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Need for regulations on taxation of US beneficiaries of foreign trusts owning PFICs

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For more than 20 years advisers to US beneficiaries of foreign non-grantor trusts have struggled with the US passive foreign investment corporation (PFIC) rules. The PFIC rules attribute stock owned by a non-grantor trust to its beneficial owners. If applied literally, a US beneficiary could be attributed ownership of the PFIC stock owned by a foreign non-grantor trust and charged with income as if the beneficiary had actually received from the PFIC the portion of the dividend received by the trust, even though the beneficiary may not actually be receiving any comparable distributions from the trust. The American College of Trust and Estate Counsel (ACTEC), a professional body of US tax and trust advisers with an active subcommittee of experienced international practitioners, recently made recommendations to the US Treasury on how regulations could be drafted to avoid tax on phantom income for US beneficiaries, while still following the law's original intention to curtail offshore tax deferral for investments in PFICs.[(1)]

Background

A PFIC 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 on 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.

Trustees of foreign trusts created by non-US persons often invest trust assets in non-US passive investment companies, which in turn may own publicly traded stocks of active operating businesses. Beneficiaries who live in the United States or who later immigrate there could face a US tax liability under the PFIC rules on the investment company's income and gains, plus an interest charge for delayed payment, even though they received no distributions from the trust. This is sometimes referred to as a tax on 'phantom' income. Such a tax liability is not imposed when a US person invests directly in a PFIC without the intervening trust, or when the foreign trust invests directly in active operating companies. The 1986 legislation that introduced the PFIC tax called for regulations to address how US beneficiaries of foreign non-grantor trusts should be taxed when these trusts invest in PFICs but regulations have never been issued. (For a discussion of the classification of trusts as grantor versus non-grantor and the criteria for when a trust is considered foreign for US tax purposes, please see "Taxation of offshore trusts and impact of new lower tax rates").

Anti-deferral rules for PFICs and foreign non-grantor trusts

An important goal of the US tax law is to prevent US persons from avoiding or deferring the payment of US taxes by holding funds offshore. A US citizen and any non-citizen resident in the United States for income tax purposes (together referred to as 'US persons') is subject to US income tax on his or her worldwide income. A non-resident alien is generally subject to US income tax only on US source income (for further details, please see the Overview (March 2008)). Accordingly, absent any special tax rules, a US person could invest in a non-US corporation, earning only non-US source income, free of US tax until the US person receives a distribution from the corporation or disposes of the stock (at which point the proceeds could qualify as long-term capital gains, which are currently taxed at preferred rates). Likewise, a US person could be a beneficiary of a foreign non-grantor trust, earning only non-US source income, free of US tax until distributions are made to that beneficiary.

To prevent this result, US shareholders of PFICs and US beneficiaries of foreign non-grantor trusts must pay income tax plus an interest charge when a defined event occurs, such as a disposition of PFIC stock or receipt of a trust distribution. The interest charge is imposed to offset the prior deferral of tax. A distribution, under both the PFIC tax rules and foreign trust tax rules, is the trigger for imposing the tax and interest charge. However, these two sets of anti-deferral rules deal with two different kinds of ownership – shareholders who have invested directly and beneficiaries who have no direct control over trust investments.

The PFIC rules were enacted to address the fact that US persons were moving funds offshore by investing in non-US investment companies. These rules are designed around the assumption of outright ownership. When PFIC shares are sold, or when a so-called 'excess distribution' occurs, the US shareholder pays a tax at the highest rate for ordinary income even on what would otherwise be capital gains (and often without any credit for basis). The interest charge imposed to offset the interim tax deferral is calculated as if the sales proceeds represent corporate income that was earned ratably over the shareholder's entire holding period (ie, spread evenly on a per day basis) and for which a tax would have been due each year but for the deferral. The PFIC excess distribution rules also tax other kinds of disposition and deemed disposition, and tax a dividend to the extent that it exceeds 125% of the prior three years' average level of distributions.

As an alternative to the excess distribution rules, a US shareholder can (i) make an election to be treated as a qualified electing fund (QEF), which allows the tax to be calculated on a current basis with capital gains character preserved, or (ii) if the PFIC shares are marketable securities, make a mark-to-market election where gain is taxed annually at ordinary income rates. The QEF election allows the US shareholder to postpone paying tax until receiving a distribution or disposing of the PFIC stock, although the tax then due is subject to an interest charge.

Thus, under both the excess distribution rules and the QEF rules, tax is not generally due until there is a disposition of the stock or a distribution from the corporation – events which the shareholder typically controls or which provide cash to pay the resulting tax.

Problem for US beneficiaries

Trust beneficiaries usually have no control over the acquisition and disposition of trust investments or the decision to make trust distributions, and in a typical foreign trust situation would not even be aware of the PFIC investment or its details. The rules for taxing accumulation distributions made by foreign non-grantor trusts adjust well to this situation, taxing US beneficiaries only when they receive a distribution, and imposing an interest charge (for further details please see "Taxation of offshore trusts and impact of new lower tax rates"). However, under the PFIC rules, stock ownership is determined through a set of attribution rules applicable to family members and to intermediate entities such as companies, partnerships and trusts. Applying the attribution rules is quite difficult when an intermediate entity (eg, a trust) owns the stock of the foreign investment company. Stock owned by a non-grantor trust is to be 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 non-grantor trust, despite the fact that attribution to beneficiaries has been part of the Internal Revenue Code for over 20 years.

When the foreign non-grantor trust invests in a PFIC, the beneficiary often does not have a sufficient ownership interest or knowledge to make a timely QEF election. On the other hand, the PFIC rules cannot allow trust ownership to be used as a means to shield a PFIC sale or dividend from tax. A distribution is the common tax trigger event for both the PFIC and trust rules in the simple case, but what happens when the distribution from the PFIC is made to the trust and not to the beneficiary? What if, as is typical for a discretionary trust, it is unclear whether the PFIC proceeds will ever go to a US beneficiary, and what if that distribution may not occur for some time?

IRS application of PFIC rules to foreign trusts

In the absence of regulations, the Internal Revenue Service (IRS) has tried to require the US beneficiaries of foreign non-grantor trusts to pay tax under the PFIC rules when the trust receives an excess distribution, even if the trust does not make a corresponding distribution to the beneficiaries, if the facts and circumstances indicate that the US beneficiaries are the true owners in some sense of the PFIC proceeds. In IRS Technical Advice Memorandum 200733024 (August 17 2007) the IRS articulated in some detail for the first time how it would seek to apply the PFIC rules to US beneficiaries of foreign non-grantor 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 on 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. The taxpayer case that prompted this memorandum was settled on other terms so the IRS position was never tested before the courts (for further details please see "Technical advice memorandum on foreign trusts owning investment company stock").

Without regulations, the PFIC rules do not provide the IRS with a consistent method for deferring the tax and interest due under those rules until a US person receives a trust distribution. A facts and circumstances test is inherently unpredictable and cannot adjust to the reality that the facts and circumstances, however defined, will change over time while the PFIC tax and the trust accumulation tax must be able to identify taxable income over long periods of time, since neither system presumes an annual collection of the tax. Regulations are needed to impose a tax and an interest charge when distributions are actually made to the US beneficiaries and to take into account both the deferral at the trust level and the prior deferral at the PFIC level. That is the genesis of the ACTEC proposals.

ACTEC proposals

US tax practitioners are hopeful that the ACTEC recommendations will lead to a predictable and fair method of taxing US beneficiaries of foreign non-grantor trusts. The ACTEC has proposed a framework for potential regulations addressing the interaction between the foreign non-grantor trust accumulation distribution rules and the PFIC excess distribution rules which preserve the interest charge on the deferred income tax.[2] The proposals recognise that most foreign non-grantor trusts do not give legal control over investments to the US beneficiary, nor provide for fixed and vested income interests payable to beneficiaries.

The ACTEC proposes that regulations be enacted to provide that US beneficiaries of foreign trusts should not be subject to tax until they receive a distribution from the trust, even if the trust owns stock in PFICs. On receiving a trust distribution, the US beneficiary's tax liability would include taxes and interest charges that are coordinated with both the tax on PFIC distributions and the tax on distributions from foreign trusts. Thus, the ACTEC proposals are designed to maintain the integrity of the foreign trust tax rules and the PFIC rules.

The ACTEC proposals do not contain actual implementing language for the regulations and some details are left to be worked out in the implementation. Nevertheless, the proposals offer a concrete and important step forward out of the uncertainty facing US beneficiaries of foreign non-grantor trusts. When the PFIC rules were first enacted, Congress stated that regulations needed to carry out the purposes of the provisions should prevent circumvention of the interest charge. Importantly, it also stated that the general accumulation distribution rules already applied to trusts without PFIC investments should apply to determine how "any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust".[3] The ACTEC proposals adhere to these principles, seeking to preserve the interest charge without taxing beneficiaries on income that they may never receive.

Comment

It is no easy task to harmonise the core principles of the PFIC rules, which are focused on preventing deferral through outright ownership of offshore investment company shares, with the foreign non-grantor trust rules, which accommodate the reality that the beneficiaries are not making these investments and should not pay taxes until distributions are made. The

ACTEC proposals identify ways in which such harmony could be attained. However, until the IRS takes action, advisers to international families will continue to face uncertainty in determining whether a US beneficiary of a foreign non-grantor trust will be subject to current taxation on PFIC income.

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Endnotes

(1) The complete text of the ACTEC proposals, dated June 23 2010, is available at www.actec.org/public/Governmental_Relations/ACTEC_Proposals_06_23_10.asp.

(2) Don Kozusko, an ACTEC fellow, was one of the primary authors of the ACTEC's memorandum to the US Treasury.

(3) General Explanation of the Tax Reform of 1986 prepared by the Staff of the Joint Committee on Taxation, May 4 1987 (the Blue Book), at p 1032.