Foreign Trusts and Gifts - It's Getting Warm Offshore

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NOTE: This article was published in two parts in the Journal of International Taxation August and September 1997 issues. The article was somewhat reorganized for the Journal and the following sidebar added to address the repeal of section 1491. Certain other minor changes were also made in response to the enactment of the Taxpayer Relief Act and to comments from the editor of the Journal. The text of the article as printed will be available in electronic format in October.

Sidebar

On August 5, 1997, after Part I of the article went to print, the Taxpayer Relief Act of 1997 was enacted (the "1997 Act"). Section 1131 of the 1997 Act, among other things, (i) repeals excise tax and information reporting rules of Sections 1491-1494 that applied to certain transfers of appreciated property by a U.S. person to a foreign estate or trust and (ii) adds a new Code Section 684 which requires gain recognition on the transfer of appreciated property by a U.S. person to a foreign estate or trust, except as provided in regulations. The 1997 Act clarifies that, for purposes of new Section 684, a U.S. trust that becomes a foreign trust is treated as having transferred all of its assets to a foreign trust. Further, new Section 684 does not apply to a transfer to a trust to the extent that any person is treated as the owner of the trust under Code Section 671.

The effective date for these amendments is the date of enactment of the 1997 Act, August 5, 1997. Accordingly, the additional layer of Section 1494 reporting of Section 1491 transfers (described in Part I of the article) is relevant only for transfers made before that date; however, it should be noted that the Section 6048 reporting requirements (also described in Part I) remain in place with effect for transactions involving foreign trusts.

Section 1161 of the 1997 Act is intended to provide grandfather relief for certain domestic trusts that would have become foreign trusts under the Act as a result of failing the new two-part residency test for trusts prescribed by Section 7701(a)(30)(E) (described in Part I of this article). The 1997 Act authorizes the IRS to issue regulations allowing a nongrantor trust that was in existence on August 20, 1996 (the date of enactment of the Act), and that was treated as a domestic trust on the day before that date, to elect to continue to be treated as a domestic trust, notwithstanding the trust's failure to satisfy both parts of the two-part residency test for tax years after 1996. Affected trusts should nevertheless plan to follow the modification procedure prescribed by Notice 96-65 until the IRS issues regulations or other guidance under this provision.

INTRODUCTION

A hot current of legislative and IRS attention to foreign trusts is flowing. The unaware could be swept away and the well-advised will feel the heat. If it cannot diffuse the heat, this article will try to shed some light on an area which has seen a great deal of activity in the past two years.

Prior law offered significant tax planning opportunities and inadequate reporting obligations. In the Small Business Job Protection Act of 1996,[1] Congress responded to administration proposals first published in February 1995 with a series of changes designed to narrow planning opportunities, counteract tax avoidance and evasion and enhance compliance.

The key changes in 1996 were:

(1) Changes designed to expand "grantor trust" treatment for outbound foreign trusts established by U.S. persons, for inbound foreign trusts established by foreign grantors who subsequently become U.S. persons (sometimes called "pre-immigration trusts"), and for U.S. trusts which subsequently become foreign trusts ("outbound trust migrations").

(2) Changes designed to treat certain loans and other indirect transfers from foreign non-grantor trusts to beneficiaries as distributions.

(3) Changes designed to decrease the likelihood that a foreign trust created or funded by a foreign person would be treated as a grantor trust if a beneficiary is a U.S. person;

(4) Introduction of a more objective test for determining whether a trust is domestic (U.S.) Or foreign (non-U.S.).

(5) Increasing the scope of reporting of foreign trusts, requiring reporting of gifts by foreign persons to U.S. persons and imposing heavy penalties for noncompliance; and

(6) Changes broadening the scope of section 1491 and its companion provisions.

The new legislation, in some cases deliberately and in others as a result of the use of vague statutory language, left much to the IRS to cover in regulatory guidance. In early June, the IRS published

1 Public Law 104-188, 110 Stat. 1755 (August 20, 1996) (the "Act"). All references to the IRC and all unprefixed section references are to the Internal Revenue Code of 1986, as amended by the Act.

Notice 97-34[2] and proposed regulations under section 672(f) and 7701(a)(30) which are the subject matter of this two-part article. This article focuses primarily on the notice and the proposed regulations but also describes some of the legislative changes which have yet to be interpreted by regulations. Section 1491 has received a great deal of coverage elsewhere and, except with respect to the new reporting requirements of section 1494, it will not be covered in detail here.

The IRS is continuing to work on other foreign trust-related regulation projects, in particular under IRC § 679. It's getting warm offshore.

2. EXPANDING GRANTOR TRUST TREATMENT FOR U.S. GRANTORS

a. The Treatment of Loans to Foreign Trusts. Under section 679, a transfer by a U.S. person to a foreign trust results in automatic grantor trust treatment if the trust has, at any time in the year, any beneficiary who is a U.S. person. One way to avoid this was for a grantor trust established by a foreign person to be leveraged by indefinite loans from a U.S. beneficiary.[3] Although the U.S. lender was required to report interest equal at least to the applicable Federal rate on such loans, any profits of the trust after paying such interest belonged to the trust and could be distributed to the beneficiaries free of tax.

To counteract this, at least where the loan appears unlikely to be repaid, the Act provides that if a U.S. person transfers money or other property to a related foreign trust, any obligation issued by the trust (or any obligation of a person related to the trust) will not be taken into account in determining if the U.S. person received fair market value, except to the extent provided by regulations.[4] The definition of whether a person is related to a trust is extraordinarily broad: it includes any person who, without regard to the transfer, is a grantor of the trust, a beneficiary of the trust, or a person who is related (within the meaning of section 643(i)(2)(B)) to any grantor or beneficiary of the trust.[5]

(1) Exception for Qualified Obligations. The Conference Committee report expresses an intent that the IRS should provide an exception from this treatment for loans with arm's length terms. In applying the exception, Congress expected that consideration would be given to whether there is a reasonable expectation that an obligation of the trust would be repaid.[6]

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2 Notice 97-34, 1997-25 I.R.B. 22 (June 23, 1997).

3 H.R. Rep. No. 542, 104th Cong., 2d Sess., pt. 2 at 25 (1996).

4 IRC §§ 679(a)(3)(A)(i), 6048(a)(3)(B)(i).

5 IRC § 679(a)(3)(C).

6 H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 335 (1996).

The IRS responded to this invitation with a narrowly crafted exception. Notice 97-34 announces that regulations will provide that the U.S. transferor will be treated as receiving fair market value from the foreign trust only if the obligation is a "qualified obligation".[7] The rule applies where after February 6, 1995, whether or not in accordance with a preexisting arrangement or understanding, the U.S. person transfers money or other property to a related foreign trust in exchange for an obligation from that trust (or an obligation of a person related to such trust). If an obligation issued on or before February 6, 1995 is modified after that date, and the modification is a significant modification within the meaning of section 1.1001-3, the obligation is treated as if it were issued on the date of the modification.

An obligation is a qualified obligation only if:

(i) It is evidenced by an express written agreement; (ii) the term of the obligation does not exceed five years (taking account extensions allowed by the agreement); (iii) payments are denominated in U.S. dollars; (iv) the yield to maturity of the obligation must not be less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate in effect for the day on which the obligation is issued; (v) the U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation;[8] (vi) the U.S. transferor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding; (vii) the obligation is not a demand loan or an annuity contract.

The only exception to the requirement to extend the statute of limitations is if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period.

Additional provisions of the notice narrow the exception still further, by treating a qualified obligation as having the maturity date of any subsequent extension of credit involving the U.S. transferor, the trust and a person related to the trust. The IRS also will treat a series of obligations issued and repaid by the trust (or a person related to the trust) as a single obligation if the transactions are structured with a principal purpose to avoid the application of the new provision.

(2) Consequences of Disqualification. The consequence of disqualification is for the U.S. transferor to be treated as making a gratuitous transfer to the trust in an amount equal to the original obligation's adjusted issue price plus any accrued but unpaid qualified stated interest as of the date of disqualification or some other date determined by the District Director based on facts and

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7 Notice 97-34, *supra*, Section III. B.

8 According to the Notice, such an agreement, when properly executed and filed, will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of Treas. Reg. § 301.6501(c)-1(d).

circumstances. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the gratuitous transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation will be separately tested to determine if it is a qualified obligation.

(3) Collateral Consequences. Notice 97-34 is silent on the collateral consequences of treatment of non-qualified obligations. For example, suppose the transaction giving rise to the obligation involves an extension of credit in connection with a sale of property. Is the result that, since the transferor is treated as owning the portion of the trust attributable to the obligation, no gain should be recognized on the sale? That is the current IRS ruling position.[9] Now suppose that the non-qualified obligation is issued, not by the trust, but by a corporation owned by the trust. Should the transaction somehow be triangulated, so that the grantor is treated as giving the property to the grantor trust and the trust as having contributed it to the corporation? How, in such circumstances, does one calculate the portion of the trust of which the grantor is treated as the owner? What if the corporation is only partly owned by the trust? Is the treatment of the corporation affected in any way?

Notice 97-34 is also silent on the treatment of payments with respect to non-qualified obligations. The legislative history cited above expresses an expectation that principal payments by the trust on any trust obligation (presumably other than a qualified obligation) will be treated as reducing the portion of the trust attributable to the portion of the property transferred. This suggests that such payments of principal are simply a return of trust principal with no other consequences and should not, for example, be treated as made out of distributable net income of the trust.

The treatment of interest is not discussed at all, but it might be expected that payment of interest might be disregarded for tax purposes as a payment to the grantor from the grantor's *alter ego*. However, the situation becomes more complicated, once again, if the borrower is not the trust itself but an entity owned by the trust.

(4) Recommendations for Revision. The IRS appears to have ignored the legislative history's instructions to a significant degree. As noted earlier, Congress directed the IRS to provide an exception from this treatment for loans with arm's length terms. The qualified obligation rules will exclude innumerable loans on arm's length terms. Congress also expected that consideration would be given to whether there is a reasonable expectation that an obligation of the trust would be repaid. The qualified obligation rules interpret this as permitting the imposition of an outside maturity of five years, including any possible extensions, whenever negotiated. Indeed, these rules make it impossible to make more than one loan if a later loan will have a maturity more than five years beyond the making of an earlier loan.

Any regulations implementing the new rules should be significantly moderated:

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9 IRS Notice 96-65, 1996-52 I.R.B. 28, which confirms the continued applicability of Rev. Rul. 87-61, 1987-2 C.B. 219, revoking Rev. Rul. 69-450, 1969-2 C.B. 168.

(a) A safe harbor should be provided for routine extensions of credit involved in sales of property in the ordinary course of business, whether or not the obligation is outstanding at the end of the taxable year.

(b) The arm's length standard should be judged under well-established principles of sections 482 (transfer pricing) and 7872 (below-market loans). The requirement that a qualified obligation be denominated in dollars and that it have a minimum or maximum rate has no support in the legislative history and should be deleted. There is no need for the IRS to develop a whole new body of law on this issue. In particular, the rules should be much more flexible where the lender holds a minority beneficial interest in the foreign trust.

(c) The requirement for an express extension of the statute of limitations should be eliminated and replaced with a provision deeming such an extension to have been elected whenever the taxpayer treats an obligation as a qualified obligation.

(d) Whether there is a reasonable expectation that a loan will be repaid should be judged separately for each loan according to the facts and circumstances. The automatic five-year rule is too harsh and may force a U.S. lender into requiring bad commercial decisions. For example, suppose a U.S. lender makes a loan to a corporation owned by a trust in which the lender has a small beneficial interest. Assume the loan is at arm's length in all other respects. Three years later the corporation requires additional capital for expansion and more time to repay the original loan. The qualified obligation rules would make it impossible to grant an extension or provide an additional loan with a maturity of more than two years, even if both parties were willing for the loan to be on arm's length terms.

b. Pre-Immigration Trusts. A non-U.S. person who becomes a U.S. person will generally be treated as the owner, under the grantor trust rules, of any property which he or she transferred to a foreign trust within the five-year period prior to his or her U.S. residency starting date.[10] The person will be treated as having transferred such property (together with any undistributed income, appreciation and gains thereon) to the trust on his or her U.S. residency starting date. This rule will not apply, however, if the foreign trust does not have any U.S. beneficiaries after the grantor's U.S. residency starting date. This is a critical issue in planning immigration to the United States for an individual who wishes to give away assets in trust to family members who do not plan to move to the United States.

10 IRC § 679(a)(4); for the residency starting date, see IRC § 7701(b)(2)(A).

c. Outbound Trust Migrations and Immigrant Beneficiaries. If a U.S. grantor transfers property to a U.S. trust, and the trust subsequently becomes a foreign trust during the grantor's lifetime, then the U.S. grantor will generally be treated as the owner of the property previously transferred by the grantor to the trust.[11] For purposes of section 679, the U.S. grantor will be treated as having transferred such property (together with any undistributed income, appreciation and gains thereon) to the trust on the date the trust became a foreign trust.

On the other hand, a non-U.S. beneficiary who becomes a U.S. citizen or resident more than five years after the funding of such a trust will not be considered a "U.S. beneficiary" for purposes of determining whether the U.S. transferor will be treated as the owner of the trust under the grantor trust rules.[12]

3. NEW SUBSTANTIVE RULES FOR U.S. BENEFICIARIES OF FOREIGN NONGRANTOR TRUSTS

A U.S. beneficiary who receives a distribution from a foreign nongrantor trust out of trust income is generally subject to income tax on the amount received. The Act amends the rules applicable to U.S. beneficiaries who receive direct, indirect or constructive distributions from foreign nongrantor trusts to limit the opportunities for deferral or avoidance of U.S. Federal income tax on these distributions.

a. Direct Distributions of Accumulated Income. As under prior law, a U.S. beneficiary who receives a distribution from a foreign nongrantor trust out of income accumulated by the trust in prior taxable years may be subject to an additional tax under sections 665-67, commonly referred to as the "throwback tax." The throwback tax is generally designed to tax the U.S. beneficiary as if he or she had received the accumulation distribution in the prior year or years in which the income was earned by the trust. Prior to the Act, the U.S. beneficiary's throwback tax liability was also subject to a nondeductible six percent simple interest charge under Section 668, calculated from the year the U.S. beneficiary would have paid income tax on the accumulation distribution, had the trust distributed its income in the year the income was earned by the trust. The Act amends the throwback tax rules in several ways.

(1) New Floating Interest Charge. The Act amends section 668(a) to change the interest rate applicable to payments of the throwback tax by U.S. beneficiaries from simple interest at a six percent rate to compounded interest at the rate used for underpayments of tax under present law (which is a floating rate based on prevailing market rates). The new interest rate will apply for periods beginning on or after January 1, 1996. Under a transition rule contained in section 668(a)(6), the interest rate for periods before 1996 will remain at six percent, non-compounded. However, the accumulated total simple interest charge for pre-1996 periods will be subject to compounding under the new floating rate after 1995.

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11 IRC § 679(a)(5).

12 IRC § 679(c)(3).

(2) Allocation of the Accumulation Distribution to Prior Years. Under prior law, for purposes of computing the interest charge, an accumulation distribution was deemed to have been made out of income accumulated in the earliest year for which there was accumulated income. The Act amends section 668(a) to provide that an accumulation distribution will be allocated proportionately to the prior trust years in which (1) the trust had accumulated income and (2) the beneficiary receiving the distribution was at all times a citizen or resident of the United States. Accordingly, if a nonresident alien of the United States becomes a U.S. citizen or resident, and subsequently receives an accumulation distribution from a foreign trust, the interest charge will not be imposed for any accumulation periods prior to the taxable year the beneficiary became a U.S. person. This rule applies to accumulation distributions made after August 20, 1996.

(3) Anti-Abuse Rules. The Act granted the IRS authority to issue regulations to prevent avoidance of the tax rules relating to trusts, including the throwback tax rules. These regulations may be effective from the date of enactment of the Act.[13] According to the general explanation prepared by the U.S. Treasury Department in connection with the President's February 1995 foreign trust proposals, these anti-abuse rules will target strategies designed to convert a trust's accumulated income into current income, such as by the use of tiered trusts, trust divisions and mergers, and similar transactions with corporations. However, the terms of new section 643(a)(7) are not limited by the legislative history and the regulations may include anti-avoidance rules that have no relationship to accumulation distributions from foreign trusts. For example, the regulations might attempt to foil certain intentionally "defective" grantor trusts.

b. Indirect Payments from Foreign Trusts. In general, a distribution of current or accumulated income from a foreign nongrantor trust to a U.S. beneficiary is subject to U.S. Federal income tax, whereas a direct gift by a foreign donor to a U.S. donee is not. The Act attempts to prevent the use of non-U.S. intermediaries (nominees) to disguise taxable trust distributions as tax-free gifts. Under new section 643(h), any amount paid to a U.S. person, which the payor received directly or indirectly from a foreign trust, will be treated as if the amount had been paid by the foreign trust directly to the U.S. person. This rule does not apply to a withdrawal from a foreign trust by its grantor, followed by a subsequent gift from the grantor to a U.S. person. This rule became effective on August 20, 1996.

c. Loans from Foreign Trusts to U.S. Grantors and Beneficiaries. As amended by the Act, section 643(i) now provides that, except as provided in regulations, if a foreign trust directly or indirectly makes a loan of cash or marketable securities to a U.S. grantor or U.S. beneficiary of the trust, the amount of such loan will be treated as a distribution to that grantor or beneficiary. The Notice announces that future regulations will treat such a loan as a distribution unless the loan is in consideration for a qualified obligation, as described earlier, from the grantor, beneficiary or a related person.

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13 IRC § 643(a)(7).

4. EXCLUDING GRANTOR TRUST TREATMENT FOR GRANTOR TRUSTS WITH BY FOREIGN GRANTORS

The Act amended Section 672(f) to limit the circumstances in which a person who was not a U.S. citizen or resident ("foreign person") would be treated as the owner of a trust under the grantor trust rules.

a. Background. Under prior law, a trust, foreign or domestic, of which the grantor was a foreign person was treated in essentially the same way as a domestic trust. It followed that if the trust would be treated as a grantor trust under those rules, the foreign grantor would be the owner of the income.[14] The foreign grantor-owner was taxed on such income only under the limited rules for taxing nonresident individuals and foreign corporations.

Although Rev. Rul 69-70 did not say this explicitly, it also followed (and the IRS confirmed in recently issued proposed regulations) that distributions from the trust to U.S. beneficiaries were treated as gifts from the foreign grantor-owner. Such gifts generally were not taxable to the U.S. beneficiary as income and were not subject to gift tax so long as the subject matter of the gift was either intangible property or situated outside the United States.[15]

b. Limitation on Grantor Trusts.

(1) In General. The new rules are designed to prevent foreign persons from establishing trusts for the benefit of U.S. beneficiaries that would escape U.S. income tax. Generally, the new rules allow a person to be treated as the owner of trust assets under the grantor trust rules only to the extent that the application of those rules causes income to be taxable to a U.S. citizen or resident.

(2) Anti-Avoidance. To prevent tax avoidance, the following additional rules apply:

As described in greater detail below, distributions made from a trust to an intermediary for transfer to a U.S. beneficiary are treated as if made directly from the trust to the U.S. beneficiary. This rule does not apply if the intermediary is the grantor. Previously, this intermediary rule applied only to trusts established by U.S. grantors. This rule will present some difficulties in practice.

The IRS is given authority to recharacterize distributions from a partnership or from a foreign corporation to a U.S. person which the U.S. person treats as a gift. For example, distributions from partnerships and foreign corporations that were functioning like trusts could either be treated as trust distributions taxable to U.S. beneficiaries or as distributions to the U.S. person as a partner or shareholder.

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14 Rev. Rul. 69-70, 1969-1 C.B. 182

15 IRC § 102; IRC § 2501(a).

A U.S. beneficiary of a trust may be treated as the grantor and owner of a trust if it was funded by a foreign grantor who received a gratuitous transfer from the U.S. beneficiary.

c. **Distributions by certain foreign trusts through intermediaries.** Under new section 643(i) and the proposed regulations[16], a distribution made after August 20, 1996 is treated as made through an intermediary if any *one* of the following applies:

(1) The intermediary is related either to the U.S. person who received property from the intermediary or to the foreign trust and the property is traceable to the distribution from the foreign trust. The definition of related person is very broad. This creates a "trap" because a person might have independent reasons for making gifts and fail to carefully trace the gift to other financial sources. The regulations should allow exceptions where the facts warrant it.

(2) The U.S. person would not have received the property "but for" the distribution from the foreign trust to the intermediary. It is not clear whether this rule applies if the distribution is made after the payment by the intermediary.

(3) The intermediary received the property as part of a tax avoidance plan.

A grantor is never an intermediary for purposes of this rule. It is not clear whether an agent of the grantor is covered by this exception. For example, the trust might make a distribution to the grantor which was paid directly into the grantor's bank account, perhaps by wire transfer not involving any action on the part of the grantor. From this account a payment is made to the beneficiary. It would be reasonable to suppose (but it would also be helpful were the IRS to clarify) that the bank is not an intermediary in this position.

If a distribution is treated as made through an intermediary, the U.S. person generally includes any amount in income in the year in which the U.S. person receives the property, even if the distribution was made to an intermediary in an earlier taxable year. However, if the intermediary is the "agent" of the U.S. person, the U.S. person includes the amount in income when his/her agent received the distribution. Usual agency principles are applied to determine whether the intermediary is the agent of the U.S. person. It is not clear how much is deemed to have been distributed to the U.S. person where the amounts distributed from the trust are not the same as the amounts paid to the U.S. person and there is a period of time that elapses between the two events. For example, if the trust distributions $100 to the intermediary who invests the sum and two years later pays $125 to the U.S. person, how is the U.S. person taxed?

A *de minimis* exception applies if the aggregate amount of distributions to a U.S. person that are made through one or more intermediaries does not exceed $10,000 in any one year.

16 Prop. Treas. Reg. §1.643(h)-1

d. Definition of "grantor". The proposed regulations include, for the first time, a more comprehensive definition of the term "grantor", a term used extensively in relation to trusts but previously not the subject of much statutory or regulatory guidance.[17] A grantor is defined as a person (which may include an individual and a non-natural person) to the extent such person either creates a trust or directly or indirectly makes a "gratuitous transfer" of property to a trust.

A gratuitous transfer means a transfer other than for fair market value or a distribution made by a corporation or a partnership. A transfer for fair market value means a transfer in consideration for and equal to the value of (i) property received from the trust (other than an interest in the trust); (ii) services rendered by the trust; or (iii) the right to use property owned by the trust.

A distribution made by a corporation or partnership is nongratuitous if the distribution is described in Sections 301, 302, 305, 355, 356 or 731. It is not clear whether distributions described in section 736 were intended to be excluded.

A grantor includes a person who purchases an interest in a trust from the grantor and a person who receives an interest in a fixed investment trust. For example, if A makes an investment in a fixed investment trust, T, and B subsequently acquires A's interest in T, B is treated as the grantor of T with respect to such interest whether or not the transfer was gratuitous. This reflects market practice to which the IRS has acquiesced for many years, essentially on the theory that B was in effect acquiring the trust property from A and resettling in a new trust.

A grantor does not include a person who funds a trust as an accommodation for another person. For example, if A, an attorney, creates a trust for the benefit of his client, B, and B's children, names himself as the grantor, and funds T with a nominal contribution out of his own funds (which A views as an investment in the generation of fees for future legal services), B is treated as a grantor. It is not clear whether A is also considered a grantor because A created the trust. Probably, the regulations intend that B be considered the only grantor.

e. Foreign Persons Not Treated as Owners. Prop. Treas. Reg. §1.672(f)-1 provides that there is a two-step process for determining whether a foreign person will be treated as the owner of a trust.

First, the regular grantor trust rules are applied to determine whether the foreign person would be treated as the owner of the trust without regard to the rules of section 672(f), .

Second, the "worldwide amount" and the "U.S. amount" are compared and the rules of section 672(f) apply only to the extent that the worldwide amount is greater than the U.S. amount.

The "worldwide amount" is defined as the net income that would be taken into account in computing the worldwide taxable income of any person, whether or not a U.S. person, determined by applying U.S. tax principles. The worldwide amount includes income attributable to foreign persons even if

17 Prop. Treas. Reg. §1.671-2

such amounts are not subject to U.S. income taxation. For example, the worldwide amount includes income of a controlled foreign corporation that is not Subpart F income taxable currently to U.S. shareholders.

The "U.S. amount" is defined as the net income that would be taken into account in computing the taxable income of a U.S. taxpayer, including income imputed to such a taxpayer through other entities (such as a controlled foreign corporation or foreign personal holding company). The U.S. amount also includes tax-exempt income, such as municipal bond income.

The proposed regulations illustrate the workings of these rules with a series of examples. Example 2 shows how the basic result changes under the new law:

> In the Example, A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his U.S. son, B. A has a reversionary interest within the meaning of section 673. If the basic grantor trust rules were applied, A would be treated as the owner of DT, and any distributions to B would be considered nontaxable gifts from A to B. Under Prop. Treas. Reg. § 1.672(f)-1(c)(2), there is no U.S. amount, because all the income would be taken into account by A and no amount is taken into account for the current year under the basic grantor trust rules in computing the taxable income of a U.S. taxpayer. Under Prop. Treas. Reg. § 1.672(f)-1(c)(1), the worldwide amount is equal to DT's net income. Accordingly, under Prop. Treas. Reg. § 1.672(f)-1(b)(2), A is not treated as the owner of any portion of DT. Consequently, DT is a separate taxable entity, and distributions from DT to B must be taken into account in computing B's income.

If the worldwide amount and the U.S. amount are the same, then the basic grantor trust rules apply and section 672(f) is not applicable. A simple example (Example 1 in the proposed regulations) would be where the grantor is a U.S. person, in which case all of the income is includible in the hands of a U.S. person under section 679. A more complex example, Example 4, concerns a U.S. corporation that creates an irrevocable foreign trust which cannot benefit any U.S. person and gives its foreign subsidiary the unlimited right to withdraw assets from the trust. This makes the subsidiary the owner of the trust under section 678 without regard to the principles of section 672(f). Section 672(f) does not change the result because the worldwide amount is zero. This is because the owner of the income, whether the beneficiaries of the trust or a person with section 678 powers, are foreign and the income could not be included in the income of any U.S. person.

If a trust that was a grantor trust before the enactment of the new rules becomes a nongrantor trust as of August 20, 1996, the trust is treated as if it were resettled on August 20, 1996. For example, if the trust had accumulated income as of that date, the accumulated income is deemed to be a contribution to a new trust as of August 20, 1996.

f. Trusts Created by Foreign Corporations. The proposed regulations deal with various issues relating to trusts created by foreign corporations.[18]

A controlled foreign corporation (CFC), a passive investment company (PFIC) or foreign personal holding company (FPHC) is treated as the owner of a trust under the grantor trust rules applicable to U.S. grantors, but only to the extent that the application of such rules causes income to be currently taken into account in computing the gross income of a U.S. person.

U.S. shareholders are taxed currently on the undistributed Subpart F income of a CFC and on all undistributed income of a FPHC. U.S. shareholders may elect to be taxed currently on undistributed PFIC income. If this election is not made, PFIC shareholders postpone the recognition of income until distributions are made to them but an interest charge is imposed on tax attributable to income deemed to have accrued in earlier years.

Because the interest charge on excess distributions (distributions in excess of 125% of the average distributions in the three years preceding the year of the distribution) is based on the shareholder's holding period for the stock and income is treated as accruing ratably over a shareholder's holding period, there is no need to attribute income accruing to a trust funded by a PFIC to the PFIC to avoid the interest charge.

The proposed regulations treat a CFC, PFIC or FPHC as the owner of trust assets only to the extent that this requires that the trust's income be taken into account in computing the current year's taxable income of a U.S. person. For example, a CFC owned by a U.S. partnership with only foreign persons as partners will not be treated as the owner of a trust funded by the CFC unless the rules of section 672(f) are satisfied because the income accruing to the CFC will not be taxable to U.S. persons.

In the case of a PFIC whose U.S. shareholders do not elect to be taxed currently on undistributed income, the limitations of section 672(f) will apply to limit the circumstances in which the trust will be treated as owned by the PFIC, with one exception. For purposes of determining whether a foreign corporation is a PFIC, the grantor trust rules are applied as if section 672(f) had not come into effect. This means that, for purposes of determining whether the income and assets of the corporation are of a character that causes the corporation to be classified as a PFIC, the income accruing to a trust established by the PFIC will be taken into account.

One of the examples used in the proposed regulations to illustrate the rules for a CFC, PFIC and FPHC. If a foreign trust funded by a CFC has $200x of Subpart F income and $50x of other income, the CFC is not treated as the owner of the portion of the trust which is attributable to the $50x of non-Subpart F income. The "worldwide amount" is $250x and the "U.S. amount" is $200x. The example also states that if the CFC later becomes the owner of the entire trust, the trust will be deemed to have distributed to the CFC the undistributed trust income from previous years that was not taxed currently to the CFC. The statutory support for this conclusion is not clear.

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18 Prop. Treas. Reg. §1.672(f)-2

g. Exceptions to General Rule. There are a number of exceptions to the general rule of section 672(f). The exceptions are elaborated in the proposed regulations.[19]

(1) Revocable Trust. A trust is exempt from section 672(f)(1) if it is revocable by the grantor alone or with the consent of a "related and subordinate party" as defined in §672(c) who is subservient to the grantor. A related and subordinate party is a "nonadverse party" who is the grantor's mother, father, issue, sibling, employee, a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. A nonadverse party is a person who does not have a sufficient beneficial interest in the trust to be adverse to the exercise of the power of revocation.

Persons within the category of related and subordinate are presumed to be subservient to the grantor unless shown by a preponderance of the evidence to be not subservient. De facto control over the person who holds the consent power is insufficient. For example, if an independent bank has the consent power and the grantor can remove and replace the trustee, the revocation power is insufficient to cause the grantor to be treated as the owner of the trust because the bank is not a related and subordinate person.

The revocation power must be exercisable for a period aggregating 183 days or more during the taxable year of the trust. The proposed regulation cites section 643(a)(7) as authority for this rule. Section 643(a)(7) gives the IRS authority to prevent abusive transactions designed to avoid the rules of Part I of Subchapter J.[20] The proposed regulations do not give guidance as to whether a trust revocable in some years but not other years is a grantor trust in the years it is revocable. For example, if a trust becomes revocable after 5 years, it should be a grantor trust in year 6, but the regulations are not clear.

A trust revocable by the grantor with the consent of his/her spouse is treated as revocable by the grantor without anyone's consent. The consent of the grantor's spouse is disregarded because powers held by a spouse are attributed to the grantor under section 672(e).

A beneficiary who has a withdrawal right is not treated as the de facto grantor. For example, a beneficiary who can withdraw all of the assets of a trust at any time is not defined as the grantor, and thus cannot be treated as the owner of the trust under section 672(f)(2)(A)(i). If the beneficiary actually withdrew trust assets and funded a new trust, the beneficiary would be treated as the grantor-owner if he or she retained the same right to withdraw the assets from the trust.

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19 Prop. Treas. Reg. §1.672(f)-3.

20 IRC §§ 641-683.

(2) Trust for the Benefit of Grantor and Spouse. A trust that benefits only the grantor and his/her spouse during the lifetime of the grantor is exempt from section 672(f)(1).

If any amount is distributable to another person, even temporarily, the trust will not be a grantor trust under this exception. For example, if a trust benefits only the grantor except that distributions may be made to the grantor's child during the period the child attends graduate school, the trust will not be a grantor trust even after the child graduates.

Amounts distributable to discharge a legal or support obligation of the grantor or his/her spouse are treated as distributable to the grantor or his/her spouse. The proposed regulations define legal obligation and support obligation narrowly. It is not clear whether a power to distribute "to or for the benefit of" the grantor or a power to distribute "to or on the order of" the grantor will satisfy these rules.

If the grantor is divorced, the trust will cease to be a grantor trust after the divorce (unless another exception to section 672(f)(1) applies), but it is not necessary that the trust provide *ab initio* that divorce terminates the spouse's interest in the trust.

Nongratuitous distributions, such as trustee fees, can be paid to persons other than the grantor and his/her spouse without jeopardizing the exception for trusts that benefit only the grantor and his/her spouse.

The exception in section 672(f)(2)(A)(ii) also applies to certain business trusts established by a corporation or other business entity. For example, a reinsurance trust established by a corporation will be a grantor trust under this exception if distributions may only be made to satisfy the legal obligations of the corporate grantor arising out of its reinsurance policies.

(3) Limited Grandfathering for Trusts Funded as of September 19, 1995. Section 672(f)(1) does not apply to trusts that are grandfathered. Grandfathered trusts are trusts to the extent funded as of September 19, 1995 that were either:

(a) Treated as owned by the grantor because distributions could be made to the grantor or the grantor's spouse without the consent of an adverse party; or

(b) Treated as owned by the grantor because the trusts were revocable by the grantor without the consent of an adverse party.

Grantor trust status continues as long as the trust otherwise would continue to be so treated under the basic grantor trust rules and only if any portion of the trust that is attributable to transfers to the trust that are made after September 19, 1995, are separately accounted for. Such additions are not grandfathered.

(4) Certain Compensatory Trusts. Compensatory trusts of the types listed in the proposed regulations are exempt from section 672(f)(1); any other compensatory trust is not exempt.

However, a compensatory trust that is not on the list -- such as an IRA -- may be exempt either because distributions are limited to the grantor during his/her lifetime or because the trust is revocable by the grantor. The IRS may issue rulings adding to the categories of exempted compensatory trusts. Compensatory trusts on the list are --

(a) A qualified trust described in section 401(a);

(b) A trust described in section 457(g);

(c) A non-exempt employees' trust described in section 402(b);

(d) A trust that is an IRA described in section 408(k) or 408(p);

(e) A trust that is an IRA the only contributions to which are rollover contributions listed in section 408(a)(1);

(f) A trust that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of Treas. Reg. § 1.83-3(e) (commonly referred to as a "rabbi trust").

h. Recharacterization of purported gifts. Where a U.S. person receives a purported gift or bequest from a partnership (directly or indirectly), the entire amount must be included in the U.S. donee's gross income as ordinary income without regard to the amount of partnership income.[21]

Where a U.S. person receives a purported gift or bequest from a foreign corporation (directly or indirectly), the amount must be included in the U.S. donee's income as if it were a distribution from the foreign corporation. The distribution will be taxed as a dividend or as a redemption, depending upon the circumstances. If the distribution is taxed as a redemption, the donee's basis will be deemed to be zero. The donee's holding period for determining whether any gain is short or long term is equal to the weighted average of the holding periods of the actual shareholders.

There are the following exceptions to the above rules:

(1) If the donee can establish that a U.S. citizen or resident who directly or indirectly holds an interest in the partnership or foreign corporation treated the gift as a distribution to the U.S. partner or shareholder and as a subsequent gift by such partner or shareholder to the U.S. donee, then the gift will not be taxable to the donee. This exception does not apply if a foreign partner or shareholder reported the distribution from the entity, even if the distribution caused the foreign person to incur U.S. tax (e.g., because it was U.S. source income).

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21 Prop. Treas. Reg. § 1.672(f)-4.

(2) The rule does not apply to donees that are charities described in §170(c).

(3) If the partnership or foreign corporation creates and funds a trust and then the trust makes distributions to a U.S. person --

(a) If the trust is a grantor trust, the distribution is deemed made by the grantor (the partnership or foreign corporation); and

(b) If the trust is not a grantor trust, the IRS may either apply these rules to treat the distribution as if it were made directly by the grantor (the partnership or foreign corporation) or, if the tax would be greater, treat the distribution as a trust distribution taxable in accordance with rules governing distributions from trusts.

The IRS may recharacterize a distribution from a partnership or foreign corporation that is subject to these rules as if the amount were a distribution from a trust if the IRS finds that this more clearly reflects income. In effect, the IRS may reclassify a partnership or a foreign corporation as a trust for purposes of determining the tax on recipients of distributions from such entities.

(4) The rules do not apply if during the taxable year of a U.S. donee, the aggregate amount of gifts and bequests received from a partnership or foreign corporation does not exceed $10,000. The amount must include gifts or bequests from persons that the U.S. donee knows or has reason to know are related to the partnership or foreign corporation. It is unclear whether purported gifts from unrelated entities must be aggregated.

The rules taxing purported gifts from partnerships and foreign corporations do not reduce the taxable income of a U.S. partner of the donor partnership or a U.S. shareholder of the foreign donor corporation. Consequently, the income of the entity may be taxed twice -- once to the purported donee and again to the real owners of the entity.

i. Special rules. If a foreign settlor funds a trust which would be a grantor trust and a U.S. person who is a beneficiary made gratuitous transfers to such foreign settlor, the U.S. beneficiary will be treated as the grantor-owner of the trust. The rule applies whether or not the beneficiary was a U.S. beneficiary at the time of the transfer to the foreign settlor. The rule does not apply to the extent the U.S. beneficiary can demonstrate that the transfer by him/her to the foreign person was wholly unrelated to any transaction involving the trust. The definition of "beneficiary" is very broad and includes anyone who could be a beneficiary. Transfers not in excess of the amount not treated as taxable gifts under §2503(b) are disregarded.[22]

A single member entity that elects to be taxed as a sole proprietorship under the check the box regulations will be treated as a corporation for purposes of Prop. Treas. Reg. §1.672(f)-4. This rule gives the IRS latitude to recharacterize purported gifts made by such entities.

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22 Prop. Treas. Reg. §1.672(f)-5.

5. TAX RESIDENCE OF TRUSTS

a. The New Two-Part Test. The classification of a trust as "domestic" or "foreign" can be important for many reasons. A "domestic" nongrantor trust, like a U.S. citizen or resident individual, is generally subject to U.S. Federal income tax on income derived from all sources. A "foreign" nongrantor trust, like a nonresident alien individual, is generally subject to tax only on income derived from U.S. sources. Transfers to "foreign" trusts may trigger the special grantor trust rules under section 679 or the 35 percent excise tax imposed by section 1491. Transfers to and distributions from "foreign" trusts (and certain domestic trusts with substantial activities or substantial property outside the United States) are subject to the special reporting requirements imposed by section 6048.

Prior to the 1996 Act, section 7701(a)(31) defined a "foreign" trust as a trust "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A." In practice, the classification of a trust as "domestic" or "foreign" generally depended upon a subjective analysis of all relevant facts and circumstances to determine whether the trust was more like a resident or nonresident alien individual.[23]

The Act amended sections 7701(a)(30) and (31) to establish a two-part test for determining whether a trust will be classified as "domestic" or "foreign" for U.S. Federal income tax purposes. A trust that satisfies *both* tests is a domestic (or U.S.) trust; a trust that fails one or both tests is a foreign trust. The new rules do not apply to estates, which presumably continue to be governed by the more subjective tests of prior law.

A trust satisfies the first test, referred to by the IRS as the *Court Test*, if "a court within the United States is able to exercise primary supervision over the administration of the trust." A trust satisfies the second test, referred to by the IRS as the *Control Test*, if "one or more United States fiduciaries have the authority to control all substantial decisions of the trust."

Unlike many of the other foreign trust-related provisions in the Act, the new two-part test was generally regarded as an improvement over prior law. Closer inspection, however, soon revealed problems.

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23 *See* Rev. Rul. 60-181, 1960-1 C.B. 257; *B.W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), *aff'd*, 132 F.2d 914 (4th Cir. 1943).

First, the new test threatened to change the classification of many trusts, sometimes with dire consequences. In particular, many trusts that had been treated as domestic trusts under prior law would become foreign trusts under the Act, usually because foreign fiduciaries controlled one or more substantial decisions of the trust. Such an involuntary outbound trust migration could trigger a 35 percent excise tax on any built-in gain in the trust's assets under section 1491, as revised by the Act. Such a migration could also cause a U.S. person who had transferred property to the trust to become taxable as the owner of part or all of the trust assets under the outbound foreign grantor trust rules of section 679, as revised by the Act. While the Act provided that the new trust residency rules would generally apply to taxable years beginning after December 31, 1996, many trusts could not comply with the new criteria to remain domestic before the effective date of the new rules. Fortunately, in Notice 96-65 as described further below, the IRS granted affected trusts additional time to comply with the criteria for remaining a domestic trust.[24]

Second, the new two-part test contained its own ambiguities. Could a "foreign" trust with one or more U.S. fiduciaries be subject to U.S. Federal income taxation as a resident alien? How did one determine which court had "primary supervision" over a trust, particularly an inter vivos trust? What decisions by the trustees were "substantial" decisions? Did U.S. fiduciaries "control" decisions of a trust if a foreign person could veto their decisions? On June 4, 1997, the IRS issued a proposed regulation, Treas. Reg. § 301.7701-7, that would, if adopted, answer some, but not all, of these and other important questions.[25] The IRS chose not to issue the proposed regulation as a temporary regulation, leaving trustees, beneficiaries and grantors with no official guidance beyond Notice 96-65.

b. Section 301.7701-7 of the Proposed Regulations. In its proposed form, Prop. Treas. Reg. § 301.7701-7 clarifies the residence status of a foreign trust for U.S. Federal income tax purposes, defines key terms used in the two-part test, offers a safe harbor for certain trusts to qualify as domestic trusts, and imposes special rules on trusts that contain "automatic migration" clauses. The effective date of the new regulation would be the same as the effective date of the two-part test under the Act (generally applying for taxable years beginning after 1996).[26]

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24 Notice 96-65, 1996-52 I.R.B. 28 (December 23, 1996).

25 Prop. Treas. Reg. § 301.7701-7 (June 5, 1997).

26 Prop. Treas. Reg. § 301.7701-7(f).

The proposed regulation confirms that, except as otherwise provided in sections 641-83, the taxable income of a foreign trust will be computed in the same manner as the taxable income of a *nonresident* alien. Section 7701(b), which defines a *resident* alien, will not apply to a foreign trust. Furthermore, a foreign trust is not considered to be "present" in the United States for purposes of section 871(a)(2), which imposes a 30 percent tax on U.S. source capital gains of nonresident aliens who are present in the United States for 183 days or more during the taxable year.[27]

Under the proposed regulation, once a trust is classified as a foreign trust, the trust is generally treated as a nonresident alien individual for tax purposes even though one or more trust fiduciaries may be U.S. citizens or residents. However, even nonresident alien individuals are subject to U.S. Federal income tax in the same manner as U.S. citizens and residents on taxable income which is effectively connected with the conduct of a trade or business within the United States.[28] The proposed regulation does not address whether the presence of one or more fiduciaries in the United States, or the carrying on of any trust administration activities within the United States, may cause a foreign trust to be considered to be engaged in a U.S. trade or business. Most foreign trusts should be able to take comfort from the fact that trading by a nonresident alien in stocks and securities for the alien's own account is not considered to be a U.S. trade or business.[29] In addition, the IRS recognizes that an "ordinary trust" (as distinguished from a business trust) generally lacks a business purpose.[30]

(1) The Court Test. A trust satisfies the Court Test if "a court within the United States is able to exercise primary supervision over the administration of the trust."[31] The proposed regulation defines the key terms in this test and provides examples of how the test is to be applied.

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27 Prop. Treas. Reg. § 301.7701-7(a)(3).

28 IRC § 871(b).

29 IRC § 864(b)(2)(A)(ii).

30 *See* Treas. Reg. § 301.7701-4.

31 IRC § 7701(a)(30)(E)(i); Prop. Treas. Reg. § 301.7701-7(a)(1)(i).

The term “court” means any Federal, state or local court.[32] The term “United States” refers only to the fifty states and the District of Columbia, and not to territories or possessions of the United States (although the IRS has asked for comments as to whether the term should include territories and possessions).[33] A court “is able to exercise” “primary supervision” over a trust if that court has or would have the authority under applicable law to render orders or judgments resolving *substantially all* issues regarding the administration of the *entire* trust.[34] The “administration” of a trust is the carrying out of duties imposed on a fiduciary by the terms of the trust instrument and applicable law, including maintaining books and records, filing tax returns, defending the trust from suits by creditors, and determining the amount and timing of distributions.[35]

Several situations will be deemed to satisfy the Court Test:

(a) A trust registered by an authorized fiduciary in a court within the United States under a state statute that substantially conforms to Article VII, *Trust Administration*, of the Uniform Probate Code;[36]

(b) A testamentary trust established under a Will probated within the United States (other than by ancillary probate) if all fiduciaries of the trust have been qualified as trustees of the trust by a court within the United States;[37] and

(c) An inter vivos trust if the fiduciaries and/or the beneficiaries take steps with a court within the United States to cause the administration of the trust to be subject to the primary supervision of that court.[38]

The Court Test appears to have been derived from the Restatement (Second) of Conflicts of Laws.[39] According to the Restatement, the determination of which court (or courts) may supervise the administration of a trust depends in the first instance on whether the trust holds an interest in moveable property (section 267) or an interest in land (section 276).

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32 Prop. Treas. Reg. § 301.7701-7(d)(1)(i).

33 Prop. Treas. Reg. § 301.7701-7(d)(1)(ii).

34 Prop. Treas. Reg. § 301.7701-7(d)(1)(iii) and (iv).

35 Prop. Treas. Reg. 301.7701-7(d)(1)(v).

36 Prop. Treas. Reg. § 301.7701-7(d)(2)(i).

37 Prop. Treas. Reg. § 301.7701-7(d)(2)(ii).

38 Prop. Treas. Reg. § 301.7701-7(d)(2)(iii).

39 Restatement (Second) of Conflicts of Laws (1971).

Section 267 of the Restatement provides that the administration of a trust of interests in movables is usually supervised by the court, if any, in which the trustee has qualified as trustee, or by the courts of the state in which the trust is to be administered.[40] Where the trustee has qualified as trustee in a court of the state in which the trust is to be administered, that court has "primary supervision" over the administration of the trust, that is, that court has and will exercise jurisdiction as to all questions which may arise in the administration of the trust.[41] Testamentary trustees are generally required to qualify as trustees in the court of the state that has jurisdiction over the administration of the estate; however, trustees of inter vivos trusts generally do not have to qualify with the courts of any state to become trustee.[42] Where the trustee has not qualified as trustee in any court, and the trust is to be administered in a particular state, the courts of that state will have "primary supervision" over the administration of the trust.[43] A Will or trust instrument may expressly provide that the trust will be administered in a particular state. In the absence of such a provision, it may be reasonable to infer that the testator or settlor intended for the trust to be administered at the place of the trustee's domicile or place of business.[44]

Section 276 of the Restatement provides that the administration of a trust of an interest in land is supervised by the courts of the situs as long as the land remains subject to the trust.[45] An example in the proposed regulation illustrates this rule in a simple case: A trust satisfies the Court Test where its only asset is an interest in land located in a state within the United States, and the laws of that state provide that a trust owning solely real property in that state is subject to the primary supervision of the courts of that state.[46]

Although the Restatement provides some help, it does not provide an answer in all situations. It may be difficult to determine which court, if any, has primary supervision where there are multiple trustees from several jurisdictions, or where the trustee of a trust of moveables has qualified in the courts of one state but will administer the trust in another state, or where the trust owns moveables subject to administration in one jurisdiction and land located in another jurisdiction, or where the trust owns land in several jurisdictions. The proposed regulation does at least provide a tie-breaker rule: If both a United States court and a foreign court are able to exercise primary jurisdiction over the administration of a trust, that trust will satisfy the Court Test.[47] Where no court is able to

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40 *Id*. at § 267.

41 *Id*. at § 267 cmt. e.

42 Id. at § 267 cmt. b.

43 *Id*. at § 267 cmt. e.

44 *Id*. at § 267 cmt. c.

45 *Id*. at § 276.

46 Prop. Treas. Reg. § 301.7701-7(d)(3), Example 2.

47 Prop. Treas. Reg. § 301.7701-7(d)(2)(iv).

exercise primary jurisdiction over a trust, the proposed regulation is silent, but it may be safely assumed that such a trust fails the Court Test.

One factor that does not appear to be relevant in determining whether a trust satisfies the Court Test is the governing law of the trust. Here the IRS appears to have reconsidered its original position. According to the general explanation prepared by the U.S. Treasury Department in connection with President Clinton's February 1995 foreign trust proposals, the Court Test would normally be satisfied if the trust instrument were governed by the laws of a U.S. state or the District of Columbia. Not only does the proposed regulation fail to incorporate this statement, it includes an example in which a trust with a U.S. settlor, trustee and beneficiaries, and which is governed by U.S. law, fails the Court Test because the trust is to be administered in a foreign country, the laws of that country authorize the courts of that country to exercise primary supervision over the trust (while applying U.S. law), and no U.S. court is able to exercise primary supervision.[48] While a test based on the governing law of a trust may have provided a brighter line than the Court Test does, it would not have served the IRS's purpose in treating as domestic trusts only those trusts with a substantial connection to the United States.

(2) The Control Test. A trust satisfies the Control Test if "one or more United States fiduciaries have the authority to control all substantial decisions of the trust."[49] Again, the proposed regulation defines key terms in this test and provides examples of how the test is to be applied.

The term "fiduciary" includes any person described as a fiduciary in section 7701(a)(6) and Treas. Reg. § 301.7701-6(b).[50] This includes a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person (other than an agent). The term "fiduciary" also includes any person who has the power to control one or more substantial decisions of the trust. This would treat most so-called trust "protectors" as fiduciaries of the trust for this purpose. A "United States fiduciary" is a fiduciary that is a "United States person" within the meaning of section 7701(a)(30).

One of the most helpful provisions in the proposed regulation provides a partial list of what decisions are "substantial" decisions:

(a) Whether and when to distribute income and corpus;

(b) The amount of any distributions;

(c) The selection of a beneficiary;

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48 Prop. Treas. Reg. § 301.7701-7(d)(3), Example 1.

49 IRC § 7701(a)(30)(E)(ii); Prop. Treas. Reg. § 301.7701-7(a)(1)(ii).

50 Prop. Treas. Reg. § 301.7701-7(e)(1)(i).

(d) The power to make investment decisions;

(e) Whether a receipt is allocable to income or principal;

(f) Whether to terminate the trust;

(g) Whether to compromise, arbitrate or abandon claims of the trust;

(h) Whether to sue on behalf of the trust or to defend suits against the trust;

(i) Whether to remove, add or replace a trustee.[51]

"Ministerial" decisions, on the other hand, include bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries.[52]

The term "control" means having the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto substantial decisions.[53]

A grantor who retains, in his or her individual capacity, the power to veto substantial decisions made by another person, is not considered to "control" " substantial decisions" made by that other person.[54] Likewise, a beneficiary who has, in his or her individual capacity, the power to veto substantial decisions made by another person that affect solely the beneficiary's interest in the trust, does not control substantial decisions made by the other person.[55] As a result, grantors and beneficiaries acting in their individual capacities will generally not be "fiduciaries" for purposes of the proposed regulation.[56]

Where an inadvertent change in fiduciaries also changes the tax residence of the trust, such as where a sole U.S. trustee dies or resigns abruptly and the trust instrument names a foreign person as successor trustee, the trust will have six months to adjust the fiduciaries or their residence in order to avoid a change in tax residence for the trust.[57]

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51 Prop. Treas. Reg. § 301.7701-7(e)(1)(ii)(A).

52 Prop. Treas. Reg. § 301.7701-7(e)(1)(ii)(B).

53 Prop. Treas. Reg. § 301.7701-7(e)(1)(iii).

54 Prop. Treas. Reg. § 301.7701-7(e)(ii)(B) and (e)(iii).

55 *Id*.

564. Prop. Treas. Reg. § 301.7701-7(e)(4), Examples 1, 2 and 7.

57 Prop. Treas. Reg. 301.7701-7(e)(2); see also Prop. Treas. Reg. § 301.7701-7(e)(4), Example 6.

(3) Safe Harbor for Certain Domestic Trusts. Although the new test for classifying domestic and foreign trusts has been hailed as an "objective" test, it can be difficult to apply in many common situations. This is particularly true of the Court Test. The proposed regulation attempts to address this situation by offering a safe harbor for certain trusts to qualify as domestic trusts. Under the safe harbor provision, a trust will be a domestic trust if the trust has only United States fiduciaries, the trust is administered exclusively in the United States pursuant to the terms of the trust instrument, and the trust is not subject to an automatic migration provision (as discussed below).[58] The IRS explanation to the safe harbor provision (but not the provision itself) refers to the principle that "when the administration of a trust is conducted entirely within a particular locality, the local courts will exercise primary jurisdiction over the trust," citing Section 267 of the Restatement (Second) of Conflicts of Laws.

(4) Special Rules for Trusts with Automatic Migration Clauses. The IRS has targeted a special rule at trusts that qualify as domestic trusts under the general two-part test but are subject to "automatic migration" or "flee" clauses that will cause the trust to become a foreign trust in certain situations. Many so-called "asset protection" trusts are organized in this fashion, in part to avoid the reporting rules applicable to foreign trusts for so long as the trust remains a domestic trust.

A trust will automatically fail the Court Test if the trust instrument provides that an attempt by a U.S. court to assert jurisdiction or otherwise supervise the administration of the trust will cause the trust to migrate from the United States.[59] A trust will automatically fail the Control Test if the trust instrument provides that an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States fiduciaries.[60]

c. Temporary Grandfathering of Pre-August 21, 1996 Domestic Trusts. As noted earlier, Notice 96-65 permits a domestic trust that was in existence on August 20, 1996 and complies with the Notice to continue filing tax returns as a domestic trust for taxable years beginning after 1996. For a trust to qualify for relief under the Notice, the trustees must:

(a) Initiate modification of the trust to conform to the domestic trust criteria by the due date (including extensions) for filing the trust's income tax return for its first taxable year beginning after 1996;

(b) Complete the modification within two years of that date (the "two-year period"); and

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586. Prop. Treas. Reg. § 301-7701-7(c)(1).

59 Prop. Treas. Reg. § 301.7701-7(d)(2)(v).

60 Prop. Treas. Reg. § 301.7701-7(e)(3).

(c) Attach a statement to the trust's income tax return for each year the trust relies on the Notice that must contain, among other information, a description of the actions taken and to be taken to modify the trust.

For purposes of the Notice, a "modification" is any judicial or nonjudicial action to reform, amend, modify or alter the trust that is effective under local law. If a trust is modified to satisfy the domestic trust criteria by the end of the two-year period, it will be considered to have remained a domestic trust for U.S. Federal tax purposes. If a trust fails to meet the conditions specified in the Notice, it will be considered to have become a foreign trust for all taxable years beginning after 1996. If such a failure triggers the section 1491 excise tax, the trustees must report the transfer and pay the tax no later than thirty days after the end of the two-year period, to avoid the penalty for not reporting a section 1491 transfer under section 1494(c).

d. Recommendations for Revision. One may wonder whether anything useful has been gained by scrapping the old facts and circumstances test in favor of the new two-part test. In the short run, the new test has generated concern and uncertainty, particularly among U.S. corporate trustees that have had to re-evaluate the status of thousands of existing trusts. Notice 96-65 and Prop. Treas. Reg. § 301.7701-7 only address part of the problem. There will be further problems going forward, such as in applying the Court Test to inter vivos trusts, and in dealing fairly with potential changes in the tax status of a trust following a change in the identity or residence of trust fiduciaries.

Nevertheless, the IRS could take a large step toward addressing these problems by revising Treas. Reg. § 301.7701-7 as follows:

(1) There should be a broader safe harbor provision (and different safe harbor provisions) to enable a trust to qualify as a domestic trust. For example, why not permit a trust that satisfies the Court Test or the Control Test, but not both, to elect to be treated as a domestic trust? This would prevent the migration of U.S. testamentary trusts when and if U.S. fiduciaries did not control all substantial decisions. It would also enable an inter vivos trust with U.S. fiduciaries to qualify as a U.S. trust even though the trust was administered in whole or in part in a foreign country. (This may require a legislative amendment, but the key terms in the Court Test and Control Test are sufficiently vague to permit the IRS to reach this result by regulation.)

(2) There should be one or more safe harbor provisions to enable a trust to qualify as a foreign trust. Of course, one way to do this is to allow a foreign fiduciary to control at least one substantial decision of the trust. But a settlor may have valid reasons for allowing U.S. persons to control all substantial decisions. Why not provide that a trust will fail the Court Test if substantially all "ministerial" administration activities are performed by a foreign fiduciary in a foreign country?

(3) The proposed regulation contains some special rules which need to be clarified. For example, a trust subject to an automatic migration provision to flee the United States for a foreign

country is not a domestic trust.[61] Does this mean that a trust subject to an automatic migration provision to flee a foreign country for the United States is a domestic trust? Presumably not, but this should be made clear because many existing trusts are subject to such provisions.

61 Prop. Treas. Reg. § 301.7701-7(d)(2)(v) and (e)(3).

Another example is the statement in the proposed regulation that, for purposes of the Control Test, "a fiduciary which is a United States corporation owned by a nonresident alien is a United States fiduciary."[62] It would be helpful if the proposed regulation confirmed that the nonresident alien owner is *not* a "fiduciary" for this purpose, even though he or she may have voting control over the United States fiduciary. The proposed regulation should also confirm that the reverse also applies, namely, that a fiduciary which is a foreign corporation owned by a U.S. person *is* a foreign fiduciary, and the U.S. owner *is not* a fiduciary, for purposes of the Control Test. Without such a rule, every trust for which all substantial decisions were controlled by a foreign trust company subsidiary of a U.S. bank or trust company would fail the Control Test.

The same question may be asked of an investment manager with discretion to make investment decisions for a trust account. Under the proposed regulation, such a manager would appear to be a "fiduciary" who "controls" a substantial decision of the trust. If so, any domestic trust which opened a discretionary investment account with a foreign investment advisor would become a foreign trust.

(4) The proposed regulation should clarify whether the list of "substantial" decisions may be relied on as such in all cases, or whether the decision must be substantial in the context of that particular trust. For example, there is no need to distinguish "income" from "principal" in some trusts (such trusts are sometimes called "one-pot" trusts). Would the power of a foreign fiduciary to control the decision of whether a receipt is allocable to income or principal in such a case be considered a "substantial" decision? What if the timing of a distribution to a beneficiary or the termination of the trust were fixed by the trust instrument or by U.S. fiduciaries to occur within a thirty-day period, but a foreign fiduciary could control the decision as to what day during the thirty-day period the distribution or termination would actually occur?

The proposed regulation should clarify whether a person who holds the power to remove, add or replace a trustee is thereby also considered to "control" all substantial decisions that may be made by the trustees subject to that person's power. For example, many existing foreign trusts have a U.S. "protector," who only has the power to remove and appoint foreign trustees. In some foreign jurisdictions, such a "protector" may be subject to certain fiduciary obligations. The proposed regulation should provide that such a person will not be considered to "control" any substantial decisions of the trust that may be made by the trustees subject to that person's power, so long as that person may not appoint himself or herself (or any related or subordinate person within the meaning of IRC section 672(c)) as trustee, and there is no evidence that the trustees have acted at such person's direction and control. This would be consistent with existing case law and the IRS's current position in the corresponding domestic context.[63]

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62 Prop. Treas. Reg. § 301.7701-7(e)(1)(i).

63 *See Estate of Vak v. Commissioner*, 973 F.2d 1409, 92-2 U.S.T.C. ¶60,110 (8th Cir. 1992); *Estate of Wall v. Commissioner*, 101 T.C. 300 (1993); Rev. Rul. 95-58, 1995-2 C.B. 191 (revoking Rev. Rul. 79-353, 1979-2 C.B. 325).

6. REPORTING AND PENALTIES

The Act imposed new information reporting requirements (and penalties for nonreporting) on U.S. persons who establish a foreign trust, transfer property to a foreign trust, or receive a distribution from a foreign trust and the recently-issued Notice provides guidance in this area. The information reporting rules apply to reportable events occurring after August 20, 1996.

In Notice 97-34,[64] the IRS provided preliminary guidance on the new foreign trust and foreign gift reporting provisions added by the Act. The IRS expects to issue regulations incorporating the guidance provided in the Notice. Until such regulations are issued, however, taxpayers must comply with the rules set forth in the Notice. Earlier, in Notice 97-18, the IRS had provided preliminary guidance relating to transfers to foreign trusts covered section 1491. This part of the article covers reporting and related requirements under the two notices.

a. Reporting Transfers to Foreign Trusts. As revised by the Act, section 6048(a) generally requires any U.S. person who establishes a foreign trust, or who transfers property to a foreign trust, to notify the IRS within 90 days of the "reportable event." The notice must describe the property transferred to the trust and identify the trustees and beneficiaries of the trust. The executor of the estate of a U.S. decedent must provide a similar notice if a transfer was made to a foreign trust as a result of the decedent's death, or if the decedent had been treated as the owner of any portion of the property of a foreign trust under the grantor trust rules, or if any portion of such property was included in the decedent's gross estate for U.S. Federal estate tax purposes. These reporting requirements do not apply to certain sales at fair market value or to transfers made to certain foreign deferred compensation or charitable trusts. However, these reporting requirements will apply to a U.S. person who is treated as the owner of the assets of a pre-immigration trust under the Act.

The Notice clarifies that section 6048(a) generally requires that a U.S. person report any "gratuitous transfer" to a foreign trust on Form 3520.[65] A "gratuitous transfer" includes (i) any transfer that is structured with a principal purpose of avoiding the application of sections 679 or 6048 and (ii) any transfer other than (A) a transfer for fair market value or (B) certain corporate or partnership distributions. A transfer for fair market value includes only transfers in consideration for (i) property received from the trust, (ii) services rendered by the trust, or (iii) the right to use property from the trust. Further, a transfer is for fair market value only to the extent that the value of such consideration received is equal to the fair market value of the property transferred. The determination of whether a transfer by a U.S. person is for fair market value does not take into account (i) the receipt by the U.S. person of any interest in the trust, (ii) the recognition by the U.S. person of gain on the transaction, or (iii) whether the transfer is a gift for gift tax purposes.

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64 1997-25 I.R.B. 22.

65 Notice 97-34, Section III. B.

In addition to the reporting of gratuitous transfers by U.S. persons to foreign trusts, section 6048(a) also requires that U.S. persons report certain nongratuitous transfers to foreign trusts unless such transfers are in exchange for "qualified obligations". The definition and treatment of qualified obligations is described in greater detail above. Although the rules treating the issuance to a U.S. person by related foreign trust apply to obligations issued on or after February 6, 1997, the penalty contained in revised section 6677 will only apply to the failure to report transfers in exchange for obligations issued after August 20, 1996.[66]

b. Section 1494 Reporting. Certain transfers of property by U.S. persons to foreign trusts may be described in section 1491 as well as section 6048(a). Under section 1491, a U.S. person who transfers property to a foreign trust generally is subject to a 35 percent excise tax on any unrecognized gain in the transferred property. Section 1494 generally requires the reporting of transfers to foreign trusts described in section 1491.

A Section 1491 transfer is generally reportable on Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust, or Foreign Partnership, on the day the transfer is made. Under new Section 1494(c), as added by the Act, failure to file the return can result in a penalty equal to 35 percent of the gross reportable amount. However, in Notice 96-60,[67] the IRS announced that no Section 1491(c) penalty would be imposed if a section 1491 transfer was reported no later than 60 days after the issuance of additional guidance.

Recognizing that section 1491 applies to a broad range of transactions, the IRS announced in Notice 97-18[68] that it intends to amend the existing Treasury Regulations to narrow the scope of the transfers subject to reporting on Form 926 and to provide for annual reporting. Until that time, a Section 1491 transfer is only reportable on Form 926 if reporting is required under the Notice.

Under Notice 97-18, a U.S. transferor will not be required to report a Section 1491 transfer on Form 926 if:

(a) The U.S. transferor immediately recognizes gain (if any) on the transfer equal to the difference between the fair market value of the property transferred and the U.S. transferor's tax basis in that property; and

(b) The U.S. transferor does not have a "significant interest" in the transferee immediately after the transfer. A U.S. transferor is treated as having a "significant interest" in a foreign transferee if the two are related persons under Section 643(i)(2)(B), with certain modifications.

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66 Notice 97-34, *supra*, III. C last sentence.

67 1996-49 I.R.B. 7 (December 2, 1996)

68 1997-10 I.R.B. 35 (March 10, 1997)

In addition, a U.S. transferor is not required to report a Section 1491 transfer on Form 926 if the transfer is adequately reported on another form, such as (a) Form 5471, Information Return of U.S. Persons with Respect to Certain Foreign Corporations (filed under Section 6038); (b) Form 5472, Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (filed under Section 6038A); or (c) the forthcoming revised version of Form 3520 for transfers to a foreign trust (filed under Section 6048).

When Form 926 must be filed, the Notice permits it to be filed with the U.S. transferor's annual tax or information return, rather than on the day of the transfer. However, if any tax is due under Section 1491, interest will be owed on the amount of the tax liability from the date of the transfer until the date the tax is paid. No interest is due if the tax is paid on the transfer date.

The Notice is effective for Section 1491 transfers occurring after August 20, 1996. However, the Notice provides that no penalty will be imposed under Section 1494(c) if the appropriate form is filed by (a) the due date for the U.S. transferor's income tax return (including extensions) for the taxable year of the transfer, or, if later, (b) the date which is sixty days after the date of the Notice (that is, by May 9, 1997).

Notice 97-18 provides that, until further guidance is issued, a U.S. corporation or partnership is not required to report any distribution made by it on Form 926 even if the distribution constitutes a Section 1491 transfer. In addition, the Notice provides that a transfer to a foreign organization that has made a Section 761(a) election not to be treated as a partnership for U.S. Federal tax purposes will not constitute a Section 1491 transfer.

In the case of such transfers to foreign trusts, the IRS provided in Notice 97-18 that the satisfaction of the section 6048(a) reporting obligations would fulfill the section 1494 reporting obligations if the U.S. transferor does not owe excise tax under section 1491.

However, under Notice 97-34, notwithstanding the general rule that nongratuitous transfers to foreign trusts are not reportable, nongratuitous transfers must be reported on Form 3520 if (i) the U.S. transferor does not immediately recognize all of the gain on the transfer (or recognizes gain solely by reason of a section 1057 election), or (ii) the U.S. transferor is related to the trust. A transferor is related to the trust if the transferor is the grantor of the trust, a beneficiary of the trust, or a person related to a grantor or beneficiary. If a transfer is gratuitous in part and nongratuitous in part, the gratuitous portion of the transfer must be reported under section 6048 and the nongratuitous portion must be reported under section 1494.[69]

69 Notice 97-34, Section III. D.

c. **Other Reporting Issues.**

(1) Deferred Compensation and Charitable Trusts. The Act did not require reporting for transfers to certain foreign deferred compensation and charitable trusts.[70] The Notice clarifies that to qualify for such exemption, a charitable trust must have a determination letter from the IRS (that has not been revoked) recognizing its tax-exempt status. Furthermore, the Notice states that, based on the Secretary's authority under section 6048(d)(4) to suspend reporting requirements as necessary, reporting is not required on transfers to Canadian Registered Retirement Savings Plans ("RRSPs") if the trust would qualify for treaty benefits at the time of transfer under the U.S.-Canada tax treaty; however, a U.S. person relying on the U.S.-Canada tax treaty to avoid reporting requirements must disclose this position under the treaty-based return position rules.[71] If a transfer to a foreign trust is exempt from reporting under the deferred compensation trust, charitable trust or RRSP exception, then, according to the Notice, any transfer to such a trust is also exempt from reporting under section 1494 and no penalties under sections 6677 or 1494(c) will apply for a failure to report any transfer to such a trust.

(2) Domestic Trusts with Foreign Property. The Act gives the IRS authority to provide in regulations that the Section 6048 reporting requirements (and the penalties for nonreporting) will also apply to U.S. persons who establish, transfer property to, or receive a distribution from a *U.S.* trust, if the U.S. trust has substantial activities, or holds substantial property, outside the United States.[72] However, the Notice states that the IRS and Treasury are studying the appropriate scope of section 6048(d)(2) and that, until further guidance is issued, domestic trusts will not be treated as foreign trust pursuant to that section.

(3) U.S. Owners of Foreign Trusts. For taxable years beginning in or after 1996, the U.S. grantor/owner of an outbound foreign grantor trust "shall be responsible to ensure" that the foreign trust (a) files a return with the IRS which sets forth a full and complete accounting of all trust activities and operations for the year, the name of the U.S. agent for such trust (if any) and other relevant information as the IRS may prescribe, and (b) furnishes such information as the IRS may prescribe to the U.S. grantor/owner and to each U.S. beneficiary who received (directly or indirectly) a distribution from the trust in that year.[73] Although the Act contemplates that the foreign trust will file the return directly with the IRS, the responsibility for "ensuring" that the return is filed is placed on the U.S. grantor/owner, and not on the foreign trustee. Furthermore, as explained below, in the event that an outbound foreign grantor trust does not file such a return, the penalty for nonreporting is imposed on the U.S. grantor/owner, not on the foreign trust.

70 IRC § 6048(a)(3)(B)(ii).

71 IRC § 6114.

72 IRC § 6048(d)(2)

73 IRC § 6048(b)

A foreign trust may appoint a U.S. agent to respond to any requests by the IRS for further information regarding the trust. While the appointment of a U.S. agent is not required, if an agent is not appointed the IRS will have broad discretion to determine the amount of taxable income derived by the U.S. grantor from the trust. According to the "Blue Book" prepared by the staff of the Joint Committee on Taxation, Congress intended that the IRS's exercise of this authority will be subject to judicial review under an "arbitrary and capricious" standard, which provides a high degree of deference to the IRS.[74] A foreign trust which appoints such an agent will not be considered to have an office or permanent establishment in the United States, or to be engaged in a U.S. trade or business, solely because of the activities of the agent under section 6048.

The Notice indicates that the IRS plans to revise Form 3520-A to allow that form to be used by foreign trusts to satisfy their annual information reporting requirements. Until the revised Form 3520-A is available, the U.S. owner must ensure that a trustee who is authorized to sign Form 3520-A files the form and takes a number of actions (see box). Except as provided under the transition rules described below, Form 3520-A must be filed and the required statements furnished to the U.S. grantors and U.S. beneficiaries by the fifteenth day of the third month after the end of the trust's taxable year (or later, if pursuant to an extension of time to file).

What the foreign trustee of a foreign grantor trust must do:

(1) file the revised Form 3520-A
(2) write "FOREIGN GRANTOR TRUST" at the top of the form
(3) complete the identifying information on the form as if the foreign trust were the U.S. owner required to file the form
(4) sign the form
(5) attach a Foreign Grantor Trust Information Statement (see Appendix A) to the form
(6) send a Foreign Grantor Trust Owner Statement (see part 4 of the Foreign Grantor Trust Information Statement) to each U.S. owner of a portion of the trust, and
(7) send a copy of a Foreign Grantor Trust Beneficiary Statement (see part 5 of the Foreign Grantor Trust Information Statement) to each U.S. beneficiary who received a distribution from the trust during the taxable year.

A U.S. owner of a foreign trust should ensure that the foreign trust appoints a U.S. person to act as the trust's limited agent with respect to a request by the Secretary to examine records or produce testimony related to the proper treatment of amount required to be taken into account under certain of the information reporting rules. If such an agent is not appointed, the Secretary may determine the amounts required to be taken into account by the U.S. owner. The Notice specifically provides that in order to authorize a U.S. person to act as agent for the trust, (i) a binding agreement must be entered by the agent and trust (the form and terms are described in Appendix A), (ii) the name, address and TIN of the U.S. agent must be identified on Form 3520-A and (iii) the U.S. agent and the trust must comply with its obligations under the binding agreement.

74 *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 276.

(4) U.S. Beneficiaries of Foreign Trusts. Beginning with distributions received after August 20, 1996, the Act requires a U.S. person who receives during any taxable year, directly or indirectly, any distribution from a foreign grantor or nongrantor trust to report to the IRS information regarding the name of the trust, the amount of distributions received from the trust, and such other information as the IRS may require.[75] Prior to the Act, only distributions from nongrantor trusts had to be reported.

If adequate records are not provided (by the beneficiary or some other person) to enable the IRS to determine the proper tax treatment of any distribution received from a foreign trust, then the distribution will be treated as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax. For purposes of determining the interest charge on the throwback tax, the deemed accumulation period will be one-half of the years the trust has been in existence. To the extent provided in regulations, this rule will not apply if the foreign trust has appointed a U.S. agent for the purpose of responding to IRS inquiries. The legislative history to the Act and the Blue Book are silent regarding the appropriate standard of judicial review for IRS determinations in this area, suggesting that the IRS may have a greater burden of proof than when it determines the taxable income of a U.S. settlor of an outbound foreign grantor trust.

The Notice specifies that reporting by a U.S. beneficiary of the actual or constructive receipt of distributions from a foreign trust must be reported on Form 3520. Further, the Notice clarifies that, except as otherwise provided, a distribution includes any gratuitous transfer of money or property from a foreign trust, including the receipt of (i) trust corpus and (ii) a gift or bequest. The Notice provides several examples of distributions received by U.S. beneficiaries that must be reported under this provision.

(a) Exceptions. Beneficiaries need not report (i) distributions from trusts taxable as compensation for services rendered that are reported as such on the recipient's federal income tax return, or (ii) distributions from foreign trusts received by U.S. charitable organizations, provided that such organization has a determination letter from the IRS (that has not been revoked) recognizing its tax-exempt status

75 IRC § 6048(c).

(b) Beneficiary Statements. The Notice provides various means for a U.S. beneficiary to avoid treatment of a distribution as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax. A U.S. beneficiary will not be required to treat the entire distribution as an accumulation distribution if, with respect to the distribution, the beneficiary obtains from the foreign trust either (i) a Foreign Grantor Trust Beneficiary Statement (see part 5 of the Foreign Grantor Trust Information Statement in Appendix A), to be attached to Form 3520, which would allow the beneficiary to treat the distribution as a nontaxable gift, (ii) a Foreign Nongrantor Trust Beneficiary Statement (see Appendix _) to be attached to Form 3520, or (iii) certain information, to be described on revised Form 3520, regarding actual distributions from the trust for the prior three years ("default treatment"). Under the default treatment, a U.S. beneficiary will be allowed to treat a portion of the distribution as current income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution subject to the throwback tax.

d. Reporting of Foreign Gifts. The Act imposes information reporting requirements on any U.S. person (other than certain tax-exempt organizations) who after August 20, 1996 receives, in the aggregate, foreign gifts in excess of $10,000 in any taxable year.[76] This $10,000 threshold will be indexed for inflation after 1996.

A U.S. person who fails to report such foreign gifts will be subject to penalties equal to five percent of each gift for each month of noncompliance (not to exceed 25 percent of the aggregate foreign gifts). The IRS is also authorized to determine the tax consequences of any unreported gift based on the information available to it. The Conference Report to the Act states that the IRS's exercise of this authority will be subject to review under an "arbitrary and capricious" standard. These sanctions will not apply if the failure to file was due to reasonable cause and not due to willful neglect.

The Notice provides that reporting will be required on an annual basis on the new unified Form 3520. It is expected that Form 3520 (i) will only require general information necessary to determine whether a purported gift is properly classified as a gift or income (e.g., a brief description of the property received and whether the foreign donor is an individual, corporation, partnership or estate) and (ii) will not require information on the identity of the foreign donor unless the foreign donor is (A) a partnership, (B) a foreign corporation or (C) a nominee or intermediary acting for such an entity. Upon request, the U.S. donee may be required to provide additional information including the identity of the donor.

(1) Exceptions. Qualified tuition and medical payments are not taxable gifts under section 2503(e) and will not have to be reported. Distributions made from a foreign trust to a U.S. beneficiary, and which are reported by the U.S. beneficiary under section 6048(c), do not have to be reported again by the U.S. beneficiary under section 6039F.

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76 IRC § 6039F

(2) Interaction of Sections 6039F and 6048. U.S. beneficiaries who receive distributions from foreign trusts should report the amounts under the trust reporting rules section 6048(c) rather than the gift reporting rules section 6039F. This is true even if the trust is grantor trust and the distribution is treated as a gift under principles of substantive law.

Similarly, U.S. beneficiaries need not comply with section 6039F reporting with respect to contributions by foreign persons to trusts in which the U.S. beneficiaries have an interest, unless the U.S. beneficiaries are treated as receiving the contribution in the year of transfer. A domestic trust that receives a contribution from a foreign person must comply with section 6039F reporting if the trust is not treated as owned by another person. A domestic trust that receives a contribution from a foreign person need not comply with section 6039F reporting if the trust is treated as owned by a foreign person; however, a U.S. beneficiary receiving a distribution from such a trust must report it under section 6039F.

(3) Reporting Thresholds. The Notice states that it is expected that Form 3520 will apply different reporting thresholds, as described below, for gifts received from (i) foreign individuals and foreign estates and (ii) foreign partnerships and foreign corporations. The annual reporting threshold for the aggregate amount of gifts from a foreign individual or foreign estate is $100,000 with respect to that individual or estate. Once the $100,000 threshold is met, Form 3520 will require the U.S. donee to separately identify each gift in excess of $5,000; however, the U.S. donee will not be required to identify the donor.

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of gifts from such entities exceeds $10,000 (as adjusted for the cost of living under section 6039F(d)) in the taxable year. Once the $10,000 threshold is met, Form 3520 will require the U.S. donee to separately report all gifts from such entities, including the identity of the donor entity.

In calculating the threshold amounts with respect to a particular foreign person, a U.S. donee must aggregate gifts from foreign persons that he or she knows, or should know, are related (under section 643(i)(2)(B)). If the relevant reporting threshold is exceeded, Form 3520 will require that the donee (i) separately report each aggregated gift in excess of $5,000 from a foreign individual or foreign estate without identifying the donor, and (ii) separately report each aggregated purported gift from a foreign corporation or foreign partnership, including the identity of the donor.

e. Unified Reporting Forms. The IRS is revising Form 3520 ("Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") to allow U.S. persons generally to use a single form to comply with all the new foreign trust and foreign gift reporting requirements. In addition, the IRS is revising Form 3520-A to allow foreign trusts to use that form to comply with the section 6048(b) reporting requirements under section 6048(b).

Generally, to avoid the penalties for nonreporting under sections 1494(c), 6039F, or 6677, taxpayers must file Form 3520 as an attachment to their income tax return by the due date (including extensions) of the return with a copy of Form 3520 sent to the Philadelphia Service Center by the same date. Foreign trusts will be required to file Form 3520-A with the Philadelphia Service Center by the fifteenth day of the third month following the end of the trust's taxable year (or later, if pursuant to an extension of time to file).

f. Penalties for Nonreporting. The Act amends the penalty provisions of section 6677 to provide that:

(1) 35% funding penalty. A U.S. grantor or transferor who fails to report the creation or funding of a foreign trust under section 6048(a) will be subject to a penalty equal to 35 percent of the gross value of the property transferred.

(2) Five percent annual report penalty. A U.S. grantor/owner who fails to ensure that a foreign trust complies with its annual information reporting requirements to the IRS under section 6048(b) will be subject to a penalty each year equal to five percent of the gross year-end value of the trust assets treated as owned by the U.S. grantor under the grantor trust rules.

(3) 35% distribution penalty. A U.S. beneficiary who fails to report distributions from a foreign trust under section 6048(c) will be subject to a penalty equal to 35 percent of the amount distributed.

In each case, additional penalties can be imposed for continuing noncompliance; however, the total penalties may not exceed the reportable amount. Under section 6677(e), the IRS is authorized to assess and collect these penalties without prior judicial review.

Under section 6677(d), the IRS is permitted to waive any penalty if the failure to file was due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on any person for disclosing the required information will not be considered a reasonable cause for failure to file.

These penalties generally apply to reportable events occurring or distributions received after August 20, 1996. However, the penalties on a U.S. grantor who fails to ensure that a foreign trust files its annual reports will apply to taxable years of U.S. grantors beginning after December 31, 1995. The Notice clarifies that the section 6677 penalties apply only to the portion of the transaction that is not reported or is reported inaccurately.

The Notice clarifies the "reasonable cause" standard for failure to file under section 6677(d). In particular, reasonable cause does not include refusal on the part of a foreign trustee to provide information. This is true whatever the reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of information.

If penalties for nonreporting could apply under both (i) sections 6677 and 1494(c) or (ii) sections 6677 and 6039F, then in each case, the section 6677 penalty will be assessed and will reduce any penalty otherwise imposed under either section 1494(c) or 6039F.

g. Transition Rules. For the taxable year that includes August 20, 1996 (the "transition year"), a taxpayer may avoid penalties for nonreporting by filing Form 3520 either (i) on or before November 15, 1997 with the Philadelphia Service Center, or (ii) by the due date (including extensions) for the taxpayer's income tax return for the first taxable year beginning on or after January 1, 1997, but only if the taxpayer's return for the transition year reflects the information contained in the Form 3520.

Similarly, for the transition year, a U.S. owner of a foreign trust may avoid penalties for nonreporting by filing Form 3520-A either (i) on or before October 15, 1997, or (ii) by the due date (including extensions) for the Form 3520-A for the first taxable year beginning on or after January 1, 1997, but only if the U.S. owner reflects the information contained in Form 3520-A on the owner's income tax return for the transition year.

Appendix A - Foreign Grantor Trust Information Statement

The Foreign Grantor Trust Information Statement should be submitted in substantially the following format:

FOREIGN GRANTOR TRUST INFORMATION STATEMENT

1. Foreign Trust Background Information
   - A. Name, address and employer identification number ("EIN") of trust
   - B. Name, address and taxpayer identification number ("TIN") of the U.S. agent (if any)
   - C. Name, address and TIN (if any) of the trustee who signed Form 3520-A
   - D. Method of accounting used by the trust (cash or accrual)
   - E. The taxable year of the foreign trust to which the statement applies

2. Foreign Trust Balance Sheet. The foreign trust balance sheet should contain both beginning and end of year balances. Amounts may be aggregated within each category listed below and should be stated at their approximate fair market value. A good faith estimate of fair market value is satisfactory.
   - A. Assets
     1. Cash
     2. Accounts receivable
     3. Inventory
     4. Government obligation
     5. Other marketable securities
     6. Other non-marketable securities
     7. Depreciable (depletable) assets
     8. Real property
     9. Other assets (attach summary schedule)
     10. Total assets

   - B. Liabilities
     1. Accounts payable
     2. Contributions, gifts, grants, etc. payable
     3. Mortgages and notes payable
     4. Other liabilities (attach summary schedule)
     5. Total liabilities

   - C. Retained Earnings
     1. Contributions
     2. Accumulated trust income
     3. Other (state nature)
     4. Total net worth

3. Foreign Trust Income Statement. Use U.S. tax principles to determine the trust's income.
   - A. Income

1. Interest
2. Dividends
3. Rents, royalties, distributive share of partnership income, etc.
4. Capital gains
    a. Net short-term capital gain
    b. Net long-term capital gain
5. Other (state nature)
6. Total income

B. Deductions
1. Interest
2. Foreign taxes
3. State and local taxes
4. Trustee and advisor fees
5. Amortization and depreciation
6. Other (state nature)
7. Total deductions

C. Net Income or loss (A.6. less B.7.)

D. Distributions to beneficiaries (separately state for each U.S. beneficiary)

E. Tax credits (attach summary schedule)

4. The Foreign Grantor Trust Owner Statement

A. Foreign Trust Background Information
1. Name, address and EIN of trust
2. Name, address and TIN of U.S. agent (if any)
3. Name, address and TIN (if any) of the trustee who signed Form 3520-A
4. Method of accounting used by the trust (cash or accrual)
5. The taxable year of the foreign trust to which the statement applies
6. Name, address and TIN of the U.S. owner
7. A good faith estimate of the U.S. owner's gross reportable amount (the fair market value of the trust's assets treated as owned by the U.S. person)

B. Statement of Net Income Attributable to the Owner. Use U.S. tax principles to determine the owner's income.
1. Income attributable to the owner
    a. Interest
    b. Dividends
    c. Rents, royalties, distributive share of partnership income, etc.
    d. Capital gains
        1. Net short-term capital gain
        2. Net long-term capital gain

e. Other (state nature)
f. Total income

2. Deductions attributable to the owner
   a. Interest
   b. Foreign taxes
   c. State and local taxes
   d. Trustee and advisor fees
   e. Amortization and depreciation
   f. Other (state nature)
   g. Total deductions
3. Net Income or loss attributable to the owner (B.1.f. less B.2.g.)
4. Tax credits attributable to the owner (attach summary schedule)
5. The Foreign Grantor Trust Beneficiary Statement
   A. Foreign Trust Background Information
      1. Name, address and EIN of trust
      2. Name, address and TIN of U.S. agent (if any)
      3. Name, address and TIN (if any) of the trustee who signed Form 3520-A
      4. The taxable year of the foreign trust to which the statement applies
   B. U.S. Beneficiary Information
      1. Name, address and TIN of U.S. Beneficiary
      2. A description of the property (including cash) distributed or treated as distributed to the U.S. person during the taxable year, and the fair market value of the property distributed.
   C. Owner Information.
      1. An explanation of the facts and law (including the section of the Internal Revenue Code) that establishes that the foreign trust (or the portion of the foreign trust from which the beneficiary received a distribution) is treated for U.S. tax purposes as owned by another person.
      2. A statement identifying whether the owner of the foreign trust (or the portion of the foreign trust from which the beneficiary received a distribution) is an individual, trust, corporation or partnership, and whether that person is a U.S. or foreign person. If the owner is a U.S. person, a foreign partnership, a foreign corporation, or a foreign trust, attach the name, address and TIN (if any) of the owner.

Appendix B - Foreign Nongrantor Trust Beneficiary Statement

A Foreign Nongrantor Trust Beneficiary Statement must contain the following information and be set forth in substantially the following format:

FOREIGN NONGRANTOR TRUST BENEFICIARY STATEMENT

1. Foreign Trust Background Information

A. Name, address and employer identification number ("EIN") of the trust

B. Name, address and taxpayer identification number ("TIN") (if any) of the trustee furnishing this statement

C. Method of accounting used by the trust (cash or accrual)

D. The taxable year of the foreign trust to which the statement applies

E. A statement identifying whether any grantor of the trust was a partnership or foreign corporation. If so, attach an explanation of the relevant facts.

2. U.S. Beneficiary Information

A. Name, address and TIN of U.S. Beneficiary

B. A description of the property (including cash) distributed or deemed distributed to the U.S. person during the taxable year, and the fair market value of the property distributed.

3. Sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes. Normally, information similar to the information required by Schedule K-1 of Form 1041 would be adequate for this purpose. If relevant, the trust must also provide the beneficiary with adequate information for the beneficiary to complete Forms 4970, 5471, and 8621.

4. Representation on Access to Books and Records

A. A statement that, upon request, the trust will permit either the Service or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and such other documents that are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes; or

B. The name, address and EIN of the trust's U.S. agent.

Regarding the procedures for the foreign trust to appoint a U.S. agent, see Part 5(c)(3) of this article.