INTERNATIONAL

TAX GUIDES

FOR THE U.S. ADVISOR

CAUTION!!!

Please be advised that the below description of tax developments and planning techniques is by no means complete from a technical legal or tax viewpoint. The memorandum is being provided for preliminary discussion purposes only and should in no way be treated as the provision of legal advice to be acted upon in any way. The efficacy of any tax plan or compliance action based on these materials the developments as described will be largely dependent upon the soundness of the proper implementation of the plan, inclusion of appropriate special provisions contained in any implementing documents, timely filing of the required compliance documents with tax authorities, the existence of ongoing economic substance of the relationships established and compliance with applicable foreign law.

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CHAPTER 1

GUIDE TO FEDERAL INCOME TAX TREATMENT OF A U. S. OWNED FOREIGN CORPORATION

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Introduction

The earnings of a foreign corporation owned wholly or partially by U.S. persons are generally not subject to U.S. Federal income tax until the earnings are distributed. This general principle of U.S. federal income tax deferral is subject to numerous exceptions described below. The most pervasive limitations are found in "Subpart F." See IRC §951 through §964. These limitations on U.S. tax deferral apply only to "controlled foreign corporations" or "CFC's." Other limitations apply to "foreign personal holding companies" and "passive foreign investment companies." A CFC may also be a "foreign personal holding company" and a "passive foreign investment company." Even the amount of any claimed deferred earnings may be subject to intercompany pricing adjustment. See Section 482 and the regulations thereunder.

A "U.S. shareholder" which owns directly (or through one or more intervening foreign corporations) stock in a "foreign corporation" on the last day of a taxable year in which such corporation was a controlled foreign corporation ("CFC") for an uninterrupted period of 30 days or more is required to include in its gross income its pro rata share of such corporation's "Subpart F income." For this purposes the status of a foreign company as a "foreign corporation" is determined under U.S. Federal tax principles and the so-called check-a-box system. For income recognition purposes, the stock ownership must be direct or indirect through one or more intervening foreign corporations in a chain. Constructive ownership other than through a chain of corporations is ignored for income recognition purposes but is applicable for determining CFC status as explained in the first section below.

For Subpart F income characterization purposes, a CFC may be required to take into account its distributive share of partnership gross income as if it had earned the gross income directly. See Notice 96-39. Compare Brown Group, Inc. v. Comm'r. 96-1 U.S.T.C. ¶¶50, 055 (8th Cir. 1996). But see Notice 98-11. The Subpart F income is deemed distributed directly to the "United States shareholder" which is lowest in the chain of ownership leading to the subject CFC. IRC §951(a)(1). The United States shareholder's pro rata share is further limited to the amount of Subpart F income which is proportionate to the number of days of the given taxable year the foreign corporation is a CFC. IRC §951(a)(2). The amount included is deemed distributed as of the close of the taxable year of the United States shareholder in which or with which the taxable year of the foreign corporation ends. IRC §951(a)(2).

Definition of a CFC

CFC is defined as a foreign corporation of which either more than 50 percent of the voting power or the total value is owned directly, indirectly or constructively by one or more United States shareholders. IRC §957(a). A "United States shareholder" is essentially a "United States citizen, United States resident, or domestic corporation", which owns directly, indirectly or by attribution (i.e., constructively) 10 percent or more of the voting stock of the subject foreign

corporation. For the purpose of determining CFC status and not income recognition, actual stock ownership and constructive stock ownership are considered. IRC §957(a).

In certain instances. U.S. shareholder(s) which in the aggregate own only a minority of the voting shares will nevertheless be deemed to own a majority of the voting power for purposes of determining CFC status. This would be so if, for instance: *(i)* the U.S. shareholder(s) have the power to elect a majority of the Board of Directors; *(ii)* the U.S. shareholder(s) have just 50 percent of the voting power but also have the power to break deadlocks; or *(iii)* the majority shareholders who are not U.S. shareholders have no compelling economic interest to exercise their voting power, e.g., the return of their shares is fixed. See Treas. Reg. §1.957-1(b).

A CFC is required to conform its tax year to the tax year of the U.S. shareholder who owns more than 50 percent of the total voting power or value of the outstanding stock that is owned by all U.S. shareholders on any day during the CFC's taxable year. See IRC §898. In addition, a CFC may elect to use a tax year-end that provides no more than one month of income deferral to the majority U.S. shareholder. See Rev. Proc. 90-26, 1990-17 I.R.B. 16 for details regarding making of the election.

Classes of Subpart F Income

There are nine classes of Subpart F Income. Only three (3) of the classes are frequently encountered by a U.S. person "going international," namely, *(i)* foreign personal holding company income, *(ii)* foreign base company sales income, and *(iii)* foreign base company services income earnings invested in excess passive assets. Each of these three classes as Subpart F income are described below. IRC §§952(a) and 959(a).

Foreign Personal Holding Company Income

Certain types of passive income are treated as foreign personal holding company income. The legislative purpose of limiting deferral for this type of income is to discourage the establishment of companies in a jurisdiction solely for the purpose of accumulating low taxed passive income. Typical activities which may generate FPHC income include the following: software licensing, motion picture distribution, leasing of office machines, car rental, apartment or office building rental and oil drilling equipment rental. With exclusions described below, foreign personal holding company income for CFC purposes is gross income which consists of:

1. Dividends, interest, royalties and annuities;

2. Gains from sale or exchange of stock or securities except in the case of dealers; and

3. Rents.

4. The net gains from transactions in commodities except for net gains resulting from bona fide hedging transactions, necessary to the conduct of business or from active conduct, of a trade or business in commodities;

5. Net foreign currency gains;

6. Any income equivalent to interest; and

7. The net gains from sales of any non-inventory property that gives rise to passive types of income or does not give rise to any income. See IRC §954(c) and 553.

An exclusion from foreign personal holding company income treatment is provided for rents derived from the active conduct of a trade or business. These rents may include rentals from *(a)* any property manufactured by the lessor, or to which substantial value was added by lessor, *(b)* personal property ordinarily used by the lessor in its business but temporarily leased out during a slack period; and *(c)* any property leased as a result of substantial marketing efforts in the country of organization of the CFC.

A limited exclusion from the definition of FPHC income for certain export financing conducted by banks. An additional exclusion is provided for certain income known as "same country income" even though it is derived from a related person as follows: *(a)* dividends and interest received from a related person which (1) is organized in the same country as the recipient CFC, and (2) has a substantial part of its assets used in a business location within such country; and *(b)* rents, royalties and similar amounts for the use of property within the same country in which the recipient CFC is organized. The exception for same country income is not available where the interest, rent or royalty reduces the payor's Subpart F income. Further, to qualify for the same country exclusion for taxable years beginning after September 30, 1993, the earnings distributed must have been accumulated while the CFC held the stock of the distributing corporation. Finally, the use of hybrid entities to qualify for the exclusions described above is limited under recently issued temporary regulations. See Treas. Regs. §1.954-2T.

Foreign Base Company Sales Income

Four classes of sales income of a CFC known as "foreign base company sales income" are treated as Subpart F income as follows: *(i)* purchase of personal property from a related person and its sale to any person; *(ii)* sale of personal property to any person "on behalf of" a related person, *e.g.,* CFC acts as a commission sales agent for U.S. manufacturer; *(iii)* purchase of personal property from any person and its sale to a related person; and *(iv)* purchase of personal property from any person on behalf of a related person, *e.g.,* CFC acts as a commission purchasing agent. The form of profit is not relevant. *e.g.,* commissions, service, interest, fees earned from sale of personal property. <u>See</u> Private Letter Ruling 85-360 07.

The legislative purpose is to eliminate any Federal income tax incentive to use an intermediate sales company incorporated in a jurisdiction other than the country of manufacture or consumption of the product being sold. The subject personal property need not be inventory. However, personal property sold to an unrelated person after substantial use by the CFC in its business will not generate FBC sales income. There is no application to gains from personal property sold pursuant to the discontinuation of the business of the CFC as long as substantially all of the property is sold.

Sales income derived from property manufactured, produced, constructed, grown or extracted in country where the CFC is organized is excluded from foreign base company treatment. The determination of whether property has been manufactured or produced is often difficult. The Treasury Regulations define manufacture, production, or construction to be *(i)* a "substantial transformation" of the subject property, *e.g.,* wood pulp to paper, steel rods to screws and bolts, fresh tuna to canned tuna; *(ii)* any activity including "assembly" where the property conversion costs for direct labor and factory burden equals or exceeds 20 percent of the cost of the goods sold, or *(iii)* the subject activities are substantial in nature and generally considered to constitute manufacturing. However, packaging, repacking, labeling will not be treated as manufacturing. <u>See</u> Treas. Reg. §1.954-3(a)(4). <u>See</u> <u>also</u> <u>Bausch & Lomb v. Comm'r.</u>, 71 T.C.M. 2031 (1996) and <u>Dave Fishbein Manufacturing Co. v. Comm'r</u>, 59 T.C. 338 (1972).

Generally there is no application to property manufactured by the CFC itself. However, the manufacturing or sales branch rules may nullify the exception by treating one or more branches of a CFC as if it were a separate corporation. For instance, if a sales branch of a CFC has the same tax effect as if it were a wholly owned subsidiary of the CFC, it will be so treated solely for purposes of determining the existence of FBC sales income, the application of

the de minimis and full inclusion rules, and the application of the not availed of rule. The procedures for determining tax effect are as follows:

1. Allocate the sales income earned by the branch from all transactions which would be FBC sales income if such branch were itself a CFC.

2. Determine the actual effective rate of income tax imposed on such sales income.

3. Determine hypothetically the effective rate of income tax that would have been imposed in the subject sales income by the country in which the CFC is organized under the following conditions: *(a)* all income of the CFC was derived from sources within the country of organization; *(b)* all income was attributable to a permanent establishment located in such country; and *(c)* the CFC is managed and controlled where the sales branch is located.

Sales branch is treated as separate subsidiary if effective rate actually imposed on the sales income is less than 90 percent of, and at least 5 percentage points less, than the effective rate that would be imposed if such income were earned in the country in which the CFC is organized. See Treas. Reg §1.954-3(b)(1)(i).

If a manufacturing branch of a CFC has substantially the same tax effect as if the branch were a wholly-owned subsidiary corporation of the CFC, it will be so treated solely for the purposes of determining the existence of FBC sales income, the application of the de minimis and full inclusion rule and the application of the not availed of rule. Procedures to determine the tax effect are as follows:

1. Allocate the sales income earned by the branch from all transactions which would be FBC sales income if such branch were itself a CFC;

2. Determine the actual effective rate of income tax imposed on such sales income; and

3. Determine hypothetically the effective rate of tax that would have been imposed on the subject sales income by the country where the manufacturing branch is located under the following conditions: *(a)* all the income was earned from sources within the country where the manufacturing branch is located; *(b)* all the income was attributable to a permanent establishment located in such country, and *(c)* the establishment was a corporation managed and controlled in the country where the manufacturing branch is located.

The manufacturing branch is treated as a separate subsidiary if sales income is actually taxed at a rate less than 90 percent of, and at least 5 percentage points less, than the effective rate that would have been imposed if such sales income were earned in the country where the manufacturing branch is located. See Treas. Reg. §1.954-3(b)(1)(ii). The branch rules are an attempt to limit the artificial use of branches to achieve low rates of tax on sales income only. If the CFC has more than one sales branch, each such branch is treated as if it were the only one. If the CFC has a manufacturing branch and several sales branches, treat each manufacturing branch and each sales branch respectively as if each such pair were the only branches of the CFC.

Where the operation of a branch of a CFC has substantially the same effect as if that branch were a wholly owned subsidiary of the CFC, the branch is treated as a wholly owned subsidiary for purposes of applying the FBC sales income rules. IRC §954(d)(2). The Treasury Regulations provide that where a branch is engaged in manufacturing, the branch will only be treated as a separate entity if the activities conducted by the rest of the controlled foreign corporation include purchase or sale activity of the manufactured product. Treas. Reg. §1.954-3(b)(1)(ii).

The IRS was unsuccessful in a recent attempt to have an unrelated contract manufacturer considered a branch or "similar establishment" for purposes of IRC §954(d)(2). As a result, the taxpayer was able to avoid having FBC sales income. See Ashland Oil, Inc. v Comm'r, 95 T.C. No. 25 (September 27, 1990). See also VETCO, Inc. et al. v. Comm'r, 95 T.C. No. 40 (November 29, 1990), where a related contract manufacturer was not considered a branch of another corporation that was a CFC. Compare recently revoked Rev. Rul. 75-7 75-1 C.B. 244 to Rev. Rul 97-48.

Foreign Base Company Services Income

A CFC is treated as earning FBC services income if income is compensation, commission or fees for the performance of skilled services performed for or on behalf of a "related person" outside of the country in which the CFC is organized. The services will be treated as being provided "for or on behalf of a "related person" under any of the following conditions:

1. CFC receives substantial financial benefit from the "related person" for performance of subject services;

2. CFC performs services that the "related person" is or has been obligated to perform;

3. CFC performs services with respect to property sold by "related persons" and services are a condition or material term of sale; or

4. Related person provides substantial assistance to CFC in connection with the latter's performance of services.

Substantial assistance by a related person includes *(a)* assistance furnished in the form of direction and supervision so long as: such skills are a principal element in earning the subject income, or the cost to the CFC of the relative party assistance equals 50 percent or more of the cost of the CFC to provide the subject services and *(b)* financial assistance, equipment, machines and supplies, but only to the extent, if any, that such items are furnished at less than an arm's-length charge.

Even if the assistance mentioned above would not be treated as substantial when viewed separately, such assistance may nevertheless constitute substantial assistance when taken together. Examples of substantial assistance from the Treasury Regulations included a situation where the CFC performs installation services in connection with sale of machine by a related person and where the CFC acts as factory authorized service organization for related person selling machines used by industrial organizations.

Earnings Invested in Excess Passive Assets (Historical)

For taxable years beginning after September 30, 1993 and before January 1, 1997, the amount of a CFC's earnings invested in "excess passive assets" is deemed distributed to its "U.S. shareholders." IRC §956A(a). For this purpose, "excess passive assets" are defined as the amount of "passive assets" held by a CFC in excess of 25 percent of its total assets. IRC §956A(c). The determinations are made quarterly and are averaged for each year. With exceptions, a "passive asset" is one that generates "passive income" defined to include all classes of foreign personal holding company income. IRC §956A(c)(2). See discussion above. The application of the provision in the covered period is coordinated with the application of the investment in U.S. property provision discussed above.

General Limitations and Escape Hatches from Subpart F

The amount of foreign base company income is reduced by deductions (including taxes) properly allocable to such income. IRC §954(b)(4) and Treas. Reg. §1.952-1(b). Essentially, separate baskets are established for accumulated deficits related to FBC shipping income, FBC oil related income, Subpart F insurance income for insurance companies only and FPHC income for banking or financial institutions only. Other categories of Subpart F income may not be reduced by accumulated deficits. The separate limitations described above do not apply to current year deficits in earnings and profits. See IRC §952(c)(1).

If a corporation reduces its income by a deficit in earnings and profits described above, any excess of earnings and profits over Subpart F income in any subsequent year is to be recharacterized as Subpart F income under rules similar to those for the recapture of an overall foreign loss subject to separate limitations for foreign tax credit purposes. The purpose is to simplify the separate limitation look through rules for CFC's by conforming them and the Subpart F rules more closely. See IRC §952(c)(2).

Amount of earnings and profits of a CFC are reduced by blocked foreign income. Blocked income includes any income that cannot be distributed because of currency exchange regulations. Such restrictions must, according to the Treasury Regulations, be imposed throughout a 150-day period beginning 90 days before the close of the subject taxable year and ending 60 days after the close of such year. Restrictions are deemed to exist if either the ready conversion (directly or indirectly) into the U.S. dollars or property is prohibited, or the distribution of a dividend to the U.S. shareholder is prevented. Treas. Reg. §1.964-2(b)(2).

If the amount of gross income of a CFC qualifying as foreign base company income (excluding oil related income) plus the amount of gross insurance income is less than the lesser of *(1)* 5 percent of gross income or *(2)* $1,000,000 then no part of the gross income of the CFC will be treated as foreign base company income or insurance company income. IRC §954(b)(3). However, if the sum of foreign base company income (excluding oil related income) plus the amount of gross insurance income exceeds 70 percent of gross income then the entire gross income of the CFC shall be treated as foreign base company income or insurance income.

Subpart F income does not include income that is received by a controlled foreign corporation if it is established that the income was subject to an <u>effective</u> rate of income tax in the foreign country of greater than 90 percent of the maximum U.S. corporate rate. IRC §954(b)(4). The special exception does not apply to foreign base company oil related income. The rule is meant to apply with respect to each item of income although regulations may be issued permitting reasonable groupings of gross income. Insurance companies are also subject to the new "not availed of" exception.

Any item of gross income of a CFC which is effectively connected with the conduct of a U.S. trade or business will not be Subpart F income unless such item is exempt from taxation (or is subject to a reduced rate of tax) pursuant to a treaty obligation of the United States. IRC §952(b).

Deemed Distribution of Earnings Invested in U.S. Property

The amount (if any) by which a CFC's earnings invested in U.S. property at the end of a given taxable year exceed the CFC's earnings so invested at the beginning of the taxable year is included pro-rata in the income of its qualifying U.S. shareholders (U.S. shareholders holding 10 percent or more of combined total voting power or value of stock). IRC §956. For these purposes, U.S. property includes tangible property located in the United States, stock of a domestic corporation and an obligation of a U.S. person. Generally, U.S. property does not include the following items:

1. Obligations of the United States;

2. Deposits with persons carrying on the banking business;

3. Certain debts arising in the ordinary course of business from the sale or processing of property;

4. Certain moveable property used in transporting persons or property in foreign commerce; and

5. Shares of, and loans to, domestic corporations, less than 25 percent of the total voting power of which is owned by the CFC or by the 10 percent or more U.S. shareholders of the CFC. IRC §956(c)(2).

Corporate Level Taxes and Reallocations of Income

A CFC may itself also be subject to U.S. federal taxes. Personal holding company tax may be imposed with respect to its gross income from sources within the United States. IRC §§542–547. The accumulated earnings tax may be imposed with respect to unreasonable accumulations of U.S. source income. IRC §§531-541. Any of its income effectively connected with the conduct of a U.S. trade or business will be subject to tax. IRC §882. Its fixed, determinable, annual or periodical income derived from sources with the United States will be subject to withholding. IRC §881. Dividend equivalent amounts are interest paid by a U.S. trade or business and excess interest allocable to “income effectively connected” with a U.S. trade or business will be subject to the branch tax. IRC §884. Even if a foreign corporation is able to structure its activities to avoid U.S. taxes on itself and its shareholders, all or a portion of its reportable income may be reallocated to a related person subject to current U.S. federal income tax. Under Section 482, the IRS may reallocate income and deductions between related persons to conform to the arm’s length standard.

Passive Foreign Investment Company

The shareholder in a passive foreign investment company ("PFIC") is required to pay U.S. federal income tax plus an interest charge based on the value of the tax deferral when they dispose of their stock in a PFIC and receive "excess distributions" of earnings. IRC §1291(a). A qualified PFIC may file an election with the IRS that will cause its shareholders to currently recognize gain on their share of the earnings and profits of a PFIC. IRC §1295(b). A mark to market election is also available for holdings in traded shares. However, individual shareholders of a qualified electing PFIC may elect to defer U.S. tax, subject to an interest charge, on amounts included in income in excess of current distributions. IRC §1294.

A PFIC is defined as any foreign corporation in which 75 percent or more of the gross income is passive income or 50 percent or more of the adjusted basis of its assets produce or are held to produce passive income. IRC §1296. Certain look through rules are provided for 25 percent subsidiaries of foreign corporations. A deemed basis is given to certain research and experimental expenditures and licensing costs. A CFC may also be a PFIC. Thus, a CFC may avoid successfully the application of Subpart F but its shareholders still may be subject to the interest charge on any U.S. tax deferred earnings under the PFIC rules. See Rev. Rul. 87-90, 1987-2 C.B. 216, which involved a manufacturing company which was not subject to Subpart F but was nonetheless a PFIC. Beginning with period after December 31, 1997, a 10 percent or more shareholder of a foreign corporation that is both a CFC and a PFIC will be subject only to Subpart F. IRC §1297(e).

Foreign Personal Holding Corporation

A U.S. shareholder of a FPHC must include in gross income a pro-rata amount of undistributed FPHC income. IRC §551(c). A foreign corporation is a FPHC if *(a)* more than 50 percent of the total combined voting power or value of its shares are owned directly or indirectly at any time during the taxable year by five or fewer individuals who are citizens or residents of the United States; and *(b)* sixty percent (50 percent after the first taxable year) or more of its gross income from whatever sources for the taxable year consists of items of FPHC income. IRC §552.

FPHC income includes items of gross income derived from investment activities such as dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, gains from futures transactions on any regulated commodities exchange, personal service compensation, income from the use of property by a 25 percent (or more) shareholder and rents (unless constituting 50 percent or more of the gross income). Computer software royalties derived by corporations actively engaged in the computer software business are excluded from the definition of royalties includable in personal holding company income and foreign personal holding company income. IRC §553.

A foreign corporation may be both a "foreign personal holding company" ("FPHC") and a CFC. In such cases, the CFC rules "preempt" the FPHC rules. It should be noted that certain closely held foreign corporations owned by U.S. persons may be a foreign personal holding company whose U.S. shareholders are subject to adverse U.S. federal income tax treatment even though the company has no "Subpart F income." IRC §951(d).

A Foreign Investment Company

A foreign investment company ("FIC") is a foreign corporation 50 percent of whose voting power or value is owned directly or indirectly by U.S. persons and which is either *(1)* registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust, or *(2)* is engaged primarily in the business of investing, reinvesting, or trading in securities or commodities. IRC §1246(b). Gain from the sale or exchange of stock in a FIC held for more than one year is treated as ordinary income to the extent of the taxpayer's ratable share of earnings and profits accumulated in taxable years beginning after December 31, 1962. IRC §1246(a). Ordinary income treatment may be avoided if the FIC makes a special election to distribute 90 percent of its net income currently. IRC §1247. Section 1246 will not apply to any gain to the extent it is treated as ordinary income under IRC §1248 (determined without regard to IRC 1248(g)(2)) as briefly described below. See IRC §1246(g).

Re-characterization of Gain from the Sale or Exchange of Stock in a CFC as Dividend Income

Gains derived by a U.S. person from the sale or exchange of shares of a CFC are included in the gross income of the disposing person as a dividend to the extent of earnings or profits accumulated in taxable years beginning after December 31, 1962. See IRC §1248. For this purpose, earnings previously subject to federal income tax (and certain other earnings) including prior inclusion in shareholder gross income under Subpart F are not part of the measure used to determine the amount of re-characterized gain from the sale of shares. See IRC §1248(d).

Planning for U.S. Federal Income Tax Deferral

Planning for deferral of offshore business income from U.S. Federal income tax is now more practical than ever before. Because of the limitation of passive foreign investment company treatment to less than ten percent shareholders and the recent repeal of the excess passive asset provisions, a substantial measure of earnings in a foreign corporation may be invested passively and not immediately used in an active business. However, the issuance of Notice 98-11 with the recent issuance (followed by withdrawal) of hybrid branch regulations under subpart F puts a chill on the use of flow through structure(s) (so-called hybrids) to obtain deferral of U.S. tax of low taxed foreign operations.

Even with recent changes, U.S. income tax deferral for the closely business is often best achieved currently through the use of a Foreign Sales Corporation, Interest Charge Disc. However, the Foreign Sales Corporation will need to be changed in the near future to comply with a recent WTO decision. Because of the "reach" of the PFIC regime, U.S. tax deferral for U.S. individuals making passive investments is practically available only through

investments in annuities, contingent payment contracts, insurance policies or perhaps through a death funded foreign trusts.

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CASE STUDY

Offshore Tax Deferred Planning Concept for a U.S. Based Business

International, Inc. is a closely held U.S. based corporation with expanding international operations. We have identified two basic structures that International, Inc. and its shareholders might use to establish or to develop further their international operations.

One structure is known as a **Controlled Offshore Structure** which essentially requires the U.S. principals to establish a foreign corporation perhaps in a low tax jurisdiction such as the Cayman Islands to carry on certain international business activities for or on behalf of the U.S. enterprise.

An alternative structure known as the **Uncontrolled Offshore Structure** would require the principals of the U.S. based enterprise to request an independent offshore finance group to facilitate the establishment of an independently owned offshore services company in the low tax jurisdiction which company would support the U.S. based enterprise in its international operations.

Below, we describe, in detail, the two alternative structures and provide a brief description of the U.S. Federal income tax treatment of this structure and the benefits to be derived.

1. CONTROLLED OFFSHORE STRUCTURE

As a benchmark, we first describe the establishment of the controlled offshore structure. The structure would be established as follows:

i) The U.S. principals establish a corporation in the Cayman Islands to be known as Overseas Promotions Ltd. in which they would own all of the shares.

ii) Overseas Promotions Ltd. and International, Inc. forms a new domestic (U.S.) company to be known as Onshore Representation Office to provide administrative coordination services to its two shareholders.

iii) Overseas Promotions Ltd. establishes sales branches in various foreign country markets.

iv) Overseas Promotions Ltd. enters into contracts with international clients for promotion and premium activities outside the United States or outside of North America.

v) International, Inc. continues to enter into promotional and premium contracts with domestic and perhaps North American based customers or clients.

vi) International, Inc. provides consulting and support services to Overseas Promotions under a services contract.

vii) Overseas Promotions Ltd. provides contract commercial services to International, Inc. to support international contracts or international activities of International, Inc.

In order to avoid U.S. Federal income taxation of its own earnings at the entity level and to avoid current U.S. Federal taxation of its shareholders, namely the U.S. principals, Overseas Promotions needs to carefully structure its activities as follows:

First, Overseas Promotions needs to avoid generating "foreign based company services income" that is, earn commissions or fees for the performance of technical skills or commercial services outside its jurisdiction of incorporation where "substantial assistance" in performing these services is furnished by a "related person." In this case, a "related person" would only be an individual or corporation or other person who singly or by attribution owns more than 50 percent of the voting power or value of Overseas Promotions Ltd. No such related person would exist unless there is a U.S. principal who has more than 50 percent of the vote or value of Overseas Promotions. In any event, the requisite ownership levels could be carefully controlled to avoid "related person" status for any principal and, hence, the generation of adversely tax treated foreign based company income. If Overseas Promotions Ltd. buys and sells merchandise, it will also need to avoid generating "foreign base company sales income." This is done easily by *i)* avoiding buying from and selling to "related persons" or *ii)* manufacturing in the jurisdiction of incorporation or in another jurisdiction whose tax rate is not higher than the tax rate in the jurisdictions of incorporation and location or sales activities.

Second, Overseas Promotions needs to have a plan for investment of the funds represented by deferred profits. If the profits are ploughed back into the business, *e.g.* inventories and trade receivables, there should be no loss of U.S. Federal tax deferral. If Overseas Promotions invests in securities, the returns in the form of dividends, interest and capital gains will be treated as subpart F income currently attributable to its shareholders with limited exceptions. If Overseas Promotions makes loans and related U.S. persons or acquires equity interests in related U.S. affiliated corporations or partnerships; the investment will be treated as deemed dividends to its U.S. Shareholders.

Third, the Overseas Promotions needs to avoid the conduct of a trade or business within the United States. In these circumstances, Overseas Promotions would be treated as conducting a business in the United States only to the extent *i)* it maintains an office or other fixed place of business in the United States or *ii)* it has agents located in the United States who have the power to contract on its behalf and regularly do so, provided in either case the activities in the United States are "considerable, regular and continuous." Overseas Promotions should be able to avoid conducting any U.S. trade or business by *1)* providing in its contracts with International, Inc. that the U.S. company will have no power to conclude contracts on behalf of Overseas and *2)* having Overseas conducting significant business activities, preferably management and administration in the Cayman Islands or some other offshore location.

Fourth, Overseas Promotions needs to deal with its U.S. affiliates on an "arm's length basis." In the case of transactions between two corporations commonly owned, as in this case between International, Inc. and Overseas Promotions, the profits reported by the overseas corporation may be attributed to the domestic company and be subject to U.S. Federal income tax in its hands. The IRS has the power to allocate income with respect to transactions between related parties so that income reportable for U.S. tax purposes by each of the parties to a "controlled transaction" is at arms' length, i.e., the allocation of income is as if the parties were unrelated. In this situation, if Overseas actually enters into its own contracts with clients and assumes substantial risk with respect to its sales, operations and sourcing of manufacturing, it should be entitled to a significant profit without substantial risk of a reallocation by the IRS. The determination or exact amount of profit that may be properly reported by Overseas would require a more detailed study.

2. UNCONTROLLED OFFSHORE STRUCTURE

As an alternative, we need to consider the Uncontrolled Offshore Structure where the overseas operations are not significantly owned by U.S. principals. Under such a structure, the profits derived from the overseas operations will be received by the U.S. principals not in the form of dividends or capital gains but in some form of deferred fees or compensation earned by

an offshore company as described below. The Uncontrolled Offshore Structure would essentially be set up as follows:

i) The U.S. principals would make arrangements for an independently owned offshore financial company to facilitate the organization of an offshore services company to be known as Offshore Services. Offshore Services will then be owned by an independent financial services company and a shareholding purpose trust. The U.S. principals may own a minority voting and value share interest in Offshore Services.

ii) Offshore Services enters into premium and promotion contracts with its own offshore clients. Further, it would enter into a contract services agreement with International, Inc. to provide contract commercial services for the international clients of International, Inc.

iii) International, Inc. would enter into a services contract with Offshore Services to provide certain key staff support and creative services to the offshore company. Under the consulting services agreement, the fees and compensation to be paid to International would be deferred and set aside in a funds holding purpose trust where the funds would be invested and reinvested and then pursuant to the contract at some later date, paid to International, Inc.

The described structure has several limitations and exposures. First, the contractual relationship between Offshore Services and International, Inc. would need to be carefully structured so that Offshore does not conduct a U.S. trade or business. Offshore Services' contracts would need to provide that International, Inc. is not the former's agent for purposes of entering into and concluding contracts. Further, Offshore Services itself should not have a U.S. office or have its employees based in the United States. Offshore should provide for significant management and administrative services to be performed in offshore locations in the Cayman Islands or elsewhere, provided the location is outside the United States.

The contract under which International, Inc. provides consulting services to Offshore Services needs to be drafted so that the compensation payable to International, Inc. is eligible for U.S. Federal income tax deferral. In order that the funds will actually be available to make payments to International, Inc. at a later date, we suggest that a special funds holding purpose trust be set aside. The funds in the trust, if properly drafted, will not be treated as having been received by International, Inc. for U.S. Federal income tax purposes until actual payments are made to it. To the extent the U.S. principals can perform services without the United States, they can also enter into corporate special services contracts with Offshore Services under which they could be special employees or consultants performing all of their services offshore. The compensation payable by Offshore under the contracts could be then deferred and set aside in a separate funds holding purpose trust designed for that purpose.

Second, the unrelated owners of Offshore Services must retain some measure of profits as equity holders. Thus, it is not possible for International, Inc. to draw out as deferred compensation all of the profits of Offshore. Since Offshore Services would apparently have limited need for a capital investment, the return to its independent equity holders could be relatively modest. Offshore would, however, be an independently controlled company which would be, in these circumstances, largely dependent upon the efforts of International, Inc. and its principals for its own business vitality.

Third, there is the risk that Overseas Promotions eventually would be treated as a "passive foreign investment company" or "PFIC". The qualification of Overseas Promotions as a PFIC would materially reduce any U.S. Federal tax deferral benefit available to its U.S.

shareholders even though they were only to have a minority interest. Overseas Promotions may quickly become a passive foreign investment company if it is profitable, begins to accumulate earnings and holds those earnings in the form of cash, working capital and marketable securities of any type essentially any form other than plant, machinery, equipment or inventories.

Overseas Promotions as a foreign corporation would be treated as a PFIC if it satisfies one of two tests as follows: 75 percent or more of its gross income in a given year is passive income, or more than 50 percent of value (or adjusted basis) of its assets for any year generate passive income. Passive income includes dividends, interest, certain royalties, certain rents and annuities and gains from the sale of certain property realized other than in the ordinary course of business as well as certain currency gains and any income equivalent to interest. Exceptions from passive income treatment are available with respect to rents and royalties described above only if the gross income is derived in the active conduct of a trade or business and received from a person other than a so-called related person.

If Overseas Promotions were treated as a PFIC, then whenever its income is distributed or shares were sold, the U.S. Federal income tax imposed on income or gain as the case may be in the hands of its U.S. Shareholders would be subject to U.S. Federal income tax **and** an interest charge. The amount of the interest charge would be the current interest rate for tax deficiencies multiplied by the number of years that the earnings of the company as represented by the gain or income being reported have been deferred to the particular point in time.

In other words, the U.S. Federal income tax eventually paid is treated as if it has been borrowed at an earlier time when the underlying earnings represented by the reported income or gain were in fact initially earned by the foreign company. Thus, unless the accumulated earnings of the foreign corporation earn a high rate of return, i.e., considerably higher than the U.S. Federal tax deficiency rate of nine or ten percent, the U.S. tax deferral available under the Uncontrolled Offshore Structure would not be particularly advantageous.

In these particular circumstances, there does not seem to be a need for substantial investments in assets used in a trade or business or in inventories. Thus, it will be virtually impossible for Overseas to avoid being a passive foreign investment company in the long term. No change in ownership will affect its exposure to PFIC treatment. In other words, if Overseas were owned to any extent by U.S. persons, the gains or dividends received by the U.S. persons will be subject to PFIC treatment if in fact the company ever meets the income or asset test described above.

3. EVALUATION

The Controlled Offshore Structure may not practical as long as International, Inc. does not require substantial investments in inventories or customer receivables. Without a need for investments in business assets, the U.S. controlled offshore vehicle will necessarily be limited to investments in securities thereby causing a loss of any U.S. Federal income tax deferral benefits for the income derived from the investment of its tax deferred business profits. The tax deferred business profits themselves will still be eligible for deferral unless distributed or invested in “U.S. property.”

In contrast, the Uncontrolled Offshore Structure provides a means to allow passive investment of deferred business profits. The major limitation of the Uncontrolled Offshore Structure is that some measure of residual profits must be available and “left on the table” for the independent owners of the offshore company. To the extent the U.S. principals are minority shareholders, the deferred profits not paid as compensation allocated to the U.S. principals may be subject to the interest charge regime for a PFIC.

Under either alternative, it will be necessary as a practical matter for International to arrange for staffing of the offshore company. Some permanent employees will be needed to be based in an offshore located office to serve as officers of the company. Perhaps one or more "working officers" could be located in the foreign representation offices if local tax considerations are not adverse. In any event, some physical presence will be required in the jurisdiction where the offshore company is incorporated.

* * *

CHAPTER 2

GUIDE TO U.S. TAX TREATMENT OF FOREIGN TRUSTS, GRANTORS AND BENEFICIARIES THEREOF

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Introduction

Foreign or offshore trusts have and are being used for variety of tax planning purposes as follows:

-- Foreign trusts provide a will substitute for a foreign national holding assets located outside their country of domicile or residency and thus allow the avoidance of a local probate of his or her assets.

-- Foreign trusts provide a means for a foreign national to avoid the application of "forced heirship laws" of his or her country of domicile.

-- Foreign trusts provide a long term planning vehicle for a foreign national intending to immigrate to the United States at least five years in the future to make gifts and divert future income with favorable U.S. tax consequences.

-- Foreign trusts provide an effective means for both foreign nationals and U.S. citizens to protect against claims of certain future creditors.

-- Foreign trusts provide limited means for a U.S. citizen or resident to achieve U.S. tax deferral.

Some but not all of the above-described purposes for foreign trusts have been limited by recent legislation and regulations as next described.

A) Definition of "Foreign Trust" for Federal Tax Purposes under Section 7701(a)(i)(31)

1) Overview

Recently enacted measures modify the definition of a foreign trust (which under previous law was a facts and circumstances test) by expressly defining a foreign trust as any trust other than a domestic trust. The superceded facts and circumstances test is set forth in Revenue Ruling 60-181. To qualify as a domestic trust, a trust must meet two tests: (1) a court within the United States is able to exercise primary supervision over the administration of the trust ("court test"); and (2) one or more U.S. fiduciaries have authority to "control" all "substantial decisions" of the trust ("control test").

Effective date in the change in the definition of a "foreign trust" is for tax years beginning after December 31, 1996 or at the election of the trustee is for the trust tax years ending after August 20, 1996. See Notice 96-65, 1996-52 IRB1 and Notice 98-25 for additional time for a domestic trust in existence on August 20, 1996 to comply and availability of

retroactive election. The trustee must i) initiate modification of the governing trust instrument by due date (including extensions) for filing the trust income tax return for first taxable year beginning after December 31, 1996, ii) complete the modification within two years thereafter and iii) file the required statement entitled "Election to Rely on Notice 96-65 to File as a Domestic Trust". Further and definitive guidance on making an election to remain a domestic trust is provided by Treasury Regulation 301.7701-7(f).

2) Safeharbors

a) Court Test

Under Treasury Regulation Section 301.7107-7(f) a special so-called safe harbor of domestic status under the court test is provided for a trust 1) whose instrument does not direct the trust to be administered outside the United States, 2) which is in fact administered exclusively in the United States, and 3) which pursuant to the terms of the trust instrument, is not subject to an "automatic migration provision". A provision providing for migration only in the case of foreign invasion or widespread confiscation or nationalization of property is permitted.

Also under the regulations, domestic status can be obtained if an authorized fiduciary registers the trust with a U.S. court, the fiduciaries or beneficiaries petition or other cause the administration of the trust to be subject to the primary jurisdiction of a U.S. court, or the trust was created under a will probated in the United States and all fiduciaries have been qualified as trustees by the U.S. court.

b) Control Test

Under Treasury Regulation 301.7701-7(d)(ii), the term "substantial decisions" means those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law and that are not ministerial. Decisions that are ministerial include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions. Substantial decisions include, but are not limited to, decisions concerning:

(A) Whether and when to distribute income or corpus;

(B) The amount of any distributions;

(C) The selection of a beneficiary;

(D) Whether a receipt is allocable to income or principal;

(E) Whether to terminate the trust;

(F) Whether to compromise, arbitrate, or abandon claims of the trust;

(G) Whether to sue on behalf of the trust or to defend suits against the trust;

(H) Whether to remove, add, or replace a trustee;

(I) Whether to appoint a successor trustee to succeed a trustee who has died, resigned, or otherwise ceased to act as a trustee, even if the power to make such a decision is not accompanied by an unrestricted power to remove a trustee, unless the power to make such a decision is limited such that it cannot be exercised in a manner that would change the trust's residency from foreign to domestic, or vice versa; and

(J) Investment decisions except if a United States person hires an investment advisor for the trust, investment decisions made by the investment advisor will be considered substantial decisions controlled by the United States person provided the United States person can terminate the investment advisor's power to make investment decisions at will.

The term control means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions. To determine whether United States persons have control, it is necessary to consider all persons who have authority to make a substantial decisions of the trust, not only the trust fiduciaries.

3) Tax Treatment of Foreign Trusts

A foreign trust other than a grantor trust is subject to U.S. Federal income tax in the same manner as a nonresident alien. Thus a foreign nongrantor trust is eligible for exemption from capital gains (other than from real estate) and portfolio interest paid by a U.S. resident.

Distributions to a U.S. beneficiary from a foreign nongrantor trust will generally carry out income. Exceptional gift treatment is provided for certain specific sum or property distributions made by a trustee in not more than three installments.

The portion of a foreign trust established or funded directly or indirectly by a U.S. citizen or resident will be a grantor trust if it has a U.S. beneficiary. Exceptions from grantor trust treatment in such circumstances are provided only for transfers at death and certain transfers at fair market value.

B) Limitations on Circumstances under which a Foreign Person May Create a "Grantor Foreign Trust"

1) Establishment of Grantor Trusts by Foreign Persons

Under prior law, if an NRA grantor created a foreign grantor trust, the income from such a trust (other than U.S. source income) was not subject to U.S. income tax and distributions by such a trust to U.S. persons were also not taxed to such persons as income. The distribution was treated as a gift not included in gross income and if appropriately structured not subject to gift tax. This planning technique had been used for a number of years and was sanctioned in Revenue Ruling 69-70.

Under current law, with exceptions described below, a foreign trust is generally not a grantor trust unless income (and deductions) are attributed to a citizen or resident of the United States or a domestic corporation. Section 672(f). Any income from a foreign trust which fails to meet one of these exceptions if paid to a U.S. person will be taxed to the recipient as income. Foreign trusts that do not fall into one of these exceptions will be treated as non-grantor trusts for federal income tax purposes (i.e., those trusts in which the grantor or settlor is either deceased, or in which he no longer has any rights or possible interest). As a result, the United States will subject to tax all income distributed to U.S. persons at ordinary rates until all income in the trust is distributed, and under a throwback calculation will impose interest charge at market rates on the tax imposed on amounts of income earned and accumulated in the trust in prior year when such accumulated income is deemed distributed.

It is important to note that even if a foreign trust's income is subject to a U.S. income tax as a result of the new law, there may still be U.S. estate tax and other advantages to keeping a trust that is a grantor trust for U.S. Federal income tax in place.

2) Exception for Revocable and Retained Lifetime Benefit Trusts

The new rules provide exceptions for trusts which are revocable by an NRA grantor (or revocable with the consent of certain people who are related to the grantor) or, if the trust is not revocable, for trusts which may only make distributions to the grantor or the grantor's spouse during the grantor's lifetime. Under Treasury Regulation Section 1.672(f)(2), a safe harbor for grantor treatment is provided if the power to revoke is exercisable for a period or periods aggregating 183 days or more during the taxable year. Under the regulation, amounts distributed to support a family member of the grantor will qualify as "distributions to the grantor or the grantor's spouse" if the family member would be treated as "dependent" under IRC Section 152(9)(1) through (8).

3) Other Exceptions

Further exceptions are provided for compensatory trusts (including "Rabbi Trusts") if a trust distribution would be taxable as compensation for services rendered. In addition to these exceptions, the new law also "grandfathers" foreign trusts in existence on September 19, 1995, provided that such trusts are treated as owned by the grantor under Section 676 or 677(a)1) or (2) of the Internal Revenue Code (i.e., the trusts are either revocable or the grantor or the grantor's spouse are in the class of beneficiaries). Under Treasury Regulations Section 1.672(f), special rules are provided under a trust that has both U.S. and foreign persons as grantors.

4) Effective Date

Effective date is generally August 20, 1996 except for transfers made before September 20, 1995 to a trust in existence on September 19, 1995.

C) Expansion of Circumstances under which a Foreign Trust is Treated as a Grantor Trust under Section 679

1) Narrow Sale Exception to Grantor Trust Treatment for Funding of a Foreign Trust by a U.S. Person

Prior law provided that U.S. persons who sold property at fair market value to a foreign trust with U.S. beneficiaries would not be regarded as its grantor for income tax purposes. The current law provides that, in determining whether a transfer qualifies for the fair market value sales exception, debt obligations of our guarantees by the trust or related parties will be disregarded and taxpayers will be deemed to be grantors of foreign trusts if they structure transfers to foreign trusts as sales in exchange for trust notes or other similar instruments. Grantor trust status can still be avoided if the trust pays the seller full market value for the property and the seller recognizes all the gain at the time of transfer.

Effective date is for all property transferred after February 6, 1995.

2) Grantor of a Foreign Trust Who Becomes a Nonresident within Five Years

An NRA who becomes a U.S. resident within five years after directly or indirectly transferring property to a foreign trust will be treated as having transferred such property (and any undistributed income) to the foreign trust on the date he became a U.S. resident. Thereafter, unless no U.S. person could ever benefit from the trust and no other grantor trust powers are retained, the U.S. resident will continue to be subject to U.S. Federal income tax on all the income of the trust earned thereafter. This provision of the new law is designed to prevent the use of foreign trusts as “pre-immigration” planning structures to avoid U.S. income tax. However, even under the new law there will continue to be substantial U.S. gift and estate tax advantages to the creation of irrevocable trusts as a pre-immigration planning technique.

Effective date is for transfers of property made after February 6, 1995.

3) Domestic Trust that Expatriates

If a U.S. trust (not otherwise a so-called “grantor trust”) becomes a foreign trust after February 6, 1995, the U.S. grantor will thereafter be considered grantor of the trust and taxed as if the trust was a grantor trust. If a U.S. trust becomes a foreign trust after August 20, 1996, any property that was transferred by a U.S. grantor to the trust prior to the trust becoming a foreign trust will be subject to gain recognition when the trust becomes a foreign trust unless the grantor or another person is treated as the owner of the trust under IRC Sections 673 through 679. Section 684. Note that the excise tax on transfers by a U.S. person to a foreign trust is repealed effective August 5, 1997.See Notice 97-18 for guidance on reporting transfers to foreign entities including trusts..

Effective date is for redomiciliations occurring after February 6, 1995.

4) Presettlement Gifts by U.S. Beneficiary to Foreign Grantor

A U.S. person is treated as grantor of a trust if (1) the grantor of the trust would otherwise be a foreign person 2) the U.S. person is the beneficiary of the trust and 3) the beneficiary directly or indirectly transferred property (other than in a sale for full and adequate consideration) to the foreign person. IRC Section 672(f).

Effective date is generally August 20, 1996 except for transfers made before September 20, 1995 to a trust in existence on September 19, 1995.

5) Recharacterization of Gifts by Corporations or Partnerships

The Treasury is authorized to recharacterize direct or indirect gifts from corporations (presumably including gifts from "corporate grantor trusts") and partnerships if such recharacterization would prevent the avoidance of tax. Under Treasury Regulation 1.672(f)(4)(a) with exceptions, a purported gift or bequest directly (and indirectly with exceptions) from a partnership or foreign corporation to a U.S. donee is treated as a distribution to the donee includible in gross income as ordinary income. Exceptions are provided for situations where 1) U.S. citizen or resident is shareholder or partner and report the transaction as the receipt of distribution and followed by a gift, 2) all beneficial owners of the entity are U.S. citizens or residents, 3) the transaction is treated as a contribution to the capital of the donor, or 4) the transfer was made pursuant to an exempt purpose.

Effective date is for gifts received after August 20, 1996.

6) Definition of Grantor

Under Regulation Section 1.671-2(e)(1), grantor is defined to include the person who "creates" the trust, and the person who directly or indirectly makes a gratuitous transfer to the trust. A transfer for fair market value and distribution by a corporation or by a partnership to a trust owning an equity interest in same are not treated as gratuitous.

If a person creates or funds any portion of a trust primarily as an accommodation for another person, the other person is a grantor of the trust with respect to such portion. However, a person is not treated as an owner of any portion of the Trust if he creates a trust but makes no gratuitous transfer or he funds a trust and is reimbursed within a reasonable time.

D) Exception to Grantor Treatment of a Foreign Trust for a Beneficiary who Becomes a U.S. Person within Five Years

A trust settled by a U.S. person will not become a grantor trust because the trust has a U.S. beneficiary if no trust beneficiary becomes a U.S. person at any time during the five year period following the original transfer to the trust. Section 679(b)(3)

Effective date is for transfers of property made after February 6, 1995.

E) Treatment of U.S. Beneficiary of a Foreign Nongrantor Trust

1) Interest on Tax Imposed on Accumulation Distributions

The interest charge imposed on accumulations distributions under the throwback calculation is determined using the Federal tax deficiency rate.

Effective date is for distributions made after August 20, 1996.

2) Loans of Cash or Marketable Securities from a Foreign Trust Are Treated as a Distribution to Beneficiaries.

If a U.S. beneficiary (or his or her relatives) receives a loan from a foreign trust, the value of such loan will be taxed as a constructive distribution to that beneficiary. Limited grandfathering is granted for loans of cash and marketable securities entered into prior to September 19, 1995. A provision specifically taxing the use of real property by U.S. beneficiaries was proposed but was omitted from the 1996 legislation. However, the Treasury is authorized to issue regulations for situations which may lead to tax avoidance.

Effective date is for made after September 19, 1995. Note that a significant modification of an obligation will be treated as an issuance on the date of the modification.

3) Distributions through Nominees Recharacterized

Amounts paid to a U.S. person which are derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be treated as paid directly to the U.S. person. See IRC Section 643(h). Under Regulation Section 1.643(h)-1, an amount will be deemed to have been paid directly if 1) the intermediary is "related" to the grantor of the foreign trust, 2) the proceeds are received from the intermediary within a period beginning 24 months before and ending 24 months after the receipt by the intermediary, and, 3) it is not demonstrated that a reasonable basis exist for a gratuitous transfer, the intermediary acted independently, the intermediary is not an agent of the U.S. person, and the U.S. person reports the gift in a timely fashion. Also a special accounting rules apply dependent upon whether the intermediary is the agent of the trust, the agent of beneficiary or the agent of neither one.

Effective date is for amounts paid after August 20, 1996.

F) Expatriation of Domestic Trust Treated as Transfer to a Foreign Trust Subject to Excise Tax under Section 1491 until August 5, 1997 and as a Gain Recognition Event Thereafter

The change of status of a domestic trust to a foreign trust is treated as a transfer of property to the foreign trust if the grantor of the domestic trust is a citizen or resident of the United States and the change of domiciliation takes place while the grantor is alive. A covered deemed transfer is a reportable event and subject to the excise tax provisions and the exceptions thereto. The excise tax provisions applicable to the deemed transfer are repealed effective August 5, 1997.

Effective date is for imposition of excise tax transfers of property made after February 6, 1995. Effective date for repeal of excise tax and gain recognition is August 5, 1997.

G) Notices (Form 3520) to be Filed by Responsible Parties to IRS with Respect to Certain Reportable Events under Section 6048(a)

1) Notice of Creation of Foreign Trust by U.S. Person by Grantor

If, at any time during any taxable year of a U.S. person the person is treated as the owner (i.e., "grantor") of any portion of a foreign trust under the grantor trust rules, the person shall be responsible for ensuring that the foreign trust files a return setting forth a full and complete accounting of the trust's activities and operations for the relevant taxable year, the name of the trust's U.S. agent, and any other information as prescribed by regulations. Moreover, the U.S. person must also ensure that the foreign trust furnishes the proper information, as prescribed by regulations, to each U.S. person who is treated as an owner of part of the trust or who receives, directly or indirectly, any distribution from the trust.

2) Notice of Transfer of Money or Property (Directly or Indirectly) to a Foreign Trust by a U.S. Person.

A U.S. person who creates a foreign trust must report the creation of the trust to the IRS. Second, upon the death of a U.S. citizen or resident, the decedent's executor must report the decedent's death to the IRS if: (i) the decedent was treated as an owner of part of a foreign trust under the grantor trust rules; or (ii) part of a foreign trust was included in the decedent's gross estate.

3) Notice of Death of a Citizen or Resident of United States Who Was the Grantor for Income Tax Purposes of a Foreign Trust

The Executor for a U.S. person who was the grantor of a foreign trust must report the death of the grantor. Exceptions are provided for certain defined compensations and charitable trusts. Grantor status with respect to another is ignored for purposes of determining who is the responsible party for transfers to and receipt of distributions from a foreign trust.

The fact that another U.S. person may be treated as an owner of part of a foreign trust under the grantor trust rules is disregarded in determining whether a reportable transfer to the trust has occurred. No reporting obligation is imposed with respect to a transfer to a foreign trust by a U.S. person if the transfer was made in exchange for consideration with a value equal to, or greater than, the value of the transferred property, although such transfers may attract U.S. Federal capital gains tax. Certain domestic trusts are treated as foreign for reporting purposes.

The effective date is for reportable events occurring after August 20, 1996. Under Notice 97-34 issued June 3, 1997, the report (using revised Form 3520) for 1996 may be filed without penalty by November 15, 1997 or by the due date of 1997 return of the reporting party provided the 1996 return of the reporting person reflects the information required to be contained on the Form 3520 for 1996.

4) U.S. Person (Beneficiary) Receiving Distribution from a Foreign Trust Required to Provide Information.

If a U.S. person receives, after August 20, 1996, directly or indirectly, during any taxable year of the person, any distribution from a foreign trust, the person must file an information return regarding the trust for the relevant taxable year. The fact that another U.S. person may be treated as an owner of part of the trust under the grantor trust rules is disregarded in determining whether a reportable distribution from the trust has occurred. The return must include: (i) the name of the trust; (ii) the aggregate amount of distributions the person received from the trust during the taxable year; and (iii) any other information prescribed by regulations.

If adequate records are not provided to the IRS to determine the proper tax treatment of a distribution to a U.S. person from a foreign trust, the distribution will be treated as a taxable accumulation distribution. However, to the extent provided by regulations, this characterization rule will not apply to a trust if the trust elects to appoint a U.S. agent to act as the trust's limited agent solely for purposes of the application of certain investigative provisions of U.S. tax law.

H) New "Foreign Gift" Reporting (Form 3520) by U.S. Persons

Under the Code provisions, a U.S. person who receives "foreign gifts" in any taxable year with an agreed value in excess of $10,000 is required to file an annual report with the IRS. Section 6039F. Only gifts received after August 20, 1996 count for this purpose. A "foreign gift" is any amount treated as a gift by the recipient received from a person other than a "United States person". Qualified transfers for educatonal or medical expenses are not gifts for this purpose. See Section 2503(e)(2) and reporting for such transfers under Section 6048(c). If the gift is not properly reported, the character of the receipt will be determined by the IRS. In addition, the recipient is subject to a penalty equal to 5 percent of the value of the gift to each month the gift is not reported not to exceed 25 percent.

Under Notice 97-34, the reporting thresholds have changed and a U.S. person is required to report the receipt of gifts from a nonresident alien or foreign estate only if the aggregate amount of gifts from any one such person exceeds $100,000 during the taxable year. Once the threshold is met, the donee will need to identify each gift in excess of $5,000 but not the donor.

A U.S. person is required to report the receipt of gifts from foreign corporations and foreign partnership if the aggregate amount from all such entities exceeds $10,000 during the year. Once the threshold is met, the donee is required to identify all such gifts and the donee. Gifts from related persons must be aggregated if the applicable threshold is exceeded.

I) Returns and Information Filings (Form 3520-A) Required for Foreign Trusts under Section 6048(b) and (c)

The creation of a foreign trust by a U.S. person or the transfer of property to such a trust, or the receipt of a distribution by a U.S. person from any foreign trust whether created by a U.S. person or otherwise, gives rise to a series of periodic reporting requirements on the part of transferors and of U.S. beneficiaries which are discussed in more detail below.

1) U.S. Grantor as Responsible Party for Returns and Information

If, at any time during any taxable year of a U.S. person that begins after December 31, 1995, the person is treated as the owner (i.e., "grantor") of any portion of a foreign trust under the grantor trust rules, the person shall be responsible for ensuring that the foreign trust files a return setting forth a full and complete accounting of the trust's activities and operations for the relevant taxable year, the name of the trust's U.S. agent, and any other information as prescribed by regulations. Moreover, the U.S. person must also ensure that the foreign trust furnishes the proper information, as prescribed by regulations, to each U.S. person who is treated as an owner of part of the trust or who receives, directly or indirectly, any distribution from the trust.

2) Appointment of U.S. Agent

If a foreign trust does not appoint a U.S. agent, the IRS may determine, in its discretion, the proper amount to be taken into income by a U.S. person under the grantor trust rules with respect to the trust. However, if the trustee timely agrees, in the prescribed manner

and subject to any applicable conditions, to appoint a U.S. agent, the IRS will not have the discretionary authority to determine the amount of income to be taken into account by a U.S. person under the grantor trust rules with respect to the trust.

A foreign trust's U.S. agent is a U.S. person authorized to act as the trust's limited agent solely for purposes of the application of certain provisions of U.S. tax law pertaining to: (i) requests by the IRS to examine records or produce testimony related to the proper treatment of amounts required to be taken into income by a U.S. person under the grantor trust rules; or (ii) summonses issued by the IRS for such records or testimony.

The relevant provisions also state that the appearance of persons or the production of records by reason of a U.S. person being a foreign trust's U.S. agent, as described above, will not subject such persons or records to legal process for any purpose other than determining the correct treatment of amounts required to be taken into account by a U.S. person under the grantor trust rules. Also, it is explicitly stated that a foreign trust will not be deemed to have a U.S. office or permanent establishment, or to be engaged in a U.S. trade or business, solely by reason of having a U.S. person acting as the trust's U.S. agent as described above.

J) Penalties for Failure to Report

In addition to any criminal penalty under U.S. law, if any return or notice required to be filed with respect to a foreign trust is not filed on or before the appointed time, or does not include the required information or includes incorrect information, the person required to file, or to ensure the filing of, as the case may be, the return or notice shall pay a penalty equal to thirty-five percent, or five percent in the case of a U.S. person required as the owner of part of a foreign trust under the grantor trust rules, to ensure the filing of a return, or notice by the trust, of the gross reportable amount.

The term "gross reportable amount" means: (i) with respect to a so-called reportable event (e.g., the creation of a foreign trust by a U.S. person), the gross value of the property involved in the reportable event determined as of the date of such event; (ii) with respect to a U.S. person required as the owner of a portion of a foreign trust under the grantor trust rules to ensure the filing of a return or notice by the trust, the gross value of the portion of the trust's assets, as of the close of the relevant taxable year, treated as being owned by such person; and (iii) with respect to a U.S. person receiving distributions from a foreign trust, the gross amount of the reportable distributions.

If any failure continues for more than ninety days after the day on which a notice of the failure is mailed to the person required to pay a penalty as described above, the person must pay an additional US$10,000 penalty for each thirty day period, or fraction thereof, during which the failure continues after the expiration of the ninety day period. This additional penalty amount may not, with respect to any failure, exceed the gross reportable amount at issue.

No penalty shall be imposed if the failure was due to reasonable cause and not willful neglect. However, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the relevant taxpayer, or any other person, for disclosing the required information is not reasonable cause for the failure. Accordingly, bank secrecy laws will not excuse a failure to satisfy the relevant requirements.

Moreover, the coverage of these penalty provisions is extended to any case of a failure to file a required return to report U.S. excise tax due upon a taxable transfer of appreciated property by a U.S. citizen, resident, corporation, partnership, estate or trustee to a foreign trust, estate, partnership or corporation. The excise tax provisions are repealed effective August 5, 1997.

Finally, no deficiency procedures are provided.

See Notice 97-34 for interim guidance on reporting of transfers to foreign trusts, reporting responsibility of U.S. owners and beneficiaries. Under Notice 97-34 no penalty will be imposed if the foreign trust files the Form 3520A for 1996 by October 15, 1997 or the due date (including extensions) of the Form 3520 for 1997 provide Form 3520A on March 15, 1998 the U.S. grantor reflects the information required for 1996 Form 3520A on his or her own return for 1996 including any amendment thereto. An extended filing date to April 15, 1998 is also provided for Form 3520 for 1996 if the U.S. grantor reflects the information required for the Form 3520 on his or her 1996 individual tax return. Under Announcement 98-30, the date for filing of Form 3520-A for 1997 is further extended to the 15th day of the seventh month following the end of its taxable year beginning in 1997 (July 15, 1998 in most instances) or the extended date granted under Form 2758.

K) Remaining Planning Opportunities Available Using Foreign Trusts

1) Nonresident Aliens Should Consider the Following Alternatives:

- Establishment of a nongrantor trust five years before immigration of grantor to the United States

- Delay of U.S. residency status of all aliens (not U.S. citizens) who are beneficiaries of any foreign trust established for 5 years after most recent transfer of property to the trust

- Provision for a spinoff of share of corpus of a foreign trust intended for U.S. beneficiaries to a domestic trust

- Establishment of a private family investment funds company as a trust substitute especially where the "beneficiaries" remain nonresident aliens.

- Decant trust income including capital gains from foreign trust with U.S. beneficiaries to second trust with NRA beneficiary

- Use of a foreign trust holding private placement insurance with right to borrow against cash surrender value to finance distributions of corpus to U.S. resident or citizen beneficiaries

2) U.S. Persons Should Consider the Following Foreign Trust Alternatives:

- Establishment of a foreign asset protection trust in an appropriate jurisdiction with no income tax deferral or estate tax avoidance advantages.

- Establishment of a foreign trust for foreign beneficiaries not likely to become U.S. citizens or residents.

- Establishment of a foreign grantor trust with no retained interest for estate tax purposes to allow "leveraged gifts" through the annual payment of income taxes by grantor.

- Provision for the funding of foreign dynasty trusts at death with a corresponding allocation of generation-skipping transfer tax exempt amount

- Establishment of a foreign irrevocable life insurance trust with private placement insurance with right to borrow against cash surrender value to finance distributions to beneficiaries

- Establishment of a foreign charitable remainder trust

- Establishment of foreign charitable lead trusts with no U.S. beneficiary

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CHAPTER 3

GUIDE TO SELECTED OFFSHORE INVESTMENT PRODUCTS FOR U.S. CITIZENS AND RESIDENTS

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Introduction

The controlled foreign corporation, foreign personal holding company, and passive foreign investment company provisions of the U.S. Federal Internal Revenue Code have a broad reach. Thus without special structures, it is generally not possible for a U.S. citizen or resident individual to make an investment in a foreign company that does not conduct active business activities without being either currently subject to income tax in the United States or being subject to an interest charge on the U.S. income tax due when income or gain is finally realized. In response to the demand for a cross-border investment products for U.S. citizens and residents that provide some effective measure of deferral without an interest charge, several investment products have been developed.

These products include the hybrid investment contract, the variable deferred annuity issued by a licensed foreign insurance company, the deferred private variable annuity issued by a foreign company, a foreign irrevocable life insurance trust holding shares of private annuity obligation company, and an offshore nongrantor trust with after death change in beneficiary. As a general survey, we provide below a brief description, analysis and evaluation of each product. Specific legal advice should be obtained before making any investment in the products described.

Hybrid Investment Contract ("Contingent Payment Contract")

A hybrid investment contract is issued by a special purpose foreign hybrid company limited by a guarantee. The special voting shares of the special purpose foreign corporation are held by a foreign purpose trust which in turn has its own "enforcer". The so-called "ordinary shares" of the foreign corporation may be held by an independent financial services company. The "ordinary shares" held by the independent financial services company carry a right to vote and distribution rights limited to the sum of a fixed percentage return of the face value of the share capital for such shares, an annual percentage of the net asset value of the foreign corporation itself and a right to return of the original capital contributed upon liquidation. The special voting shares held by the purpose trust are essentially only voting shares and carry only limited economic rights. The special purpose corporation itself is typically managed by a contract manager who is selected by the holders

of all of the shares, that is the holders of ordinary shares and the special voting shares.

The investor as the holder of the hybrid investment contract has no voting rights in and no rights to current distributions from the special purpose company. The economic rights under the hybrid investment contract mature at an indefinite date in the future when the specially designed corporation is liquidated. The liquidation of the foreign corporation is not controlled in any direct way by the holder of the contract. The amount received by the holder of the contract at the time of liquidation of the corporation is essentially the residual value of the assets of the company remaining after payments are made to cover the winding up costs and distribution rights of the holders of ordinary shares and special voting shares. The holder of the investment contract may assign or transfer his contract.

The basic objective of the above-described structure is to provide a vehicle for the U.S. investor essentially to hold an interest in the assets of the foreign corporation that is *neither* a share interest so as to cause the foreign corporation to be a controlled foreign corporation, foreign personal holding company or a passive foreign investment company *nor* debt so as to result in the current imputation of interest on a debt obligation to the investor. Further, the investment is structured so that the interest is not to be treated as an investment account held by the company as agent for the investor but rather as a contract interest that does not result in a current recognition of income for the investor until actual distributions are made.

Income is recognized by the investor for U.S. federal income tax purposes when the foreign corporation is liquidated. Basis is recovered pro rata and any built-in gain in property used to purchase the annuity is also recovered pro rata. Sale or transfer of the contract interest including even the "settlement" would be subject to U.S. capital gains taxation. The transfer of the contract interest at death or inter vivos would be subject respectively to U.S. federal estate or gift taxation.

Deferred Variable Private Annuity Issued by a Special Purpose Foreign Company ("Deferred Variable Private Annuity")

A special purpose annuity foreign company ("Obligation Company") is formed. The Obligation Company is neither an insurance company nor is it licensed to be one or required to be so licensed. Further, the Obligation Company is not in the business of issuing annuity contracts from time to time. The sole shareholders of the Obligation Company are typically a foreign financial services corporation and a shareholding purpose trust. The U.S. citizen or resident investor transfers cash (or other property) to the Obligation Company in consideration for the issuance of a deferred private variable annuity contract. The funds (or other property) held by the Obligation Company are set aside in a special funds holding purpose trust whose trustee invests the funds pursuant to directions from the Obligation Company.

The deferred variable private annuity contains a specially designed life expectancy contingency that may be based on more than one life to as not to cause the annuity obligation to be treated as a "debt instrument" for U.S. federal income tax purposes. The owner of the obligation retains the right to change the designation of beneficiary including the recipient of death benefit. After the issuance date of the obligation, neither the owner of the obligation nor any beneficiary has the right to change the date on which the annuity obligation will move from the accumulation phase during which period no payments are made to the annuitization phase during which period payments are made under a fixed schedule. The owner may not trade or surrender the obligation without the approval by the Obligation Company. Under the annuity contract, the owner may only suggest an allocation of investments among the notional funds used to adjust payments to be made periodically under a schedule contained in the annuity obligation contract.

The payments made under the schedule are adjusted from time to time for the investment performance of the notional funds held by the funds holding purpose trust. For U.S.

income tax purposes, the owner is not required to recognize any income or gain until cash is actually distributed. There is no deduction for the owner for payments of consideration paid for the purchase of the annuity obligation. If properly structured, the obligation will not be treated as an installment sale obligation requiring the imputation of interest. For U.S. federal income tax purposes, the owner reports the receipt of payments under the obligation as they are actually received. The amount recognized as gain or income is determined under an exclusion ratio under which there will be ratable cost recovery of basis (purchase price) and recognition of income under the contract. Distributions made to the beneficiary before the age of 59-1/2 will generally be subject to a premature distribution federal income tax equal to 10 percent of the tax otherwise to be imposed on the income.

The gift of the obligation will result in recognition of gain and ordinary income and will be subject to U.S. federal gift tax. No gift results from the revocable designation of the recipient of the death benefit. If the owner dies before the maturity of the obligation, the amount payable at death less unrecovered basis is reported as gain and ordinary income and the value of any portion of the contract transferred is subject to U.S. federal estate tax.

Deferred Variable Annuity Contract Issued by Foreign Insurance Company ("Insurance Company Issued Annuity")

An independent foreign insurance company fully licensed and qualified in its place of organization offers an annuity contract for an all-cash premiums. A portion of the premium will represent mortality costs. The annuity contract provides the maximum flexibility needed to meet the requirements for life insurance and not be a "modified endowment contract". The investor purchases the contract for cash. The cash received by the insurance company is either set aside in a "segregated account". The investor, at the time of the contract and from time to time thereafter, indicates the portfolio allocation strategies to be followed by the insurance company. The investor retains no direct control over the investments being made. The investment allocation is subject to the diversification requirements of the U.S. Federal Internal Revenue Code.

The purchase will result in the imposition of a 1 percent U.S. premium tax. The death benefit is not subject to U.S. income tax in the hands of the beneficiary but will be included in the estate tax base of the decedent. The investment returns are accumulated income tax-free and investment returns are reflected in the amounts payable under the contract either the annuity payments themselves or as death benefits. Income is recognized as payments are received by the investor. During the accumulation phase, gains and income are accumulated by the segregated fund. Losses will also be charged to the fund. The investment performance of the notional fund held in the segregated account results in either increases or decreases in the deferred benefits and death benefits.

Foreign Irrevocable Life Insurance Trust Holding Shares of Private Annuity Obligation Company ("ILIT Annuity Product")

U.S. individual establishes and makes a gift of cash to a foreign irrevocable life insurance trust ("ILIT"). The ILIT purchases an insurance policy on life of U.S. individual from a licensed offshore life insurance company. The insurance company establishes a segregated account for the policy and invests in an International Business Company (IBC"). The insurance company also reinsures the policy with a reinsurance company. The IBC offers a variable deferred private annuity to the U.S. individual in exchange for cash or appreciated property. The annuity obligation is subject to a "qualified life expectancy contingency" as required by IRC Section 1275(a)(1)(B)(i).

The basic objective is to allow the U.S. individual to exchange his appreciated property for a deferred variable annuity obligation without current U.S. income taxation of the existing appreciation in the relinquished property. Income is recognized when payments are

received under the annuity contract. Basis and any built-in gain in property used to acquire the annuity are recovered pro rata. Further to avoid the possible adverse effect of the life expectancy contingency, any "windfall" resulting from an early death of the annuitant "owned" by the IBC is ultimately part of the return on the insurance policy of the the ILIT whose beneficiaries have been selected by the U.S. individual.

Offshore Nongrantor Trust with After Death Shift of Beneficial Interests

U.S. individual as settlor establishes and funds with cash an irrevocable foreign trust. The initial beneficiaries of the trust are foreign persons. The funds received by the trustees are invested. No distributions are ever made to either the settlor or his spouse. One year after the death of Settlor, the family of the deceased settlor becomes the sole beneficiaries of the trust.

The transfers made to the trust by the settlor are subject to gift tax. The settlor can use his $625,000 applicable credit amount (increasing to $1,000,000 over the next seven years) to minimize or eliminate any gift tax. The settlor retains no reversionary interest, powers to control, beneficial enjoyment for him or his spouse, or significant administration powers as described in IRC Section 671 through 678.

The beneficiaries of the trust cannot be a U.S. person during the period through last year of the lifetime of the settlor. The trust has a U.S. beneficiary for this purpose unless under the trust no part of the income may be paid or accumulated during the taxable year for the benefit of a U.S. person and if the trust was terminated at any time during the year, no part of the income or corpus could be paid to or for the benefit of a U.S. person.

Evaluation of Described Products

Products similar to all except the last described above (the offshore nongrantor trust) are currently available from U.S. insurance companies. A higher rate of return will often be available from a foreign company than from a U.S. company. A foreign company, even one licensed as an insurance company, will be subject to less regulation and perhaps a more favorable tax regime. Further, with all of the above-described cross-border products, the investor is likely to have more flexibility in the selection of investment strategy than would be the case with a domestically offered product. There may also be a measure of asset protection available for a foreign contract or assets held in a foreign trust not would not be available for a domestic product unless the holder is resident in a liberal judgment debtor exemption state.

For the foreign insurance company issued annuity product, the requirements for diversification will limit the investor's change of investment strategies. The need to provide for a life expectancy contingency for any insurance company annuity product (foreign or domestically issued) acceptable for insurance contract purposes under the Internal Revenue Code and the applicable insurance company regulatory authority purpose will result in higher cost to the investor than for a foreign private annuity. The major advantage of a properly qualified insurance company issued product is the avoidance of income tax on any death benefit paid. Estate tax is not easily avoided with this or any other annuity product except with the ILIT product.

A carefully drafted life expectancy contingency is needed for the private annuity to avoid current imputation of interest. The contract is structured not to be a "debt instrument". The life expectancy contingency of the foreign private annuity often is based on several lives. The issuer of a foreign private annuity contract will need a reasonable amount of capital. In all cases, except where a spouse is the survivor, income and estate tax will be imposed on the death of the owner of the contract.

The life contingency expectancy contingency required for the annuity products is entirely avoided through the use of the hybrid investment contract. However, to provide a

reasonable degree of comfort to the investors, rights may be created that may cause the hybrid contract to be treated as debt or equity in a foreign company with attendant adverse U.S. income tax consequences. Presumably, a product acceptable to the investor can be designed to provide the desired income tax benefits. Income is recognized when the liquidation proceeds are made available to the investor. Death tax cannot be avoided except through a gift of the contract before “maturity”.

The adverse effect of the life expectancy contingency of a private annuity contract is avoided through the ILIT product. Under the ILIT product, the annuitant has provided for any economic benefit to be derived by the annuity obligation company essentially to be routed to his own “preselected” beneficiary of the ILIT. Depending on the circumstances, a true life expectancy contingency will exist for the ILIT product as required by Section 1275(a)(1)(B)(i). A properly designed ILIT product avoids all income and estate taxes for any “death benefits” realized by the ILIT.

The nongrantor trust is tax advantageous only if no benefits are “available” or distributed to the settlor or his spouse. Further, the initial beneficiaries through the end of the year of death of the settlor must be foreign persons to avoid current imputation of all net income to the settlor. Unless the initial beneficiaries received substantial distributions, it could be argued that the income of the trust is being accumulated for the benefit of the ultimate U.S. beneficiaries whose interests “spring forth” only in the year after the death of the settlor.

In general, attempts to satisfy non-tax concerns of the investor may result in a significant risk that the desired tax benefits will be challenged. Efforts to lower investor risks or to increase investor influence over investment may increase the risk that the desired tax benefits will not be available. A properly designed product will likely survive challenge from the IRS, but the investor must be willing to assume a measure of risk and give up all direct legal control of investment decisions, and mount a competent and professionally directed defense effort before the IRS (or perhaps in Court).

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CHAPTER 4

GUIDE TO U.S. FEDERAL TAXATION OF EXPATRIATES

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Introduction

In 1966, U.S. Congress enacted a special federal tax regime applicable to a nonresident alien who gave up his U.S. citizenship for a tax avoidance purpose within the preceding ten years. The 1966 law did not apply to resident aliens who surrendered their green card after a long period of U.S. residency. In 1996, amendments to the expatriation tax provisions were enacted because Congress believed that an incentive continued to exist under the Code for U.S. citizens and U.S. resident aliens holding green cards to expatriate and move abroad. The 1996 amendments apply to persons who lose their U.S. citizenship on or after February 6, 1995, or, in the case of resident aliens, to persons who give up their long term residency on or after June 13, 1995.

The special U.S. Federal income tax regime of Section 877 as amended to date applies only to the ten year period immediately preceding the close of the year in which the U.S. citizen "lost" U.S. citizenship (or a resident alien who surrenders his green card after a long period of U.S. residency) and only to a non-resident alien individual who renounces (or surrenders) with at least one of his principal purposes being the avoidance of Federal income, estate or gift taxes. Under Section 877, a covered nonresident alien individual is subject to an "alternative" U.S. Federal income tax on gains from the sale or exchange of property located in the United States, stock issued by a domestic corporation and debt obligations of U.S. persons, the United States, a state of the United States or the District of Columbia. Section 877(b). For purposes of computing the gain subject to the special alternative income tax, no capital loss carryover is allowed. A "proper" allocation and apportionment of deduction incurred in the taxable year are allowed. Section 877(b)(2).

Companion provisions are found for estate taxes under Section 2107. The gross estate of a nonresident (not domiciled) alien who lost his U.S. citizenship with at least one of his principal purposes being the avoidance of U.S. Federal income, estate or gift taxes shall include the fair market value of the shares of a "controlled foreign corporation" the decedent owned to the extent of the value attributed to U.S. property owned by the foreign corporation. The value of the shares of a "controlled" foreign corporation attributed to U.S. assets is the product of the value of its shares times the ratio of the fair market value of its assets situated in the United States over the fair market value of all of its assets.

For all nonresident alien decedents, shares of domestic corporation and debt obligation of a U.S. person are treated as situated in the United States. Thus shares of domestic corporations and debt obligations of U.S. persons are included in the estate tax base of a covered

nonresident alien whether or not held directly or through a controlling foreign corporation. For this purpose, the foreign corporation is "controlled" if the nonresident alien (a) owns directly or indirectly through intervening entities 10 percent or more of the total combined voting power of all classes of voting stock and (b) owns directly, indirectly, or by attribution more than 50 percent of the total combined voting power of all classes of voting stock. See Section 2107(b).

Companion provisions are also found for gift taxes under Section 2501. The otherwise applicable exclusion from taxable transfers by a nonresident alien of "intangible property is not applicable to shares of stock issued by a domestic corporation or debt obligation of a United States person, the United States, a State of the United States, political subdivision thereof or the District of Columbia. See Sections 2501(a) and 2511.

Per Se Tax Avoidance

In response to the disingenuous claim by the IRS that it could not administer the tax avoidance standard under the original 1966 provisions, certain former U.S. citizen individuals are, under the 1996 amendments, now treated as having an irrebuttable tax avoidance purpose. These individuals are ones which either have (1) an average annual net income tax liability for the period of the five taxable years ending before the date of "loss" of citizenship of greater than $100,000 or (2) a net worth as of the date of the loss of citizenship of $500,000 or more. The financial trigger amounts are increased in any calendar year beginning after 1996 by a cost of living adjustment factor. The general rule is that an individual reaching one or the other of the trigger amounts has a tax avoidance purpose *per se* and hence is subject to a special tax regime of Section 877.

Several exceptions from the above described *per se* rule are provided for the individuals who (1) file within one year after the date of the loss of citizenship a ruling request to the Service and (2) fit into one of six categories of so-called "described individuals." A "described individual" is eligible for an exemption from irrebuttable tax avoidance taint provided he timely filed a ruling request and is within one of the following categories:

1. An individual who at birth became both a citizen of the United States and the citizen of another country and continues to be a citizen of the other country;

2. An individual who becomes, not later than a reasonable period after the loss of the U.S. citizenship, a citizen of the country in which the individual was born;

3. An individual who becomes, not later than after the close of a reasonable period after the loss of the U.S. citizenship, a citizen of the country in which the spouse of such individual was born; or

4. An individual who becomes, not later than the close of a reasonable period after the loss of the U.S. citizenship, a citizen of a country of which either of the individual's parents were born;

5. An individual who is, in each year of the ten year period ending on the date of the "loss" of the U.S. citizenship, not present in the United States for more than thirty days;

6. An individual who loses his U.S. citizenship before he attained the age of 18-1/2; or

7. An individual who is prescribed in regulations issued by the IRS.

If either of the financial triggers amounts are reached, only a small class of individuals with a very strong connection by birth themselves or of a close family member or long overseas residency with little contact with the United States will be able to show a lack of tax avoidance purpose. Note that even "described individuals" are required to establish a lack of tax avoidance purpose. The new law represents a major expansion of the concept of tax avoidance. The provision allows the IRS by regulation to create other categories of individuals not treated as having a tax avoidance purpose for expatriating.

Surrender of Green Card Also Treated as Tax Avoidance

Under the new law, lawful permanent residents who cease to be U.S. tax residents (or commence to be treated as residents of a foreign country under a U.S. treaty without waiving the benefits thereunder) are also subject to the same regime if they are so-called long term residents, i.e., it is a person who has been a lawful permanent resident for at least eight years out of the period of fifteen years ending on the year in which lawful U.S. residency is given up. No special exceptions to covered lawful permanent residents is provided as for U.S. citizens.

In Notice 97-19, 1997-10 IRB1, the IRS stated that it intends to issue regulations to provide exempt categories for former long-term residence. Until regulations are issued, a formal long-term resident may request a ruling under any of the following circumstances:

1) Individual becomes (not later than the close of reasonable period after expatriating fully liable to tax in any of the following countries: a) the country of which the individual was a citizen on the date of expatriation, b) the country where the spouse of the expatriate was born, or c) the country where either of the parents of the expatriate was born;

2) The individual was present in the United States for no more than 30 days during each year of the 10 year period prior to expatriation;

3) The individual ceased to be taxed as a lawful permanent resident, or commenced to be treated as resident of another country under an income tax treaty and does not waive benefits under the treaty before reaching age 18-1/2;

4) Any former long-term resident who "narrowly fails" to satisfy the criteria for any of the above-enumerated categories.

Solely for purposes of determining the tax on disposition transactions occurring during the ten year period after the alien ceases to be a long term U.S. resident, basis is determined to be fair market value at the time of immigration. However, the basis adjustment rules apply only with respect to an alien who becomes a U.S. resident and thereafter gives up long term residence.

Source and Credit Rules

Special source rules include a category of income or gain that will be treated as being derived from U.S. sources and hence subject to the special Section 877 regime. Section 877(d). This income would include income or gain derived from a controlled foreign corporation which the individual "owned" at any time during the two year period ending on the date of the "loss" of U.S. citizenship if more than 50 percent of its combined voting power or total value is owned by the expatriate. Section 877(d)(1)(C). The gain is recognized only to the extent the income or gain does not exceed the earnings and profits attributable to the stock of the foreign corporation to the shares owed by a covered expatriate that were earned or accumulated before the loss of U.S. citizenship. Gains from the sale of stock issued by a domestic corporation and debt obligations of U.S. persons continue to be treated as U.S. source income. A credit is given for foreign income taxes imposed on income treated as U.S. source to minimize the effect of double taxation. Section 877(b). No credit is available for foreign income taxes imposed on other U.S. source income.

Certain Exchanges Not Entitled to Nonrecognition

Recognition of gain on certain exchanges is provided. Section 877(d)(2). The property is treated as sold for fair market value and gain recognized where (1) the gain on the exchange would not have otherwise been recognized, (2) the income from the exchanged property is or would have been treated as derived from U.S. sources, and (3) the income derived from the property received in exchange would be from sources outside the United States. Section 877(d)(2). To avoid cash flow difficulties arising from the above described nonrecognition override, the individual is entitled to enter into a special deferred recognition agreement under which the gain will be recognized over the next ten year period as income sourced within the United States and hence subject to the special regime of Section 877.

In connection with the exchange rules described above, the IRS may issue regulations extending the ten year period to a fifteen year period beginning five years before the loss of citizenship. Further, the running of the ten year period is suspended during the period the individual risk of loss with respect to the property to be exchanged is "diminished" by either 1) the holding of a put, 2) the holding by another person of a right to acquire the property or a short sale or other transaction. In Notice 97-19, 1997-10 IRB1, the IRS stated that it intends to issue regulations to extend the 10 year period and "to expand" the definition of "exchange".

Foreign Corporation Lookthrough

Gains from the sale of property by a foreign corporation that had been contributed to the foreign corporation by the expatriate (or other property whose basis was determined in whole or in part by the basis of the contributed property) are attributable to the expatriate if 1) the sale occurs during the ten year period after expatriation, 2) income derived from the property was

(or would have been) income from sources within the United States, 3) the corporation would have been a controlled foreign corporation if the covered expatriate were a U.S. person. Section 877(d)(4). Further, if stock in a foreign corporation described above or other stock whose basis was determined in whole or in part by the basis of the stock of the foreign corporation is disposed of during the ten year period, a pro rata share of the above described property held by the corporation that had been contributed by the expatriate will be treated as having been sold immediately before the sale of stock.

Special Situs Determinations for Estate and Gift Tax Purposes

Provisions dealing with the application of the estate tax to expatriates under Section 2107 apply to the same categories of "covered expatriates" with the same financial thresholds and exceptions for "described individuals" discussed above. The direct, indirect or by attribution stock ownership threshold for the inclusion of the value of the stock of a foreign corporation attributed to U.S. situs property owned by the corporation has been changed to "more than 50 percent of (A) total combined voting power of all classes of stock entitled to vote of such corporation or (B) the total value of the stock of such corporation." The nonresident must still own directly or indirectly through intervening entities 10 percent or more of the total combined voting power.

A credit is given for any foreign estate, inheritance, legacy or succession taxes ("death taxes") actually paid. The amount of the credit is the lesser of 1) the product of the death taxes actually paid to the foreign country times the ratio of value of the property included in the gross estate solely by reason of Section 2107 to the value of all property subject to death taxes or 2) the product of the U.S. death taxes imposed times the ratio of value of the property included in the gross estate solely by reason of Section 2107 to the value of the gross estate.

The provisions dealing with the application of the gift tax to expatriates under Section 2501(a) are changed to apply to the same categories of "covered expatriates" with the same financial thresholds and exceptions for "described individuals" discussed above. A credit is available for the amount of foreign gift taxes actually paid with respect to any gift taxable solely because of the expatriation provisions.

Special Reporting

Individuals who lose U.S. citizenship are required to file special reports including Form 8854. Section 6039. The information required includes the taxpayer's TIN, mailing address of the individual's principal foreign residence, the identity of the foreign country in which the individual is residing, the identity of the foreign country in which the individual is a citizen and in the case of the individual with one of the triggering financial amounts, information "detailing" the assets and liabilities and finally other such information as the IRS may prescribe. Under Notice 97-19, 1997-10 IRB1, until Form 8854 was issued in 1995, individuals who expatriate were subject to the following filing dates and addresses:

1) Former U.S. citizens whose reporting date is on or before March 10, 1997 but who have not already furnish information to an appropriate entity prior to February 24, 1999 to Internal Revenue Service, 950 L'Enfant Plaza SW, Washington, D.C. 20224, Attention: Compliance Support and Service, on or before June 8, 1997.

2) Former U.S. citizen whose reporting date is after March 10, 1997 but on or before June 8, 1998 to either American Citizens Services Unit, Consular Section of the nearest American Embassy or Consulate; Office of Policy Review and Interagency Liaison (Ca/OCS/PRZ) Room 4817, Department of State, Washington, D.C. 20520-4818, or a Federal Court (if the expatriate's Certificate of Nationality was canceled by such court on or before June 8, 1997.

3) Former U.S. citizens whose report date is after June 8, 1998 to American Citizens Services Unit Consular Section of nearest American Embassy or consulate, or Federal Court (if the expatriate's Certificate of Nationality was canceled by such court on or before such cancellation date.

4) Former long-term resident who expatriated after February 5, 1993 but before January 1, 1996 and who did not provide the required information before January 1, 1997 must file and attach an information statement to each 1996 Form 1040NR, and his 1995 amended return if his tax liability has changed.

4) Former long-term resident who expatriated after 1995 and not provided information before February 24, 1997 must attach an information statement to his U.S. income tax return for the year of expatriation.

In the absence of reasonable cause, the penalty for failure to provide the statement (or Form 8854) is the greater of 5 percent of the tax required to be paid under Section 877 or $1,000 unless the failure is due to a reasonable cause. The amendment also provides that certain federal agencies and courts who collect statements of expatriation are required to provide the IRS with appropriate copies of documents, presumably so the IRS will have some means of determining whether they want to audit the particular expatriates reporting under this new provision.

Mark to Market Proposals as Harbingers of Further Changes

In 1996, the Senate also passed a Bill that would have changed the treatment of U.S. citizens who expatriate. The provisions of the Senate Bill were rejected in the Conference on the Health Act in 1996 and never became law. The 1996 Senate bill was essentially reproposed as part of the President's 2001 Budget.

Senate proposals would have established a new Section 877A where the regime is quite different from the tax avoidance regime of current Section 877. Section 877 would be preserved and new Section 877A provisions for a parallel anti-avoidance regime would be added to the Code. Under Senate proposal, if a covered expatriate gives up U.S. citizenship, all property of the individual, whether foreign or U.S. would have been treated as having been sold on the expatriation date for fair market value. Losses will also be taken into account, so there can be an offsetting of gains and losses.

Gain up to an amount of $600,000 will be excluded, i.e., gross income reportable by this individual is reduced, but not below zero, by $600,000. The property to which this mark-to-market regime would have applied includes all property with some exceptions including real

property which would be subject to tax anyway in the hands of a nonresident alien, and interests in certain foreign retirement plans up to an amount of $500,000. There are special rules which apply with respect to interests in trusts.

To avoid this proposed regime, the expatriate would have had to elect to be taxed with respect to all of the property which he owns on the date of the expatriation in the same manner as if he had remained a U.S. citizen. There would be no time limitation on the application of the special regime as long as the individual holds property or property whose basis is derived from property that would be subject to taxation under this provision as if expatriation had not occurred. In order for the special election to apply, the individual would also have had to provide acceptable security for the payment of tax, consent to the waiver of an income tax treaty and comply with any other requirements of the Service.

If an election to defer taxes is made, then the taxpayer's tax for the year in which the property is ultimately disposed of would have been increased by the deferred tax amount. In other words there would be essentially an interest charge imposed on the deferred tax beginning on the 91st day after the expatriation and ending on the date when the property is disposed of. The rate of interest applicable to underpayments of federal income tax would have been used. The election once made would have been irrevocable.

The covered expatriates to which this mark-to-market system applies would have been those which meet the same financial triggers described above with respect to the new law, that is an expatriate whose average annual net income tax liability for a period of five years ending before the expatriation date is $100,000 or whose net worth on the date of expatriation is $500,000 or more. There would also have been a cost of living adjustment provision provided beginning in 1996 for the Senate financial triggers.

Under the Senate Bill, expatriates include long term resident aliens, which are defined to be individuals who are lawful permanent residents of the United States in at least eight years during the period of fifteen years ending on the taxable year in which the expatriation occurs. The individual is not considered to be a covered expatriate if (1) he became a dual citizen by reason of birth or (2) has been a resident of the United States for not more than eight years during a fifteen-year period including the taxable year during which the expatriation date occurs or (3) the individual's relinquishment of U.S. citizenship occurs before year 18-1/2 or (4) he has been a resident of the United States for not more than five years before the date of relinquishment.

Tax Planning Opportunities Remain with a Major Practical Constraint

The 1996 Senate Bill and its reproposal in essence by the President in 2000 provides for a parallel system of taxation that could exist alongside the amended Section 877 regime. Individuals contemplating expatriation should consider taking action in 2000 to avoid the risk of a change to the mark to market regime. Before any action is taken, consideration should be given to a provision of the recent U.S. federal immigration act providing as follows: "Any alien who is a former citizen of the United States who renounces United States citizenship and who is determined by the Attorney General to have renounced United States citizenship for the purpose of avoiding taxation by the by the United States is excludible." Section 362. The

provision is applicable to individuals who renounced U.S. citizenship on or after September 30, 1996.

Tax planning opportunities remain under the expatriation provisions as amended in 1996. Only "foreign situs assets" (other than controlled foreign corporations with retained earnings) are covered by the alternative income tax provisions. Thus, an intending expatriate with little or no unrealized appreciation in his covered assets could sell his assets and reinvest in "foreign situs assets". With appropriate planning and transactional structuring, gifts of unappreciated U.S. situs assets can effectively be made. An expatriate could wait out the ten year period before selling, making gifts, or dying. Avoiding income tax on gains attributed to U.S. real estate will generally not be possible even after the ten (10) year period has expired. However, with a ten year waiting period after expatriation and appropriate transactional structuring, estate and gift taxes could be avoided on transfers of U.S. real estate.

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FOOTER PAGE:

INTERNATIONAL TAX GUIDES FOR THE U.S. ADVISOR
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