Tax Report #839

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June 15, 1995

The Honorable Daniel P. Moynihan
United States Senate
Committee on Finance
464 Russell Senate Office Building
Washington, D.C. 20510

Re: **Proposed Legislation Regarding <u>Expatriates and Foreign Trusts</u>**

Dear Senator Moynihan:

Enclosed please find a report commenting on various legislative proposals to amend the taxation of United States expatriates, and to change the U.S. tax treatment of certain foreign trusts. The report comments on legislative proposals that were introduced over the past few months as H.R. 981, S. 453, H.R. 831, and S. 700. The report is a joint product of our Committees on Estates and Trusts, Foreign Activities of U.S. Taxpayers and U.S. Activities of Foreign Taxpayers, and was drafted principally by Carlyn S. McCaffrey.

The report is divided into two sections. Section I discusses the various expatriation proposals that were included in the foregoing bills. The report essentially supports S. 700, (which was the version of the expatriation tax proposal introduced by Senator Moynihan). We note, however, that there are a number of important questions raised by each of the expatriate proposals. As more fully discussed in the report, these concerns include the following:

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1. We are concerned that the requirement of S. 700 that security be provided might, as a practical matter, make expatriation impossible where an individual does not have sufficient directly-held assets to satisfy the security requirement.

2. We believe these proposals present risks of double taxation in a number of different situations, and these need to be addressed so that individuals who expatriate will not be subjected to greater taxation than had they remained U.S. citizens or residents.

3. The proposals' treatment of interests in trusts raises a number of technical issues, as well as difficult problems in identifying an expatriating beneficiary's share of trust assets.

4. S. 700 generally adopts what we believe is the theoretically correct approach of stepping up the basis of assets when a foreigner comes into the United States, but we have a number of technical comments on the language of this proposal.

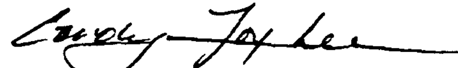
5. The application of the proposals to individuals who believe themsleves to have expatriated prior to February 6, 1995 raises some unwarranted (and perhaps unintended) problems.

Section II of the report sets forth commentary on the portions of H.R. 981 and S. 453 that propose various changes to the U.S. tax treatment of foreign trusts. Among the most significant of these comments is our belief that attempts to impose current tax on U.S. beneficiaries of foreign trusts, where those beneficiaries have no access to or control over the trust assets, create significant problems of enforcement and equity. This is a problem with the proposal to treat certain U.S. beneficiaries as grantors of foreign trusts, and with the proposal to treat certain foreign trusts as non-grantor trusts.

We note that on Friday of last week a new legislative proposal for taxing expatriates (H.R. 1812) was made public, and that proposal was the subject of a markup in the Committee on Ways & Means on Tuesday of this week. This new bill takes the approach of tightening the 10-year taxing regime currently imposed under section 877 by addressing some of the obvious defects in the current statutory provision. Given the time constraints, the enclosed report does not comment on H.R. 1812. We are currently reviewing that bill and expect to offer comments on it at a later date. Initially, we have observed certain technical problems in H.R. 1812; we also believe that tightening section 877 can be a valid approach to the problem of tax-motivated expatriation. However, whether the expatriate problem is better addressed by imposing a 10-year rule that taxes U.S. assets of former citizens, as under current law and H.R. 1812, or by imposing an exit tax with an alternative election to continue to be taxed as a U.S. citizen, as under S. 700, is essentially a question of policy that requires analysis and balancing of concerns about equity, enforceability, and the proper reach of U.S. taxing jurisdiction. We believe each approach has merit and each has shortcomings, and we hope to comment on these issues in greater detail in the near future.

Please do not hesitate to call me should you wish to discuss the report further. Thank you.

Very truly yours,



Carolyn Joy Lee
Chair

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June 15, 1995

The Honorable Bill Archer
House of Representatives
Committee on Ways & Means
1236 Longworth House Office Building
Washington, D.C. 20515

Re: **Proposed Legislation Regarding <u>Expatriates and Foreign Trusts</u>**

Dear Mr. Archer:

Enclosed please find a report commenting on various legislative proposals to amend the taxation of United States expatriates, and to change the U.S. tax treatment of certain foreign trusts. The report comments on legislative proposals that were introduced over the past few months as H.R. 981, S. 453, H.R. 831, and S. 700. The report is a joint product of our Committees on Estates and Trusts, Foreign Activities of U.S. Taxpayers and U.S. Activities of Foreign Taxpayers, and was drafted principally by Carlyn S. McCaffrey.

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June 15, 1995

The Honorable Sam M. Gibbons
House of Representatives
Committee on Ways & Means
2204 Rayburn House Office Building
Washington, D.C. 20515

Re: **Proposed Legislation Regarding**
Expatriates and Foreign Trusts

Dear Mr. Gibbons:

Enclosed please find a report commenting on various legislative proposals to amend the taxation of United States expatriates, and to change the U.S. tax treatment of certain foreign trusts. The report comments on legislative proposals that were introduced over the past few months as H.R. 981, S. 453, H.R. 831, and S. 700. The report is a joint product of our Committees on Estates and Trusts, Foreign Activities of U.S. Taxpayers and U.S. Activities of Foreign Taxpayers, and was drafted principally by Carlyn S. McCaffrey.

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June 15, 1995

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: **Proposed Legislation Regarding <u>Expatriates and Foreign Trusts</u>**

Dear Secretary Samuels:

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June 15, 1995

Hon. Margaret Richardson
Commissioner
Internal Revenue Service
Room 3000
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Proposed Legislation Regarding <u>Expatriates and Foreign Trusts</u>

Dear Commissioner Richardson:

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June 15, 1995

Mr. Kenneth J. Kies
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20220

Re: **Proposed Legislation Regarding <u>Expatriates and Foreign Trusts</u>**

Dear Mr. Kies:

Enclosed please find a report commenting on various legislative proposals to amend the taxation of United States expatriates, and to change the U.S. tax treatment of certain foreign trusts. The report comments on legislative proposals that were introduced over the past few months as H.R. 981, S. 453, H.R. 831, and S. 700. The report is a joint product of our Committees on Estates and Trusts, Foreign Activities of U.S. Taxpayers and U.S. Activities of Foreign Taxpayers, and was drafted principally by Carlyn S. McCaffrey.

The report is divided into two sections. Section I discusses the various expatriation proposals that were included in the foregoing bills. The report essentially supports S. 700, (which was the version of the expatriation tax proposal introduced by Senator Moynihan). We note, however, that there are a number of important questions raised by each of the expatriate proposals. As more fully discussed in the report, these concerns include the following:

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NEW YORK STATE BAR ASSOCIATION TAX SECTION REPORT ON PROPOSED LEGISLATION ON EXPATRIATION AND FOREIGN TRUSTS

This report[1] comments on proposed legislation included in the President's fiscal 1996 budget and introduced in the House as H.R. 981 and in the Senate as S. 453, relating to the taxation of U.S. citizens and resident aliens who relinquish their citizenship or residency, and to the taxation of certain foreign trusts and their beneficiaries (the "Administration Proposal").

A modified version of the Administration Proposal's provisions dealing with expatriation made a second legislative appearance in the form of a Senate Finance Committee amendment to H.R. 831, the legislation intended to extend the health insurance deduction for self-employed individuals (the "Senate Finance Committee Proposal"). The major difference between the two expatriation proposals is the failure of the Senate Finance Committee Proposal to tax long-term resident aliens who relinquish their U.S. residency.

The Conference Committee removed the Senate Finance Committee Proposal and replaced it with a directive to the staff of the Joint Committee on Taxation to undertake a comprehensive study of the issues relating to the taxation of expatriation and to report its results no later than June 1, 1995 to the Chairmen of the Committee on Ways and Means and of the Committee on Finance.[2]

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1. This report is a joint product of the Committees on Estates and Trusts, Foreign Activities of U.S. Taxpayers, and U.S. Activities of Foreign Taxpayers, and has been drafted principally by Reuven Avi-Yonah, Henry Christensen, III, Michael I. Frankel, Robert C. Lawrence, III, Michael Hirschfeld, Carlyn S. McCaffrey, Gideon Rothschild, and Philip R. West. Helpful comments were received from Sanford H. Goldberg, Richard L. Goldman, Carolyn Joy Lee, Richard O. Loengard, Jr., and Steven C. Todrys.

2. Appendix A to this report includes the full text of § 6 of H.R. 831, which contains this directive.

Senator Moynihan then introduced another version of the expatriation proposal on April 6, 1995 as S. 700 (the "Moynihan Proposal").[3] The Moynihan Proposal restores provisions applying the expatriation proposal to certain long-term residents who terminate their residency,[4] provides for an asset-by-asset election for continued treatment of property as subject to the jurisdiction of U.S. tax in lieu of current taxation, and resolves some of the problems members of the Tax Section had raised in previous commentary.[5]

I. THE EXPATRIATION PROPOSAL

A. The Proposal

The expatriation proposal (section 1 of the Moynihan Proposal, section 5 of the Senate Finance Proposal, and section 201 of the Administration Proposal) would add new section 877A to the Internal Revenue Code, which would treat an individual who expatriates after February 5, 1995[6] as having sold all of her property at fair market value at the time she relinquishes her citizenship or, if she is a long-term resident alien,[7] at the time she ceases to be subject to tax as a resident of the United

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3. This report refers to the expatriation proposals of all three bills as the "expatriation proposal." Where appropriate, it explains the differences among (1) H.R. 981 and S. 453, (2) H.R. 831, and (3) S. 700.

4. The term "long-term resident" is defined in proposed § 877A(e)(4) in §1(a) of the Moynihan Proposal as "any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States in at least 8 taxable years during the period of 15 taxable years ending with the taxable year. . . " during which she relinquishes U.S. residency.

5. See the Tax Section memorandum to the members of the House Ways and Means Committee on Oversight dated March 27, 1995.

6. For convenience of reference, the term "expatriate" is used to refer both to an expatriating citizen and a departing alien, except where indicated to the contrary.

7. The term "long-term resident" is defined in proposed § 877A(e)(2) in § 201(a) of the Administration Proposal as "any individual (other than a citizen of the United States) who is a lawful permanent resident of the United States and, as a result of such status, has been subject to tax as a resident in at least 10 taxable years during the period of 15 taxable years ending with the taxable year during which [she ceases to be treated as resident of the United States]."

States.[8] She is required to recognize gain or loss for tax purposes on all such deemed sales.

The Moynihan Proposal offers the expatriate a choice, on an asset-by-asset basis, between immediate recognition of gain or loss or continued exposure to U.S. tax as if she were a U.S. citizen on property with respect to which she has made an election. The choice is available, however, only if the expatriate provides security for the payment of future tax, waives future rights under treaties that would otherwise protect her from U.S. tax, and complies with such other requirements as may be imposed by Treasury.

Each of the expatriation proposals would replace provisions under current law that subject expatriating U.S. citizens to U.S. income tax, at rates applicable to citizens, on U.S. source income, including, for this purpose, gains from the sale of stock or debt of a U.S. issuer, for 10 years after expatriation if a principal purpose of the expatriation was to avoid U.S. tax.[9]

For purposes of calculating the expatriation tax, the expatriate is treated as owning: (1) those assets that would have been included in her gross estate if she had died on the date of expatriation, (2) certain interests in trusts, and (3) "any other interest in property specified by the Secretary as necessary or appropriate to carry out the purposes of this section." The first $600,000 of gains are excluded, as are U.S.

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8. Proposed § 877A(a) in all three proposals. For an earlier recommendation of this approach *see* the August 1991 report of the Committee on Taxation of International Transactions of the Association of the Bar of the City of New York entitled "The Effect of Changes in the Type of United States Tax Jurisdiction Over Individuals and Corporations: Residence, Source and Doing Business" reprinted in 46 *Record of the Association of the Bar* 914 (1991).

9. § 877. Section 201(c) of the Administration Proposal, § 5(c) of the Senate Finance Committee Proposal, and § 1(c) of the Moynihan Proposal provide that § 877 will not apply to any individual who relinquishes U.S. citizenship within the meaning of proposed § 877A. Similarly, § 201(c)(2) of the Administration Proposal and § 1(c)(5) of the Moynihan Proposal provide that § 7701(b)(10), the provision that subjects certain long-term residents whose residency terminates to § 877, will not apply to any individual who is subject to the expatriation tax, in the case of the Administration Proposal or an expatriate within the meaning of § 877A, in the case of the Moynihan Proposal. The estate and gift tax provisions that correspond to § 877, §§ 2107 and 2511(b), are not affected by the proposed legislation.

real property interests as defined in section 897(c)(1), interests in qualified retirement plans, and interests in foreign pension plans not in excess of $500,000.

A U.S. citizen expatriates for purposes of the proposed legislation on the earliest to occur of: (1) the date she renounces her U.S. nationality before a diplomatic or consular officer of the United States pursuant to section 349(a)(5) of the Immigration and Nationality Act,[10] (2) the date she furnishes to the U.S. Department of State a signed statement of voluntary relinquishment of U.S. nationality that confirms one of the expatriative acts described in paragraphs (1) through (4) of section 349(a) of the Immigration and Nationality Act,[11] or (3) the date the Department of State issues a certificate of loss of nationality for any other reason.[12]

Under the Moynihan Proposal, a long-term resident expatriates on the date she ceases to be a lawful permanent resident of the U.S. within the meaning of section 7701(b)(6) or begins to be treated as a resident of a foreign country under the provisions of a treaty between the U.S. and that country, unless she waives the benefits of that treaty.[13]

Until the occurrence of the expatriation event described above, a U.S. citizen will continue to be treated as a U.S. citizen for all purposes of U.S. tax.[14]

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10. 8 U.S.C. § 1481 (a)(5).

11. 8 U.S.C. § 1481 (a)(1)-(4).

12. The text describes the expatriation provisions of the Senate Finance Committee Proposal and the Moynihan Proposal. The Administration Proposal would delay the expatriation date until the issuance by the United States Department of State of a certificate of loss of nationality or the date a U.S. court cancels a naturalized citizens certificate of nationalization. Proposed § 877A(e), Administration Proposal § 201(a).

13. Proposed § 877A(e)(1)(B), Moynihan Proposal § 1(a).

14. Section 201(b) of the Administration Proposal, § 6(b) of the Senate Finance Committee Proposal, and § 1(b) of the Moynihan Proposal would add new paragraph (47) to § 7701(a) to provide that an individual will continue to be a U.S. citizen until her citizenship is treated as relinquished under proposed § 877A(e)(1).

B. General Comments

In general, but subject to the comments discussed below, we support the Moynihan expatriation proposal. The critical distinction between the Moynihan Proposal and the earlier proposals is the existence in the Moynihan Proposal of the election to avoid a current tax as to any property by consenting to continue to be subject to tax with respect to such property as if the expatriate were a U.S. citizen.

As discussed in further detail below, if the election is available for all individuals, including those who have insufficient resources to provide security for the future payment of the tax, the Moynihan expatriation proposal seems to be an appropriate anti-abuse device that corrects the deficiencies of current section 877. If, however, the need to provide such security is applied in a manner which makes expatriation financially impractical in some cases, we fear even the Moynihan Proposal would act as a barrier to the exercise of an individual's right to relinquish citizenship. We find this troublesome.

Section 877, as the Joint Committee has stated, "has been applied in very few cases."[15] Section 877 is hard to enforce because of the difficulty in proving the required tax-related motivation for the expatriation. In addition, it is limited to U.S. source income of former citizens, which makes the provision easy to avoid,[16] and may not apply to those former citizens who reside in countries with which the U.S. has a treaty.[17] As an example of the shortcomings of section 877, it is not coordinated with section 367, so a former citizen may, instead of selling stock in a U.S. corporation directly, transfer the stock to a foreign (tax haven) corporation and have that corporation dispose of the stock, without fearing the potential application of

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15. Joint Committee on Taxation, "Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Citizenship," JCX-14-95 (March 20, 1995), reprinted in Tax Notes Today, March 22, 1995 (the "JCT Report #1"); Joint Committee on Taxation, "Background and Issues Relating to Taxation of U.S. Citizens Who Relinquish Their Citizenship and Long-Term Resident Aliens Who Relinquish their U.S. Residency," JCX-16-95 (March 23, 1995) reprinted in Tax Notes Today, March 27, 1995 (the JCT Report #2).

16. See the testimony of Leslie Samuels and of H. David Rosenbloom before the Finance Committee, reprinted in Tax Notes Today, March 22, 1995.

17. *See Crow v. Commissioner*, 85 T.C. 376 (1985) in which the Tax Court held that an expatriate living in Canada was entitled to protection from § 877 under the U.S.-Canada treaty. *But see* Rev. Rul.79-152, 1979-1 C.B. 237 in which the IRS expressed a contrary view.

either section 367 or of the various anti-deferral regimes, which only apply to U.S. citizens or residents.[18] In broad concept, we consider the Moynihan Proposal a proper measure designed to curb such abuse and to maintain confidence in the U.S. tax system, and a proper extension of the U.S. policy of taxing all its citizens, whether resident or non-resident, on their worldwide income.[19]

The expatriation tax does represent a major tax policy change, in that instead of taxing U.S. citizens and residents on their world-wide income as it is realized, the proposals seek to tax expatriating citizens on the appreciation that accrued during the period they were citizens or residents, without requiring a realization event. In doing so, the expatriation proposals go beyond the deemed sale resulting from the application of section 367 to outbound transfers, because those transfers involve a realization event that would otherwise benefit from non-recognition. A similar approach by the Treasury may be found in the proposed PFIC regulations, which treat a shareholder as having disposed of her stock in a PFIC on the last day that she is a U.S. person (*i.e.*, a U.S. citizen or resident).[20]

The expatriation tax has been criticized as unconstitutional because it applies despite the absence of income realization, and as a violation of international law banning restrictions on travel and immigration. We are not experts on international law, and therefore will not opine on the second argument.[21] On the constitutionality issue, it appears to us that the development of the law has increasingly supported the imposition of tax even when there has been no realization event, notwithstanding *Eisner v. Macomber*.[22] The existence of various provisions in the international arena

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18. Until 1976, § 367 did apply to transfers to foreign corporations by expatriates. The exclusion of expatriates by the amendments made to § 367 by the Tax Reform Act of 1976 (P.L. 94-455, § 1042(a)) was probably inadvertent.

19. A discussion of this policy is beyond the scope of this report. We note, however, that the U.S. policy of subjecting its nonresident citizens to income tax on their world-wide income is unusual. It is shared by only the Philippines and Eritrea. *See* JCT Report #1, 9 and JCT Report #2, 13.

20. Prop. Treas. Reg. § 1.1291-3(b)(2). The validity of this proposed regulation, however, has not yet been determined.

21. We note, however, that the expatriation proposal does not restrict the right of U.S. citizens to travel (unlike the Soviet laws targeted by the Jackson-Vanik Amendment in 1974).

22. 252 U.S. 189 (1920).

providing for deemed distributions (*e.g.*, the FPHC rules from 1937, the Subpart F rules from 1962, and the PFIC rules from 1986), some of which have been upheld against constitutional challenges, and the proliferation of domestic mark-to-market regimes, are, in our view, sufficient support for the conclusion that the expatriation tax is constitutional.[23]

We also note that the expatriation proposals are something of a theoretical hybrid. Individuals who expatriate are no longer subject to U.S. income tax on non-U.S. assets, nor are they subject to U.S. estate tax on non-U.S. assets. The expatriation proposals address this by imposing income tax on world-wide assets at the time of expatriation. However, because the income tax functions differently from the estate tax, and because this deemed sale approach is overlaid on the existing income tax treatment of nonresident aliens, this approach has several effects. First, it subjects to current taxation assets that remain subject to U.S. taxing jurisdiction notwithstanding expatriation; these issues are discussed below. The deemed sale approach also means that individuals with low-basis assets can be subjected to substantial income tax liability on expatriation, while (particularly with encumbered assets) the value subject to U.S. estate tax on the expatriate's death might give rise to a smaller estate tax. This anomaly is substantially resolved by the election contained in the Moynihan Proposal, at least when the expatriating individual is able to satisfy the requirements for the election. Finally, the deemed sale approach means that individuals with high-basis assets might achieve tax savings by expatriating, for the current income tax on a deemed sale could be considerably less than the eventual income tax on an actual sale, and less than the U.S. estate tax. For such individuals, the expatriation proposals may actually serve to encourage expatriation. Presumably, in selecting the deemed sale approach, these anomalies were weighed against other considerations, and judged to be tolerable. Indeed, subject to the comments below, we believe the Moynihan Proposal is a reasonable approach, and we support it. However, it should be understood that, because of its hybrid nature, the expatriation tax will likely give rise to some unusual results.

C. **Specific Comments**

Although we support the Moynihan Proposal in general, we believe that all three versions of the proposed expatriation tax suffer from major flaws that should be corrected before any of the proposals is enacted into law. Specifically, we have

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23. *See, e.g., Eder v. Commissioner*, 138 F.2d 27 (2d Cir. 1943) (upholding the constitutionality of the FPHC rules); *Garlock, Inc. v. Commissioner*, 489 F.2d 197 (2d Cir. 1973) (same for Subpart F); and §§ 1256 and 475, providing for mark-to-market regimes in the domestic context.

identified five major problem areas: first, the application in the Administration's Proposal and in the Senate Finance Committee's Proposal of the tax to appreciation accrued prior to becoming a U.S. citizen, and in all three proposals, to appreciation accrued prior to the receipt of property by gifts from nonresident aliens; second, the effect of the proposals on involuntary expatriation and on individuals who expatriated prior to February 6, 1995; third, the need to prevent double taxation; fourth, the imposition of the expatriation tax without sufficient options for deferring payment or recognition; and fifth, the application of the expatriation proposals to interests in trusts, particularly discretionary trusts. Each of these problem areas is discussed below.

1. Property Acquired Prior to Becoming a U.S. Citizen or Resident and Property Acquired by Gifts From Nonresident Aliens

The Treasury's press release accompanying the Administration Proposal identified the goal of the proposal as preventing U.S. citizens from renouncing their citizenship, "taking their wealth with them and not paying any taxes on the appreciation in value of those assets accumulated while they enjoyed the benefits of U.S. citizenship."[24] Similarly, the Treasury stated that "gains accruing during the time that a taxpayer was a citizen or long-term resident should be subject to U.S. tax if those persons abandon their U.S. status."[25]

However, the Administration Proposal would tax expatriating U.S. citizens on their gain on all of their worldwide property, including gains that accrued before they became U.S. citizens or residents. The Administration Proposal (but not the Senate Finance Committee Proposal) would also extend to long-term residents. In that case, the Administration Proposal provides an election to have property that was held by the resident when she first became a resident receive a stepped up basis for purposes of the expatriation tax to its fair market value upon becoming a resident, so that only the gain accrued during the period of U.S. residence will be subject to tax.[26] However, this election is available only to long-term residents, not to citizens, and in the case of the Senate Finance Committee Proposal, has been eliminated together with the application of the tax to non-citizens.

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24. Treasury Release Announcing Proposals on Expatriation, Foreign Trusts, Tax Notes Today (Feb. 7, 1995) (emphasis added).

25. Treasury Explanation of Clinton's Proposals to Curb Foreign Tax Avoidance, Tax Notes Today, Feb. 7, 1995.

26. Proposed § 877A(g), Administration Proposal § 201(a).

We believe that the rationale of the expatriation proposal, as quoted above, does not support extending it to gains accrued before an expatriating citizen became a U.S. citizen or resident or to gains that accrued before property was given to a U.S. citizen or resident by a nonresident alien. For example, suppose a nonresident alien immigrated to the U.S. in 1987, owning considerable property in foreign countries, became a naturalized citizen in 1992, and expatriated in 1995. In a world in which there is a deemed realization on expatriation, should she not be taxed only on the gain that accrued on her world-wide property after 1987 when she became a resident? Similarly, suppose a U.S. citizen or resident received a gift of appreciated property from her foreign parent in 1993 and expatriated in 1995. Although it might be appropriate to subject any additional appreciation that accrued in the property between 1993 and 1995, subjecting the pre-1993 appreciation to the expatriation tax does not seem justified.[27]

We strongly recommend extending the election proposed by the Administration to citizens as well as residents, as does the Moynihan Proposal, and extending it to gifts from nonresident aliens. The election should provide for fair market value basis for an expatriate's property on the earlier of the date of the expatriate's acquisition of U.S. citizenship or residency, or the date property first became subject to U.S. tax because it was used in a U.S. trade or business or was a U.S. real property interest.[28] In the case of property acquired by gift from a nonresident alien, the basis should be the fair market value as of the earlier of the date of the gift or the date it first became subject to U.S. tax.

Section 2 of the Moynihan Proposal, which proposes new Code section 1061, does offer a basis adjustment to citizens and resident aliens for property held by them before acquiring citizenship or residency, whichever is first acquired, for purposes of determining gain or loss but does not offer any adjustment for gifts received from nonresident aliens. We recommend that it do so. In addition, we have the following technical concerns with the text of this portion of the Moynihan Proposal:

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27. Certainly in the case of marketable securities, the failure to have a "step-up" may merely be a trap for the unwary since the securities could have been sold and repurchased prior to the gift.

28. While there may be a problem in determining the value of the property upon immigration, there is a similar problem upon expatriation, and we do not believe such administrative difficulties should prevent application of the tax only to gains accrued while the taxpayer enjoyed the benefits of U.S. citizenship or residence.

a. The adjustment applies only to property "held on the date the individual becomes a citizen or resident." The language should be clarified to extend to after-acquired property to the extent its basis is determined with reference to the basis of the property held on such date, such as, for example, property acquired in a section 1031 or 1034 exchange or stock acquired in a section 351 transfer.

b. The adjustment applies only for purposes of determining gain or loss and apparently only with respect to the individual who held the property at the time she became a citizen or resident. Thus, for example, if an individual transferred such property to another person such as a corporation in a transfer protected from income tax by section 351, to a partnership in a transfer protected from income tax by section 721, or to an individual or trust by gift, the recipient does not appear to be entitled to a basis adjustment. Any basis adjustment to which an individual is entitled should carry over to any person who receives such property from the individual and in whose hands the basis of such property is determined with reference to the individual's basis.

Similarly, if the individual owned an interest in an entity which, in turn, owned assets, the sale of which might be subject to U.S. income tax, there is no mechanism to provide a basis adjustment for assets held by the entity. Proposed section 1061(d) directs Treasury to prescribe "look-thru rules" but only in the case of U.S. real property or property used in a U.S. trade or business; the look-thru rules need instead to cover all types of assets that are held in a "pass-thru" entity such as a partnership.

Moreover, it is not clear from the proposal whether the basis adjustment is available to an individual with respect to her share of assets held in trusts. Since trust interests may be subject to the expatriation tax, the basis adjustment is available to such interests. However, given the mechanism for imposing expatriation tax on trust interests in which the trust is treated as selling and distributing sale proceeds, an individual who becomes a U.S. citizen or resident at a time when the trust holds appreciated assets and undistributed income needs a basis adjustment at the trust level to protect that individual from tax on the gain accrued and the income accumulated prior to the time she became a citizen or resident.

c. The adjustment is available only once. The justification for this limitation is not apparent to us. Should a person become a resident, then relinquish residency (thereby becoming subject to tax), and then return and reestablish residency, we see no reason to bar a step-up in basis for property held on the date the second residency commenced if such property was acquired after the first expatriation or, if held at the time of the first expatriation, was subjected to the expatriation tax at that time. For example, the tax consequences of an alien becoming resident should

not vary merely because, years before, she also happened to become resident, *e.g.*, at age 5 (because her parents came here) or at age 25 (as a student).

We favor the Administration Proposal's and the Moynihan Proposal's application of the expatriation proposal to long-term residents in general, because otherwise long-term residents would face a considerable disincentive to becoming citizens. We take no position, however, on the specific definition of long-term resident proposed by the Administration and Senator Moynihan, and suggest consideration of a broader definition that includes, for example, persons defined as residents under the substantial presence test of section 7701(b) for a similar number of years.[29]

2. Involuntary Expatriation and the Effect of the Proposal on Individuals who Expatriated Prior to February 6, 1995

Under current law, a U.S. citizen can lose her citizenship by performing any of the following acts with the intention of relinquishing United States nationality:

> "(1) obtaining naturalization in a foreign state upon his own application or upon an application filed by a duly authorized agent, after having attained the age of eighteen years; or
>
> (2) taking an oath or making an affirmation or other formal declaration of allegiance to a foreign state or a political subdivision thereof, after having attained the age of eighteen years; or
>
> (3) entering, or serving in, the armed forces of a foreign state if (A) such armed forces are engaged in hostilities against the United States, or (B) such persons serve as a commissioned or noncommissioned officer; or
>
> (4) (A) accepting, serving in, or performing the duties of any office, post, or employment under the government of a foreign state or a political subdivision thereof, after attaining the age of eighteen years if he has or acquires the nationality of such foreign state; or (B) accepting, serving in, or performing the duties of any office, post, or employment under the government of a foreign state or a political subdivision thereof, after attaining the age of eighteen years for which office, post, or employment an oath, affirmation, or declaration of allegiance is required; or

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29. *See also* Section II.D.3. below.

(5) making a formal renunciation of nationality before a diplomatic or consular officer of the United States in a foreign state, in such form as may be prescribed by the Secretary of State; or

(6) making in the United States a formal written renunciation of nationality in such form as may be prescribed by, and before such officer as may be designated by, the Attorney General, whenever the United States shall be in a state of war and the Attorney General shall approve such renunciation as not contrary to the interests of national defense; or

(7) committing any act of treason against, or attempting by force to overthrow, or bearing arms against, the United States, violating or conspiring to violate any of the provisions of section 2383 of title 18, United States Code, or willfully performing any act in violation of section 2385 of title 18, United States Code, or violating section 2384 of said title by engaging in a conspiracy to overthrow, put down, or to destroy by force the Government of the United States, or to levy war against them, if and when he is convicted thereof by a court martial or by a court of competent jurisdiction."[30]

Until 1986, the Immigration and Nationality Act did not, by its terms, require an intent to renounce citizenship. The Supreme Court supplied this requirement by determining that Congress lacks the constitutional authority to establish acts, the commission of which will effect a renunciation of U.S. citizenship, unless the act is accompanied by a specific intent to renounce citizenship.[31] Thereafter, on November 14, 1986 the Immigration and Nationality Act was amended to expressly state this requirement.[32]

The Administration Proposal requires the issuance of a certificate of loss of nationality by the State Department or a cancellation of a naturalized citizen's certificate of nationalization by a U.S. court.[33] The Senate Finance Committee Proposal and the Moynihan Proposal will also recognize (1) the renunciation of citizenship before a consular officer (under paragraph 5 above) and (2) the provision to the State Department of a signed statement of voluntary relinquishment of

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30. Immigration and Nationality Act, 8 U.S.C.S. § 1481(a).

31. *See, e.g., Vance v. Terrazas*, 444 U.S. 252 (1980); *Afroyim v. Rusk*, 387 U.S. 253 (1967).

32. Immigration and Nationality Act of 1986, Pub.L. No. 99-653, § 18(a).

33. Proposed § 877A(e)(1), Administration Proposal § 201(a).

nationality confirming the performance of an act of expatriation described under paragraphs 1 through 4 above but only if the renunciation or relinquishment is subsequently approved by the issuance of a certificate of loss of nationality by the State Department.[34]

There are two difficulties with the proposals' standards for determining when an individual has relinquished her U.S. citizenship. First, all of the proposals reach an event that is not sufficient to result in an actual relinquishment of citizenship - - the issuance of a certificate of loss of nationality. Second, the proposals include a new definition of citizenship that would, we believe, recognize loss of citizenship under fewer circumstances than does the Immigration and Nationality Act. This would have the effect of treating individuals who are not citizens for any other purpose as citizens for tax purposes and of apparently retroactively reinstating the U.S. "tax" citizenship of individuals who expatriated before February 6, 1995 in compliance with the then existing standards for expatriation.

a. Application of the Expatriation Tax to Individuals Who Remain U.S. Citizens

The issuance of a certificate of loss of nationality by the State Department is authorized by section 50.41 of Title 22 of the Code of Federal Regulations. Such a certificate may be issued whenever a diplomatic or consular officer has reason to believe that a person in a foreign country has lost her U.S. citizenship. We understand that the issuance does not result in the loss of citizenship but merely reflects the opinion of the State Department that a particular individual has performed an act that resulted in the loss of her citizenship. Unless an actual loss of citizenship has occurred within the meaning of the Immigration and Nationality Act, the mere issuance of a certificate of loss of nationality should not cause the imposition of the expatriation tax.

b. Impact on Individuals Who Are Not U.S. Citizens

All of the proposals provide that an individual who was a U.S. citizen remains one for tax purposes until one of the proposals' criteria for loss of citizenship is met.[35] This will be so whether or not she continues to be a U.S. citizen for any

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34. Proposed § 877A(e), Senate Finance Committee Proposal § 5(a); Proposed § 877A(e)(3), Moynihan Proposal § 1(a).

35. Proposed § 7701(a)(47), Administration Proposal § 201(b); Proposed §
(continued...)

other purpose. The requirements for a relinquishment of citizenship for tax purposes should be no different than the requirements for a relinquishment for all other purposes. It is difficult to justify imposing a U.S. tax on an individual based on a tax definition of citizenship if in fact she no longer enjoys the benefits and protections of that citizenship.

On a prospective basis, the imposition of specific tax rules for relinquishing citizenship is not particularly troublesome and can be justified as necessary to protect the IRS from the difficulty of determining when an individual performed an expatriative act with the intent required by the Supreme Court for an actual relinquishment. The tax standards are easily satisfied.

Nevertheless, a requirement that individuals perform specific acts in order to expatriate for tax purposes is very troublesome when applied to individuals who performed an expatriative act, accompanied by the requisite intent before February 6. 1995. Many of these individuals, in reliance on then existing tax standards for expatriation, have structured the tax and other financial aspects of their lives in reliance on the fact that they are no longer U.S. citizens. They have failed to pay U.S. tax on income and gifts; tax has been withheld from their incomes from sources within the U.S.; they have failed to claim treaty protection when they have paid income taxes in the countries of their citizenship and domicile.

The effective date provision of the Moynihan Proposal does not protect these individuals. The expatriation tax and proposed section 7701(a)(47), which provides that a citizen continues to be a citizen until the date her citizenship is treated as relinquished under section 877A, apply to individuals whose expatriation date occurs on or after February 6, 1995.[36] If the State Department issues a certificate of loss of nationality to an individual who expatriated prior to February 6, 1995, the date of issuance will be treated as that individual's expatriation date. As a result, she will be subject to the expatriation tax and to U.S. tax in general for all years between her actual relinquishment of citizenship and the issuance of the certificate.

In considering this point, it is important to keep in mind that proposed section 877A's requirements for the relinquishment of citizenship are not limited to wealthy individuals who have unrealized gains in excess of $600,000. It will define the future

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35. (...continued)
7701(a)(47), Senate Finance Committee Proposal § 5(b); Proposed § 7701(a)(47), Moynihan Proposal § 1(b).

36. Moynihan Proposal § 1(e).

(and perhaps the past) U.S. tax liabilities of all individuals who were expatriates on February 6, 1995 to whom the State Department issues a certificate of loss of nationality.[37]

We recommend that the new requirements for achieving expatriation apply only to those individuals who had not expatriated, under then applicable standards, prior to February 6, 1995. If this recommendation is not accepted, we urge that the effective date provisions of new section 7701(a)(47) be amended to make it clear that it does not apply to tax years that ended before December 31, 1995.[38]

The requirement in the Senate Finance Committee Proposal and the Moynihan Proposal that the renunciation of citizenship before a diplomatic or consular officer of the U.S. or by the furnishing to the State Department of a signed statement of relinquishment confirming the performance of an expatriative act is not sufficient for tax purposes, unless the State Department subsequently issues a certificate of loss of nationality raises questions of fairness as well as administrability.

As to fairness, the Immigration and Nationality Act does not give the State Department the right to continue an individual's U.S. citizenship until it determines it is appropriate to issue a certificate of loss of nationality. If an individual performs one of the acts required by proposed section 877A for the relinquishing of citizenship, the State Department ought not to have the authority to require her to continue to be a citizen for tax purposes by its failure to issue a certificate of loss of nationality.

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37. Apparently, until the State Department issues a certificate of loss of nationality, the effective date provision will protect the individual from the expatriation tax and from any citizen based U.S. tax. It seems inappropriate to give State Department personnel the power to bring a former U.S. citizen back into the reach of the U.S. tax system. If the State Department is to be given such broad authority, the legislation should give it guidance as to the circumstances under which it should be exercised.

38. Administrative precedent for this approach is suggested by Rev. Rul. 92-109, 1992-2 C.B. 3, Rev. Rul. 75-357, 1975-2 C.B. 5 and Rev. Rul. 70-506, 1970-2 C.B. 1 in which the IRS, pursuant to its authority under § 7805(b), ruled that individuals who lost their citizenship pursuant to certain statutory provisions that were later held to be unconstitutional would not be required to pay U.S. income tax for years prior to the year after the issuance of the rulings. *See also United States v. Rexach*, 558 F.2d 37 (1st Cir. 1976).

As to administrability, proposed section 877A(h) requires an expatriating individual to pay the expatriation tax within 90 days after her expatriation date.[39] If an individual performs an expatriative act within the meaning of proposed section 877A(e) and if the State Department fails to issue a certificate of loss of nationality within the 90 day period after the expatriative act, she will not know on the due date of the tax whether she will be subject to the expatriation tax.

3. Double Taxation

For purposes of U.S. tax, the expatriation proposal (in its Senate Finance and Moynihan versions) provides for a step-up in basis following expatriation, so that double taxation of the same gain is avoided if the expatriate's asset is later sold and the gain thereon is subject to U.S. tax (for example, because the asset is used in a U.S. trade or business).[40] However, taxation of the gain inherent at the time of expatriation by other countries still presents a substantial risk of double taxation and exposes the expatriate to a greater combined U.S. and foreign tax liability than she would have had if she had not expatriated. For example, the jurisdiction to which the taxpayer has moved, and/or the jurisdiction in which the assets are located may also impose tax when the expatriate sells assets. Double taxation of the same gain that was taxed by the U.S. at expatriation is a substantial risk because, as the Joint Committee points out, most countries do not exempt gains that accrued prior to immigration from tax upon realization.[41] The double tax burden is one that would not have been imposed if the individual had not relinquished her citizenship or status as a permanent resident but had simply become a resident of a foreign country. In that case, it is likely that the U.S. would have permitted a credit against U.S. tax for the foreign taxes paid on sale.

Under the Code and current U.S. treaties, if a U.S. citizen or resident recognizes gain, for example, on an asset sale, the citizen or resident is permitted to credit against her U.S. tax liability any foreign country's income tax paid on the sale,

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39. Proposed § 877A(h), Senate Finance Committee Proposal § 5(a); Proposed § 877A(h), Moynihan Proposal § 1(a).

40. Senate Finance Committee Proposal § 877A(i); Moynihan Proposal § 877A(j). Treasury is directed to prescribe such regulations as are necessary or appropriate to provide appropriate adjustments to basis to reflect gain recognized by reason of § 877A.

41. Exceptions are Australia, Canada, and Israel. JCT Report #1, 9; JCT Report #2, 13.

so that double taxation of the same income or gain is avoided.[42] Such provisions generally would not, however, apply to expatriates, because at the time the tax is imposed by the other country, the expatriate is no longer a U.S. citizen or resident. In certain circumstances, a nonresident alien may be allowed a credit, *i.e.*, for certain foreign taxes paid with respect to effectively connected income, unless such taxes are imposed solely due to citizenship or residence in the foreign country.[43] This problem is solved by the Moynihan Proposal if (but only if) the election means that the expatriate is treated as a citizen with respect to the elected property for purposes of the credit provisions of section 901(b)(1)-(3) and U.S. treaties; and then is solved only insofar as the expatriate can make the election. Certainly the expatriate should be treated as a citizen who is a nonresident of the U.S. for foreign tax credit purposes so that the gain will be regarded as foreign source in most cases and a credit will be available for foreign taxes paid.[44] In cases in which the gain is U.S. source in the case of a foreigner, *e.g.*, a sale of U.S. real estate, the foreign jurisdiction will presumably give a credit for the U.S. tax.

To prevent a violation of international tax norms and avoid double taxation, we recommend that the expatriation proposal be amended to clarify that these are the intended results. An expatriate should be allowed a reduction or refund of U.S. tax paid on an item of income or gain if she can prove that the same income or gain was also subject to income tax imposed by a foreign country, to the extent that the U.S. would have been required under the Code or under an applicable treaty to grant a credit for the foreign tax had the recognition event occurred while the taxpayer was a U.S. citizen but not a U.S. resident.

In addition, the possibility of double tax exists for individuals who pay an expatriation tax on property that is subsequently subject to gift or estate tax. Proposed section 877A(i) of the Moynihan Proposal provides limited relief for those individuals who are subject to U.S. gift or estate tax under section 2107 or 2501(a)(3) because their expatriation was effected for purposes of avoiding U.S. tax. Such individuals, or their estates, are allowed to credit the expatriation tax against the U.S. estate or gift tax caused by the application of section 2107 or 2501(a)(3). We see no reason to limit this relief to individuals whose estate or gift tax is attributable to section 2107 or 2501(a)(3). It should be available whenever property that was subject to the expatriation tax is subjected to U.S. estate or gift tax. This could occur, for example, if an expatriated nonresident alien dies owning assets situated in the U.S. or

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42. §§ 901, 904 and 865.

43. § 906.

44. *See* § 904. This result may require amendment of § 865(g)(1)(A)(i).

if a nonresident alien is treated as domiciled in the U.S. for transfer tax purposes. If the individual had not expatriated, she would not have paid an expatriation tax and the foreign estate tax paid would have been credited against her U.S. estate tax to the extent attributable to foreign assets. Moreover, the credit should not be limited to those instances in which the individual holds at death or transfers by gift the same property that was subject to the expatriation tax. The credit should also apply to other property to the extent that its basis is determined with reference to the basis of the original property, such as, for example, shares of stock received in a section 351 exchange ("carry-over basis property").

Finally, the possibility of double tax exists for individuals who pay U.S. tax (at expatriation or under the Moynihan election) and then transfer by gift property with respect to which the election was made or die holding such property (or carry-over basis property) while domiciled in a country that imposes a gift or estate tax. In such cases, the transfer will be subject to foreign gift or estate tax as well as the U.S. expatriate tax.[45] To avoid this incidence of double taxation, we suggest that the expatriation proposal be amended to provide for a reduction of U.S. estate or gift tax or a refund of a previously paid expatriation tax to the extent that the expatriate or her estate can prove that the same property was also subject to estate or gift tax imposed by a foreign country, and if the U.S. would grant a credit for that foreign tax if the individual were still a U.S. citizen or resident.

4. The Imposition of the Expatriation Tax Without Sufficient Options for Deferring Payment or Recognition

The expatriation tax will be particularly burdensome to those individuals who expatriate at a time when they lack sufficient liquidity to pay the tax or at a time when they believe it is inappropriate to measure gain (for example, on an interest in a trust).[46] The Senate Finance Committee Proposal and the Moynihan Proposal permit the IRS to extend the time for payment for reasonable cause for up to 10 years, in the case of the Senate Finance Committee Proposal,[47] and for as many years as are

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45. The U.S. estate or gift tax of an electing taxpayer is limited in the case of non-U.S. property, to the aggregate amount of income tax that would have been imposed if the property had been sold immediately before the gift or death. § 877A((a)(3)(B), Moynihan Proposal § 1(a). In many cases, given the lower income tax rates and basis recovery, the limitation amount will be less than the estate or gift tax otherwise imposed.

46. See discussion at Section I.C.5.

47. Proposed § 877A(h)(2), Senate Finance Committee Proposal § 5(a).

deemed appropriate, in the case of the Moynihan Proposal.[48] This option will not be appealing to many individuals since it will require the payment of interest, may require furnishing a bond,[49] and will require the eventual payment of the tax based on values at the time of expatriation, whether or not they ever recognize an actual gain on the disposition of the property held at the time of expatriation.

The addition in the Moynihan Proposal of a provision that permits the expatriate to elect out of the tax as to any particular property by agreeing to subject herself to continued U.S. tax on the property as if she were a U.S. citizen relieves much of this burden and is critical to our support of this proposal.[50] However, we do have the following substantive and technical concerns with the text of this portion of the Moynihan Proposal:

a. The election out is not available unless the individual "provides security for payment of tax in such form and manner, and in such amount, as the Secretary may require." We believe the security requirement should not apply to the extent the expatriate lacks the financial resources to provide it. This is likely to occur, for example, if the individual holds little property in her own name but is treated under the provisions discussed below,[51] as owning an interest in a trust, when that interest is either nonmeasurable (because, for example, it is a discretionary interest) or nontransferable.[52] To require security from an individual in amounts that

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48. § 877A(h)(2), Moynihan Proposal § 1(a).

49. *See* section 6165 which gives Treasury the authority to require a taxpayer to furnish a bond when she is given an extension of time within which to pay any tax.

50. § 877A(a)(3), Moynihan Proposal § 1(a).

51. *See* Section I.C.5.

52. Proposed § 877A(h)(3), Moynihan Proposal § 1(a) requires the U.S. trustees of a trust in which an expatriate is treated as holding an interest to "provide security in connection with any tax imposed by reason of this section" if requested to do so by the expatriate. Since no tax will be imposed by reason of section 877A on an expatriate who makes a Moynihan election, it is not clear that an expatriate will be able to require a trustee to provide the necessary security to make the election. Query whether the tax law can or ought to impose on a trust a financial burden relating to a particular beneficiary if that burden exceeds the beneficiary's transferrable interest in the trust.

substantially impair or exceed her individual assets imposes an insupportable burden on the exercise of an individual's right to expatriate.[53]

b. Similarly, the election out is not available unless the individual "complies with such other requirements as the Secretary may prescribe." Since the election out is critical to the integrity of the Moynihan Proposal, we believe the statute or the legislative history should better describe the parameters of and limits on the scope of Treasury's discretion to impose additional requirements.

c. The text of the proposal states that "such property shall be subject to tax under this title. . . ." Technically, persons, not property, are subject to tax. We suggest using the following language instead:

> "(A) In general. - - If an expatriate elects the application of this paragraph with respect to any property - -
>
> > (i) this section (other than this paragraph) shall not apply to such property, but
> >
> > (ii) such individual shall be subject to tax under this subtitle with respect to such property in the same manner as such individual would have been subject to tax if such individual were a U.S. citizen.
>
> For purposes of this provision, those items of income, deductions, and credits against tax which are attributable to such property shall be taken into account under this chapter in computing taxable income or credits against the tax of such individual (including, but not limited to, the credit for foreign taxes permitted under section 901), and the transfer of such property shall be subject to tax under chapters 11, 12, and 13 to the same extent that such transfer would have been subject to such tax if the individual were a U.S. citizen at the time of the occurrence of such transfer."

d. In the case of property held in trust, we think it appropriate to permit the election with respect to the trust as a unit and to further provide that the expatriate will thereafter be subject to tax with respect to distributions from the trust as if she were a citizen and that the election will be applicable to any trust property distributed to her which is treated as a distribution of principal.

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53. This issue is discussed in greater detail in Section I.D.6.

5. Application to Trusts

As indicated above, the expatriation proposals treat an expatriate as owning certain interests in trusts. These (1) include any interest in a trust to the extent that the property of the trust would be included in her gross estate for U.S. estate tax purposes if she had died immediately prior to expatriation,[54] (2) appear to include any interest in a trust of which the expatriate is treated as owner under section 671 through 679 (the so-called "grantor trust" rules),[55] and (3) include any other interest which she is treated as owning based upon "all relevant facts and circumstances."[56] Each of these categories contains flaws in scope and in application.

a. First Category - Trust Property Includible in the Gross Estate of the Expatriate

Most trusts that fall within the first category seem appropriate subjects for the expatriation tax since one of the purposes of the expatriation tax is to compensate the U.S. for the future estate taxes it will lose as a result of the expatriation. This provision will, however, reach assets in which the expatriate has no economic interest, or has only a limited interest.

While the inclusion of these interests in the expatriate tax base may be justifiable in the case of a trust created by the expatriate, there are cases where an interest in a trust not created by the expatriate will be included in the expatriate's gross estate solely because of an interest or power other than an interest or power that gives her the ability to withdraw or control trust assets. This will not be an unusual fact pattern. It will occur, for example, in any case in which the expatriate is a

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54. Proposed § 877A(c)(1), Administration Proposal § 201(a); Proposed § 877A(c)(1), Senate Finance Committee Proposal § 5(a); Proposed § 877A(c)(1), Moynihan Proposal § 1(a).

55. JCT Report #1, 4; JCT Report #2, 7. This position is consistent with the longstanding IRS position of treating the individual to whom a trust's items of income, deduction, and credit are attributed under § 671 as the "owner," for income tax purposes, of the trust's assets. *See, e.g.*, Rev. Rul. 85-13, 1985-1 C.B. 184. *But see also Rothstein v. United States*, 735 F.2d 704 (2d Cir. 1984) in which the Second Circuit took a contrary position. In Rev. Rul. 85-13, the IRS specifically refused to follow the Second Circuit's position in *Rothstein*.

56. Proposed §§ 877A(c)(2) and 679(e), Administrative Proposal § 201(a) and 203(a); Proposed § 877A(c)(2) and (f)(1), Senate Finance Committee Proposal § 5(a); Proposed § 877A(c)(2) and (f)(1), Moynihan Proposal § 1(a).

beneficiary of a trust with respect to which she has a general power of appointment which is exercisable only with the consent of another, such as a trustee, or is not presently exercisable but, instead, is exercisable at some time in the future to the extent trust property has not been distributed to another beneficiary. Under these circumstances, the property will be included in her gross estate notwithstanding her inability to withdraw any of the assets.

This provision also will subject to tax the surviving spouse's interest as a beneficiary of a so called qualified terminable interest property trust ("QTIP Trust")[57] even though, generally, the spouse-beneficiary of a QTIP Trust has no interest in the trust other than an income interest. When the expatriation tax is imposed she will have no ability to reach trust assets to use to pay the tax or to post security.

If this provision remains in the proposal, consideration should be given to enacting an income tax analogue to section 2207 or section 2207A which enables the estate of the holder of a general power of appointment and the estate of the income beneficiary of a QTIP Trust to recover from the beneficiaries of the trust an amount equal to her estate tax attributable to the inclusion of the trust in her gross estate. This solution, which requires the use of trust funds that are being held for future distribution to an individual other than the expatriate, can be justified when the trust would be included in the expatriate's gross estate if she died a citizen or resident of the U.S. In effect, the payment by the trustee of the income tax is a rough substitute for the estate tax it would have been required to pay if the individual had not expatriated. It would not, however, be appropriate in the case of a trust that will not be subject to estate tax in the expatriate's estate, as, for example, a discretionary trust of which the expatriate is one of several beneficiaries. Moreover, we do not believe this solution will be available in the case of a trust organized and administered under foreign law.

Additionally, it should be made clear that, to the extent a trust interest is treated at any particular time as held by an individual because it would be included in her gross estate that interest should not be treated at the same time as held by other individuals under the "facts and circumstances" test discussed below. Otherwise, the expatriation of multiple members of the same family could easily result in multiple expatriation taxes on the same assets. Section 877A(j) directs Treasury to prescribe regulations to prevent an interest in property from being treated as held by more than one taxpayer.

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57. The requirements for a QTIP are described in § 2056(b)(7).

b. Second Category - Grantor Trusts

Most trusts within the second category involve cases in which the individual who is treated as the owner of a trust for income tax purposes under the grantor trust rules, by the creation of the trust (or her failure to exercise a section 678 withdrawal power), voluntarily assumed the burden of tax ownership of the trust's assets. We do have the following concerns with the inclusion of grantor trusts in the expatriation tax base:

(1) We have concluded that property held in a trust treated as owned by the expatriate under section 671 (a "grantor trust") is intended to be treated as held by her for purposes of the expatriation tax based on statements contained in JCT Report #1 and JCT Report #2.[58] In fact, this result is not at all clear from the language of the proposal. In particular, the provision in the Moynihan Proposal that treats a grantor as holding an interest in a trust only if the application of the facts and circumstances test does not determine which beneficiaries hold all the interests in a trust, and then only if she is a beneficiary of that trust, is inconsistent with this conclusion.[59] This issue should be clarified.

(2) As noted with respect to Category 1 above, it should be made clear that to the extent a trust at any particular time is treated as owned by one individual under the grantor trust rules that interest should not at the same time be attributed to another individual under the third category's "facts and circumstances" test. Absent such a rule, the expatriation of multiple members of the same family could easily result in multiple expatriation taxes on the same assets.

(3) The expatriation tax should not apply to life insurance policies on the life of an expatriate held in irrevocable trusts of which she is the grantor unless she is a beneficiary or holds a power over the trust sufficient to result in its inclusion in her gross estate if she were to die immediately before expatriation. Such trusts are generally treated as grantor trusts under section 677 even though the grantor has no economic interest in the trust and even though the trust assets will not be included in her gross estate. Life insurance policies should be treated differently from other property held in grantor trusts of which the grantor is not a beneficiary since if the grantor had died a citizen of the U.S. the policies would not have been subject to the estate tax and the beneficiaries generally would have received the cash proceeds of the policy free of income tax. One does not, therefore,

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58. JCT Report #1, 4; JCT Report #2, 7.

59. Proposed § 877A(f)(1)(B), Moynihan Proposal § 1(a).

expatriate to avoid U.S. tax on the proceeds of life insurance policies held in irrevocable trusts, and there is no reason to include the value of such policies in the expatriation tax base merely because section 677 treats the life insurance trust as a grantor trust.

(4) The expatriation tax should not apply to a grantor trust to the extent grantor trust status is attributable to a failure to exercise withdrawal rights that lapsed while an individual lacked legal competence to exercise her withdrawal rights because of minority or otherwise. Such an individual should not have to bear a tax penalty for a failure to act that was not within her control.

(5) If an expatriate is treated as holding property in a grantor trust, the trust property will not necessarily be included in her gross estate nor will it necessarily be subject to gift tax if it is distributed from the trust to a beneficiary. Additionally, the termination after expatriation of grantor trust status is normally not a tax recognition event,[60] and would not result in the imposition of tax under the Moynihan election. It should be recognized, therefore, that an expatriate who elects continued U.S. status with respect to a grantor trust may never be taxed on any unrealized appreciation in trust assets unless the assets are sold or unless the trust is also one that would be subject to inclusion in her estate. This seems an appropriate result under the Moynihan election, for, had the individual not expatriated, there would have been no U.S. estate or gift tax due.

c. Third Category - Facts and Circumstances

The method by which third category interests are to be determined is unclear. Moreover, the manner in which the expatriation proposal subjects such interests to the expatriation tax is technically flawed and inconsistent with existing statutory methods for taxing trusts and their beneficiaries.

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60. The termination of grantor trust status is treated as a transfer for income tax purposes from the grantor to the trust, which, by reason of such termination, has become a new, separate entity. However, unless the grantor is treated as receiving something of value on account of such termination, as would be the case if, for example, the trust property were subject to an obligation in excess of basis, such deemed transfer is not a tax recognition event. *See* Treas. Reg. § 1.1001-2(c), Example (5), relating to treatment of the termination of grantor trust status as a recognition event when trust property is subject to obligations in excess of basis. *But see*, Rev. Rul. 87-61, 1987-2 C.B. 219, in which the IRS took the position that the termination of the grantor trust status of a foreign trust would subject the grantor to the tax imposed by § 1491.

(1) Determining the Beneficiary's Interest

A beneficiary's interest in a trust is to be determined based upon "all relevant facts and circumstances," including not only the terms of the trust instrument, but also a group of factors that, at best, reflect the expatriate's expectations as to her trust interest rather than any definable property interest. These other factors include "any letter of wishes or similar document, historical patterns of trust distributions, and the existence of and functions performed by a trust protector or any similar advisor."

Except where an individual's trust interest can be actuarially valued, as in the case of an interest such as the right to receive trust income for a term, it is impossible to predict how these factors measure an individual's interest in a trust. We are therefore very concerned that the expatriation proposals' inclusion of these interests in the expatriate tax base will give rise to substantial inequities.

The Moynihan Proposal provides an alternate method for those cases where a beneficiary's interest cannot be determined based on facts and circumstances. The alternate method treats the grantor as holding all the interests if she is a beneficiary. If she is not, it allocates trust interests among the beneficiaries "under rules prescribed by the Secretary similar to the rules of intestate succession."[61]

The alternate method will apply whether or not the expatriate has any actual access to or expectation of receiving trust distributions. The application of this approach can be illustrated by the following example:

> **Example:** Mary established a discretionary trust for all of her issue 10 years ago. The terms of the trust instrument give complete discretion to a corporate trustee as to the timing and amount of distributions. The interests of Mary's issue in the trust are specifically nonassignable. The trust is to last until the last to die of Mary's issue living at the time of the trust's creation. At that time, all trust property will be paid to charity. When Mary created the trust, she had three living children and ten living grandchildren. Ten years after the trust's creation, Maureen, one of Mary's daughter's expatriates. Maureen's two sisters are alive at the time of expatriation. There are no letters of wishes and no trust protector or advisor. No distributions have ever been made

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61. Proposed § 877A(f)(1)(B), Moynihan Proposal § 1(a). The reference to the rules of intestate succession is troublesome since there is no federal standard for intestate succession. Each state has its own system of intestate succession. It is unclear how Treasury should select among the various systems.

because the trustee has determined that none of Mary's issue is in need of funds. Maureen has no reason to believe she will ever receive any distributions from the trust. Since it is impossible to determine trust interests on the basis of facts and circumstances, if the rules of intestate succession selected by Treasury would distribute property to an intestate's children, Maureen will be deemed to hold one-third of the trust.

To the extent that the Moynihan Proposal's election to continue U.S. status is available to a trust beneficiary, identifying the beneficiary's interest will not be a problem. When the election is made, the tax will not be imposed until a trust distribution is made to the expatriate. At that point, it is clear that the expatriate's interest in the trust is at least as great as the amount of the distribution. As discussed above, however, it is not clear that the election will be available to trust beneficiaries who lack the resources to provide security for the future payment of tax, nor is it clear how the amount of security is to be computed in a situation like this.

(2) Calculating the Tax

The expatriate who is deemed to hold an interest in a trust must calculate her expatriation tax allocable to the trust interest in the following manner:

(a) The proposals appear to assume that the expatriate's interest will be quantifiable as a percentage share of the trust as a whole. This share is then to be treated as a separate trust.

(b) The deemed separate trust is then deemed to have sold all of its assets for their fair market value immediately before the beneficiary expatriates and to have distributed all such assets to the expatriate.

(c) The expatriate is then deemed to have recontributed the distributed assets back to the trust.

We understand that the object is to require the expatriate to include in her gross income any gain deemed to have been recognized on the deemed sale as well as any previously undistributed income allocable to beneficiary's share. This result, however, interacts uneasily with the various existing methods for taxing trusts and their beneficiaries and creates a number of anomalies and unanswered questions. For example:

i) Will capital gain realized on the deemed sale of assets be included in distributable net income so that the deemed distribution to the

beneficiary will make the beneficiary (rather than the trust) taxable on capital gain? Normally capital gain is not included in distributable net income of a domestic trust.

ii) Will these rules apply if the trust actually sells assets and distributes amounts to the expatriating beneficiary?

iii) After the expatriate is treated as having recontributed the assets to her separate trust, will the trust continue to be treated as a separate trust so that she will receive the benefit of the basis adjustment to the contributed assets if they are distributed to her in the future? If so, how will the trust treat future distributions? In the example set forth above, will future income distributions from the trust to any beneficiary other than Maureen be treated as coming from the two-thirds share of the trust that is not her share? If so, an actual distribution of all trust income to Maureen's sister will give rise to a deduction of only two-thirds of such income. The sister will pay tax on only two-thirds of the income (*i.e.*, any post-expatriation income) while tax on the remaining income will be imposed on the trust.

iv) How will the deductions of the trust, such as the deductions for expenses and charitable contributions, be allocated and reflected in the expatriate's tax calculation?

v) For what tax purposes will the expatriate be treated as having received a distribution? If she is a grandchild of the trust's grantor (or otherwise assigned to the grantor's grandchildren's generation), will she be subject to the generation-skipping transfer tax on account of her receipt of a taxable distribution? If so, will the generation-skipping transfer tax be deductible in computing the expatriation tax? Arguably, expatriation should not accelerate the generation-skipping transfer tax. If it does not accelerate the generation-skipping transfer tax, the expatriate will be subject to the tax when she receives actual distributions from the trust. The generation-skipping transfer tax should be amended to permit the expatriate to reduce the amount of any the amount of such future distributions by the expatriation tax before calculating her generation-skipping transfer tax liability.

vi) For what tax purposes will the expatriate be treated as having recontributed the assets? Will she be subject to the normal gift and estate tax consequences that flow from contributions to trusts? If she is a child of the trust's grantor (or is otherwise assigned to the grantor's children's generation), will she be treated as the transferor of the trust for generation-skipping transfer

tax purposes, thereby avoiding the generation-skipping transfer tax on subsequent distributions to the grantor's grandchildren.

vii) In the case of an expatriate whose trust interest consists of an income interest, should such recontribution be treated as a purchase of an income interest so that she would be able to take an amortization deduction against future income distributions? If so, Code Section 167(e), which generally precludes the amortization of term interests when related persons hold the remainder interests, should be amended.

viii) Will the expatriate's share of the trust be treated as a so-called "grantor trust" as to the recontributed share with the result that all items of income, deduction, and credit allocable to her share will be attributable to her?

ix) In the case of an interest in a charitable remainder trust, how is the distribution to be allocated among the various categories of accumulated income? Will the expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust? Will a charitable remainder annuity trust lose its status as a charitable remainder trust because of the deemed contribution by its expatriating beneficiary? Charitable remainder annuity trusts are not permitted to accept additions.

x) In the case of an interest in a pooled income fund within the meaning of section 642(c) and in the case of a charitable lead trust, will the expatriate receive a charitable deduction for the deemed recontribution of assets back to the trust?

As suggested by the examples above, the expatriation proposal's provisions regarding the taxation of interests in trusts raise a number of technical problems. In some cases, the correct treatment may be readily apparent; in other cases, the appropriate solution requires further study.

Given the technical problems described above, as well as the difficulty of measuring an expatriate's interest in a trust and the potential unfairness of requiring an expatriating beneficiary to post security when she does not have access to trust assets, the best solution to the taxation of expatriates' interests in U.S. trusts may simply be to impose a withholding tax on distributions to the expatriate, to the extent such distributions are attributable to pre-expatriation income or gain of the trust. We strongly urge that this approach be given consideration.

D. Further Technical Comments

1. Treasury's Authority to Include Any Property

Proposed section 877A(c)(3) gives Treasury the authority to treat any property as held by an expatriating individual to the extent "necessary or appropriate to carry out the purpose of this section." This provision grants Treasury very broad authority. There should be some specific guidance in the legislative history that suggests the kinds of property interests intended to be covered by this provision.

2. Treasury's Authority to Determine the Security Required for the Election to Avoid the Tax

As discussed above, the presence in the Moynihan Proposal of the election to avoid the expatriation tax as to particular assets by consenting to continued treatment as a U.S. citizen is crucial to our support of the Proposal. Because of the significance of this feature, we believe it imperative that every individual have the opportunity to make this election regardless of whether she is in a position to secure fully the future payment of tax.

We suggest that proposed section 877A(3)(C)(i) be amended to make clear that Treasury may not require security from a particular individual in excess of the lesser of (i) the expected future tax liability and (ii) a specified fraction, such as 50%, of the net assets of that individual that are transferrable or assignable by her. To illustrate, suppose Maureen, the individual who is the beneficiary of the discretionary trust described in the example above, had assets in her own name worth $500,000 at the time of her expatriation and that the assets in the discretionary trust that were deemed to be held by her at the time of her expatriation were worth $1,000,000. Since her transferrable net assets are worth only $500,000, Treasury should not be able to require security from her in excess of $250,000.

From Treasury's point of view, we do not believe great emphasis should be placed on the security requirement. In the end, collection of the expatriate tax, like the income tax generally, will be largely dependent upon voluntary compliance. The expatriate who is seeking to make the election could easily evade the tax by removing herself and her assets from the jurisdiction of the U.S. In fact, whether or not she has an intent to evade, it is likely that she will no longer be in the U.S. at the time of her expatriation. As a practical matter, therefore, the U.S. is in no better a position to collect tax at the time of the expatriation than it will be in the future. In fact, the expatriate's attempt to make the election is indicative of a willingness to pay future U.S. taxes and should be encouraged. If Treasury instead denies the election on the basis of inadequate security, it is unlikely that the expatriate will be either willing to

or able to pay the expatriation tax currently. The result of a denial of the election based on an inability to post the required security, would, therefore, likely decrease rather than increase the revenue collected.

3. Expatriation Event for Individuals Who Continue to Be Subject to U.S. Tax

Proposed section 877A(e)(1)(B)(ii) of the Moynihan Proposal treats an alien as expatriating when she ceases to be a lawful permanent resident within the meaning of section 7701(b)(6) or when she begins to be treated as a resident of a foreign country under the provisions of a tax treaty and does not waive the provisions of the treaty. It treats a citizen as expatriating when she relinquishes her citizenship. The date on which an individual ceases to be a lawful permanent resident or a citizen does not always terminate her obligation to pay U.S. income tax, however. For example, if an individual surrenders her right to be a lawful permanent resident on June 1, 1995 and does not establish a closer connection to any other country after such surrender, she will be subject to U.S. income tax for all of 1995.[62] Moreover, after an individual surrenders her right to be a lawful permanent resident, she may continue to be treated as a resident alien under the substantial presence test.[63] If an individual relinquishes her citizenship, she may continue to be treated as a resident under the substantial presence test. If an individual continues to be subject to U.S. income tax, it seems inappropriate to subject her to the expatriation tax.[64]

4. Impact of Deemed Sale and Election on Third Parties

When an individual expatriates, she is deemed to have sold all assets held by her at the time of expatriation. The occurrence of a deemed sale could have a tax

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62. § 7701(b)(2)(B).

63. § 7701(b)(3).

64. To coordinate that result with the expatriation tax generally, the expatriation tax might be extended to include long-term residents who are not lawful permanent residents or at least long-term residents who once were, but no longer are lawful permanent residents. If the change suggested in the text is adopted without extending the expatriation tax to include individuals who have actually resided in the U.S. for long periods of time, it would be possible for a long-term resident to avoid the expatriation tax by surrendering her permanent resident status and remaining in the U.S. as a resident for 8 years. When she left at the end of the 8-year period, she would not be subject to the expatriation tax since she would not have been a lawful permanent resident for 8 of the last 15 taxable years.

impact on third parties. For example, under certain circumstances if an individual makes a tax-free exchange under section 1031 with a related party but the related party then sells the property, the original taxpayer will have a recognition event. If the related party is deemed to have sold the property because of her expatriation, will the original owner be required to recognize gain? This seems to be an inappropriate result. We suggest adding the following language to the end of section 877A (a)(1):

> "Except as otherwise specifically provided, the sale deemed to have occurred by reason of this section shall not be treated as a sale for purposes of determining the income tax liability of any person other than the expatriate who is deemed to have made the sale."

Consideration also should be given to whether an electing individual will be treated as a citizen or resident of the U.S. for purposes of determining the U.S. tax status of other persons such as, for example, whether foreign corporations are foreign personal holding companies.[65]

5. Rights to Receive Future Income

None of the proposals define "property" for purposes of the expatriation tax. Since the proposals all contain an exception for rights under certain pension plans, however, it appears that the proposals intend to reach property that consists of the right to receive future income. Such rights would include, for example, the right to receive future alimony, deferred compensation, royalties, and annuities.

If these rights are satisfied in the future by payments from a U.S. source, the expatriate will be required to include such payments in their U.S. gross incomes and to pay U.S. income tax on such payments under section 871 at a 30% rate or at a lower applicable treaty rate. There is no provision in any of the proposals that would permit the expatriate to amortize the basis in the rights that she acquired as a result of payment of the expatriation tax against such income. We suggest that section 873 be amended to permit such a deduction. A corresponding change should be made to the withholding provisions of section 1441.

Furthermore, subjecting an individual's rights to receive future alimony to the expatriation is inappropriate. The right to receive alimony relates not to gain that accrued while an individual was a citizen or resident of the U.S. but to the future

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65. § 552(a)(2).

support needs of the alimony recipient. We suggest that the right to receive alimony be specifically excluded from property treated as held when expatriation occurs.[66]

6. Requirement That Trustees Provide Security

Section 877A(h)(3) of the Moynihan Proposal gives an expatriate who is required to "provide security in connection with any tax imposed by [section 877A] with respect to the holding of an interest in a trust" the right to require that any U.S. trustee (*i.e.*, a trustee who is either a U.S. citizen or a domestic corporation) of such trust to provide such security.

This requirement is troublesome for a number of reasons. First, it seems to impose this obligation on the U.S. trustee whether or not she has the authority to use trust assets for this purpose. The obligation, if it is to be imposed, should instead be imposed on the trust property. If the trust is a foreign trust, it should be made clear that the U.S. trustee cannot be required by U.S. law to use trust property for this purpose if she is not permitted to do so by the laws of the jurisdiction which governs the administration of the trust.

Second, it is not clear whether this requirement applies to the security that may be required in connection with the Moynihan Proposal's election of continued U.S. status under section 877A(a)(3) or whether it is limited to the security that may be required in connection with a deferral of the expatriation tax under section 877A(h)(2) by reason of section 6165.[67] The language does not seem to reach the Moynihan election since it speaks only of security for a tax imposed by reason of section 877A. When an election to be treated as a citizen is made, there will be no tax under section 877A.

Third, if an expatriate is a beneficiary of a trust but has no measurable interest in that trust, and if she elects to defer the expatriation tax, a requirement that the trustees of a trust of which she is a beneficiary furnish security for that tax forces the

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66. If this suggestion is not adopted, § 215, which allows the spouse who pays alimony to deduct such payments to the extent includible in the gross income of the receiving spouse should be amended to make it clear that she will continue to be entitled to the deduction even if the receiving spouse is permitted to exclude some portion of the payments to reflect the fact that he was taxed on the present value of such payments at the time of expatriation.

67. Section 6165 authorizes Treasury to require a bond in connection with the grant of an extension of time within which to pay any tax.

trustees to use trust property for a beneficiary who might never receive a distribution from that trust and could deprive the other beneficiaries of trust property that should have been theirs.

7. Application of the Expatriation Tax to Certain Nonresident Citizens

Under the Moynihan Proposal, an individual will not be subject to the expatriation tax if she relinquishes her U.S. citizenship before attaining age 18 1/2 if she has been a resident of the U.S. within the meaning of section 7701(b)(1)(A)(ii) for less than five taxable years before she renounces her citizenship.[68]

We favor this provision since it protects from the expatriation tax those individuals who have not received significant benefits from their U.S. citizenship, and who were unable to renounce their citizenship while still minors. We suggest that consideration be given to extending this rule to any U.S. citizen or lawful permanent resident, regardless of age, who has been an actual resident of the U.S. for less than five years. We recognize that such individuals have enjoyed certain benefits and protections afforded to U.S. citizens and lawful residents living abroad, and might, therefore, be appropriately taxed upon expatriation. However, where a citizen of the U.S. or a lawful permanent resident of the U.S. has actually resided in the U.S. for fewer than five years, query whether the premises underlying the expatriation proposals are satisfied.

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68. Moynihan Proposal § 877A(e)(1).

II. THE TRUST PROPOSAL

This proposal has several principal parts, each is discussed separately below.

A. Reporting Requirements[69]

1. The Proposal

Section 202 of H.R. 981 would amend sections 6048 and 6677 in their entirety. Proposed section 6048, like current section 6048, would require reporting pertaining to foreign trusts. More specifically, it would require reporting in the case of certain "reportable events" and annual reporting in certain cases. It would also require trustees of certain foreign trusts to appoint a limited agent in the U.S. for purposes of providing the IRS with information that it might request. Proposed section 6677, like current section 6677, would provide penalties for failure to comply with the foreign trust reporting requirements.

a. Proposed Section 6048(a): Notice of Certain Events

Upon the occurrence of a "reportable event," proposed section 6048(a)(1) would require the "responsible party" to notify each trustee of the trust of the requirements of proposed section 6048(b), and to provide written notice of such event to the Secretary, in accordance with the rules of proposed section 6048(a)(2).

The "reportable events" and the corresponding "responsible parties" are set forth below:

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69. Appendix B contains a description of the current reporting requirements that apply to foreign trusts.

Reportable Event	Responsible Party
Creation of a foreign trust by a U.S. person.	The grantor.
Transfer of any money or property to a foreign trust by a U.S. person including a transfer by reason of death.	The transferor or her executor if the transfer is by reason of death.
A U.S. trust becomes a foreign trust.	The trustee of the domestic trust.
The death of a U.S. person who was the grantor of a foreign trust.	Unclear - Presumably should be the executor of the grantor.
The U.S. residency starting date under Code Section 7701(b)(2)(A) of a grantor of a foreign trust subject to the tax under proposed Code Section 679(a)(3) (relating to pre-immigration trusts.	The grantor.

The only explicit exception to these notice requirements is for the creation of foreign trusts or transfers to foreign trusts when the foreign trust is described in section 404(a)(4) or 404A (relating to qualified employee benefit trusts).

Notice to the trustee and to the IRS must take place on or before the

90th day after the reportable event or such later day as the Secretary may prescribe.[70]

Under proposed section 6048(a)(2), the notice to the IRS of a reportable event shall contain such information as the Secretary may prescribe, including -

(1) the amount of money or other property (if any) transferred to the trust in connection with the reportable event,

(2) the identity of the trust and of each trustee and beneficiary (or class of beneficiaries) of the trust, and

70. Such 90th day will not be treated as being earlier than the 90th day after the date of enactment. § 202(d)(2) of H.R. 831. As discussed below, the IRS is given additional general authority with respect to the time and manner of filing information under proposed § 6048.

(3) a statement that each trustee of the trust has been informed of the [reporting requirements of proposed section 6048(b)].[71]

b. Proposed Section 6048(b) Reporting Requirements

A foreign trust is subject to the reporting requirements of proposed section 6048(b) if, at any time during a taxable year of the trust, the trust meets one of the following three tests:

(1) the trust has a grantor who is a U.S. person and such grantor is treated as the owner of any portion of such trust under the grantor trust rules;

(2) the trust has a grantor who is a U.S. person and "any portion of such trust would be included in the gross estate of such grantor if the grantor were to die at such time"; or

(3) the foreign trust "directly or indirectly distributes, credits or allocates money or other property to any United States person" whether or not the trust has a grantor who is a U.S. person.

A foreign trust that satisfies one of these three tests must meet the reporting requirements of both proposed section 6048(c) (relating to the appointment of a limited agent for providing the IRS with information regarding the trust) and proposed section 6048(d) (relating to the filing of an annual return).

(1) The Section 6048(c) Statement

Under proposed section 6048(c), the trust must file a statement with the IRS (which the Treasury Department's General Explanation of H.R. 981 (the "General Explanation") calls the "Section 6048 Statement") that

(1) contains such information as the Secretary may prescribe;

(2) identifies a U.S. person as the trust's limited agent to provide the IRS with such information that reasonably should be available to the trust for purposes of applying sections 7602 [Examination of Books and Witnesses], 7603 [Service of Summons], and 7604 [Enforcement of Summons] with respect to any request by the Secretary to examine trust records or produce testimony related to any transaction by the trust or

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71. Proposed § 6048(a)(2).

with respect to any summons by the Secretary for such records or testimony; and

(3) contains an agreement to comply with the annual return requirements of proposed section 6048(d).

(2) The Annual Return Requirement

Any trust subject to the reporting requirements of proposed section 6048(b), must file an annual return and furnish information statements to certain U.S. beneficiaries and grantors. Specifically, the trust must:

(1) make a return for the taxable year setting forth "a full and complete accounting of all trust activities and operations for the taxable year" and containing such other information as the Secretary may prescribe; and

(2) furnish "such information as the Secretary may prescribe to each U.S. person (a) who is treated as the owner of any portion of the trust under the grantor trust rules, (b) to whom any item with respect to the taxable year is "credited or allocated," or (c) who receives a distribution with respect to the taxable year.[72]

c. General Rules Applicable to All Filing Obligations under Proposed Section 6048

The Secretary is given the authority to prescribe the time and manner for making any notice, statement and return required under proposed section 6048.[73]

The Secretary is also given the authority to suspend or modify any requirement of proposed section 6048 "if the Secretary determines that the United States has no significant tax interest in obtaining the required information."[74]

d. Penalties

Section 202(b) of H.R. 981 would amend section 6677 in its entirety. Proposed section 6677(a) would provide penalties for failure to provide notice of reportable events. Proposed section 6677(b) would provide penalties for failure to

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72. Proposed § 6048(d).

73. Proposed § 6048(e).

74. Proposed § 6048(f).

satisfy the proposed section 6048(b) requirements of making a Section 6048 Statement and making annual returns. None of the penalties are imposed on trustees of foreign trusts.

(1) Failure to Provide Notice of Reportable Events

Any "responsible person" who does not timely file the notice of a "reportable event" with the IRS is subject to a penalty of $10,000. If such failure continues for more than 90 days after the Secretary mails notice of the failure to the responsible party, an additional $10,000 penalty is imposed for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period.[75]

In the case of three types of reportable events, however, there is a minimum aggregate penalty for failure to provide notice of the event. The minimum penalty is equal to 35% of the gross value of the property involved in the reportable event, determined as of the day of the event.[76] The reportable events to which the minimum 35% penalty is applicable are (1) the creation of a foreign trust by a U.S. person; (2) the transfer of money or property to a foreign trust by a U.S. person, including a transfer by reason of death; and (3) a domestic trust becoming a foreign trust.[77]

A reasonable cause exception, discussed below, is provided in proposed section 6677(c).

(2) Failure to Comply with the Proposed Section 6048(b) Reporting Requirements

Two different types of consequences are provided in the case of a failure to comply with the reporting requirements of proposed section 6048(b), which requires the making of both the Section 6048 Statement (appointing a limited agent) and an annual return. First, in the case of any failure to meet the requirements of proposed section 6048(b):

> "the appropriate tax treatment of any trust transactions or operations shall be determined by the Secretary in the Secretary's sole discretion

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75. Proposed § 6677(a)(1).

76. Proposed § 6677(a)(2).

77. Proposed § 6677(a)(3).

from the Secretary's own knowledge or from such information as the Secretary may obtain through testimony or otherwise."[78]

Similarly, section 666(d) would be amended to provide, in the case of a distribution from a foreign trust to which section 6048(b) applies, that adequate records to establish the first year of the trust's existence will not be considered available unless the requirements of section 6048(b) are met. As a consequence, the Secretary "may use any reasonable approximation based on available evidence."

The General Explanation provides three examples of how the IRS may exercise its "sole discretion." First, the IRS could impose a gift tax on property transferred to a foreign trust. Second, "in appropriate circumstances" the IRS could impute a taxable return on property transferred to or held in a foreign trust. Third, a distribution to a U.S. beneficiary could be deemed to come from income accumulated in the year the trust was organized.[79]

The second type of consequence for failure to meet the reporting requirements of proposed section 6048(b) is a monetary penalty. The monetary penalty is imposed only on trusts that are subject to these requirements by virtue of having a grantor who is a U.S. person.

If a foreign trust fails to comply with the requirements of proposed section 6048(b), a penalty of $10,000 is imposed on the U.S. grantor for each taxable year in which the trust fails to meet such requirements. If such failure continues for more than 90 days after the Secretary mails notice of the failure to the U.S. grantor, an additional $10,000 penalty is imposed for each 30-day period (or fraction thereof) during which such failure continues after the expiration of the 90-day period.

A reasonable cause exception, discussed immediately below, is provided.

(3) Reasonable Cause Exception

No penalty may be imposed under proposed section 6677 on any failure "which is shown to be due to reasonable cause and not due to willful neglect."[80] The fact that a civil or criminal penalty may be imposed by a foreign jurisdiction on

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78. Proposed § 6677(b)(1).

79. *But see* § 207(b) of H.R. 981, amending section 666(d), which, if enacted, would apparently require this result.

80. Proposed § 6677(c).

the taxpayer or any other person for disclosing information does not constitute reasonable cause.[81]

(4) Deficiency Procedures Do Not Apply

The deficiency procedures of Subchapter B of chapter 63 of the Code do not apply to the assessment or collection of any penalties imposed by proposed section 6677.[82] Thus, in order to challenge a penalty, the taxpayer would have to pay the entire penalty and sue for a refund in federal district court or the Claims Court.

e. Effective Dates

Proposed sections 6048 and 6677 would apply to reportable events occurring on or after February 6, 1995.[83] If annual reporting is required for a taxable year, the proposed rules would apply to taxable years beginning after the date of enactment.[84] If making a notice of a reportable event is required, the 90th day referred to in proposed section 6048(a) will be treated as occurring no earlier than the 90th day after the date of enactment.[85]

2. General Comments

The reporting requirements of proposed section 6048 may be divided into two parts. First, proposed section 6048(a) generally corresponds to existing section 6048(a) in that it requires a one-time filing of a notice of the creation of or transfer to a foreign trust (satisfied under current law by the filing of Form 3520). Second, proposed section 6048(b) generally corresponds to existing section 6048(c) in

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81. There is precedent for the rule that penalties imposed by a foreign jurisdiction for disclosing information does not constitute reasonable cause. *See* Senate Finance Committee Print, 101st Cong., 1st Sess. 159 (Oct. 12, 1989) (discussing amendments made by the Omnibus Reconciliation Act of 1989 to § 6038A, relating to information required with respect to certain foreign-owned domestic corporations).

82. Proposed § 6677(d). We assume that this rule is not applicable to the assessment or collection of additional tax imposed as a result of the exercise of the IRS's "sole discretion" authority under proposed § 6677(b)(1).

83. § 202(d)(1)(A) of H.R. 981.

84. § 202(d)(1)(B) of H.R. 981.

85. § 202(d)(2) of H.R. 981.

that it requires a filing of annual returns for certain foreign trusts (satisfied under current law by the filing of Form 3520-A).

Proposed section 6048(a) and proposed section 6048(b) are discussed separately below. Briefly, we believe that proposed section 6048(a) represents a necessary and generally successful effort to amend existing section 6048(a) to add to the notice filing obligation the additional types of foreign trusts covered by proposed section 679. Thus, if proposed section 679 is enacted as proposed, proposed section 6048(a) should be enacted, with the technical changes suggested below. On the other hand, we believe that proposed section 6048(b) contains flaws and would not achieve its stated goal of enhancing compliance.

3. Specific Comments

a. Proposed Section 6048(a)

Under existing section 6048(a), a grantor or transferor must file a Form 3520 upon the creation of a foreign trust or a transfer to a foreign trust, other than a transfer by way of a sale or exchange made for full and adequate consideration. The proposed legislation would expand the events under which the IRS must be notified to include three new events: (1) a domestic trust becoming a foreign trust, (2) the death of a U.S. citizen or resident who had been the grantor of a foreign trust, (3) a grantor of a foreign trust subject to tax under proposed section 679(a)(3) (relating to pre-immigration trusts) becoming a U.S. resident. Those three events are also events that are covered by proposed section 679, but are not covered by existing section 679. To the extent proposed section 679 is enacted as proposed, the changes made by proposed section 6048(a) are necessary and appropriate, subject to two technical comments, discussed below. If, on the other hand, proposed section 679 is not enacted, there is probably no reason to enact proposed section 6048(a).

b. Proposed Section 6048(b)

The General Explanation's reasons for the changes proposed to be made to the foreign trust reporting and related penalty provisions are as follows:

"The existing information reporting statute predates the significant expansion of the foreign grantor trust rules in 1976. In general, penalties for noncompliance with reporting requirements are minimal. U.S. grantors of foreign trusts often do not report the income earned by foreign trusts and often do not comply with required information reporting. These foreign trusts are frequently established in tax haven jurisdictions with stringent secrecy rules. Consequently, the IRS's attempts to verify

income earned by foreign trusts are often unsuccessful. Existing penalties have not proven adequate to encourage some U.S. taxpayers to comply with existing rules."

The Administration's press release of February 6, 1995, which announced the proposals, also cited taxpayer fraud as a problem in the case of a U.S. grantor who receives an annual report from a foreign trustee, realizes the IRS is unlikely to ever find out about the income, and fraudulently omits the income from her U.S income tax return.

The major problem under current law, as described in the General Explanation, is the lack of significant penalties. Foreign trust reporting should be an important enforcement tool for the IRS, and it is true that the existing penalties are apparently not adequate to provide an incentive for some taxpayers to report. Therefore, the proposed enhanced penalties seem generally necessary and may be useful to encourage compliance.

As described in some detail in Appendix B, however, there are extensive reporting requirements for foreign trusts under existing law. It does not appear that increasing the amount and complexity of the required reporting would encourage reporting from those for whom the proposed penalties and the threat of criminal prosecution are not enough of an incentive.

Those who are undaunted by the proposed penalties and the threat of criminal prosecution will not be hindered by the proposed enhanced reporting requirements; they will simply choose trustees who will not, or whose jurisdictions will not allow them to, furnish reports to the IRS. Therefore, the proposed reporting rules would serve primarily to increase the burden on those who would comply with existing law. The way to improve the compliance of those who would otherwise fraudulently omit income from their returns is to enhance the government's enforcement efforts, both civil and criminal.

We understand that the Treasury Department believes that there is a significant amount of nonreporting because it receives relatively few Form 3520's each year. There are several possible explanations for this other than fraud.

1. In many cases, asset protection trusts are set up so as to qualify as domestic trusts for federal income tax purposes. Form 3520 is not required for the creation of or transfers to domestic trusts. The rules under current law for determining the residence of a trust are loose enough to allow taxpayers to legitimately take such a position. The definitions proposed under section 208 of H.R. 981 would prevent taxpayers from taking such positions.

2. Form 3520 is not required if the transfer to the foreign trust is made in the form of a sale or exchange for full and adequate consideration. As the General Explanation points out, U.S. grantors often attempt to fall under this exception by selling property to a foreign trust in exchange for a note from the trust with the intention not to collect on the note. The changes section 203 of H.R. 981 proposes to make to section 679 would eliminate such strategies.

3. Transfers to entities owned by foreign trusts may not be reportable on Form 3520, although they may be reportable on Form 926.

Therefore, the problem of nonreporting can be solved by a combination of enhanced penalties and technical rule changes that are included in H.R. 981 as well as increased enforcement activity. Adding to the amount and types of information currently required to be reported will only add complexity to the Code and increase the burden on law-abiding taxpayers.

c. Treatment of Beneficiaries

One of the more important problems with the proposed section 6048(b) reporting rules is that, in conjunction with proposed section 6677, they could unfairly impose penalties on beneficiaries of foreign trusts who are treated as transferors under proposed section 679(b).

If a beneficiary who is treated as a transferor under proposed section 679(b) is also treated as a transferor and grantor under the proposed reporting and penalty rules, the beneficiary could be subject to severe penalties even though she was not involved in the creation or funding of the trust, has no say in whether or not the trustees comply with proposed section 6048, and may never receive any distributions or other benefits from the trust.

> **Example:** Kate, who is a U.S. citizen, creates a discretionary foreign trust and makes a $1,000,000 contribution to the trust. The class of beneficiaries includes her two children (one of whom is a U.S. person), any grandchildren and various specified charities. Several years later Kate dies. The trust assets are now worth $2,000,000. Under proposed section 679(b)(1), all of the beneficiaries are treated as having transferred to the trust, on the date of Kate's death, their respective interests in the trust. Assume further that the beneficiaries' respective interests in the trust cannot be determined under the proposed section 679(e) "facts and circumstances" test, and each child is treated as having a one-half interest in the trust property under the proposed section 679(e) "closest degree of kinship" test.

Under proposed section 679(b), each child would be treated as having transferred $1,000,000 to the trust on the date of the parent's death. Since the transfer of money or property by a U.S. person to a foreign trust is a reportable event, the U.S. child apparently would be required to file a notice of the reportable event. In addition, a Section 6048 Statement appointing a limited agent as well as annual reporting would be required for any foreign trust that has a U.S. grantor who is treated as the owner of any portion of the trust under the grantor trust rules. Under proposed section 679(a) and (b), the U.S. child would be treated as the owner of 50% of the trust property. Thus, the foreign trust probably would be treated as being subject to the Section 6048 Statement requirement and the annual return requirement.[86]

If the trust fails to file an annual report or fails to file a Section 6048 Statement appointing a limited agent, the U.S. child, as the "grantor,"[87] would be subject to a $10,000 penalty each year and also would be subject to the IRS's "sole discretion" authority to determine the consequences of trust transactions and operations. This would be an extremely unfair result. In the case of discretionary trusts, the beneficiary might not ever receive a benefit from such trust. Moreover, unlike an actual grantor of a foreign trust, a beneficiary who is treated as having made a transfer to a foreign trust under proposed section 679(b) generally has no control over the identity of the trustee and little or no power over the trustee. Thus, the beneficiary would not be able to compel the trustee to satisfy the proposed section 6048(b) reporting requirements.[88]

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86. There is a technical argument under proposed section 6048(b) that these reporting obligations would not apply because new sections 6048(b) and 6677(b) are written in terms of U.S. *grantors*, but section 679 applies to U.S. *transferors*. *See* discussion below. Even if this position is correct, however, the annual reporting and Section 6048 Statement filing obligations apply if the foreign trust directly or indirectly distributes, credits, or allocates money or property to a U.S. beneficiary. Although the monetary penalty would not apply if there is no U.S. person treated as the grantor, the IRS's authority to determine the appropriate tax treatment of trust transactions and operations would be triggered.

87. *But see* note 86, *supra*.

88. While it may also be true that an actual grantor may not have the power to compel a trustee to comply with proposed § 6048(b), a U.S. person who makes a contribution to a foreign trust is now on notice of the possible consequences of doing so. Such a grantor can take steps to protect himself or herself, including (1) drafting the trust to ensure that he or she has adequate controls over the trustee or that the

(continued...)

There will also be cases in which the U.S. beneficiary does not know of the existence of her parent's foreign trust, especially if the beneficiary is a minor. Similarly, when the event that causes the beneficiary to be treated as a transferor to the foreign trust is the transfer of property to a foreign trust by reason of the death of a citizen or resident of the U.S. or a domestic trust becoming a foreign trust, the beneficiary often will be unaware of the event.

As for the failure to file a notice of a reportable event, it would, in many cases, be unfair to penalize a beneficiary who is treated as having made a transfer to a foreign trust under proposed section 679(b) for not filing a notice of reportable event. Again, the beneficiary might not be aware of the existence of the trust or of the event that would cause her to be treated as having made a transfer to the trust. In this respect, the rules of proposed section 6048(b) would be a trap for those who are unaware of the reportable activities of other people.

For these reasons, beneficiaries of foreign trusts who are treated as grantors or transferors under proposed section 679(b) should not be treated as grantors or transferors for purposes of the proposed reporting rules and related penalties.

d. The "Sole Discretion" Penalty

Under the proposed legislation, if a foreign trust "directly or indirectly distributes, credits, or allocates money or other property to any United States person," it must file a Section 6048 Statement and meet certain annual return requirements. In the Section 6048 Statement, the trustee would be required to appoint a limited agent to provide the IRS with certain information and agree to comply with the annual reporting rules.

> If these requirements are not satisfied, the appropriate tax treatment of any trust transactions or operations shall be determined by the Secretary in the Secretary's sole discretion from the Secretary's own knowledge or from such information as the Secretary may obtain through testimony or otherwise.[89]

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88. (...continued)
trustee binds itself to report as required by the Code and (2) not making a transfer to a foreign trust.

89. Proposed § 6677(b)(1).

This "sole discretion" rule is based on a similar rule under section 6038A, relating to reporting obligations of certain foreign-owned corporations. The proposed section 6677 rule, however, goes beyond the section 6038A rule in two important respects.

The section 6038A rule applies if a foreign party fails to authorize its related "reporting corporation" as its limited agent for providing certain information or if the reporting corporation does not comply with an IRS summons for information regarding transactions between the reporting corporation and the related foreign party.

Significantly, the section 6038A "sole discretion" rule does not apply to a mere failure to file a Form 5472, which is required by section 6038A. The proposed foreign trust legislation, however, would apply the sole discretion rule to "*any* failure to meet the reporting requirements of proposed section 6048(b)."[90] Thus, any failure to file a form or notice required under section 6048(b) or any technical failure to comply fully with proposed section 6048(b) potentially would result in the application of the "sole discretion" rule even if the trust complies with the Section 6048 Statement requirement and the limited agent in the U.S. complies with all IRS requests for information. This extends the sole discretion rule to situations well beyond the situations covered by the section 6038A sole discretion penalty. The appropriateness of this extension is questionable in light of the IRS's access to information from the trust's limited agent.

Accordingly, if the sole discretion penalty is retained, it should be amended to apply only to failures of the trust to appoint a limited agent or to the limited agent's failure to comply with an IRS summons. At a minimum, a *de minimis* exception should be provided as discussed below.

Perhaps a more basic concern with the proposed "sole discretion" rule is that the scope of the IRS's power to use the penalty is not limited, as it is under section 6038A. Under section 6038A, if the sole discretion penalty applies, the IRS's power to exercise its sole discretion authority is limited to determining (1) the amount of the deduction allowed for any amount paid or incurred by the domestic reporting corporation to the related party in transactions between the two and (2) the cost to such reporting corporation of any property acquired from the related party in such a transaction.

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90. Proposed § 6048(b) (emphasis added).

By contrast, the proposed foreign trust legislation would allow the IRS to determine the tax treatment of "*any* trust transactions or operations."[91] The appropriateness of such a broad grant of discretion is questionable. The example given in the General Explanation that the IRS could impute a taxable return on property transferred to a trust goes far beyond the section 6038A power to determine arm's length prices.

e. Technical Comments

(1) The structure of proposed section 6048 generally indicates that the notice of reportable event requirement is intended to cover the types of foreign trusts that are covered by proposed section 679. If that is true, an exception should be added for transfers made to a foreign trust if (1) the trust pays fair market value for the property and (2) all of the gain to the transferor is recognized at the time of the transfer, under the rules of proposed section 679(a).

(2) Proposed section 6048 does not specify who is the responsible party when the reportable event is the death of a U.S. citizen or resident who was the grantor of a foreign trust. Proposed section 6048(a)(4) should be amended to provide that the executor of the grantor's estate is the responsible person. It would be appropriate to amend proposed section 6048(a)(4)(D) to read as follows:

> "(D) the executor of the decedent's estate in the case of a transfer by reason of death <u>or in the case of a reportable event described in paragraph (3)(D)</u>." (The suggested added language is underlined.)

(3) Under proposed section 6048(b), reporting is required, *inter alia,* if a foreign trust "directly or indirectly distributes, credits, or allocates" money or property to any U.S. person.[92] The meaning of the phrase "distributes, credits, or allocates" should be clarified, at least in the legislative history. It should only cover situations where the trust money or other property is irrevocably set aside for, and available to, the U.S. beneficiary. This is the standard for the inclusion in income under section 662(a)(2) of trust distributions other than

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91. Proposed § 6677(b)(1) (emphasis added).

92. Proposed § 6048(b)(2).

amounts required to be distributed currently.[93] A mere bookkeeping entry should not suffice.

It would be consistent with section 662 as well as the policy behind new section 6048(b) if reporting were also required if the foreign trust, by its terms, is required to make distribution to a U.S. person, whether or not the distribution is actually made.

(4) It is important to clarify the intended scope of judicial review under the "sole discretion" standard. The Conference Committee Report to the Omnibus Budget Reconciliation Act of 1989 contains an extensive and balanced discussion regarding the "sole discretion" standard and procedures under section 6038A, upon which the proposed section 6677 sole discretion standard was modeled.[94] The Conference Committee Report essentially interprets the sole discretion standard as requiring the taxpayer to show by clear and convincing evidence that the Secretary abused that discretion. For clarification, the legislative history to proposed section 6677 should explicitly state that the scope of judicial review is the same as the scope of judicial review under the sole discretion standard of section 6038A.

The legislative history to proposed section 6677 should also require the IRS, for purposes of making a "sole discretion" determination, to consider information submitted by the taxpayer even after the taxpayer's initial noncompliance with the requirement to appoint an agent or comply with a summons, as the legislative history under section 6038A seems to require.[95] According to the Conference Committee

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93. *See Commissioner v. Stearns*, 65 F.2d 371, 373 (2d Cir. 1933), *cert. denied sub nom. Stearns v. Burnet*, 290 U.S. 670 (1933); *Estate of Johnson v. Commission*, 88 T.C. 225 (1987), *aff'd mem.*, 838 F.2d 1202 (2d Cir. 1987). The relevant language under section 662(a)(2) is "amounts properly paid, credited, or required to be distributed."

94. *See* H. Rep. No. 386, 101st Cong., 2d Sess., 593-595 (1989). This discussion is reproduced in Appendix C.

95. *See* Appendix C. *See also* Treas. Reg. § 1.6038A-7(b), which is consistent with the Conference Committee Report:

> "The District Director shall consider any information or materials that have been submitted by the reporting corporation or a foreign related party. The District Director, however, may disregard any information,

(continued...)

Report, however, the weight, if any, given to any such information is subject to the limited scope of review described in the Report.[96]

(5) It should be clarified that the sole discretion rule is subject to the reasonable cause exception of proposed section 6677(c).

(6) There should be an exception to the proposed penalty rules where the failure to report or the amount involved is *de minimis*. For example, the $10,000 penalty should not apply to a failure to report a transfer of $5,000 to a foreign trust. Such a *de minimis* exception should also apply to prevent the Secretary from exercising its authority to determine the consequences of trust transactions in its "sole discretion."[97] For example, this penalty should not apply if the document that was not filed would not have helped the Secretary to determine the appropriate tax treatment of trust transactions or operations.[98]

(7) Proposed sections 6048 and 6677 use the words "transferor" and "grantor" in various places. It is not clear what, if any, significance should be attached to the use of the word "grantor" rather than "transferor," in a particular provision, and vice versa.[99]

B. Application of Grantor Trust Rules to Individuals Who Create or Transfer Assets to Foreign Trusts

1. The Proposal

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95. (...continued)
documents, or records submitted by the reporting corporation or the related party if (in the District Director's sole discretion) the District Director deems that they are insufficiently probative of the relevant facts." Treas. Reg. § 1.6038A-7(b).

96. *See* Appendix C.

97. *Compare* Treas. Reg. § 1.6038A-6(d).

98. *See id.*

99. The use of the word "transferor" apparently refers to transferors under section 679, which unlike most of the other grantor trust provisions, does not use the term "grantor."

Section 203 of H.R. 981 would amend section 679 to expand its scope. The current version of section 679 treats a U.S. person who transfers property to a foreign trust at a time when she is a U.S. person as the owner of the portion of the trust attributable to her transfer in any year in which the trust has one or more U.S. beneficiaries. It excepts transfers that are made for consideration equal to fair market value in transactions in which either gain is recognized at the time of the transfer or is deferred under section 453.

Proposed section 679 would expand the vulnerability of transferors to section 679 in two principal ways. First, section 679(a)(2) would exclude from the fair market value transfer exception any transfer to a foreign trust if part or all of the consideration for the transfer was an obligation (1) of the trust, (2) of the grantor or beneficiary of the trust, (3) of any person related within the meaning of section 643(i)(3)[100] to any grantor or beneficiary of the trust or (4) of any other individual to the extent that the obligation was guaranteed by any person described in the preceding clauses (1) through (3) (except as provided in regulations). Second, section 679(a)(3) would treat any nonresident alien who creates a foreign trust and becomes a U.S. person within 5 years of such transfer as having transferred property to a foreign trust for purposes of section 679.

2. General Comments

a. Use of Notes

The General Explanation describes sales to foreign trusts for notes as a method used by transferors to avoid section 679. The proposed cure, which disregards obligations issued by the trust (and certain related parties), is consistent with the

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100. Section 643(i)(3) is a new provision to be added by section 207 of H.R. 981. Under proposed section 643(i)(3)(F), an individual would be treated as related to any person if sales between the individual and that person would be disallowed under section 267(b) or 707(b). For this purpose, the scope of section 267 is expanded in the following ways: (1) section 267(e) is to be applied as if the individual and the person were pass-thru entities (The meaning of this in the context of a section 679 transfer is impenetrable), (2) those provisions of section 267(b) which treat an individual as related to an entity if she owns more than 50% of it are changed to require only a 10% ownership; and (3) the family of an individual will include not only her present spouse, ancestors, descendants, and siblings, but also any present spouse of any of her ancestors, descendants, siblings and any former spouse of any of these individuals (including, apparently, former spouses of former spouses).

general intent of the original 1976 legislation. The legislative history[101] states that loans to the trust, by either the transferor or another person, are to be "disregarded" in determining the portion of the trust owned by the transferor. An example in the legislative history indicates that if a transferor gives $10 to a foreign trust and lends the trust another $90, she will be treated as owner of the entire $100.[102]

However, the 1976 legislation created a limited exception to this rule for installment sales of property to a trust. The General Explanation appears to regard this exception as abusive because, "[o]ften, the U.S. transferor does not intend to collect on the note." If this is the abuse intended to be prevented, proposed section 679 goes too far. It would be sufficient to provide that a note will be considered in determining whether the transferor received fair market value only if (1) it requires that interest be paid currently and interest is so paid and (2) principal must be fully paid within a limited period. This approach would eliminate the abuse while retaining the spirit of the carefully crafted exception included in the 1976 legislation.

b. Foreign Grantors

The General Explanation describes the creation of foreign trusts by nonresident aliens prior to becoming residents as a method of avoiding U.S. income taxation. It is not clear to us why the use of trusts by a nonresident alien to arrange her affairs before becoming a U.S. resident is abusive. Outright gifts made prior to becoming a U.S. resident are not subject to U.S. gift tax if the subject of the gift is not real or tangible personal property located in the U.S. However, if the nonresident alien does not wish to make outright gifts but wishes to utilize a trust, for any of the many non-tax reasons for which individuals use trusts, then proposed section 679((a)(3) may yield unduly harsh results. Consider this example:

> **Example:** Pat, a nonresident alien, establishes a trust for issue, which include three children and eight grandchildren, all nonresident aliens. Four years later, Pat moves to the U.S. and becomes a U.S. resident. Three years after that Megan, one of Pat's grandchildren, moves to the U.S. and becomes a U.S. resident. The trust has accumulated all income since its inception, because none of Pat's issue is viewed as requiring any trust income. When Megan becomes a U.S. resident Pat

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101. *See* S. Rep. 938, 94th Cong., 2d Sess. 218 (1976).

102. *See also* the General Explanation of the Tax Reform Act of 1976, prepared by the Staff of the Joint Committee on Taxation, at page 221, which states that loans to a foreign trust by the grantor may be treated as transfers of corpus.

becomes the "owner" of the trust. As a result, Pat is immediately subject to tax on all of the accumulated income of the trust, (even income and gains which accrued prior to Pat becoming a U.S. resident). Thereafter Pat will be taxed on all of the trust income on an annual basis. This will be so even though Pat, who is not a trust beneficiary, will be unable to receive property from the trust to pay the tax liability.

3. Specific Comments

a. Use of Notes

(1) As drafted, proposed section 679(a) would apply to a sale or exchange to a foreign trust by a person who has no relationship or even personal acquaintance with the trust's creator or any trust beneficiaries; the unrelated party would then become a grantor of the trust. The General Explanation states: "Exceptions would be provided for legitimate commercial transactions, such as credit extended by unrelated persons." It is difficult to see how a regulatory exception for unrelated transferors could be crafted under the very specific terms of the statute.[103] Proposed section 679 should be clarified to include appropriate language to except such transfers.

(2) As noted in the General Explanation, the perceived abuse is that the "U.S. transferor does not intend to collect on the note." However, no relief is provided if the full amount of principal and interest on the note is later paid by the trust; the trust remains a grantor trust as to the property transferred in the sale or exchange. If the principal and interest on the note is paid, the trust should cease to be a grantor trust as to the portion of the trust property for which full consideration has been paid.

(3) The existing version of section 679 creates the opportunity for a trust to have multiple grantors. Suppose, for example that one U.S. person created a foreign trust for the benefit of her U.S. children by giving $100,000 to it. The next day her sister, who is also a U.S. person, loaned $100,000 to the trust. Under existing section 679, both individuals are treated as grantors of the trust. Since Congress presumably did not intend to tax the same income twice, each individual should be treated as the owner of only a portion of the trust. Nothing in the

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103. The problem of the unrelated transferor is a problem under existing section 679.

legislative history suggests how the trust fund is to be allocated between the two individuals.

The proposed amendment to section 679 will compound the multiple grantor problem. Suppose, for example, that a U.S. individual funds a trust for the benefit of her U.S. children by transferring to it a note issued by her wholly owned corporation. The next day her sister sells securities to the trust in exchange for the corporate note. Again, both sisters appear to be owners of the same trust.

The drafters of the tax law should use the current legislative focus on section 679 as an opportunity to cure this anomaly.

b. Foreign Grantors

(1) The logic behind the proposed revisions to section 679 suggests that trust income that accrues while the trust has a U.S. grantor and U.S. beneficiary should be taxed in the U.S. This same logic would suggest that gain on property which accrued before the grantor became a U.S. resident (and possibly before the trust acquired a U.S. beneficiary, if later) should be protected from U.S. tax by an appropriate basis adjustment. The proposal contains no such basis adjustment.

(2) In the above example, if Megan subsequently leaves the U.S., the trust seems to remain a grantor trust even though there is no current U.S. beneficiary. This is because section 203 of H.R. adds a new sentence at the end of section 679(d) (formerly section 679(c)), which states that to the extent provided by the Secretary, a U.S. person includes any person who was a U.S. person "at any time during the existence of the trust." Thus, although Megan ceases to be a U.S. resident she could be deemed to continue to be a U.S. person under regulations promulgated by the Secretary. There is no discussion in the General Explanation of this provision and its purpose is unclear. Clarification should be provided as to the intent of this provision.

(3) In the above example, if Megan had been a U.S. resident when Pat established the trust, but left the U.S. before Pat became a U.S. resident, the trust still seems to be a grantor trust under the new language in section 679(d), discussed above. This result is not in harmony with the statement in the General Explanation that section 679 will apply "if the trust has U.S. beneficiaries *after* the grantor becomes a U.S. person" (emphasis added).

(4) If the purpose of the extension of section 679 to trusts created by nonresident aliens is to discourage transfers on the eve of U.S. residency, the five year period appears too long.

C. Application of Grantor Trust Rules to U.S. Beneficiaries of Foreign Trusts

1. The Proposal

Section 203 of H.R. 981 would also add a new subsection (b) to section 679 treating the beneficiaries of a foreign trust as the owners of the trust for U.S. income tax purposes in certain cases.

New section 679(b) would provide:

> "(b) BENEFICIARIES TREATED AS TRANSFERORS IN CERTAIN CASES. - For purposes of this section and section 6048, if -
>
> (1) a citizen or resident of the United States who is treated as the owner of any portion of a trust under subsection(a) dies,
>
> (2) property is transferred to a foreign trust by reason of the death of a citizen or resident of the United States, or
>
> (3) a domestic trust to which any United States person made a transfer becomes a foreign trust,
>
> then, except as otherwise provided in regulations, the trust beneficiaries shall be treated as having transferred to such trust (as of the date of the applicable event under paragraph (1), (2), or (3)) their respective interests (as determined under subsection (e)) in the property involved."

The effect of these provisions is to impose current U.S. income tax on the U.S. beneficiaries' deemed share of a foreign trust's income whenever a U.S. individual has transferred property to a foreign trust and the U.S. individual for some reason (most often, death) cannot be taxed on the trust income under section 679.

Each beneficiary's respective interest in the trust is to be determined in accordance with new subsection (e) of section 679. This subsection establishes the same set of criteria as was discussed above in connection with the application of the Expatriation Tax to a beneficiary's interest in a trust. All of the facts and circumstances, including not only the terms of the trust instrument, but also a group

of factors that, at best reflect a beneficiary's hopes as to what she will receive from the trust, are to be taken into account. In those cases where the application of the facts and circumstances test does not yield an answer (or yields only a partial answer), the beneficiary or beneficiaries who have the closest degree of kinship to the grantor[104] are treated as owning equal interests.

2. General Comments

We believe that this attempt to impose current income tax on individuals who have no access to the income on which they are being taxed will cause significant enforcement problems as well as serious problems of equity.

In contrast to the provisions of Subpart F of Subchapter N of the Code, which tax shareholders of controlled foreign corporations, these provisions would apply to purely discretionary trusts. A beneficiary having no vested interest in a trust, and no ability to realize upon the income of a trust, might still be treated as the owner of the trust assets, based upon the pattern of income distributions. For example, if a beneficiary received 25% of the income of a trust for 3 years, would that beneficiary thereafter be treated as the "owner" of 25% of the trust, even if the trustee made no future distributions of income to that beneficiary?

Section 679(e)(2)'s allocation of any income not allocated under the provisions of section 679(e)(1) to descendants of the grantor, based on degree of relationship, so that no income would ever be unallocated is even more problematic. For example, if a grantor were to create a trust upon her death to be administered in a foreign jurisdiction, the income to be distributed to a friend resident in that country to the extent needed for support, and to the extent not needed to be accumulated, with all of the trust assets to be distributed upon the death of the individual beneficiary to the grantor's children resident in the U.S., this provision would tax accumulated income to the grantor's children, even if they could receive nothing until the death of the income beneficiary.

In contrast to these arbitrary provisions, section 957 provides for current U.S. taxation of passive income accumulated in foreign corporations only if more than 50% of the vote or value of the stock of the corporation is owned by "United States shareholders," defined by section 951(b) as 10% shareholders. In other words, Subpart F imposes current taxation in the U.S. only where a small group of U.S.

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104. It is unclear whether the term "grantor" as used here is intended to refer to the actual creator of the trust or to any individual who made a transfer to it within the meaning of § 679.

persons controls the foreign corporation, and could require it to remit the accumulated income to the U.S. shareholders if they wished. If there is no current U.S. shareholder in control of the corporation, the Code does not impose the current taxation regime of Subpart F, but instead the Passive Foreign Investment Company rules of Part VI of the Code, which impose appropriate interest charges when the income is actually remitted.

Particularly as section 207 of H.R. 981 would modify section 668(a) of the Code to impose interest at market rates, rather than a fixed six percent rate, on the tax on accumulation distributions when they are finally made (see discussion of this provision below), we believe that the provisions of new section 679(e) are unnecessary. If the U.S. beneficiaries do not have a vested interest foreign trust, and the foreign trustee can either distribute income to them, or to others, or to no one, to impose a U.S. income tax currently upon them is confiscatory.

We submit that section 679(b) goes too far in all respects. At a minimum it should have application to U.S. beneficiaries (not otherwise taxed already) only if they can cause income to be distributed to them, as Subpart F recognizes for passive foreign corporations. And overall, given a market rate of interest on the on accumulation distributions and stringent reporting rules, we believe section 679(b) is ill advised.

3. Specific Comments

a. Proportionality

While section 679(e) would attempt to allocate appropriate portions of trust income and deductions among the trust beneficiaries as "owners," section 679(b) is not as clear as section 679(a) in applying only to property transferred by a U.S. person. The flush language at the end of section 679(b) would tax the beneficiaries on their respective interests "in the property involved." We assume that the drafters do not intend that grantor trust treatment would extend to property transferred by foreign persons. We suggest that the concluding flush language instead read, "in the portion of such trust attributable to property transferred by U.S. persons."

b. Application to All Transfers at Death

The new provisions would apply to all transfers to foreign tr[illegible] reason of the death of a U.S. person. The scope of this provision raises two issues, one substantive and one technical. As to the substantive issue, it does not seem to us that this provision ought to apply to a foreign trust unless it is primarily a tax deferral mechanism for the benefit of U.S. persons. If, for example, a U.S. person transfers

property to a foreign trust for the benefit of her ten grandchildren living from time to time, the income to be accumulated until each grandchild reaches age 21, and if only one of the grandchildren is a U.S. person, it is reasonable to assume that the trust is not a tax deferral mechanism for U.S. persons. Yet the proposed provision would tax 10% of the income currently to the U.S. grandchild, even if she had no right to the income. Perhaps, the provision, if it is enacted, should be limited to instances in which the U.S. beneficiaries are treated as owning more than 50% of the beneficial interests in the trust.

As to the technical issue, the text of proposed section 679(b)(2) would reach trusts to which no U.S. person had ever made a transfer. For example, suppose a nonresident alien established a U.S. trust for her U.S. daughter the terms of which provided that she was to receive all of the trust income for life and that on the death of the daughter, the remaining property in the trust was to be transferred to a foreign trust for the benefit of all of the nonresident alien's issue. Since the transfer to the foreign trust was made "by reason of the death" of a U.S. person, proposed section 679(b) would apply. We assume this result was not intended. Proposed section 679(b)(2) should be changed to prevent it.

D. Application of Grantor Trust Rules to Foreign Grantors

1. The Proposal

Section 204(a) of H.R. 981 would amend section 672(f) to provide that a person would be treated as owning trust assets under the grantor trust rules of subpart E of Subchapter J of the Internal Revenue Code of 1986, as amended (the "Code"), only if that person is a citizen or resident of the U.S.[105] or a domestic corporation. No trust, foreign or domestic, that had a nonresident alien grantor would qualify as a grantor trust, and all trusts with nonresident alien settlors would be treated as non-

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105. The meaning of the phrase "resident of the United States" for these purposes is not entirely clear. For example, under Treas. Reg. § 1.861-2(a)(2) a "resident of the United States," includes a foreign corporation or a foreign partnership which at any time during its taxable year is engaged in a trade or business in the United States. To the extent that a foreign entity described in Treas. Reg. § 1.861-2(a)(2) remains eligible to establish a grantor trust, there may remain opportunities to achieve the very types of arrangement that § 204(a) apparently is intended to prevent.

grantor trusts, the income of which potentially would be taxable upon distribution to any U.S. beneficiaries.[106]

2. General Comments

While we recognize Treasury's concern that there may be some abuse occurring with respect to the use of foreign grantor trusts established for the benefit of U.S. citizens and residents by foreign grantors, proposed section 672(f)'s effective reclassification of **all** grantor trusts with foreign grantors as non-grantor trusts is an overly broad response to the problem. Although it may not be appropriate in all cases for a foreign settlor of a foreign trust with U.S. beneficiaries to obtain grantor status under some of the grantor trust provisions, such as those contained in section 675 of the Code,[107] certain grantor trusts with foreign grantors should continue to be given grantor trust status.

At a minimum, we believe that fully revocable domestic and foreign trusts established by foreign grantors should retain grantor trust status as under current law, with the grantor treated as owning (and being taxable on) the income of the trust. Such revocable trusts generally are not created to evade U.S. taxes but rather frequently are utilized to provide centralized administration of the trust property (especially if the grantor becomes incapacitated), to provide anonymity, to avoid the local probate process and, in some instances, rules such as the forced heirship rules of

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106. The legislative language used to achieve this result is unnecessarily broad. To achieve the legislative objective, the section should provide that no trust that would, under the normal rules of §§ 671 through 678, be treated owned by a foreign individual shall be subject to § 671. Instead, it provides that no trust shall be a grantor trust except to the extent that grantor trust status will result in the inclusion of an amount in the gross income of a U.S. person. As a result, the proposal causes needless complication by reaching trusts of which the grantors are U.S. persons. For example, irrevocable life insurance trusts, which generally produce no gross income at all, would no longer be treated as grantor trusts under proposed § 672(f).

107. Under § 675, a grantor is treated as the owner of any portion of a trust over which she has retained any of a number of largely administrative powers which may include, among others, the power to borrow the corpus or income without adequate interest or without adequate security, and the power to reacquire the trust corpus by substituting other property of an equivalent value. If the latter power is exercisable by **any person** without the approval or consent of any person in a fiduciary capacity, the grantor will be treated as the owner of the property over which the power is exercisable.

many civil law countries that may be inconsistent with the grantor's testamentary plans.

The proposed legislation, if enacted in its current form, would impose an inappropriate tax penalty on the U.S. children (and more remote descendants) of a foreign parent who chooses to use this simple planning technique. Instead, an exception to the rule in proposed section 672(f) should be carved out for a fully revocable trust, which could be defined as a trust with respect to which the power to revest absolutely in the grantor title to the trust property is exercisable solely by the grantor without the approval or consent of any other person or with the consent of another person whose interests are not adverse to such revocation.[108]

Section 672(f) as currently proposed imposes an unduly harsh tax burden on the U.S. beneficiaries of what otherwise would be grantor trusts with foreign grantors. The inappropriateness of taxing the U.S. beneficiaries of fully revocable trusts with foreign grantors is perhaps most apparent when one considers the tax consequences of an outright gift from a nonresident alien donor to a U.S. beneficiary. An outright gift of property to a U.S. beneficiary from a nonresident alien is not subject to U.S. income tax (nor to U.S. gift tax if not completed in the U.S.). Therefore, in order to avoid what, in effect, would amount to a penalty tax proposed to be imposed on the U.S. beneficiaries of fully revocable trusts with foreign grantors, a foreign grantor would simply need to revoke the trust in whole or part and make an outright gift of what otherwise would have been trust income to the U.S. beneficiaries. Because a foreign grantor of a fully revocable trust essentially is the outright owner of the trust assets, with effective dominion and control thereof, a distribution from such a trust to a U.S. beneficiary should be treated the same as a direct gift from the grantor to the beneficiary. To tax U.S. beneficiaries when they receive distributions from fully revocable trusts with foreign grantors is to elevate unwisely and inappropriately form over substance.

If section 672(f) is enacted in its current form, one result may be that well advised potential foreign grantors will refrain from forming trusts to avoid the penalty imposed on the trust form by this rule. Section 672(f) would also give well-to-do foreign individuals and members of their families a strong incentive not to become

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108. This simple approach should provide a "safe haven" and eliminate the possibility of abuse. There are other areas where Code principles govern foreign entities for characterization purposes, such as for partnerships and associations taxable as corporations. Thus, legislation by foreign jurisdictions would not be able to affect the classification of a trust as revocable if it did not meet the criteria imposed by U.S. law.

U.S. citizens or residents by spending too much time in the U.S. (or marrying U.S. citizens), thereby avoiding the imposition of the penalty tax.[109] Additionally, non-U.S. citizen beneficiaries of what are currently grantor trusts with foreign grantors would find it in their best interests not to remain in the U.S. for substantial time (more than 121 days during each of three calendar years) in order to avoid being labeled U.S. residents who would be subject to U.S. income tax on the distributions they receive from the trust. This result may not be in the economic best interest of the U.S.

The General Explanation states that the proposed change is intended to prevent foreign grantors from "inappropriately using the domestic anti-abuse rules" concerning grantor trusts. These rules were enacted to prevent the shifting of income from a grantor to one or more beneficiaries who might be subject to lower federal income tax rates. However, the domestic anti-abuse rules reflect a more fundamental tax principle, to wit, that income should be taxed to its true owner.[110] It is questionable as a matter of tax policy for such a rule to vary depending on whether that true owner is a foreign or a U.S. person.

The General Explanation also indicates that the proposed legislation is designed to ensure that U.S. beneficiaries of foreign trusts do not receive trust income without that income being subject to U.S. income tax. If Treasury's goal is merely to subject foreign trust income received by U.S. beneficiaries to U.S. income tax, section 672(f) could have been drafted with greater precision to achieve that goal. Since the proposed legislation subjects a U.S. beneficiary to tax on all items of trust income, including those items that are already subject to U.S. tax under current law, as currently proposed the legislation may be excessive. It is not necessarily the case that no tax is paid by a foreign grantor under current law.

For example, under current law where a fully revocable foreign or domestic trust with a foreign grantor[111] receives a dividend from a U.S. corporation, that dividend ordinarily is subject to withholding or other taxation of the grantor, and to achieve Treasury's stated objective it would only be necessary to impose a tax on the

109. Multinational corporations may also be affected because certain qualified employees may not want to work in the U.S. if they are beneficiaries of what are currently foreign grantor trusts with foreign grantors.

110. See Treas. Reg § 1.671-2.

111. This result would also apply to other situations where a foreign grantor created a trust that is classified under current law as a grantor trust.

U.S. beneficiaries of trusts with foreign grantors with respect to those items of trust income that are not currently subject to U.S. taxation.

Treasury's concerns may well be not only that U.S. beneficiaries of trusts with foreign grantors are receiving trust income without that income ever being subject to U.S. tax, but rather more generally that such income is being received without being taxed at all; neither by the U.S. nor by a foreign country. One might infer this broader concern from the associated proposal in section 672(f) (discussed below) to provide the U.S. beneficiary with a tax credit for any foreign income taxes paid by the trust or its settlor. Although Treasury may perceive it as unfair that tax free results are available for some U.S. beneficiaries of foreign trusts with foreign grantors when it is impossible for U.S. beneficiaries of trusts with U.S. grantors to obtain the same benefit, the rule imposing a tax on the U.S. beneficiaries of what otherwise would be foreign grantor trusts could, of course, be limited to situations where the grantor is not liable to tax on the trust income in her jurisdiction of residence. This, however, is not the approach adopted by section 672(f).

The problem is not only that U.S. beneficiaries of trusts with foreign grantors would be subject to tax under the proposed regime (which would appear to be an inappropriate result in and of itself) but also that the amount of the tax, and the circumstances under which it would be imposed, could be unreasonable. For example, suppose a nonresident alien settlor funds a fully revocable trust, for the benefit of two U.S. beneficiaries, with 100% of the stock of a foreign corporation that earns all of its income from passive investments. Under the proposed legislation that trust would be classified as a non-grantor trust and the U.S. beneficiaries would be treated as the shareholders of the foreign corporation which would qualify both as a controlled foreign corporation and as a foreign personal holding corporation under sections 957 and 552 of the Code.[112]

Thus, the beneficiaries would be taxable on the income derived by the foreign corporation to the extent of their proportionate interests in the trust, and each U.S. beneficiary would be required to include in her annual U.S. federal taxable income 100% of her proportionate share of the annual income of the foreign corporation, whether or not the foreign corporation actually paid dividends to the trust or the trust actually made distributions to the U.S. beneficiaries. To the extent that the trust does not make any distribution to the U.S. beneficiaries, it seems particularly harsh to impose a tax since the beneficiaries will not receive any money with which to pay that

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112. The corporation in question also would qualify as a passive foreign investment corporation under § 1296 of the Code, which would implicate yet another series of anti-avoidance issues for the U.S. beneficiaries.

tax and may never receive any distribution from the trust in light of the grantor's ability to revoke the trust. Furthermore, the U.S. beneficiaries of such a trust would be required to file various information returns with respect to the foreign corporation,[113] and they may have no way of obtaining the information they are required to report from the trustee.

Even if the foreign trust were not to derive its income from holding the stock of a foreign investment corporation, imposition of the non-grantor trust rules on what otherwise would be a foreign grantor trust would have other severe consequences for U.S. beneficiaries. Foreign source income earned by such a trust that is not currently paid out to the U.S. beneficiaries would not be taxed to the beneficiaries in the year earned but rather would be accumulated by the trust, causing such amounts to be converted from distributable net income (DNI) to undistributed net income (UNI) for tax accounting purposes. When this accumulated income is distributed in a later year it will be treated as ordinary income to the U.S. beneficiaries, even if it was capital gain income when actually earned by the trust.[114]

Furthermore, under proposed section 672(f), the tax imposed on the accumulation distribution, including capital gain income, will be subject to an annual interest charge at the same floating rate applicable to underpayments of tax generally. Under certain circumstances the sum of the interest charge and the tax incurred on the distribution could completely wipe out the distribution itself. Such taxation of a distribution that is comprised of foreign source income and that in the case of a revocable trust is the functional equivalent of a gift from the foreign grantor seems unwarranted.

The tax consequences associated with a domestic trust are significantly less burdensome than those confronting the otherwise foreign grantor trust if section 672(f) were enacted. This is because section 643 of the Code defines DNI, which is the annual taxable income of the trust, so as to exclude capital gains that are allocated to corpus and are not (A) paid, credited, or required to be distributed to any beneficiary during the taxable year, or (B) paid, permanently set aside, or to be used for any of the charitable purposes specified in section 642(c). However, section 643(a)(6)(C) provides that the DNI of a foreign trust includes its net capital gains. This is true regardless of whether the trust agreement gives the trustee the power to distribute

113. See I.R.C. §§ 6035 (applicable to foreign personal holding companies) and 6038 (applicable to controlled foreign corporations).

114. This point about capital gain income is discussed more fully in the next two paragraphs.

capital gains. The importance of this is that if DNI attributable to the capital gains is not distributed in the year earned it will become UNI and will be transformed from capital gain to ordinary income. Consequently, when the UNI is eventually distributed it will be taxed at the marginal ordinary income tax rate to which the beneficiary would have been subject if the distribution had been paid in the year in which it is deemed to have been earned. In addition, the accumulation distribution just described would be subject to an annual interest charge not applicable to distributions from domestic trusts. The unequal treatment of foreign as compared to domestic trusts for U.S. income tax purposes just described should bring into focus just how severe the consequences of denying grantor status to all foreign trusts is.

3. Specific Comments

Section 672(f) also creates a number of issues that should be addressed explicitly by legislation.

a. Shifting Status

Under section 672(f) a year-by-year determination would be required regarding the status of a trust as either grantor or non-grantor: assume that a trust that otherwise would be a grantor trust under current law is established by a nonresident alien settlor in year one; because of the operation of section 672(f), the trust would be a non-grantor trust at that time, whereas if the settlor subsequently became a U.S. resident, the trust would become a grantor trust at that subsequent time.

The fact that the status of a trust can change from year to year with changes in the residency status of the settlor of the trust raises a number of issues that the existing rules do not address. In particular, there are no ordering rules for distributions made to U.S. and foreign beneficiaries of a trust in a tax year following a status change. Assume that the trust described above is classified as a non-grantor trust for the first two years of its existence, in each of which it has DNI of $100x that is not distributed and therefore becomes UNI and that in year three the trust becomes a grantor trust, earns income of $100x and makes a distribution of $150x to a U.S. beneficiary. Is the first $100x of the distribution DNI for year three or a portion of the UNI for years one and two? A grantor trust ordinarily has neither DNI nor UNI. How is the additional $50x characterized? Is it UNI? Is it principal? These and other similar questions need to be answered because it is not uncommon for settlors of trusts to change their residency status from year to year. In addition, the rules of section 672(f) also need to be coordinated with the status change rule of section 679(a)(3) as it would be amended by section 203(a) of the legislation.

b. Exception for Investment Trusts

Section 672(f) of the proposed legislation contains one exception to the proposed general rule that a trust with a foreign grantor cannot be a grantor trust. The exception allows a foreign grantor of a portion of an investment trust to continue to be treated as the grantor of such portion if the grantor is the sole beneficiary of such portion. Although we agree that this is an appropriate exception, we believe it should be clarified that a qualifying investment trust is one referred to in regulation § 301.7701-4(c). In addition, it should be explicitly stated that the sole beneficiary requirement is met even if the grantor's spouse is a beneficiary.

c. Credit for Certain Taxes

Section 204(b) of H.R. 981 would amend section 665(d) to provide the U.S. beneficiaries of what otherwise would be foreign grantor trusts, with a tax credit for any taxes imposed on the settlor by any foreign country or possession of the U.S. While some type of tax credit is appropriate in light of the proposed amendment of section 672(f) described previously, in certain situations the mechanism selected may be inadequate to provide the relief intended. To the extent that a trust with a nonresident alien settlor earns U.S. source income that is taxed by a foreign jurisdiction, a foreign tax credit available to the U.S. beneficiary may provide no practical benefit because of the limitation rules of section 904.

d. Distributions by Certain Foreign Trusts Through Nominees

Section 204(c) of H.R. 981 would amend section 643 to provide that any amount received by a U.S. person which was derived directly or indirectly from a foreign trust of which the payor was not the grantor would be deemed to have been directly paid by the foreign trust to the U.S. person. The proposed amendment is too vague. How would it be determined whether a payment was derived directly or indirectly from a foreign trust? The tracing of assets that this provision seems to require would be very difficult to perform. Would it apply to distributions made prior to the enactment date and, if so, how much prior?[115]

In addition, the heading of proposed section 643(h) implies that the provision is limited to payments through "nominees" but the words of the section, read without the heading, are broad enough to encompass any distribution to a person that is subsequently transferred to another beneficiary. Furthermore, the proposed section

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115. A similar problem exists with regard to § 672(f) as recently enacted.

implies, but does not clearly state, that a distribution to a grantor, even as a nominee, followed by a transfer to a U.S. person, is not to be recharacterized as a distribution directly from the trust to the U.S. beneficiary. In short, this section should be made clearer.

e. Section 204(d) - Effective Date

The proposed effective date of section 204 of H.R. 981 is the date of enactment. We believe that the proposed effective date is unfair and that existing foreign trusts, particularly those that are irrevocable, should be excepted from the new rules. Those nonresident aliens who created irrevocable foreign trusts in reliance on the characterization of such trusts as grantor trusts under current law and the beneficiaries of these trusts should not now be injured by the application of a new system of tax to trust arrangements that are no longer subject to change.

The proposed effective date would also leave considerable confusion as to how existing foreign trusts will be taxed. If a few days after enactment of the proposed legislation a distribution were to be made from what otherwise would be a foreign grantor trust to a U.S. beneficiary, how would the distribution be treated for U.S. tax purposes? Would the trust be deemed to have been a non-grantor trust from the day it was settled, which may have been many years prior to enactment of the new provisions? If not, what portion of the distribution is taxable? If income had been accumulating in a foreign holding company owned by the foreign trust and the holding company made a distribution to the trust shortly after the enactment of the proposed provisions, would the entire amount distributed be treated as trust income taxable to the U.S. beneficiary? The proposed effective date will raise many questions regarding the taxation of existing foreign trusts that should be explicitly addressed in the legislation.

f. Section 204(e) - Transitional Rule

Section 204(e) of H.R. 981 is an appropriate transition rule that would permit domestic trusts with foreign grantors that become non-grantor trusts because of the proposed legislation to either become foreign trusts, or transfer their assets to foreign trusts, prior to January 1, 1996, without being subject to the section 1491 excise tax otherwise applicable to such transfers.

E. Modification of Rules Relating to Foreign Trusts Which are Not Grantor Trusts

1. The Proposal

Section 207 of H.R. 981 changes the rates at which interest is charged on taxes paid on accumulation distributions to a market rate of interest and institutes a tax on the use of foreign trust property.

Unlike domestic trusts, which are taxed currently on worldwide accumulated income, accumulation distributions from foreign trusts are not taxed until the distributions are actually made to the U.S. beneficiary. To compensate for the deferral, section 668 imposes a 6% simple interest charge on the amount of taxes on the deferred payments. The total amount of the interest, when added to the amount of tax, is limited to the amount of the accumulation distribution.

The proposed new method for calculating interest would use, for periods of accumulation after December 31, 1995, a rate of interest that corresponds to the rate taxpayers generally pay on underpayments of tax - 3% plus the applicable federal rate for short term obligations. The interest would be calculated on the "allocable share of the partial tax" for each year, which is determined by the following method multiplying the partial tax on the accumulated distribution by a fraction the numerator of which is the amount deemed distributed on the last day of the throwback year and the denominator is the total amount of the accumulation distribution.

Section 207(d) would add a new section 643(i) that would treat a "trust participant" as having received from a foreign trust an amount equal to the "use value" of her use of trust assets. For this purpose, the use of trust assets by a related person is treated as use by the trust participant. This rule would apply to any participant whose aggregate use value during a particular taxable year exceeds $2,500.

"Use value" is defined as the fair market value of the use of the property reduced by any amount paid for by the trust participant or a related party. Additionally a direct or indirect loan of cash from a foreign trust shall be treated as a use of trust property by the borrower, and the full amount of the principal of the loan shall be treated as a use value.

A "trust participant" is each grantor and each beneficiary of a trust. Proposed section 643(i)(3)(F) would treat a participant as related to any person if sales between the participant that and that person would be disallowed under section 267(b) or 707(b). For this purpose, the scope of section 267 is expanded in the following ways:

(1) section 267(e) is to be applied as if the individual and the person were pass-thru entities, (2) those provisions of section 267(b) which treat an individual as related to an entity if she owns more than 50% of it are changed to require only a 10% ownership; and (3) the family of an individual will include not only her present spouse, ancestors, descendants, and siblings, but also any present spouse of any of her ancestors, descendants, siblings and any former spouse of any of these individuals (including, apparently, former spouses of former spouses).

2. Comments

a. Interest Charges

Although the new method for calculating interest on accumulation distributions will undoubtedly complicate the process, we support the proposal as a reasonable method of requiring the beneficiary to compensate for the receipt of income on which has been allowed to grow free of U.S. tax for a number of years.

b. Use of Foreign Trust Property

(1) The Use of Tangible Property

The imputation of income to a trust beneficiary who uses trust property as a distribution is a fundamental change from existing tax law, which, for purposes of administrative convenience, does not tax imputed income from the possession of tangible property.[116] The reason for the proposal is the concern that a beneficiary of a trust should not be able to avoid tax on income that might have been distributed out to him or her, but was instead retained by the trust for such person's benefit. The Treasury uses, as an example, a foreign trust which purchases a luxury condominium, vacation house, and Rolls Royce all for the use of the U.S. beneficiary who has no income and therefore pays no U.S. income tax.

While Treasury has recognized an area of potential abuse, we are concerned about the administrative difficulty of administering this provision, which may require the annual determination of the rental value of a wide variety of properties located in and out of the U.S. The determination of use value can lead to extensive litigation and use of government resources and complexity in administration and reporting

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116. *See, e.g.*, Staff of Joint Comm. on Tax'n, 103d Cong., 1st Sess., Estimates of Federal Tax Expenditures for Fiscal Years 1994-1998, at 3-4 (Comm. Print 1993). *Cf.*, *DuPont Trust v. Commissioner*, 574 F.2d 1332 (5th Cir. 1978); *Commissioner v. Plant*, 76 F.2d 8 (2d Cir. 1936) *aff'g* 30 B.T.A. 133 (1935).

which does not appear warranted in view of the limited revenues to be raised thereby. Taxpayers will also be forced to incur substantial expenses to obtain annual appraisals of use value.

Moreover, this provision, which applies to use by foreign as well as U.S. beneficiaries, may actually reduce revenue. This would occur in the case of any particular trust if the use of a trust's tangible property by a nonresident alien were permitted to reduce the trust's DNI and UNI available for distribution to U.S. beneficiaries.

(2) Loans

If a person pays a market rate of interest on funds loaned to her by a foreign trust, we do not understand why such a loan should be treated as a distribution. This provision may also actually reduce revenue. It would make it possible to eliminate all UNI from a foreign trust by simply lending trust property, the value of which is equal to aggregate UNI, to a nonresident alien who is either a trust participant or is related to a trust participant. Thereafter, tax free distributions could be made S. beneficiaries from the trust.

Proposed section 643(i)(3)(G) provides that payment of principal on a loan treated as a distribution is to be disregarded for all tax purposes. A similar provision should be added to cover the payment of interest required on such loans.

(3) Allocation of Use by a Related Party Among Trust Participants

The related party rules of section 643(i)(3(c)(ii)) will be difficult to apply if two or more trust participants are equally closely related to the individual who has the use of trust property.

APPENDIX A

Following is the complete text of § 6 of H.R. 831:

"SEC. 6. STUDY OF EXPATRIATION TAX

(a) IN GENERAL. - - The staff of the Joint Committee on Taxation shall conduct a study of the issues presented by any proposals to affect the taxation of expatriation, including an evaluation of - -

(4) the effectiveness and enforceability of current law with respect to the tax treatment of expatriation,

(5) the current level of expatriation for tax avoidance purposes,

(6) any restrictions imposed by any constitutional requirement that the Federal income tax apply only to realized gains,

(7) the application of international human rights principles to taxation of expatriation,

(8) the possible effects of any such proposals on the free flow of capital into the United States,

(9) the impact of any such proposals on existing tax treaties and future treaty negotiations,

(10) the operation of any such proposals in the case of interests in trusts,

(11) the problems of potential double taxation in any such proposals,

(12) the impact of any such proposals on the trade policy objectives of the United States,

(13) the administrability of such proposals, and

(14) possible problems associated with existing law, including estate and gift tax provisions.

(b) REPORT. - - The Chief of Staff of the Joint Committee on Taxation shall, not later than June 1, 1995, report the results of the study conducted under

subsection (a) to the Chairmen of the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate."

APPENDIX B

Current Law Reporting Requirements Pertaining to Foreign Trusts

There are extensive reporting requirements with regard to foreign trusts under current law, each of which is described below:

A. Form 3520 (Section 6048(a))

Every United States person[1] who either creates a foreign trust or directly or indirectly transfers money or property to a foreign trust must file Form 3520, Creation of or Transfers to Certain Foreign Trusts.[2] The obligation to file Form 3520 does not apply in the case of (1) transfers of money or property to a foreign trust as part of a sale or exchange made for full and adequate consideration, and (2) employers and employees who make contributions to plans which provide employee benefits.[3]

Form 3520 must be filed by the 90th day after the reportable creation of, or transfer to, the foreign trust.[4] The Assistant Commissioner (International) is authorized to grant reasonable extensions of time.[5]

Among the types of information required by Form 3520 are the following:

(1) the name, address and identifying number of the grantor or transferor;
(2) the name of the trust;
(3) the foreign country under whose laws the trust was created;
(4) the date the trust was created;
(5) the date of the transaction;

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1. A United States person is a citizen or resident of the United States, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust. § 7701(a)(30); Temp. Treas. Reg. § 16.3-1(b)(2).

2. § 6048(a); Temp. Treas. Reg. § 16.3-1(a).

3. Temp. Treas. Reg. § 16.3-1(a)(4), (b)(4).

4. § 6048(a); Temp. Treas. Reg. § 16.3-1(a).

5. Temp. Treas. Reg. § 16.3-1(e)(1); *see also* § 6081(a) and Treas. Reg. § 1.6081-1.

(6) the amount of money and value of property transferred;

(7) the name and business address of the foreign trustee;

(8) the name, address and identifying number for each beneficiary who is named in the trust instrument or whose identity can definitely be determined at the time the form is filed, and the date of birth of each beneficiary who is a U.S. person and whose rights under the trust are determined, in whole or in part, by reference to the beneficiary's age;

(9) the name and address of the creator of the trust;

(10) the trust's termination date or a description of the conditions that will cause the trust to terminate;

(11) if the trustee is not required to distribute all trust income currently, either the trust instrument must be submitted or a statement must be attached "showing each beneficiary's (a) right to receive income or corpus, or both; (b) proportionate interest in the income or corpus, or both; and (c) any condition governing the time a distribution to the beneficiary may be made, such as a specific date or age";

(12) a statement listing the property transferred to the trust in the transaction being reported, including "a detailed description of each item transferred, and the consideration, if any, paid by the foreign trust for the property"; and

(13) the name and address of the person or persons having custody of the books of account and records of the trust and the location of the books and records.[6]

The penalty for failure to file Form 3520 on time, or failure to report the required information, is the <u>lesser</u> of 5% of the amount transferred to the trust and $1,000. Section 6677(a). The penalty does not apply if it is shown that the failure was due to reasonable cause.[7]

The Code's generally applicable criminal penalties for failure to file on time and for filing a false or fraudulent return also apply.[8]

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6. *See* Form 3520; Temp. Treas. Reg. § 16.3-1(c).

7. *Id.*

8. *See* §§ 7203 (failure to file), 7206 (fraud and false statements), and 7207 (fraudulent returns); Temp. Treas. Reg. § 16.3-1(f)(1).

B. Form 3520-A (Section 6048(c))

Form 3520-A, Annual Return of Foreign Trust with U.S. Beneficiaries, is an annual return that must be filed by the transferor of property to a foreign trust when such transferor is subject to tax under existing section 679.[9] Thus, a U.S. person who has directly or indirectly transferred property to a foreign trust that has at least one U.S. beneficiary during the taxable year must file Form 3520-A for the year of transfer and annually thereafter as long as the trust has at least one U.S. beneficiary.[10]

Form 3520-A must be filed by the 15th day of the 4th month following the end of the transferor's or grantor's tax year.[11] Extensions of time for filing may be granted.[12]

Form 3520-A does not need to be filed with respect to the following transfers, which correspond to the exceptions under section 679:

(1) transfers to foreign trusts by reason of the death of the transferor;

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9. § 6048(c); Treas. Reg. § 404.6048-1(a)(1).

10. A foreign trust is treated as having a U.S. beneficiary for these purposes unless both (1) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and (2) no part of the income or corpus of the trust could be paid to or for the benefit of a United States person if the trust were terminated during the taxable year. § 679(c)(1). The breadth of this definition is illustrated in the Senate Finance Committee Report to the Tax Reform Act of 1976, which states that a foreign trust is treated as having a U.S. beneficiary if income or corpus may be distributed "to unnamed persons generally or to any class of persons which includes U.S. persons" unless the terms of the trust "which cannot be amended" provide that no distributions may be made to a U.S. person. S. Rep. No. 938, 94th Cong., 2d Sess. 219 (1976).

Attribution rules are provided for purposes of deterring whether an amount is treated as being paid to or for the benefit of a United States person. § 679(c)(2).

11. Treas. Reg. § 404.6048-1(c).

12. Treas. Reg. § 404.6048-1(c)(3). *See also* § 6081(a) and the regulations thereunder.

(2) sales or exchanges at fair market value in which the transferor recognizes gain;

(3) transfers to a foreign trust that is a qualified employee benefit trust under section 404(a)(4) or 404A; and

(4) transfers made before May, 22, 1974.[13]

In general, Form 3520-A asks for the same type of information as Form 3520. In addition, Form 3520-A requires the names, addresses and identifying numbers of U.S. beneficiaries and whether or not each U.S. beneficiary is a U.S. citizen; a description of amendments to the trust made during the year; an income statement of the foreign trust indicating the income and expenses of the foreign trust and the grantor's or transferor's portion of the trust's income and expenses; and a balance sheet for the trust.[14]

The penalty for failure to file Form 3520-A on time or for filing a false or fraudulent return is the lesser of 5% of the value of the corpus of the trust at the close of the tax year and $1,000.[15] The penalty does not apply if it is shown that the failure is due to reasonable cause.[16]

The Code's generally applicable criminal penalties for failure to file on time and for filing a false or fraudulent return also apply.

C. Form 926

Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, Foreign Estate or Trust or Foreign Partnership, is the return used to report transfers

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13. *See* Form 3520-A, Instructions.

14. The information required by form 3520-A is specified only on the Form, not in the Code or regulations. By contrast, the information required by Form 3520 is set forth in the regulations as well as in the Form. In both cases, the Code gives the Secretary the authority to prescribe regulations without specifying the types of information that may be required. § 6048(b), (c).

15. § 6677(a).

16. *Id.*

described in section 1491, which imposes an excise tax on certain transfers of appreciated property to foreign entities, including foreign trusts.[17]

In general, U.S. citizens and residents, domestic corporations and partnerships, and domestic estates and trusts must file Form 926 to report, *inter alia*, transfers to foreign trusts.[18] Form 926 generally must be filed on the day the transfer is made to the foreign trust.[19]

Form 926 asks for identifying information about the transferor, the transferee (*i.e.*, the foreign trust), and the name and address of each beneficiary of the foreign trust. In addition, for transfers subject to the section 1491 excise tax, a description of the property transferred and a calculation of the tax due (along with payment of the tax) is required.[20]

There are no penalties that expressly apply to a failure to file Form 926, but the general civil and criminal penalties for failure to file a return apply (and, in the case tax is due and not paid, the general civil and criminal penalties for failure to pay would apply). Moreover, if information is required by section 6038B relating to the reporting of transfers to foreign persons and that information is not supplied, a

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17. The excise tax is equal to 35% of the excess of the fair market value of the property transferred over the sum of (1) the adjusted basis of the property, plus (2) the amount of gain recognized at the time of the transfer. § 1491. Various exceptions apply, including an exception for transfers for which the taxpayer elects to recognize gain under § 1057 and an exception for transfers with respect to which the taxpayer elects to apply principles similar to the principles of § 367. § 1492(2)(B), (3). Form 926 must be filed even if an exception to § 1491 applies, and the taxpayer must attach a statement summarizing all the facts relating to the transfer and a copy of the plan under which the transfer was made. If the taxpayer elects to apply the principles of § 367(b), the taxpayer must also attach the information required under § 6038B and Temp. Treas. Reg. § 1.6038B-1T(c), relating to the reporting of transfers to foreign persons.

18. Treas. Reg. § 1.1494-1(a).

19. *Id.*

20. Information regarding the property transferred and the circumstances surrounding the transfer are required even if the transfer is exempt from the excise tax. *See* note 17, *supra*.

penalty equal to 25% of the amount of gain realized is imposed on the transferor, unless the failure is due to reasonable cause and not due to willful neglect.[21]

D. Other Filing Requirements Relating to Foreign Trusts

1. Income Tax Return

The trustee of a foreign trust that engages in a U.S. trade or business or has U.S.-source income in a taxable year generally must file a U.S. federal income tax return.[22]

2. Gift Tax Return

A U.S. person who makes a transfer to a trust (including a foreign trust) which is a gift for U.S. gift tax purposes (whether complete or incomplete) is generally required to report the transfer on Form 709, United States Gift (and Generation-Skipping Transfer) Tax Return.[23]

3. Estate Tax Return

Trusts (including foreign trusts) created by a decedent and interests in trusts (including foreign trusts) held by a decedent are reportable on Form 706, United States Estate (and Generation-Skipping Transfer Tax) Return, even if the trust property is not included in the decedent's estate.[24] In both cases, the trust instrument must be attached to the return.

4. Form TD F 90-22.1

Any United States person who has a financial interest in or signature authority over, bank, securities, or other financial accounts in a foreign country is required to file Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, if the

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21. § 6038B(b).

22. The trustee of such a trust is required to file Form 1040NR, U.S. Nonresident Alien Income Tax Return, and is instructed to modify that Form to reflect the fact that the taxpayer is a trust subject to taxation under Subchapter J of chapter 1 of the Code.

23. *See* Treas. Reg., § 25.2511-2(j).

24. *See* Form 706, Part 4, line 12.

aggregate value of the accounts exceeds $10,000 at any time during the calendar year. A United States person who either (1) has a greater than 50% present beneficial interest in the assets of a trust or (2) receives more than 50% of the current income of a trust is considered to have a financial interest in the trust's foreign accounts and is required to disclose such accounts on Form TD F 90-22.1.

APPENDIX C

Excerpt from H. Rep. No. 386, 101 1st Cong., 2d Sess., 593-595 (1989)

"Under the conference agreement, in cases of noncompliance, the amount of any deduction for any amount paid or incurred to the related party by the reporting corporation, or the cost of property transferred between such persons shall be determined by the Secretary in the Secretary's sole discretion, based on the Secretary's own knowledge or from such information as the Secretary may choose to obtain. The conferees intend that, where this noncompliance penalty applies, the Secretary shall consider any information or materials that have been submitted by the reporting corporation or the related party unless, in the Secretary's sole discretion, such information or materials are insufficiently probative of the relevant facts.

The conferees wish to clarify that the exercise of the Secretary's sole discretion to establish allowable amounts of deductions and the cost of goods sold in the event of noncompliance shall be subject only to limited judicial review. The conferees recognize that under the conditions where a penalty may be imposed for failure to comply with a summons, the Secretary must of necessity establish the amount of a deduction or the cost of goods sold in the absence of information the Secretary deems relevant to that determination. Accordingly, the amounts established by the Secretary cannot be overturned by a court on the basis that they diverge from actual costs or other amounts incurred, or on the basis that they do not clearly reflect income. The fact that amounts established by the Secretary can be proven to be clearly erroneous, by reference to information or materials that were not within the Secretary's knowledge or possession, would not alone, in the conferees' view, be sufficient cause for a court to redetermine allowable amounts of deductions and the cost of goods sold. In addition, the conferees do not expect a court to overturn a determination on grounds that the Secretary might have sought to obtain additional information but failed to do so.

The conferees intend that a taxpayer seeking judicial review of the exercise of the Secretary's sole discretion under the noncompliance rules shall bear the burden of proof by clear and convincing evidence that the Secretary abused that discretion. The conferees do not intend to foreclose a court from overturning a determination by the Secretary that was proven (by clear and convincing evidence) either to have been made with improper motive, or to have been clearly erroneous by reference to all reasonably credible interpretations or assumptions of facts. On the other hand, the conferees do not expect a court to overturn a determination unless it could do so even after accepting as true all allegations and inferences that may support the Secretary's position.

Similarly, the exercise of the Secretary's sole discretion in determining how much weight, if any, to give to any individual document or other item of information that has been submitted is subject to the same scope of review, *i.e.*, proof by clear and convincing evidence that the Secretary abused that discretion, while accepting as true all allegations and inferences that may support the Secretary's position.

Under present law, determinations by the Secretary as to the proper allocation or apportionment of items of income and expense under section 482 must be sustained absent a showing of abuse of the Commissioner's discretion.[1] The taxpayer thus bears the heavier-than-normal burden of proving that the Commissioner's allocations under section 482 are arbitrary, capricious or unreasonable in order for a court to redetermine the deficiency.[2] The conferees are informed, however, that some interpretations of that standard of review have been criticized for giving little deference to the Commissioner[3] and permitting the court to effectively substitute its own judgment for that of the Commissioner. The conferees intend that the standard of review applicable to the exercise of the Secretary's sole discretion under the conference agreement shall not permit a court to so substitute its own judgment, but rather shall accord a high degree of deference to the determination of the Secretary under this provision."

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1. *Paccar, Inc. v. Commissioner*, 85 T.C. 754, 787 (1985), *aff'd* 849 F.2d 393 (9th Cir. 1988), cited in *Bausch & Lomb, Inc v. Commissioner*, 92 T.C. 525, 581 (1989).

2. *Your Host, Inc. v. Commissioner*, 489 F.2d 957 (2d Cir. 1973); *G.D. Searle & Co. v. Commissioner*, 88 T.C. 252, 359 (1987), both cited in *Bausch & Lomb, Inc. v. Commissioner*, at 581.

3. *See, e.g., Bausch & Lomb v. Commissioner*, at 597 (in which the court stated that the taxpayers "have adequately demonstrated the unreasonableness" of the Commissioner's adjustment, even though the court did not "completely embrace the approach or results arrived at by any of the experts." The court instead decided to "extract relevant findings from each [expert] in drawing [its] own conclusions.").