Re: Comments of The American College of Trust and Estate Counsel on the Proposed Regulations Relating to Information Reporting by Foreign Financial Institutions and Withholding on Certain Payments to Foreign Financial Institutions and Other Foreign Entities (REG-121647-10) Released February 15, 2012

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the “College”) is pleased to submit the following comments on the Proposed Treasury Regulations under Sections 1471 through 1474 of the Internal Revenue Code, published by the Treasury Department on February 15, 2012 (REG-121647-10). The Proposed Regulations would be promulgated under the Sections of the Hiring Incentives to Restore Employment Act of 2010 (Public Law 111-147, the “HIRE Act”) that constitute the Foreign Account Tax Compliance Act (“FATCA”).

The College is a professional organization of approximately 2,600 lawyers from throughout the United States. Fellows of the College 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 the College 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. The College 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 the recommendations, please contact Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. at (202) 663-8316, or ellen.harrison@pillsburylaw.com or Henry Christensen, III of McDermott Will & Emery in New York, New York at (212) 547-5658, or hchristensen@mwe.com. Review was provided by Ronald D. Aucutt, Chair of the ACTEC Washington Affairs Committee, at (703) 712-5497, or raucutt@mcguirewoods.com.

Respectfully submitted,

Louis A. Mezzullo
President

Enclosure
The American College of Trust and Estate Counsel (ACTEC) offers the following comments on the Proposed Treasury Regulations under Sections 1471 through 1474 of the Internal Revenue Code, published by the Treasury Department on February 15, 2012 (REG-121647-10) (the “Proposed Regulations”). The Proposed Regulations would be promulgated under the Sections of the Hiring Incentives to Restore Employment Act of 2010 (Public Law 111-147, the “HIRE Act”) that constitute the Foreign Account Tax Compliance Act (“FATCA”).

These comments discuss only those aspects of the Proposed Regulations that impose reporting obligations (i) on U.S. beneficiaries of foreign trusts and estates, (ii) on fiduciaries of foreign trusts and estates and of domestic trusts and estates that may have foreign accounts, and (iii) on foreign financial institutions (“FFIs”) that hold accounts for domestic or foreign trusts or estates. We would like to assist the Treasury Department in crafting and adopting understandable and administrable Regulations that will ensure, at acceptable costs to institutions and fiduciaries, that the Treasury Department receives all the information we understand it needs and seeks.

These comments are divided into two sections. The first section discusses some overarching policy issues that we believe are fundamental to structuring the approach to trusts the Final Regulations should take. We note that there are no provisions in the Proposed Regulations that deal specifically and in detail with trusts, and we suggest that there should be. The second section of these comments offers technical comments on certain provisions in the Proposed Regulations.

I. GENERAL COMMENTS

A. Should Foreign Trusts Be Treated as Foreign Financial Institutions (“FFIs”)?

In ACTEC’s Report filed with the Treasury Department on January 7, 2011 concerning the FATCA provisions of the HIRE Act and Notice 2010-60, we questioned whether a foreign trust should be treated as a Foreign Financial Institution, or FFI, as defined in Section 1471(d)(4) and (5), or as a Non-Financial Foreign Entity, or NFFE, as defined in Section 1472(d). Notice 2010-60 suggested, but did not expressly state, that trusts should be treated as FFIs. The Proposed Regulations similarly suggest, but do not expressly state, that foreign trusts will be treated as FFIs under the Final Regulations. For example, Proposed Reg. §1.1471-3(d)(7)(iv) speaks of “[a]n FFI that is a partnership, simple trust, or grantor trust.” We urge that the Final Regulations expressly confront this question, and that Treasury consider the impact of treating foreign trusts as FFIs.
In ACTEC’s January 7, 2011 Report, we suggested that in our view a foreign trust could be found to be an FFI only as a “Type iii” Section 1471(d)(5)(C) FFI, which is an entity that “is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities (as defined in section 475(c)(2) without regard to the last sentence thereof), partnership interests, commodities (as defined in section 475(e)(2)), or any interest (including a futures or forward contract or option) in such securities, partnership interests, or commodities.” We did not think that a trust could be a “Type i” FFI, which “accepts deposits in the ordinary course of a banking or similar business,” although a trust company might fit such a definition. We also did not think that a trust should be treated as a “Type ii” FFI, which “as a substantial part of its business, holds financial assets for the account of others.” Our difficulty with applying these rules to trusts as such is that under Treasury Reg. §301.7701-4 the two fundamental ways in which trusts are distinguished from associations or corporations is that trusts do not have associates, but rather have a trustee who takes title to property for the purpose of protecting or conserving it for the beneficiaries, and trusts do not hold themselves out as engaging in business.

Other professional organizations shared ACTEC’s concerns about treating foreign trusts as FFIs. We understand why Treasury seeks to obtain full information about the beneficiaries of trusts, but we suggest that all needed information can be obtained without treating foreign trusts as FFIs and urge that this issue be considered carefully in crafting final regulations. Alternatively, if trusts are to be classified as FFIs, simplified reporting obligations should be imposed to qualify as participating FFIs which require only that trusts report distributions made to U.S. beneficiaries in recognition of the fact that beneficiaries of trusts do not have separate accounts.

B. Should the FATCA Rules Apply to Trusts, or to Trustees?

Trust lawyers recognize that under the common law a trust does not exist as an entity. Rather, the Trustee holds legal title to property for the equitable benefit of the trust beneficiaries, who are given the right to enforce their interests in chancery or equity courts. Under the Internal Revenue Code, generally, trusts are treated as entities, and trustees are not treated as taxpayers. Rather, the trustee is similar to an officer or director of a corporation who has the obligation to pay the tax liabilities of the trust, and the trust itself is the taxpayer under Subchapter J of the Internal Revenue Code. We believe that Treasury intends to take the same approach with respect to FATCA, but we suggest that it do so expressly. For example, an individual trustee (and many millions of trusts have individual, not corporate, trustees) could not be an FFI under Section 1471(d)(4), because an individual is not an “entity,” and only “entities” can be FFIs. The Final Regulations should make clear that they apply to FFIs and to NFFEs, and that trusts are one or the other, but that trustees are not separately subject to the rules.

C. Consideration Should Be Given to What Information Treasury Needs to Have Regarding Foreign Trusts and Their Beneficiaries.

At a meeting ACTEC representatives had with representatives of the Treasury Department in 2011 to discuss our January 7, 2011 filing, we were given to understand that, with respect to foreign trusts, the information that Treasury felt it must have was full information on ownership of foreign trusts by U.S. persons (whether under Section 679 or otherwise), such that
the U.S. person should be reporting the income of the foreign trust currently on his or her U.S. income tax return, Form 1040, as well as timely information on distributions made to U.S. persons that they should be reporting to the Internal Revenue Service, but may not be reporting. Under current Section 6048, any U.S. person who is treated as the owner of a foreign trust is required to see to it that the trust files a current return, on Form 3520-A, of the income and deductions of the trust, and then to report himself or herself all of that income and deductions with a Form 3520 filed with his or her Form 1040 for the year. Further, any beneficiary of a foreign trust is required to file a Form 3520 that discloses all distributions that the beneficiary received from the foreign trust during the tax year. The new Form 8938 called for by the new Section 6038D, another part of FATCA, increases reporting responsibilities for U.S. taxpayers having interests in foreign accounts, but again does not require reporting by the FFI with respect to the account.

There is at this time no requirement that the foreign trust file a report with the Treasury Department, on a Form 1099 or Schedule K-1, disclosing all distributions made to U.S. persons during the tax year. This is the information, taxable income, that Treasury needs to have each year. It does not seem to us that Treasury needs to know who all possible discretionary beneficiaries of a foreign trust might be, if they have not received any income. To the extent that the FATCA regulations are to apply to foreign trusts as such, and not just to FFIs (banks, brokers, custodians, and the like) that hold accounts for foreign trusts, we urge that Treasury direct its efforts to obtaining timely reports from the foreign trust of any distributions it has in fact made to a U.S. person, rather than exhaustive, and unneeded, information on all possible discretionary beneficiaries. As we have discussed with representatives of the Treasury Department, many, if not most, offshore trusts are broad discretionary trusts for the possible benefit of a donor’s entire family. Disclosure of the names, addresses, and taxpayer identification numbers of all of those persons, many or most of whom may be nonresident aliens of the United States, would be intrusive and unduly expensive, and would not serve the needs of the United States Treasury in collecting tax obligations of U.S. taxpayers.

II. SPECIFIC TECHNICAL COMMENTS

A. Rules Applicable to Accounts of Trusts Held by FFIs

Generally, we believe that the rules in the Proposed Regulations applicable to the reporting obligations of FFIs that hold accounts for trusts are sound and workable. Trusts, whether domestic or foreign, that hold deposit or investment accounts with banks, brokers, or custodians must report sufficient information to the FFI to allow it to comply with FATCA.

Proposed Reg. §1.1471-5(a)(3)(i) states that, in general, “if a trust (including a simple trust or grantor trust) or an estate is listed as the holder or owner of a financial account, the financial account shall be treated as held by the trust or estate itself rather than by its owners or beneficiaries.” The statute (Section 1471) provides that an FFI must obtain required information about each “holder” of each “account” at the FFI (Section 1471(b)(1)(A)), and that, in the case of a foreign account holder, the FFI must obtain further information about each “substantial United States owner” of the foreign entity (Section 1471(c)(1)(A)). Thus, in the case of a U.S. domestic trust that holds an account at the FFI, the FFI need only obtain the required information about the
trust itself, because the trust is a U.S. taxpayer and all income passing through the trust will be reported to the Internal Revenue Service.

In the case of a foreign trust that holds a financial account with an FFI, the FFI must obtain information on all “substantial United States owners” of the foreign trust. Section 1471(c)(1)(A). For this purpose, it is not necessary to determine whether the foreign trust is to be treated as an FFI or as an NFFE, because it is a foreign entity maintaining a financial account with an FFI. Generally, under the Code, a “substantial United States owner” of a foreign trust is either the “owner” as determined under the grantor trust rules (Section 1473(2)(A)(iii)(I)), or the holder of more than a 10 percent interest, as determined under Regulations, of a foreign trust that is not a grantor trust (Section 1473(2)(A)(iii)(II)). The statute has a special rule, in Section 1473(2)(A)(B), that “Type iii” investment vehicles described in Section 1471(d)(5)(C) shall have a “0 percent” threshold, rather than a 10 percent threshold, for determining “substantial United States owners.” This may have troublesome implications for trusts, as discussed below.

With respect to financial accounts held at FFIs for foreign trusts that are not “grantor” trusts with United States owners, Proposed Reg. §1.1473-1(b)(1)(iii)(B) states that generally a substantial United States owner is “[a]ny specified U.S. person that holds, directly or indirectly, more than ten percent of the beneficial interests of such trust.” We suggest that this Regulation define a substantial United States owner as “any specified U.S. person that holds, directly or indirectly, more than ten percent of the beneficial interest in the distributable net income of such trust, as defined [for a foreign trust] in section 643(a)(6).” We suggest this definition because, actuarially, in the case of a trust with fixed interests, the remainder beneficiary may hold an interest having a value of more than ten percent of the whole of the value of a foreign trust, but nevertheless have no interest in the income of the trust. It seems to be only the beneficiaries having an interest in the income of the trust that Treasury needs information about for purposes of FATCA.

We also note that the Proposed Regulations deal specifically with foreign trusts deemed to be owned by U.S. persons, but not with foreign trusts deemed to be owned by foreign persons, from which distributions are or may be being made to U.S. persons. We would suggest, for clarity, that a new subparagraph be added to the Proposed Regulations, perhaps as a new Proposed Reg. §1.1473-1(b)(1)(iii)(C), which could state:

To the extent the trust is deemed owned by a nonresident alien person under the rules of Subpart E of Subchapter J, in particular section 672(f), no U.S. person shall be deemed to be a “substantial owner” under section 1473(2), even if more than ten percent of the trust income is distributed to such person.

Proposed Reg. §1.1473-1(b)(3)(iii) goes on to state that in the case of a discretionary trust, where no beneficiary has a fixed entitlement to the income, the substantial United States owners” are to be determined annually, with reference to distributions actually made to the beneficiaries. Example 2 in Proposed Reg. §1.1473-1(b)(7) is on point and instructive.

Proposed Reg. §1.1473-1(b)(3) provides workable “bright line” rules for determining whether a discretionary non-grantor trust has a substantial United States owner. However, the Proposed Regulations abandon these bright-line rules for purposes of determining such a
beneficiary’s interest in a corporation owned by the foreign discretionary non-grantor trust. Consequently, under the Proposed Regulations, a U.S. person may be treated as an owner of a corporation owned by a trust even when such individual is not treated as owning an interest in the trust which actually owns the shares of the corporation. Proposed Reg. §1.1473-1(b)(2)(v) follows the “facts and circumstances” test in Treasury Reg. §1.958-1 to determine the beneficial owners of the stock of a corporation owned by a trust. These rules are extremely difficult to apply in the case of a discretionary trust. ACTEC submitted to representatives of the Department of the Treasury on June 23, 2010, a paper titled “Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J” (a copy of which is attached) suggesting a more workable solution to the problem of indirect ownership of foreign corporations held by foreign trusts. Pending resolution of this issue, we recommend that the indirect owners of a corporation be determined in the same manner as ownership is determined with respect to the trust itself.

In short, with the minor suggested changes described above, we believe that the Proposed Regulations are sensible and workable in their application of the Section 1471 reporting responsibilities to FFIs that hold financial accounts for foreign trusts. The FFI needs to obtain information on and report to the Internal Revenue Service each year, as “substantial United States owners” of a foreign trust, U.S. persons who received more than 10 percent of the distributions made from a foreign trust in the prior year. This is the information that ACTEC understands Treasury needs to enforce the tax laws, in light of our discussion with Treasury last year, and the Proposed Regulations go about obtaining the information in a sensible way. The difficulty with the Proposed Regulations is not the manner in which they apply to FFIs holding financial accounts for foreign trusts, but how they apply to foreign trusts themselves if they are to be treated as FFIs.

B. Rules Applicable to Foreign Trusts if They Are to Be Treated as NFFEs

Non-financial foreign entities, or NFFEs, are defined in Section 1472 and the Proposed Regulations thereunder. Of course, while the statute and Proposed Regulations speak of withholding on payments made to the NFFE, if the assets of the NFFE are held in custody at an FFI, withholding could be done upon a payment made to the FFI as record owner for the account of the NFFE, or to the NFFE as beneficial owner. We believe that if a foreign trust were treated as an NFFE, the Proposed Regulations under Section 1472 would be workable and would give the Treasury Department the information it needs for a foreign trust.

An NFFE is a foreign entity that is not a financial institution. There are three types of NFFEs under the regulations—active NFFEs, excepted NFFEs, and passive NFFEs. Proposed Reg. §1.1471-1. An active NFFE is one subcategory of excepted NFFEs. Other excepted categories include publicly traded corporations and their affiliates, entities owned by bona fide residents of a U.S. territory, and entities owned by exempt beneficial owners.

An active NFFE, which is one type of excepted NFFE, is defined as an NFFE less than 50 percent of the gross income of which in the preceding calendar year came from passive sources, or less than 50 percent of the value of whose assets in the preceding calendar year were assets that produce passive income. Proposed Reg. §1.1472-1(c)(1)(v). A passive NFFE is any
NFFE that is not an excepted NFFE. It seems likely that most foreign trusts would be treated as passive NFFEs, if they are to be treated as NFFEs under the Final Regulations.

A U.S. withholding agent must withhold 30 percent upon withholdable payments made to non-excepted NFFEs unless (i) the NFFE is the beneficial owner of the payment, (ii) the NFFE has provided the requisite documentation for the withholding agent to determine that it either has no substantial United States owner or has identified its substantial United States owners, and (iii) the withholding agent agrees to report to the IRS by March 15 of each year the identity of the United States owners and any other information the United States may require.

There are significant differences between treating foreign trusts as NFFEs and treating them as FFIs. In particular:

1. A foreign trust may satisfy the requirements of Section 1472 if it certifies to the withholding agent that it has no substantial United States owners. Section 1472(b)(1)(A); Proposed Reg. § 1.1472-1(b)(1)(ii). The majority of foreign trusts that are investing in the United States have no U.S. beneficiaries, and no U.S. relationship except that their trustees have chosen to invest in U.S. securities. An FFI does not have the ability to certify to the U.S. withholding agent that it has no U.S. beneficiaries. An owner-documented FFI can certify that it has no U.S. owners only if it obtains an “auditor’s letter substitute,” as discussed below. Therefore, if foreign trusts are to be treated as FFIs, rather than NFFEs, the trustee of a foreign trust with no U.S. beneficiaries has the choice of complying with onerous reporting obligations, including the giving of confidential information on foreign persons to the United States Treasury, or of not investing in the United States.

2. NFFEs may obtain a refund of taxes withheld under Section 1472, but FFIs may not obtain a refund of taxes withheld under Section 1471. Section 1474(b)(2)(A)(ii) provides that in general, unless required by treaty, an FFI cannot obtain a refund of taxes withheld under Section 1471, if the FFI was the beneficial owner of the payment upon which taxes were withheld. Section 1474(b)(2)(A)(ii); Proposed Reg. § 1.1474-5(a)(2). In the case of a trust, therefore, overwithheld taxes might be refunded if the income were distributed to a beneficiary currently, so that the trust was not the “beneficial owner” of the payments under the principles of Subchapter J, but a foreign trust that was treated as an FFI could not obtain a refund of taxes withheld under Section 1471 if the income was accumulated in the trust during the taxable year. This harsh rule does not apply to NFFEs.

3. The “0 percent” substantial owner rule applicable to “Type iii” FFIs under Section 1473(2)(B) and Proposed Reg. § 1.1473-1(b)(5) will apply to a foreign trust if it is treated as an FFI, but not if it is treated as an NFFE. In practical effect, there is no difference between a “Type iii” FFI and a “passive NFFE,” but the rules applicable to passive NFFEs are workable for foreign trusts, while the rules for “Type iii” FFIs are not. In this case, the sensible rules of Proposed Reg. § 1.1473-1(b)(3)(iii) will not apply to a foreign trust if it is treated as an FFI, as discussed below.
C. Rules Applicable to Foreign Trusts if They Are to be Treated as FFIs

We believe that a foreign trust company will be treated as an FFI under Section 1471(d)(5)(A) and Proposed Reg. §1.1471-5(e)(1)(i), because it accepts deposits as part of its business. Even if it does not accept deposits, under the Proposed Regulations an institution is treated as in a banking or similar business if it “holds itself out” as offering trust or fiduciary services, and thus is treated as an FFI. The issue is whether a foreign trust will itself be treated as an FFI. As noted above, we find several inferences in the Proposed Regulations that foreign trusts are to be treated as FFIs, but no clear statement that in all cases they are to be so treated, with perhaps minor exceptions for small personal trusts.

If a foreign trust is to be treated as an FFI, it can avoid withholding upon payments of U.S. source income by becoming a participating FFI or a deemed-compliant FFI.

In order to become a participating FFI, the foreign trust will have to enter into a participating FFI agreement with the Internal Revenue Service. Proposed Reg. §1.1471-4. In order to become a participating FFI, a trust will have to agree to report the name, address, and TIN of every U.S. account holder (with a “0 percent” threshold), and report the account balance of each U.S. account holder, as well as the interest, dividends, other income, and/or gross proceeds allocable to the account of each U.S. account holder. This is not possible because beneficiaries of a discretionary trust in fact have no “accounts” within the trust,

Instead of agreeing to make such reports, which as a practical matter a trust could not do, a participating FFI may make an election under Proposed Reg. §1.1471-4(d)(5) to file information returns required under sections 6041, 6042, 6045, and 6049 as if it were a U.S. person. This seems to be a very promising way to address compliance issues. However, we suggest that the election be modified to allow an electing trust to agree to file the same forms that a U.S. trustee would file with respect to distributions to beneficiaries – namely, Forms K-1 – as required by Code §6034A (which is not one of the sections listed in the proposed regulations).

Other than becoming a participating FFI, a foreign trust could also avoid withholding by becoming an “owner-documented FFI” under Proposed Reg. §1.1471-3(d)(7). However, as written, the information required to be reported to the Treasury Department by an “owner-documented FFI” for a complex trust is far too extensive to be administrable. If the foreign trust is a simple trust or a “grantor” trust owned by one or more taxpayers, the foreign trust treated as an FFI must supply the Service with name, address, taxpayer identification number, and account ownership information on each beneficiary or “grantor.” But if the foreign trust is a complex, discretionary trust with multiple beneficiaries without fixed interests, in order to become an “owner-documented FFI” the trust must supply the IRS with name, address, taxpayer identification number, and account value information for every person, both U.S. and non-U.S., having an interest in the trust, with a “0 percent” threshold, thus requiring the trustee to give the IRS information on every possible beneficiary, U.S. or foreign, of the trust. The statement to be provided to the withholding agent must set forth the percentage interest of each account holder in the trust, and of course they have no fixed or determinable interest. And the statement must be annually updated. If that is what the Final Regulations were to require, it would be an impossible task.
As an alternative to providing an FFI owner reporting statement, an ownerocumented FFI may provide an “auditor’s letter substitute” from a U.S. auditor dated within one year of the payment, certifying that the auditor has reviewed the payee’s documentation with respect to all of its owners under the due diligence standard of Proposed Reg. §1.1471-4(c), the FFI qualifies to be an owner-documented FFI, and no direct or indirect owners are non-participating FFIs, U.S. persons, or passive NFFEs with any substantial U.S. owners. This costly review is impractical.

D. Recommendations

If one applies the Proposed Regulations to a large discretionary trust, with individual or corporate trustees, that is a foreign trust with both U.S. and non-U.S. persons as eligible beneficiaries, the Proposed Regulations are administrable for the bank, custodian, or other FFI that holds the account of a foreign trust, and are also administrable for the trust itself if the foreign trust is to be treated as an NFFE. For these reasons, we recommend that the Final Regulations should clearly treat foreign trusts as NFFEs. However, if for some reason Treasury believes that foreign trusts must be treated as FFIs, we submit that the Proposed Regulations are not administrable, and that it will be necessary to adopt specific provisions applying to discretionary trusts treated as FFIs. We submit that the Final Regulations should do three things if they are to treat foreign trusts as FFIs:

1. They should provide that a foreign trust treated as an FFI should be able to be treated as a compliant FFI if it makes the certification provided for by Section 1472(b)(1)(A), for NFFEs, that it has no substantial United States owners.

2. They should recognize that discretionary trusts do not have “account holders” as such, and that the only account holder for a discretionary trust is a beneficiary who has actually received a distribution.

3. They should adopt the sensible and practical guideline of Proposed Reg. §1.1473-1(b)(3)(iii) that, in the case of a discretionary trust, an interest can be determined only by reference to the distributions actually made to the U.S. person in the preceding year. The Proposed Regulation defines “substantial United States owner” for a discretionary trust by adopting a rule that such a person had to have received more than 10 percent of the amounts distributed by the trust in the prior calendar year. Even if Treasury were to determine that it had an interest in applying the “0 percent” threshold for “Type iii” FFIs, and treated foreign trusts as such FFIs and subject to the “0 percent” threshold for withholding, we would urge Treasury to adopt a regulation, specific to discretionary trusts being treated as FFIs, recognizing that the only “accounts” they hold as an FFI are the amounts actually distributed to the beneficiaries in the prior calendar year. Such a regulation could also provide that the trust must report to Treasury, as a “compliant” FFI, all amounts actually distributed by the trust to U.S. persons in the prior year, on a Form 3520-A, as modified by Regulation, or on a Form 1099.
June 23, 2010

Honorable Michael F. Mundaca
Assistant Secretary of the Treasury for Tax Policy
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J

Dear Mr. Mundaca:

The American College of Trust and Estate Counsel ("ACTEC") submits the enclosed memorandum setting forth proposals for guidance with respect to the coordination of the foreign corporation anti-deferral rules and subchapter J.

The Internal Revenue Code of 1986, as amended (the "Code") contains rules to protect the right of the U.S. to tax U.S. citizens and residents on their worldwide income, including income which has been accumulated offshore. These rules prevent U.S. taxpayers from using foreign trusts and foreign corporations to avoid payment of U.S. tax. However, the rules overlap and create problems and inconsistencies when both foreign trusts and foreign corporations are involved. The preamble to the Proposed PFIC regulations, issued on April 1, 1992, notes the need to coordinate the accumulation distribution and the PFIC tax regimes. We believe that adjustments to the trust accumulation distribution rules and adjustments to and coordination with certain of the PFIC rules are necessary to achieve the result of preserving the interest charge on untaxed income. We recommend that Treasury adopt one or more
regulations that will integrate the rules for taxation of PFICs with the taxation of accumulation distributions from foreign trusts, under the structure of Subchapter J.

ACTEC is a national professional association of approximately 2,600 lawyers elected to membership by their peers on the basis of professional reputation and ability in the field of trusts and estates and on the basis of having made substantial contributions to these fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in rendering advice to taxpayers on matter of federal taxes, with a focus and estate and gift 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.

Principal contacts for a discussion of the enclosed proposals are Henry Christensen, III of McDermott Will & Emery in New York, New York (212.547.5658) and Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. (202.663.8316). Members of your staff should not hesitate to contact either of them for more information regarding these proposals.

Very truly yours,

Karen M. Moore
President

cc: Emily McMahon, Esquire
Manal Corwin, Esquire
Honorable William J. Wilkins
Catherine V. Hughes, Esquire
American College of Trust and Estate Counsel ("ACTEC") Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J*

The Internal Revenue Code of 1986, as amended (the "Code") contains rules to protect the right of the U.S. to tax U.S. citizens and residents on their worldwide income, including income that has been accumulated offshore. These rules prevent U.S. taxpayers from using foreign trusts and foreign corporations to avoid payment of U.S. tax. However, the rules overlap and create problems and inconsistencies when both foreign trusts and foreign corporations are involved.

This memorandum addresses certain aspects of the rules currently applicable to controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") that in some instances permit U.S. beneficiaries of trusts that hold interests in such entities to avoid or postpone taxation on income generated by such corporations and in other instances subject such beneficiaries to inappropriate income taxation on such income. It contains ACTEC’s proposals for a regulatory approach to the coordination of the foreign corporate anti-deferral rules with the rules of Subchapter J that would ensure that the U.S. beneficiaries of foreign trusts that hold investments in foreign corporations are taxed in a manner that is more consistent with the objectives of the anti-deferral rules.1

**Foreign trust tax rules**

A foreign trust is subject to U.S. tax only on U.S. source income. However, U.S. persons who are the beneficiaries of foreign trusts are taxed on all of their worldwide income from the trust, either currently or at some future date when the accumulated income is finally distributed to them.

Various rules prevent or inhibit the use of foreign trusts to avoid U.S. income tax, or even to postpone tax. In particular, section 6792 treats as grantor trusts, owned by the grantor, foreign trusts created by U.S. persons if they have U.S. beneficiaries. This memorandum will deal only with the U.S. income taxation of foreign trusts that are not taxed as grantor trusts. Due to the broad application of section 679, in most cases such trusts will have been created either by non-U.S. grantors or by U.S. grantors who are deceased.

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* The primary authors of this memorandum are Henry Christensen III, Ellen K. Harrison, Donald D. Kozusko and Edward C. Northwood. Anne O'Brien, Carlyn S. McCaffrey, and Ronald D. Aucutt provided helpful comments.


2 References in this memorandum to “section” or “sections” refer to sections of the Code.
Under the rules of Subchapter J of the Code, U.S. taxpayers have long been subject to tax on the worldwide income of foreign trusts when the income is distributed to them, even though the income is not taxed to the trust itself. Three principles apply to accomplish this end. First, under section 641(b) all trusts, whether domestic or foreign, are taxed in a manner similar to the manner in which individuals are taxed. Since 1997, section 641(b) has included a sentence making clear that a foreign trust will be treated as a nonresident alien individual not present in the U.S. at any time. Second, because the trust is treated as a nonresident alien individual not present in the U.S. at any time, foreign source income and U.S. source capital gains (with some exceptions) will not be taxed to a foreign trust, but will still be part of the income of the trust, computed under sections 641 and 643, and will be taxed to U.S. beneficiaries when distributed to them from the foreign trust. Because of the modification to the distributable net income (“DNI”) rules under section 643(a)(6) for foreign trusts, all income collected from any source by the trust, including foreign source income, will be included in the trust’s DNI and therefore will be carried out to U.S. beneficiaries as part of any distribution to the beneficiary, even though the same income would not have been taxed by the U.S. to the trust itself.

Third, and most importantly for this discussion, sections 665 et seq. of the Code impose a tax (the accumulation distribution tax) on distributions to U.S. beneficiaries from foreign nongrantor trusts that are deemed to come out of undistributed net income (“UNI”). UNI is the trust’s DNI for prior years minus income deemed distributed to beneficiaries in prior years. While foreign source income that is accumulated in a foreign nongrantor trust is not taxed currently by the U.S., either to the trust or the beneficiaries, the benefit of deferral is taken away by the accumulation distribution tax. First, the accumulation distribution is taxed as ordinary income regardless of the character of the accumulated income (unless the accumulated income was tax exempt income); most importantly, capital gains that become UNI will be taxable as ordinary income when distributed to U.S. beneficiaries. Second, a U.S. beneficiary who receives UNI is taxed at a rate equal to the average marginal tax rate of the beneficiary for the prior five years, the UNI is allocated to the taxable years in which it was deemed to have been accumulated in the foreign trust and an interest charge is applied on the tax allocated to each such year, to appropriately charge the taxpayer and recompense the Treasury for any deferral in collecting a tax. The interest charge eliminates the benefit of deferring the time for payment of tax on foreign source income accumulated in a foreign nongrantor trust.

However, the operation of the accumulation distribution tax may be undermined by the use of foreign holding companies. If a foreign nongrantor trust invests through or in a foreign holding

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3  Code §665(a) reduces UNI by the amount of income taxes imposed on the trust but a distribution of UNI carries out taxes attributable to that income and the beneficiary is allowed to credit the accumulation distribution tax by the amount of income tax imposed on the trust that is allocated to such beneficiary. Code §§666(c) and 667(d).

4  Code §667(a).

5  Code §§667(b) and 668.

6  References in this memorandum to “foreign holding companies” refer to corporations organized under the laws of a nation other than the U.S. or a political subdivision of the U.S. As discussed below in more detail, such companies may be either controlled foreign corporations or passive foreign investment companies.
company, the trust will not have any taxable income until either the holding company makes a
distribution to the trust or the trust sells the shares of the holding company. If the holding company
makes distributions to the foreign trust which the trust in turn distributes currently to the U.S.
beneficiaries, then, in our view, it would be appropriate to tax the income accumulated in the
holding company in prior years, as PFIC income to the U.S. beneficiaries. But while we believe it
appropriate to tax the distribution as PFIC income, unless Treasury adopts a clarifying regulation, at
present the distribution from the holding company cannot be taxed as UNI because it constitutes
current income, not UNI.\(^7\) If the holding company liquidates into, or makes a distribution to the
foreign trust and the trust makes no current distribution to its U.S. beneficiaries, it is not clear
whether any of the U.S. beneficiaries would be subject to current tax on the event.

We propose that this potential loophole be closed by adopting a rule that the DNI of a foreign
nongrantor trust be calculated by treating income that was accumulated in the foreign holding
company owned by the trust as income of the trust when it is distributed by the foreign holding
company, and then taxing it through to the U.S. beneficiaries when distributed to them under the
rules of Subchapter J. This rule would be consistent with Congressional intent\(^8\) and Treasury’s
statement in 1992,\(^9\) that the PFIC rules should be harmonized with Subchapter J rules, and that the
Subchapter J approach of delaying tax until a U.S. person receives an actual distribution should
prevail.

One way to reconcile the rules of Subchapter J with the PFIC tax regime would be to calculate
the DNI of the trust by applying the same rules that apply to U.S. taxpayers who own shares of
PFICs, which are discussed below. These rules currently do not apply to a foreign nongrantor trust
because it is not a U.S. taxpayer. If those rules applied, broadly speaking, the income of the PFIC
would enter into the computation of DNI of the trust for the year the income accrued to the holding
company in the same fashion as if the foreign trust were a U.S. taxpayer, and be added to the trust’s
DNI for each year that the trust owned shares of the PFIC, and thus would be part of the trust’s UNI.
Under such a rule, when the trust received a distribution from the holding company and made a
distribution to a U.S. beneficiary in the same year, a portion of that income would be treated as UNI
and the accumulation distribution tax would apply to that portion.

Another way to reconcile the rules of Subchapter J with the PFIC tax regime would be to tack
the holding period of income accumulated in PFICs owned by foreign trusts to the period in which
the UNI is held by the trust itself. Both alternatives are discussed below.

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\(^7\) Code §665(b) provides that if the amounts distributed do not exceed the income of the trust for such year, there shall
be no accumulation distribution. Code §643(b) defines “income” as fiduciary accounting income.

\(^8\) Congress intended, when a U.S. shareholder directly owned shares in a passive foreign investment company, that the
PFIC rules would track the Subchapter J accumulation distribution rules, and postpone tax until a U.S. person received an
actual distribution, General Explanation of the Tax Reform of 1986 prepared by the Staff of the Joint Committee on Taxation,
May 4, 1987 (the “Blue Book”), at p. 1032. The preamble to the PFIC regulations proposed by Treasury in 1992 states:
“Pursuant to section 1291, a U.S. person that is a shareholder of a section 1291 fund pays tax and an interest charge on receipt
of certain distributions and upon disposition of stock of the section 1291 fund.” 1992-1 CB 1124, at 1125.

\(^9\) Preamble to proposed Treasury regulations, 1992-1 C.B. 1124, at 1127.
We suggest that these rules apply in lieu of rules that have been proposed to date to treat U.S. beneficiaries of foreign nongrantor trusts as the indirect owners of the shares of PFICs owned by the trust in proportion to their beneficial interests in the trust. These indirect ownership rules, discussed below, are not workable when the beneficiary does not control the trust assets, when different beneficiaries are entitled to income and principal and when the interests of the trust beneficiaries are not fixed, clear and vested, which is the typical case. As a result, these rules have not been effective. Treasury’s current indirect ownership rules create problems with both fairness and administrability, including the following:

1. Beneficiaries of foreign trusts usually do not control the distribution of income from a foreign holding company or from the trust and may not even know what investments the trust owns.

2. Certain elections available to U.S. shareholders of PFICs may not be available to a U.S. beneficiary (at least as a practical matter).

3. The exclusion from income allowed to the U.S. shareholder of a PFIC that was previously taxed to such shareholder will not work properly if income is imputed to a U.S. beneficiary and that income is actually received by another person (or retained in the trust).

4. The application of the accumulation distribution tax and the corporate anti-avoidance taxes, discussed below, to the same amounts needs to be coordinated.

These problems can all be avoided by adopting any of the rules we recommend. We do not necessarily favor any one of our recommendations herein over the others, or over any alternative proposal that Treasury may develop. But a workable, fair set of rules must be developed.

If the use of PFICs to undermine the accumulation distribution tax can be curtailed by any of the methods we propose, there would be no need to tax currently changes in ownership of shares of PFICs owned by foreign nongrantor trusts to their U.S. beneficiaries in order to prevent “free” deferral of U.S. tax. Deferral is not “free” and it is not abusive when an appropriate interest charge is imposed in consideration of the deferral of tax payments. The accumulation distribution tax regime should be expanded and the imputation of current tax to indirect ownership of shares of investment companies owned by foreign nongrantor trusts should be limited, we think appropriately, to the rare cases when a U.S. beneficiary of a foreign nongrantor trust actually or in effect controls trust investments. Of course, U.S. grantors of foreign grantor trusts would continue to be subject to the corporate anti-avoidance rules.

Although we acknowledge that Treasury’s present approach to the indirect ownership rules, if it were effective, would be likely to expose the income of PFICs to U.S. tax sooner than the rules we propose, we think the present indirect ownership rules are not effective. Any of the rules we propose would likely result in a workable solution by imposing an interest charge on tax attributable to the distribution of income accumulated in PFICs owned by foreign nongrantor trusts.

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10 See, e.g. Code §1294 allowing a shareholder of a PFIC who has made a QEF election to defer payment of tax.
Moreover, there is little logic to allowing deferral of tax on income accruing directly to a foreign trust under the trust rules, or of allowing deferral of tax on income accruing to a PFIC whose shares are held directly by a U.S. shareholder, until there is a distribution to or a disposition by the U.S. beneficiary/shareholder, and denying such deferral to beneficiaries of foreign trusts that invest in PFICs. There are good nontax reasons for investing through PFICs and the different tax treatment merely traps U.S. beneficiaries who are served by ill advised trustees. In many cases the indirect ownership rules can be avoided by making a check-the-box election for the company to be treated as a flow-through entity. However, a foreign trustee may not be aware of the problem and potential solution.

We are not suggesting abandonment of the indirect ownership rules where a foreign trust owns an interest in a foreign holding company. Our recommendations go to establishing sound taxing rules, not to abandoning indirect ownership rules. Thus, the provisions of section 958(a)(2) and section 1298(a)(3) should be enforced in accordance with their terms, although we believe that a proper application of the “facts and circumstances” test of Treasury regulation § 1.958-1(c)(2) would defer, or make only tentative, an attribution of an interest in a foreign holding company to a U.S. person whose interest in the foreign trust is not clear and vested. What we are suggesting, however, is that the taxing rules of section 951(a) and section 1298(b)(5) be conformed to the principles of Subchapter J.

The corporate anti-avoidance rules

There are two sets of corporate anti-avoidance rules – one for CFCs and one for PFICs.

CFC rules

A foreign corporation is a CFC if “U.S. shareholders” own more than 50% of the total combined voting power or more than 50% of the total value of the stock of the company.\(^\text{11}\) For this purpose, a “U.S. shareholder” is a person who owns 10% or more of the total combined voting power of the corporation.\(^\text{12}\) If a corporation is a CFC, then each “U.S. shareholder” is required to include in income his or her share of the “subpart F income” of the CFC.\(^\text{13}\) A U.S. taxpayer who does not own at least 10% of the voting stock is not a “U.S. shareholder” for purposes of this rule and therefore is not taxed on subpart F income that is not actually distributed to him or her. Subpart F income includes most passive type income. To prevent taxing the same income twice, section 959 provides that a shareholder is not taxed on receipt of a distribution of previously taxed income, and his or her basis in the shares is increased by the income that is taxed to him or her (and reduced by distributions of such previously taxed income) so that any gain realized on the disposition of shares is reduced by undistributed previously taxed income. Upon a disposition of shares, any gain that represents accumulated earnings and profits is taxed as ordinary income.

\(^{11}\) Code §957(a).

\(^{12}\) Code §951(b).

\(^{13}\) Code §951(a).
For purposes of determining whether a corporation is a CFC and whether a person is a U.S. shareholder, a U.S. person is treated as owning stock owned directly, indirectly or constructively.\(^{14}\) However, for purposes of imposing tax on a U.S. shareholder, only shares owned directly or indirectly (not constructively) are counted.\(^{15}\)

Taxing owners of voting shares when U.S. owners who each own at least 10% of the shares collectively own more than 50% of the voting stock makes sense because such persons, acting collectively, can compel the corporation to distribute funds to them to cover the tax attributable to their shares of CFC income. In addition, they can dispose of their shares. In most cases, it does not make sense to treat a U.S. beneficiary of a foreign nongrantor trust as an indirect U.S. shareholder for purposes of the CFC rules because he or she does not have any power to compel the payment of dividends or to force a sale of the stock held by the trust. If such beneficiary directly owned nonvoting shares, he or she would not be treated as a U.S. shareholder for purposes of the CFC rules, and it is inconsistent to treat a trust beneficiary who lacks voting rights less favorably. In fact, the person who owns nonvoting shares should be treated less favorably than a beneficiary of a foreign trust since the person who owns nonvoting shares has the option to sell or dispose of such shares. By contrast, the beneficiary has no recourse to avoid being taxed on income he or she has not received and may never receive.

It is important to recognize that a U.S. person cannot create a foreign trust to defer tax on his or her own, or his or her family’s beneficial interest in income earned by a foreign investment company owned by the foreign trust. Section 679 would apply to make the trust a grantor trust. Thus, the concern is limited to trusts created by non-U.S. grantors or U.S. grantors who are no longer living. The beneficiaries of such trusts generally have no control over distributions. This is why sections 665-668 tax the U.S. beneficiary only when he or she receives a distribution from the trust and impose an appropriate interest charge.

A U.S. beneficiary of a foreign nongrantor trust is deemed to own shares of a company owned by a foreign trust in proportion to his or her beneficial interest in the trust.\(^{16}\) Section 958(a)(2) provides that “stock owned, directly or indirectly, by or for a ... foreign trust or foreign estate ... shall be treated as being owned proportionately by its ... beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.” Treasury regulation §1.958-1(b) provides that for purposes of the indirect ownership rules of section 958(a), stock owned by a foreign trust or foreign estate shall be considered as owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock, or by the beneficiaries in the case of foreign nongrantor trusts. Treasury regulation §1.958-1(c)(2) provides that

\(^{14}\) Code §957(a) provides that for purposes of determining whether a corporation is a CFC, stock is treated as owned by applying both the indirect and constructive ownership rules of Code §958.

\(^{15}\) Code §951(a) provides that income is attributed to a person who owns the shares or is treated as owning the shares indirectly by virtue of Code §958(a). The statute excludes ownership through §958(b)’s constructive ownership rules.

\(^{16}\) Code §958
The 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. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation.

If the issue is whether the income accruing to the corporation should be taxed to a beneficiary, only the interests of income beneficiaries and not remainder beneficiaries should be considered. The regulation further provides that “If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person.” This portion of the regulation should be construed to mean that a beneficiary who lacks voting power over the shares held by a foreign trust will not be considered to indirectly own the shares for purposes of determining whether he or she is a U.S. shareholder.

For purposes of the constructive ownership rules of section 958(b), Treasury regulation §1.958-2(c)(1)(ii) provides that stock owned by a trust shall be considered to be owned by the persons treated as the owners under sections 671-679 in the case of grantor trusts or, for nongrantor trusts, in proportion to the beneficiaries’ actuarial interests in such trust. However, a person who has been attributed constructive ownership who does not have indirect ownership is not a “U.S. shareholder” liable to tax under section 951(a).

Example (3) of Treasury regulation §1.958-1(d) illustrates indirect ownership through a foreign trust. Example (3) is as follows:

Foreign trust Z was created for the benefit of U.S. persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

We think that this example should be narrowly applied. It involved a short-term fixed interest trust with vested remainders; the regulation was adopted in 1966 and by the terms of the example the trust was to terminate in 1970 and all of the assets were required to be distributed to
the named income beneficiaries. In such a case, we believe that the trustee would be violating a fiduciary duty to the beneficiaries by failing to distribute amounts at least sufficient to cover the beneficiary’s tax attributable to trust income. If such a fiduciary duty exists, in practical effect the beneficiaries have sufficient indirect control over distributions to justify their being taxed currently on the subpart F income of the investment company under a theory akin to constructive receipt principles. Only in such narrow circumstances is it reasonable and consistent with the assumption underlying the CFC rules that U.S. shareholders effectively control the CFC to tax beneficiaries on a share of CFC income. In addition, because the beneficiaries’ interests in the example were vested, there is no risk that the beneficiaries (or their estates if they died prior to the termination of the trust) would not actually receive the income on which they paid tax. Therefore, the CFC rules excluding previously taxed income from tax when distributed (discussed below) would work appropriately.

Note that it is not clear whether the absence of voting rights in D, E and F in Example (3) affects their treatment as “U.S. shareholders”. Treasury regulation §1.958-1(c)(2) provides that “If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person’s proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person.” If D, E, and F lack voting rights, is it appropriate to treat them as “U.S. shareholders” for purposes of section 951(a)?

Nevertheless, even if D, E and F lack voting rights, as they almost surely do, we believe the right result is reached by the example, as long as the interests are vested.

Section 959 provides a mechanism for avoiding double tax when a shareholder receives previously taxed income from a CFC. Section 959 provides that earnings and profits of a foreign corporation attributable to amounts that are or have been included in the gross income of a U.S. shareholder under section 951(a) shall not, when such amounts are distributed through a chain of ownership described in section 958(a), be included in the gross income of such shareholder or any other U.S. person who acquires from any person any portion of the interest of such U.S. shareholder in such foreign corporation. Section 959 would apply fairly to the facts of Example 3 in Treasury regulation § 1.958-1(d) when the income was later distributed to D, E or F or their estates. But how is that mechanism to apply when a beneficiary of a trust receives a distribution of income previously taxed to another person?

For example, suppose that a foreign trust is established for the life income benefit of H and on his death the trust terminates and its assets are distributed outright in equal shares to A, B and C. Assume further that the CFC’s net income over several years includes substantial “foreign personal holding company income” defined in section 954(c) that is not distributed by the CFC and would be properly allocable to principal of the foreign trust were it to be distributed to the foreign trust by the CFC. Taxing that income to H when it is never going to inure to the benefit of H is unreasonable and unfair. That unfairness is not eliminated by allowing A, B and C (or any ultimate

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17 The example does not expressly state that the beneficiaries’ interests in the trust are vested, but we believe that to be the fair reading of the facts.
discretionary beneficiaries who receive the trust principal) to exclude from income amounts previously taxed to H when they receive the money, particularly if there is no reason to believe that H would want to benefit A, B or C.

In some cases the application of the section 959 exclusion would be very complicated. For example, assume in the above example that upon H’s death, the assets were to be retained in a wholly discretionary trust for the benefit of A, B and C and their descendants. Suppose that the trust made no distributions for five years and then made a distribution to A. Would the DNI/UNI of the foreign trust be calculated by excluding from trust income the income previously taxed to H? If not, upon a distribution to A, the previously taxed income would be taxed again. If the income is excluded in the calculation of DNI/UNI, then how is the excluded amount apportioned among A, B and C?

Section 961 and Treasury regulation §1.961-1 provide that a U.S. shareholder’s basis in his or her shares is increased by the amount the shareholder is required to include in income under section 951(a) and reduced by the amount of distributions of previously taxed income that is excluded from income under section 959. If a U.S. shareholder indirectly owns shares through a trust or estate, Treasury regulation §1.961-1(b)(1) provides that the basis of his or her beneficial interest in the foreign estate or trust is adjusted. According to this regulation, if income is taxable to beneficiaries under section 951(a) but not distributed, the trust may not increase its basis in the shares of the CFC. The adjustment of the basis of a beneficiary’s beneficial interest in the foreign trust is ineffective to avoid double tax. Basis in a trust or estate generally is meaningless in the rules governing the taxation of trusts and estates. Basis does not affect the determination of a beneficiary’s share of income derived from the trust or estate. Rather, a beneficiary is taxed on his or her share of trust or estate income, and a beneficiary’s basis in his or her beneficial interest would not enter into the calculation of trust or estate income.

Our recommendation is that foreign trusts owning shares in corporations that would be classified as CFCs be treated as owning shares in PFICs, and not CFCs, except in the rare and limited circumstance that (1) the U.S. beneficiaries serve as trustees or co-trustees, (2) the U.S. beneficiaries have the right to remove and replace the trustee of the foreign trust with trustees subservient to them, or (3) the interests of the U.S. beneficiaries, in all classes of income, are so fixed, clear and vested that the trustee of the foreign trust would have a fiduciary duty to distribute the income of the foreign investment company currently to the U.S. beneficiaries, and not accumulate it in the corporation.

**PFIC rules**

A foreign corporation is a PFIC if 75% or more of the gross income of such corporation is passive income or the average percentage of assets held by such corporation which produce passive income or which are held for the production of passive income is at least 50 percent.18 The PFIC rules were adopted in the Tax Reform Act of 1986 because Congress recognized that while income

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18 Code §1297(a)
accumulated in foreign trusts was being taxed to the U.S. beneficiaries with an appropriate interest charge, income being accumulated in foreign corporations was not being appropriately taxed to the less than 10% U.S. shareholders. Instead, they could effectively dispose of their shares at capital gains tax rates after years of accumulating income in the foreign investment company.\(^1\)

As originally passed in the House bill, the new provisions would have subjected less than 10% shareholders to current tax on accumulated passive income in foreign investment companies. The Senate, noting with approval the operation of the foreign trust rules, which delayed imposition of tax until a beneficiary actually received a distribution, but then imposed tax with an appropriate interest charge to compensate the Treasury for the delay in payment of taxes, amended the House bill to apply to foreign investment companies a regime similar to the Subchapter J regime. With modifications, the Senate approach became law.

A U.S. shareholder of a PFIC is not taxed currently on PFIC income unless certain elections are made. Instead, a regime similar to the accumulation distribution tax applies when a U.S. shareholder receives (or is deemed to receive) an “excess distribution.” An excess distribution is (i) a distribution that exceeds 125% of the average distributions received in the prior three years; and (ii) gain realized on a disposition (or gain deemed realized on a disposition) of PFIC shares. Certain nontaxable transfers are treated as generating an excess distribution equal to the excess of fair market value of the shares over basis.\(^2\)

The PFIC rules apply regardless of the percentage of ownership of shares held by U.S. persons. Because control of the PFIC is not important to the application of the PFIC rules, the fact that a beneficiary of a trust does not control the trust investments is not important to the application of the PFIC rules to trust beneficiaries. However, a corporation may be both a CFC and PFIC. In that case, the CFC rules take precedence.\(^3\)

When a U.S. person receives or is treated as receiving an excess distribution, the excess distribution is allocated equally to all prior years in the person’s holding period, tax is calculated for each such year and an interest charge is imposed on the tax allocated to each prior year for the number of years between the tax due date for each such year and the date the tax is paid.\(^4\)

A U.S. person may avoid the excess distribution tax regime by making certain elections. One election is the “qualified electing fund” or “QEF” election. Under this election, which is only available if the PFIC agrees to provide the necessary tax information to shareholders, the U.S. shareholder includes in his or her income his or her share of PFIC income as it accrues. If this election is made, the character of the income to the shareholder is the same as the character of the income realized by the PFIC. Capital gain income, for example, retains its character. 

\(^{20}\) Code §1291.
\(^{21}\) Code §§951(c) and 1297(d).
\(^{22}\) Code §1291.
distribution of previously taxed income is not taxed again and a U.S. shareholder’s basis in the PFIC
shares is adjusted for the income taken into account under the QEF election. In addition, a U.S.
shareholder may elect to defer the payment of tax on income imputed under a QEF election, but
interest accrues on the deferred tax.

A second election is the mark-to-market election, which is available only for publicly traded
securities. Under the mark-to-market election, the U.S. shareholder includes in his or her income
annual appreciation in the market value of securities and is entitled to a loss if the value declines, to
the extent of appreciation previously included in income. As under the QEF election, the basis of the
PFIC shares is adjusted for the appreciation or depreciation taken into account under the mark-to-
market elections.

Shares of an investment company held by a nonresident alien are not treated as PFIC shares.
Only a U.S. person is treated as a PFIC shareholder. Thus, a U.S. person’s holding period of PFIC
shares does not include the holding period of the shares when they were previously owned by a
nonresident alien because the shares were not PFIC shares in the hands of the nonresident alien
owner. Similarly, a corporation is not treated as a PFIC with respect to a shareholder for those days
included in the shareholder’s holding period before the shareholder became a U.S. person. While
this rule is correct as a matter of tax policy for shares that are owned by a nonresident alien
individual, this rule should not apply to shares owned by a foreign trust, even though a foreign trust
is taxed like a nonresident alien individual, because application of this rule to a foreign trust would
undermine the application of the accumulation distribution tax rules, as discussed below.

A U.S. person is treated as indirectly owning shares of a PFIC held by a foreign nongrantor
trust of which he or she is a beneficiary in proportion to his or her beneficial interest. The
definition of indirect ownership is identical to the definition used for a CFC. Proposed Treasury
regulation §1.1298-1(b)(8) defines an indirect shareholder as a person who is treated as owning
the stock of a corporation that is owned by another person (the actual owner) under this paragraph.
In applying this paragraph, the proposed regulation provides that the determination of a person’s
indirect ownership is made on the basis of all the facts and circumstances in each case; the
substance rather than the form of ownership controls, taking into account the purposes of section
1291. Paragraph (8) cross references Treasury regulation §1.958-1(c)(2). Proposed Treasury
regulation §1.1291-1(b)(8)(iii)(C) provides that the beneficiaries of an estate or trust that owns
stock of a corporation will be deemed to own “a proportionate amount” of such stock.

23 Code §1293.
24 Code §1294.
25 Code §1296.
26 Treasury regulation §1.1291-9(j)(1), which defines a PFIC, provides “A corporation will not be treated as a PFIC
with respect to a shareholder for those days included in the shareholder’s holding period when the shareholder, or a
person whose holding period of the stock is included in the shareholder’s holding period, was not a U.S. person within
the meaning of section 7701(a)(30).”
27 Proposed Treasury regulation §1.1291-1(b)(1)(i).
28 Code §1298(a)(3).
Unlike the CFC rules, the proposed regulations do not limit indirect ownership rules to shares held by foreign entities. The application of the indirect ownership rules to shares held by domestic entities seems to be unintended because other PFIC regulations recognize the domestic pass through entity as the shareholder, e.g. for purposes of making a QEF or mark-to-market election.\textsuperscript{29} It serves no apparent purpose to impute ownership from a domestic trust to a U.S. beneficiary, since the PFIC tax regime would apply to the U.S. trust itself. In addition, section 1298(a)(1)(B) implies that this should not be the case. Section 1298(a)(1)(B) provides that “except to the extent provided in regulations, [attribution of ownership] shall not apply to treat stock owned (or treated as owned under this subsection) by a United States person as owned by any other person.” Because a domestic trust is a U.S. person, ownership of corporate shares held by a domestic trust should not be attributed to any other person, including a beneficiary of such trust. The PFIC regulations should be changed to prevent the application of the indirect ownership rules to PFIC shares held by domestic entities.

When a person is treated as indirectly owning shares owned by an entity, including a trust, a transaction that results in a reduction of his or her indirect ownership of PFIC shares may be treated as a disposition of those shares. Section 1298(b)(5) provides:

\textbf{(A) IN GENERAL. –} Under regulations, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a) [providing that beneficiaries are treated as owning proportionately shares owned by a trust] –

\textbf{(i)} any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock or

\textbf{(ii)} any distribution of property in respect of such stock to the person holding such stock,

shall be treated as a disposition by, or distribution to, the United States person which respect to the stock in the passive foreign investment company.

Although there are no regulations implementing section 1298(b)(5), Treasury regulation §1.1291-3(e) does define an “indirect disposition” as any transfer that results in an indirect shareholder’s interest being reduced. For example, a U.S. beneficiary of a foreign nongrantor trust would be treated as making an indirect disposition of shares of a PFIC that he or she is treated as indirectly owning if the trust disposes of the PFIC shares either by sale, liquidation or distribution.

\textsuperscript{29} Treasury regulation §1.1295-1(d)(2)(iii). Treasury regulation §1.1296-1(e)(1) provides that for purposes of the mark-to-market election, only shares owned by a foreign trust or foreign estate are deemed to be indirectly owned by beneficiaries.
to another beneficiary. Such deemed disposition could be treated as generating an excess distribution. If so, what is the U.S. beneficiary’s basis in the PFIC shares and what is his or her holding period? Would shifting beneficial interests cause multiple excess distributions to be generated? In thinking about these problems, it must be recognized that the U.S. beneficiary would not necessarily have received distributions to cover any tax imposed by these rules.

Similarly, under section 1298(b)(5), if implemented by regulations, a distribution from the PFIC to the foreign trust could be treated as a distribution to the indirect shareholder/beneficiary. If the distribution is an excess distribution, the PFIC tax regime could be made to apply to the beneficiary.

The issue of whether the excess distribution amounts are properly allocable to the trust’s income or principal accounts should affect the determination of which beneficiary is appropriately treated as owning the income and therefore appropriately taxed on such income. For example, if income is payable to A in the trustee’s discretion and principal is payable to B, taking into consideration all relevant facts, if anyone is to be imputed income from the trust, dividends should be imputed to A and capital gains or liquidating distributions to B. But under the PFIC regime, only either A or B is treated as indirectly owning the shares. There is no mechanism for allocating fiduciary income to A and principal receipts to B.

The elections available to U.S. shareholders of PFICs mitigate the harsh tax treatment of excess distributions. However, these elections are not, at least as a practical matter, available to U.S. beneficiaries who are treated as indirectly owning the shares held by a foreign trust. Although the QEF and mark-to-market elections may be made by a U.S. beneficiary of a foreign trust who is treated as the indirect shareholder, in most cases the beneficiary does not have a fixed right to any share of the trust and would not want to elect to be taxed on amounts he or she does not, in any common meaning of the term, own. Moreover, when such an election could be made, for example when the trust had a single beneficiary or fixed shares, the rules for dealing with previously taxed income would need to be clarified or modified to make sure that the same income is not taxed more than once.

For example, assume that a beneficiary makes a mark-to-market election. Treasury regulation §1.1296-1(d)(2) provides that the basis of shares in the hands of a foreign partnership or foreign trust is adjusted for amounts taken into income by a partner or beneficiary who has made a mark-to-market election, but only for purposes of determining the subsequent income tax treatment of the U.S. person who is treated as owning such stock. The regulation provides:

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30 In PLR 200733024, a technical advice memorandum involving disposition of shares in a PFIC by a foreign discretionary trust, the IRS asserted that U.S. beneficiaries should be treated as receiving an excess distribution when the trust disposed of PFIC shares the beneficiaries were treated as indirectly owning even though regulations had not been issued under that statute. The beneficiaries were treated as owning the shares indirectly in proportion to an actuarial allocation of the interests in the trust among the beneficiaries, even though they had no current right to the income and no distributions had ever been made to them. The matter described in the TAM has been settled on other terms.

31 Treasury regulation §§1.1295-1(d)(2)(iii)(B) and 1.1296-1(h).
Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person’s interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

Although paragraph (e) pertains to trusts as well as partnerships, the regulations fail to address how the adjustment to basis will function in the case of a trust. The regulation quoted above does not work appropriately for a trust since there is no mechanism under the trust rules to adjust the taxable amount received by a beneficiary for the adjustment to basis of the shares owned by the trust.

In the case of a QEF election, the regulations provide no guidance at all as to how income that is taxed to a U.S. beneficiary of a foreign trust is to be accounted for when actually distributed to avoid double taxing the income attributable to the corporation.

**Coordination of accumulation distribution and PFIC rules**

The preamble to the proposed PFIC regulations notes the need to coordinate the accumulation distribution and PFIC tax regimes:

> [T]he regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or indirectly owns stock of a section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge.32

We believe that adjustments to the accumulation distribution rules are necessary to achieve the result of preserving the interest charge on untaxed income.

A beneficiary of a trust who receives a distribution that represents the current year’s income is taxable on his or her share of the trust’s DNI.33 DNI is taxable income from all sources, including (in the case of a foreign trust) capital gains and foreign source income. The character of the income received by the beneficiary in the same year it accrues to the trust is the same as the character of the income to the trust.34 If a foreign trust’s receipt of a distribution from a foreign holding company would be treated as an excess distribution if the shares were held by a U.S. taxpayer, it

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32 Preamble to proposed regulations issued 4/1/92, 1992-1 C.B. 1124, 1127.

33 Code §662(a).

34 Code §662(b).
would be consistent with the trust income tax rules to tax a beneficiary who receives that excess distribution in the same year as subject to the PFIC tax regime.

However, there is no authority clearly applying the above rule. Moreover, an argument could be made that because the holding company shares are not PFIC shares in the hands of a foreign trust, the character of the income to the trust (which flows through to the beneficiary) is not PFIC income. Shares held by a foreign person are not PFIC shares. As noted below, one of our alternative recommendations is the adoption of a regulation under section 643(a)(6) stating that income distributed from a PFIC through a foreign trust to a U.S. beneficiary in the current year as part of DNI will be treated and taxed to the beneficiary as PFIC income.

In addition, if a foreign nongrantor trust receives an excess distribution in a year (or what would be an excess distribution if made to a U.S. shareholder) and does not make a distribution to a U.S. beneficiary in the same year, the PFIC tax regime cannot apply to the U.S. beneficiary (unless a beneficiary is treated as indirectly owning the PFIC shares). That is because the excess distribution accumulated in the trust would become UNI. The character of income that becomes UNI is not preserved and is taxed as ordinary income to the beneficiary when distributed, subject to an interest charge. However, the interest charge would be based only on the number of years the income was accumulated in the trust and would exclude the number of years the income was accumulated in the holding company. The tax result of not treating a U.S. beneficiary as the indirect owner of PFIC shares will be satisfactory only if the trust accumulation distribution rules are changed to increase the interest charge to cover the period that the income was accumulated in the holding company.

**Proposed solutions**

We recommend that Treasury adopt one or more regulations that will integrate the rules for taxation of PFICs with the taxation of accumulation distributions from foreign trusts, under the structure of Subchapter J. We believe that the situations in which foreign trusts should be deemed to own CFCs is extremely limited, as discussed above. Alternative solutions for the taxation of PFICs owned by foreign trusts follow. We believe these solutions can be effected by regulations.

We further recommend that all PFIC events that occur at the trust level—that is, a disposition by a foreign trust of an interest in a PFIC or an excess distribution by the PFIC to the foreign trust—should not be taxed to the U.S. beneficiary at the time of the PFIC event, but instead should be taxed only at such time as the U.S. beneficiary actually receives a distribution. Consistent with both the Subchapter J and PFIC rules, the U.S. beneficiary should pay an appropriate tax with appropriate interest charges, reflecting the total period that the income has been accumulated offshore, when he or she receives the distribution.

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35 Code §667(a).
36 Code §668(a)(3) and (4).
1. One way to accomplish the integration of the Subchapter J and PFIC rules is to modify the accumulation distribution rules of Subchapter J so as to treat the excess distribution received by the trust as if the trust were a U.S. taxpayer for the limited purpose of allocating the excess distribution to prior taxable years of the trust and to calculate the UNI of the trust for such prior years. This allocation of excess distributions to UNI would apply to distributions made in the year of the trust’s receipt of the excess distribution and in future years but would not require any change in the tax treatment of distributions that had been made to beneficiaries in prior years.

Precise integration for the taxation of the income accumulated in the PFIC to the income accumulated in the foreign trust would be achieved by requiring the PFIC to give to the trustee of the foreign trust (and, ultimately, the U.S. beneficiary) detailed financial information similar to that for a QEF election, and to require the trustee of the foreign trust, upon receiving the excess distribution, to analyze the PFIC’s income and to allocate the excess distribution to the appropriate prior years of the trust in computing UNI, as if the PFIC had never existed and the income had been earned and accumulated directly in the trust. If the PFIC did not provide sufficient information to the trustee, the trustee of the foreign trust would be permitted to allocate the excess distribution among prior years on the basis of the annual changes in the net fair market value of the PFIC. Either of these two integration methods would, we believe, operate fairly.

If the information necessary to achieve such an integration is not available, then the trustee would have to allocate the excess distribution without regard to the PFIC’s actual history of earnings and appreciation. For example, under this method, if a trust owned shares in a PFIC for ten years and received an excess distribution in the tenth year, the excess distribution would be allocated equally to all prior years and treated as UNI. This produces the same result as treating the foreign trust as a U.S. taxpayer subject to the PFIC tax rules for the sole purpose of calculating DNI and UNI.

A distribution to a beneficiary in the year that the trust receives an excess distribution or any subsequent year that exceeds the DNI and accounting income of the trust for the year of distribution would be an accumulation distribution. Regardless of the method of integration that is used, to protect the application of the accumulation distribution tax in this context, the excess distribution that is allocated to prior years would have to be excluded in computing accounting income of the trust in the year it is received. If the excess distribution were treated as DNI and/or accounting income, the distribution in the year of receipt would not be an accumulation distribution because a distribution that does not exceed the greater of DNI or accounting income is not an accumulation distribution. If the portion of the excess distribution that is allocated to prior years is excluded from the computation of DNI and accounting income, the distribution of the excess distribution would be treated as a distribution of UNI taxable under the accumulation distribution rules. An interest charge would be applied to the tax allocated to each of the prior years in the trust's holding period of the corporation’s shares.

We also suggest that the PFIC rules be modified to allow a foreign trust to make a QEF or mark-to-market election even though it is not a U.S. taxpayer. If this election were made, the elections would not accelerate the due date for payment of U.S. tax. Rather, the elections would be used solely for purposes of calculating the DNI of the trust and calculating the interest charge due
on an accumulation distribution. The election would cause income to accrue to the trust as such income was earned by the holding company rather than equally over the holding period of the shares, as is the case under the PFIC tax rules. The mark-to-market election would cause income to accrue to the trust as the investment appreciated.

2. An alternative way to compute a fair amount of tax and interest would be to adopt a "tacking" of the period that income is accumulated in the PFIC to the period the income is accumulated in the foreign trust, but not integrate the PFIC income into UNI unless it is in fact accumulated in the trust after being distributed by the PFIC. Two steps would be needed to adopt this alternative method.

   a. First, Treasury could adopt a regulation under section 643(a)(6) stating that any distributions received from a passive foreign investment company that are distributed through to U.S. beneficiaries in the current year as part of DNI shall retain their character as PFIC income and shall be taxed to the U.S. beneficiary as such.

   We believe that this may be the result under current law, but recommend adoption of a regulation to remove all doubt. We believe that Treasury has the authority to adopt such a regulation under the provisions of section 643(a)(7). We suggest that Treasury adopt a regulation under section 643 stating that PFIC income will be treated as such when received by a foreign trust (even though it is a foreign person), will constitute part of DNI and will retain its character as PFIC income if distributed currently to U.S. beneficiaries as part of DNI. This is consistent with the treatment in Subchapter J of foreign trusts as modified conduits. The trust itself is taxed as a nonresident alien individual. But every class of income collected by the trust passes through to U.S. beneficiaries with its character maintained, if it is distributed in the current year.

   b. In addition, Treasury could adopt a regulation under section 1298(b)(5) that called for tacking the period that income is accumulated in a PFIC to the period that the income is accumulated in the foreign trust, if the PFIC distribution is not distributed currently to the U.S. beneficiaries by the foreign trust.

   By this method, Treasury would ensure that an appropriate interest charge was imposed upon the U.S. taxpayer for the full period that the income was accumulated, either in the PFIC or in the trust. If the trustee had full information from the PFIC on the income that had been accumulated in the PFIC, the trustee could provide all of that information to the beneficiary receiving a distribution as part of the trustee’s beneficiary statement. If not, the trustee (and the beneficiary) would compute the accumulation distribution tax for the "tacked" period of accumulation in the PFIC by allocating the income equally to the years during which the foreign trust had owned shares in the PFIC, using any of the allocation methods described in the first alternative, so that when the trust later made an accumulation distribution, interest would be charged for the full period that tax was deferred. The resulting tax and interest charge may not be the same in all cases as under the first alternative, but in either case the U.S. beneficiary will not have received a benefit from accumulation of income offshore that is not fairly taxed.
We believe that any of the methods proposed here would achieve a fair result, and do not urge the adoption of one of them over another.

If either of the integration or tacking rules is adopted as proposed above, a regulation under section 1298(b)(5) should be adopted to limit the circumstances in which a beneficiary of a foreign trust is deemed to be taxable under that section to cases (admittedly rare) where a beneficiary voluntarily transfers his or her beneficial interest in a foreign trust that owned PFIC shares. If the U.S. beneficiary voluntarily transfers his or her interest in the foreign trust, he or she presumably will have received consideration for the interest transferred, and have funds to pay the PFIC tax. A regulation might postpone the tax in the case of a donative transfer, but again tack holding periods.

Conclusion

The goal of the PFIC and CFC rules is to prevent U.S. taxpayers from escaping an appropriate tax and interest charge when tax is deferred through the use of foreign corporations. The same result should occur if the interest is held directly or through a foreign trust. The accumulation distribution tax rules under Subchapter J can be modified to accomplish this result. The accumulation distribution rules are equitable because they impose tax on a beneficiary only at the time he or she receives a distribution from the trust. For the same reason, such rules are more administrable. If beneficiaries are treated and taxed as indirect shareholders, complex rules will be necessary to avoid a beneficiary paying tax on income that may ultimately be distributed to someone else and avoid imposing tax on previously taxed income. In addition, the unfairness of imposing tax on income that a beneficiary has no right to receive creates an incentive for taxpayers to try to evade their tax responsibilities.

Our proposals are consistent with the legislative history of the PFIC rules. The 1986 Blue Book explained that:

The Act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act’s provisions and to prevent circumvention of the interest charge. **Another instance when regulations may be necessary to carry out the purposes of the Act’s provisions is when the ownership attribution rules attributed stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. Similarly, if necessary to avoid circumvention of the Act’s interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.**

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37 Blue Book, at 1032.
In the case of a trust, a beneficiary generally is not able to transfer his or her beneficial interest and thereby escape the PFIC tax regime. In those rare cases when a beneficiary can (and does) sell his or her beneficial interest in a foreign trust, it may be appropriate to impose the PFIC tax regime to preserve the interest charge. However, the PFIC tax regime should not be imposed on a U.S. beneficiary whose beneficial interest (and therefore indirect ownership) is reduced involuntarily, either by the exercise of fiduciary discretion or pursuant to the terms of the trust instrument.

In conclusion, we submit that our proposals are administrable, are fair, meet the goal of Congress when it adopted the PFIC rules of delaying tax to U.S. beneficiaries until they receive a distribution, and integrate the operation of the PFIC Rules with Subchapter J. We would welcome an opportunity to discuss this memorandum with Treasury staff.