ACTEC
THE AMERICAN COLLEGE OF
TRUST AND ESTATE COUNSEL

McPherson Building
901 15th Street, NW, Suite 525
Washington, DC 20005
(202) 684-8460 • Fax (202) 684-8459
actec.org

Please Address Reply to:

Executive Director
DEBORAH O. McKINNON

July 8, 2024
Submitted Electronically at www.regulations.gov (IRS and REG-124850-08)

CC: PA: 01: PR (REG-124850-08)
Room 5203, Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC. 20044

RE: COMMENTS OF THE AMERICAN COLLEGE OF TRUST AND ESTATE COUNSEL ("ACTEC")
ON PROPOSED REGULATIONS REGARDING TRANSACTIONS WITH FOREIGN TRUSTS AND INFORMATION REPORTING ON TRANSACTIONS WITH FOREIGN TRUSTS AND LARGE FOREIGN GIFTS

Treasury Notice 89 Fed. Reg. 39440 (5/8/24) requested comments on proposed regulations (the "Proposed Regulations") that would provide guidance regarding information reporting of transactions with foreign trusts and receipt of large foreign gifts and regarding loans from, and uses of property of, foreign trusts. The Proposed Regulations also contain proposed amendments to the regulations relating to foreign trusts having one or more United States beneficiaries. The Proposed Regulations affect United States persons who engage in transactions with, or are treated as the owners of, foreign trusts, and United States persons who receive large gifts or bequests from foreign persons. ACTEC commends Treasury and the IRS (collectively "Treasury") for their careful efforts in drafting the Proposed Regulations, and we appreciate the opportunity to comment on the Proposed Regulations.

ACTEC is a nonprofit association of lawyers and law professors. Its more than 2,400 members are called "Fellows" and practice throughout the United States, Canada, and other foreign countries, with extensive experience in the preparation of wills and trusts, estate planning, and administration of trusts and estates of decedents, minors, and incompetents. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar association activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of transfer tax and charitable planning. These comments were prepared by members of ACTEC's International Estate Planning Committee in conjunction with members of ACTEC's Washington Affairs Committee. ACTEC offers technical comments about the law and its effective administration but does not take positions on matters of policy or political objectives.

ACTEC's comments regarding the Proposed Regulations are set forth in the attached memorandum. If you or your staff would like to discuss the contents of this memorandum with the ACTEC Fellows who created it, please contact Michelle B. Graham (858-450-1307, michelle.graham@withersworldwide.com), Chair of ACTEC's International Estate Planning Committee, Kevin Matz (212-745-9576, kevin.matz@afslaw.com), Vice Chair of ACTEC's Washington Affairs Committee, William I. Sanderson, Chair of ACTEC's Washington Affairs Committee (202-875-1743, wsanderson@mcguirewoods.com), or Deborah McKinnon, ACTEC Executive Director (202-684-8460, domckinnon@actec.org).

Also attached is ACTEC's request to testify with a supporting outline.

Respectfully submitted,

Susan D. Snyder, President of ACTEC
ACTEC President 2024–2025

Comments of the American College of Trust and Estate Counsel ("ACTEC")

Treasury Notice 89 Fed. Reg. 39440 (5/8/24) requested comments on proposed regulations (the "Proposed Regulations") that would provide guidance regarding information reporting of transactions with foreign trusts and receipt of large foreign gifts and regarding loans from, and uses of property of, foreign trusts. The Proposed Regulations also contain proposed amendments to the regulations relating to foreign trusts having one or more United States beneficiaries. The Proposed Regulations affect United States persons who engage in transactions with, or are treated as the owners of, foreign trusts, and United States persons who receive large gifts or bequests from foreign persons. ACTEC commends Treasury and the IRS (collectively "Treasury") for their careful efforts in drafting the Proposed Regulations, and we appreciate the opportunity to comment on the Proposed Regulations.

EXECUTIVE SUMMARY OF ACTEC'S RECOMMENDATIONS

ACTEC's comments address the following aspects of the Proposed Regulations and are briefly summarized below:

1. **Prop. Reg. § 1.643(i)-2**. Section 643(i)[1] treats a loan from a foreign trust to a U.S. grantor or beneficiary of the trust or to a person related to a U.S. grantor or beneficiary as a distribution to the U.S. grantor or beneficiary, except as provided in regulations. To the extent that the required distribution treatment results in the attribution of a portion of the lending trust's current and previously accumulated income to a borrower, the application of section 643(i) to a borrower who has issued an enforceable note with arm's length terms, the principal amount of which is equal to the amount of the loan, risks violating the Due Process Clause.

   Perhaps anticipating the possibility of a Due Process challenge, Congress granted Treasury the authority to create exceptions to the application of section 643(i) and stated its expectation that Treasury use this authority to create an exception for arm's length loans reasonably expected to be repaid. Treasury exercises this authority in Prop. Reg. § 1.643(i)-2(a) by providing that a loan of cash will not be treated as a section 643(i) distribution if the loan is in exchange for a qualified obligation. Prop. Reg. §1.643(i)-2(b) describes a set of stringent requirements for an obligation to be treated as a qualified obligation, including a requirement that the loan have a term that does not exceed five years.

   ACTEC suggests that the definition of qualified obligation be liberalized in order to achieve consistency with Congressional intent and in order to provide the exceptions to section 643(i)'s application that may be necessary for the provision to survive a Due Process challenge.

2. **Foreign Retirement Trusts**. The proposed expansion of the exception for tax-favored foreign retirement trusts that cover multiple participants is welcome, with the addition of inflation adjustments, and perhaps more importantly the value threshold, which allows tax-

1 Unless otherwise stated, references in these Comments to “section(s)” or to “Code” are to the Internal Revenue Code of 1986, as amended. References in these Comments to “§” are to relevant sections of the Treasury regulations promulgated under the Code.

favored foreign retirement trusts to qualify for the exception if they do not exceed the $600,000 threshold. However, as laid out below, much more can be done by the IRS to better educate Americans working abroad and their U.S. return preparers concerning all of the various U.S. tax filing obligations with respect to their foreign retirement accounts.

3. **Penalties for failure to report foreign large gifts under Prop. Reg. § 1.6039F-1(e**). Prop. Reg. § 1.6039F-1(a) imposes upon taxpayers a general obligation to report in Form 3520 foreign gifts received that exceed an aggregate amount of $ 100,000 in a taxable year. Failure to report would subject that taxpayer to a penalty of 5% of the amount of the foreign gift for each month for which the failure to report persists, without exceeding 25% percent of the aggregate amount of the foreign gift ("Gift Penalty"). In addition to the Gift Penalty, the IRS can also assess the tax consequences of the receipt of foreign gifts based on all facts and circumstances.

The Gift Penalty is problematic due to its high effective penalty amount and particularly as a result of the manner in which it would be applied by IRS according to the Penalty Handbook of its Internal Revenue Manuals ("IRM"). We recommend that Treasury be more lenient when considering penalty abatements under a reasonable cause argument. ACTEC suggests that Treasury consider the following:

(a) Include in the Proposed Regulations a provision or, if not, instruct examiners to implement a policy that grants an automatic one-time Gift Penalty abatement to taxpayers who fail to report a foreign gift on Form 3520 for the first time. We also suggest abatement where there is no evidence of a tax avoidance purpose, in cases where the taxpayer has a history of tax compliance, there is no unreported income, when the taxpayer received erroneous advice from a tax professional and/or when the taxpayer did not know or have reason to know that the source of the property was a foreign person or foreign trust.

(b) Instruct examiners to allow taxpayers an opportunity to appeal the reasonable cause abatement before the penalty is assessed and postpone commencement of the accrual of continuing penalties until the appeal of the abatement decision is rejected.

(c) Add a new question to Form 1040, schedule B, which asks whether the taxpayer has received any foreign gifts, and if the answer is "yes," reminds the taxpayer that Form 3520 may need to be filed.

4. **Penalties for failure to report the creation of, transfers of property to, and distributions of property from a foreign trust under Prop. Reg. § 1.6677-1.** Prop. Reg. § 1.6677-1 elaborates on the penalties for failure to report in Forms 3520 and/or 3520-A certain information with respect to foreign trusts pursuant to section 6048 and its respective Proposed Regulations. Prop. Regs. §§ 1.6048-2 through 1.6048-4 provide the following three main reporting obligations:

(a) Under Prop. Reg. § 1.6048-2 the grantor of a foreign trust, the transferor of property to a foreign trust, or the executor of the decedent's estate are obligated to report in Part I of Form 3520 certain reportable events. These reportable events consist of (1) the creation of a foreign trust by a US person, (2) the direct, indirect, or constructive transfer of any money or property to a foreign trust by a US person, including a transfer by reason of death, and (3) the death of a citizen or resident of the US who was treated

as the grantor of the foreign trust and any portion of such foreign trust was included in the decedent's gross estate ("Reportable Event").

(b) Under Prop. Reg. § 1.6048-4 any person who receives directly, indirectly, or constructively any distribution from a foreign trust is obligated to report such distribution in Part III of Form 3520.

(c) Under Prop. Reg. §1.6048-3 any US person who is wholly or partly treated as owner of a foreign trust is responsible for ensuring that a Form 3520-A along with its respective owner and beneficiary statements are duly furnished and filed by the end of the tax year.

Failure to comply with the reporting obligations contained in Prop. Regs. §§ 1.6048-2 and 1.6048-4 on Form 3520 would subject the taxpayer to a penalty equal to the greater of $10,000 or 35% of the gross reportable amount ("Transaction Penalty"). Additionally, failure to comply with the reporting obligation contained in Prop. Reg. §1.6048-3 in Form 3520-A would subject the taxpayer to a penalty equal to the greater of $10,000 or 5% of the gross reportable amount ("Owner Penalty"). Taxpayers subject to these penalties would be penalized by an additional $10,000 for every 30-day period the failure to report continues after the first 90 days following payment notice from the IRS ("Continuing Penalty" and jointly with the Transaction Penalty and the Owner Penalty the "6677 Penalties"). In any case, the aggregate amount of the initial 6677 Penalties cannot exceed the gross reportable amount with respect to the particular reporting failure.

We recommend that the Continuing Penalty commence to run only after the IRS has considered and rejected the reasonable cause waiver arguments timely submitted by a taxpayer.

5. **Lawyer's obligation to report the creation of trusts on Form 3520 under Prop. Regs. §§ 1.6048-2(b) and 1.6048-2(c). A lawyer who "creates" a foreign trust has a reporting requirement.** Prop. Regs. §§ 1.6048-2(b) and 1.6048-2(c) are to be read in conjunction with Treas. Reg. § 1.671-2(e). The Proposed Regulations should define what it means to "create" a trust. We recommend that a lawyer who participates in the design and drafting of a trust, but who is not named as the trustor or settlor and who does not make a gratuitous contribution to the trust, is not the "creator" and has no reporting obligation.

6. **Prop. Reg. § 1.6048-4(b)(4).** Treasury should clarify that Prop. Reg. § 1.6048-4(b)(4) imposes a disclosure obligation that is intended to capture information on certain events even though such event may not constitute a taxable event in its own right. For example, a domestication of a foreign trust is not a taxable event. Form 3520 should be revised to include a new question that asks whether the taxpayer is reporting a domestication of a foreign trust. Once the box is checked, then the income and corpus would be reported solely for information purposes.

7. **Prop. Reg. § 1.6039F-1(f)(1).** The Proposed Regulations amend the definition of a U.S. person. For purposes of sections 6039F and 6048, a dual resident who claims benefits under an income tax treaty will no longer be classified as a U.S. person. This is helpful in a number of regards but creates confusion for a U.S. person receiving a gift from such

person, specifically with respect to the Form 3520 reporting obligation. Example 3 of Prop. Reg. § 1.6039F-1 demonstrates the manner in which this is applied. It provides as follows: X is a lawful permanent resident of the U.S. within the meaning of § 301.7701(b)-1(b) of this chapter and is a resident of Country F under the domestic law of Country F. X is a resident of Country F under the residence article of the U.S.-Country F income tax treaty and notifies the U.S. by taking such a position on Form 1040NR and Form 8833 for Year 1. Pursuant to § 301.7701(b)-7 of this chapter, X is treated as a nonresident alien for purposes of computing X's U.S. income tax liability for Year 1. During Year 1, X makes a gift of $150,000 to Y, a U.S. citizen. Under paragraph (f)(1) of this section, X is not treated as a U.S. person for purposes of this section. Because X is not treated as a U.S. person for Year 1, the gift is a foreign gift within the meaning of paragraph (b) of this section. Y must report the foreign gift on Part IV of Form 3520 under paragraph (a) of this section. The problem with this approach is that Y may not have knowledge as to the X's treaty claim, which causes X to be foreign. As far as Y is concerned, Y received a gift from a US person. Y should not be in a position to be penalized based upon a decision X made in regard to X's tax filing. The issue also arises in regard to section 6048. If X creates a domestic trust while a U.S. taxpayer, and then elects to make a treaty election, the domestic trust becomes a foreign trust. Y receives a distribution from a domestic trust and has no reporting obligation. However, X's decision causes the trust to become foreign, and now Y must file a Form 3520. ACTEC believes while well intentioned to minimize the filing obligations by those persons who have dual status, the consequence is complexity and confusion for taxpayers who receive gifts from persons they otherwise thought were U.S. taxpayers or from trusts they thought were domestic. ACTEC recommends that Treasury provide an exception from Form 3520 reporting by U.S. persons whose obligation to file is premised upon a treaty election made by another party. This can be combined with a question on Form 8833 that requires gifts made by the individual and/or trusts that have been funded by the individual to be disclosed.

8. **Prop. Reg. § 1.643(i)-1(b)(3)** provides that if a nonresident alien individual who is a grantor or beneficiary of a foreign trust receives a loan from the trust, and, while the loan is outstanding, subsequently becomes a U.S. person within two years of the loan origination date, the individual will be deemed to have received a distribution from the foreign trust with respect to the outstanding amount of the loan as of the first day the individual is considered a U.S. person. ACTEC recognizes this Proposed Regulation is an anti-abuse provision, to perhaps tax a distribution to a nonresident alien beneficiary who is "planning" to become a U.S. resident or become naturalized. However, this Proposed Regulation is an overreach, is unjustified, and should be eliminated. There is no basis under the applicable statute or any authority that would justify any lookback period.

9. **Prop. Reg. § 1.643(i)-1(b) and (c)** does not address whether a deemed taxable distribution to a beneficiary due to a loan (or through the use of trust property) gives the beneficiary a corresponding tax credit for the taxes paid on the deemed taxable distribution that can be used against taxes that would otherwise be due as a result of a future actual distribution. For example, if a US beneficiary is treated as having received a $1,000,000 distribution from a foreign trust and pays a federal income tax of $400,000 on the deemed distribution, the amount of the tax paid should be allowed as a credit against the tax that would be imposed as a result of a future actual distribution of $1,000,000 to the beneficiary.

10. **Prop. Reg. § 1.643(i)-3(b)** provides that if a person who is not a U.S. grantor or beneficiary of a foreign trust, but who is related to more than one U.S. grantor or beneficiary of the trust, receives a loan of cash or marketable securities, or uses trust property, that is treated as a taxable distribution under section 643(i), then each U.S. grantor and beneficiary of the foreign trust who is related to such related person is treated as receiving an equal share of the taxable distribution. There is no basis under the applicable statute or any authority that would justify apportioning tax to persons who are not involved in or in some manner benefitting from the loan to a related person and who may have no knowledge of such loan. This Proposed Regulation is unjustified, and should be eliminated.

11. **Election for Entities Comparable to a U.S. Trust to be Classified as Trusts.**

The Proposed Regulations address in part transactions with foreign trusts, yet there remains significant uncertainty whether certain foreign structures, such as usufructs, fideicomisos, stiftungs and foundations, are trusts for U.S. tax purposes. We recommend that Treas. Reg. § 301.7701-4 be amended to add a new provision that provides that an entity or arrangement (hereinafter referred to as a "structure") that functions similar to a U.S. ordinary trust as described in Treas. Reg. § 301.7701-4(a) can elect to be classified as a trust for federal income tax purposes, similar to how an eligible business entity may elect tax classification under Treas. Reg. § 301.7701-3(a).

DISCUSSION

1. **The proposed definition of "Qualified Obligation" should be liberalized.**

Section 643(i) treats a loan from a foreign trust, directly or indirectly, to a U.S. grantor or beneficiary of the trust or to a person related to a U.S. grantor or beneficiary as a distribution to the U.S. grantor or beneficiary, except as provided in regulations.

The treatment of a loan by a foreign trust as a distribution, if the trust is a nongrantor trust, may cause serious negative tax consequences for the beneficiary. Section 662 requires a beneficiary of a trust to include in his, her, or their gross income the amount of any distributions from the trust to the extent the distribution, when added to all other distributions from the trust that year, does not exceed the trust's distributable net income ("DNI") for the year. An appropriate adjustment is made to the amount of the inclusion if distributions exceed the trust's DNI. If the amount of the distribution to a beneficiary exceeds the trust's DNI or the beneficiary's share of the DNI, and if the trust has income accumulated in prior years, (undistributed net income or "UNI"), section 667 may require the beneficiary to include in gross income a portion of the trust's UNI and to pay, under section 668, an interest charge on the income tax resulting from the inclusion.

To the extent that the lending trust is a grantor trust, and a U.S. person is the grantor, Prop. Reg. § 1.679-2(a)(5)(v) provides that section 643(i) does not apply, presumably because section 643 applies only to nongrantor trusts. It is not clear why this statement in the Proposed Regulations is limited to grantor trusts with U.S. grantors. Grantor trusts with foreign grantors are similarly not subject to section 643. However, reporting instead might be required as a gift from a foreign person – the foreign grantor-owner. The reporting obligations of recipients of gifts indirectly made by the foreign grantor-owner of a foreign grantor trust should be addressed.

Section 643(i)'s treatment of a loan as a distribution, in effect, results in the attribution of trust income to a grantor or beneficiary. When that attribution occurs as a result of a bona fide loan made in exchange for the borrower's enforceable obligation to repay, that attribution could be characterized as arbitrary. The U.S. Supreme Court in its recent decision in *Moore v. United States*[2] acknowledged (and observed that the Government in its oral argument had agreed) that the Due Process Clause imposes limits on the Government's power to attribute the income of one person to another person.

If a foreign nongrantor trust makes a loan that is treated as a distribution to a U.S. grantor, the trust may become a grantor trust under section 679, because it will then be deemed to have a U.S. beneficiary. As a result, the grantor will be treated as owning the entire trust for income tax purposes under 679(a) and under section 679(b) will be required to include in gross income all of the undistributed net income of the trust as well as its income for the current year. If the trust has other grantors and all of them are U.S. persons, the loan will cause each of them to become the owner of the portion of the trust attributable to his, her, or their transfers to the trust with similar inclusion requirements for the trust's accumulated and current income.

If the trust has other grantors and they are foreign, a portion of the trust will continue to be a nongrantor trust. To the extent the loan is allocated to the nongrantor portion of the foreign trust, the income tax treatment of the loan is unclear. Sections 662 and 667, by their terms, do not apply to trust distributions to persons who are not beneficiaries. Prop. Reg. § 1.663(i)-3(c)(1), which requires that any U.S. person who has received a distribution from a foreign trust determine the tax consequences of the distribution under either the actual calculation method or the default calculation method, referring to Prop. Reg. § 1.6048-4(d)(3), seems to assume that a grantor who has received a distribution from a foreign trust will be treated for reporting and determining income tax liability as if the grantor were a beneficiary.

Section 643(i) was enacted in 1996 as part of the Small Business Job Protection Act of 1996 (the "1996 Act"). The Conference Report that accompanied the 1996 Act stated that "[i]t is expected that Treasury regulations will provide an exception from this treatment for loans with arm's-length terms. In applying this exception, it is further expected that consideration be given to whether there is a reasonable expectation that a loan will be repaid."[3]

In Notice 97-34[4] the Service announced that it would issue regulations providing that a loan described in section 643(i) would not be treated as a distribution if the loan was made in consideration for a qualified obligation. The notice defined a qualified obligation as one that is (i) in writing, (ii) has a term of five years or less, (iii) is denominated in U.S. dollars, and (iv) has a yield to maturity of not less than 100% or more than 130% of the applicable federal rate, provided that (v) the U.S. person extends the period of assessment of any income tax attributable to the loan for three years after the loan's maturity date, and (vi) the U.S. person reports the status of the loan on Form 3520 for each year that the loan is outstanding.

Prop. Reg. § 1.643(i)-2(iii) is the promised regulation. It adds the following two requirements: (1) the obligation must be issued at par and provide for stated interest at a fixed or qualified floating rate within the meaning of Treas. Reg § 1.1275-5(b) and (2) all stated interest must be qualified stated interest within the meaning of Treas. Reg. § 1.1273-1(c). Treas. Reg. § 1.1273-1(c) defines qualified stated interest as

---

[2] 602 U.S. ___ (2024).

[3] H.R, Conf. Rep. No 737, 104th Cong. 2d Sess. At 334 (1996).

[4] 1997-1 C.B. 422.

interest that is unconditionally payable at least annually. It further provides that interest is unconditionally payable only (1) if reasonable remedies exist to compel timely payment or the debt instrument otherwise provides terms that make the likelihood of late payment beyond a reasonable grace period or nonpayment a remote contingency, (2) if the lending transaction reflects arm's length dealing, and (3) if the lender intends to enforce the remedies in the event of late or nonpayment.

Prop. Reg. § 1.643(i)-2(iii) neither fulfills Congress's expectation that the regulations provide an exception for loans with arm's length terms that are reasonably expected to be repaid nor prevents section 643(i) from being applied in a manner that arbitrarily attributes trust income to one or more of its beneficiaries.

Arm's length loans are regularly negotiated between unrelated persons with terms very different from those required for qualified obligations. The mortgage loans banks make available to customers purchasing homes, for example, are often 30-year loans. Loans made by foreign persons are typically denominated in currencies other than U.S. dollars. The interest rates charged on arm's length loans are frequently higher than 130% of the applicable federal rate. The applicable federal rate for 5-year loans, for example, is currently 4.56%; 130% of that is 5.9% while the interest rate charged by the major banks on loans to their best customers is now in the vicinity of 8.5%.

In *Hoeper v. Tax Commissioner of Wisconsin*[5] the U.S. Supreme Court established the principle that measuring the tax on one person's income by reference to the income of another violates Due Process. Taxing a trust beneficiary on trust income that was not actually distributed to such person because of a loan made by the trust in exchange for an arm's length enforceable obligation to repay seems to be proscribed by this principle.

The requirements in the Proposed Regulations that the beneficiary report the loan on Form 3520 and extend the period of time for assessment of any income tax attributable to the loan for three years after the loan's maturity date are understandably necessary to ensure the Service's ability to effectively enforce section 643(i). They are, however, impossible conditions for a beneficiary to meet when the beneficiary has no knowledge that the foreign trust has made a loan to a related person.

Recommendation

ACTEC understands that the goal of section 643(i) is to prevent the tax-free enjoyment by U.S. persons of foreign trust income that was accumulated free of U.S. income tax and agrees with that goal. It believes, however, that that goal should instead be pursued in a manner that is both consistent with the section's legislative history and does not risk violating the Due Process Clause.

To that end, ACTEC suggests the following changes to the definition of qualified obligation:

(a) Replacement of the 5-year maximum duration with a 30-year maximum duration.

(b) Elimination of the requirement that the loan be denominated in U.S. dollars.

(c) Elimination of the requirement that the interest rate on the loan be no more than 130% of the applicable federal rate.

---

[5] 284 U.S. 206 (1931).

(d) Addition of the following requirement, modeled after the current requirement as to qualified interest, with respect to principal payments:

(i) Principal payments must be unconditionally payable on the dates stated in the debt instrument.

(ii) Principal is unconditionally payable only if reasonable legal remedies exist to compel timely payment or the debt instrument otherwise provides terms and conditions that make the likelihood of late payment (other than a late payment that occurs within a reasonable grace period) or nonpayment a remote contingency. For purposes of the preceding sentence, remedies or other terms and conditions are not taken into account if the lending transaction does not reflect arm's length dealing and the holder does not intend to enforce the remedies or other terms and conditions.

(e) In the case of loans to persons related to U.S. beneficiaries, elimination of the requirement that the U.S. beneficiary either report the loans on Form 3520 or extend the period of assessment of any income tax attributable to the loan for three years after the loan's maturity date for beneficiaries until they have actual knowledge that the loans have been made.

The foregoing suggested changes seem consistent with what Congress intended when it enacted section 643(i) and should not compromise the Service's ability to effectively enforce the section. If, notwithstanding the requirement that both interest and principal must be unconditionally payable, a beneficiary fails to make the required payments, Prop. Reg. § 1.643(i)-2(b)(6) will operate to treat failure as a section 643(i) deemed distribution of the unpaid amounts, including accrued and unpaid interest.

2. **Better Guidance on Foreign Pension Plans**

Americans working abroad require access to pensions and retirement plans where they live and work. Often, such individuals have no other option for retirement savings other than participating in a foreign employer-sponsored retirement plan. Many of these Americans living abroad do not plan to return to the U.S. to live during retirement, which makes restrictions upon U.S.-based retirement investment products a major detriment for such individuals.

Although savings for retirement is critical for these Americans, the U.S. tax rules and reporting obligations in connection with foreign employer-sponsored retirement plans and individual pension arrangements present a major obstacle for Americans working abroad seeking to secure a financially-sound retirement. These Americans need to comply with the local tax systems where they reside as well as the U.S. tax system. In general, these two systems are incompatible, frustrating Americans living abroad who must comply with the onerous U.S. tax rules that govern the reporting of their foreign retirement plan accounts.

It is quite common that Americans working abroad, and their U.S. tax return preparers, are subject to complex annual reporting obligations that only a competent well-informed U.S. return preparer can satisfy. Most lay persons are not qualified to comply with the various and obscure U.S. international tax filing obligations applicable to Americans working abroad who participate in foreign retirement plans. Moreover, even U.S. tax practitioners are not necessarily in agreement over what U.S. tax returns must be filed on behalf of their American clients working abroad.

The absence of guidance from the IRS was highlighted by the GAO in "Workplace Retirement Accounts: Better Guidance and Information Could Help Plan Participants at Home and Abroad Manage Their Retirement Savings" published in January 2018. The GAO Report starts by underscoring the size of the problem: there are nearly 9 million U.S. citizens living abroad, many of whom have interests in local retirement plans. The GAO Report prominently notes that these foreign retirement plans are not ordinarily considered "tax-qualified" retirement plans under the Internal Revenue Code. Depending on several factors, including the characteristics of the plan, local law, and the provisions of the applicable bilateral tax treaty, U.S. individuals who participate in foreign retirement plans might be taxed currently by the U.S. on (1) contributions to the plan, by themselves or by their employers; (2) the undistributed annual earnings on the accrued vested benefits (AVBs) in the plan; and (3) distributions from the plans that they have not actually received, such as many plan-to-plan "rollovers."

The GAO Report identified numerous problems facing Americans working abroad. IRS guidance is insufficient and unclear concerning foreign workplace retirement plans. A major issue addressed by the GAO Report, but unknown to many U.S. individuals living abroad and their tax practitioners, is that changing jobs and transferring (*i.e.,* rolling over) savings from one foreign workplace retirement plan to another likely triggers immediate U.S. taxation. GAO Report at p. 46.

The GAO Report also indicates that some practitioners advise their American clients working abroad to report all of their foreign workplace retirement accounts as passive foreign investment companies (PFICs) on Forms 8621 *(Return by a U.S. Shareholder of a Passive Foreign Investment Company).*

These issues were also highlighted in the National Taxpayer Advocate's 2024 Report to Congress. In Most Serious Problem # 9: Compliance Challenges for Taxpayers Abroad, the Taxpayer Advocate wrote that "Treasury should issue guidance covering the pension plans non-resident citizens may participate in in their country of residence and provide straight forward instructions for the tax reporting rules that apply."

Practitioners were initially optimistic when the IRS issued Rev. Proc. 2020-17, which offers beneficial treatment, on a retrospective and prospective basis, to certain U.S. individuals with interests in "applicable tax-favored foreign trusts." Spirits were raised by the tax community as they realized that when the IRS uses the term "foreign trust" in the context of Rev. Proc. 2020-17, it is referring to something much broader, including foreign trusts, plans, funds, accounts and other arrangements, which provide pension, retirement, medical, disability, or educational benefits. Taxpayers and their professional advisors generally are pleased by the elimination of the duty to file Forms 3520 *(Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts)* and Form 3520-A (*Annual Information Return of Foreign Trusts with a U.S. Owner)* in the future, as well as the opportunity to seek abatements or refunds of prior penalties. Now that practitioners have had time to analyze Rev. Proc. 2020-17 within a broader framework, its limitations have become clearer.

The background to Rev. Proc. 2020-17, section 1 indicates that its primary purpose is to create an exemption from certain information-reporting requirements, but not income reporting and tax payment requirements, for some U.S. individuals with respect to their ownership of, and transactions with, certain types of foreign trusts. Rev. Proc. 2020-17 was prospective, in that it relieves certain U.S. individuals from filing Forms 3520 and Forms 3520-A in the future. The Rev. Proc. 2020-17 was also retrospective, in that it contained a process for individuals sanctioned by the IRS in the past to seek abatement or refund of penalties. Pursuant to the authority granted the IRS under section 6048(d)(4), the IRS is empowered to suspend or modify the information-reporting duties, if the IRS unilaterally determines that it "has no significant tax interest" in obtaining the relevant information.

The proposed 6048 regulations are a very modest expansion upon Rev. Proc. 2020-17, and far more overall guidance in the foreign retirement plan area should be provided to unwary and uninformed Americans working abroad. In Rev. Proc. 2020-17, the reporting exemption only applies if the plan meets numerous criteria, including contributions based on a percentage of the participant's earned income, subject to an annual limit.

The Proposed Regulation expands upon the initial relief provided in 2020 and would allow limited contributions by unemployed individuals and requires that the foreign trust must satisfy either a new value threshold or a contribution limit. For the value threshold, the aggregate value of the trust is limited to no more than $600,000 during the taxable year, adjusted for inflation. For the contribution limit, contributions to the trust must either be limited by a percentage of earned income, an annual limit of $75,000 or a lifetime limit of $1M, as adjusted for inflation.

ACTEC further notes that the latest provisions concerning foreign pension plans in the 2016 U.S. Model Income Tax Convention provides that the U.S. may not tax an American citizen resident in the treaty country on income earned inside a pension fund in the treaty country unless it is paid out to the individual taxpayer.

ACTEC also notes that, under Rev. Proc. 2020-17, section 5.03, a "tax favored foreign retirement trust" must satisfy all of the requirements laid out in that section of the Rev. Proc. Section 5.03(6) of Rev. Proc. 2020-17 stipulates that in the case of an employer-maintained trust, the trust must be non-discriminatory in that a wide range of employees at different levels must be eligible to participate, and the trust must provide significant benefits for a substantial majority of employees.

Recommendation

ACTEC welcomes the proposed expansion of the exception for tax-favored foreign retirement trusts that cover multiple participants, with the addition of inflation adjustments, and perhaps more importantly the value threshold, which allows tax-favored foreign retirement trusts to qualify for the exception if they do not exceed the $600,000 threshold. ACTEC suggests that much more can be done by the IRS to better educate Americans working abroad and their U.S. return preparers concerning all of the various U.S. tax filing obligations in respect to their foreign retirement accounts. Set forth below are some recommendations to accomplish this.

(a) To ensure equitable treatment among overseas American citizens in various treaty countries, ACTEC recommends that the IRS regulations applicable to foreign pensions be aligned with Treasury's latest position in the model treaty.

(b) For clarity, ACTEC recommends that the IRS regulations applicable to foreign pensions affirmatively state that the reporting requirements under section 6048 apply to all foreign individual retirement arrangements which are comparable to U.S. individual retirement accounts.

(c) Taxpayers and their advisors may be unaware that in order to be an "eligible individual" under Rev. Proc. 2020-17, a taxpayer must have filed all his annual Forms 1040 and reported all worldwide income, which ordinarily includes all contributions to, accrued-yet-undistributed passive income generated by, and/or actual distributions from the "applicable tax-favored foreign trust." ACTEC recommends that the IRS specifically state that many taxpayers with foreign plans

cannot meet this criterion because they failed to declare all income based on the incorrect understanding of the taxpayer and/or their U.S. tax return preparer who mistakenly thought that they could treat their foreign retirement plans like section 401(k) plans for U.S. tax purposes.

(d) Taxpayers and their advisors may be unaware that foreign retirement plans do not qualify for the Form 3520 and Form 3520-A waiver unless they meet a long list of requirements to be an "applicable tax-favored foreign trust." Foreign plans might satisfy some but not all of the conditions laid out in Rev. Proc. 2020-17. ACTEC recommends that that IRS specifically warn taxpayers and their return preparers that obtaining all the necessary data, translating it into English, adjusting for currency conversion and adjusting to account for different legal and tax systems can be challenging for taxpayers dealing with foreign companies, labor authorities, and foreign tax agencies.

(e) Even if a taxpayer were entitled to a future waiver under Rev. Proc. 2020-17, he likely still would need to report the "applicable tax-favored foreign trust" to the IRS on Form 8938, the FBAR, Part III of Schedule B of Form 1040, and perhaps elsewhere. Moreover, unless the "applicable tax-favored foreign trust" is located in one of the few countries with which the U.S. has a treaty exempting current taxation of accrued-yet-undistributed-passive income (*e.g.*, Canada, U.K.), the taxpayer must declare such income on his Form 1040. ACTEC recommends that the IRS specifically list the countries with which it has a tax treaty exempting current taxation of accrued-yet-undistributed-passive income, so that taxpayers and their return preparers have clear guidance from the U.S. concerning whether the treaty with the U.S. prevents current U.S. tax on accrued-yet-undistributed-passive income from their foreign workplace retirement accounts. ACTEC also recommends that the IRS specifically list the other U.S. tax forms that an American who participates in a foreign workplace plan or foreign individual retirement arrangement may have to file to be fully U.S. tax compliant.

(f) To the extent an American working abroad has set up a foreign individual employee retirement account solely for the benefit of himself as account owner (and not part of an "applicable tax-favored trust" covering multiple participants) and invests in a foreign mutual fund or funds, such investments likely trigger Form 8621 annual reporting with respect to each separate underlying foreign mutual fund. ACTEC recommends that the IRS specifically provide clear guidance to Americans working abroad and their U.S. return preparers that a foreign individual employee retirement account which invests in a foreign mutual fund must annually file a Form 8621.

(g) Given the GAO Report and the Taxpayer Advocate's 2024 Report to Congress highlighting the complexity of the regulations as they may apply to foreign retirement plans, as well as the fact that most U.S. tax return preparers are unaware of the applicable tax rules in this area, ACTEC recommends that reporting exceptions should be provided in cases where an American working abroad was unable to correctly report any contributions to, earnings of, or distributions from the foreign pension or retirement plan. ACTEC believes that imposing confiscatory

penalties of up to 35% of the total balance of the pension or retirement plan is draconian in the case of *non-willful* taxpayers who demonstrate reasonable cause. In fact, imposing penalties of this magnitude, sometimes through automatic assessments, are counter-productive in seeking voluntary compliance in this complicated area. Education of taxpayers – and not punitive penalty collection -- should be the overarching objective of the IRS in this area.

3. **Penalties for failure to report foreign large gifts under Prop. Reg. § 1.6039F-1(e)**

Automatic Assessment of Gift Penalties

The IRM generally instructs examiners to make an automatic assessment of Gift Penalties. According to IRM 20.1.9.10.3(1), Gift Penalties should be automatically asserted on Form 8278 once the examiner determines that a US person (1) received a foreign gift, (2) failed to file Form 3520, and (3) has not shown reasonable cause justifying the failure to file.

Although there is a possibility to challenge certain Gift Penalties through a deficiency procedure, the IRS has stated that the deficiency procedure would not apply to standalone Gift Penalties. In a deficiency procedure pursuant to section 6213, the taxpayer has the opportunity to dispute the assessment by filing a claim before the Tax Court before paying the challenged tax and penalty. However, IRM 20.1.1.4.2(2) provides that the deficiency procedure would only apply if the Gift Penalty in question originates from a tax underpayment assessment from the receipt of a foreign gift. Therefore, standalone Gift Penalties would be processed through a non-deficiency assessment procedure.

In the particular case of Gift Penalties, and differently from other types of similar penalties, examiners do not give taxpayers a warning before assessing the penalty. For example, when assessing a penalty for failure to report the creation or transfer of property to a foreign trust pursuant to section 6048 in Form 3520, IRM 20.1.9.13.2 expressly instructs the examiner to first provide the taxpayers with a Notice Letter with the express purpose of warning the taxpayer of the penalty assessment. The taxpayer can thereafter decide whether to agree or to protest the Notice Letter. This is not the case for Gift Penalties. IRM 20.1.9.10.2 (1) expressly instructs the examiner to directly send the taxpayer a Notice of Penalty Charge (CP 15 or CP 215 Notice) containing the Gift Penalty assessment without any previous warning. Applying the Gift Penalty in such a manner deprives the taxpayer of the opportunity to engage in a dialogue with the examiner before assessing the penalty. This puts taxpayers subject to Gift Penalties at a disadvantage compared to taxpayers subject to other penalties that derive from a similar failure to report.

Limited Options for Taxpayer to Challenge Gift Penalties

Taxpayers' options to challenge the Gift Penalty assessment in the Notice of Penalty Charge are limited as they do not include the possibility to dispute the penalty before the assessment is made. IRM 20.1.1.4 (2) generally provides that taxpayers may challenge the assessment of a penalty (1) before the assessment, (2) after the assessment but before paying, or (3) by requesting a refund after paying the penalty assessment.

Other penalties assessed under other Code provisions are expressly granted pre-assessment appeal rights. For example, pre-assessment appeal rights are granted in the case of trust fund recovery penalties under section 6672 and preparer penalties under section 6694. However, the IRM does not grant that same deference to Gift Penalties. Once the Notice of Penalty Charge has been received by the taxpayer, the taxpayer has already been assessed with the Gift Penalty. Therefore, if the taxpayer wishes

to challenge the assessment, the taxpayer is left only with the options of either (1) appealing and absorbing the administrative costs associated with the appeal process, or (2) paying the penalty first and claiming a refund later. This is another occasion in which the taxpayer subject to a Gift Penalty is put in a less favorable position compared to taxpayers subject to other similar penalties for failure to report.

Limited Grounds to Argue Reasonable Cause

Empirical evidence and a review of the IRM indicate that the IRS is poised to systemically deny Gift Penalty abatements under reasonable cause grounds. From the outset, IRM 20.1.9.10.5(1) provides that before reasonable cause is even considered for abatement of a Gift Penalty, the IRS recommends that the examiner ensures that the taxpayer did not receive similar gifts in prior open taxable years. As a result, a taxpayer with a valid reasonable cause argument would most likely not receive penalty relief just because he had received a gift before. In strict application of this IRS recommendation, this could apply even in the case where the taxpayer received a reportable gift before the Prop. Reg. § 1.6039F-1(e) entered into force and failed to report its first reportable gift received once Prop. Reg. § 1.6039F-1(e) became final and entered into force.

Furthermore, even if the taxpayer has not received any foreign gifts before, IRM 20.1.9.2 (15)(d) recommends that no reasonable cause should be generally granted to a taxpayer merely because the taxpayer relied on another person to file the return. As the AICPA has already pointed out, denying penalty abatement based on this IRM criterion is particularly detrimental to taxpayers, as taxpayers significantly rely on tax professionals to prepare and file their IRS tax forms.

In their letter dated August 14, 2023, addressed to Mr. Andy Keyso (IRS Chief of Appeals) and Ms. Lisa Colbert (Commissioner SB/SE), the AICPA voiced concerns regarding the IRS's significant and systemic denials of requests of penalty abatements for failure to file Forms 3520 and 3520-A based on reasonable cause grounds. In particular, AICPA reaffirmed that the law associated with filing Forms 3520 and 3520-A is considerably complex and that the costs to taxpayers of contesting these penalties can be significant. Simply put, if professionals specialized in the field are struggling to comply with the requirements of Forms 3520 and 3520-A, it becomes even more important for the IRS to consider how challenging it must be for a regular taxpayer who is not as well versed in the topic to comply with the same filing obligations. Consequently, the IRS should consider adopting more lenient recommendations to its examiners when assessing the validity of a reasonable cause claim derived from a failure to report a foreign gift pursuant to Prop. Reg. § 1.6039F-1(c). This becomes even more relevant in the context of penalties under Prop. Reg. § 1.6677-1, as the reporting requirements on Forms 3520 and 3520-A pursuant to section 6048 are more complex in nature.

Recommendation

ACTEC suggests that the effective penalty amount and severity of Gift Penalties require the IRS to be more flexible in their application and adopt a more lenient approach when considering penalty abatements under a reasonable cause argument. Treasury should specifically consider the challenges professionals and taxpayers are currently facing with filing Forms 3520 and 3520-A, as already expressed by AICPA. Based on the above, we propose that Treasury consider the following:

(a) Include in the Proposed Regulations a provision or, if not, instruct examiners to implement a policy that grants an automatic one-time Gift Penalty abatement to taxpayers who fail to report a foreign gift on Form 3520 for the first time. We also suggest abatement where there is no evidence of a tax avoidance purpose, in

cases where the taxpayer has a history of tax compliance, when the taxpayer received erroneous advice from a tax professional and/or when the taxpayer did not know or have reason to know that the source of the property was a foreign person or foreign trust.

(b) Instruct examiners to not implement an automatic assessment approach with respect to Gift Penalties. As in the case of the penalties under section 6677, examiners could first send a Notice Letter warning the taxpayer and granting them the ability to request an appeal before the Gift Penalty assessment is made.

(c) Withdraw the recommendation to examiners to deny the abatement of penalties merely because the taxpayer had received gifts before or relied on another person to file Form 3520, as indicated in IRMs 20.1.9.10.5(1) and 20.1.9.2 (15)(d).

(d) Postpone commencement of liability for Continuing Penalties until the IRS rejects an appeal for waiver of penalties due to reasonable cause so that the potential cost of the appeal is not increased by the Continuing Penalty.

(e) Add a new question to Form 1040, schedule B, asking whether the taxpayer has received any foreign gifts, and if the answer is "yes", remind the taxpayer that Form 3520 may need to be filed**.**

4. **Penalties for failure to report the creation of, transfers of property to, and distributions of property from a foreign trust under Prop. Reg. § 1.6677-1.**

The automatic policy of assessing penalties without giving taxpayers a reasonable opportunity to explain why they believe a waiver is appropriate is especially difficult for taxpayers who lack the financial resources to contest the IRS's position.

Because IRM 20.1.9.2 (15)(d) also applies to 6677 Penalties, taxpayers subject to such penalties will most likely be unsuccessful in arguing for a penalty abatement due to the reliance on another person (*i.e*., accountant or tax lawyer) in filing the respective IRS forms. Similar to the Gift Penalties, and even more pronounced in the case of the 6677 Penalties, the tax laws associated with furnishing and submitting Forms 3520 and/or 3520-A are extremely complex. In particular, the requirements pursuant to section 6048 require a more complex analysis from a quantitative and qualitative perspective than the reporting requirements under section 6039F. Therefore, the IRS should act with greater leniency in applying the 6677 Penalties (as suggested by the AICPA).

Recommendations

(a) Include in the Proposed Regulations a provision or, if not, instruct examiners to implement a policy that grants an automatic one-time 6677 Penalty abatement to taxpayers who fail to report a reportable event or a distribution on Forms 3520 or 3520-A for the first time. We also suggest abatement where there is no evidence of a tax avoidance purpose, in cases where the taxpayer has a history of tax compliance, when the taxpayer received erroneous advice from a tax professional and/or when the taxpayer did not know or have reason to know that the source of the property was a foreign person.

(b) Give taxpayers the right to appeal assessment of penalties based on reasonable cause and postpone commencement of Continuing Penalties until after rejection of a taxpayer's appeal for waiver for reasonable cause.

(c) Instruct examiners to have a more lenient approach as described above in considering 6677 Penalty abatements under reasonable cause grounds. The absence of leniency in denying reasonable cause arguments have proven to be counterproductive, as reflected in AICPA's letter of August 14, 2023. In particular, consider withdrawing the recommendation for examiners to deny the abatement of penalties simply because the taxpayer relied on another person to file Forms 3520 and 3520-A, as indicated in IRM 20.1.9.2 (15)(d).

5. **Lawyer's obligation to report the creation of trusts on Form 3520 under Prop. Regs. §§ 1.6048-2(b) and 1.6048-2(c).**

Prop. Reg. §1.6048-2(b) in conjunction with Treas. Reg. §1.671-2(e) could be construed to say that a lawyer's drafting of a foreign trust or advising in the establishment of a foreign trust creates a reporting obligation. The circumstances in which an attorney is regarded as "creating" a foreign trust should be defined and limited to cases where the attorney signs the trust as the settlor or trustor or actually makes a gratuitous transfer to the trust.

Recommendation

Based on the above three points, ACTEC requests that Treasury and the IRS define the circumstances in which attorneys are regarding as "creating" a foreign trust and that such definition be limited to circumstances in which the attorney signs the trust agreement as the settlor or trustor or makes a gratuitous contribution to the trust.

6. **Prop. Reg. § 1.6048-4(b)(4) – Reporting by U.S. Persons Receiving Distributions from Foreign Trusts.**

There may be confusion as to whether the migration of a foreign trust to the U.S. is subject to tax. The Proposed Regulations indicate that such a transaction will be a deemed distribution of the trust corpus and income to the domestic trust. Examples 11 and 12 in the Proposed Regulations further indicate that the domestic trust (which in essence means the trustee of the domestic trust) must file Form 3520 and complete Part III. Distributions reflected in Part III are subject to tax and possibly the throwback tax rules. The Proposed Regulations and Form 3520 should be amended to clarify that the migration into the United States is a reporting obligation but not a tax payment obligation.

In addition, there is another issue with Example 11 of Prop. Reg. § 1.6048-4. The example provides as follows: FB, a foreign bank, resigns as trustee of FT, a foreign trust, and DB, a domestic bank, becomes the new trustee of FT. Pursuant to section 7701(a)(30)(E), the FT becomes a domestic trust, DT. Under paragraph (b)(4) of this section, DT is treated as receiving a distribution of the trust corpus and income from FT. Under paragraph (a) of this section, DT must report the deemed distribution of the trust corpus and income on Part III of Form 3520 for the year in which the inbound migration occurs. DB becoming a trustee would not of itself cause the trust to become a domestic trust unless the "court test" under Treas. Reg. § 301.7701-7(c) is also satisfied. If the court test is not satisfied, the fact that DB is the new trustee will not of itself cause the trust to become a domestic trust for federal income tax purposes.

Recommendations

ACTEC recommends that Treasury clarify that a trust migration into the United States triggers a reporting obligation but is not a taxable distribution, and amend Example 11 to include the court test in order for the foreign trust to become a domestic trust in accordance with section 7701(a)(31)(B).

7. **Prop. Reg. § 1.6039F-1(f)(1).**

The Proposed Regulations amend the definition of a U.S. person. For purposes of sections 6039F and 6048, a dual resident who claims benefits under an income tax treaty will no longer be classified as a U.S. person. This is helpful to avoid having to file a Form 3520 to report a gift from a foreign person (pursuant to section 6039F) or transfer to or distribution from a foreign trust (pursuant to section 6048). In addition, a nonresident alien who elects to be treated as a U.S. resident under either section 6013(g) or (h) shall be treated as a U.S. person. Similarly, if a taxpayer relinquishes U.S. citizenship or residency during a year or obtains U.S. citizenship or residency during the year, the taxpayer will not be treated as a U.S. person for the portion of the year in which the taxpayer was a nonresident alien.

Example 3 of Prop. Reg. § 1.6039F-1 demonstrates the manner in which this is applied. It provides as follows: X is a lawful permanent resident of the U.S. within the meaning of Treas. Reg. § 301.7701(b)-1(b) of this chapter and is a resident of Country F under the domestic law of Country F. X is a resident of Country F under the residence article of the U.S.-Country F income tax treaty and notifies the U.S. by taking such a position on Form 1040NR and Form 8833 for Year 1. Pursuant to Treas. Reg. § 301.7701(b)-7 of this chapter, X is treated as a nonresident alien for purposes of computing X's U.S. income tax liability for Year 1. During Year 1, X makes a gift of $150,000 to Y, a U.S. citizen. Under paragraph (f)(1) of this section, X is not treated as a U.S. person for purposes of this section. Because X is not treated as a U.S. person for Year 1, the gift is a foreign gift within the meaning of paragraph (b) of this section. Y must report the foreign gift on Part IV of Form 3520 under paragraph (a) of this section.

The problem with this approach is that Y may not have knowledge as to the X's treaty claim, which causes X to be foreign. As far as Y is concerned, Y received a gift from a US person. Y should not be penalized based upon a decision X made in regard to X's tax filing. The issue also arises in regard to section 6048. If X creates a domestic trust while a U.S. taxpayer, and then elects to make a treaty election, the domestic trust becomes a foreign trust. Y receives a distribution from a domestic trust and has no reporting obligation. However, X's decision causes the trust to become foreign, and now Y must file a Form 3520. ACTEC believes while well intentioned to minimize the filing obligations by those persons who have dual status, the consequence is complexity and confusion for taxpayers who receive gifts from persons they otherwise thought were U.S. taxpayers or from trusts they thought were domestic.

Recommendations

ACTEC recommends that Treasury provide an exception from Form 3520 reporting by U.S. persons whose obligation to file is premised upon a treaty election made by another party. Rather than imposing a reporting obligation on the recipient of the property, the IRS can obtain information about gifts by including a question on Form 8833 that requires disclosure of gifts to a U.S. person that were made by the individual and/or trusts that have been funded by the individual.

8. **Prop. Reg. § 1.643(i)-1(b)(3)**

Prop. Reg. § 1.643(i)-1(b)(3) provides that if a nonresident alien individual, who is a grantor or beneficiary of a foreign trust, receives a loan from the trust, and, while the loan is outstanding, subsequently becomes a U.S. person within two years of the loan origination date, the individual will be deemed to have received a distribution from the foreign trust with respect to the outstanding amount of the loan as of the first day the individual is considered a U.S. person. A U.S. person is one who meets the definition of section 7701(b). If a beneficiary falls within this lookback period, the regulation will essentially treat a loan that is not taxable in the U.S. as a taxable distribution under section 643.

Recommendation

This Proposed Regulation exceeds the statutory authority, and should be eliminated. There is no basis under the applicable statute to justify a lookback period of two years in this context.

9. **Prop. Reg. § 1.643(i)-1(b) and (c)**

Section 643(i) generally provides that if a foreign trust makes a loan of cash or marketable securities (or permits the use of any other trust property) directly or indirectly to or by any grantor or beneficiary of the trust who is a U.S. person, or a. person that is related to such grantor or beneficiary, the amount of such loan (or the fair market value of the use of such property) shall be treated as a distribution by such trust to such grantor or beneficiary. Notice 97-34 provided guidance regarding related parties under this section before the Proposed Regulations were released.

Recommendations

(a) Prop. Reg. § 1.643(i)-1(b) and (c) should address whether a deemed taxable distribution to a beneficiary due to a loan (or through the use of trust property) gives the beneficiary a corresponding tax credit for the taxes paid on the deemed taxable distribution that can be used against taxes that would otherwise be due as a result of a future actual distribution. For example, if a US beneficiary is treated as having received a $1,000,000 distribution from a foreign trust and pays a federal income tax of $400,000 on the deemed distribution, the amount of the tax paid should be allowed as a credit against the tax that would be imposed as a result of a future actual distribution of $1,000,000 to the beneficiary.

(b) The Proposed Regulations should exempt bona fide loans from recharacterization as distributions where there is no significant tax avoidance purpose by adopting criteria similar to the intermediary rules addressed in Treas. Reg. § 1.643(h)-1(a) and Treas. Reg. § 1.679-3(c). A loan (particularly a loan to a person who is not a beneficiary but only related to a U.S. beneficiary or related to a U.S. grantor) should be treated as bona fide where there is a reasonable expectation of repayment of the loan and the loan terms are commercially reasonable. A loan to a related person also should be exempt from recharacterization where the beneficiary or grantor who is deemed to have received a distribution had no knowledge of the loan made to the related person.

(c) We recommend that Prop. Reg. § 1-643(i)-3(b), which allocates a section 643(i) distribution equally among multiple beneficiaries, be modified. The impact of this rule would be to treat multiple siblings who are beneficiaries of a foreign trust as having received an equal share of a loan made to the US corporation owned only by one of them. There should be a rational basis for allocating income to a beneficiary or grantor.

10. **Prop. Reg. § 1.643(i)-3(b)**

Prop. Reg. § 1.643(i)-3(b) provides that if a U.S. person who is not a U.S. grantor or beneficiary of a foreign trust but who is related to more than one U.S. grantor or beneficiary of the trust receives a loan of cash or marketable securities, or uses trust property, that is treated as a taxable distribution under section 643(i), then each U.S. grantor and beneficiary of the foreign trust who is related to such U.S. person is treated as receiving an equal share of the taxable distribution.

This Proposed Regulation exceeds statutory authority, is patently unfair and should be eliminated. There is no basis under the applicable statute to justify apportioning tax to beneficiaries who are not involved in a deemed taxable distribution.

We recognize this proposed rule is an anti-abuse provision; however, the impact would be inequitable in far more scenarios than those the guidance is intended to address and appears to violate due process. For example:

a. Such treatment assumes beneficiaries are aware of the deemed distribution and equally "benefitted" by the deemed distribution. This may not be the case.

b. Such treatment is punitive to those beneficiaries who are not aware of the deemed distribution and/or those beneficiaries whose relationship to the borrower is attenuated.

c. Such treatment provides no notice requirement to the beneficiaries..

There should be a rational basis for allocating a deemed distribution to a particular beneficiary or grantor that results from recharacterizing a loan from a foreign trust to a related person who is not a grantor or a beneficiary.

Recommendation

We recommend that this Proposed Regulation be eliminated.

11. **Election for Entities Comparable to a U.S. Trust to be Classified as Trusts**

The Proposed Regulations address transactions with foreign trusts, yet the determination of what is a foreign trust remains unclear. This would be a good opportunity for Treasury to provide clear guidance on whether a foreign structure is a trust for U.S. tax and reporting purposes. As a starting point, it is important to understand that in the United States, trusts are commonly used in estate planning. In contrast, many civil law countries do not recognize trusts and often have enacted legislation providing for similar planning type entities or arrangements ("structures") in an attempt to accomplish similar objectives as the trust. Many of these structures do not exist in the United States so it is necessary that each structure be analyzed under the laws of the U.S. and the foreign country to determine how that structure will be treated for U.S. tax purposes.

In the case of a foreign structure, it may be difficult to determine how the structure should be treated for U.S. tax and reporting purposes without an extensive review and analysis. In order to determine how the structure will be classified for U.S. purposes, a complex analysis is often required that includes reviewing and interpreting foreign law and the formation and governing documents of the structure to opine as to whether the structure is an ordinary trust as described in Treas. Reg. § 301.7701-1-4(a). The governing documents of the structure may need to be translated into English and advice will likely be required from

counsel in the foreign country where the structure was formed regarding various legal and tax aspects of the structure. The analysis can be very expensive and time consuming.

The starting point of the analysis is Treas. Reg. § 301.7701-1(b), which provides that the classification of organizations that are recognized as separate entities is determined under Treas. Reg. §§ 301.7701-2, 301.7701-3, and 301.7701-4 unless a provision of the Code provides for special treatment of that organization. Whether an organization is an entity separate from its owners for federal tax purposes is a matter of federal tax law and does not depend upon whether the organization is recognized as a trust under local law.

In general, an arrangement will be treated as an ordinary trust if it can be shown that the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. If an entity has both associates and a business purpose, it cannot be classified as a trust for federal income tax purposes.

There are other arrangements which are known as trusts because the legal title to property is conveyed to trustees for the benefit of beneficiaries, but which are not classified as ordinary trusts for purposes of the Code because they are not simply arrangements to protect or conserve the property for the beneficiaries. These trusts, which are often known as business or commercial trusts, generally are created by the beneficiaries simply as a device to carry on a profit-making business which normally would have been carried on through business organizations that are classified as corporations or partnerships under the Code.

In civil law countries where trusts are not typically recognized, there are entities or arrangements (structures) that may hold similar attributes to a trust in that they are formed to protect or conserve the property for designated beneficiaries or to serve noncommercial purposes. The following are a few examples of foreign entities that may be classified as a trust for U.S. tax purposes: stiftungs, foundations, waqfs, fideicomisos, and usufructs. In addition, two states (New Hampshire and Wyoming) have adopted foundation legislation that present similar uncertainties regarding how they will be classified for U.S. tax purposes. Delaware allows nonstock corporations to be formed for charitable or noncharitable purposes that might function in a manner similar to a purpose trust, but the tax classification is likely to be a corporation.

In IRS Chief Counsel Advice Memorandum 2009-012 (“AM 2009-012”), the Office of Chief Counsel of the Internal Revenue Service analyzed the tax classification of a Liechtenstein Anstalt and Stiftung. It was noted that in most situations, the primary purpose for the establishment of an Anstalt is to conduct an active trade or business and to distribute the income and profits therefrom to the beneficiaries of the Anstalt. AM 2009-012 concluded that Anstalts generally are not properly treated as trusts under Treas. Reg. § 301.7701-4(a) because, in most cases, their primary purpose is to actively carry on business activities. Therefore, Liechtenstein Anstalts are generally classified as business entities under Treas. Reg. § 301.7701-2(a).

In AM2009-012, based on the information submitted, it was determined that, subject to the facts and circumstances of each situation, Liechtenstein Stiftungs generally are properly treated as trusts under Treas. Reg. § 301.7701-4(a) because in most cases the Stiftung’s primary purpose is to protect or conserve the property transferred to the Stiftung for the Stiftung’s beneficiaries and is usually not established primarily for actively carrying on business activities. However, it is important to note that if the facts and

circumstances indicate in a particular case that a Stiftung was established primarily for commercial purposes as opposed to the purpose of protecting or conserving property on behalf of the beneficiaries, the Stiftung in such case may be properly classified as a business entity under Treas. Reg. § 301.7701-2(a). Accordingly, it is important to analyze the facts and circumstances of each case to determine whether a particular Stiftung was established to protect and conserve property of the Stiftung or alternatively, was created as a device to carry on a trade or business.

In *Estate of Swan v. Commissioner*,[6] the court, in determining whether the value of the assets of the Stiftungs should be includable in the decedent's gross estate, considered the application of the federal estate tax under prior Code section 811(d) (now section 2036) to a Swiss Stiftung and to a Liechtenstein Stiftung and concluded that the Stiftungs were comparable to trusts for U.S. estate tax purposes, rather than corporations. Because the court concluded that the Stiftungs are comparable to trusts, the court held that the transfers to the Stiftungs in that case are encompassed by the broad statutory language "by trust or otherwise" in former Code section 811.

The Court of Appeals for the Fifth Circuit, affirming a district court, held that a Lichtenstein Stiftung created by a U.S. person was a foreign trust for tax reporting purposes, and that the trust and the grantor were liable for substantial penalties for failure to file a timely and correct Forms 3520 and 3520-A. *Rost v. United States*, 44 F.4th 294 (5th Cir. 2022), *aff'g*, 2021 WL 5190875 (W.D. Tex. 2021) (slip copy).

U.S. taxpayers have long questioned whether Mexican fideicomisos (which means "trust" in Spanish) are "trusts" for U.S. tax purposes. If a fideicomiso is considered a trust for U.S. tax purposes, an Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts (Form 3520) and Annual Information Return with a U.S. Owner of Foreign Trust (Form 3520-A) likely will be required, along with a Statement of Specified Foreign Financial Assets (Form 8938) and possibly Report of Foreign Bank and Financial Accounts (Form FinCEN Report 114). In Revenue Ruling 2013-14, the fideicomiso in the ruling was ruled not to be a trust based on the terms of the fideicomiso. Key in that decision was the fact that the trustee did not engage in activity other than holding title to the land. The arrangement was more like a nominee arrangement than a trust. The determination of whether a fideicomiso is a trust or more like a nominee arrangement is based on the facts and circumstances. For fideicomisos that do not merely hold title to real property in Mexico, Revenue Ruling 2013-14 will not apply and the taxpayers are faced with determining how the fideicomiso will be classified for U.S. tax purposes.

Even where there is guidance on how an entity may be treated, an extensive analysis is necessary, and the conclusion remains uncertain. The penalties taxpayers face for classifying a foreign structure incorrectly can be significant.

After many years of debate over the proper classification of business entities, in 1996, the IRS implemented "check-the-box" regulations allowing certain ("eligible") business entities to make an election to be treated as a corporation or partnership/disregarded entity for federal tax purposes. An eligible entity can make an election to change its default tax classification by filing Form 8832, Entity Classification Election, with the Internal Revenue Service (Form 8832). A trust is not an eligible entity under Treas. Reg. § 301.7701-3(a). T.D. 8697 explains:

> "The regulations provide that trusts generally do not have associates or an objective to carry on business for profit. The distinctions between trusts

[6] 24 T.C. 829 (U.S.T.C. 1955).

> and business entities, although restated, are not changed by these regulations."

The determination of whether the structure will be classified as a trust is based on the governing documents and appliable law, along with the specific facts and circumstances. When a determination such as this is subjective, different conclusions can be reached. The guidance in this area consists of case law, private letter rulings and an Advice Memorandum by IRS counsel. While helpful, the guidance is fact specific and does not give the taxpayer certainty as to entities that should be classified as trusts, much like the certainty the check-the-box elections afford business entities. Taxpayers with foreign structures that are similar to trusts should be afforded the same certainty that taxpayers with eligible business entities have concerning the tax classification of such entity or arrangement.

Recommendation

We recommend that an "eligible trust" (defined as an entity or arrangement the primary purpose of which is to protect or conserve the property for the beneficiaries (who are not associates) and is not established primarily for actively carrying on business activities) may make an election to be classified as an ordinary trust for U.S. tax purposes, similar to how an eligible business entity makes a check-the-box election.

ACTEC
THE AMERICAN COLLEGE OF
TRUST AND ESTATE COUNSEL

McPherson Building
901 15th Street, NW, Suite 525
Washington, DC 20005
(202) 684-8460 • Fax (202) 684-8459
actec.org

Please Address Reply to:

Executive Director
DEBORAH O. McKINNON

July 8, 2024
Submitted Electronically at www.regulations.gov (IRS and REG-124850-08)

CC: PA: 01: PR (REG-124850-08)
Room 5203, Internal Revenue Service
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Re: Treasury Notice 89 Fed. Reg. 39440 (5/8/24) (IRS and REG-124850-08): Comments on Proposed Regulations on Transactions with Foreign Trusts and Information Reporting on Transactions with Foreign Trusts and Large Foreign Gifts

Dear Ladies and Gentlemen,

I respectfully request to speak in person at the public hearing on the proposed regulations on Transactions with Foreign Trusts and Information Reporting on Transactions with Foreign Trusts and Large Foreign Gifts scheduled for August 21, 2024, beginning at 10 a.m., in the Auditorium of the Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC.

I will speak on behalf of The American College of Trust and Estate Counsel ("ACTEC"), and have set forth below an outline of the topics I will address and the amount of time that I plan to devote to each topic.

The proposed definition of qualified obligation set forth in Prop. Reg. § 1.643(i)-2 should be liberalized.	3 minutes
Treasury and the IRS should adopt a more lenient approach when considering penalty abatements in connection with taxpayer reporting on the IRS Forms 3520 and 3520-A.	4 minutes
Treas. Reg. § 301.7701-4 should be amended to add a new provision that provides that an entity or arrangement that functions similar to a U.S. ordinary trust as described in Treas. Reg. § 301.7701-4(a) can elect to be classified as a trust for federal income tax purposes, similar to how an eligible business entity may elect tax classification under Treas. Reg. § 301.7701-3(a).	3 minutes

These topics are addressed in the enclosed Comments submitted by ACTEC.

Thank you for allowing me this opportunity to speak.

Sincerely,

Kevin Matz

Kevin Matz