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Technical advice memorandum on foreign trusts owning investment company stock

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Several US tax provisions affect US persons who are shareholders of non-US corporations. The United States does not generally tax non-US corporations on foreign source income, but does tax US persons on foreign source income. As such, certain tax rules are designed to prevent US persons from using non-US corporations to avoid tax by accumulating income offshore. The rules require that certain types of passive income of controlled foreign corporations and passive foreign investment companies be taxed to shareholders who are US persons currently, no matter whether distributions are made to them. The effect of these rules can be particularly disruptive if, for instance, a non-US trust owns one or more such passive investment corporations and the trust has one or more US beneficiaries governed by these rules.

Passive Foreign Investment Company Tax Rules

A US beneficiary of a foreign trust may be subject to tax on income earned by a passive foreign investment company (PFIC) which is owned in whole or in part by the foreign trust. This tax is in addition to any tax on actual trust distributions and may be levied whether or not funds pass from the PFIC to the US beneficiary.

A PFIC, unlike a controlled foreign corporation, can have any number of shareholders and need not be controlled, directly or indirectly, by US shareholders. A non-US corporation is a PFIC for any given taxable year if (i) 50% or more of its assets produce passive income, or (ii) 75% or more of its gross income is passive.

Passive income is income derived from real estate and business investments in which the corporation is not actively involved, including rents, dividends and interest income.

Under the PFIC rules, a US person who owns or is considered to own shares of a PFIC may be subject to income tax at ordinary rates upon a sale of or extraordinary dividend from a PFIC. In addition, the tax is subject to an interest charge, calculated for the years of the tax deferral, during which the income was deemed to have been earned by but accumulated in the company.

Beneficiaries of Trusts Owning PFIC Stock

Stock ownership is determined through an application of attribution rules applicable to family members and to intermediate entities such as trusts. Applying the attribution rules is quite difficult when an intermediate entity, such as a trust, owns the stock of the foreign investment company. Stock owned by a trust is attributed proportionately to the beneficiaries of the trust. The application of the attribution rules remains unclear when stock is attributed to US beneficiaries of a discretionary foreign trust, despite the fact that attribution to beneficiaries has been part of the Internal Revenue Code for over 10 years.

Technical Advice Memorandum

In Internal Revenue Service (IRS) Technical Advice Memorandum 200733024 (August 17 2007) the IRS articulates in some detail for the first time how it would seek to apply the PFIC rules to US beneficiaries of non-US trusts owning foreign corporate stock. The facts of the memorandum are complex and many issues are addressed. The memorandum concludes that US beneficiaries of a non-grantor trust are taxable on the gain arising upon the trust's disposition of PFIC stock. According to the memorandum, the IRS is prepared to attribute taxable income and interest charges to US beneficiaries based upon a 'facts and circumstances' test, borrowed from the controlled foreign corporation rules. Such attribution may conflict with the trust distribution rules of the Internal Revenue Code.

'Facts and Circumstances' Test

The memorandum sets out the IRS view that a 'facts and circumstances' test is the only reasonable basis for determining attribution of PFIC shares to US beneficiaries of foreign trusts and estates. The memorandum involved the issue of whether a liquidation or distribution attracted a PFIC tax when Fund B, a foreign trust, liquidated a PFIC in one year and made a distribution in the following year to a new US trust with all US beneficiaries. The liquidation of the PFIC (known as Corp J) that was owned by Fund B was, according to the memorandum, the critical taxable event, but alternatively it suggested that in any event the tax could be collected by reason of the distribution in the following year.

The taxpayer took the position that under the Internal Revenue Code's trust distribution rules, a distribution made in the prior year (the year of liquidation of Corp J) from Fund B to a new foreign trust, which had only foreign beneficiaries, had carried out all the distributable net income so that no income was left to be attributed to the US beneficiaries when their share was distributed to the new trust the following year. The taxpayer argued that this result was a reasonable application of the PFIC rules in the absence of regulations on attribution and taxation of PFICs owned by trusts. In addition, the taxpayer argued that the tax laws were not intended to reach the income of non-US persons, who were not subject to the laws of the United States. As such, according to the taxpayer, there should have been no US tax under the PFIC regime on account of the new foreign trust, or a holding company subject to the new foreign trust's control, receiving a distribution from Fund B.

However, the IRS held that the application of the PFIC rules in this case would be consistent with congressional intent, and that the language of these rules is clear on its face. According to the IRS, the provision which treats stock owned by a trust as owned proportionately by its beneficiaries provides an independent basis for treating the gain from the liquidating distribution to Fund B as an excess distribution to its US beneficiaries.

The IRS further held that taxpayers' method of applying the PFIC rules was unreasonable because it was contrary to a plain reading of the statute and resulted in the circumvention, rather than the preservation or triggering, of the PFIC tax and interest charge. Instead, a reasonable method would have been to apply the PFIC rules to treat the US beneficiaries of Fund B as receiving an excess distribution from the corporation when the liquidating distribution commenced.

More specifically, in the absence of temporary or final regulations, a reasonable method of applying the PFIC rules would be to adopt a 'facts and circumstances' test similar to that used under the controlled foreign corporation rules. Under a 'facts and circumstances' test, each of the three US beneficiaries of Fund B should be treated as receiving an excess distribution equal to 16.66% (one-third of 50%) of the gain from the liquidating distribution from the corporation to Fund B.

Comment

In many ways the memorandum adds to the uncertainty in determining a US beneficiary's income tax liability. It does not establish a workable framework for determining whether a US beneficiary of a foreign non-grantor trust will be subject to current taxation on PFIC income. The issue is made particularly difficult by the risk that taxable income may be allocated to trust beneficiaries who are not currently receiving income and may never receive it, especially given that the beneficial interests in the customary foreign trust are largely indeterminate, as a result of the trustee's broad discretion over distributions. Moreover, the PFIC regime often applies to accumulations that occur over many years and would usually result in an interest charge that often does not reflect the economic reality of the actual tax deferral. Congress provided for a special election that ameliorates these problems for shareholders. Under the IRS approach, however, the beneficiaries of a discretionary trust would be determined to be the "true shareholders" over the course of time, based on an 'after the fact' subjective reading of the facts and circumstances. As a result, these deemed shareholders would be unable to make the curative election on a timely basis. Thus, it may come as no surprise that the IRS position is not supported by the legislative history of what Congress intended.

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