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

Re: **Comments on Regulations under Sections 643(i), 679, 6039F, 6048, and 6677 Regarding Transactions with Foreign Trusts and Information Reporting on Transactions with Foreign Trusts and Large Foreign Gifts**

Ladies and gentlemen:

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These Comments refer to proposed regulations published by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") under sections 643(i), 679, 6039F, 6048, and 6677 (the "Proposed Regulations").[1] The Proposed Regulations pertain to the tax treatment of loans from, and the uses of property of, foreign trusts and also information reporting concerning loans, distributions and other transactions with foreign trusts and the receipt of large foreign gifts.

Although I and my firm have several clients who might be affected by the federal tax principles addressed by these Comments, neither my firm nor I have been engaged to make a government submission with respect to, or otherwise to influence the development or outcome of one or more specific issues addressed by, these Comments.

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[1] 89 Fed. Reg. 30,440 (May 8, 2024). Unless indicated otherwise, all references to (i) "section" or "subsection" are to the Internal Revenue Code of 1986, as amended (the "Code"); (ii) "Reg. section" are sections of the treasury regulations promulgated under the Code currently in effect (the "Treasury Regulations"); and (iii) "Prop. Reg. section" are to sections of the Proposed Regulations.

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1. Timing of Inheritances

When does a taxpayer have to report an inheritance? It would be helpful if the regulations would provide some guidance. There are a number of situations that can make this a difficult area for taxpayers and the IRS.

In the purely domestic area, determining when an inheritance of U.S. property is received is relatively straightforward. If the property is administered by a personal representative (in a probate proceeding or via a living trust), the time is generally when the property is distributed, assuming no unreasonable or manipulative delay. Where no administration or living trust is involved, then the time may be determined based on automatic transfers such as where property was held with rights of survivorship, or POD (payable on death) provisions for a financial account, and so on. Life insurance proceeds are not so clear – it could be when the insurance company actually pays the recipient (as opposed to the executor or trustee). But generally, it should be relatively easy to determine.

But when the death occurs abroad and/or the property is situated abroad, it can be harder for the U.S. beneficiary to determine the timing. In some countries, especially common law countries, the rules are similar to those found in the United States (I am not sure about Louisiana, but everywhere else). But in many countries, especially civil law countries, inheritance is automatic; there may be no estate as such and no need for a court or administrative proceeding, unless there is a dispute or it is difficult to determine who is entitled to what based on a complex web of laws, especially reserved share/forced heirship rules. Sometimes, notaries and/or court proceedings may have to be involved.

Another problem that I have frequently encountered in practice is what to do about distributions made to heirs with a conditional obligation to return them in whole or in part if, for example, foreign tax claims or other claims are made against the decedent. How and when should the heir report in these situations? And what amount should be reported – the full amount or the amount net of potential claims? What if the claim cannot be quantified?

One specific area on which guidance is needed concerns usufructs and bare property interests under civil law. In many civil law countries, it is possible to divide interests in property into a usufructuary interest, where the holder of the interest is entitled to the current income derived from the property for the duration of the usufruct (often but not necessarily, the life of the holder), and a bare property interest, where the holder of the interest will become the outright owner of the property at the end of the term of the usufructuary interest. Typically, civil law will provide that the bare property owner (and not the usufructuary) is entitled to sell the property but the proceeds remain subject to the obligation to pay income derived from the proceeds to the usufructuary. The question that arises in practice is what reporting is required (a) when a usufructuary interest and a bare property interest are created and (b) when the usufructuary interest expires, again, usually on the death of the usufructuary. Further complications can arise when there are multiple bare property owners and/or multiple

usufructuaries. The issues are sufficiently general that there should be guidance that should apply consistently to most such situations.[2]

The IRS may be unable to give specific guidance about all the possible timing issues here. But given the complexities, at the very least, this should be specifically articulated as a factor in determining whether reasonable cause exists for late filing. While I commend the government for providing that the principles set out in Reg. section 1.6664–4 and Reg. section 301.6651–1(c) should be used in making a determination of whether reasonable cause exists,[3] those principles do not identify or give examples concerning any issues relating to foreign gifts. At the very least, you could give some broad examples to explain how a taxpayer should go about determining when an inheritance has been received.

2. Prop. Reg. section 1.6048-4(d)(1) – Assumed 10-Year Life of Trust

As currently provided by Notice 97-34[4] and implemented by Part III of IRS Form 3520, Prop. Reg.. § 1.6048-4(d)(3)(i)(A) provides for a default method of computation (the "Default Method") under which a U.S. person who has received a distribution from a foreign trust treats a portion of the distribution as a distribution of current income based on 125% of the average amount of the distributions that the U.S. person received from the foreign trust during the prior three taxable years. The amount of the distribution that exceeds the portion that is treated as a distribution of current income is treated as an accumulation distribution within the meaning of section 665(b) (consisting of the undistributed income ("UNI" of the trust). Tax on such excess distribution is subject to the interest charge of section 668.

In applying the Default Method, in the absence of actual information provided on a statement described in Prop. Reg.. § 1.6048-4(c), the U.S. person must presume that the applicable number of years the foreign trust has been in existence is ten years and that no taxes described in section 665(d) have been imposed on the trust in any applicable previous year (even if a distribution has been made and the tax under section 665(d) has previously been imposed). These rules are consistent with the Default Method that is currently prescribed in the instructions for Part III of Form 3520. The U.S. person's use of the Default Method does not affect any calculations made by the foreign trust for purposes of trust accounting.[5]

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[2] A helpful introduction to usufructs and bare property is contained in Krauthamer, Lee and Ruchelman, "Tax Considerations for a U.S. Holder of Bare Legal Title in a Usufruct Arrangement", Insights vol. 10 no. 2 (March 28, 2023). A more detailed discussion is contained in a three-part article by Longman and Muller published in Tax Notes Federal beginning in 2023: "Grin and Bare It: Usufruct and Naked Ownership Structures in the United States", Tax Notes Federal (Jan. 20, 2023); Grin and Bare It, Part II: Tax Issues for the Usufruct Owner in the United States June 19, 2023); and Grin and Bare It, Part III: U.S. Tax Consequences for a Bare Owner Who Is a U.S. Taxpayer (Feb. 5, 2024).

[3] See Prop. Reg. section 1.6039F–1(e)(2).

[4] 1997-1 CB 422.

[5] *See* Prop. Reg.. § 1.6048-4(d)(3)(ii).

Prop. Reg. section 1.6048-4(d)(3) provides that the ten-year period must be used "(in the absence of actual information provided on a statement described in § 1.6048–4(c))", i.e., the actual number of years can be used if the beneficiary receives a foreign non-grantor trust beneficiary statement. This requirement is unnecessarily restrictive. In many cases, the beneficiary may have sufficient information to determine the known date the trust was formed or became a non-grantor trust, without the need to obtain a foreign non-grantor trust beneficiary statement from the trustee. I therefore recommend that the beneficiary be permitted to establish to the satisfaction of the Service what the actual period should be and that the statement be one but not the only way of doing it.

3. The Default Method and Domesticated Trusts

The Default Method applies to distributions from foreign trusts. The Default Method addresses a problem with computing the distributable net income (DNI) and the UNI of a foreign trust. The problem may exist because the trustee does not have information or records that would allow for such computation or because the beneficiary cannot obtain such information or records from the trustee for any number of reasons.

In 1997, the IRS recognized this problem for foreign trusts and developed the Default Method, which is now proposed to be continued in the regulations. The Default Method appears to me to be a reasonable approach and, in any event, I assume that it will be adopted in the final regulations, perhaps with some technical changes (including in response to the issue raised above in relation to the ten-year period).

However, the same issue arises in connection with distributions from a domestic trust that was formerly a foreign trust. The position in respect of such a domestic trust is not addressed in the Proposed Regulations and it should be, especially since the current position is not clear.

Under current law, a distribution from a non-grantor trust is treated first as attributable to DNI, then to UNI (which few domestic non-grantor trusts will have these days and none formed since 1997[6], except for former foreign trusts), and then to trust corpus.[7] Income that is attributable to UNI must be attributed to prior years under the rules of section 666 and tax is computed on such UNI under section 667. Finally, if the trust is foreign, an interest charge is imposed under section 668.

Where a domestic trust that has inherited UNI from a foreign trust ("inherited UNI") because the trust has become a domestic trust or is treated as a continuation of a foreign trust, section 666 will apply. The IRS also took the position that the interest charge also applies.[8] I believe that Rev. Rul. 91-6 is wrong and would not survive a judicial challenge, but the problem of

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6 Section 665(c).
7 This is the combined effect of sections 661 and 665.
8 Rev. Rul. 91-6. 1991-1 C.B. 89.

computing UNI of such a trust for purposes of applying sections 666 and 667 would remain even if no interest charge could be imposed.

This then raises the question – how should inherited UNI be computed? The IRS has not provided clear guidance on this point. The Default Method applies by its terms to foreign trusts. Form 3520, under which the computation is made, is not required (or arguably even permitted) to be filed in relation to a domestic trust, including a former foreign trust. On the other hand, the instructions to Form 4970 (Tax on Accumulation Distribution of Trusts) 4970 state that "Note: If the accumulation distributions are from a domestic trust that used to be a foreign trust, see Rev. Rul. 91-6, 1991-1 C.B. 89." This at least might be taken to suggest that the same computation rules that apply to foreign trusts also apply to domestic trusts that used to be foreign trusts. But this suggestion is undercut by the fact that Rev. Rul. 91-6 predated Notice 97-34 and therefore did not contemplate the Default Method.

It is therefore not clear if the Default Method can be used after the trust becomes domestic. I think it should. There is no reason why domestication of a foreign trust should result in a change of the method of computing UNI. This would be in the interests of both taxpayers, so that they would have a clear method of dealing with the problem of not having information to do an actual calculation, and the government, so that taxpayers could not, by domesticating the trust, get round the rule that the actual method cannot be used by a beneficiary once that beneficiary has used the Default Method (except when the trust terminates).[9]

4. Pension Plans and the Definition of "Trust"

(a) Authority to Exempt or Limit Reporting. In a story already published online in Tax Notes and stated to be posted on July 8, 2024,[10] it was reported that Rebecca Lammers of Democrats Abroad had met with the "IRS reg drafters" in June. Ms. Lammers was reported as saying that the IRS claims that it doesn't have the authority to change the definition of a foreign trust to except retirement plans from reporting. Ms. Lammers was further reported as not being convinced by this explanation.

Not only am I not convinced but, if that is the IRS position, it is simply incorrect. Section 6048(d) is quite clear that the IRS has the authority to "suspend or modify" *any* requirement of section 6048 if it determines that the United States has no significant interest in obtaining the required information. So you have to decide whether you really need information about foreign retirement plans, assuming that those plans are properly classified as trusts (see below). In many cases, you do not. And you have already shown that you are willing to apply this

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[9] I realize that this would mean that the rules for domestic trusts that have never been foreign trusts would be different from the rules for former foreign trusts. But this is a minor issue given that today, as a result of the enactment of section 665(c) in 1997, so few domestic trusts are subject to sections 666 and 667. Also, information about domestic trusts is almost always available because the trust should have been filing Form 1041 for all of its existence based on actual data.

[10] Velarde, "IRS Urged to Make Trust Reporting Changes for Retirement Accounts", Tax Notes (July 8, 2024).

provision in the case of Canadian registered retirement savings plans or registered retirement income plans.[11] You have chosen to offer narrow and complicated relief in the case of some foreign pension plans.[12] That relief is too narrow and it should be expanded. It should be sufficient if interests in pension plans are reported on Form 8938 and in an FBAR, and that taxpayers that are in fact currently taxable on income associated with the plan be required to report such income in the usual way on Form 1040.

(b) The Definition of a Trust. The term "trust" is not defined in the Internal Revenue Code. The Code provides for whether a trust is domestic or foreign, but it does not say what is a trust.[13] Treasury Regulations differentiate among ordinary trusts, business trusts, investment trusts, and certain others.[14] They say nothing about trusts or other entities established to provide retirement or disability benefits. Nor do the regulations say anything about foreign entities that may have trust-like features. The issue has occasionally been in case law and, notably, by the IRS in AM2009-012 (Oct. 7, 2009) (relating to Liechtenstein Stiftungen and Anstalten) and Rev. Rul. 2013-14[15] (relating to the Mexican fideicomiso). But the government has never issued comprehensive guidance on how to classify a foreign arrangement or entity as a trust or something else (such as an association or an investment contract).

My understanding is that Comments to be submitted by the Section of Taxation of the American Bar Association will address comprehensively issues relating to the definition of a trust for purposes of section 6048 and 6677. I strongly urge Treasury and the IRS to provide guidance on what constitutes a trust, since this is a predicate to determining whether a trust is foreign or domestic, and therefore whether those sections are relevant to a taxpayer. I do not think it is acceptable that computation of the tax consequences of a distribution by a foreign trust and reporting of such distribution (and its very heavy attendant penalties, automatically imposed by the Ogden campus without reading reasonable cause statements) should depend on whether an entity or an arrangement is classified as a trust, and especially a foreign trust, when there are so many uncertainties about what constitutes a trust.

These uncertainties include the nature of foreign retirement plans as well as other foreign entities and arrangements. Most civil law countries do not recognize trusts at all or only recognize them if they exist under the laws of foreign countries.[16] For such entities to be treated as trusts for U.S. tax purposes demands that the government provide more guidance on how to make the determination that the subject entity or arrangement is a trust in the first place.

Authority to define what constitutes a trust surely exists, given the lack of a definition of trust in the Code and the fact that for decades, the only general guidance is set out in Reg. section

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[11] Rev. Proc. 2014-55, 2014-44 I.R.B. 753
[12] Prop. Reg. section 1.6048–5(b).
[13] Section 7701(a)(30)€
[14] Reg. section 301.7701-4.
[15] 2013-26 I.R.B. 1267.
[16] See also footnote 2 above and the accompanying text.

301.7701-4(a).[17] If the IRS had the authority to issue that guidance in 1960, there can be no reason why it cannot issue additional guidance to deal with these uncertainties. Congress has clearly contemplated the possibility that a trust can be foreign but it has not defined what is a trust. The IRS can and should fill that gap.

I would also urge that uncertainties as to the proper classification of an entity or arrangement should be identified as a factor in determining whether there was reasonable cause for reporting failures. As in the case of foreign gifts, the regulations provide that principles set out in Reg. section 1.6664–4 and Reg. section 301.6651–1(c) should be used in making a determination of whether reasonable cause exists,[18] but those principles do not identify the issue of the uncertainties of classifying entities and arrangements as trusts or otherwise. They should.

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Generally, I commend Treasury and the IRS for issuing the Proposed Regulations. They have been long overdue. Over the past nearly three decades, numerous issues have been identified or intensified in relation to the taxation and reporting of foreign gifts and trusts. Those issues, including the ones described in these Comments, need the government's attention. The Proposed Regulation can and should be the vehicle for addressing the issues.

Sincerely,

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[17] T.D. 6503 (Nov. 15, 1960).
[18] See Prop. Reg. section 1.6677–1(d).