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In this first installment of a two-part report, Harrison and Lee examine changes made by the Tax Cuts and Jobs Act that estate planners should consider if they represent U.S. taxpayers who have foreign investments, nonresident aliens who have U.S. investments, or estate plans that involve the transfer of assets owned by an NRA or a foreign trust to U.S. beneficiaries. The second installment will discuss planning strategies to mitigate some of the adverse tax consequences of the TCJA.

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A major issue in representing foreign persons and U.S. persons with foreign investments is the treatment of investments in foreign corporations that are classified either as controlled foreign corporations or passive foreign investment companies. The tax rules that apply to CFCs and PFICs were designed to prevent the tax law from making investments in foreign corporations more attractive than investments in comparable domestic corporations. However, the rules go beyond leveling the playing field and can produce punishing tax treatment.

For example, to prevent the deferral of U.S. tax through ownership of a CFC or a PFIC, the rules sometimes tax U.S. owners on undistributed income of foreign corporations and treat as taxable some dispositions of shares of foreign corporations that would otherwise be nontaxable transfers (such as gifts or trust distributions to beneficiaries). The undistributed income is a deemed dividend that is not a qualified dividend and is therefore taxable at a higher rate than would apply to a dividend from a U.S. corporation. Moreover, rules that attribute ownership of stock in a CFC or PFIC owned by a trust to its beneficiaries (including stock deemed to be owned indirectly by a trust through an entity owned by the trust) may expose U.S. persons to tax on income that they have not received, have no right to receive, and may never receive, with respect to stock that they are unable to sell. As this report explains, the Tax Cuts and Jobs Act[1] expanded those rules.

I. The Corporate Anti-Deferral Tax Regimes

A. The CFC Regime

1. What is a CFC?

A CFC is a foreign corporation that meets an ownership test: More than 50 percent of the stock must be owned by U.S. Shareholders.[2] A person is not a U.S. Shareholder unless such person owns at least 10 percent of the stock by vote or value.[3] Both ownership thresholds must be met for the corporation to be a CFC. For example, if 11 unrelated U.S. persons own shares of a foreign corporation equally, the corporation is not a CFC because none of the U.S. owners own 10 percent of the stock. Both ownership thresholds are tested after taking into consideration not only direct ownership, but also indirect and constructive ownership. For example, if I own 9 percent of the stock of a foreign corporation and my daughter owns 1 percent, both of us meet the 10 percent threshold, although each of us is treated as owning and taxed on only the income allocable to the shares we own directly or indirectly and not constructively.[4]

2. How U.S. Shareholders of CFCs are taxed.

The CFC tax rules are designed to avoid the deferral of subpart F income (which includes passive income and some other types of income) accruing to U.S. Shareholders through the ownership of foreign corporations.[5] That goal is achieved by requiring that subpart F income be taxed as if it were distributed by the CFC to the U.S. Shareholder in the year the income was earned by the foreign corporation,[6] and by requiring gains on the sale of shares of a CFC to be characterized as dividend income to the extent that the corporation had earnings and profits attributable to the years the U.S. Shareholder owned the shares.[7]

If a foreign corporation is a CFC at any time during a tax year, every U.S. Shareholder who directly or indirectly owns stock in the corporation on the last day in the tax year in which it is a CFC must include in gross income (regardless of whether the CFC makes a distribution) for the tax year in which or with which that tax year of the corporation ends their pro rata share of the corporation's subpart F income for the year. Subpart F income and global intangible low-taxed income (which, as discussed later, is taxed as subpart F income) are effectively taxed as dividend income that does not qualify for the preferential rate on qualified dividends. A U.S. Shareholder will have subpart F income only if the corporation has E&P in the relevant tax years, computed using U.S. principles. The pro rata share is the amount that would have been distributed with respect to the stock that the U.S. Shareholder owns directly or indirectly in the corporation if, on the last day of the tax year in which the corporation is a CFC, the corporation had distributed pro rata to its shareholders an amount that (1) bears the same ratio to its subpart F income for the tax year as (2) the part of the year during which the corporation is a CFC bears to the entire year, reduced by specified dividend

[1] P.L. 115-97. The Senate parliamentarian removed the short title "Tax Cuts and Jobs Act" as extraneous. Hereinafter, P.L. 115-97 will nonetheless be referred to as the TCJA.

[2] Section 957.

[3] Section 951(b). "U.S. Shareholder" means, for any foreign corporation, a U.S. person (as defined in section 957(c)) that owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of that foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of that foreign corporation.

[4] Section 951(a)(1) taxes U.S. Shareholders on stock that they own or are treated as owning under section 958(a). Section 958(a) defines indirect ownership. Section 958(b) defines constructive ownership.

[5] Section 956 also requires U.S. Shareholders to include in income an amount equal to investments made by the CFCs in specified U.S. property.

[6] Section 951. Amounts included under this section are taxable as ordinary income even if an actual divided might qualify as a qualified dividend taxable at capital gains rates. Section 1(h)(11). Dividends paid by qualified foreign corporations are qualified dividends. Qualified foreign corporations are (1) those eligible for the benefits of a comprehensive income tax treaty with the United States that includes exchange of information provisions, (2) corporations organized in specified U.S. possession, and (3) foreign corporations whose stock is traded on a U.S. stock exchange. A PFIC may not be a qualified foreign corporation, however.

[7] Section 1248.

distributions received by any other person during that year with respect to the stock.[8]

U.S. Shareholders include persons who own shares indirectly through one or more foreign entities. For a foreign estate or trust, beneficiaries are deemed to own shares in proportion to their beneficial interests.[9] The proportional interests of beneficiaries is determined based on all the facts and circumstances and taking into account the purposes for which the attribution of ownership rules are being applied. For example, if the rules are being applied to determine who is taxable on the subpart F income, generally the indirect owners will be the persons who are entitled to receive income.[10] However, it is not clear how proportional interests of beneficiaries are determined for a discretionary trust.[11]

U.S. Shareholders may exclude from income amounts distributed to them from a CFC that are attributable to amounts previously taxed to them under section 951.[12] U.S. Shareholders may increase their basis in the CFC by the amounts previously taxed to them, and they must reduce their basis as previously taxed income is distributed.[13] The U.S. Shareholder's successors in interest can enjoy the same benefits.[14] The basis adjustment reduces gain on a sale of shares of a CFC that occurs before the previously taxed amounts are distributed. This is done to avoid double inclusion. However, when CFC shares are indirectly owned by a beneficiary of a trust, the basis adjustment rules do not function properly because the basis adjustment that is allowed is an adjustment to the beneficiary's basis in the trust, not an adjustment in the shares of the CFC.[15] A basis adjustment to a trust interest does not enter into the calculation of a beneficiary's income from a trust.

3. Changes made by the TCJA.

The TCJA made four important changes to the CFC regime: (1) it modified the definition of U.S. Shareholder; (2) it changed the rules for attribution from some foreign persons; (3) it eliminated the requirement that a corporation be a CFC for a minimum of 30 days before subpart F income can be taxable to U.S. Shareholders; and (4) it created a new category of income taxable as subpart F income — GILTI (discussed in Part 2 of this report).[16]

a. Definition of U.S. Shareholder.

Before the TCJA, the definition of U.S. Shareholder was based solely on the ownership of 10 percent of the *voting* stock. A U.S. Shareholder is now any U.S. person who directly, indirectly, or constructively owns 10 percent of the voting stock or stock whose value is at least 10 percent of the value of all stock of the corporation.

b. Attribution from foreign persons.

The TCJA also changed constructive ownership attribution rules for determining whether the ownership threshold is met for a person to be a U.S. Shareholder.

Section 958(b) provides that the constructive ownership rules of section 318(a) apply to the extent that the effect of the application is, *inter alia*, to treat a U.S. person as a U.S. Shareholder and to treat a corporation as a CFC, with some modifications. One important modification is that stock owned by a nonresident alien (other than a trust or estate) is not considered owned by a citizen or resident individual in applying the family attribution rules.[17] For example, if two spouses each own 50 percent of a foreign corporation and one spouse is an NRA and one is a U.S. citizen, the corporation is not a CFC because shares owned by the NRA spouse cannot be

[8] Section 951(a)(2).

[9] Section 958(a).

[10] Reg. section 1.958-1(c)(2); FSA 199952014.

[11] Reg. section 1.958-1(d), Example 3, illustrated the application of indirect ownership rules by reference to a trust that had three beneficiaries who had fixed and equal shares of trust income and principal, but most foreign trusts are wholly discretionary. The IRS has not published any guidance on how to apply the facts and circumstances test of section 958(a)(2) to determine proportionate ownership of beneficiaries of discretionary trusts. *But see* TAM 200733024 (discussing how a facts and circumstances test would apply to a beneficiary of a foreign non-grantor trust who indirectly owned shares in a PFIC).

[12] Section 959. For a U.S. Shareholder who makes a section 962 election, the exclusion is the amount of tax paid rather than the amount included in gross income.

[13] Section 961. For a U.S. Shareholder who makes a section 962 election, the adjustment to basis is limited to the tax paid rather than the amount included in gross income.

[14] Reg. section 1.959-1(d).

[15] Reg. section 1.961-1(a) and (b)(1)(iii).

[16] Hereinafter, subpart F income is treated as including GILTI.

[17] Section 318(a)(1).

attributed to the U.S. citizen spouse. This rule is not changed.

Before the TCJA, shares owned by a foreign partner, beneficiary, owner, or shareholder were not attributed to a U.S. partnership, trust, estate, or corporation. The TCJA repealed that exception. For example, suppose that a foreign parent corporation owns 95 percent of a foreign subsidiary and 100 percent of a domestic subsidiary. The domestic subsidiary owns the other 5 percent of the foreign subsidiary. As a result of the repeal of section 958(b)(4) by the TCJA, the shares owned by the foreign parent are attributed to the domestic subsidiary, which causes the foreign subsidiary to be a CFC and the domestic subsidiary to be a U.S. Shareholder. This means that the U.S. subsidiary is taxable on 5 percent of the subpart F income of the foreign subsidiary (related to the direct ownership by the U.S. subsidiary). If the U.S. subsidiary did not directly own stock in the foreign subsidiary, the foreign subsidiary would still be considered a CFC, but in that case no subpart F income would be taxable to the U.S. subsidiary because it would not own, directly or indirectly (only constructively), shares of the foreign subsidiary.

In the above example, if the foreign parent owned less than 50 percent of the stock of the domestic corporation, the foreign subsidiary would not be a CFC because none of the foreign parent's shares would be treated as constructively owned by the U.S. corporation. Attribution to a corporation (the domestic subsidiary in the above example) requires that the parent own at least 50 percent of the stock of the domestic corporation.[18] For trusts, attribution requires that either (1) the value of the beneficiary's interest, assuming the maximum exercise of discretion in her favor, has an actuarial value of at least 5 percent of the value of the trust; or (2) the beneficiary is the owner of the trust under the grantor trust rules.[19] There is no similar de minimis ownership rule for attribution to partnerships and estates.[20]

Regulations under section 965 limit attribution for purposes of the transition tax (discussed later) to attribute ownership from a foreign partner, beneficiary, or owner to a U.S. partnership or trust only if the foreign partner, beneficiary, or owner owns at least 10 percent of the U.S. entity (the de minimis rule).[21] However, the de minimis rule does not apply for other purposes.

Proposed regulations issued May 20[22] provide that there no longer will be downward attribution from shareholders, partners, beneficiaries, and owners to corporations, partnerships, trusts, or estates regardless of the level of ownership of such shareholder, partner, beneficiary, or owner. Thus, a lower tier entity would not be treated as constructively owning shares of a CFC owned by its shareholder, partner, beneficiary, or owner. The preamble makes it clear that a corporation is not treated as constructively owning shares of a CFC that are owned by a 51 percent shareholder.

c. The 30-day rule.

Before the TCJA, U.S. Shareholders were not subject to tax on the undistributed income of a CFC unless the corporation qualified as a CFC for an uninterrupted period of 30 days or more during the year.

The TCJA eliminated the 30-day requirement. Therefore, if a U.S. person inherits shares of a foreign corporation from an NRA decedent and the ownership thresholds are met, the U.S. Shareholder will be taxed on her pro rata share of the corporation's subpart F income. For example, if a U.S. person acquires 100 percent of the shares of a foreign corporation from a decedent, the corporation would be a CFC, and a fraction of its subpart F income earned in that year would be taxable to the U.S. person. If the U.S. person retained the stock until the end of the year, the numerator of the fraction would be the number of days in the year that the U.S. person owned the stock, and the denominator would be the number of days in the corporation's tax year.

Before the TCJA, a U.S. person that inherited shares from a foreign person could make a check-the-box election retroactive to within 29 days of the death of the foreign person and avoid tax under the CFC rules. If the election was a deemed

[18] Section 318(a)(3)(C).

[19] Section 318(a)(3)(B).

[20] Section 318(a)(3)(A).

[21] Reg. section 1.965-1(f)(45)(ii).

[22] REG-125135-15.

liquidation, this allowed a tax-free basis adjustment for the assets owned by the CFC.[23] As a result of the TCJA, a U.S. Shareholder of a CFC will be taxed if she owns shares at any time during the year on a portion of the CFC's subpart F income. Subpart F income would include any gain realized on a deemed liquidation, thus eliminating the tax-free basis step-up for the CFC's assets. Tax can be avoided only if the check-the-box election is effective before death. In this case, the corporation would never become a CFC. However, a check-the-box election with a pre-death effective date also would eliminate the estate tax shield of holding assets through a foreign corporation.

Not all foreign corporations qualify for a check-the-box election.[24] If a check-the-box election is made, the entity becomes either disregarded (if there is only one shareholder) or a partnership (if there is more than one shareholder). If the classification of the entity was relevant for U.S. tax purposes before the election was made, the election by the corporation to be a disregarded entity or a partnership is a deemed liquidation.[25] The check-the-box election may have an effective date of up to 75 days before the election is filed.[26] Thus, the check-the-box election gives the U.S. person that inherits the shares more time to accomplish a timely liquidation.

[23] Sections 331 and 334.

[24] Reg. section 301.7701-2 contains a list of foreign entities classified as per se corporations for which a check-the-box election is not allowed.

[25] Reg. section 301.7701-3(g)(1). Classification is relevant if it affects the liability of any person for federal tax or information purposes, or if it affects the determination of the amount of tax to be withheld by a withholding agent, the type of tax or information return to file, or how the return must be prepared. Reg. section 301.7701-3(b)(ii) and (d)(i). If the classification was not relevant for U.S. tax purposes, the check-the-box election may be treated as an initial classification and not a deemed liquidation. Reg. section 301.7701-3(d)(2). Relevance is defined in reg. section 301.7701-3(d)(1)(i) by reference to whether it affects the income tax liability or information reporting of a U.S. taxpayer. The regulation states that there is relevance if classification of the entity "might affect the documentation that the withholding agent must receive from the entity, the type of tax or information return to file or how the return must be prepared." There is no gain if there is no deemed liquidation, but the treatment of the entity as a disregarded entity or a partnership from inception means that there is no shield from U.S. estate tax if the entity owns U.S.-situs assets (unless you believe, as some do, that a single-member limited liability company or a partnership also is an effective estate tax shield). The tax consequences of a deemed liquidation are the same as the tax consequences of an actual liquidation — the corporation recognizes gain on the distribution of appreciated assets, which gain is subpart F income, and all assets acquire a new basis in the hands of the shareholders. Sections 336(a) and 334(a).

[26] Reg. section 301.7701-3(c)(1)(iii). Form 8832, "Entity Classification Election," is used for this purpose.

Because a U.S. person is deemed to indirectly own shares owned by a foreign estate or trust in proportion to her beneficial interest in the estate or trust, the change of ownership may occur on the date of death, even if the U.S. person does not acquire direct ownership. For example, if the shares are held in a foreign grantor trust, the foreign grantor will be deemed the owner of the shares during her lifetime.[27] Upon her death, the beneficiaries will be deemed to own the shares held by a foreign non-grantor trust in proportion to their beneficial interests.[28]

Check-the-box planning is still important after the TCJA because it allows a U.S. Shareholder more control over the timing of the deemed liquidation and therefore the amount of subpart F income on which she will be taxable. As mentioned earlier, the pro rata share of subpart F income of a CFC that is taxable to the U.S. Shareholder is based on the number of days in the tax year that the U.S. person was a U.S. Shareholder of the CFC. For example, if the U.S. Shareholder acquired the shares on June 1 and the deemed liquidation as a result of the check-the-box election occurred on June 2, the pro rata share of subpart F income taxable to the U.S. Shareholder would be 1/181 because there would be only 181 days in the final tax year of the CFC — January 1 to June 2.[29] If the U.S. Shareholder acquired the shares on January 1 and the deemed liquidation occurred on January 2, half of the subpart F income would be taxable to the U.S. person. If the NRA died in December and the corporation is on a calendar year, a retroactive check-the-box election effective after death but in the prior year would produce a very small fraction. The amount of subpart F income that will be taxable to a U.S. Shareholder is reduced when the numerator of the fraction is as small as possible and the denominator is as large as possible. As the previous examples illustrate, this is easier to accomplish if the shares are inherited later in the tax year. Minimizing the numerator is

[27] Reg. section 1.958-1(b).

[28] Section 958(a)(5); reg. section 1.958-1(b).

[29] For purposes of sections 951 to 964, the holding period of the shares does not include the date of acquisition but includes the date of disposition. Reg. section 1.951-1(f).

made simpler if the foreign corporation is eligible to make a check-the-box election.

Owning U.S. situs assets through a foreign corporation may avoid U.S. estate tax because stock of a foreign corporation is foreign situs for U.S. estate tax purposes.[30] However, an NRA investor does not need to invest through a foreign corporation to shield non-U.S. securities from U.S. estate tax. Therefore, those non-U.S. investments should either not be made through a foreign corporation or be made through a different foreign corporation than the one that invests in U.S. securities. It is also important to use a foreign corporation that is eligible for a check-the-box election.[31] This permits the check-the-box election for the corporation that is not needed for an estate tax shield to be made effective before the death of the NRA owner.

U.S. real estate should be owned in a separate structure because the deemed liquidation of the foreign corporation would be taxable.[32]

B. The PFIC Regime

1. What is a PFIC?

A PFIC is a foreign corporation that has mostly passive income or passive-income-producing assets. Unlike the CFC rules, the PFIC rules apply without regard to any threshold ownership by U.S. persons. A foreign corporation is a PFIC if 75 percent or more of its gross income is passive or the average percentage of assets it holds that produce passive income is at least 50 percent.[33] The 50 percent test is based on value for publicly traded securities, or on adjusted basis if the shares are not publicly traded and the corporation either is a CFC or elects to value assets at their adjusted basis.[34] Subject to limited exceptions,[35] passive income is foreign personal holding company income as defined in section 954(c) (a category of income included in the definition of foreign base company income, which is considered subpart F income). Foreign personal holding company income includes dividends, interest, royalties not derived from an active trade or business, rents not derived in the conduct of an active trade or business, annuities, gains from property transactions (excluding business property or inventory), commodities transactions, foreign currency gains, and income equivalent to interest. A typical PFIC would be a foreign mutual fund or other pooled investment vehicle that is structured as a corporation or treated under U.S. entity classification rules as an association taxable as a corporation.[36]

a. Insurance company exception.

Insurance companies, by their nature, hold significant liquid investments that produce passive income. If these assets and income were classified as passive for purposes of the PFIC rules, most foreign insurance companies would be PFICs. Recognizing the importance of passive investments to an active insurance business, Congress provided an exception from passive income for income derived in the active conduct of an insurance business (the active insurance exception). The TCJA amended the active insurance exception to PFIC classification.

For tax years beginning after December 31, 2017, only income derived by a qualifying insurance corporation in the active conduct of an insurance business is eligible for the exception.[37] A foreign corporation is a qualifying insurance

[30] Section 2104(a). Some treaties classify shares of a U.S. corporation as non-U.S. situs unless associated with a permanent establishment. For example, estate tax treaties with Australia, France, Germany, the Netherlands, and the United Kingdom do not allow the United States to impose estate tax on intangibles unless associated with a permanent establishment in the United States. In those cases, a retroactive check-the-box election to cause a deemed liquidation to occur on the day before death would re-base the investment portfolio to date-of-death values without exposure to either the CFC regime or U.S. estate tax.

[31] Entities classified as corporations under reg. section 301.7701-2(b)(1), (3), (4), (5), (6), (7), and (8) are ineligible for a check-the-box election. Reg. section 301.7701-3(a).

[32] Section 897.

[33] Section 1297(a).

[34] Section 1297(e).

[35] Exceptions include income from the active conduct of a banking business or insurance business, and interest, dividends, rents, and royalties received from a related person as defined in section 954(d)(3). A related person is an individual, corporation, partnership, trust, or estate who controls or is controlled by the foreign corporation. Control means direct or indirect ownership of more than 50 percent of the vote or value of the stock (for a corporation) or more than 50 percent of the beneficial interests (for a partnership, trust, or estate).

[36] *See* ILM 201003013: A Canadian mutual fund structured as a trust under Canadian law was classified as a corporation under U.S. classification rules in reg. section 301.7701-1 through -4.

[37] Section 1297(f).

corporation during a tax year if (1) it would be subject to tax under subchapter L if it were a domestic insurance corporation and (2) its applicable insurance liabilities constitute more than 25 percent of its total assets. The term "applicable insurance liabilities" is narrowly defined: Loss and loss adjustment expenses of a life or property and casualty insurance business are counted. But only limited reserves are considered in determining applicable insurance liabilities — deficiency, contingency, and unearned premium reserves are specifically excluded. And the amount of the applicable insurance liabilities is limited to the lesser of (1) the amounts reported to the applicable insurance regulator on the insurance company's financial statements and (2) amounts determined under regulations, if promulgated.

U.S. owners of foreign insurance companies failing the 25 percent applicable insurance liabilities test are granted a limited, partially subjective, alternative active insurance exception test. Under this alternative test, a U.S. person may treat a foreign corporation as a qualifying foreign corporation if: (1) its applicable insurance liabilities constitute at least 10 percent of its total assets; (2) it is, under regulations promulgated by the IRS, predominately engaged in an insurance business; and (3) its failure to satisfy the 25 percent applicable insurance liabilities test is "due solely to runoff-related or rating-related circumstances involving such insurance business." It is unclear whether the alternative test is self-executing or instead requires the issuance of regulations.

Foreign insurance companies facing PFIC classification because of the narrowed active insurance exception have options. Those on the border should reevaluate operations to satisfy the new requirements. Those that will not qualify should consider domesticating or filing section 953(d) elections to be taxed as domestic corporations, which would extricate their U.S. owners from the PFIC rules. Alternatively, insurance companies may choose to remain offshore but provide their U.S. owners with notice of PFIC status and comply with the requirements to permit those owners to treat the insurance company as a qualified electing fund (QEF), thereby avoiding the harsh PFIC anti-deferral regime, described later. In all cases, foreign insurance companies with U.S. owners should analyze the new active foreign insurance exception and evaluate the potential impact on their U.S. owners.

b. Look-through rule.

In determining whether a foreign corporation is passive, a look-through rule applies if the corporation owns 25 percent or more of the stock of another corporation.[38] For example, if FC1 owns 25 percent of the stock of FC2, which is engaged in an active trade or business, 25 percent of FC2's income and 25 percent of its assets are attributed to FC1 in determining whether FC1 is a PFIC.

c. Exception for some U.S. Shareholders of a CFC.

A corporation will not be a PFIC for any year after December 31, 1997, for a shareholder if that shareholder qualifies as a U.S. Shareholder and the foreign corporation is a CFC during that year.[39] Because that U.S. Shareholder is currently taxable on her share of the CFC's subpart F income, it is unnecessary to subject her to the PFIC regime. However, if the corporation was previously a PFIC for that shareholder, the corporation remains a PFIC. For example, if a shareholder held PFIC shares in year 1 and in year 2 the entity became a CFC, the PFIC taint from year 1 would carry forward, but the PFIC rules for year 2 would be inapplicable.

d. 'Once a PFIC, always a PFIC' rule.

If a foreign corporation is a PFIC in any year in the shareholder's holding period, then in any subsequent year it remains subject to the PFIC regime of taxation even if it would not otherwise qualify as a PFIC.[40] This is referred to as the "once a PFIC, always a PFIC" rule. An exception applies to corporations during the start-up year (defined as the first year in which the corporation has gross income) if it is not a PFIC in the following two years and no predecessor of that corporation was a PFIC. A second exception applies to a

[38] Section 1297(c).

[39] Section 1297(d). However, this exception will apply if the corporation was a PFIC unless the shareholder makes a purging election under section 1298(b)(1).

[40] Section 1298(b).

corporation that would otherwise first become a PFIC because of the sale of a business and the temporary reinvestment of proceeds in passive income producing assets, if the corporation does not meet the definition of a PFIC in the following two years.

There are two additional exceptions to the "once a PFIC, always a PFIC" rule. Under the first exception, the rule does not apply to a U.S. shareholder that makes a timely and valid QEF election (as discussed later) for the first tax year in which the shareholder holds the PFIC shares.[41] The second exception provides that the rule does not apply for any year after the year in which a valid mark-to-market election (also discussed later) is in effect for the PFIC shares held by the shareholder.[42]

2. How shareholders of a PFIC are taxed.

a. Distributions.

Unlike the normal rules of U.S. taxation of corporations and shareholders, a PFIC's E&P are generally not relevant to the taxation of a PFIC distribution. Rather, the taxation of a PFIC distribution depends on its size compared with distributions in prior years. Distributions fall into two categories: excess and non-excess.

An excess distribution is a distribution to a shareholder that is more than 125 percent of the average distributions made to the shareholder who owns the shares directly or indirectly for the prior three years (or the years in the shareholder's holding period if less than three years).[43] A distribution that is made in the first year of the shareholder's holding period is not an excess distribution.[44] In calculating 125 percent of average distributions for the prior years, only prior year non-excess distributions are counted. A non-excess distribution is the part of a distribution that is not an excess distribution. A non-excess distribution is taxed to the shareholder based on the general rules of U.S. corporate income taxation, which will generally result in dividend treatment.[45] However, the non-excess distribution will not be a qualified dividend taxable at the capital gains tax rate because a PFIC by definition is not a qualified foreign corporation.[46]

Because shares owned by a foreign shareholder are not PFIC shares,[47] a U.S. Shareholder who inherits stock from a foreign person is not treated as receiving an excess distribution in the first year of her ownership. The distributions in the first year will count in calculating whether future distributions are excess distributions. The holding period begins on the date the shares are inherited from a foreign person.

Excess distributions are subject to a special tax regime. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares.[48] Whether the PFIC had E&P in those years is irrelevant. The portion of the excess distribution that is allocated to the current year and the pre-PFIC years is included in the taxpayer's income for the year of receipt as ordinary income.[49] A pre-PFIC year is a tax year beginning before December 31, 1986, or a year in which the shares were owned by an NRA.[50] The portion of the excess distribution allocated to other years in the

[41] Reg. section 1.1291-1(b)(2)(ii); prop. reg. section 1.1291-1(c)(1). A PFIC to which this exception applies is sometimes referred to as a "pedigreed QEF."

[42] *See* section 1296(j), reg. section 1.1291-1(c)(4), and reg. section 1.1296-1(f) and (h)(2)(ii).

[43] Section 1291(b)(2)(A).

[44] Section 1291(b)(2)(B).

[45] Prop. reg. section 1.1291-2(e)(1).

[46] Section 1(h)(11)(C)(iii).

[47] Reg. section 1.1291-9(j)(1): A corporation will not be treated as a PFIC for a shareholder for those days included in the shareholder's holding period when the shares, or a person whose holding period is included in the shareholder's holding period, is not a U.S. person within the meaning of section 7701(a)(3).

[48] Section 1291(a)(1)(A).

[49] Section 1291(a)(1)(B). As mentioned in the text, a PFIC is by definition not a qualified foreign corporation.

[50] Section 1291(a)(1)(B)(ii); reg. section 1.1291-9(j)(1).

taxpayer's holding period (the prior PFIC years[51]) is not included in the shareholder's income. Rather, it is subject to a deferred tax, which is added to the tax that is otherwise due.[52] In calculating the deferred tax, the taxpayer multiplies the distribution allocated to each prior PFIC year by the highest marginal tax rate for the prior PFIC year.[53] The aggregate amount of the tax for each year is treated as unpaid tax.[54] The taxpayer must then compute interest on those "unpaid" taxes as if the shareholder had not paid the tax for each prior PFIC year when due, using the applicable federal underpayment rate.[55] The taxpayer includes the deferred tax and interest as separate line items on her individual income tax return.[56]

For example, if A acquired PFIC shares in 1990 but was an NRA from 1990 to 2000 and a U.S. taxpayer from 2001 through 2010, an excess distribution received in 2010 would be allocated to all years in A's holding period, but the amount allocated to 1990-2000, which are pre-PFIC years, would be included in current-year income as ordinary income. Amounts allocated to 2001-2009, which are prior PFIC years, would be subject to the deferred tax and interest charge described earlier. If A were a trust and not an individual, only the amount allocated to the current year would be included in the calculation of distributable net income, because distributable net income is based on the trust's taxable income with some adjustments.[57]

The deferred tax and interest calculation is similar to the default method for computing tax on an accumulated distribution from a foreign trust under subchapter J.[58] However, the tax and interest on an excess distribution can exceed the amount the taxpayer receives. There is no cap similar to the one in section 668(b) for the throwback tax.

If the PFIC shares in the above example were owned by a foreign trust and the default method for determining accumulation distributions had not been elected, a distribution to a beneficiary of the amount the trust received from the PFIC, assuming it is allocated to fiduciary income, would not be an accumulation distribution because a distribution of an amount that does not exceed fiduciary net income is not an accumulation distribution.[59] No interest charge would be imposed unless a U.S. beneficiary of Trust A was deemed to indirectly own the PFIC shares. This is why the IRS is intent on attributing ownership to beneficiaries. In our view, this is not the right approach. The better solution would be to amend the rules of subchapter J to preserve the interest charge, such as by treating distributions from the PFIC as creating undistributed income for the trust in the years the income was deemed to have been accumulated in the PFIC. In the above example, the excess distribution allocated to prior PFIC years (2001-2009) would be treated as undistributed net income of the foreign trust for each year. The undistributed net income would be subject to the accumulation distributions rules of subchapter J, including an interest charge, when distributed to a U.S. beneficiary.

b. Dispositions.

Gains realized on the disposition of PFIC shares are taxed in the same manner as excess distributions.[60] This means that gains are taxable as ordinary income to the extent allocable to the current year and pre-PFIC years and are subject to the deferred tax regime to the extent allocable to prior PFIC years. The first-year exception in section 1291(b) does not apply to gains (which are

[51] Prior PFIC years and pre-PFIC years are different. Pre-PFIC years are tax years in which the PFIC regime had not yet been enacted and years in which the corporation was not a PFIC, which includes years in the shareholder's holding period in which the shares were owned by an NRA. Prop. reg. section 1.1291-1(b)(3). Prior PFIC years are years in a shareholder's holding period before the current year that are not pre-PFIC years. If a shareholder makes a purging election, years before the year of the election are no longer considered to be in the shareholder's holding period. Sections 1291(d)(2)(C)(ii) and 1298(b)(1); reg. sections 1.1291-9, -10, 1.1297-3, and 1.1298-3.

[52] Section 1291(c).

[53] Section 1291(c)(1).

[54] Section 1291(c)(2).

[55] Section 1291(c)(3).

[56] *See* section 1291(a)(1)(C).

[57] Section 643(a).

[58] *See* instructions to Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," for an explanation of the default rule.

[59] Section 665(b) provides that a distribution that does not exceed income for the year is not an accumulation distribution. The term "income" for this purpose means fiduciary net income. Section 643(b).

[60] Section 1291(a)(2).

not "excess distributions" but only taxed as excess distributions under section 1291(a)(2)), but if a disposition occurs in the first year in the taxpayer's holding period, all the gain should be allocated to the current year. Unfortunately, it appears that any losses on a disposition would be capital losses. This leads to unreasonable results.

For example, assume that U.S. person A inherits shares of a PFIC from an NRA. The shares are worth $1 million and acquire a new basis of $1 million at the NRA's death. The PFIC owns shares in another PFIC. A's share of the indirectly owned PFIC is worth $300,000, and A's share of the basis is $100,000 (because the basis of the shares the NRA owned indirectly were not adjusted at her death). If A sells the shares of the PFIC for $1 million shortly after the NRA's death, there will be little or no gain on the shares A owned directly, but according to proposed regulations there would be gain of $200,000 on the shares that A owned indirectly and ceased to own indirectly after the sale.[61] That gain is taxed as an excess distribution. There are no prior PFIC years in this example, so all the gain is allocated to the current year and taxed as ordinary income.[62] A should receive a basis adjustment of $200,000 to the shares she owned directly for the income she recognized on the sale of shares she owned indirectly.[63] However, the basis adjustment is not helpful because the loss would be a capital loss and therefore would not materially reduce A's tax on the ordinary income of $200,000. However, if A made a QEF election (discussed below) for the shares she inherited and owns directly and for the shares of any underlying PFICs she owns indirectly, this result should be avoided because any gain would be capital gain and the capital loss would offset the gain.[64]

To the extent provided in regulations, gain is recognized on any transfer of shares in a PFIC even if gain would not otherwise be recognized (for example, a gift).[65] The amount of gain is the excess of the fair market value of the shares over basis. Only proposed regulations have been issued.[66] Under those proposed regulations, the following are taxable dispositions: a sale, an exchange, a gift, a transfer at death, an exchange under a liquidation or a section 302(a) redemption, a distribution described in section 311, 336, 337, 355(c), or 361(c), and the expatriation of a U.S. citizen or resident.[67] Exceptions to the general rule of recognition apply for a gift to a U.S. person (other than a charitable organization) or to a passthrough entity if the transferor continues to own the PFIC shares indirectly. Gain is not recognized to a shareholder on a transfer at death provided that the will does not permit transfer to either a foreign beneficiary or a trust, whether domestic or foreign, that is not a grantor or beneficiary-owned trust owned by a U.S. person.[68] A transfer to a testamentary complex trust will be taxable even if the trust is a domestic trust. Proposed regulations provide that the taxable event is deemed to occur the moment before death and that the gain is taxable on the decedent's final return.[69]

c. Basis rules.

PFIC shares are nominally eligible for a step-up in basis at death. However, section 1291(e)(1) provides that a succeeding shareholder's basis in PFIC shares is the fair market value of the shares on the date of death reduced by the difference between the new basis under section 1014 and the decedent's adjusted basis immediately before the date of death.[70] Thus, a succeeding shareholder's basis in PFIC shares received from a decedent is limited to the adjusted basis of the decedent before death. However, PFIC shares inherited from an NRA decedent do acquire a new basis.[71]

[61] Prop. reg. section 1.1291-3(e)(4).

[62] Prop. reg. section 1.1291-3(e)(2).

[63] Prop. reg. section 1.1291-3(e)(4)(iii).

[64] Section 1293(a).

[65] Section 1291(f).

[66] Prop. reg. section 1.1291-3 and -6.

[67] Prop. reg. section 1.1291-3(b) and -6(b). A pledge is also a disposition under reg. section 1.1291-3(d).

[68] Prop. reg. section 1.1291-6(c). Gains realized on the disposition of PFIC shares owned by a pooled income fund are not taxed if the gain is permanently set aside for the charitable remainder beneficiary.

[69] Prop. reg. section 1.1291-6(d)(2).

[70] Section 1291(e)(1).

[71] Section 1291(e)(2).

d. Exceptions.

The PFIC regime is avoided if the QEF or mark-to-market elections are made, as discussed below. The PFIC regime also is not applicable to stock that is marked to market under section 475 or any other provision of Chapter I, "Normal Taxes and Surtaxes."[72] The regime also does not apply to some U.S. Shareholders of CFCs, as mentioned earlier.[73]

3. PFIC elections.

a. QEF elections.

A U.S. person, other than a tax-exempt organization,[74] who directly or indirectly owns the shares of a PFIC can elect to be taxed on her pro rata share of the PFIC's E&P by making a QEF election.[75] The election is made by the first U.S. person in the chain of title.[76] The election must be made on a return filed by the due date for the year of the election.[77] A retroactive election may be made in the year the shareholder can show that she first knew or had reason to know that the corporation was a PFIC, or later if she obtains the commissioner's consent.[78] The election may be made only if the PFIC provides the shareholder with the information she needs to calculate her tax liability.[79]

A domestic passthrough entity, which includes an estate or trust, may make a QEF election, in which case "shareholders owning stock of a QEF by reason of an interest in a domestic trust or estate take into account the section 1293 inclusions with respect to the QEF shares under the rules applicable to inclusions of income from the trust or estate."[80] The term "shareholders" does not include domestic partnerships, S corporations, or grantor or beneficiary-owned trusts, except for information reporting purposes. Domestic estates and non-grantor trusts are not excluded from the definition of shareholder.[81] However, beneficiaries of domestic estates and non-grantor trusts may be indirect owners.[82] Thus, it is uncertain whether a domestic trust that makes a QEF election can report income from the PFIC as a result of the QEF election and pay tax on that income to the extent that distributions are not made to beneficiaries (applying the usual rules of subchapter J), or whether the beneficiaries who are deemed to be the indirect owners must report the income regardless of whether it is received.

If a QEF election is made for all years in the shareholder's holding period in which the corporation was a PFIC, the PFIC tax regime is not applicable.[83] In this case, the PFIC is referred to as a "pedigreed QEF."[84] If a QEF election is in effect for only some years, the PFIC regime continues to apply unless a purging election is made.[85] There are two kinds of purging elections: a deemed sale election and a deemed dividend election.[86] A deemed sale election is an election to treat the shares as if they were sold, gain was recognized, and the shares were repurchased.[87] A deemed dividend election is available only to shareholders of a CFC that is also a PFIC (regardless of whether the shareholder is a U.S. Shareholder). It is an election to treat all post-1985 E&P as distributed.[88] A purging election causes the shareholder to be treated as receiving an excess distribution.

If a purging election is not made and the QEF election is not in effect for all years in the shareholder's holding period during which the corporation was a PFIC, dividends and gains continue to be taxable under the PFIC regime.[89]

[72] Section 1291(d) (flush language).

[73] Section 1297(d).

[74] Reg. section 1.1295-1(d)(1) and (6).

[75] Section 1295.

[76] Reg. section 1.1295-1(d)(1).

[77] Reg. section 1.1295-1(e).

[78] Reg. section 1.1295-3(g).

[79] Section 1295(a)(2).

[80] Reg. section 1.1295-1(d)(2)(iii).

[81] Reg. section 1.1291-1(b)(7).

[82] Reg. section 1.1291-1(b)(8)(iii)(C).

[83] Section 1291(d)(1).

[84] Reg. section 1.1291-9(j)(2)(ii).

[85] Reg. section 1.1291-1(c)(2).

[86] Reg. section 1.1297-3.

[87] Reg. section 1.1291-10.

[88] Reg. section 1.1291-9.

[89] Prop. reg. section 1.1291-1(c)(2).

However, dividends paid from undistributed income that was previously taxed as a result of the QEF election are not again taxed when distributed.[90] Similarly, if a QEF election is made, the basis in the PFIC shares is increased by the undistributed E&P that are taxed as a result of the QEF election.[91]

A shareholder who makes a QEF election also may elect to extend the time for payment of tax imposed on undistributed earnings as a result of a QEF election, although an interest charge is imposed on the deferred tax liability.[92]

b. Mark-to-market election.

If the shares of a PFIC qualify as marketable stock,[93] a U.S. person who directly or indirectly owns the shares of the PFIC can make a mark-to-market election to pay tax at ordinary income rates on unrealized appreciation in the value of PFIC shares (operating as if the PFIC stock were sold at the end of each year).[94] If the PFIC shares have declined in value, the loss may be deducted as an ordinary loss, but only to the extent of gains previously taxed to the taxpayer. The deferred tax and interest charge regime described earlier does not apply to any year after that in which a mark-to-market election is in effect.[95] For the year of the election, the deferred tax and interest charge can be avoided if the PFIC was previously a pedigreed QEF or if the PFIC is a regulated investment company that makes an election to pay the interest charge that otherwise would have been incurred under section 1291(c)(3).[96] A retroactive mark-to-market election may be made in accordance with reg. section 301.9100.

If a U.S. person is treated as indirectly owning PFIC shares that are subject to a mark-to-market election, any disposition that results in the U.S. person being treated as no longer owning the shares, such as a disposition of the shares by the person who directly owns the shares, is treated as a disposition by the U.S. owner, but the holding period will be deemed to begin on the first day of the first tax year beginning after the last tax year for which the mark-to-market election was in effect.[97]

The indirect ownership rules under the mark-to-market regime apply only to shares owned through foreign entities, "except as provided in regulations."[98] In this case, unlike the rules for section 1291 attribution, applicable regulations only attribute ownership from foreign entities.[99] A CFC that owns stock in a PFIC for which a mark-to-market election is in effect is treated as a U.S. person, the amount taken into income is subpart F income, and the U.S. Shareholder is not taxed under the PFIC rules.[100] This rule does not apply to a shareholder who is not a U.S. Shareholder for purposes of the CFC rules.

Upon the death of a person who has made a mark-to-market election, the transferee's basis is a carryover basis limited to fair market value on the date of death.[101] If an NRA who owns shares in a PFIC becomes a U.S. taxpayer and makes a mark-to-market election, the shareholder's basis is the greater of fair market value on the first day of her tax year as a U.S. taxpayer and adjusted basis on that date.[102]

4. Indirect ownership.

As under the CFC rules, U.S. Shareholders are taxed on income attributable to PFIC shares that they own directly or indirectly. Under the indirect ownership rules, beneficiaries of an estate or trust may be treated as owning the shares owned directly or indirectly by the estate or trust. The regulations provide limited guidance on how to determine when a beneficiary will be deemed to indirectly own PFIC shares owned by an estate or trust. The regulations state that beneficiaries own PFIC shares in proportion to their beneficial interests, but there is no guidance on how to

[90] Section 1293(c).

[91] Section 1293(d).

[92] Section 1294.

[93] Stock that is regularly traded on an established securities exchange generally qualifies as marketable stock for this purpose. *See* section 1296(e) and reg. section 1.1296-2.

[94] Section 1296.

[95] Section 1291(a)(3)(A)(ii).

[96] Section 1296(j).

[97] Reg. section 1.1296-1(f) and (g)(1).

[98] Section 1296(g).

[99] Reg. section 1.1296-1(e).

[100] Reg. section 1.1296-1(g)(2).

[101] Section 1296(i). The decedent's tax basis would have been increased for unrealized gains before death.

[102] Section 1296(l).

determine beneficial ownership among the beneficiaries of a discretionary trust.

Depending on how indirect ownership is determined, a U.S. beneficiary may be taxable on (1) distributions from a PFIC that are not made to her and that she has no right to receive and (2) dispositions of PFIC shares not made by her and that she does not control, including nontaxable dispositions.

Section 1298(b)(5) provides that:

> *Under regulations*, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a) —
>
> i. any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock, or
> ii. any distribution of property in respect of such stock to the person holding such stock,
>
> shall be treated as a disposition by, or distribution to, the United States person with respect to the stock in the passive foreign investment company. [Emphasis added.]

For example, if a trust distributed PFIC shares to a foreign beneficiary and the shares had been treated as indirectly owned by a U.S. beneficiary, the U.S. beneficiary would be deemed to have disposed of her shares for fair market value and realized gain that is taxable as an excess distribution equal to the excess of value over basis. If the trust is a U.S. trust, gain would be recognized by it under proposed regulations if shares of a PFIC are distributed to a beneficiary other than a U.S. individual or a domestic corporation (other than an S corporation).[103]

Even though section 1298(b)(5) by its terms requires implementing regulations, the IRS maintains that this rule concerning indirect dispositions can apply without the need for final regulations, which still do not exist.[104] In TAM 200733024 the IRS took the view that the beneficiaries would be deemed to indirectly own PFIC shares owned by a trust based on historic patterns of distributions the trust had been making. The attribution of ownership defeated an attempted stripping distribution — a sale of PFIC shares in year 1 and a distribution in that year to foreign beneficiaries, and an equivalent distribution in year 2 to the U.S. beneficiaries.

Although the statute and the regulations make it clear that a beneficiary of an estate or trust will be deemed to indirectly own PFIC shares held directly or indirectly by the estate or trust — regardless of whether the estate or trust is domestic or foreign[105] — Treasury has given U.S. taxpayers no guidance on how to determine indirect ownership, and it has provided only limited guidance on how the PFIC rules are to apply to estates and trusts and their beneficiaries. There seems little purpose in looking through a domestic estate or trust, because it could pay the same tax on PFIC shares that a beneficiary would pay if the beneficiary were treated as the indirect owner.[106]

To date, applicable regulations have reserved on the issue of how beneficiaries of an estate or trust are to report amounts distributed from PFICs that they are deemed to own indirectly,[107] and on deemed dispositions of indirectly owned PFIC shares.[108] Proposed regulations provide that a disposition occurs upon the happening of *any* event as a result of which an indirect shareholder's ownership in the PFIC is reduced or eliminated.[109] Any gain is an excess distribution allocated over the indirect owner's holding period (not the actual owner's holding period). The basis of the indirect owner's interest in the entity directly owned by her is increased by the gain recognized.

For a trust beneficiary, her interest in the entity directly owned by her is the trust, and the basis of a trust has no effect on the tax treatment of

[103] Prop. reg. section 1.1291-6(a)(2) and (c)(2)(i).

[104] TAM 200733024.

[105] Section 1298(a)(3); reg. section 1.1291-1(b)(8)(iii)(C).

[106] If the domestic trust is a charitable remainder trust, treating it as the owner of the shares would eliminate the risk of attributing ownership to the annuitants.

[107] Prop. reg. section 1.1291-2(f)(2)(i).

[108] Prop. reg. section 1.1291-3(e)(5)(ii).

[109] Prop. reg. section 1.1291-3(e)(4)(iii).

distributions made from the trust to her under the rules of subchapter J. Further, the direct owner (here the trust) may increase the basis in the shares by the gain recognized by the indirect owner.[110] The principles of sections 959 and 961 are to apply to distributions from a PFIC that are attributable to previously taxed income.[111] However, proposed regulations reserve on the subject of how to apply these principles to trusts, estates, and their beneficiaries.[112] Guidance is necessary because the application of these principles to trusts may cause tax to be imposed on one beneficiary (for example, an income beneficiary who is treated as indirectly owning shares of the PFIC), and the exclusions or basis adjustments under the principles of sections 959 and 961 may benefit another beneficiary (for example, a remainder beneficiary) if the distribution of PTI or the sale of shares occurs after the income beneficiary's interest has terminated. Moreover, the termination of the income beneficiary's interest in the trust may be a deemed disposition of the beneficiary's indirectly owned PFIC shares so that the beneficiary who received no benefit would be taxed again on the unrealized gain.

Pending further guidance, the preamble to the 1992 proposed regulations advised taxpayers to "apply the PFIC rules and Subchapter J in a reasonable method that preserves the interest charge."[113] The preamble to temporary regulations issued in 2013 similarly advised taxpayers:

> These temporary regulations also provide special rules for nongrantor trusts and grantor trusts. In particular, Treas. Reg. section 1.1291-1T(b)(8)(iii)(D) provides that if a foreign or domestic grantor trust directly or indirectly owns PFIC stock, a person that is treated under sections 671 through 679 as the owner of any portion of the trust that holds an interest in the stock is considered to own an interest in the stock held by that portion of the trust. In addition, Treas. Reg. section 1.1291-1T(b)(8)(iii)(C) provides that, in general, if a foreign or domestic estate or nongrantor trust directly or indirectly owns PFIC stock, each beneficiary of the estate or trust is considered to own a proportionate amount of such stock. The cross-referenced notice of proposed rulemaking on this subject in this issue of the Bulletin requests comments on the determination of proportionate ownership by a beneficiary of PFIC stock held by a domestic or foreign estate or nongrantor trust. Until further guidance is provided on estate and trust attribution rules, beneficiaries of estates and nongrantor trusts that hold PFIC stock subject to the section 1291 regime should use a reasonable method to determine their ownership interests in a PFIC held by the estate or nongrantor trust. Moreover, until further guidance is provided, beneficiaries of estates and nongrantor trusts that are subject to the section 1291 regime with respect to PFIC stock held by the estate or nongrantor trust are exempt from section 1298(f) filing requirements for taxable years in which the beneficiary is not treated as receiving an excess distribution (within the meaning of section 1291(b)) or as recognizing gain that is treated as an excess distribution (under section 1291(a)(2)) with respect to the stock of the PFIC that the beneficiary is considered to own through the estate or trust. See, for example, section 1.1298-1T(b)(3)(iii).[114]

However, the final regulations were silent on these critical issues.

II. Changes Made by the TCJA

A. The Section 965 Transition Tax

In general, before the TCJA, U.S. Shareholders were not taxed on the active business income of foreign corporations until dividends were paid (or were deemed paid as a result of a CFC investing in U.S. property), or shares were sold. This created an incentive to keep profits offshore.

[110] *Id.*

[111] Prop. reg. section 1.1291-3(e)(4)(iv).

[112] Prop. reg. section 1.1291-3(e)(5)(ii).

[113] 1992-1 C.B. 1124, 1127.

[114] *See* T.D. 9650.

Only subpart F income was taxed on a flowthrough basis to U.S. shareholders of CFCs.

One of the most significant changes made by the TCJA is the enactment of section 965, a transition tax on U.S. Shareholders (as defined for purposes of the CFC rules) of specified foreign corporations. A specified foreign corporation is a CFC or any foreign corporation that is not a CFC that has a corporate U.S. Shareholder[115] (although a PFIC that is not a CFC is not a specified foreign corporation).[116] The tax is referred to as a "transition tax" because it was part of a transition from a deferral tax system to a participation exemption tax regime. Under the new participation exemption tax regime, foreign earnings from an active trade or business can be distributed free of tax (through a 100 percent dividends received deduction) to corporate U.S. Shareholders that own at least 10 percent of the stock.[117] This eliminates a disincentive to keeping profits offshore. As part of this transition, some U.S. Shareholders of foreign corporations were required to include as subpart F income for 2017 the untaxed and undistributed foreign earnings that were accumulated by those corporations since 1986. The U.S. Shareholders of those corporations are subject to this transition tax on the shareholders' pro rata shares of that subpart F income. Unfortunately, the transition tax also applies to individual shareholders, who do not get the benefit of the participation exemption tax regime because dividends paid to individual shareholders that represent foreign E&P that have not previously been subject to U.S. tax remain subject to U.S. tax when distributed.

1. Calculation of the transition tax.

A person who is a U.S. Shareholder, as defined for purposes of the CFC rules, is required to include in gross income her share of all post-1986 previously untaxed accumulated earnings of a specified foreign corporation measured as of November 2, 2017, or December 31, 2017, whichever is greater, that was owned by the U.S. Shareholder in the last tax year that began before January 1, 2018 (2017 for a calendar-year taxpayer). This amount is taxed as subpart F income. A U.S. Shareholder's share of deficits of specified foreign corporations offsets the amount includable in income.[118] The netting of positive and negative E&P as well as the determination of the cash position of the foreign corporation which affects tax rate is done at the level of a domestic flow-through entity and not at the level of the owner of the domestic flow-through entity.[119]

Individual U.S. Shareholders (including trusts and estates) are subject to the transition tax but do not benefit from the participation exemption tax regime. As discussed in Section II.B, corporate U.S. Shareholders (but not individuals) that own 10 percent of the stock of a foreign corporation may deduct the foreign-source portion of dividends received from the foreign corporation (other than a PFIC[120]) if a one-year ownership requirement is met.[121]

The transition tax is imposed at a reduced rate.[122] To the extent that the specified foreign corporation's assets consist of assets other than cash and cash equivalents, the maximum tax rate is an "8 percent equivalent percentage";[123] and to the extent that its investments consist of cash and cash equivalents, the maximum tax rate is a "15.5 percent equivalent percentage."[124] The equivalent percentages are achieved by allowing a deduction under section 965(c) sufficient to reduce the tax rate to the stated percentages.[125] However, the deductions are keyed off the tax rates applicable to domestic corporations.[126] As a result, and

[115]Prop. reg. section 1.965-1(47) defines U.S. Shareholder by reference to the definition in section 951(b).

[116]Section 965(e); reg. section 1.965-2(f)(45)(iii).

[117]Section 245A. Section 245A(b)(1) defines a specified 10-percent-owned foreign corporation as a foreign corporation that has a domestic corporation that is a "United States shareholder." There is no cross-reference to the definition of U.S. Shareholder in section 951(b), which includes shares owned directly, indirectly, and constructively in determining whether the 10 percent ownership threshold is met. It is likely that the same definition used in section 951(b) will be adopted when regulations are issued.

[118]Section 965(b).

[119]Reg. section 1.965-5(d)(3). *See* Part II.F of the preamble to the regulations, at 8.

[120]Section 245A(a).

[121]Section 246(e)(5).

[122]The reduced rate is not applicable to taxes imposed by section 4940 or section 1411. Reg. section 1.965-3(f)(3) and (4).

[123]Section 965(c)(1)(A).

[124]Section 965(c)(1)(B).

[125]Section 965(c). The deduction is not an itemized deduction. Reg. section 1.965-3(f)(1).

[126]Section 965(c)(2)(A). The deduction is based on the highest rate of tax imposed under section 11.

because individual rates are higher than corporate rates, the maximum equivalent percentage rates for individuals, estates, and trusts are 9.05 percent and 17.5 percent for calendar-year foreign corporations and 14.05 percent and 27 percent for fiscal-year foreign corporations. If a U.S. taxpayer expatriates, the person must pay a tax equal to 35 percent of the section 965(c) deduction.[127]

The section 965(c) deduction is an above-the-line deduction used to compute adjusted gross income and is not an itemized deduction.[128] Therefore, this deduction is available to individuals. However, the section 965(c) deduction is not available to offset a shareholder's net investment income tax (aka the Medicare tax)[129] or the tax imposed by section 4940 on tax-exempt organizations.[130]

A deemed paid foreign tax credit offsets the transition tax for corporate U.S. Shareholders of a specified foreign corporation and for individual U.S. Shareholders of a CFC who make an election under section 962 to be taxed at corporate rates.[131] However, the deemed paid credit for foreign taxes associated with the earnings subject to the transition tax is reduced to take into account the deduction allowed by section 965(c). The amount disallowed is 77.1 percent of the foreign taxes on earnings subject to tax at an 8 percent rate, and 55.71 percent of the foreign taxes on the earnings subject to tax at a 15.5 percent rate.[132]

2. Deferral elections.

In addition to lower rates, U.S. Shareholders are allowed deferral elections under section 965(h) and (i).

a. Who makes the election?

A domestic passthrough owner who is subject to the transition tax, and not the domestic passthrough entity, makes the deferral election.[133] A domestic passthrough entity includes a partnership, S corporation, or any other person other than a corporation to the extent that the income or deductions of the person are included in the income of one or more direct or indirect owners or beneficiaries.[134] A domestic trust is subject to income tax on a portion of the section 965(a) amount, and its beneficiaries or owners are subject to tax on the remaining portion. The domestic trust is treated as a passthrough entity for the portion of the income on which it is not taxable.[135] Thus, the non-grantor trust can make a deferral election for its share of the transition tax, and the beneficiaries may make elections for their shares of the tax.

The person who is liable to pay the transition tax (for example, the direct owner or the owner of a domestic passthrough entity, such as a grantor of a grantor trust, a partner of a partnership, a member of a limited liability company, or a beneficiary of the portion of a trust taxable to the beneficiary) can elect to pay the transition tax over eight years.[136] In the first five years, only 8 percent of the tax is due; in the sixth year, 15 percent is due; in the seventh year, 20 percent is due; and in the eighth year, 25 percent of the tax is due. No interest is due on the deferred tax. If the transition

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[127] Reg. section 1.965-3(d)(2).

[128] Reg. section 1.965-3(f)(1).

[129] Section 1411.

[130] Reg. section 965-3(f)(3).

[131] Section 960 allows U.S. shareholders of CFCs to credit foreign taxes paid by the foreign corporation. The deemed paid credit is allowed only to corporations and to individuals who make a section 962 election. For specified foreign corporations that are not CFCs, domestic corporate shareholders and shareholders who make a section 962 election generally would be entitled to a deemed paid credit under section 902 because section 965 requires inclusion in income for the last tax year of a deferred foreign corporation beginning before January 1, 2018. Section 960 was amended by the TCJA effective for tax years beginning after December 31, 2017, to apply only to CFCs, but the tax imposed by section 965 was for the prior year, when the deemed paid credit (then allowed by section 902) was not so limited.

[132] Section 965(g).

[133] Reg. section 1.965-7(b).

[134] Reg. section 1.965-1(f)(28).

[135] Reg. section 1.965-2(f)(28). This regulation provides: "For example, if a domestic trust is subject to federal income tax on a portion of its section 965(a) inclusion amount and its domestic pass-through owners are subject to tax on the remaining portion, the domestic trust is treated as a domestic pass-through entity with respect to such remaining portion."

[136] Section 965(h); reg. section 1.965-7(b)(1). For a domestic passthrough entity, the person who is treated as the owner of the entity makes the election — for example, the grantor of a grantor trust. A subchapter S shareholder may elect to defer all the tax, as discussed later.

tax is later increased, the deficiency can be prorated over the unpaid installments, unless the underpayment was the result of negligence, intentional disregard of rules and regulations, or fraud.[137]

b. Acceleration events for tax deferred under section 965(h).

The tax deferred by a section 965(h) election may be due sooner if an acceleration event occurs. The tax is due on the date of the acceleration event.[138]

Acceleration events include[139]:

- failure to timely pay an installment;
- liquidation, sale, exchange, or other disposition of substantially all of the assets of the person making the installment election, including bankruptcy or death (for an individual);
- for a person that is not an individual, cessation of business by the person;
- any event that results in the person no longer being a U.S. person;
- change in membership of a consolidated group; and
- a determination by the IRS that there was a material misstatement or omission in a transfer agreement.

Death of the person who is liable for the transition tax is an acceleration event and requires immediate payment of any tax deferred under a section 965(h) election.[140] In some cases (a "covered" acceleration event), but not for death, which is not a covered acceleration event, an acceleration event will not accelerate the time for payment of tax if within 30 days of the acceleration event, a transfer agreement is signed and filed by an eligible transferee. An eligible transferee must agree to assume the deferred tax liability (although the transferor, if it continues to exist, remains jointly and severally liable for the tax) and represent that the eligible transferee is able to pay tax.[141] An eligible transferee is "a single United States person that is not a domestic pass-through entity . . . that acquires substantially all of the assets of an eligible section 965(h) transferor."[142] For acceleration events occurring on or before February 5, the date of publication of final regulations under section 965, a transfer agreement must have been filed by March 7 to maintain deferral. Section 9100 relief is not available.[143]

Note that it is *not* the taxpayer's transfer of shares of the specified foreign corporation that necessarily is an acceleration event, but rather a disposition of substantially all of the assets of the taxpayer who owes the transition tax. Therefore, a transfer of shares of a specified foreign corporation by an individual shareholder to a subchapter C corporation would not be an acceleration event if the shares did not represent substantially all of the assets of the individual. On the other hand, a transfer by a non-grantor trust to a C corporation of substantially all of its assets would be an acceleration event. However, a subchapter C corporation is an eligible transferee, so the acceleration event is a covered acceleration event and a transfer agreement may be filed to prevent acceleration of the tax. An eligible transferee is a single U.S. person *who is not a domestic passthrough entity* and who receives substantially all of the assets of the transferor.[144] Therefore, a transfer of all the assets of a non-grantor trust to a flow-through entity, such as another trust, a subchapter S corporation, or a partnership, would be an acceleration event that is not a covered acceleration event. Similarly, the conversion of a grantor trust to a non-grantor trust may be an acceleration event that is not a covered acceleration event. A transfer agreement would not be available to avoid acceleration of the tax. A subchapter S election by a C corporation might be an acceleration event (because the tax ownership changes). A subchapter S election by a

[137] Section 965(h)(4).

[138] Reg. section 1.965-7(b)(3)(i).

[139] Reg. section 1.965-7(b)(3)(ii).

[140] Reg. section 1.965-7(b)(3)(iii)(A)(1)(ii). Death is not a covered acceleration event and therefore is ineligible for a continuation of installment payments if the parties file a transfer agreement.

[141] Reg. section 1.965-7(b)(3)(iii)(B)(4)(ii) and (vii).

[142] Reg. section 1.965-7(b)(3)(iii)(B).

[143] Reg. section 1.965-7(b)(3)(iii)(B)(2).

[144] Reg. section 1.965-7(b)(3)(iii)(B)(1).

C corporation might be an acceleration event (because tax ownership changes). The regulations do not clarify whether a change of tax ownership that does not change ownership for property law purposes is a disposition for purposes of section 965(h)(3). If so, because the resulting entity is a domestic passthrough entity, the tax would be accelerated and a transfer agreement would not be available to defer tax.

According to the preamble, nonrecognition events may be acceleration events, such as transferring the stock of the specified foreign corporation in a section 351 or 721 exchange, inbound F reorganizations, and liquidations of foreign subsidiaries.[145] The regulations do not clarify whether decanting, reformation, modification, merger, severance, or material modification of trusts are acceleration events. If they are acceleration events, and if the transferee is a domestic flow-through entity, the transfer would not be a covered acceleration event, and tax would be due immediately.

3. Subchapter S shareholders making section 965(i) deferral elections; triggering events.

For a shareholder of a subchapter S corporation that is a U.S. Shareholder of a specified foreign corporation, all the transition tax can be deferred in full until a triggering event occurs.[146] The treatment of triggering events is much more taxpayer-friendly than the treatment of acceleration events.

Because of the more favorable treatment afforded to S corporations, some taxpayers transferred stock of CFCs or specified foreign corporations to subchapter S corporations before the last day of the CFC's last year beginning before January 1, 2018, or they made entity classification elections to have LLCs taxed as S corporations. There was concern that these transfers might be disregarded under an antiabuse rule. However, the final regulations take the position that the antiabuse rules do not apply to disregard a transfer of stock by a U.S. shareholder to a domestic corporation, including an S corporation, as long as the taxable amount and the aggregate foreign cash position of the specified foreign corporation is not changed.[147] This rule also applies to entity classification elections made effective on or before November 2, 2017.

Triggering events include:

- the U.S. shareholder ceasing to be an S corporation;
- the liquidation, sale, exchange, or other disposition of substantially all of the assets of the S corporation, including bankruptcy and a cessation of its business;
- a transfer of any shares of the S corporation (including because of death or otherwise) that results in a change of ownership for federal income tax purposes; and
- a determination by the IRS that there has been a material misrepresentation or omission in a transfer agreement.

If an S corporation shareholder transfers less than all her shares, the transfer will be a triggering event only for the portion of shares transferred.[148] Moreover, as long as there is only one transferee for each portion of the shares transferred, there can be multiple transferees for a section 965(i) election. Separate transfer agreements are signed for each portion.

If a triggering event occurs, deferral may continue if (1) the triggering event is a covered triggering event; (2) there is an eligible transferor and an eligible transferee;[149] and (3) a transfer agreement is timely filed.[150] As for a section 965(h) election, death is a triggering event for purposes of the section 965(i) election, but unlike the section 965(h) election, death is a covered triggering event for purposes of section 965(i), so continued deferral of the payment of tax is possible.[151] For a triggering event resulting from death, a transfer agreement is due to be filed on the due date (determined without extensions) for the

[145] T.D. 9843, preamble at VII.B.1.

[146] Section 965(i).

[147] Reg. section 1.965-4(e)(3).

[148] Reg. section 1.965-7(c)(3)(iii).

[149] An eligible transferee is a single U.S. person other than a domestic passthrough entity. Reg. section 1.965-7(c)(3)(iv) provides that an eligible transferee includes a person treated as the owner of the subchapter S shares under reg. section 1.1362-6(b)(2). For multiple partial transfers, a separate transfer is deemed made to each transferee, and a separate transfer agreement is signed for each.

[150] Reg. section 1.965-7(c)(3)(iv).

[151] Reg. section 1.965-7(c)(3)(iv) provides that a covered triggering event includes a transfer of shares, including by reason of death or otherwise that results in a change of ownership for federal income tax purposes.

decedent's final income tax return. In other cases, the due date for the transfer agreement is 30 days after the date of the triggering event.

The transfer agreement must be signed by an eligible transferee. In the case of death, the executor of the decedent's estate is the eligible transferee unless the identities of the beneficiaries (other than a domestic passthrough entity) who are entitled to receive the shares of the S corporation are known as of the due date for filing the transfer agreement, in which case the beneficiaries are the eligible transferees. For a qualified subchapter S trust or grantor trust, the eligible transferee is the person who is treated as the owner of the stock. For a testamentary trust or a trust that makes a section 645 election, the eligible transferee is the executor of the estate.[152]

If an executor is the eligible transferee, a second triggering event occurs when the estate transfers shares of the S corporation to the beneficiaries. The executor and the beneficiaries then must sign and file the transfer agreement within 30 days of the transfer of shares. The transferor, the transferee, and the S corporation are all jointly and severally liable for the unpaid transition tax.[153] As with a section 965(h) election, the transfer agreement must contain a representation that the transferee is able to pay the transition tax, and if the debt leverage ratio of the transferee exceeds 3 to 1, the IRS may not allow continued deferral of the tax.

Following a triggering event, payment of all the transition tax may continue to be deferred if a transfer agreement is signed. If a transfer agreement is unavailable or is not timely signed and filed, the transferee can elect to pay the tax in installments over eight years as described earlier.[154] However, if the triggering event is the liquidation, sale, or disposition of substantially all the assets of the S corporation; bankruptcy; or cessation of business, the election to pay the 965(a) tax in installments requires the consent of the IRS.

[152] Reg. section 1.965-7(c)(3)(iv).

[153] Reg. section 1.965-7(c)(3)(iv)(D)(2) and (c)(4).

[154] Reg. section 1.965-7(c)(3)(v).

While the tax is deferred under a section 965(i) election, the taxpayer (and any eligible transferee) must file annual reports.[155] Failure to file reports is not a triggering event, but a penalty equal to 5 percent of the deferred tax applies if the annual report is not timely filed.[156]

The statute of limitations begins to run on the collection of the tax deferred under section 965(i) when a triggering event occurs.[157]

B. Dividends Received Deduction — Section 245A

The TCJA enacted section 245A to allow domestic corporations to deduct the foreign portion of a dividend received from a "specified 10 percent owned foreign corporation." A specified 10-percent-owned foreign corporation is a corporation for which the domestic corporation is a U.S. Shareholder,[158] but the definition specifically excludes any PFIC.[159] The foreign-source portion of the dividend is the fraction of undistributed earnings that is foreign-source divided by total undistributed earnings.[160] No foreign tax credit or deduction is allowed for foreign taxes paid on a dividend for which a deduction is allowed. Section 246(c)(5) imposes a one-year holding period requirement to qualify for the deduction allowed by section 245A.

Section 245A allows all future profits from an active trade or business of a foreign corporation that are earned by a corporate U.S. Shareholder and are not subpart F income or GILTI to avoid corporate-level U.S. tax. Subpart F income will continue to be taxable. However, individual U.S. Shareholders cannot deduct the foreign portion of dividends received from a specified 10-percent-owned foreign corporation.

When a U.S. Shareholder sells stock in a CFC, the portion of gain realized that is attributable to the seller's share of untaxed E&P may be taxed as

[155] Reg. section 1.965-7(c)(6).

[156] Reg. section 1.965-7(c)(6)(ii).

[157] Reg. section 1.965-7(c)(5).

[158] Section 245A(b)(1). There is no cross-reference to the definition of U.S. Shareholder in section 951(b), although this is the probable intent. Incorporation of this definition may be necessary to allow indirect and constructive ownership to count toward the 10 percent ownership threshold necessary to take the deduction under section 245A.

[159] Section 245A(b)(2).

[160] Section 245A(c).

a dividend.[161] Because of new section 245A, treating some portion of the gain as a dividend may reduce the U.S. tax owed by a seller that is a domestic corporation. However, section 1248 did not incorporate the new definition of U.S. Shareholder enacted in the TCJA for purposes of section 951(b), and it still defines U.S. Shareholder solely by reference to ownership of voting shares (and not vote or value).

C. CFC Investment in U.S. Property — Section 956

A U.S. Shareholder is deemed to receive a dividend, and therefore is subject to U.S. tax, on amounts that the CFC invests in U.S. property.[162] Because section 245A eliminates tax on the foreign-source portion of dividends actually paid by a specified 10-percent-owned foreign corporation to corporate U.S. Shareholders, proposed regulations under section 956[163] provide that an amount otherwise taxable under section 956 as a deemed dividend is reduced to the extent that the U.S. Shareholder would be allowed a deduction under section 245A if the U.S. Shareholder had received an actual dividend from the CFC. Because section 245A does not apply to individuals, individuals will receive no benefit from the proposed regulations, and thus will continue to be taxable on both actual dividends and deemed dividends (under section 956).

D. New GILTI Tax — Section 951A

The TCJA enacted section 951A, which requires U.S. Shareholders of a CFC to include in subpart F income their share of the CFC's GILTI. In general, the GILTI provision is designed to impose a minimum residual U.S. tax on each shareholder's income of a CFC exceeding a 10 percent return on that shareholder's pro rata share of the CFC's qualified business asset investments (tangible depreciable property used in a trade or business),[164] reduced by some interest expense and, for corporate shareholders, a partial foreign tax credit. However, unlike subpart F income, GILTI is determined on an aggregate basis at the U.S. Shareholder level. The formula to compute GILTI is:

GILTI = net tested income - ((10 percent of QBAI) - qualified interest expense)

Net tested income does not include subpart F income, income that would have been subpart F income but for the high-taxed income exception, income effectively connected with a U.S. trade or business, or some dividends from related persons. Interest expense is taken into account only to the extent that the corresponding interest income is not taken into account in determining net tested income — for example, because it is paid to an unrelated person. The QBAI of a CFC with a tested loss is not taken into account in calculating net tested income.

As discussed in Section II.E, corporate U.S. Shareholders and individual taxpayers who make a section 962 election to be taxed at corporate rates may deduct 50 percent of GILTI and take a foreign tax credit for 80 percent of foreign income taxes associated with GILTI.[165] If a credit is claimed, all the foreign income taxes associated with GILTI are added to income, and then a deduction is allowed for 50 percent of the gross-up.[166]

Below is an example showing the different tax rates for corporations and individuals. Suppose that a CFC has $100 of GILTI and pays $10 of foreign tax. The CFC has $40 basis in depreciable tangible personal property used in generating the GILTI and has no interest expense. A corporate U.S. Shareholder would have tested income of $90 ($100 - $10), which would be reduced by $4 (10 percent of $40 of QBAI). The GILTI would be $86. The corporate U.S. Shareholder would have gross income of $96 ($86 + $10 gross-up) and then deduct 50 percent of that amount, or $48. The tax before credits would be 21 percent of $48 = $10.08. The tax would be reduced by 80 percent of the foreign tax paid (80 percent of $10 = $8), and the net liability would be $2.08. If the foreign tax credit exceeds the U.S. tax liability, the excess foreign tax credit or excess deduction may not be credited or deducted in any other year.

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[161] Section 1248.

[162] Section 956.

[163] REG-114540-18.

[164] Section 951A(d).

[165] Section 960(d); prop. reg. section 1.962-1(b)(1)(i)(B)(3).

[166] Section 78.

For an individual U.S. Shareholder (other than a shareholder who makes a section 962 election), the net tax would be $31.82. The GILTI would be $86 ($100 - $10 - $4), and tax at the 37 percent rate would be $31.82. Plus, an individual may be liable for the 3.8 percent Medicare tax. There would be no foreign tax credit for tax paid by the corporation.

If the individual U.S. Shareholder made a section 962 election to be taxed on the income of the CFC as if she were a corporation, the tax calculation would be the same as for a corporate shareholder. Although it was not clear from the statute that the deduction allowed by section 250 would be available to individual shareholders who made a section 962 election, proposed regulations released March 4 confirm that the deduction will be allowed.[167] However, if this election is made, a portion of CFC income subject to tax as GILTI will be subject to tax as a dividend when distributed to the individual. The portion of the dividend income treated as excludable is limited to the amount of the tax paid on that income.[168] If a section 962 election is not made, all the GILTI is PTI that may be excluded when later distributed.[169] The basis adjustment allowed by section 961 also is limited to the amount of tax paid.[170]

Assuming that the income of the CFC would be subject to tax to an individual shareholder at a rate of 37 percent plus the 3.8 percent Medicare tax (an aggregate tax rate of 40.8 percent, and further assuming that the dividend from the CFC to an individual shareholder who makes a section 962 election would be taxable as a qualified dividend under section 1(h)(11)), the combined effective tax rate resulting from a section 962 election is lower, even if the section 250 deduction were not allowed. Assume $100 of CFC income, which is taxed at 21 percent at the corporate level. The CFC distributes the after-tax amount ($79), which is taxed at 23.8 percent ($18.80). The combined tax is $39.80. The individual tax without an election would be $40.80.

E. Deduction for FDII and GILTI — Section 250

New section 250 allows a domestic corporation a deduction equal to 50 percent of the sum of (1) (A) its GILTI and (B) the amount treated as a dividend under section 78 that is attributable to GILTI (the GILTI-attributable gross-up amount), and (2) 37.5 percent of foreign-derived intangible income.[171] FDII is a domestic corporation's deemed intangible income multiplied by the ratio of foreign-derived deduction-eligible income (FDDEI) to its total deduction-eligible income (DEI). Deemed intangible income is DEI exceeding a 10 percent return on QBAI (as defined for purposes of GILTI). DEI is foreign-derived income less expenses.

The formula for FDII can be expressed as follows:

FDII = (DEI - (10 percent of QBAI))

Multiplied by the following fraction:

(FDDEI/DEI)

FDDEI is income earned in connection with property sold to a foreign person for foreign use, services to a foreign person, and services regarding foreign property.[172] DEI means, for any domestic corporation, the excess (if any) of the gross income of the corporation determined without regard to specific types of income (noted below) over deductions (including taxes) properly allocable to that gross income.[173] Royalty and rental income is deduction eligible if the licensed or leased property is used in connection with providing goods or services to foreign persons. However, subpart F income, section 956 investments in U.S. property, GILTI inclusions, dividends from CFCs, and foreign branch income are excluded from deduction-eligible income.

[167] Prop. reg. section 1.962-1(b)(1)(i)(B)(3); REG-104464-18. The preamble to the section 250 regulations at page 50 recites the legislative history of section 962 (S. Rep. No. 87-1881, 1962-3 C.B. 784, 798) in support of this regulation. Section 962 was intended to allow individual shareholders to incur tax burdens "no heavier than they would have been had they invested in an American corporation doing business abroad."

[168] Section 962(d).

[169] Section 959.

[170] Section 961(a) (last sentence).

[171] Section 250(a)(1).

[172] Section 250(b)(4).

[173] Section 250(b)(3)(A).

The effect of the deduction is to tax GILTI at the rate of 10.5 percent (50 percent of 21 percent) less FTCs. The effect of the 37.5 percent deduction for FDII is to tax income from providing sales and services to foreign persons at an effective tax rate of 13.125 percent. For tax years beginning after December 31, 2025, the deduction for GILTI is reduced to 37.5 percent and the deduction for FDII is reduced to 21.875 percent, producing an effective tax rate of 13.125 percent for GILTI and 16.406 percent for FDII.

A foreign tax credit is allowed for 80 percent of the foreign taxes associated with GILTI. However, section 78 requires inclusion in gross income of the full amount of taxes taken as a credit (the GILTI-attributable section 78 gross-up amount), and not only 80 percent.

As with subpart F income, the amount of GILTI included in the income of a U.S. Shareholder (before the 50 percent deduction) becomes PTI for purposes of section 959, and a basis adjustment is allowed under section 961.

F. Sales of Partnership Interests

A foreign person who is a general or limited partner in a partnership engaged in a U.S. trade or business is deemed to be engaged in that trade or business.[174] When a limited partnership conducts a business activity in the United States through a fixed place of business in the United States, each limited partner is deemed to have a place of business in the United States.[175]

In Rev. Rul. 91-32, 1991-1 C.B. 107, the IRS concluded that this rule applied not only to income from the business carried out by the partnership, but also to gain realized on the disposition of that partnership interest. In *Grecian Magnesite*,[176] the Tax Court rejected the conclusion in Rev. Rul. 91-32: The court held that gain from the redemption or sale of a partnership interest by a foreign person is a capital transaction, so if the seller is foreign, the gain is foreign-source income except for gain attributable to U.S. real property owned by the partnership and section 751 items. An exception applies only if the gain is attributable to a U.S. office or other fixed place of business. However, gain is not attributable to the fixed place of business in the United States if that office is not involved in the sale and the sale was not made in the ordinary course of the partnership's business carried on in that office. This rule allowed the purchaser of the partnership interest to acquire a new basis in partnership assets, assuming certain elections were made, without the seller recognizing gain. The parties agreed that the portion of the gain attributable to a U.S. real property interest owned by the partnership was taxable.[177]

The TCJA added paragraph (8) to section 864(c) to provide that gain or loss on the sale or exchange of a partnership interest is effectively connected income or loss to the extent that the transferor would have had effectively connected gain or loss had the partnership sold all its assets at fair market value as of the date of the sale or exchange. This change resulted in an outcome that was similar to the IRS's position in Rev. Rul. 91-32. A partner's share of the gain or loss is determined in the same manner as the partner's share of the non-separately stated taxable income or loss of the partnership. To enforce this tax, the TCJA also amended the partnership withholding rules to require a transferee to deduct and withhold a tax equal to 10 percent of the amount realized on the disposition of a partnership interest by a non-U.S. taxpayer.[178] Withholding applies to the entire amount realized, not only the amount attributable to the effectively connected income. No withholding is required if the transferor furnishes an affidavit that the transferor is a U.S. person. If the transferee fails to withhold, the partnership has a withholding obligation.

In Notice 2018-8, 2018-4 IRB 352, the IRS suspended the withholding obligations for dispositions of interests in some publicly traded partnerships, and in Notice 2018-29, 2018-16 IRB 495, it provided interim guidance for withholding on sales of interests in non-publicly traded

[174] Section 875(1); reg. section 1.864-2(c)(2)(ii) excepts partnerships that trade in securities for their own accounts unless they are dealers.

[175] Rev. Rul. 85-60, 1985-1 C.B. 187; *Donroy Ltd. v. United States*, 301 F.2d 200 (9th Cir. 1962).

[176] *Grecian Magnesite Mining, Industrial and Shipping Co. v. Commissioner*, 149 T.C. 63 (2017).

[177] Section 897(g).

[178] Section 1446(f).

partnerships. Under this interim guidance, withholding is not required if the transferor certifies that there is no gain or that the transfer results in a small amount of ECI. Further, withholding is not required if the transferor certifies that for each of the past three years, the transferor's share of ECI from the partnership was less than 25 percent of the transferor's total income from the partnership, or if the partnership certifies that less than 25 percent of the gain the partnership would have realized had the partnership sold all its assets would be from assets effectively connected with the partnership's U.S. trade or business.

Proposed regulations[179] were released May 7, 2019, for withholding required on the transfer by NRAs of partnership interests under new section 1446(f). The proposed regulations adopt many of the rules in Notice 2018-29. The proposed regulations also explain the withholding rules for sales of publicly traded partnerships that will become effective when the regulations become final. Withholding obligations for publicly traded partnerships are shifted from the buyer to the broker, who is in a better position to know whether the transferor is an NRA. The proposed regulations also address the application of double-tax treaties to modify the withholding obligations under section 1446(f).

As a result of this change, a foreign person holding an interest in a partnership engaged in a U.S. trade or business directly rather than through a domestic corporation no longer may be able to provide a basis adjustment to partnership assets to a purchaser without paying U.S. tax on the sale. A foreign person's sale of shares of the domestic corporation that owns the partnership interest will avoid U.S. tax, but the purchaser will not obtain a new basis in partnership assets. Although a sale of the partnership interest by the domestic corporation will be taxable, the sale will avoid the new withholding rules. ■

[179] REG-105476-18.

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Taxation of U.S. Shareholders of Foreign Corporations After Tax Reform, Part 2

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In this second installment of a two-part article, the authors examine estate planning strategies to mitigate some of the adverse tax consequences of the Tax Cuts and Jobs Act's changes to the corporate anti-deferral tax regime.

The first part of this article discussed changes made by the Tax Cuts and Jobs Act that estate planners should consider if they represent U.S. taxpayers who have foreign investments, nonresident aliens who have U.S. investments, or estate plans that involve the transfer of assets owned by an NRA or a foreign trust to U.S. beneficiaries.[1] This second part focuses on the implications for estate planning.

I. Planning Implications

A. Choice of Entity for NRAs Investing in the U.S.

1. Grantor Trust

A grantor trust is a trust that is treated as owned by the grantor. During any period when a trust is a grantor trust, any controlled foreign corporations or passive foreign investment companies owned by the trust will be treated as owned indirectly by the grantor.[2] If the grantor is not resident in the United States for income tax purposes (hereinafter referred to as a "foreign person"), none of the CFC or PFIC rules will be applicable. Also, distributions to U.S. beneficiaries are not taxable income.[3] Therefore, classification as a grantor trust usually is desirable. For this reason, an NRA grantor will be treated as the owner of a trust under the grantor trust rules only in limited circumstances. Unless the trust is grandfathered[4] or is a compensatory trust, an NRA grantor generally will be treated as the owner only if the grantor has the right to revest the assets in the trust (such as in a revocable trust) or if the trust can benefit only the grantor or the grantor's spouse during the grantor's lifetime (a sole benefit trust).[5]

However, if the trust is a grantor trust, the U.S. situs assets it owns may be includable in the

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[1] Ellen K. Harrison and Paul S. Lee, "Taxation of U.S. Shareholders of Foreign Corporations After Tax Reform," *Tax Notes Int'l*, June 10, 2019, p. 1085.

[2] Reg. sections 1.958-1(b) and 1.1291-1(b)(8)(iii)(D).

[3] Rev. Rul. 69-70, 1969-1 C.B. 182. Note, however, that during the grantor's lifetime, tax-free gifts to U.S. beneficiaries of non-grantor trusts can be accomplished by making distributions through the grantor because a grantor is not an intermediary. Distributions to U.S. persons from foreign trusts made by intermediaries are treated as if made directly from the trust to the U.S. recipient. Section 643(h).

[4] P.L. 104-188, section 1904(d)(2) provides an exception for trusts that were grantor trusts under section 676 or 677 (other than subsection (a)(3) thereof) and in existence as of September 19, 1995, except for portions of the trust contributed after that date.

[5] Section 672(f).

grantor's U.S. gross estate as a result of the grantor's retained interests or powers. This is costly because the estate tax exemption allowed to the estates of NRA[6] decedents is only $60,000. Certainly, U.S. situs assets owned in a revocable trust will be includable in the grantor's gross estate,[7] but that won't necessarily be the case for U.S. situs assets owned by a sole benefit trust. Even if the grantor retains only a discretionary beneficial interest, to exclude the U.S. situs assets from the grantor's U.S. gross estate, the assets must not be reachable by the grantor's creditors,[8] and there must not have been an implied understanding or agreement that the assets would be made available to the grantor upon request.[9] This may be difficult to establish if there is a pattern of distributions to the grantor.

The most commonly used way to shield assets owned by an NRA or her grantor trust from U.S. estate tax is to invest in U.S. situs assets through a foreign corporation. However, after the grantor's death, if the beneficiaries are U.S. persons, it is desirable to dispose of the shares to avoid the tax inefficiencies of CFCs and PFICs. A sale may be an option. Note that only non-U.S. persons are likely to want to acquire the shares. If a trust sells the shares, there may be no gain if the shares acquired a new fair market value basis upon the grantor's death under section 1014.[10] However, if the trust indirectly owns shares of a CFC or a PFIC through an upper-tier company, those shares would not acquire a new basis; only the top-tier company shares would be rebased at death. Thus, it is important when representing NRAs to consider the investment structure of their holdings.

For example, assume that an NRA owns shares of a foreign fund that's classified as a PFIC. If a basis step-up occurs at death, there will be no U.S. tax and no gain if shares are sold immediately after death. This is true even if the fund invests in U.S. equities.[11] However, if the fund owns PFICs, there will be gain on the sale of the mutual fund shares because the indirectly owned shares would not have been rebased at death. A sale of the shares of the top-tier entity would be deemed to be a sale of the shares of a PFIC owned by the upper-tier entity.[12] The gain on the deemed sale of the lower-tier shares would be taxable as ordinary income to any U.S. person who is deemed to indirectly own the lower-tier shares. The basis of the shares in the top-tier entity owned by that person would be increased, but the resulting loss would be a capital loss. That result can be avoided if the U.S. person who inherits the shares makes a qualified electing fund (QEF) election, as discussed in Part 1 of this article.

If the trust is a grantor trust, it does not necessarily mean that assets will acquire a new basis on the grantor's death under section 1014. For a basis step-up to occur, the trust must be revocable or the grantor must have the power to control beneficial enjoyment, either of which would cause any U.S. situs assets owned by the trust to be included in the grantor's gross estate.[13] However, a basis step-up may occur by making a taxable liquidation of a holding company owned by the trust if the classification of the entity was relevant for U.S. tax purposes before the liquidation. Any income realized in connection with the liquidation would be taxable solely to the foreign grantor-owner. However, care must be taken that any such liquidation does not expose the assets of the grantor trust to U.S. estate tax upon the grantor's death. For example, the taxable liquidation of a holding company will not be an issue if the assets held by the holding company are foreign-situs assets. A basis step-up is usually an important part of the planned disposition of CFC and PFIC shares owned by a trust.

2. Non-Grantor Trust

A non-grantor trust usually can be structured to avoid any risk of inclusion in the grantor's gross estate, particularly if the grantor retains no

[6]For this purpose, the term "nonresident alien" means an individual who was not domiciled in the United States and does not refer to "nonresident" for income tax purposes.

[7]Sections 2036 and 2038. Owning assets through a foreign trust does not change the situs of assets owned by the trust.

[8]Section 2041; *Outwin v. Commissioner*, 76 T.C. 153 (1981) (*acq.*, 1981-2 C.B. 2); *Estate of Uhl v. Commissioner*, 25 T.C. 22 (1955), *rev'd on other grounds*, 241 F.2d 867 (7th Cir. 1957).

[9]Section 2036; reg. section 20.2036-1(c)(1): "An interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred."

[10]Rev. Rul. 84-139, 1984-2 C.B. 168; LTR 8904046; and LTR 201245006.

[11]ILM 201003013.

[12]Section 1298(a) and (b).

[13]Section 1014(b)(2) and (3).

interest in the trust and no power over the trust assets.[14] However, any CFC or PFIC shares owned by a non-grantor trust might be deemed to be indirectly owned by U.S. beneficiaries of the trust. If there is no risk of U.S. estate tax, however, there is no need to invest through a foreign corporation, and in that case, if there is no foreign holding company and no PFICs, the CFC and PFIC rules will not apply. A foreign holding company can still be used if desired for other purposes, but a check-the-box election should be made so that the entity is treated as a passthrough entity for U.S. tax purposes.

Note, however, that there will not be a basis step-up at the death of a grantor or beneficiary unless the decedent had a testamentary general power of appointment.[15] And in that case, the general power would expose U.S. situs assets of the trust that are subject to the general power of appointment to U.S. estate tax.

Although a check-the-box election also can be used to step up the basis of the shares owned by the non-grantor trust, this will generate distributable net income for the trust. Unless that income is distributed to foreign beneficiaries, it will be taxable to the U.S. beneficiaries when they receive it.

3. Foreign Corporations

An NRA who invests in U.S. situs assets through a foreign corporation faces the same issues relevant to a grantor trust owned by an NRA. A transfer of shares of a foreign corporation will not be subject to U.S. gift or estate tax unless the corporation is disregarded as lacking substance.

4. Domestic Corporations and Tiered Entities

Unless a treaty applies, shares of a U.S. corporation are U.S. situs assets for estate tax (but not gift tax) purposes. Investing through a U.S. corporation (except for gifting purposes) usually is desirable only as part of a tiered structure. For example, it is common for an NRA to create a foreign corporation with a domestic subsidiary to invest in U.S. real estate and U.S. partnerships. This is favored to avoid the NRA having to file U.S. tax returns, suffer withholding tax, and incur liability for the branch profits tax that would be imposed if the foreign corporation invested directly in U.S. assets that generate effectively connected income. The reduced corporate tax rate enacted by the TCJA makes the use of domestic corporations more attractive.

This tiered structure must be sequenced properly to avoid the inversion rules.[16] If the NRA transfers shares of a domestic corporation to a foreign holding company and owns at least 80 percent of the stock of the foreign holding company (by vote or value), the foreign corporation will be treated as a U.S. corporation for all tax purposes.[17] If the foreign corporation creates the domestic subsidiary, the inversion rules should not be applicable.

5. Partnerships

There is a long-standing debate about whether a partnership interest is a U.S. situs asset for gift and estate tax purposes. There are different situs rules for gift and estate tax purposes.

a. Gift tax. The gift tax statute and regulations do not specifically address the situs of an interest in a partnership or limited liability company. However, U.S. gift tax is not imposed on gifts of intangible property made by an NRA.[18] If a partnership or LLC interest is viewed as an interest in an entity, similar to shares of a corporation, a gift of the interest should not be subject to gift tax because it is an intangible asset. However, if the partnership or LLC is viewed as an aggregation of assets and not as an entity, a gift of the interest would be deemed to represent a transfer of a pro rata share of each asset owned by the partnership or LLC. In that case, whether gift tax applies depends on the situs and nature of the assets owned by the entity. If, for example, the partnership owns U.S. real estate, a gift of a partnership interest might be deemed to be a gift

[14] An NRA may retain an interest as a creditor (*e.g.*, an installment note) or a preferred interest in a partnership in which the non-grantor trust has an interest.

[15] Section 1014(b)(4) requires exercise of the general power of appointment by will, but if the power is not exercised, a basis step-up should be allowed under section 1014(b)(9) for U.S. situs assets because those assets will be included in the power holder's gross estate.

[16] Section 7874.

[17] Section 7874(b).

[18] Section 2501(a)(2).

of the portion of the partnership's real estate allocable to the gifted interest.

Although it seems intuitive that a gift of a partnership interest is a gift of intangible property, the IRS has refused to rule on this issue.[19] This no-rule policy indicates that there may be some doubt about the answer. Moreover, there remains a risk that the partnership would be disregarded in appropriate circumstances. For example, in *De Goldschmidt-Rothschild*,[20] the court applied the step transaction doctrine to impose tax when an NRA donor converted her U.S. securities to Treasury bonds shortly before making an irrevocable gift to qualify for the gift tax exemption, which was allowed at the time for Treasury bonds but not for other U.S. securities. See also *Bongard*,[21] in which the court disregarded a family limited partnership because it lacked a significant nontax purpose; and *Fillman*,[22] in which a foreign corporation was ignored as the true owner of corporate assets because the corporate formalities were not observed. However, in other cases the transfer of an interest in an LLC classified as a disregarded entity was treated as a transfer of an intangible asset and not as an interest in the assets owned by the LLC.[23]

b. Estate tax. The estate tax statute and regulations also do not specifically address the situs of an interest in a partnership or LLC, and they provide even less guidance than the gift tax statute and regulations concerning the situs of partnership and LLC interests owned by an NRA decedent. This is because, unlike the treatment of intangibles under the gift tax, not all intangible property owned by an NRA decedent is exempt from U.S. estate tax.

The sparse guidance thus far appears to favor the view that a partnership interest is an intangible (an interest in an entity) and is not taxed on a look-through basis (the aggregate theory).[24] The Second Circuit in a 1930s case adopted a look-through approach, but the holding was premised on a finding that the partnership terminated at the decedent's death.[25] The inference drawn from the decision is that if the partnership does not terminate at death, a look-through rule does not apply. Curiously, some treaties do adopt a look-through rule for determining the situs of an interest in an entity. However, this simply means that under the treaty, the U.S. could impose tax using a look-through rule. This is insufficient to impose a tax obligation if the United States does not enact a statute imposing a tax on that basis.

As noted, the code does not exempt all intangible property owned by NRA decedents from U.S. estate tax. For example, stock of a U.S. corporation and, with important exceptions, debt obligations enforceable against a U.S. person are U.S. situs assets for estate tax purposes even though they are intangibles.[26] Stock of a foreign corporation and debt obligations enforceable against an NRA are not U.S. situs assets.[27] Therefore, simply deciding that the entity approach is correct and that a partnership interest should be treated as an intangible does not answer whether it is a U.S. situs intangible for estate tax purposes.

Assuming that a partnership or LLC interest is an intangible, its situs could be based on any one of the following factors: (1) where it is engaged in a trade or business; (2) where it is legally organized or deemed resident; (3) where the

[19]Rev. Proc. 2017-7, 2017-1 IRB 269, section 4.01(28). The allowance of discounts in valuing gifts of partnership interests presumes that the interest being transferred is an intangible — an interest in an entity — and not a transfer of a fraction of the assets the entity owns.

[20]*De Goldschmidt-Rothschild v. Commissioner*, 168 F.2d 975 (2d Cir. 1948).

[21]*Bongard v. Commissioner*, 124 T.C. 95 (2005).

[22]*Fillman v. United States*, 355 F.2d 632 (Ct. Cl. 1966).

[23]*Pierre v. Commissioner*, 133 T.C. 24 (2009).

[24]LTR 7737063. *See also Blodgett v. Silberman*, 277 U.S. 1 (1928), *aff'g Appeal of Silberman*, 134 A. 778 (Sup. Ct. Errors Conn. 1926), upholding the right of Connecticut to tax a Connecticut decedent's interest in a partnership that owned New York real property, because the partnership interest was intangible personal property, so Connecticut could impose tax based on the decedent's domicile. This case does not settle what the statutory rule is for determining the situs of a partnership interest owned by an NRA decedent, even assuming that it is an intangible. It simply concludes that it is constitutional to tax a partnership interest based on the domicile of the deceased partner.

[25]*Sanchez v. Bowers*, 70 F.2d 715 (2d Cir. 1934).

[26]Section 2104.

[27]Section 2105. Of course, if the corporation is a sham, the IRS may disregard it and look through to the situs of the assets it owns. Historically, this has been viewed as a matter of respecting the corporate formalities. *See Fillman*, 355 F.2d 632 (foreign corporation was disregarded because the shareholder disregarded corporate formalities and dealt with assets as if he were the absolute owner). It is possible, however, that the IRS could take a more aggressive position and argue, based on the case law that has developed for family limited partnerships, that an entity will be ignored if it lacks a significant nontax purpose. *E.g.*, *Bongard*, 124 T.C. 95.

decedent is domiciled; or (4) where its legal records are maintained and where transfer of title to the partnership interest occurs.

The estate tax regulations, like the gift tax regulations, do not mention the word "partnership." However, they provide limited guidance on the situs of "intangibles." Reg. section 20.2104-1(a)(4) provides that "intangible personal property the written evidence of which is not treated as being the property itself" has a U.S. situs if it is enforceable against a resident of the United States. The reference to written evidence that is treated as being the property itself seems to refer to bearer obligations. Partnership interests would almost never fall in this category. Most partnerships are transferable only on the books of the partnership. Therefore, the test for the situs of a partnership interest would seem to depend on whether it is enforceable against a resident of the United States or a resident of another country. This should turn on whether the partnership is a U.S. resident rather than where its partners are resident, because any liability owed to a partner under the terms of the partnership agreement would be primarily an obligation of the partnership itself.

Until it was changed in 2004, reg. section 301.7701-5 defined a partnership as a U.S. resident if it was engaged in a U.S. trade or business:

> A partnership engaged in a trade or business within the United States is referred to in this chapter as a resident partnership, and a partnership not engaged in trade or business within the United States, as a nonresident partnership. Whether a partnership is to be regarded as resident or nonresident is not determined by the nationality or residence of its members or by the place in which it was created or organized.

Of course, it is not always clear where a partnership is doing business, and a partnership could do business in more than one country or in no country (for example, trading in securities may not constitute conducting a trade or business[28]). Therefore, this definition did not provide a helpful rule for determining the situs of an interest in a partnership or LLC for estate tax purposes.

Reg. section 301.7701-5 now classifies a partnership as a domestic entity if it is organized under U.S. law or the laws of a state of the United States. Although the regulation does not mention "residence," this definition could provide a basis for holding an interest in a domestic partnership as a U.S. situs asset and holding an interest in a foreign partnership as foreign situs even if it is doing business in the United States. This is the rule for shares of corporations.

Rev. Rul. 55-701, 1955-2 C.B. 836, adopts the rule that the estate tax situs of a partnership interest is based on where the partnership is doing business. The 1955 ruling involved an interest in a partnership doing business in New York that was owned by a U.K. resident. Although there was an estate tax treaty in effect at the time, it did not address the situs of partnership interests. The IRS rejected the idea of treating a partnership interest like a debt obligation, which, under the treaty, would have given the United Kingdom taxing rights. It also declined to apply a look-through rule to tax based on the situs of partnership assets, citing insufficient authority for that position.

The United States has estate tax treaties with Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, South Africa, Switzerland, and the United Kingdom. The treaties define the property that each contracting state may tax. A treaty overrules the situs rules in the code, but it does not enact a tax that hasn't been adopted by a contracting state. That is, the fact that a treaty allows the United States to tax an interest does not mean that there is U.S. tax.

Under most treaties, a contracting state in which a decedent is not domiciled may tax real estate (referred to as "immovable property") located in that state and intangible property forming part of a trade or business that has a permanent establishment in that state. Under most treaties, the right to impose estate and gift tax is reserved to the state of domicile for all other property, including intangible property. If such a treaty is applicable, the United States should be able to impose gift or estate tax on a partnership or LLC interest owned by an NRA person who is domiciled in a treaty country only if it is

[28] Section 864(b)(2).

associated with a trade or business having a PE in the United States. Under some treaties, it is unclear whether the right to tax based on situs requires only that the partnership maintain a fixed place of business in the country that seeks to tax based on situs, or whether the deceased partner must have maintained a fixed place of business with which the partnership interest is associated. Under some treaties, the decedent is considered to have a PE if the partnership has a PE, as discussed later.

Discussed next are a few treaties that specifically address the situs of interests in partnerships for gift and estate tax purposes.

i. Australia. Under Article III(g) of the estate tax treaty and a separate gift tax treaty, a partnership interest is deemed situated where the business of the partnership is carried on, but only to the extent of the partnership business at that place.

ii. France. The treaty with France has two articles that are relevant to the situs of a partnership or LLC interest.

First, article 5(3) applies a look-through rule for any entity, including both a corporation and an unincorporated entity, if 50 percent of the assets consist of real estate located in one of the contracting states. Shares, participations, and other rights in that entity will be deemed to be situated in the contracting state in which the real property is located.

Second, article 6(2) provides: "If an individual is a member of a partnership or other pass-through entity which is engaged in industrial or commercial activity through a fixed place of business, he shall be deemed to have been so engaged to the extent of his interest therein."

The fixed place of business refers to the partnership's fixed place of business, not the individual's fixed place of business. However, it is unclear whether "therein" refers to the decedent's interest in the partnership or to her interest in the industrial or commercial activity of the partnership. The latter interpretation would apply a quasi-aggregate theory and exclude from the U.S. gross estate the portion of the value of the partnership or LLC interest attributable to assets of the partnership that are not associated with that business activity. That interpretation would be preferable as a practical matter (even though it would present difficult questions of apportionment of value to the business assets) because it would avoid double tax in cases in which a partnership or LLC conducts a business in more than one country.

The treaty allows the United States to impose gift and estate tax on a French person's interests in entities owning U.S. real property if the law is changed to impose such a tax. However, the United States has not adopted legislation to impose estate tax on U.S. real property that is owned by a foreign corporation owned by a foreign person. It is unclear what the U.S. position is on the situs of a partnership interest in a partnership that owns U.S. real property.

iii. Germany. Article 8 of the estate and gift tax treaty with Germany provides:

> An interest in a partnership which forms part of the estate of or of a gift made by a person domiciled in a Contracting State, which partnership owns property described in Article 5 [immovable property] or 6 [business property of a PE], may be taxed by the State in which such property is situated, but only to the extent that the value of such interest is attributable to such property.

The language of this provision is clearer than the French treaty in applying an aggregate theory and limiting the amount taxable on a situs basis to the portion of the value of the partnership interest that is attributable to real estate (without regard to the 50 percent limitation in the French treaty) or business property of a PE. The reference to a place of business is to the partnership's place of business.

iv. The Netherlands. Article 7(1) provides:

> (1) Assets . . . forming part of the business property of a permanent establishment may be taxed by a State if the permanent establishment is situated in that State.
>
> (2) . . . The term "permanent establishment" means a fixed place of business through which a decedent was engaged in a trade or business. A decedent shall be deemed to have been so engaged as a sole proprietor or through a partnership or other unincorporated

> association, but in the case of a partnership or association, only to the extent of his interest therein.

This treaty makes it very clear that the decedent is considered to have a PE if the partnership has a PE.

v. Sweden. Article 7, paragraph 2 provides:

> If the law of a Contracting State treats a partnership right as property described in Article 5 [immovable property] or 6 [business property of a PE] but the law of the other Contracting State treats the right as an interest in a partnership or trust governed by paragraph 1 [property only taxable based on domicile] the nature of that right shall be determined by the law of the Contracting State in which the transferor was not domiciled.

Article 7 allows a contracting state to impose tax based on where the partnership is doing business, and it requires the state of domicile to give first right to tax to the state where the business is conducted, but it does not otherwise prevent taxation of a partnership interest based on domicile of the partner.

vi. Austria. The treaty with Austria has a provision similar to article 7 of the treaty with Sweden, but it does not specifically mention partnerships.

For planning purposes, it is risky to rely on a partnership to shield assets from U.S. estate tax. However, if the partnership is encumbered by debt, only the equity value of the partnership interest is subject to U.S. estate tax, even assuming that the partnership is not an effective estate tax shield. Without the partnership, only a fraction of the decedent's debt can offset U.S. estate tax, based on the ratio of U.S. situs assets to the worldwide estate.[29]

Consider, for example, an NRA who owns U.S. real estate. If she owns the real estate directly, she will be exposed to U.S. estate tax on the value (reduced by any nonrecourse debt and by a share of recourse debt based on the ratio of U.S. situs assets to the worldwide estate), and a basis adjustment is allowed. If the real estate is owned by a foreign corporation, there would be no estate tax, but there would also be no basis adjustment, and corporate and shareholder level taxes would apply to the income and gains. If the real estate is owned by a partnership that has debt equal to 90 percent of value, the effective estate tax rate is only 4 percent (40 percent of 10 percent), and a basis adjustment is available. Further, there is only a single level of tax. In our experience, most NRAs are not attracted to this partnership option because they do not want to have to file a federal estate tax return. Moreover, they are concerned about whether the debt will be respected if the lender is a related party.

B. Post-Death Choice of Entity and Elections

1. Liquidation of PFICs and CFCs

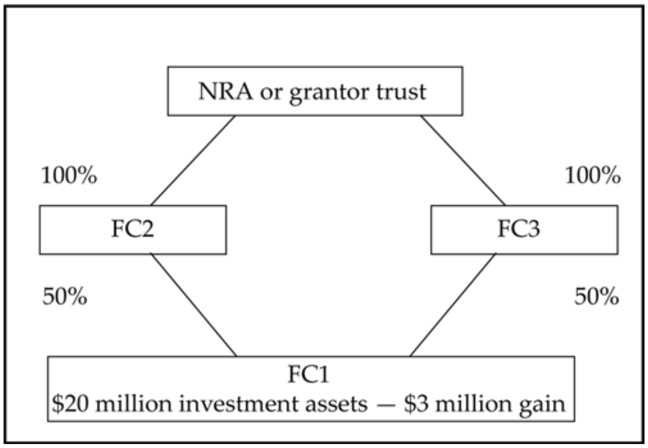
A liquidation of a CFC or a PFIC can be accomplished by making a check-the-box election or by actually liquidating the corporation. However, a liquidation will likely attract tax because the TCJA repealed the 30-day rule, as discussed in Part 1.

The amount of tax imposed on a U.S. shareholder who liquidates a CFC will be greater if there is a significant amount of unrealized appreciation in the investment portfolio owned by the CFC. If the unrealized appreciation is de minimis — for example, because the foreign holding company, before becoming a CFC, turned over the investment assets periodically to recognize gains while the NRA owned the shares — the gain on liquidation after death may be quite small. For some owners, a mark-to-market election under section 475(f) may minimize the difference between value and basis. The tax consequences to the NRA shareholder may make this strategy unacceptable. Moreover, this strategy will not be effective if the portfolio includes illiquid assets.

An alternative way to minimize tax on the liquidation of a foreign holding company is by using a technique referred to as the "triple blocker plan."

This plan involves putting only U.S. equities and obligations subject to U.S. estate tax (investment assets) in a foreign corporation (FC1), the shares of which are owned 50 percent by FC2 and 50 percent by FC3. (See figure.)

[29] Section 2106(a)(1).



The NRA or the NRA's grantor trust would own 100 percent of the shares of FC2 and FC3. After the NRA's death, FC1 would make a retroactive check-the-box election to be deemed liquidated on a date up to 75 days before the NRA's death (date A). Because neither FC2 nor FC3 would own 80 percent or more of the stock of FC1, the deemed liquidation would be a taxable liquidation for U.S. tax purposes even though no U.S. tax would be due.[30] This taxable liquidation would (1) cause FC1 to recognize gain as if all its assets were sold (assume gain is $3 million); (2) cause FC2 and FC3 to have gain equal to the excess of their share of the value of FC1 over their tax basis in FC1 (assume that this is $1.5 million for each); and (3) cause FC2 and FC3 to acquire an FMV basis in the investment assets (assume that this is $20 million — $10 million for each of FC2 and FC3).

There would be no U.S. or foreign tax consequences to FC1 from the deemed liquidation as a result of the check-the-box election because FC1 is not a U.S. taxpayer and the election has no effect outside the United States. Check-the-box elections would be filed for FC2 and FC3 effective two days after death (date B) to preserve them as estate tax blockers. (The election is made effective two days after death because the liquidation is deemed to occur on the day before the effective date of the election, and the company should remain a corporation until the day after the death of the owner.) There would be little or no gain on the deemed liquidation of FC2 and FC3 because both the investments in FC1 and the stock of FC2 and FC3 would have a basis of $20 million. The investment assets acquired an FMV as of the date of the deemed liquidation of FC1, and the stock of FC2 and FC3 acquire a new FMV basis upon the NRA's death. There may be some gain because of changes in value between dates A and B.

However, the gain realized by each of FC2 and FC3 from receiving investment assets having a value exceeding their basis in FC1 stock is $1.5 million, and $3 million in total. Because after his death the NRA's children will be treated as owning the stock of FC2 and FC3 (indirectly through the estate or trust), a share of that gain may be taxable to them. With careful timing, the amount of gain and the fraction of gain taxable to the children may be quite small.

The fraction of the gain taxable to the children is determined as follows: The numerator of the fraction is the number of days that the children were U.S. shareholders of each of FC2 and FC3 during the corporation's tax year. The denominator of the fraction is the total number of days in the relevant tax year of FC2 and FC3. The numerator could be as small as 1. If a check-the-box election for FC2 and FC3 is made effective two days after the NRA's death, the deemed liquidation occurs the day before.[31] The children's holding period does not include the date the shares were acquired but includes the date of disposition.[32] The liquidation terminates the tax year of the CFC. If the NRA died late in the tax year, the denominator would be large and the fraction would be quite small.

However, if the NRA died early in the tax year, the denominator of the fraction could be small, leaving a larger fraction of the gain to be taxed to the children. But because a check-the-box election can be made retroactive up to 75 days before Form 8832 (the form used to make the election) is filed, if the NRA died in the first 74 days of the year, the deemed liquidation of FC1 could be made retroactive to an earlier tax year so

[30]Section 332(a) should not apply to the liquidation of FC1 because there is no common parent as described in section 1504(a). If section 332 is not applicable, the assets of FC1 that are deemed to have been received by FC2 and FC3 are treated as received in exchange for stock of FC1 and acquire a new basis. FC2 and FC3 have gain on the liquidation, but the gain is foreign source and FC2 and FC3 are foreign persons.

[31]Reg. section 301.7701-3(g)(3).

[32]Reg. section 1.951-1(f).

that none of the gain realized by FC2 and FC3 that is attributable to the deemed liquidation of FC1 would be earnings in the year the corporation acquired U.S. shareholders. No earnings from the prior tax year would be exposed to U.S. tax.

For example, assuming that the corporation's tax year is the calendar year[33] and the NRA died on or before March 15, the effective date of the deemed liquidation resulting from a check-the-box election for FC1 could be December 31 of the prior calendar year. In that case, no portion of the income realized by FC2 and FC3 would be taxable to a U.S. shareholder who acquired shares in a subsequent year.

If one assumes instead that the NRA died on March 16 and that the check-the-box elections for FC2 and FC3 are made effective March 18, the deemed liquidations occur the day before, on March 17.[34] The fraction of the income taxable to NRA's children is one-seventy sixth because the U.S. shareholder's holding period does not include the date he acquired the shares (March 16) and includes the date of disposition (March 17, the end of the day before the effective date of the election, March 18).[35] There are only 76 days in the tax year of FC2 and FC3 (January 1 to March 17). There should be little or no further gain on the liquidation of FC2 and FC3 because the basis of the shares should have been adjusted upon the death of the NRA, and the assets that are deemed to be distributed to the children acquired a new basis upon the deemed liquidation of FC1.

2. Disposition

A much simpler option would be to sell the CFC or PFIC shares to a foreign person that, because it is foreign, could liquidate the foreign corporation or retain the shares as an investment without concern for the U.S. tax consequences of liquidation or retention. This works, of course, only for the top-tier company shares that acquired a stepped-up basis. Any shares in lower-tier companies would incur gain because the seller would not have acquired a step-up in the basis of the indirectly owned lower-tier shares. As discussed in Part 1, Section II.B.2, the gain on the sale of PFIC shares would be taxable as ordinary income, and even though a basis adjustment for gain on the lower-tier shares would generate a loss on the sale of upper-tier shares, the loss would be capital and unable to eliminate the tax cost. This result would be avoided if a QEF election were made. For CFCs, the gain is capital gain except to the extent that the CFC has earnings and profits that are treated as a dividend.[36]

The purchaser could be a foreign family member, a foreign trust for a foreign family member, or a foreign financial institution. There is some risk, however, that the IRS could recharacterize the sale under the step transaction or substance-over-form doctrine to treat the sale as a deemed liquidation by the sellers if the purchaser liquidates the corporation soon after the purchase.

3. Domestication of Foreign Corporations

A CFC will cease to be a CFC if it becomes a U.S. corporation. Any untaxed earnings and profits of the foreign corporation will be taxable upon domestication, but only to the extent of the U.S. shareholder's pro rata share of E&P accumulated during the shareholder's holding period.[37] In this case, we are assuming that the shares were recently inherited, so the U.S. shareholder's share of E&P may be zero. However, only the shares of the corporation, and not the assets owned by the corporation, would have acquired a new basis upon the death of the NRA decedent.

If the domesticated corporation elects to be taxable as a subchapter S corporation, the assets it owns could be sold after expiration of the five-

[33] Section 898(c) adopts a default rule that a CFC has the same tax year as the majority U.S. shareholder and may elect a year ending one month earlier. We assume that U.S. beneficiaries of a trust or estate will be deemed to be majority U.S. shareholders and will have a calendar year as their tax year. If there is no majority U.S. shareholder, regulations under section 441 determine the tax year of the CFC.

[34] The deemed liquidation is deemed to occur at the end of the day before the effective date of the election. Reg. section 301.7701-3(g)(3)(i). For this reason, the effective date of the election should be two days after death to preserve the estate tax shield provided by the foreign corporation.

[35] The date the shares are acquired is not counted in the U.S. shareholder's holding period, but the date of disposition is counted. Reg. section 1.951-1(f).

[36] Section 1248.

[37] Section 367(b); reg. section 1.367(b)-2(d).

year gain recognition period,[38] and it could be liquidated without further gain. The sale of the assets before liquidation of the S corporation would increase the shareholder's basis, and the ensuing liquidation in the same year would generate an offsetting loss (assuming all the gain realized is capital gain). Any foreign income taxes paid by the S corporation's foreign business generally would be creditable by the U.S. shareholder. Any further entanglements with the CFC rules would cease to be applicable.

However, there are several obstacles to this plan. First, the S corporation would incur corporate-level tax and lose its S election if it has too much passive income and has E&P from the time it was a C corporation.[39] This problem is mitigated by the fact that the E&P that carries over from the foreign corporation upon its liquidation into a domestic corporation is limited to the E&P of the foreign corporation that were attributable to the conduct of a trade or business within the United States; all other E&P do not carry over and are eliminated.[40] Thus, if there was no U.S. business carried on by the foreign corporation, there would be no accumulated E&P. If there is some E&P, the corporation could elect to distribute it as a taxable dividend.[41]

Another disadvantage of this strategy is that the investment portfolio would have to be maintained "as-is" during the five-year gain recognition period. Any investment turnover before then would be exposed to tax at the corporate level.

4. Domestication of Foreign Trust

Foreign trusts with U.S. beneficiaries have to deal with complicated reporting rules and accumulation distribution rules. These obligations can be eliminated or mitigated by domesticating a trust (or a portion of it), either by decanting or migration. A decanting to a U.S. trust generally is taxed like any other distribution to a U.S. beneficiary and could trigger tax. A migration, which could occur because of a change of trustees and governing law, should have no immediate tax consequences, although any accumulated income would remain subject to the accumulation distribution rules when later distributed.[42]

One significant advantage of domesticating a trust that owns a CFC or PFIC is that only the domestic trust, not the beneficiaries, would be (or, in the case of PFIC shares, *should* be) deemed to own the shares and be taxable on subpart F or PFIC income, unless that income is taxable to the beneficiaries under the rules of subchapter J. Attribution of indirect ownership of a CFC stops with the first U.S. shareholder, which would be the domestic trust.[43] For a PFIC, except to the extent provided by regulations, attribution also stops with the first U.S. shareholder.[44] Regulations provide that a shareholder of a domestic corporation will not be attributed ownership of shares of a PFIC owned directly or indirectly by the domestic corporation.[45]

Unfortunately, there is no similar provision concerning attribution from a domestic trust to a beneficiary. In fact, regulations provide that that if a foreign *or domestic* estate or non-grantor trust owns shares, directly or indirectly, each beneficiary is considered to own a proportionate amount of the stock. Similar rules apply to treat the partners or shareholders of a domestic partnership or subchapter S corporation as the shareholder. However, only a domestic partnership or S corporation is expressly not treated as a shareholder.[46] A domestic estate and a domestic trust are not expressly precluded from being treated as shareholders. If the domestic estate or trust and not a beneficiary is the owner, the complications of applying the PFIC regime to

[38] Section 1374.

[39] Sections 1375 and 1362(d).

[40] Reg. section 1.367(b)-3(f) ("Earnings and profits of the foreign acquired corporation that are not included as a deemed dividend under section 367(b) regulations . . . are eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation under section 381(c)(2) only to the extent such earnings and profits . . . are effectively connected with the conduct of a trade or business within the United States. . . . All other earnings and profits of the foreign acquired corporation shall not carry over to the domestic acquiring corporation and, as a result, shall be eliminated.").

[41] Section 1368(e)(3).

[42] Rev. Rul. 91-6, 1991-1 C.B. 89.

[43] Section 958(a). Attribution continues for purposes of determining constructive ownership.

[44] Section 1298(a)(1)(B).

[45] Reg. section 1.1291-1(b)(8)(ii)(C)(ii); and reg. section 1.1291-1(b)(8)(iv), Example 1.

[46] Reg. section 1.1291-1(b)(7).

a class of beneficiaries and the need to coordinate the PFIC and subchapter J regimes would be avoided for domestic trusts.

Owners of PFIC shares are required to file Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," annually for each PFIC they own.[47] In general, only the first U.S. person in the chain of ownership (for example, a U.S. trust) files information returns reporting the PFIC shares, unless the top-tier owner (for example, the beneficiary) is (1) treated as receiving an excess distribution or recognizing gain as a result of a disposition of shares; (2) required to include an amount in income as a result of a QEF or mark-to-market election; or (3) required to report the status of a section 1294 election.[48]

Unfortunately, the regulations do not tell us whether the excess distribution or gain attributable to the PFIC shares is taxable to a domestic estate or trust in the chain of ownership if no distribution is made from the domestic estate or trust to any U.S. beneficiary that carries out that income to a beneficiary under the rules of subchapter J. Regulations do provide that if a QEF election is made, a domestic passthrough entity (which includes a trust or estate) includes the income from the PFIC and the owners of the domestic passthrough entity (for example, beneficiaries) are taxed "according to the general rules applicable to inclusions of income from the domestic pass through entity."[49] In the case of a trust, those rules are the rules of subchapter J.

Unless the domestic trust is taxable on PFIC income not actually distributed to a beneficiary, the domestication of the trust will not solve any of the complications of owning PFIC shares through a foreign trust. Ownership through a domestic C corporation would, because the regulations make it clear that only the domestic corporation is taxed on PFIC income. For example, a domestic (or foreign) trust could transfer the PFIC shares to a domestic corporation and avoid attribution to U.S. beneficiaries. The transfer may be a disposition of indirectly owned shares, but there might be no gain if the assets recently acquired a new basis upon the death of the prior NRA owner.

5. PFIC Elections

U.S. persons who inherit shares of a PFIC individually (and not in trust) usually have the option to sell the shares or make either a QEF or mark-to-market election to avoid the PFIC tax regime. Another option may be to persuade the company to make a check-the-box election to be taxable as a partnership or a disregarded entity.

A U.S. beneficiary of a trust that owns PFIC shares has far fewer options. The beneficiary usually cannot force the trustee to sell the shares. A spendthrift clause may bar a sale of her beneficial interest. If the interest is discretionary, it is not marketable because it is incapable of valuation. A beneficiary, by law and without the requirement to obtain anyone's consent, could make a QEF or mark-to-market election if her beneficial interest were sufficiently clear to attribute ownership of the PFIC shares to her, but this would not be prudent until the IRS clarifies how indirect ownership will be determined and how beneficiaries who are treated as indirect owners are taxed. In the absence of guidance, a U.S. beneficiary who accepts the designation of indirect owner is at risk of being taxed punitively and may be better off maintaining the position that her interest is insufficient for her to be treated as the indirect owner of the shares.

If a domestic estate or trust owns marketable securities and makes a mark-to-market election, the code and regulations are clear that the U.S. beneficiaries will not be treated as indirectly owning the shares.[50]

C. Structuring Foreign Investments

1. Incorporation

As discussed in Part 1, U.S. persons who hold shares of CFCs directly or through an S corporation, partnership, or trust are taxed at a higher rate than corporations. The lower corporate rate can be achieved by transferring the shares to a domestic corporation, but in that case, there is a second level of tax on distributions to the individual shareholder of the domestic

[47] Section 1298(f).

[48] Reg. section 1.1298-1(b).

[49] Reg. sections 1.1293-1(c)(1) and 1.1295-1(d)(2)(iii).

[50] Section 1296(g); reg. section 1.1296-(e).

corporation. A transfer of the individual U.S. shareholder's shares to a domestic corporation should not accelerate the due date of the transition tax if the individual has elected to defer payment of the transition tax under section 965(h), unless the transfer represents substantially all of the taxpayer's assets. If the shares are held through an S corporation, the transfer would be a triggering event for purposes of section 965(i). The domestic corporation could then elect to pay the transition tax in installments under section 965(h).

Ownership of foreign corporation shares through a domestic corporation would be beneficial if the foreign corporation's dividends were not qualified dividends taxable at capital gains rates. The foreign-source portion of the dividends paid to the domestic corporation would qualify for the 100 percent deduction under section 245A, and the dividends paid by the domestic corporation to the U.S. shareholder would constitute qualified dividends.

The table illustrates the benefits of obtaining qualified dividend treatment.

2. Section 962 Election

An individual U.S. shareholder may make a section 962 election to enjoy the benefit of lower corporate rates, the section 250 deduction, and the deemed foreign tax credit under section 960. However, there will be a second level of tax when distributions are made from the foreign corporation to the shareholder, as shown in the table. Moreover, distributions from the foreign corporation are excluded from the shareholder's income only to the extent of the tax previously paid on those amounts, and the basis adjustment under section 961 is limited to the amount of tax actually paid by the individual shareholder (excluding taxes deferred under a section 965(h) election).

3. Check-the-Box Election

If a foreign corporation makes a check-the-box election, it will be classified for U.S. tax purposes either as a disregarded entity or a partnership. The CFC and PFIC rules will no longer apply because the entity will no longer be treated as a corporation. If the classification is made for a new entity, there are no tax consequences to the election. If the classification election is made for an existing corporation and the entity's classification was relevant for U.S. tax purposes, the check-the-box election will be a deemed liquidation of the entity.[51] Tax may be due on the deemed liquidation because corporate-level gain will be subpart F income or global intangible low-taxed income that will be taxable to any U.S. Shareholder, as described in Part 1. Moreover, the liquidation may result in gain at the shareholder level if the shareholder's basis is less than the value of the assets received in the liquidation. However, if the shareholder is a corporation, the liquidation may be nontaxable under section 332. Any foreign income taxes paid by the checked entity should be creditable by the U.S. owners of the entity. The income will be subject to the individual rate of tax, but only one level of tax.

4. Partnership/S Corporation

Conducting foreign business through a flow-through entity will also avoid the CFC and PFIC rules. Instead, the U.S. partner or shareholder will be taxed currently on all of the partner's or shareholder's share of the flow-through entity's income.

II. Conclusion

The foreign tax provisions of the TCJA create some new challenges for estate planners.

In particular, the repeal of the 30-day rule for taxing U.S. shareholders of CFCs makes it more difficult to efficiently liquidate CFCs inherited by U.S. persons after the death of an NRA decedent. This report has suggested some ways to solve that problem, including:

- the triple blocker plan;
- the sale of CFC and PFIC shares to a foreign person;
- QEF and mark-to-market elections;
- domestication of trusts;
- domestication of a foreign corporation followed by an S election;
- the use of foreign partnerships as estate tax blockers (but partnerships as blockers should be used only for those with high risk tolerance); and

[51] Reg. section 301.7701-3(d) and (g).

GILTI Example — Structuring Alternatives Post-250 Regulations

	Passthrough Structure	C Corp. Blocker Structure	Electing Section 962 (treaty jurisdiction)	Electing Section 962 (non-treaty jurisdiction)
GILTI	$100	$100	$100	$100
(Less 50 percent deduction)	$0	-$50	-$50	-$50
Foreign tax (10 percent)	$10	$10	$10	$10
U.S. tax	$37 ($100 * 37%)	$10.50 ($50 * 21%)	$10.50 ($50 * 21%)	$10.50 ($50 * 21%)
Foreign tax credit	$10 (get 100 percent of FTC)	$8 ($10 * 80%)	$8 ($10 * 80%)	$8 ($10 * 80%)
Tax upon distribution	—	$17.50 (20% * $87.50)	$17.50 ($90 - $2.50) * 20% (assuming QDI)	$32.375 ($90 - $2.50) * 37% (because not QDI)
Effective tax rate	**37 percent ETR:** • $27 U.S. tax • $10 foreign tax	**12.5 percent pre-distribution:** • $2.50 U.S. tax • $10 foreign tax **30 percent ETR:** • $17.50 U.S. tax on distribution	**12.5 percent pre-distribution:** • $2.50 U.S. tax • $10 foreign tax **30 percent ETR:** • $17.50 U.S. tax on distribution	**12.5 percent pre-distribution:** • $2.50 U.S. tax • $10 foreign tax **44.875 percent ETR:** • $32.375 U.S. tax on distribution

- transfers of PFIC shares to domestic corporations to block ownership attribution and have dividends treated as qualified dividends taxable at capital gains rates.

For some NRAs, accessing the U.S. equity market through a publicly traded PFIC that invests in U.S. equities seems to be the most practical solution. As long as the foreign entity is classified as a corporation for U.S. tax purposes (even if not so classified for foreign law purposes), it should be an effective estate tax shield and, if the shares are publicly traded, it should not be difficult to promptly sell the shares when the NRA dies.

Estate planners must be mindful of the acceleration events and triggering events that may move up the due date for payment of tax deferred under section 965(h) and (i) and should plan for the acceleration of tax deferred under section 965(h) on the death of a shareholder. If those events occur, sometimes deferral may continue if a transfer agreement is filed. Except in the case of the death of a subchapter S shareholder who has made a section 965(i) election, the transfer agreement is due a mere 30 days after the event that accelerates the tax, and no section 9100 relief is available if the deadline is missed.

U.S. persons who have investments in foreign corporations may consider making a section 962 election (particularly if the foreign corporation is subject to GILTI and is in a treaty jurisdiction) or transferring foreign shares to a domestic corporation. ■