C. Conclusion

LTR 200923001 stands for the proposition that when a U.S. C corporation owns stock in a REIT, that REIT stock will be treated as qualifying stock for purposes of testing domestic control, regardless of who owns the stock of the U.S. corporation. That approach is supported by the regulations and is mandated by the lack of any precise set of attribution rules in the statute. The IRS's guidance allows greater certainty for foreign investors who are planning and structuring their U.S. real estate investments.

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if *Entity B* and *Entity C* were themselves REITs rather than regular C corporations. There does not appear to be any technical support for this distinction, however, because a REIT that owns stock in a subsidiary REIT is ''required to include in gross income in [its] return the dividend received on the stock'' in the same manner as a regular C corporation.

ACTEC Proposals Integrate Subch. J, PFIC Regime for Foreign Trusts

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The author reviews the American College of Trust and Estate Counsel's proposals to Treasury for a regulatory framework that integrates the foreign corporation anti-deferral regimes and the trust taxation provisions of subchapter J as they apply to foreign nongrantor trusts.

In a June 23 memorandum to Treasury's assistant secretary for tax policy, the American College of Trust and Estate Counsel (ACTEC) submitted proposals for future Treasury guidance coordinating the foreign corporation antideferral rules with the trust taxation provisions found in subchapter J of the code.[1] Regulations adopting the ACTEC proposals would clarify how to treat U.S. discretionary beneficiaries of a foreign nongrantor trust that owns shares in what would be a passive foreign investment company or controlled foreign corporation if the requisite U.S. ownership were established.

The ACTEC proposals recommend that the U.S. beneficiary be attributed share ownership for determining whether there are U.S. shareholders for CFC purposes and resulting tax liability only if the U.S. beneficiary exercises a certain level of control over the foreign nongrantor trust or has a fixed interest in trust income. The more complex and ambitious proposals address the much more common question of whether PFIC shareholder treatment should be applied to U.S. beneficiaries when those beneficiaries exercise no authority over trust decisions and have only discretionary interests in the trust.

This article first outlines existing law regarding taxation of foreign trusts and offshore holding companies. Relevant legislative history is then discussed, followed by the ACTEC proposals.

A. Existing Law

1. Taxation of foreign trusts. A so-called nongrantor trust, or a trust that is treated as a separate person for U.S. income tax purposes, pays U.S.

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[1]For the ACTEC letter, see *Doc 2010-20490* or *2010 TNT 183-21*.

taxes on its worldwide income if it is considered a ''resident'' of the United States, much like a U.S. individual. If the trust is not a U.S. resident (that is, a foreign trust), it is taxed much the same as a nonresident alien.

A foreign nongrantor trust (FNT) is not resident in the United States for income tax purposes but still is governed by the same basic section 643(a)[2] distributable net income (DNI) regime as domestic trusts when it makes a distribution. An FNT will be regarded for federal income tax purposes as a conduit to the extent the trust distributes — or is deemed to distribute — only amounts attributable to its DNI for the current tax year.[3] The tax treatment will thus flow through to the beneficiaries, and the beneficiary will be taxed in roughly the same manner as if he had earned the ''distributed'' income directly.[4] This is the traditional rule for DNI, defined in section 643, which is roughly equivalent to the trust's net ordinary income, capital gains if currently paid or payable, and other taxable income, as determined under U.S. income tax principles.

There are, however, several special rules that apply to distributions by an FNT to a U.S. beneficiary if the trust has accumulated income. These rules basically levy an income tax at ordinary rates, plus an interest charge on this previously deferred tax, to the extent there is an ''accumulation distribution.'' An accumulation distribution will occur whenever distributions for the year exceed the current year's income (as measured for both income tax purposes and accounting purposes), and there is undistributed net income (UNI) in the trust from previous years, *including undistributed capital gains*.[5] This is the same principle that applied to U.S. trusts before the 1997 repeal of the ''throwback rule'' for most domestic trusts.[6]

An accumulation distribution from an FNT can have serious adverse tax implications for a U.S. beneficiary. Since the United States does not tax the trust's net worldwide income,[7] the code provides that U.S. beneficiaries will be taxed on later accumulation distributions on a worldwide basis. Further, a distribution of more than the current year's income is almost certain to include an accumulation distribution because in calculating UNI, ''income'' includes foreign-source income even though such income is not taxable to the trust because it is not resident in the United States.[8] Capital gains also are taxed adversely when accumulated and later distributed from the FNT. They are added to UNI, and the substantially lower effective rate on long-term capital gains (15 percent) as compared to ordinary income (for example, 35 percent) is lost because such accumulation distributions from an FNT are all taxed as ordinary income.[9] Finally, the trust may have expenses that are not deductible against income under U.S. tax law (for example, expenses of maintaining a personal residence). Thus, income that is not taxable to the FNT but is taxable to the U.S. beneficiaries and not used for deductible trust expenses will be considered UNI for this purpose.

Before 1996 an accumulation distribution was taxed at the U.S. beneficiaries' average marginal tax rate for the previous five years, plus interest.[10] Interest was computed at a fixed annual rate of 6 percent, with no compounding.[11] When an accumulation distribution involved amounts accumulated in more than one year, the deferral period for the 6 percent charge was the average number of years of deferral, but the average was not weighted to take into account the amount of the distribution from each year.[12] As a result, the effective interest charge could be manipulated by creating small accumulations in a year shortly before a distribution to offset large accumulations dating back several years. The ability to manipulate the interest charge ended in 1996.

In 1996 Congress provided for a nondeductible *compound* interest charge applied to the amount of tax effectively deferred while the beneficiary receiving the distribution was a U.S. person (regardless of the beneficiary's age). The interest rate is 6 percent per year for distributions from accumulations attributed to the period before 1996, applied on a compound basis as of January 1, 1996. For income earned and accumulated thereafter, the varying rate for tax underpayments applies.[13]

2. Taxation of foreign investment companies. Several special U.S. tax provisions address ownership in foreign corporations by U.S. persons, particularly investment companies or companies located in a tax haven. Since the United States generally does not tax non-U.S. corporations on foreign-source income, these special U.S. tax rules are designed to prevent U.S. persons from using foreign corporations to

[2]Section references are to the Internal Revenue Code of 1986 unless otherwise specified.
[3]*See* section 651(b).
[4]Section 652.
[5]Sections 643(b), 665(b), and 666(a).
[6]*See* Taxpayer Relief Act of 1997, section 507(a)(1) (amending section 665 by inserting a new subsection (c)).
[7]Section 641(b).
[8]*See* section 643(a)(6).
[9]*See* sections 643(a)(6) and 667(e).
[10]*See* sections 666 and 667(a).
[11]*See* section 668(a), before its amendment in the Small Business Job Protection Act of 1996.
[12]*Id.*
[13]*See* sections 665(b), 667(a)(3), 668, and 6621(a)(2).

defer tax by accumulating income offshore. These rules are principally, although not entirely, directed at the passive investment assets of non-U.S. corporations controlled by U.S. persons. The effect of these rules can be particularly disruptive if, for example, a foreign trust in a tax haven jurisdiction owns one or more passive investment corporations and the trust has one or more U.S. beneficiaries governed by these rules.

The CFC rules require closely held U.S. ownership of the stock, but include corporations with a much wider variety of assets and activities than the PFIC rules. In broad outline, a foreign corporation is a CFC if more than 50 percent of its stock, by value or vote, is owned directly or indirectly by U.S. shareholders who, for CFC purposes, hold 10 percent or more of the company's stock by vote.[14] A U.S. shareholder of a CFC must include in his own income the pro rata share, with modifications, of the CFC's income, along with other items, such as any increase in the company's earnings invested in U.S. property.[15] Such U.S. shareholders generally are not subject to the PFIC rules on the same stock.[16]

In 1986 Congress also addressed the broader issue of investments by U.S. taxpayers in a foreign investment company with 50 percent or less U.S. ownership. Investments in offshore mutual funds had been actively marketed in the United States as tax-deferred investments because the CFC rules did not apply due to the lack of control by U.S. persons. This changed with the passage of the PFIC rules in the Tax Reform Act of 1986. A PFIC is characterized by a passive income/assets test (very differently defined than in the CFC rules), but the stock ownership can be *closely or widely held* and the percentage of U.S. ownership is irrelevant. Unlike the CFC, there is no automatic ''deemed distribution,'' but a U.S. shareholder of a PFIC, such as a foreign mutual fund, now must choose among unappealing alternatives: (i) current inclusion in income of the U.S. shareholder's pro rata share of ordinary income and capital gains of the PFIC under a shareholder election (a so-called qualified electing fund, or QEF, election)[17]; (ii) a mark-to-market election for marketable PFIC securities with gain taxed annually at ordinary income rates[18]; or (iii) ordinary income tax treatment and an interest charge on the receipt (or deemed receipt) of an ''excess distribution,'' which is a distribution that exceeds 125 percent of the average distributions received in the previous three years or the gain recognized on disposition (or deemed disposition) of the PFIC stock.[19] Importantly, the interest charge added to the tax liability arising from an excess distribution is calculated on assumptions that are purportedly designed to estimate the deferral of U.S. tax on undistributed gains and income but instead seem to assume the greatest possible deferral and corresponding interest charge by treating the gain as earned equally over the deferral period.

3. Attribution of investment company stock to U.S. beneficiaries. In each of these offshore investment company provisions, Congress addressed ownership by foreign trusts. The CFC and PFIC rules attribute stock owned by a nongrantor trust to its beneficial owners. When such an investment company is held by an FNT, these rules would lead to harsh results if they categorically made every trust transparent and caused the corporate income to be includable and taxable to a U.S. beneficiary as if the stock were owned directly.[20] A U.S. beneficiary then may (i) need to satisfy reporting obligations without having access to the needed information, (ii) be attributed taxable income without current distributions, (iii) never in fact receive the economic benefit of the corporate accumulation, and (iv) lack any legal remedy under the trust document and trust law to avoid such results.

The context of this trust attribution to beneficiaries is a comprehensive statutory scheme. The CFC rules have broad and detailed provisions attributing ownership among family members and to and from entities to test for CFC status. Attribution for income inclusion purposes is much more limited, but ownership by foreign entities generally cannot be used to shield the U.S. shareholder from having to include CFC income in his personal income tax obligation. As indicated in Example 3 in reg. section 1.958-1(d), if a trust owns the shares, the code provides that this ownership can be attributed to U.S. beneficiaries.

Because closely held ownership or U.S. control is irrelevant for defining a PFIC, attribution of ownership is generally not as important. However, the PFIC attribution rules[21] do attribute ownership of PFIC stock held by an entity to the owner of the entity, proportionately, through multiple tiers, to impute ownership to a U.S. person for purposes of applying the alternative taxing regimes.[22]

[14]*See generally* section 957.
[15]*See* section 951.
[16]*See* section 1297(d).
[17]*See* section 1295.
[18]*See* section 1296.

[19]*See* section 1291.
[20]*See* sections 958(a)(2) and 1298(b)(5); reg. section 1.951-1.
[21]*See* section 1298.
[22]Also, when the PFIC rules measure the critical time period for computing the tax deferral and the related interest charge, sections 1291(a)(3) and 1223(2) provide for ''tacking'' if the transferor passed on a carryover basis. Thus, a transfer by gift

(Footnote continued on next page.)

The PFIC regime ordinarily does not cause phantom income in the absence of a cashless disposition of stock.[23] There is no automatic deemed distribution to the shareholder, which is consistent with the concept that closely held ownership or U.S. control is irrelevant for defining a PFIC.[24] If section 1298(b)(5) is applied literally, however, ownership of the PFIC stock owned by a foreign trust could be attributed to a U.S. beneficiary, as could the phantom income when the PFIC pays a dividend *to the trust*. The beneficiary could be charged with income as if the beneficiary had actually received from the PFIC the portion of the dividend received by the trust and attributed to the beneficiary from the trust, even though the beneficiary may not actually be receiving any comparable distributions from the trust. The result is quite different than the treatment of a U.S. beneficiary whose beneficial interest in an FNT is swelling with income accumulated from other sources (investment partnerships, for example) that is taxed under the accumulation distribution rules of subchapter J. This result is also quite different from the treatment of an outright U.S. owner of PFIC shares. Outright owners generally are free of U.S. tax liability on the corporate income until it is received by the U.S. shareholder.

Despite the fact that trust attribution to beneficiaries has been part of the code now for many years, the application of the rule remains unclear. In each part of the CFC and PFIC regimes, the statute calls for the stock to be attributed ''proportionately'' to the beneficiaries. This begs the obvious question: in proportion to what? Sometimes the regulations refer to attributing ownership to the beneficiaries ''proportionately,'' without defining the term.[25] As to PFICs, prop. reg. section 1.1291-1(b)(8)(i) cross-references the CFC regulations and provides that the determination of the amount of PFIC stock owned by an ''indirect shareholder,'' such as a trust beneficiary, is ''made on the basis of all the facts and circumstances in each case'' and that ''the substance rather than the form of ownership is controlling, taking into account the purpose of section 1291.''[26]

There is even a question of whether and when a U.S. beneficiary of an FNT could be subject to current taxation on phantom income under the PFIC or CFC antideferral regimes. Taxable income might be allocated to trust beneficiaries who are not receiving it now and may *never* receive it, if a vague facts-and-circumstances-like test is applied to the largely indeterminate beneficial interests customarily used in offshore trusts that grant enormous discretion over distributions.

At first, the CFC attribution question seems most troublesome because of the need to identify some measurable interest that meets the definition of a 10 percent U.S. shareholder and to find some basis for concluding that the beneficiary has control as if a voting shareholder. Under the CFC attribution regulations, the sole example of trust-to-beneficiary attribution deals with U.S. beneficiaries of a short-term trust who have a vested interest — either technically or at least in substance — in a fixed percentage of the income of the foreign trust, the sole asset of which is a 90 percent share ownership in the corporation.[27] Including such beneficiaries in a U.S. shareholder group liable for current U.S. income tax is troublesome — despite their fixed interest in the trust — because beneficiaries cannot be accurately characterized as shareholders entitled to vote for the election of directors or on the dividend policy of the company in which the trustee owns shares.[28] This example seems to be inconsistent with the CFC provisions of the code, unless it was not intended to identify ownership for purposes of imputing income but instead addressed actuarial value for purposes of testing for 50 percent of value under section 957(a).

The CFC provisions impute income based on voting rights, not passive economic ownership; under section 951(b), only persons owning 10 percent of the voting rights are subject to tax liability for subpart F income. Ordinarily, trust beneficiaries do not vote such stock. Moreover, the CFC regulatory guidance dealing with nonvoting shares in a holding company (reg. section 1.958-1(c)(2)) and with agreements to shift actual voting control (reg. section 1.957-1(b)) shows that the voting rights must be real and exercisable. The intent is not to

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(or bequest, section 1291(e)) from one generation to the next will not purge the taint of the deferred tax and accumulating interest charge due on sale by an ultimate U.S. resident or citizen owner.

[23]Prop. reg. section 1.1291-3(b).

[24]Congress sought to avoid attributing cashless income to PFIC shareholders in view of their lack of control over corporate distribution policy and lack of access to information; hence, Congress allowed a deferral of tax liability arising under that election until there is a disposition. *See* Joint Committee on Taxation, General Explanation of the Tax Reform of 1986 (May 4, 1987), at 1023.

[25]*See* reg. section 1.958-1(c)(2); reg. section 1.958-2(c)(1)(ii)(a); *see also* Rev. Rul. 90-106, 1990-2 C.B. 162 (grantor trust); prop. reg. section 1.1291-1(b)(8) pmbl. of Apr. 1, 1992 (suggestion to define ''proportionate'' for PFIC purposes by reference to the attribution rules in reg. section 25.2701-6 concerning estate freezes).

[26]*Cf.* section 1.958-1(c)(2). *See also* TAM 200733024, *Doc 2007-19133*, *2007 TNT 161-15*.

[27]Reg. section 1.958-1(d), Example 3.

[28]Moreover, the example refers to a trust with only one asset: the shares of the corporation in question, avoiding the issue of how the rules apply when income beneficiary distributions can be made up from other sources.

apply formalistic rules, such as actuarial values, about who owns the vote. Nevertheless, reg. section 1.958-1(d), Example 3 may illustrate a workable rule if it is interpreted as applying only to vested beneficial interests as the ACTEC report suggests. In that event, economic ownership is clear. Example 3 could then be used to define the outer limits of attribution in imputing income, and not as a beginning point. The trust in Example 3 more closely represents a business or investment entity relationship rather than a typical trust relationship. Each vested U.S. beneficiary is entitled to a defined portion of the trust assets for all practical economic purposes other than the timing of distributions, and the short duration of the trust renders even that factor unimportant.[29]

The CFC question and Example 3 demonstrate why the PFIC attribution issue is so difficult. The PFIC regime is designed to operate over long as well as short periods of deferral, unlike the CFC regime that attributes taxable income annually. If a facts-and-circumstances test is used to attribute corporate-level annual income based on which beneficiaries are receiving discretionary trust income distributions in a given year, what solution does that provide for a PFIC regime that is designed to impose a special tax and interest charge after a long period of further deferral at the corporate level? What if the income distributions from the trust have shifted to other beneficiaries during the ensuing deferral period, or what if corporate-level income becomes part of trust principal and passes much later to still another class of beneficiaries? What if other distributions are made from noncorporate sources, whether from high- or low-basis assets? And what if the U.S. tax residency status of individual beneficiaries changes over the deferral period, or the class size changes, or persons other than trustees control the class through powers of appointment without being constrained by any fiduciary duty?

The PFIC attribution question warrants closer attention unless we are prepared to tax phantom income to trust beneficiaries knowing that they might never receive it, a result that Congress did not intend.[30] To eliminate the benefit of deferral by assessing tax and interest, the PFIC system first must identify the trust beneficiary who economically benefits from that deferral. Logically, there seem to be only two ways to do that. One is to impose tax liability based on expected future benefit, relying on indications in present and past facts and circumstances — a hazardous course because the facts and circumstances change as deferral continues. The other alternative is to wait until the deferral ends and impose tax and accumulated interest when the actual distributions identify who receives the benefit.

B. Economic Distinctions

Neither Treasury nor Congress has articulated fundamental principles from the FNT or PFIC rules that would result in attributing phantom income to a U.S. beneficiary when a PFIC is held by an FNT. In both the FNT and PFIC regimes when applied separately, a U.S. taxpayer — either as beneficiary of a trust not holding PFICs or as an outright shareholder — generally is not subject to tax until amounts are actually received, either in the form of a trust distribution or an excess distribution. Why then might the taxation change so dramatically when the two regimes are combined through an FNT's ownership of PFICs?

One explanation might be an unwillingness to allow PFIC deferral within an FNT if it allows U.S. taxpayers to indirectly change their economic investment in an asset and remain insulated from U.S. taxation. In the U.S. tax system, gains and losses generally are taken into account only when realized by sale or exchange. This gives a U.S. taxpayer the opportunity for prolonged deferral as long as the taxpayer maintains his economic investment in a specific asset. From a tax policy perspective, taxpayers can put capital to its best use, and the resulting tax will not be collected until the taxpayer decides that a particular use should be replaced by another.

Under the FNT regime, the tax consequences of a sale or exchange of an asset are tracked in the trust's DNI and UNI accounts. Those accounts, when coupled with the accumulation interest charge, attempt to parallel the tax result that a direct U.S. owner would have had if he made investments identical to the trust investments over the same time period, allowing the postponement of tax payments.

In the PFIC regime, the assumption is that the U.S. taxpayer has decided that investment in a PFIC is the best use of capital at the time. Shareholders then pay tax on dividends when actually received. When the shareholder receives a dividend, she has the opportunity to put that capital (in the amount of the dividend) to use elsewhere. Like the domestic corporate scenario, sales and exchanges at the corporate level do not affect the shareholder-level determination of

[29]*Cf*. section 674(b)(6).

[30]*See* footnote 23 and text under the heading "Legislative History."

tax because a dividend is taxed when received regardless of how or when the amounts were earned at the corporate level.[31]

The U.S. tax system will tolerate a U.S. shareholder's deferral of PFIC gain as long as the resulting excess distribution — or gain from the sale of the stock — is taxed now and treated as earned over the holding period of the PFIC. Similarly, when the PFIC is owned by an FNT, the trust can maintain its PFIC investment indefinitely, and the PFIC can change its economic investment in specific assets without any U.S. tax consequences, as long as funds never leave the PFIC. But the ability to change investments within the PFIC without U.S. tax consequences does not necessarily mean that a second level of deferral should be permitted once *the trust* changes its economic investment in the PFIC by receipt of an excess distribution or sale of PFIC stock. Treasury might argue that combining the deferral within the PFIC with the deferral allowed under the FNT regime when investment in the PFIC is eliminated or reduced was never intended because the PFIC excess distribution is a sufficient change in economic investment to justify taxing the then-existing U.S. beneficiaries. In effect, U.S. taxpayers could apply the deferral allowed in the FNT regime or the deferral allowed in the PFIC regime, but not both. Of course if Treasury intends to adopt this approach, it must be squared with congressional intent as expressed in the legislative history of the relevant provisions. The legislative history, however, provides that such a strict interpretation should not apply in all cases but only in ''appropriate cases'' and ''as necessary to avoid circumvention'' of the PFIC interest charge.

C. Legislative History

Congress did intend to curb the use of ''intervening entities'' as a shield against taxing offshore corporate accumulations. As noted earlier, section 1298(b)(5) provides that a distribution to an intervening entity with respect to its interest in a PFIC, such as a PFIC distribution to a trust holding PFIC stock, or a disposition by the U.S. person or by the entity that results in the U.S. person being treated as no longer holding such stock shall be treated as a distribution to or disposition by the U.S. person with respect to the PFIC stock. This section complements the proportionality language that attributes ownership through tiers, which has been used consistently and without distinction in reference to attribution through corporations, partnerships, and trusts. Yet the legislative history on the use of ''proportionately'' and the intervening entity rule supports different attribution principles for trusts than for investment entities and for application of the principles of subchapter J in the context of trusts.

Before the PFIC rules were enacted in 1986, the same proportionality language was borrowed from the 1984 CFC rules as part of the Deficit Reduction Act of 1984 (DEFRA) and used to refine the now repealed rules that applied to a foreign personal holding company (FPHC).[32] Before DEFRA, it was possible to take the position that the FPHC provisions did not literally apply if the shareholder of the investment company was a non-U.S. trust, even if the trust had U.S. beneficiaries. The U.S. taxpayer, as beneficiary of the trust, arguably would be insulated from current taxation under the then-existing FPHC rules.[33] In DEFRA, Congress eliminated this result when it passed a rule that attributed stock of a foreign investment company owned by a foreign trust directly to the beneficiaries of the trust.[34] Shortly thereafter, Congress further clarified the law by dealing with dividends paid by the investment company to the trust. The Technical and Miscellaneous Revenue Act of 1988 provided that *distributions* to an intervening foreign trust owning stock in the FPHC would be treated as distributions to the trust's beneficiaries.[35]

Yet the attribution provisions of DEFRA should not be interpreted to mean that Congress intended foreign trusts to be treated in the same way for attribution purposes as if they were holding companies or partnerships. The Conference Committee

[31]This might not be the case, however, if a U.S. shareholder owns stock in a non-PFIC corporation that receives an excess distribution from a lower-tier PFIC that by regulation is treated as taxable to the U.S. shareholder. *See generally* discussion of section 1298(b)(5) under the heading ''Legislative History,'' and New York City Bar Committee on Taxation of Business Entities Report on PFIC Rules (Sept. 24, 2009). This exception actually illustrates why trusts holding PFICs are troublesome since it appears to be a similar structure. *See* text at footnote 40.

[32]Since ''proportionately'' is used for both PFIC and CFC attribution, the PFIC legislative history should be relevant to CFC attribution for trusts (although not necessarily controlling). Further, the legislative history of the FPHC provisions provides relevant evidence of intent in dealing with attribution for CFC purposes because those two regimes were similar, imputing income from closely held foreign corporations to U.S. owners. The FPHC rules, like the CFC regime, required a finding of U.S. control by a small shareholder group, but unlike the CFC regime, imputed income to less than 10 percent shareholders. *See* section 132(b) of Tax Reform Act of 1984; H.R. Rep. No. 98-432, pt. 2, at 1535 (1984). Indeed the FPHC rules were replaced as duplicative, and FPHC income is now taxed as subpart F income under the CFC regime for tax years beginning after December 31, 2004. The American Jobs Creation Act of 2004, section 413(a)(1) and (d)(1).

[33]*See* H.R. Rep. No. 98-432, pt. 2, at 1535.

[34]*See* Tax Reform Act of 1984, P.L. 98-369, 98 Stat. 666.

[35]*See* S. Rep. No. 100-445, at 329-330 (1988); *see also* H.R. Rep. No. 99-426, at 932 (1985).

report clarified that the new FPHC provision was not intended to change the rule that shares held in a grantor trust are attributed to the grantor, not the beneficiaries.[36] This basic principle continues today with congressional sanction as a unique rule for trusts even though it overrides the corporate antideferral rules by allowing a trust's corporate holdings to be attributed to a foreign grantor — avoiding U.S. taxation — even when the corporate income accumulation could be expected to later benefit the U.S. beneficiaries of the grantor trust.

Moreover, just two years after DEFRA, Congress created the PFIC regime and expressly called for the application of the principles of subchapter J. Specifically, when ''proportionately'' was used in new section 1298(a)(3), the 1986 blue book explained: ''In attributing stock owned by a trust, it is intended that the general rules of Subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust.''[37] Further, in explaining the intervening entity rule of section 1298(b)(5), the blue book made clear that the distribution from a PFIC to an intervening entity or the disposition of an interest in such an entity is not to be treated as a PFIC distribution to or disposition by the ultimate U.S. shareholder in all cases but only ''in appropriate cases'' or ''as necessary to avoid circumvention of the Act's interest charge.''[38]

So the question becomes: What is an ''appropriate case''? To avoid circumventing the PFIC interest charge, when and how should an FNT's ownership of a PFIC be attributed to a U.S. beneficiary if the FNT receives what would otherwise be an excess distribution? Exploring this question reveals why trusts should not be swept into a regulatory framework that was designed to address a corporate problem. The 1986 blue book again provides useful insights.

The 1986 blue book provides specific examples in which regulations may be required to prevent circumvention of the PFIC interest charge.[39] The examples involve U.S. shareholder ownership of a non-PFIC foreign corporation that in turn owns an underlying PFIC. Absent regulations, the U.S. shareholder would pay no PFIC interest charge when the directly owned non-PFIC corporation receives an excess distribution from the underlying PFIC. Although not specifically stated, the examples clearly suggest that *no other antideferral regime otherwise applies to the intervening entity*. If some other antideferral regime — such as the interest charge on trust accumulation distributions — applied, there is no avoidance because the PFIC interest charged has been replaced with a comparable interest charge as provided in subchapter J.[40] Once the excess distribution is integrated into the DNI/UNI of the FNT — using one of the ACTEC proposals or some other comparable approach — the opportunity for avoidance ends because the PFIC interest charge has been replaced by the interest charge on trust accumulation distributions when amounts later pass to a U.S. beneficiary.

The legislative history requires consideration of how subchapter J principles provide different answers for trusts and what changes are necessary or appropriate in attribution regulations to apply the statutory scheme. Congress would not have referenced subchapter J in discussing attribution if it intended trusts to be treated as transparent. Trusts are respected under subchapter J, and actual distributions control allocations of trust income. The ACTEC proposals follow this approach and integrate the corporate antideferral regimes into the comprehensive framework of subchapter J.

D. ACTEC Proposals

1. Application of the CFC antideferral regime. The ACTEC proposals first address the admittedly rare situation in which U.S. beneficiaries of an FNT exercise sufficient influence over the trust (or the beneficiaries have a fixed and vested interest in trust income) to justify taxing U.S. beneficiaries currently under the CFC regime regardless of whether amounts are distributed from the FNT to the beneficiaries. Sufficient U.S. beneficiary influence over the trust would exist when (1) the U.S. beneficiaries serve as trustee or cotrustee of the FNT, or (2) the U.S. beneficiaries have the right to remove and replace the trustee of the FNT and install a trustee subservient to the U.S. beneficiaries. ACTEC's apparent rationale for this proposal is that the U.S. beneficiaries exercise sufficient influence

[36]*See* H.R. Rep. No. 98-861, at 958 (1984).

[37]JCT, General Explanation of the Tax Reform of 1986, at 1032.

[38]*Id.* This intention was not articulated in the statute itself until the 1988 amendments, made retroactive, adopted more comprehensive language and a similar change was made to the FPHC rules. TAMRA section 1012(b)(b)(1)(A); *see* S. Rep. No. 100-445, at 329-330 (1988); *see also* H.R. Rep. No. 99-426, at 932 (1985).

[39]*See supra* note 24, at ''anti-avoidance rules.''

[40]*Cf.* TAMRA, H.R. Conf. Rep. No. 100-1104, at 11 (1988), in which a distribution from a wholly owned lower-tier PFIC should not be treated as having been paid to a U.S. investor in the upper-tier PFIC when the lower-tier PFIC has annually distributed all its income to the upper-tier PFIC, unless such distributed amounts are made available to the U.S. investor.

over the FNT to cause a distribution of amounts necessary to pay tax currently under the CFC regime.

Also, ACTEC proposes that if the U.S. beneficiaries' interests in all classes of trust income are so fixed and vested that the trustee of the FNT would have a fiduciary duty to distribute CFC income currently to the U.S. beneficiaries, rather than accumulate that income in the CFC or the trust, U.S. beneficiaries should be taxed currently under the CFC regime. The apparent rationale here is that the U.S. beneficiaries in effect have access to the income through the necessary exercise of the trustee's fiduciary duty to distribute income in accordance with the terms of the trust.

Except for these limited situations, ACTEC proposes that FNTs owning shares in corporations that would be classified as CFCs be treated instead as owning shares in PFICs for purposes of determining the tax liability of U.S. beneficiaries of the FNT.

2. Application of the PFIC antideferral regime. Most FNTs do not have U.S. beneficiaries serving as trustees and do not allow the U.S. beneficiaries to replace the trustee with a person subservient to the U.S. beneficiary. Also, FNTs rarely provide for fixed and vested income interests payable to beneficiaries. Thus, under the ACTEC proposals, the vast majority of FNTs owning shares in a foreign investment company would be subject to the PFIC regime and not the CFC regime.

When the PFIC regime applies to an FNT, the ACTEC proposals provide that for trust-level events that could be treated as PFIC events, the tax consequences of those events pass to the U.S. beneficiaries only when a distribution occurs. The proposals maintain the integrity of subchapter J (that is, a beneficiary is taxed on its allocable share of distributed trust income) and the PFIC provisions (that is, applying an interest charge to PFIC excess distributions) through one of two alternatives.

a. Integrate PFIC excess distributions into UNI. The first alternative applies an interest charge to the PFIC-enabled deferral by allocating a PFIC excess distribution to the FNT's UNI for the current year and for previous years in which the trust owned the PFIC (but the allocation to UNI for previous years would only apply prospectively, that is, for distributions that exceed DNI in future years). In other words, a trust that received an excess distribution would allocate that excess distribution to trust UNI as if the PFIC never existed and the income instead had been earned in the trust. The allocation of excess distributions to UNI would apply to distributions made in the year of the FNT's receipt of the excess distribution and in future years. Under this alternative, distributions in excess of DNI in future years would carry out the previous years' UNI amounts generated from the excess distribution.

The integration of the excess distribution into UNI would require that the excess distribution allocated to previous years be excluded in computing accounting income and/or DNI of the trust in the year received, which is what ACTEC proposes. If the excess distribution were not excluded in computing accounting income and DNI, the trust's receipt and distribution of the excess distribution amounts in the same year would not result in an accumulation distribution (and the interest charge would be avoided) because an accumulation distribution only occurs when the distribution exceeds the greater of DNI or accounting income. Under the ACTEC proposal, a trust receiving an excess distribution would allocate that amount to trust UNI as if the PFIC never existed and the income instead had been earned in the trust.

The trustee would allocate the excess distribution to UNI of previous years based on the PFIC's actual history of earnings and appreciation (similar to how income would have been allocated if the FNT itself were able to make a QEF election). If the actual history of earnings and appreciation were not available, the trustee would allocate the excess distribution to UNI of previous years based on the annual changes in the net fair market value of the PFIC stock (similar to how income would have been allocated if the FNT itself was able to make a mark-to-market election). If the PFIC financial information were not available, the trustee would allocate the excess distribution to UNI equally over the years of PFIC ownership.

b. Tacking of the PFIC accumulation period. The second alternative would burden an accumulation distribution with an interest charge calculated over the period that income was accumulated in the trust or the PFIC by tacking the period that income is accumulated in the PFIC to the period income is accumulated in the trust. Presumably, the interest charge associated with the PFIC accumulation period would apply only if the PFIC had made an excess distribution to the trust, and only to that extent.[41]

As part of the second alternative, ACTEC proposes a regulation under section 643 to clarify that the trust's receipt of an amount that could be treated as an excess distribution at the trust level would be treated as such when a U.S. beneficiary of the trust receives a corresponding distribution in

[41]If not, the U.S. beneficiary would be worse off than a direct owner of the PFIC because a direct owner can receive PFIC distributions that are not necessarily excess distributions.

the same year. Such a clarification would be consistent with the concept under subchapter J that amounts received by a trust and distributed to a beneficiary in the same year retain their initial character to the trust when passed to the beneficiary, treating the trust as a conduit.

3. Issues remaining under ACTEC proposals. While the ACTEC memorandum does not contain implementing language for the regulations, it offers an important first step and describes a framework for future regulations that coordinates the accumulation distribution regime and the PFIC excess distribution regime. The proposals understandably leave some details to be worked out in the implementation. Under ACTEC's first alternative proposal, one issue would be which PFIC distributions are treated as excess distributions that must be integrated into the trust UNI (for example, how would one classify a PFIC "excess distribution" that occurred when the trust had no U.S. beneficiaries). Under ACTEC's second alternative proposal, similar issues exist when addressing what PFIC holding period should be tacked to the trust accumulation period. Although the two alternative proposals raise similar issues, ACTEC's tacking proposal provides the best backdrop for illustrating the types of questions that likely will need to be addressed.

For example, it is unclear whether a U.S. beneficiary would be required to tack the PFIC accumulation period in all events. The PFIC accumulation period presumably should not be tacked to the trust accumulation period if the trust receives what would otherwise be an excess distribution and then, in the year received, distributes that entire amount to a non-U.S. beneficiary. This result would follow from the concept under subchapter J that amounts received by a trust and distributed to a beneficiary in the same year retain their initial character to the trust when passed to the beneficiary.

The above example highlights a question that Treasury has not squarely addressed — should a U.S. beneficiary pay an interest charge on tax-free PFIC accumulations if those accumulations allow the U.S. beneficiary to receive more of the FNT's *other* assets? If Treasury answers yes, it is unlikely that ACTEC's first alternative — which allows the U.S. beneficiary of an FNT to avoid the PFIC interest charge if the trustee distributes the FNT's non-PFIC assets to the U.S. beneficiary *before* an excess distribution occurs — will be accepted. Depending on which PFIC accumulation period gets tacked to the FNT accumulation period, ACTEC's second proposal may or may not yield the same result. ACTEC's tacking proposal might make it easier to tack a PFIC accumulation period to the trust accumulation period whether or not the trust has received an excess distribution from the PFIC, but the initial question of which PFIC period should be tacked still must be addressed.

Which PFIC accumulation period gets tacked to the FNT accumulation period would seemingly require an assessment of PFIC ownership. For example, assume FNT owns PFICs. There exists a second-generation U.S. beneficiary (G2), but G2 receives *no* distributions from the FNT. If G2's newborn child (G3) then becomes a beneficiary of the FNT, it is not clear that the PFIC holding period during G2's lifetime — but before G3's birth — should be tacked to the FNT accumulation period when FNT makes a later distribution to G3. The lack of distributions to G2 establishes that G2 had no economic interest in the FNT assets during his lifetime. Arguably, the underlying holding companies were not PFICs at all because G2 had no ownership. Even if Treasury were inclined to tack G2's holding period to G3's due to the familial relationship, that rationale becomes tenuous if G3 were G2's nephew and nonexistent if G3 were not related to G2 at all. If G2 had held the PFIC stock directly, G2's disposition of that stock to G3 would trigger an excess distribution to G2 under section 1291(a)(2) to the extent of G2's gain on the disposition. Nonetheless, using the direct ownership analogy to tack G2's holding period to G3 is not compelling because G2 had no mechanism to realize an economic benefit from the PFIC shares and arguably never enjoyed economic ownership over the PFIC shares held in the FNT.

Treasury could address the issue in a manner similar to that used in subchapter J and apply the tacking rule so as to exclude years that the beneficiary receiving the distribution was not a U.S. person. This approach would apply the tacking rule consistent with the interest charge for trust accumulation distributions under section 668(a)(4). Doing so would apply PFIC tacking only to those years of PFIC deferral during which the U.S. beneficiaries actually receiving the economic benefit of the PFIC were U.S. persons.

A trustee's ability (under either ACTEC proposal) to manage the receipt of excess distributions so as to minimize the PFIC interest charge should not cast a cloud over the viability or usefulness of the ACTEC proposals. A trustee of an FNT already has the ability to influence the tax liability of a U.S. beneficiary by selling specific high-basis trust assets and passing the proceeds currently to a U.S. beneficiary when the trust has no UNI. Even the trustee of an FNT with substantial UNI dating back many years can minimize the accumulation interest charge by, for example, selling specific assets and making current distributions of DNI taxed at the lower capital gain rates to a U.S. beneficiary. As long as the distribution does not carry out UNI, there will be no accumulation distribution and no corresponding interest charge. Similar planning for an FNT that owns PFICs should not necessarily be characterized as improper.

If Treasury rejects ACTEC's alternative proposals because a trustee could minimize the interest charge paid by a U.S. beneficiary in some circumstances, it is difficult to imagine what alternative that maintains the integrity of subchapter J and the PFIC excess distribution regime Treasury would find acceptable. One possible alternative would be for Treasury to levy an interest charge on any distribution to a U.S. beneficiary of an FNT trust when the FNT owns appreciated PFICs, but that approach would rely on a deemed recognition event and deemed excess distribution where neither exists. If a trust may hold a variety of assets, would this approach simply target the deemed disposition of the PFIC, or would it adopt a radical accounting convention that in effect assumes every beneficiary of a discretionary trust has a proportionate ownership interest in each trust asset and that distributions sourced from one selected asset represent a taxable exchange of the beneficiary's proportionate share of all other assets? The latter is contrary to existing law if the foreign trust expressly authorized the trustee to distribute different assets to different beneficiaries, since this would not generate a taxable exchange.

Another alternative would be to adopt a substantial economic effect test that disallows selective dispositions and sourcing of distributions unless the allocations had corresponding economic consequences.[42] While this concept has been used in subchapters K and J, it is difficult to see how it could be applied to the discretionary foreign trust without undue complexity and compliance issues unless it were used to test only those distributions made within a few years of each other.[43] Otherwise, the system would break down when applied to a longer history of discretionary trust distributions occurring amidst changing family and financial circumstances, when different distributions are prompted by a wide variety of factors other than tax treatment and when, unlike in a partnership, there is no previous agreement on an economic baseline as to how to share gains and losses.

4. Ownership for reporting purposes without a determination of tax liability. The lack of guidance on taxation of distributions from FNTs that own PFICs inhibits U.S. beneficiary disclosure under the indirect ownership rules. Beneficiaries are understandably reluctant to report their indirect PFIC ownership under the current rules because those rules fail to articulate how indirect ownership translates into a tax obligation. By clarifying the taxing rules, the ACTEC proposals would allow U.S. beneficiaries to disclose their indirect PFIC ownership without committing to a corresponding but uncertain future tax liability. Treasury likely would enhance U.S. discretionary beneficiary compliance with PFIC disclosure rules if the taxation rules made clear that discretionary beneficiaries of an FNT would have no U.S. tax obligation until their interest in the FNT became vested or the beneficiary actually received distributions from the FNT.

Clarifying the taxation of a U.S. beneficiary's indirect ownership of a PFIC has become more important since passage of the Hiring Incentives to Restore Employment Act (HIRE).[44] The HIRE Act added new PFIC reporting rules requiring U.S. persons who are shareholders of a PFIC to report such information as the IRS may require,[45] effective March 18. Previously, reporting was required only upon disposition of PFIC stock, receipt of a distribution, or the making of some elections.[46] The IRS has released a notice stating that it is developing further guidance on this expanded reporting obligation.[47] Absent clearer rules on how such indirect ownership of a PFIC will be *taxed*, few U.S. beneficiaries of FNT's that own PFICs will be willing to report their indirect ownership (as currently defined) because they know they may never realize any economic benefit from the trust and therefore do not consider themselves ''owners'' of the FNT's assets.

E. Conclusion

For over 20 years, practitioners have wrestled with the interaction of the accumulation distribution rules applicable to FNTs and the excess distribution rules applicable to PFICs. Guidance on integrating the two systems has been sparse and of limited value in the vast majority of cases. ACTEC has outlined workable rules integrating the two systems in a way that will give taxpayers much needed clarity while at the same time preserving Treasury's desire to collect tax and an interest

[42]*See* NYC Bar Committee Report, *supra* note 31, under the heading ''Allocation of Excess Distributions to U.S. Beneficiaries of a Foreign Trust.''

[43]Reg. section 1.652(b)-2(b) applies an economic effect requirement to trust distributions to different beneficiaries that are purportedly sourced from different classes of income, but only if the distributions are made in the same year.

[44]P.L. 111-147, section 521(a).

[45]Section 1298(f).

[46]*See* Instructions for Form 8621, ''Return by a Shareholder of a Passive Foreign Investment Company of Qualified Electing Fund'' (Feb. 2008).

[47]Notice 2010-34, 2010-17 IRB 612, *Doc 2010-7577*, *2010 TNT 66-7*.

charge on amounts accumulated through non-U.S. trust structures owning PFICs.

Adoption of the ACTEC proposals would benefit Treasury's efforts to increase taxpayer compliance and reporting of offshore structures. U.S. beneficiaries are understandably reluctant to report ''ownership'' of PFIC shares through an FNT when the resulting tax consequences of that ownership remain unclear. Integrating the rules of subchapter J with the PFIC excess distribution regime as outlined by ACTEC would allow taxpayers to fulfill their reporting and tax obligations in a way that enhances the integrity of subchapter J and the PFIC regime. Integrating the two systems would eliminate much of the current uncertainty, which all too often leads to actual or apparent noncompliance.

Response to Jacobus on *G-I Holdings*

By Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein

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In this article, the authors respond to Richard G. Jacobus's criticism of their earlier article regarding the *G-I Holdings* case. In their earlier article, the authors wrote that the court's conclusion on the partnership disguised sale issue was dicta, in light of its holding that the government's claim was time barred. Jacobus argued that the court's partnership disguised sale conclusion was not dicta because it was a prerequisite to performing the computations required to determine whether the six-year statute of limitations applied. The authors explain that under no government-proposed disguised sale theory was the omission from gross income sufficient to trigger application of the six-year statute of limitations, and the court therefore did not need to decide the partnership disguised sale issue to conclude that the statute of limitations for the year at issue had expired.

In his August 16 article entitled ''Partnership Disguised Sales: *G-I Holdings* Is Not Dicta,''[1] Richard G. Jacobus criticizes our analysis of the district court's decision in *G-I Holdings*[2] and in particular, our view that the district court's decision on the disguised sale issue was dicta.[3] In an analysis that spanned more than 45 pages, the district court in *G-I Holdings* discussed the application of the partnership disguised sale rules to a transaction structured as a nontaxable contribution to a partnership. The district court ultimately decided that the six-year statute of limitations under section 6501(e)(1)(A) did not apply and that the government's claim was therefore time barred by the three-year statute of limitations. In our view, the district court's partnership disguised sale analysis

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[1]*Tax Notes*, Aug. 16, 2010, p. 769, *Doc 2010-16075*, *2010 TNT 159-4*.

[2]*In re G-I Holdings Inc.*, 2009 WL 4911953 (D.N.J. 2009), *Doc 2009-25898*, *2009 TNT 225-18*.

[3]Blake D. Rubin, Andrea Macintosh Whiteway, and Jon G. Finkelstein, ''Partnership Disguised Sales: *G-I Holdings* Misses the Mark,'' *Tax Notes*, May 3, 2010, p. 553, *Doc 2010-7727*, *2010 TNT 86-6*.