STRATEGIC WEALTH ADVISORY GROUP

Cross-border estate planning

Navigating the complexities of foreign structures with U.S. beneficiaries

Cross-border estate plans with U.S. beneficiaries can be complex.[1] Careful advanced planning is usually required to comply with U.S. taxation of foreign trusts. There is the potential for severe tax consequences if these trusts are not properly structured. Proper administration and ongoing compliance are also required to ensure adherence to applicable regulations and to mitigate the risk of penalties or unfavorable tax outcomes.

The United States employs a worldwide tax system, requiring U.S. persons to report and pay taxes on their net income, regardless of whether it is earned within the U.S. or abroad.[2] Non-U.S. persons are generally subject to U.S. tax payment and filing requirements on income and certain gains from U.S. sources and on income or gains that are effectively connected with a U.S. trade or business. Foreign investors also are generally not subject to taxes on interest and certain capital gains.[3]

While foreign investors enjoy certain advantages from an income tax perspective in the U.S., they could be exposed to the U.S. estate tax if they hold U.S. situs assets[4] in their personal names. For example, if an individual who is a tax resident in Mexico invests in U.S. securities in his personal name, he or she would be subject to up to 40% estate tax in the U.S. on amounts greater than $60,000.[5]

As a result, cross-border families where the benefactor is a non-U.S. resident may want to consider establishing foreign structures to protect them against the U.S. estate tax. These structures may also allow these benefactors to enjoy the favorable income tax treatment that is available for foreign investors.

Part I:

Caught in the throwback: U.S. beneficiaries of foreign non-grantor trusts

Non-U.S. persons typically use foreign entities to protect their U.S. situs assets from the U.S. estate tax. This standard planning technique has traditionally used a foreign trust established by the non-U.S. person, typically a grantor trust. This kind of trust means that the non-U.S. person is treated as owning the assets of the trust for U.S. income tax purposes. The trust, in turn, owns a non-U.S. corporation, with assets that were contributed by the foreign grantor.

With this structure in place, the non-U.S. corporation can invest in U.S. situs assets, avoiding U.S. estate tax because upon death, the grantor is deemed to own, through the trust, the stock of a non-U.S. corporation. Consequently, the foreign grantor is not treated as the owner of the U.S. situs assets since they are owned by the foreign corporation. In this arrangement, the non-U.S. corporation is known as an estate tax blocker or foreign blocker because it blocks direct ownership of the U.S. situs assets by the foreign investor/grantor for U.S. estate tax purposes.

Typically, this structure does not create any tax consequences for U.S. beneficiaries until the foreign grantor passes away. Upon the death of the grantor, the trust becomes a non-grantor trust, leaving the U.S. beneficiaries as the indirect owners of the foreign blocker. This can pose significant challenges and punitive tax consequences to U.S. beneficiaries as a result of the application of anti-deferral rules. Furthermore, there are significant reporting obligations associated with these trusts, and failure to comply can result in harsh penalties.

Anti-deferral rules

Generally, when income is generated by a non-grantor trust, it becomes taxable to the trust beneficiary at the time of distribution.

- If a domestic non-grantor trust does not distribute all of its income to the beneficiary, the trust itself would have to pay the income taxes, as domestic non-grantor trusts are U.S. taxpayers subject to federal income tax on worldwide income.
- Foreign non-grantor trusts are considered non-U.S. residents, and as such, they are only subject to U.S. income tax if they generate U.S.-sourced income. Therefore, the trust's foreign income would remain untaxed by the U.S. until it is distributed to a U.S. beneficiary. This concept is known as tax deferral, where the payment of taxes is postponed, potentially resulting in significant financial advantages as the untaxed income can continue to be reinvested without tax loss.

To prevent the accumulation of untaxed income by foreign non-grantor trusts, the U.S. system has implemented a comprehensive anti-deferral regime. This regime applies to both foreign non-grantor trusts and to foreign corporations and it is specially designed to discourage the indefinite deferral of income tax liability for U.S. persons.

The anti-deferral regime includes throwback rules for the taxation of distributable net income (DNI) undistributed net income (UNI) of foreign non-grantor trusts, as well as rules for the income taxation of U.S. persons who own controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs).

In this first part, we discuss the potential risks and consequences that U.S. beneficiaries of foreign trusts may face in the absence of proper planning.

Throwback rules or throwback tax

The throwback rules target the realized income and gains of foreign trusts that are not distributed to a U.S. beneficiary until a later year. Any undistributed net income is taxed at the highest ordinary income tax rates upon distribution, regardless of their original classification as capital gains. In addition, an interest charge is generally applied, compounding over the period during which the income was accumulated in the trust, to account for the deferral of the tax payment during that period of time.

Certain foreign trusts, specifically foreign non-grantor trusts, can trigger these throwback rules for U.S. beneficiaries. Therefore, a key consideration in proper planning for U.S. beneficiaries lies in the significance of a foreign trust being classified as a *non-grantor trust* or as a *grantor trust* to potentially mitigate the impacts of the throwback tax.

A comparison of foreign grantor and foreign non-grantor trusts

Foreign grantor trust	Foreign non-grantor trust
U.S. income and gains of a foreign grantor trust are taxable directly to the foreign grantor[6] and are not subject to the throwback regime.	A foreign non-grantor trust is subject to U.S. income tax on U.S. income that is effectively connected with a U.S. trade or business, gains from the sale of U.S. real property interests, and certain other U.S. income. U.S. and foreign income distributed from a foreign non-grantor trust to a U.S. beneficiary could be subject to the throwback regime.
A foreign grantor trust must: • Be revocable by the grantor; or • Allow distributions only to the grantor and/or the grantor's spouse during the grantor's lifetime.[7]	A foreign non-grantor trust is: • Any trust that is not a grantor trust is considered a non-grantor trust; typically the grantor has no power or rights over the trust assets.
Foreign grantor trusts become foreign non-grantor trusts upon the passing of the foreign grantor. All foreign trusts that do not qualify as grantor trusts are characterized as non-grantor trusts.	Foreign non-grantor trusts are separate taxpayers for U.S. federal tax purposes.

Distributing income from a non-grantor trust

A domestic non-grantor trust's distributable net income (DNI) generally consists of its taxable income for the taxable year, often net of the trust's capital gains, with certain adjustments. Distributions made by a domestic non-grantor trust first constitute DNI. To the extent that the distributions exceed the trust's DNI, they are a non-taxable distribution of principal for the U.S. beneficiaries. The trust will receive an income tax deduction for any DNI distributed to the beneficiaries, such that the trust will pay tax only on undistributed income and capital gains.

Distributions from a domestic non-grantor trust are taxable in the hands of the recipient beneficiaries to the extent they constitute DNI. Capital gains of a domestic non-grantor trust are often excluded from DNI and are, therefore, taxed to the trust, rather than the beneficiaries.

However, the same tax treatment does not apply to foreign non-grantor trusts. First, the DNI of a foreign non-grantor trust would include the trust's capital gains. Furthermore, if a foreign trust does not distribute all of its DNI in the current year, the after-tax portion of the undistributed DNI will become undistributed net income (UNI). UNI is subject to the onerous throwback rules which attempt to replicate the taxation of the beneficiary as if the beneficiary had received the income in the year in which it was earned by the trust. If a trust has UNI from multiple years, any distribution of UNI is deemed to be a proportionate share of each year's UNI.

Therefore, not only will UNI be taxed at the recipient's marginal income tax rate, but also any capital gains accumulated by a foreign trust for distribution in a later taxable year will lose its favorable capital gains tax rate and instead be taxed at the higher ordinary income tax rates.

In addition, the throwback rule adds an interest charge to the taxes on a UNI throwback distribution. This additional interest charge is designed to offset the benefits of tax deferral. The interest charge is calculated based on the number of years elapsed between when the income was earned and when the UNI was actually distributed. The interest is assessed at the rate applicable to underpayments of tax and compounded daily.[8]

The UNI throwback regime can result in significant tax disadvantages for U.S. beneficiaries who receive distributions from a foreign non-grantor trust. Careful review is required when establishing a trust with U.S. beneficiaries to understand:

- Is the trust treated as grantor or non-grantor for U.S. tax purposes?
- Who is the grantor of the trust and who are the beneficiaries?
- Is the trust considered foreign or domestic under U.S. law?

Proper tax advice is essential to mitigate potential adverse consequences where U.S. beneficiaries are concerned, including when adopting a U.S.-friendly investment strategy. Both the beneficiaries and the trustee should understand and be familiar with specific U.S. tax and reporting obligations applicable to the different types of trusts as well as the underlying entities and investment holdings.

Strategies to address throwback rules

The most common planning tools to mitigate the adverse tax consequences of the throwback rules are:

1. A U.S. grantor trust that is considered foreign for U.S. tax purposes, as per the U.S. tax code, and that becomes a *domestic* non-grantor trust upon the passing of the foreign settlor.
2. A foreign non-grantor trust that domesticates by subjecting the trust to the jurisdiction of the U.S. courts and giving a U.S. person authority to control all substantial decisions of the trust.
3. A foreign non-grantor trust that decants the trust assets to a domestic trust where the income can be accumulated without being subject to the throwback rules.
4. A foreign non-grantor trust that requires the distribution of income or allows for trustee discretion to distribute all income to its U.S. beneficiaries in order to avoid the issues of UNI and DNI.

It is vitally important that trustees, grantors and beneficiaries understand the implications, take appropriate action and plan ahead for the consequences of a foreign trust having a U.S. connection that might expose the trust to U.S. income taxation, e.g., a trust having beneficiaries who are U.S. persons or beneficiaries who are considering becoming U.S. persons. A properly established structure can help to minimize adverse tax consequences and should be regularly reviewed as circumstances change.

Part II:

The challenge of U.S. CFC and PFIC rules, for U.S. persons

In Part II, we discuss the potential risks and consequences that U.S. beneficiaries may face when they are indirect owners of foreign corporations or certain foreign investments. This includes the rules that govern the treatment of controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs).

In general, the income of foreign subsidiary corporations will not be taxed in the U.S. until dividends are distributed to the U.S. shareholders. This is known as tax deferral, which is the general expectation of clients. However, in the U.S., tax deferral may be overridden by provisions accelerating the imposition of U.S. tax on U.S. shareholders of certain foreign corporations. As a result, income may be taxed before a dividend is distributed.

What are CFC rules?

A foreign corporation is a CFC when more than 50% of the vote or value of the stock is owned, directly or indirectly, by U.S. shareholders, which can be individuals or entities. A U.S. shareholder is defined as a U.S. person who owns 10% or more of the total combined vote or total value of the stock of the CFC.

Historically, the CFC rules were implemented to disincentivize U.S. persons and entities from making investments in foreign companies, and instead more attractive for U.S. persons and U.S. entities than investing in domestic corporations. The CFC rules reduce the tax deferral opportunities for U.S. corporations with operating businesses overseas.

However, the CFC regime and its complex attribution rules can negatively impact U.S. shareholders and even U.S. beneficiaries of a trust owning a foreign corporation. This is because, under the CFC rules, U.S. persons are taxed on their pro rata share of certain types of income of the CFC (under Subpart F), regardless of whether such earnings are distributed to the U.S. shareholders. In addition, certain attribution rules can apply to attribute ownership of shares in the foreign corporation to U.S. trust beneficiaries thereby also triggering taxation on a pro rata share of such income.

U.S. beneficiaries of a trust that owns a CFC face additional challenges with respect to the basis adjustment to their interest in the trust. Since rule changes that went into effect in 2017, achieving both estate tax protection and a basis adjustment for the estate of the foreign grantor has become increasingly difficult.

The pre-2017 planning landscape for U.S. beneficiaries of foreign trusts with CFCs

Traditional structure using the 30-day rule

Tax obligations associated with a foreign corporation are attributed to the foreign grantor in the case of a foreign grantor trust. However, upon the death of the grantor, the trust becomes a non-grantor, which means it is subject to different taxation rules.

To avoid triggering the onerous CFC rules following the foreign grantor's death, the non-U.S. corporation used to be able to immediately make a U.S. entity classification election (known as a 'check-the-box' election) indicating that the entity was to be disregarded for U.S. federal income tax purposes. This estate planning technique was a powerful tool before 2017, when U.S. persons inherited foreign holding companies that were part of a structure created to protect U.S. investments from the U.S. estate tax.

By making a check-the-box election to be treated as a disregarded entity within 30 days after the date of death, the foreign corporation would be a CFC for less than 30 days during the year (30-day rule). Since U.S. shareholders of a CFC (including indirect shareholders through a trust) were not taxable on CFC Subpart F income unless the foreign corporation was classified as a CFC for more than 30 days during the year, the U.S. beneficiaries would not need to report this foreign income if the election was properly executed. Importantly, they would also be entitled to a basis adjustment in the U.S. securities held by the foreign entity.

Unfortunately, the above strategy was rendered largely obsolete by the Tax Cuts and Jobs Act of 2017 (TCJA), which made significant changes to the Internal Revenue Code of 1986. One of the key changes was the repeal of the 30-day rule for CFCs. Without the flexibility of the 30-day rule, the foreign corporation is potentially subject to immediate CFC classification and tax treatment following the foreign grantor's death. Therefore, making a check-the-box election effective even a few days after the date of death may result in significant capital gains taxable to the U.S. beneficiaries of a foreign non-grantor trust owning a CFC.

Consequently, timing of the check-the-box election was critical in order to minimize the income tax issues for the U.S. beneficiaries, but also to prevent any U.S. situs assets owned by the foreign entity from being subject to U.S. estate tax upon the death of the foreign grantor.

How the elimination of the 30-day rule impacted CFCs

Prior to the TCJA	After the TCJA
The U.S. shareholder of a CFC is subject to U.S. tax on its pro rata share of the CFC's Subpart F income, but only if the U.S. shareholder owns stock in the CFC for an uninterrupted period of 30 days or more during the year. The foreign corporation could have made a check-the-box (CTB) election to be treated as a disregarded entity, for U.S. federal income tax purposes, thereby avoiding the CFC rules. If the effective date of the CTB election was between the 2nd and the 30th day after the foreign grantor's death, they would have obtained estate tax protection on U.S. situs assets, and the U.S. beneficiaries would not be taxed on such assets under the CFC rules. The CTB election would cause the foreign corporation to be treated as liquidating without triggering income tax for the foreign corporation. The stock of the foreign corporation received a basis adjustment equal to the value on the grantor's date of death. As a result, only the appreciation in the investment portfolio between the foreign grantor's death and the CTB election, if any, would be subject to U.S. federal income tax.	A foreign corporation is a CFC and a U.S. shareholder is subject to U.S. federal income tax on the CFC's Subpart F income if the U.S. shareholder owns the foreign corporation for any period of time. The U.S. shareholder does not need to own stock in the CFC for an uninterrupted period of 30 days or more during the year in order to trigger the CFC rules. As a result, the CTB election would not produce the same results; if the election is made before the foreign grantor's death, the investment portfolio would be subject to U.S. estate tax and if the election is made after death, the corporation would be considered a CFC and therefore U.S. shareholders (including trust beneficiaries, if applicable) would be subject to U.S. federal income tax on their pro rata share of any Subpart F income, even if the foreign corporation has been a CFC for only one day during the tax year.

Post-2017 planning strategies for U.S. beneficiaries of foreign trusts with CFCs

Following the repeal of the 30-day rule by the TCJA, the primary objectives remain the protection of a non-U.S. person's estate from U.S. estate taxes, achieving a basis adjustment, and mitigating the adverse effects of the CFC regulations on U.S. beneficiaries of foreign trusts. Under these new rules, new strategies are required to address these challenges. Some of the more common strategies are covered below, although each case would require a comprehensive analysis.

Strategy 1: Avoid U.S. situs assets, receive a basis adjustment

The repeal of the 30-day rule is only an issue for those who invest in U.S. situs assets since it requires making a choice between avoiding U.S. estate taxes or triggering CFC classification that could potentially generate adverse income tax implications for U.S. beneficiaries of a foreign trust.

If investments are limited to non-U.S. situs assets, a simple foreign corporation owned by a foreign trust could be a solution. The non-U.S. situs assets are not subject to U.S. estate tax and although the foreign corporation is technically not necessary, the CTB election of the foreign corporation, made effective a day before the foreign grantor's death, allows for a basis adjustment in the assets held in the portfolio, thereby also avoiding any CFC income tax implications for the U.S. beneficiaries.

Strategy 2: Separate U.S. situs and foreign situs assets

Given the disparate treatment of U.S. situs and foreign situs assets, another approach to mitigating the federal income tax impact on U.S. beneficiaries inheriting potential CFCs is to allocate foreign assets and U.S. situs assets into separate structures.

Foreign assets could be held in the single foreign corporation owned by the foreign trust. The foreign corporation would make a CTB election to be treated as a disregarded entity, effective immediately before the foreign grantor's death. This would not trigger U.S. estate taxes, because there would be no U.S. situs assets in the investment portfolio. At the same time, the CTB election avoids the CFC rules for the U.S. beneficiaries, while generating a basis adjustment for the assets owned by the foreign corporation. The U.S. situs assets could be held by a separate foreign corporation. This separate entity would be considered a CFC, but only the assets in the separate entity's portfolio would be subject to the adverse CFC rules.

Another option is to allocate the U.S. situs assets to a foreign corporation that would allow CTB elections to be treated as a partnership for federal income tax purposes, effective the day before the foreign grantor's death. The election to be treated as a partnership would trigger a deemed liquidation of the foreign corporation, which may result in a basis adjustment. Since the foreign corporation is treated as having been terminated through its deemed liquidation under the check-the-box regulations, this effectively eliminates the impact of the CFC rules.

Strategy 3: The Diamond Structure

The Diamond Structure, also referred to as the Multi-Tier Structure or Triple Blocker Structure, has become a common solution to provide estate tax protection for the foreign grantor combined with a basis adjustment for assets received by U.S. beneficiaries.

In this strategy, U.S. situs assets would be held in a foreign blocker corporation owned in equal shares by two foreign holding companies.[9] The foreign holding companies would be owned by a foreign grantor trust created by the foreign grantor. Upon the foreign grantor's death, the trust would become a non-grantor trust, and the U.S. beneficiaries would become indirect owners of the foreign block corporation and the two foreign holding companies. A CTB election is made to treat the foreign blocker as a disregarded entity for U.S. federal income tax purposes, effective prior to the date of death. This election would cause a deemed exchange of the foreign blocker's shares for the foreign blocker's assets (that is not taxable for the foreign holding companies) and would result in a basis adjustment in the assets in the portfolio owned by the foreign blocker. Because the election for the foreign blocker would be filed with an effective date (and deemed liquidation) prior to death, the foreign blocker never becomes a CFC. The two foreign holding companies each would also make a CTB election to be treated as a disregarded entity for U.S. federal income tax purposes, effective after the date of death. Therefore, the foreign holding companies would be CFCs. The U.S. beneficiaries would become indirect owners of the CFCs, but there would be no U.S. estate tax, and the gain, if any, would be expected to be minimal as the assets received a basis adjustment as a result of the CTB election by the foreign blocker. This strategy can also be used without the use of a trust, where the non-U.S. person owns the foreign holding companies directly.

Although common, the Diamond Structure should not automatically be selected over a single foreign corporation, as there are several factors that must be analyzed on a case-by-case basis to determine if the benefits outweigh the additional complexity of establishing and maintaining three foreign corporations.

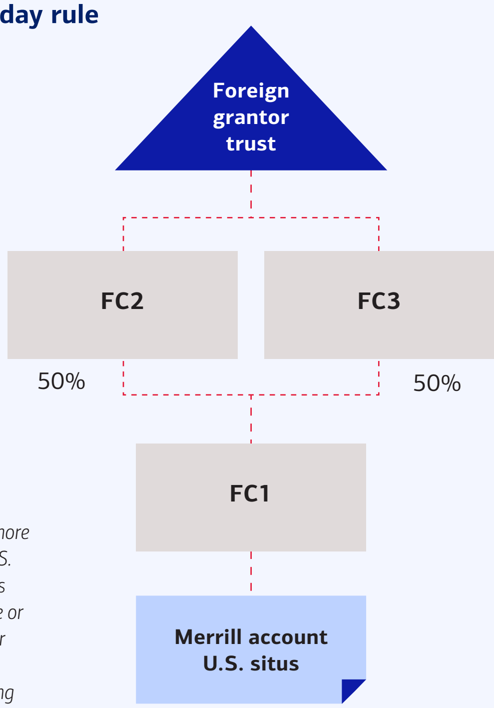
The decision would require an in-depth analysis of the type of assets and potential built-in gains and losses, as well as the higher administrative costs of implementing and maintaining the additional two holding companies.

Planning after repeal of 30-day rule "Diamond Structure"

Settlor/Grantor: Non-U.S person.

Beneficiaries: Solely the Settlor during Settlor's life; following Settlor's lifetime, outright to Settlor's U.S. children.

Investable assets: U.S. situs assets (i.e. U.S. stock, U.S. ETFs).



Note: A CFC is a foreign corporation which is more than 50% owned by "U.S. shareholders." A "U.S. shareholder" means any U.S. person who owns at least 10% of the foreign corporation by vote or value. In determining CFC and U.S. shareholder status, certain attribution rules apply. The CFC rules eliminate income tax deferral by subjecting U.S. shareholders to U.S. federal income tax on their pro rata share of the CFC's "Subpart F income" each year. Subpart F income generally includes passive income and gain.

- Foreign grantor trust is established for succession planning purposes.
- FC1 is owned by FC2 and FC3 (50/50). FC2 and FC3 should not own more than 80% each, otherwise the liquidation is considered non-taxable, and for these purposes it needs to considered a deemed liquidation.
- After the Settlor's death the Trust becomes non-grantor, and the U.S. beneficiaries become indirect owners of FC1, FC2 and FC3, which in principle would qualify as CFCs.
- FC1 would make a CTB election to be treated as a partnership for U.S. federal tax purposes; the effective date of the CTB would be prior to the foreign grantor's death. This creates a deemed exchange of FC1 shares for FC1 assets, that is not taxable for FC2 and FC3, and "steps up" the cost basis of the assets in the portfolio received by FC2 and FC3.
- Simultaneously, FC2 and FC3 would make a CTB election to be treated as disregarded entities for U.S. federal tax purposes. The effective date of these elections would be after the foreign grantor's death. FC2 and FC3 would be CFCs.
- The U.S. beneficiaries would become indirect owners of CFCs, but there would be no U.S. estate tax, and the gain — if any — is expected to be minimal as the cost basis of the assets were stepped-up by the CTB election of FC1.

Strategy 4: Refreshing assets

Finally, grantors can opt to frequently sell and repurchase the U.S. securities owned by the foreign corporation. The purpose of this technique is to periodically reset and update the cost basis of the assets, thereby minimizing the amount of unrealized appreciation that would be recognized when the blocker is eventually liquidated upon the death of the non-U.S. person.

Although the foreign corporation holding the assets would be a CFC for a short period of time, the federal income tax impact may be significantly minimized as there may be little in the way of built-in gain upon the liquidation. However, this approach results in higher investment costs and should not be used for any U.S. real property interests, as the gains upon sale would be taxable to the foreign corporation.[10]

Trustees, grantors and beneficiaries should understand the respective implications and take appropriate action to plan ahead for the consequences of a foreign trust having a U.S. connection, such as beneficiaries who are U.S. persons or who may become U.S. persons. A properly established structure can help minimize adverse federal income tax implications and should be regularly reviewed, in particular when circumstances change.

Additional planning considerations regarding PFICs

There is an additional complexity that may arise for cross-border families when trusts invest in certain offshore investment products that may eventually be indirectly owned by U.S. beneficiaries if the trust holds these assets directly or through offshore holding companies. These are governed by the passive foreign investment company ("PFIC") rules.

What is a PFIC?

A PFIC is defined as a foreign corporation primarily engaged in generating passive income or predominantly holding assets that produce passive income. Unlike the CFC rules, PFIC rules apply regardless of the level of ownership held by U.S. persons. Two primary tests determine whether a foreign corporation is a PFIC:

- **The asset test:** A foreign corporation is classified as a PFIC if 50% of the average percentage of its assets generate passive income, or
- **The income test:** A foreign corporation is classified as a PFIC if 75% or more of its gross income is considered passive.

Passive income includes rents, interest, dividends, royalties, annuities, specific types of gains from commodities, the sale of properties that produce passive income, and/or transactions involving foreign currencies.

Based on these two tests, most non-U.S. collective investment schemes typically used by international clients, such as non-U.S. mutual funds, non-U.S. ETFs, non-U.S. hedge funds and certain non-U.S. private equity funds, will be classified as PFICs. This definition applies whether the trust holds these assets directly or indirectly through offshore holding companies.

Furthermore, the holding company itself could also be classified as PFIC if it does not fall within the definition of a CFC, so the antideferral effect may be captured under either classification. PFIC rules are considered anti-deferral since they are designed to prevent U.S. persons from deferring federal income tax on passive income earned through foreign corporations or by utilizing preferential capital gains tax rates. However, the taxable event is not actually attributed to a U.S. person, but rather, a penalty tax regime applies, which may impose a higher tax rate and late payment interest.

What PFIC rules mean for U.S. beneficiaries[11]

Depending on the overall facts and circumstances following the grantor's passing, if a foreign trust holds PFICs — directly or through a foreign corporation — then the U.S. beneficiaries may be subject to federal income tax. Taxes on certain distributions from the PFIC, as well as any gain from a disposition of PFIC shares, are imposed at the highest personal federal income tax rate, along with compounding interest charges. Where the PFIC is owned by a trust, a U.S. beneficiary can be subject to the taxes even if no current distribution is made to the U.S. beneficiary. This is because, under PFIC rules, PFIC shares owned by a trust may be treated as owned directly by the trust's U.S. beneficiaries, and therefore distributions from the PFIC to the trust and dispositions of the PFIC by the trust are treated as distributions to, or dispositions by, the U.S. beneficiaries.

This often raises additional accounting and reporting complexities as U.S. GAAP[12] standards for accounting differ from those in Europe and other parts of the world. In many cases, multinational attorneys and accountants work together to reconstruct each element of the individual investments associated with a mutual fund in order to determine the cost basis and assess whether the underlying investment has generated a taxable gain or loss in a given tax year.

Finally, although gain from the disposition of a PFIC is taxed as ordinary income, losses from the disposition of a PFIC are treated as capital losses, meaning a loss from a PFIC cannot offset a gain from a PFIC. U.S. beneficiaries are also required to report each separate foreign mutual fund PFIC on the IRS Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund."

Strategies to address PFIC rules

There are some elections that can be filed to help mitigate the effects of PFIC reporting and federal income taxation:

- A U.S. person who directly or indirectly owns the shares of a PFIC can elect to be taxed on the pro rata share of the PFIC's earnings and profits using a Qualified Electing Fund strategy. With this election, the U.S. owner of the PFIC is taxed on its share of the ordinary income and net capital gains, essentially in the same way a partner in a partnership is taxed. This is only feasible if the PFIC provides the information needed to calculate the U.S. owner's federal income tax liability, which is sometimes not available.
- If the shares of the PFIC qualify as marketable stock according to Section §1296(e),[13] a U.S. person who directly or indirectly owns these shares may elect a mark-to-market valuation option. This election allows the taxpayer to recognize a gain or loss on the PFIC each year as if they had sold the PFIC at fair market value at the end of each tax year. Although still taxed at ordinary income rates on unrealized gains, the election would avoid the compounded interest that applies under the punitive PFIC tax regime, and any losses may be treated as ordinary income losses.

Determining the appropriate election and the most effective approach for dealing with PFICs requires careful consideration with a tax advisor and will depend on many factors including: the specific circumstances of each individual case, the accounting information available to the U.S. beneficiary, whether the trust was structured to qualify for a basis adjustment, the structure of the PFICs holdings, and how the check-the-box planning was implemented upon the foreign trust grantor's passing.

In summary, investing directly or indirectly through a CFC or PFIC can result in adverse U.S. federal income tax treatment, significant additional costs for tax compliance and possible interest penalties for U.S. persons. Managing the complexities of the throwback rules, CFC and PFIC rules for U.S. beneficiaries requires careful planning and a deep understanding of the applicable U.S. federal income tax laws. It is essential to consult with an experienced international tax attorney in the U.S. to develop a strategy that aligns with the specific circumstances of each family.

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About the authors

MARIA DEL CARMEN DIEZ

Director, International Private Wealth Strategist,
Strategic Wealth Advisory Group

Maria advises global clients throughout Latin America with interests in estate and other wealth planning services in conjunction with their International Financial Advisors. She has over 19 years of experience as an international tax attorney. Previously, she was a senior tax attorney in Ernst & Young Venezuela, where she advised on cross-border transactions and international tax planning strategies for inbound and outbound investments, especially from the United States and Latin America. Currently, she assists families on estate and succession planning, pre-immigration planning, and international tax compliance. Maria is an Attorney at Law* in Venezuela and Spain. She received her Master's degree in Tax Law and a LL.M in International Legal Practice from IE Business School in Madrid, Spain. She also holds the Series 7 and 66 FINRA registrations and is a member of the Society of Trust and Estate Practitioners in Miami. Maria is fluent in English and Spanish.

JOHANNA GIANNI

Managing Director, International Private Wealth Strategist,
Strategic Wealth Advisory Group

Johanna assists international clients with interests in legacy and other wealth planning services, working in conjunction with their International Financial Advisors. She has over 29 years of experience in delivering tailored wealth structuring and cross-border solutions for international high net worth individuals. Her extensive expertise in offshore structuring solutions comes from a combined background in the areas of trust administration, client relationship management, and product development acquired in fiduciary roles both in Switzerland and in Miami. Johanna received her B.S. in Economics from American College of Switzerland and her Master's degree in International Business and Economic Development from the University of Reading in England. She also holds the Series 7 and 66 FINRA registrations and is a member of the Society of Trust and Estate Practitioners. Johanna is fluent in English and Spanish, and conversant in French.

** Members of the Strategic Wealth Advisory Group do not provide tax or legal advice.*

Endnotes

[1] U.S. beneficiaries (and U.S. persons) for federal income tax purposes mean U.S. Citizens, Green Card holders and those who meet the substantial presence test, and, with respect to federal transfer taxes, U.S. citizens, Green Card holders, and those domiciled in the U.S.

[2] U.S. persons are also subject to reporting obligations on certain foreign assets.

[3] Nonresident aliens are subject to the U.S. government's taxing authority when A) they derive certain types of U.S. source income: (i) Income effectively connected with a U.S. trade or business is generally taxed at graduated federal income tax rates; and (ii) U.S. source income that is considered "fixed, determinable, annual, or periodic" (FDAP) generally are subject to a 30% withholding tax; or (B) they derive from the disposition of certain (i) U.S. real property interests or (ii) shares of U.S. companies predominantly holding U.S. real property interests.

Note that FDAP income is passive income such as interest, dividends, rents or royalties. Generally, dividends are subject to a non-refundable withholding tax of 30% (unless a reduced rate is applicable under a Treaty to Avoid Double Taxation), and most interest income is generally exempt for nonresident aliens, such as interest on certain deposits with banks, financial institutions and insurance companies, and portfolio interest (which includes interest on most publicly offered debt instruments). In general, income from real property located in the United States that is owned by a nonresident alien is subject to a 15% withholding tax.

Capital gains generally are not subject to U.S. tax (or withholding) for nonresident aliens, unless connected to a U.S. trade or business. Note: If your only U.S. business activity is trading in stocks, securities, or commodities (including hedging transactions) through a U.S. resident broker or other agent, you are NOT engaged in a trade or business in the United States.

[4] U.S. situs assets generally include real estate located in the U.S., tangible personal property located in the U.S., cash held in a U.S. safe deposit box or brokerage account, and stocks of U.S. formed corporations (regardless of where held) and U.S. formed mutual funds (regardless of where held). The estate of a non-U.S. person continues to be entitled to the longstanding tax credit of USD $13,000 (which is equivalent to an exemption on the first USD $60,000 in the value of U.S. situs assets). For additional information refer to the "United States estate tax applicable to non-U.S. Domiciliaries" publication.

[5] Non-U.S. persons do not receive the benefit of the $15MM estate tax deduction available for U.S. persons, they only receive a $60,000 exemption for estate and gift tax purposes.

[6] A grantor for purposes of Section 679 is defined in Treas. Reg. Section 1.671-2(e) to include any person to the extent such person either creates the trust or, directly or indirectly, makes a gratuitous transfer to the trust, as well as any person who acquires an interest in a trust from a grantor of the trust if the interest is acquired is an interest in certain special purpose trusts. In addition, if one person creates or funds a trust on behalf of another person, both persons may be treated as a grantor with respect to such a trust. Except as the context otherwise requires, references to "Section" herein are to sections of the Internal Revenue Code of 1986, as amended.

[7] Note that this rule is much more restrictive than the U.S. grantor trusts rules which allow for irrevocable trusts to be classified as grantor trusts.

[8] Different rules apply to accumulations made in 1995 or earlier.

[9] Neither foreign holding company should own more than 80% of the foreign blocker corporation, otherwise the liquidation is considered non-taxable, and for the purpose of the Diamond Structure, the liquidation should be considered a deemed liquidation.

[10] Nonresidents are exempt from capital gains tax unless the capital gains are considered Effectively Connected Income (ECI). Capital gains from the sale of U.S. real property interests would be deemed to be ECI.

[11] While the One Big, Beautiful Bill Act (OBBBA), signed into law on July 4, 2025, did not change the requirements for PFIC treatment, the attribution environment and the coordination between the PFIC and CFC rules did change, which can cause more taxpayers to fall under the PFIC regime even though the PFIC definition itself did not change.

[12] GAAP stands for Generally Accepted Accounting Principles and are a set of rules, guidelines and procedures that companies in the United States use as standardized financial reporting practice.

[13] Section 1296(e)(1) The term marketable stock means:

Any stock which is regularly traded on a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934; any exchange or other market which the Secretary determines has rules adequate to carry out the purposes of section 1296(e)(1); to the extent provided in regulations, stock in any foreign corporation which is comparable to a regulated investment company and which offers for sale or has outstanding any stock of which it is the issuer and which is redeemable at its net asset value, and section 1296(e)(1); to the extent provided in regulations, any option on stock described in section 1296(e)(1)(A) or (B).

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