REPORT #916

TAX SECTION

New York State Bar Association

Report on Proposed Regulations on Treatment of Payments Made to U.S. Persons Directly or Indirectly from a Trust of Which a Foreignor is a Grantor

Table of Contents

TAX SECTION

New York State Bar Association

December 4, 1997

Honorable Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Room 3120
Washington, D.C. 20220

Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Dear Secretary Lubick and Commissioner Rossotti:

I am pleased to enclose a report prepared by the Committee on Estates and Trusts of the Tax Section of the New York State Bar Association commenting on the Proposed Regulations under Sections 643(h), 671, and 672(f) (the “Proposed Regulations”). The Proposed Regulations implement the new sections of the Internal Revenue Code of 1986, as amended (the “Code”), enacted by the Small Business Job Protection Act of 1996, concerning inbound grantor trusts, and, in addition, provide, for the first time, a regulatory definition of the term “grantor.”

The complexity of the new sections of the Code that deal with inbound grantor trusts and the importance of such trusts in personal planning as well as commercial transactions makes the need for these regulations compelling. The Proposed Regulations address a great many difficult issues in a rational and constructive way. Nevertheless, we have several serious concerns as to certain of the conclusions reached in the Proposed Regulations and urge that these conclusions be revised in the final regulations.

Our principal comments are as follows:

1. The Proposed Regulations implementing the rule dealing with distributions by foreign trusts through nominees should be narrowed. In their present form, they could reach virtually any transfer made to a United States person by any person who has received a distribution from a foreign trust. We do not believe this was intended by Congress and we propose alternative rules which we believe are more consistent with that intent. These issues are discussed on pages 3 through 9 of our report.

2. The report suggests that the Proposed Regulations defining the term “grantor,” particularly those portions that permit a shifting of grantor status from the original grantor to another person, should be changed to permit a shift of such status in connection with all transfers of trust interests in commercial trusts, as is now permitted for investment trusts but not other commercial trusts, such as liquidating trusts, and to prevent a shift of such status from the original grantor to his or her trust when, the trust makes distributions to other trusts. These issues are discussed on pages 9 through 12 of our report.

3. The report suggests that the Proposed Regulations implementing new Code § 672(f), the provision that denies grantor trust status to certain trusts with foreign grantors, should be changed to eliminate the proposed rule that would protect trusts from Code § 672(f) when the application of the grantor trust rules would not result in any person taking income, gain, deduction or loss into account. This issue is discussed on pages 13 through 15 of our report.

4. The Proposed Regulations interpret those provisions of Section 672(f) which exclude from its scope certain trusts, e.g. those created by foreign corporations and those which are revocable. We believe these exceptions have been interpreted too narrowly. The issues are discussed on pages 16 through 22 of our report.

5. The Proposed Regulations treat all transfers (other than transfers for fair market value) from United States and foreign partnerships and from foreign corporations to United States persons who are not partners or shareholders as income to those persons unless a United States partner or shareholder treats the transfer as a distribution to him or her and as a gift by him or her to the transferee. We believe that there is no authority for this proposed rule and that it is unjustifiably broad. We urge mat it be limited. This issue is discussed on pages 22 through 25 of our report.

Please let us know if we can be of further assistance in finalizing the proposed regulations.

Very truly yours,

Richard O. Loengard, Jr.
Chair

cc: Joseph H. Guttentag
Deputy Assistant Secretary
International Tax Affairs
Department of the Treasury
Interstate Commerce Commission Building
1201 Constitution Ave., N.W.
Washington, D.C. 20224

Philip R. West
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue
Room 4206
Washington, D.C. 20220

Michael Danilack
Associate Chief Counsel (International)
Internal Revenue Service
CC:INTL - Room 4552
1111 Constitution Avenue
Washington, D.C. 20224

Barbara A. Felker
Branch Chief
Internal Revenue Service
(CC:INTL:BR3)
950 L'Enfant Plaza South, S.W.
Washington, D.C. 20024

M. Grace Fleeman (7 copies)
Attorney Advisor
Internal Revenue Service
(CC:INTL:BR3)
950 L'Enfant Plaza South, S.W.
Washington, D.C. 20024

Comments of the Section of Taxation of the New York State Bar Association on New Proposed Regulations under Sections 643(h), 671 and 672(f) of the Internal Revenue Code[1]

On June 5, 1997, Treasury published Proposed Regulations §§ 1.643(h) and 1.672(f), implementing the new sections of the Internal Revenue Code of 1986, as amended (the "Code"), enacted by the Small Business Job Protection Act of 1996 (the "Act") concerning inbound grantor trusts with foreign grantors. Treasury also published Proposed Regulations § 1.671-2(e), of broader application. The Tax Section of the New York State Bar Association offers the following comments:

I. The Payment Through Nominee Rule - Proposed Regulation § 1.643(h)-1.

A. The Statute - Code S 643(h)

Since 1962 die Code has contained a rule intended to prevent the use of intermediaries as a means of circumventing the general rules which tax United States persons on distributions from foreign trusts created by United States persons. Former Code § 665(c) provided as follows:

> "(c) SPECIAL RULE APPLICABLE TO DISTRIBUTIONS BY CERTAIN FOREIGN TRUSTS. - For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person

[1] This report was drafted principally by Henry Christensen m, Robert C. Lawrence m, who was assisted by Edmund, W. Granski, Jr., Richard O. Loengard, Jr., and Carlyn S. McCaffrey. Helpful comments were received from Kimberly S. Blanchard, Harvey P. Dale, Sanford H. Goldberg, Sherwin Kamin, Stephen B. Land, David S. Miller, Jeffrey A. Robins, and Leslie J. Schreyer.

shall be deemed hi the year of payment to have been directly paid by the foreign trust.”

The language of former Code § 665(c) was broader than needed to accomplish the statutory objective. The Treasury, however, perhaps in recognition of the unnecessary breadth of the provisions, brought it within reasonable boundaries by regulation. Treasury Regulation § 1.665(c)- 1 A(b) provided that the section would not apply

> “if die distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 ... was enacted.”

New Code § 643(h) extends the scope of the old rule (1) to amounts derived from trusts created by non-United States persons (other than amounts received from the grantor of certain foreign trusts that would have been so-called “grantor trusts” prior to the Act) and (2) to payments received from United States persons.

It provides as follows:

> (h) DISTRIBUTIONS BY CERTAIN FOREIGN TRUSTS THROUGH NOMINEES. - For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payer is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person.

The expansion of the rule to trusts created by non-United States persons was presumably necessary to prevent what would otherwise have been a means of circumventing certain other provisions of the Act which enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts which are not taxed as grantor trusts under Code § 679 or otherwise.[2]

The reason for extending the rule to payments received from United States persons seems to us less urgent. Foreign trust payments channeled through United States persons would, in the absence of new Code § 643(h), already have been exposed to United States taxation, and in the case of accumulation distributions, to the Act's additional costs imposed on the receipt of such distributions.

B. The Proposed Regulations

The proposed regulations follow an approach opposite to the one reflected in the regulations promulgated under former Code § 665(c). No reason for that change can be discerned from the statutory change. Instead of protecting distributions that were not intended to circumvent United States taxation of foreign trust income, Proposed Regulation § 1.643(h)-1(a) provides two specific sets of circumstances in which the rule applies regardless of intent. It then provides that the rule will also apply to any other instance in which the intermediary who received property from the foreign trust received it "pursuant to a plan, one of the principal purposes of which was the avoidance of U.S. tax."

> The two circumstances in which Code § 643(h) will apply, regardless of intention, are:

---

[2] See Section 668.

> "(1) The intermediary is related (within the meaning of paragraph (e) of this section)[3] to either the United States person or the foreign trust and the intermediary transfers to the United States person either property that the intermediary received from the foreign trust or proceeds from the property received from the foreign trust;
>
> (2) The intermediary would not have transferred the property to the United States person (or would not have transferred the property to the United States person on substantially the same terms) but for the fact that the intermediary received property from the foreign trust;"

In addition, the proposed regulations create a set of income timing rules that depend for their application on general concepts of agency law but give the district director the right to determine, "based on all the relevant facts and circumstances, that the intermediary should be treated as the agent of the United States person."

Finally, Proposed Regulation § 1.643(h)-1(b) limits the statutory exception for payments made by the grantor of a foreign trust to payments made by such grantor to the extent such payments were derived from the portion of the trust as to which he or she is the grantor.

C. Substantive Comments

1. Comments on the Scope of the Proposed Regulations

We are concerned that Proposed Regulation §1.643(h)-1 will impose tax in more situations than intended by Code § 643(h). We understand that Treasury was concerned about

---

[3] The proposed regulations expand the concept of "related" beyond the normal rules of Section 643(i)(2)(B) by generally substituting a 10% entity interest rule for the normal 50% rule and by extending the relationship rules that apply between trusts and beneficiaries to estates and beneficiaries. The latter extension is no longer necessary since Section 1308(a) of the Taxpayer Relief Act of 1997 accomplishes this by an amendment to Section 267, one of the sections on which Section 643(i)(2)(b) is based.

transactions in which an intermediary is used to transfer property from a foreign trust to a United States person to avoid the United States federal income tax which would apply if the United States person were to receive income directly from a foreign trust, including the imposition of an interest charge on the tax on any accumulation distribution under the provisions of Code § 668.

Yet the proposed regulations pull the net of Code § 643(h) over far more transactions than necessary. The net will reach ordinary intra-family transfers that are made for family purposes without any thought of avoiding United States income taxes.

The scope of Example 1 illustrates our concerns. In this example, I, a nonresident alien, receives a distribution of stock from FT, a foreign trust, sells the stock the year after the distribution and gives the sale proceeds to his daughter. I is not the grantor of the trust. In the first place, we see no reason why the grantor's relationship to I and B and his intent should be completely irrelevant since if I is acting as an intermediary, it is presumably as an intermediary between the grantor and B. To disregard the grantor's role in this fashion seems to distort the purpose and language of the statute. Under the facts stated in the example, neither I nor B is said to be related to the grantor of FT, and there is no reason to believe the grantor in fact intended B to be the beneficiary of FT. Second, this Example seems to introduce a tracing rule which makes it totally irrelevant what other assets I may own, when the asset was received by him from the trust, or what I's motives were for making the gift. Thus, the example vastly expands the scope of the provision beyond what seems to have been intended by

Congress without support in either the statutory language or the legislative history.

Example 4 of the proposed regulations, also illustrates our concerns. In this example, W, a nonresident alien who is a beneficiary of a foreign trust, FT, created by her husband H, makes a gift to her United States resident son S. The gift is made from income she received from her own investments rather than from funds she received from FT. The example concludes that the gift to S should be treated as a gift rather than a distribution from a trust apparently because it was traceable to W's investment income. The example raises an alarming vision of the tax nightmare into which a United States person would be plunged if his mother makes a Christmas gift to him using funds she received from a foreign trust rather than her other assets.[4]

There is nothing in the legislative history to suggest that Congress intended such an enormous change in established principles as to whom trust distributions should be taxed. Indeed, the caption of Code § 643(h) suggests that the Congressional focus in enacting this provision was on the use of “nominees” to accomplish this tax avoidance purpose. There is nothing in the statute suggesting that Congress intended its reach to include gifts freely made to United States persons who are related to the intermediary choosing to make a gift from foreign trust income.

We suggest that the basic approach of the proposed regulations be changed. Instead of specifying situations in which Code § 643(h) will automatically apply and then backstopping it

---

[4] Fortunately, Proposed Regulation § 1.643(h)-1(d) creates a de minimis exception that applies if the aggregate amount of distributions received by a United States person in any one year from foreign trusts through intermediaries is $10,000 or less.

with a broad catch-all clause focusing on the existence of a plan to avoid United States tax, we propose that the proposed regulations follow the approach taken by the regulations promulgated under former Code § 665(c).

The basic requirement for the application of the section should be the existence of an intention to avoid United States tax. Unless, based on the surrounding facts and circumstances, it is concluded that the trust was formed or availed of as a device to transfer money to the ultimate recipient without payment of United States income tax, the intermediary should not be disregarded. If, based on the surrounding facts and circumstances, it can be determined that the intermediary was availed of by the donor or the trustee in order to transfer funds to the ultimate recipient without paying United States tax, generally the intermediary should be treated as the agent or extension of the trustee, and no distribution should be taxed to the ultimate United States recipient until he or she actually receives it. The distribution would then be subject to the accumulation distribution rules.

After stating the basic requirement, the proposed regulations should describe the types of facts and circumstances that would generally justify a conclusion that the basic requirement for the imposition of Code § 643(h) had not been satisfied, or, in the alternative, had been satisfied. The following factors might each be taken as evidence that the transfers to an intermediary were not part of a tax avoidance plan:

a. The United States Person Is Not a Beneficiary of the Foreign Trust

Trustees are subject to laws which restrict their ability to make distributions of income and/or principal to persons other man those who are beneficiaries of the trust for which they are trustees. We do not believe that Code § 643(h) should apply when a foreign trust distributes property to an intermediary who redistributes, as a gift or otherwise, all or part of such property to a United States person who would not have been eligible to receive a direct distribution from the trust.

It is unlikely that a payment from a person who has received a distribution from a foreign trust to a person who is not a beneficiary of that trust could be part of a plan to avoid United States taxes on trust distributions to that person. Indeed, under the law of most jurisdictions, it would likely be a breach of trust for a trustee to make a distribution to a trust beneficiary in order to facilitate that beneficiary's gift to a person who is not a beneficiary. If it could be shown, based on the facts and circumstances, that hi fact it was the intention of the donor that distributions would be made ultimately to a United States person who was not a beneficiary of the trust through those who are the listed beneficiaries of the trust, we believe that this distribution could be taxed under Code § 643(h).

b. The Intermediary Is an Ancestor of the United States Person

Gifts made by a parent or grandparent to a child or grandchild are more likely to be part of the normal gifting arrangements mat typically occur within families rather than part of a plan to avoid United States tax even if the parent or grandparent had received property from a foreign trust.

c. The Intermediary Paid Tax in Significant Amounts on the Trust Distributions

If the amount of tax the intermediary was required to pay to any taxing jurisdiction on the distribution from the foreign trust is substantial, particularly if it is substantial in relation to the tax the United States person would be required to pay if Code § 643(h) applied, it is unlikely that the payments were motivated by an intent to avoid United States tax.

d. The Intermediary Was a Natural Object of the Grantor's Bounty

A trust arrangement for the benefit of any natural object of the grantor's bounty is not likely to be formed or availed of as a device to transfer money to another person, even if that other person is also related to the grantor.

e. The Amount Transferred by the Intermediary to the United States Person Substantially Exceeds the Amount He or She Received From the Trust

Normally a person should not be regarded as an intermediary with respect to a distribution from a trust if the amount he or she transfers to a United States person substantially exceeds the amount he or she received from the foreign trust. The fact that his or her transfer exceeds the amount of the distribution suggests that he or she likely had a donative purpose of his or her own.

f. <u>A Substantial Period of Time Elapsed Between the Distribution From the Foreign Trust to the Intermediary and the Intermediary's Payment to the United States Person</u>

The lapse of a substantial period of time, more than one year, for example, between the date foreign trust property is distributed to the intermediary and the date he or she makes a transfer to a United States person, suggests that the subsequent transfer was the intermediary's own, independent act rather than the final step in a plan to avoid United States tax on a distribution to a United States beneficiary. A plan to put funds in the hands of the United States person would be unlikely to permit the trust funds to remain unrestricted in the hands of an intermediary for any extended period of time since, during that time, the trust funds would be exposed to investment risk, would be subject to the claims of her creditors, and, in the event of the intermediary's death, to the claims of his or her heirs.

If the basic approach outlined above is rejected, we urge that the scope of Proposed Regulation § 1.643(h)-1(a)(1) and (2) be narrowed. Subparagraph (1) creates a substantial trap for those who are not familiar with the rules set forth in the proposed regulations and an unreasonable administrative burden on those who are familiar with the rules and who intend to avoid them. It traps those who happen to use assets received from foreign trusts (or the proceeds from those assets) to make gifts to United States persons. And, for all persons who receive distributions from foreign trusts and who believe they may at some future time make gifts to United States persons, it imposes the burden of keeping property received from foreign trusts separate from other assets. At a minimum, as suggested above, a time limitation should be imposed on the application of this rule so that it does not apply to transfers of property received more than one year before the transfers.

As to subparagraph (2), we believe there should not be an irrefutable rule that imposes Code § 643(h) simply because a distribution from a foreign trust made it possible for the intermediary to make a gift to a foreign person. For example, we do not believe the rule should apply to testamentary transfers, either (i) made to an intermediary in trust upon the death of the donor, or (ii) made by the intermediary upon his or her death with property received by the decedent from a foreign trust. Few plans to avoid taxation require the death of a principal for their success.

If Treasury decides to retain the “but for” test in subparagraph (2), we suggest it be modified to exclude the parenthetical language. The “but for” test is actually two tests. Code § 643(h) will apply if either test is satisfied.

The first test is the one that would be established without the parenthetical language. This test is satisfied if it can be established that the intermediary would not have made the transfer if he or she had not received property from a foreign trust. Thus, if A receives 100X from a foreign trust, if A then” makes a 100X gift to B, and if it can be shown that A would not have given B 100X if he or she had not received 100X from the trust, the “but for” test would be satisfied. Conversely, if A had planned to give B 100X prior to his or her receipt of the 100X from the trust (and presumably without knowledge that he or she was going to receive the distribution) the test would not have been satisfied.

The use of this test requires an inquiry into the state of mind of an individual, generally a difficult task. But, this first test, at least, confines itself to one aspect of the transaction, whether the transfer would have been made at all.

The second test is satisfied even if the intermediary would have made the transfer without regard to the trust distribution. It is sufficient that he or she would not have made the transfer on the same terms. For example, if A would have given B 100X over a two year period but is willing to give him or her this entire sum immediately, the second test seems to be satisfied.

We believe that the second test calls for an extraordinarily imprecise and subjective test and recommend that the parenthetical be deleted from subparagraph (2) of Proposed Regulation §1.643(h)-(1)(a).

2. Comments on Proposed Timing of Imposition of Tax

Proposed Regulation § 1.643(h)-1(c) imposes United States federal income taxation upon the United States person with different results depending on whether the intermediary is deemed to be the agent of the foreign trust or the United States person. If the intermediary is deemed to be the agent of the foreign trust, United States federal income tax would be imposed only when the United States person actually receives the funds from the intermediary. On the other hand, if the intermediary is treated as the agent of the United States person, United States federal income tax would be imposed when the intermediary receives the funds.

Assume, for example, that A receives an income distribution in year one from a foreign trust and makes a gift to B in year two that is deemed to have been paid to B from the foreign trust. The distribution would be taxable to B in year one if A were treated as the agent of the United States person but taxable in year two if A were treated as the agent of the foreign trust.

We understand and agree with the principles of agency law stated. If A is clearly the agent of B, B should be deemed to have received the funds when A receives them from the trust. Indeed, this result would be reached independently of Code § 643(c).

It should be recognized, however that the use of "generally applicable agency principles," while appearing to be a simple test, will be difficult to apply in virtually every case involving a foreign trust. Often, the foreign trust will be settled and administered in accordance with the laws of one country, X, the intermediary will be a resident of another country, Y, and the ultimate beneficiary will be a citizen or resident of the United States. In such case, a determination will need to be made whether the laws of Country X or Y pertain to the relationship between the trust and the intermediary, and a separate determination will need to be made to determine whether the laws of country Y or the United States will apply to the relationship between the intermediary and the United States person. While the application of conflicts of law principles will provide guidance to resolve these issues, there will be uncertainty and expense.

The uncertainty caused by the normal application of agency principles is exacerbated by

Proposed Regulation § 1.643(h)-1(c)(2)(ii), which gives the District Director the power to determine, "based on all of the relevant facts and circumstances, that the intermediary should be treated as the agent of the United States person." No guidance is given as to the kinds of facts and circumstances, apart from the existence of an actual agency, that would justify such a determination.

We believe that whatever tax payment timing advantage might inure to the Government by application of the agency rule does not justify the complexity that would be caused by the necessity of first determining whether an actual agency exists and, if it does not, then determining whether the existing facts and circumstances justify the application of the agency rule. We suggest that the United States person should be taxed prior to receipt only if the intermediary is clearly a nominee or agent for such person.

3. Comments on Examples

Example 1. If the suggestions above are accepted, Example 1 under Proposed Regulation § 1.643(h)1(f) should be changed to read as follows:

Example 1. I, a nonresident alien who is not the grantor of FT, receives a distribution of stock from FT in 2001. In the year 2002,1 sells the stock to an unrelated party for its fair market value of 100X and gives 100X to her sister B, who is a U.S. resident. B will not be deemed to have received a distribution from FT unless the distribution was made to I subject to an agreement or understanding that she would make the subsequent transfer to B, or at die request of B.

Example 2. This example attempts to clarify the "but for" condition set forth in the proposed regulations. In the example FT, in 2001, makes a 500X deposit in I, a foreign bank which is unrelated to the trust or to its beneficiaries. In 2002, I transfers 400X to B, a United States person. The example states that I would not have made the transfer to B but for the fact that I had received 500X from FT. The example concludes that B will be deemed to have received 400X from FT in 2002.

This is not a useful example because it does not explain why I, the foreign bank, transferred 400X to B. Normally, I would be nothing more than a conduit in these transactions. When a deposit was made in I, it was either made to an account in the name of FT, or an account in the name of B. The bank could not have been an intermediary; it merely held the funds subject to instructions received originally from FT, if the account was FT's account, or B, if the account was B's account. If the account was FT's account, the transfer by I to B would have been made pursuant to FT's instructions and, in every sense of the word, would be treated as a direct transfer from FT to B. If the account was B's account, FT's transfer to the account would have been the transfer to B.

This example could be made useful by using M, the mother of B, who is a beneficiary of FT, in place of I. As discussed above, we do not believe that a transfer by a mother to a child should be treated as a transfer from a foreign trust to the child, but if that result is intended, Example 2 should make it clear.

Suggested Additional Example. Proposed Regulation § 1.643(h)-1(a)(1) includes situations in which the intermediary transfers to the United States person either property that the intermediary received from the foreign trust or “proceeds from the property that the intermediary received from the foreign trust.” If this test is retained, the proposed regulations should include an example which provides guidance as to the definition of the term “proceeds.”

For example, it is possible that a distribution of property valued at 100X could be made by a foreign trust to a person who qualifies as an intermediary related to the foreign trust or the United States person. The intermediary might at some time thereafter transfer the property to a third party hi an arm's length transaction for 150X in cash. Should the subsequent gift of 150X in cash to the United States person by the intermediary be deemed a transfer from the foreign trust of 100X or 150X? Other than in abusive situations under Proposed Regulation § 1.643(h)-1(a)(3), we believe that the term “proceeds” should not include amounts distributed by the intermediary to the United States person in excess of the amount distributed by the foreign trust to the intermediary. Similarly, a foreign person who qualifies as an intermediary related to a foreign trust might receive a distribution of 100X and invest the funds, thereafter earning income of 10X upon the distribution. If in a subsequent year, the intermediary distributes 110X as a gift to a United States person, should the 10X be treated as “proceeds” taxable to the United States person under Code § 643(h), or only the 100X originally received?

These problems are further evidence of the need to limit the intermediary concept to transactions taking place, within a short period of time, and to situations involving a clear “intermediary,” as opposed to an agent of the trustee. Thus, if the trustee of a foreign trust makes a deposit in a bank account in the name of the trust, or to a subtrust or a company owned by the trust, we would not utilize Code § 643(h) at all. We would say that no distribution has taken place until the assets are no longer under the control of the trustee. “Proceeds” would not be an important concept hi this case.

D. Technical Comments

We have the following comments of a technical nature:

1. Code § 643(h) applies to “any amount paid to a United States person which is derived directly or indirectly from a foreign trust.” The focus of the proposed regulations, therefore, should be on explaining the concept of direct or indirect derivation. Instead, the rules set forth in the proposed regulations appear to assume the existence of a direct or indirect derivation and then operate as a limitation on the operation of Code § 643(h). We assume this was not intended.

2. The proposed regulation does not differentiate between gratuitous and nongratuitous transfers from the intermediary. A literal application of the proposed regulations, therefore, would result hi a United States person who sells property to another person being treated as having received a distribution from a foreign trust if the other person used funds she received from a foreign trust to pay the purchase price. We assume this was not intended.

To resolve these two problems, and if our basic suggestion is not adopted, we suggest that the first paragraph of Proposed Regulation § 1.643(h)-1(a) be changed to read as follows:

> "(a) In general. For purposes of sections 641 through 683, any amount of cash or other property that is transferred to a United States person, except to the extent the transfer is a nongratuitous transfer (within the meaning of § 1.671-2(e)(4)(ii)), shall be deemed to have been derived directly or indirectly from a foreign trust if any one of the three following conditions is satisfied with respect to the person from whom the United States person received the cash or other property (the intermediary) - "

3. Code § 643(h), unlike its statutory predecessor, applies to amounts paid to a United States person by another United States person. As discussed above, it is difficult to discern the rationale for this departure from the normal rules used to determine the identity of recipients of trust distributions. In the absence of this rule, the United States payer would have already paid the appropriate United States income tax on the receipt of the distribution from the foreign trust.

In any event, we assume that it was not the intention of Congress to impose a double United States income tax on a single distribution from a foreign trust - first on the actual United States recipient of the distribution and second on the United States person who is deemed under Code § 643(h) as having received the distribution.

The statutory language, which states that the payment to the deemed recipient is "deemed . . . to have been directly paid by the foreign trust to such United States person," supports this conclusion. If the payment was directly made by the foreign trust to such United States person, it could not also have been made, for United States income tax purposes, to the actual recipient.

To avoid confusion as to this issue, we suggest that the following paragraph be added to the proposed regulations:

> "(_) Treatment of Intermediary. If an amount paid to a United States f person by an intermediary is treated, pursuant to this section, as paid directly by a foreign trust to a United States person, such amount shall be excluded from the gross income of the intermediary for all purposes of Subtitle A."
>
> Such a provision is consistent with Proposed Regulation § 1.672(f)-4(b)(1).

4. Subparagraph (b) of Proposed Regulation § 1.643(h)-(1) provides an exception to the tests in subparagraph (a) of Proposed Regulation § 1.643(h)-(1) when the intermediary is the grantor "of the portion of the trust from which the amount is derived." In order to apply paragraph (b), further guidance is required. Are the principles of Treas. Reg. § 1.671-3 to be used in determining the "portion" of which the intermediary is the deemed grantor?

II. Definition of "Grantor" - Proposed Regulation § 1.671-2(e).

A. The Statute

Subpart E of Subchapter J, which has been part of the Code since 1954, depends for its operation on an understanding of the meaning of the term "grantor." Despite the critical role played by the term, the Code fails to define it.

B. The Proposed Regulations

Proposed Regulation § 1.671-2(e) provides the first regulatory definition of the term "grantor." The definition is intended to apply not only for purposes of foreign trusts, but for purposes of all of the grantor trust provisions of subpart E of Subchapter J of the Code.

The new definition defines “grantor” as

> “any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(4)(i) of this section) of property to a trust.” And
>
> “a person who acquires an interest in a trust from a grantor of the trust if either (i) The transfer is nongratuitous (within the meaning of paragraph (e)(4)(ii) of this section); or (ii) The transfer is of an interest in a fixed investment trust.”

A gratuitous transfer is defined as “any transfer other man a transfer for fair market value, or a corporate or partnership distribution,” whether or not the transfer is a gift for gift tax purposes. A transfer to a trust from a corporation or partnership will be treated as a corporate or partnership distribution (and therefore, not as a gratuitous transfer) only if, in the case of a distribution from a corporation, it is a distribution described in Code §§ 301, 302, 305, 355, or 356, and, in the case of a distribution from a partnership, only if it is described in Code § 731.

C. Substantive Comments

We have a number of problems with the new definition.

1. Creator of Trust Treated as Grantor

We note first mat Proposed Regulation § 1.671-2(e)(1) includes within the definition of “grantor” any person who either creates a trust or directly or indirectly makes a gratuitous transfer of property to a trust. We have historically advised our clients that a grantor for United States federal tax purposes includes any person who makes a gratuitous transfer of property to a trust, but not a person who serves as the nominal creator of the trust. We see no reason why the nominal creator should be treated as a "grantor" for tax definitional purposes. The Proposed Regulations threaten to cause further confusion because generally the operative concept under subpart E is "owner," not "grantor," and under Regulations § 1.671-2(a), a "grantor" is taxed only upon the income, deductions and credits of the portion of the trust of which he or she is treated as the "owner" under Code §§ 673 through 678. A nominal creator cannot be treated as an owner, and we urge that he or she should not be treated as a grantor.

If a creator who has made no transfer to a trust is treated as a grantor, we ask that the final regulations describe the portion of the trust with respect to which he or she will be treated as the grantor. If the portion is zero, and we assume that it is, we ask that the final regulations tell us the tax significance of treating such a creator as the grantor.

2. Treatment of Joint Owners

The proposed regulations fail to provide guidance as to the identification of the grantor in the case where property contributed to the trust is contributed by joint owners or a married couple. It is unclear whether the tracing rules similar to the provisions of Code § 2040(a) apply or whether, similar to the provisions of Code § 2040(b) in the case of United States citizen spouses, each spouse will be deemed the grantor as to an equal portion of the property. Similarly, the proposed regulations fail to provide guidance in the situation where the property contributed by the grantor is community property in which his or her spouse has an ownership interest. Is the non-contributing spouse who has an ownership interest in the property deemed to be a grantor with respect to his or her interest in the property?

3. Transferees of Trust Interests

We question why all purchasers for fair market value of interests in trusts from the grantors of trusts should be treated, under Proposed Regulation § 1.671-2(e)(2)(i), as the on-going grantor for purposes of these rules. For example, if the grantor of a grantor trust, shortly before his or her death, sells his or her interest in the grantor trust to one family member, such that the purchasing family member will continue to be treated as the "owner" of a trust which is otherwise for the benefit of a different family member, should the grantor trust rules apply? With respect to ordinary,[5] personal trusts, we would limit the transfer of grantor status to a transferee in a nongratuitous transfer to cases where the original grantor was in fact a nominee, who purportedly created and funded the trust and then "sold" his or her interest in the trust to the true grantor.

On the other hand, the ability to transfer grantor status as a component of a transfer of an interest in a trust is critically important if the trust is a commercial vehicle such as a fixed investment trust or a liquidating trust, rather than an ordinary trust. If grantor status could not be so transferred, whenever the owner of an interest in such a trust transferred his or her trust interest, the trustees would be required to treat his or her interest as a separate trust, taxable under the normal rules of Subchapter J rather than under the grantor trust rules.

---

[5] By "ordinary trust" we mean the type of trust referred to in Treasury Regulation §301.7701-4(a) i.e., "an arrangement created either by a will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."

Proposed Regulations § 1.672(e)(2)(i) and (ii) permit the transfer of grantor status in connection with any nongratuitous transfer but, in the case of gratuitous transfers, only if the transferred trust interest is an interest in a fixed investment trust. We urge that this rule be extended to all transfers of interests in trusts that are not ordinary trusts. We see no statutory or policy basis for distinguishing between fixed investment trusts and other types of commercial trusts, such as liquidating trusts. More important, the denial of grantor status to gratuitous transferees will create a significant administrative burden for the trustees of these types of trusts.

4. Treatment of Corporate and Partnership Distributions

We are troubled by the concept in Proposed Regulation § 1.671-2(e)(4)(i) that corporate or partnership distributions are considered gratuitous transfers unless, as provided in subparagraph (6) of Proposed Regulations § 1.671-2(e)(4)(i), the distribution is described in a particular Code section. We suggest that this is a dangerous methodology because applicable sections of the Internal Revenue Code may well change. Moreover, even under current law, the list seems to be incomplete. For example, Code §331, which describes distributions received in complete liquidation, is not included in the list. The basic point, however, is that corporate and partnership distributions are by their nature not gratuitous unless the corporation or partnership is making the transfer as the agent of the individual or trust which owns the interest in the corporation or partnership.

5. Treatment of Inter-Trust Distributions

Finally, the conclusion in the proposed regulation that "[a] distribution from one trust to another trust that is a beneficiary of the first trust is a gratuitous transfer" (as illustrated in Example 7), is capable of causing enormous mischief in the application of the grantor trust rules. For example, a literal application of this rule would mean that a domestic trust that made a distribution to a foreign trust the terms of which permit the distribution of property to any United States person, would be treated as the owner of the foreign trust. It, not the beneficiaries who receive distributions from the foreign trust, would be liable for United States income taxes on the foreign trust's income. This will apparently be so whether or not the trust had retained sufficient assets to enable it to pay future income taxes on the foreign trust's income. The beneficiaries who receive either current or accumulated income would receive it free of any United States income tax. Surely this cannot be the intended result.

We see no reason why a trust, which is making a distribution, pursuant to the terms of its governing instrument, to another trust, should be treated as a grantor of that trust any more than a corporation should be treated as a grantor of a trust to which it, pursuant to the direction of its directors, pays a dividend to a trust which is one of its shareholders.

We note that Thomas Hines, Esq., an IRS senior technical reviewer in branch 2 (passthroughs and special industries) stated at an August 27, 1997 Internal Revenue Service conference that the regulatory definition of “grantor” was not intended to make any changes to existing law. We submit that the treatment of one trust as the “grantor” of another trust to which it is required to make distributions would represent a substantial change from our understanding of existing law. We suggest that, throughout, the regulations should attempt to identify the true grantor of a donative transfer, and draw conclusions from that starting point.

6. Comments on Examples

Consistent with the provisions of new § 643(h) of the Code, and the historic provisions of Regulation § 1.671-2(e), a corporation can be the grantor of a trust, and may act as an intermediary in making a transfer. Thus, if a corporation is involved in a donative transfer, existing law will effect appropriate United States federal income taxation. Example 8 under Proposed Regulations § 1.671-2(e)(5) seems to us to make the entirely unnecessary point that a publicly traded corporation whose stock is held as an investment of a trust shall not be treated as a “grantor” by reason of paying dividends on that stock.

Example 2 makes the point that an investment in a fixed investment trust which is sold by A to B will continue to be taxed under the grantor trust principles, with B as the grantor. Presumably the same results should apply if A gives or bequeaths the interest in a fixed investment trust to B. It would be helpful if the example confirmed this.

Example 3 speaks of A, an attorney, creating a trust for the benefit of his client B and B's children. The fourth sentence of the example states that the attorney "views the contribution as an investment in the generation of fees for future legal services." We find this sentence gratuitous and urge its deletion. The final sentence of the regulation states that B is "a" grantor of T, suggesting, perhaps, that A may also be a grantor. We do not think this is intended and, to avoid confusion, suggest that the final sentence be revised to read, "Under paragraph (e)(3) of this section, B is the only grantor of T."

III. Proposed Regulation § 1.672(f)-1. Foreign Persons Not Treated as Owners.

A. The Statute

> Code § 672(f) provides that the rules of subpart E, the so-called "grantor trust" rules, "shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation."

B. The Proposed Regulations

Proposed Regulation § 1.672(f)-1(a) provides for an annual determination to be made as to whether the imposition of the rules of subpart E of subchapter J would result in an amount being currently taken into account for purposes of computing United States federal income taxation.

Under Proposed Regulation § 1.672(f)-1(b), with respect to any trust the taxpayer is first to make an annual determination of the taxation of the trust's income under the grantor trust rules without regard to the special rule of Code § 672(f). This is done by computing the “worldwide amount,” the net amount of income, gains, deductions and losses that would be taken into account under generally applicable United States grantor trust rules hi calculating the taxable income of any person with respect to the trust, and the “United States amount,” the portion of the worldwide amount which is taken into account under such rules hi calculating the taxable income of a United States person. Proposed Regulation § 1.672(f)-1(b)(2) provides that if there is a worldwide amount for any year of a trust and that amount is greater than the United States amount, a foreign person shall not be treated as the owner of the trust in that year to the extent of the portion of the trust attributable to the excess of the worldwide amount over the United States amount. If there is no worldwide amount or if the worldwide amount is does not exceed the United States amount, the proposed regulation concludes mat Code § 672(f) does not apply.

C. Substantive Comments

1. In General

We agree with the general statement in Proposed Regulation § 1.672(f)-1(a) that Code § 672(f) will not apply with respect to a trust so long as the application of the grantor trust rules with respect to such a trust will result in amounts being “taken into account,” hi computing the income of a United States person. There is no requirement that such amounts be taxable. We also agree with the construction that the determination is to be made annually, although we note that this may provide for complicated compliance efforts.

Such complicated compliance efforts will be exacerbated hi instances hi which the taxpayer cannot compile the “United States amount” and “worldwide amount” because the taxpayer may, in such instances, merely receive a distribution of income and/or principal from a foreign trust without receiving the information needed to compute the United States amount and the worldwide amount.

We question, however, why this new and complex annual calculation need be made at all. Using the general principles of Regulations § 1.671-3, could not a calculation be made (if necessary annually) of what portion of a foreign trust is deemed to be owned by each grantor, and then calculate (in accord with Code § 672(f)(1)) the extent to which such attribution results hi “an amount being currently taken into account” with respect to a United States person?

2. Requirement That There Be a Worldwide Amount

More importantly, the rules describing the application of the general statement, which appear in Proposed Regulation § 1.672(f)-1(b) are inconsistent with the general statement. The general statement, as does the statute, looks to whether or not a trust item is “taken into account” in calculating the income of a United States person. In contrast, Proposed Regulation § 1.672(f) 1(b)(2), as described above, adopts a second level test. Even if no trust item is taken into account in calculating the income of a United States person, Code § 672(f) will not apply unless the trust has worldwide income. If a trust has no income, it has no worldwide income, and, under the proposed regulations, Code § 672(f) will not apply.

The application of this principle is illustrated in Example 4. Example 4 describes a United States corporation, USC, with a wholly owned foreign subsidiary, FC, which is a beneficiary of a foreign trust, FT, which was created by USC. Under the normal application of the grantor trust rules, FC would be treated as the owner of FT because it has a withdrawal power within the meaning of Code § 678. FT acquires a note issued by FC. The only items of income, deduction, loss or credit mat FT has is the item of income resulting from the interest paid or accrued on PC's note. The note and its interest would be disregarded under the normal grantor trust rules since the trust would be ignored and FC would be treated as both the debtor and creditor. Thus, there would be no worldwide amount and the basic grantor trust rules apply.

The conclusion that a trust with a foreign grantor will be subject to the basic grantor trust rules, notwithstanding Code § 672(f), simply because the application of those rules would not result in any person taking income, gain, deduction, or loss into account is inconsistent with the statute. Moreover, such a conclusion has the potential for generating results that may not have been intended. For example, suppose F, a nonresident alien, creates and funds a foreign trust, FT, for the benefit of her United States children. F retains the power to determine how her children will share in the distributions from the trust. FT transfers all of its assets to a wholly owned foreign corporation, FC. FC makes no distributions. Under the basic grantor trust rules, specifically Code § 674(a), F would be treated as the owner of FT. The application of those rules, however, would not result in any worldwide amount. This is so because, FT has no income, gain, loss, or deduction.

3. Definition of "U.S. Taxpayer"

As indicated above, we disagree with the conclusion in the proposed regulations that a trust can be treated as the grantor of another trust. But, if a trust is to be treated as a grantor, we do not understand why it should be treated, for purposes of Code § 672(f), any differently from any other United States taxpayer. Specifically, we are confused by the provision that excludes a domestic trust from the definition of "U.S. taxpayer" except to the extent mat the trust "actually pays" United States tax with respect to its income, gains, deductions, and losses. Is this intended to exclude charitable trusts, exempt from income taxation under Code § 501(c)(3) or trusts that pay no tax because they distribute all of their income currently? If so, what is intended to be accomplished by this exclusion? Or, is it only intended to exclude domestic trusts which are taxable as grantor trusts?

If it is intended to exclude domestic trusts mat distribute all of their income currently, we believe this is inappropriate. Consider, for example, a domestic trust, DT, which creates a foreign trust, FT, of which it is a beneficiary. The only other beneficiaries of FT are A, a United States person, and B, a nonresident alien. A and B are the only beneficiaries of DT. In 1999, DT earns interest of 100X. It distributes the interest of 100X plus 100X from principal to B. In 1999, FT earns 100X and retains it. DT pays no United States tax with respect to the income it actually earned, nor would it have paid any tax on income attributed to it from FT under the grantor trust rules because its distributions for the year were equal to the total amount of such income. Therefore, under the proposed regulations, the basic grantor trust rules would not apply to FT. As a consequence, in 2000, when FT distributes 100X to A, A will not only have taxable income, but she will also be subject to substantial interest charges under Code § 668. If DT had not created FT, it would have earned 200X in 1999. It would not have paid tax on the 200X because of the 200X distribution to B. The distribution to A in 2000, A would have no income (except to the extent of any additional earnings of DT in 2000). If trusts are to be treated as grantors and owners of other trusts, their beneficiaries ought not to be treated any differently than they would have been treated if the trusts had not been created.

4. Comments on Examples

Example 3 should be changed. While we recognize that the statute says that the rules of Subpart E of Subchapter J shall be applied only “to the extent” that the application results in an amount being currently taken into account under this chapter, we question the basis for providing in a regulation that if FP, a foreign partnership, is treated as the grantor, that the rules of subpart E of Subchapter J shall be taken into account for the 50% partnership interest of FP which is owned by a United States person, but not for the 50% partnership interest of which is owned by a non-United States person. We think the result under this regulation would better reflect the statute if Treasury were to treat C and D, the two partners of FP, as the grantors of the trust rather than FP.

Further, on the facts set forth in the example, it appears that FP is acting only as an agent for C and D, and that each should be treated as the grantor of one-half of FT. Code § 679 should apply to the half of FT created by D. Code § 672(r) should apply to the half of FT created by C, although reallocation of all of the income to D may be appropriate as there is no evident reason for C to create a trust for E.

D. Technical Comments

We have the following comments of a technical nature:

1. We recommend the revision of Proposed Regulation § 1.672(f)-1(c)(2) by deleting the provision in the parenthetical which says “directly or through one or more entities” so that the provisions of Proposed Regulations §§ 1.672(f)-1(c)(1) and (2) are the same. Otherwise, it should be clarified why the clause is contained in subparagraph (2) and not (1).

2. Example 3 of Proposed Regulation § 1.672(f)-1(d) provides, in the fifth sentence that “(i)f the basic grantor trust rules were applied, FT would be treated as the owner of FP.” We believe that the sentence should be corrected to provide “(i)f the basic grantor trust rules were applied, FP would be treated as the owner of FT.”

3. We are not sure why Example 4 requires that FT, the foreign trust, “cannot benefit any U.S. person.” Should not the same result apply in a year hi which FT hi fact does not benefit a United States person? We would use the test of Code § 679(a)(1) of whether “for such year there is a United States beneficiary of any portion of such trust.”

4. The definitions of “worldwide amount” and “U.S. amount” use the phrase “income, gains, deductions, and losses.” In Example 4, the phrase, used for the same purpose, is “income, deduction, losses, or credit.” We assume the phrase used in Example 4 is intended to be the same as the phrase used in the definitions.

IV. Proposed Regulation § 1.672(f)-2. Trusts Created by Foreign Corporations.

A. The Statute

Code § 672(f)(3)(A) provides that for purposes of the special rules of Code § 672(f), generally, a controlled foreign corporation shall be treated as if it were a domestic corporation (so that the grantor trust rules shall continue to apply to the extent they attribute ownership of a trust to a controlled foreign corporation) and the special rules of Code § 672(f) shall not apply to passive foreign investment companies.

B. The Proposed Regulations

The proposed regulations would apply the principles of Code § 672(f)(3)(A) to foreign personal holding companies, as well as to controlled foreign corporations and passive foreign investment companies. Proposed Regulation § 1.672(f)-2(b) limits the application of Code § 672(f)(3)(B), by providing that the rules of Code § 672(f) will apply to a grantor trust treated as owned by a passive foreign investment company, except to the extent that the shareholders have elected to be taxed currently under Code § 1293.

C. Substantive Comments

1. In General

We agree with the proposed regulatory extension of the statutory rule to foreign personal holding companies.

We do, however, question several aspects of the proposed regulations. The statutory exception to the application of Code § 672(f) to controlled foreign corporations and passive foreign investment companies was intended to allow these statutory regimes to continue to operate as intended, without partial modification by Code § 672(1) by reason of the use of a grantor trust. Thus, if a controlled foreign corporation is treated as the owner of a grantor trust, by treating the controlled foreign corporation as if it were a domestic corporation Code § 672(f)(3)(A) assures mat all of the income of the trust (assuming that the controlled foreign corporation is the “owner” of the entire trust under the principles of Code § 671) will be treated as owned by the controlled foreign corporation, and thus looks to Code § 951 to determine how mat income shall be taxed.

Proposed Regulation § 1.672(f)-2(a) alters and complicates this statutory regime by proposing that the rules of Code § 672(f) shall be ignored only to the extent that, under the rules of Code § 951, the income of the controlled foreign corporation, and of the trust which it “owns” under the rules of

Subpart E, is currently taxed to a United States person. We question the authority for, and wisdom of, this complicating limitation. Assume a controlled foreign corporation meeting the statutory definition of Code § 957, 80% of the stock of which is owned by United States shareholders (as defined in Code §951(b)), and 20% by a nonresident alien individual. Ordinarily the 20% of the corporation's Subpart F income attributable to the nonresident alien individual would be taxed under general principles of United States federal corporate income taxation, and probably would never be subjected to United States federal income taxation. Under the proposed regulations, if a controlled foreign corporation were to create a grantor trust in the United States, the trust would not exist (because Code § 672(f) would not apply) as to 80% of its income, but the trust would exist as to 20% of its income.

Furthermore, if we read these rules correctly, a CFC could transfer an operating business to a foreign trust of which it was the sole beneficiary but lacked the power to revoke, and its income would not include the income of the trust. As a result, distributions from the CFC might be treated as a return of capital, the foreign tax calculation with respect to any CHC dividends would be substantially altered, and the trust income might be excluded from any calculation of earnings and profits for Section 1248 purposes. We doubt very much that these results were intended.

2. Comments on Examples

Example 1 under Proposed Regulation § 1.672(f)-2(d) provides that Code § 672(f) shall effectively apply to a trust which is treated under subpart E as owned by a controlled foreign corporation without ultimate United States ownership. Under the facts in this example, a controlled foreign corporation creates and funds a trust to benefit the United States resident daughter of A, one of the two ultimate shareholders of the controlled foreign corporation. While the facts hypothesized are highly unlikely, the example represents a trap for the unwary. Here A is the true grantor of the trust, and the controlled foreign corporation is paying to A's daughter, through the trust, income allocable to A. If Treasury wishes even to consider the controlled foreign corporation as the grantor of the trust, the example should offer the availability of the unrestricted power to revoke exception to the application of Code § 672(f) to a trust created by a controlled foreign corporation.

In Example 3 of Proposed Regulations § 1.672(f)(2)(d) the reference to “199X” in the fourth sentence is confusing. It appears that the reference is to the year “1999.” We recommend that the sentence read as follows: “FT has no deductions or losses for 1999.”

In addition, the last sentence of Example 3 provides that “Distributions to USP with respect to such portion of FT will be included in USP's income under section 662 and may be subject to the section 668 interest charge on accumulation distributions.” Since USC, not USP, is the beneficiary of FT, we assume that the reference to “USP” was intended to refer to “USC.”

V. Proposed Regulations § 1.672(f)-3. Exceptions to General Rule

A. The Statute

Code § 672(f)(2) creates an exception to the general rule of Code § 672(f) for trusts that are wholly revocable by their grantors or by their grantors in conjunction with related or subordinate parties who are subservient to them, for trusts that may distribute during their grantors' lives only to their grantors or their grantors' spouses, and for trusts distributions from which are taxable as compensation for services.

In addition, a transitional rule excludes trusts that were in existence on September 19, 1995 and which are treated as owned by the grantor under either Code § 676 or Code § 677 (without regard to subsection (a)(3)). The transitional rule is not applicable to a trust to the extent of transfers made to it after September 19, 1995.

B. The Proposed Regulations

1. Proposed Regulation $ 1.672(f)-3(a) - Revocable Trusts

Proposed Regulation § 1.672(f)3(a) provides that the grantor will be treated as having a power to revest the trust property in himself or herself only if the grantor had such power for a period or periods aggregating 183 days or more during the taxable year of the trust. The proposed regulations cross-reference Code § 643(a)(7), authorizing the Secretary to prescribe by Regulations definitions of distributable net income which preclude abusive transactions, as the authority for this provision.

2. Proposed Regulation S 1.672(f)-3(b)(1)-(3) - Trusts That Distribute Only to the Grantor and/or the Grantor's Spouse

Proposed Regulation § 1.672(f)-3(b)(1) provides that the exception for trusts that may distribute only to their grantors and/or their grantors' spouses during their grantors' lives will not apply to any trust that permitted distributions among a wider class of beneficiaries at any time after October 20, 1996. It also provides that payments of “nongratuitous amounts” within the meaning of Proposed Regulation § 1.671-2(e)(4)(ii) are not to be considered “amounts distributable.”

Proposed Regulation § 1.672(f)-3(b)(2) provides that amounts distributable in discharge of certain legal obligations of a grantor or his or her spouse “shall be treated as amounts distributable to the grantor or to the spouse of the grantor for purposes of . . . [this provision].” For this purpose, an obligation is treated as a “legal obligation” if “it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.” Legal obligations do not include obligations owed to persons who are related (within the meaning of Proposed Regulation § 1.643(h)-1(e)) to the grantor or his or her spouse “except to the extent the obligation was contracted bona fide and for adequate and full consideration in money or money's worth. . . . “

Proposed Regulation § 1.672(f)-3(b)(3) provides that amounts distributable in discharge of a support obligation of the grantor or his or her spouse are treated as amounts distributable to the grantor or his or her spouse only if the individual to whom the support obligation is owed (i) would be a dependent of the grantor or his or her spouse within the meaning of § 152(a)(1) through (8) if either or both of them provided more than one-half of such individual's support and (ii) the individual is either (a) permanently and totally disabled (within the meaning of Code § 22(e)(3)) or (b) a son, daughter, stepson or stepdaughter of the grantor or his or her spouse and is younger than age 24.

3. Proposed Regulations $ 1.672(f)-3(a)(2) and (b)(4) - Protection of Certain Pre-Existing Trusts

Proposed Regulations § 1.672(f)-3(a)(2) and (b)(4) states, consistent with § 1904(d) of the Act, that the general rule of Code § 672(f) shall not apply to a trust which was treated as a grantor trust on September 19, 1995 under the rules of Code § 676 or Code § 677 (without regard to subsection (a)(3)) but will apply to the extent of later additions to that trust. This rule applies only to trusts treated as grantor trusts under the rules of Code § 676 or Code § 677 on September 19, 1995, and not the other sections of Subpart E. The proposed regulations, however, extend the protection of this rule so long as such trust continues to be treated as owned by the grantor after September 19, 1995 under any of the other sections of Subpart E. Thus, a trust in existence on September 19, 1995 which could be revoked by a non-adverse party on and after that date will continue to be taxed as a grantor trust even if that power subsequently lapses if some other provision, for example, Code § 674 or Code § 675, would normally result in such treatment.

If any amounts are transferred after September 19, 1995 to a trust that is protected by § 1904(d) of the Act, the proposed regulations require that "the amounts that were held in the trust on September 19, 1995, together with all income, gains, and losses derived therefrom (less all post-September 19, 1995, distributions therefrom) . . . [be] separately accounted for from the amounts that were transferred to the trust after September 19, 1995, together with all income, gains, and losses derived therefrom (less all distribution therefrom). The penalty for failure to separately account is draconian. The entire protection of § 1904(d) of the Act is lost.

C. Substantive Comments

1. Proposed Regulation § 1.672(f)-3(a) - Revocable Trusts

No examples are provided for the application of the 183-day rule, and it is difficult to understand Treasury's concern. At one end of the spectrum, the rule may be benign. For example, under both Regulations §§ 1.674(d)-2(a) and 20.2038-1(a)(3), a trustee's powers are not imputed to the grantor if the grantor's power to remove the trustee and substitute himself is exercisable only under limited conditions that do not exist at the time in question (e.g., the death, resignation or breach of fiduciary duty of the existing trustee). The 183-day rule also may be appropriate in cases in which a person other than the grantor has the power to take the action that would cause the trust to qualify under the revocable trust exception (e.g., the power to remove the trustee and appoint the grantor as replacement trustee).

On the other hand, under a broader interpretation, the 183-day rule would have an effect similar to the effect of Example 3 to Proposed Regulation § 1.672(f)-3, discussed below. For example, the 183-day rule might serve to deny grantor trust status to a trust in which the foreign grantor has the power to remove the trustee and appoint himself as successor trustee unless that power is actually exercised while there are still 183 days remaining in the trust's taxable year. Under an even broader interpretation, the 183-day rule might apply to a trust that is not expressly revocable but mat may be amended by the grantor to become revocable. We recommend that the Proposed Regulations clarify the need for, and scope of, any 183-day rule.

If there is to be a 183-day rule, it should be modified to except the first and last tax years of trusts from its operation or to pro rate the days. If a grantor creates a fully revocable trust after July 2 of any year, or if the grantor of a fully revocable trust dies before July 2, the trust should in either case be taxed as a grantor trust for its partial year.

Another issue that arises under the 183-day rule is whether a trust that fails to meet the 183-day rule in a particular year may become a grantor trust in a subsequent year. The proposed regulations do not seem to address this issue, but under existing authority the answer should be that a trust that is a nongrantor trust at one point in time may become a grantor trust at a future time. See, e.g., Code § 676(b) and Regulation § 1.676(b)-1 (grantor trust status triggered when the grantor acquires the power to revoke the trust).

Also, for purposes of Proposed Regulation § 1.672(f)-3(a)(1) and (2), we believe that the situation where the grantor becomes incapacitated should be clarified to reflect that a grantor trust shall continue to be treated as such as long as, under applicable law, a legal representative of the grantor who has the unrestricted power to revoke on the grantor's behalf exists or could be appointed.

2. Proposed Regulation § 1.672(f)-3(b)(1)(3) - Trusts That Distribute Only to the Grantor and/or the Grantor's Spouse

The proposed regulations treatment of amounts distributable in discharge of certain obligations of a grantor or his or her spouse is inconsistent with the manner in which distributions in discharge of obligations are treated in the regulations promulgated under other provisions of the Code, and may effectively preclude the application of Code § 672(f)(A)(ii) to most trusts.

The operative phrase in Code § 672(f)(A)(ii) is “distributable to the grantor or the spouse of the grantor.” A virtually identical phrase appears in Code § 677(a). This subsection provides that the grantor of a trust will be treated as the owner of any portion of the trust if the income of such portion (without the consent of any adverse party) may be “distributed to the grantor or the grantor's spouse.” Regulation § 1.677(a)-1(d) interprets the phrase “may be distributed to” to include “may be applied in discharge of a legal obligation of the grantor . . . or his [or her] spouse.” A similar phrase also appears in Code § 662(a)(2), the subsection that requires a beneficiary to include certain amounts paid to him or her from a trust. Regulation § 1.662(a)-4 interprets this phrase to include "[a]ny amount which, pursuant to the terms of a will or trust instrument, is used in full or partial discharge or satisfaction of a legal obligation of . . . [such beneficiary]."

In both cases, amounts are treated as distributed to or paid to an individual if they are used to satisfy his or her legal obligations. There is no exception, as there is in the proposed regulations, for obligations to family members that are not based on full and adequate consideration in money or money's worth.

There is nothing in the legislative history of Code § 672(f)(A)(ii) to suggest any justification for this substantial departure from the normal way of treating amounts paid in discharge of an individual's obligations. Indeed, if a trust is not treated as owned by its grantor because of the application of Code § 672(f) and the trustee uses trust funds to discharge an obligation of the grantor, regardless of the source of that obligation, Treas. Reg. § 1.662(a)-4 would require the treatment of such use as a payment to the grantor. Nor is it apparent what enforcement or other concerns prompted the proposal of such a requirement.

Proposed Regulation § 1.672(f)-3(b) is a governing instrument requirement. This means that the test for determining eligibility for the Code § 672(f)(A)(ii) exception is applied with reference to the terms of the trust instrument, not with reference to the actual distributions made from the trust. As a result, any trust, the terms of which permit the trustees to use trust funds to discharge the support obligation of its grantor or its grantor's spouse will not qualify. We believe that, under the laws of most jurisdictions, a trust provision that permits distributions to a beneficiary would be construed to permit distributions to be made in satisfaction of that beneficiary's obligations, regardless of the source of those obligations. Thus, Proposed Regulation § 1.672(f)-3(b), as a practical matter, is likely to exclude most trusts from qualification under Code § 672(f)(A)(ii). This cannot have been intended by Congress.

We are troubled that words and phrases which have appeared in the Code for many years and have been interpreted as having a certain meaning are given a different meaning in these regulations. We believe that it is important that Congress be presumed to have known the law and that when it amends the Code using phrases used in related provisions, which have been previously interpreted, that those phrases will be similarly interpreted hi applying the amendment. If this is not the rule, it is difficult to see how Congress can understand the laws it is enacting or the public can understand and comment upon bills which are under consideration by Congress.

3. Proposed Regulations S 1.672(f)-3(a)(2) and (b)(4) - Protection of Certain Pre-Existing Trusts

The provision in the proposed regulations that withdraws the protection of § 1904(d) of the Act from a trust to which post-September 19, 1995 additions are made unless the trust separately accounts for such additions and the income, gains, losses and distributions associated with such additions, is unnecessarily harsh and is inconsistent with the manner in which similar transitional rules have been construed.

For example, § 1433(b)(2) of the Tax Reform Act of 1986 protected trusts that were in existence and which were irrevocable on September 25, 1985 from the generation-skipping transfer tax but only to the extent that a generation-skipping transfer is not made from corpus added to such trusts (or to income attributable to such added corpus) after September 25, 1995. Regulation § 26.2601-1(b)(1)(iv), which interprets this provision, provides that transfers that are made from such trusts are to be treated as deriving from pre-September 26, 1995 property and from post-September 25, 1995 additions in proportion to the relative values of the trust on the date or dates additions are made and the value or values of such additions on such date or dates. We suggest that a similar rule be made available for those trusts for which there is no separate accounting.

4. Comments on Examples

We note that Examples 2 and 6 make clear that Code § 678 powers are not to be included within the exception to the general rule of Code § 672(f)(2)(A)(i). While we do not disagree with the statutory analysis, we find the results anomalous. If FP2 (in Example 2) has the unrestricted power to revoke, or control foreign bank FB, which has the unrestricted power, should not FP2 be treated as the owner? Why require FP2 to revoke and recreate the trust?

We also recommend that the reference to the word “itself in the fifth sentence in Example 6 be changed to “himself or herself” because we believe that a nonresident alien can only be an individual. Thus, the sentence would read “Although A has the power to revest absolutely in himself or herself title to the appreciated property, A is not a grantor of FT with respect to the appreciated property.”

We disagree with the result in Example 3. Generally, under existing grantor trust rules, if the grantor has the power to remove the trustee and substitute any person including himself as trustee, the trustee's powers will be imputed to the grantor. See Regulation § 1.674(d)-2(a); cf. Regulation § 20.2038-1(a)(e) (estate tax); Rev. Rul. 95-58, 1995-2 C.B. 191 (estate tax). This is consistent with other authorities under the existing grantor trust rules that prevent the grantor from doing indirectly what he could not do directly. For example, a trust that is not revocable by the grantor by its express terms is nevertheless treated as revocable under the grantor trust rules if the grantor (or a nonadverse party) can amend the trust to cause it to be revocable. Regulation § 1.676(a)-1.

Notwithstanding the foregoing authorities, Example 3 provides that the revocable trust exception does not apply to a trust that is revocable by its foreign grantor with the consent of a trustee who is not a related or subordinate party even though the grantor has the power to remove and replace the trustee at any time for any reason. Example 3 does not state whether the grantor has the power to replace the trustee with himself or a related or subordinate party, but if it is read to encompass such a situation (which literally it does), then it is inconsistent with long-standing authority.

Example 2 makes clear, with respect to the exception in Code § 672(f)(2)(A)(ii), that if at any time income from a trust could have been distributed to a person other than the grantor or the spouse of the grantor, the statutory exception shall not apply. We question whether the result under Example 2 is necessary. During the time that C, the child of H who is in law school, could have been a beneficiary, the statutory exception would not apply. However, under the facts stated in Example 2, from and after the date that C graduates from law school, “the only amounts distributable from such portion during the lifetime of the grantor [will be] amounts distributable to the grantor or the spouse of the grantor” and we would think that the statutory exception to the general rule would become applicable.

On a similar subject, we note that the proposed regulations do not deal with a trust which was not unconditionally subject to revocation by the grantor in year 1, but is unconditionally subject to revocation by the grantor in year 2.

VI. Proposed Regulation § 1.672(f)-4. Recharacterization of Purported Gifts.

A. The Statute

New Code § 672(f)(4) provides:

> (4) RECHARACTERIZATION OF PURPORTED GIFTS.
>
> -- In the case of any transfer directly or indirectly from a partnership or foreign corporation which the transferee treats as a gift or bequest, the Secretary may recharacterize such transfer in such circumstances as the Secretary determines to be appropriate to prevent the avoidance of the purposes of this subsection.

B. The Proposed Regulation

Proposed Regulation § 1.672(f)-4(a)(1) provides that, “except as provided in paragraphs (b) and (f) of this section, and without regard to the existence of any trust, if a United States person directly or indirectly receives a purported gift or bequest from a partnership, the purported gift or bequest must [emphasis added] be included in the United States donee's gross income as ordinary income.”

Proposed Regulation § 1.672(f)-4(a)(2) provides similarly with respect to distributions received by a United States person from a foreign corporation.

Proposed Regulation § 1.672(f)-4(d) defines a “purported gift or bequest” as any transfer by a partnership or by a foreign corporation to a person who is not a partner in the partnership or a shareholder of the foreign corporation other than a transfer for fair market value.

Proposed Regulation § 1.672(f)-4(b) creates an exception to the general rule that applies if a United States partner or shareholder treats the purported gift or bequest as a distribution to him or her and a gift by him or her to the United States “donee.” It also excepts transfers to United States donees that are described in Code § 170(c), relating to charitable contributions.

Proposed Regulation § 1.672(f)-4(f) gives the district director the power to recharacterize purported gifts or bequests subject to this rule “to prevent the avoidance of U.S. tax or clearly to reflect income.”

C. Substantive Comments

We do not believe there is any authority for these Proposed Regulations.

New Code § 672(f)(4) does not give Treasury sufficiently broad discretion to the Secretary as to recharacterize all distributions from any partnerships (domestic or foreign), or from foreign corporations, in each case without regard to the existence of a trust, to a United States person as income subject to United States federal income taxation.

We believe these Proposed Regulations are overly broad. First, Code §672(f)(4) and Proposed Regulation § 1.672(f)-4(a)(1) apply to all partnerships, whether domestic or foreign, and are therefore of unnecessarily broad application.

Second, both subparagraphs (1) and (2), applicable to partnerships and corporations, apply without exception if no United States person has taken the distribution into his or her income for United States federal income tax purposes. In the context of an individual shareholder, the simple situation which we propose for consideration is that of a closely held foreign corporation which has as a controlling shareholder a non-resident alien who instructs the corporation to pay his or her share of the income for mat year to his or her United States resident child. In such a case, the foreign corporation is simply following an instruction to pay, as an agent, and the United States federal income tax result should be no different than it would have been had the individual shareholder received the income distribution and then made a gift of the same to his or her child who is resident in the United States.

The same issue exists with respect to partnerships, except that in the case of partnerships the rule would also apply to United States domestic partnerships with a foreign partner, who asks the partnership to make an accommodation payment to his or her child who is resident of the United States as a charge against the parent's share of partnership income. This will apparently be so even if the foreign partner pays United States income tax on the income of the partnership.

Third, in the context of a corporation, the breadth of Proposed Regulation § 1.672(f)-(4) gives rise to consequences that are wholly inappropriate and certainly unintended. For example, if a foreign corporation organizes and funds a United States subsidiary with cash, Proposed Regulation § 1.672(f)-(4) would apparently treat the contribution as a taxable distribution to the subsidiary.

As indicated above, the rule applies to any transfer for less than fair market value. Although Proposed Regulation § 1.672(f)-4(d) does not itself define the phrase “transfer for fair market value,” Proposed Regulation § 1.671-2(e)(4)(i)(A) (which defines transfers for fair market value in the context of transfers to a trust) provides that, in determining whether a transferor has received fair market value, “any type of interest in the trust (or other entity) shall be disregarded in determining whether fair market has been received.” Accordingly, a foreign parent corporation that contributes cash to the capital of a United States subsidiary appears to be treated under the Proposed Regulations as making a purported gift to its United States subsidiary.

Proposed Regulation § 1.672(f)-4(a)(2) requires any purported gift to be included in the United States donee's gross income as if it were a distribution from the foreign corporation. Thus, the Proposed Regulations appear to treat a United States subsidiary that receives what otherwise would be a tax-free contribution of capital from its foreign parent as receiving a taxable distribution from its foreign parent.

Moreover, the Proposed Regulations appear to override Code § 482. For example, if a foreign parent corporation sells or leases property to its United States subsidiary for an amount that is determined to be less than fair market value, Proposed Regulation § 1.672(f)-4 apparently would treat the difference as taxable income to the subsidiary rather than as a fair market transaction plus a tax-free contribution to capital.

We also believe that Proposed Regulation § 1.672(f)-4 is overly broad in two other situations. First, Proposed Regulation § 1.672(f)-4(b)(2) limits the exception for charitable contributions only to contributions made to United States donees that are described in Code, § 170(c). This exception would not include amounts paid by foreign charities to United States individuals. For example, under the Proposed Regulations, the United States individual victims of natural disasters who receive relief from the International Red Cross (and other foreign humanitarian organizations) would be taxable on the gifts.

Second, the Proposed Regulations would overturn the Supreme Court's decision in Bogardus v. Commissioner, 302 U.S. 34 (1937). In *Bogardus*, the former shareholders of a target corporation indirectly (through another corporation) made certain payments to the employees of the target after the target was sold to an unrelated purchaser. The shareholders treated and reported the payments as a “gift or honorarium” to their former employees (who were otherwise unrelated to the shareholders) in recognition of the valuable and loyal services of the employees. The Supreme Court agreed that the payments should be treated as non-taxable gifts to the former employees for federal income tax purposes. The Proposed Regulations would reverse *Bogardus* for foreign shareholders making payments to former United States employees. We believe that the circumstances of *Bogardus* are not an avoidance of Code § 672(f) and, therefore, the application of the Proposed Regulations to the facts of *Bogardus* is beyond the scope of the authority granted in Code § 672(f)(4).

These examples demonstrate some of the numerous situations in which foreign persons may make less man fair market value transfers (as defined in the Proposed Regulations) to United States persons and to which Code § 672(f)(4) was not intended to apply.

We urge that the scope of this proposed regulation be restricted so mat it applies only to situations in which, based on the surrounding facts and circumstances, it appears that the corporation or partnership is being used principally as a device to avoid United States tax. Thus the provision should probably have no application to a transfer from a partnership or corporation, which is in substance a gift from a partner of that partnership or a shareholder of that corporation unless the use of the partnership or corporation enables the avoidance of the ordinary rules that subject United States beneficiaries to tax on income from foreign trusts. This could be so, for example, if a foreign trust is a partner in the case of a transfer from a partnership, or a shareholder in the case of a transfer from a corporation. The rule should generally not apply if such partner or shareholder is an individual.

D. Technical Comments

We have the following comments of a technical nature:

1. The definition of a “purported gift or bequest” as a transfer other than a transfer for fair market value will impose an intolerable burden of proof on virtually all United States person who receives property from partnerships other than property, the full value of which is intended to produce ordinary income. Suppose, for example, that D, a United States person, purchases 10% of the shares of stock in X, a closely held corporation, from a partnership that owns 20% of X's outstanding stock. The partnership is owned 50% by D's mother M and 50% by D's father F, both of whom are United States persons. D paid 100X for the shares. The Internal Revenue Service, successfully argues that the purchase price paid by D should have been 110X rather than 100X. As a result, both M and F are treated as having made a taxable gift to D, for federal gift tax purposes, to the extent of the 10X undervaluation. Under these circumstances, it seems unreasonable to treat D as having received 10X of ordinary income.

If the example is reversed, another harsh result is created. Suppose, D is the seller rather than the purchaser. She sells the shares to the partnership for 100X and the Internal Revenue Service successfully argues that the value is 110X. Now D will be treated as having made a taxable gift to her parents.

In addition, the cash she received, which she believed would be treated as long term capital gain (because she had held the shares for more than 18 months) will be treated as ordinary income. This result also seems unreasonable.

If the recharacterization of purported gift rule is retained, we suggest that the definition be modified to except transactions that were intended to be transfers for fair market value. In any event, the fair market value standard should be modified to protect transfers at least to the extent they are made for fair market value. This would protect D, in the examples above, to the extent of the 100X finally determined value.

2. The definition of a “purported gift or bequest” excludes transfers to persons who are partners or shareholders in the partnership or corporation making the transfer. Presumably it is not intended that a partnership interest or a shareholder interest that has no relationship to the transfer would protect the transferee from the application of this rule.