RECENT DEVELOPMENTS IN INTERNATIONAL ESTATE PLANNING: THE U.S. BEGINS TO EMBRACE TRANSPARENCY

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I. OFFSHORE TAX ENFORCEMENT EFFORTS AND LACK OF RECIPROCITY BY U.S.

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A. Background

- Recent years have seen an expansion of reporting requirements for both U.S. taxpayers with holdings abroad and non-U.S. investors with holdings in the U.S.
- As global information sharing to combat tax evasion and money laundering becomes the norm, the U.S. faces increasing pressure from FATCA partners to reciprocate.
- Some the new measures could impact a wide range of existing structures and require many non-U.S. taxpayers who previously managed to avoid direct exposure to the U.S. tax system to acquire taxpayer ID numbers.
- The IRS has also broadened foreign asset reporting requirements to apply to certain domestic business entities and trusts while, at the same time, offering U.S. taxpayers limited relief with respect to certain other foreign asset reporting obligations.

B. Importance of FATCA IGAs to Enforcement Efforts

- The U.S. has enjoyed considerable success with its efforts to combat offshore tax evasion and other financial crimes overseas, in large part due to cooperation from other countries.
- The Foreign Account Tax Compliance Act (“FATCA”) enacted in 2010 created third-party reporting by:
    1. Requiring certain foreign financial institutions (“FFIs”) to identify, document and report their U.S. account holders to the IRS; and
    2. Requiring many non-financial foreign entities (“NFFEs”) to identify their U.S. owners to withholding agents or certify that they do not have any substantial U.S. owners.
- The U.S.’s network of intergovernmental agreements (“IGAs”) with partner jurisdictions has been critical to FATCA’s success.

C. Types of IGAS

- If an FFI or NFFE is a resident of a country that has an IGA with the U.S., the procedures in the applicable IGA (and the country's local laws) will govern.
- Two types of model IGAs have evolved and been adopted by FATCA partner jurisdictions:
  1. Model 1 IGAs require FFIs to report to tax authorities in the partner jurisdictions rather than to the IRS, and obligate the FATCA partner to automatically exchange that information with the IRS.
  2. Model 2 IGAs require FFIs to report directly to the IRS.
- Some IGAs are reciprocal. Reciprocal IGAs require U.S. FIs to collect and report information about Reportable Accounts held at the U.S. FIs by persons resident in the FATCA partner jurisdiction. Similarly, foreign FIs must collect and report information about Reportable Accounts held at the foreign FIs by U.S. persons.

D. Lack of Reciprocity by U.S.

There is a considerable disparity between the information FFIs are required to provide with respect to direct and indirect U.S. owners of foreign financial accounts and the information their U.S. counterparts are required to provide.

- FFIs subject to Model 1 reciprocal IGAs are required to look through entities wherever they are resident and report information on certain U.S. owners. No such look-through requirement is imposed on U.S. FIs subject to the same IGAs.
- Reporting by U.S. FIs does not extend to accounts held by entities that are not resident in the FATCA partner jurisdiction and no reporting is required for non-cash U.S. accounts, whether held by individuals or entities, unless there is U.S. source income that is subject to withholding in the U.S.
- The reason for these lopsided reporting obligations is that Congress has not enacted implementing legislation allowing the Treasury Department to fully reciprocate.

E. The Common Reporting Standard (CRS)

Spurred by FATCA's success, the OECD developed the Common Reporting Standard ("CRS") to facilitate the collection and reporting of information about accounts held at financial institutions in participating jurisdictions.

- These standards are similar to the standards used in the FATCA Model 1 IGAs. However, unlike FATCA, CRS is not enforced by a system of withholding. Instead, the automatic exchange of information will be the sole enforcement mechanism (as is the case under the IGAs). This information exchange will be governed by treaties adopted in participating jurisdictions.
- More than 100 countries have signed up. Of these, 49 have committed to first exchange of information in 2017.
- Implementation is still in its early stages and depends on local law, but early adopters have already begun sharing beneficial ownership information on taxpayers in other participating countries.
- The U.S. is almost alone among developed countries in opting not to join.

F. Other Transparency Efforts: Beneficial Ownership Registries and Suspicious Transaction Reporting

Following the enactment of the Fourth European Union Anti-Money Laundering Directive on June 25, 2015 ("Fourth AML Directive"), EU member states began adopting the following measures:

- Beneficial ownership registries to share information on the ultimate beneficial ownership of trusts and business entities.
- Imposition of suspicious activity reporting requirements on lawyers, accountants and other related professionals. (A number of countries, including the UK, already had such measures in place.)
- The U.S. does not regulate the legal profession and only imposes these requirements on financial institutions.

II. ADOPTION OF LIMITED TRANSPARENCY MEASURES BY THE UNITED STATES

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A. Role of U.S. as Potential Tax Haven: Unique Vulnerabilities

The U.S. has a few unique vulnerabilities to potential abuse due to the interplay of (1) the U.S. Treasury regulations governing entity classification (a.k.a. the “check-the-box” regulations”) and (2) state laws in certain jurisdictions that afford a high degree of privacy to the owners of business entities and trusts and require minimal disclosure of beneficial ownership information.

1. Single-member LLCs are “disregarded entities” for U.S. income tax purposes under the check-the-box regulations, so funding an LLC – even with millions of dollars – is a non-event for federal income tax purposes and, until recently, would not have triggered any reporting obligation.
2. Some states require only minimal information from those forming business entities or settling trusts. For example, in Delaware, only the company name and the name and address of the registered agent typically appear on the certificate of formation. The Delaware Division of Corporations does not request, obtain or store information on the LLC’s members or managers.

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A. Role of U.S. as Potential Tax Haven: Unique Vulnerabilities

Less scrupulous taxpayers could use single-member LLCs to hide their income and assets from tax authorities back home without triggering any tax liabilities or reporting obligations in the U.S.

- With no exchange of information under CRS – and often no information collected at the state level when LLCs are formed – foreign investors could use such vehicles to launder the proceeds of illegal activities.
- For example, an investor could use an LLC to anonymously make an all-cash purchase of high-end real estate.

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A. Role of U.S. as Potential Tax Haven: Pressure on U.S. to Address Potential Loopholes

The ability of wealthy foreign nationals to hold assets anonymously in LLCs and trusts formed in states with minimal disclosure requirements has been a significant point of contention with other countries.

- A report issued by the European Parliament in March 2017 described this situation in blunt terms: "The United States of America (USA) is seen as an emerging leading tax and secrecy haven for rich foreigners. By resisting new global disclosure standards, it provides an array of secrecy and tax-free facilities for non-residents at federal and state levels, notably in Nevada, Delaware, Wyoming, and South Dakota."
- Similar concerns were raised by the Financial Action Task Force ("FATF") in its Mutual Evaluation Report of the United States issued in December 2016.

A. Role of U.S. as Potential Tax Haven: Measures Adopted by Treasury Department

The U.S. has not adopted automatic disclosure of ownership of entities or trusts comparable to what many EU members have already put in place, but in the last year it has adopted more limited measures:

1. Geographic targeting orders requiring title insurers to identify the beneficial owners of shell companies;
2. Updated customer due diligence rules for financial institutions; and
3. IRS Form 5472 reporting requirements for U.S. disregarded entities with foreign owners.

These measures are targeted at the vulnerabilities previously identified – i.e., the ability to use single-member LLCs as shell companies to hide assets without triggering any tax liabilities or reporting obligations.

B. Geographic Targeting Orders

The U.S. Treasury Department issued geographic targeting orders ("GTOs") requiring title insurers to determine the identities of the owners of limited liability companies, limited liability partnerships, corporations and similar business entities that buy high-end residential real estate in all cash transactions above specified dollar thresholds in designated markets.

- Real estate transactions were identified by FinCEN as an area that is particularly ripe for abuse. As explained in a recent FinCEN advisory: "Criminals can use all-cash purchases to make payments in full for properties and evade scrutiny – on themselves and the origin of their wealth – that is regularly performed by financial institutions in transactions involving mortgages." FIN-2017-A003 (Aug. 22, 2017).
- As of May 2, 2017, over 30% of the real estate transactions reported under the GTOs involved a beneficial owner or purchaser that had previously been the subject of unrelated suspicious activity reports by U.S. financial institutions.

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B. Geographic Targeting Orders (continued)

Overview of new GTOs:

- Individuals who directly or indirectly own 25% or more of the purchasing entity must be reported on FinCEN Form 8300.
- The GTOs do not extend to purchases financed in whole or in part by a bank loan, as financial institutions already are subject to customer due diligence and suspicious activity reporting requirements under the Bank Secrecy Act and FinCEN regulations
- The GTOs do not yet extend to purchases made by trusts.
- The original GTOs were limited to all-cash purchases in Manhattan and Miami, but were expanded in July 2016 and August 2017 to cover purchases in other geographic areas.
- The GTOs did not previously cover wire transfers, but as of August 22, 2017 they now extend to all cash purchases made by wire or funds transfer.

B. Geographic Targeting Orders (continued)

Geographic Area	Reporting Threshold
Manhattan, New York	$3,000,000
Brooklyn, Queens, Bronx and Staten Island, New York	$1,500,000
Miami-Dade, Broward and Palm Beach Counties, Florida	$1,000,000
Southern California: San Diego and Los Angeles Counties	$2,000,000
Northern California: San Francisco, San Mateo and Santa Clara Counties	$2,000,000
Bexar County, Texas (San Antonio area)	$500,000
Honolulu (City and County), Hawaii	$3,000,000

C. FinCEN Customer Due Diligence Regulations

On May 11, 2016, FinCEN announced new customer due diligence ("CDD") rules, effective May 11, 2018, for banks, brokers, mutual funds and futures commission merchants.

- Affected financial institutions will be required to collect information on individuals who own (directly or indirectly) 25% or more of the equity of the entity holding the account or who have significant responsibility to control, manage or direct the entity (such as a CEO, CFO, COO, President, Vice president, Managing Member, General Partner, Treasurer or other officer with similar authority).
- Trusts are not covered by the new rules because they are not legal entities, so institutions are not required to report information on trust beneficiaries. However, covered institutions are required to obtain information on the trustees and any other control persons (for example, the settlor in the case of a revocable trust).

D. New Form 5472 Filing Requirements: Overview

On December 12, 2016, the Treasury Department and the IRS announced final regulations requiring U.S. disregarded entities (such as single-member LLCs) with foreign owners to file IRS Form 5472 information returns identifying their foreign owners and reporting certain related party transactions.

- The new reporting requirements are effective for tax years beginning on or after January 1, 2017 and ending on or after December 13, 2017. Thus, reporting will not be required until next year.
- Entities covered by the new rules will continue to be disregarded for most federal tax purposes, but they will be "regarded" for Form 5472 reporting, record-keeping and other compliance requirements.
- Covered entities will need to obtain employer identification numbers ("EINs"). This could present further complications if the owners or other responsible persons do not already have individual taxpayer identification numbers ("ITINs") or Social Security Numbers ("SSNs").

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D. New Form 5472 Filing Requirements: Expanded Scope

The Section Form 5472 reporting requirements for foreign-owned disregarded entities were piggybacked onto the existing Form 5472 reporting obligations for 25% foreign-owned U.S. corporations.

- The regulations not only extended the filing requirements to disregarded entities, but also greatly expanded the range of transactions and activities that would trigger a reporting obligation for a disregarded entity.
- The new reporting requirements were specifically intended to capture transactions, such as contributions to, and distributions from, disregarded entities, that would not otherwise have any income tax significance or trigger a reporting obligation.
- ***It is very difficult to unwind an existing structure with assets held by a non-U.S. person through a U.S. disregarded entity without triggering a reporting obligation under the new rules.***

D. New Form 5472 Filing Requirements: What Types of Transactions Are Reportable?

The term "reportable transaction" includes a broad range of transactions between the disregarded entity and any foreign "related party" (including the owner):

- "[Any] sale, assignment, lease, license, loan, advance, contribution, or any other transfer of any interest in or a right to use any property (whether tangible or intangible, real or personal) or money, ***however such transaction is effected, and whether or not the terms of such transaction are formally documented***."
- Any services for the benefit of, or on behalf of, another taxpayer.
- Amounts paid or received in connection with the formation and dissolution of the entity, including contributions to and distributions from the entity, whether or not such amounts would otherwise be reportable.
- The regulations include transactions for which no consideration is received (e.g., rent-free use of property, interest-free loans, free services, etc.).

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D. New Form 5472 Filing Requirements: What is a “Related Party”?

Only transactions with foreign related parties are considered reportable transactions. Related parties include:

- Any direct or “indirect” 25% owner (by vote or value) of the reporting entity, including owners by attribution (discussed in next slide).
- Any foreign person “related” to the reporting entity or an owner, including (among others):
  - Spouses, ancestors, descendants and siblings of the owner.
  - A corporation or partnership with a greater than 50% interest in the owner or reporting entity, or that either is owned more than 50% by the owner or reporting entity or under common control.
  - Certain trust fiduciaries where the trust or grantor owns a requisite interest in the underlying entity.

D. New Form 5472 Filing Requirements: Attribution Rules for Related Parties

Attribution rules apply in determining whether someone "indirectly" owns 25% of the reporting entity:

- Where the reporting entity is owned by a foreign corporation, partnership or (nongrantor) trust, the shareholders, partners or beneficiaries thereof will be considered to own their proportionate shares of the reporting entity (with a 10% minimum ownership threshold for attribution from a corporation).
  - A beneficiary's share of a trust's interest in the reporting entity is based on the relative actuarial value of his or her beneficial interest in the trust.
  - It is not entirely clear how a discretionary beneficiary's interest would be determined, but informal guidance in other contexts suggests one would look to the pattern of distributions, mortality assumptions and relationships among the trustees and beneficiaries.
  - Where the owner is a foreign grantor trust, the grantor of such trust.

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D. New Form 5472 Filing Requirements: Attribution Rules for Related Parties (continued)

- An individual may be attributed ownership of a direct or indirect interest in the reporting entity held by certain family members (spouses, children, grandchildren and parents, but *not* siblings).
- Successive attribution rules apply.

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D. New Form 5472 Filing Requirements: Example of Reportable Transactions

A foreign irrevocable discretionary trust is the sole shareholder of a BVI corporation that in turn is the sole member of a Delaware LLC. The LLC owns a duplex condominium apartment in New York City.

- The trust, whose late settlor was a non-US person, has two discretionary beneficiaries – the settlor's two daughters, both of whom are nonresident aliens. Their mother and brother, also nonresident aliens, are not beneficiaries of the trust, but all of four of them use the apartment rent-free when they are visiting New York.
- The trust periodically advances funds to the BVI corporation, which in turn advances funds to the LLC (and sometimes pays carrying charges on behalf of the LLC). There is no history of distributions from the trust.
- As explained in the next slides, there appear to be reportable transactions not only with the BVI corporation, but also with all four living family members on account of their rent-free use of the apartment.

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D. New Form 5472 Filing Requirements: Example of Reportable Transactions

Related Parties. The BVI corporation, the trust, the two daughters, their mother and their brother likely would all be considered related parties.

- The Delaware LLC is the reporting entity. The BVI corporation, as its sole member, is a direct 25% owner. The trust, as the sole shareholder of the BVI corporation, is an indirect 25% owner of the LLC. Thus, both the BVI corporation and the trust would be identified as owners on the Form 5472.
- Since they are the only two beneficiaries, both daughters are likely indirect 25% owners of the LLC even if the trust is discretionary, particularly given their prior use of trust property which could serve as a proxy for distribution history. Their mother is likely an indirect 25% owner as well by way of family attribution from her daughters. As such, they are all related parties.
- The brother is not an indirect owner because there is no sibling attribution or re-attribution from his mother. However, he is nonetheless a related party because he is related to three indirect owners.

D. New Form 5472 Filing Requirements: Example of Reportable Transactions

Reportable Transactions. The following transactions are reportable:

- Both direct funding and indirect funding of the LLC is considered a reportable transaction. Thus, advances from the BVI corporation, as well as the BVI corporation's payment of expenses on behalf of the LLC, are reportable on IRS Form 5472.
- Because the two beneficiaries, as well as their mother and brother, are related parties, their rent-free use of the LLC's property would appear to be a reportable transaction. Both the payment of rent and the rent-free use of property are considered reportable transactions. (Note that if one of the children was a U.S. person, then his or her rent-free use of the apartment would be reportable on IRS Form 3520 and potentially taxable.)
- *Note: If the BVI corporation dissolved the LLC and took direct ownership of the apartment, the "distribution" of the apartment would itself be a reportable transaction.*

D. New Form 5472 Filing Requirements: Record Maintenance Requirements and Penalties

Record Maintenance Requirements. The disregarded entity would be required to keep permanent books and records sufficient to establish the correct U.S. tax treatment of any transactions with related parties, including information, documents and records of the foreign owner that may be relevant.

Penalties. The penalty for failure to timely file a correct Form 5472 is $10,000. If the IRS issues notice of the reporting entity's failure to file and no form is filed within 90 days of such notice, an additional $10,000 penalty will apply for each additional 30 days that the form is delinquent.

D. New Form 5472 Filing Requirements: EIN (and Possible ITIN) Requirement

EIN Requirement. An EIN is required to file Form 5472. If the LLC or other reporting entity does not already have an EIN, it will need to apply for one by filing IRS Form SS-4.

- If the reporting entity has a bank account, then it likely already has an EIN. Most banks will not let an LLC or other entity open an account without one.

Responsible person. The Form SS-4 instructions require the applicant to identify a "responsible person" and provide his or her taxpayer identification number. For a closely held entity, this is "the individual who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage or direct the entity and the disposition of its funds and assets."

- In many cases, the responsible person will be the owner.

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D. New Form 5472 Filing Requirements: EIN (and Possible ITIN) Requirement

ITIN. If the responsible person is a nonresident alien who does not already have an ITIN, then he or she will need to apply for an ITIN by filing IRS Form W-7.

- The process can take a few months and requires original or certified copies of the applicant's passport or other official documents confirming his or her identity. Only the issuing agency or a U.S. embassy or consulate can certify the documents. Recent legislation eliminated the option of using certified acceptance agents to assist individuals who reside outside the U.S. with the certification process. Now such individuals must apply by mail or in person to an IRS employee or designee at a U.S. diplomatic mission or consular post.
- Taxpayers have been able to obtain EINs for LLCs by fax without a responsible person ITIN or SSN. However, there is a significant risk of pushback from the IRS. We strongly advise anyone who needs an EIN for a Form 5472 filing obligation to apply for one well in advance.

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D. New Form 5472 Filing Requirements: Getting Ready for 2017 Tax Year Filings

- Foreign owners of U.S. disregarded entities and their advisors should be taking steps to identify and quantify potentially reportable transactions.
- Now is the time to apply for an EIN (or an ITIN if one is required in order to obtain an EIN).
- Taxpayers should familiarize themselves with the new form. Although the final updated form and instructions likely will not be available until December, early drafts of the form and instructions are available on the IRS website:
  - Draft Form: https://www.irs.gov/pub/irs-dft/f5472--dft.pdf
  - Draft Instructions: https://www.irs.gov/pub/irs-dft/i5472--dft.pdf

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III. RECENT CHANGES TO FOREIGN ASSET REPORTING REQUIREMENTS

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A. Overview of Changes

Recent changes to foreign asset reporting requirements have been more of a mixed bag, with the IRS expanding the classes of taxpayers subject to IRS Form 8938, but offering some relief in other areas, including an automatic extension of the filing dates for FBARs.

- ***Automatic Extension of FBARs.*** The Treasury Department's Financial Crimes Enforcement Network (FinCEN) announced an automatic six-month extension for taxpayers required to file FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR).
- ***Certain Entities and Trusts Now Required to File Form 8938.*** Until recently, only individual taxpayers were required to file Form 8938 (Statement of Specified Foreign Financial Assets). However, certain closely held business entities and trusts are now required to file Form 8938.
- ***Relief from Form 8938 and 8621 Filing Obligations.*** Limited relief has been offered to dual residents and certain other taxpayers required to file IRS Forms 8621 and 8938.

B. FBAR Automatic Extension

FBAR Overview. Subject to certain exceptions, any United States person with an interest in, or signature or other authority over, one or more foreign financial accounts whose aggregate value exceeds $10,000 at any time during a calendar year is required to file an FBAR in the following year.

- For FBAR purposes, U.S. persons include U.S. citizens, residents, domestic trusts, estate and entities, including disregarded entities that would not otherwise be considered "persons" for most tax purposes. Thus, a U.S. disregarded entity or "hybrid trust" (discussed later) with offshore accounts or a controlling interest in an offshore entity that owns an offshore account could be required to file the FBAR.

- Foreign financial accounts include bank accounts, brokerage accounts, mutual funds and other pooled investment funds at foreign financial institutions, including many types of foreign retirement plans and life insurance policies.

B. FBAR Automatic Extension (continued)

Controlling Interests. For FBAR purposes a U.S. person can be treated as the owner of a foreign financial account owned (directly or indirectly) by a corporation or a partnership if the U.S. person owns more than 50% of the stock (by vote or value) of the corporation or more than 50% of the capital or profits interests in the partnership (as applicable). A U.S. person can be treated as owner if the owner of record is his agent or representative.

- The above rule also applies to a U.S. person owning (directly or indirectly) more than 50% of the beneficial interest in the income or assets of a trust. However, beneficiaries of a trust are not required to file FBARs with respect to accounts held by the trust if a U.S. trustee files the necessary returns.
- If the grantor of a trust is treated as the owner of the trust's income or assets for tax purposes under the "grantor trust" rules, the grantor is required to file FBARs for reportable accounts held by the trust.

B. FBAR Automatic Extension (continued)

Signature Authority. Signature authority refers to the authority to control the disposition of the assets in the foreign account by direct communication with the financial institution. A decision to allocate assets or instruct others with signature authority is not enough to trigger a filing requirement.

Automatic Extension of Filing Deadline to October 15. Until last year, FBARs were generally due on June 30th, with no automatic extensions. Recent legislation changed the standard FBAR due date to April 15th beginning with the 2016 calendar year report (due in 2017) and mandated a maximum six-month extension. In order to reduce the administrative burden and facilitate compliance, FinCEN granted all filers an automatic extension to October 15th every year, without the need for specific requests, until further notice. ***FBARs for 2016 may be submitted as late as Monday, October 16, 2017.***

- ***This automatic extension is limited to FBARs.*** The deadline for most IRS returns for foreign assets will not be extended unless the taxpayer files an extension request with respect to the underlying tax return.

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C. Changes to IRS Form 8938
Overview of Reporting Requirements

- A “specified individual” is required to report his or her interest in “specified foreign financial assets” on Form 8938, which is filed with such individual’s income tax return, if the aggregate value exceeds an applicable threshold ($50,000 on last day of tax year or more than $75,000 at any time during the year for an unmarried individual living in the U.S.).
- A specified individual is a U.S. citizen or resident (including a part-year resident), a nonresident who makes an election to be treated as a resident for the purpose of filing a joint return and a nonresident who is a bona fide resident of Puerto Rico or American Samoa.
- A “financial interest” is an asset that produces income, gains, losses, deductions, credits, gross proceeds or distributions the specified individual would otherwise report on an income tax return. A financial interest is reportable even if it produces no income, with an exception for taxpayers who are not otherwise required to file an income tax return that year.

C. Changes to IRS Form 8938
Overview of Reporting Requirements (continued)

- Specified foreign financial assets include depository or custodial accounts at foreign financial institutions and (if not held in an account): (1) stock or securities issued by foreign persons, (2) any other financial instrument in which counterparty is not a U.S. person and (3) an interest in a foreign entity, including a trust or estate.
- An interest in a trust is not a specified foreign financial asset unless the individual knows or should have known of it, has a mandatory interest or received a distribution.

C. Changes to IRS Form 8938
Expansion of Reporting to Domestic Entities

Expansion of reporting to domestic entities and trusts. Last year, the IRS exercised its regulatory authority under the statute to extend Form 8938 reporting requirements to "specified domestic entities" – including certain trusts – for tax years beginning after December 31, 2015.

- A "specified domestic entity" means: (1) a domestic corporation, (2) a domestic partnership, or (3) a domestic trust (as defined for U.S. tax purposes), if "formed or availed of for purposes of holding, directly or indirectly, specified foreign financial assets."
- This test (as described below) is applied annually.

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C. Changes to IRS Form 8938
Expansion of Reporting to Domestic Entities (cont.)

- ***When a Domestic Corporation or Partnership is Subject to Form 8938 Filing.*** A domestic corporation or partnership meets the "formed or availed of" test if

  (i) a specified individual owns directly, indirectly or constructively, (A) at least 80 percent (by vote or value) of the corporation on the last day of the corporation's tax year or (B) at least 80 percent of the capital or profits interest of the partnership on the last day of the partnership's tax year, and

  (ii) at least 50 percent of the entity's gross income for the tax year is passive income, or at least 50 percent of the entity's assets produce or are held for the production of passive income.

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C. Changes to IRS Form 8938
Expansion of Reporting to Domestic Entities (cont.)

- ***When a Domestic Trust is Subject to Form 8938 Filing.*** A domestic trust meets the "formed or availed of" test if the trust has one or more "specified persons" as a current beneficiary. A specified person is a specified individual or a specified domestic entity.
  - A "Current beneficiary" is, with respect to the tax year, any person who at any time is entitled to, or at the discretion of any person may receive, a distribution from the principal or income of the trust (determined without regard to any power of appointment to the extent that such power remains unexercised at the end of the taxable year). This includes any holder of a general power of appointment, whether or not exercised, that was exercisable at any time during the taxable year.
  - ***Exceptions.*** There are exceptions for grantor trusts because the obligation falls on the grantor, as well as for certain domestic trusts with institutional trustees who timely file annual returns for the trust.

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D. Form 8938 and 8621 Relief for Certain Taxpayers

Recognizing that there is little to gain in requiring dual resident taxpayers who elect under a tax treaty to be taxed as nonresident aliens to comply with burdensome reporting requirements targeted at U.S. taxpayers, recent regulations and other IRS guidance have eliminated a few foreign asset reporting requirements for dual residents and other taxpayers.

Dual Residents. Eligible dual resident individuals of the U.S. and certain treaty countries may invoke treaty "tie-breaker" provisions to determine their U.S. federal income tax liabilities as nonresidents (for example, to avoid being taxed in the U.S. on foreign source income). However, they are still considered U.S. residents for other tax purposes and often are required to file foreign information returns even when there is no associated tax liability.

- New rules introduced at the end of 2016 and 2014 exempt dual residents from the obligation to file (i) IRS Form 8621 to report an interest in a passive foreign investment company for the part of the year that they are treated as nonresidents, and (ii) IRS Form 8938 if they compute their tax liability as nonresidents as of the end of the tax year.

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D. Form 8938 and 8621 Relief for Certain Taxpayers

30 Day De Minimis Exception. U.S. taxpayers who hold interests in a PFIC for less than 30 days during a slightly extended taxable year (the 423 day period beginning 29 days before and ending 29 days after the taxable year) are no longer required to report such interests on IRS Form 8621 if (a) they have not disposed of received certain distributions from the PFIC during the taxable year, and (b) they have not made a Qualified Electing Fund election or a Mark to Market election with respect to the PFIC.

Expansion of Exception for PFICs Held in Foreign Pension Funds. Under an existing reporting exception, U.S. beneficiaries of a foreign pension fund are not required to file IRS Form 8621 with respect to PFICs held by a foreign pension fund classified as a trust for U.S. tax purposes if, under an applicable treaty, income earned by the pension is not taxable to the beneficiaries in the U.S. until distribution. This exception was recently expanded to include all treaty-protected pension funds, without regard to whether they are classified as trusts for U.S. tax purposes.

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IV. CRS AND DOMESTICATION OF OFFSHORE STRUCTURES

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A. Reasons for Establishing Trusts in the U.S.

It is becoming increasingly common for nonresident individuals to settle trusts in States such as Nevada, Wyoming, Delaware and South Dakota. These States have favorable trust laws and strong creditor protection.

Tax Planning. There are a number of situations where establishing a trust in the U.S. could be more tax efficient than a non-U.S. trust. For example:

- If a foreign nongrantor trust has U.S. beneficiaries and income is not distributed currently, punitive tax rules apply to distributions of income earned in prior years while the trust was a nongrantor trust. In general, these accumulation distributions are taxed as ordinary income and subject to an interest charge for the period over which they were earned.
- These punitive rules on accumulation distributions do not apply if the trust qualifies as a U.S. nongrantor trust for tax purposes. Even if the trust is structured to start out as a foreign grantor trust for tax purposes, administering the trust in a U.S. jurisdiction provides an easy mechanism for domestication on the grantor's death.

A. Reasons for Establishing Trusts in the U.S.

- A trust that will invest in U.S. real estate holdings can be structured to provide the same estate tax protections as a foreign blocker corporation (assuming the settlor will not retain any "impermissible strings"), while preserving long-term capital gain treatment (if applicable).
- Although long-term capital gain treatment would apply to U.S. and foreign trusts alike, U.S. trusts offer a number of advantages over foreign trusts, including:
  - No FIRPTA withholding when the property is sold.
  - U.S. beneficiaries can use trust property rent-free without having to report the fair rental value of their use of the property as a potentially taxable distribution on IRS Form 3520.
  - No punitive taxes on accumulation distributions.

A. Reasons for Establishing Trusts in the U.S. (cont.)

U.S. and Foreign Trust Status. In order for a trust to be a U.S. trust for tax purposes, (i) a court in the U.S. must be able to exercise primary (but not exclusive) jurisdiction over the administration of the trust, and (ii) U.S. persons must control all "substantial decisions" of the trust (such as power over distributions, appointment and removal of trustees, etc.). Power (including veto rights) over a single substantial decision of the trust can cause a trust to "flunk" the control test and be treated as a foreign trust for tax purposes.

Hybrid Trusts. A foreign trust may be structured as a "hybrid" trust – e.g., with an institutional trustee in a jurisdiction like Delaware, but with a feature, such as a foreign protector with a power to remove and replace the trustee, that causes the trust to be a "foreign" trust for U.S. tax purposes.

- This might be desirable where the trust is structured as a foreign grantor trust during the non-U.S. grantor's lifetime, but will become a nongrantor trust with U.S. beneficiaries upon the settlor's death.

A. Reasons for Establishing Trusts in the U.S. (cont.)

Avoiding CRS. More questionably, some individuals have begun to look to the U.S. as a possible "haven" from reporting in their home countries.

- As more and more jurisdictions commit to the automatic exchange of information under CRS, there has been growing interest in the U.S. as one of the few remaining holdouts among developed countries with stable financial systems.
- A foreign trust settled in the U.S. with a foreign settlor or protector, as noted above, would not be subject to CRS reporting requirements. It would instead come under the FATCA reporting regime. If there are no U.S. beneficiaries, there would be nothing to report to the IRS. However, as discussed in the next two slides, we offer some words of caution for both would-be settlors and their advisors.

B. Limits of Domestication Planning and Other Observations

Entity Owned by Trust in CRS Jurisdiction. If the trust owns any entities or accounts in one of the more than 100 jurisdictions that have adopted CRS, then there is a good chance that the Controlling Persons will have their information reported back to their home countries anyway because the trust itself would be considered a passive NFE for CRS purposes (even if is an FFI under FATCA).

- Controlling Persons of a trust under CRS are defined in OECD guidance as including the settlor, trustee, beneficiaries, protectors or any other natural persons exercising ultimate effective control over the trust, which would include an investment advisor or distribution advisor.
- Where beneficiaries are not individually named, but, rather, are identified as a class, they generally do not have to be individually identified until they receive distributions per OECD guidance. Similar rules may apply to discretionary beneficiaries, depending on the jurisdiction.

B. Limits of Domestication Planning and Other Observations

However, if a resident of a CRS jurisdiction funds a U.S. trust that owns solely domestic entities and accounts, CRS reporting may be avoided. However, a foreign blocker corporation may be needed to avoid U.S. estate taxes, particularly if the settlor wishes to retain any degree of control over or benefit from the trust.

- Further, if the trust is structured as a hybrid trust (i.e., such that it still is a foreign trust for U.S. tax purposes), then, if there are U.S. beneficiaries, the settlor will want the trust to qualify as a grantor trust so that the accumulation distribution rules do not apply. This generally requires that the trust either be revocable or limit distributions to the settlor and/or the settlor's spouse, which would necessitate the use of a foreign blocker for any U.S. situs assets (or avoidance of U.S. investments altogether).
- A U.S. disregarded entity (such as a wholly owned limited liability company) owned by the trust will be subject to the new Form 5472 reporting requirements for foreign-owned disregarded entities.

B. Limits of Domestication Planning and Other Observations

U.S. FIs, tax advisors and other U.S. persons will want to carefully consider their own exposure to being implicated in an arrangement to avoid payment of foreign taxes.

- If a nonresident approaches a U.S. advisor for help in setting up a trust in the U.S., to what extent is the U.S. advisor obligated to make sure that the client has complied with all applicable tax reporting obligations with respect to the funds that will be transferred to the trust?
- Are U.S. tax advisors precluded from recommending the use of structures that avoids CRS reporting?
- A basic question one should be able to answer when assisting a client in domesticating an offshore structure is why they are choosing the U.S. as a jurisdiction. This may be evident where U.S. beneficiaries and/or assets are involved, but a structure with no apparent U.S. nexus might give one pause.

B. Limits of Domestication Planning and Other Observations

Risk-Based Approach. In evaluating clients for potential money-laundering risk, ACTEC, the ABA, IBA and FATF all recommend a risk-based approach, taking into account the country/region, client and services involved. Some arrangements may raise more red flags than others:

- For example, is the client a politically exposed individual or from a country with a high degree of endemic corruption?
- Is there a level of opacity to the structure that cannot be readily explained?
- Are there a large number of transfers that do not appear to serve any purpose other than obscuring the origins of the funds or properties involved?

Input from Foreign Counsel. One may need input from local counsel on compliance with tax laws and other rules in the client's home country. In some cases, remedial action may be required before the client can fund the structure.

- *Note: Transferring assets out of a CRS jurisdiction may itself be reportable.*

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Dina Kapur Sanna has 20 years of experience in advising U.S. and non-U.S. taxpayers on wealth management structures which accommodate multi-jurisdictional tax and legal considerations. Her practice involves foreign trusts, pre-immigration and expatriation planning, planning for the purchase of U.S. property by non-U.S. persons and compliance with tax and reporting obligations for those with overseas interests in foreign accounts, corporations and trusts.

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Carl works extensively in the international tax arena. He advises non-U.S. clients on structuring inbound investments to minimize federal and state income and estate tax exposure. He advises U.S. clients on tax aspects of foreign investments, including anti-deferral rules, entity classification issues and reporting requirements for foreign entities and trusts.

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