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March 10, 2016

Karlene Lesho and Leslie Finlow
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CC:PA:LPD:PR (REG-112997-10) Room 5205
Internal Revenue Service
PO Box 7604 Ben Franklin Station
Washington, DC 20044

Via http://www.regulations.gov (REG 112997-10)

Dear Ms. Lesho and Ms. Finlow:

The American College of Trust and Estate Counsel ("ACTEC") is pleased to submit the enclosed comments on proposed regulations issued, September 20, 2015, to implement § 2801 of the Internal Revenue Code of 1986, as amended (the "Code"). 80 Fed. Reg. 54,447 (September 10, 2015).

ACTEC is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift, and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

If you or your staff would like to discuss ACTEC's recommendations, please contact Ellen Harrison, Chair of the Washington Affairs Committee, at (202) 756-8635 or by email at eharrison@mwe.com, or Leah Weatherspoon, ACTEC Communications Director, at (202) 688-0271, or by email at lweatherspoon@actec.org.

Respectfully submitted,

Bruce Stone

Bruce Stone, President

Enclosure: ACTEC Comments on Proposed § 2801 Regulations

COMMENTS OF ACTEC ON PROPOSED § 2801 REGULATIONS

Section[1] 2801 was enacted in 2008 as part of the Heroes Earnings Assistance and Relief Act[2], to impose a tax (the "§ 2801 tax") on U.S. citizens and residents ("U.S. individuals") who receive covered gifts and bequests. The § 2801 tax also applies to domestic trusts and to foreign trusts that elect to be treated as domestic trusts. A covered gift is any property acquired by gift directly or indirectly from a covered expatriate. A covered bequest is any property acquired directly or indirectly by reason of the death of a covered expatriate. A covered expatriate is a citizen or long-term lawful permanent resident who relinquished citizenship or residency on or after June 17, 2008 and who met a net worth test, a net income tax liability test or failed to certify compliance with U.S. tax obligations, subject to limited exceptions for certain dual citizens and persons who relinquish citizenship upon attaining majority. These comments refer to a covered expatriate as a "CE".

Announcement 2009-57 and Notice 2009-85[3] delayed the due date for reporting and paying the § 2801 tax until final regulations are issued. The proposed regulations continue to defer the date for reporting and payment of the § 2801 tax until a reasonable period of time after final regulations are issued. The proposed regulations confirm that retroactive reporting for gifts and bequests made after June 17, 2008 will be required, but no interest for late payment of tax will be due because payment of the § 2801 tax will not be due until the date fixed in final regulations.[4]

In commenting on the proposed regulations, we are mindful of the legislative history stating that the purpose of § 2801 was to make expatriation "tax neutral."[5] That is, § 2801 was intended to eliminate the avoidance of gift and estate tax that otherwise would result from expatriation. Despite the legislative purpose, the statute does not achieve tax neutrality, and the statutory language limits the ability of the regulations to achieve legislative intent.[6] It is our view, however, that the proposed regulations could ameliorate the disparity in treatment between a CE and a U.S. donor/decedent to a greater extent than is accomplished in the proposed regulations.

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[1] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

[2] Pub. L. No. 110-245, 122 Stat. 1624 (2008).

[2] Pub. L. No. 110-245, 122 Stat. 1624 (2008).

[3] I.R.S. Announcement 2009-57, 2009-29 I.R.B. 158; I.R.S. Notice 2009-85, 2009-45 I.R.B 598.

[3] I.R.S. Announcement 2009-57, 2009-29 I.R.B. 158; I.R.S. Notice 2009-85, 2009-45 I.R.B 598.

[4] The last sentence of the preamble provides "[i]nterest will not accrue on the section 2801 tax liability for any taxable years until the due date for payment, as specified in the final regulations, has passed."

[5] H.R. Rep. No. 110-431, at 113-114 (2007) provides that § 2801 was not intended to discourage individuals from expatriation or to reward those who do expatriate, but to make expatriation tax neutral by exposing to U.S. transfer tax property that would otherwise escape such tax by reason of the donor or decedent's expatriation.

[6] We regret that the statutory language seems to preclude extending the tuition and medical expense exclusion in § 2503(e) to § 2801, for example. Section 2801(c) allows an annual exclusion only for the dollar amount in effect under § 2503(b).

1. Definition of "resident" as "domiciliary".

The term "resident" plays two roles in § 2801. First, it defines the class of individuals potentially subject to the tax. Individuals are subject to the tax only if they are either citizens or residents of the U.S. Second, it serves as the definitional requirement for the application of an exception from CE status for expatriates who are subject to tax as residents of the U.S. The exception lasts for the period of time that the expatriate is subject to U.S. tax. In both cases, the proposed regulations define "resident" by reference to the domicile test that is used for gift and estate tax purposes, rather than the visa or substantial presence test that is used for income tax purposes.[7] The preamble states:

> Section 28.2801-2 of the proposed regulations defines … the term "citizen or resident of the United States" as an individual who is a citizen or resident of the United States under the estate and gift tax rules of chapter 11 and chapter 12 … Accordingly, whether an individual is a "resident" is based on domicile in the United States, notwithstanding that section 877A adopts the income tax definition of that term. The Treasury Department and the IRS believe that, because section 2801 imposes a tax subject to subtitle B, the tax definition of resident under subtitle B generally should apply for purposes of section 2801. See §§ 20.0-1(b)(1) and 25.2501-1(b).

Section 2801(f) provides that an individual is a CE for purposes of this section only if she is a CE within the meaning of § 877A(g)(1). Section 877A(g)(1)(C) provides that an individual is not a CE for purposes of either § 877 or § 2801 during any period of time that she is subject to tax as a U.S. resident.[8] A literal application of § 2801(f) and § 877A(g)(1)(C) would prevent the application of the § 2801 tax to gifts and bequests made by an individual who is no longer a CE because she is subject to U.S. income tax but who is not subject to U.S. estate or gift tax because she is not either a U.S. citizen or a U.S. domiciliary. This literal application would permit a CE to become a U.S. income tax resident by satisfying the substantial presence test for one year, and to make gifts or bequests that were not subject to either U.S. gift or estate tax (because the CE was not domiciled in the U.S.) or to the § 2801 tax. In the case of a gift, the CE could terminate her U.S. income tax residency the following year. This would create a fairly simple way of avoiding the § 2801 tax. Although the construction in the proposed regulations of the term "resident" to mean "domiciliary" appears inconsistent with the text of the statute, the decision to adopt this construction was arguably necessary to achieve the legislative purpose of tax neutrality. We suggest that the principle of liberal construction to achieve neutrality should be applied to make certain of the changes that we suggest in these comments that would advantage the § 2801 taxpayer.

2. Definition of covered bequest.

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[7] Prop. Reg. § 28.2801-2(b); Prop. Reg. § 28.2801-2(h).

[8] Section 877A(g)(1)(C) provides: "in the case of any covered expatriate who is subject to tax as a citizen or resident of the United States for any period beginning after the expatriation date, such individual shall not be treated as a covered expatriate during such period for purposes of subsection (d)(1) and (f) and section 2801."

The basic definition in Prop. Reg. § 28.2801-2(f) of the term "covered bequest" is the same as the statutory definition.[9] A covered bequest is "any property acquired directly or indirectly by reason of the death of a covered expatriate." Prop. Reg. § 28.2801-3(b) extends the meaning of "acquired 'by reason of the death of a covered expatriate'" to include any property that would have been included in the CE's gross estate under any of §§ 2036 through 2042 whether or not acquired by reason of the death of the CE. This extension seems consistent with the legislative intent.

The basic definition, however, is far broader than what is necessary to accomplish the legislative purpose of preventing the avoidance of gift and estate tax that otherwise would result from expatriation. It appears to reach, for example, property that would pass by beneficiary designation to a U.S. individual from a trust created by her non-resident alien grandparent, the term of which was measured by the life of her CE parent. This type of property interest would not have been subject to estate tax at the death of the CE parent if she had remained a U.S. citizen until death. We suggest that the regulations make it clear that it would also not be subject to the § 2801 tax. The following suggested definition could be inserted at the end of Prop. Reg. § 28.2801-2(f):

> The term covered bequest means any property acquired by reason of the death of a covered expatriate but only to the extent the property would have been included in the gross estate of the covered expatriate if the covered expatriate were a United States citizen at the time of the covered expatriate's death, regardless of the property's situs and whether it was acquired before or after expatriation from the United States.

We also suggest that the regulations provide a mechanism for removing from covered bequest status any property that had previously been subject to the § 2801 tax as a covered gift. Suppose, for example that a CE made a gift to a domestic trust for the CE's child and retained the power to change the timing of the child's enjoyment of the property for the rest of the CE's life. At the death of the CE, the trust is to terminate and the trust property is to be distributed to the child. The CE's gift would have been subject to the § 2801 tax. It is apparently subject to a second § 2801 when the CE dies. The double tax could be avoided by adding the following text to the regulations:

> The term covered bequest shall not include property acquired by reason of the death of a covered expatriate if the property had previously been subject to the § 2801 tax as a covered gift.

3. Election into U.S. gift tax rules.

The most egregious deviation from the neutrality principle results from the fact that the tax imposed by § 2801 is imposed on the donee and the gift tax is imposed on the donor. The disparity of results is extreme. For example, if a donor (who has otherwise used her exemption and annual exclusion) makes a gift of $1,000,000, the donor will pay a gift tax of $400,000 and the donee will receive $1,000,000 free of tax. If a CE makes a covered gift of $1,000,000, the

[9] § 2801(e)(1)(B); Prop. Reg. § 28.2801-2(f).

donee rather than the donor pays $400,000 of tax and the donee keeps only $600,000. The effective tax rate is 67% of what the donee retains ($400,000/$600,000) rather than 40% ($400,000/$1,000,0000).

If the CE makes a gift of U.S. situs property (real estate or tangible personal property, including currency, located in the U.S.), the § 2801 tax would not apply. Instead, a U.S. gift tax would be paid by the donor so that the effective rate is 40% assuming the gift is timely reported and the gift tax is timely paid. If the gift is not timely reported and the gift tax is not timely paid, the § 2801 tax will apply.[10]

In order to remove the incentive for CEs to structure their gifts to cause the lower effective tax rate to apply, we suggest that the regulations allow a CE to elect to pay tax on covered gifts as if the gift were a gift of U.S. situs property, so that if the gift is timely reported and the gift tax is timely paid, the same effective rate of 40% will apply.

4. Timing and value of covered gifts.

a. Timing.

(i) Gifts to Individuals. The proposed regulations apply the gift tax rules of chapter 12 governing the timing of gifts made to individuals to § 2801 in the same manner as they are applied to transfers that are subject to U.S. gift tax.[11] Different timing rules should apply to § 2801 because the § 2801 tax is imposed on the donee rather than on the donor. A gift is complete for gift tax purposes when the donor parts with dominion and control of property,[12] but this date may not be the same as the date of receipt by the donee. In fact, § 25.2511-2(a) of the gift tax regulations specifically notes that there is a difference between the time of transfer and the time of receipt:

> The gift tax is not imposed upon the receipt of property by the donee, nor is it necessarily determined by the measure of enrichment resulting to the donee from the transfer, nor is it conditioned upon ability to identify the donee at the time of the transfer.

A U.S. donor is treated as having made a gift, for example, when she contractually obligates herself to make a donative transfer in the future.[13] The proposed regulations would impose the § 2801 tax on the donee at the time the contract becomes binding even though that date could precede actual receipt by many years.

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[10] The statute requires only timely reporting but the proposed regulations add the timely payment rule. Prop. Reg. § 28.2801-3(c)(1), (2).

[11] Prop. Reg. § 28.2801-4(d)(2), dealing with the date of receipt of a covered gift. By contrast, the date of receipt of a covered bequest from an estate is the date of distribution from the estate or revocable trust of the decedent and not the date of death, or, if later, resolution of any dispute concerning the bequest. *See* Example 3 of Prop. Reg. § 28.2801-4(f) (settlement of a dispute about inheritance is the time of receipt of a covered bequest).

[12] Reg. § 25.2511-2(b).

[13] *See*, *e.g.,* Comm'r v. Copley's Estate, 194 F.2d 364 (7th Cir. 1952), *aff'g* 15 T.C. 17 (1950).

Because the § 2801 tax is imposed upon the "receipt" rather than "transfer" of property and the tax is an obligation of the donee and not the donor, the opposite conclusions from those drawn in Reg. § 25.2511-2(a) are more appropriate. That is, the tax should not be imposed until the donee actually receives the gifted property (as it is in the case of covered bequests).[14]

We also suggest that the regulations permit a donee who receives a gift of a future interest in property to elect to treat the date the interest becomes possessory as the date of receipt for purposes of the § 2801 tax. Examples of future interests for which a tax deferral should be permitted include remainder interests following life estates or terms of years or bare title ownership interests in usufructs. Usufructs are important to consider because they are a common form of ownership in civil law countries. A usufruct is similar in some respects to a legal life estate. The holder of the life estate is referred to as the "usufructee," and the holder of the remainder is referred to as the "bare title owner." The precise rules concerning the rights of the usufructee and bare title owners are not uniform from jurisdiction to jurisdiction. When applicable law gives the bare title holder indefeasible rights, § 2801 may apply to impose the § 2801 tax on a bare title owner who has not yet received anything of real value and may not have any assets to use to pay the tax.

(ii) Gifts to Trusts. The proposed regulations appear to take a different approach to covered gifts made to domestic trusts. They provide that a revocable trust is treated as receiving a transfer on the date the covered expatriate relinquishes the right to revoke the trust. The date that the right to revoke is relinquished is not necessarily the date a gift is made for purposes of chapter 12. Any retained right over the trust that gives the donor the right to alter the beneficial enjoyment of the trust property is enough to cause the gift to be incomplete under chapter 12. The proposed regulations provide no timing guidance for gifts to trusts that are not revocable.

We suggest that the regulations should not treat a gift to a trust as subject to the § 2801 tax until the later to occur of actual receipt of the gifted property by the trustee and the earliest date on which the gift would have been treated as complete under chapter 12 if it had been made by a U.S. citizen or domiciliary.

b. Valuation. The proposed regulations apply the gift tax valuation rules of Chapter 14 to covered gifts. In determining the value of a "transfer" for gift tax purposes, §§ 2701 and 2702 of Chapter 14 require that certain interests retained by the grantor or applicable family members be disregarded. For example, if a donor transfers common stock in a corporation to her child and retains a preferred interest, § 2701 may require her to value her retained preferred interest at zero so that the donor is taxable on the full amount of her preferred stock as if she had not retained it. Similarly, if a donor transfers property to a trust for her child and retains the right to receive trust income for life, the value of her gift is determined as if she had given, rather than retained, the income interest.

Neither § 2701 nor § 2702 purports to value the interest received by the donee. Because the § 2801 tax is imposed on the donee rather than the donor, the proper subject of the tax should be the value of what is received net of the value of any interests retained by the donor. We

[14] *See* Prop. Reg. § 28.2801-4(d)(3).

suggest, therefore, that §§ 2701 and 2702 should play no role in valuing gifts for purposes of the § 2801 tax and that the amount subject to the § 2801 tax in the case of a gift to a domestic trust (or a foreign trust that elects to be treated as a domestic trust for purposes of § 2801) should be reduced by the value of any interest retained by the CE.[15]

5. Timing and value of covered bequests.

a. Timing.

The proposed regulations treat a covered bequest as received on the date of the CE's death only if the bequest passes by operation of law, beneficiary designation or some similar contractual arrangement. A covered bequest under a will or revocable trust is not considered to have been received until it is distributed. If there is a dispute about inheritance rights, the time of receipt is the time of the resolution of the dispute.[16] These timing rules are not consistent with the rules concerning the timing of covered gifts.

The proposed treatment of a covered bequest that passes on the death of a CE by beneficiary designation as if received on the date of death can impose an unreasonable burden on the recipient. In many cases designated beneficiary status, particularly when an individual is designated as the beneficiary of a terminating trust, will not result in an immediate receipt of property. Months, and in some cases years, may pass before the beneficiary actually receives a distribution. We suggest that this proposed regulation be changed to treat a covered bequest as received only when there has been actual receipt, subject to the election suggested in the last paragraph of this section.

Clarification would be helpful concerning the timing of receipt rules for covered bequests. For example, in civil law countries, heirs are deemed to inherit a share of an estate at date of death. There is no probate estate, but in fact there is a delay in dividing assets among heirs during which period of time the heirs allocate assets and settle debts. Because this is common to most civil law countries, a specific example would be useful to guide taxpayers concerning the relevant date of receipt.

For most purposes, date of death value controls the amount of tax due and the basis of the assets inherited. For convenience and to avoid the need for additional appraisals, we recommend that a taxpayer be allowed to elect to treat a gift as received as of date of death rather than date of actual distribution.

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[15] This suggestion is consistent with the conclusion reached by the Internal Revenue Service when it issued the proposed and final regulations under Chapter 14. The preamble to the proposed regulations stated:

> Generally, sections 2701 and 2702 determine gift tax consequences at the time a transfer is made by imposing special rules for determining the existence and amount of any gift resulting from the transfer. Although these two sections apply to determine the amount of the gift, they do not change the value of the transferred property for other tax purposes. Thus, in general, sections 2701 and 2702 do not apply for purposes of the generation-skipping transfer tax.

56 Fed. Reg. 14321, 14322 (1991). The Internal Revenue Service confirmed this conclusion in the preamble to the final Chapter 14 regulations. T.D. 8395, 1992-1 C.B. 316.

[16] Prop. Reg. § 28.2801-4(d)(3).

b. Valuation.

The proposed regulations apply the gift tax valuation rules of Chapter 14 to covered bequests. For the reasons discussed in section 4 of these comments relating to the valuation of covered gifts, we believe the application of §§ 2701 and 2702 of Chapter 14 to covered bequests is inappropriate. In addition, the application of these sections to covered bequests, which have no application to the estate tax, would be inconsistent with the goal of neutrality.

6. Exception for gifts of annual exclusion amounts.

Section 2801 applies only to the extent the U.S. individual or domestic trust receives covered gifts and bequests in a particular year in excess of the annual exclusion amount under § 2503(b) in effect in that year.[17] There is no requirement that the gift or bequest be eligible for the annual gift tax exclusion. The reference in § 2801(c) to § 2503(b) is made solely for purposes of defining the annual amount eligible for the exception.

The proposed regulations take the position that a gift to a domestic trust that is subject to withdrawal rights held by one or more beneficiaries is treated as made to the trust and not to the individuals who hold withdrawal rights.[18] This treatment is inconsistent with general gift tax principles, which treat gifts to trusts as if made to individual beneficiaries to the extent they have withdrawal rights. We see nothing in § 2801 that requires this result. Allowing the use of withdrawal rights to reduce the amount subject to tax under § 2801 the same way as they reduce taxable gifts would serve the statutory goal of neutrality.

We are aware that withdrawal powers have been used to artificially multiply the number of annual exclusions that shield contributions to a trust from gift tax. However, making withdrawal powers irrelevant to § 2801 doesn't prevent, but only changes the strategies that can be used in order to multiply the amounts protected by the § 2801(c) exception.

Each domestic trust is a separate taxpayer for purposes of § 2801, and the annual exception is allowed for purposes of § 2801 without regard to the "present interest" requirement in § 2503. Therefore, multiple § 2801 annual exceptions can easily be obtained by making gifts to multiple domestic trusts.

We suggest that the proposed regulations be changed to treat, solely for purposes of calculating the amount of the § 2801 tax imposed on a domestic trust, the individual beneficiaries of the trust as having received the amounts that they have the right to withdraw from the trust.

7. Defining "indirect gifts" and "indirect bequests".

The § 2801 tax applies to gifts and bequests acquired indirectly as well as directly from a CE. Prop. Reg. § 28.2801-2(i) provides four examples of an indirect acquisition. Each of these examples is discussed below.

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[17] § 2801(c).

[18] Prop. Reg. § 28.2801-3(d).

First, a covered gift or bequest to an entity other than a trust or estate is treated as an indirect gift or bequest to the U.S. individuals who own that entity in proportion to their ownership interests.[19] This conclusion is consistent with Reg. § 25.2511-1(h)(1), which treats a gift to a corporation as a gift to its shareholders to the extent of their proportionate interest in the corporation.

Second, a U.S. individual's acquisition of property from a foreign trust that received a covered gift or bequest "through one or more other foreign trusts, other entities, or a person not subject to the section 2801 tax" is treated as an indirect gift or bequest to the U.S. individual.[20] This example goes too far. It contains no requirement that the property acquired by the U.S. individual have any relationship to the covered gift or bequest. We suggest that this example be modified to limit its scope to trust distributions that are attributable to the trust property acquired as a covered gift or bequest. The following text should be considered:

> (2) Property acquired by or on behalf of a U.S. citizen or resident, from a foreign trust[21] that received a covered gift or covered bequest, through one or more other foreign trusts, other entities, or a person not subject to the section 2801 tax to the extent the property is attributable to the covered gift or covered bequest.[22]

Third, the payment of a U.S. individual's debt by a CE or by a foreign trust that received a covered gift or bequest is treated as an indirect acquisition of property by the U.S. individual.[23] The conclusion that an individual's payment of the debt of another is a gift by the individual to the debtor is consistent with basic gift tax principles.[24] This example also goes too far in the same manner that the preceding example does. There is no requirement of any relationship between the property used by the foreign trust to pay the individual's debt and the covered gift or bequest. We suggest this example be modified in a manner similar to the modification we have suggested for the preceding example.

The fourth example concludes that property received by a U.S. individual as a result of the exercise of a general power of appointment granted to a non-CE by a CE over property not held in trust is a covered gift or bequest.[25] We suggest that this example be changed to include the exercise of a non-general power of appointment and to exclude the exercise of a general power of appointment. The holder of a non-general power of appointment acts as an agent of the donor of the property. Property that passes to a U.S. individual by the exercise of a non-general

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[19] Prop. Reg. § 28.2801-2(i)(1).

[20] Prop. Reg. § 28.2801-2(i)(2).

[21] The reference in the proposed regulation to property acquired from a CE is not necessary. Property acquired from a CE would be a direct, not an indirect, covered gift or bequest.

[22] The suggested language is similar to the text of § 2801(e)(4)(B)(i) dealing with distributions to U.S. individuals from a foreign trust that has received a covered gift or bequest.

[23] Prop. Reg. § 28.2801-2(i)(3).

[24] *See, e.g.*, Estate of Woody v. Comm'r, 36 T.C. 900 (1961); Rev. Rul. 81-110, 1981-1 C.B. 479; Rev. Rul. 78-362, 1978-2 C.B. 248.

[25] Prop. Reg. § 28.2801-2(i)(4). The example includes an exception for property previously subject to the § 2801 tax.

power of appointment granted to a non-CE by a CE, therefore, should be viewed as acquired from the CE. We suggest that the exercise of a general power of appointment be viewed in the same manner as we recommend treating property received from non-CE's who have received donative transfers from CEs or distributions from foreign trusts to which CEs have made covered gifts or bequests. This suggestion is discussed starting in the next paragraph.

After providing the examples discussed below, the proposed regulations provide a catch-all category that provides no real guidance. The catch-all category includes property acquired by a U.S. individual "in other transfers not made directly by the covered expatriate to the U.S. citizen or resident."[26] Because transfers not made directly by a CE include transfers made by all persons who are not CEs, a literal application of this rule would result in all transfers received by a U.S. individual being treated as covered gifts or bequests. Presumably, the catch-all category is intended to include transfers made to U.S. individuals by persons who are not CEs of property given to them by CEs with the expectation that they would give the property to U.S. individuals.

To deal with this issue, we recommend that rules similar to those in Reg. §§ 1.643(h)-1 and 1.679-3(c) apply. All of these statutes - §§ 643, 679 and 2801 - deal with a common problem, the use of intermediaries to avoid tax. Sections 643 and 679 address when distributions from or contributions to foreign trusts will be treated as made through intermediaries to avoid income tax. Under Reg. §§ 1.643(h)-1 and 1.679-3(c), a transfer is not deemed made through an intermediary if there is no tax avoidance purpose or if the purported intermediary has a relationship with a recipient that establishes a reasonable basis for the purported intermediary making a transfer and the purported intermediary acted independently. In the case of § 1.643(h)-1, which deals with distributions from foreign trusts to U.S. persons, there is a presumption of tax avoidance if the purported intermediary received funds within 24 months before or 24 months after the transfer to the recipient. The presumption is rebuttable.

It will often be the case that a gift or bequest to a family member of a CE who is neither a U.S. person nor a CE will be followed by a gift or bequest from that family member to a U.S. person. This is not necessarily abusive. As long as the purported donor has dominion and control and acts independently, the structure of the transaction should be respected.[27] The actual donor should not be considered to be an intermediary in such circumstances.

Consider, for example, a gift by a CE to her non-CE spouse followed by a gift from the non-CE spouse to their U.S. children. Unless the non-CE spouse was acting as an agent and not independently, there is no reason for the gift by the non-CE spouse to the children to be treated as an indirect gift from the CE, since both spouses have a reasonable basis for making gifts to their children. Moreover, if the spouse is a U.S. person, there would be potential for a double § 2801 tax, one when the spouse receives the gift and one when the child receives the gift from the spouse.

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[26] Prop. Reg. § 28.2801-2(i)(5).

[27] *See, e.g.*, Estate of Bies v. Comm'r, 80 T.C.M. (CCH) 628 (2000) (concluding that the transfers at issue were transfers to intermediaries and that the donor intended to make transfers to the ultimate recipients, thus disallowing annual exclusions for amounts transferred to the intermediaries, but acknowledging that, "as a general rule" the form of a transaction will be respected and that substance over form principles will not apply unless the circumstances so warrant).

8. Double tax.

Section 2801(e)(2) excepts from the § 2801 tax any gift or bequest that is subject to U.S. gift or estate tax if the transfer is timely reported on a U.S. gift or estate tax return. The proposed regulations add another requirement for which there is no statutory basis: that the gift or estate tax be timely paid.[28] The proposed regulations fail to consider the fact that the payment of the § 2801 tax does not relieve the donor or the decedent's estate from gift or estate tax liability, or prevent collection of the gift or estate tax from the transferee (who is likely to be the same person who paid the § 2801 tax on the same transfer).[29] The final regulations should eliminate the double tax and allow the person who paid the § 2801 tax a refund if the gift or estate tax is paid, regardless of whether payment is timely.

9. Credit for foreign taxes.

Section 2801(d) allows a credit for foreign gift or estate taxes imposed on a covered gift or bequest.[30] Many foreign countries tax gifts and bequests using different tax regimes. In most civil law countries, an inheritance tax is imposed in lieu of an estate tax. In the U.K., gifts may be potentially gift tax free but subject to tax if the donor dies within seven years. We suggest that the regulations allow a credit for any taxes imposed on gifts or bequests even if the taxes are labeled or structured differently, and allow a refund of the § 2801 tax if the foreign tax is later paid. Compare, for example, § 2014 which allows a foreign tax credit for U.S. decedents' estates for foreign "estate, inheritance, legacy and succession taxes." While the statutory language in § 2801 is narrower than the language in § 2014, in the interest of neutrality, the same definition should be used.

10. Application of treaties.

Several of the examples in the proposed regulations stipulate that the CE referenced in the example does not reside in a country with which the U.S. has a gift or estate treaty.[31] The implication of these statements is that § 2801 does not override treaties. Otherwise the statements referencing treaties would be superfluous. However, the proposed regulations do not expressly state that treaties are not overridden, and the legislative history is silent on this point. Based on the long-established principle that Congressional intent to override treaties should not be presumed,[32] the regulations should state that treaties are not overridden.

11. Distributions from non-electing foreign trusts.

a. Marital and charitable deductions.

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[28] Prop. Reg. § 28.2801-3(c)(1), (2).

[29] Section 6324(b) imposes liability for the gift tax on a donee if the donor fails to pay the gift tax and § 6324(a)(2) imposes liability for estate tax on beneficiaries who receive property from an estate if the estate tax is not paid.

[30] *See* Prop. Reg. § 28.2801-4(e).

[31] *E.g.*, Examples 1, 2 and 3 in Prop. Reg. § 28.2801-3(f).

[32] *See, e.g.,* Menominee Tribe of Indians v. United States, 391 U.S. 404, 1711 (1968).

Proposed regulation § 28.2801-2(i)(2) defines an indirect gift to include property acquired by a U.S. person from a foreign trust that received a covered gift or covered bequest. The date of receipt of the gift or bequest is the date of distribution from the foreign trust.[33] A gift or bequest is not a "covered" gift or bequest if it qualifies for the marital or charitable deduction.[34] The proposed regulations take the position that the marital and charitable deduction is not applicable to distributions from a non-electing foreign trust to a spouse or charity unless the marital or charitable deduction was allowable when the CE transferred property to the trust.[35] This is not consistent with the statute. Section 2801 expressly provides for distributions attributable to covered gifts or bequests from foreign trusts to be treated "in the same manner as if such distribution were a covered gift or bequest."[36] That means that at the time of the taxable transfer, i.e., the distribution from the foreign trust, the gift or bequest must qualify for the marital or charitable deduction.

It is true that this would treat a non-electing foreign trust differently from a domestic trust, but that is only because the timing of the taxable transfer is different. The marital or charitable deduction should be determined to be available if the transfer qualifies for the relevant deduction at the time of the taxable transfer.

(i) Marital deduction for gifts to trusts.

The proposed regulations provide that covered gifts and covered bequests do not include transfers that would qualify for the marital deduction "if the covered expatriate had been a U.S. citizen or resident at the time of the transfer."[37] Section 2801 and the proposed regulations make it clear that this exception applies to a CE's gift or bequest to a marital trust. In the case of a gift to a qualified terminable interest property trust (a "QTIP") or a qualified domestic trust (a "QDOT"), the proposed regulations take the position that the exception will not apply unless a valid QTIP or QDOT election is made. Guidance is needed to explain how these elections may be made by a CE who is gifting or bequeathing property that is not subject to U.S. gift or estate tax. These issues could be avoided for gifts to foreign trusts if the marital deduction is allowed as and when distributions from a foreign trust are made to the surviving spouse.

The QTIP or general power of appointment foreign marital trust for the benefit of a U.S. citizen surviving spouse should not expose the assets to the § 2801 tax when the surviving

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[33] Prop. Reg. § 28.2801-4(d)(4).

[34] § 2801(e)(3).

[35] Prop. Reg. § 28.2801-3(c)(3) and (4). The preamble is more explicit on this point: "[t]o the extent a covered gift or covered bequest is made to a non-electing foreign trust … a distribution from the trust … to the U.S. citizen spouse of the covered expatriate who funded the trust (whether in whole or in part) will not qualify for the exception [for transfers that would qualify for the gift or estate tax marital deduction if given by a U.S. citizen or resident]." Further, the preamble says: "a gift or bequest to a covered expatriate's U.S. citizen spouse is excepted from the terms 'covered gift' and 'covered bequest' if the gift or bequest, if given by a U.S. citizen or resident, would qualify for the gift or estate tax marital deduction. In the case of a gift or bequest to a trust, this means that, to the extent the gift or bequest to the trust … would qualify for the estate or gift tax marital deduction, the gift or bequest is not a covered gift or a covered bequest." 80 Fed. Reg. 54447, 54449 (2015).

[36] § 2801(e)(4)(B)(i).

[37] Prop. Reg. § 28.2801-3(c)(4).

spouse dies because the assets will be subject to U.S. estate tax under § 2044 or § 2041 when the surviving spouse dies. Because the foreign trust will have a § 2801 ratio of zero, the distribution to the remainder beneficiaries should not be subject to the § 2801 tax. However, it would be helpful if the regulations clarified this point with a specific example.

However, if the surviving spouse is not a U.S. citizen, a QDOT election is necessary to qualify for the marital deduction and the application of the QDOT rules in the context of § 2801 is confusing.

A QDOT election allows a decedent's estate to defer U.S. estate tax on a transfer to a noncitizen spouse of assets that otherwise would be subject to U.S. estate tax.[38] In the case of a decedent who is a CE, the transfer of non U.S. situs assets would not be subject to U.S. estate tax and therefore no QDOT election would be made for the CE's estate. It would be helpful if the regulations clarified that a QDOT election may be made for all of a CE's worldwide estate and explained how the election will apply if it is made solely to defer the § 2801 tax.

(ii) Charitable deduction.

Treating the charitable deduction as available if the distribution qualifies for the charitable deduction at the time of the taxable transfer avoids imposing a tax on U.S. charities.

b. Income and throwback tax deductions for § 2801 tax.

Section 2801(e)(4)(B)(ii) allows an income tax deduction under § 164 for the § 2801 tax paid or accrued attributable to trust income carried out from a foreign trust. However, under the proposed regulations, a cash basis taxpayer is not allowed to accrue the § 2801 tax and use it to reduce income tax in the year the income tax payment is due.[39] In addition, it is not clear that this deduction could offset tax imposed on a distribution of accumulated income taxable under § 665. These rules could result in tax being owed in excess of the amount received. For example, if the recipient received a trust distribution of $100x that consisted of previously undistributed income, the income and throwback taxes may equal the entire amount distributed, but not more.[40] In addition, the § 2801 tax could be due. The total tax could be $140x, which is $40x more than was received. If the § 2801 tax could be accrued and deducted in determining the income and throwback taxes due (even if the taxpayer is a cash basis taxpayer, as most individuals are), then the income and throwback tax would be capped at 60% of the amount distributed and the total tax, including the § 2801 tax, would be 100% of the amount distributed, but not more.

c. Determining amount "attributable to" covered gifts or bequests.

The proposed regulations adopt the same rules used in the generation-skipping tax regulations to determine how much of a distribution from a foreign trust is attributable to a gift or bequest from a CE. These rules establish a "§ 2801 ratio" (similar to the "inclusion ratio" for

[38] § 2056A(b)(1), (2)(a).

[39] Prop. Reg. § 28.2801-4(a)(3)(ii). *See also*, Prop. Reg. § 28.2801-4(f) Example 2.

[40] § 668(b).

generation-skipping tax purposes) for each non-electing foreign trust based on the proportion that covered gifts and bequests to the trust bear to non-covered gifts and bequests, adjusted for changes in the value of the trust at the time of each contribution. The "§ 2801 ratio" is referred to as the "covered portion" of the trust. Each distribution from a non-electing foreign trust carries out a proportion of the covered portion of the trust, i.e., the "§ 2801 ratio" multiplied by the amount of the distribution. This is the amount subject to the § 2801 tax.

For example, if a $50x contribution is made by a CE to a trust that has a value of $100x (none of which is attributable to covered gifts or covered bequests), the § 2801 ratio is 33% and 33% of every distribution is deemed "attributable to" a covered gift. If the CE makes another gift of $10x a year later when the trust has a value of $190x, then the § 2801 ratio must be recalculated based on the value of the trust at the time of the second covered gift. The new § 2801 ratio would be (($190x * 33%) + $10x) divided by $200x = 36%.

This method is extremely complicated because it requires revaluation of all trust assets every time a contribution is made to a trust in order to recalculate the § 2801 ratio.[41] A simpler method is needed to encourage compliance. We suggest consideration of the following three alternatives:

(i) Separate accounting.

We recommend that trustees be allowed to separately account for covered gifts or bequests. Separate accounting is used for other tax purposes. For example, separate accounting is used to determine the portion of a trust a foreign grantor is deemed to own for purposes of § 672(f) effective date rules when subsequent additions are made to a "grandfathered" trust.[42] Separate accounting also is essentially what is used to avoid the complications of the formula for generation-skipping tax purposes when a qualified severance occurs.[43] Rather than use the fractional share method to calculate the inclusion ratio (the taxable portion of a trust), the trust is divided into exempt and taxable portions which are administered as separate trusts. Most estate planners routinely provide that property subject to generation-skipping tax be segregated and held in a separate trust from property not subject to generation-skipping tax, in which case the division does not require all of the formalities of (or the statutory authority for) a qualified severance. Because this type of severance or division is almost always advisable, it should be presumed.

(ii) Specific gifts.

In addition, we suggest that covered gifts or bequests to foreign trusts that specifically bequeath a particular asset to a particular beneficiary be treated as a separate share of the trust for purposes of § 2801, as is the case for income tax purposes under § 663.[44]

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[41] Prop. Reg. § 28.2801-5(e) Example 2.

[42] Reg. § 1.672(f)-3(d) allows the trustee to separately account for additions to "grandfathered" trusts (trusts funded on or before September 19, 1995) which are not subject to the grantor trust rules of § 672.

[43] § 2642(a)(3)(A).

[44] § 663(c).

(iii) Ignore changes in value.

As a less desirable alternative, simpler to administer but far from accurate, we suggest that the trustee be permitted to determine the § 2801 ratio of the trust using a numerator equal to the total value of all covered gifts/bequests to the trust that were received prior to the date of distribution and the denominator equal to the total value of all gifts/bequests to the trust that were received prior to the date of distribution, so that assets do not have to be revalued each time a contribution is made. For example, if the trust received a covered gift of $50x and a non-covered gift of $100x, the § 2801 ratio would be 33%. If in the following year, an additional covered gift was made of $10x, the new § 2801 ratio would be $60x/$160x = 38%.

d. Identifying covered gifts.

An additional problem for foreign trustees and U.S. individuals who receive distributions from foreign trusts is how to determine whether a gift or bequest is a covered gift or bequest and whether a donor was a CE. A simplified method for making these determinations is necessary. We recommend that trustees and U.S. individuals be allowed to rely on the certification of the donor or decedent's estate that a gift or bequest is or is not a covered gift or bequest unless they know or have reason to know that the certification is false.

e. Defining "distributions".

The proposed regulations define a "distribution" from a foreign trust to mean any direct or indirect or constructive transfer from a foreign trust without regard to whether any person is treated as the owner of the trust for income tax purposes and without regard to whether the U.S. person receiving the distribution is designated as a beneficiary of the foreign trust. It also includes distributions made by a trust pursuant to a person's exercise or release of a power of appointment, whether or not it is a general power.[45] We do not believe that property distributed from a foreign trust to a U.S. individual pursuant to the exercise or release of a general power of appointment should automatically be subject to the § 2801 tax. Property subject to a general power of appointment should be viewed as property owned for transfer tax purposes by the donee of the power. When she exercises the power, the property is passing from her to the appointee, not from the CE to the appointee. Whether that passage of property should be subject to the § 2801 tax should depend on whether the donee of the power is acting as an intermediary for the CE. We discuss our recommendations for dealing with this issue in section 7 of these comments.

The proposed regulations do not address whether the deemed distribution rules of § 643(i) are applicable. These rules should not apply to § 2801. We suggest that the regulations make this clear.

Section 643(i) treats certain loans from foreign trusts as deemed distributions even if the loans bear interest at the applicable federal rate. In addition, that section provides that to the extent that a U.S. person uses trust property and does not compensate the trust for the use of the property, there is a deemed distribution. In each case, however, the deemed distribution is

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[45] Prop. Reg. § 28.2801-5(b).

taxable only to the extent that the trust has current or accumulated net income. Just as the proposed regulations disregard the grantor trust rules in applying § 2801, the proposed regulations also should disregard § 643(i) in applying § 2801.

Section 2801 is designed to tax transfers that would be gifts if the person were a U.S. person rather than a CE. A loan that bears interest at the applicable federal rate is not a gift for a U.S. person. In the interest of tax neutrality, a loan also should not be a covered gift for purposes of § 2801. Similarly, allowing a person to use a residence or tangible personal property without payment of rent is commonly done by U.S. persons and is not a gift. For the same reason, it also should not be a covered gift.

12. Electing foreign trusts

The requirements for a foreign trust making an election to be taxed as a domestic trust for purposes of § 2801 are so burdensome that it is unlikely that many trusts would make this election. In particular, the trust must disclose all its beneficiaries, including discretionary and future beneficiaries.[46] Foreign trustees are not likely to be willing to make this disclosure because privacy is very important.

Information about contingent beneficiaries and future beneficiaries is not relevant to enforce the tax laws unless a distribution is made to them because that is when the tax accrues. A similar issue was presented in determining the level of information reporting required by FATCA to avoid withholding under §§ 1471 and 1472. The same level of reporting used for FATCA should be adopted for purposes of the election allowed by § 2801. A FATCA compliant foreign trust is required to disclose the names of beneficiaries who actually receive a distribution or who have a mandatory payment right. Discretionary beneficiaries who do not receive distributions do not have to be disclosed.

Moreover, § 2801 relies on voluntary compliance by U.S. individuals who receive gifts and bequests directly from a CE. There is no reason to impose extensive information reporting on the trustee of a foreign trust as the price for making the election to be treated as a domestic trust.

In addition, a foreign electing trust is not given any opportunity to contest valuation determinations made by the IRS.[47] A domestic trust that receives covered gifts or bequests is not forced to accept the IRS's determination as to the value. We suggest that final regulations allow foreign trusts the same procedural protections that a domestic trust would have when there is a dispute about valuation.

13. Basis adjustment for § 2801 tax.

Section 1015 allows a donee to increase her basis in property received by gift by all or a portion of the amount of gift tax paid by the donor attributable to unrealized appreciation.[48] The

[46] Prop. Reg. § 28.2801-5(d)(3)(ii)(E).

[47] Prop. Reg. § 28.2801-5(d)(6).

[48] § 1015(d).

proposed regulations make it clear that this basis adjustment is not allowed for the § 2801 tax.[49] In the case of covered bequests, a basis adjustment might be permitted under § 1014, if the requirement of this section are met.

When a "net gift" is made to a donee, the transfer is taxed as if it were a bargain sale, that is, a sale by the donor to the donee in consideration of the donee's payment of gift tax, and the donee gets basis adjustment for the consideration paid.[50] The § 2801 tax is as much a part of the cost of the donee's acquisition of property from a CE as is the gift tax paid by a donee on a net gift from a U.S. citizen.

In the interests of tax neutrality and simple fairness, we suggest that the § 2801 tax be allowed to adjust basis in the same manner as in the case of a net gift. Thus, the donee's basis would not be less than the § 2801 tax paid.[51]

14. Income in respect of a decedent.

No basis adjustment is allowed for items of income in respect of a decedent. However, § 691(c) allows an income tax deduction for the estate tax attributable to an item of income in respect of a decedent. Although the tax imposed by § 2801 is not an estate tax, in substance it is an estate tax. In the interest of preserving neutrality, a deduction should be allowed under § 691(c) for the § 2801 tax as if it were an estate tax.

15. Charitable remainder trust ("CRT")

Section 2801 imposes a tax on a domestic CRT's receipt of a covered gift or bequest.[52] Under the proposed regulations, the § 2801 tax is not taken into account in computing the value of the remainder of the trust.[53] The proposed regulations do not indicate whether the § 2801 tax also is disregarded in computing the amount of annuity or unitrust distributions, the requirement that the value of the remainder be at least 10% of the initial value of the trust or the probability of exhaustion test. The preamble does clarify that the payment of the § 2801 tax does not disqualify the CRT despite the requirement of § 664(d)(1)(B) and (d)(2)(B) that no amount may be paid from a CRT other than to the annuitant and the remainder beneficiary.[54] This point should be covered in the text of the regulations.

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[49] Prop. Reg. § 28.2801-6(a).

[50] Reg. § 1.1015-4(a).

[51] Reg. § 1.1015-4(a), -5.

[52] The preamble states that a CRT cannot be a foreign trust. 80 Fed. Reg. 54447, 54450 (2015). This is not true because a U.S. decedent could fund a foreign CRT. Because the presumption is made that a CRT cannot be foreign, the proposed regulations do not cover foreign CRTs.

[53] Prop. Reg. § 28.2801-4(a)(iii).

[54] The preamble says that § 664(d)(1)(B) and (d)(2)(B) and Reg. § 1.664-3(a)(4) do not apply. 80 Fed. Reg. 54447, 54450 (2015). Those provisions disqualify a CRT if any amounts are payable from the CRT other than to the beneficiaries. The preamble distinguishes Rev. Rul. 82-128, 1982-2 C.B. 71, which disqualified a CRT because estate tax could be paid from the trust under state tax apportionment laws, because, unlike the estate tax, the § 2801 tax is the primary liability of the CRT.

If the tax imposed by § 2801 were taken into account in determining the minimum remainder required to qualify as a CRT[55] or to determine the probability of exhaustion,[56] then most CRTs that owe tax under § 2801 are likely to be disqualified. If the tax is not considered in determining the annuity amount, the charitable remainder is overvalued.

Consider this example. If the CRT is funded with $1,000,000 and is required to pay 5% of the initial value of the trust to A for life, remainder to charity, A is 72 years old and the section 7520 rate is 2% (the rate for December, 2015), the annuity amount is $50,000 and the remainder has a present value of $454,050 and the probability of exhaustion test for CRTs is satisfied. However, if the CRT has only $781,620 left after paying the § 2801 tax of $218,380 (40% of ($1,000,000 - $454,050)) and the annuity payout is not reduced to 5% of the net remaining, then the "real" annuity percentage is 6.4%, the remainder has a present value of only $235,411 and the probability of exhaustion test is not met. However, to complicate matters, the § 2801 tax is not due and payable for 18 months or more, so that the CRT would have more funds available for investment until the tax is due, and there is some question about how the tax liability should be taken into consideration in this context.

16. Powers of appointment not in trust.

The proposed regulations explain that when a CE grants a U.S. individual a general power of appointment over property not held in trust, the covered gift or bequest is deemed made to the power holder, and the date of receipt is the first date on which the power is exercisable and the grant of the power of appointment is irrevocable.[57] The proposed regulations do not provide an example of a grant of a power of appointment over property not held in trust. An example would be helpful because powers of appointment are more typically held over trust property and not property not held in trust.[58]

17. Information returns

Proposed regulation § 28.2801-6(c) requires filing of information returns (Form 3520), citing § 6039F. However, § 6039F is applicable only to persons who are resident in the United States for income tax purposes, and not to those persons who may be domiciled in the United States for gift and estate tax purposes but not resident in the United States for income tax purposes.[59] If a nonresident alien who is domiciled in the U.S. receives a covered gift or

[55] § 664(d)(1)(D) and (d)(2)(D).

[56] Under the probability of exhaustion test, the charitable deduction is disallowed in full if there is a more than 5% probability that the remainder would be exhausted. Reg. §§ 20.2055-2(b)(1); 25.2522(c)-3(b); Rev. Rul.70-452, 1970-2 C.B. 199; 77-374, 1977-2 C.B. 329.

[57] Prop. Reg. §§ 28.2801-3(e)(2) and -4(d)(5)(ii).

[58] In the case of a power of appointment over property held in a domestic trust or an electing foreign trust, the covered gift or bequest is made when property is transferred to the trust, and in the case of property held in a non-electing foreign trust, the gift or bequest is received when the general power is exercised. Prop. Reg. § 28.2801-4(d)(5)(ii).

[59] Section 6039F applies only to United States persons. Under § 7701(a)(30) an individual is a United States person only if he or she is a citizen or resident of the United States. Section 7701(b) determines an individual's United States residency status without reference to his or her domicile.

bequest, he or she is required to file Form 708 in any case. Thus, in addition to the fact that there is no statutory authority to require filing of another information return, additional reporting seems to serve no purpose other than to increase potential penalties for noncompliance.

18. Presumption for protective returns.

A U.S. person who receives a gift or bequest from a nonresident alien has the burden of proving that the donor or decedent was not a CE or that the gift or bequest is otherwise not a covered gift or bequest. Proposed regulation § 28.6011-1(b) allows a taxpayer to file a protective Form 708 but only if he or she "reasonably concludes that the gift or bequest is not a covered gift or a covered bequest." A safe harbor (or at a minimum, guidelines) should be included to determine when a taxpayer has satisfied this requirement and may file a protective return.

19. Extension of time to pay tax.

Proposed regulation § 28.6081-1(c) provides that no extension of time to pay tax imposed by § 2801 is allowed. Because the time for payment of tax is not fixed in the statute, there is latitude to grant such extensions in the regulations. At a minimum, the same sort of extensions of time to pay tax that are allowed for purposes of the estate tax (e.g. where the estate is illiquid) should be allowed to U.S. persons who owe tax under § 2801. Such a rule would serve the goal of tax neutrality, which is the purported justification for the enactment of § 2801. In fact, extensions should be allowed in the gift tax context as well since the recipient of the gift, unlike the donor, has no control of the timing of receipt of the gift. Where the subject matter of the gift is illiquid, imposing tax and not allowing extensions to pay creates a duty that may be incapable of fulfillment.