

IRS Provides Guidance on 1996 Foreign Trust Changes

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In recent months, the United States Internal Revenue Service has issued substantial guidance on the changes brought about by the Small Business Job Protection Act of 1996 (P.L. 104-188, the "Act") in the United States federal tax treatment of foreign trusts and their grantors and beneficiaries. The foreign trust provisions of the Act cover—

- Residence of trusts,
- Inbound foreign trusts with foreign grantors,
- Foreign trusts that are not grantor trusts,
- Outbound foreign grantor trusts with U.S. grantors,
- Information reporting and penalties related to foreign trusts and
- Reporting of foreign gifts.

The Act's changes are of particular significance to—

- Trusts classified as domestic trusts under prior law with foreign trustees or subject to foreign court supervision which now risk reclassification as foreign trusts and attendant imposition of a 35 percent excise tax on the unrealized gain inherent in the trust's assets,
- Trusts designed to avoid U.S. taxation of U.S. beneficiaries through the use of foreign grantors and the prior grantor trust rules,
- U.S. taxpaying beneficiaries who face a substantially increased tax burden on foreign trust distributions,
- U.S. beneficiaries of foreign trusts having outstanding loans to such beneficiaries or to related persons,

See "[Materials Available On-Line](#)" on page 13 for a list of and links to the legislative and administrative materials discussed in this bulletin.

- U.S. transferors to foreign trusts structured to avoid the U.S. grantor trust rules through the sale of property to the trust for installment obligations,
- Nonresident grantors and beneficiaries engaged in trust tax planning prior to immigration to the United States and
- U.S. recipients of gifts from foreign sources.

In addition, foreign trusts with U.S. grantors or beneficiaries, as well as those grantors and beneficiaries, are now subject to more burdensome U.S. information reporting requirements and increased penalties for noncompliance.

Trust Residence

Under prior law, the status of a trust as domestic or foreign depended upon the consideration of various factors—the location of trust assets, the jurisdiction under the laws of which the trust was created, the residence of the trust fiduciaries, the nationalities of the creator or settlor and beneficiaries and the location of the trust's administration. See, e.g., *Rev.Rul. 60-181, 1960-1 C.B. 257.*

The Act replaced this test with a two-prong objective test under which a trust is treated as a United States person if (i) a court within the United States is able to exercise primary supervision over the administration of the trust and (ii) one or more United States fiduciaries have the authority to control all substantial decisions of the trust. This new test applies to taxable years beginning after December 31, 1996 or, at the election of the trustee of a trust, to taxable years ending after August 20, 1996, the date of enactment of the Act. *Act § 1907(a) amending IRC § 7701(a)(30) and (31).*

In addition, the Act specifies that a domestic trust under prior law which becomes a foreign trust by virtue of the Act's provisions is treated as transferring all its assets to the foreign trust immediately prior to the change in status (whether on the first day of the taxable year beginning after December 31, 1996 or due to a trustee election). The trust is thus potentially subject to the 35 percent excise tax of Internal Revenue Code section 1491

on the deemed transfer of assets to the foreign trust. *Act § 1907(b)*.

Proposed Regulations

In the June 5, 1997 edition of the Federal Register, the Internal Revenue Service published a Notice of Proposed Rulemaking concerning new Procedure and Administrative Regulations section 301.7701-7, providing additional guidance on the new test for domestic status of a trust. A public hearing on the proposed regulations has been scheduled for September 16, 1997.

In addition to repeating the two-prong test of the statute, denominated the “court test” and the “control test,” the proposed regulations specify that once a trust is classified as foreign under those tests, the trust is subject to U.S. federal income taxation in the same manner as a nonresident alien individual. The proposed regulations then note that, as a result, Internal Revenue Code section 7701(b), containing objective residency tests, does not apply to the trust and that the trust is not considered present in the United States for purposes of Internal Revenue Code 871(a)(2), which subjects U.S.-source capital gains of nonresident alien individuals to U.S. tax when the individual is so present for 183 days or more during a taxable year. *Prop.Proc. & Admin.Reg. § 301.7701-7(a)*.

Safe Harbor

Because the IRS was concerned that a lack of applicable trust law authority might make it difficult to determine whether a court of a particular state would exercise primary supervision over the administration of a trust, the proposed regulations adopt a safe harbor based upon principles found in section 267 of the Restatement (2d) of Conflicts of Laws. Specifically, under the safe harbor a trust is a domestic trust if it has only United States fiduciaries, is administered exclusively within the United States pursuant to the terms of the trust instrument and is not subject to an automatic migration provision or “flee clause” (a provision under which the assertion of supervisory jurisdiction by a U.S. court, whether directly or indirectly, causes the trust to migrate from the United States). *Prop.Proc. & Admin.Reg. § 301.7701-7(c)*.

Court Test

In addition to defining relevant terms, “court,” “is able to exercise,” “primary supervision” and “administration,” the proposed regulations specify that the term “United States” is used in its geographic sense and is accordingly

limited to the states and the District of Columbia. Thus, a trust subject to supervision only by a court in a U.S. territory or possession does not satisfy the court test. *Prop.Proc. & Admin.Reg. § 301.7701-7(d)(1)*.

The proposed regulations also provide that the court test is satisfied in certain specific circumstances—(i) the trust is registered by an authorized fiduciary in a court within the United States under a state statute substantially similar to Article VII, Trust Administration, of the Uniform Probate Court, (ii) the trust is created pursuant to the terms of a will probated within the United States (other than ancillary probate) and all trust fiduciaries have been qualified by a court within the United States and (iii) the trust is other than a testamentary trust and the fiduciaries or beneficiaries take steps to cause the administration of the trust to be subject to the primary supervision of a U.S. court. *Prop.Proc. & Admin.Reg. § 301.7701-7(d)(2)*.

A trust does not fail the court test solely because a foreign court can also exercise primary supervision over the administration of the trust. Finally, a U.S. court cannot be regarded as having primary supervision over the administration of a trust if the trust instrument contains an automatic migration provision or “flee clause.” *Prop.Proc. & Admin.Reg. § 301.7701-7(d)(2)(iv) and (v)*.

Control Test

The proposed regulations define “substantial decisions” as decisions that are not ministerial; such decisions include—

- Whether and when to distribute income or corpus,
- The amount of any distributions,
- The selection of a beneficiary,
- The power to make investment decisions,
- Whether a receipt is allocable to income or principal,
- Whether to terminate the trust,
- Whether to compromise, arbitrate or abandon claims of the trust,
- Whether to sue on behalf of the trust or to defend suits against the trust and
- Whether to remove, add or replace a trustee.

In addition, substantial decisions do not include decisions exercisable by a grantor, unless the grantor is acting as a fiduciary, or by a beneficiary that affect solely the portion

of the trust in which the beneficiary has an interest, again unless the beneficiary is acting as a fiduciary. *Prop.Proc. & Admin.Reggs. § 301.7701-7(e)(1)*.

In the event of an inadvertent change in fiduciaries that would cause a change in the residency of a trust, the trust is allowed six months to change either the fiduciaries or the residence of the fiduciaries so as to avoid a change in trust status. Inadvertent changes include the death of a fiduciary or an abrupt resignation of a fiduciary. If the necessary changes are made within the six-month period to preclude a change in trust status, the trust retains its prior status during the entire six-month period. *Prop.Proc. & Admin.Reggs. § 301.7701-7(e)(2)*.

The proposed regulations also provide that U.S. fiduciaries are not considered to control all substantial decisions if the trust is subject to an automatic migration provision or “flee clause” under which any attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust no longer to be controlled by U.S. fiduciaries. *Prop.Proc. & Admin.Reggs. § 301.7701-7(e)(3)*.

Notice 96-65

In the Internal Revenue Bulletin for December 23, 1996, the IRS published Notice 96-65, 1996-52 I.R.B. 28, in which it—

- Grants trusts that meet specified conditions additional time to comply with the new domestic trust criteria contained in the Act and allows such trusts to continue to file as domestic trusts during that period,
- Addresses the time and manner for making the election to apply the new trust criteria of the Act retroactively and
- Provides guidance regarding the application of Internal Revenue Code sections 1491 through 1494 if the status of the trust changes from domestic to foreign.

Additional Time to Comply with New Domestic Trust Criteria

The IRS recognized that many existing domestic trusts may have difficulty in meeting the new domestic trust criteria prior to their first taxable year beginning after December 31, 1996. Accordingly, Notice 96-65 permits a domestic trust in existence on August 20, 1996 to continue

to file tax returns as a domestic trust for taxable years of the trust beginning after December 31, 1996 if—

- The trustee initiates modification of the trust to conform with the domestic trust criteria by the due date (including extensions) for filing the trusts’ income tax return for its first taxable year beginning after December 31, 1996,
- The trustee completes the modification within two years of that date and
- The trustee attaches a prescribed statement to the trust’s income tax return.

The prescribed statement must be entitled “Election to Rely on Notice 96-65 to File as a Domestic Trust,” must be attached to the trust’s income tax return for each taxable year that Notice 96-65 is relied upon to file as a domestic trust, must be signed under penalties of perjury by the trustee and must contain—

- A statement that the trust is relying on Notice 96-65 to file as a domestic trust for the taxable year,
- A statement that the trustee filed original income tax returns treating the trust as a domestic trust for each taxable year of the trust beginning after 1994, and will continue to file as a domestic trust while actions are being taken to meet the domestic trust criteria,
- The date on which actions to modify the trust to meet the domestic trust criteria were initiated and a brief description of both completed and forthcoming actions necessary to meet the domestic criteria,
- The name, taxpayer identification number and address of any U.S. person who, but for the relief provided in Notice 96-65, would be treated as the owner of all or any portion of the trust under Internal Revenue Code section 679 for any taxable year of the trust beginning after December 31, 1996 and
- A statement that, if the trust does not meet the domestic trust criteria by the end of the two-year relief period, the trustee will file all of the trust’s applicable returns (whether original or amended) for taxable years of the trust beginning after December 31, 1996, treating the trust as a foreign trust.

If an existing domestic trust fails to meet the new domestic trust criteria by the end of the relief period, not

only is the trust treated as a foreign trust for all taxable years beginning after December 31, 1996, but any U.S. person treated as owning all or a portion of the trust for any of such taxable years and any beneficiary whose tax liability was affected by the change in the trust's status must file amended returns correcting their U.S. federal income tax liability. If reasonable actions have been taken to meet the domestic trust criteria, but due to circumstances beyond the trustee's control the trust is unable to meet them by the end of the relief period, the pertinent IRS District Director, upon written application by the trust but in the sole discretion of the District Director, may grant the trust an extension of time.

Election to Apply New Trust Criteria Retroactively

A trust may elect to apply the new domestic trust criteria of the Act to its first taxable year ending after August 20, 1996 (rather than to its first taxable year beginning after December 31, 1996) by attaching a statement entitled "Election under Section 1907(a)(3)(B) of the Small Business Job Protection Act of 1996 to Apply New Trust Criteria Retroactively" to the trust's income tax return for its first taxable year ending after August 20, 1996. The statement must be signed under penalties of perjury by the trustee and contain—

- A statement that the trust is relying on Notice 96-65 to apply the new trust criteria for its first taxable year ending after August 20, 1996,
- A declaration stating whether the trustee has filed an original U.S. income tax return treating the trust as a domestic trust for any of the three immediately preceding taxable years and
- A declaration stating whether, during the election year, there has been a change in trust status.

If a trust changes status from domestic to foreign as a result of the election the trustee must also attach a statement agreeing to treat the change in trust status as a transfer of the trust's assets to a foreign trust for purposes of Internal Revenue Code section 1491, except to the extent the grantor or another person is treated as the owner of trust property when such trust becomes a foreign trust. In addition, if the election is made, the new trust criteria must be applied for the entire election year. For example, if a domestic trust having a calendar taxable year and a single foreign trustee elects to apply the new trust criteria to its 1996 taxable year, then the trust is treated as a foreign trust beginning on January 1, 1996.

Application of Sections 1491 through 1494

Notice 96-65 notes that the change in status of a trust from domestic to foreign may trigger application of the 35 percent excise tax of Internal Revenue Code section 1491; this excise tax is generally due and payable at the time of the deemed transfer of assets from the domestic to the foreign trust. It goes on to state that it is expected that regulations will be issued that will provide that any excise tax due in these circumstances may be paid by attaching Form 926 and any applicable excise tax to the trust's income tax return for the taxable year for which the transfer occurs. However, if the excise tax is not paid until filing of the trust's income tax return, interest must be paid on the amount of excise tax due for the period between the date of transfer and the date on which the excise tax is actually paid, computed at the rates generally applicable to underpayments. Notice 96-95 provides that taxpayers may now utilize this method to report and to pay any excise tax due until regulations are issued. Where a domestic trust has failed to meet the new domestic trust criteria by the end of the two-year relief period, the trustee must file a return on Form 926 and pay any excise tax and interest due no later than thirty days thereafter. Notice 96-65 provides that no penalties will be imposed if Form 926 is filed no later than the expiration of that thirty-day period.

Trusts with Foreign Grantors

Prior to the Act, U.S. beneficiaries of foreign trusts were not subject to U.S. federal income tax on trust distributions where a foreign person was treated under the so-called "grantor trust" rules as the owner of the trust property, irrespective of whether income tax was imposed by any jurisdiction on the income of the trust. As an exception to this general rule, a U.S. beneficiary of a foreign grantor trust who made a gift to the foreign grantor was treated as the owner of trust property to the extent of the gift. Another special rule provided that intermediaries or nominees interposed between foreign trusts created by U.S. persons and their U.S. beneficiaries could be disregarded.

Legislative Changes

The Act amends the grantor trust rules so that they apply only to the extent their application results in an amount being currently taken in account (directly or through one or more intermediate entities) in computing the income of a citizen or resident of the United States or

a domestic corporation. This new rule does not apply to, and a foreign grantor continues to be treated as the owner of, any portion of trust property if either (i) the power to revert in the grantor title to the property comprising such portion of the trust is exercisable solely by the grantor without the approval or consent of any other person or with the consent of a related or subordinate party who is subservient to the grantor or (ii) the only amounts distributable from such portion of the trust during the grantor's lifetime are distributable to the grantor or the grantor's spouse.

In addition, except as provided in implementing U.S. Treasury Department regulations, the new rule does not apply (i) to so-called "compensatory trusts" where distributions are taxable as compensation for services rendered, (ii) where the foreign grantor is a "controlled foreign corporation" (a "CFC") and (iii) for purposes of determining whether a foreign corporation is a "passive foreign investment company" (a "PFIC").

The Act retains but modifies prior law relating to gifts by a U.S. beneficiary of a foreign grantor trust to the foreign grantor. If the foreign grantor would be treated as the owner of trust property but for application of the new rule then the U.S. beneficiary in turn is treated as the owner of trust property to the extent of any transfer of property by the U.S. beneficiary to the foreign grantor, except transfers for full and adequate consideration and gifts qualifying for the annual gift tax exclusion of Internal Revenue Code section 2503(b). The Act also grants the IRS authority to recharacterize certain purported gifts from a partnership or foreign corporation. *Act § 1904(a) amending IRC § 672(f)*.

The Act also provides that, under regulations to be adopted by the U.S. Treasury Department, where a foreign person that would be treated as the owner of a trust but for the new rules actually pays tax on the income of the trust to a foreign country, U.S. beneficiaries that are subject to U.S. federal income tax on the same income will be treated, for foreign tax credit purposes, as having paid the foreign taxes. *Act § 1904(b) amending IRC §§ 665(d)(2), 901(b)(5)*.

The Act also expands the rule treating certain payments to U.S. beneficiaries derived from foreign trusts but made through intermediaries as made by the trusts directly so that it applies to any foreign trust of which the payor is not the grantor and not just to trusts created by U.S. persons. *Act § 1904(c) adding IRC § 643(h) and repealing IRC § 665(c)*.

The new rules took effect on August 20, 1996, the date of enactment of the Act, but do not apply to any trust the property of which is treated as owned by the grantor under Internal Revenue Code section 676 (power to revoke) or 677(a)(1) or (a)(2) (income for the benefit of the grantor) and which was in existence on September 19, 1995. This exception does not apply to the portion of any such trust attributable to any transfer after September 19, 1995. *Act § 1904(d)*. Under a special transition rule the 35 percent excise tax of Internal Revenue Code section 1491 is not to be imposed if as a result of the new rules any person other than a U.S. person ceases to be treated as the owner of a portion of a domestic trust and before January 1, 1997 such trust becomes a foreign trust or the assets of such trust are transferred to a foreign trust. *Act § 1904(e)*.

Proposed Regulations

The June 5, 1997 edition of the Federal Register also contains another IRS Notice of Proposed Rulemaking with respect to regulations implementing the foreign grantor trust provisions of the Act. A hearing on these proposed regulations is scheduled for August 27, 1997.

U.S. Inclusion Standard

The proposed regulations adopt an interesting test to determine whether and to what extent the application of the grantor trust rules results in any amount being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. The proposed regulations first define the "basic grantor trust rules" as the rules without regard to the changes made by the Act to Internal Revenue Code section 672(f). They next define "worldwide amount" as the net amount of income, gains, deductions and losses, computed in accordance with U.S. income tax principles, that would be taken into account for the current year under the basic grantor trust rules in computing the worldwide taxable income of any person and "U.S. amount" as the net amount of income, gains, deductions and losses that would be taken into account for the current year under the basic grantor trust rules (directly or through one or more entities) in computing the taxable income of a U.S. taxpayer. The trust is treated as owned by a foreign person based on an annual comparison at the end of the trust's taxable year of the worldwide amount and the U.S. amount. If the worldwide amount exceeds the U.S. amount, under Internal Revenue Code section 672(f) as revised by the Act, the foreign person is not treated as the owner of the portion of the trust attributable to such

excess. Otherwise, the basic grantor trust rules are applied without regard to the limitation of revised section 672(f). *Prop. Income Tax Regs. § 1.672(f)-1.*

Excluded Grantor Trusts

The proposed regulations augment the exception to the new rules for trusts where the power to revest absolutely in the grantor title to trust property is exercisable solely by the grantor without the approval or consent of any other person other than a related or subordinate party who is subservient to the grantor by providing that the power to revest must be exercisable for a period or periods aggregating 183 days or more during the taxable year of the trust. The proposed regulations also provide that a trust is not excepted from the new rules as a trust the only amounts distributable from which are distributable to the grantor or the spouse of the grantor if at any time after October 20, 1996 any amounts are distributable to any person other than the grantor or the grantor's spouse. The proposed regulations treat amounts distributed in discharge of a legal obligation of the grantor or the spouse of the grantor or in discharge of the grantor's or the grantor's spouse's obligation to support a family member as distributable to the grantor or the grantor's spouse. In the latter case, however, and because of different rules in different jurisdictions regarding support obligations, the supported family member must be a dependent of the grantor or the grantor's spouse (determined without regard to the percentage of the person's support provided by them) and either permanently and totally disabled or, in the case of a son, daughter, stepson or stepdaughter, less than 24 years old. *Prop. Income Tax Regs. § 1.672(f)-3(a) and (b).*

Compensatory Trusts

The proposed regulations provide that the only trusts which will be regarded as compensatory trusts, and thus excluded from application of the new rules, are (i) qualified pension trusts (IRC § 401(a)), (ii) governmental and tax-exempt organization deferred compensation trusts (IRC § 457(g)), (iii) certain nonexempt employees' trusts (IRC § 402(b)), (iv) individual retirement account ("IRA") trusts that are either simplified employee pensions (IRC § 408(k)) or simple retirement accounts (IRC § 408(p)), (v) IRA trusts to which the only contributions are rollover contributions (IRC § 408(a)(1)), (vi) certain so-called "rabbi trusts" and (vii) welfare benefit fund trusts (IRC § 419(e)), without regard to whether they provide taxable benefits. The proposed regulations also provide that the list of compensatory trusts can be expanded through the

publication of subsequent guidance in the Internal Revenue Bulletin. *Prop. Income Tax Regs. § 1.672(f)-(3)(c).*

Foreign Corporate Grantors

The proposed regulations also exercise the regulatory authority conferred by the Act with respect to exclusion from the new foreign grantor trust rules for trusts created by certain foreign corporations. For purposes of the new rules, a controlled foreign corporation is treated as a domestic corporation to the extent that income earned by the trust for the taxable year would be currently taken into account under the subpart F rules in computing the gross income of a citizen or resident of the United States or a domestic corporation if the basic grantor trust rules were applied. Similarly a passive foreign investment company is also treated as a domestic corporation to the extent that application of the basic grantor trust rules results in income earned by the trust for the taxable year being currently being taken into account under the passive foreign investment company rules in computing the gross income of a citizen or resident of the United States or a domestic corporation. In addition, for purposes of determining whether a foreign corporation is a passive foreign investment company the new rules of Internal Revenue Code section 672(f) are disregarded. Finally, a foreign personal holding company is treated as a domestic corporation to the extent that the basic grantor trust rules result in income earned by the trust for the taxable year being currently being taken into account under the foreign personal holding company rules in computing the gross income of a citizen or resident of the United States or a domestic corporation. *Prop. Income Tax Regs. § 1.672(f)-2.*

Purported Gifts

In exercising the regulatory authority granted by the Act with regard to purported gifts, the proposed regulations define a purported gift to mean any transfer by a partnership or foreign corporation (other than a transfer for fair market value) to a person who is not a partner in the partnership or shareholder of the foreign corporation. If any U.S. person directly or indirectly receives a purported gift from a partnership, the purported gift is included in the U.S. person's gross income as ordinary income. If a U.S. person directly or indirectly receives a purported gift from a foreign corporation, the purported gift is included in the U.S. person's gross income as if it were a distribution from the foreign corporation. For this purpose, the U.S. person is treated as having no basis in stock of the foreign corporation and as having a holding period for such stock on the date of the deemed

distribution equal to the weighted average of the holding periods of the actual interest holders. These new rules do not apply if the U.S. person receiving the purported gift can establish that a U.S. citizen or resident alien who directly or indirectly holds an interest in the partnership or foreign corporation treated the purported gift as a distribution to the U.S. partner or shareholder and a subsequent gift to the U.S. person. The new rules also do not apply to transfers to charitable organizations described in Internal Revenue Code section 170(c) nor during the taxable year of a U.S. person if the aggregate amount of purported gifts to such U.S. person does not exceed \$10,000. These rules are applicable for any transfer by a partnership or foreign corporation on or after August 20, 1996. *Prop. Income Tax Regs. § 1.672(f)-4.*

Intermediaries

The proposed regulations also provide that any amount of property derived directly or indirectly by a U.S. person from a foreign trust through an intermediary is treated as having been paid directly by the foreign trust to the U.S. person if—

- The intermediary is related (generally using a 10 percent test) to either the U.S. person or the foreign trust and the intermediary transfers to the U.S. person property that the intermediary received from the foreign trust or proceeds derived therefrom,
- The intermediary would not have transferred the property to the U.S. person (or would not have transferred the property to the U.S. person on substantially the same terms) but for the fact that the intermediary received property from the foreign trust or
- The intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax.

If an intermediary is disregarded and is an agent of the foreign trust then the payment is treated as paid to the U.S. person when the intermediary makes payment to the U.S. person. If, however, the intermediary is an agent of the U.S. person, the payment is treated as paid to the U.S. person when paid by the foreign trust to the intermediary. Where the intermediary is not an agent of the foreign trust or the U.S. person, the proposed regulations treat the intermediary as if it were an agent of the foreign trust. The new rules apply to transfers made by foreign trusts

on or after August 20, 1996, the date of enactment of the Act, but do not apply if during the taxable year of the U.S. person the aggregate amount transferred to such person from all foreign trusts through one or more intermediaries does not exceed \$10,000. *Prop. Income Tax Regs. § 1.643(h)-1.*

Existing Trusts

The proposed regulations implement the grandfather rule of the Act for trusts in existence on September 19, 1995 but require separate accounting with respect to transfers made to such trusts after September 19, 1995. *Prop. Income Tax Regs. §§ 1.672(f)-3(a)(2) and (b)(4).*

Foreign Nongrantor Trusts

Under prior law a distribution by a foreign nongrantor trust of previously accumulated income (income in excess of distributable net income for prior taxable years) was generally taxed at the U.S. beneficiary's average marginal rate for the prior five years plus interest. Interest was computed at a fixed annual rate of six percent with no compounding. A distribution was treated as an accumulation distribution out of income earned during the first year of the trust if adequate records of the trust were not available to determine proper application of the accumulation distribution rules. In addition, foreign nongrantor trusts were generally permitted to make loans to their beneficiaries without causing the principal amount of such loans to be taxable to the beneficiaries as income.

Legislative Changes

Accumulation Distributions

The Act changes the interest rate applicable to accumulation distributions, increasing it from six percent to the rate generally applicable to underpayments of tax, and provides for the compounding of interest. Simple interest continues to accrue at six percent through 1995, but thereafter, the new compounding rate applies not only to the tax amounts determined under the accumulation distribution rules but also to the simple interest accrued through 1995. Accumulation distributions are allocated proportionately to prior years in which the trust has undistributed net income (and during which the beneficiary receiving the distribution was a U.S. citizen or resident) rather than to the earliest of such years. An accumulation distribution is treated as reducing proportionately undistributed net income from prior years and the period for which the interest charge accrues is

determined by a formula which weights the prior years in proportion to the amounts of undistributed net income from such years. *Act § 1906(a) amending IRC § 668(a).*

Loans

The Act also provides that, except as provided in regulations, a loan from a foreign trust of cash or marketable securities directly or indirectly to any grantor or beneficiary of such trust who is a U.S. person (or to any U.S. person related to such grantor or beneficiary) is treated as a distribution by such trust to the U.S. grantor or beneficiary. This rule does not apply to organizations exempt from U.S. federal income tax. *Act § 1906(c) adding IRC § 643(i).*

Effective Dates

The changes made by the Act regarding accumulation distributions apply to distributions made after August 20, 1996, the date of enactment of the Act, while the new rules with respect to loans from foreign trusts apply to loans of cash or marketable securities made after September 19, 1995. *Act § 1906(d).*

Notice 97-34

In enacting the rules recharacterizing certain loans as trust distributions, Congress intended that the IRS would exclude from their application loans with arm's-length terms and that consideration would be given to whether a loan could reasonably be expected to be repaid. *See H.Rpt. 104-737, 104th Cong., 2d Sess., 334.* In section V(A) of Notice 97-34, 1997-25 I.R.B. 22, 28 (June 23, 1997), the IRS announced that forthcoming regulations will treat "qualified obligations" as not giving rise to deemed distributions under Internal Revenue Code section 643(i), as added by the Act. An obligation is a qualified obligation only if—

- The obligation is reduced to writing by an express written agreement,
- The obligation's term is no greater than five years,
- All payments on the obligation are denominated in U.S. dollars,
- The obligation's yield to maturity is neither less than 100 percent of the applicable federal rate (the "AFR") nor more than 130 percent of the AFR, as in effect on the date the obligation is issued,
- The U.S. person who would be affected were the loan treated as a distribution extends the applicable

statute of limitations for assessment of any U.S. federal income tax attributable to the loan for each year that the loan is outstanding to a date no earlier than three years following the obligation's maturity and

- The U.S. person reports the status of the obligation, including payments of principal and interest, on IRS Form 3520 (which the IRS is revising and retitling "Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") for each year the obligation is outstanding.

No extension of the statute of limitations is required for the taxable year the obligation matures if it is paid in due course.

Notice 97-34 provides special rules to be used in determining the term of an obligation in the case of a series of loans by the trust or where loans are "rolled over." If an obligation ceases to be a qualified obligation, the trust is treated as making a distribution at that time, unless the pertinent IRS District Director determines that the distribution should be treated as occurring earlier (for example, where upon issuance it was known or should have been known that the obligation would not be repaid).

U.S. Grantor Foreign Trusts

Under prior law, a U.S. person that transferred property to a foreign trust was regarded as the owner of that portion of the trust comprising the property for any taxable year in which there was a U.S. beneficiary of any portion of the trust. There were exceptions to this rule in the case of transfers by reason of death, transfers made before the transferor became a U.S. person and transfers representing sales or exchanges at fair market value where gain was recognized by the transferor. Concern was expressed that this latter exception was subject to potential abuse through the use of installment sale arrangements where it was not expected that the installment obligation would ultimately be satisfied.

Legislative Changes

Sale or Exchange Exception

The Act retains the sale or exchange exception but provides that in determining whether a transfer is at fair market value certain obligations are not taken into account except as otherwise provided in regulations. The obligations which are to be disregarded are obligations of or guaranteed by the trust, any grantor or beneficiary of

the trust or any person related to any grantor or beneficiary of the trust. *Act § 1903(a) amending IRC § 679(a)(2)(B) and adding IRC § 679(a)(3).*

Change in Status

The Act also provides that any nonresident alien individual who transfers property, either directly or indirectly, to a foreign trust and then within five years becomes a resident of the United States is treated as making a transfer to the foreign trust on the individual's "residency starting date" (as defined in Internal Revenue Code section 7701(b)(2)(A)). The amount of the deemed transfer is the portion of the trust (including undistributed earnings) attributable to the previously transferred property. Thus, the individual would then generally be regarded as the owner of that portion of the trust in any taxable year during which the trust has U.S. beneficiaries. *Act § 1903(c) adding IRC § 679(a)(4).* A beneficiary is not to be regarded as a U.S. person in applying these rules with respect to any transfer of property to a foreign trust if that beneficiary first becomes a U.S. person more than five years after the transfer. *Act § 1903(d) adding IRC § 679(c)(3).* Finally, the Act treats an individual citizen or resident of the United States who transfers property to a domestic trust which thereafter becomes a foreign trust while such individual is alive as making a transfer to the foreign trust on the date of its change of status equal to the portion of the trust (including undistributed earnings) attributable to the previously transferred property. Thus, that individual would then generally be regarded as the owner of that portion of the trust in any taxable year during which the trust had U.S. beneficiaries. *Act § 1903(c) adding IRC § 679(a)(5).*

Effective Date

The Act's changes in the rules treating U.S. persons as the owners of foreign trusts apply to transfers of property after February 6, 1995. *Act § 1903(g).*

Notice 97-34

In revising the sale or exchange exception, Congress intended that the IRS would permit loans with arm's-length terms to be taken into account in determining whether fair market value was received. *See H.Rpt. 104-737, 104th Cong., 2d Sess., 334, 335.* Thus, in Section III(C) of Notice 97-34, 1997-25 I.R.B. 22, 23 (June 23, 1997), the IRS announced that forthcoming regulations will permit qualified obligations (with

essentially the same definition and subject to the same special rules as applies under Internal Revenue Code section 643(i) in the case of loans from foreign trusts) to be taken into account under Internal Revenue Code section 679 in determining whether fair market value is received in exchange for a transfer of property. *See "Foreign Nongrantor Trusts—Notice 97-34," above.*

Information Reporting and Associated Penalties

Under prior law, information reporting was required (i) by any U.S. person creating or transferring property to a foreign trust, whether a grantor or nongrantor trust, (ii) annually by any U.S. person transferring property to a foreign trust having U.S. beneficiaries and (iii) by any U.S. person making a transfer described in Internal Revenue Code section 1491 (relating to transfers to foreign corporations, partnerships, estates and trusts). Any person required but failing to report the creation of or transfer of property to a foreign trust was potentially subject to a penalty of five percent of the value of the amount transferred. Similarly, any person required but failing to file an annual return with respect to a foreign trust with U.S. beneficiaries was potentially subject to a penalty of five percent of the value of the trust's corpus at the end of the taxable year. Congress was concerned that many U.S. persons were ignoring their reporting obligations and that secrecy laws in foreign jurisdictions were preventing the IRS from obtaining information necessary for the proper determination of U.S. federal income taxes owed by U.S. grantors and beneficiaries of foreign trusts.

Legislative Changes

Information Reporting

The Act expands the information reporting regime and requires a "responsible party" to report any "reportable event" within 90 days of its occurrence (or such later time as is prescribed in regulations). A "reportable event" is (i) the creation of any foreign trust by a U.S. person, (ii) the direct or indirect transfer of money or property to a foreign trust by a U.S. person, including a transfer by reason of death, or (iii) the death of a U.S. citizen or resident if the decedent was treated as the owner of any portion of a foreign trust or any portion of a foreign trust is included in the decedent's gross estate. A sale or exchange for fair market value is not a reportable event, but in determining whether fair market value is received the rules relating to trust obligations in Internal Revenue

Code section 679 apply. See “U.S. Grantor Foreign Trusts—Legislative Changes—Sale or Exchange Exception” and “U.S. Grantor Foreign Trusts—Notice 97-34,” above. A “responsible person” is the grantor in the case of creation of an inter vivos trust, the transferor in the case of a transfer to foreign trust (other than by reason of death) and the executor of the decedent’s estate in all other cases. *Act § 1901(a) amending IRC § 6048(a).*

The Act also requires any U.S. person who at any time during the person’s taxable year is treated under the grantor trust rules as owning any portion of a foreign trust to ensure that (i) the trust files a U.S. return for the year setting forth a full and complete accounting of the trust’s operations and the name of the trust’s U.S. agent and (ii) the trust furnishes required information to U.S. grantors and direct and indirect U.S. recipients of trust distributions. In addition, unless a foreign trust with a U.S. grantor appoints a U.S. agent to act for the trust regarding any IRS request to examine records or to take testimony, or any summons for records or testimony, the IRS may determine the tax consequences of amounts to be taken into account under the grantor trust rules, subject to judicial review only under an arbitrary and capricious standard. The Act does provide that the appearance of persons or production of records owing to the existence of a U.S. agent of the foreign trust does not subject such persons or records to legal process for any purpose other than determining the correct amounts to be taken into account under the grantor trust rules and that the appointment of a U.S. agent will not in and of itself cause the foreign trust to be regarded as having a U.S. permanent establishment or as being engaged in a U.S. trade or business. *Act § 1901(a) amending IRC § 6048(b).*

Any U.S. person receiving a distribution from a foreign trust, whether directly or indirectly, is now required to file a return for the taxable year of the distribution setting forth, among other information, the name of the trust and the aggregate amount of distributions received from the trust during the taxable year. If adequate records are not provided to the IRS to determine the proper treatment of any foreign trust distribution, it is treated as an accumulation distribution with the interest charge computed for a period equal to one-half the number of years of the foreign trust’s existence. *Act § 1901(a) amending IRC § 6048(c).*

Penalties

The Act increases the penalties applicable to failures to file required information under Internal Revenue Code

section 6048 to be 35 percent of the “gross reportable amount” (five percent in the case of a failure by a U.S. grantor to comply with Internal Revenue Code section 6048(b)). If the reporting failure continues for more than 90 days after notice from the IRS an additional penalty of \$10,000 is imposed for each ensuing 30-day period (or portion thereof) during which the failure continues. However, the penalty cannot exceed the “gross reportable amount,” defined as (i) the gross value of the property involved in the case of a failure to comply with Internal Revenue Code section 6048(a) (transfers by U.S. persons), (ii) the gross value of the portion of the trust treated as owned by the U.S. grantor in the case of a failure to comply with Internal Revenue Code section 6048(b) (annual reports by foreign trusts with U.S. grantors) and (iii) the gross amount of the distribution in the case of a failure to comply with Internal Revenue Code section 6048(c) (reports by U.S. recipients of foreign trust distributions). The penalty is subject to a reasonable cause exception. *Act § 1901(b) amending IRC § 6677.* The Act also imposes a new penalty for failure to file a return regarding a transfer described in Internal Revenue Code section 1491, determined under Internal Revenue Code section 6677 as if the failure were one to file a report required under Internal Revenue Code section 6048(a). *Act § 1902(a) adding IRC § 1494(c).*

Effective Dates

The Act’s new reporting rules and penalties are effective—

- To reportable events under Internal Revenue Code section 6048(a) and Internal Revenue Code section 1491 transfers occurring after August 20, 1996, the date of enactment of the Act,
- To taxable years of U.S. persons beginning after December 31, 1995 in the case of annual trust returns required by Internal Revenue Code section 6048(b) and
- To distributions received after August 20, 1996, in the case of reporting by U.S. beneficiaries under Internal Revenue Code section 6048(c). *Act §§ 1901(d), 1902(b).*

Notice 96-60

Following enactment of the Act, the IRS published Notice 96-60, 1996-49 I.R.B. 7 (December 2, 1996), which announced that no return under Internal Revenue Code section 6048(a) (reportable events) or 1494(c) (Internal

Revenue Code section 1491 transfers) need be filed any earlier than 60 days following issuance by the IRS of subsequent guidance regarding those provisions.

Notice 97-18

In Notice 97-18, 1997-10 I.R.B. 35 (March 10, 1997), the IRS provided the additional guidance contemplated by Notice 96-60 with respect to Internal Revenue Code section 1491 transfers. The Notice provides in section II(A) that such a transfer need not be reported under Internal Revenue Code section 1494 on IRS Form 926 if—

- The U.S. transferor recognizes the full amount of gain in the transferred property (fair market value less adjusted basis) at the time of the transfer and
- Neither the U.S. transferor nor any related person (as defined and generally utilizing a 10 percent standard) has a significant interest in the transferee after the transfer.

Notice 97-18 is also intended to avoid duplicative reporting and thus reporting under Internal Revenue Code section 1494 is not required with respect to transfers to foreign trusts which are also reportable under Internal Revenue Code section 6048(a) (reportable events). See “*Notice 97-34*,” below. However, Form 926 must be filed if the transfer results in imposition of the 35 percent excise tax under Internal Revenue Code section 1491. *Notice 97-18 § II(B)(4)*.

Notice 97-18 provides that in accordance with existing regulations taxpayers may continue to file Form 926 on the day of any transfer reportable under Internal Revenue Code section 1494 or may, until new regulations are issued, file the form with the transferor’s annual tax or information return for the taxable year of the transfer. *Notice 97-18 § III(A)*. However, interest accrues from the date of the transfer and at the rate generally applicable to underpayments on any excise tax due. *Notice 97-18 § III(D)*. An election under Internal Revenue code section 1057 to recognize gain in lieu of paying the 35 percent excise tax can also be made on Form 926 filed with the transferor’s tax return for the taxable year which includes the transfer date. *Notice 97-18 § III(B)*. When reporting transfers on Form 926 each item of appreciated property must be separately identified if the full amount of gain is not recognized on the transfer; reportable transfers of money or other property with no gain or with respect to which the transferor recognizes the full amount of gain can be aggregated within specified categories on a

statement attached to Form 926. *Notice 97-18 § III(C)*. The form on which nongratuious transfers to foreign trusts are to be reported under Internal Revenue Code section 1494 has apparently been changed to Form 3520. See “*Notice 97-34*,” below.

In accordance with Notice 96-60, section VIII of Notice 97-18 provides that no penalties will be imposed under Internal Revenue Code section 1494(c) if Form 926 is filed by the later of the due date (including extensions) of the U.S. transferor’s income tax return for the taxable year in which the transfer occurs or May 9, 1997 (the date 60 days following publication of Notice 97-18 on March 10, 1997). This relief was further extended in Notice 97-42, 1997-29 I.R.B. 12 (July 21, 1997) which provides that, in addition, no such penalty will apply with respect to Form 926 for the taxable year which includes August 20, 1996 if that form is attached to the taxpayer’s timely filed (including extensions) income tax return for the first taxable year beginning on or after January 1, 1997 as long as the taxpayer’s tax return for the taxable year which includes August 20, 1996 includes items of gross income required to be taken into account as a result of an election on Form 926 (for example, any gain resulting from an election under Internal Revenue Code section 1057).

Notice 97-34

The IRS has provided guidance on compliance with the information reporting rules of Internal Revenue Code section 6048 in Notice 97-34, 1997-25 I.R.B. 22 (June 23, 1997). The IRS first notes that revised Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts, will be issued to allow U.S. persons to utilize a single form to comply with the new reporting rules and that Form 3520-A will also be revised to allow foreign trusts to satisfy the reporting requirements of Internal Revenue Code section 6048(b). *Notice 97-34 § I*.

The Notice provides that gratuitous transfers to foreign trusts are reportable on Form 3520 under Internal Revenue Code section 6048(a) and repeats the rule that nongratuious transfers are reportable under Internal Revenue Code section 1494 if the transferor does not immediately recognize gain on the transfer or the transferor is related to the trust. The Notice states that because full fair market value is not received when a taxpayer elects to recognize gain under Internal Revenue Code section 1057, transfers for which that election is made are treated as gratuitous. In addition, the Notice

modifies Notice 97-18 by specifying that nongratuities transfers to foreign trusts reportable under Internal Revenue Code section 1494, as well as elections to recognize gain under Internal Revenue Code section 1057 on such transfers, should be reported or made on Form 3520. *Notice 97-34 § III.*

Section IV of Notice 97-34 specifies the information which must be included by a foreign trust with a U.S. grantor on current Form 3520-A until revised Form 3520-A is available and contains a form of authorization for a U.S. agent of the foreign trust.

Section V of Notice 97-34 contains special rules designed to implement the provisions of Internal Revenue Code section 6048(c) which treat distributions as accumulation distributions if adequate records are not provided. Adequate records are provided if the U.S. beneficiary obtains from the foreign trust either a Foreign Grantor Trust Beneficiary Statement (an item required under section IV of the Notice) or a Foreign Nongrantor Trust Beneficiary Statement (containing specified information). In the absence of such statements, if the U.S. beneficiary can produce information regarding actual distributions from the foreign trust for the preceding three years, the U.S. beneficiary can treat the current year's distribution as a distribution of current income to the extent of average trust distributions for those prior three years; any excess is then treated as an accumulation distribution.

Section VIII of Notice 97-34 provides that in order to avoid penalties under Internal Revenue Code section 1494(c) or 6677, Form 3520 must be attached to the taxpayer's timely filed (including extensions) income tax return. A copy of Form 3520 must generally also be sent to the IRS Philadelphia Service Center by the same date. However, with respect to Form 3520 for the taxable year which includes August 20, 1996, no penalties will be imposed if either (i) Form 3520 is filed with the Philadelphia Service Center no later than November 15, 1997 or (ii) Form 3520 is attached to the taxpayer's timely filed (including extensions) income tax return for the first taxable year beginning on or after January 1, 1997 as long as the taxpayer's income tax return for the taxable year which includes August 20, 1996 reflects the information included on Form 3520. This relief is comparable to that contained in Notice 97-42. *See "Notice 97-18," above.* Similarly, no penalties will be imposed on a U.S. grantor of a foreign trust if the trust files Form 3520-A with the Philadelphia Service Center no later than the 15th day of the third month following the close of the trust's taxable

year (or later if pursuant to a valid extension). With respect to Forms 3520-A for taxable years which include August 20, 1996, the due date is extended to October 15, 1997 or to the due date of Form 3520-A for the first taxable year of the trust beginning on or after January 1, 1997 as long as the U.S. grantor reflects the information on Form 3520-A for 1996 on the grantor's income tax return for the taxable year which includes August 20, 1996.

Reporting of Foreign Gifts

Prior to the Act there was no requirement that U.S. persons report gifts or bequests from foreign sources. Such a requirement has now been imposed on any U.S. person (other than certain tax-exempt organizations) who receives purported gifts or bequests from foreign sources totaling more than \$10,000 during a taxable year. The \$10,000 reporting threshold is indexed for inflation. If a U.S. person fails to report foreign gifts without reasonable cause, the IRS is authorized to determine the tax treatment of the purported gifts, subject to judicial review only under an arbitrary or capricious standard. In addition, the U.S. person is subject to a penalty equal to five percent of the amount of the gift for each month for which the failure to report continues, limited to 25 percent of the amount of the foreign gift. This new reporting requirement applies to amounts received after August 20, 1996, the date of enactment of the Act. *Act § 1905 adding IRC § 6039F.*

Notice 97-34

Section VI of Notice 97-34, 1997-25 I.R.B. 22, 30 (June 23, 1997), provides additional guidance with regard to reporting by U.S. recipients of foreign gifts. It states that reporting will be required on an annual basis on Form 3520 but that it is expected that (i) Form 3520 will only require the reporting of general information necessary to determine whether a purported gift is properly classified as a gift for income and (ii) the form will not require information on the identity of the foreign donor unless that foreign donor is a partnership or foreign corporation or is acting as a nominee or intermediary for such an entity.

The Notice also establishes reporting thresholds based upon the status of the donor. A U.S. person is required to report the receipt of gifts from a nonresident alien or foreign estate only if the aggregate amount of gifts from that nonresident alien or foreign estate exceeds \$100,000 during the taxable year. Once that threshold has been met, Form 3520 will require the donee to identify each separate gift in excess of \$5,000, but will not require the identification of the donor. On the other hand, a U.S.

person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of purported gifts from all such entities exceeds \$10,000 (as adjusted for inflation) during the taxable year. Once that threshold has been met, Form 3520 will require the donee to identify separately all purported gifts from a foreign corporation or foreign partnership and to identify the donor. For purposes of determining whether a threshold has been met, a U.S. person must aggregate gifts from foreign persons the U.S. person knows or has reason to know are related. *Notice 97-34 § VI(B)*.

Materials Available On-Line

Readers who are using Acrobat Reader 3.0 (or an Acrobat 3.0-enabled web browser) to review this bulletin can obtain the legislative and administrative materials listed below simply by following the link embedded in each list item. Alternatively, the html version of this bulletin at www.pmstax.com/intl/bull9707.html contains links to the material or it can be obtained via ftp in the intl/ftsr9707 directory at <ftp.pms.tax.com> (file names and sizes are indicated in the list below).

- [Small Business Job Protection Act of 1996](#), P.L. 104-188, §§ 1901-1907 [pl104188.pdf, 39K].
- [Conference Committee Report](#), H.Rpt. 104-737, pp. 330-338 [h104737.pdf, 93K].
- [House Ways & Means Committee Report \(H.R. 3286\)](#), H.Rpt. 104-542, part 2, pp. 23-34 [h104542.pdf, 168K].
- [Notice of Proposed Rulemaking, Residence of Trusts and Estates](#), Federal Register, June 5, 1997, pp. 30796-30800 [pr7701.pdf, 41K].
- [Notice of Proposed Rulemaking, Inbound Grantor Trusts with Foreign Grantors](#), Federal Register, June 5, 1997, pp. 30785-30796 [pr672f.pdf, 132K].
- [Notice 96-60](#), 1996-49 Internal Revenue Bulletin, December 2, 1996, pp. 7-8 [n9660.pdf, 24K].
- [Notice 96-65](#), 1996-52 Internal Revenue Bulletin, December 23, 1996, pp. 28-30 [n9665.pdf, 25K].
- [Notice 97-18](#), 1997-10 Internal Revenue Bulletin, March 10, 1997, pp. 35-40 [n9718.pdf, 56K].
- [Notice 97-34](#), 1997-25 Internal Revenue Bulletin, June 23, 1997, pp. 22-32 [n9734.pdf, 103K].
- [Notice 97-42](#), 1997-29 Internal Revenue Bulletin, July 21, 1997, p. 12 [n9742.pdf, 40K].
- [IRS Form 926](#), April 1996 [f926.pdf, 41K].
- [IRS Form 3520](#), June 1995 [f3520.pdf, 33K].
- [IRS Form 3520-A](#), August 1995 [f3520a.pdf, 40K].