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May 18, 2011

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on the Provisions of the HIRE Act Regarding Foreign Trusts with U.S. Beneficiaries

Dear Commissioner Shulman:

Enclosed are comments on provisions of the HIRE Act regarding foreign trusts with U.S. beneficiaries. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Charles H. Egerton
Chair, Section of Taxation

Enclosure

cc: William J. Wilkins, Chief Counsel, Internal Revenue Service
Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
Mark J. Mazur, Deputy Assistant Secretary (Tax Analysis), Department of the Treasury

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**ABA SECTION OF TAXATION
COMMENTS ON PROVISIONS OF THE HIRE ACT
REGARDING FOREIGN TRUSTS WITH U.S. BENEFICIARIES**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by H. Carter Hood of the Fiduciary Income Tax Committee of the ABA Section of Taxation. Substantive contributions were made by Scott Bowman, Steven Caywood, Stephanie Chapman, Nicholas E. Christin, and Jonathan Ingber. The Comments were reviewed by Jeanne L. Newlon, Committee Chair. The Comments were further reviewed by David Pratt of the Section’s Committee on Government Submissions and by Mary Ann Mancini, Council Director for the Fiduciary Income Tax Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who may be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 18, 2011

**ABA SECTION OF TAXATION
COMMENTS ON PROVISIONS OF THE HIRE ACT
REGARDING FOREIGN TRUSTS WITH U.S. BENEFICIARIES**

Prior to 1976, when a U.S. person established a non-grantor trust in a low-tax foreign jurisdiction for the benefit of a U.S. family member, the trust's accumulated income was sheltered from U.S. income taxation. Section 679,¹ which was enacted as part of the Tax Reform Act of 1976,² eliminated the advantages of this planning technique by treating any foreign trust established by a U.S. person as a grantor trust, if the trust had a U.S. beneficiary. The U.S. grantor must pay U.S. tax on all of the grantor trust's income, independent of the tax law of the jurisdiction in which the trust is established.

In March 2010, Congress amended section 679 as part of the Hiring Incentives to Restore Employment Act ("HIRE Act")³ by making five statutory additions. On April 19, 2010, the Internal Revenue Service (the "Service") issued a request for comments⁴ relating to the HIRE Act. These Comments respond to that request by discussing each of these five statutory additions in turn, and offering suggestions for the Service and the Department of the Treasury ("Treasury") to consider when promulgating guidance under amended section 679.

I. Codification of Section 679 Regulations

The first three amendments to section 679(c) essentially codify the Regulations promulgated under section 679 in 2001.⁵ Because the language of the existing Regulations and the new statutory language in section 679(c)(1), (c)(4), and (c)(5) are so similar, the existing Regulations do not appear to require any modifications to implement these three statutory additions. Each of these additions is discussed below.

a. Section 679(c)(1) – Contingency Stipulation

The first amendment to section 679 treats a foreign trust as having a U.S. beneficiary if a U.S. person may become a beneficiary based on some future, contingent event. The new sentence added to section 679(c)(1) reads "[f]or purposes of

¹ References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

² Pub. L. No. 94-455, 90 Stat 1520, 1615.

³ Pub. L. No. 111-147, §§ 531-33, 124 Stat. 71, 113-4.

⁴ Announcement 2010-22, 2010-16 I.R.B. 602.

⁵ T.D. 8955, 66 Fed. Reg. 37,886 (2001).

subparagraph [679(c)(1)](A), an amount shall be treated as accumulated for the benefit of a United States person even if the United States person’s interest in the trust is contingent on a future event.” Regulation section 1.679-2(a)(2)(i) already includes a contingency requirement, stating that:

This determination [of whether a foreign trust is treated as having a U.S. beneficiary] is made without regard to whether income or corpus is actually distributed to the U.S. person during that year, and without regard to whether a U.S. person’s interest in the trust income or corpus income is contingent on a future event.

The meaning of contingent in the Regulations is broad, but the Regulations include an exception if “the person’s contingent interest in the trust is so remote as to be negligible.”⁶ We recommend retaining the exception found in Regulation section 1.679-2(a)(2)(ii) for contingent remainders that are so remote as to be negligible, and suggest adding a safe harbor provision, such as a five percent test, for additional guidance. At a minimum, we recommend the Service confirm that the newly added flush language of section 679(c)(1) does not eliminate the exception found in the pre-amendment Regulations.

b. Section 679(c)(4) – Discretion in Trust Distributions

The second amendment to section 679 provides that a trust will be treated as having a U.S. beneficiary if “any person has the discretion . . . of making a distribution from the trust to, or for the benefit of, *any person*”⁷ unless the trust instrument specifically identifies the class of beneficiaries and no beneficiary is a U.S. person. This statutory language appears to be broader than the current Regulations, which are triggered “if, during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a *U.S. person*”⁸ rather than “any person” as provided in the new section 679(c)(4). The new statutory language might be interpreted to mean that every foreign trust settled by a U.S. grantor must be treated as a grantor trust if “any person” has discretion to distribute to “any person.” As a consequence, all such discretionary trusts would be grantor trusts under section 679(c)(4) unless “(A) the terms of the trust specifically identify the class of persons to whom such distributions may be made, and (B) none of those persons are United States persons during the taxable year.”⁹

If this expansive reading is the correct one, the expansion is perhaps targeted at indirect transfers to a U.S. person through a non-U.S. intermediary. Nevertheless, this

⁶ Reg. § 1.679-2(a)(2)(ii).

⁷ I.R.C. § 679(c)(4) (emphasis added).

⁸ Reg. § 1.679-2(a)(2)(i) (emphasis added).

⁹ I.R.C. § 679(c)(4).

reading may be overbroad. We recommend that consideration be given before any change is made to the existing Regulation section 1.679-2(a)(2)(i) that would expand its application to all trusts in which someone has discretion over distributions to “any person” rather than to a “U.S. person.” If the Service is concerned about indirect transfers, the “directly or indirectly” language of Regulation section 1.679-2(a)(2)(i) would appear to address the issue, and not require a change to the Regulations.

c. Section 679(c)(5) – Terms of the Trust

The third amendment to section 679 treats certain understandings and agreements as terms of the trust for purposes of determining if section 679 applies. The new section 679(c)(5) provides:

(5) Certain agreements and understandings treated as terms of the trust. For purposes of paragraph [679(c)](1)(A), if any United States person who directly or indirectly transfers property to the trust is directly or indirectly involved in any agreement or understanding (whether written, oral, or otherwise) that may result in the income or corpus of the trust being paid or accumulated to or for the benefit of a United States person, such agreement or understanding shall be treated as a term of the trust.

The Regulations are similarly broad when examining terms of the trust and include “(A) All written and oral agreements and understandings relating to the trust; (B) Memoranda or letters of wishes; (C) All records that relate to the actual distribution of income and corpus; and (D) All other documents that relate to the trust, whether or not of any purported legal effect.”¹⁰ In addition, Regulation section 1.679-2(a)(4)(ii) takes the following factors into account for purposes of determining whether a foreign trust is treated as having a U.S. beneficiary:

(A) If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

(B) If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and

(C) If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.

¹⁰ Reg. § 1.679-2(a)(4)(i).

The current Regulations are quite broad and section 679(c)(5) largely codifies these Regulations. For this reason, we recommend that no changes be made to the current Regulations.

II. Expansion of Section 679

The final two additions to section 679, section 679(c)(6) and section 679(d), expand the scope of section 679 significantly, and we recommend that Treasury and the Service issue new Regulations to clarify the scope of, and govern the implementation of, these two new provisions.

a. Section 679(c)(6) – Loans of Trust Property

Prior to the passage of the HIRE Act, section 643(i) provided that loans of cash or marketable securities from a foreign trust to its grantor, a beneficiary, or a related party would be treated as a distribution (rather than a loan) from the trust, unless the borrower paid fair market value for such property. The HIRE Act expanded the scope of section 643(i) to include not only loans of cash or marketable securities, but also the loans of any other trust property, including the use of tangible personal property.

The HIRE Act also added section 679(c)(6), which is similar to the expanded section 643(i). Section 679(c)(6) provides that if a foreign trust with a U.S. grantor allows “a loan of cash or marketable securities (or the use of any other trust property) directly or indirectly to or by any United States person,” then such loan will be treated as being paid or accumulated for the benefit of a U.S. person, thereby triggering grantor trust status for the trust. However, grantor trust status will not be triggered if the U.S. person “repays the loan at a market rate of interest (or pays the fair market value of the use of such property) within a reasonable period of time.”¹¹

Section 679(c)(6) applies to a loan or use “directly or indirectly to or by any United States person.” In the expanded section 643(i), which serves a purpose similar to the new Section 679(c)(6), “United States person” does not include tax exempt entities.¹² We recommend that Treasury and the Service provide an exclusion from § 679(c)(6) for tax exempt entities. Otherwise, if non-U.S. trust established by a U.S. grantor loaned artwork to a tax-exempt U.S. museum, that loan would automatically trigger grantor trust status under § 679(c)(6).

Under section 679(c)(6), any loan of trust property to or use of trust property by any U.S. person will trigger grantor trust status unless such person repays the loan at a “market rate of interest” or pays “the fair market value of the use of such property” and, in each case, does so within a reasonable time. The market rate of interest applicable to

¹¹ I.R.C. § 679(c)(6).

¹² I.R.C. § 643(i)(2)(C).

the loan of and the fair market value of the use of certain types of property are easily determinable by reference to publicly available market data, but determining the market rates for loans of and fair market value of the use of other property may be more difficult. This is particularly true for unique property that is not frequently rented, such as artwork or jewelry. Although establishing fair market value is always a subjective matter, the lack of market comparables for the use of (as opposed to the sale of) property adds additional uncertainty to the appraisal process.

If the Service determines that a U.S. person paid less than fair market value for the use of property, the tax consequences under section 679(c)(6) may be severe. If section 679(c)(6) triggers grantor trust status for the foreign trust, the change of status from non-grantor to grantor trust will, in effect, trigger the “throwback rules” of sections 665 through 668. To the extent that the former non-grantor trust has any undistributed net income (“UNI”) as defined in section 665, all such UNI will be taxed to the U.S. grantor and such tax will be subject to a non-deductible interest charge, which together with the tax can equal 100% of such UNI, particularly for older trusts. The U.S. grantor is then deemed to have contributed such UNI back to the foreign trust. So, if a U.S. person pays less than fair market value for the use of trust property (in theory, even \$1.00 less), the foreign trust becomes a grantor trust. On the other hand, if a U.S. grantor or beneficiary pays more than the fair market value for the use of trust property, the excess payment could be treated as an additional taxable gift to the trust. Further, even if the payment of fair market value for the use of or the repayment of the loan does not occur “within a reasonable time” the foreign trust becomes a grantor trust.

Because the fair market value for the use of property may be difficult to determine, and because a loan of trust property to or the use of trust property by any U.S. person (even unrelated third parties) may have such severe tax consequences if the amount paid for the use of such property is determined upon audit to be too low, we recommend that any Regulations issued under section 679(c)(6) include some type of *de minimus* exception for misvaluations, as well as safe harbors and a reasonable cause exception.

In addition, or as part of these exceptions, we recommend inclusion of concepts of relationship to the grantor or a beneficiary similar to those found in section 643(i) and guidance issued thereunder, to eliminate risk on transactions between non-U.S. trusts and unrelated U.S. third parties. We also encourage Treasury and the Service to provide specific guidance regarding the meaning of “within a reasonable time.” Examples might be particularly helpful in this regard.

Until Regulations are issued that provide specific guidance and examples of acceptable transactions, trustees of foreign trusts with U.S. grantors will likely be reluctant to lease or otherwise provide access to trust property to a U.S. person, even if such person is completely unrelated to the grantor or the beneficiaries of the trust. This chilling effect may effectively put an end to the leasing of property to U.S. persons from foreign trusts with U.S. grantors.

b. Section 679(d) – Presumption of a U.S. Beneficiary

Section 679(c)(1) and Regulation section 1.679-2(a)(1) treat any foreign trust with a U.S. grantor as having a U.S. beneficiary (and thereby treat such trust as a grantor trust) unless the trust satisfies the following two-prong test:

(i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

(ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.¹³

The HIRE Act added section 679(d), which effectively creates a reporting obligation requiring the U.S. grantor to prove that the two-prong test stated above is met. Under section 679(d), the Service may presume that a foreign trust with a U.S. grantor has a U.S. beneficiary (thereby making it a grantor trust) unless the grantor (1) reports to the Service each transfer he or she makes to the trust and “(2) demonstrates to the satisfaction of the Secretary that such trust satisfies the requirements of” the two-prong test described above. Thus, under the new section 679(d), the Service may deem a foreign trust to be a grantor trust if the grantor fails to make adequate disclosures or prove that the trust has no U.S. beneficiary, even though the trust in fact satisfies the two-prong test of section 679(a) and Regulation section 1.679-2(a)(1).

The requirement that the grantor demonstrate “to the satisfaction of the Secretary” that a trust has no U.S. beneficiary in effect requires the taxpayer to prove a negative. We suggest that the U.S. grantor of a foreign trust be permitted to satisfy the new reporting requirement of section 679(d) by filing a timely Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts, in accordance with section 6048. The Joint Committee on Taxation referred to section 6048 in its discussion of section 679(d).¹⁴ Form 3520 requires that any U.S. transferors who directly or indirectly transfer money or other property to a foreign trust report such transfer. Form 3520 also requires reporting by any U.S. person who receives a distribution from a foreign trust (including loans treated as distributions by statute). We recommend that Form 3520 be amended to allow it to be used to satisfy the expanded filing obligations under section 679(d).

If a foreign trust is deemed to be a grantor trust under section 679, the foreign trust is then required to file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner. Form 3520-A is due by the fifteenth day of the third month after the

¹³ Reg. § 1.679-2(a)(1).

¹⁴ Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the “Hiring Incentives to Restore Employment Act,” Under Consideration by the Senate* JCX-4-10 (Feb. 23, 2010), at 72-73, available at <http://www.jct.gov/publications.html?func=startdown&id=3648>.

end of the trust's tax year, with an available six month extension (*i.e.*, March 15 and September 15, for calendar year taxpayers). Form 3520 is due on the date that a taxpayer's income tax return is due, including extensions (generally April 15 and October 15, respectively). We recommend that the due date, including extensions, of Form 3520-A be changed to match that of Form 3520. We believe this should reduce confusion and the likelihood that a return preparer, while preparing a Form 3520 in April, will realize that the trust should have filed Form 3520-A in March.

Section 679(d) uses the word "may" rather than "shall," meaning that the Service may treat (but is not required to treat) a foreign trust as a grantor trust for failure to report transfers or prove the absence of U.S. beneficiaries. We recommend that any Regulations promulgated under section 679(d) reflect that the application of the statute by the Service is discretionary and not mandatory. The section 679(d) reporting requirement, although understandable from the point of enforcement, provides a classic trap for the unwary grantor, with potentially severe tax consequences if converting an older foreign non-grantor trust to a grantor trust. For this reason, we recommend that the Treasury consider issuing Regulations under section 679(d) that would impose only a limited civil penalty in the case of a U.S. grantor's non-willful failure to report a foreign trust that, in fact, does not have a U.S. beneficiary (*i.e.*, a trust that would not have been treated as a grantor trust if it had reported properly under section 679(d)).

Conclusion

The new language of section 679(c)(1), (c)(4), and (c)(5) closely tracks the current Regulations, and should not in our view result in substantial changes to the operation of section 679 or require the modification of the corresponding Regulations. However, the addition of section 679(c)(6) and (d) introduce, respectively, a requirement to pay fair market value for the use of trust property and a requirement to demonstrate that a foreign trust has no U.S. beneficiaries. Failure to satisfy either of these requirements may trigger grantor trust status with potentially severe tax implications. We therefore recommend that any Regulations promulgated under these new provisions include some type of safe harbor, a *de minimis* exception, and a good faith or reasonable basis exception (in the case of use of trust property under section 679(c)(6)) and an exception for non-willful failures to report (in the case of the new reporting requirements under section 679(d)).