Bloomberg Tax

Tax Management
International Journal™

May Guidance for Domestic Trusts Be Drawn From the Final §1.958-1(d) Regulations?

By Robert E. Ward, J.D., LL.M.[*]
WardChisholm, LLP
Vancouver, British Columbia and Bethesda, Maryland

INTRODUCTION: GUIDANCE PUBLISHED FOR DOMESTIC PARTNERSHIPS OWNING FOREIGN STOCK

On January 25, 2022, the Treasury Department and Internal Revenue Service published guidance under §958 for determinations of stock ownership in foreign corporations owned through domestic partnerships (the "Final Regulations").[2] The Final Regulations reflect the duality of partnerships: in some cases regarded as entities separate and apart from their partners and in other cases considered to be an aggregation of the partners. Partnerships are regarded as entities for purposes of determining whether any foreign corporation owned by a domestic partnership is a controlled foreign corporation (CFC) and whether any United States person is a United States shareholder (as defined in §951(b)) ("U.S. shareholder"). The entity concept is further applied to determine whether a CFC has made an investment in United States property (as defined in §956(c) ("U.S. property"), applying §1248 (gain from sale of passive foreign investment company stock), and determining whether any U.S. shareholder is a controlling domestic shareholder (as defined in Reg. §1.964-1(c)(5)).[3] In contrast, aggregate principles determine income inclusions under §951 (Subpart F), §951A (GILTI) and §956(a) (CFC investments in U.S. property), as well as other provisions of the Code and Regulations referred which specifically reference those Code provisions. With respect to income inclusions, the Final Regulations treat domestic partnerships in the same manner as foreign partnerships under §958(a)(2). Helpfully, the Final Regulations provide three examples in which entity and aggregate principles are applied.[4] For purposes of this article, the first example as illustrated by the following diagram, is sufficient.

Since PRS is a domestic partnership, it is regarded as a U.S. person.[5] Since PRS is a U.S. person that owns 100% of the combined voting power and value of the stock of FC, FC is a CFC and PRS is a U.S. shareholder. Each of these conclusions views PRS as an entity. USP is also a U.S. shareholder because it is deemed to own 95% of the stock of FC under §958(b) and under §318(a)(2)(A). In contrast, A is not a U.S. shareholder of FC because the 5% which A is deemed to own is insufficient to satisfy the 10% threshold required for characterization as a U.S. shareholder.

With regard to income inclusions arising from the ownership structure illustrated by Example 1, aggregate principles are applied. Accordingly, PRS as an entity does not exist. Instead, for purposes of §951and

---

[*] Robert E. Ward, J.D., LL.M. is a fellow of the American College of Tax Counsel who advises businesses and individuals on U.S. international and domestic tax matters from his firm's offices in Vancouver, British Columbia and Bethesda, Maryland.

This article may be cited as Robert Ward, *May Guidance for Domestic Trusts Be Drawn From the Final §1.958-1(d) Regulations?*, 51 Tax Mgmt. Int'l J. No. 6 (June 3, 2022).

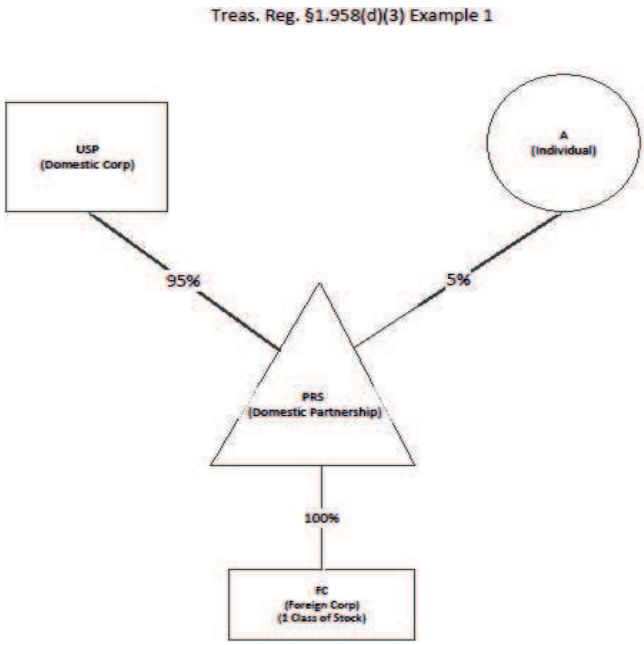
[2] T.D. 9960. All section references herein are to the Internal Revenue Code of 1986 as amended (the "Code") or the Treasury Regulations promulgated thereunder unless otherwise indicated.

[3] *See* Reg. §1.958-1(d)(2). *See generally* Carrie Brandon Elliot, *Final Regs Clarify Stock Ownership Rules for U.S. Partnerships*, Tax Notes (May 16, 2022); David Sites, Wei Fan, and Olivia Arnold, *Domestic Pass-Through Entities: New §958 Final Regulations and Proposed PFIC Regulations*, 51 Tax Mgmt. Int'l J. No. 2 (Feb. 4, 2022).

[4] *See* Reg. §1.958-1(d)(3).

[5] §7701(a)(30)(B).

ISSN 0090-4600



§951A, and USP is treated as owning 95% of the stock of FC relying solely on the provisions of §958(a). USP is a U.S. shareholder of FC. A is not. Depending upon the character of the income earned by FC, USP will have income inclusions under §951 and §951A. A will not. USP and its partners are treated in the same manner as a foreign partnership and its partners. A is not a U.S. shareholder. Nonetheless, but for the aggregate analysis required by Reg. §1.958-1(d)(1), A would be taxable on its distributive share of partnership income under the principles of §704, with a tax result similar to an income inclusion under §951 and §951A.

WHAT IF THE DOMESTIC PARTNERSHIP IS A TRUST?

Proposed regulations requested comments whether aggregate treatment should be extended to other pass-through entities such as non-grantor trusts and estates.[6] The preamble to the Final Regulations notes that only one comment was received in response to this request. That comment seized upon an important distinction in the taxation of trusts and estates. In contrast to partnerships, trusts and estates are taxable entities when those entities fail to make distributions to their beneficiaries.[7] Whether the trust or estate is, in fact, taxable on the income realized depends on whether that income is required to be distributed (in the case of a simple trust) or actually distributed (or properly paid or credited for distribution) in the case of a complex trust. The commentator noted the difficulty and complexity required to apply aggregate principles to trusts and estates which own shares of foreign corporations. The preamble to the Final Regulations confirms the complexity the comment describes and declines to extend the aggregate principles of Reg. §1.958-1(d)(1) implemented by the Final Regulations to domestic trusts and estates.

Consider the ownership structure illustrated by Example 1 if PRS 1 were replaced by a complex trust.[8]

Unlike §958(b), §958(a) applies for all purposes of subpart F, except as expressly indicated (for example, §960). The attribution rules of §958(a) apply ''primarily for use in determining the amount taxable to a U.S. shareholder under section 951(a).''[9] Section 958(a)(1) provides that stock ownership for purposes of subpart F means stock owned directly and indirectly by application of §958(a)(2). Section 958(a)(2) provides that stock of a foreign corporation owned by a foreign trust or foreign estate is to be considered as being owned proportionately by its beneficiaries. Thus, §958(a) provides no insight into the stock ownership (if any) of USP and A through a domestic trust. Section 958(b) provides that for purposes of §951(b), §954(d)(3), §956(c)(2), and §957, the constructive ownership rules of §318(a) apply ''to the extent that the effect is to treat any United States person as a United States shareholder. . .or treat a foreign corporation as a controlled foreign corporation. . . .''[10] The language of §958(b) could be read as foreclosing further application of the attribution rules of §318(a) once the CFC and its U.S. shareholder have been identified. Thus, in the preceding diagram, foreign corporation is a CFC and domestic trust is a U.S. shareholder, but §318(a) has no application to USP and A. This (most likely novel) reading of the ''to the extent'' language of §951(b) is in a sense consistent with §951(a). Section 951(a) addresses foreign stock owned through foreign entities but is silent regarding domestic entity ownership of foreign stock. Without ''looking through'' the foreign entity to its shareholders, partners, or beneficiaries who are U.S. persons, no foreign corporation could be a CFC. In contrast, there is no need to look through a domestic entity to assign CFC status to the foreign corporations owned by that domestic corporation, partnership, or trust or to find additional U.S. shareholders.

---

[6] REG-101828-19.

[7] *See generally* §641. Under §661, a trust or estate is allowed a deduction in computing taxable income for distributions (to the extent of the distributable net income of the trust) which are required to be distributed currently or properly paid or credited for distribution in the year in which the income is received by the trust or estate.

[8] A complex trust a trust which is not regarded as a grantor trust under the provisions of §671–§679 and which is not required to distribute all income currently to its beneficiaries. *Compare* §651 *with* §661.

[9] Reg. §1.958-1(a).

[10] §958(b).

Tax Management International Journal

ISSN 0090-4600

The Final Regulations do not limit U.S. shareholders to PRS1 in Example 1 and rely on §958(b) and §318(a)(2)(A) to conclude USP is also a U.S. shareholder because USP is treated as owning 95% of the stock of FC.[11] Applying the same analysis to a domestic trust and its beneficiaries, would mean beneficiaries with a sufficient requisite interest in a non-grantor domestic trust would also be U.S. shareholders. This begs the question as to how a beneficiary's interest in a domestic trust should (can) be determined. In the real world in which special allocations may be found, it is difficult to determine how much foreign stock partners should be treated as owning when their partnership (or one several tiers below) holds shares of a foreign corporation. As explained below, it is practically impossible to determine how much foreign stock beneficiaries should be treated as owning when their trust holds (even directly) shares of a foreign corporation.

Treat Similarly as a Foreign Trust?

Guidance for beneficiaries of domestic trusts may be found in the treatment of beneficiaries of foreign trusts.[12] In the case of a foreign trust, Reg. §1.958-1(c)(2) provides that ''determination of a person's proportionate interest in a . . . foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case.''[13] A ''facts and circumstances'' response to needed guidance is akin to ''I don't know, but you can guess.'' Moreover, exactly which facts and circumstances apply to determine indirect ownership varies depending upon the context. For purposes of §951(a), a person's interest in a foreign corporation is based on that person's interest in the income of the foreign corporation.[14] In contrast, for purposes of §951(b) a person's interest in a foreign corporation is based on that person's voting power.[15]

Examples 3 and 4 of Reg. §1.958-1(f), respectively, illustrate how facts and circumstances determine stock ownership by beneficiaries of foreign trusts and estates. Example 3 posits a foreign trust divided into three separate and equal shares for the benefit of three U.S. persons. Each beneficiary is deemed to own one-third of the foreign stock owned by the trust. In the case of Example 4, the foreign estate has two assets: Blackacre and ''a block of stock.'' Under the terms of the decedent's will governing the estate, the block of stock is left to a U.S. person. The stock is deemed to be owned by the beneficiary entitled to receive the stock under the terms of the will. As applied to the diagram above, USP and A own the stock of FC corresponding to their respective share of Domestic Trust and its assets.

But what are USP's and A's shares of Domestic Trust in the illustration above? Moving from the simple examples found in Reg. §1.958-1(f) to the real world in which discretionary trusts may be found to own stock of foreign corporations, a facts-and-circumstances approach quickly proves wanting. Section 318(a)(2)(B)(i) expressly provides that stock owned by a trust ''shall be considered as owned by its beneficiaries in proportion to the actual interest of such beneficiaries in such trust.''[16] This recognizes a trust may have income and remainder beneficiaries. The interests of remainder beneficiaries may be vested or contingent. The two examples in the §318 regulations which address attribution from a trust describe a situation in which an individual holds a vested remainder with an actuarial value equal of 4% of the value of the trust property. In that circumstance, 4% of the stock of the foreign corporation owned by the trust is regarded as being owned by that beneficiary.[17] Because the beneficiary's interest in the trust is a vested remainder interest instead of a contingent interest, shares owned by the beneficiary are also attributed to the trust. However, this result changes when the beneficial interest is a contingent remainder interest.[18] The beneficiary is still considered as owning 4% of the shares of the foreign corporation owned by the trust, but there is no attribution from the beneficiary to the trust. When beneficial interests in a trust or estate are apparent and fixed, assigning stock ownership may be simple, but, as explained below, does not necessarily render the outcome more certain. In the case of a foreign trust, Reg. §1.958-1(c)(2) provides that ''determination of a person's proportionate interest in a . . . foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case.''[19]

Unfortunately, in many circumstances, facts and circumstances are not much help. Based on §958(b) as applied to the ownership structure illustrated by Example 1 of Reg. §1.958-1(d)(3), it is reasonable to conclude when PRS is replaced by a domestic trust, USP is a U.S. shareholder, but A is not *if trust income and corpus were actually distributed 95% to USP and*

---

[11] *See* Reg. §1.958-1(d)(3)(i)(B)(2).

[12] *See generally* M. Read Moore, *Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts*, 108 J. Tax'n No. 2 (Feb. 2008).

[13] Reg. §1.958-1(c)(2).

[14] *Id.*

[15] *Id.*

[16] §318(a)(1)(B)(i). In the case of a grantor trust, stock of the trust is considered to be owned by the settlor regarded as the owner of trust income in corpus under the provisions of §671–§679. §318(a)(2)(B)(ii).

[17] *See* Reg. §1.318-2(c) *Ex.* 2.

[18] *Id.*, *Ex.* 3.

[19] Reg. §1.958-1(c)(2).

ISSN 0090-4600

5% to A. In contrast to a trust that has fixed shares, consider the case of a wholly discretionary trust of which USP and A are beneficiaries. In one year, the trustee may distribute all trust income to USP, in another year to A, and in another year (or perhaps several years) make no distributions whatsoever. Is USP a U.S. shareholder? Is A a U.S. shareholder? Does USP or A become a U.S. shareholder only in the year in which a distribution of 10% or more of the §951, §951A, or §956(a) inclusion of the trust is distributed to those beneficiaries? What if the trust has remainder beneficiaries whose interests may be vested or contingent? Does the presence of a remainder beneficiary and the actuarial value of that remainder interest (as §318(a)(2)(B)(i) suggests) reduce the interests of USP and A as income beneficiaries? For 60 years since enactment of subpart F in 1962, Treasury and the IRS have avoided these and related questions.

PFIC Rules

Guidance in the passive foreign investment company (PFIC) rules is similarly unhelpful. In the case shares of a foreign corporation owned directly or indirectly by an estate or nongrantor trust (foreign or domestic), ''each beneficiary of the estate or trust is considered to own a proportionate amount of such stock.''[20]

Notice 97-19

The only context in which the IRS has provided slightly more robust guidance regarding the treatment of discretionary trusts is in connection with computation of the exit tax. In that context, the ''Special rules for determining beneficial interests in Trusts'' set forth in Notice 97-19 yields results which may be fairly described as ''bizarre.'' The Notice provides that interests in property held by a trust are allocated to the beneficiaries based on ''all relevant facts and circumstances including the terms of the trust instrument, letter of wishes (and any similar document), historical patterns of trust distributions, and any functions performed by a trust protector or similar advisor.''[21] That direction implicitly acknowledges that interests in trust property change as circumstances change with the passage of time. In a desperate quest for certainty, the Notice concludes that if interests in trust property cannot be allocated among the beneficiaries based on the preceding factors, the allocations default to align with the beneficiaries' interests in the settlor's estate under principles of intestate succession. Reliance on intestate succession statutes to determine a beneficiary's interest in a trust may be suitable for a one-time event such as computation of the exit tax, but it is not well-suited for a year-after-year allocation of income inclusions under §951, §951A, and §956.[22]

As observed above, Reg. §1.958-1(c)(2) also invokes facts and circumstances to determine a shareholder's, partner's, or beneficiary's interest in a foreign corporation, partnership, or trust, but varies the manner of doing so based on the purpose of the determination. One might conclude that treating beneficiaries of a trust as U.S. shareholders based upon the distributions made by the trust in any given year provides a workable solution for allocating income inclusions §951, §951A, and §956(a). On further consideration, such a solution quickly becomes problematic. For example, if in a year in which the trust has an inclusion under §951, §951A, or §956(a) the trust in the illustration above distributes all of its income to USP, USP assumes all the burdens and attributes arising from income inclusion under those Code provisions. But what if this is the first distribution made to USP and in the 10 years preceding the distribution and the 10 years that follow all trust income were distributed to A? How is this approach affected by varying amounts of §951A and §956(a) inclusions? Discretionary trusts often have varying patterns of accumulations and distributions and varying patterns of distributions among multiple beneficiaries.

CONCLUSION: GIVEN NO EXPRESS GUIDANCE, ADOPT A REASONABLE(IF UNCERTAIN) POSITION?

A lesson should be taken from the rules that govern valuation of beneficial interests in trusts for charitable

[20] Reg. §1.1291-1(b)(8)(iii)(C).

[21] Notice 97-19, §III.

[22] Maryland Estates and Trusts Code §3-102. Intestate succession statutes are surprisingly inconsistent from state to state and entirely fact specific. For example, in the case of a decedent residing in Maryland at the time of death, the decedent's estate passes entirely to the decedent's spouse (if any) unless the decedent is also survived by one or more children or parents. When children or parents are present, the surviving spouse's share of the Maryland decedent's estate is reduced to one-half; the other half passing either to the child or children or, if no descendants, to the surviving parent or parents. Maryland Estates and Trusts Code §3-102. In contrast, the assets of an intestate decedent residing in Virginia pass exclusively to the decedent's surviving spouse (if any) unless the decedent is also survived by children or descendants who are not descendants of the surviving spouse. Children outside the marriage reduce the share of the spouse to one. Code of Virginia §64.2-200(A). By further contrast, in the case of a decedent dying intestate while residing in the District of Columbia, the surviving spouse (if any) receives all the intestate's assets unless the decedent is also survived by one or more children. The surviving children reduce the spouse's share to two-thirds or one-half, depending upon whether or not the children are also children of the surviving spouse. D.C. Code §19-302. Not only will the beneficiary's share of the trust change as the beneficiary moves from Maryland to Virginia to D.C. It will also change as members of the beneficiary's family change. Regardless of the beneficiary's state of residence, one can be fairly confident that USP is not an intestate heir of the settlor of the trust in the diagrams above and, in many circumstances, neither is A.

ISSN 0090-4600

income and estate tax deductions and assessment of gift taxes.[23] If the beneficiary's interest is not sufficiently fixed so as to be capable of valuation consistent with a similarly certain financial benefit attributable to the beneficial interest, the value is zero. In response to taxpayer abuse, Congress limited (often in very precise terms) the beneficial interests to which values could be assigned. The same approach should be taken in subpart F, as well as other areas of the Code in which tax effects and information reporting obligations are determined by beneficial interests in trusts.[24] In the case of stock of a foreign corporation owned directly or indirectly by a domestic trust, simply stop with the trust. This is truly an entity approach. If the trust in conjunction with other U.S. shareholders owns more than 50% of the stock of the foreign corporation by vote or value, the foreign corporation whose stock the trust owns will be a CFC. If the trust owns directly or indirectly enough stock of the foreign corporation to be a U.S. shareholder, the trust is a U.S. shareholder. Its beneficiaries need not be.

In addition to the difficulties in determining a beneficiary's interest in a trust as discussed herein, the literal construction of the ''to the extent'' language in §958(b) and the unwillingness of the Final Regulations to apply aggregate principles to beneficiaries of trusts and estates may be taken as supportive of the approach advocated above. However, the most compelling reason is that it is not necessary to do so. Trusts and estates are not pass-through entities when compared with partnerships and S corporations. Unless a trust or estate makes a distribution with respect to the year in which income or gain is realized by the trust or estate, the trust or estate pays the tax. If the trust or estate makes a distribution qualifying for deduction under §643, then the character rule of §663(b) will treat the distribution to the beneficiary as a distributive share of the subpart F or GILTI income of the trust or estate. While such an approach would subject A in Example 1 of Reg. §1.958-1(d)(3) to income otherwise avoided by a non-U.S. shareholder, the amount of the distribution will be certain and taxation will only occur when a distribution is made. Subpart F can end with the domestic trust. Let the rules of subchapter J do the rest.[25]

---

[23] *See generally* §170(f)(2)–§170(f)(5), §664, §2055(c)(2), §2055, §2522(c)(2), and §2702, and Treasury regulations thereunder.

[24] PFIC and foreign account reporting are two areas which immediately come to mind.

[25] For further discussion and complexities created by foreign holding companies, see ACTEC letter to LG ''Chip'' Harter, Deputy Assistant Secretary, Office of Int'l Tax Counsel, Dept. of Treas. (Mar. 8, 2019).

ISSN 0090-4600