POINT SQUARE CONSULTING
INTERNATIONAL TAX CONSULTING AND ADVOCACY

SPECIAL TAX ISSUES FOR EXPATRIATE AMERICANS

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Objective

Discussion regarding special international tax issues that effect Americans living abroad and immigrants to the U.S. The focus of this course will be on foreign retirement arrangements (i.e., pensions, non-U.S. social security, annuities etc.) and financial instruments.

Obligatory Items

- All "Section (§)" references are to the U.S. Internal Revenue Code of 1986, as amended, and the U.S. Department of the Treasury regulations promulgated thereunder unless stated otherwise.
- Unless stated otherwise, the term "tax" means income tax.

- Disclaimer: Information contained herein is provided solely for educational benefits. No information contained herein is to be construed as the rendering of tax, legal or other professional advice by Point Square Consulting, Inc.

Agenda

Overview of two broad areas that every tax practitioner with an expat client needs to be aware of:

- Foreign pension, retirement and social security *type* plans
- Foreign mutual funds, stocks, money market accounts and similar financial accounts

Foreign Retirement, Pension and Social Security *Type* Schemes ("Such Schemes")

American taxpayer moves to a foreign country to work for a foreign employer. American taxpayer is given the option to enroll in an employer provided non-U.S. retirement plan. American taxpayer is in for a nasty surprise…

Tax Treatment of Such Schemes

- Tax treatment depends on the specifics of any given retirement arrangement
- Default rule: Three levels of taxation
- Treaty modifications (e.g., Canada and the U.K.)
  - Form 8833 to elect treaty-based return positions
  - $1,000 penalty for failing to disclose

Foreign Trust Reporting for Such Schemes

- Generally foreign trusts under U.S. law (Reg. § 301.7701-4(a))
- Trust reporting via Forms 3520/3520-A (PLRs 2011-0096, 2008-07003)
- Applicable treaty articles do not prevent trust reporting
  - $10,000 penalty per year per scheme (§ 6677)
  - Exception for foreign trust reporting provided only through specific administrative rulings (e.g., Canada)

Foreign Mutual Funds, Index Funds, Stocks and Similar Financial Accounts ("Such Financial Accounts")

- It is the IRS's position that the onerous Passive Foreign Investment Company ("PFIC") regime applies to such financial accounts (CCA 201003013)
- PFIC classification (§ 1297)
  - Income test: 75% or more of the income is passive
  - Asset test: 50% or more of the assets produce passive income

Tax Return Reporting

- Three alternative methods for PFIC income reporting via Form 8621.
  - Deferred interest charge default method (§ 1291)
  - Qualified electing fund ("QEF") election method (§ 1295)
  - Mark-to-market ("MTM") election method (§ 1296)

Form **8621**
(Rev. December 2014)
Department of the Treasury
Internal Revenue Service

Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund

► Information about Form 8621 and its separate instructions is at *www.irs.gov/form8621*.

OMB No. 1545-1002

Attachment Sequence No. **69**

Name of shareholder	**Identifying number** (see instructions)
Number, street, and room or suite no. (If a P.O. box, see instructions.)	Shareholder tax year: calendar year 20 or other tax year beginning , 20 and ending , 20 .
City or town, state, and ZIP code or country	

Check type of shareholder filing the return: ☐ Individual ☐ Corporation ☐ Partnership ☐ S Corporation ☐ Nongrantor Trust ☐ Estate

Name of passive foreign investment company (PFIC) or qualified electing fund (QEF)	**Employer identification number** (if any)
Address (Enter number, street, city or town, and country.)	**Reference ID number** (see instructions)
	Tax year of PFIC or QEF: calendar year 20 or other tax year beginning , 20 and ending , 20 .

Part I Summary of Annual Information (See instructions.)

Provide the following information with respect to all shares of the PFIC held by the shareholder:

1 Description of each class of shares held by the shareholder: ____________
☐ Check if shares jointly owned with spouse.

2 Date shares acquired during the taxable year, if applicable: ____________

3 Number of shares held at the end of the taxable year: ____________

4 Value of shares held at the end of the taxable year (check the appropriate box, if applicable):
(a) ☐ $0-50,000 **(b)** ☐ $50,001-100,000 **(c)** ☐ $100,001-150,000 **(d)** ☐ $150,001-200,000
(e) If more than $200,000, list value: ____________

5 Type of PFIC and amount of any excess distribution or gain treated as an excess distribution under section 1291, inclusion under section 1293, or inclusion or deduction under section 1296:

(a) ☐ Section 1291 $ ____________
(b) ☐ Section 1293 (Qualified Electing Fund) $ ____________
(c) ☐ Section 1296 (Mark to Market) $ ____________

(Page 1 only)

Part II Elections (See instructions.)

A ☐ **Election To Treat the PFIC as a QEF.** I, a shareholder of a PFIC, elect to treat the PFIC as a QEF. *Complete lines 6a through 7c of Part III.*

B ☐ **Election To Extend Time For Payment of Tax.** I, a shareholder of a QEF, elect to extend the time for payment of tax on the undistributed earnings and profits of the QEF until this election is terminated. *Complete lines 8a through 9c of Part III to calculate the tax that may be deferred.*

Note: *If any portion of line 6a or line 7a of Part III is includible under section 951, you may* **not** *make this election. Also, see sections 1294(c) and 1294(f) and the related regulations for events that terminate this election.*

C ☐ **Election To Mark-to-Market PFIC Stock.** I, a shareholder of a PFIC, elect to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e). *Complete Part IV.*

D ☐ **Deemed Sale Election.** I, a shareholder on the first day of a PFIC's first tax year as a QEF, elect to recognize gain on the deemed sale of my interest in the PFIC. *Enter gain or loss on line 15f of Part V.*

E ☐ **Deemed Dividend Election.** I, a shareholder on the first day of a PFIC's first tax year as a QEF that is a controlled foreign corporation (CFC), elect to treat an amount equal to my share of the post-1986 earnings and profits of the CFC as an excess distribution. *Enter this amount on line 15e of Part V. If the excess distribution is greater than zero, also complete line 16 of Part V.*

F ☐ **Election To Recognize Gain on Deemed Sale of PFIC.** I, a shareholder of a former PFIC or a PFIC to which section 1297(d) applies, elect to treat as an excess distribution the gain recognized on the deemed sale of my interest in the PFIC on the last day of its last tax year as a PFIC under section 1297(a). *Enter gain on line 15f of Part V.*

G ☐ **Deemed Dividend Election With Respect to a Section 1297(e) PFIC.** I, a shareholder of a section 1297(e) PFIC, within the meaning of Regulations section 1.1297-3(a), elect to make a deemed dividend election with respect to the Section 1297(e) PFIC. My holding period in the stock of the Section 1297(e) PFIC includes the CFC qualification date, as defined in Regulations section 1.1297-3(d). *Enter the excess distribution on line 15e, Part V. If the excess distribution is greater than zero, also complete line 16, Part V.*

H ☐ **Deemed Dividend Election With Respect to a Former PFIC.** I, a shareholder of a former PFIC, within the meaning of Regulations section 1.1298-3(a), elect to make a deemed dividend election with respect to the former PFIC. My holding period in the stock of the former PFIC includes the termination date, as defined in Regulations section 1.1298-3(d). *Enter the excess distribution on line 15e, Part V. If the excess distribution is greater than zero, also complete line 16, Part V.*

Taxation of § 1291 Funds: A Very Simplified Illustration (Loosely Based on a Very Complex Actual Case)

- Nicholas (“Nick”) K., a U.S. citizen, invests in a single foreign mutual fund during 2012.
- The mutual fund pays dividends of $200 each during 2012 and 2013.
- Nick reports the dividends as ordinary dividends on his 2012 and 2013 Forms 1040.
- Nick sells the mutual fund at a gain in 2014 and reports the gain as a long-term gain.
- So far, so good, right?

Taxation of § 1291 Funds: International Tax Horror

- Absolutely not! He's subject to, at the very minimum, a $10,000 penalty for FATCA and § 1298(f) noncompliance. He's separately also subject to accuracy related penalties and interest.

Taxation of § 1291 Funds: Methodology

- Correct dividend reporting
- Incorrect gain reporting
- The deferred interest charge method applies to the gain (Form 8621)
- Financial math (Basic idea):
  - Spread the gain over the entire period of PFIC ownership
  - Tax calculation based on the highest applicable rates for the year
  - Interest calculation (using variable interest rates)
  - Current day roll-forward

Electing QEF Taxation

- Election to include a pro rata share of the fund's ordinary income and capital gains (dividends are never qualified) into the owner's taxable income
- Think partnership taxation
- Greatly reduces compliance costs but only available to shareholders provided with a PFIC Annual Information Statement (Reg. § 1.1295-1(g))

(Presenter's comments and observations)

Passive Foreign Investment Company (PFIC)
Annual Information Statement

The amounts listed below represent your share of ordinary earnings, capital gains, distributions, and sales gain. They **are not** included in your Schedule K-1 and should be reported on Form 8621. See notes below and consult your tax advisor for additional guidance.

Name & Address of PFIC (note 1)	Taxable Year	Ordinary Earnings	Capital Gains	Distributions (note 2)	Sales Gain (note 3)
Brookfield Peterborough (UK) Limited Level 2, 40 Berkeley Square London W1J5AL, England	01/01/2012 to 12/31/2012	0	0	0	0
Peterborough (Progress Health) Holdings Limited 3 White Oak Square, London Road Swanley, Kent BR8 7AG, England	01/01/2012 to 12/31/2012	0	0	0	0
Peterborough (Progress Health) Nominee Limited 3 White Oak Square, London Road Swanley, Kent BR8 7AG, England	01/01/2012 to 12/31/2012	0	0	0	0
Peterborough (Progress Health) PLC 8 White Oak Square, London Road Swanley, Kent BR8 7AG, England	01/01/2012 to 12/31/2012	0	0	0	0
Prime Infrastructure Trust 2 Level 26, 135 King Street Sydney, NSW 2000 Australia	01/01/2012 to 12/31/2012	0	0	0	0
Depending on the election made on Form 8621 (note 4)		**Report on this line of Form 8621**			
Part II: QEF Election Made Part IV: QEF Election Not Made		Line 1a N/A	Line 2a N/A	Line 3b Line 10a	N/A Line 10f

Notes

(1) Each of the PFICs listed above will permit its shareholders to inspect and copy the permanent books of account, records, and such other documents maintained by the PFIC that are necessary to establish that the PFIC's ordinary earnings and net capital gains, as provided in §1293(e) of the U.S. Internal Revenue Code are computed in accordance with U.S. income tax principles.

(2) These amounts represent the cash and fair market value of other property distributed or deemed distributed by the PFIC.

(3) If you have not made a QEF election with regard to the PFICs reporting a value for Sales Gain, please see the additional information and instructions (see next page). If you have made a QEF election, these values are not applicable to you.

(4) Brookfield Infrastructure Partners, L.P. has invested directly or indirectly in passive foreign investment companies ("PFICs"). U.S. partners can simplify reporting their share of PFIC earnings by electing to treat the PFICs as "qualified electing funds" (a "QEF" election). U.S. partners make a QEF election for each PFIC using Form 8621. Each U.S. partner should consult Form 8621 instructions and their tax advisor regarding the implications of making or not making a QEF election.

If a U.S. partner makes a QEF election, each U.S. partner is required to include in income their portion of the ordinary income and capital gains of the PFIC (per the above schedule) on Form 8621. These amounts **are not** included on Schedule K-1 and should be reported on Form 8621. If a U.S. partner makes a QEF election they should include in their cost basis the amount of PFIC earnings reported on Form 8621.

U.S. partners choosing not to make a QEF election should report the information above on Form 8621 and consult their tax advisor with any additional questions.

Late QEF Elections

- The election generally must be made during the year of fund acquisition (concept of “pedigreed fund”)
- A QEF election for an unpedigreed fund also requires a deemed-sale election (“purging election”) to cleanse the PFIC taint (§ 1291(d)(2)(A)) * *Proceed with caution* *
- Gain on PFIC sale = BOY FMV – adjusted basis
- Taxpayer must recognize gain (taxed under § 1291) ; losses are disallowed
- Thereafter file Form 8621 in every subsequent year for all QEFs

Electing MTM Taxation

- The MTM election is available only for “marketable” funds
- The MTM election allows recognition of realized gains
- Gain computation: EOY FMV – BOY adjusted basis
- Income taxed at ordinary rates (2014 Form 1040, line 21)
- Losses are only allowed to the extent of “unreversed inclusions” (§ 1296(d))

Late MTM Elections

- Similar (not identical) to making a late QEF election
- Painful taxation in the year of untimely election because of the deemed-sale attributed to the EOY (versus BOY in the case of a late QEF election)
- The details are complicated. Basic idea: MTM treatment is inapplicable until the year *following* the late election whereas the default rules of § 1291 fully apply in the year of late election (Reg. § 1.1296-1(i)(2))
- <u>Dilemma</u>: Instructions for Form 8621 are incorrect in a late MTM election scenario, i.e., the guidance conflicts with federal law.

PFIC Attribution Through Foreign Trusts

- Remember that most all foreign pension/retirement arrangements are trusts for U.S. tax purposes
- PFIC stock ownership through a trust is attributed to its beneficiaries (§ 1298(a)(3))
- Indirect ownership permits the IRS to directly tax the U.S. beneficiaries of the foreign trust (TAM 200733024)
- Introduces considerable complexity as the income effectively becomes subject to two separate tax regimes, i.e., the PFIC regime *and* Subchapter J (fiduciaries)

Coordination of Election and Attribution Rules – Presenter’s Comments & Observations

EIN:
Attachment to Schedule K-1

Partner Name:
Partner No: 1326

Additional Partner Footnotes:

Note: L.P. holds direct and/or indirect interest(s) in Passive Foreign Investment Company(s) ("PFIC(s)"). If held directly, or if held indirectly and , L.P. is the first U.S. shareholder, L.P. has made a timely Qualified Electing Fund ("QEF") election with respect to each PFIC investment, effective for each year of ownership, and has filed the required form 8621. If held indirectly through an underlying U.S. partnership, the underlying U.S. partnership has made a timely QEF election with respect to each PFIC investment.

Each PFIC described above was acquired for cash. The first U.S. shareholder making a QEF election for a PFIC is required to include income currently under IRC section 1293 and to file form 8621. Your distributive share of such amount, if any, has been included in your schedule K-1. As a partner in a U.S. partnership that has made the QEF election and filed form 8621, your distributive share of this income is not required to be further reported on an additional form 8621. Therefore, the partnership has not provided form 8621 or the information necessary to prepare form 8621 to its partners.
Please consult your tax advisor.

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Employee Trusts: The "Opaque Doctrine"

- PFIC attribution suspended for employee trusts (Reg. § 1.641(a)-0)
- Resultantly, U.S. beneficiaries not considered owners of the underlying assets thereby relieving them from filing Forms 8621, 8938, FBARs etc.
- This leads us to the question: "What is an employee trust?" (Which in turn necessitates discussing what are grantor, nongrantor and hybrid trusts.)

Credit: Andrew Mitchell, Esq. – Andrew Mitchell, LLC

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Trusts in the Foreign Pension Context

- Most foreign pensions are classified as trusts under U.S. law
- Specific classification will depend on a given pension's unique financial and legal terms
- Grantor trusts: Donor is the beneficiary (fiscally transparent entity)
- Nongrantor trusts: Degree of separation is the determining factor
- Employee trusts: The law refers to employee trusts but provides no definition of such. Nongrantor trust in which the employer maintains a high degree of control.

Employee Trusts

- Employee trusts are conceptualized by reference to § 402(b). Likely an employee trust if/when the trust is:
  - Created by the employer for the benefit of the employee
  - Administered by the employer on behalf of the employee
  - Over 50% funded by the employer for the benefit of the employee
- Hybrid employee trusts
  - Bifurcation requirement in the event that the employee's contributions exceed those of the employer (Reg. § 1.402(b)-1(b)(6)).
  - Opaque doctrine inapplicable to the portion of the trust treated as a grantor trust.

Role of Income Tax Treaties

- As previously discussed, treaties can modify the default taxation of foreign retirement arrangements
- In similar fashion, Reg. § 1.1298-1T(b)(3)(ii) provides an exception to the PFIC reporting requirements when PFIC ownership is attributed through a foreign pension where a treaty allows deferral.

IRS Voluntary Disclosure Programs to Redress Prior-Year Noncompliance

- Offshore Voluntary Disclosure Program
- Streamlined Domestic Offshore Procedure
- Streamlined Foreign Offshore Procedure
- Delinquent International Information Return Submission Procedure
- Delinquent FBAR Submission Procedure
- Quiet disclosure (Not an IRS program per se)

Quick Recap

- Foreign retirement/pension schemes
  - Default U.S. tax rule: No enjoyment of tax deferral unless specified by an applicable international tax treaty
  - Trusts for U.S. tax purposes necessitating special tax reporting via Forms 3520 and 3520-A
- Passive Foreign Investment Companies ("PFICs")
  - The HIRE Act in 2010 imposed the onerous PFIC reporting requirements on certain forms of foreign financial instruments namely mutual funds, index funds, money market accounts etc.
  - Three alternative methods of reporting PFIC income (i.e., default, QEF, MTM) via Form 8621. The default rules are punitive.
  - PFIC ownership through trusts is attributable to the beneficiaries.

Suggested Further Reading

- *"Passive Foreign Investment Company Reporting: It's No Longer Just a Concern of the High-Net-Worth Investor,"* EA Journal, National Association of Enrolled Agents, September/October 2013. (Accessible to NAEA members at www.naea.org. Discussion valid-to-date)

- *"Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts,"* Journal of Taxation, Thomson Reuters, February 2008. (Google-accessible – Read for conceptual grounding *only*)

Questions

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