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Report No. 1364

January 23, 2017

The Honorable Thomas C. West  
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The Honorable John Koskinen  
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The Honorable William M. Paul  
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Re: *Proposed Section 2801 Regulations*

Dear Messrs. West, Koskinen, and Paul:

I am pleased to submit the attached report of the Tax Section in response to the Treasury Department's request for comments on proposed regulations under section 2801 (the "**proposed regulations**").

The proposed regulations generally are relevant to individuals who cease to be U.S. citizens or long-term lawful permanent residents of the United States on or after June 17, 2008 and who have incomes or net worths in excess of certain thresholds or who are unable to certify compliance with their U.S. tax obligations ("**covered expatriates**"). In particular, the proposed regulations address the succession tax on imposed on U.S. citizens and residents and domestic trusts that directly or indirectly receive

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gifts or bequests from covered expatriates (“**covered gifts**” or “**covered bequests**”).

Our principal recommendations to the proposed regulations are as follows:

**1. Timing and Value of Covered Gifts and Bequests**

Because section 2801 imports principles of the gift tax (a tax that is paid by donor) and principles of the estate tax (a tax that is paid by a decedent’s estate prior to the distribution of property to the decedent’s heirs) and seeks to apply these principles to a tax that is borne by recipients of gifts and bequests, a recipient of a covered gift or a covered bequest may be subject to tax under section 2801 on an amount in excess of the value of the property received and at a time when the recipient’s interest in the property is not yet possessory. We suggest that the regulations be modified to allow a U.S. recipient of a covered gift or bequest to defer payment of the section 2801 tax, with an interest charge, until the recipient’s interest in the gift or bequest becomes possessory. We also suggest that the amount of the tax and interest payable by the recipient be capped at the value of the property he or she ultimately receives.

**2. Indirect Gifts and Bequests**

The section 2801 tax applies to gifts and bequests acquired indirectly as well as directly from a covered expatriate. The proposed regulations provide examples of when an indirect covered gift or bequest would be considered to occur. We suggest that these examples be modified to clarify the scope of indirect gifts and bequests to which the regulations apply. The proposed regulations also include language that, read literally, could result in *any* transfer received by a U.S. individual being treated as a covered gift or bequest. We recommend that this language be modified to incorporate rules similar to those described in Regulations under sections 643(h) and 679, which were also adopted to address a concern that intermediaries would be used to avoid tax.

**3. Section 2801 and Treaties**

The proposed regulations suggest that the application of section 2801 may be impacted by existing gift and estate tax treaties, but do not provide particular guidance as to the relationship between section 2801 and treaties. We recommend that the final regulations clarify the interaction between section 2801 and existing gift and estate tax treaties.

#### **4. Basis Adjustment for Section 2801 Tax Paid**

The proposed regulations state that section 1015(d), which provides a basis adjustment to property received by gift to reflect gift tax paid, does not apply to adjust the basis of a covered gift to reflect tax paid under section 2801. We suggest that the regulations clarify that the inapplicability of section 1015(d) does not preclude an adjustment to the basis of a covered gift for taxes paid under section 2801, because the basis of property acquired by way of a covered gift may be increased under section 164.

#### **5. Defining “Distributions” from Foreign Trusts**

Under the proposed regulations, a distribution from a non-electing foreign trust to a U.S. recipient is subject to the section 2801 tax if the distribution is attributable to one or more covered gifts or bequests received by the foreign trust. We suggest that the regulations be modified to clarify the circumstances under which property transferred to a U.S. recipient by reason of the exercise or release of a general power of appointment will be subject to tax under section 2801.

#### **6. Determining the Amount Attributable to a Covered Gift or Bequest or a Distribution from a Foreign Trust**

Based on the proposed regulations, if a portion of the contributions made to a non-electing foreign trust are covered gifts or bequests, a portion of each distribution from the foreign trust to a U.S. recipient is subject to the section 2801 tax. In circumstances where a covered expatriate’s contributions to a foreign trust can be traced to specific assets, we recommend that the regulations permit the trustees to separately account for the portion of the trust comprising these assets.

#### **7. Marital and Charitable Transfers and Foreign Trusts**

Section 2801(e)(3) provides an exception to covered gift or bequest treatment for transfers that would qualify for the marital or charitable deduction if the donor or decedent were a U.S. person. Given the statutory construct, we recommend that the determination of whether the marital or charitable exception applies be made at the time that a distribution is made from a foreign trust to a U.S. citizen or resident spouse of the donor or decedent or to a U.S. charitable organization.

## **8. Deduction for 2801 Tax Paid on Distribution from a Foreign Trust**

Under the proposed regulations, a U.S. recipient of a distribution from a foreign trust is allowed a deduction under section 164 in the year in which the section 2801 tax is paid or accrued. It seems that the section 2801 tax cannot be deducted against accumulated income of a trust that is distributed to a U.S. beneficiary. We suggest that Treasury modify the regulations so that the section 2801 tax may be deductible against an accumulation distribution.

## **9. Treatment of Electing Foreign Trusts**

A foreign trust may elect to be treated as a domestic trust for purposes of section 2801 (an “**electing foreign trust**”). An electing foreign trust is required to pay the section 2801 tax upon receipt of a covered gift or bequest. If the IRS disagrees with value of a covered gift or bequest or if the IRS otherwise disputes the amount of tax paid by the electing foreign trust, the proposed regulations require the trustee either to pay the disputed amount or forfeit the trust’s election to be treated as a domestic trust, without an opportunity for judicial review. We recommend that Treasury modify the regulations to provide an opportunity for judicial and administrative review of the disputed amount of the section 2801 tax.

## **10. Information Returns**

The proposed regulations require U.S. persons who receive covered gifts or bequests to file IRS Form 3520 in addition to Form 708. We suggest that Treasury reconsider the necessity of requiring both of these forms to be filed. If the regulations continue to require U.S. recipients of covered gifts or bequests to file Form 3520 in addition to Form 708, we recommend that the regulations at least clarify that the Form 3520 filing requirement extends only to the class of persons for whom there is a statutory basis to require the filing of this form.

## **11. Protective Form 708**

We recommend that a U.S. recipient of a gift, bequest or distribution from a foreign trust be able to file a protective Form 708 not only when the recipient is able to conclude that the transferor is not a covered expatriate and that the gift, bequest or trust distribution is not subject to the section 2801 tax, but also when the recipient has conducted a reasonably diligent investigation and is unable to make a determination as to the transferor’s U.S. tax status.

The Honorable Thomas C. West  
The Honorable John Koskinen  
The Honorable William M. Paul

January 23, 2017

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Respectfully Submitted,



Stephen B. Land  
Chair

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