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May 26, 2017

Internal Revenue Service  
CC:PA:LPD:PR (Notice 2017-28)  
Room 5203  
Post Office Box 7604  
Ben Franklin Station  
Washington, D.C. 20044

Submitted electronically via [www.regulations.gov](http://www.regulations.gov)

Re: Recommendations for 2017-2018 Priority Guidance Plan (Notice 2017-28)

Dear Ladies and Gentlemen,

The American College of Trust and Estate Counsel (“ACTEC”) is pleased to submit recommendations pursuant to Notice 2017-28, I.R.B. 2017-19, published April 21, 2017, which invites recommendations for items that should be included on the 2017-2018 Priority Guidance Plan.

ACTEC is a professional organization of approximately 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

ACTEC’s 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.
3. Clarification that QTIP and general power of appointment marital trusts holding retirement benefits in states that have adopted the 2008 revisions to the Uniform Principal and Income Act (“UPIA”) approved by the Uniform Law Commission satisfy the safe harbor for the estate tax marital deduction.

## GIFTS AND ESTATES AND TRUSTS

1. 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.
2. Guidance regarding the completion of gifts and includibility in the gross estate in the context of self-settled asset protection trusts.
3. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.

## INTERNATIONAL ISSUES

1. 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.
2. 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.
3. Regulation changing the due date for filing Form 3520-A from March 15 to April 15.
4. Guidance concerning the coordination of the foreign corporation anti-deferral rules and Subchapter J.

Each recommendation is described in detail in the enclosed memorandum.

If you or your staff would like to discuss the recommendations, please contact Beth Shapiro Kaufman, Chair of the ACTEC Washington Affairs Committee, at (202) 862-5062 or [bkaufman@capdale.com](mailto:bkaufman@capdale.com), or Deb McKinnon, ACTEC Executive Director at (202) 684-8455 or [domckinnon@actec.org](mailto:domckinnon@actec.org).

Respectfully submitted,



Susan T. House  
ACTEC President 2017-2018

Enclosure

**The American College of Trust and Estate Counsel (ACTEC)  
Recommendations for the  
2017-2018 Priority Guidance Plan (Notice 2017-28)  
May 26, 2017**

**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.**
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- 3. Safe Harbor Guidance concerning the application of the Reciprocal Trust Doctrine.**

**INTERNATIONAL ISSUES**

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

### **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. 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 con-

siderations [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. 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.

**3. Clarification that QTIP and general power of appointment marital trusts holding retirement benefits in states that have adopted the 2008 revisions to the Uniform Principal and Income Act ("UPIA") approved by the Uniform Law Commission satisfy the safe harbor for the estate tax marital deduction.**

Rev. Rul. 2006-26, 2006-1 C.B. 939, considered whether the "all income" requirement of I.R.C. §2056 and Treas. Reg. §§20.2056(b)-5(f)(1) and 20.2056(b)-7(d)(2) was satisfied in three fact situations. In each, a marital deduction trust held an IRA or a defined contribution plan. In the fact pattern, assuming that a QTIP marital trust was governed by the law of a state that had adopted the 1997 version of the UPIA, the ruling concluded that the trust may not meet the "all income" requirement if: (1) the trust language did not require the trustee to distribute to the

spouse the greater of all the income of the IRA (considered as if the IRA were a separate trust) or the annual required minimum distribution under I.R.C. §408(a)(6), and (2) the governing law included §§409(c) and (d) of the 1997 version of the UPIA. This was because UPIA §409(c) provided that a required minimum distribution from the IRA was allocated 10 percent to income and 90 percent to principal, whereas the view of the Service was that such an apportionment between principal and income was not based on the total return of the IRA and did not reflect a reasonable apportionment of the total return between income and remainder beneficiaries. If the trust language did not require the distribution of at least the income of the IRA when the spouse exercised the spouse's right to direct a withdrawal and UPIA §409(c) applied, the "all income" requirement may not be satisfied, according to the ruling.

Although §409(d) of UPIA 1997 states that a trustee must allocate a larger portion of any distribution to income to the extent that doing so is necessary to qualify for the marital deduction, the Service in Rev. Rul. 2006-26 stated that this provision was ineffective to reform an instrument for tax purposes, analogizing the statute to a savings clause in a document that would be ineffective to reform the document for federal tax purposes.

The ruling set forth a "safe harbor" that would apply if a QTIP election were made over both the trust and the IRA or retirement plan and the spouse had the power exercisable annually to compel the trustee to withdraw the income earned on the IRA or retirement plan and to distribute that income and all income earned on the other trust assets to the spouse.

The ruling concluded that marital trusts governed by §§409(c) and (d) of UPIA 1997 could not qualify for the safe harbor.

The Uniform Law Commission considered Rev. Rul. 2006-26 and made the changes discussed below to permit trusts governed by the 2008 version of the UPIA to qualify for the safe harbor. A copy of §409 of the 2008 version of the UPIA with the official comments of the Uniform Law Commission is enclosed. Both ACTEC and the American Bar Association's Real Property, Trust & Estate Law Section endorsed the changes before the Uniform Law Commission approved these changes.

The 2008 UPIA §409 retains a 90/10 allocation for trusts other than QTIP and general power of appointment marital trusts. However, for trusts intended to qualify for the estate tax marital deduction, the trustee is required to separately determine the income of each "separate fund" in such a trust for each accounting period. Separate funds include annuities, IRAs, pensions, profit sharing and bonus stock funds and stock ownership plans.

All distributions received by a trust from such a separate fund are considered income until the income determined in this manner is reached. Distributions in excess of that amount are considered principal.

If the distributions are less than this amount, the 2008 UPIA §409 states that the spouse may require that the trustee allocate principal from a source other than the separate fund to income, to make up the difference.

Subsection (f) of the 2008 UPIA §409 requires that a trustee demand that the person administering the fund distribute the internal income to the trust upon the request of the surviving spouse.

Under UPIA 2008, if a trustee cannot determine the income of a separate fund, the trustee is to apply a percentage between 3 and 5 percent, depending on the adopting state's choice, to the fund's value to determine the income.

Further, if the value of the separate fund cannot be determined, the trustee is to compute an income equivalent by multiplying the I.R.C. §7520 rate by the present value of the payments, based on the §7520 rate.

The Service has published no new guidance on this issue since the 2008 revisions to the UPIA. A new revenue ruling replacing Rev. Rul. 2006-26 and concluding that the "all income" requirement is satisfied by marital trusts governed by the laws of a state adopting §409 of UPIA 2008 is needed. The fact pattern is an extremely common one affecting a large number of taxpayers. Rather than putting taxpayers to the difficulty and expense of requesting private letter rulings and consuming the time of the National Office, we believe that the Service should provide a revenue ruling concluding that marital trusts governed by UPIA 2008 that hold IRAs or defined contribution plan benefits satisfy the "all income" requirement. This guidance would not involve changes to the Treasury regulations.

## GIFTS AND ESTATES AND TRUSTS

### **1. 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.<sup>1</sup> The exceptions are in turn followed by “flush language” excepting certain situations from their reach (the exception to the exception).<sup>2</sup>

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.<sup>3</sup>**

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

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<sup>1</sup> 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.

<sup>2</sup> I.R.C. § 2632(c)(3)(B)(flush language).

<sup>3</sup> I.R.C. § 2632(c)(3)(B)(ii).



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)<sup>4</sup> because no portion of the trust property would be distributed to the child at the death of a person unless the child had already reached the specified age. Therefore, assuming that none of the other exceptions apply,<sup>5</sup> 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.<sup>6</sup>**

Several of the exceptions,<sup>7</sup> 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

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<sup>4</sup> 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 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.

<sup>5</sup> 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.

<sup>6</sup> I.R.C. § 2632(c)(3)(B)(flush language).

<sup>7</sup> 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).

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 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.

## **2. 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).

### **3. 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 (6<sup>th</sup> 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. Additional 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.**

In 2014, ACTEC recommended that guidance be issued 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. Since then, final regulations have been issued (See T.D. 9610, 2013-15 I.R.B. 765 (2013); T.D. 9657, 2014-13 I.R.B. 687 (2014)), and additional guidance has been forthcoming in the form of new Intergovernmental Agreements (“IGA”s) with many other countries (“FATCA Partners”). Several FATCA Partners have issued Guidance Notes to explain the provisions of the IGA. Although the final regulations and Guidance Notes have been extremely helpful, some issues remain. Some issues are (i) whether a person’s future interest in a trust is considered to be a mandatory beneficial interest for purposes of FATCA reporting; (ii) whether a private trust company and a trust managed by a private trust company are foreign financial institutions; and (iii) whether a trust managed by an individual trustee becomes a foreign financial institution if some of the trust funds are invested in one or more separate investment funds that are financial institutions (such as a mutual fund).

#### **a. Who is a “beneficiary” for purposes of FATCA?**

For purposes of FATCA, a beneficiary means a beneficiary who has a mandatory distribution right and a discretionary beneficiary if and to the extent such beneficiary actually receives a distribution. Treas. Reg. §1.1471-5(b)(3)(iii)(B). A person whose interest is wholly discretionary and who does not actually receive a distribution is not a beneficiary. Treas. Reg. §1.1471-5(b)(3)(iii)(B)(3). However, the regulations do not specifically address the treatment of a person who has a mandatory future interest in the trust, whether vested or contingent. For example, suppose the trust instrument says that income should be distributed to A for life and then to B for life and then to C if C is then living. Do the interests of B and/or C have to be reported?

I.R.C. §6038D(a) requires U.S. taxpayers with specified foreign financial assets (including certain interests in foreign entities) to report these investments on an information return (Form 8938) when the aggregate value of the investments exceeds \$50,000. A U.S. taxpayer’s interest in a foreign trust is not considered to be a specified foreign financial asset for these purposes unless he or she knows or has reason to know (based on readily accessible information) of the interest. Treas. Reg. §§1.6038D-2(b)(4)(iv), 1.6038D-3(c). Receipt of a distribution from the foreign trust constitutes actual knowledge for this purpose. Treas. Reg. §1.6038D-3(c). The maximum value of a beneficiary’s interest in a foreign trust (*i.e.*, the value required to be reported on Form 8938) equals the sum of the amount actually received in the taxable year plus the present value of a mandatory right to receive a distribution. Treas. Reg. §§1.6038D-5(f)(2). The regulations do not distinguish between reporting obligations of

taxpayers who have mandatory present interests versus those who have mandatory future interests in foreign trusts.

We suggest that future interests be ignored for FATCA reporting purposes because reporting is not necessary to protect the right to collect taxes. A beneficiary of a future interest is not required to pay income tax and should not be required to file information returns.

This suggestion is consistent with the FBAR regulations, which also disregard future interests. See 31 C.F.R. §1010.350(e)(2)(iv) (defining “financial interest” to include “[a] trust in which the United States person either has a present beneficial interest in more than 50 percent of the assets or from which such person receives more than 50 percent of the current income.”)

We recommend that the FATCA regulations be amended to address future interests in the same manner that the FBAR regulations do, by adding specific language to Treas. Reg. §1.1471-5(b)(3)(iii)(B) saying that: “A future interest is not an equity interest in a trust for these purposes.” We recommend adding specific language to Treas. Reg. §1.6038D-3(c) saying that: “A future interest in a foreign trust is not a specified foreign financial asset of a specified person.”

- b. Private trust companies and trusts managed by private trust companies should not be treated as financial institutions for purposes of FATCA because they are not engaged in a trade or business with the general public and therefore function more like an individual trustee than an institutional trustee.**

We note that in at least one Guidance Note (for Cayman Islands) the conclusion is reached that a private trust company that is not “doing business” in the Cayman Islands is not a financial institution. Guidance Notes on the International Tax Compliance Requirements of the Intergovernmental Agreements between the Cayman Islands and the United States of America and the United Kingdom, §6.14, U.S.-Cayman Is.-U.K., Dec. 15, 2014.

We suggest that Treas. Reg. §1.1471-5(e)(4)(i) be amended to provide that “A private trust company that is not engaged in the trade or business of providing services to the general public is not a financial institution, and trusts managed by such a private trust company are not, for that reason alone, treated as investment entities under (e)(4)(i)(B) of this section or as financial institutions under (e)(1)(iii) of this section.”

- c. Clarify whether all trusts that are FFI’s can use the “Trustee-documented trust” method of reporting if the trust is not resident in a country that has an IGA and whether a private trust company may use the Trustee-documented reporting method whether or not the private trust company is an FFI.**

The FATCA regulations do not provide for the Trustee-documented trust method of reporting. This method is provided for in both model 1 and model 2 IGA's, Annex II, paragraph IV, which provide:

The Financial Institutions described in paragraphs A through E of this section are Non-Reporting Cayman Islands Financial Institutions that are treated as deemed-compliant FFIs for purposes of section 1471 of the U.S. Internal Revenue Code. In addition, paragraph F of this section provides special rules applicable to an Investment Entity.

**A. Trustee-Documented Trust.** A trust established under the laws of the Cayman Islands to the extent that the trustee of the trust is a Reporting U.S. Financial Institution, Reporting Model 1 FFI, or Participating FFI and reports all information required to be reported pursuant to the Agreement with respect to all U.S. Reportable Accounts of the trust.

The classification of private trust companies as FFIs is uncertain. The Cayman Islands Guidance Notes to the IGA, indicate that not all private trust companies may be FFIs. Section 6.14 of the Cayman Islands Guidance Notes version 2.1 (July 2015 ) provides as follows:

A Private Trust Company (PTC) which is registered, or a similar trust company which is licensed, and conducting business in or from within the Islands, *may be considered* a Financial Institution for these purposes.

In the case of a trust of which a PTC is the trustee and the trust has all its income derived from financial assets, under the definitions of Investment Entity outlined in Section 2.9, the trust *may be* a Financial Institution.  
(Emphasis added)

We recommend that the trustee-documented method of reporting be permitted for all trustees, wherever located, who agree to perform the necessary reporting and for private trust companies whether or not they are classified as FFIs.

**d. Trusts managed by individual trustees are not financial institutions. Treas. Reg. §§1.1471-5(e)(4)(i)(B), 1.1471-5(e)(4)(v), Example (5). However, if a trust with an individual trustee engages a financial institution to manage investments on a discretionary basis, then the trust may be a financial institution. Treas. Reg. §§1.1471-5(e)(4)(i)(B), 1.1471-5(e)(4)(v), Example (6).**

The regulations are not clear whether a trust becomes a financial institution if the individual trustee invests some or all of the trust funds in one or more pooled investment vehicles, such as mutual funds. It is very typical for individual trustees to invest trust funds in mutual funds. It does not seem to be the intent of the regulations to make such a trust a financial institution because in this case the individual trustee remains responsible for investments, and monitoring the performance of a fund seems to be the same as monitoring the performance of



individual stocks and bonds, but clarification of this point would be helpful so that the filing status of a trust could be clear.

## **2. 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.<sup>8</sup> 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.

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<sup>8</sup> 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.

Guidance is needed concerning the following issues:

- 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.

**3. 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.<sup>9</sup> 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 15<sup>th</sup>.

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 15<sup>th</sup> due date for the Form 3520-A acts as a trap for the unwary. In most cases, the U.S. Owner has an April 15<sup>th</sup> deadline for his own income tax return and therefore may not consider the filing obligations with respect to the trust until after the March 15<sup>th</sup> deadline has passed.

The likely rationale for the March 15<sup>th</sup> 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 15<sup>th</sup> 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.

#### **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 on this issue in twenty years.

On December 31, 2013, final, temporary and proposed regulations were issued that provide guidance on determining ownership of a PFIC.<sup>10</sup> The temporary regulations adopt the rule set forth in the proposed regulations by treating beneficiaries of nongrantor trusts and estates

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

<sup>10</sup> T.D. 9650.

as owning stock in proportion to their beneficial interests, which are determined by applying a facts and circumstances test.<sup>11</sup> The temporary regulations provide that a beneficiary may be attributed ownership of PFIC stock owned by a nongrantor trust or estate whether the trust or estate is foreign or domestic. The temporary regulations also provide guidance on the annual filing requirement imposed by Section 1298(f) on owners of PFIC stock. Under these regulations, a beneficiary of a foreign nongrantor trust or foreign estate who is considered to be the indirect owner of PFIC shares held by the foreign nongrantor trust or foreign estate is not required to report under Section 1298(f) provided that no PFIC elections have been made for such year and no excess distribution has occurred.<sup>12</sup> This rule is significantly different from the regulations adopted under Sections 1471-1474 and 6038D which treat a discretionary beneficiary of a foreign trust who has not received a trust distribution in a particular year as not having a beneficial interest in such trust. Treas. Reg. §1.1298-1T(b)(iii) supports the conclusion that a beneficiary who is deemed to have received an excess distribution because he/she is treated as an indirect shareholder of a PFIC would have a reporting requirement, and a tax payment obligation, whether or not he/she received, or was entitled to receive, a distribution from the trust.

The preamble to the regulations issued in T.D. 9650 requests guidance on the determination of proportionate ownership by beneficiaries of PFIC shares owned by a nongrantor trust or estate. The preamble also states that the regulations are not providing guidance on the application of the PFIC tax rules when an estate or nongrantor trust, or a beneficiary thereof, receives or is treated as receiving an amount taxable under the PFIC rules as an excess distribution. Until further guidance is issued, the preamble states that the PFIC and Subchapter J rules must be applied in a reasonable manner to preserve or trigger the tax and interest charge rules on excess distributions under Section 1291. The preamble also states that it would be unreasonable for the shareholders to take the position that neither the beneficiaries of an estate or trust nor the estate or trust itself is subject to the tax and interest charge on excess distributions under Section 1291. However, it should not be unreasonable to take the position that such income was not taxable under Section 1291 if the income was attributable to a foreign person either because the foreign person was the indirect owner of the stock or because a domestic trust or estate distributed such income to a foreign beneficiary in the year it was received.

In light of the preamble, we request that Priority Guidance Plan include the issues of (1) attribution of ownership of PFIC and CFC shares to beneficiaries of nongrantor trusts and estates; and (2) treatment of income attributable to ownership of stock of a CFC or PFIC through a nongrantor trust or estate.

Comments previously submitted by ACTEC suggested a set of rules that would better coordinate the overlapping PFIC/CFC and subchapter J rules with the objective that tax would be owed at the time a beneficiary of a foreign nongrantor trust or estate received distributions (and not before) but the interest charge on delayed payment of tax would be preserved. Under such rules, it would not be necessary to attribute ownership through nongrantor trusts and estates. The prior comments did not address attribution of ownership through domestic trusts or estates, which we believe is not advisable.

The possible issues include:

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<sup>11</sup> Treas. Reg. §1.1291-1T(b)(8).

<sup>12</sup> Treas. Reg. §1.1298-1T(b)(iii).

- a. If ownership is allocated to beneficiaries, how such allocation will be made, whether it is fair and practical to impose tax on a person based on income he/she has not received and has no enforceable right to obtain, and what adjustments will be made to avoid double tax when income imputed and taxed to a beneficiary is later distributed to someone else or when the trust disposes of shares.
- b. Whether, instead of imputing income to beneficiaries, beneficiaries should be taxed only 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. Whether it is necessary or advisable to impute to beneficiaries ownership of PFICs held by domestic nongrantor trusts and domestic estates (ownership of CFCs by statute may not be imputed through U.S. entities).

Attribution from domestic nongrantor trusts and domestic estates is unnecessary to protect the PFIC tax regime, since the tax on excess distributions from a PFIC (and gains treated as excess distributions) could be collected from the U.S. taxpayer-trust and/or its U.S. beneficiaries to the extent such income is taxable to the domestic trust and/or its U.S. beneficiaries under the rules of Subchapter J. Moreover, this attribution rule is inconsistent with the attribution rule for CFCs and would interfere with the CFC and PFIC “overlap” rule in Section 1297(d), which generally provides that where a foreign corporation is both a CFC and a PFIC, the CFC rules “trump” the PFIC rules. Attribution from domestic trusts also is inconsistent with the regulations issued under Section 1411 addressing the tax treatment of PFIC income received by a U.S. charitable remainder trust (which is not attributed to beneficiaries of such a trust).<sup>13</sup>

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<sup>13</sup> Prop. Treas. Reg. §1.1411-3(d)(2)(ii) Provides that income treated as an excess distribution within the meaning of section 1291 or gain treated as an excess distribution is included in the tier system applicable to distributions from charitable remainder trusts, which thus could not also be imputed to the beneficiaries of the charitable remainder trust. This is the correct result because imputing the income to beneficiaries would be inconsistent with the rules of section 664.



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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.<sup>1</sup> 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 Internal 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

<sup>1</sup> 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.<sup>2</sup>

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?

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<sup>2</sup> 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.<sup>3</sup>

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.<sup>4</sup>

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

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<sup>3</sup> 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.

<sup>4</sup> 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 C had 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.<sup>5</sup> 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

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<sup>5</sup> 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.

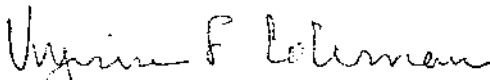
We are aware, of course, that the estate of *the employee* cannot be a designated beneficiary because only an individual can be a designated beneficiary. Reg. § 1.401(a)(9)-4, A-3. There is no inconsistency between this rule, however, and a recognition that the estate of *an individual, named beneficiary* 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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Please Address Reply to:

April 15, 2009

**Via Hand Delivery**

Henry S. Schneiderman  
 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. Schneiderman:

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,<sup>1</sup> 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.

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<sup>1</sup> 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.<sup>2</sup> 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:

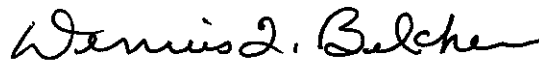
We respectfully request that the IRS issue as soon as practicable a revenue ruling (or other pronouncement upon which taxpayers may rely) that a spousal rollover may be accomplished by a surviving spouse with a distribution (other than a required minimum distribution) actually received by him or her 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

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<sup>2</sup> Internal Revenue Code §6110(k)(3).



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**Executive Director**  
DEBORAH O. MCKINNON

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

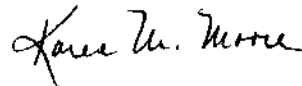
The Honorable Michael F. Mundaca  
Page 2 of 2  
June 23, 2010

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.<sup>1</sup>

**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 679<sup>2</sup> treats as grantor trusts, owned by the grantor, foreign trusts created by U.S. persons if they have U.S. beneficiaries. This memorandum will deal only with the U.S. income taxation of foreign trusts that are not taxed as grantor trusts. Due to the broad application of section 679, in most cases such trusts will have been created either by non-U.S. grantors or by U.S. grantors who are deceased.

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

<sup>1</sup> 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.

<sup>2</sup> 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.<sup>3</sup> 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.<sup>4</sup> 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.<sup>5</sup> 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.<sup>6</sup> If a foreign nongrantor trust invests through or in a foreign holding

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<sup>3</sup> 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).

<sup>4</sup> Code §667(a).

<sup>5</sup> Code §§667(b) and 668.

<sup>6</sup> 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.<sup>7</sup> If the holding company liquidates into, or makes a distribution to the foreign trust and the trust makes no current distribution to its U.S. beneficiaries, it is not clear whether any of the U.S. beneficiaries would be subject to current tax on the event.

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

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

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

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<sup>7</sup> 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.

<sup>8</sup> 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.

<sup>9</sup> 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.<sup>10</sup> The accumulation distribution tax regime should be expanded and the imputation of current tax to indirect ownership of shares of investment companies owned by foreign nongrantor trusts should be limited, we think appropriately, to the rare cases when a U.S. beneficiary of a foreign nongrantor trust actually or in effect controls trust investments. Of course, U.S. grantors of foreign grantor trusts would continue to be subject to the corporate anti-avoidance rules.

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

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<sup>10</sup> 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.<sup>11</sup> For this purpose, a “U.S. shareholder” is a person who owns 10% or more of the total combined voting power of the corporation.<sup>12</sup> 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.<sup>13</sup> 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.

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<sup>11</sup> Code §957(a).

<sup>12</sup> Code §951(b).

<sup>13</sup> 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.<sup>14</sup> However, for purposes of imposing tax on a U.S. shareholder, only shares owned directly or indirectly (not constructively) are counted.<sup>15</sup>

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.<sup>16</sup> 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

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<sup>14</sup> 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.

<sup>15</sup> 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.

<sup>16</sup> 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.<sup>17</sup> Therefore, the CFC rules excluding previously taxed income from tax when distributed (discussed below) would work appropriately.

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

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

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

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

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<sup>17</sup> 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.<sup>18</sup> The PFIC rules were adopted in the Tax Reform Act of 1986 because Congress recognized that while income

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<sup>18</sup> 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.<sup>19</sup>

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.<sup>20</sup>

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.<sup>21</sup>

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.<sup>22</sup>

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

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<sup>19</sup> 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”).

<sup>20</sup> Code §1291.

<sup>21</sup> Code §§951(c) and 1297(d).

<sup>22</sup> 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.<sup>23</sup> 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.<sup>24</sup>

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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup> 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.<sup>28</sup> 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.

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<sup>23</sup> Code §1293.

<sup>24</sup> Code §1294.

<sup>25</sup> Code §1296.

<sup>26</sup> 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)."

<sup>27</sup> Proposed Treasury regulation §1.1291-1(b)(1)(i).

<sup>28</sup> 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.<sup>29</sup> 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

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<sup>29</sup> 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.<sup>30</sup> 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,<sup>31</sup> in most cases the beneficiary does not have a fixed right to any share of the trust and would not want to elect to be taxed on amounts he or she does not, in any common meaning of the term, own. Moreover, when such an election could be made, for example when the trust had a single beneficiary or fixed shares, the rules for dealing with previously taxed income would need to be clarified or modified to make sure that the same income is not taxed more than once.

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

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<sup>30</sup> 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.

<sup>31</sup> 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.<sup>32</sup>

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.<sup>33</sup> 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.<sup>34</sup> If a foreign trust's receipt of a distribution from a foreign holding company would be treated as an excess distribution if the shares were held by a U.S. taxpayer, it

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

<sup>33</sup> Code §662(a).

<sup>34</sup> 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.<sup>35</sup> 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.<sup>36</sup> The tax result of not treating a U.S. beneficiary as the indirect owner of PFIC shares will be satisfactory only if the trust accumulation distribution rules are changed to increase the interest charge to cover the period that the income was accumulated in the holding company.

### **Proposed solutions**

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

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

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<sup>35</sup> Code §667(a).

<sup>36</sup> 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.<sup>37</sup>

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<sup>37</sup> 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.