholding certificate. For NRA individuals without other ties to the United States, this may require obtaining an individual taxpayer identification number (ITIN) by filing IRS Form W-7. This form must be processed and an ITIN assigned prior to issuance of the withholding certificate. Once issued, the withholding certificate provides the transferee protection against the future assessment of tax, penalties, and interest in relation to the FIRPTA withholding requirement.

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CONCLUSION

This second installment in Foreign Affairs, a series of articles aimed at providing a primer on international taxation for domestic estate planners and tax practitioners, provided a high-level functional overview of the specialized tax regimes applicable to U.S. expatriates, controlled foreign corporations, passive foreign investment companies, and inbound investments in U.S. real estate. The third installment of this series will focus on the U.S. reporting obligations imposed on taxpayers with ties to the United States, including FATCA and related information exchange regimes, and other information reporting requirements applicable to U.S. persons with interests in foreign entities.

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