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Report on Proposed Section 2801 Regulations

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New York State Bar Association Tax Section

Report on Proposed Section 2801 Regulations

I. INTRODUCTION

A. Background

This report[1] comments on proposed regulations under section 2801 of the Code (the "**proposed regulations**").[2] Section 2801 was enacted as part of the Heroes Earnings Assistance and Relief Tax Act of 2008 (the "**HEART Act**"), along with section 877A. These sections are relevant to "covered expatriates." A covered expatriate, generally, is an individual who ceases to be a U.S. citizen or a long-term lawful permanent resident of the United States on or after June 17, 2008 and who has an income or net worth in excess of certain thresholds or who is unable to certify compliance with his or her U.S. tax obligations.[3] Limited exceptions to covered expatriate status apply to individuals who were dual citizens from birth or who relinquish their citizenship before reaching 18 ½ years of age.[4]

There are three principal consequences to being a covered expatriate. *First*, a covered expatriate is treated under section 877A as if she sold her worldwide assets on the day before her

[1] The principal drafters of this report are Max P. Biedermann, Alan S. Halperin, Amy E. Heller, Dina Kapur Sanna, Joseph Septimus and Michael D. Shapiro. The authors received helpful comments from Megan L. Brackney, Peter J. Connors, Mitchell M. Gans, Elizabeth T. Kessenides, Stephen B. Land, Michael L. Schler and David R. Sicular and ideas and input from Ellen K. Harrison and Carlyn S. McCaffrey, who participated in drafting a report on behalf of the American College of Trust & Estate Counsel. Opinions expressed in this report are those of the Tax Section of the New York State Bar Association and do not represent those of the New York State Bar Association House of Delegates.

[2] Notice of Proposed Rulemaking, *Guidance Under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests From Covered Expatriates,* REG-112997-10, 80 Fed. Reg. 54447 (Sept. 10, 2015) (the "**Notice**"). References in this report to the "**Code**" are to the Internal Revenue Code of 1986, as amended. References to "sections" are to sections of the Code, and references to "**Treas. Reg. §**" are to sections of the Treasury Regulations promulgated under the Code.

[3] In particular, an individual who has an average annual net income of more than $161,000 (the 2016 inflation-indexed figure) for the five years ending with the taxable year of expatriation or who has a net worth of over $2 million on the expatriation date generally is a covered expatriate. Section 877A(g) (defining "covered expatriate" by reference to section 877(a)(2); Rev. Proc. 2015-53 (Nov. 2, 2015)).

[4] Section 877A(g)(1)(B).

expatriation. The covered expatriate is required to include in her income the net gain from the sale of these assets, in excess of certain thresholds.[5] *Second*, under section 877A distributions to a covered expatriate following her expatriation date from domestic nongrantor trusts and certain deferred compensation plans are subject to a 30% withholding tax, to the extent that these distributions would have been taxable had the expatriate been a U.S. person at the time of distribution.[6] *Third*, and most significantly for purposes of this report, a succession tax is imposed under section 2801 (the "**section 2801 tax**") on U.S. citizens and residents and domestic trusts that directly or indirectly receive gifts or bequests from a covered expatriate ("**covered gifts**" or "**covered bequests**").

The section 2801 tax is imposed on the value of a covered gift or bequest at the highest applicable gift and estate tax rate in effect at the time of receipt of the covered gift or bequest (currently 40%). The section 2801 tax applies regardless of whether the property transferred was acquired by the covered expatriate before or after the expatriation date. There are certain exceptions for marital and charitable transfers of a covered expatriate. Special rules apply to covered gifts or bequests made to foreign trusts. In particular, assuming that the foreign trust does not elect to be treated as a domestic trust for purposes of section 2801 (a "**non-electing foreign trust**"), the section 2801 tax is imposed on distributions to U.S. beneficiaries that are attributable to the covered gift or bequest made to the trust.

Even though the section 2801 tax applies to covered gifts and bequests received on or after June 17, 2008, in Notice 2009-85, the IRS deferred the due date for reporting and paying the section 2801 tax until a reasonable period of time after final regulations are issued.[7] The preamble to the proposed regulations provides that no covered gift or bequest needs to be reported and no section 2801 tax needs to be paid until Form 708, *U.S. Return of Gifts or Bequests from Covered Expatriates*, is released. According to the preamble, Form 708 will be released once the final regulations have been issued.

The legislative history to section 2801 and the preamble to the proposed regulations explain that the intent of section 2801 is to subject gifts or bequests made by a covered expatriate to a U.S. person to a transfer tax equal to the estate or gift tax that would have been payable by the expatriate if she had not relinquished her citizenship or terminated her long-term residency.[8] In other words, section 2801 is intended to make expatriation "tax neutral," meaning that that "an

[5] In 2016, a covered expatriate is required to recognize as income net gain in excess of $693,000. Section 877A(a)(2); Rev. Proc. 2015-53, I.R.B. 2015-44.

[6] Section 877A(d), (f).

[7] I.R.B. 2009-45.

[8] H.R. Rep. No. 110-431 at 113-114 (2007) (the "**House Report**").

individual's decision to relinquish citizenship or terminate long-term residency should not affect the total amount of taxes imposed."[9]

There are, however, a number of ways in which gifts and bequests of covered expatriates are subject to harsher tax treatment than gifts and bequests of U.S. citizens and residents. For example, the gift tax is "tax exclusive," meaning that the tax imposed does not reduce the amount received by the recipient (because it is paid by the donor), whereas the section 2801 tax is "tax inclusive," because the tax is imposed on the recipient thereby reducing the amount actually received by the recipient.

In addition, gifts and bequests made by a U.S. citizen or resident benefit from the so-called "unified credit," which currently protects $5,450,000 of taxable gifts or bequests from gift or estate tax.[10] The unified credit is not available to protect any portion of a covered expatriate's gifts or bequests from the section 2801 tax. The unavailability of the unified credit may have a particularly harsh effect on those covered expatriates who have relatively modest estates. If these covered expatriates had remained U.S. citizens or long-term permanent residents, all of their gifts or bequests may have been protected from federal wealth transfer taxes by the unified credit. Following expatriation, none of their gifts or bequests will be protected by the unified credit.[11] We recognize that it would be administratively difficult to implement rules that allow U.S. recipients of covered gifts or bequests to benefit from the unified credit that a covered expatriate would have had if she had not relinquished her citizenship or long-term permanent resident status. This may be at least part of the reason why section 2801(a) precludes covered expatriates from benefiting from the unified credit, in spite of the legislation's stated goal of tax neutrality.

Where feasible though and where consistent with the Code, the report suggests that the regulations be modified to better advance the goal of tax neutrality. Our specific recommendations are described in the sections that follow below.

B. Summary of Recommendations

A brief summary of the recommendations described in this report follows. These recommendations are described more fully in parts II through XII.

[9] *Id.*

[10] Sections 2010 and 2505.

[11] We acknowledge, however, that, following expatriation, an expatriate's gifts and bequests to non-U.S. persons will not be subject to U.S. transfer taxes.

1. Timing and Value of Covered Gifts and Bequests

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

2. Indirect Gifts and Bequests

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

3. Section 2801 and Treaties

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

4. Basis Adjustment for Section 2801 Tax Paid

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

5. Defining "Distributions" from Foreign Trusts

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

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

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

7. Marital and Charitable Transfers and Foreign Trusts

Section 2801(e)(3) provides an exception to covered gift or bequest treatment for transfers that would qualify for the marital or charitable deduction if the donor or decedent were a U.S. person. Given the statutory construct, we recommend that the determination of whether the marital or charitable exception applies be made at the time that a distribution is made from a foreign trust to a U.S. citizen or resident spouse of the donor or decedent or to a U.S. charitable organization. In the case of marital transfers, we also recommend that the U.S. citizen or resident spouse make relevant marital trust tax elections on a Form 708 filed in connection with the distribution from the foreign trust.

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

Under the proposed regulations, a U.S. recipient of a distribution from a foreign trust is allowed a deduction under section 164 in the year in which the section 2801 tax is paid or accrued. The amount of the deduction is equal to the portion of the section 2801 tax attributable to the distribution, to the extent that the portion of the distribution is includible in the U.S. recipient's gross income. This means that the section 2801 tax can be deducted against the current year income of a trust that is distributed from a trust to a U.S. beneficiary. However, it seems that the section 2801 tax cannot be deducted against accumulated income of a trust that is distributed to a U.S. beneficiary (referred to as an "accumulation distribution"). This is because an accumulation

distribution, while taxable to a U.S. beneficiary, technically is not included in the beneficiary's gross income. We suggest that Treasury modify the regulations so that the section 2801 tax may be deducible against an accumulation distribution.

9. Treatment of Electing Foreign Trusts

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

10. Information Returns

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

11. Protective Form 708

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

II. TIMING AND VALUE OF COVERED GIFTS AND COVERED BEQUESTS

The proposed regulations may subject a recipient of a covered gift or a covered bequest to tax under section 2801 on an amount in excess of the value of the property received and at a time when the recipient's interest in the property is not yet possessory. As a general matter, this is because section 2801 imports principles of the gift tax (a tax that is paid by donor) and principles of the estate tax (a tax that is a paid by a decedent's estate before the distribution of property

to the decedent's heirs) and seeks to apply these principles to a tax that is borne by recipients of gifts and bequests.

Part II.A below addresses issues related to the timing and value of covered gifts. Part II.B addresses issues related to the timing and value of covered bequests.

A. Timing and Value of Covered Gifts

The proposed regulations provide that for purposes of determining the tax under section 2801, the value of a covered gift is the fair market value of the property transferred as determined in accordance with federal gift tax principles of section 2512.[12] The value is determined as of the "date of receipt" by the U.S. recipient.[13]

The proposed regulations define the "date of receipt" to be "the same as the date of the gift for purposes of chapter 12 as if the covered expatriate had been a U.S. citizen at the time of the transfer."[14] Under chapter 12, the federal gift tax is "an excise upon [the donor's] act of making the transfer" and is imposed when the donor has "parted with dominion and control" over the property being transferred."[15] The regulations under chapter 12 specifically provide that the gift tax "is not imposed upon the receipt of the property by the donee."[16] Accordingly, by defining the "date of receipt" by reference to chapter 12 principles, the proposed regulations create a potential mismatch in timing between the date on which a covered gift actually is received and the date on which liability for tax under section 2801 is determined.

In some cases, this mismatch in timing may be only a matter of a few days. In other cases, however, applying donor-centric principles to determine the date of receipt of a covered gift may cause a tax liability to attach to a covered gift years before a donee's interest in the transferred property becomes possessory. For example, consider a covered expatriate who transfers a

[12] Prop. Treas. Reg. § 28.2801-4(c).

[13] Prop. Treas. Reg. § 28.2801-4(d)(1).

[14] Prop. Treas. Reg. § 28.2801-4(d)(2).

[15] Treas. Reg. § 25.2511-2(a), (b). The proposed regulations include a provision that, under certain circumstances, may be inconsistent with the principle of chapter 12 that a donor makes a taxable gift when she parts with dominion and control over property being transferred. Specifically, under Prop. Treas. Reg. § 28.2801-4(d)(2), a revocable trust is treated as receiving a gift from a covered expatriate on the date on which the covered expatriate relinquishes her right to revoke the trust. The date on which a covered expatriate relinquishes her right to revoke a trust, however, is not necessarily the date on which her gift to the trust will be complete for purposes of chapter 12. The gift to the trust will be complete for purposes of chapter 12 only once the donor has ceased to have any powers that would allow her to alter beneficial enjoyment of the trust property.

[16] Treas. Reg. § 25.2511-2(a).

life estate in property to her spouse and a remainder interest to her child. In civil law countries, where trusts are not recognized as a means of dividing beneficial ownership of property on a temporal basis, it is common for donors to transfer life estates or term interests in property to certain family members (or to retain these term interests or life estates) and to transfer remainder interests in the property to other family members.[17] As a result of the donor-based principles of chapter 12 described above for determining the "date of receipt" of a covered gift, a U.S. recipient of a remainder interest in property could be subject to tax under section 2801 years before her remainder interest becomes possessory.

In view of these potentially harsh consequences, we suggest that that the regulations be modified to allow a U.S. donee of a covered gift that will not become possessory until a future date to elect to defer payment of the section 2801 tax, with an interest charge, until the donee's interest in the gifted property becomes possessory. We also suggest that the regulations cap the total tax and interest charges for a donee who elects to defer payment of the section 2801 tax at the value of the property that the donee ultimately receives.

B. Timing and Value of Covered Bequests

The proposed regulations provide that for purposes of determining the tax imposed under section 2801, the value of a covered bequest is the fair market value of the property as determined in accordance with federal estate tax principles of section 2031 and chapter 14.[18] The value is determined as of the "date of receipt" by the U.S. recipient.[19]

The proposed regulations generally define the "date of receipt" of a covered bequest as the date of distribution from a covered expatriate's estate.[20] However, the proposed regulations provide that under certain circumstances, the "date of receipt" of a covered bequest will be the date of the decedent's death. These include circumstances in which property passes to a recipient by beneficiary designation or by operation of law.[21] In civil law countries, a decedent's property generally devolves to her heirs upon the decedent's death by operation of law. This is the case even though time may elapse before the heirs' interests in the property become possessory. During this time, the heirs form a "community of heirs," giving them joint ownership of the estate. The probate court might appoint an official to administer the estate during this time, though, un-

[17] In certain civil law countries, arrangements like these often are referred to as "usufructs." *See, e.g.,* PLR 8748043 (Sept. 1, 1987) (analyzing certain U.S. tax consequences of a Dutch usufruct).

[18] Prop. Treas. Reg. § 28.2801-4(c).

[19] Prop. Treas. Reg. § 28.2801-4(d)(1).

[20] Prop. Treas. Reg. § 28.2801-4(d)(3).

[21] *Id.*

like the administrator of an estate in a common law country, the administrator will not take title to the assets.

In this circumstance, a U.S. recipient of a covered bequest may be subject to the section 2801 tax before her interest in the property becomes possessory. A recipient of a covered bequest also may be subject to the section 2801 tax before her interest in property becomes possessory in circumstances similar to those described in Part II.A above (*e.g.*, the U.S. recipient receives a bequest of a remainder interest in property, to become possessory following an intervening life estate).[22] We suggest that the regulations be modified to allow a U.S. recipient of a covered bequest to elect to defer payment of the section 2801 tax, with an interest charge, until the recipient's interest in the property becomes possessory. We also suggest that the regulations cap the total tax and interest charges at the value of the property that the recipient ultimately receives.

Furthermore, the proposed regulations apply the gift tax valuation rules of chapter 14 to covered bequests. We also believe that these sections also should not apply in determining the tax liability of a recipient of a covered bequest, because these sections have no application to the estate tax.

III. INDIRECT GIFTS AND BEQUESTS

The section 2801 tax applies to gifts and bequests acquired indirectly as well as directly from a covered expatriate. Prop. Treas. Reg. § 28.2801-2(i) provides four examples of when an indirect covered gift or bequest would be considered to occur. Each of these examples is discussed below.

First, the proposed regulations provide that a covered gift or bequest to an entity other than a trust or estate is treated as an indirect gift or bequest to the U.S. individuals who own the entity in proportion to their ownership interests. This conclusion is consistent with Treas. Reg. § 2511-1(h)(1), which treats a gift to a corporation as a gift to its shareholders to the extent of their proportionate interests in the corporation.

Second, a U.S. individual's acquisition of property from a foreign trust that received a covered gift or bequest "through one or more other foreign trusts, other entities, or a person not subject to the section 2801 tax" is treated an indirect gift or bequest to the U.S. individual. This example seems to go too far. It includes no requirement that the property acquired by the U.S.

[22] The estate tax also may be imposed before an heir's interest in property becomes possessory. However, the estate tax is imposed on the estate, not the decedent's heirs. It therefore is logical that the estate tax may be paid by the executor of the estate prior to the receipt of the property by the heirs. Further, the executor of the estate should have possession of the estate's property and therefore should have the means to pay the estate tax imposed.

individual have any relationship to the covered gift or bequest. We suggest that this example be modified as follows to limit its scope to trust distributions that are attributable to the trust property acquired as a covered gift or bequest:

> (2) Property acquired by or on behalf of a U.S. citizen or resident, from a foreign trust[23] that received a covered gift or covered bequest, through one or more other foreign trusts, other entities, or a person not subject to the section 2801 tax to the extent the acquired property is attributable to the covered gift or covered bequest.[24]

Third, the payment of a U.S. individual's debt by a covered expatriate or by a foreign trust that received a covered gift or bequest is treated as an indirect acquisition of property by the U.S. individual. The conclusion that an individual's payment of the debt of another is a gift by the individual to the debtor is consistent with basic gift tax principles.[25] However, this example goes too far in the same manner as the preceding example. There is no requirement that there be any relationship between the property used by the foreign trust to pay the U.S. individual's debt and the covered gift or bequest. We suggest this example be modified in a manner similar to the modification we suggested for the preceding example.

The fourth example concludes that property received by a U.S. individual as a result of the exercise of a power of appointment granted to a non-covered expatriate by a covered expatriate over property not held in trust is a covered gift or bequest. As a preliminary matter, this is one of several instances where the proposed regulations refer to a power of appointment granted "over property not in trust."[26] While powers of appointment frequently are granted over property held in trust, we are unfamiliar with the concept of a power of appointment being granted over property not held in trust. An example illustrating a power of appointment granted over property not held in trust would be helpful.

Furthermore, we suggest that the fourth example be modified to include the exercise of a non-general power of appointment and to exclude the exercise of a general power of appoint-

[23] The reference in the proposed regulation to property acquired from a covered expatriate is not necessary. Property acquired from a covered expatriate would be a direct, not an indirect, covered gift or bequest.

[24] The suggested language is similar to the text of section 2801(e)(4)(B)(i) and Prop. Reg. § 28.2801-5(c), which deal with distributions to U.S. individuals from foreign trusts that have received covered gifts or bequests. Prop. Reg. § 28.2801-5(c) is discussed below in Part VII.

[25] *See, e.g.*, Est. of Woody v. Comm'r, 36 T.C. 900 (1961); Rev. Rul. 81-110, 1981-1 C.B. 479; Rev. Rul. 78-362, 1978-2 C.B. 248.

[26] *See also* Prop. Treas. Reg. § 28.2801-3(e)(1).

ment.[27] The holder of a non-general power of appointment may be viewed as the agent of the donor.[28] Accordingly, property that passes to a U.S. individual by reason of the exercise of a non-general power of appointment granted by a covered expatriate may be viewed as acquired from the covered expatriate. In contrast, the holder of a general power of appointment—who has the ability to appoint the property over which she holds the general power to herself, to her creditors, to her estate or to the creditors of her estate— should not necessarily be viewed as the agent of the donor. We suggest that property acquired by a U.S. individual as a result of the exercise of a general power of appointment by a non-covered expatriate be subject to rules regarding transfers through intermediaries that are similar to those that apply to property acquired from a non-covered expatriate who previously received a donative transfer from a covered expatriate or who previously received a distribution from a foreign trust to which a covered expatriate had transferred property. The rules we suggest for this purpose are discussed starting in the next para-paragraph.

After providing the four examples described above, the proposed regulations provide a broad catch-all category that offers limited guidance. The catch-all category includes property acquired by a U.S. individual "in other transfers not made directly by the covered expatriate to the U.S. citizen or resident."[29] Because transfers not made directly by a covered expatriate include transfers made by all persons who are not covered expatriates, a literal application of this rule could result in all transfers received by U.S. individuals being treated as covered gifts or bequests. Presumably, the catch-all category is intended to include transfers made to U.S. individuals by persons who are not covered expatriates of property given to them by covered expatriates with the expectation that they would give the property to the U.S. individuals.

To deal with this issue, we recommend that the proposed regulations be modified to incorporate rules similar to those described in Regulations under sections 643(h) and 679. These sections were adopted to address a concern similar to the concern reflected in the proposed regulation addressing indirect covered gifts and bequests—namely, the concern that intermediaries will be used to avoid tax. Under section 643(h), a distribution *from* a foreign trust to a U.S. person through an intermediary will be treated as having been made directly from the trust to the

[27] The holder of a non-general, or limited, power of appointment over the assets of a trust may not appoint the assets in favor or herself, her estate, her creditors, or the creditors of her estate. The value of assets of the trust generally will not be includible in the gross estate of a decedent who dies holding a non-general power of appointment. In contrast, if the holder of a power of appointment over a trust can appoint assets to any of herself, her estate, her creditors, or the creditors of her estate, the power is a general power of appointment. and the value of the trust's assets will be includible in her gross estate. Section 2041.

[28] *See* Self, Jr. v. United States, 142 F. Supp. 939 (Ct. Cl. 1956).

[29] Prop. Treas. Reg. § 28.2801-2(i).

U.S. person. Under section 679, an indirect transfer *to* a foreign trust by a U.S. person through an intermediary will be treated as having been made directly by the U.S. person.

Regulations under these Code sections, however, rationally limit the circumstances in which a transfer will be treated as made to or from a foreign trust through an intermediary. Under Treas. Reg. §1.679-3(c), a transfer to a foreign trust is not treated as made through an intermediary if the transfer does not have a principal purpose of tax avoidance. A transfer is deemed not to have a principal purpose of tax avoidance if the taxpayer can demonstrate to the satisfaction of the Commissioner that (a) the purported intermediary has a relationship with the beneficiary of the trust that establishes a reasonable basis for concluding that the intermediary would have made a transfer to the trust and (b) the intermediary acted independently of the U.S. person.

Treas. Reg. § 1.643(h)-1 includes a similar rule limiting the circumstances under which a transfer will be treated as having been made from a foreign trust through an intermediary. In addition, this regulation provides that a principal purpose of tax avoidance will be presumed to exist if the purported intermediary receives property from a foreign trust during the 24-month period before or after the transfer to the recipient.

If the regulations under section 2801 adopt a rule similar to that in Treas. Reg. § 1.679-3(c) or § 1.643(h)-1, this should help prevent intermediaries from being used to avoid the tax under section 2801 while, at the same time, protecting legitimate transfers from non-covered expatriates to U.S. persons from triggering a tax. For example, consider a covered expatriate who under his Will leaves property to his wife. Assume that on the wife's later death, she leaves her property to the couple's children. The wife clearly has a relationship with her own children that would provide a basis for her to leave them property under her Will. As long as she acted independently, it seems appropriate that her transfer to her children should not trigger a tax under section 2801.

IV. SECTION 2801 AND TREATIES

Several of the examples in the proposed regulations provide that the covered expatriate in the example is domiciled in a country with which the United States does not have an estate or gift tax treaty.[30] There are no examples that specify that the covered expatriate is domiciled in a country with which the United States does have an estate or gift tax treaty. This suggests that the application of section 2801 is impacted by existing gift and estate tax treaties. We recommend that the final regulations clarify the interaction between section 2801 and gift and estate tax treaties.

[30] *See, e.g.,* Prop. Treas. Reg. § 28.2801-3(f), Exs. 1–3; § 28.2801-4(f), Ex. 3.

Part IV.A below addresses whether section 2801 is covered by existing gift and estate tax treaties. Part IV.B discusses whether section 2801 overrides existing estate and gift and treaties, in principle. Part IV.C illustrates a particular situation where a conflict may exist between section 2801 and a treaty.

A. Whether Section 2801 is Covered by Existing Treaties

In considering the interaction between section 2801 and gift and estate tax treaties, a preliminary question is whether the tax imposed by section 2801 is within the scope of existing gift and estate tax treaties.[31] We believe that the section 2801 tax is within the scope of existing gift and estate tax treaties.

First, section 2801 is found within Subtitle B of the Code, which is titled "Estate and Gift Taxes."[32] Second, even if the section 2801 tax is not viewed as an "estate or gift" tax for purposes of existing treaties, the section 2801 tax should nevertheless be covered by these treaties. This is because all of the existing U.S. estate and gift tax treaties, other than the treaty with Greece, apply to taxes imposed by the U.S. after the date of the treaty that are "substantially similar" to the U.S. estate and gift taxes."[33] The legislative history to section 2801 specifically refers to the section 2801 tax as a tax that is "similar" to the U.S. estate and gift taxes.[34]

[31] The United States currently has estate or gift tax treaties with 16 countries: Australia, Austria, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, the Netherlands, Norway, South Africa, Switzerland, and the United Kingdom. The United States is negotiating an estate tax treaty with Belgium. *See* https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-&-Gift-Tax-Treaties-International (last visited Jan. 19, 2016). Some of these treaties address only estate taxes; others address both estate and gift taxes.

[32] Subtitle B has five chapters: (1) chapter 11, titled Estate Tax, (2) chapter 12, titled Gift Tax, (3) chapter 13, titled Tax on Certain Generation Skipping Transfers, (4) chapter 14, titled Special Valuation Rules and (5) title 15, titled Gifts and Bequests from Expatriates. There is no estate or gift tax treaty that refers to the "estate tax under chapter 11" (or similar) or to the "gift tax under chapter 12" (or similar). A number of provisions of the Code that are headed "estate and gift taxes" actually have application to all taxes imposed under Subtitle B. Consider, for example, the penalties imposed under section 6662(g) on "substantial estate and gift tax valuation understatements," which are applicable to all taxes imposed under Subtitle B. *See* section 6662(g)(1); Prop. Treas. Reg. § 28.2801-6(d).

[33] *See, e.g.,* Article 2 of the treaties with France, German and Italy, each of which provides, "This Convention also shall apply to any identical or substantially similar taxes on estates, inheritances and gifts, which are subsequently imposed by a Contracting State in addition to, or in place of, the existing taxes."

[34] *See* the House Report at p. 114 (the section 2801 tax is "similar" to the U.S. estate and gift taxes that "are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor"). As described above, the House Report at p. 113 also provides that the section 2801 tax is intended to be

As described above in Part I.B, one way in which the section 2801 tax differs from the estate and gift taxes is that the section 2801 tax is imposed on the recipient of a gift or a bequest, similar to an inheritance or succession tax, rather than on the donor of a gift or the estate of a decedent. The fact that the section 2801 tax is imposed on a taxpayer different from the taxpayer on whom the estate or gift tax is imposed should not in and of itself prevent the section 2801 tax from being covered by existing treaties. In fact, a number of the countries with which the U.S. has estate and gift tax treaty treaties have inheritance or succession taxes, instead of or in addition to estate and gift taxes.[35] This means that a majority of our existing treaties apply to a different taxpayer in the United States and in the treaty partner country. In the case of the section 2801 tax, these treaties will apply to the same taxpayer in the United States and in the treaty partner country.

B. Whether Section 2801 Overrides Existing Treaties

Even if the section 2801 tax is covered by the language of existing treaties, there is a question as to whether Congress intended section 2801 to override existing treaties.

As a general matter, the Code reflects the principle that treaties and the Code are to be given equal weight, with neither to be given preferential status.[36] When interpreting the relationship between a treaty and statute, courts endeavor to construe them harmoniously, so as to give effect to both. "[W]e must read the treaty and the statute to give effect to each if we can do so while preserving their sense and purpose."[37] If, and only if, a conflict exists between the treaty and statute will the one enacted later in time control.

Courts, including the U.S. Supreme Court, repeatedly have held that a conflict between a treaty and a later enacted statute will be found to exist only when Congress has clearly expressed an intent to override the treaty. In *Trans World Airlines, Inc. v. Franklin Mint Corp.* the Supreme Court stated:

> There is, first, a firm and obviously sound canon of construction against finding an implicit repeal of a treaty in ambiguous congressional action. A treaty will not be deemed to have been abrogated or modified by a later statute, unless

"tax neutral" and is intended to be a substitute for the estate and gift taxes that an individual avoids by relinquishing citizenship or terminating long-term residency.

[35] *See, e.g.,* the U.S. treaties with Austria, Denmark, Finland, France, Germany, Greece, Italy, the Netherlands, Norway and Switzerland.

[36] Section 7852(d)(1) ("For purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or law.")

[37] Crow v. Comm'r, 85 T.C. 376, 384 (1985) (internal quotations omitted).

> such purpose on the part of Congress has been clearly expressed. Legislative silence is not sufficient to abrogate a treaty.[38]

Similarly, in *Menominee Tribe of Indians v. United States*, the Supreme Court wrote that "the intention to abrogate or modify a treaty is not to be lightly imputed to the Congress."[39]

The IRS has applied similar principles in analyzing the interaction between a treaty and the Code. In Revenue Ruling 79-199, the IRS reasoned:

> When an act of Congress and a treaty relate to the same subject, the courts will endeavor to construe them so as to give effect to both, if that can be done without violating the language of either. The courts do not favor the repudiation of an earlier treaty by implication and require clear indications that Congress, in enacting subsequent inconsistent legislation, meant to supersede the earlier treaty.[40]

Congress expressed no intent to override existing treaties with the enactment of section 2801. As described in Part I.A above, section 2801 was enacted as part of the HEART Act. Both the text of section 2801 and the legislative history of the HEART Act are silent regarding the interaction between section 2801 and treaties. However, Congress was aware of tax treaty obligations when section 2801 was enacted and specifically expressed an intent to override treaties in connection with section 877A, which, as described above, also was enacted as part of the HEART Act. In particular, section 877A(f) provides that if a covered expatriate is the beneficiary of a nongrantor trust prior to expatriation, the trustee of the trust must deduct and withhold tax on a portion of any distribution to the covered expatriate. The covered expatriate is "treated as having waived any right to claim any reduction under any treaty with the United States in withholding on any [such] distribution."[41] Congress thus expressly overrode applicable treaties in section 877A(f) and simultaneously was silent regarding treaties in section 2801. This silence, especially in light of the simultaneous treaty override in section 877A(f), seems insufficient to override existing treaties.

Furthermore, if Congress intended section 2801 to override treaties, the United States likely would be required to inform certain treaty counterparties. In general, the IRS characterizes U.S. estate and gift tax treaties as "old" or "new" depending on which situs rules and other pro-

[38] 466 U.S. 243, 252 (1984) (quotations and citations omitted).

[39] 391 U.S. 404, 413 (1968).

[40] 1979-1 C.B. 246 (1979).

[41] Section 877A(f)(4).

visions are included in the treaty.[42] The "new" treaties provide that "[t]he competent authorities of the Contracting States shall notify each other of any substantial changes which have been made in their respective laws relating to taxes on estates, inheritances, and gifts."[43] Accordingly, if Congress intended section 2801 to override treaties, which likely would constitute a "substantial change," the United States likely would need to notify countries that are parties to the "new" treaties. We have found no evidence of Congressional intent to notify treaty counterparties of the enactment of section 2801. Congress' silence in this regard seems to further support a lack of Congressional intent for section 2801 to override existing treaties.

C. Circumstances Where a Conflict May Exist Between Section 2801 and a Treaty

If the view is taken that section 2801 does not override existing treaties, this does not by it terms mean that section 2801 never will apply to a gift or bequest made by a covered expatriate resident or domiciled in a treaty country. There may be situations where there is no conflict between section 2801 and a relevant treaty, with the application of section 2801 and the treaty producing the same tax result.

This section IV.C illustrates one situation where section 2801 and a treaty do appear to conflict. The treaty that is the subject of the illustration is the Gift, Estate and Inheritance Tax Treaty between the United States and Germany, entered into force on June 27, 1986 (the "**German Treaty**").

Suppose that X is a U.S. citizen who is resident and domiciled in Germany. Under German law, X's U.S. heirs would be subject to German inheritance tax by virtue of X being domiciled in Germany. X's estate also would be subject to U.S. estate tax on account of X's U.S. citizenship. In this situation, both the U.S. and Germany have a right to tax under their internal laws, and the so-called "tiebreaker" rules in Article 4 of the German Treaty would apply to determine which jurisdiction has primary taxing jurisdiction. Assume that the tiebreaker rules grant Germany primary taxing jurisdiction because X has a home available to her in Germany but not in the United States. In this case, the United States would nevertheless retain jurisdiction to tax X's estate under the savings clause under Article 11(1) of the German Treaty.[44] Under Article 11(2) of the German Treaty, double taxation would be mitigated through a tax credit, provided

[42] *See* https://www.irs.gov/Businesses/Small-Businesses-&-Self-Employed/Estate-&-Gift-Tax-Treaties-International (page last updated by the IRS June 2, 2015).

[43] *See, e.g.*, U.S.-France Estate Tax Treaty, Art. 2(3).

[44] Article 11(1) of the U.S.-Germany Estate and Gift Tax Treaty provides that the "provisions of this Convention shall not preclude … the United States of America from taxing in accordance with its law the estate of a decedent or the gift of a donor who, at his death or at the making of the gift, was … a citizen of the United States of America." U.S.-Germany Estate and Gift Tax Treaty, Art. 11(1).

by the United States, and subject to limitations, for the amount of inheritance tax X's heirs paid to Germany.[45] Section 2801 is not implicated in this scenario because X remained a U.S. citizen.

Now assume that X renounces her U.S. citizenship and becomes a covered expatriate. At some point after renouncing her citizenship, X dies and leaves her estate to her U.S. heirs. German law would subject X's U.S. heirs to German inheritance tax by virtue of X being domiciled in Germany. In this case though, the U.S. tax result will depend on whether section 2801 overrides the German Treaty.

First, assume that section 2801 does not override the German Treaty. In this case, the United States would still have the right to tax X's U.S. heirs on the value of the property they receive from X's estate under section 2801. However, Article 11(2) of the German Treaty would permit X's U.S. heirs to claim a credit against the section 2801 tax for the German inheritance tax paid on the assets they received. This result is consistent with the principle of tax neutrality described above in part I.A because the tax imposed is essentially the same as if X had retained her U.S. citizenship.[46]

In contrast, assume that section 2801 does override the German Treaty. In this case, the United States would be able to levy the section 2801 tax on X's U.S. beneficiaries. Germany also would levy its inheritance tax on X's beneficiaries. However, X's U.S. beneficiaries would no longer be able to seek relief from double taxation under the Treaty and likely would be subject to tax by both the U.S. and Germany.[47] This outcome does not result in X's decision to relinquish citizenship or terminate long-term residency being tax neutral because X's U.S. heirs would be

[45] *See* U.S.-Germany Estate and Gift Tax Treaty, Art. 11(2).

[46] The main difference in the result is the fact that A's US beneficiaries and not A's estate would be liable for the U.S. tax.

[47] Section 2801 includes a provision intended to provide relief from double taxation. However, the provision is more limited than that afforded by treaties like the German Treaty, and on its face, would not reach the situation in the example described in the text above. Specifically, section 2801(d) provides that the section 2801 tax "shall be reduced by the amount of any *gift or estate tax* paid to a foreign country with respect to such covered gift or bequest." Section 2801(d) (emphasis added). Based on a literal reading of the statute, X's U.S. heirs are not entitled to a credit for the amount of tax they paid to Germany because they paid a German inheritance tax as a result of the decedent's German domicile, not a gift or estate tax. At least in the absence of further guidance interpreting section 2801(d) to specifically include inheritance taxes, we believe that a literal reading of the section to exclude inheritance taxes may be appropriate. Other sections of Subtitle B the Code specifically include foreign inheritance taxes as creditable taxes. *See e.g.*, section 2104, which provides a credit for foreign "estate, inheritance, legacy or succession taxes" paid to the government of a foreign country respect to property situated in that foreign country. Furthermore, Treasury has ruled and the Tax Court has held that the foreign taxes that are creditable section 2014 include only those that are specifically enumerated in the section and do not include other types of taxes. *See* Rev. Rul. 82-82, 1982-1 C.B. 127 and *Estate of Ballard v. Comm'r*, 85 T.C. 300 (1985).

subject to double tax as a result of the decision. For this reason, a treaty override does not appear to us to be appropriate in this circumstance.

V. BASIS ADJUSTMENT FOR SECTION 2801 TAX PAID

The proposed regulations state that section 1015(d), which provides a basis adjustment to property received by gift to reflect gift tax paid, does not apply to adjust the basis of a covered gift in respect of tax paid under section 2801.[48] We understand why the proposed regulations reach this conclusion, in spite of the intent reflected in the legislative history to section 2801 and the preamble to the proposed regulations for gifts made by covered expatriates and gifts made by U.S. citizens to produce similar tax burdens, or be "tax neutral." The proposed regulations reach this conclusion because section 1015(d) by its terms applies only to gift taxes paid under chapter 12 of the Code. And section 2801 is found in chapter 15 of the Code, not chapter 12.

The inapplicability of section 1015(d) should not, however, preclude an adjustment to the basis of a covered gift for taxes paid under section 2801. This is because the basis of the property acquired by way of a covered gift is appropriately increased under section 164.

Section 164 identifies the types of taxes that are deductible for income tax purposes when paid by a taxpayer. Section 164 also provides that a tax that is paid by a taxpayer in connection with an acquisition of property that is not identified as deductible in section 164 is treated as part of the cost of the acquired property.[49] Neither the section 2801 tax nor any similar tax is identified in section 164 as deductible for income tax purposes. Accordingly, any tax that is paid by a taxpayer under section 2801 in connection with the acquisition of a covered gift should increase the basis of the property acquired under section 164.[50] We suggest that the final regulations, or the preamble to the final regulations, clarify this point.

[48] The proposed regulations do not preclude a basis adjustment in the case of a covered bequest if the requirements of section 1014 are satisfied. *See* Prop. Treas. Reg. § 28.2801-6(a).

[49] *See* section 164(a) (last sentence of flush language).

[50] We note that section 164 generally does not increase the basis of property for gift taxes paid on a gift of property by a U.S. citizen. As described above in Part II.A, in the case of a gift made by a U.S. citizen, gift tax is imposed on the donor, rather than on the donee of property. Accordingly, section 164, which provides for an increase to the basis of property for certain taxes paid by a taxpayer in connection with the taxpayer's acquisition of property, does not increase the basis of a donee for taxes paid by a donor. Section 1015(d) is needed to ensure that the donee receives a basis adjustment for gift taxes paid by the donor. Section 1015(d) is not similarly needed in the case of a covered gift, since the obligation to pay the section 2801 tax falls on the donee.

VI. DEFINING "DISTRIBUTIONS" FROM FOREIGN TRUSTS

Under section 2801 and the proposed regulations, the section 2801 tax generally is imposed on a U.S. recipient who receives a distribution from a foreign trust to the extent the distribution is attributable to a covered gift or bequest that previously was made to the foreign trust.[51] This Part VI of the report, and Parts VII, IX and X below, address issues specifically related to distributions from foreign trusts.

The proposed regulations provide that "the term *distribution* means any direct, indirect or constructive transfer from a foreign trust…without regard to whether the U.S. recipient of the transfer is designated as a beneficiary by the terms of the trust."[52] The proposed regulations also specify that the term "distribution" includes property transferred from a foreign trust to a U.S. recipient by reason of the exercise or release of a power of appointment.[53] The proposed regulations do not, however, draw a distinction between property transferred to a U.S. recipient by reason of the exercise or release of a *limited* power of appointment or by reason of the exercise or release of a *general* power of appointment.[54]

We believe that property that is transferred to a U.S. recipient by reason of the exercise or release of a general power of appointment should not automatically be subject to tax under section 2801. As described above in Part III, property transferred by reason of the exercise of a general power of appointment should be viewed as transferred by the holder of the general power of appointment, consistent with the treatment other tax purposes.[55] Whether property transferred by virtue of the exercise or release of a general power of appointment will trigger a tax under section 2801 should then be determined based on whether the holder of the general power of appointment appropriately is treated as an "intermediary" for the covered expatriate who transferred property to the foreign trust. Our recommendations related to this issue are described above in Part III.

[51] Section 2801(e)(4)(B) and Prop. Treas. Reg. § 28.2801-5. An exception to the imposition of the section 2801 tax on a distribution from a foreign trust applies in the case of a foreign trust that previously made an election to be treated as a domestic trust for purposes of section 2801 (addressed below in Part X). We believe an exception also should apply in the case of certain spousal and charitable distributions (addressed below in Part VIII).

[52] Prop. Treas. Reg. § 28.2801-5(b).

[53] *Id.*

[54] For a discussion of the distinction between a limited power of appointment and a general power of appointment, see note 27 *supra.*

[55] *See* Treas. Reg. § 1.671-2(e)(5) (defining "grantor" for income tax purposes); section 2652(a) (defining "transferor" for generation-skipping transfer tax purposes).

In addition, Treasury may wish to modify the proposed regulations to provide guidance addressing when a loan from a foreign trust to a U.S. person will be treated as a distribution from the trust. For example, if the loan satisfies requirements similar to the requirements for a "qualified obligation" under section 643(i) and Notice 97-34, we think it would be appropriate for the loan not be a deemed distribution for purposes of section 2801.[56]

VII. DETERMINING THE AMOUNT ATTRIBUTABLE TO A COVERED GIFT OR BEQUEST OR A DISTRIBUTION FROM A FOREIGN TRUST

Under the proposed regulations, a distribution from a non-electing foreign trust to a U.S. recipient is subject to the section 2801 tax if the distribution is attributable, in whole or in part, to one or more covered gifts or bequests received by the foreign trust.[57] The proposed regulations provide that the amount of the distribution attributable to the covered gift or bequest is determined on a proportional basis by multiplying the distribution by the percentage of the trust that consists of its "covered portion" immediately before the distribution (the "**Section 2801 Ratio**").[58] The covered portion, in turn, is the value of the trust attributable to the covered gift or bequest, including the ratable portion of appreciation and income that has accrued on the trust's assets from the date of the covered gift or bequest.[59]

Consequently, a portion of every distribution from a foreign trust that has received a covered gift or bequest is deemed to be attributable to the covered gift or bequest. Moreover, the Section 2801 Ratio must be re-determined by the trustee every time a contribution is made to the trust, necessitating a revaluation of all trust assets each time a contribution is made. In order to reduce complexity and administrative costs, in circumstances where a covered expatriate's contributions to a foreign trust can be traced to specific assets, we suggest that the regulations permit the trustees to separately account for the portion of the trust comprising these assets.

[56] An obligation generally is a "qualified obligation" if (1) the obligation is reduced to writing by an express written agreement, (2) the term of the obligation does not exceed five years; (3) all payments on the obligation are denominated in U.S. dollars; (4) the yield to maturity of the obligation is not less than 100% of the applicable Federal rate in effect under section 1274(d) on the day the obligation is issued and is not greater than 130% of the applicable Federal rate; (5) the U.S. borrower extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation; and (6) the U.S. borrower reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding. Notice 97-34, Section III.C.2, 1997-1 C.B. 422.

[57] Prop. Treas. Reg. § 28.2801-2(e)(3).

[58] Prop. Treas. Reg. § 28.2801-5(c)

[59] Prop. Treas. Reg. § 28.2801-5(c)(1).

Treasury has permitted separate accounting in other cases. The Small Business Job Protection Act of 1996[60] made amendments to section 672(f) to provide that, subject to limited exceptions, the grantor trust rules apply only to the extent they result in income being taken into account by a U.S. citizen or resident or by a domestic corporation. Certain trusts in existence on September 19, 1995, however, were "grandfathered" against the application of these new rules with respect to amounts contributed prior to or on that date.[61] As a condition of the grandfather treatment, separate accounting was required to be maintained for contributions to a trust prior to and after September 19, 1995. These separate accounting rules, which are found in Treas. Reg. § 1.672(f)-3(d), do not require any physical separation of assets transferred to the trust prior to and after September 19, 1995.[62]

VIII. MARITAL AND CHARITABLE TRANSFERS

Treasury specifically requested comments on the following issue: "How contributions to or distributions from a non-electing foreign trust to a U.S. citizen spouse could qualify for the marital exception in section 2801(e)(3), taking into account the rules applicable to domestic trusts and foreign trusts in section 2801(e)(4)."[63]

A. Approach of the Proposed Regulations to Marital Transfers

The proposed regulations address this issue. Specifically, Treasury interprets the marital deduction exception under section 2801(e)(3) *not* to apply to distributions from a non-electing foreign trust to a U.S. citizen spouse. Instead, the proposed regulations appear to treat contributions to non-electing foreign trusts in the same manner as contributions to domestic trusts: the determination of whether the marital exception applies is made at the time of the covered expatriate's contribution to the trust.[64] The preamble to the proposed regulations specifically states that "[t]o the extent a covered gift or covered bequest is made to a foreign trust (or to the separate share of the trust), a distribution from the trust (or from the separate share of the trust) to the U.S. citizen spouse of the covered expatriate who funded the trust (whether in whole or in part) will not qualify for the [marital] exception." [65] On the other hand, the proposed regulations

[60] Pub. L. No. 104-188 § 1904, 110 Stat. 1755, 1910 (1996).

[61] Pub. L. No. 104-188 § 1904(d)(2), 110 Stat. 1755, 1912 (1996). The grandfathering applied to trusts that were grantor trusts under section 676 or 677(a)(1) or (a)(2).

[62] Treas. Reg. § 1.672(f)-3(d).

[63] Notice, at 54454.

[64] Prop. Treas. Reg. §§ 28.2801-5(a) and -3(c)(4).

[65] Notice, at 54449–50.

acknowledge that a gift or bequest from a covered expatriate to his or her U.S. citizen spouse directly is exempt from the section 2801 tax as a result of the marital exception.[66]

We believe that the statutory language supports a different interpretation.

B. Statutory Analysis and Suggested Approach to Marital Transfers

As described above, under section 2801, a covered gift or bequest is generally a gift or bequest made by a covered expatriate to a U.S. citizen or resident.[67] In the case of a non-electing foreign trust, the section 2801 tax is imposed on a distribution from the foreign trust to a U.S. citizen or resident "in the same manner as if such distribution were a covered gift or bequest" and not upon contribution by a covered expatriate to the non-electing foreign trust.[68] The statute provides an exception to covered gift or bequest treatment for transfers that would qualify for the marital deduction if the donor or decedent were a U.S. person.[69] We believe that the determination of whether the marital exception applies, given the statutory construct, should be made at the time of the distribution from a non-electing foreign trust.

Because the section 2801 tax is imposed at the time of a distribution from a non-electing foreign trust to a U.S. trust beneficiary, the applicability of the marital exception should be determined at the time of the taxable event (that is, when the tax is imposed upon distribution). This approach also is consistent with the application of the marital deduction in the context of the estate and gift tax regime. The determination of whether the marital deduction applies under the estate and gift tax rules is made at the time the potential transfer tax is imposed on the donor or estate. [70] The proposed regulations provide a similar rule with respect to domestic trusts. In that case, the marital exception is considered upon a contribution to the trust, which is the taxable event. [71] In the case of a non-electing foreign trust, however, the taxable event occurs at the time of a distribution from the trust to the U.S. person and not on the contribution of property to the

[66] Prop. Treas. Reg. § 28.2801-3(c)(4).

[67] Section 2801(e)(1).

[68] Section 2801(e)(4)(B).

[69] Section 2801(e)(3).

[70] Whether the estate tax marital deduction applies is determined at the time the estate tax is imposed. *See* sections 2001(a) and 2056. Likewise, whether the gift tax marital deduction applies is determined at the time the gift tax is imposed. *See* sections 2501(a)(1) and 2523. In determining whether the marital deduction applies, the transferor must look at the facts at the time of the transfer to determine if the gift or bequest is of a terminable interest (subject to a prohibited contingency). *See* sections 2523(b) and 2056(b); Estate Planning Explanations (RIA) 20,564.06 ("The date of death is the point of time from which to judge the nature of the surviving spouse's interest for purposes of terminability").

[71] Prop. Treas. Reg. §§ 28.2801-3(d), -4(a)(2).

trust.[72] Therefore, it is appropriate to test whether the marital exception applies upon the occurrence of the distribution (and not upon a contribution to the non-electing foreign trust).

1. Distributions to or for U.S. Citizen Spouses

In view of these principles, if the covered expatriate's spouse is a U.S. citizen, an outright distribution from a non-electing foreign trust to the spouse should qualify for the marital exception and no tax should be imposed under section 2801. Similarly, distributions from a non-electing foreign trust to a domestic trust meeting the marital deduction trust requirements should qualify for the marital exception.[73] This should be the case regardless of whether the non-electing foreign trust itself was in a form qualifying for the marital deduction.[74]

2. Distributions to or for U.S. Resident (Noncitizen) Spouses

In the case of transfers to U.S. resident (noncitizen) spouses, Treasury interprets section 2801 as providing that "gifts and bequests made by a covered expatriate to his or her noncitizen spouse are subject to an annual limit under section 2523(i)."[75] In addition, "a bequest from a covered expatriate to his or her noncitizen surviving spouse who is a U.S. resident is not a covered bequest to the extent the bequest is to a qualified domestic trust (a "**QDOT**") that satisfies the requirements of section 2056A and the corresponding regulations, and for which a valid QDOT election is made."[76] The proposed regulations do not specifically discuss the applicability of the marital exception to distributions from a non-electing foreign trust to or for a U.S. resident (noncitizen) spouse.

With respect to distributions from a non-electing foreign trust to or for a U.S. resident (noncitizen) spouse, the determination of whether the expanded annual exclusion applies or whether a transfer was made to a QDOT should occur at the time the section 2801 tax otherwise would be triggered: namely, at the time of the distribution from the non-electing foreign trust.

[72] For instance, as described above in Part VII, upon a distribution from a foreign trust, the distributee must determine what portion of the trust was transferred by a covered expatriate based on the trust's Section 2801 Ratio. Prop. Treas. Reg. § 28.2801-5(c)(i).

[73] Sections 2056(b)(5), 2056(b)(7), 2056(b)(8), 2523(e), and 2523(f).

[74] Under section 2801(e)(4)(B), the non-electing foreign trust would be deemed the donor or decedent of a covered gift or bequest since distributions should be considered in the same manner as if they were covered gifts or bequests.

[75] Notice, at 54450. Section 2523(i) provides that the unlimited marital deduction is not available for outright, lifetime gifts to a non-U.S. citizen spouse. However, an expanded annual exclusion amount is available for gifts to a non-U.S. citizen spouse. It is not clear why bequests should be subject to the gift tax limitation under section 2523(i).

[76] *Id.*; Prop. Treas. Reg. § 28.2801-3(c)(4).

Accordingly, if the covered expatriate who made a covered gift or bequest to a non-electing foreign trust is not living at the time of the distribution to or for a U.S. resident (noncitizen) spouse, the distribution will qualify for the marital exception only if it is made to a QDOT. If the covered expatriate is living at the time of the distribution, the expanded annual exclusion amount should apply under section 2523(i), sheltering that amount of a distribution to a U.S. resident (noncitizen) spouse from the section 2801 tax.

3. Similar Tax Treatment for Economically Similar Transfers

Our interpretation of the marital exception under section 2801 also will result in economically similar transfers being afforded similar tax treatment. Under the proposed regulations, a tax would be imposed on a U.S. citizen spouse upon the receipt of a distribution from a foreign trust that has not elected to be treated as a domestic trust, but not upon a direct payment to a U.S. citizen spouse from a covered expatriate. Similarly, a tax would be imposed on a distribution from a foreign trust to a domestic trust for a U.S. citizen spouse that qualifies for the marital deduction, yet a direct gift or bequest by a covered expatriate to such a trust would not be subject to tax.

In addition, a distribution from a non-electing foreign trust to a U.S. resident (noncitizen) spouse would not benefit from the expanded annual exclusion or the availability of a QDOT, while a direct gift or bequest from a covered expatriate to a U.S. resident (noncitizen) spouse would benefit from these special rules for marital transfers. The tax result should not differ based on whether there is an intervening non-electing foreign trust.[77] Our interpretation of section 2801 treats gifts or bequests made by covered expatriates to U.S. spouses in the same manner, whether the gifts are made directly or indirectly through non-electing foreign trusts.

We recognize that our interpretation of section 2801 may provide more flexibility for a covered expatriate to transfer property to a trust for a non-citizen spouse than for a U.S. citizen or resident to transfer property to a trust for a non-citizen spouse. Specifically, based on our interpretation, no section 2801 tax would be due in the case of a covered expatriate who makes a gift to a trust for a non-citizen spouse or who makes a bequest to a trust that does not qualify as a QDOT. A similar gift by a U.S. citizen or resident donor generally would be a taxable gift, and a similar bequest by a U.S. citizen or resident decedent generally would be subject to estate tax.

[77] Section 2611(b), in the context of the generation-skipping transfer tax, offers a helpful analogy. A distribution made from a trust to pay the tuition of a grandchild of the transferor qualifies for the tuition exception as if the payment were made by an individual rather than a trust.

C. Marital Deduction Trust Elections

In the preamble and proposed regulations, Treasury refers to the requirement that a covered expatriate make an effective QTIP or QDOT election so that the marital deduction may apply to a transfer in trust for a U.S. citizen or resident spouse. However, it is unclear, absent a transfer of U.S. situs property to the trust, how a covered expatriate or his or her estate is to make a QTIP or QDOT election for a direct transfer to a qualifying marital trust, since neither Form 706 nor Form 706-NA is required to be filed by the covered expatriate, his or her executor or another person.

Assuming that the regulations adopt the approach suggested above in Part VIII.B, guidance also should be provided concerning a QTIP or QDOT election with respect to a distribution from a non-electing foreign trust to an otherwise qualifying marital trust for a U.S. spouse. Since the section 2801 tax is imposed on the U.S. recipient and not on the covered expatriate or his or her estate, the U.S. recipient should make the QTIP or QDOT election at the time the tax is imposed (that is, at the time of a distribution from a non-electing foreign trust to a qualifying marital trust). Therefore, for purposes of the marital exception under section 2801, we recommend that the U.S. recipient should make the QTIP or QDOT election on Form 708. In addition, the regulations should confirm that the QDOT taxable distribution rules would apply to the section 2801 tax in the same manner as the estate tax under section 2001.

D. Charitable Transfers

Section 2801 also provides an exception to covered gift or bequest treatment for transfers that would qualify for the gift or estate tax charitable deduction if the donor or decedent were a U.S. person.[78] The proposed regulations do not specifically discuss the applicability of the charitable exception to distributions from a non-electing foreign trust to or for a U.S. charitable organization.[79]

The marital exception analysis described above should apply equally in the case of a distribution from a non-electing foreign trust to a U.S. charitable organization. The determination of whether the charitable exception under section 2801 applies should be made at the time of the

[78] Section 2801(e)(3).

[79] The proposed regulations do specifically address how a contribution by a covered expatriate to a charitable remainder trust is taxed under section 2801. *See* Prop. Treas. Reg. § 28.2801-4(a)(2)(iii). The proposed regulations and preamble assume that a charitable remainder trust cannot be a foreign trust. The preamble provides, "A CRT must be a domestic trust." Notice, at 54450. However, a U.S. decedent could create a foreign charitable remainder trust. Presumably, distributions from a foreign charitable remainder trust that does not elect to be treated as a domestic trust for purposes of section 2801 would be subject to the section 2081 rules for non-electing foreign trusts.

distribution from a non-electing foreign trust to a U.S. charitable organization (when the tax is imposed) and not at the time of a contribution to the trust by a covered expatriate. To provide otherwise would mean that a U.S. charitable distributee of a non-electing foreign trust funded by a covered expatriate may be required to report and pay the section 2801 tax.[80]

In addition, based on the definitions of "citizen or resident of the United States" and "U.S. recipient" in the proposed regulations, Treasury did not seem to contemplate that the section 2801 tax would be imposed on a nonprofit corporation. The statute provides that the section 2801 tax is imposed on a "citizen or resident of the United States."[81] The proposed regulations further provide that the section 2801 tax is imposed on a "U.S. recipient" of a distribution from a non-electing foreign trust.[82] The proposed regulations define a "citizen or resident of the United States" to include an individual who is a citizen or resident of the United States, a domestic trust and an electing foreign trust. The proposed regulations further provide that "U.S. recipient" includes a "citizen or resident of the United States" and "the U.S. citizen or resident shareholders, partners, members, or other interest-holders, as the case may be (if any), of a domestic entity that receives a covered gift or covered bequest."[83] However, neither the definition of "citizen or resident of the United States" nor "U.S. recipient" includes nonprofit corporations since nonprofit corporations typically do not have interest holders like for-profit domestic entities. Therefore, it would appear that the section 2801 tax should not be imposed on nonprofit corporations since they are not within the scope of the definitions of "citizen or resident of the United States" and "U.S. recipient." There is no reason why a charitable entity organized as a domestic charitable trust, which appears to be included in these definitions, should be treated differently from a nonprofit corporation for purposes of section 2801.

Accordingly, based either on the charitable exception to section 2801 (determined at the time of distribution from a non-electing foreign trust) or on the limitations in the definitions of the proposed regulations, no tax should be imposed under section 2801 on a distribution from a non-electing foreign trust to a U.S. charitable organization if the covered expatriate is then living and the transfer, if made by a U.S. citizen or resident, would have qualified for the charitable gift tax deduction. Similarly, if the covered expatriate is deceased at the time of the trust distribution, no section 2801 tax should be imposed if the transfer would have qualified for a charitable estate

[80] However, based on the proposed regulations a charitable distributee may not have to pay the § 2801 tax if the initial contribution to the foreign trust qualified under section 2055 or section 2522. Prop. Treas. Reg. § 28.2801-3(c)(3)

[81] Section 2801(a), (b).

[82] Prop. Treas. Reg. §§ 28.2801-4(a)(3)(i), 28.2801-5(a),(b)

[83] Prop. Treas. Reg. § 28.2801-2(e).

tax deduction if made by a U.S. citizen or resident decedent. This treatment should apply regardless of whether the charity is organized as a nonprofit corporation or a charitable trust.[84]

IX. DEDUCTION FOR SECTION 2801 TAX PAID ON A DISTRIBUTION FROM A FOREIGN TRUST

Under the proposed regulations, a U.S. recipient of a distribution from a foreign trust is allowed a deduction under section 164 in the year in which the section 2801 tax is paid or accrued. The amount of the deduction is equal to the portion of the section 2801 tax attributable to the distribution, to the extent that the portion of the distribution is included in the U.S. recipient's gross income.[85]

This means that the section 2801 tax can be deducted against current year income of a trust that is distributed from the trust to a U.S. beneficiary (referred to in the Code as "**distributable net income**").[86] However, it seems that the section 2801 tax cannot be deducted against accumulated income of a trust that is distributed to a U.S. beneficiary (referred to in the Code as an "**accumulation distribution**").[87] This is because, as described in the preceding paragraph, the section 2801 tax is deductible only to the extent a distribution is included in the recipient's gross income. An accumulation distribution, while taxable to a U.S. beneficiary under the throwback rules (described below), is not included in a beneficiary's gross income, at least under the fiduciary income tax rules of subchapter J of chapter 1 of subtitle A of the Code.[88]

A U.S. beneficiary who receives an accumulation distribution is subject to a "throwback tax" on the distribution as well as an interest charge.[89] The throwback tax rules are designed so that the throwback tax and interest charge can equal, but not exceed, the amount of the accumu-

[84] Treasury also should address the following inconsistency: Section 2801(e)(3) provides that the charitable exception should apply as if "the decedent or donor were a United States person." The proposed regulations provide that "a gift to a donee described in *section 2522(b)* or a bequest to a beneficiary described in section 2055(a) is not a covered gift or bequest to the extent a charitable deduction under section 2522 or section 2055 would have been allowed if the covered expatriate had been a U.S. citizen or resident at the time of the transfer." Prop. Treas. Reg. § 28.2801-3(c)(3) (emphasis added). The proposed regulations refer to section 2522(b), which lists the eligible gift tax exempt donees applicable to gifts made by *non-U.S.* residents. Section 2522(a), on the other hand, lists the eligible gift tax exempt donees applicable to gifts made by U.S. citizens or residents. Since section 2801(e)(3), itself, states that the charitable exception should apply as if the donor were a U.S. person, the proposed regulations should reference section 2522(a) instead of 2522(b).

[85] Prop. Treas. Reg. § 28.2801-4(a)(3)(ii).

[86] Section 643(a).

[87] Section 665(b).

[88] Sections 665–668.

[89] *Id.*

lation distribution.[90] However, in a case where a U.S. recipient of an accumulation distribution is subject to a throwback tax and an interest charge on the distribution, and, in addition, is subject to a non-deductible tax under section 2801, the taxes and interest charge may exceed the amount of the distribution. We believe that this result is inequitable.

The language in the proposed regulations addressing the availability of a deduction under section 164 is similar to language in the Code. Specifically, section 2801(e)(4)(B)(ii) includes the same gross income requirement that is included in the proposed regulations:

> (ii) DEDUCTION FOR TAX PAID BY RECIPIENT.— There shall be allowed as a deduction under section 164 the amount of tax imposed by this section which is paid or accrued by a United States citizen or resident by reason of a distribution from a foreign trust, *but only to the extent such tax is imposed on the portion of such distribution which is included in the gross income of such citizen or resident.* [emphasis added]

In spite of the language of the Code, we suggest that Treasury modify the regulations to allow the section 2801 tax to be deducible against an accumulation distribution. We believe that Treasury can accomplish this result by changing the proposed regulations to provide that for purposes of section 2801(e)(4)(B)(ii), the term "gross income" includes an accumulation distribution from a foreign trust. As a general matter, "gross income" is defined in section 61. The language of section 61 suggests, however, that the definition in section 61 applies only for purposes of Subtitle A of the Code. Section 2801 is in Subtitle B of the Code, not Subtitle A. The text of section 61 also suggests the definition of "gross income" in this section can be modified in certain circumstances.

X. TREATMENT OF ELECTING FOREIGN TRUSTS

As described above in Part VIII, a covered gift or bequest to a domestic trust generally will trigger the imposition of a section 2801 tax, payable by the trust.[91] A covered gift or bequest to a foreign trust with U.S. beneficiaries, however, generally will not trigger the section 2801 tax.[92] Instead, the tax applies to distributions from the foreign trust to beneficiaries who are U.S. citizens or residents, in the same manner as if the distribution itself was a covered gift or bequest.[93] As described above in Part VII, under the proposed regulations, the 2801 tax is

[90] Section 668(b).

[91] Section 2801(e)(4)(A).

[92] Section 2801(e)(4)(B)(ii).

[93] *Id.*

determined by multiplying the fair market value of the distribution to the U.S. recipient by the trust's Section 2801 Ratio.

Under section 2801, a foreign trust may elect to be treated as a domestic trust solely for purposes of section 2801 (an "**electing foreign trust**"). An electing foreign trust is required to pay the section 2801 tax upon receipt of a covered gift or bequest. [94]

A. Approach of the Proposed Regulations to Electing Foreign Trusts

1. Consequences of Election

The proposed regulations provide the following consequences for an electing foreign trust once the IRS has accepted its election to be treated as a domestic trust:

(i) All covered gifts or bequests made to the trust during the year of the election are subject to the section 2801 tax.

(ii) The portion of the trust attributable to covered gifts and bequests in prior years is subject to the section 2801 tax in the year of election.

(iii) All future covered gifts or bequests to the trust are subject to the section 2801 tax in the year that the covered gift or bequest is made, until the point in time that the election is terminated.

(iv) After making the election the Section 2801 Ratio of the foreign trust will be zero, and all subsequent distributions from the trust to U.S. recipients will not be subject to the section 2801 tax.[95]

2. Procedure for Making Election

Based on the proposed regulations, an electing foreign trust must:

(i) timely file Form 708 for the year that it seeks to make the election;

(ii) make the election on Form 708 and pay all the taxes described above in (i) and (ii);

(iii) provide a computation as to how the trustee calculated the tax under (i) and (ii) and as to how the trustee determined the section 2801 ratio for the trust;

(iv) designate a U.S. agent to act on behalf of the trust solely for purposes of section 2801;

[94] Section 2801(e)(4)(B)(iii).

[95] Prop. Treas. Reg. § 28.2801-5(d)(1).

(v) agree to file Form 708 annually;

(vi) list the amount and year of all prior distributions from the trust that were attributable to covered gifts and bequests that were made to U.S. recipients and provide identifying information for those recipients; and

(vii) notify the trust beneficiaries of the election and provide to the IRS identifying information about the beneficiaries.[96]

3. Dispute Regarding Tax Owed by Electing Foreign Trust

If the IRS disputes the value of a covered gift or bequest transferred to an electing foreign trust or if the IRS otherwise disagrees with the amount of tax reported on the electing foreign trust's Form 708, the proposed regulations establish the following procedure:

Initially, the IRS will issue a letter (the **"2801 Letter"**) to the trustee and U.S. agent for the trust setting forth the IRS's calculation of the proper amount of section 2801 tax owed by the trust. The proposed regulations specifically state that this letter is "not a notice of deficiency."[97] Upon receiving the 2801 Letter, the foreign trust must pay the additional tax (including interest and penalties if applicable) in the manner set forth in the letter and enter into a closing agreement with the IRS.[98] If the trust fails to make the payment in the amount and time as set forth in the letter, the foreign trust's election to be treated as a domestic trust is treated as an "imperfect election" and is terminated as of the first day of the calendar year for which the Form 708 was filed with respect to the disputed tax liability.[99]

Once the election to be treated as a domestic trust terminates, distributions from the foreign trust to U.S. recipients cause the recipients to be subject to tax on the trust's allocable portion of covered gifts and bequests, determined based on the trust's Section 2801 Ratio. The proposed regulations account for the section 2801 tax that was paid by the foreign trust when it filed its election by providing that the value of the property reflected on the Form 708 on which the trust paid the section 2801 tax is not considered to be attributable to a covered gift or bequest for purposes of computing the Section 2801 Ratio.[100] The additional value asserted by the IRS, however, is considered to be attributable to a covered gift or bequest for purposes of computing the Section 2801 Ratio.

[96] Prop. Treas. Reg. § 28.2801-5(d)(1).

[97] Prop. Treas. Reg. § 28.2801-5(d)(6)(i).

[98] *Id.*

[99] Prop. Treas. Reg. § 28.2801-5(d)(6)(iii).

[100] *Id.*

The proposed regulations further provide that any dispute regarding the additional value asserted by the IRS will be resolved through review of the Form 708 that ultimately is filed by a U.S. recipient of a distribution from the trust.[101]

B. Recommendations Regarding Electing Foreign Trusts

Based on the proposed regulations, the trustee of an electing foreign trust who disagrees with the 2801 Letter is left with the choice of forfeiting the trust's election or agreeing to pay a tax that the trustee does not believe the trust owes, without the opportunity for judicial review. We recommend that Treasury adopt a rule that allows the foreign trust to retain its election to be treated as a domestic trust and litigate any issue set forth in the 2801 Letter. We also recommend that the regulations clarify that the electing foreign trust may avail itself of administrative remedies within the IRS in attempting to resolve the issues set forth in the 2801 Letter. Finally, to the extent that Treasury retains the rule that revokes the foreign trust's election to be treated as a domestic trust, we recommend that the regulations allow the foreign trust to request a refund of the entire section 2801 tax that was paid along with its disputed Form 708 and revoke the election in its entirety or allow the trust to be severed into trust trusts, one of which has a Section 2801 Ratio of zero and the other of which has a Section 2801 Ratio of one. These recommendations are discussed below in paragraphs 1, 2 and 3.

1. Permit Judicial Review of Issues Raised in the 2801 Letter

As described above, the proposed regulations provide that if the IRS disputes the value of a covered gift or bequest or the amount of section 2801 tax that is owed, the IRS "will issue a letter (*but not a notice of deficiency as defined in Section 6212)* to the trustee of the electing foreign trust and the appointed U.S. agent that details the disputed information and the proper amount of section 2801 tax as recalculated."[102]

There are several consequences to the 2801 Letter not being classified as a notice of deficiency. First, the IRS cannot collect the taxes owed by way of administrative action or through a court proceeding. Section 6213(a) provides that "no assessment of a deficiency in respect of any tax imposed by Subtitle A or B, chapter 41, 42, 43 or 44 and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice [of deficiency] has been

[101] *Id. See also* Prop. Treas. Reg. § 28.2801-5(e), Ex. 4.

[102] Prop. Treas. Reg. § 28.2801-5(d)(6)(i) (emphasis added). We note that there are specific circumstances in which the Code does not require a notice of deficiency to be issued, such as in the case of mathematical or clerical errors under section 6213.

mailed to the taxpayer." Second, the lack of a notice of deficiency precludes the taxpayer from bringing a cause of action in Tax Court.[103]

As a general matter, taxpayers who are not able to seek Tax Court review may still obtain judicial review by paying the asserted tax liability, filing a claim for refund, and, if the IRS denies the claim or does not otherwise act in a timely manner, filing a suit for refund in United States District Court.[104] However, the proposed regulations foreclose any form of judicial review, including a refund suit, by requiring the foreign trust to enter into a closing agreement with the IRS. Specifically, the proposed regulations state that "[i]f the trustee of the foreign trust timely pays the additional amounts specified in the Commissioner's letter…and enters into a closing agreement with the IRS as described in section 7121, then the foreign trust's election to be treated as a domestic trust…remains in effect."[105] Once the foreign trust enters into a closing agreement, it will be precluded from bringing any suit for a refund.[106] Accordingly, the proposed regulations appear to deprive the foreign trust of any form of judicial review as to disputed aspects of the 2801 Letter.

We recommend that the final regulations allow for judicial review of a disputed 2801 Letter without termination of the trust's 2801 election. Terminating the foreign trust's election as contemplated by the proposed regulations will create uncertainty as to the section 2801 tax that will be owed by U.S. beneficiaries of the trust, potentially for a considerable time. More specifically, as described above in Part X.A.3, the proposed regulations provide that any dispute about the value of property transferred to an electing foreign trust will be resolved through IRS review of the Form 708 that ultimately is filed by a U.S. beneficiary when a distribution is made from the trust. This Form 708 may not be filed until years after the covered expatriate made her transfer to the foreign trust, and, as a policy matter, the early resolution of valuation issues that affect tax liability is preferable.[107] Moreover, a beneficiary who files the Form 708 may lack infor-

[103] Section 6213.

[104] *See generally* section 7422.

[105] Prop. Treas. Reg. § 28.2801-5(d)(6)(ii).

[106] Section 7121(b)(2) provides that "[i]f such agreement is approved by the Secretary…such agreement shall be final and conclusive, and,…in any suit, action, or proceeding such agreement…shall not be annulled, modified, set aside or disregarded."

[107] This policy preference can be seen in the history to section 6501(c)(9). Prior to 1997, the Tax Court held that a taxpayer's gifts could be revalued on her death, notwithstanding that the statute of limitations had run on the taxpayer's gift tax returns, in order to determine her "adjusted taxable gifts" for estate tax purposes. *See* Est. of Smith v. Comm'r, 94 T.C. 872 (1990). In *Smith*, the Tax Court also allowed a corresponding adjustment to the taxpayer's "gift taxes payable" under section 2001(b)(2) in order to prevent the IRS from collecting barred gift taxes through the imposition of a higher estate tax without an offsetting adjustment. *See also* Est. of Prince v. Comm'r, T.C. Memo., 1991-208 (1991) and Est. of Lenheim v. Comm'r, T.C. Memo., 1990-403 (1990). In the Taxpayer Relief Act of 1997, Congress modified

mation about the assets transferred to the trust that was accessible to the trustee at the time of the transfer. Finally, as described above in the introduction to this report, based on the legislative history to section 2801 and the preamble to the proposed regulations, a goal of section 2801 is to subject gifts or bequests made by a covered expatriate to tax treatment comparable to gifts or bequests made by a U.S. citizen or resident. Constraining rights of judicial appeal when a covered expatriate makes a taxable transfer to a trust seems inconsistent with this goal.

We also encourage Treasury to consider whether a unilateral termination of a foreign trust's election to be treated as a domestic trust would be valid under *Mayo*[108] and *Chevron,*[109] controlling Supreme Court precedent. The two-step analysis utilized by the *Mayo* and *Chevron* courts is applicable in determining the validity of a tax regulation. The first step of the analysis is to determine whether the Code section at issue is ambiguous. If it is ambiguous, the second step is to determine whether the regulation reasonably resolves the ambiguity or is instead arbitrary and capricious. In *RLC Industries*,[110] the Ninth Circuit held that a regulation that takes away a taxpayer's right to judicial review is "exceptional" and when Congress intends to bestow such authority upon the IRS "it expresses that intent with great clarity."[111]

Section 2801(e)(4)(B)(iii) appears unambiguous in two respects. *First*, it provides that a foreign trust has an ability to elect to be treated as a domestic trust. There is no indication in the statute or the legislative history that Congress intended to endow the IRS with the authority to undermine this election. In addition to administrative convenience, the election allows the value of the assets transferred to a foreign trust to be frozen at their value as of the date of receipt by the trust and thereby may reduce the section 2801 tax that ultimately is imposed.[112] If Congress

the Code to eliminate the possibility of such a revaluation of gifts once the statute of limitations on the gift tax return had run (assuming adequate disclosure on the gift tax return). *See* Section 6501(c)(9). The proposed regulations, contrary to the policy preference for early resolution of valuation issues, defer the resolution of these issues for an indefinite period of time and ultimately require the issues to be disputed by a taxpayer who was not a party to the original transfer. It therefore would seem preferable to adopt a rule that allows for immediate judicial review of a valuation dispute.

[108] Mayo Found. for Med. Educ. & Res. v. United States, 562 U.S. 44 (2011).

[109] Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc., 467 U.S. 837 (1984).

[110] RLC Industries Co. v. Comm'r, 58 F.3d 413, 419 (9th Cir. 1995).

[111] *Id.*

[112] For example, if a covered expatriate makes a covered gift to a non-electing foreign trust of an asset valued at $100, no tax is owed at the time of the gift. If, at some point in the future, the asset has a value of $1,000 and at this time is distributed to a U.S. beneficiary, the section 2801 tax will be imposed on the $1,000 of value received by the beneficiary. If the foreign trust instead had in place an election to be treated as a domestic trust, the foreign trust would have been subject to section 2801 tax on $100 and no further section 2801 tax would be imposed on the later distribution to the beneficiary.

intended to give the IRS the ability to unilaterally terminate an election that could significantly reduce tax liability, it may not have remained silent on that point.

Second, properly treating an electing foreign trust as a domestic trust (as required by the unambiguous language of the statute) appears to mandate that the foreign trust have rights to judicial review in the same manner as a domestic trust. Although the statute is silent as to how a valuation dispute should be adjudicated between the IRS and an electing foreign trust, there is no reason to assume that it should be resolved any differently than a valuation dispute with a domestic trust. Indeed, treating them congruously would fulfill the statute's mandate of treating the electing foreign trust as a domestic trust. Moreover, we are not aware of any substantive provision of the Code that includes specific rules addressing how a controversy relating to the provision is to be adjudicated.

Even if section 2801 is ambiguous as to how disputes between the IRS and the electing foreign trust should be resolved, we encourage Treasury to consider whether the proposed regulations reasonably resolve the ambiguity, as required under the second prong of the analysis in *Mayo* and *Chevron*. The proposed regulations effectively force a trust to forfeit its election to be treated as a domestic trust if the trustee disagrees with the IRS about the value of the property contributed to the trust or the amount of the section 2801 tax that is due. As a general matter, when a dispute about the amount of tax due arises between the IRS and a taxpayer, the IRS is required to issue a notice of deficiency and to thereby confer on the taxpayer the right of judicial review. The principle of judicial review is fundamental to the Code and general principles of due process,[113] and we encourage the IRS to consider whether it should disregard this principle by regulation in the absence of a clear expression of Congressional intent.[114]

[113] Where tax deficiencies are challenged, the Supreme Court has explained that "[t]he procedure provided in [the Internal Revenue Code] *satisfies the requirements of due process* <u>because</u> two alternative methods of eventual judicial review are available to the [taxpayer]." *Phillips v. Comm'r,* 283 U.S. 589, 612 (1931) (emphasis added). The taxpayer may either (1) "voluntarily pay[] the tax" and "contest his liability by bringing an action…against the United States…to recover the amount paid"; or (2) "avail himself of the provisions for immediate redetermination of the liability by the [Tax Court]…." *Id.* at 597–98

[114] *Cf.* RLC Industries Co. v. Comm'r, 58 F.3d 413, 419 (9th Cir. 1995) ("when Congress intends to leave individual taxpayers to the mercy of the Commissioner on disputes over deductions or penalties, rather than leaving those disputes to be resolved by the courts, it expresses that intent with great clarity"). In *RLC*, the IRS had included an abusive discretion standard in a regulation under section 611. Finding this to limit the process of judicial review, with no clear statement that Congress intended to alter the nature of judicial review, the court invalidated the regulation.

2. Permit Administrative Review Within the IRS

The proposed regulations as drafted make no mention of whether the 2801 Letter is appealable within the IRS, although the proposed regulations indicate that there may be some form of administrative review. Specifically, the regulations state that "[i]f the trustee of the foreign trust timely pays the additional amount(s) specified in the Commissioner's letter, *or such other amount as agreed to by the Commissioner*…."[115] The emphasized language appears to anticipate some form of dialogue between the trustee of the foreign trust and the IRS, but the proposed regulations do not address or anticipate a formal appeals process. Whether or not the final regulations adopt our recommendation to allow for judicial review of issues raised by the 2801 Letter (described above in part 1), we recommend that the regulations clarify that an administrative appeal is available and that the 2801 Letter is equivalent to a 30-day letter described in Treas. Reg. § 601.105(d).

3. Permit Refund of 2801 Tax Paid with an Imperfect Election or Permit Severance of a Trust Having a Section 2801 Ratio Between 0 and 1 as a Result of an Imperfect Election

As described above in Part X.A.3, if the IRS issues a 2801 Letter and the trustee fails to make the additional payment set forth in the letter, the trust's election to be treated as a domestic trust is terminated. In this case, the proposed regulations provide that the IRS will keep the tax that was paid along with the Form 708, but the value of the property reflected on the Form 708 will not be treated as a covered gift or bequest.

If the IRS does not adopt our recommendation to allow the foreign trust to retain its election and litigate directly with the IRS, we recommend that, in the alternative, the regulations give the trustee the ability to obtain a refund of the section 2801 tax that was paid with the disputed Form 708 and treat the full value of the assets contributed to the trust as a covered gift or bequest. If a trustee is not going to be afforded the opportunity for review of the 2801 Letter, the trustee at least should have the option to withdraw the election and obtain a refund of the tax that the trustee chose to accelerate by filing the election.

As another alternative, Treasury could allow a trust having a Section 2801 Ratio between 0 and 1 as a result of an imperfect election to be severed on a fractional basis into two separate trusts. The severance rules could be similar to those that have been adopted for generation-skipping transfer tax purposes.[116] In particular, one of the trusts could be funded with a fractional share of the total value of all assets equal to the single trust's Section 2801 Ratio immediately

[115] Prop. Treas. Reg. § 28.2801-5(d)(6)(i) (emphasis added). *See also* Notice, at 54452.

[116] Section 2642(a)(3); Treas. Reg. § 26.2642-6(d).

before the severance. Following the severance, this trust would have a Section 2801 Ratio of 1, and distributions from this trust would be fully subject to the section 2801 tax. The other trust resulting from the severance would have a Section 2801 Ratio of 0, and distributions from this trust would not attract a section 2801 tax.

XI. INFORMATION RETURNS

The proposed regulations require U.S. persons who receive covered gifts or covered bequests to file IRS Form 3520, in addition to Form 708. The proposed regulations provide that the requirement to file Form 3520 derives from section 6039F and the Treasury Regulations under section 6039F (of which there are none) and that penalties under section 6039F(c) will be imposed on U.S. recipients of covered gifts and bequests who do not file Form 3520, even if they timely file Form 708.[117]

While Form 708 has not yet been released, based on the proposed regulations, the information that recipients of covered gifts or bequests are likely to be required to provide on Form 708 should fulfill any information reporting obligations imposed by section 6039F. Accordingly, Treasury may wish to reconsider the necessity of requiring recipients of covered gifts or bequests to file both Form 708 and Form 3520.

In addition, as a technical matter, the proposed regulations provide that for purposes of applying the section 6039F reporting requirements to U.S. persons who receive covered gifts or bequests, the class of U.S. persons to whom the reporting requirements apply is different from the class described in the statute. Under the statute, section 6039F reporting is required of U.S. persons as defined in section 7701(a)(30).[118] These persons include individuals who are U.S. citizens or U.S. residents for income tax purposes. The proposed regulations provide that for purposes of applying the section 6039F reporting requirements to recipients of covered gifts and covered bequests, the term "U.S. persons" instead includes individuals who are U.S. citizens or U.S. residents, as determined based on the domicile test that applies for estate and gift tax purposes.[119]

This modification to the usual definition of "U.S. persons" seems logical in that under the proposed regulations, the section 2801 tax applies to covered gifts and bequests that are received by U.S. residents, determined based on the domicile test that applies for estate and gift tax purposes, rather than to U.S. residents for income tax purposes.[120] However, the modification also

[117] Prop. Treas. Reg. § 28.2801-6(c)(1).

[118] Section 6039F(a).

[119] Prop. Treas. Reg. §§ 28.2801-6(d) and 28.2801-2(b).

[120] Section 2801 by its terms applies to U.S. residents, without specifying whether the term "U.S. residents" is intended to mean U.S. residents for income tax purposes or to U.S. residents, determined based on the

imposes a reporting requirement (and potential penalties for noncompliance) on a class of persons—individuals who are neither U.S. citizens nor income tax residents but are U.S. domiciliaries—for which there is no statutory authority.

Accordingly, if the regulations continue to require U.S. recipients of covered gifts and bequests to file IRS Form 3520, in addition to Form 708, we recommend that any Form 3520 filing requirement be imposed only on those persons who are both potentially subject to section 2801 and who fall within the class of U.S. persons for whom section 6039F reporting is relevant under the statute (*i.e.*, U.S. citizens and income tax residents). We do not think that the government will be disadvantaged if this recommendation is adopted, particularly because any U.S. recipient of a covered gift or bequest to whom the section 2801 tax may potentially apply will be required to separately file Form 708 to report the gift or bequest.

XII. PROTECTIVE FORM 708

Under the proposed regulations, U.S. recipients of gifts, bequests and distributions from foreign trusts are responsible for determining whether the transferor was a covered expatriate and whether the gift, bequest or distribution is subject to tax under section 2801.[121] A U.S. recipient who "reasonably concludes" that a transferor is not a covered expatriate and that a gift, bequest or trust distribution is not subject to section 2801 may file a protective Form 708 to start the period for the assessment of the section 2801 tax.[122] The "reasonably concludes" language suggests that the taxpayer must be able to obtain information sufficient to enable the taxpayer to reach a conclusion about the status of the gift, bequest or trust distribution, and that a taxpayer who conducts a reasonably diligent investigation but is unable to obtain this information may not file a protective Form 708.

The preamble to the proposed regulations acknowledges that a taxpayer may have difficulty obtaining this information:

> The Treasury Department and the IRS realize that, because the tax imposed by this section is imposed on the U.S. citizen or resident receiving a covered gift or covered bequest, rather than on the donor or decedent covered expatriate making the gift or bequest, U.S. taxpayers may have difficulty determining whether they are liable for any tax under section 2801…. The Treasury and the IRS understand that a U.S. citizen or resi-

domicile test that applies for estate and gift tax purposes. The proposed regulations, however, make it clear that the statute applies to recipients of covered gifts and bequests who are U.S. residents, determined based on the domicile test that applies for estate and gift tax purposes.

[121] Prop. Treas. Reg. § 28.2801-7(a).

[122] Prop. Treas. Reg. § 28.6011-1(b).

> dent receiving a gift or bequest from an expatriate may be unable to obtain directly from the expatriate, the expatriate's attorney, the expatriate's executor, or other reliable sources the information necessary to make the [relevant] determinations. [123]

These acknowledged challenges may be particularly acute in a case where a U.S. person receives a distribution from a foreign trust that was established a significant number of years ago.

We recommend that a taxpayer be able to file a protective Form 708 not only when the taxpayer is able to conclude that the transferor is not a covered expatriate and that the gift, bequest or trust distribution is not subject to the section 2801 tax, but also when the taxpayer has conducted a reasonably diligent investigation and is unable to make a determination as to the transferor's status. In this case, the regulations could require the taxpayer to file an affidavit setting forth her unsuccessful efforts to obtain the necessary information.

[123] Notice, at 54453.