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May 17, 2016

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
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Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
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Mr. Thomas West
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Internal Revenue Service
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Washington, DC 20224

Re: IRS Proposed Regulations on Guidance Under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests From Covered Expatriates (REG-112997-10)

Dear Messrs. Koskinen, Wilkins, West and Wilson:

The American Institute of CPAs (AICPA) is submitting the attached comments to the Department of the Treasury (Treasury) and the Internal Revenue Service (IRS or "Service") on proposed regulations providing guidance under section[1] 2801 regarding the imposition of tax on certain gifts and bequests from covered expatriates. The proposed regulations relate to a tax on United States (US) citizens and residents who receive gifts or bequests from certain individuals who relinquished United States citizenship or ceased their status as lawful permanent residents of the United States on or after June 17, 2008.

The AICPA is the world's largest member association representing the accounting profession, with more than 412,000 members in 144 countries and a history of serving the public interest since 1877. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium size businesses, as well as America's largest businesses.

In the attached comments, we provide the following recommendations:

- Allow marital and charitable deductions for outright distributions from a non-electing foreign trust.
- Recognize a Crummey power holder as a donee of the gift.

[1] All references herein to "section" or "§" are to the Internal Revenue Code of 1986, as amended, or the Treasury Regulations promulgated thereunder.

- Define date of receipt.
- Allow a US recipient to elect to treat and report a covered bequest as received on the date of death to avoid a second appraisal.
- Define value of received property.
- Allow a covered expatriate to elect to treat a gift as a gift or bequest of a US situs asset.
- Allow an electing foreign trust to challenge valuations.
- Eliminate the double taxation on US situs assets.
- Allow cash basis taxpayers to accrue the section 164 deduction for the section 2801 tax payable with respect to a distribution.
- Clarify the charitable remainder trust (CRT) provisions.
- Exclude the charitable income interest of a charitable lead trust (CLT) from the definition of a covered gift or bequest.
- Provide that a taxpayer can determine the amount of the charitable lead payments for a qualified charitable lead annuity trust (CLAT) or the first year payment of a qualified charitable lead unitrust (CLUT) after taking into account the amount of the tax imposed by section 2801.
- Provide simpler and more practicable rules to determine the taxable amount of distributions from a non-electing foreign trust and to calculate the amount of distribution from a covered gift or covered bequest.
- Clarify whether section 643 deemed distribution rules apply to section 2801 with regard to loans and uncompensated use of foreign trust property.
- Allow separate accounting for a non-electing foreign trust.
- Provide a form or certification, documenting whether a donor is a covered expatriate.
- Clarify that the regulations take into account treaties and that conflicting treaty provisions prevail over the statute.

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We welcome the opportunity to discuss these comments or answer any questions that you may have. You can reach me at (801) 523-1051, or at tlewis@sisna.com; or you may contact Evelyn Capassakis, Chair of the AICPA Section 2801 Estate Tax Expat Task Force, at (646) 471-2363, or evelyn.capassakis@pwc.com; Mary Kay Foss, Chair of the AICPA Trust, Estate & Gift Tax Technical Resource Panel, at (925) 648-3660 or marykay@cpaskllp.com; or Eileen Sherr, Senior Manager – AICPA Tax Policy & Advocacy, at (202) 434-9256, or at esherr@aicpa.org.

Sincerely,

Troy K. Lewis, CPA, CGMA
Chair, Tax Executive Committee

cc: Ms. Catherine Veihmeyer Hughes, Estate and Gift Tax Attorney Advisor, Office of Tax Policy, Department of the Treasury
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THE AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

COMMENTS ON PROPOSED REGULATIONS ON GUIDANCE UNDER SECTION 2801 REGARDING THE IMPOSITION OF TAX ON CERTAIN GIFTS AND BEQUESTS FROM COVERED EXPATRIATES

(REG-112997-10)

MAY 17, 2016

In the below comments, we provide the following recommendations:

- Allow marital and charitable deductions for outright distributions from a non-electing foreign trust.
- Recognize a *Crummey* power holder as a donee of the gift.
- Define date of receipt.
- Allow a US recipient to elect to treat and report a covered bequest as received on the date of death to avoid a second appraisal.
- Define value of received property.
- Allow a covered expatriate to elect to treat a gift as a gift or bequest of a US situs asset.
- Allow an electing foreign trust to challenge valuations.
- Eliminate the double taxation on US situs assets.
- Allow cash basis taxpayers to accrue the section 164 deduction for the section 2801 tax payable with respect to a distribution.
- Clarify the charitable remainder trust (CRT) provisions.
- Exclude the charitable income interest of a charitable lead trust (CLT) from the definition of a covered gift or bequest.
- Provide that a taxpayer can determine the amount of the charitable lead payments for a qualified charitable lead annuity trust (CLAT) or the first year payment of a qualified charitable lead unitrust (CLUT) after taking into account the amount of the tax imposed by section 2801.
- Provide simpler and more practicable rules to determine the taxable amount of distributions from a non-electing foreign trust and to calculate the amount of distribution from a covered gift or covered bequest.

- Clarify whether section 643 deemed distribution rules apply to section 2801 with regard to loans and uncompensated use of foreign trust property.

- Allow separate accounting for a non-electing foreign trust.

- Provide a form or certification, documenting whether a donor is a covered expatriate.

- Clarify that the regulations take into account treaties and that conflicting treaty provisions prevail over the statute.

I. Proposed Reg. § 28.2801-3, Rules and Exceptions Applicable to Covered Gifts and Covered Bequests

A. Allow Marital and Charitable Deductions for Outright Distributions from a Non-electing Foreign Trust

Issue: The proposed regulations provide that marital and charitable deductions do not apply to distributions from non-electing foreign trusts.

Background:

Proposed Reg. § 28.2801-5(a): The section 2801 tax is imposed on a US recipient who receives distributions, whether of income or principal, from a foreign trust to the extent the distributions are attributable to one or more covered gifts or covered bequests made to that foreign trust.

Proposed Reg. § 28.2801-4(a)(3): A foreign trust that receives a covered gift or covered bequest is not liable for payment of the section 2801 tax unless the trust makes an election for treatment as a domestic trust. Absent such an election, each US recipient is liable for payment of the section 2801 tax on that person's receipt, either directly or indirectly, of a distribution from the foreign trust to the extent that the distribution is attributable to a covered gift or covered bequest made to the foreign trust.

Proposed Reg. § 28.2801-3(c)(4): A transfer from a covered expatriate to the covered expatriate's spouse is not a covered gift or covered bequest to the extent a marital deduction under section 2523 or section 2056 would have been allowed if the covered expatriate had been a US citizen or resident at the time of the transfer.

Proposed Reg. § 28.2801-3(c)(3): A gift to a donee described in section 2522(b) or a bequest to a beneficiary described in section 2055(a) is not a covered gift or covered bequest to the extent a charitable deduction under section 2522 or section 2055 would have been allowed if the covered expatriate had been a US citizen or resident at the time of the transfer.

Analysis:

Distributions to a US spouse or US charity from a foreign non-electing trust do not qualify for the marital or charitable deduction even if a gift or bequest made outright from the covered expatriate at the time of distribution would have qualified.

Distributions to a US spouse or US charity from a foreign non-electing trust are different than transfers to or from a domestic trust because the date of the taxable transfer is different.

Recommendations:

The IRS should deem an outright distribution from a foreign non-electing trust to a US citizen spouse to qualify for the marital deduction if an outright gift to such spouse would have qualified for the marital deduction, given that such a distribution is in effect an "indirect acquisition of property" by the surviving spouse within the meaning of Prop. Reg. § 28.2801-2(i).

The IRS should deem an outright distribution from a foreign non-electing trust to a US charity to qualify for the charitable deduction if an outright gift to charity would have qualified for the charitable deduction. (Prop. Reg. § 28.2801-2(i)).

The IRS should allow a spouse to make a QTIP or QDOT election in order to qualify distributions from the foreign non-electing trust for the marital deduction under section 2056 or section 2523.

B. Recognize a *Crummey* Power Holder as a Donee of the Gift

Issue: Section 2801 treats a domestic trust as a donee of a covered gift or covered bequest and allows only a single annual exclusion.

Background:

Proposed Reg. § 28.2801-3(d): A covered gift from a covered expatriate is deemed made to a domestic trust, without regard to the beneficial interests in the trust or whether any person has a general power of appointment or a *Crummey* power.

In such case, if there are two *Crummey* power holders, there is only one $14,000 exclusion. If, however, the transfer is made to a foreign trust, and the foreign trust makes two distributions to two different recipients, under section 2801, there are two $14,000 exclusions.

Similarly, if a covered gift or covered bequest is made to multiple domestic trusts, each trust is entitled to one annual exclusion, regardless of who the beneficiaries are.

Analysis:

There is no authority to permit the redefinition of the donee to exclude the *Crummey* power holder as donee. For gift tax purposes, the gift is deemed made to the *Crummey* power holder,

even if through a trust. Therefore, the section 2801 rules should also follow the gift tax rules, as described in Prop. Reg. § 28.2801-3(a).

At a minimum, if either the *Crummey* power holder is a US person, or if the power holder actually exercises the power, the IRS should deem the gift as made directly to the power holder, thereby qualifying each donee for a separate $14,000 annual exclusion. Consider that if the power is exercised, the trust may not have the funds from the gift to pay tax imposed on the trust.

Recommendation:

IRS should recognize a *Crummey* power holder as the donee of the gift to a domestic trust to conform to gift tax rules, and avoid treating similarly situated taxpayers differently, depending on the form of the gift.

II. Proposed Reg. § 28.2801-4, Liability for and Payment of Tax on Covered Gifts and Covered Bequests; Computation of Tax

A. Define Date of Receipt

Issue: This issue has two parts.

Because the tax imposed by section 2801 is imposed on the donee, the IRS should not treat the date of receipt of a covered gift as the date when the donor parts with dominion and control (as in the case of a gift), but rather the time when dominion and control is received by the donee.

Also, IRS should treat the amount of a covered gift as the value of what the donee actually receives and not include any "phantom gift" that might be taxable to a donor as a result of the application of Chapter 14. Otherwise, the donee will have no funds to pay the tax imposed on the donee.

Background:

Proposed Reg. § 28.2801-4(d)(1): The section 2801 tax is imposed upon the receipt of a covered gift or covered bequest by a US resident.

Proposed Reg. § 28.2801-4(d)(2): The date of receipt of a covered gift is the same as the date of the gift for purposes of chapter 12 as if the covered expatriate had been a US citizen at the time of the transfer.

Proposed Reg. § 28.2801-4(d)(3): The date of receipt of a covered bequest is the date of distribution from the estate or the decedent's revocable trust rather than the date of death of the covered expatriate. However, for property passing on the death of the covered expatriate by operation of law, beneficiary designation or other contractual agreement, the date of receipt is the date of death.

Analysis:

Treasury Reg. § 25.2511-2(a) provides the "gift tax is not imposed upon the receipt of the property by the donee . . . nor is it conditioned upon ability to identify the donee at the time of the transfer. On the contrary, the tax is a primary and personal liability of the donor . . . and attaches regardless of the fact that the identity of the donee may not then be known or ascertainable."

Treasury Reg. § 25.2511-2(b) provides that a gift is complete on the date the donor has "so parted with dominion and control as to leave him no power to change its disposition."

Treasury Reg. § 25.2511-2 provides that the gift tax is imposed on the date of transfer while under section 2801, the tax is imposed on the date of receipt.

Treasury Reg. § 25.2511-2 signifies the recognition of Treasury and the IRS that the date of transfer and the date of receipt are not necessarily the same date.

Proposed Reg. § 28.2801-4(d)(2) references the date of a gift under chapter 12 as the date of receipt for purposes of section 2801; however, section 2501 imposes gift tax on the date of transfer.

The proposed regulations adopt different timing rules for a covered bequest depending upon whether the bequest is received under a will or by operation of law or other means. Clarification is needed as to which rule applies in particular circumstances.

Recipients of future interests become subject to the section 2801 tax before they have the economic benefit of the property (e.g., remainder interest in a life estate) possibly leaving such recipients without the ability to pay the tax when it is due.

There is no definition of "date of receipt" for property passing under a civil law jurisdiction where title may transfer upon the date of death but actual distributions do not occur until after a period of administration (often referred to as "a meeting of the community of heirs").

Recommendations:

In defining the date of receipt of a covered gift, the regulations should use language similar to the language used in section 170(a)(3) regarding the date of a charitable contribution of a future interest (i.e., treat the property as received when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by others).

In defining the date of receipt, the regulations should include the date when the recipient derives a "substantial economic benefit" from the property as such term is used in *Commissioner v. Hackl*, 118 T. C. 279 (Mar. 27, 2007) (i.e., the IRS should treat the date of receipt as the date the recipient receives noncontingent, independently exercisable rights of substantial economic benefit).

IRS should add "as of the date of receipt" to the 3rd sentence under Prop. Reg. § 28.2801-4(c) in order for it to read as follows: "As in the case of chapters 11 and 12, the fair market value of a covered gift or covered bequest is the price *as of the date of receipt* 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."

B. Allow a US Recipient to Elect to Treat and Report a Covered Bequest as Received on the Date of Death to Avoid a Second Appraisal

Issue: The date of receipt of a covered bequest is different for transfers under a will than for transfers by operation of law, and the appropriate application of the rules is not clear in some circumstances. In addition, the timing rules may require an additional appraisal for some assets.

Background:

Proposed Reg. § 28.2801-4(d)(3) provides the rules for determining when a covered bequest has been received and the method for valuing the bequest.

The general rule is that the section 2801 tax applies in the year the US recipient receives the covered bequest from the decedent's estate or revocable trust.

However, if the US recipient receives the property by operation of law, a beneficiary designation or some similar contractual relationship, then IRS will deem the receipt to have occurred at the time of the covered expatriate's death.

Analysis:

The meaning of "operation of law" and "time of receipt" are not clear. For example, in civil law, forced heirship jurisdictions, title "vests" in beneficiaries at death, but the executor may defer time of possession until claims are settled.

Where compliance with other tax laws requires that the executor determine the date of death value, using a different date for imposing the section 2801 tax may require a second appraisal.

Recommendations:

IRS should permit the US recipient the option to treat the covered bequest as having been received as of the date of the covered expatriate's death.

IRS should provide clarity as to the meaning of "operation of law."

C. Define Value of Received Property

Issue: The proposed regulations state that Chapter 14 applies to covered gifts. Sections 2701 and 2702 should not apply to covered gifts because the rules should not tax a donee on a phantom asset.

Background:

This discussion pertains to Prop. Reg. § 28.2801-4(c).

The value of a covered gift or covered bequest is the fair market value ("FMV") of the property as of the date of its receipt by the US recipient (see Prop. Reg. § 28.2801-4(d) for date of receipt).

FMV is the price at which property would change hands between a willing buyer and willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts (estate and gift tax definition of FMV).

The proposed regulations state that the FMV of a covered gift is determined in accordance with the federal gift tax valuation principles of section 2512 and chapter 14 and corresponding regulations.

FMV of a covered bequest is determined by applying the federal estate tax valuation principles of sections 2031, 2703 and 2704 and corresponding regulations, but without regard to sections 2032 and 2032A.

Analysis:

In general, the purpose of sections 2701 and 2702 is to prevent estate freezes executed by US citizens and residents designed to transfer property to certain related parties under circumstances where Chapter 12 valuation principles do not properly reflect the economic value transferred to such related parties.

IRS should base the value of property subject to the section 2801 tax on the FMV in the hands of the recipient, not on the value transferred by the covered expatriate. For example, if a covered expatriate retains a life estate and transfers the remainder to US heirs, the IRS should tax the amount of the gift to the donee on the value of the remainder; not the full value of the property as the IRS might if the donor were taxed under Chapter 14. Under these circumstances, the IRS should consider the gift to be received when the prior interest terminates, because the donee will have no funds with which to pay the tax until then.

Recommendations:

The regulations should create an exception to sections 2701 and 2702 for covered gifts.

At a minimum, the regulations should create an exception to sections 2701 and 2702 for a covered gift that is not US situs property since such property is not otherwise subject to US estate or gift tax unless it passes to a US person in the future, at which time the IRS should subject it to the tax under section 2801.

D. Allow a Covered Expatriate to Elect to Treat a Gift as a Gift or Bequest of a US Situs Asset

Issue: The effective tax rate on a covered gift is much higher than the tax rate of a gift.

Background:

The gift tax is tax exclusive, and the tax imposed by section 2801 is calculated on the gross amount transferred, i.e. it is tax inclusive.

If a covered expatriate makes a gift of US situs property, timely reports the gift, and timely pays the gift tax, the effective tax rate is lower.

Recommendations:

Rather than "require" a covered expatriate to use US situs assets to make a gift in order to lower the tax, allow the covered expatriate to elect to treat an asset as US situs for this purpose.

Regarding covered gifts, allow a covered expatriate to elect into the US gift tax regime and pay gift tax on a transfer-by-transfer basis. This approach would bring gifts by covered expatriates directly to US individuals in line with transfers to foreign trusts, which the IRS allows an election to treat as domestic trusts for purposes of section 2801 (see II.E., below).

E. Allow an Electing Foreign Trust to Challenge Valuations

Issue: The proposed regulations do not allow trustees of electing foreign trusts to challenge valuations and require potentially burdensome information reporting.

Background:

Section 2801(e)(4)(B)(iii) provides that for purposes of section 2801, a foreign trust may elect treatment as a domestic trust.

If elected, the trust is subject to tax on: (A) all covered gifts and bequests received by the trust during that calendar year; (B) the portion of the trust attributable to covered gifts and bequests in prior years; and (C) all covered gifts and bequests in future years as long as the election is in effect.

Upon election, the trustee must comply with certain information reporting requirements, including notifying the IRS of US beneficiaries who are permissible beneficiaries of the trust.

Annual reporting is required.

If the IRS disputes the value of a covered gift or bequest, the IRS will issue a letter that details the disputed information and the recalculated tax.

If the additional tax, interest and penalties are not paid, the trust's election is terminated retroactively to the year of the gift in question.

Analysis:

Information reporting is burdensome and intrusive, particularly in the case of a foreign trust with many discretionary beneficiaries.

It does not appear that there is any ability for the trustee to challenge an IRS disagreement as to valuation. If the IRS disputes the value of a covered gift or covered bequest, or otherwise challenges the computation of the section 2801 tax, the IRS will issue a letter (but not a notice of deficiency as defined in section 6212) that details the disputed information and the proper amount of section 2801 tax including interest and penalties.

Recommendations:

The regulations should not require the reporting of discretionary beneficiaries who have not received distributions during the relevant period.

The regulations should provide that trustees of an electing foreign trust can challenge valuations. We recommend that the IRS issue a notice of deficiency as defined in section 6212, rather than an uncontestable letter as provided in the regulations. We note that section 6212 provides that the IRS is authorized to send a notice of deficiency with respect to certain taxes, including Subtitle B (which encompasses section 2801). The notice of deficiency would allow the trustee to challenge the IRS's valuation under usual procedural rules.

F. Eliminate the Double Taxation on US Situs Assets

Issue: Covered gifts and covered bequests of US situs assets are exposed to double tax if the gift or estate tax is not timely reported and timely paid.

Background:

Section 2801 is not imposed on gifts or bequests of US situs assets by covered expatriates only if the gift or bequest is timely reported and the gift or estate tax is timely paid.

However, payment of the section 2801 tax does not eliminate the obligation to pay the US gift or estate tax, and the untimely payment of such tax does not allow the person who paid the section 2801 tax to obtain refund. The US gift and estate tax liability attaches not only to the covered expatriate or his or her estate, but also to a transferee if the donor or decedent's estate does not pay the tax due.

The transferee is likely the same individual or trust on whom the section 2801 tax is imposed. See section 6324.

In addition, section 6324 imposes a lien on the property so that the IRS can collect the gift or estate tax from a subsequent transferee.

Analysis:

There is no mechanism for a donor or decedent's estate to obtain a credit for the section 2801 tax paid by the recipient or for a refund of the section 2801 tax. Thus, the IRS may impose two taxes on the same transfer.

Recommendation:

The IRS should provide in the final regulations a provision to avoid double tax on the same transfer.

G. Allow Cash Basis Taxpayers to Accrue the Section 164 Deduction for the Section 2801 Tax Payable with Respect to a Distribution

Issue: The proposed regulations do not allow a cash basis taxpayer an income tax deduction for tax under section 2801 until it is paid.

Background:

Section 2801(e)(4)(B)(ii) allows a deduction under section 164 for the section 2801 *tax paid or accrued* by a US citizen or resident by reason of a distribution from a foreign trust to the extent that the distribution is included in gross income. This provision is addressed at Prop. Reg. § 28.2801-4(a)(3)(ii).

Analysis:

The proposed regulations do not allow a cash basis taxpayer receiving a covered gift of foreign trust income to deduct the section 2801 tax imposed on that income until it is paid.

Because the section 2801 tax is due in a year subsequent to the year in which the income tax is due, the deduction does not offset the income tax on the same distribution.

A cash basis taxpayer will pay income tax on more than the net benefit he/she receives and could potentially lose the benefit of the deduction.

Recommendation:

The regulations should allow a cash basis taxpayer to deduct tax "accrued" but not yet paid as permitted by the statute.

H. Clarify the Charitable Remainder Trust (CRT) Provisions

Issue 1: Payment of the tax imposed by section 2801 by a charitable remainder unitrust (CRUT) will reduce the unitrust amount payable to its income recipients, but it is not clear whether the accrued and unpaid tax can similarly reduce the unitrust amount payable.

Background:

Section 664(d)(2)(A) and Treas. Reg. § 1.664-3(a)(1)(i)(a) define a CRUT as a trust that pays an amount (computed by multiplying the net fair market value of the trust's assets by a fixed percentage) to a non-charitable beneficiary at least annually for a term specified in the trust agreement. Once the specified term has ended, the remainder interest is payable to a qualified charitable remainder beneficiary.

Section 2801(e)(4)(A) requires that the trust pay the tax imposed by section 2801 on a domestic trust.

Analysis:

As a domestic trust, a CRT must pay the tax on the covered gift or bequest it receives. This treatment reduces the assets available to generate the return necessary to pay a CRUT's income recipients.

Recommendation:

The regulations should permit the taxpayer to take into account the amount of tax due under section 2801, even if not yet due and payable, in arriving at the net fair market value of the trust assets.

Issue 2: Payment of the tax imposed by section 2801 by a charitable reimainder annuity trust (CRAT) may cause it to fail the exhaustion test described in Rev. Rul. 70-452, 1970-2 C.B. 199.

Background:

Section 664(d)(1)(A) and Treas. Reg. § 1.664-2(a)(1)(i) define a CRAT as a trust that pays a sum certain to a non-charitable beneficiary at least annually for a term specified in the trust agreement. Once the specified term has ended, the remainder interest is payable to a qualified charitable remainder beneficiary.

Rev. Rul. 70-452 requires that a CRAT must pass an exhaustion test designed to ensure that there is no greater than a five percent probability that the trust will exhaust before the end of its term.

A key factor in determining whether a CRAT will pass the Rev. Rul. 70-452 exhaustion test is the amount of payments made from the trust during its term.

Analysis:

Failure to take the section 2801 tax into account in computing the annuity amount of a CRAT may result in the trust failing the exhaustion test.

Further, where a CRAT by its terms fails to pass the exhaustion test, one remedy is to reduce the annuity amount. However, the annuity amount may not be less than five percent of the net fair market value of the assets initially transferred to the CRAT. See section 664(d)(1)(A). Given the tax rate on covered transfers, it is likely that the taxpayer would need to reduce the annuity amount to an amount much less than 5 percent of the net fair market value of the assets initially transferred to the trust in order to pass the Rev. Rul. 70-452 exhaustion test.

Recommendation:

For both (i) the purpose of determining whether a CRAT's annuity amount is greater than or equal to five percent of the net fair market value of the initial transfer to the trust, and (ii) whether a CRAT passes the Rev. Rul. 70-452 exhaustion test, the taxpayer should reduce the net fair market value of the initial transfer to the CRAT by the accrued section 2801 tax.

Issue 3: The regulations fail to designate whether a taxpayer should allocate the payment by a CRT of the tax imposed by section 2801 to a particular category of income or to corpus.

Background:

Proposed Reg. § 28.2801-4(a)(2)(iii): A domestic trust qualifying as a CRT is subject to the section 2801 tax when it receives a covered gift or covered bequest. However, the regulations do not provide guidance on the category to which the taxpayer should allocate the section 2801 tax.

Section 664(b) and Treas. Reg. § 1.664-1(d)(1) define a unique ordering rule used to characterize beneficiary distributions from a CRT.

Treasury Reg. § 1.664-1(d)(2) provides guidance on the allocation of deductions and non-deductible expenses to categories and classes of income. In particular, certain types of non-deductible expenses, including the tax on unrelated business taxable income, are charged to the corpus.

Analysis:

The regulations fail to designate to which category a CRT's payment of the tax imposed by section 2801 is allocated.

Recommendation:

The regulations should clarify that the tax under section 2801 is charged to the corpus. Since the section 2801 tax is imposed on the CRT (and not its beneficiaries), the section 2801 tax should be charged to corpus.

Issue 4: The proposed regulations do not allow a section 2801(c) amount for CRTs with multiple income beneficiaries.

Background:

Section 2801(c) provides that the taxable amount on which the section 2801 tax is imposed is the amount that "exceeds the dollar amount in effect under section 2503(b)" (the annual exclusion amount), which at present is $14,000.

Proposed Reg. § 28.2801-4(b)(2) provides that in arriving at net covered gifts and covered bequests, the total value of all covered gifts and bequests is reduced by the section 2801(c) amount.

Proposed Reg. § 28.2801-4(a)(2)(iii) provides that the value of the covered gifts and bequests to a CRT is equal to the present value of the income interest as determined by reference to the regulations under section 664.

Analysis:

Where a CRT has more than one income beneficiary that is a non-charitable US citizen or resident, it is possible to compute the value of the income interest of each such non-charitable beneficiary. Notwithstanding the ability to compute the value of each income beneficiary's income interest, the proposed regulations only permit one section 2801(c) amount.

Recommendation:

IRS should amend the regulations to permit a section 2801(c) amount for each income beneficiary.

Note that the taxpayer could achieve the same result by creating a separate CRT for each income recipient.

I. Exclude the Charitable Income Interest of a Charitable Lead Trust (CLT) from the Definition of a Covered Gift or Bequest

Issue: Unlike CRTs, the proposed regulations do not provide for the exclusion of the charitable interest created upon formation of the CLT from the definition of covered gift. See Prop. Reg. § 28.2801-4(a)(2)(iii) for the rule applicable to CRTs.

Background:

A CLT is a type of trust described in IRC section 2522(c)(2)(B) that makes distributions no less than annually to a person or for a purpose described subsections 2522(a) or (b). Accordingly, a qualified CLT has both a charitable income interest and a noncharitable remainder interest.

Proposed Reg. § 28.2801-4(a)(2)(iii) specifically excludes the value of the charitable remainder in a CRT but not the value of the charitable income interest in a CLT from the definition of a covered gift or bequest.

Analysis:

Without a specific exclusion of the charitable income interest of a CLT from the definition of a covered gift, the amount of covered gifts subject to the tax imposed by section 2801 will equal the total value of the transfer to the CLT.

Recommendation:

IRS should amend the regulations to exclude the charitable income interest in a CLT from the definition of covered gifts and bequests.

J. Provide that a Taxpayer can Determine the Amount of the Charitable Lead Payments for a Qualified Charitable Lead Annuity Trust (CLAT) or the First Year Payment of a Qualified Charitable Lead Unitrust (CLUT) After Taking into Account the Amount of the Tax Imposed by Section 2801

Issue: Payment of the tax imposed by section 2801 by a CLT may either reduce the value of the trust such that it will exhaust the trust assets before the expiration of its term (in the case of a CLAT) or reduce its principal so as to impair its ability to make meaningful charitable lead payments for the full term of the trust (in the case of a CLUT).

Background:

A qualified CLT must make payments in the form of a guaranteed annuity amount or unitrust amount each year to a charitable recipient described in sections 2055(a) or 2522(a) or (b). The taxpayer may express the guaranteed annuity amount as a stated amount or as a percentage of the value of the assets initially transferred to the trust. Similarly, the unitrust amount is computed as a percentage of the value of the assets held in the trust on a given day each year, generally the first day of the taxable year.

Proposed Reg. § 28.2801-3(d) states that "[t]he US recipient of a covered gift or a covered bequest to a domestic trust or an electing foreign trust *is the domestic or electing foreign trust* ..." (emphasis added).

Section 2801(e)(4)(A) requires the trust pay that the tax imposed by section 2801 on a domestic trust.

Because the CLT is liable for the tax imposed by section 2801, it necessarily follows that fewer assets will exist to support the required annuity or unitrust payment during the term of the trust.

Analysis:

Because a CLAT must pay its charitable recipients a stated annuity amount, the requirement that a qualified CLAT make an annuity payment based on the value of the assets transferred in trust rather than the amount of the assets transferred net of the tax imposed by section 2801 creates a risk that the trust assets will be exhausted before the expiration of the trust term and, therefore, harm the charitable income beneficiary. Moreover, if the trust assets are exhausted, the remainder beneficiaries will receive nothing when the basis of the tax in the first place was predicated on the notion that the remainder beneficiaries would receive some amount of assets.

Further, the requirement that the taxpayer compute the first year payment of a CLUT on the basis of the value of the assets transferred in trust rather than the amount of the assets transferred net of the tax imposed by section 2801 may create a large initial payment that reduces the trust corpus in a manner that detrimentally affects the size of future payments, thereby harming the charitable income beneficiary.

Recommendation:

IRS should amend the regulations to permit the computation of a CLT's required annuity amount or unitrust amount based on the value of the transfer to the the trust net of the tax imposed by section 2801.

III. Proposed Reg. §28.2801-5, Foreign Trusts

A. Provide Simpler and more Practicable Rules to Determine the Taxable Amount of Distributions from a Non-electing Foreign Trust and to Calculate the Amount of Distribution from a Covered Gift or Covered Bequest

Issue 1: If a taxpayer cannot prove that a distribution from a foreign trust is not attributable to a covered gift or bequest, the IRS may subject the entire distribution to the section 2801 tax. We suggest that the IRS establish rules to make it simpler to avoid this result where all of the information that is necessary to determine the taxable amount is not available.

Background:

Proposed Reg. § 28.2801-5(c): When a non-electing foreign trust has received covered gifts and covered bequests, as well as contributions that were not covered gifts or covered bequests, the amount of each distribution from the non-electing foreign trust that is considered attributable to covered gifts and bequests is determined by a "section 2801 ratio." The ratio, which is redetermined after each contribution to the trust, is computed in accordance with the regulations, and requires that the trustee has maintained detailed historical records of the trust funding and has knowledge as to whether or not the transfers to the trust were from a covered expatriate. If the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio, or if the US recipient is unable to obtain the necessary information with regard to the foreign trust, the IRS will subject the entire distribution to section 2801.

The proposed regulations request practitioners to comment on "How to calculate the amount of a distribution from a foreign trust that is attributable to a covered gift or covered bequest if the US recipient does not have adequate books and records or information available to make such a determination."

Analysis:

There are many concerns for a trustee and beneficiary of a foreign trust regarding the US taxation of distributions. A foreign trust may have been in existence for a number of years and may have had multiple fiduciaries over the years.

Recommendations:

In the absence of detailed historical records, the IRS should permit the trustee to use a reasonable method and estimate the section 2801 ratio based upon available information, such as contributions by others, and reasonable assumptions as to growth rates, prior year distributions, and other relevant information.

Where appropriate, in lieu of the section 2801 ratio, the IRS should allow the trustee to create separate accounts or separate shares to determine whether a distribution is attributable to a covered gift or bequest. See III.C. for further discussion of this recommendation.

Issue 2: The interplay between a distribution from a non-electing foreign trust and application of the "throwback" rules in sections 665 through 668 is unclear.

Background:

When a distribution from a foreign trust is a distribution of undistributed net income (UNI), it results in a throwback tax plus interest. The total tax and interest is limited to the amount of the distribution according to section 668(b).

Analysis:

A section 2801 tax imposed on the same distribution could result in total tax in excess of distribution.

Recommendation:

We recommend that Treasury and the IRS clarify the interaction of sections 2801 and section 668(b) and limit the total tax including throwback tax, interest and section 2801 tax in order that the total tax does not exceed the amount of the distribution.

Issue 3: Distribution from a non-electing foreign trust is determined on a fractional basis.

Analysis:

There is no ability for tracing or trust severance, etc.

Recommendation:

See comments regarding separate accounting above and below in section III.C.

Issue 4: The IRS's retroactive termination of a foreign trust's election due to value dispute or failure to file annual Form 708 will cause an additional reporting burden on beneficiaries.

Background:

Section 2801(e)(4)(B)(iii) provides that for purposes of section 2801, a foreign trust can elect treatment as a domestic trust.

Proposed Reg. § 28.2801-2(d)(2): An electing foreign trust is a foreign trust that has in effect a valid election to be treated as a domestic trust solely for purposes of section 2801.

Proposed Reg. § 28.2801-5(d)(2): If elected, the trust is subject to tax on: (A) all covered gifts and bequests received by the trust during that calendar year; (B) the portion of the trust attributable to covered gifts and bequests in prior years; and (C) all covered gifts and bequests in future years as long as the election is in effect.

Proposed Reg. § 28.2801-5(d)(4)(ii): An election for treatment as an electing foreign trust is terminated either by the failure of the foreign trust to file Form 708 annually or to pay timely any possible additional section 2801 tax with respect to recalculations due to disputed amounts of section 2801 tax owed.

Analysis:

Retroactive termination will require recalculation of the section 2801 portion of the trust and will require beneficiaries to file amended returns.

Recommendations:

The regulations should permit a trustee to cure late filing of Form 708 and avoid termination of election.

The regulations should allow a trustee to challenge IRS valuation and avoid termination due to an imperfect election.

B. Clarify Whether Section 643 Deemed Distribution Rules Apply to Section 2801 with Regard to Loans and Uncompensated Use of Foreign Trust Property

Issue: Clarification is needed regarding whether taxpayers may treat loans from a foreign non-electing trust to a US beneficiary or the uncompensated use by a US beneficiary of property owned by a foreign non-electing trust as a distribution for purposes of section 2801.

Background:

Proposed Reg. § 28.2801-5(a): The section 2801 tax is imposed on a US recipient who receives distributions, whether of income or principal, from a foreign trust to the extent the distributions are attributable to one or more covered gifts or covered bequests made to that foreign trust.

Proposed Reg. § 28.2801-5(b): Distribution means any direct, indirect, or constructive transfer from a foreign trust.

Analysis:

Section 2801 fails to define the term "distribution." Section 2801 further does not give the Secretary the authority to issue regulations that expand the breadth of the statute beyond the intention of Congress. Thus, the Secretary may only issue regulations that are interpretive of the statute.

Proposed Reg. § 28.2801-5(b): A distribution means any direct, indirect or constructive transfer from a trust. It provides no further explanation of the term. Specifically, it fails to state whether a loan from a foreign trust or the uncompensated use of property from a foreign trust is a distribution for purposes of section 2801. It has been reported that Treasury and the IRS take the postion that the term "distribution under section 2801" does encompass loans and the uncompensated use of property much the same way as section 643(i) treats these items as distributions.

If Prop. Reg. § 28.2801-5(b) is revised to clarify that such loans or use of property are considered distributions, it must further provide guidelines regarding how to determine the amount of the distribution that is subject to the section 2801 tax.

If Prop. Reg. § 28.2801-5(b) treats a loan from a foreign trust as a distribution, the regulations should address how the IRS will treat the repayment of the loan.

Recommendations:

Section 643(i) is an income tax concept and should not apply to section 2801 as the statutory language does not address loans and the uncompensated use of property and such items are normally not treated as distributions from a trust (but for the specific statutory provision in section 643(i)).

If the regulations provide that section 643(i) does apply:

- The IRS should allow non-electing foreign trusts to use the qualified obligation rules under Notice 97-34, 1997-1 C.B. 422, in order that bona fide loans fall outside the scope of section 2801.

- For administrative ease with respect to uncompensated use of foreign trust property, a safe harbor provision should apply; for example, the regulations could provide that: (1) if the value of the uncompensated use is less than the annual exclusion amount in effect under 2503(b); or (2) if the use of the property is less than 30 days in a calendar year, the IRS would not subject it to the section 2801 tax, and no reporting would be required.

The regulations should also provide guidance for determining the value of the uncompensated use of foreign trust property.

C. Allow Separate Accounting for a Non-Electing Foreign Trust

Issue: The "section 2801 ratio" computation for non-electing foreign trusts is complex.

Background:

Proposed Reg. § 28.2801-5(c)(1): When a non-electing foreign trust has received covered gifts and covered bequests, as well as contributions that were not covered gifts or covered bequests, the amount of each distribution from the non-electing foreign trust that is considered attributable to covered gifts and bequests is determined by a "section 2801 ratio." The ratio, which is redetermined after each contribution to the trust, is computed in accordance with the regulations, and requires that the trustee has maintained detailed historical records of the trust funding and has knowledge as to whether or not the transfers to the trust were from a covered expatriate. If the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio, or if the US recipient is unable to obtain the necessary information with regard to the foreign trust, the IRS will subject the entire distribution to section 2801.

To determine the amount attributable to covered gifts or bequests, a fractional share approach is used, identical to the one used to determine the inclusion ratio of a trust for generation-skipping transfer tax purposes.

The proposed regulations solicit comments on how the taxpayer should calculate the amount attributable to covered gifts or bequests if the taxpayer lacks necessary information to determine the taxable amount.

Analysis:

The formula for calculating tax is very complicated because it requires revaluation of all trust assets each time a contribution to the trust is made that may affect the proportion of the trust that is taxable.

Recommendations:

The IRS should consider as an alternative to the fractional share approach, which is quite difficult, allowing trustees to create separate shares for the portions of the trust representing covered gifts and bequests, in a manner analogous to the separate accounting rule in Treas. Regs. §1.672(f)-3(b)(3) and 1.672(f)-3(d).

Also, the IRS should not subject property to the fractional share rule where such property contributed to a trust is specifically earmarked under the trust for a particular beneficiary or a particular share of a trust. See Treas. Reg. §1.663(c)-3 dealing with the separate share rule for trusts. We note that the easier it is for a trustee to provide the required information, the greater the likelihood that the trustee will comply.

IV. Proposed Reg. § 28.2801-7, Determining Responsibility under Section 2801

A. Provide a Form or Certification, Documenting Whether a Donor is a Covered Expatriate

Issue: It is unclear how donees will fulfill the requirement that they obtain documentation regarding whether a donor is a covered expatriate.

Background:

Proposed Reg. § 28.2801-7(a): It is the responsibility of the donee or beneficiary of a foreign trust to ascertain whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest.

Analysis:

We recognize that in order to ensure the appropriate collection of tax under section 2801, the donor must provide some documentation to the donee in order to determine whether the donor is a covered expatriate.

We also acknowledge that taxpayer privacy and the exponential growth in identity theft are issues that the IRS should consider when formulating how the taxpayer should provide this documentation.

Recommendations:

We should look first to existing rules and forms for possible solutions to requesting taxpayer information and certification of taxpayer status so that the donee may accurately report the gift and pay the necessary tax, if applicable.

- The first approach is to utilize Form 8821, *Tax Information Authorization*, which the IRS could modify to include a section authorizing the IRS to share only that the donor is, or is not, a covered expatriate for a given tax period based on the donor's filings. The IRS would

not require any other information, and, thus, the donee would not have access to any unnecessary donor tax information. This method would work for any years in which the donor has filed an income or gift tax return.

- A second approach is to use a Form W-8 certification modified to add a section indicating the donor is or is not a covered expatriate, including the year(s) covered. This method would work for all years, including those in which a donor has not yet filed or has neglected to file an income tax return.

- If the IRS is not able to modify either of these forms and there are no other appropriate forms, the IRS should consider creating a form specifically for certification by the donor of covered expatriate status.

- Finally, if the donor files a US gift tax return and provides a copy to the donee, the IRS should provide an allowable presumption by the donee that the donor is not a covered expatriate.

V. Other Issues

A. Clarify that the Regulations Take Into Account Treaties and that Conflicting Treaty Provisions Prevail Over the Statute

Issue: Clarification is needed as to whether section 2801 overrides treaties.

Background:

The provisions of section 2801 conflict with the provisions of most or all US estate and gift tax tax treaties. If the treaties prevail, then in cases where the competent authority ("CE") is entitled to the benefit of the treaty, the IRS may impose no tax under section 2801 on transfers to US individuals from a covered expatriate.

Courts ruled in two landmark cases that taxpayers should broadly construe a conflict between an estate tax treaty and a later-enacted statute in favor of the treaty, where the legislative history of the statute was silent (as it is in this case). See *Burghardt Est.*, 80 T.C. 705 (1983), and *Mudry v. US*, 86-2 USTC para. 13,706 (where Congress had replaced the lifetime estate tax exemption in 1976 with a unified credit, and where an existing estate tax treaty allowed the estate of a treaty-country domiciliary in calculating US estate tax on US-situs assets to claim a pro rata lifetime exemption, *held* that the treaty in effect allowed the estate to claim a pro rata unified credit under the new law).

Analysis:

Some commentators argue (incorrectly, in our view) that the enactment of section 2801 had the effect of overriding the provisions in those treaties that conflict with it. This argument is based on an interpretation of section 7852(d)(1) (enacted in 1988), which provides that where a federal statute conflicts with a post-8/16/1954 tax treaty, "neither the treaty nor the law shall have

preferential status," and that a "later in time" rule should apply where the legislative history of the later-enacted statute is silent on how to resolve a conflict with a tax treaty.

Examples in the proposed regulations specifically assume that no treaty applies to the facts in the example. Taxpayers may infer that there is no treaty override because otherwise the statement in the examples is irrelevant. However, more assurance on this point is needed.

Failure to clarify how to resolve the conflict between section 2801 and tax treaties is unfair to US individuals who may receive transfers in the future from "covered expatriates" who are residents in a tax treaty country, without knowing whether the transfer is taxable or not.

Recommendation:

The regulations should state that treaties are to prevail when there is a conflict between section 2801 and a treaty.

APPENDIX:

H.. Miscellaneous Foreign Provisions

1.. Relationship with treaties (sec. 112(aa) of the bill, Title VII and Title XII of the Reform Act, and sec. 7852 of the Code)

Present Law

Relationship of statutes and treaties in general

. . .

Treaty-statute interactions in other cases

Notwithstanding Congress' intent that the Act and income tax treaties be construed harmoniously to the extent possible, conflicts other than those addressed in this bill or in the Act ultimately may be found or alleged to exist. Similarly, conflicts between treaties and other acts of Congress affecting revenue are likely to be found **4833 or alleged to exist in the future, either with respect to existing or future treaties and statutes. The bill provides that for purposes of determining the relationship between a provision of a treaty and any law of the United States affecting revenue, neither the treaty nor the law shall have preferential status by reason of its being a treaty or a law. In adopting this rule, the committee intends to permanently codify (with respect to tax-related provisions) present law to the

effect that canons of construction applied by the courts to the interaction of two statutes enacted at different times apply also in construing the interactions of revenue statutes and treaties enacted and entered into at different times. The committee does not intend this codification to alter the initial presumption of harmony between, for example, earlier treaties and later statutes. Thus, for *322 example, the bill continues to allow an earlier ratified treaty provision to continue in effect where there is not an actual conflict between that treaty provision and a subsequent revenue statute (i.e., where it is consistent with the intent of each provision to interpret them in a way that gives effect to both). Nor does the committee intend that this codification blunt in any way the superiority of the latest expression of the sovereign will in cases involving actual conflicts, whether that expression appears in a treaty or a statute.

. . .

The committee believes that, in view of this incentive to bring meritorious cases to light, the residual later-in-time rule may have allowed the identification of virtually all cases where there would have been an application of that rule that violates the spirit of a treaty, so that the Act and the bill actually conflict with treaties in very few if any inappropriate cases. The committee believes that *327 codification of the equality of statutes and treaties will similarly help prevent assertion of hypertechnical treaty claims that have no basis in the spirit of the treaty. The committee believes that in order for this clarification to have its intended practical effect on taxpayers, it is necessary to enact the provision requiring that where a taxpayer takes a position relying on a treaty in a case where the application of a later-enacted statutory rule would call for a different result absent a treaty, disclosures will be made adequate to alert the IRS to the issue.

FN29. 101 S.Ct. 549, 66 L.Ed.2d 513.

On the other hand, the committee believes that this bill's rule is preferable to the introduced bill's residual override. Although the introduced bill was generally intended to ensure the application of the judicially recognized doctrine regarding the superiority of the latest expression of the sovereign will as it was believed that doctrine would apply to the 1986 Act and its technical corrections, principally with the view of clarifying that doctrine and placing on taxpayers the burden of justifying any departure from the prima facie intent of a subsequently enacted statute, the committee is concerned that the introduced bill would have changed the rules by which the United States adheres to its international agreements. The committee believes that it is in everyone's best interests that this concern be alleviated, so long as the Congress and the Executive branch can be assured that treaty claims affecting later-enacted statutes can be promptly brought to the attention of both branches of government.

As stated above, the committee does not believe that codifying the equality of treaties and statutes changes what the committee perceives to be the present law analysis for resolving treaty/statute interactions. For example, assume that an income tax treaty provides for a 5 percent withholding tax (rather than the statutory rate of 30 percent) to be applied to dividend payments from a U.S. person to a person eligible for benefits under the treaty, and Congress **4839 subsequently repeals the Code and reenacts it without specifically stating the effect of the repeal and reenactment on treaties. (Such a repeal and reenactment was contained in the House version of H.R. 3838, the legislative history of

which provided that earlier treaties were to prevail over reenacted provisions.) Although the 30 percent withholding rate is contained in a later statute, under the bill the reduced treaty rate would likely continue to have effect on the ground that the intent of Congress in enacting the subsequent statute was not to change then-current rates of withholding. By contrast, the committee is concerned that the bill as originally introduced might have had the effect of imposing 30 percent withholding on items previously subject to reduced tax under existing treaties (if it is further assumed that the 1986 Act had contained the above repeal and reenactment and that neither the 1986 Act or the bill contained a statement of its effect on treaties).

...

Except as indicated in this bill, the 1987 Budget Reconciliation Act or its legislative history, or in other portions of the legislative history of this bill, the committee understands that neither this bill nor the 1987 Budget Reconciliation Act conflicts with any treaty. For example, the committee does not believe that any nondiscrimination **4840 provision of any U.S. treaty bars the application of the bill's requirement that treaty-based positions modifying the operation of later-enacted statutes be disclosed. Nationals of treaty partners are typically protected by nondiscrimination clauses from the imposition of other or more burdensome requirements connected to taxation than those imposed on nationals of the United States in the same circumstances. The committee is aware that the primary impact of the disclosure requirement may fall on treaty-country nationals. However, the committee believes that imposing a disclosure requirement on taxpayers who rely on treaties is a reasonable, nondiscriminatory means to assure the U.S. taxing authorities that treaty relief claimed is properly available. The requirement is akin to disclosure and return filing requirements imposed in other circumstances on U.S. nationals to preserve the integrity of the self-assessment system (e.g., sec. 6661). Again, should a conflict ultimately appear after taking into account applicable canons of construction, then in accordance with the later-in-time rule, the bill's and the Act's provisions are to take effect.