

# International Taxation

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## I. New Foreign Trust Provisions

### A. FOREIGN TRUST DEFINED

Under the Small Business Job Protection Act of 1996 (the Small Business Act), a foreign trust is defined under the Internal Revenue Code of 1986, as amended (Code), as any trust other than a domestic trust.<sup>1</sup> To qualify as a domestic trust, a trust must meet two tests: (i) a court within the U.S. must be able to exercise primary supervision over the administration of the trust; and (ii) one or more U.S. fiduciaries must have authority to control all substantial decisions of the trust.<sup>2</sup> This new definition will generally apply to taxable years beginning after December 31, 1996.<sup>3</sup> Existing trusts should be amended, if necessary and permitted, to obtain a desired classification as a foreign or domestic trust.

### B. INBOUND GRANTOR TRUSTS

In general, after the enactment of Small Business Act, only U.S. citizens and residents and domestic corporations will, in general, be treated as potential grantors of foreign trusts under the Code's grantor trust rules.<sup>4</sup> Exceptions are made, however, for foreign trusts that are revocable by an nonresident alien grantor alone or with the consent of certain persons who are related to such grantor,<sup>5</sup> irrevocable trusts that may only make distributions to the nonresident alien grantor or his or her spouse during the grantor's lifetime,<sup>6</sup> certain compensatory trusts,<sup>7</sup> and certain "grandfathered" foreign trusts.<sup>8</sup> Although, if a foreign person would, but for the general rule, be treated as the grantor of a trust and the trust has a U.S. beneficiary, such beneficiary will be treated as the grantor of a portion of the trust to the extent he or she has

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1. I.R.C. § 7701(a)(31)(B) (1994).

2. *Id.* § 7701(a)(30)(E).

3. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1907(a)(3).

4. I.R.C. § 672(f)(1).

5. *Id.* § 672(f)(2)(A)(i).

6. *Id.* § 672(f)(2)(A)(ii).

7. *Id.* § 672(f)(2)(B).

8. Small Business Act § 1904(d)(2).

made direct or indirect transfers, other than gifts subject to the annual U.S. federal gift tax exclusion, to the foreign person for less than adequate consideration.<sup>9</sup>

The U.S. Treasury Department is expressly authorized to issue regulations to carry out the purpose of the foregoing general rule and its exceptions, including regulations setting forth situations in which the general rule will not apply.<sup>10</sup> Further, the U.S. Treasury Department is also expressly given the authority to recharacterize gifts, whether in trust or otherwise, from partnerships and foreign corporations to prevent avoidance of the general rule and its exceptions.<sup>11</sup>

In light of the foregoing changes to the Code made by the Small Business Act, any income distributed to a U.S. person from a foreign trust settled by a foreign person, excluding a foreign trust that is treated as a grantor trust under an exception, will potentially be taxed to such U.S. person as income. In effect, foreign trusts that do not fall into one of the exceptions will be treated as nongrantor trusts. As a result, the U.S. has expanded its tax base to tax all income distributed to U.S. persons from most foreign trusts, at ordinary rates, until all income in such trust is distributed. Moreover, because most foreign trusts will no longer be treated as grantor trusts, interest, at market rates due to a change by the Small Business Act, will be imposed on amounts of income earned in prior years and accumulated in the trust when such income is deemed distributed to U.S. persons.<sup>12</sup>

Further, new provisions were enacted under the Small Business Act to combat perceived abuses arising through "indirect" distributions from foreign nongrantor trusts. For example, under the Code as amended by the Small Business Act, if a U.S. beneficiary of a foreign trust or a U.S. relative of such beneficiary receives a loan of cash or marketable securities from a foreign nongrantor trust, the value of such loan will generally be taxed as a constructive distribution to the beneficiary.<sup>13</sup> Moreover, in general, any amount directly or indirectly paid to a U.S. person from a foreign nongrantor trust of which the U.S. person is not the grantor shall be deemed, in the year of payment, to have been directly paid by such foreign trust.<sup>14</sup>

### C. OUTBOUND GRANTOR TRUSTS

In general, prior to the Small Business Act, a U.S. grantor of a foreign trust with U.S. beneficiaries was taxed on the income of the foreign trust as if the grantor directly owned the trust's assets.<sup>15</sup> An exception to such rule allowed a U.S. person to sell property, at fair market value, to a foreign trust with U.S. beneficiaries without being treated as the trust's grantor, provided all of the gain, if any, was realized upon the transfer and recognized either immediately or under the installment sale provisions.<sup>16</sup> The Small Business Act kept this exception subject to modifications.

Under new provisions applicable to all property transfers to foreign trusts after February 6, 1995,<sup>17</sup> a transfer to a foreign trust by a U.S. person qualifies for the fair market value sale exception provided the U.S. person receives consideration having a value at least equal to the property transferred to the trust. However, except as provided in regulations, certain debt obligations of, or obligations guaranteed by, the trust, any grantor or beneficiary of the trust,

9. I.R.C. § 672(f)(5).

10. *Id.* § 672(f)(6).

11. *Id.* § 672(f)(4).

12. *Id.* § 668(a).

13. *Id.* § 643(i).

14. *Id.* § 643(h).

15. *Id.* § 679(a)(1) as amended by the Small Business Act.

16. *Id.* § 679(a)(2)(B) as amended by the Small Business Act.

17. Small Business Act § 1903(g).

or certain persons related to any such grantor or beneficiary will be disregarded for purposes of the fair market value sale exception.<sup>18</sup>

Accordingly, a U.S. person will be deemed to be a grantor of a foreign trust if he or she transfers property to a foreign trust in exchange for notes or other similar instruments. Alternatively, a foreign trust with U.S. beneficiaries will not be a grantor trust as to a U.S. person who sells property to the trust provided the trust pays the U.S. person full market value for the property and the U.S. person recognizes the appropriate gain at the time of the transfer.

Moreover, under newly enacted provisions of the Small Business Act, if a U.S. citizen or resident transferred property to a domestic trust and, while the U.S. citizen or resident is alive, the trust becomes a foreign trust, the U.S. citizen or resident shall be treated as if he or she transferred to the trust on the date on which the trust becomes a foreign trust that portion of the trust attributable to the property that was previously transferred to the trust by him or her.<sup>19</sup> Thereafter, such U.S. person may be considered, under Code § 679, the grantor of the trust and taxed on its income. Additionally, if a U.S. trust becomes a foreign trust, any property that was transferred by a U.S. grantor to the trust prior to the trust becoming a foreign trust will be subject to an excise tax.<sup>20</sup>

Newly enacted provisions of the Small Business Act also provide that, with respect to a transfer to a foreign trust, a foreign beneficiary of a foreign trust will not be a U.S. person for purposes of Code § 679 if he or she becomes a U.S. person more than five years after such transfer.<sup>21</sup> Therefore, a U.S. person making a transfer to an otherwise nongrantor foreign trust will not become a grantor of such trust under Code § 679 merely because a beneficiary of such trust becomes a U.S. person after the five-year period following the transfer.

Further, after the Small Business Act, a nonresident who becomes a U.S. citizen or resident within five years of a direct or indirect transfer to a foreign trust shall be treated as making, on his or her residency starting date, a transfer to such trust of that portion of the trust attributable to his or her previous transfer to the trust during such five-year period.<sup>22</sup> Accordingly, if a nonresident alien plans to establish, or make a transfer to, a foreign trust prior to becoming a U.S. citizen or resident, he or she may do so without consequences under Code § 679(a) provided he or she settles the trust or transfers the relevant property more than five years before his or her residency starting date.

#### D. NEW INFORMATION REPORTING REQUIREMENTS AS TO FOREIGN TRUSTS

The Small Business Act imposes new information reporting requirements, and attendant compliance penalties, on U.S. persons with respect to their transfers to, their ownership of, and their interests in foreign trusts. Moreover, to the extent provided in regulations, these new requirements will also affect the obligations of U.S. persons to report their transfers to, their ownership of, and their interests in domestic trusts that have substantial activities, or hold substantial property, outside of the United States.<sup>23</sup> However, any of the new requirements may be suspended if it is determined that the United States has no significant tax interests in obtaining the required information.<sup>24</sup>

18. I.R.C. §§ 679(a)(3)(A) and 679(a)(3)(C).

19. *Id.* § 679(a)(5).

20. *Id.* § 1491.

21. *Id.* § 679(d)(3).

22. *Id.* § 679(a)(4)(A).

23. *Id.* § 6048(d)(2).

24. *Id.* § 6048(d)(4).

### 1. *Reporting Requirements as to Certain Reportable Events*

Expanded information reporting requirements will apply to certain reportable events involving foreign trusts, other than certain deferred compensation trusts and charitable trusts, that occur after August 20, 1996.<sup>25</sup> First, a U.S. person who creates a foreign trust must report the creation of the trust to the U.S. Internal Revenue Service (the "IRS").<sup>26</sup> Second, upon the death of a U.S. citizen or resident, the decedent's executor must report the decedent's death to the IRS if: (i) the decedent was treated as an owner of part of a foreign trust under the grantor trust rules; or (ii) part of a foreign trust was included in the decedent's gross estate.<sup>27</sup> Third, a U.S. person who transfers money or property, whether directly or indirectly, to a foreign trust must report the transfer to the IRS.<sup>28</sup> The preceding rule also applies to a transfer to a foreign trust by reason of death, in which case the reporting obligation falls upon the decedent's executor.<sup>29</sup> Moreover, the fact that another U.S. person may be treated as an owner of part of a foreign trust under the grantor trust rules is disregarded in determining whether a reportable transfer to the trust has occurred.<sup>30</sup> However, no reporting obligation is imposed with respect to a transfer to a foreign trust by a U.S. person if the transfer was made in exchange for consideration with a value equal to, or greater than, the value of the transferred property.<sup>31</sup>

The required written notice must be given on or before the ninetieth day after the occurrence of the reportable event or on such later day as prescribed by regulations.<sup>32</sup> The notice must contain any information required by regulations, including the amount of any money or other property transferred in connection with the reportable event, the identity of the relevant trust, and each trustee and beneficiary, or class of beneficiaries, of the relevant trust.<sup>33</sup>

### 2. *Reporting Requirements of U.S. Grantors of Foreign Trusts*

If, at any time during any taxable year of a U.S. person that begins after December 31, 1995, the person is treated as the grantor of any portion of a foreign trust under the grantor trust rules, the person shall be responsible for ensuring that the foreign trust files a return setting forth a full and complete accounting of the trust's activities and operations for the relevant taxable year, the name of the trust's U.S. agent, and any other information as prescribed by regulations.<sup>34</sup> Moreover, the U.S. person must also ensure that the foreign trust furnishes the proper information, as prescribed by regulations, to each U.S. person who is treated as an owner of part of the trust or who receives, directly or indirectly, any distribution from the trust.<sup>35</sup>

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

25. Small Business Act § 1901(d)(1).

26. I.R.C. § 6048(a)(3)(A)(i).

27. *Id.* § 6048(a)(3)(A)(iii).

28. *Id.* § 6048(a)(3)(A)(ii).

29. *Id.* §§ 6048(a)(3)(A)(ii) and 6048(a)(4)(C).

30. *Id.* § 6048(d)(1).

31. *Id.* § 6048(a)(3)(B)(i).

32. *Id.* § 6048(a)(1).

33. *Id.* § 6048(a)(2).

34. *Id.* § 6048(b)(1)(A); Small Business Act § 1901(d)(2).

35. I.R.C. § 6048(b)(1)(B).

or (ii) summonses issued by the IRS for such records or testimony.<sup>36</sup> If a foreign trust does not appoint a U.S. agent, the IRS may determine, in its discretion, the proper amount to be taken into income by a U.S. person under the grantor trust rules with respect to the trust.<sup>37</sup> However, if the trustee timely agrees, in the prescribed manner and subject to any applicable conditions, to appoint a U.S. agent, the IRS will not have the discretionary authority to determine the amount of income to be taken into account by a U.S. person under the grantor trust rules with respect to the trust.<sup>38</sup>

The relevant provisions also state that the appearance of persons or the production of records by reason of a U.S. person being a foreign trust's U.S. agent, as described above, will not subject such persons or records to legal process for any purpose other than determining the correct treatment of amounts required to be taken into account by a U.S. person under the grantor trust rules.<sup>39</sup> Also, it is explicitly stated that a foreign trust will not be deemed to have a U.S. office or permanent establishment, or to be engaged in a U.S. trade or business, solely by reason of having a U.S. person acting as the trust's U.S. agent as described above.<sup>40</sup>

### 3. Reporting Requirements of U.S. Beneficiaries of Foreign Trusts

If a U.S. person receives, after August 20, 1996, directly or indirectly, during any taxable year of the person, any distribution from a foreign trust, the person must file an information return regarding the trust for the relevant taxable year.<sup>41</sup> The fact that another U.S. person may be treated as an owner of part of the trust under the grantor trust rules is disregarded in determining whether a reportable distribution from the trust has occurred.<sup>42</sup> The return must include: (i) the name of the trust; (ii) the aggregate amount of distributions the person received from the trust during the taxable year; and (iii) any other information prescribed by regulations.<sup>43</sup>

If adequate records are not provided to the IRS so that the IRS can determine the proper tax treatment of a distribution to a U.S. person from a foreign trust, the distribution will be treated as a taxable accumulation distribution.<sup>44</sup> However, to the extent provided by regulations, this characterization rule will not apply to a trust if the trust elects to appoint a U.S. agent to act as the trust's limited agent solely for purposes of the application of certain investigative provisions of U.S. tax law.<sup>45</sup>

### 4. Applicable Penalties

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

36. *Id.* § 6048(b)(2)(B).

37. *Id.* § 6048(b)(2)(A).

38. *Id.* § 6048(b)(2)(B).

39. *Id.*

40. *Id.*

41. *Id.* § 6048(c)(1).

42. *Id.* § 6048(d)(1).

43. *Id.* § 6048(c)(1).

44. *Id.* § 6048(c)(2)(A).

45. *Id.*

reportable amount.<sup>46</sup> The term "gross reportable amount" means: (i) with respect to a so-called reportable event (*e.g.*, the creation of a foreign trust by a U.S. person), the gross value of the property involved in the reportable event determined as of the date of such event; (ii) with respect to a U.S. person required as the grantor of a portion of a foreign trust to ensure the filing of a return or notice by the trust, the gross value of the portion of the trust's assets, as of the close of the relevant taxable year, treated as being owned by such person; and (iii) with respect to a U.S. person receiving distributions from a foreign trust, the gross amount of the reportable distributions.<sup>47</sup>

If any failure continues for more than ninety days after the day on which a notice of the failure is mailed to the person required to pay a penalty as described above, an additional \$10,000 (U.S.) penalty for each thirty-day period, or fraction thereof, during which the failure continues after the expiration of the ninety-day period is imposed.<sup>48</sup> This additional penalty may not, as to any failure, exceed the gross reportable amount at issue.<sup>49</sup>

No penalty shall be imposed if the failure was due to reasonable cause and not willful neglect.<sup>50</sup> However, the fact that a foreign jurisdiction would impose a civil or criminal penalty on the relevant taxpayer, or any other person, for disclosing the required information is not reasonable cause for the failure.<sup>51</sup> Accordingly, bank secrecy laws will not excuse a failure to satisfy the relevant requirements.

## II. Notice of Large Gifts Received from Foreign Persons

Under the Small Business Act, new information reporting requirements are imposed on U.S. persons, other than certain tax-exempt charitable organizations, with respect to foreign gifts received after August 20, 1996, in taxable years ending after such date.<sup>52</sup> For purposes of the new requirements, the term "foreign gifts" means amounts received from persons, other than U.S. persons, which the recipient treats as gifts or bequests.<sup>53</sup> However, such term does not include certain gifts made by a donor through certain qualified direct payments of the donee's medical or tuition bills.<sup>54</sup>

If the [total] value of foreign gifts received by a U.S. person during any taxable year exceeds \$10,000 (U.S.), the person must furnish, at the time and in the manner as prescribed by regulations, any required information regarding each foreign gift received during the relevant taxable year.<sup>55</sup> The reporting threshold will be subject to a cost-of-living adjustment.<sup>56</sup> If a U.S. person fails to timely furnish the required information regarding a foreign gift, the tax consequences of the receipt of the gift shall be determined by the IRS, and the U.S. person may be subject to a penalty.<sup>57</sup>

46. *Id.* § 6677(a); Small Business Act § 1901(d)(3).

47. I.R.C. § 6677(c).

48. *Id.* § 6677(a).

49. *Id.*

50. *Id.* § 6677(d).

51. *Id.*

52. Small Business Act § 1905(c).

53. I.R.C. § 6039F(b), *as added by* the Small Business Act.

54. *Id.*

55. I.R.C. § 6039F(a), *as added by* the Small Business Act.

56. I.R.C. § 6039F(d), *as added by* the Small Business Act.

57. I.R.C. § 6039F(c), *as added by* the Small Business Act.

### III. Expatriation Provisions

Pursuant to newly enacted provisions of the Health Insurance Portability and Accountability Act of 1996 (Health Insurance Act), the tax treatment of U.S. citizens and long-term permanent U.S. residents (*i.e.*, green card holders) who terminate U.S. citizenship or U.S. residency, respectively, has been tightened. The new provisions generally apply to former U.S. citizens who relinquished their U.S. citizenship on or after February 6, 1995, and to "long-term" permanent resident aliens who terminated their U.S. residency on or after that date.<sup>58</sup> For purposes of the new provisions, a long-term permanent resident alien is any individual who was a lawful permanent resident of the United States in at least eight taxable years out of the period of fifteen taxable years ending with the taxable year in which the termination of his or her U.S. residence occurred.<sup>59</sup>

The new provisions provide that a former citizen or long-term resident, who within ten years of the taxable year expatriated or terminated U.S. residency, respectively, having at least one of his or her principal purposes the avoidance of U.S. federal income, gift, or estate tax, is potentially subject to a stricter tax regime under Code § 877, as opposed to the typical regime applicable to a nonresident alien under Code § 871.<sup>60</sup> The stricter regime of Code § 877 will apply to tax a covered nonresident alien if his or her tax liability under such regime is greater than his or her tax liability under the regime of Code § 871 which typically applies to tax a nonresident alien.<sup>61</sup>

For purposes of such provisions, an individual had a tax-avoidance motive if: (i) the individual's average annual U.S. federal income tax liability for the previous five years exceeds \$100,000 (U.S.); or (ii) the individual's net worth on the date of expatriation or termination of residence is at least \$500,000 (U.S.).<sup>62</sup> The threshold amounts will be indexed for inflation.<sup>63</sup>

A former U.S. citizen is not, however, subject to the tax-avoidance presumptions if, within the one-year period beginning with the date of loss of citizenship and provided he or she is otherwise eligible, such former citizen submits a ruling request to the IRS asking for a determination as to whether his or her loss of U.S. citizenship had as a principal purpose the avoidance of U.S. tax.<sup>64</sup> A person is eligible to apply for a ruling if: (i) he or she was born with dual citizenship and retains his or her non-U.S. citizenship; (ii) he or she becomes, no later than the close of a reasonable period after loss of U.S. citizenship, a citizen of the country in which he or she, his or her spouse, or either of his or her parents was born; (iii) he or she was an individual not present in the United States for more than thirty days in any of the ten years prior to loss of U.S. citizenship; (iv) he or she surrendered his or her citizenship before he or she reached age eighteen and a half; or (v) he or she is permitted under subsequently prescribed regulations.<sup>65</sup> However, a "long-term" permanent resident may not apply for a ruling request to avoid the tax-avoidance presumptions.<sup>66</sup>

58. Health Insurance Act § 511(g)(1).

59. I.R.C. § 877(c)(2).

60. *Id.* § 877(a)(1).

61. *Id.*

62. *Id.* § 877(a)(2).

63. *Id.*

64. *Id.* § 877(c)(1).

65. *Id.* § 877(c)(2).

66. *Id.*

For purposes of Code § 877, the new provisions broaden the scope of U.S. source income subject to tax and qualify other rules to expand the amount of the former citizen's or resident's income subject to tax under Code § 877 as compared to Code § 871. For example, income or gain derived from stock in a foreign corporation owned, at any time two years prior to a person's loss of U.S. citizenship or termination of U.S. residency, more than fifty percent by such person (by voting power or value) will be treated as U.S. source income for purposes of Code § 877.<sup>67</sup> Moreover, the new provisions of Code § 877 also tax immediately gains on exchanges of property that give rise to U.S. source income for property that will give rise to foreign-source income, unless the taxpayer enters into a ten-year gain recognition agreement with the IRS, by which any income or gain derived from the property acquired in the exchange during such ten-year period would be taxed as U.S. source income or gain.<sup>68</sup>

Further, the new provisions also authorize the IRS to issue regulations which would cause immediate taxation upon the removal of appreciated tangible personal property from the United States or upon any other occurrence which results in a change of the source of the income or gain from the United States to any other jurisdiction.<sup>69</sup> Moreover, in determining whether a sale or exchange of property is subject to Code § 877, the ten-year coverage period of Code § 877 is suspended during any period in which an individual's risk of loss with respect to the property is substantially diminished by: (i) [the holding of a put with respect to such property;] (ii) the holding by another person of a right to acquire such property; or (iii) a short sale or any other transaction.<sup>70</sup>

For purposes of Code § 877, the new provisions also disregard the existence of any corporation which would be a controlled foreign corporation (if the expatriating shareholder was a U.S. person) which has U.S. source income.<sup>71</sup> Any U.S. source income or gain of such a corporation shall be treated as being received or accrued directly by the shareholder and not by such corporation itself.<sup>72</sup>

All U.S. citizens and "long-term" residents who terminate U.S. citizenship or U.S. residency, respectively, are required to provide detailed information concerning their assets and liabilities, foreign citizenship and residence, and foreign address to the appropriate federal agency or court depending on the scenario in which the termination occurs.<sup>73</sup> Agencies, other than the IRS, and the courts are directed to provide such information to the IRS.<sup>74</sup> Any person failing to make such a statement will be subject to a penalty for each year during any portion of which such failure continues in an amount equal to the greater of five percent of the tax required to be paid under Code § 877 for the taxable year ending during such year or U.S. \$1,000.<sup>75</sup> Moreover, the names of expatriating persons must be published in the *Federal Register*.<sup>76</sup>

67. *Id.* § 877(d)(1)(C).

68. *Id.* § 877(d)(2).

69. *Id.* § 877(d)(2)(E).

70. *Id.* § 877(d)(3).

71. *Id.* § 877(d)(4).

72. *Id.*

73. I.R.C. § 6039F, as added by the Health Insurance Portability and Accountability Act of 1996, Pub. L. No. 104-191, 110 Stat. 136 (codified in scattered sections of 26 and 42 U.S.C.). Because both the Small Business Act and the Health Insurance Act added a § 6039F to the Internal Revenue Code, the IRS has stated that it will seek a technical correction to redesignate I.R.C. § 6039F, as added by the Health Insurance Act, as I.R.C. § 6039G. Rev. Proc. 96-60, 1996-49 I.R.B. 1.

74. I.R.C. § 6039F(e), as added by the Health Insurance Act.

75. I.R.C. § 6039F(d), as added by the Health Insurance Act.

76. I.R.C. § 6039F(e), as added by the Health Insurance Act.



The applicable provisions of the U.S. federal gift and estate taxes as they apply to former U.S. citizens and former "long-term" residents were also modified to be consistent with the new income tax regime under Code § 877.<sup>77</sup> For example, the tax-avoidance presumptions were incorporated into such provisions.<sup>78</sup>

#### IV. Code § 7701: "Check-the-Box" Regulations

In general, under newly promulgated regulations under Code § 7701, certain types of foreign entities will automatically be treated as corporations for U.S. federal tax purposes.<sup>79</sup> However, a foreign entity that is recognized for U.S. federal tax purposes and not classified automatically as a corporation or as a trust will be classified as a corporation or partnership, or as a sole proprietorship or branch in the case of an entity wholly owned by one person or one corporation, as the entity's members or an authorized officer, manager, or member of the entity elect.<sup>80</sup> If no election is made for an eligible foreign entity, it will generally be treated for U.S. tax purposes as follows: (i) a partnership if it has two or more members and any member has unlimited liability; (ii) a corporation if no member has unlimited liability; or (iii) a sole proprietorship or branch if it has a single owner who has unlimited liability.<sup>81</sup>

These regulations could provide a useful planning tool for U.S. investors making outbound investments. For example, it has been suggested that U.S. multinationals may have an effective opportunity to reduce their overall worldwide tax exposure with respect to outbound investments by establishing structures using Dutch holding companies subject to the special Dutch tax regime for intra-group financing, licensing, and leasing coupled with effective use of the "check-the-box" rules as to the Dutch holding company's subsidiaries formed in the countries in which direct investment is desired.<sup>82</sup>

#### V. Proposed Withholding Regulations

The IRS has issued proposed regulations that will alter procedures pertaining to the withholding of income tax under Code §§ 1441, 1442, or 1443 on amounts paid to foreign persons, the claiming of foreign status to avoid backup withholding under Code § 3406 on certain payments, and the reporting to the IRS of payments to foreign persons.<sup>83</sup> The proposed regulations represent an effort by the IRS to reduce the burden on withholding agents and increase compliance.<sup>84</sup> A basic description of the withholding scheme of the proposed regulations is set forth below.

Under the proposed regulations, a withholding agent must generally withhold thirty percent of the gross amount of a payment of income subject to withholding made to a payee who is a foreign person unless the beneficial owner of the income is a foreign person entitled to a reduced rate of tax and for whom the withholding agent holds an appropriate withholding certificate or documentation or unless the beneficial owner is a U.S. person.<sup>85</sup> With respect

77. See I.R.C. §§ 2107 and 2501.

78. I.R.C. §§ 2107(a)(2) and 2501(a)(3).

79. Treas. Reg. § 301.7701-2(b)(8) and (c) (as amended in 1996).

80. Treas. Reg. §§ 301.7701-2(a), 301.7701-3(a) and (c)(2) (as amended in 1996).

81. Treas. Reg. § 301.7701-3(b)(2) (as amended in 1996).

82. Memorandum from D. A. Hofland, Loyens & Volkmaars (September 12, 1996) (on file with author).

83. 61 Fed. Reg. 17614, 17615 (1996) proposed Apr. 22, 1996.

84. 61 Fed. Reg. 17614, 17617 (1996) proposed. Apr. 1996.

85. Prop. Treas. Reg. § 1.1441-1(b), 61 Fed. Reg. 17614, 17634 (1996).

to a foreign person, a withholding agent may, absent actual knowledge or reason to know otherwise, respect a beneficial owner's claim of foreign status if: (i) the withholding agent holds a valid beneficial owner withholding certificate or an intermediary withholding certificate; (ii) the withholding agent complies with the electronic confirmation procedures, if required; and (iii) the withholding agent has not been notified by the IRS that any of the information on the withholding certificate is incorrect or unreliable.<sup>86</sup> Likewise, procedures are set forth describing when a withholding agent may rely on a claim of U.S. status by a payee or beneficial owner.<sup>87</sup>

As to a foreign beneficial owner, a beneficial owner withholding certificate is a statement by which the beneficial owner represents that the owner is a foreign person and, if applicable, claims a reduced rate of withholding under Code § 1441.<sup>88</sup> In general, a withholding certificate will be valid only if: (i) it is provided on a Form W-8; (ii) its validity period has not expired; (iii) it is signed under penalties of perjury by the beneficial owner; and (iv) it contains the name, permanent residence address, and taxpayer identifying number of the beneficial owner, if required, the basis for the reduced rate of withholding claimed, if applicable, including any applicable tax treaty provisions, and any other information as may be required by the regulations under Code § 1441 or by a form or accompanying instructions.<sup>89</sup> A taxpayer identification number will be required if: (i) the beneficial owner is claiming the benefit of a reduced rate under an income tax treaty, other than with respect to dividends on stock traded on a U.S.-established financial market; (ii) an exemption from withholding because income is effectively connected with a U.S. trade or business; (iii) an exemption under Code § 871(f) for certain annuities received under qualified plans; or (iv) an exemption based on a foreign organization's tax-exempt status under Code § 501(c) or private foundation status.<sup>90</sup>

Detailed provisions regarding the issuance and use of intermediary withholding certificates are also set forth in the proposed regulations<sup>91</sup> as are specific provisions pertaining to a claim of treaty benefits.<sup>92</sup> General provisions pertaining to withholding agents, such as due diligence standards,<sup>93</sup> and withholding with respect to pass-through entities<sup>94</sup> and tax-exempt foreign organizations and private foundations<sup>95</sup> are also present.

## VI. New U.S. Tax Treaties and Protocols

In 1996, the U.S. Senate ratified the U.S.-Kazakhstan income tax treaty and protocols relating to the U.S.-Indonesia and the U.S.-Netherlands Antilles income tax treaties. Legislative action was postponed on several other treaties, including proposed treaties with Austria, Luxembourg, and Turkey, until the next congressional session. Further, new treaties with Ireland and South Africa remain in the works, while new treaties with Switzerland and Thailand have been signed. Moreover, the Treasury has also issued a new model tax treaty which includes new language regarding limitations on claiming treaty benefits.

86. Prop. Treas. Reg. § 1.1441-1(e)(1), 61 Fed. Reg. 17614, 17637 (1996).

87. Prop. Treas. Reg. § 1.1441-1(d), 61 Fed. Reg. 17614, 17636-17637 (1996).

88. Prop. Treas. Reg. § 1.1441-1(e)(2)(i), 61 Fed. Reg. 17614, 17637 (1996).

89. Prop. Treas. Reg. § 1.1441-1(e)(2)(ii), 61 Fed. Reg. 17614, 17637 (1996).

90. Prop. Treas. Reg. § 1.1441-1(e)(4)(vii), 61 Fed. Reg. 17614, 17638-17639 (1996).

91. Prop. Treas. Reg. § 1.1441-1(e)(3), 61 Fed. Reg. 17614, 17637-17638 (1996).

92. Prop. Treas. Reg. § 1.1441-6, 61 Fed. Reg. 17614, 17649-17652 (1996).

93. Prop. Treas. Reg. § 1.1441-7, 61 Fed. Reg. 17614, 17652-17653 (1996).

94. Prop. Treas. Reg. § 1.1441-5, 61 Fed. Reg. 17614, 17648-17649 (1996).

95. Prop. Treas. Reg. § 1.1441-9, 61 Fed. Reg. 17614, 17653 (1996).