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April 30, 2013

Internal Revenue Service
CC:PA:LPD:PR (Notice 2013-22)
Room 5203
Post Office Box 7604
Ben Franklin Station
Washington, DC 20044

Via Electronic Mail: Notice.Comments@irscounsel.treas.gov

Re: Recommendations for 2013-2014 Guidance Priority List (Notice 2013-22)

Dear Ladies and Gentlemen:

The American College of Trust and Estate Counsel (the "College") is pleased to submit these recommendations pursuant to Notice 2013-22, I.R.B. 2013-15 released on March 22, 2013, which invites recommendations for items that should be included on the 2013-2014 Guidance Priority List.

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.

The recommendations include items in the following categories and, as encouraged by the Notice, we have placed the items under each category in what we believe to be the order of their priority.

EMPLOYEE BENEFITS

1. Guidance identifying the "successor beneficiaries" of a trust who may be disregarded in determining a decedent's designated beneficiary when a non-conduit "see-through" trust is named beneficiary of qualified plan or IRA benefits.
2. Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

GIFTS AND ESTATES AND TRUSTS

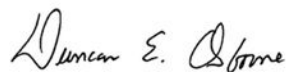
1. Clarification that QTIP elections in estate tax returns required only to elect portability are valid.
2. Regulations or other guidance defining "GST Trust" under section 2632(c), particularly relating to trusts that give beneficiaries continuing withdrawal rights attributable to prior year gifts to a trust and trusts that make distributions to a nonskip beneficiary dependent upon both the death of a person more than ten years older and the beneficiary attaining a specified age.
3. Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.
4. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.

INTERNATIONAL ISSUES

1. Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.
2. Regulation changing the due date for filing Form 3520A from March 15 to April 15.
3. Guidance concerning the application of the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010)) on reporting and withholding with respect to trusts and their beneficiaries.
4. Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.

If you or your staff would like to discuss the recommendations, please contact Ellen Harrison, Chair of the ACTEC Washington Affairs Committee, at (202) 663-8316, or ellen.harrison@pillsburylaw.com; or Leah Weatherspoon, ACTEC Communications Director, at (202) 688-0271, or lweatherspoon@actec.org.

Respectfully submitted,



Duncan E. Osborne
President

Enclosure

**The American College of Trust and Estate Counsel (ACTEC)
Recommendations for the
2013-2014 Guidance Priority List (Notice 2013-22)
April 30, 2013**

EMPLOYEE BENEFITS

- 1. Guidance identifying the “successor beneficiaries” of a trust who may be disregarded in determining a decedent’s designated beneficiary when a non-conduit “see-through” trust is named beneficiary of qualified plan or IRA benefits.**
- 2. Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent’s interest.**

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INTERNATIONAL ISSUES

- 1. Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.**
- 2. Regulation changing the due date for filing Form 3520-A from March 15 to April 15.**
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EMPLOYEE BENEFITS

1. Guidance identifying the “successor beneficiaries” of a trust who may be disregarded in determining a decedent’s designated beneficiary when a non-conduit “see-through” trust is named beneficiary of qualified plan or IRA benefits.

Reg. §1.401(a)(9)-4, A-5 provides that if a trust is named as beneficiary and certain threshold requirements for a “see-through trust” are satisfied, the beneficiaries of the trust (and not the trust itself) will be treated as having been designated for purposes of determining the minimum required distribution period under Section 401(a)(9). Reg. §1.401(a)(9)-5, A-7 provides that “contingent beneficiaries” of such a trust must be counted among the trust’s beneficiaries for purposes of determining the distribution period, but “successor beneficiaries” will be disregarded. The distinction between the two is not articulated in the regulations apart from two examples. From one example (Reg. §1.401(a)(9)-5, A-7, Ex. 2), one may extrapolate that remaindermen of a conduit trust (a trust under which all plan or IRA distributions are required to be paid out currently as opposed to accumulated in the trust) that lasts for the lifetime of the conduit beneficiary will be treated as successor beneficiaries. The second example (Reg. §1.401(a)(9)-5, A-7, Ex. 1) deals with a non-conduit trust, but is of limited utility since it describes a trust which in the real world would not exist.

Non-conduit trusts are widely used as estate planning vehicles for time-honored reasons having nothing to do with income tax planning. The lack of guidance on the contingent beneficiary and successor beneficiary concepts since 2002, when the regulations were issued, has complicated standard planning for millions of plan participants and IRA owners and has introduced unnecessary uncertainty. These issues continue after the death of the participant or IRA owner who has named a trust as beneficiary, when a decision needs to be made as to the applicable payout period. The ad hoc process of private letter rulings is an expensive and, for most taxpayers, unfeasible way of obtaining certainty.

Please see the attached March 27, 2003 ACTEC letter addressed to Marjorie Hoffman, Esq., Senior Technician Reviewer, Employee Benefits & Exempt Organizations, Internal Revenue Service (also transmitted to George Bostick, Esq., Benefits Tax Counsel, Office of Tax Policy at the Department of Treasury by the attached July 1, 2010 ACTEC letter). The 2003 letter provides examples of six non-conduit trusts named as beneficiaries of qualified plan or IRA benefits, suggests which beneficiaries should be identified as successor beneficiaries in each case, discusses the rationale for the results, and emphasizes the need for clear rules to make these determinations. The 2003 letter reviews the “snapshot rule” that has been applied in many private letter rulings and compares that rule to a suggested “life expectancy rule” that might instead be applied to a greater number of non-conduit trust provisions.

The 2003 letter also proposes for consideration a rule to apply to trusts that defer distributions to a younger beneficiary until a specified age is attained. The proposed rule is contrary to the result reached in certain private letter rulings, but it is supported by strong policy considerations [recognized in the generation-skipping transfer (GST) tax law] and produces a simpler, more understandable method of determining successor beneficiaries in this common form of non-conduit trust. Finally, the 2003 letter discusses instances where a trust beneficiary’s estate is the recipient or potential recipient of trust benefits upon the beneficiary’s death and the

reasons such a circumstance should not prevent the trust beneficiary from being treated as a designated beneficiary.

2. Guidance concerning spousal rollovers of qualified plan and IRA benefits when an estate or trust is named beneficiary of a decedent's interest.

Spousal rollovers of qualified retirement plans and IRAs are allowed under Sections 402(c) and 408(d). More than a hundred private letter rulings have been issued since the late 1980s allowing a spousal rollover when an estate or trust (not the surviving spouse) is named as beneficiary. In the vast majority of these rulings, the spouse as executor, trustee and/or beneficiary may unilaterally effect the rollover, and this appears to be key to the result reached. The preamble to the final Section 401(a)(9) regulations, however, suggests a broader approach, which would permit a surviving spouse who does not unilaterally control distributions from an IRA but who does actually receive a distribution from a decedent's IRA to complete a spousal rollover.

The basic fact pattern found in the private letter rulings arises frequently. Therefore, we believe that a published ruling is needed. Currently, after the death of a plan participant or IRA owner, the spouse may be obliged to obtain his or her own ruling at considerable cost and inconvenience, either because the plan administrator or IRA sponsor insists on a ruling or simply because the spouse knows that even numerous private letter rulings issued to others may not be relied on. A Revenue Ruling would provide assurance to plan sponsors and guidance to taxpayers as to the circumstances (whether a spouse's unilateral control over the decision to distribute the decedent's interest in the plan or account, the spouse's actual receipt of a distribution, or both) under which a spousal rollover is valid if an estate or trust is named as the beneficiary.

Please see the attached April 15, 2009 ACTEC letter addressed to Henry S. Schneidermann, Assistant Chief Counsel, Internal Revenue Service (also transmitted to George Bostick, Esq., Benefits Tax Counsel, Office of Tax Policy at the Department of Treasury by the attached July 1, 2010 ACTEC letter). The 2009 letter provides more detail of the issues, requests clarifying guidance, underscores the need for that guidance, and presents a proposed resolution that would avoid the current need for private letter rulings.

GIFTS AND ESTATES AND TRUSTS

1. Clarification that QTIP elections in estate tax returns required only to elect portability are valid.

Rev. Proc. 2001-38, 2001-24 I.R.B. 1335, announced circumstances in which the IRS "will disregard [a QTIP] election and treat it as null and void" if "the election was not necessary to reduce the estate tax liability to zero, based on values as finally determined for federal estate tax purposes." The procedure "does not apply in situations where a partial QTIP election was required with respect to a trust to reduce the estate tax liability and the executor made the election with respect to more trust property than was necessary to reduce the estate tax liability to zero." The procedure "also does not apply to elections that are stated in terms of a formula designed to reduce the estate tax to zero."

Thus, the paradigm case to which Rev. Proc. 2001-38 applies is the case where the taxable estate would have been less than the applicable exclusion amount anyway, so the estate would not be subject to federal estate tax, but the executor listed some or all of the trust property on Schedule M to the estate tax return and thus made a redundant QTIP election.

Rev. Proc. 2001-38 is a relief measure. The transitional sentence between the summary of the background law and the explanation of the problem states that “[t]he Internal Revenue Service has received requests for relief in situations where an estate made an unnecessary QTIP election.”

The American Taxpayer Relief Act of 2012 made permanent the “portability” of the unused exclusion amount of a predeceased spouse for the use of the surviving spouse. By statute (section 2010(c)(5)(A)) and regulation (Reg. §20.2010-2T(a)) portability is available only if it is elected on a federal estate tax return for the estate of the predeceased spouse. The regulations (Reg. §§20.2010-2T(a)(1) & (7)(ii)(A)) contemplate that a federal estate tax return will be required for the purpose of electing portability even if it would not be required for federal estate purposes alone, such as a return for an estate where the gross estate, and thus necessarily the taxable estate, are less than the applicable exclusion amount, the paradigm case to which the relief of Rev. Proc. 2001-38 applies.

This leads to the question whether a QTIP election that is “not necessary to reduce the estate tax liability to zero,” because it is made on a federal estate tax return filed to elect portability but not otherwise required for federal estate tax purposes, is therefore “null and void,” by reason of Rev. Proc. 2001-38. The “relief” origin of Rev. Proc. 2001-38, the likelihood that a revenue procedure announcing the Service’s administrative forbearance would not be used to negate an election authorized by statute, and the unseemliness of denying a QTIP election to smaller estates while allowing it to larger estates all suggest that a QTIP election *will* be respected in such a case. This view is reinforced by the explicit reference in Reg. §20.2010-2T(a)(7)(ii)(A)(4) to QTIP elections in returns filed to elect portability but not otherwise required for estate tax purposes.

Clarification of that result would be appropriate and welcome.

2. Regulations or other guidance defining “GST Trust” under section 2632(c), particularly relating to trusts that give beneficiaries continuing withdrawal rights attributable to prior year gifts to a trust and trusts that make distributions to a nonskip beneficiary dependent upon both the death of a person more than ten years older and the beneficiary attaining a specified age.

Section 2632(c)(3)(B) defines the type of trust to which GST exemption will be automatically allocated in the absence of an election to the contrary (a “GST Trust”). The definition is in the form of a very broad general rule (“a trust that could have a generation-skipping transfer with respect to the transferor”), followed by six exceptions. The six exceptions are designed to exclude trusts to which donors are unlikely to want GST exemption to be allocated, most often because, although a generation-skipping

transfer is possible under the terms of the trust, it is unlikely that a generation-skipping transfer will occur with respect to more than 75% of the trust property.¹ The exceptions are in turn followed by “flush language” excepting certain situations from their reach (the exception to the exception).²

In the more than a decade since the subsection 2632(c) was enacted, it has become increasingly apparent that this goal of conforming the automatic rules to a transferor’s likely intent based on the terms of the trust has been frustrated in certain common types of trusts by a literal reading of two parts of the definition – the second exception to the general rule and a portion of the flush language exception to the exception. We believe that it is possible to interpret both of these provision by regulation in a manner that will cause them to be applied as necessary to better accomplish the goals of the provision. However, because many taxpayers have relied on the literal language of these provisions, any such regulations should apply prospectively and allow a period for taxpayers to elect into their retroactive allocation.

a. The second exception.³

Under the second of the six exceptions, a trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons who are living on the date of death of another person identified in the instrument (by name or by class) who is more than ten years older than such individuals. For example, a trust that will terminate in favor of a child of the transferor on the death of the transferor or the transferor’s spouse (if more than ten years older than the child) would fit within this exception and as a result GST exemption would not be automatically allocated to it.

Unfortunately, in the absence of a regulation to the contrary, this exception may be read to not apply to the following common types of trusts to which we believe the exception was intended to apply: (1) a trust that provides for a parent and his or her child or children until the parent’s death and then holds the trust property in further trust until the child reaches a specified age, with an outright distribution of the property thereafter, or (2) an insurance trust that provides for distribution of the trust property on the last to occur of the insured’s death, the insured spouse’s death or when the insured’s child reaches a specified age (often younger than age 46, the age specified in the first exception)⁴ because no portion of the trust property would be distributed to the child at

¹ According to the House Report to H.R. 8 as passed by the House on April 4, 2001, the “Committee recognizes that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating generation-skipping transfer tax exemption to an indirect skip, *e.g.*, because the taxpayer or the taxpayer’s advisor inadvertently omitted making the election on a timely-filed gift tax return or the taxpayer submitted a defective election. Thus, the Committee believes that automatic allocation is appropriate for transfers to a trust from which generation-skipping transfers are likely to occur.” House Report, p. 35.

² I.R.C. § 2632(c)(3)(B)(flush language).

³ I.R.C. § 2632(c)(3)(B)(ii).

⁴ I.R.C. § 2632(c)(3)(B)(i), which provides that a trust is not a GST trust if the trust instrument provides that more than 25% of the trust corpus must be distributed to or may be withdrawn by one or more non-skip persons before

the death of a person unless the child had already reached the specified age. Therefore, assuming that none of the other exceptions apply,⁵ the trusts would be GST trusts and GST exemption would be allocated automatically in the absence of an election to the contrary and except in the case of an addition to the trust after the child has attained the specified age. **However, in both types of trusts at least 25% of the trust principal is likely to pass to a non-skip person (the child) because most individuals outlive their parents and reach age 46 (if the specified age is younger than age 46).** As a result, it is likely that most transferors would not want to allocate GST exemption to the trust.

We believe regulations could and should make it clear that the second exception to the general rule applies (1) even if in addition to surviving a person who is at least 10 years older than the non-skip person, the non-skip person has to reach an age younger than age 46, the age specified in the first exception and (2) even if the non-skip person needs to survive more than one person, as long as each is at least 10 years older than the non-skip person. A narrower approach to the second suggested clarification would be to provide that for purposes of this exception a married couple is treated as a single person.

b. The flush language exception to the exceptions.⁶

Several of the exceptions,⁷ without more, would apply to trusts in which one or more non-skip persons are granted a temporary right to withdraw trust property whenever property is contributed to the trust. Such lapsing withdrawal rights are often limited to the amount of the annual exclusion and lapse during or at the end of the year of the contribution, at least to the extent the lapse will not cause the power holder to be treated as having made a taxable gift by reason of the so called 5 x 5 rule of Code section 2514(e). Because many trusts that grant these powers are likely to give rise to generation-skipping transfers, an exception to this deemed allocation exceptions provides that the value of transferred property is not considered to be includible in the gross estate of a non-skip person or subject to a right of withdrawal by reason of such person holding a right to withdraw so much of such property as does not exceed the annual exclusion amount referred to in I.R.C. § 2503(b) with respect to any transferor. Thus, a trust with such a withdrawal right that does not fall within any of the other exceptions will be a GST trust and the deemed allocation will occur.

Unfortunately, in the absence of a clarifying regulation, this special rule for withdrawal rights tied to the annual exclusion may not always apply to trusts with powers

that individual reaches 46 years of age, on or before one or more dates specified in the trust instrument that will occur before such individual attains 46 years of age, or upon the occurrence of an event that in accordance with Treasury regulations may reasonably be expected to occur before the date that such individual attains age 46. I.R.C. § 2632(c)(3)(B)(i) That exception applies, for example, to a trust that will terminate in favor of its beneficiary when the beneficiary reaches age 45.

⁵ Note that these type of trusts do not fit within the first exception because the death of an individual's parent or parents, in most instances, may not reasonably be expected to occur before the child reaches age 46.

⁶ I.R.C. § 2632(c)(3)(B)(flush language).

⁷ The fourth exception, for example, provides that a trust is not a GST trust if any portion of it would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer. I.R.C. § 2632(c)(3)(B)(iv).

that lapse each year only to the extent of the 5 x 5 rule. Put differently, it may not apply to transfers made at a time when the total amount that may be withdrawn (the sum of the withdrawal right arising by reason of the transfer in the current year and all prior year withdrawal rights that have not lapsed as of the date of the transfer) exceeds the current year's annual exclusion with respect to any transferor. Without this exception to the exceptions, such a trust will meet the fourth exception (and perhaps the first exception if the withdrawal amount exceeds 25% of the value of the trust property, which would not be unusual in the early years of an insurance trust) and thus will not be a GST trust for those transfers. Thus, in the first year that transfers are made to such a trust, if the amounts that could be withdrawn are within annual exclusion amount, the trust will be a GST trust and the deemed allocation will apply. In future years, the continuation of a portion of a power from one year to the next may cause the trust to no longer be a GST trust such that no deemed allocation will apply.

We believe regulations could and should rectify this confusing and complicated situation by providing that the exception to the exceptions for annual exclusion withdrawal rights applies if at the time of any transfer that gives rise to a withdrawal right, the amount subject to the withdrawal right "does not exceed the amount referred to in section 2503(b) with respect to any transferor" without regard to whether in future years all or a portion of the withdrawal right from a prior year remains outstanding. Put differently, we believe regulations could provide that once it is determined pursuant to the flush language that a withdrawal amount is not to be taken into account in applying the exceptions to the broad definition of a GST trust, such withdrawal amount is not to be taken into account in any year even if unlapsed.

3. Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.

In an environment of increasing concern that wealth can attract claims and create risks, it is becoming more common for grantors to create trusts in which, for their lives, they themselves (and sometimes others too) have an interest, often in a trustee's discretion. The trust is designed to protect the trust assets from both opportunistic claims and the unwise decisions of grantors themselves. Because the amount of wealth involved in such self-settled trusts is often substantial, it is important for those grantors to know the gift and estate tax consequences – that is, whether and to what extent the transfer will be complete enough to be a taxable gift for federal gift tax purposes and whether and to what extent the value of the trust property will be included in the grantor's gross estate for federal estate tax purposes. Of those two issues, the completed gift issue is the most important, because it has immediate impact.

The principle typically applied to determine whether a transfer is a completed gift is in Reg. §25.2511-2(b):

As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. But if upon a transfer of property (whether in trust or otherwise) the

donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.

The completed gift issue was spotlighted by the disclosure of an Office of Chief Counsel Internal Revenue Service Memorandum dated September 28, 2011 (opened to public inspection on February 24, 2012, as CCA 201208026). Quoting the above regulation, CCA 201208026 concludes that Donors had made completed gifts to a Trust (albeit not a “self-settled” trust from which the Donors themselves could receive distributions). CCA 201208026 has attracted attention among practitioners because it finds a completed gift despite the Donors’ testamentary powers over the disposition of the trust property upon their deaths, powers that estate planners have frequently used specifically to prevent a transfer from being a completed gift. This in turn has raised questions about the continued application of the published guidance on which those practitioners have relied, including in the context of self-settled trusts.

As an example, Rev. Rul. 62-13, 1962 C.B. 180, ruled a transfer in trust incomplete because trustees had discretion to pay income and/or principal to the grantor and others during the grantor’s life and there was therefore “no assurance that anything of value would ever pass to the remaindermen,” even though the grantor retained no power to direct the disposition of the remainder. Thus, CCA 201208026 presents the anomaly that its Donors with a power of appointment over the trust property at death were left with “no power to change [the trust property’s] disposition,” while the grantor in Rev. Rul. 62-13 who retained no power had not “parted with dominion and control.” But CCA 201208026 does not cite Rev. Rul. 62-13 (or Rev. Rul. 77-378, 1977-2 C.B. 347, which “clarified” it).

As another example, CCA 201208026 rests its holding on the fact that the Donors’ “limited power to appoint so much of [the trust property] as would still be in the Trust at his or her death” would be reduced or eliminated – in effect terminated – by the trustee’s discretionary distributions during the Donors’ lives. Reg. §25.2511-2(f) specifically addresses the “termination” of such a power, including termination by the “receipt of income or of other enjoyment of the transferred property by the transferee or by the beneficiary (other than by the donor himself),” which “operates to free such income or other enjoyment from the power.” But CCA 201208026 does not cite Reg. §25.2511-2(f).

We appreciate that CCA 201208026 is necessarily a part of a larger file, that it is addressed to Area Counsel and thus possibly written in contemplation of litigation (or at least serious pursuit of issues in audit), and that it recites that it “may contain privileged information” (although no redaction other than identifying details, including identification of the jurisdiction, is apparent), and for all those reasons it may not tell the whole story. We also appreciate that CCA 201208026 may not be used or cited as precedent (and it so recites). Nevertheless, such documents, when made available for public inspection, are used by practitioners to guide their own best practices and assist

them in advising clients. Thus, balanced (and citable) guidance that seeks to resolve questions rather than to pursue a litigation position would be desirable and would foster uniform treatment and compliance. As we have seen in other contexts (such as Rev. Rul. 81-51, 1981-1 C.B. 458, and Rev. Rul. 2004-64, 2004-2 C.B. 7), such guidance could and perhaps should address the extent to which it will be applied prospectively under Section 7805(b)(8).

4. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.

Since 1940, the courts have recognized there were circumstances when trusts can be so interrelated that the economic positions of the persons who created the trusts have not changed enough to honor the separate trusts for certain tax purposes. As a result, it is possible that trusts created at about the same time may be “uncrossed” and one or more of the retained power provisions (Sections 2036-2038) applied to cause a portion or all of the value of a trust to be included in the settlor’s gross estate. This result can obtain even though the settlor was not a beneficiary of that included trust and did not retain a power with respect to that trust which would cause such inclusion absent the existence of the so-called reciprocal trust. This has come to be known as the “Reciprocal Trust Doctrine.”

Even though the Doctrine was recognized and applied by the United States Supreme Court in *United States v. Grace* (395 U.S. 316 (1969)) the federal courts and the Internal Revenue Service have been required to define and apply the doctrine in a variety of settings with varying results. See, for example, *Estate of Bischoff* (69 T.C. 32 (1977)), *Estate of Herbert Levy* (T.C. Memo 1983-453 (1983)), *Estate of Green v. United States* (68 F. 3d 151 (6th Cir. 1995)), and Private Letter Rulings 199643013 and 200426008. Taxpayers and their advisors frequently are faced with a planning situation where both spouses are planning to engage in an arrangement concerning the wealth of the spouses and their family that is best structured using two trusts, which ideally might be identical in terms but for the identity of the settlors. This is most common when spouses are designing mirror image arrangements for themselves and younger family members. Skilled practitioners are able to create degrees of difference which should decrease the possibility of uncrossing such trusts. However, in the absence of a definitive set of rules addressing this issue, taxpayers and their advisors are left to speculate, which can lead to extreme variations in plans solely to assure that one does not run afoul of the Doctrine.

While it may not be necessary to address the full range of variations that should result in trusts that need not be uncrossed, it should be possible to create greater clarity by acknowledging a set of safe harbors such as the existence of separate trustees (or co-trustees when the settlors have been named as fiduciaries) or differences in the powers granted to the spouses, both of which would make it possible to have trusts with a common purpose without requiring some of the differentiation and distortion commonly applied currently to avoid the application of the Doctrine.

INTERNATIONAL ISSUES

1. Guidance concerning the tax consequences under Section 643(i) of the undercompensated use by a U.S. person of property owned by a foreign trust.

Section 643(i) was amended by the Foreign Account Tax Compliance Act (“FATCA”) provisions of the Hiring Incentives to Restore Employment (“HIRE”) Act (P.L. No. 111-147, 124 Stat. 71 (2010)) to provide that the use by certain U.S. persons of property owned by a foreign trust would be deemed to be a distribution by the trust equal to the fair market value of the use of such property except to the extent adequate consideration for such use was timely paid. The amendment was effective on date of enactment, March 18, 2010. Prior to this amendment, the statute applied only to loans of cash or marketable securities and not to “loans” of other property, such as residences or works of art.

The statute applies to use by a U.S. person who is a grantor, a beneficiary or any other person who is related to a grantor or beneficiary. A person is related to a grantor or beneficiary by application of the rules in section 267 or section 707(b) applied as if family members included spouses of members of the family.⁸ If the person using the trust property is not a grantor or beneficiary, the deemed distribution is treated as made to the grantor or beneficiary to whom such person is related rather than to the person who is or was actually using the trust property. If the person using the property is related to more than one grantor and/or beneficiary, the deemed distribution to the grantor and/or beneficiaries is to be allocated among them in accordance with regulations. No regulations or other guidance has been issued.

If compensation is paid for the use of property other than cash or marketable securities, the deemed distribution is reduced by the amount of such compensation if it is paid within a reasonable period of time of such use.

If the statute applies to deem a distribution to have been made, any subsequent transaction, such as the return of such property to the trust, shall be disregarded.

Guidance is needed concerning the following issues:

⁸ Thus, related persons include members of the family (sibling, brother or sister-in-law, spouse, ancestors and their spouses, and descendants and their spouses), an individual and a corporation more than 50% owned by such individual, two corporations which are members of the same controlled group, a grantor and a fiduciary of a trust created by such grantor, fiduciaries of separate trusts created by the same grantor, a fiduciary and a beneficiary, a fiduciary and a beneficiary of another trust if the same person is the grantor of both trusts, a fiduciary of a trust and a corporation more than 50% owned by the trust or by the grantor of the trust, a person and an exempt organization if the organization is controlled by the person or a member of such person’s family, a corporation and a partnership if more than 50% of the stock or more than 50% of the capital or profits interest in the partnership interests are owned by the same persons, S corporations if the same persons own more than 50% of the stock of both, an executor of an estate and a beneficiary of an estate, a partner and a partnership if the partner owns more than 50% of the capital or profits interest and two partnerships in which the same persons own more than 50% of the capital or profits interest. In applying the related party rules, a person is treated as indirectly owning stock held through a corporation, partnership, estate or trust in which such person has an interest, and is treated as constructively owning stock owned by a family member.

- How should the trustee and the taxpayer determine the fair market value of the use of property where there is inadequate data for determining the fair market value of the use of such property? An example would be the fair rental value of fine art. To make compliance easier, a rule of convenience would be helpful. A similar rule of convenience exists, for example, for determining fair market interest rates and the present value of life estates, annuities and remainders. A similar rule could be used for determining the fair rental value of property for which no market data is readily available.
- How should the trustee and the taxpayers allocate the deemed distribution where more than one person uses the property owned by the trust or the person using such property is related to more than one beneficiary and/or the grantor?
- What are the tax consequences of the receipt by the trust of compensation for the use of trust property paid by a grantor, beneficiary or related person? For example, will a beneficiary realize gross income from payments such beneficiary herself made to the trust which are distributed or required to be distributed back to her? If the rental is for the use of U.S. property, is tax withholding required? Will compensation for the use of property include expenses of use (such as utilities and condominium fees) paid by the person who uses the property and, if so, will the foreign trust be deemed to have received gross income where such person pays such expenses?
- It would be helpful to confirm that the deemed distribution carries out trust income and accumulated income but does not create income.
- It would be helpful to confirm that the statute does not apply to grantor trusts covered by Subpart E of Subchapter J.
- It would be helpful to clarify the provisions of section 643(i)(3) providing that subsequent transactions, such as the return of property to the trust, will be disregarded.

2. Guidance under Section 6048 changing the due date for filing Form 3520-A from March 15 to April 15.

Under section 6048(b), U.S. persons treated as “owners” of a foreign trust (“U.S. Owners”) must annually file a return confirming such status and must also ensure that the trust files a return providing a full and complete accounting of all trust activities and operations. The trust’s return is filed on Form 3520-A. The Form 3520-A instructions and Notice 97-34, 1997-1 C.B. 422, indicate that Form 3520-A is due by the 15th day of

the third month following the close of the trust's tax year.⁹ Because section 644 provides that all trusts other than tax exempt and charitable trusts must adopt a calendar year as their taxable year for U.S. tax purposes, as a practical matter most Forms 3520-A are due on March 15th.

The Form 3520-A filing was conceived as the filing obligation of a foreign trust. However, because it is the U.S. Owner, not the trust itself, who is responsible for ensuring the form is filed, in practice the preparation and filing of the form falls to the U.S. Owner. As a result, the March 15th due date for the Form 3520-A acts as a trap for the unwary. In most cases, the U.S. Owner has an April 15th deadline for his own income tax return and therefore may not consider the filing obligations with respect to the trust until after the March 15th deadline has passed.

The likely rationale for the March 15th deadline is to ensure that the U.S. Owner has time to review the Form 3520-A information and include it on his own return and Form 3520. Because the U.S. Owner is responsible for ensuring that the Form 3520-A is filed, however, in most cases the U.S. Owner's tax preparer is charged with completing the Form 3520-A, making this lead time unnecessary. Thus, we would suggest that the IRS issue guidance adopting an April 15th due date the Form 3520-A to avoid confusion and simplify administration. In addition, the IRS should consider issuing guidance that the filing of a Form 4868 by the U.S. Owner to extend his own return is effective to extend the due date for the Form 3520-A.

3. Guidance concerning the application of the Foreign Account Tax Compliance Act ("FATCA") provisions of the Hiring Incentives to Restore Employment ("HIRE") Act (P.L. No. 111-147, 124 Stat. 71 (2010)) on reporting and withholding with respect to trusts and their beneficiaries.

ACTEC submitted comments to representatives of the Department of the Treasury on January 7, 2011, concerning the application of FATCA to trusts and their beneficiaries. A copy is attached. Since that time, proposed and temporary regulations were issued under Section 6038D, final Form 8938 was issued, and final regulations were issued concerning Sections 1471-1474. This guidance clarified a number of important issues, but some additional guidance would be very helpful. In addition, a number of intergovernmental agreements ("IGAs") have been signed modifying the rules for purposes of Sections 1471-1474.

The regulations under Sections 6038D and Sections 1471-1474 were extremely helpful in providing bright line tests for determining when a beneficiary has a beneficial interest that must be reported and quantifying the value of such interest. In particular, the regulations are helpful in stating that a person whose interest is mandatory is deemed to own a portion of the trust based on his or her mandatory distribution rights valued using the rules under Section 7520, a beneficiary whose interest is wholly discretionary is considered to own only the value of what he or she actually received from the trust in the

⁹ Confusingly, regulations under section 6048 applicable solely to foreign grantor trusts described in section 679 specify an April 15th deadline for filing the Form 3520-A. Treas. Reg. § 401.6048-1(c)(1). These regulations pre-date the current version of section 6048.

relevant year, the interest of a beneficiary in a trust that is deemed owned by another U.S. person under the grantor trust rules may be disregarded (so that only the U.S. person who is deemed to be the owner under Sections 671-679 is considered to own the trust) and certain de minimis interests may be disregarded. This rule acknowledges the difficulty of allocating beneficial interests to discretionary beneficiaries. However, certain questions remain such as whether mandatory distribution rights include remainder and contingent interests, whether the de minimis rules apply to trusts classified as foreign financial institutions (“FFIs”) as well as to trusts classified as non-financial foreign entities (“NFFES”), whether the rules for determining beneficial interests are applicable to owner reports filed by owner-documented FFIs, and whether Treas. Reg. section 1.1473-1(b)(2)(v) (attributing ownership among related parties) applies to related parties who are foreign persons and to trusts that are FFIs. For example, if a foreign person is treated as owning all or a portion of a trust, will a U.S. relative of that foreign person be attributed ownership even though the U.S. relative received no distribution?

In addition, the regulations under Sections 1471-1474 do not allow the bright line test for determining beneficial ownership of a trust to be applied for purposes of determining indirect ownership of shares of a holding company owned by a trust. Instead, Treas. Reg. section 1.1473-1(b)(2) requires that a “facts and circumstances” test be used. The same bright line rule is necessary to determine indirect ownership of the holding company in order to make administration of the withholding rules practicable. The use of different rules for determining ownership of the trust and holding company may lead to illogical results. For example, it may be possible for a beneficiary whose interest in the trust is zero percent to be considered to indirectly own some of the shares of the underlying holding company owned by the trust.

A simplified method for determining ownership of shares of foreign corporations held indirectly through foreign trusts also is necessary to comply with the new passive foreign investment company (“PFIC”) information reporting rules under Section 1298(f). FATCA requires annual reporting of PFIC interests held or deemed held indirectly through a foreign trust even if the taxpayer has not received a distribution or made any of the elections available to PFIC shareholders. A preferable alternative to aggressive application of indirect ownership rules would be adoption of reforms to the treatment of corporations owned through trusts which are discussed in paragraph 4 below.

The rules and regulations under Sections 1471-1474 are extremely complex. It would be very helpful if the IRS would issue simplified guidance as to how these rules apply specifically to trusts and estates. In addition to the specific guidance described above, clarification of the following would be helpful:

- a. How to determine who is the “payee” for purposes of withholding under Section 1471 when payment is made to a trust (i.e., is the payee the trustee, the custodian, the holding company owned by the trust, the trust itself as an entity, the grantor in the case of a grantor trust, or the beneficiary in the case of a beneficiary-owned trust), is the payee different depending upon whether the trustee is an FFI or an NFFE, whether the payment is U.S. source fixed and determinable annual periodic income and whether the trust beneficiaries are exempt persons? In particular, the rules of Treas. Reg. section 1.1471-3(a)(3)(ii) are confusing.

- b. Whether an estate is disregarded as a specified U.S. person for all withholding tax purposes or whether the exception to the definition of U.S. accounts to exclude accounts held by an estate¹⁰ applies only to accounts held directly by a U.S. estate. For example, is a trust that has only a U.S. estate and foreign persons as beneficiaries considered to be a U.S. owned entity?
- c. Whether a trust that is a participating FFI must report “accounts” deemed held by U.S. beneficiaries or may report account information in the aggregate in the same manner as an owner-documented FFI or NFFE may report or in the alternative whether the trustee may elect to instead file those forms that a U.S. trustee would file, such as Forms K-1 (in lieu of Forms 1099 or FATCA reports).¹¹
- d. Guidance for determining when and how a beneficiary of a foreign trust can claim a refund of overwithheld tax as the “beneficial owner” of the income. The beneficiary is the beneficial owner to the extent of distributions made to such beneficiary that carry out income of the trust to the beneficiary. However, the beneficiary could not be the beneficial owner of that portion of trust income that has been withheld to pay tax unless the trustee were able to assign that tax refund to the beneficiary.
- e. Guidance for determining the “controlling persons” of foreign trusts subject to an IGA. The IGA defines controlling person to include the grantor and beneficiaries or class of beneficiaries, as well as trustees, protectors, holders of powers of appointment and any other person in control of the trust. The definition is confusing because grantors and beneficiaries would not normally have any control over the trust, so that the adjective “controlling” is misleading (as is the reference to any other person in control of the trust). Does a “controlling person” include a beneficiary whose discretionary beneficial interest is disregarded under the bright line test in the regulations?
- f. Clarification of when a trust is eligible to avoid withholding by becoming an owner-documented FFI, and in particular, those affiliations that make a trust ineligible to be an owner-documented FFI.¹²
- g. Guidance concerning an election by a foreign trustee to file US information returns.
- h. Further clarification of the distinction between an FFI and an NFFE including: whether a private trust company and/or a trust managed by a private trust company is an FFI or an NFFE, whether a trust managed by a professional individual trustee is an FFI or an NFFE, and whether a trust managed by an individual trustee who hires a financial institution to advise on investments but doesn’t delegate investment authority is an FFI or an NFFE.

¹⁰ Treas. Reg. section 1.1471-5(b)(2)(iii) and 1.1471-2(a)(4)(vii).

¹¹ Treas. Reg. section 1.1471-4(d)(3).

¹² Treas. Reg. section 1.1471-3(d)(6).

4. Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.

ACTEC submitted comments to representatives of the Department of the Treasury on June 23, 2010. A copy is attached. The corporate anti-deferral rules applicable to controlled foreign corporations (“CFCs”) and passive foreign investment companies (“PFICs”) and the accumulation distribution rules applicable to trusts serve the same purpose – preventing the use of foreign entities to defer payment of tax or imposing an interest charge if tax payment is deferred. Proposed regulations on the corporate anti-deferral rules for passive foreign investment companies were issued on April 1, 1992, and have not been finalized. The preamble notes the need to coordinate the accumulation distribution rules of Subchapter J and the PFIC tax regime. We agree, but there has been no further published guidance in twenty years. The need for guidance is increased by the penalties imposed by new Section 1298(f) for a beneficiary’s failure to report indirect ownership of PFIC shares. ACTEC comments suggested a set of rules that would better coordinate the overlapping rules with the objective that tax would be owed at the time a person received distributions (and not before) but the interest charge on delayed payment of tax would be preserved.

The possible issues include:

- a. Whether beneficiaries should be deemed to indirectly own CFCs and PFICs through a discretionary non-grantor trust and if so, how the allocation of ownership will be made and how adjustments will be made to avoid double tax when income imputed to a beneficiary is later distributed to that person or another person or when the trust disposes of shares.
- b. Whether, instead of imputing income to beneficiaries, beneficiaries should be taxed when they receive distributions (as under Subchapter J) but the interest charge under the accumulation distribution rules would be modified to treat the trust as having accrued income at the time the income accrued to the CFC or PFIC owned by the trust.
- c. Clarification of indirect ownership of PFICs through US entities.



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March 27, 2003

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Re: Request for Published Ruling Clarifying Reg. § 1.401(a)(9)-5, A-7(b) and (c)

Dear Marjorie:

This letter is submitted by the American College of Trust and Estate Counsel on behalf of its Employee Benefits Committee.¹ It follows up on your suggestion to your fellow panel members prior to the ALI-ABA Video Law Review program this past May that with the issuance of "final" regulations under Section 401(a)(9) the Federal Revenue Service would be amenable to issuing further guidance in the form of published rulings. You also said you would welcome the input of practitioners as to where such guidance was needed.

At the time, some panel members suggested that one area that remained unclear after the final regulations, and as to which further guidance would be welcome, was the distinction between a "contingent beneficiary" and a "successor beneficiary" under Reg. § 1.401(a)(9)-5, A-7(b) and (c), respectively. This distinction is crucial to the determination of whether there is a "designated beneficiary" of a qualified plan or IRA where a trust is named as beneficiary: a potential recipient of funds under the trust that is treated as a "contingent beneficiary" will be taken into account in determining the designated beneficiary, whereas a potential recipient that is treated as a "successor beneficiary" will not be. One or more qualified plans or IRAs are the largest financial asset of many individuals, and as a result standard estate planning principles will call for the beneficiary of all or some portion of the plan or IRA to be a trust. Estate planning practitioners need to know what are the consequences under the distribution rules of naming one or another kind of trust as a beneficiary. In addition, if it is important that the plan or IRA have a designated beneficiary, practitioners need to know what are the rules that must be followed in order to achieve that result.

Recent private letter rulings have only heightened the confusion surrounding this subject and thus the need for published guidance. Private letter rulings, issued on an

¹ The American College of Trust and Estate Counsel is a professional association of over 2,600 lawyers throughout the United States, elected to membership by their peers on the basis of their professional reputation, ability, and contributions in legal matters affecting estate planning.

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ad hoc basis in response to particular fact situations, are not intended to provide general guidance and are a poor vehicle for this purpose. The purpose of this letter, therefore, is to illustrate for you by example the questions which need to be answered, and to offer our suggestions in each case as to what the result should be. It is hoped that the examples could form the basis for a published ruling.

In all the following examples, it is assumed that the trust described is named as beneficiary of a qualified plan or IRA, and that the trust is not a "conduit" trust, so that some portion of the distributions from the plan or IRA will or may be accumulated in the trust and not paid out currently.

1. Trust provides for all income to be paid to X for life, remainder at the death of X to Y, who is younger than X, if Y is then living. If Y does not survive X, the remainder will go to C, which is a charity?

Suggested result: C is a successor beneficiary and not a contingent beneficiary. Thus C will not be taken into account in determining the identity of the designated beneficiary, and X is the designated beneficiary.

There are two possible rules which could lead to this result, either of which would be equally workable. Since the rules may lead to different results in different situations, however (see, for instance, Example 2, below), it is important for practitioners to know which rule is operative.

One rule is that a contingent remainderman under a trust (C in the above example), who will take only if the primary remainderman (Y in the above example) does not survive to take, will be treated as a successor beneficiary except a primary remainderman who is older than the current beneficiary. The rationale behind this rule is that a primary remainderman who is younger than the current beneficiary will be presumed to survive the current beneficiary and thus to take. By contrast, if the primary remainderman is older than the current beneficiary, the primary remainderman will be presumed not to survive the current beneficiary, so that the contingent remainderman will take on the death of the current beneficiary. Applying this principle, which we will call the "life expectancy rule," to Example 1, since Y is younger than X and C will take only if Y does not survive X, C is treated as a successor beneficiary.

The other rule which could be applied in this circumstance is that a remainderman under a trust will be treated as a contingent beneficiary if and only if he or she would take upon the hypothetical death of the current beneficiary on the beneficiary determination date. All remaindermen who would not take in this circumstance will be treated as successor beneficiaries. Under this principle, which we will call the "snapshot rule," contingent remaindermen would always be treated as successor beneficiaries. Applying this rule to Example 1, since Y would take if X were to die on the beneficiary determination date, and C would take nothing, C is treated as a successor beneficiary.

We note that if instead the Service were to take the position in the above example that C was a contingent beneficiary, a position which we strongly feel is ill-advised, it would be incumbent upon the Service also to make it clear to practitioners under what circumstances, if at all, the naming of a charity, or intestate heirs, or some other beneficiary which was not an individual, as a contingent remainderman would *not* cause the trust to fail to have a designated beneficiary. For instance, assume the trust in the above example instead provided on the death of X for distribution to the descendants of the grantor by right of representation (per stirpes) with C charity to take only if no descendants survived X, and on the beneficiary determination date the grantor had five children, twelve grandchildren and three great-grandchildren. Would C be treated as a contingent beneficiary in that circumstance? If not, what rule would be applied to differentiate that case from the trust described in Example 1?

² This example is identical in substance to Example 1 in Reg. § 1.401(a)(9)-5, A-7(c)(3) except for the addition of C as contingent remainderman. The example in the regulation postulates that no one has a beneficial interest in the trust other than the primary remaindermen, the children of the grantor. This is a somewhat puzzling statement, since the trust property must pass to some person or entity, either by the terms of the governing instrument or applicable state law, if the children do not survive the income beneficiary.

2. Trust is the same as in example 1 except that Y, the primary remainderman, is older than X.

Suggested result: The result depends on whether the operative rule is the life expectancy rule or the snapshot rule. We are indifferent as to which rule is to be applied, so long as the rule is clearly stated and consistently applied.

Under the life expectancy rule, C would be a contingent beneficiary and thus there would be no designated beneficiary, because Y is older than X and thus will be assumed not to survive to take on the death of X. Thus, one must look to the next remainderman, which is C. Note, however, that if the trust provided that if Y did not survive X Y's children would succeed to Y's interest, and C would take only if none of Y's children survived, and if at the beneficiary determination date Y had one or more children who were younger than X, C would be treated as a successor beneficiary under the life expectancy rule, and the designated beneficiary would be X.

Under the snapshot rule, C would be a successor beneficiary, because if X died at the beneficiary determination date Y would take. The fact that Y was older than X would be irrelevant.³

3. Trust is the same as in example 1 except that X also has a testamentary special power of appointment exercisable in favor of the grantor's children and more remote descendants, all of whom are younger than X.

Suggested result: The result is the same as in Example 1 and is not affected by the special power of appointment, regardless of whether the life expectancy rule or the snapshot rule is applied. Under either rule, all the possible appointees are contingent beneficiaries: under the life expectancy rule because they are all younger than X, and under the snapshot rule because any of them could take on the hypothetical death of X on the beneficiary determination date depending on how the power of appointment was exercised. Because all possible appointees are younger than X, X remains the designated beneficiary. This result would be the same no matter how the class of appointees was defined, so long as members of the class were "identifiable" within the meaning of Reg. § 1.401(a)(9)-4, A-1 and were all younger than the holder of the power of appointment.⁴

4. Trust is a discretionary trust for the benefit of minor child A until A reaches age 30, whereupon the trust will terminate by distribution outright to A. If A does not survive until age 30, the trust will terminate in favor of A's children or, if none, in favor of charity C. A has no children at the beneficiary determination date.

Suggested result: All remaindermen other than A, who will take only if A does not survive until age 30, will be treated as successor beneficiaries, so that A is the designated beneficiary.

We feel that there are powerful policy reasons for this result. This kind of trust is a standard vehicle for the holding of property for young children; its sole purpose is to defer outright ownership until the child

³ PLR 200252097, although it did not by its terms apply the final regulations, suggests that the Service is applying the snapshot rule. There the trust named as beneficiary was for the benefit of Taxpayer C for life, terminating in favor of C's children at C's death or, if none, in favor of the heirs of the grantor living at C's death. At the beneficiary determination date, C was childless, and the grantor's heirs were C's siblings, all of whom were older than C. The Service held that D, the oldest of C's siblings, was the designated beneficiary.

⁴ The result we suggest is consistent with what appears to be the view of the Service as stated in PLR 200235038. There the beneficiary of an IRA was a trust for the benefit of child C, under which Chad a testamentary power of appointment exercisable in favor of anyone other than C's estate, his creditors, or a "Disqualified Appointee". A "Disqualified Appointee" was defined as any individual older than C, any person other than a trust or an individual, or any trust having as a beneficiary an individual older than C. The Service held that the designated beneficiary under the trust was C because "any potential beneficiary of taxpayer C's interest in IRA X must be no older than taxpayer C."

reaches sufficient maturity to be able to deal responsibly with the assets. The probability that the child will survive to the termination date of the trust is overwhelming. To require that someone else be treated as a designated beneficiary, or that there be no beneficiary at all, based on a hypothetical disposition of the trust which almost certainly will not happen, seems arbitrary and not in accordance with the reality as to who is the beneficiary of the trust. We note also that in this circumstance, a determination that the designated beneficiary is anyone other than the minor child is likely to have a severe adverse consequence in terms of the permissible payout period.

We understand that there might be concern about abuse if a rule were adopted that the designated beneficiary of all trusts which by their terms terminated in favor of the current beneficiary during the beneficiary's actuarially determined life expectancy was the current beneficiary. At some point, if the trust terminates at age 50, 60 or beyond, the likelihood that the current beneficiary will in fact take becomes less than overwhelming, and the likelihood that the trust will terminate in favor of remaindermen other than the current beneficiary becomes more than negligible. We suggest, therefore, that the Service adopt a cut-off age beyond which, if the trust does not by its terms terminate, the designated beneficiary will be determined on the same basis as if the trust by its terms lasted for the beneficiary's lifetime. Extrapolating from the generation-skipping transfer tax (IRC § 2632(c)), we would further suggest age 46 as the cut-off age.⁵ In other words, if a trust will terminate in favor of the current beneficiary at age 45 or before, remaindermen other than the current beneficiary will be disregarded; if, however, the trust will terminate in favor of the current beneficiary at age 46 or older, remaindermen who take if the current beneficiary does not survive to take will be taken into account on the same basis as if the trust by its terms went for the life of the current beneficiary.

We are aware that our suggested result is contrary to the result reached in PLR 200228025, which was decided under the 1987 proposed regulations. PLR 200228025 involved a trust for the benefit of two grandchildren, which would terminate with respect to 50% when each grandchild reached age 30. If one grandchild died before that age, the other would take the entire trust. If *both* grandchildren died before age 30, a collateral relative, age 67, would take. The ruling does not state who would take if the 67 year old was not alive to take, which was surely highly probable in the extremely unlikely event that both grandchildren died before age 30; that evidently was not considered relevant. The ruling held that the designated beneficiary was the 67 year old. We respectfully submit that at least under the final regulations this result is wrong, and that the older of the two grandchildren should instead have been treated as the designated beneficiary.

5. Trust is a discretionary trust for A for life, terminating at A's death in favor of A's estate.

Suggested result: A is the designated beneficiary, because A's estate should be treated as "stepping into the shoes of" the beneficiary for 401(a)(9) purposes and thus as the equivalent of the beneficiary.

A position the Service has recently taken in the charitable remainder trust ("CRT") area strongly supports this result. Normally, a CRT set up for the benefit of a second trust for an individual, rather than for the benefit of the individual directly, may last only for a term of up to 20 years rather than for the individual's lifetime. In Rev. Rul. 2002-20, however, the Service held that in certain circumstances, a trust as beneficiary of a CRT will be treated as the equivalent of an individual beneficiary, thus permitting the CRT to run for the life of the individual beneficiary of the second trust.

Rev. Rul. 2002-20 involved three CRTs established for the benefit of three slightly different trusts for the benefit of C, a disabled individual. All three of the beneficiary trusts lasted for C's lifetime and provided for distributions to be made solely to C. On C's death, two of the three beneficiary trusts terminated in favor of C's estate; the other gave C a general power of appointment over all funds which were not required to reimburse Medicaid for assistance provided to C during life, in default of which the trust assets would be distributed to charity. The ruling holds that in all three situations, the CRT may

⁵ Section 2632(c) defines a "GST trust" in part in terms of whether or not the trust will distribute to a "non-skip person" (*i.e.* a member of the generation immediately below the grantor) before age 46. If so, there is a statutory presumption that the non-skip person will take.

Marjorie Hoffman, Esq.
March 27, 2003
Page 5

last for C's lifetime, because "Upon C's death, the assets remaining in Trust B will be distributed either to C's estate or, after reimbursing the state for any Medicaid benefits provided to C, will be subject to C's general power of appointment. In these situations, the use of the assets in Trust B during C's life and at C's death is consistent with the manner in which C's own assets would be used. C, therefore, is considered to have received the unitrust amounts directly from Trust A [the CRT] ...". Similarly in this context, payment of the trust assets to the beneficiary's estate on termination of a trust should be treated as the equivalent of payment to the beneficiary himself, because it is the same ultimate disposition of the property which would have occurred had the beneficiary received the trust assets during life.

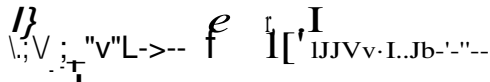
We are aware, of course, that the estate of the employee cannot be a designated beneficiary because only an individual can be a designated beneficiary. Reg. § 1.401(a)(9)-4, A-3. There is no inconsistency between this rule, however, and a recognition that the estate of an individual, named beneficiary will be treated in the same way as the named beneficiary.

6. Same as in example 5, except that upon A's death A has a testamentary general power of appointment, exercisable in favor of any person or persons including A's estate. In default of appointment, distribution will be made to C charity.

Suggested answer: A is the designated beneficiary, because a testamentary general power of appointment, exercisable in favor of the estate, should be treated in the same way as if the estate were directly named as beneficiary. To draw a distinction between the two would elevate form over substance. Rev. Rul. 2002-20 treats the two as indistinguishable in the CRT context, and they should likewise be treated as indistinguishable in this context.

We would very much appreciate your consideration of these questions for a published ruling, and would be pleased to work with you toward this end in any way that you felt was helpful. Although in all cases, as described above, we have our own views as to what we feel the answer should be, at this point we feel any answers at all, so long as they are clear, would be preferable to the current state of confusion.

Yours sincerely,



Virginia F. Coleman, Immediate Past Chair
Employee Benefits Committee



Ronald D. Aucutt, President



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April 15, 2009

Via Hand Delivery

Henry S. Scmeiderman
Assistant Chief Counsel (field Service)
Internal Revenue Service
Attn: CC:PA:LPD:PR (Notice 2008-47)
Room 5203
P. O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Re: Notice 2008-47: Request for Revenue Ruling
Regarding Spousal Rollovers – IRC Sections
402(c) and 408(d)(3)

Dear Mr. Scmeiderman:

I am writing on behalf of The American College of Trust and Estate Counsel (ACTEC), a professional association of more than 2,500 lawyers skilled and experienced in estate planning and administration and dedicated to the improvement of the law as it affects estate planning and administration.

We request that the Internal Revenue Service (IRS) issue a Revenue Ruling or similar pronouncement upon which all taxpayers may rely dealing with spousal rollovers of qualified retirement plan accounts and IRAs. The issuance of such a ruling would be in the public interest.

Background:

The qualified retirement plan and individual retirement account (IRA) have become some of the most significant assets in a person's estate. The income tax treatment of these assets affects a very large number of taxpayers. One of the most important federal income tax provisions relating to these assets involves the IRA "spousal rollover" provided for under Internal Revenue Code (Code) sections 402(c) and 408(d)(3)(A).

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Under these provisions, eligible distributions from a qualified retirement plan or IRA that are paid into an IRA for the benefit of the surviving spouse of the qualified retirement plan participant or IRA owner within sixty days of the distribution date (a "spousal rollover") are not subject to inclusion in gross income under Code section 72. Such spousal rollovers are very important, because they allow the surviving spouse to take distributions over his or her own life expectancy, redetermined annually using the Uniform Table, and also to name his or her own beneficiary, who in turn can take distributions over that beneficiary's life expectancy.

The preamble to the Final Income Tax Regulations promulgated under Code section 401(a) (9) (the "Preamble Language") states as follows with respect to the circumstances in which a spousal rollover is available:

If [a surviving] spouse actually receives a distribution from the IRA, the spouse is permitted to roll that distribution over within 60 days into an IRA in the spouse's own name to the extent that the distribution is not a required distribution, regardless of whether or not the spouse is the sole beneficiary of the IRA owner. Further, if the distribution is received by the spouse before the year that the IRA owner would have been 70 1/2, no portion of the distribution is a required minimum distribution for purposes of determining whether it is eligible to be rolled over by the surviving spouse.

These "spousal rollover" portions of the Code and regulations thereunder are extremely complicated, and often are poorly understood by the average estate planning attorney or accountant, when they are applied to circumstances in which the surviving spouse is not named directly as a beneficiary. Most troubling is the fact that a significant number of retirement plan and IRA plan sponsors are now requiring that a surviving spouse obtain a private letter ruling before the plan sponsor will allow a spousal rollover to be made when an estate or trust, and not the spouse, is named as beneficiary. As a result, the many private rulings addressing this issue (discussed below) and the Preamble Language itself in many cases effectively have been rendered moot. The cost to both the IRS and taxpayers of each taxpayer having to request a private ruling in this circumstance will be enormous.

Therefore, a Revenue Ruling is needed addressing spousal rollovers of a decedent's interest in a Retirement Plan or IRA (the "Decedent's Interest") where an estate or trust (not the surviving spouse) is the named beneficiary of such Decedent's Interest.

Private Rulings:

The IRS has issued many private letter rulings, going back more than a decade,¹ in which a surviving spouse was allowed to roll over a Decedent's Interest even though the beneficiary of the Decedent's Interest in the Retirement Plan or IRA was the decedent's estate or trust. In each of the private letter rulings, the rollover was valid because the surviving spouse was either the executor or trustee of the estate or trust, was in control, and was the sole person who could make the decision to distribute the Decedent's Interest to the surviving spouse. In other words, the Decedent's Interest was *not* treated as having passed through a third-party estate or trust. Instead, the surviving spouse was treated as having received the Decedent's Interest from the decedent.

A recent ruling, PLR 200807025 (Nov. 23, 2007), allowed a spousal rollover where an IRA passed to an estate and became part of a grantor trust which became irrevocable upon the grantor's death. The IRA could have been allocated to any one of four separate subtrusts. The surviving spouse was *not* in complete control of the distributions from the trust. One Co-Trustee of the Marital Trust was the spouse. She and the other Co-trustee of the Marital Trust were required to approve the allocation of the Decedent's Interest to the Marital Trust. The spouse then withdrew the Decedent's Interest from the Marital Trust and requested a favorable ruling that she could roll over the withdrawal to an IRA maintained in her name. The IRS granted her request and quoted the Preamble Language for justification.

In a recent Webcast, however, an IRS representative indicated that the Preamble Language should be read as applying only when the surviving spouse has control and that PLRs similar to 200807025 will likely *not* be granted. He explained that the taxpayer in that private ruling represented that there was no choice as to how the IRA would be allocated among the trusts presented in that fact pattern.

Need for Guidance:

A Revenue Ruling is necessary in order to provide assurance to plan sponsors and guidance to taxpayers as to the circumstances under which a spousal rollover is valid if an estate or trust is named as the beneficiary. As mentioned above, such a ruling will avoid the very significant cost to taxpayers and to the IRS of compelling taxpayers faced with these circumstances to request a private ruling to address this issue, a requirement that is being placed on taxpayers by a significant number of plan sponsors.

See. e.g., PLR 200324059 (Mar. 18, 2003); PLR 200634065 (April 7, 2006); PLR 200637033 (June 20, 2006), for three examples of more recent rulings.

Further, taxpayers may not rely on private letter rulings granted to others.² This means that, regardless of the interpretation applied to the Preamble Language in private letter rulings, practitioners may not wish to recommend spousal rollovers when an estate or trust, rather than the spouse, is named as the beneficiary unless they obtain a private letter ruling for the client or the IRS makes its position official, such as by issuing a revenue ruling. Given the ubiquitous nature of retirement plans and IRAs, such an official position would be of great benefit to all.

In addition, clarifying the meaning of the Preamble Language would be beneficial. Based upon the private letter rulings and informal statements from IRS representatives, it is unclear whether a surviving spouse must be in complete control of the distribution for a rollover to be valid, or whether the spouse can roll over the distribution to a spousal IRA regardless of whether the spouse is in control of the distribution as long as a spouse receives a distribution pursuant to the terms of the estate or trust.

Proposed Resolution:

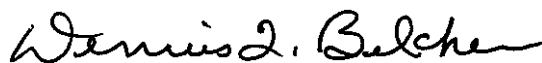
We respectfully request that the IRS issue as soon as practicable a revenue ruling (or other pronouncement upon which taxpayers may rely) that a spousal rollover may be accomplished by a surviving spouse with a distribution (other than a required minimum distribution) actually received by him or her from a deceased spouse's qualified retirement plan or IRA even though a trust or estate is named as the beneficiary of that qualified retirement plan or IRA.

In addition, the ruling should clarify whether spousal control over the distribution from the trust or estate named as beneficiary is or is not required.

In our view, based on the Preamble Language, it seems that it is sufficient for a valid spousal rollover that the spouse actually receives a distribution of the Decedent's Interest in accordance with the terms of the decedent's estate or trust or governing state law. Therefore, control by the spouse should not be required. However, clarification of this point, regardless of the outcome, is essential to provide certainty in this area and eliminate the need for seeking individual private letter rulings in order to complete a spousal rollover.

We appreciate your attention to this request.

Very truly yours,



Dennis I. Belcher,
President

² Internal Revenue Code §6110(k)(3).



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Executive Director
DEBORAH O. MCKINNON

January 7, 2011

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

Re: Comments on the Hiring Incentives to Restore Employment ("HIRE")
Act, Pub. L. No. 111-147, 124 Stat. 71 (2010) and Notice 2010-60

Dear Mr. Mundaca:

The American College of Trust and Estate Counsel ("ACTEC") submits the enclosed comments on the Hiring Incentives to Restore Employment ("HIRE") Act and the preliminary guidance provided under Notice 2010-60.

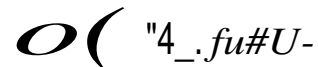
These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on US beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have US beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

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 this field 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.

Honorable Michael F. Mundaca
Page 2 of 2
January 7, 2011

The principal authors of these comments were Ellen K. Harrison and Henry Christensen. Helpful comments were provided by Carlyn S. McCaffrey, Duncan E. Osborne, Carolyn A. Reers, Mamin J. Michaels and G. Warren Whitaker. Principal contacts for a discussion of the enclosed proposals are Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. (202.663.8316) and Henry Christensen, III of McDermott Will & Emery in New York, New York (212.547.5658). Members of your staff should not hesitate to contact either of them for more information regarding these proposals.

Very truly yours,

A handwritten signature in black ink, appearing to read "Karen M. Moore".

Karen M. Moore
President

KMM:ls
attachments

cc: Emily McMahon, Esquire
Manal Corwin, Esquire
Honorable William Wilkins
Honorable Douglas Schulman
Michael Plowgian, Esquire
Catherine V. Hughes, Esquire

ACTEC COMMENTS ON HIRE ACT

REPORTING REQUIREMENTS FOR FOREIGN ACCOUNTS

The Hiring Incentives to Restore Employment ("HIRE") Act of 2010¹ was signed into law by President Obama on Thursday, March 18, 2010. As its title suggests, the HIRE Act is primarily aimed at providing businesses with tax incentives to help finance the hiring and retention of new employees. To offset the projected revenue loss from these incentives, the Foreign Account Tax Compliance Act ("FATCA") was added to the bill.² FATCA was originally introduced in the House by Ways and Means Committee Chair Charles B. Rangel, Democrat of New York,³ and in the Senate by Finance Committee Chair Max Baucus, Democrat of Montana,⁴ on October 27, 2009.

The purpose of FATCA is to "detect, deter, and discourage offshore tax evasion" by Americans through the use of financial institutions outside of the United States as well as to close certain information reporting loopholes that allowed U.S. persons to avoid disclosure of offshore assets and income.⁵ Additionally, FATCA attempts to regulate certain perceived abuses concerning the use for the benefit of U.S. persons of property held in trust that were identified by the Senate Subcommittee on Investigations in its 2006 Report on tax haven abuses.⁶

These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on U.S. beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have U.S. beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

I. Foreign Entities Subject to the Provisions of FATCA

The HIRE Act imposes an obligation on withholding agents⁷ to withhold a 30 percent tax of "withholdable payments" to foreign financial institutions ("FFIs")⁸ and certain non-financial foreign entities ("NFFEs").⁹ Withholding is not required for payments to an FFI that has entered into an agreement with the IRS to obtain and report information regarding its U.S. account holders or certifies that it has no U.S. account holders. Withholding is waived for payments to a NFFE that certifies that it has no "substantial U.S. owners" (a defined term) or identifies such owners. On August 27, 2010, the U.S. Treasury issued Notice 2010-60, 2010-37 I.R.B. 329 ("the Notice"), which was the first preliminary guidance in this area.

A. *Definition of "Financial Institution"*

Section 1471(d)(4) of the Internal Revenue Code (the "Code") provides that an FFI is a "financial institution" that is a foreign entity. Under § 1471(d)(5) of the Code, the term "financial institution" means any entity that:

- (A) accepts deposits in the ordinary course of a banking or similar business:

- (B) holds financial assets for the account of others as a substantial portion of its business; or
- (C) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities.

The Notice discusses each of the above categories and also identifies certain classes of foreign entities that will not be subject to the new withholding tax regime in any case. These include FFIs that the IRS believes should be either (1) excluded from the definition of a financial institution and treated as NFFEs, (2) deemed to be compliant without the need to enter into an FFI Agreement or (3) identified as posing a low risk of tax evasion and thus exempt from the new withholding tax regime. The different categories of FFIs are discussed under the Notice as follows:

1. Accepts Deposits

According to the Notice, this category of financial institution generally includes (but is not limited to) entities that would qualify as banks under Code § 585(a)(2), savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions. The Notice points out that being subject to banking and credit laws, or subject to regulatory oversight by a regulatory authority, is not necessarily determinative of whether the entity qualifies as a financial institution.

2. Holds Financial Assets for the Account of Others

The Notice describes this category of financial institution as including entities that, as a substantial portion of their business, hold financial assets for the account of others. Such institutions may include, for example, broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee benefit plans. As above, whether the entity is subject to banking and credit laws or regulatory supervision is relevant but not necessarily determinative of whether the entity is a financial institution.

3. Engaged Primarily in the Business of Investing, Reinvesting or Trading in Securities, etc.

Under the Notice, this category has potentially the broadest sweep of the three categories, and includes any entity engaged (or holding itself out as engaged) primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interest in such instruments. According to the Notice, this category of financial institution generally includes (but is not limited to) mutual funds, funds of funds, exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and other investment vehicles.

According to the Notice, the term "business" differs in scope and content from the term "trade or business" as used elsewhere in the Code. The example given in the Notice explains that while an isolated transaction may not give rise to a trade or business in other sections of the Code, it may cause an entity to be considered a financial institution depending on such factors as the magnitude and importance of the transaction in comparison to the entity's other activities. From this, it would appear that a foreign legal entity that simply buys and holds portfolio investments would, potentially, be in the "business" of investing in securities. The Notice indicates that whether an entity is in such a "business" will depend on all the facts and circumstances, but promises that future guidance will provide guidelines to determine what types of activity constitute a "business," and when an entity is "primarily" in such a business.

B. Entities Excluded from the Definition of Financial Institution and/or Exempt from Some or All of the New Withholding Tax Rules for FFIs

Given the extremely broad scope of the definition of an FFI, it is not surprising that the Notice contains a substantial discussion of entities that, on one basis or another, the IRS proposes will not be subject to the new withholding tax regime for FFIs.

Certain foreign entities that would be FFIs *solely* because they are engaged primarily in investing, reinvesting or trading in securities will *not* be classified as FFIs, providing they fall within one of the categories of entities described below. Generally, if a foreign entity is not an FFI, it will be an NFFE, and NFFEs are subject to their own new withholding tax regime. Despite this, these types of entities would not be subject to either the new FFI or NFFE withholding tax rules, because the Notice states that they will be exempted. The specific categories of exempted entities in the Notice include:

1. Certain holding companies

A holding company may not be classified as an FFI if it is an entity whose primary purpose is to act as a holding company for a subsidiary or group of subsidiaries that primarily engage in a trade or business other than that of a "financial institution." The Notice specifically excludes from this exemption any entity functioning as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund the start-up of companies and then hold those companies for investment purposes for a limited period of time.

2. Start-up companies

Start-up entities that intend not to operate as financial institutions, but are not yet operating their intended business, will be excluded as FFIs for the first 24 months after their organization. This does not include venture funds or other investment funds that invest in start-up entities.

3. Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy

Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy are excluded as FFIs if they intend to continue or recommence operations as non-financial institutions, but only if they were not previously a financial institution.

4. Hedging/financing centers of a non-financial group

Foreign entities that primarily engage in financing and hedging transactions for members of its expanded affiliated group, i.e., group finance companies, will not be treated as FFIs, provided that they render no services to non-affiliates and the group as a whole is not engaged in the business of being a financial institution.

The Notice requests comments on how to define the foregoing categories, and whether new categories of entities should also be excluded as FFIs.

C. *Treatment of NFFEs*

Non-financial foreign entities are defined by Code § 1472(d) as any foreign entity which is not a financial institution. Code § 1472(a) requires withholding agents to withhold tax at a 30 percent rate on all payments to NFFEs unless the beneficial owner of the NFFE has provided the withholding agent with a certification that it has no substantial United States owners, or has provided the withholding agent with the name, address and TIN of every substantial U.S. owner. Importantly, Code § 1474(b)(3) denies a credit for the 30 percent tax withheld to a U.S. person who did not provide the identifying information to the withholding agent required by Code § 1472(a), effectively negating the credit historically provided by Code § 1462.

D. *Definition of Substantial U.S. Owner*

Code § 1473(2)(A)(iii) provides that a beneficiary of a trust is a substantial U.S. owner of the trust if (i) he or she is treated as the owner of the trust under the grantor trust rules and, (ii) to the extent provided in regulations or other guidance, he or she holds directly or indirectly more than 10 percent of the beneficial interest in the trust.

In the case of an FFI described in § 1471(d)(5)(C)- an FFI that is engaged primarily in the business of investing or trading securities- a substantial U.S. owner includes a person who owns any interest in the entity, even if less than 10 percent. The Notice implies that a trust is treated as an FFI under § 1471(d)(5)(C). If so, then the 10 percent threshold for reporting beneficial interests in trusts is rendered meaningless. As discussed below, we believe that the issue to consider is whether a trust (as opposed to a trust company) should be treated as an FFI or as an NFFE.

It is not clear what the reporting threshold is when a beneficiary has less than a 10 percent interest in a trust which owns an interest in an FFI that is engaged primarily in the business of investing or trading securities.

E. *Treatment of Trusts and Trustees*

1. Trustees

Section II. A. 2 of the Notice cites "trust companies" as an example of an FFI that is included in the second category of financial institutions described in new Code § 1471(d)(S)(B) –an entity that holds financial assets for the account of others as a substantial portion of its business.

2. Trusts

The Notice implies that trusts will be treated as FFIs. While the reference on page 332 of 2010-37 I.R.B. to trusts is not definitive, the suggestion that small family trusts settled by a single person for the sole benefit of his or her family should be treated as deemed compliant FFIs implies that other trusts will be treated as FFIs rather than as NFFEs on the theory that under Code § 1471(d)(5)(C), a trust is an entity that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities.¹⁰ The Notice advises that Treasury and the IRS intend to issue guidance under which certain foreign entities that are FFIs described in Code § 1471(d)(5)(C), but which are not described in § 1471(d)(5)(A) or (B), would be treated as deemed compliant FFIs if the withholding agent (i) specifically identifies each individual, specified U.S. person, or excepted NFFE that has an interest in such entity, either directly or through ownership in one or more other entities, (ii) obtains from each such person the documentation that the withholding agent would be required to obtain from such person under the guidance described in the Notice if such person were a new account holder or direct payee of the withholding agent, and (iii) reports to the IRS, in such manner as will be provided in future guidance, any specified United States person identified as a direct or indirect interest holder in the entity.

It is important to note that the Notice provides no *de minimis* threshold for the obligation of a "deemed compliant FFI" to report ownership, including beneficial ownership in a trust. Literally, the Notice could be read to require reporting of remote contingent interests even in deemed compliant FFIs.

II. Collection and Reporting of Information by Covered Foreign Entities

Although the new withholding regime generally requires that withholding agents withhold 30 percent on withholdable payments to either FFIs or NFFEs, the new withholding requirements may be avoided. In particular, an FFI can avoid withholding on payments it receives if it enters into an FFI Agreement with the IRS, thus becoming a "Participating" FFI ("PFFI"). NFFEs can also avoid 30 percent withholding by providing information on their "substantial" U.S. owners, or certifying that they have no such U.S. owners. The Notice describes the proposed FFI Agreement's requirements, as well as the procedures for NFFEs to avoid withholding.

A. *FFI Agreement*

An FFI can avoid withholding if it enters into an FFI Agreement thereby becoming a PFFI. When entering into the agreement the FFI agrees, among other requirements, to:

1. Obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which (if any) of such accounts are U.S. accounts,
2. Comply with due diligence procedures the Secretary may require with respect to the identification of U.S. accounts,
3. Report certain information with respect to U.S. accounts maintained by the FFI and
4. Withhold on certain payments to non-participating FFIs and recalcitrant account holders.

B. *Duplicative Reporting*

The Notice provides that Treasury and the IRS intend to issue regulations providing that in the case of a PFFI that maintains an account of another PFFI, only the PFFI that has the more direct relationship with the investor or customer will be required to report.

III. Recommendations

A. *Application of HIRE Act to Trusts and Trustees*

We suggest that the approach of the proposed regulations to be issued under FATCA for foreign trusts should focus upon what trusts are, what information the Trustees are able to provide, what information needs to be made available to the United States Treasury concerning interests held by United States persons in foreign trusts and how duplicative reporting may be avoided.

1. Trustees

We agree with the position taken in the Notice that foreign trust companies, which often are banks, should be treated as FFIs and are capable of supplying all of the information required of FFIs, and entering into FFI Agreements. Trust companies are for profit business organizations that hold themselves out to the public as managers of investment assets, which act as investment advisors, and which hold bank deposit and custody accounts. They should be treated as FFIs.

However, not every trustee is a trust company. Individuals frequently serve as trustees. Sometimes the individual serves as co-trustee with a trust company, but not always. The ordinary meaning of the term "financial institution" would not include an individual. Moreover, it is not clear that every entity serving as a trustee should be treated as an FFI. For example, a private trust company serving

as a trustee of trusts for a single family is an entity, but by statute a private trust company usually cannot accept business from the public and indeed cannot engage in business in the ordinary sense. A private trust company can only act as Trustee of trusts for the family creating the private trust company.

Further, unlike a commercial trust company, a private trust company, as well as an individual trustee, typically would custody its securities accounts with a financial institution. To avoid duplicative reporting, we recommend that a trustee be classified as a deemed compliant FFI if it maintains accounts with another FFI which has entered into an agreement to provide information to the IRS or maintains accounts with a U.S. financial institution.

2. Trusts

We suggest that trusts should be treated as NFFEs, not FFIs.

We believe that trusts should not be treated as FFIs fundamentally because, unlike traditional investment companies, (i) trusts are not entities engaged in the business of soliciting customers to make investments on their behalf and (ii) the beneficiaries are not the owners of trust investments.

Treasury regulations define a "trust" as an arrangement "whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the rules applied in chancery or probate courts."¹¹ The regulations further provide that in order to be a trust, an arrangement must be one "for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility." If the beneficiaries voluntarily associate to participate in the trust and the trust is engaged in a business, the trust will be classified as an association taxable as a corporation. In the seminal Supreme Court case which was the genesis of the Treasury Regulations under Code§ 7701, *Morrissey v. Commissioner*,¹² the Supreme Court in setting forth seven factors that distinguished among trusts, partnerships and associations (corporations) for Federal income tax purposes, held that trusts lack two essential characteristics of associations: associates (owners), and "an objective to carry on business and divide the gains therefrom." We submit that the definition of investment company FFIs in new Code§ 1471(d)(5)(C), particularly in referring to entities which "hold themselves out" as being engaged in the business of investing, contemplates entities which hold themselves out to the public (thereby soliciting "associates") to engage in the business of investing, which is something that trusts do not and cannot do. Section 1471 (d)(5)(C) is not referring to trusts when it speaks of a class of entities that are engaged in the business of investing securities.

Although trusts are arrangements and not entities, for some purposes trusts have long been treated as entities under the Code. While they have their own rate brackets, and are taxed as "modified conduits," paying tax themselves upon

income accumulated in the trust, and distributing to the beneficiaries for taxation to the beneficiaries any income which the trust distributes, in all relevant sections of the Internal Revenue Code, trusts are taxed in a manner similar to that of individuals, not in a manner similar to corporations. Indeed, Code § 641(b) now states, in its final sentence with regard to foreign trusts, "For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time."

We believe that the fundamental issue which should be recognized in any regulations under Code § 1471 is that trusts are not business enterprises and trusts have no owners. The beneficiaries of trusts do have beneficial interests in the assets, which may be enforced in courts of equity, but they are not owners. Only the Trustee owns the trust assets. But the trustee owns the assets for the benefit of the beneficiaries. This difference between corporations and trusts is recognized in the way the Code taxes the income of foreign trusts, delaying taxation of income to the United States beneficiaries until it is actually distributed to them, and then applying proper penalty interest charges under Code §§ 665 through 668. By contrast, in the case of corporations with United States owners, Subpart F of the Code (§§ 951 through 965) will tax currently to the "United States shareholders" (defined as direct or indirect owners of 10 percent or more of the total combined voting power of the foreign corporation) their share of Subpart F passive income which was accumulated in, not distributed currently from, the foreign corporation.

For all of these reasons, we do not believe that a trust meets the definition of an entity in Code § 1471(d)(5)(C) that should be treated as an FFI.

There are further practical reasons why a trust should not be treated as an FFI. Beneficiaries do not have separate accounts representing their interest in the trust. The reporting requirements of Code § 1471 relate to "United States accounts" in the FFI. A "United States account" is defined under new Code § 1471(d)(1) as "any financial account which is held by one or more specified United States persons or United States owned foreign entities." A foreign trust with United States beneficiaries may have a "United States account" at an FFI in the name of the trust, but the trust itself does not hold "accounts" for each of its United States beneficiaries. In the case of the typical foreign trust which is a discretionary trust for the benefit of a class of beneficiaries, for example, the descendants of the creator of the trust, no one of the beneficiaries has an "account" with the trust. This inconsistency is further demonstrated by the definition of "financial account" in new Code § 1471(d)(2) that defines a financial account to mean a depository or custodial account. A trust creates neither a depository account nor a custodial account in the name of any trust beneficiary. An FFI will only have a depository or custodial account in the name of the trust.

New Code § 1471(c) defines the information which an FFI will have to agree to supply with respect to United States accounts. The information includes the

account number of each United States account (again, the only account number will be for accounts in the name of the trust itself), the TIN of each United States beneficiary (a foreign trustee could supply this information for all eligible beneficiaries known by the Trustee to be United States persons), the account balance or value (there will be no account balance or value for each individual beneficiary, but rather only for the trust as a whole) and the gross receipts and gross withdrawals from the account (there will be no gross receipts or withdrawals allocable to an individual United States beneficiary, but all distributions to individual United States beneficiaries will be disclosed on Forms 3520).

New Code § 1473(2)(A)(iii) states that the term "substantial United States owner" means, in the case of a trust which is not a grantor trust, a United States person who holds, directly or indirectly, more than 10 percent of the beneficial interests in such trust. Further, in the case of a payment made by a United States withholding agent to a non-financial foreign entity, the NFFE must, under new Code § 1472(b), certify to the withholding agent the name, address and TIN of every substantial United States owner of the foreign account. Thus, the focus of the statutory provisions applicable to trusts is on the holders of more than 10 percent beneficial interests. Yet, at the same time, new Code § 1473(2)(B) sets forth a "Special Rule for Investment Vehicles" by providing that "[i]n the case of any financial institution described in § 1471(d)(5)(C), clauses (i),(ii) and (iii) of subparagraph (A) shall be applied by substituting '0 percent' for '10 percent'". If the provisions of new Code § 1473(2)(B) were deemed to apply to trusts (because trusts were deemed to come within the definition of a financial institution under § 1471(d)(5)(C)), the 10 percent threshold expressly applicable to trusts would be rendered meaningless. The fact that the statute adopts a 10 percent ownership threshold for trusts and a zero percent ownership threshold for investment companies is persuasive that there was no intention to classify trusts as FFIs.

Thus, trusts should not be classified as FFIs under Code § 1471(d)(5)(C) so that new Code § 1473(2)(B) will not be applied to trusts and contradict the 10 percent reporting threshold adopted for defining a substantial owner of a trust. This result will be achieved by treating trusts as NFFEs, not FFIs, in the Regulations.

In sum, trusts are not in the "business of investing," within the meaning of Code § 1471(d)(5)(C), and individual United States beneficiaries of foreign trusts are not the owners of trust assets and do not have "accounts" as to which there can be disclosure. Moreover, any reporting required of a foreign trust will be duplicative of the reporting provided either by the trustee, if a trust company (and thus, an FFI), or by the FFI at which the foreign trust will have deposited or custodied its funds.

B. Regulation to Define "Substantial U.S. Owner"

The withholding obligations imposed by the HIRE Act will be very difficult to administer if a facts and circumstances test is used to determine whether a trust or estate has a

substantial U.S. owner; a bright-line test is essential. A test based on actual distributions in excess of a *de minimis* threshold will be easier to administer in many cases than a test based on percentage interests. Even though the statute defines a substantial U.S. owner by reference to a percentage interest, in most cases an individual's percentage interest in a trust or estate will be very difficult to determine. Even where a fixed income interest is granted to a beneficiary, if the beneficiary's interest terminates upon the happening of some event, including the death of the beneficiary, actuarial calculations will be necessary to value the income interest. But in many cases, a beneficiary's interest is discretionary, and where the interest is discretionary it will not be possible to determine a person's percentage interest. We would urge adopting as the bright-line test the \$50,000 *de minimis* amount which new Code § 1471(d)(1)(C) applies to individual accounts of U.S. persons with FFIs, which is that the total of all accounts maintained with the FFI by such individual does not exceed \$50,000.

1. We propose that a *de minimis* bright-line test be adopted for determining whether a nongrantor trust has a substantial U.S. owner regardless of the percent of beneficial interest held in the trust by U.S. persons. We propose that a beneficiary of a discretionary trust shall not be treated as a substantial U.S. owner of a nongrantor trust if all of the following apply:
 - (i) With regard to a wholly discretionary trust, if the distribution to such beneficiary in the preceding calendar year does not exceed \$50,000;
 - (ii) With regard to a wholly discretionary trust, if the average distributions to such beneficiary during the three preceding calendar years do not exceed \$50,000; and
 - (iii) If the amount of income or principal required to be distributed to such beneficiary or that may be withdrawn by such beneficiary does not exceed the amounts described in (i) or (ii) above.

Of course, if a beneficiary has a fixed percentage interest in a trust – both income and principal – which exceeds 10 percent, the beneficiary should be treated as a substantial U.S. owner. However, even a fixed right to a dollar amount should not cause the beneficiary to be treated as an owner unless the dollar amount exceeds the threshold amounts set forth above. Any other rule would require the valuation of the trust to determine whether the percentage threshold was exceeded, and this is administratively impractical. It should be remembered that in all events Code § 6048 will require a beneficiary of a foreign trust who actually receives a distribution to report that distribution currently on an income tax return.

2. We suggest that the thresholds discussed in section 1 above be coordinated with the information reporting rules for new Code § 60380, discussed below.
3. In the case of a grantor trust, we recommend that the grantor, and no other beneficiary, be treated as the owner of the portion of the trust that the grantor is treated as owning.

4. In the case of an estate, we recommend that the estate will have a substantial U.S. owner if any beneficiary of the estate (including a U.S. trust) is entitled to receive a bequest of more than \$50,000 or at least 10 percent of the residuary estate is payable to a U.S. beneficiary.
5. We recommend that a U.S. beneficiary who does not satisfy the \$50,000 *de minimis* threshold for being deemed a U.S. substantial owner of an estate or trust also not be treated as a substantial owner of an FFI engaged primarily in the business of investing or trading securities (for example, a hedge fund) that is owned by the estate or trust.
6. We recommend that reporting of interests in foreign trusts be limited to disclosure of all United States persons having a substantial interest in the trust as defined in § 1473(2)(A)(iii) of the Code.
7. We suggest that an underlying holding company wholly owned by a trust be treated either as an NFFE or a deemed compliant FFI if the only account to which receipts and disbursements will be allocated is the trust. Moreover, reporting would be duplicative since the trust will disclose U.S. beneficial owners and the holding company is likely to maintain its accounts with an FFI.

IV. Code § 1298(f): Passive Foreign Investment Company ("PFIC") Reporting and Attribution from Trusts to Beneficiaries

A. Background of PFIC Rules

A foreign corporation is a PFIC if 75 percent of its income is from passive sources or 50 percent of its assets produce or can produce passive income. Prior to enactment of the HIRE Act, PFIC shareholders were required to file an annual return on Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund," only if the U.S. person recognized gain on a direct or indirect disposition of PFIC stock, received certain direct or indirect distributions from a PFIC or was making certain elections.¹³ If no election is made, U.S. shareholders pay tax on certain income or gain realized through the PFIC, plus an interest charge intended to eliminate the benefit of deferral, and are required to file Form 8621 only if a taxable event occurs.¹⁴ If an election is made for the PFIC to be a "qualified electing fund" ("QEF"), electing U.S. shareholders currently include in gross income their respective shares of the company's earnings (and a separate election may be made to defer payment of tax, subject to an interest charge) on income not currently received.¹⁵ Another election may be made for PFIC shares that are publicly traded under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as "marking to market."¹⁶

Prior to the HIRE Act, the Code included a general reporting requirement for certain PFIC shareholders which was contingent upon the issuance of regulations.¹⁷ Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually

Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current IRS Form 8621 requires reporting only based on one of the triggering events described above.¹⁸ In a conforming amendment, Section 521(b) of the HIRE Act removes the general reporting requirement by deleting the reference to § 1246(f) in Code § 1291(e).

B. *HIRE Act Reporting*

Section 521 of the HIRE Act adds § 1298(f) to the Code to require annual reporting by U.S. persons who own, directly or indirectly, stock of a PFIC.⁹ The new section states:

Except as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require.

A person who meets the reporting requirements of new Code § 1298(f) may also meet the reporting requirements of new Code § 6038D (enacted by Section 511 of the HIRE Act) requiring disclosure of information with respect to foreign financial assets. The legislative history of the HIRE Act states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.²⁰

Although new Code § 1298(f) is effective on March 18, 2010, the date of enactment, Treasury promptly issued Notice 2010-34²¹ postponing the new filing requirement until the IRS develops guidance *for tax years beginning before March 18, 2010*. Persons who were required to file Form 8621 prior to enactment of Code § 1298(f) would continue to be required to file.

Section 513(b) of the HIRE Act amended Code § 6501(c) (8) to add the reporting obligation under Code § 1298(f) to the list of information returns that must be filed before the statute of limitations will begin to run on assessments of tax with respect to any event or period to which such information relates until the information return is filed.

C. *Recommendations*

1. We recommend that a *de minimis* rule be adopted exempting from the expanded reporting obligation shareholders who own less than a threshold amount of stock of a PFIC.²² We note that under new Code § 6038D, a person whose beneficial interest in a foreign entity is less than 10 percent is not required to file information returns. The threshold would not affect shareholders who otherwise were required to file, e.g., because a taxable event had occurred or a QEF or mark to market election were in place.
2. A U.S. person who is a discretionary or remainder beneficiary of a foreign nongrantor trust may be treated as an indirect shareholder of a PFIC owned by the trust. A beneficiary is treated as the indirect owner of shares owned by a trust in proportion to his or her beneficial interest. Under Proposed Treasury Regulations,²³ a person's beneficial interest is determined based on all relevant facts and circumstances. Because the rules for determining indirect ownership are

vague, at least until clear guidance is issued to determine indirect ownership, a discretionary or remainder beneficiary of a foreign nongrantor trust that owns PFIC shares should not be required to file Form 8621 (or another information return under Code § 1298(f)), particularly if the beneficiary has not received distributions from the trust (and therefore may not be aware of the existence of the beneficial interest).

We recommend that the expanded reporting obligation under Code § 1298(f) not apply to a beneficiary of a trust that owns PFIC shares if such beneficiary is not required to file under Code § 6038D. *See* Recommendation at III.C.3 below.

3. Because a U.S. person who receives, or is deemed to receive, a distribution from a foreign trust is required to file Form 3520, we recommend that the expanded filing obligation a trust beneficiary may have with respect to PFIC shares owned by a foreign trust under Code § 1298(f) be included as part of Form 3520, and that the "beneficiary statements" that are required to be filed with Form 3520 be amended to clarify the disclosure required with respect to any PFIC income or gain that may be taxable to a beneficiary.²⁴ Currently, the explanation for line 30 of Form 3520 says that the statement should include "[a]n explanation of the appropriate U.S. tax treatment of any distribution or deemed distribution for U.S. tax purposes, or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution for U.S. tax purposes." This statement could be revised to specifically require whatever information is required under Code § 1298(f). Form 8621 still would be required if a taxable event occurred or a QEF or mark to market election were in place.
4. A beneficiary may not have information necessary to determine whether he or she should be reporting under Code § 1298(f). In recognition of this practical problem, Form 3520 allows the beneficiary who does not receive a beneficiary statement providing the information needed to calculate tax on a trust distribution to calculate tax using a so-called "default method" that mimics the PFIC tax rules. The filing required by Code § 1298(f) should address the alternatives available to a U.S. beneficiary who does not have information to satisfy his or her reporting obligation.
5. If the trustee of a foreign nongrantor trust, or a U.S. agent for the trustee, provides the information required by Code § 1298(f), a trust beneficiary should not be required to file such form. This is an approach adopted in proposed FBAR regulations.
6. If a trust is a U.S. nongrantor trust, the beneficiaries should not be required to file information returns under Code § 1298(f). Instead, the U.S. trustee should have the filing obligation. Filing by beneficiaries would be duplicative and unnecessary because any taxes imposed under the PFIC regime should be payable from the U.S. trust.

7. If a U.S. grantor or another U.S. person is treated as the owner of the PFIC shares under Subpart E of Subchapter J, the grantor or other owner (and not the trustee or another beneficiary of the trust) should be required to file the information required by Code § 1298(t).²⁵
8. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 1298(±), nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.

V. New Code § 6038D

Under current law, an individual who is a beneficiary of a foreign trust is obligated to report distributions received from the trust and may be required to file an FBAR if his or her beneficial interest is 50 percent or more. The HIRE Act expands the reporting obligations of beneficiaries of foreign trusts.

A. *Filing Threshold for Individuals*

Section 511 of the HIRE Act, provides:

Any individual who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset if the aggregate value of all such assets exceeds \$50,000 (or such higher dollar amount as the Secretary may prescribe).

While the statute says that the threshold is met if "the aggregate value of all such assets exceeds \$50,000," we believe that the clear intent of Congress was for the threshold to be met only if the aggregate value of *the individual's interests in* all such assets exceeds \$50,000. For instance, if an individual held a .00001 interest in a foreign mutual fund with total assets under management of \$1 billion, the individual's interest would be \$10,000 and he or she would have no filing requirement, even though the aggregate value of the foreign financial asset in which the individual has an interest exceeds the threshold. This should be clarified.

B. *Filing Rules Applicable to Beneficiaries of Foreign Trusts*

The Technical Explanation to the HIRE Act indicates that beneficiaries of foreign trusts must report their trust interests under the new law under the concept that a foreign trust is itself a "foreign financial asset":

For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust, together with the value of other specified foreign financial assets, exceeds the aggregate value threshold?⁶ (Emphasis added.)

New Code § 60380 (b)(2) includes in the definition of Foreign Financial Assets "any interest in a foreign entity (as defined in section 1473)."

Code § 1473(5) provides that "[t]he term 'foreign entity' means any entity which is not a United States person."

Therefore it appears that a foreign trust is itself a foreign financial asset, and the beneficiary of a foreign trust must report his interest if its value (i.e. the percentage interest of the beneficiary in the trust multiplied by the aggregate value of all assets of the foreign trust) exceeds the \$50,000 threshold, regardless of whether any of the assets of the foreign trust are themselves "foreign financial assets."

C. *Recommendations*

1. A beneficiary should not be required to report any foreign financial assets held by the foreign trust. It is the beneficiary's interest in the trust itself, and not the trust's assets, that gives rise to the filing requirement under Code § 60380. Underlying financial accounts held in the trust would remain subject to the reporting requirements under Title 31 (the Bank Secrecy Act) of the United States Code²⁷ and Treasury Department Form TO F 90-22.1, "Report of Foreign Bank and Financial Accounts" ("FBAR") as they pertain to trust beneficiaries.²⁸
2. While foreign trustees are not obligated to file under Code § 60380, it may sometimes be more convenient for the trustee to file, particularly if the trust has many U.S. beneficiaries. It should be clarified that if the trustee files, there is no requirement under Code § 60380 for each trust beneficiary to file as well. (A similar rule for avoidance of duplication is found in the Title 31 FBAR proposed regulations.) The Technical Explanation states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.²⁹
3. Questions arise as to how the interest of a beneficiary in a foreign trust should be computed. If the beneficiary has a fixed income interest or the current right to withdraw a percentage of the capital (an "ascertainable trust interest"), this is a relatively straightforward task. With a wholly discretionary trust, valuation is more problematic. Some foreign trusts may have dozens of permissible beneficiaries and the power in the trustee to add almost anyone as a beneficiary, and most of these potential beneficiaries will never receive a distribution. We believe that it would be reasonable and administratively workable to establish by regulation that an individual who is a potential discretionary beneficiary (current or contingent) of a foreign trust, or a potential appointee under a power of appointment held over a foreign trust, has no reportable interest in that trust under Code § 60380 until he or she receives a distribution. Once the first distribution has been made to that person, we suggest that the value of his or her interest be computed using a bright-line test based upon the value or average value of those distributions. We suggest that the beneficiary's interest for any calendar year be equal to the greater of the amount distributed to her in such year or the amount of the average distributions she received in such calendar year and the prior 2 years.

4. If a U.S. grantor or another U.S. person is treated as the owner of the foreign trust under Subpart E of Subchapter J of the Code, the grantor or other owner (and not the trustee or another beneficiary of the trust), should be required to file the information required by Code § 6038D.³⁰
5. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 6038D, nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.
6. Code § 6038D applies only to individuals and not to domestic entities.³¹ Thus, any obligation to report ownership of a foreign financial asset owned by a domestic trust should rest with the trustee and not with the individual trust beneficiaries. This should be true even if the domestic trust owns PFIC shares and the beneficiary's beneficial interest is ascertainable.
7. Clarification would be helpful that Code § 6038D does not apply to individuals who are not U.S. taxpayers.
8. Avoiding duplicate filings:
 - (i) We believe that it will be necessary for the IRS to introduce a new form to meet the reporting obligations for foreign financial assets under Code § 6038D. In the case of an individual with only foreign bank and financial accounts, both an FBAR filing and a filing under new Code § 6038D will be required (subject to the different thresholds), with the same information contained on both forms. A single form should be used to satisfy both filing obligations. Individuals should be given the option of filing the FBAR with their income tax return in satisfaction of their Code § 6038D reporting obligation.
 - (ii) A U.S. person who is treated as the owner of a foreign trust under the grantor trust rules for income tax purposes must file a report on Form 3520, which will contain the same information as the Code § 6038D filing. The Form 3520 filing (including the attached Form 3520-A signed by the foreign trustee) should be sufficient for Code § 6038D purposes.
 - (iii) Whether or not a trust is a grantor trust, if a U.S. individual receives a distribution, he or she must report the distribution on Form 3520. In order to avoid duplicative filing, the Code § 6038D reporting obligation for trust beneficiaries should be included as a new Part to Form 3520, and there should be no requirement of a separate filing on a different form.
 - (iv) We recommend that Form 3520 be amended to allow it to be used to satisfy the expanded filing obligations imposed by Code § 6038D so that all trust filing obligations can be consolidated. A U.S. individual may have a reporting obligation under Code § 6038D even if she does not have

an obligation under Code § 6048 to file Form 3520 (for example because she did not receive a distribution).

- (v) We suggest that a foreign trustee (although not obligated to file under Code § 6038D) be able to satisfy the Code § 6038D reporting requirement for all U.S. trust beneficiaries on Form 3520-A. We suggest that Form 3520-A be amended to permit such a report, in order to consolidate all foreign trust filing in one place.

- 9. Section 534 of the HIRE Act added language to Code § 6048 specifically imposing an obligation upon a U.S. person treated as the owner of a foreign trust under Subpart E of Subchapter J of the Code to "submit such information as the Secretary may prescribe with respect to such trust for such year..." This is in addition to the pre-HIRE § 6048 requirement that such a person "ensure" that the trust files Form 3520-A. Form 3520-A is signed by the trustee; however, a foreign trustee has no U.S. filing obligations. The new language provides an affirmative filing duty upon a U.S. owner of a foreign trust, presumably to encompass foreign trusts that are not filing Form 3520-A because the foreign trustee has no U.S. filing obligation and the U.S. owner has no control over the trustee to "ensure" filing. We recommend that the new language be interpreted to mean that the information required by the Secretary is the information required on Form 3520-A, and that all Code § 6048 filing obligations are satisfied if either the U.S. grantor or the foreign trustee files the form.
- 10. Finally, we suggest that Forms 3520 and 3520-A clarify that the filing deadlines prescribed on such Forms override the language in Code § 6048 requiring filing on or before the 90th day after any reportable event. Code § 6048 specifically gives the Secretary discretion to prescribe a different filing date. We also suggest that the due date for Form 3520-A be the same as the filing date for Form 3520 and that extensions of time to file Form 1040 also extend the time for filing Form 3520-A.

Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

Id. § 501, at 97.

H.R. 3933, 111th Cong. (2009).

S. 1934, 111th Cong. (2009).

Cong. Rec. S10785 (daily ed. Oct. 27, 2009) (statement of Sen. Max Baucus, Chair, S. Comm. on Finance).

Staff of the S. Perm. Subcomm. on Investigations, 109th Cong., Tax Haven Abuses: The Enablers, the

Tools and Secrecy (Aug. 1, 2006).

⁷ Withholding agent is defined broadly to include "all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment." See Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 106 (2010).

⁸ *Id.* § 501, at 97.

Id. § 501, at 102.

¹⁰ We do not think that trusts should be classified as FTIs. However, if Treasury does decide to treat trusts as FTIs, clarification of what constitutes a "small family trust" is needed.

¹¹ Treas. Reg. § 301.7701-4.

¹² *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

¹³ Instructions to IRS Form 8621 state that reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e).

¹⁴ Code § 1291.

¹⁵ Code §§ 1293-1295.

¹⁶ Code § 1296.

¹⁷ Code § 1291(e) by reference to § 1246(f).

¹⁸ Prop. Treas. Reg. § 1.1291-1(i).

¹⁹ A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income. Code § 1297.

²⁰ Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 66.

²¹ 2010-17 I.R.B. 612, 4/6/2010.

²² Compare for example Code § 1246(f) prior to its repeal by the American Jobs Creation Act of 2004 (P.L. 108-357) which waived filing of information returns for shareholders of foreign investment companies if the shareholder did not own as much as 5 percent of the stock of the company. While the HIRE Act repeals the vestiges of § 1246(f) by amending Code § 1291(e) to delete references to subsection (f) of § 1246, some *de minimis* rule for filing information returns is appropriate.

²³ Proposed Treasury Regulation § 1.1291-1(b)(8).

²⁴ Clarification is needed as to how beneficiaries are appropriately taxed when a trust owns PFIC shares. There is an overlap and lack of coordination between the trust and PFIC rules.

²⁵ Cf., Treasury Regulation § 1.958-1(b).

²⁶ Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 60.

²⁷ 31 U.S.C. 5311 et seq.

²⁸ The Technical Explanation specifically provides "Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision." Ibid.

²⁹ Technical Explanation at 66.

³⁰ In his comments to Congress, Senator Levin expressed that the purpose of Sections 531 through 535 of the HIRE Act is to "tighten U.S. tax rules for foreign trusts and address a variety of abuses...exposing how U.S. taxpayers use foreign trusts to evade their U.S. tax obligations." Until a trust beneficiary receives a distribution from a foreign nongrantor trust, he has no U.S. tax obligation. And if the foreign trust is a grantor trust with a U.S. grantor, it is already subject to U.S. reporting and income tax. Providing a clear formula for the computation of a beneficiary's interest in a wholly discretionary foreign trust, premised on the receipt of actual trust distributions, promotes the purpose of assuring that U.S. tax obligations are reported.

³¹ The Technical Explanation states that "[section 6028D] permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly."



THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL

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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

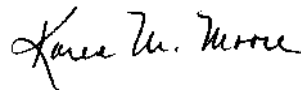
The Honorable Michael F. Mundaca
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June 23, 2010

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.

* 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.

¹ Excellent background for the issues addressed in this memorandum is found in four articles prepared by Fellows of ACTEC, copies of which are being sent under separate cover: “Respect for ‘Form’ as ‘Substance’ in US Taxation of International Trusts”, by Donald D. Kozusko and Stephen K. Vetter, published in the Vanderbilt Journal of Transactional Law, Volume 32(675), 1999, in particular, Section III beginning on page 693; a paper entitled “Thinking Outside the Box: US Federal Income Issues for Trusts and Estates that Own Shares in Foreign Corporations”, prepared and presented by M. Read Moore at the Second Annual International Estate Planning Institute held in New York, New York, on March 16, 2006; a paper entitled “PFICs and CFCs: Recent Developments”, prepared and presented by Donald Kozusko at the Fourth Annual International Estate Planning Institute held in New York, New York, on May 27-28, 2008; and “Indirect Ownership of CFC and PFIC Shares by US Beneficiaries of Foreign Trusts,” by M. Read Moore, published in the Journal of Taxation, Volume 108, No. 2, February 2008.

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.³ 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.⁴ 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.⁵ 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.⁶ If a foreign nongrantor trust invests through or in a foreign holding

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 intent⁸ 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.

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.¹⁰ 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.

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.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.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.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.¹⁷ 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

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, then 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

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.¹⁹

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.²⁰

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.²¹

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.²²

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. The

¹⁹ See Report of the Senate Finance Committee on H.R. 3838, the Tax Reform Act of 1986, Report 99-313, May 29, 1986, at 393 (“Reasons for Change”).

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.²³ 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.²⁴

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.²⁵

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.²⁶ 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.²⁷ 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.²⁸ 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.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:

(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] –

(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

(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

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.³⁰ 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,³¹ 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:

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

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.³⁵ 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.³⁶ 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.

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.³⁷

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.