U.S.-UK Dual Taxation Pitfalls: Reporting Issues and Planning Opportunities for U.S. Taxpayers

THURSDAY, AUGUST 27, 2020, 1:00-2:50 pm Eastern

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U.S.-UK Dual Taxation Pitfalls

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United States-United Kingdom: Dual Taxation Issues and Considerations

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- Patrick exclusively handles matters covering international taxation, frequently publishing articles and giving presentations on assorted areas of international tax law. Patrick works with accountants and other advisors both throughout the United States and internationally on matters faced by their clients.

Introduction

- United Kingdom-based taxpayers – whether individuals or entities – increasingly engage in United States activities/maintain United States holdings
  - For individuals, United States investments can either be passive or part of ongoing American connections
    - Significant planning opportunities exist for nonresidents with United States activities – though improper structuring of activities can create draconian American tax consequences
  - Corporate entities with United States operations are subject to tax on United States-sourced business profits
- United States taxpayers with U.K. activities/assets are also subject to special tax rules by both jurisdictions
  - Cognizance of U.K.-specific factors – both from the tax and business perspective – is critical when entering the market

U.S. Taxpayers

- United States citizens and residents are taxable on their worldwide income
  - Sourcing determinations less relevant – taxable on all income, whether domestic or foreign-sourced
  - Entities typically domiciled based on place of formation/incorporation
- Foreign tax credits alleviate burdens of double taxation for U.S. taxpayers with U.K-sourced income
  - Generally, citizens/residents utilize FTC rather than income tax treaties
    - Tax treaties contain "savings" clause, exempting citizens/residents from most treaty benefits
- United States taxpayers subject to capital gains on worldwide asset dispositions

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Taxpayer Classification

- Which individuals are United States taxpayers?
  - Citizenship – persons born in the United States, naturalized in the United States, or (under specified circumstances) where parents were United States citizens at the time of their birth
  - Classified as a "resident" for United States income tax purposes if:
    - Lawfully admitted for permanent residence (green card holder); or
    - Meet substantial presence requirements
      - Substantial presence test: must be present in the United States for 31 days during the relevant tax year and the sum of days for the last three years (after use of applicable multipliers) exceeds 183
  - Individuals not classified as United States taxpayers termed "nonresident aliens" for income

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Taxpayer Classification

- Who is a U.S. taxpayer?
  - Exceptions exist to resident classification: (1) closer connection to another country and (2) treaty tiebreaker provisions
    - Closer connection exception: look to whether individual's facts and circumstances show a closer connection to another country
      - Available *only* for substantial presence residents!
    - Income tax treaties – individuals classified as residents of both treaty party countries are reclassified as a resident of only the one which contains their permanent adobe or (if a permanent abode available in both) their "center of vital interests"
      - Available to *both* substantial presence residents and green card holders – but <u>not</u> citizens!
        - Treaty reclassification **only** for income tax liability purposes – information reporting requirements largely unmodified

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U.S. Taxpayers – Interests in U.K. Corporate Entities

- Special tax rules come into play for U.S. taxpayers with interests in foreign corporations
  - Technically, the foreign corporation is respected as a separate taxpayer; however, current inclusion (irrespective of corporate distributions) can be required for U.S. shareholders
    - Subpart F/GILTI regimes create current inclusion for significant income amounts if ownership thresholds met
    - Passive foreign investment company ("PFIC") rules do not require ownership thresholds, and carry potential for punitive tax ramifications on dispositions/excess distributions
  - Special anti-deferral rules inapplicable to flow-through entities – because no deferral occurs!
    - Threshold question: How is a U.K. entity classified for U.S. tax purposes?

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U.S. Taxpayers – Interests in U.K. Corporate Entities

- Foreign-domiciled business entities generally are able to elect their entity classification for United States tax purposes
  - EXCEPTION: Per-se corporations (as listed in the Regulations)
    - U.K. public limited company automatically classified as a corporation under U.S. rules
  - Default rules for classification exist, which hinge on the limited liability of owners/members
    - If limited liability for owner/owners – association taxable as a corporation
    - If no limited liability for at least one owner – partnership if multiple members, disregarded entity if one
  - Elections out of default rules are available - can elect to be a partnership, corporation, or disregarded entity
    - Election made on Form 8832 – initial election required within 75 days of entity becoming “relevant”

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U.S. Taxpayers – Interests in U.K. Corporate Entities

- Subpart F imposes a direct tax on a U.S. shareholder of a controlled foreign corporation ("CFC") as to the CFC's Subpart F income
  - Tax imposed directly on U.S. shareholder, regardless of whether distributions of income are made to the shareholder
    - Provides a method for the United States to disincentivize transactions improperly sourcing income to foreign jurisdictions
- Threshold requirements must be met for Subpart F regime to apply
  - Requirements: look to (1) whether a U.S. shareholder exists, (2) whether there is a CFC, and (3) whether the CFC has Subpart F income
    - U.S. shareholder – United States person owning at least 10% of the foreign corporation's voting stock *or* value
    - Controlled foreign corporation exists if on any day during a given year U.S. shareholders own more than 50% of the stock of the foreign corporation

U.S. Taxpayers – Interests in U.K. Corporate Entities

Subpart F income is primarily comprised of “movable income” – income that can be shifted to foreign jurisdictions more easily

- Foreign base company income is typically the largest component of Subpart F income
  - Includes foreign personal holding company income, foreign base company sales income, foreign base company services income, etc.
    - Foreign personal holding company income: dividends, interest, rents, royalties, annuities
      - Also includes certain net gains from sale of property which generates passive income
    - Foreign base company sales/services income – look to activities outside the corporation’s country of domicile and the transactions with related persons

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U.S. Taxpayers – Interests in U.K. Corporate Entities

- What if Subpart F application requirements are not met?
  - No mechanism for immediate tax is implemented; however, prospective distributions by the foreign corporation (or dispositions of the shares of the foreign corporation) potentially subject to PFIC regime
    - PFIC – punitive ramifications for shareholders of foreign corporations with significant passive income
      - Income automatically classified as ordinary (taxable at highest rates), with an interest charge applicable based on the holding period for the interest
  - Sec. 1297(d) – if a shareholder's interest in a foreign corporation meets both Subpart F and PFIC requirements, only Subpart F applies
    - Often preferable to apply Subpart F – tax accelerated, but punitive PFIC ramifications avoided

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U.S. Taxpayers – Interests in U.K. Corporate Entities

- Under Sec. 951A, U.S shareholders of a controlled foreign corporation must include their share of global intangible low-taxed income in US tax
  - GILTI: Excess of the shareholder's net CFC tested income over the shareholder's net deemed tangible income return
  - U.S. shareholder and controlled foreign corporation concepts mirror Subpart F
    - GILTI inclusion treated similarly to Subpart F in many ways, but not technically a component of Subpart F
  - **50% deduction available for GILTI, but ONLY for C-Corporations!**
    - Makes the effective tax rate for corporate shareholders 10.5%
    - For non-corporate U.S. shareholders, rate can be 37%

U.S. Taxpayers – Interests in U.K. Corporate Entities

- GILTI Application
  - Functionally, GILTI essentially is tax imposed on U.S. shareholders of a CFC on the excess of an assumed 10% rate of return on tangible business assets of the CFC
    - GILTI imposes a minimum tax on foreign earnings that exceed a standard rate of return amount
  - No direct reference to intangibles is made in Sec. 951A
    - Aim may have been intangible income, but application will be significantly more far-reaching, and not limited to one type of income (i.e. movable income)

U.S. Taxpayers – Direct U.K. Activities

Foreign-Derived Intangible Income ("FDII")

- A deduction is allowed to *domestic corporations* in an amount equal to 37.5% of the FDII of the domestic corporation for the tax year
  - Deduction ONLY available to C-corporations!
- FDII equals deemed intangible income multiplied by a fraction: foreign-derived deduction eligible income over deduction eligible income.
  - FDII is the portion of intangible income derived from serving foreign markets; like GILTI, it assumes a 10% rate of return on tangible assets
    - FDII concept offers a special reduced effective tax rate on income from US-held intangibles; concept does not explicitly look at intangibles but assumes a fixed rate of return on business assets with the balance of income being from intangibles

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United Kingdom Taxpayers – United States Income Tax

- Under default U.S. rules, U.K. resident taxpayers (who are not U.S. citizens) are subject to United States tax on:
  - (1) income effectively connected with a United States trade or business, and
  - (2) fixed or determinable annual or periodic income
- U.S.-U.K. income tax treaty provides critical modifications to default rules for qualified residents of treaty party jurisdictions
  - "Effectively connected with a United States trade or business" standard elevated to "business profits attributable to a United States permanent establishment"
    - FDAP income tax rate lowered substantially/eliminated for specified income types

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Background Considerations

- Why does existence of a permanent establishment/U.S. trade or business matter?
  - Where a trade or business/permanent establishment exists, nonresident is taxed *as if they had separately incorporated* (in terms of direct income inclusion)
    - Gains/business profits indirectly associated with the trade or business/permanent establishment – such as capital gains – are taxable
  - Where a nonresident not engaged in a United States trade or business, she is taxed only on income sourced to the United States (rather than being taxable on worldwide income sourced to her U.S. trade or business)
    - Tax scope can be drastically reduced – with capital gains generally excluded from tax (outside real estate) and treaty provisions often excluding income from covered items (like certain royalties)

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Background Considerations

- **Non-U.S. taxpayers are subject to U.S. tax primarily on income items sourced to the United States**
  - Detailed sourcing rules for income items exist; for example, interest/dividend income is sourced to the payor's location
    - Rent/royalties sourced to the place of use of the asset
    - Personal services sourced to where services performed (*not* to the location/place of incorporation of payor!)
  - Limited income sourced to a nonresident's "United States trade or business" can be taxable by the United States even if the income item itself is not sourced to the United States
    - <u>Must</u> be attributable to an office or fixed place of business in the United States (thus requiring elevated connection to the country)

United Kingdom Taxpayers – United States Income Tax

- Under default rules, income earned by individuals effectively connected to a United States trade or business is subject to tax
  - "Trade or business" undefined in the Code/regulations – but profit-oriented activities carried on in the United States which are regular, substantial, and continuous are properly classified as a trade or business for these purposes
    - Effectively connected income includes performance of U.S.-based personal services
    - Macro-level – relatively light requirements to be considered engaged in a U.S. trade or business
  - Effectively connected income taxed by the United States at graduated rates, with deductions/credits available

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United Kingdom Corporations – Branch Profits Tax

- Branch profits tax is imposed as a second tax on U.K. corporations engaged in a United States trade or business through branch operations
  - Tax equal to 30% of the corporation's "dividend equivalent amount" for the year
    - Dividend equivalent amount – U.S. effectively connected E&P minus amounts reinvested in U.S. assets
- Branch profits tax intended to equalize branch operations with subsidiary operations
  - Latter often preferable as a result of branch profit rules

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United Kingdom Taxpayers – FIRPTA

- Under the Foreign Investment in Real Property Tax Act of 1980, gain from disposition of United States real property interest by a foreign taxpayer is subject to tax
  - *Gains are automatically classified as ECI!*
  - United States real property interest: any interest in United States real property or an interest in a domestic corporation unless such corporation was not a United States real property holding corporation for the prior five years
    - United States real property holding corporation: corporation where more than 50% of the corporation’s assets are United States real property interests
  - Transferee must withhold on disposition at a rate of 15% of the amount realized
- **Vitally, nonresidents usually not subject to capital gains tax on non-ECI U.S.-sourced gains**

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United Kingdom Taxpayers – FDAP Income

- Fixed or determinable annual or periodic income ("FDAP income") also subject to tax by the United States (for income items sourced to the U.S.)
  - FDAP income functions as a catch-all for U.S.-sourced income items (aside from capital gains) not otherwise subject to U.S. tax
    - Includes interest (subject to expansive exceptions), dividends, rent, salaries, wages, premiums, annuities, compensation, remuneration, etc.
  - Interplay exists between ECI and FDAP income
    - US-sourced income is classified as effectively connected to a U.S. trade or business rather than FDAP if it satisfies an asset use test or a business activities test
- FDAP income generally subject to a flat 30% rate of tax (with tax collected through withholding by payors)
  - Deductions not permitted for FDAP income

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United Kingdom Taxpayers – U.S.-U.K. Income Tax Treaty

- The United States and the United Kingdom maintain an income tax treaty, which (upon election) can alter tax ramifications for U.K.-resident taxpayers with United States-sourced income
  - Under treaties, residents of a treaty country can (by election) be taxed at a reduced rate, or even exempted from tax, on specified items of income from the other country
    - i.e. withholding taxes on United States-sourced income
  - Savings clause prevents a United States citizen/resident/entity from using a tax treaty to alter tax on US-source income
  - Treaty-based positions generally must be disclosed
    - Subject to exemptions under the Regulations

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United Kingdom Taxpayers – U.S.-U.K. Income Tax Treaty

- Residency takes on importance in this realm – generally U.K. taxpayers are entitled to treaty benefits only when they are residents of the United Kingdom under U.K. tax rules
  - Treaty definitions of residence normally include persons liable for tax to a country based on domicile, residence, citizenship, place of management, or place of incorporation
    - Corporations are residents of countries for these purposes if liable for tax based on the country being its place of management
      - Can have conflicts as to residence where place of management and place of incorporation differ
        - Tiebreaker typically is the treaty between those two countries
  - Rules exist to prevent "treaty shopping" – entity creation solely for purposes of treaty benefits

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United Kingdom Taxpayers – U.S.-U.K. Income Tax Treaty

- Treaty modifications for business income – "effectively connected to a United States trade or business" shifted to business profits attributable to a permanent establishment
  - Treaty Article 7(1)
  - Heightened standard for U.S. taxation – though threshold still low
- Dividends – if a U.S. company pays a dividend to a U.K. shareholder, the U.S. tax rate is reduced to 5-15% (depending on the recipient's ownership level)
  - Treaty Article 10(2)
    - Under limited circumstances, source country tax can be removed under Art. 10(3)

United Kingdom Taxpayers – U.S.-U.K. Income Tax Treaty

- Treaty modifications for dependent (employee) personal services – income taxable by source country except if (1) employee present in source country for <183 days, (2) compensation paid by an employer not a resident of the source country, and (3) compensation not borne by a permanent establishment or fixed base of the employer in the source country
  - Treaty Article 14(2)
- Royalty income <u>not</u> subject to American tax where earned by a U.K. qualified resident, unless the U.K. resident maintains an American permanent establishment/fixed place of business
  - Art. 12

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Nonresident Individuals – Transfer Taxes

- Estate tax: nonresident individuals subject to tax on all property (whether tangible or intangible) sitused within the U.S.
  - Subject to some exceptions (such as bank accounts not used in association with a U.S. trade or business)
  - Real property and tangible personal property are sitused in accordance to where the assets are physically located
    - Shares of a corporation are sitused in the country in which the corporation is formed
  - Nonresident individuals receive a $60,000 estate tax exclusion with a maximum 40% rate of tax applicable

Nonresident Individuals – Transfer Taxes

- Gift tax: nonresidents normally are subject to gift tax on lifetime gratuitous transfers of tangible property within the United States
  - Generally comprising real property situated within the country and tangible personal property within the U.S. at the time of the gift, including hard currency or cash situated within the U.S.
    - Intangible property (i.e. shares of a corporation) is not subject to gift tax for nonresident alien donors
- No specific gift tax exclusion for nonresident individuals, though the $15,000 per donee annual exclusion is available

Nonresident Individuals – Transfer Taxes

- The United States and United Kingdom also maintain a treaty for transfer taxes, permitting some modification of default U.S. transfer tax rules
  - Article 4: individuals classified as both U.S. and U.K. domiciliaries for transfer tax purposes reclassified as only a domiciliary of one country
  - Article 5: domiciliaries of the United Kingdom subject to a narrowed scope of American transfer tax
  - Article 8(5): if provision elected, tax on U.K. domiciliary by the United States limited to the amount of tax assessable had they been U.S.-domiciled!

Nonresident Individuals – Transfer Taxes

- What isn't subject to transfer tax?
  - Non-U.S. sitused assets are not subject to U.S. transfer tax when donor is a NRA
    - Foreign property, foreign holdings are not subject to U.S. transfer taxes
  - Intangible assets are not subject to gift tax for NRA donor *regardless of situs*
    - i.e. stock in a U.S. corporation generally will not be subject to gift tax
      - Reliance on ability to gift asset pre-death to remove from taxable estate an option, but carries risk (i.e. sudden death)

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US Reporting Requirements of UK-Sourced Investments

Presented by: Jeffrey Rosenfeld, Partner
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IRS Information Returns

- **Form 8938 – Specified Foreign Financial Assets**
- **FBAR – Financial Accounts**
- **Form 3520 – Trusts/Gifts**
- **Form 8621 – Passive Foreign Investment Companies**
- Form 5471 – Foreign Corporations
- Form 8865 – Foreign Partnerships
- Form 8858 – Foreign Disregarded Entities
- Others!

Form 8938

- **Specified Foreign Financial Assets**
  - Foreign Stock or securities
  - Foreign bank accounts
  - Foreign pension
  - ISA
  - Foreign Life Insurance Policy
  - Foreign Annuity Policy
  - Foreign Leasehold Interest? (Real Estate is not a Specified Foreign Financial Asset)

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Form 8938

- **Filing Thresholds**
  - Reside outside U.S.
    - Other than a joint return and the total value of specified foreign assets is more than $200,000 on the last day of the tax year or more than $300,000 at any time during the year.
    - Joint return and the value of specified foreign asset is more than $400,000 on the last day of the tax year or more than $600,000 at any time during the year.
  - Reside in U.S.
    - Other than a joint return and the total value of specified foreign assets is more than $50,000 on the last day of the tax year or more than $75,000 at any time during the year.
    - Joint return and the value of specified foreign asset is more than $100,000 on the last day of the tax year or more than $150,000 at any time during the year.

Form 8938

- **Other Relevant Items**
  - Due with tax return
  - Penalties of $10,000 with an additional $50,000 continuation penalty. 40% penalty on tax from specified foreign financial assets. Statue of limitations remain open.

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FBAR

- Required as part of Bank Secrecy Act since 1970s
- U.S. taxpayers with foreign accounts have two obligations
  - Answer question “yes” on Form 1040, Schedule B, Part III (due April 15 or due date of extended return) or other applicable tax return
  - Electronically File FinCEN 114, Report of Foreign Bank and Financial Accounts (“FBAR”) (filed separately from tax return)

FBAR

- Starting 2016 tax year, due April 15
  - Eligible for automatic six-month extension – to October 15
    - Expect regulations on how to request an extension
- Filed electronically. Paper returns not accepted.

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FBAR

- An FBAR must be filed if all of the following requirements are satisfied:
  - The filer is a U.S. Person;
  - The U.S. Person has a financial account;
  - The financial account is in a foreign country;
  - The U.S. Person has a financial interest in, or signature or other authority over, the financial account; and
  - The aggregate account balance of all such foreign accounts exceed $10,000 (in U.S. dollars) at any time during the calendar year

Who is a “U.S. Person”?

- A U.S. Person includes:
  - A citizen of the U.S.,
  - A resident alien of the U.S., and
  - A U.S. corporation, partnership, trust, limited liability company, or other type of business entity
- Generally includes: expatriates, U.S. citizens and residents residing abroad, certain foreign citizens who are working and paying taxes in the U.S., and individuals that are required to file FBARs annually even if they maintain joint accounts with a non-U.S. spouse

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What is a reportable financial account?

- “Account” is broadly defined to include any foreign “bank, securities, or other financial accounts”
- “Bank accounts” include savings deposits, demand deposits, checking accounts, and any other accounts maintained with a person engaged in the business of banking
- “Securities accounts” include accounts maintained with a person in the business of buying, selling, holding, or trading stock or other securities
- “Other financial accounts” include:
  - An account with a person that is in the business of accepting deposits as a financial agency;
  - An account that is an insurance policy with a cash value or an annuity policy;
  - An account with a person that acts as a broker or dealer for futures or options transactions in any commodity on or subject to the rules of a commodity exchange or association; or
  - An account with a mutual fund or similar pooled fund which issues shares available to the general public that have a regular net asset value determination and regular redemptions (does NOT include hedge funds)

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What is a reportable financial account?

- Savings Accounts
- Brokerage Accounts
- Insurance Policies with cash values
- Mutual funds
- ISAs
- Pension Accounts?
- Bitcoin?
- Online poker accounts?

What is a “financial interest”?

- An individual has a “financial interest” in a foreign account if he or she is the owner of record of, or has legal title to, the account, regardless of whether the account is maintained for his or her own benefit or for the benefit of others.
- A U.S. person also has a reportable financial interest in a foreign bank account if the account is held by:
  - An agent, nominee, or attorney on behalf of the U.S. Person;
  - A corporation in which the U.S. Person owns more than 50% of the voting power or the total value of the shares;
  - A partnership in which the U.S. Person owns directly or indirectly more than 50% of the interest in profits or capital;

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What is a "financial interest"? (continued)

- Any other entity in which the U.S. Person owns directly or indirectly more than 50% of the voting power, total value of the equity interests or assets, or interest in profits;
- A trust, if the U.S. Person is the trust grantor and has an ownership interest in the trust for U.S. tax purposes; and
- A trust in which the U.S. Person either has a **present** beneficial interest in more than 50% of the assets or from which such person receives more than 50% of the current income.

What is "signature authority"?

- Broadly defined as the authority of an individual (alone or in conjunction with another) to control the disposition of money, funds or other assets held in a financial account by direct communication to the person with whom the financial account is maintained
- The test for determining whether an individual has signature or other authority over an account is whether the foreign financial institution will act upon a direct communication from that individual regarding the disposition of assets in that account.
- The final regulations also exempt certain individuals with signature or other authority over, but no financial interest in, foreign accounts.

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FBAR Penalties for Non-Compliance

- Criminal penalties for willful violations:
  - Up to 5 years imprisonment and $250,000 fine
- Civil penalties
  - Non-willful violation: Up to $10,000 for each violation
  - Willful violation: Greater of $100,000 or 50 percent of the balance in the account at the time of the violation
- Both civil and criminal penalties can be imposed together.

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IRS Form 3520/3520-A

- U.S. persons (and executors of estates of U.S. decedents) file Form 3520 to report:
  - Certain transactions with foreign trusts,
  - Ownership of foreign trusts under the rules of sections 671 through 679, and
  - Receipt of certain large gifts or bequests from certain foreign persons.
- 3520-A - annual information return of a foreign trust with at least one U.S. owner. The form provides information about the foreign trust, its U.S. beneficiaries, and any U.S. person who is treated as an owner of any portion of the foreign trust under the grantor trust rules

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IRS Form 3520/3520-A

- What is a foreign trust?
  - Grantor trusts/revocable trusts
    - Many foreign retirement accounts fall within this category: UK Self Invested Pension Plans (SIPPS)
    - Employee trusts if the employee contributes more than 50% of the amount in the account?
    - ISA? Is it an investment account controlled by taxpayer or held in trust by a financial institution?

IRS Form 3520/3520-A

- Potential Exemption for UK Retirement Accounts:
  - Rev. Proc. 2020-17
    - Trust operate exclusively to provide or to earn income for the provision of pension or retirement benefits
    - The trust is generally exempt from income tax in the trust's jurisdiction or is otherwise tax favored
      - Contributions to the trust are deductible or excluded from income, taxed at a reduced rate, give rise to a tax credit or be otherwise eligible for another similar tax benefit; or
      - The taxation of investment income earned by the trust is deferred until distribution or taxed at a reduced rate
    - Annual information reporting is required to relevant tax authorities.
    - Only contributions with respect to income earned from the performance of personal services are permitted
    - Contributions to the trust are limited by a percentage of earned income of the participant, subject to an annual limit of $50,000 (or less), or subject to a lifetime limit of $1,000,000 (or less).
    - Withdrawals, distributions or payments are conditioned upon reaching a specified retirement age, disability or death otherwise penalties must apply if the conditions are not met
    - The trust must be "non-discriminatory"
    - Rollovers allowed.
  - UK SIPPS probably don't qualify at this point. Too much uncertainty.

IRS Form 3520/3520-A

- Filing Dates
  - 3520 is due on the date that the income tax return is due.
  - 3520-A is due on 15th day of third month after trust's tax year closes.
  - Two separate extensions needed. One does not extend the other
- Penalties
  - Greater of $10,000 or:
    - 35% of the gross value of any property transferred to a foreign trust for failure by a U.S. transferor to report the creation of or transfer to a foreign trust; or
    - 35% of the gross value of the distributions received from a foreign trust for failure by a U.S. person to report receipt of the distribution; or
    - 5% of the gross value of the portion of the trust's assets treated as owned by a U.S. person for failure by the U.S. person to report the U.S. owner information.

Form 8621

- What is a PFIC?
  - **Income test.** 75% or more of the corporation's gross income for its tax year is passive income (as defined in section 1297(b)).
  - **Asset test.** At least 50% of the average percentage of assets (determined under section 1297(e)) held by the foreign corporation during the tax year are assets that produce passive income or that are held for the production of passive income.
  - Examples: UK mutual fund, Unit Trust, ISAs
- Who Must File?
  - U.S. person (direct or indirect) shareholder who recognizes gain from a direct or indirect disposition of PFIC stock;
  - The U.S. person who receives direct or indirect distributions from the PFICU.S. person wishing to make one of the elections on the form.
  - U.S. Persons holding more than a de minimis amount of PFIC stock

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Form 8621

- Potential Exception:
  - Temporary Regulation section 1.1298-1(b)(3)(ii) – A United States person that is considered to own an interest in a PFIC because it is a beneficiary of an estate described in section 7701(a)(31)(A) or a trust described in section 7701(a)(31)(B) that owns, directly or indirectly, stock of a PFIC, and that has not made an election under section 1295 or 1296 with respect to the PFIC, is not required under section 1298(f) and these regulations to file Form 8621 (or successor form) with respect to the stock of the PFIC that it is considered to own through the estate or trust if, during the beneficiary's taxable year, the beneficiary is not treated as receiving an excess distribution (within the meaning of section 1291(b)) or as recognizing gain that is treated as an excess distribution (under section 1291(a)(2)) with respect to the stock.

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IRS Form 8621

- Filing Dates
  - 8621 is due on the date that the income tax return is due.
- Penalties
  - No monetary penalty.
  - Statute of limitations open.
  - Cannot retroactively make an election with respect to the PFIC.

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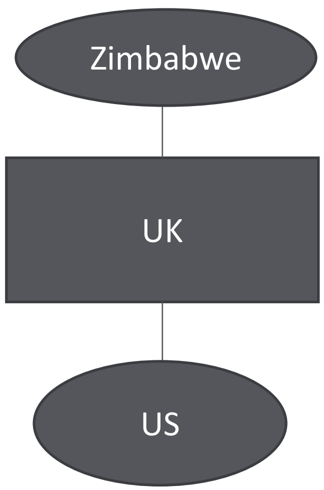
Limitation of Benefit Provisions

Presented by: Jeffrey Rosenfeld, Partner
Blank Rome LLP

Limitation on Benefits

- Only "qualified persons" can obtain benefits
- Prevents interposition of entities to obtain Treaty Benefits



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Resident of a Contracting State

- Even before we get into who a qualified person is, only a "resident of a Contracting State" is eligible for Treaty benefits.
  - any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.
    - RICs, REITs and REMICs are all residents of the United States for purposes of the treaty. Although their income normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore are regarded as "liable to tax."
    - <u>However, does not</u> include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.
    - Income earned by "Fiscally Transparent Entities" are generally deemed to be earned by its owners. So, a U.S. owner of a U.S. partnership may claim treaty benefits if the partnership earns U.K income.

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Resident of a Contracting State

- An individual who is a United States citizen or an alien admitted to the United States for permanent residence (a "green card" holder) is a resident of the United States only if the individual has a substantial presence, permanent home or habitual abode in the United States and if that individual is not a resident of a State other than the United Kingdom for the purposes of a double taxation convention between that State and the United Kingdom.
  - Prevents a U.S. citizen or green card holder who is a resident of a country other than the United States or the United Kingdom from choosing the benefits of the Convention over those provided by the treaty between the United Kingdom and his country of residence.
  - If the U.S. citizen or green card holder's country of residence does not have a treaty with the United Kingdom, however, then he will be treated as a resident of the United States as long as he meets the first requirement of an economic nexus.

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Resident of a Contracting State

- Includes:
  - “pension scheme”
  - a plan, scheme, fund, trust, company or other arrangement established in a Contracting State that is operated exclusively to administer or provide employee benefits and that, by reason of its nature as such, is generally exempt from income taxation in that State;
  - an organization that is established exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes and that is a resident of a Contracting State according to its laws, notwithstanding that all or part of its income or gains may be exempt from tax under the domestic law of that State; and
  - Certain “governmental entities”

LOB Overview

- One of four tests to be met
  - Qualified person test
  - Derivative benefits test
  - Active trade or business test,
  - Competent authority determination

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Qualified Person

- (1) Individuals
- (2) “Qualified governmental entity”
- (3) Publicly traded companies and subsidiaries of publicly traded companies
  - “Principal class” of its shares is listed on a recognized U.S. or U.K. stock exchange and
  - is “regularly traded” on one or more “recognized stock exchanges”
- (4) Publicly traded persons that are not “companies” or subsidiaries of publicly traded persons
  - Company means any body corporate or any entity that is treated as a body corporate for tax purposes
  - “Principal class” of its units are listed on a recognized U.S. or U.K. stock exchange and is “regularly traded” on one or more “recognized stock exchanges”
- (5) A tax-exempt pension scheme or employee benefit arrangement (if more than fifty percent of the beneficiaries, members or participants of the organization are individuals resident in either Contracting State), and tax-exempt organizations (organized excusively for religious/charitable/scientific purposes).

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Qualified Person

- Any person other than an individual that meets the so-called "base erosion" test
  - 50 percent or more of the aggregate voting power and value of the person is owned directly or indirectly on at least half the days of the person's taxable year by qualified persons who are themselves individuals, qualified governmental entities, publicly traded companies/persons, or tax-exempt pensions/organizations.
  - less than 50 percent of the person's gross income for that taxable period is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible for the purposes of the taxes covered by this Convention in the State of which the person is a resident (<u>but not</u> including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States)

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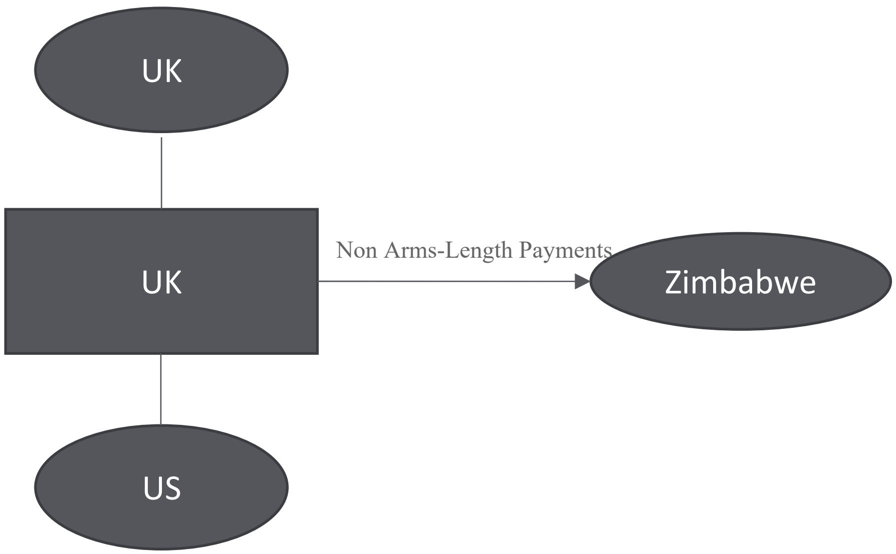
Base Erosion Test

- Trying to Prevent:



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Qualified Person

- Trusts or trustees in their capacity as such if:
  - 50 percent or more of the aggregate voting power and value of the person is owned directly or indirectly on at least half the days of the person's taxable year by persons who are themselves individuals, qualified governmental entities, publicly traded companies/persons, tax-exempt pensions/ organizations or "equivalent beneficiaries" (discussed later).
  - Meets the same gross income test described above under the base erosion test

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More on Publicly Traded Entities

- “Principal class” of its shares is listed on a recognized U.S. or U.K. stock exchange
  - Principal class is common shares of the company representing the majority of the aggregate voting power and value of the company. If the company does not have any such stock, then the “principal class of shares” is that class or any combination of classes of shares that represents, in the aggregate, a majority of the voting power and value of the company.
  - “Shares” includes depository receipts for shares or trust certificates for shares.
- “Regularly traded”
  - Aggregate number of shares of that class traded on one or more recognized exchanges during the twelve months ending on the day before the beginning of that taxable period is at least six percent of the average number of shares outstanding in that class during that twelve-month period.
- On one or more “recognized stock exchanges” generally encompasses
  - NASDAQ and any stock exchange registered with the SEC as a national securities exchange;
  - London Stock Exchange;
  - the Irish Stock Exchange, the Swiss Stock Exchange and the stock exchanges of Amsterdam, Brussels, Frankfurt, Hamburg, Johannesburg, Madrid, Milan, Paris, Stockholm, Sydney, Tokyo, Toronto, and Vienna; and
  - any other stock exchange agreed upon by the competent authorities of the Contracting States.

More on Publicly Traded Companies

- Subsidiaries of Publicly Traded Companies
  - A company is a qualified person if five or fewer direct and indirect owners of at least 50 percent of the aggregate vote and value of the company's shares are publicly traded companies as previously described, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State.
    - For example, a U.K. company, all the shares of which are owned by another U.K. company, would qualify for benefits under the Convention if the principal class of shares of the U.K. parent company were listed on the London Stock Exchange and regularly traded on the Irish stock exchange.
    - However, if the U.K. parent indirectly owned the U.K. company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the United States or the United Kingdom for the U.K. company

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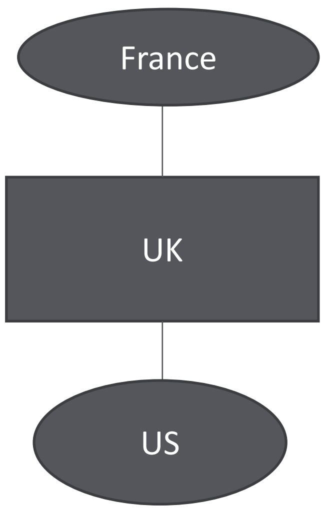
Derivative Benefits Test

- Even if a resident is not a qualifying person, it still will be entitled to treaty benefits if the owner of the resident would have been entitled to the same benefit had the income in question flowed directly to that owner.



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Derivative Benefits Test

- Requirements:
  - Seven or fewer "equivalent beneficiaries" must, directly or indirectly, own shares representing at least 95 percent of the aggregate voting power and value of the company, and, an analogous 50 percent gross income test under the base erosion test is met.
- Equivalent beneficiaries are persons meeting one of two tests:
  - (1) A person may be an equivalent beneficiary if it is entitled to equivalent benefits under a treaty between the country of source and the country in which the person is a resident. This alternative has two requirements.
    - (A) The person must be a resident of a Member State of the European Community, a European Economic Area state, or a party to NAFTA (collectively, "qualifying States").
    - (B) the person must be entitled to equivalent benefits under an applicable treaty. In other words, the person must be entitled <u>to all the benefits</u> of a comprehensive treaty between the Contracting State from which benefits of the Convention are claimed and a qualifying State.
      - If the treaty in question does not have a comprehensive LOB article, this requirement only is met if the person would be a "qualified person" as an individual, qualified governmental entity, publicly-traded company or entity, and tax-exempt organizations.
      - In addition, with respect to dividends, interest, or royalties, the person must be entitled to a rate of tax that is at least as low as the rate that would apply under the Convention to such income.

Derivative Benefits Test

- [continued from previous slide]
  - (2) a qualified person under the Treaty who are individuals, qualified governmental entities, publicly traded companies/persons, tax-exempt pensions/ organizations

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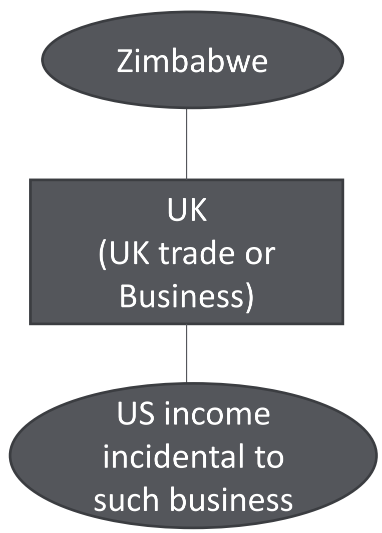
Trade or Business Test

- A resident of a Contracting State engaged in the active conduct of a trade or business in that State may obtain the benefits of the Convention with respect to an item of income, profit, or gain derived in the other Contracting State. The item of income, profit, or gain, however, must be "**derived in connection with**" or "**incidental to**" that trade or business.



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Trade or Business Test

- Income, profit, or gain "**<u>is derived in connection with</u>**" a trade or business if the income-producing activity in the State of source is a line of business that "forms a part of" or is "complementary" to the trade or business conducted in the State of residence by the income recipient.
  - A business activity generally will be considered to form part of a business activity conducted in the State of source if the two activities involve the design, manufacture or sale of the same products or type of products, or the provision of similar services.
  - For two activities to be considered to be "complementary," the activities need not relate to the same types of products or services, but they should be part of the same overall industry and be related in the sense that the success or failure of one activity will tend to result in success or failure for the other.
- An item of income, profit, or gain derived from the State of source is "**<u>incidental to"</u>** the trade or business carried on in the State of residence if production of the item facilitates the conduct of the trade or business in the State of residence
- The trade or business carried on in the State of residence, **<u>must be substantial in relation to the activity in the State of source</u>**. This determination is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State.

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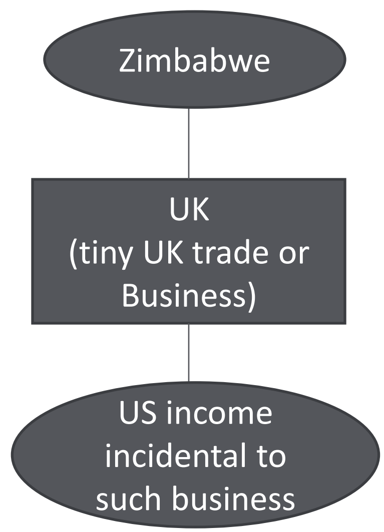
Trade or Business Test

- The trade or business carried on in the State of residence, **must be substantial in relation to the activity in the State of source**. This determination is made based upon all the facts and circumstances and takes into account the comparative sizes of the trades or businesses in each Contracting State (measured by reference to asset values, income and payroll expenses), the nature of the activities performed in each Contracting State, and the relative contributions made to that trade or business in each Contracting State.
- Intended to prevent a narrow case of treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in de minimis connected business activities in the treaty country in which it is resident (i.e., activities that have little economic cost or effect with respect to the company business as a whole).



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Competent Authority Test

- A resident of one of the States that is neither a qualified person may be granted benefits under the Convention at the discretion of the competent authority of the State from which benefits are claimed.
- In making determinations, the competent authority will take into account as its guideline whether the establishment, acquisition, or maintenance of the person seeking benefits under the Convention, or the conduct of such person's operations, has or had as one of its principal purposes the obtaining of benefits under the Convention.
- Persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief under this paragraph

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