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Report No. 1495
July 8, 2024

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Re: Report No. 1495 on Proposed Regulations Regarding Transactions With Foreign Trusts and Information Reporting on Transactions With Foreign Trusts and Large Foreign Gifts

Dear Mses. Aron-Dine and Rollinson, and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1595 of the Tax Section of the New York State Bar Association, which discusses Proposed Regulations dealing with transactions with foreign trusts and information reporting on transactions with foreign trusts and large foreign gifts.

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

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Report No. 1495

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON PROPOSED REGULATIONS REGARDING TRANSACTIONS WITH FOREIGN TRUSTS AND INFORMATION REPORTING ON TRANSACTIONS WITH FOREIGN TRUSTS AND LARGE FOREIGN GIFTS

July 8, 2024

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New York State Bar Association Tax Section

Report on Proposed Regulations Regarding Transactions With Foreign Trusts and Information Reporting on Transactions With Foreign Trusts and Large Foreign Gifts[1]

I. INTRODUCTION

This Report provides comments on proposed regulations (the "Proposed Regulations")[2] issued by the Department of the Treasury ("Treasury") on May 8, 2024, promulgated under Sections 643(i), 679, 6039F, 6048, and 6677 of the Internal Revenue Code of 1986, as amended (the "Code"), and certain related matters.[3]

Part II of this Report contains a summary of our principal recommendations. Part III contains a summary of the background. Parts IV through XVIII contain a detailed discussion of our recommendations.

II. SUMMARY OF PRINCIPAL RECOMMENDATIONS

A. Section 643(i) gives Treasury the power to except loans from the application of the Section. We recommend that Treasury use this power to craft a set of exceptions to the application of the provision to loans to related parties that will narrow its application to those loans that confer a benefit on the U.S. grantor or beneficiary.

B. We recommend that Treasury provide further clarity on how to determine the fair market value use of tangible personal property and provide a clear safe harbor to meet the fair

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[1] The principal authors of the various sections of this report (the "Report") are Megan L. Brackney, Austin Bramwell, Ellen S. Brody, Bonnie J. Daniels, Alan S. Halperin, Carlyn S. McCaffrey, and Renee Stern-Kaplan. Helpful comments were received from Kimberly S. Blanchard, Robert Cassanos, Peter Connors, Stephen B. Land, Jiyeon Lee-Lim, Stuart L. Rosow, Michael Schler, David Spitzer, Andrew R. Walker, and Libin Zhang. This Report reflects solely the views of the Tax Section of the New York State Bar Association (the "NYSBATS") and not those of the New York State Bar Association's Executive Committee or its House of Delegates.

[2] Transactions With Foreign Trusts and Information Reporting on Transactions With Foreign Trusts and Large Foreign Gifts, REG 124850–08, 89 FR 39440 (May 8, 2024).

[3] Unless otherwise indicated, all references in this Report to a "Section" shall refer to a particular section of the Code. The Code is also sometimes referred to in this Report as the "IRC."

market value requirement with respect to tangible personal property for which there is no established rental market.

C. We request that Treasury clarify that the repayment of principal and interest of a loan under Section 643(i) is treated as an exchange for consideration of at least fair market value for purposes of Section 679. We further recommend that Treasury provide a mechanism to ensure that a subsequent distribution of any repaid principal or returned property or distribution to repay a Section 643(i) loan is not treated as a distribution for purposes of subchapter J of the Code in order to avoid potential double taxation.

D. We recommend that Treasury amend the Proposed Regulations to provide expressly that the Proposed Regulations promulgated under Section 643(i) apply to obligations in effect prior to the promulgation of final regulations which are modified following the publication of final regulations and provide guidance regarding the effect of post-publication modifications of pre-existing obligations.

E. We request that Treasury amend the Proposed Regulations so that Section 643(i) does not apply to a grantor or beneficiary who receives a loan when he or she is not a U.S. person, regardless of whether the recipient of the loan later becomes a U.S. citizen or resident. If Treasury is not amenable to this change, we request that Treasury confirm that the Proposed Regulations do not apply retroactively to loans made prior to the effective date of the final regulations.

F. We recommend that the definition of grantor for purposes of Section 643(i) be limited to those persons who actually make gratuitous transfers to the trust.

G. We request that Treasury provide a reasonable cause exception to the timely payment requirement for qualified obligations under Section 643(i), consistent with the

reasonable cause waiver of penalties for late payment of income taxes under Section 6651. Further, we recommend that Treasury provide a safe harbor for what constitutes a reasonable late period.

H. Certain examples are provided in the Proposed Regulations promulgated under Section 643(i) only or in the Proposed Regulations promulgated under Section 679 only even though the examples are applicable in both contexts. Where each Section has the same example, the language should be consistent. Where an example is relevant in both contexts, it should be promulgated under both Sections.

I. We request additional clarification regarding certain aspects of qualified obligations under Sections 643 and 679. Specifically, we ask that Treasury clarify the following:

1. In order for an obligation to be a qualified obligation, a "timely" filed Form 3520 must report the status of the obligation. We submit that the Proposed Regulations should address the impact of timely extending the due date for filing Form 3520.

2. The Proposed Regulations provide that "[e]xcept as provided in § 1.643(i)-2(a)(1), the term loan of cash includes an extension of credit."[4] In turn, Section 1.643(i)-2(a)(1) of the Proposed Regulations addresses a "loan of cash that is in exchange for a qualified obligation," but is silent as to whether the term "loan of cash" includes an extension of credit. This point should be clarified.

3. The Proposed Regulations provide that, to be a qualified obligation, the loan document must provide that all payments be made in cash in U.S. dollars. We recommend that the Proposed Regulations clarify whether the U.S. dollar requirement applies solely with respect to payments on the note, or also with respect to the initial loan itself.

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[4] Prop Reg. § 1.643(i)-2(d)(6).

4. The Proposed Regulations under Section 679 provide an exception for a loan of cash received by a U.S. person in exchange for a qualified obligation, within the meaning of Proposed Regulation Section 1.643(i)-2(b)(2)(iii) (but without regard to Proposed Regulation Section 1.643(i)-2(b)(2)(iii)(B)(1) and (2)). The Proposed Regulations under Section 679, in our view, instead should reference the definition of qualified obligation within the meaning of Proposed Regulation Section 1.679-4(d)(i).

J. We request that Treasury clarify whether Treasury intended to change the substantive tax treatment of trust domestications so that trust domestications are treated as distributions for income tax purposes, as distinct from reporting purposes. In this regard, we recommend that the final regulations confirm that the mere domestication of a foreign trust is not treated a distribution for purposes of subchapter J.

K. We recommend that Treasury and the IRS[5] confirm in the final regulations under Section 6048 that no substantive change in the treatment of trust decantings, including from a foreign to a domestic trust, is intended.

L. We recommend that the final regulations apply the reporting rules of Section 1.6048-4(d) of the Proposed Regulations not only to distributions from foreign nongrantor trusts, but also to distributions from domestic nongrantor trusts that were previously foreign trusts.

M. We recommend that Treasury amend the Proposed Regulations to provide that the "knows or has reason to know" standard applies in determining whether the donor of a gift is a foreign person or whether the gift is from a "covered expatriate."

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[5] References to the "IRS" are to the Internal Revenue Service.

N. In connection with the Proposed Regulations promulgated under Section 6039F, we recommend that the IRS modify its forms and instructions to provide additional notice to taxpayers regarding the obligation to report certain foreign gifts.

O. We recommend that Treasury amend the Proposed Regulations under Section 6039F to include provisions previously included in Notice 97-34[6] (the "1997 Notice") to avoid the duplication of certain penalties under Sections 6039F and 6677. In connection with the Proposed Regulations promulgated under Section 6039F, we further provide several recommendations for improving the administration of Section 6039F penalties. Specifically, we recommend that (i) Treasury direct the IRS to discontinue or limit its use of procedures of systemically assessing penalties under Section 6039F, (ii) Treasury amend the Proposed Regulations to state affirmatively that the IRS must comply with the supervisory approval requirements of Section 6751(b) before assessing penalties under Section 6039F, (iii) Treasury direct the IRS to review any reasonable cause statements submitted by taxpayers before assessing penalties, and (iv) Treasury amend the Proposed Regulations to include a First Time Abatement ("FTA") or otherwise direct the IRS to develop such a policy or other administrative penalty waiver procedure.

III. BACKGROUND

A brief summary of the federal income tax rules governing foreign trusts is as follows.

A. Taxation of Trusts and Beneficiaries

1. Grantor Trusts

A trust may be a grantor trust or nongrantor trust for federal income tax purposes. If a trust is a grantor trust, the deemed owner of the trust will include items of income, deductions,

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[6] 1997-1 CB 422.

and tax credits which are attributable to the trust in calculating his or her taxable income.[7] Generally, a trust will be a grantor trust if (i) it is funded by a U.S. person and the U.S. person reserves certain interests or powers in respect of the trust, as described in Sections 673 through 677[8] or (ii) it is funded by a non-U.S. person and (x) the trust is revocable by such non-U.S. person or (y) the sole beneficiaries of the trust during his or her lifetime are the non-U.S. person and/or his or her spouse.[9]

2. Nongrantor Trusts

If a trust is a nongrantor trust, the trust will be subject to tax in accordance with the principles set forth in Sections 641 through 668. If a nongrantor trust makes a distribution to a U.S. beneficiary, a share of the trust's distributable net income, or "DNI," will be carried out to the beneficiary. [10] If DNI is carried out to a beneficiary, the beneficiary, in turn, will be required to include in his or her individual gross income an amount equal to the share of DNI carried out from the trust.[11] Generally, DNI does not include capital gains.[12]

B. Rules Specific to Foreign Trusts

1. Classification of a Trust as a Foreign Trust

A trust is a U.S. resident for income tax purposes only if (i) a court within the U.S. is able to exercise primary supervision over the administration of the trust and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[13] Substantial decisions

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[7] *See* Section 671.

[8] *See* Sections 673 through 677.

[9] *See* Section 672(f).

[10] *See* Section 661(a). The trust will receive a deduction for DNI distributed to a beneficiary.

[11] *See* Section 662(a).

[12] *See* Section 643(a)(3).

[13] *See* Section 7701(a)(30)(E).

with respect to a trust include, among other decisions, decisions regarding distributions and the selection of beneficiaries, and decisions regarding the removal, replacement, and appointment of trustees.[14] Any trust that is not a U.S. resident is a foreign trust for income tax purposes.[15]

2. Items of Income Includible in DNI

Generally, while the DNI of a domestic nongrantor trust excludes capital gains, a foreign nongrantor trust's DNI is its taxable income, including capital gains. The DNI of a foreign nongrantor trust includes amounts of gross income from U.S. and non-U.S. sources. DNI generally has the same character in the hands of the beneficiary as in the hands of the trust – that is, ordinary income includible in DNI is taxed at ordinary income rates and capital gains includible in DNI is taxed at capital gains rates.[16]

3. The Throwback Rules

If there is an accumulation distribution from a foreign nongrantor trust, the distribution will carry out a share of the trust's undistributed net income, or "UNI," triggering the so-called throwback rules. [17] Under the throwback rules, a U.S. resident beneficiary is liable for income tax with respect to any distributed UNI and an interest charge. Unlike DNI, UNI generally does not retain its character in the hands of the beneficiary.[18] Therefore, capital gains included in UNI are recast as ordinary income.

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[14] *See* Treas. Reg. § 301.7701-7(d).

[15] *See* Section 7701(a)(31). We note that the definition of "trust" for income tax purposes is broad and may capture foreign business structures which meet the technical definition of a trust but are unrelated to traditional intrafamily estate planning. *See* Treas. Reg. § 301.7701-4. While this Report does not comment on the definition of a trust, which we believe is outside of the scope of the Proposed Regulations, we note that the broad definition of the term trust may lead to the application of the Proposed Regulations in unintended circumstances.

[16] *See* Section 662(b).

[17] *See* Section 667.

[18] *See* Section 667(a).

4. Deemed Distributions

Under Section 643(i), a loan of cash or marketable securities from a foreign nongrantor trust to a U.S. grantor or beneficiary of the trust (or the use of foreign nongrantor trust property by a U.S. grantor or beneficiary) is treated as a distribution for income tax purposes.[19] This Section was intended to prevent the avoidance of U.S. income tax through the use of foreign nongrantor trusts. Prior to the enactment of Section 643(i), the trustee of a foreign nongrantor trust could allow a U.S. person to benefit from the trust property without distributing DNI or UNI to the U.S. person by extending a loan to the U.S. person or otherwise allowing the U.S. person to use trust property without paying rent or other consideration to the trust.

5. Foreign Trusts Funded by U.S. Persons

Under Section 679, if a U.S. person directly or indirectly transfers property to a foreign trust which has one or more U.S. beneficiaries, the trust will be treated as a grantor trust as to the U.S. transferor, even if the U.S. grantor does not retain any of the powers described in Sections 673 through 677.[20] Section 679 was intended to prevent a U.S. person from shielding income from U.S. taxation by funding a foreign nongrantor trust for the benefit of U.S. persons.

C. Reporting Requirements Regarding Foreign Trusts and Gifts and Penalties

Sections 6039F and 6048 generally require U.S. persons to report certain transactions with, and ownership of, foreign trusts and the receipt of large foreign gifts. These provisions were intended to give the IRS visibility into U.S. persons' interests in foreign trusts to determine whether U.S. beneficiaries and grantors of foreign trusts were appropriately reporting all required

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[19] *See* Section 643(i)(1).

[20] *See* Section 679(a).

income from some such foreign trusts. Sections 6039F and 6677 impose penalties on U.S. persons failing to comply with the reporting requirements under Section 6039F and 6048.

D. Notice 97-34 and the Regulations under Section 679

On June 2, 1997, Treasury issued the 1997 Notice, which provided guidance on Sections 643(i), 679, 6039F, 6048, and 6677. The 1997 Notice indicated that "Treasury and the Service expect to issue regulations incorporating the guidance set forth in this notice."[21] On July 20, 2001, Treasury published final regulations under Section 679.[22] However, until the publication of the Proposed Regulations, Treasury had not issued further guidance regarding the remaining Code provisions relating to transactions with foreign trusts, informational reporting regarding transactions with foreign trusts, and the receipt of large gifts.

E. Proposed Regulations

The Proposed Regulations expand upon the guidance provided in the 1997 Notice and address additional issues not covered by the 1997 Notice.

The Proposed Regulations under Section 643(i) provide rules for determining whether a loan from a foreign nongrantor trust (or the use of foreign nongrantor trust property) will be treated as an indirect loan to a U.S. grantor or beneficiary under Section 643(i) and provide guidance regarding subsequent transactions between the foreign nongrantor trust and a U.S. grantor or beneficiary who receives a deemed distribution under Section 643(i). The Proposed Regulations further provide guidance regarding exceptions to the application of Section 643(i). These exceptions include loans that are "qualified obligations," which are not treated as

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[21] *Id.*

[22] 66 FR 37866.

distributions for purposes of Section 643(i) under the 1997 Notice, and the fair market value use of trust property.

In addition, the Proposed Regulations amend the existing regulations under Section 679 to clarify the definition of "U.S. person" for purposes of Section 679, to ensure consistency between Sections 643(i) and 679 as it relates to the treatment of certain loans and guarantees, and to provide additional guidance regarding whether a foreign trust is deemed to have a U.S. beneficiary.

The Proposed Regulations under Section 6039F provide guidance regarding the definition of a "foreign gift" which must be reported thereunder and describes the penalties for a U.S. person's failure to report a foreign gift which falls within the purview of Section 6039F and the Proposed Regulations. The Proposed Regulations also provide specific guidance regarding the reporting requirements applicable to dual resident tax payers.

In connection with Section 6048, the Proposed Regulations define what constitutes a "reportable event" and who is a responsible party for reporting reportable events under Section 6048. Further, the Proposed Regulations provide guidance regarding reporting distributions from a foreign trust, including defining the term "distribution," and describes the information statements required to be filed under Section 6048 and the tax consequences of Section 6048 distributions.

Finally, the Proposed Regulations under Section 6677 provide rules regarding the civil penalties that may be assessed if any notice or return required under Section 6048 is not timely and accurately filed.

While we support Treasury's efforts to clarify the provisions of the Code, this Report addresses how certain approaches taken in the Proposed Regulations might be improved or further clarified.

IV. LOANS FROM A FOREIGN TRUST TO PERSONS RELATED TO THE TRUST'S U.S. GRANTOR OR U.S. BENEFICIARIES

Section 643(i) treats loans of cash or marketable securities from a foreign trust to or the permitted use of other trust property by (i) any U.S. person who is a grantor or beneficiary of the trust or (ii) any U.S. person other than a U.S. grantor or beneficiary of the trust who is related to a U.S. grantor or beneficiary as a distribution to the U.S. grantor or beneficiary except as provided in regulations.[23] For purposes of this provision, a person is related to a grantor or beneficiary of a trust if the relationship is one that would result in the disallowance of losses under Section 267 or 707(b), modified to include spouses of family members as related.[24]

Section 643(i)'s attribution to the U.S. grantors or beneficiaries of a foreign trust of loans actually made by the trust to their relatives likely is intended to prevent grantors and beneficiaries from avoiding the tax consequences of receiving loans directly from a foreign trust by arranging for loans from the trust to family members or other related persons (i) who could make the loaned property available to them or for loans to related entities, (ii) whose use of the loaned property would inure to the economic benefit of the U.S. grantors and beneficiaries or (iii) whose ability to use trust property would benefit the trust grantors or beneficiaries in some manner. Without some showing of complicity in or benefit from the loan by a U.S. grantor or beneficiary, however, the attribution required by Section 643(i) risks violating the Due Process

[23] *See* Section 643(i)(1).

[24] *See* Section 643(i)(2)(b).

Clause of the Constitution's proscription against the arbitrary attribution of income, a principle recently affirmed by the United States Supreme Court in Moore v. United States.[25]

Most of the relationships described in Sections 267 and 707(b) are not sufficiently close to provide a reasonable basis, without more, for concluding that a loan made to one person provides any benefit to any person related to him, her, or them within the meaning of either of these Sections. In our experience, for example, few economic benefits conferred on an individual sibling give any economic advantage to his, her, or their siblings. It is even less likely that a loan to a corporation would inure to the advantage of a trust beneficiary simply because that beneficiary's sibling owned more than 50% of the stock of the corporation.

Section 643(i) gives Treasury the authority to promulgate regulations that except certain loans from the reach of Section 643(i).[26] This authority gives Treasury the ability to tailor the application of the subsection to those situations in which grantors or beneficiaries are likely to benefit from the loans to related parties.

Notwithstanding the authority given to Treasury to create exemptions, the Proposed Regulations do not provide any exceptions to the general rule treating loans from foreign trusts to U.S. persons related to the U.S. grantors and beneficiaries of the trusts as loans to the U.S. grantors and beneficiaries. Instead, Section 1.643(i)-1(b)(2) of the Proposed Regulations expands the scope of Section 643(i) by applying it to (i) loans made by any person related to a foreign trust to a U.S. person related to a U.S. grantor of beneficiary of the trust and (ii) loans made by a foreign trust to a foreign person who is not a grantor or beneficiary of the trust if the foreign person is related to a U.S. grantor or beneficiary of the trust.

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[25] 602 U.S. ____(2024). *See also, Burnet v. Wells*, 289 U.S. 670 (1933); *Hoeper v. Tax Comm'r of Wisconsin,*284 U.S. 206 (1931)

[26] *See* Section 643(i)(1).

The application of Section 643(i), without a carefully designed set of exceptions, can lead to strange results. Here are four, of potentially many, examples:

1. A loan by a foreign discretionary trust to the U.S. spouse of the grantor would be treated as a Section 643(i) distribution to the U.S. beneficiaries of the trust who are descended from the same grantor, even if they have never received any benefit from the trust, can never receive any distributions from the trust without the grantor's consent, and are estranged from the grantor and the grantor's spouse.
2. A loan by a foreign trust to a U.S. corporation owned by the foreign beneficiary sibling of a U.S. beneficiary of the trust would be treated as a Section 643(i) distribution to the U.S. beneficiary although a loan directly to the foreign sibling would not be. Moreover, under Prop. Reg. § 1.643(i)-1(b)(2)(i)(C), the result would be the same even if the sibling's corporation was a foreign corporation.
3. A loan from a discretionary foreign trust for the benefit of multiple descendants of a foreign grantor to a U.S. trust created for the benefit of the grantor's U.S. nieces and nephews would be treated as a Section 643(i) distribution to the U.S. beneficiaries of the foreign trust because, under Section 267(b)(6), the beneficiaries of a trust are treated as related to the trustee of another trust, even if none of them is a beneficiary of that trust, if the same person is the grantor of both trusts.
4. The trustees of a foreign trust for the benefit of a grantor's children owns a home in a foreign country. The trustees permit the spouse of one of the foreign beneficiaries to use the home for extended periods of time on a rent-free basis.

Each of the grantor's U.S. children who are beneficiaries of the trust will be treated as having received a Section 643(i) distribution.

We recommend that Treasury amend the Proposed Regulations, subject to a comment period, to create appropriate exceptions to Section 643(i) and to Section 1.643(i)-1(b)(2) of the Proposed Regulations for loans made to persons related to the U.S. grantors and beneficiaries of foreign trusts when the U.S. grantors and beneficiaries do not derive any benefit from the loans.

V. FAIR MARKET VALUE USE OF CERTAIN TANGIBLE PERSONAL PROPERTY

Pursuant to Section 643(i), if a foreign nongrantor trust permits the use of trust property (other than cash or marketable securities) directly or indirectly by any U.S. person who is a grantor or beneficiary of the trust, the fair market value of the use of the property is treated as a distribution from the trust to such grantor or beneficiary.[27] The Code provides an exception to this rule where the U.S. grantor or beneficiary of the trust pays the trust fair market value for the use of the property within a reasonable period of time.[28] The Proposed Regulations state that a determination of the fair market value use of property for purposes of Section 643(i) is a "facts and circumstances" determination.[29]

For several U.S. tax purposes, the fair market value of the property is determined by reference to a willing buyer and a willing seller.[30] However, in the case of the fair market value

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[27] *See* Section 643(i)(1).

[28] *See* Section 643(i)(2)(E).

[29] Prop. Reg. § 1.643(i)-2(a)(2)(i).

[30] *See* Treas. Reg. § 1.170A-1(c)(2) ("[t]he fair market value [for purposes of valuing a charitable contribution of property] is the price at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts."); *see also* Treas. Reg. § 25.2512-1 ("[t]he value of the property [transferred by way of gift] is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of relevant facts"); *see also* Treas. Reg. § 20.2031-1(b) ("[t]he value of every item of property includible in a decedent's gross estate…is its fair market value at the time of the decedent's death…The fair market value is the price at which the property would change hands between a willing buyer and a

use of tangible personal property for which there is not an established rental market, such as artwork, the willing buyer/willing seller test is of limited utility.[31] We request that Treasury provide additional clarity regarding the factors Treasury would take into account in determining what constitutes the fair market value use of tangible personal property for which there is not an established rental market.

Further, to provide ease of administration for taxpayers and Treasury, we recommend that Treasury provide a safe harbor for determining the fair market value use of tangible personal property for which there is not an established rental market. As an example, Treasury may consider the approach taken by Congress with respect to term interests. There, Congress provided clear rules for valuing any interest for a term of years.[32] Here, Treasury may provide a safe harbor for the use of tangible personal property where the U.S. grantor or beneficiary of the foreign trust pays an amount to the trust equal to the fair market value of the property multiplied by the applicable rate under Section 7520[33] as of the date the use of the property begins.[34] There

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willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts.").

[31] Treasury has recognized that the value of certain tangible personal property may be unascertainable under a willing buyer/willing seller test. See, *e.g.*, Treas. Reg. § 25.2702-2(c) (If Section 2702 applies to a transfer in trust of tangible property, the value of the retained term interest is the amount the transferor establishes as the amount a willing buyer would pay a willing seller for the interest, each having reasonable knowledge of the relevant facts and neither being under any compulsion to buy or sell, unless the transferor cannot reasonably establish the value of the term interest under such a test, in which case the value of the term interest is zero.). We note that, in the case of property for which there is a robust rental market, such as real property, the willing buyer/willing seller test provides a useful guide for taxpayers, who may readily obtain an indication of fair market value use of the property based on the comparable rental market.

[32] *See* Section 7520(a).

[33] The Section 7520 rate for a particular month is 120 percent of the applicable federal midterm rate (compounded annually), rounded to the nearest two-tenths of one percent.

[34] We understand that there is a similar practice in the United Kingdom. There, the rules for determining the taxable portion of a below market loan have been applied as a safe harbor for the rental of artwork. The practice has emerged of applying the relevant statutory interest rate, akin to the applicable federal rate in the U.S., to the purchase price of the artwork (as increased for the costs of any improvements, such as restoration), to determine the fair market rent of artwork for U.K. tax purposes.

may be certain additional prescribed terms, such as what may constitute a qualified appraisal to substantiate the fair market value of the property and the frequency of payments.

VI. SUBSEQUENT TRANSACTIONS BETWEEN THE U.S. GRANTOR OR BENEFICIARY AND THE FOREIGN TRUST

Section 643(i) provides that if a loan from a foreign trust to a U.S. person who is a grantor or beneficiary of the trust (or the use of the property of a foreign trust by a U.S. person who is a grantor or beneficiary of the trust) is treated as a distribution for purposes of Section 643(i), any subsequent transaction between the trust and borrower in respect of the principal of the loan or return of the property, as the case may be, is disregarded for purposes of the Code.[35] The Proposed Regulations further clarify that (i) any payment to the trust other than the repayment of principal is treated as income to the trust, (ii) the repayment of principal is not a gratuitous transfer to the trust for purposes of Section 671 and chapter 1 of the Code, and (iii) any transfer of property to the foreign trust in satisfaction of a loan of cash or marketable securities causes the obligor to recognize gain or loss.[36] We request that Treasury provide further clarification regarding the treatment of subsequent transactions with the trust.

A. Treatment of Repayments for Purposes of Section 679

First, we request that Treasury clarify that the repayment of principal and interest of a Section 643(i) loan will be treated as an exchange for consideration of at least fair market value of the transferred property for purposes of Section 679. Under Section 679, a U.S. person who directly or indirectly transfers property to a foreign trust is treated as the owner of the trust for his or her taxable year for purposes of subchapter J of the Code if, for such year, the trust has a

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[35] *See* Section 643(i)(3).

[36] *See* Prop. Reg. §§ 1.643(i)-3(d)(2) – (3).

U.S. beneficiary.[37] There is an exception to this general rule for any transfer to a trust in exchange for "consideration of at least the fair market value of the transferred property."[38] We believe that providing an exception for principal and interest repayments in respect of a Section 643(i) loan from Section 679 is consistent with the Proposed Regulations' treatment of repayments of principal as non-gratuitous transfers. However, given Section 679's express reference to the fair market value of the property, the Proposed Regulations are unclear as to whether Section 679 would nevertheless apply to the extent of the repayments. Therefore, we recommend that Treasury clarify this issue.

B. Taxation of Subsequent Distributions

Section 643(i) expressly states that if any loan or use of property is treated as a distribution under Section 643(i)(1), any subsequent transaction between the trust and the original borrower, including by way of cancellation or discharge of the loan, is disregarded for purposes of the Code.[39] Neither the Code nor the Proposed Regulations address how subsequent distributions of repaid property or distributions for the purpose of repaying a loan will be treated for purposes of the Code.

The Code's disregard of the cancellation or discharge of a loan which is treated as a distribution under Section 643(i) suggests that Congress did not intend for amounts taxed as distributions under Section 643(i) to be taxed twice – once at the time of the deemed distribution at the inception of the loan and a second time when the property is actually distributed on account of the trust's cancellation of the loan. However, absent clarification regarding the treatment of distributions following the repayment of the loan (or return of the trust property),

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[37] *See* Section 679(a)(1).

[38] Section 679(a)(2)(B).

[39] Section 643(i)(3).

the Proposed Regulations may be understood to tax repaid amounts which are distributed subsequently.

Other areas of the Code provide relief where U.S. persons are deemed to have phantom income. For example, if a U.S. person recognizes income under Section 951 or 951A on account of owning an interest in a controlled foreign corporation, even though no distributions are made to the U.S. person, Section 959 permits him, her, or them to exclude from gross income the amount of any distribution attributable to such previously taxed phantom income.[40] An ordering rule under Section 959 provides that each actual cash or in-kind distribution made to a U.S. person from a controlled foreign corporation is first treated as being made out of previously taxed income, with only the excess over any amount of previously taxed income being taxable to the U.S. person.[41] We recommend that Treasury adopt a similar rule in the context of (i) distributions from a foreign trust to a recipient of a deemed distribution under Section 643(i) following the repayment of principal in respect of the loan and (ii) distributions from a foreign trust to a recipient of a deemed distribution under Section 643(i) for the purpose of repaying the loan, provided the loan is actually repaid in the same calendar year as such distribution, in order to avoid potential double taxation.

VII. EFFECTIVE DATE OF REGULATIONS UNDER SECTION 643(I)

The Proposed Regulations provide that the final regulations under Section 643(i) will apply to "loans of cash or marketable securities made from, and to the use of any other property of, a foreign trust after the [date of publication of the final regulations in the Federal Register]."[42] This provision could be read to apply only with respect to obligations issued after the

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[40] *See* Section 959.

[41] *See* Section 959(c).

[42] Prop. Reg. § 1.643(i)-5.

applicability date, even if a pre-existing obligation is modified after such date in a manner that would cause it not to be a qualified obligation under the final regulations. This reading does not seem consistent with the intent of the regulations. The Proposed Regulations deal with this issue in the context of Section 679 by specifying that the amended rules regarding qualified obligations in that context apply to obligations issued or modified after the date of final publication, with a discussion of the effect of post-publication date modification.[43] Proposed Regulation Section 1.643(i)-5 should be amended to provide, similarly, that the definition of qualified obligation in Proposed Treasury Regulation Section 1.643(i)-2(iii) applies to obligations issued or modified after the date of final publication, with a discussion of the effect of modification after such date. Treasury may consider limiting the provisions regarding modifications to pre-existing obligations to such modifications as would result in an exchange for purposes of Section 1001.[44]

VIII. APPLICATION OF REGULATIONS TO FOREIGN PERSONS WHO BECOME U.S. PERSONS

Under the Proposed Regulations, if a nonresident alien individual who is the grantor or beneficiary of a foreign trust receives a loan from a foreign trust and becomes a U.S. resident or citizen while the loan is outstanding within two years after the date the loan was made, the loan will be treated as a distribution on the date the individual acquires U.S. residence or citizenship.[45] The amount of the deemed distribution is equal to the amount of the outstanding balance on the loan as of such date.[46]

[43] *See* Prop. Reg. § 1.679-7(b)(7).

[44] *See* Treas. Reg. § 1.1001-3.

[45] *See* Prop. Reg § 1.643(i)-1(b)(3).

[46] *Id*.

This rule expands the scope of Section 643(i), which applies only to a loan from a foreign nongrantor trust to a U.S. grantor or beneficiary of the trust.[47] Moreover, this rule providing for a deemed distribution upon immigration was not present in the 1997 Notice. Indeed, this rule is inconsistent with the treatment of distributions from a foreign nongrantor trust to a non-U.S. person who becomes a U.S. citizen or resident. If a foreign nongrantor trust makes a distribution to a non-U.S. person who within two years becomes a U.S. resident or beneficiary, the change in the individual's citizenship or residency does not trigger additional tax with respect to the prior distribution. All the more so, a loan, which generally is not treated as a distribution for purposes of subchapter J of the Code, should not be subject to tax merely because the recipient becomes a U.S. citizen or resident. Accordingly, we respectfully request that Treasury withdraw Section 1.643(i)-1(b)(3) of the Proposed Regulations.

If Treasury is not amenable to withdrawing this Section of the Proposed Regulations, we request that Treasury confirm how the rule applies to a nonresident alien individual who becomes a U.S. resident or citizen prior to the effective date of the final regulations. While the Proposed Regulations indicate that they are effective only with respect to loans of cash or marketable securities made from, and to the use of any other property of, a foreign trust after the date on which final regulations are published,[48] the two-year lookback in the rules pertaining to nonresident alien individuals who become U.S. residents or citizens suggests that the regulations may be retroactive to the date of acquisition of U.S. residency or citizenship, regardless of whether such date occurs prior to the effective date of the final regulations. Because the rule providing for a deemed distribution upon immigration was not present in the 1997 Notice, this

[47] *See* Section 643(i)(1).

[48] *See* Prop. Reg. § 1.643(i)-5.

new rule would require an individual who became a U.S. resident or citizen in a prior year to file an amended tax return with respect to any loan from a foreign trust which was made in the two-year period prior to his or her becoming a U.S. resident or citizen and which was outstanding when he or she became a U.S. resident or citizen. We believe this result is not intended. Therefore, we ask Treasury to confirm that Section 1.643(i)-1(b)(3) of the Proposed Regulations applies only to loans made after the effective date of the final regulations.

IX. DEFINITION OF GRANTOR FOR PURPOSES OF SECTION 643(I)

The Proposed Regulations define a U.S. grantor as a U.S. person described in Treasury Regulations Section 1.671-2(e).[49] Treasury Regulations Section 1.671-2(e), in turn, defines a grantor as any person to the extent the person either creates a trust or directly or indirectly makes a gratuitous transfer to the trust. A person who creates a trust but does not make any gratuitous transfer to the trust is not treated as an owner of the trust for income tax purposes.[50]

A person who creates a trust but does not make any gratuitous transfers to it does not have the kind of relationship to the trust that would justify treating that person as receiving a benefit from the trust when distributions or loans are made to related persons. We recommend that the definition of grantor for purposes of Section 643(i) be limited to those persons who actually make gratuitous transfers to the trust.

X. TIMELY PAYMENT OF QUALIFIED OBLIGATIONS

The Proposed Regulations provide that (i) a loan of cash or marketable securities from a foreign nongrantor trust to a U.S. grantor or beneficiary will not be a deemed distribution from the trust to the borrower if the loan is a qualified obligation and (ii) a foreign trust that makes a

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[49] *See* Prop. Reg. § 1.643(i)-1(d)(11).

[50] *See* Treas. Reg. § 1.671-2(e)(1).

loan of cash to a U.S. person will not be deemed to have a U.S. beneficiary if the loan of cash is in exchange for a qualified obligation.[51] Among other requirements, for an obligation to be a qualified obligation, all payments of principal and interest must be made timely "according to the terms of the obligation (which may include a reasonable grace period of no more than thirty days for a late payment)."[52] We recommend that Treasury provide a reasonable cause exception to the timely payment requirement. This recommendation is consistent with the reasonable cause waiver of penalties for late payment of income taxes under Section 6651.[53] The IRS takes the position that reasonable cause includes, among other examples, (i) death or serious illness of the taxpayer or an immediate family member, (ii) unavoidable absence of the taxpayer, (iii) destruction by casualty of the taxpayer's place of business or business records.[54] These extenuating circumstances cannot be planned for and would make it difficult, if not impossible, to timely make a payment on a qualified obligation. Therefore, they merit a reasonable cause exception.

Further, we recommend revising the proposed grace period to function as a bright line safe harbor. As drafted in the Proposed Regulations, an obligation may provide for a "reasonable grace period" (which cannot exceed 30 days), but it is unclear whether a grace period falling within this 30 day requirement is necessarily "reasonable." Additionally, as drafted, no grace period applies in the case of a poorly documented obligation that does not incorporate a grace period into its terms. In the analogous exception for compensated use of trust property made within a reasonable time of such use, the Proposed Regulations specify that

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[51] *See* Prop Reg §§ 1.643(i)-2(a)(1) and 1.679-2(a)(iii)(B).

[52] Prop. Reg. §§ 1.643(i)-2(b)(iii)(B)(3) and 1.679-4(d)(ii) *flush language*.

[53] *See* Section 6651(a).

[54] *See* IRS Policy Statement 3-2 (12-29-70), at IRM 1.2.1.4.2.

the payment is necessarily reasonable if it is made within 60 days of the start of the use of trust property.[55] We recommend a similar bright line rule in the qualified obligation context, this time providing that a payment is deemed to be made within a reasonable period of the required payment date if it is made within 30 days of such date.

XI. COORDINATION OF EXAMPLES UNDER SECTIONS 643(I) AND 679

Certain examples are provided in the Proposed Regulations promulgated under Section 643(i) only or in the Proposed Regulations promulgated under Section 679 only even though the examples are applicable in both contexts. This approach creates confusion as to whether the application of the definition of qualified obligation should differ in the two contexts. Other examples are provided in both the Proposed Regulations promulgated under Section 643(i) and the Proposed Regulations promulgated under Section 679, but with slightly different verbiage, again introducing potential confusion. Below is a table showing the examples in each Section and illustrating how they relate to each other. Where each Section has the same example, the language should be consistent. Where an example is relevant in both contexts, it should be promulgated under both Sections.

Proposed Regulation Section 1.679-4(d)(6)	**Proposed Regulation Section 1.643(i)-2(e)**	**Comments**
Example 1: Demand Loan	*Example 1: Loan of cash not in exchange for qualified obligation*	Same approximate example - different terminology
Example 2: Private Annuity	No corollary	Applicable in both contexts
Example 3: Transfer to unrelated foreign trust in exchange for an obligation	No corollary	Applicable in both contexts
Example 4: Transfer for an obligation with term in excess of 5 years	Not applicable	

[55] Prop. Reg. §§ 1.643(i)-2(a)(2)(iii) and 1.679-1(a)(5)(iv)(A).

Proposed Regulation Section 1.679-4(d)(6)	Proposed Regulation Section 1.643(i)-2(e)	Comments
Example 5: Transfer for a qualified obligation[56]	Not applicable	
Example 6: Effect of modification treated as an exchange	No corollary	Applicable in both contexts
Example 7: Effect of subsequent obligation on original obligation	*Example 3: Effect of subsequent obligation on original obligation*	Same approximate example - different terminology
No corollary	*Example 2: Beneficiary fails to extend period of assessment and fails to report loan on Form 3520*	Applicable in both contexts
No corollary	*Example 4: Anti-abuse rule*	Applicable in both contexts

XII. ADDITIONAL CLARIFICATIONS REGARDING QUALIFIED OBLIGATIONS

A. Timely filing of Form 3520.

In order for an obligation to remain a qualified obligation, Form 3520 must be filed "timely" to report the status of the obligation and to extend the statute of limitations for assessment.[57] An example in the Proposed Regulations specifies that, if the filing due date for Form 3520 is not extended, an obligation will cease to be a qualified obligation on the due date for the return.[58] The Proposed Regulations do not address the impact of timely extending the due date for filing Form 3520. The Proposed Regulations (under Sections 643 and 679) should clarify that Form 3520 will be filed "timely" if it is filed by its due date, as extended.

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[56] Examples 4 and 5 under Prop. Reg. § 1.679-4(d)(6) address transfers of *property* in exchange for obligations. They do not apply in the Section 643(i) context, which only addresses transfers of cash or marketable securities in exchange for obligations.

[57] Prop. Reg. §§ 1.643(i)-2(b)(iii)(B)(1)-(2) and 1.679-4(d)(ii)(A)-(B).

[58] Prop. Reg. § 1.643(i)-2(e), *Example 2*.

B. Extension of Credit

The Proposed Regulations provide that, "[e]xcept as provided in § 1.643(i)-2(a)(1), the term loan of cash includes an extension of credit."[59] In turn, Section 1.643(i)-2(a)(1) of the Proposed Regulations addresses a "loan of cash that is in exchange for a qualified obligation," but is silent as to whether the term "loan of cash" includes an extension of credit.[60] Section 1.643(i)-2(a)(1) of the Proposed Regulations should be clarified to make clear the intended exception to the inclusion of an extension of credit within the meaning of the term "loan of cash" for purposes of Section 1.643(i)-2(d)(6) of the Proposed Regulations.[61]

C. Payments in U.S. Dollars

The Proposed Regulations under Sections 643(i) and 679 provide that for an obligation to be a qualified obligation all payments must be made in cash in U.S. dollars.[62] The Proposed Regulations should clarify whether the U.S. dollar requirement applies solely with respect to payments on the note, or also with respect to the initial loan itself.

D. Qualified Obligations for Purposes of Section 679

Section 1.679-2(a)(5)(iii)(B) of the Proposed Regulations provides an exception for a loan of cash received by a U.S. person in exchange for a qualified obligation, within the meaning of Proposed Regulation Section 1.643(i)-2(b)(2)(iii) (but without regard to Section 1.643(i)-2(b)(2)(iii)(B)(1) and (2) of the Proposed Regulations).[63] We believe the

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[59] Prop. Reg. § 1.643(i)-2(d)(6).

[60] Prop. Reg. § 1.643(i)-2(a)(1).

[61] We note that not all extensions of credit would involve a loan of cash. For example, a trust may provide a U.S. grantor or beneficiary of a trust access to a line of credit without ever advancing any cash to the U.S. grantor or beneficiary. We recommend that treasury clarify when an extension of credit would constitute a loan for purposes of Section 643(i) and confirm whether the only exception intended is an extension of credit which is a qualified obligation.

[62] *See* Prop. Reg. § 1.643(i)-2(b)(iii)(3) and 1.679-4(d)(C).

[63] Prop. Reg. § 1.679-2(a)(5)(iii)(B).

Proposed Regulation under Section 679 instead should refer to the definition of qualified obligation within the meaning of Section 1.679-4(d)(i) of the Proposed Regulations.

XIII. SUBCHAPTER J CONSEQUENCES OF TRUST DOMESTICATION

For Section 6048(c) reporting purposes, Section 1.6048-4(b)(4) of the Proposed Regulations treats the inbound migration of a foreign trust – that is, the conversion of a foreign trust into a domestic trust – as a distribution. For example, if a trust had a foreign bank trustee, which resigns in favor of a domestic bank, thereby satisfying both the "court test" and the "control test" set forth in Treasury Regulations Section 301.7701-7(a), the new trustee must report the deemed distribution of all income and corpus on Part III of Form 3520.[64] The proposed rule treating domestication as a distribution represents an expansion of Section 6048(c), which applies only to "distributions" and not to other types of events. Nevertheless, the requirement that a trustee report a domestication as if it were a distribution is consistent with the legislative purpose of providing the government with visibility into the repatriated income of foreign trusts.

At the same time, the treatment of domestications as distributions, for Section 6048(c) purposes, without clarification, could create confusion over whether a domestication is treated as a distribution for purposes of subchapter J of chapter 1 of the Code. Indeed, the Proposed Regulations could be read to suggest that a domestication is treated as a distribution triggering the throwback rules of Sections 665-668. The reason is that the Proposed Regulations go on to provide that a U.S. person who timely receives a Foreign Nongrantor Trust Beneficiary Statement may generally determine the income tax consequences of a distribution from a foreign nongrantor trust, including any "throwback" tax under Sections 665-668, by applying either the

[64] Prop. Reg. § 1.6048-4(g), *Example* 11.

default calculation method or the actual calculation method.[65] Further, a U.S. person who does not timely receive any of the four forms of statements described in Section 1.6048-4(c) of the Proposed Regulations must use the default calculation method.[66]

The treatment of domestication as a distribution, combined with the mandatory rules on the tax treatment of foreign trust distributions, might suggest that the mere domestication of a foreign trust is treated, not just for Section 6048 reporting purposes but also for subchapter J purposes, as a distribution that potentially triggers a tax on UNI, as well as interest charges under Section 668. This interpretation might be supported by a literal reading of Section 1.6048-4(d)(1) of the Proposed Regulations, which states that a U.S. person who receives a distribution "must determine tax consequences as follows," except in the year of termination. The rules that follow then dictate, in the case of a distribution from a foreign nongrantor trust, either the actual or default calculation method must be used.[67] There is no other alternative contemplated.[68] Thus, some readers might infer that the U.S. trustee of formerly foreign trust must treat a domestication event as an accumulation distribution that potentially triggers throwback tax on UNI.

In addition, Section 6048(c)(2) generally treats distributions as accumulation distributions, unless adequate records are provided. It would be anomalous if a domestication or any transaction treated as a distribution were required to be reported under Section 6048(c) yet exempt from default treatment under Section 6048(c)(2). Thus, absent an express limitation in

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[65] *See* Prop. Reg. § 1.6048-4(d)(1)(ii).

[66] *See* Prop. Reg. § 1.6048-4(d)(1)(iii).

[67] *See* Prop. Reg. § 1.6048-4(d)(1).

[68] *Id*.

the regulations, the statutory scheme might suggest that any event that is considered a distribution for reporting purposes must also be a distribution for purposes of computing tax.

We believe that the foregoing reading of the Proposed Regulations is not intended; that is, the Proposed Regulations are not, in fact, meant to treat the domestication of a foreign trust as a distribution for subchapter J purposes. For one thing, the mandate of Section 1.6048-4(d)(1) of the Proposed Regulations only applies to U.S. persons "who receive[] a distribution" from a foreign trust. No actual distribution is made or received when a foreign trust domesticates, which, under the rules of Treasury Regulations Section 301.7701-7, occurs solely because of a change of persons who control the trust and/or a change in the court having primary supervision over administration. Although Section 1.6048-4(b)(4) of the Proposed Regulations deems a distribution to have occurred upon domestication, there is no actual receipt of a distribution, as required for the tax treatment rules of Section § 1.6048-4(d)(1) of the Proposed Regulations to apply. Consistent with the view that domestication is not a distribution for subchapter J purposes, neither the preamble nor the Proposed Regulations anywhere announce an intent to change the substantive tax treatment of domestications. Section 1.6048-4(g), Example 11, of the Proposed Regulations, for example, only describes the reporting consequences of a domestication, without mentioning any possible throwback tax.

Meanwhile, the domestication of a foreign trust has not historically been treated as a distribution. In Revenue Ruling 91-6[69] for example, the Treasury Department and the IRS held that the Section 668 interest charge on foreign accumulations continues to apply after a foreign trust domesticates. That holding assumes that the prior domestication was not itself treated as an

[69] *See* Rev. Rul. 91-6, 1991-1 CB 89.

accumulation distribution.[70] Congress later appears to have ratified the rule that domestication is not treated as a distribution. After the enactment of the Small Business Job Protection Act of 1996, which amended Section 6048 in order to require reporting by U.S. persons of distributions from foreign trusts, Congress stated, in the legislative history accompanying the Taxpayer Relief Act of 1997, that "[t]he treatment of foreign trusts, including the treatment of foreign trusts that become domestic trusts, remains unchanged."[71] The legislative history further cites Revenue Ruling 91-6 as authority for the treatment of domestications.[72] Thus, Congress not only did not believe that its previous amendments to Section 6048 caused a change in the tax treatment of domestication but positively affirmed the view set forth in Revenue Ruling 91-6.

Congress' intent is confirmed by the enactment, in the Taxpayer Relief Act of 1997, of Section 665(c). That Section generally limits the application of the throwback rules to foreign trusts and domestic trusts that were formerly foreign. If domestication of foreign trusts were itself treated as a distribution, then there would be no need for Congress to have provided that the throwback rules continue to apply, post-domestication, to formerly foreign trusts. Thus, Section 665(c) provides compelling evidence that that a domestication event should not be treated as a distribution.

We further note that Section 6048(c)(2), which authorizes the Treasury Department to treat distributions from foreign trusts as accumulation distributions, has a limited scope. That Section provides that if adequate records are not provided to the IRS, then a distribution is conclusively presumed to be an accumulation distribution. In other words, the Section creates a

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[70] By contrast, Section 684(c) generally treats the outbound migration of a domestic trust or termination of a foreign grantor trust as gain recognition event.

[71] H.R. Rep. No. 105-148, at 361 (1997).

[72] *Id*.

default treatment if reporting is inadequate. It does not by its terms give the Treasury Department authority to revise the general rules governing foreign trusts and their beneficiaries.

Finally, treating domestications as distribution events is not necessary to discourage U.S. persons from accumulating income offshore, to tax such income when it is repatriated, or to deny U.S. persons the benefit of offshore tax deferral. On the contrary, under Section 665(c)(2)(A), U.S. beneficiaries of domestic trusts that were previously foreign remain potentially subject to throwback tax on UNI and interest charges under Section 668. Thus, the Code already contains mechanisms for taxing income accumulated by a foreign trust before it domesticates. Any rule that treats domestications as distributions, meanwhile, would discourage the migration of foreign trusts, together with their capital, to the United States.

Regardless of the intent of the Proposed Regulations, Treasury should clarify whether it intends to change the substantive tax treatment of domestications.[73] In addition, for the foregoing reasons, we recommend that the final regulations confirm that the mere domestication of a foreign trust is not treated as a distribution for purposes of subchapter J.[74]

XIV. TAX TREATMENT OF DECANTING FROM A FOREIGN TRUST TO A DOMESTIC TRUST

One form of trust distribution, commonly known as a "decanting," is the distribution of cash or other property from one trust to another trust, typically for some or all of the same beneficiaries as the beneficiaries of the decanted trust. If a distribution is made from a foreign

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[73] We note that the Proposed Regulations might technically suggest that the trustee of a domesticating should obtain, at least as a matter of best practice, either a Foreign Nongrantor Trust Beneficiary Statement, a Foreign Grantor Trust Beneficiary Statement, or a Foreign-Owned Grantor Trust Beneficiary Statement. Presumably, these statements are unnecessary when a foreign trust domesticates, as the trustee already has all of the information that would be set forth a statement. We recommend clarifying that there is no need for a formerly foreign trust to issue a statement to itself in the event of domestication.

[74] For clarity, we express no views on what other tax consequences a domestication may have, such as its effect (if any) on built-in losses and gains.

trust to a domestic trust, then, as confirmed by Section 1.6048-4(g), Example 12 of the Proposed Regulations, the distribution must be reported on Part III of Form 3520. At the same time, the Proposed Regulations are silent on the substantive tax treatment of an inbound decanting, as opposed to the reporting treatment. In particular, they do not address whether a decanting triggers a potential throwback tax under Sections 665-668.

As discussed in our prior Report No. 1265 at 16-17, the tax consequences of an inbound decanting – like the tax consequences of decanting generally – are uncertain. In general, a decanting from a foreign trust to a domestic trust should be treated as a distribution that potentially triggers a throwback tax under Section 665-68.[75] However, the IRS has sometimes treated the decanting of all assets from one trust to another as a mere continuation of the decanted trust.[76] That treatment is consistent with the reality that a complete decanting effectively amends the terms of the decanted trust by causing the trust property to be held under the terms of the receiving trust. Indeed, many jurisdictions' laws, as well as the organic decanting provisions included in many trust instruments, authorize trustees to exercise a decanting authority without actually transferring title to assets, simply by amending the terms of an existing trust. A decanting without a distribution is sometimes called a "decanting-by-amendment" or a "decanting-in-place."

If, in the case of a decanting-in-place, an inbound decanting is treated as a mere continuation and not as a distribution, then, for the reasons discussed above, it should not trigger the throwback taxes. Rather, it would be treated as a domestication of a formerly foreign trust. Section1.6048-4(g), Example 12 of the Proposed Regulations provides that a decanting is treated

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[75] New York State Bar Ass'n Tax Section, *Report on Notice 2011-101* (Report No. 1265 April 26, 2012) 1140, Jan. 3, 2008) ("Report No. 1265").

[76] *See* PLR 200607015 (February 17, 2006).

as a distribution for Section 6048(c) reporting purposes. However, if a decanting is not treated as a distribution for subchapter J purposes, then it should not cause the receiving trust to be considered to have received an accumulation distribution that triggers throwback tax. Section 1.6048-4(b) of the Proposed Regulations acknowledges that in some cases, a distribution does not have "any income tax consequences." An inbound decanting that is treated as a mere continuation may be one example.

That said, it is uncertain to what extent the Proposed Regulations, if made final, would cause inbound decantings to be treated as distributions subject to throwback tax on UNI. Unlike in the case of a domestication, an inbound decanting, unless achieved through an amendment or "decanting-in-place," entails an actual receipt by the receiving trust of a distribution and the foreign trust continues. As a result, under the general rule of Section 1.6048(d)(1) of the Proposed Regulations, an inbound decanting of a foreign nongrantor trust would be treated as a distribution requiring a determination of tax under either the actual calculation method or the default method. At the same time, the general rule might not apply at all, if the decanting is not treated as a distribution but is instead treated as mere continuation of the formerly foreign trust.

We assume that the Treasury Department and the IRS do not wish the final regulations to imply any change to the tax treatment of decantings. The tax treatment of decantings generally, after all, is larger project that is presumably outside the scope of the Proposed Regulations. Accordingly, we recommend that Treasury and the IRS confirm in the final regulations, perhaps in the preamble, that no substantive change in the treatment of decantings, including from a foreign to a domestic trust, is intended. We nevertheless do urge the Treasury Department and the IRS to provide guidance on the tax treatment of decanting generally.

Alternatively, if Treasury and the IRS do wish to take this opportunity to provide guidance on the tax consequences of decanting, at least in the context of inbound decantings, then we have the same recommendations that we offered in our Report No. 1265. Specifically, we recommend that when the decanted trust and the receiving trust have substantially similar terms, then the latter trust should be treated for income tax purpose as a continuation of the former. In the context of an inbound decanting, as discussed, this approach would mean that the inbound decanting, even if it is formally a distribution from one trust to another, is not a distribution for income tax purposes but receives the same treatment as a domestication.[77]

XV. DEFAULT METHOD WITH RESPECT TO DISTRIBUTIONS FROM DOMESTICATED TRUSTS

Under Section 665(c)(2), the throwback rules apply to accumulation distributions from two categories of trusts, namely, foreign nongrantor trusts and domestic nongrantor trusts that once were foreign trusts.[78] The Proposed Regulations, consistent with the longstanding policy set forth in the 1997 Notice, generally allow a U.S. person who receives a distribution from a foreign nongrantor trust to elect the "default" calculation method for computing taxes on the

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[77] We acknowledge that treating an inbound decanting as a mere continuation would effectively allow trustees to decide when an accumulation distribution triggering throwback tax will occur. A default rule that an inbound decanting is treated as a mere continuation would mean that a foreign trust could effectively modify its terms and domesticate through an inbound decanting. But if a trustee wishes to accelerate throwback tax, a trustee could achieve that result, before, after, or at the same time as the domestication, by decanting to a trust that does not have similar terms or by not decanting all assets. The throwback tax regime, like subchapter J rules generally already permits trustees, through the exercise of their distribution discretion, to control the timing and amount of taxable income that is carried out to beneficiaries. Further, the throwback rules themselves, including the interest charge imposed by Section 667(a)(3) (which, as explained in Revenue Ruling 91-6, continues to apply post-domestication), counter incentives to defer or accelerate distributions that carry out UNI. Thus, we do not think that the electivity created by continuation treatment is a downside to treating inbound decantings as continuations.

[78] The throwback rules also apply to (i) a rare third category, namely trusts created before March 1, 1984, that are aggregated with other trusts under the multiple trust rule of Section 643(f) and (ii) domestic grantor trusts that once were foreign nongrantor trusts. The conversion of a grantor trust to a nongrantor trust (during the grantor's lifetime) is a transfer for income tax purposes. S*ee Madorin v. Comm'r*, 84 T.C. 667 (1985); *see also* Treas. Reg. § 1.1001-2(c), *Example 5*; Rev. Rul. 77-402, 1977-2 C.B. 222. On the other hand, in describing the effect of converting a nongrantor trust to a grantor trust, the IRS did not suggest that the conversion would be treated as a transfer for income tax purposes. S*ee* Rev. Rul. 85-13, 1985-1 C.B. 184; *see also* PLR 201730017. Accordingly, a domestic grantor trust which previously was a foreign nongrantor trust may be subject to the throwback rules.

foreign trust distribution, even if the U.S. person is eligible for the actual calculation method. Conversely, the default calculation method must be used if a U.S. person either does not receive a Foreign Nongrantor Trust Beneficiary Statement or has previously computed tax under the default method (except in the year of termination).[79]

Once a formerly foreign trust domesticates, the default method, whether elective or mandatory, is no longer available under the Proposed Regulations (or under the 1997 Notice) in order to compute tax on an accumulation distribution. Rather, as the default method only applies to a distribution "from a foreign trust," a U.S. person receiving a distribution from a domesticated nongrantor trust must presumably use the exact method. Yet the difficulties of computing throwback tax on a distribution do not necessarily disappear once a foreign trust domesticates. On the contrary, a U.S. beneficiary of a domesticated trust may still not have access to the records and information that make it possible to compute that beneficiary's share of UNI (if any), as the records and information may still be retained (or perhaps lost or destroyed) in a foreign jurisdiction by persons with little incentive to facilitate U.S. tax compliance. The absence of the default method, which avoids those difficulties by deeming the distribution to consist entirely of ordinary income and providing a mechanical rule for determining the portion consisting of UNI, makes it difficult for domesticated trusts and their U.S. beneficiaries to determine the tax consequences of an accumulation distribution.

To rectify that difficulty, we recommend that the final regulations apply the rules of Section 1.6048-4(d) of the Proposed Regulations not only to distributions from foreign nongrantor trusts but also to distributions from domestic nongrantor trusts that were previously foreign trusts. Such parity of treatment would be consistent with Revenue Ruling 91-6, which

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[79] *See* Prop. Reg. § 6048-4(d).

continues to treat a domesticated trust like a foreign trust for purposes of the interest charge imposed by Section 667(a)(3). To facilitate both elective and mandatory applications of the default and exact computation methods, the final regulations also could provide that a beneficiary may obtain a Foreign Nongrantor Trust Beneficiary Statement from a domesticated trust that was previously a foreign trust. The name of the statement could be modified to avoid confusion, such as to "Foreign or Formerly Foreign Nongrantor Trust Beneficiary Statement."

XVI. KNOWLEDGE STANDARD

Section 6039F was added to the Code by the Small Business Job Protection Act of 1996,[80] and modified by the Tax Cuts and Jobs Act. Section 6039F requires U.S. persons to report the receipt of large gifts or bequests from foreign persons. Section 6039F(b) defines the term "foreign gift" as any amount received from a person other than a U.S. person that the recipient treats as a gift or bequest, with exceptions for qualified transfers within the meaning of Section 2503(e)(2),[81] or any distribution properly disclosed in a return under Section 6048(c) (reporting by U.S. beneficiaries of foreign trusts).[82] Since 1997, a U.S. person has been required to report the receipt of gifts from a nonresident alien or foreign estate if the aggregate amount of gifts exceeds $100,000 during the taxable year.[83] For gifts from foreign corporations or foreign partners, a U.S. person is required to report the receipt of such gifts if the aggregate amount of

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[80] The Small Business Job Protection Act of 1996 Act, P.L. 104-188, 110 Stat 1755 (Aug. 20, 1996); Tax Cut and Jobs Act, P.L. 115-97, 131 Stat. 2054 (Dec. 22, 2017). The legislative history does not provide any explanation for why Congress added this provision to the Code.

[81] Section 6039F excludes "qualified transfers," which is defined as "any amount paid on behalf of an individual (A) as tuition to an educational organization described in section 170(b)(1)(A)(ii) for the education or training of such individual, or (B) to any person who provides medical care (as defined in section 213(d)) with respect to such individual as payment for such medical care." Section 6039F(e)(2).

[82] *Id*.

[83] *See* Notice 97-34, 1997-1 C.B. 422, at *19.

gifts from all such entities exceeds $10,000 (as modified by cost-of-living adjustments under Section 6039F(d)) during the taxable year.[84]

Section 6039F(c) states that "a U.S. person who fails to furnish the required information is subject to a penalty equal to five percent of the amount of the foreign gift for each month (or portion thereof) for which the failure continues, but not to exceed 25 percent of the amount of the foreign gift." There is a reasonable cause exception to the penalty.[85]

A. Aggregation of Gifts

In determining whether parties are related for purposes of aggregating gifts, Treasury applies a "knows or has reason to know standard." The Proposed Regulations provide:

> Aggregation rule. To determine whether paragraph (c)(2)(i)(A) of this section applies to foreign gifts received from a transferor, each U.S. person must aggregate foreign gifts, including covered gifts and bequests described in section 2801(e), received from all foreign individuals, foreign estates, and any other foreign person (such as corporations or partnerships) that *the U.S. person knows or has reason to know* are related to the transferor within the meaning of § 1.643(i)-1(d)(9). (emphasis added).[86]

We believe that the "knows or has reason to know" standard is appropriate because information about other related persons may not be available to the taxpayer. However, this "knows or has reason to know" standard is not included in determining whether the donor of a gift is a foreign person or whether the gift is from a "covered expatriate."

Under the 1997 Notice, taxpayers were required to report foreign gifts under Section 6039F only if the U.S. person "knows or has reason to know that the donor is a foreign person."[87] However, this language is not included in the Proposed Regulations related to the

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[84] *Id*.

[85] *See* Section 6039F(c)(2).

[86] Prop. Reg. § 1.6039F-1(a)(2)(B).

[87] Notice 97-34, 1997-1 C.B. 422, Section VI.B.3.

taxpayer's knowledge of whether a gift is from a foreign person. The Preamble to the Proposed Regulations references the 1997 Notice on this point but does not explain why Treasury only has applied this standard to determining aggregation of gifts from related parties, and not more generally to whether the donor is a foreign person.[88]

B. Receipt of a Covered Gift

The Proposed Regulations add a requirement to the aggregation rules providing that, for purposes of determining whether the reporting threshold is met, all foreign gifts, including covered gifts and bequests from the transferor and from any foreign persons related to the transferor are aggregated.[89] A "covered gift" is a gift from a "covered expatriate."[90] We understand that Treasury may want to curb use of expatriation for tax avoidance, but the burden of reporting should not be on the recipient of a gift who may have no way of knowing that the donor is a covered expatriate. Accordingly, we believe that the final regulations should include a "knows or has reason to know" standard for applying the covered gift rules as well.

As noted, the "knows or has reason to know" standard was included in the 1997 Notice, and Treasury and the IRS apply this standard for determining filing obligations for other types of information reporting where the filer may not have access certain information.[91]

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[88] *See* Preamble to the Proposed Regulations, at *39442.

[89] Prop. Reg. §§ 1.6039F-1(a)(2)(B); 1.6039F-1(b).

[90] Prop. Reg. § 1.6039F-1(a)(2)(B).

[91] Some examples include: Treas. Reg. § 1.6011-4(c)(3) (A taxpayer also has participated in a listed transaction if the taxpayer *knows or has reason to know* that the taxpayer's tax benefits are derived directly or indirectly from tax consequences or a tax strategy described in published guidance that lists a transaction under paragraph (b)(2) of this section) (emphasis added); Announcement 2023-02 (IRS ANN), 2023-2 I.R.B. 344, *Transitional Guidance Under Sections 6045 and 6045A with Respect to the Reporting of Information on Digital Assets by Brokers* ("Under this new provision, brokers must report to the IRS transfers during a calendar year of digital assets that are covered securities, provided the transfer is not part of a sale or exchange and is not to an account maintained by a person that the broker *knows or has reason to know* is also a broker.") (emphasis added). Form 1099-B, Proceeds From Brother and Barter Exchange Transactions, https://www.irs.gov/uac/about-form-1099b ("[a] broker or barter exchange" file a Form 1099-B for each person: "who received cash, stock, or other property from a corporation that the broker *knows or has reason to know* has had its stock acquired in an acquisition of control or had a substantial change in capital structure reportable on Form 8806..." (emphasis added).

Taxpayers who form foreign trusts or invest in foreign entities are taking affirmative actions to do so, and it is reasonable to expect that they ensure that they have access to information necessary to comply with information return reporting requirements. Many taxpayers who receive gifts from foreign persons or estates have not taken any affirmative steps to engage in transactions outside of the U.S. but are merely the passive recipients of gifts or inheritances and may not have ready access to complete information about the donor. Accordingly, a "knows or has reason to know" standard for filing is appropriate and should be added to the Proposed Regulations.

XVII. RECOMMENDATIONS FOR AMENDMENTS TO IRS FORMS AND PUBLICATIONS TO ASSIST WITH VOLUNTARY COMPLIANCE

Many taxpayers are not aware of the requirement to report a foreign gift or inheritance on Form 3520. The IRS could encourage voluntary compliance by alerting taxpayers to this requirement on Form 1040. Currently, Schedule B on the Form 1040 asks taxpayers "During 2023, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520." The IRS could add another short phrase such as "or the recipient of a gift from a foreign person or entity or bequest from a foreign estate." We believe this modest change will assist taxpayers with compliance, as it will put them on notice of the foreign gift reporting requirement, and it will prompt tax return preparers and tax return preparation software to ask taxpayers about gifts from foreign persons. We recommend that Treasury direct the IRS to make this addition to Form 1040.

Next, we recommend an addition to the instructions to Form 1040 to clarify the filing deadline for Form 3520 for taxpayers who live abroad. In 2015, the Surface Transportation and

Veterans Health Care Choice Improvement Act of 2015 ("Surface Transportation Act"),[92] modified the due dates for Forms 3520 and 3520-A for taxable years beginning after December 31, 2015, and directed Treasury to issue regulations implementing this change. Section 2006(b)(10) of the Surface Transportation Act states that "[t]he due date of Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, for calendar year filers shall be April 15 with a maximum extension for a 6-month period ending on October 15." The Proposed Regulations implement this provision.[93]

For taxpayers living abroad, Form 3520 is due on the regular due date of Form 1040, June 15, or on the automatic extension date of October 15. Taxpayers that are living abroad can also request an additional extension to December 15. The Surface Transportation Act, however, does not authorize Treasury to extend the Form 3520 filing deadline beyond October 15. To avoid confusion and inadvertent late filing, we recommend that Treasury direct the IRS to add a statement to the Form 1040 instructions on extensions for taxpayers who live abroad that the additional extension to December 15 does not apply to Form 3520.

XVIII. PENALTIES

A. Prevent the Imposition of a Double Penalty

First, we recommend that Treasury add language to the Proposed Regulations that was previously included in the 1997 Notice to avoid duplication of penalties. The 1997 Notice stated that: "If the penalties under both Section 6039F and Section 6677 could apply to the failure to report a distribution from a foreign trust treated as a gift, the penalty under Section 6677 will be assessed, and will reduce any penalty otherwise imposed under Section 6039F."[94] This language

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[92] P.L.114-41, 129 Stat. 443,

[93] Prop. Reg. § 1.6039F-1(a)(2).

[94] Notice 97-34, VII.

is not included in the Proposed Regulations and should be added to avoid a double penalty on taxpayers.

B. Examples in Proposed Regulations Need Clarification

Second, we are concerned that Section 1.6039F-1(e)(1)(ii) of the Proposed Regulations, if not clarified, might exceed Treasury's authority. The Proposed Regulation states:

> (e) Penalty for failure to file information— (1) In general. If a U.S. person fails to furnish information required under paragraph (a) of this section with respect to any foreign gift by the due date provided under paragraph (a)—
>
> (i) The tax consequences of the receipt of such foreign gift may be determined by the Commissioner based on all the facts and circumstances, and
>
> (ii) Notwithstanding the tax consequences under paragraph (e)(1)(i) of this section, such U.S. person must pay (upon notice and demand by the Commissioner and in the same manner as tax) an amount equal to 5 percent of the amount of such foreign gift for each month (or portion thereof) for which the failure to report the foreign gift as a gift on Form 3520 continues (not to exceed 25 percent of such amount in the aggregate).

The Proposed Regulations then provide the following examples:

> Example 6: Gifts from foreign individual and related corporation. X, a U.S. citizen, is married to Y, a nonresident alien. Y is the sole shareholder of FC, a foreign corporation. During Year 1, Y makes a gift of $11,000 to X, and FC makes a gift of $9,000 to X. Because X knows or has reason to know that Y and FC are related, X must aggregate the gifts from Y and FC ($20,000). Although the $20,000 aggregate amount deemed received from Y does not exceed the $100,000 reporting threshold with respect to foreign gifts from foreign individuals, the $20,000 aggregate amount received from FC exceeds the applicable reporting threshold for foreign gifts from foreign corporations under paragraph (c)(2)(iii) of this section for Year 1 (assume that for Year 1 this amount is $18,000). Accordingly, X must report receipt of the foreign gift on Part IV of Form 3520 under paragraph (a) of this section. In

> addition, X must separately identify each foreign gift from Y and FC and must provide identifying information about Y and FC.[95]
>
> Example 7: Penalties for failure to report information. The facts are the same as in paragraph (g)(6) of this section (Example 6). X fails to report the amounts received from Y and FC on Form 3520 and does not demonstrate to the satisfaction of the Commissioner that such failure is due to reasonable cause and not due to willful neglect. Under paragraph (e)(1)(i) of this section and § 1.672(f)-4(a)(2), the Commissioner may determine that, based on all the facts and circumstances, the gift of $9,000 from FC to X should be treated as a dividend from FC to X and included in X's gross income. Under paragraph (e)(1)(i) of this section, the Commissioner also may determine that there are no tax consequences to X upon receiving the gift of $11,000 from Y. Without regard to the tax consequences determined under paragraph (e)(1)(i) of this section, under paragraph (e)(1)(ii) of this section, X must pay (upon notice and demand by the Commissioner and in the same manner as tax) $1,000, an amount equal to 5 percent of the aggregate amount of $20,000 for each month for which the failure to disclose the foreign gifts on Form 3520 continues (not to exceed $5,000, an amount equal to 25 percent of the aggregate amount of $20,000).[96]

Example 7 could be read to imply that, even though the IRS might characterize the $9,000 transfer to X from FC as taxable dividend, the IRS would still assess the Section 6039F penalty. We are concerned that this assessment might exceed Treasury's authority because Section 6039F(c) only permits the IRS to assess penalties if the U.S. person fails to timely report a "foreign gift" under 6039F(a). Section 6039F(b) defines "foreign gift" as "any amount received from a person other than a United States person which the recipient treats as a gift or bequest." In the examples, there is no indication that X treated the transfers as a gift as X did not report it on Form 3520 and there is no other information on this point provided. Example 7 could be improved by adding that X treated the transfer as a gift. Otherwise, the wording of the

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[95] Prop. Reg. § 6039F(g)(6), *Example 6*.

[96] Prop. Reg. § 6039F(g)(7), *Example 7*.

Proposed Regulation, along with Example 7, implies that any time a taxpayer does not report foreign source income, the IRS could treat that inaction as a failure to file Form 3520. We believe such treatment is justified only if the receipt of property is in fact a gift or if there is evidence that the taxpayer treated the receipt of property as a gift beyond the mere failure to report the transfer as income.[97] Accordingly, we recommend that Treasury revise Example 7.

C. Recommendations Regarding Administration.

Next, we have several recommendations to improve the administration of Section 6039F penalties. The IRS's approach to penalties for failure to report foreign gifts under Section 6039F has been perceived as creating a burden on taxpayers. We respectfully recommend that Treasury use this opportunity to direct the IRS to make some improvements in this area. The Taxpayer Advocate reported that over 50% of penalties assessed under Section 6039F were abated between 2018-2021.[98] Given this high rate, we recommend that Treasury implement changes to the IRS's methods of assessing penalties.

Our first recommendation is for Treasury to direct the IRS to discontinue or limit its use of procedures which systemically assess Section 6039F penalties. "Systemically assessed penalties are those that are automatically assessed electronically without initial review or action from IRS personnel. Assessments made based on actions taken by IRS personnel are referred to as 'manual assessment'"[99] As noted, the Taxpayer Advocate reported that over 50% of penalties

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[97] Because the statute of limitations for assessment of the Section 6039F penalty remains open until the Form 3520 is filed, there is no concern that the IRS would be foreclosed from assessing the penalty if a taxpayer does not file the form and the IRS later determines that a foreign transfer was a reportable gift. *See* Section 6501(c)(3); CCA 2013090614055395 (Sept. 6, 2013).

[98] National Taxpayer Advocate, 2023 Annual Report Congress, Most Serious Problem#8, The IRS's Approach to International Information Return Penalties Is Draconian and Inefficient ("TA Report to Congress") at 105. Section 6039F penalties may be seen as only a problem for wealthy taxpayers, but the IRS has assessed these penalties against many middle- and lower-income taxpayers. Id. at 107.

[99] *Id.* at 103, n. 13.

for late filing Form 3520 to report foreign gifts were abated between 2018-2021. However, where the penalties were manually assessed, the rate was significantly lower. Looking at data for comparable penalties for late filing of other international information returns under Sections 6038 (Forms 5471 reporting certain interests in foreign corporations) and 6038A (Form 5472 reporting foreign ownership of corporations), where the IRS has comparable procedures, TAS explained:

> TAS analyzed abatement rates for the IRC §§ 6038 and 6038A penalties since they are the most frequently assessed IIR [International Information Return] penalties, averaged across 2018-2021. We analyzed this data for systemic and for manual (Individual Master File) assessments in terms of both numbers and dollars, as shown in Figure 2.8.6. Across these four years, for systemic assessments, the abatement percentage, measured by number of penalties, was 74 percent and by dollar value was 84 percent. Manual assessments for individual taxpayers were abated at a rate of only 27 percent by number and 16 percent by dollar amount.[100]

The high rate - 74% of penalties reversed - for systemically assessed penalties causes hardship for taxpayers and increases administrative burdens for the IRS. Accordingly, we recommend that Treasury address this problem by directing the IRS to cease systemic assessment of these penalties or impose appropriate limitations on systemic assessment.

Second, and relatedly, we propose that the Proposed Regulations state affirmatively that the IRS must comply with the supervisory approval requirements of Section 6751(b) before assessing penalties under Section 6039F. Section 6751(b) states that:

> No penalty under this title shall be assessed unless the initial determination of such assessment is personally approved (in writing) by the immediate supervisor of the individual making such determination or such higher-level official as the Secretary may designate.

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[100] *Id.* at 110.

Courts have invalidated penalty assessments where the IRS did not obtain proper supervisory approval before assessment.[101] In response to this caselaw, Treasury has proposed regulations under Section 6751(b) (the "Proposed Section 6751(b) Regulations").[102] In the preamble to the Proposed Section 6751(b) Regulations, Treasury reiterates the IRS's stated policy on penalties:

> The [IRS] will demonstrate the fairness of the tax system to all taxpayers by:
>
> a. Providing every taxpayer against whom the [IRS] proposes to assess penalties with a reasonable opportunity to provide evidence that the penalty should not apply;
>
> b. Giving full and fair consideration to evidence in favor of not imposing the penalty, even after the [IRS]'s initial consideration supports imposition of a penalty; and
>
> c. Determining penalties when a full and fair consideration of the facts and the law support doing so.[103]

Consistent with this approach, the Proposed Section 6751(b) Regulations direct IRS employees to provide supervisory approval for penalties, including penalties such as under Section 6039F, which are not subject to pre-assessment Tax Court review.[104] Given the high rate of Section 6039F penalty reversals, we recommend that the Proposed Regulations specifically cross-reference the approval requirements of Section 6751(b).

In addition, we believe that Treasury should direct the IRS to review any reasonable cause statements submitted by taxpayers before assessing penalties. The Proposed Regulations require that a taxpayer who fails to comply with Section 6039F and seeks abatement of penalties must submit a reasonable cause statement under penalty of perjury. The Taxpayer Advocate

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[101] *See e.g. Chai v. Comm'r,* 851 F.3d 190 (2d Cir. 2017); *Graev* v. *Comm'r,* 147 T.C. 460 (2016), *superseded by* 149 T.C. 485 (2017).

[102] Fed. Reg. 2023-07232 (April 10, 2023).

[103] Penalty Policy Statement 20-1, IRM 1.2.1.12.1(9) (June 29, 2004).

[104] S*ee* Prop. Reg. §§ 301.6751(b)-1(a)(2); 301.6751(b)-1(b).

found that the IRS assessed Section 6039F penalties without reviewing reasonable cause statements that taxpayers submitted with late-filed Form 3520.[105] Thus, we recommend that the Proposed Regulations require that the IRS review any reasonable cause statement submitted prior to the assessment of penalties. This direction is consistent with the requirement under Section 6751(b) for supervisory approval and the IRS's stated policy of "giving full and fair consideration to evidence in favor of not imposing the penalty."[106]

Finally, we recommend that Treasury include an FTA policy in the Proposed Regulations or direct the IRS to develop such a policy or other administrative penalty waiver procedure. The IRS offers FTA for delinquency penalties under Sections 6651(a)(1) and (2) (late fling and late payment) to taxpayers who have filed or paid late and satisfy certain requirements.[107] There also should be FTA for penalties like Section 6039F penalties, subject to any reasonable limitations that the IRS deems appropriate, such as circumstances in which there has been no income tax non-compliance and the taxpayer voluntarily filed the form before being contacted by the IRS.

An FTA policy would encourage voluntary compliance, which is a primary purpose of penalties.[108] As stated in the Internal Revenue Manual:

The IRS has the obligation to advance the fairness and effectiveness of the tax system. Penalties should do the following:

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[105] TA Report to Congress at 106 ("when taxpayers provide reasonable cause statements for their late filing, IRS Campus employees routinely ignore the reasonable cause statement, assess the penalty, and furnish taxpayers with their right to go to the IRS Independent Office of Appeals, which often concedes these penalties based on factors such as reasonable cause.").

[106] IRM 1.2.1.12.1(9).

[107] IRM 20.1.1.3.3.2.1 (March 29, 2023).

[108] *See* IRM 20.1.1.2.1 (Nov. 25, 2011) ("Penalties advance the mission of the IRS when they encourage voluntary compliance."). The National Taxpayer Advocate also supports an FTA policy for these penalties. *See* TAS Report to Congress at 112; *see also International Penalties Under IRC §§ 6038 and 6038A Is Not Supported by Statute, and Systemic Assessments Burden Both Taxpayers and the IRS*, https://www.taxpayeradvocate.irs.gov/wp-content/uploads/2021/01/ARC20_MSP_08_International.pdf.

1. Be severe enough to deter noncompliance,
2. Encourage noncompliant taxpayers to comply,
3. Be objectively proportioned to the offense, and
4. Be used as an opportunity to educate taxpayers and encourage their future compliance.[109]

An FTA policy will help achieve these goals by encouraging taxpayers to voluntarily comply with the Form 3520 filing requirement if they have missed a deadline, rather than avoiding their filing obligations because of fear of penalties while at the same time, providing education so that these taxpayers are compliant in the future.[110]

XIX. CONCLUSION

We commend Treasury for providing formal guidance regarding the matters addressed in the 1997 Notice. However, we respectfully request that Treasury consider modifying the Proposed Regulations to incorporate the recommendations set forth in this Report.

[109] IRM 1.2.1.12.1(8).

[110] It appears that some taxpayers are attempting to avoid Form 3520 penalties for late filing by falsely claiming that gifts from foreign persons are loans. The Proposed Regulations address this concern by authorizing the IRS to recharacterize the purported loans as gifts from foreign persons and imposing penalties under Section 6039F. Prop. Reg. § 1.6039F-1(b)(2). Treasury also could reduce the incentive for this taxpayer behavior by creating an FTA policy so that that taxpayers who missed the deadline can get compliant without facing significant penalties.