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Please Address Reply to:

**Executive Director**  
DEBORAH O. MCKINNON

January 7, 2011

Honorable Michael F. Mundaca  
Assistant Secretary of the Treasury  
for Tax Policy  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Re: Comments on the Hiring Incentives to Restore Employment ("HIRE") Act, Pub. L. No. 111-147, 124 Stat. 71 (2010) and Notice 2010-60

Dear Mr. Mundaca:

The American College of Trust and Estate Counsel ("ACTEC") submits the enclosed comments on the Hiring Incentives to Restore Employment ("HIRE") Act and the preliminary guidance provided under Notice 2010-60.

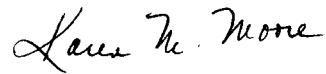
These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on U.S. beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have U.S. beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

ACTEC is a national professional association of approximately 2,600 lawyers elected to membership by their peers on the basis of professional reputation and ability in the field of trusts and estates and on the basis of having made substantial contributions to this field through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in rendering advice to taxpayers on matter of federal taxes, with a focus and estate and gift tax planning and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

Honorable Michael F. Mundaca  
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The principal authors of these comments were Ellen K. Harrison and Henry Christensen. Helpful comments were provided by Carlyn S. McCaffrey, Duncan E. Osborne, Carolyn A. Reers, Marnin J. Michaels and G. Warren Whitaker. Principal contacts for a discussion of the enclosed proposals are Ellen K. Harrison of Pillsbury Winthrop Shaw Pittman, LLP in Washington, D.C. (202.663.8316) and Henry Christensen, III of McDermott Will & Emery in New York, New York (212.547.5658). Members of your staff should not hesitate to contact either of them for more information regarding these proposals.

Very truly yours,



Karen M. Moore  
President

KMM:ls  
attachments

cc: Emily McMahon, Esquire  
Manal Corwin, Esquire  
Honorable William Wilkins  
Honorable Douglas Schulman  
Michael Plowgian, Esquire  
Catherine V. Hughes, Esquire

## ACTEC COMMENTS ON HIRE ACT

### REPORTING REQUIREMENTS FOR FOREIGN ACCOUNTS

The Hiring Incentives to Restore Employment (“HIRE”) Act of 2010<sup>1</sup> was signed into law by President Obama on Thursday, March 18, 2010. As its title suggests, the HIRE Act is primarily aimed at providing businesses with tax incentives to help finance the hiring and retention of new employees. To offset the projected revenue loss from these incentives, the Foreign Account Tax Compliance Act (“FATCA”) was added to the bill.<sup>2</sup> FATCA was originally introduced in the House by Ways and Means Committee Chair Charles B. Rangel, Democrat of New York,<sup>3</sup> and in the Senate by Finance Committee Chair Max Baucus, Democrat of Montana,<sup>4</sup> on October 27, 2009.

The purpose of FATCA is to “detect, deter, and discourage offshore tax evasion” by Americans through the use of financial institutions outside of the United States as well as to close certain information reporting loopholes that allowed U.S. persons to avoid disclosure of offshore assets and income.<sup>5</sup> Additionally, FATCA attempts to regulate certain perceived abuses concerning the use for the benefit of U.S. persons of property held in trust that were identified by the Senate Subcommittee on Investigations in its 2006 Report on tax haven abuses.<sup>6</sup>

These comments discuss only those aspects of the HIRE Act that impose information reporting obligations on U.S. beneficiaries of foreign trusts and estates and the fiduciaries of foreign trusts and estates that have U.S. beneficiaries. We propose that the Treasury adopt rules to make the new information reporting obligations imposed on fiduciaries and beneficiaries administrable, understandable, and as consistent as possible with other obligations imposed on those fiduciaries and beneficiaries.

#### **I. Foreign Entities Subject to the Provisions of FATCA**

The HIRE Act imposes an obligation on withholding agents<sup>7</sup> to withhold a 30 percent tax of “withholdable payments” to foreign financial institutions (“FFIs”)<sup>8</sup> and certain non-financial foreign entities (“NFFEs”).<sup>9</sup> Withholding is not required for payments to an FFI that has entered into an agreement with the IRS to obtain and report information regarding its U.S. account holders or certifies that it has no U.S. account holders. Withholding is waived for payments to a NFFE that certifies that it has no “substantial U.S. owners” (a defined term) or identifies such owners. On August 27, 2010, the U.S. Treasury issued Notice 2010-60, 2010-37 I.R.B. 329 (“the Notice”), which was the first preliminary guidance in this area.

##### **A. Definition of “Financial Institution”**

Section 1471(d)(4) of the Internal Revenue Code (the “Code”) provides that an FFI is a “financial institution” that is a foreign entity. Under § 1471(d)(5) of the Code, the term “financial institution” means any entity that:

- (A) accepts deposits in the ordinary course of a banking or similar business;

- (B) holds financial assets for the account of others as a substantial portion of its business; or
- (C) is engaged (or holds itself out as being engaged) primarily in the business of investing, reinvesting or trading in securities, partnership interests, commodities or any interest in such securities, partnership interests or commodities.

The Notice discusses each of the above categories and also identifies certain classes of foreign entities that will not be subject to the new withholding tax regime in any case. These include FFIs that the IRS believes should be either (1) excluded from the definition of a financial institution and treated as NFFEs, (2) deemed to be compliant without the need to enter into an FFI Agreement or (3) identified as posing a low risk of tax evasion and thus exempt from the new withholding tax regime. The different categories of FFIs are discussed under the Notice as follows:

1. Accepts Deposits

According to the Notice, this category of financial institution generally includes (but is not limited to) entities that would qualify as banks under Code § 585(a)(2), savings banks, commercial banks, savings and loan associations, thrifts, credit unions, building societies and other cooperative banking institutions. The Notice points out that being subject to banking and credit laws, or subject to regulatory oversight by a regulatory authority, is not necessarily determinative of whether the entity qualifies as a financial institution.

2. Holds Financial Assets for the Account of Others

The Notice describes this category of financial institution as including entities that, as a substantial portion of their business, hold financial assets for the account of others. Such institutions may include, for example, broker-dealers, clearing organizations, trust companies, custodial banks and entities acting as custodians with respect to the assets of employee benefit plans. As above, whether the entity is subject to banking and credit laws or regulatory supervision is relevant but not necessarily determinative of whether the entity is a financial institution.

3. Engaged Primarily in the Business of Investing, Reinvesting or Trading in Securities, etc.

Under the Notice, this category has potentially the broadest sweep of the three categories, and includes any entity engaged (or holding itself out as engaged) primarily in the business of investing, reinvesting or trading securities, partnership interests, commodities or any interest in such instruments. According to the Notice, this category of financial institution generally includes (but is not limited to) mutual funds, funds of funds, exchange-traded funds, hedge funds, private equity and venture capital funds, other managed funds, commodity pools and other investment vehicles.

According to the Notice, the term “business” differs in scope and content from the term “trade or business” as used elsewhere in the Code. The example given in the Notice explains that while an isolated transaction may not give rise to a trade or business in other sections of the Code, it may cause an entity to be considered a financial institution depending on such factors as the magnitude and importance of the transaction in comparison to the entity’s other activities. From this, it would appear that a foreign legal entity that simply buys and holds portfolio investments would, potentially, be in the “business” of investing in securities. The Notice indicates that whether an entity is in such a “business” will depend on all the facts and circumstances, but promises that future guidance will provide guidelines to determine what types of activity constitute a “business,” and when an entity is “primarily” in such a business.

***B. Entities Excluded from the Definition of Financial Institution and/or Exempt from Some or All of the New Withholding Tax Rules for FFIs***

Given the extremely broad scope of the definition of an FFI, it is not surprising that the Notice contains a substantial discussion of entities that, on one basis or another, the IRS proposes will not be subject to the new withholding tax regime for FFIs.

Certain foreign entities that would be FFIs *solely* because they are engaged primarily in investing, reinvesting or trading in securities will *not* be classified as FFIs, providing they fall within one of the categories of entities described below. Generally, if a foreign entity is not an FFI, it will be an NFFE, and NFFEs are subject to their own new withholding tax regime. Despite this, these types of entities would not be subject to either the new FFI or NFFE withholding tax rules, because the Notice states that they will be exempted. The specific categories of exempted entities in the Notice include:

1. Certain holding companies

A holding company may not be classified as an FFI if it is an entity whose primary purpose is to act as a holding company for a subsidiary or group of subsidiaries that primarily engage in a trade or business other than that of a “financial institution.” The Notice specifically excludes from this exemption any entity functioning as an investment fund, such as a private equity fund, venture capital fund, leveraged buyout fund or any investment vehicle whose purpose is to acquire or fund the start-up of companies and then hold those companies for investment purposes for a limited period of time.

2. Start-up companies

Start-up entities that intend not to operate as financial institutions, but are not yet operating their intended business, will be excluded as FFIs for the first 24 months after their organization. This does not include venture funds or other investment funds that invest in start-up entities.

3. Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy

Non-financial entities that are in liquidation or emerging from reorganization or bankruptcy are excluded as FFIs if they intend to continue or recommence operations as non-financial institutions, but only if they were not previously a financial institution.

4. Hedging/financing centers of a non-financial group

Foreign entities that primarily engage in financing and hedging transactions for members of its expanded affiliated group, i.e., group finance companies, will not be treated as FFIs, provided that they render no services to non-affiliates and the group as a whole is not engaged in the business of being a financial institution.

The Notice requests comments on how to define the foregoing categories, and whether new categories of entities should also be excluded as FFIs.

#### ***C. Treatment of NFFEs***

Non-financial foreign entities are defined by Code § 1472(d) as any foreign entity which is not a financial institution. Code § 1472(a) requires withholding agents to withhold tax at a 30 percent rate on all payments to NFFEs unless the beneficial owner of the NFFE has provided the withholding agent with a certification that it has no substantial United States owners, or has provided the withholding agent with the name, address and TIN of every substantial U.S. owner. Importantly, Code § 1474(b)(3) denies a credit for the 30 percent tax withheld to a U.S. person who did not provide the identifying information to the withholding agent required by Code § 1472(a), effectively negating the credit historically provided by Code § 1462.

#### ***D. Definition of Substantial U.S. Owner***

Code § 1473(2)(A)(iii) provides that a beneficiary of a trust is a substantial U.S. owner of the trust if (i) he or she is treated as the owner of the trust under the grantor trust rules and, (ii) to the extent provided in regulations or other guidance, he or she holds directly or indirectly more than 10 percent of the beneficial interest in the trust.

In the case of an FFI described in § 1471(d)(5)(C) – an FFI that is engaged primarily in the business of investing or trading securities – a substantial U.S. owner includes a person who owns any interest in the entity, even if less than 10 percent. The Notice implies that a trust is treated as an FFI under § 1471(d)(5)(C). If so, then the 10 percent threshold for reporting beneficial interests in trusts is rendered meaningless. As discussed below, we believe that the issue to consider is whether a trust (as opposed to a trust company) should be treated as an FFI or as an NFFE.

It is not clear what the reporting threshold is when a beneficiary has less than a 10 percent interest in a trust which owns an interest in an FFI that is engaged primarily in the business of investing or trading securities.

## ***E. Treatment of Trusts and Trustees***

### **1. Trustees**

Section II. A. 2 of the Notice cites “trust companies” as an example of an FFI that is included in the second category of financial institutions described in new Code § 1471(d)(5)(B) – an entity that holds financial assets for the account of others as a substantial portion of its business.

### **2. Trusts**

The Notice implies that trusts will be treated as FFIs. While the reference on page 332 of 2010-37 I.R.B. to trusts is not definitive, the suggestion that small family trusts settled by a single person for the sole benefit of his or her family should be treated as deemed compliant FFIs implies that other trusts will be treated as FFIs rather than as NFFEs on the theory that under Code § 1471(d)(5)(C), a trust is an entity that is engaged (or holding itself out as being engaged) primarily in the business of investing, reinvesting, or trading in securities, partnership interests, commodities, or any interest in such securities, partnership interests, or commodities.<sup>10</sup> The Notice advises that Treasury and the IRS intend to issue guidance under which certain foreign entities that are FFIs described in Code § 1471(d)(5)(C), but which are not described in § 1471(d)(5)(A) or (B), would be treated as deemed compliant FFIs if the withholding agent (i) specifically identifies each individual, specified U.S. person, or excepted NFFE that has an interest in such entity, either directly or through ownership in one or more other entities, (ii) obtains from each such person the documentation that the withholding agent would be required to obtain from such person under the guidance described in the Notice if such person were a new account holder or direct payee of the withholding agent, and (iii) reports to the IRS, in such manner as will be provided in future guidance, any specified United States person identified as a direct or indirect interest holder in the entity.

It is important to note that the Notice provides no *de minimis* threshold for the obligation of a “deemed compliant FFI” to report ownership, including beneficial ownership in a trust. Literally, the Notice could be read to require reporting of remote contingent interests even in deemed compliant FFIs.

## **II. Collection and Reporting of Information by Covered Foreign Entities**

Although the new withholding regime generally requires that withholding agents withhold 30 percent on withholdable payments to either FFIs or NFFEs, the new withholding requirements may be avoided. In particular, an FFI can avoid withholding on payments it receives if it enters into an FFI Agreement with the IRS, thus becoming a “Participating” FFI (“PFFI”). NFFEs can also avoid 30 percent withholding by providing information on their “substantial” U.S. owners, or certifying that they have no such U.S. owners. The Notice describes the proposed FFI Agreement’s requirements, as well as the procedures for NFFEs to avoid withholding.

**A. *FFI Agreement***

An FFI can avoid withholding if it enters into an FFI Agreement thereby becoming a PFFI. When entering into the agreement the FFI agrees, among other requirements, to:

1. Obtain such information regarding each holder of each account maintained by the FFI as is necessary to determine which (if any) of such accounts are U.S. accounts,
2. Comply with due diligence procedures the Secretary may require with respect to the identification of U.S. accounts,
3. Report certain information with respect to U.S. accounts maintained by the FFI and
4. Withhold on certain payments to non-participating FFIs and recalcitrant account holders.

**B. *Duplicative Reporting***

The Notice provides that Treasury and the IRS intend to issue regulations providing that in the case of a PFFI that maintains an account of another PFFI, only the PFFI that has the more direct relationship with the investor or customer will be required to report.

**III. Recommendations**

**A. *Application of HIRE Act to Trusts and Trustees***

We suggest that the approach of the proposed regulations to be issued under FATCA for foreign trusts should focus upon what trusts are, what information the Trustees are able to provide, what information needs to be made available to the United States Treasury concerning interests held by United States persons in foreign trusts and how duplicative reporting may be avoided.

1. Trustees

We agree with the position taken in the Notice that foreign trust companies, which often are banks, should be treated as FFIs and are capable of supplying all of the information required of FFIs, and entering into FFI Agreements. Trust companies are for profit business organizations that hold themselves out to the public as managers of investment assets, which act as investment advisors, and which hold bank deposit and custody accounts. They should be treated as FFIs.

However, not every trustee is a trust company. Individuals frequently serve as trustees. Sometimes the individual serves as co-trustee with a trust company, but not always. The ordinary meaning of the term “financial institution” would not include an individual. Moreover, it is not clear that every entity serving as a trustee should be treated as an FFI. For example, a private trust company serving

as a trustee of trusts for a single family is an entity, but by statute a private trust company usually cannot accept business from the public and indeed cannot engage in business in the ordinary sense. A private trust company can only act as Trustee of trusts for the family creating the private trust company.

Further, unlike a commercial trust company, a private trust company, as well as an individual trustee, typically would custody its securities accounts with a financial institution. To avoid duplicative reporting, we recommend that a trustee be classified as a deemed compliant FFI if it maintains accounts with another FFI which has entered into an agreement to provide information to the IRS or maintains accounts with a U.S. financial institution.

## 2. Trusts

We suggest that trusts should be treated as NFFEs, not FFIs.

We believe that trusts should not be treated as FFIs fundamentally because, unlike traditional investment companies, (i) trusts are not entities engaged in the business of soliciting customers to make investments on their behalf and (ii) the beneficiaries are not the owners of trust investments.

Treasury regulations define a “trust” as an arrangement “whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the rules applied in chancery or probate courts.”<sup>11</sup> The regulations further provide that in order to be a trust, an arrangement must be one “for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility.” If the beneficiaries voluntarily associate to participate in the trust and the trust is engaged in a business, the trust will be classified as an association taxable as a corporation. In the seminal Supreme Court case which was the genesis of the Treasury Regulations under Code § 7701, *Morrissey v. Commissioner*,<sup>12</sup> the Supreme Court in setting forth seven factors that distinguished among trusts, partnerships and associations (corporations) for Federal income tax purposes, held that trusts lack two essential characteristics of associations: associates (owners), and “an objective to carry on business and divide the gains therefrom.” We submit that the definition of investment company FFIs in new Code § 1471(d)(5)(C), particularly in referring to entities which “hold themselves out” as being engaged in the business of investing, contemplates entities which hold themselves out to the public (thereby soliciting “associates”) to engage in the business of investing, which is something that trusts do not and cannot do. Section 1471(d)(5)(C) is not referring to trusts when it speaks of a class of entities that are engaged in the business of investing securities.

Although trusts are arrangements and not entities, for some purposes trusts have long been treated as entities under the Code. While they have their own rate brackets, and are taxed as “modified conduits,” paying tax themselves upon

income accumulated in the trust, and distributing to the beneficiaries for taxation to the beneficiaries any income which the trust distributes, in all relevant sections of the Internal Revenue Code, trusts are taxed in a manner similar to that of individuals, not in a manner similar to corporations. Indeed, Code § 641(b) now states, in its final sentence with regard to foreign trusts, “For purposes of this subsection, a foreign trust or foreign estate shall be treated as a nonresident alien individual who is not present in the United States at any time.”

We believe that the fundamental issue which should be recognized in any regulations under Code § 1471 is that trusts are not business enterprises and trusts have no owners. The beneficiaries of trusts do have beneficial interests in the assets, which may be enforced in courts of equity, but they are not owners. Only the Trustee owns the trust assets. But the trustee owns the assets for the benefit of the beneficiaries. This difference between corporations and trusts is recognized in the way the Code taxes the income of foreign trusts, delaying taxation of income to the United States beneficiaries until it is actually distributed to them, and then applying proper penalty interest charges under Code §§ 665 through 668. By contrast, in the case of corporations with United States owners, Subpart F of the Code (§§ 951 through 965) will tax currently to the “United States shareholders” (defined as direct or indirect owners of 10 percent or more of the total combined voting power of the foreign corporation) their share of Subpart F passive income which was accumulated in, not distributed currently from, the foreign corporation.

For all of these reasons, we do not believe that a trust meets the definition of an entity in Code § 1471(d)(5)(C) that should be treated as an FFI.

There are further practical reasons why a trust should not be treated as an FFI. Beneficiaries do not have separate accounts representing their interest in the trust. The reporting requirements of Code § 1471 relate to “United States accounts” in the FFI. A “United States account” is defined under new Code § 1471(d)(1) as “any financial account which is held by one or more specified United States persons or United States owned foreign entities.” A foreign trust with United States beneficiaries may have a “United States account” at an FFI in the name of the trust, but the trust itself does not hold “accounts” for each of its United States beneficiaries. In the case of the typical foreign trust which is a discretionary trust for the benefit of a class of beneficiaries, for example, the descendants of the creator of the trust, no one of the beneficiaries has an “account” with the trust. This inconsistency is further demonstrated by the definition of “financial account” in new Code § 1471(d)(2) that defines a financial account to mean a depository or custodial account. A trust creates neither a depository account nor a custodial account in the name of any trust beneficiary. An FFI will only have a depository or custodial account in the name of the trust.

New Code § 1471(c) defines the information which an FFI will have to agree to supply with respect to United States accounts. The information includes the

account number of each United States account (again, the only account number will be for accounts in the name of the trust itself), the TIN of each United States beneficiary (a foreign trustee could supply this information for all eligible beneficiaries known by the Trustee to be United States persons), the account balance or value (there will be no account balance or value for each individual beneficiary, but rather only for the trust as a whole) and the gross receipts and gross withdrawals from the account (there will be no gross receipts or withdrawals allocable to an individual United States beneficiary, but all distributions to individual United States beneficiaries will be disclosed on Forms 3520).

New Code § 1473(2)(A)(iii) states that the term “substantial United States owner” means, in the case of a trust which is not a grantor trust, a United States person who holds, directly or indirectly, more than 10 percent of the beneficial interests in such trust. Further, in the case of a payment made by a United States withholding agent to a non-financial foreign entity, the NFFE must, under new Code § 1472(b), certify to the withholding agent the name, address and TIN of every substantial United States owner of the foreign account. Thus, the focus of the statutory provisions applicable to trusts is on the holders of more than 10 percent beneficial interests. Yet, at the same time, new Code § 1473(2)(B) sets forth a “Special Rule for Investment Vehicles” by providing that “[i]n the case of any financial institution described in § 1471(d)(5)(C), clauses (i),(ii) and (iii) of subparagraph (A) shall be applied by substituting ‘0 percent’ for ‘10 percent’”. If the provisions of new Code § 1473(2)(B) were deemed to apply to trusts (because trusts were deemed to come within the definition of a financial institution under § 1471(d)(5)(C)), the 10 percent threshold expressly applicable to trusts would be rendered meaningless. The fact that the statute adopts a 10 percent ownership threshold for trusts and a zero percent ownership threshold for investment companies is persuasive that there was no intention to classify trusts as FFIs.

Thus, trusts should not be classified as FFIs under Code § 1471(d)(5)(C) so that new Code § 1473(2)(B) will not be applied to trusts and contradict the 10 percent reporting threshold adopted for defining a substantial owner of a trust. This result will be achieved by treating trusts as NFFEs, not FFIs, in the Regulations.

In sum, trusts are not in the “business of investing,” within the meaning of Code § 1471(d)(5)(C), and individual United States beneficiaries of foreign trusts are not the owners of trust assets and do not have “accounts” as to which there can be disclosure. Moreover, any reporting required of a foreign trust will be duplicative of the reporting provided either by the trustee, if a trust company (and thus, an FFI), or by the FFI at which the foreign trust will have deposited or custodied its funds.

#### ***B. Regulation to Define “Substantial U.S. Owner”***

The withholding obligations imposed by the HIRE Act will be very difficult to administer if a facts and circumstances test is used to determine whether a trust or estate has a

substantial U.S. owner; a bright-line test is essential. A test based on actual distributions in excess of a *de minimis* threshold will be easier to administer in many cases than a test based on percentage interests. Even though the statute defines a substantial U.S. owner by reference to a percentage interest, in most cases an individual's percentage interest in a trust or estate will be very difficult to determine. Even where a fixed income interest is granted to a beneficiary, if the beneficiary's interest terminates upon the happening of some event, including the death of the beneficiary, actuarial calculations will be necessary to value the income interest. But in many cases, a beneficiary's interest is discretionary, and where the interest is discretionary it will not be possible to determine a person's percentage interest. We would urge adopting as the bright-line test the \$50,000 *de minimis* amount which new Code § 1471(d)(1)(C) applies to individual accounts of U.S. persons with FFIs, which is that the total of all accounts maintained with the FFI by such individual does not exceed \$50,000.

1. We propose that a *de minimis* bright-line test be adopted for determining whether a nongrantor trust has a substantial U.S. owner regardless of the percent of beneficial interest held in the trust by U.S. persons. We propose that a beneficiary of a discretionary trust shall not be treated as a substantial U.S. owner of a nongrantor trust if all of the following apply:

- (i) With regard to a wholly discretionary trust, if the distribution to such beneficiary in the preceding calendar year does not exceed \$50,000;
- (ii) With regard to a wholly discretionary trust, if the average distributions to such beneficiary during the three preceding calendar years do not exceed \$50,000; and
- (iii) If the amount of income or principal required to be distributed to such beneficiary or that may be withdrawn by such beneficiary does not exceed the amounts described in (i) or (ii) above.

Of course, if a beneficiary has a fixed percentage interest in a trust – both income and principal – which exceeds 10 percent, the beneficiary should be treated as a substantial U.S. owner. However, even a fixed right to a dollar amount should not cause the beneficiary to be treated as an owner unless the dollar amount exceeds the threshold amounts set forth above. Any other rule would require the valuation of the trust to determine whether the percentage threshold was exceeded, and this is administratively impractical. It should be remembered that in all events Code § 6048 will require a beneficiary of a foreign trust who actually receives a distribution to report that distribution currently on an income tax return.

2. We suggest that the thresholds discussed in section 1 above be coordinated with the information reporting rules for new Code § 6038D, discussed below.
3. In the case of a grantor trust, we recommend that the grantor, and no other beneficiary, be treated as the owner of the portion of the trust that the grantor is treated as owning.

4. In the case of an estate, we recommend that the estate will have a substantial U.S. owner if any beneficiary of the estate (including a U.S. trust) is entitled to receive a bequest of more than \$50,000 or at least 10 percent of the residuary estate is payable to a U.S. beneficiary.
5. We recommend that a U.S. beneficiary who does not satisfy the \$50,000 *de minimis* threshold for being deemed a U.S. substantial owner of an estate or trust also not be treated as a substantial owner of an FFI engaged primarily in the business of investing or trading securities (for example, a hedge fund) that is owned by the estate or trust.
6. We recommend that reporting of interests in foreign trusts be limited to disclosure of all United States persons having a substantial interest in the trust as defined in § 1473(2)(A)(iii) of the Code.
7. We suggest that an underlying holding company wholly owned by a trust be treated either as an NFFE or a deemed compliant FFI if the only account to which receipts and disbursements will be allocated is the trust. Moreover, reporting would be duplicative since the trust will disclose U.S. beneficial owners and the holding company is likely to maintain its accounts with an FFI.

#### **IV. Code § 1298(f): Passive Foreign Investment Company (“PFIC”) Reporting and Attribution from Trusts to Beneficiaries**

##### **A. Background of PFIC Rules**

A foreign corporation is a PFIC if 75 percent of its income is from passive sources or 50 percent of its assets produce or can produce passive income. Prior to enactment of the HIRE Act, PFIC shareholders were required to file an annual return on Form 8621, “Return by a Shareholder of a Passive Foreign Investment Company or a Qualified Electing Fund,” only if the U.S. person recognized gain on a direct or indirect disposition of PFIC stock, received certain direct or indirect distributions from a PFIC or was making certain elections.<sup>13</sup> If no election is made, U.S. shareholders pay tax on certain income or gain realized through the PFIC, plus an interest charge intended to eliminate the benefit of deferral, and are required to file Form 8621 only if a taxable event occurs.<sup>14</sup> If an election is made for the PFIC to be a “qualified electing fund” (“QEF”), electing U.S. shareholders currently include in gross income their respective shares of the company’s earnings (and a separate election may be made to defer payment of tax, subject to an interest charge) on income not currently received.<sup>15</sup> Another election may be made for PFIC shares that are publicly traded under which electing U.S. shareholders currently take into account as income (or loss) the difference between the fair market value of the stock as of the close of the taxable year and their adjusted basis in such stock (subject to certain limitations), often referred to as “marking to market.”<sup>16</sup>

Prior to the HIRE Act, the Code included a general reporting requirement for certain PFIC shareholders which was contingent upon the issuance of regulations.<sup>17</sup> Although Treasury issued proposed regulations in 1992 requiring U.S. persons to file annually

Form 8621 for each PFIC of which the person is a shareholder during the taxable year, such regulations have not been finalized and current IRS Form 8621 requires reporting only based on one of the triggering events described above.<sup>18</sup> In a conforming amendment, Section 521(b) of the HIRE Act removes the general reporting requirement by deleting the reference to § 1246(f) in Code § 1291(e).

## **B. HIRE Act Reporting**

Section 521 of the HIRE Act adds § 1298(f) to the Code to require annual reporting by U.S. persons who own, directly or indirectly, stock of a PFIC.<sup>19</sup> The new section states:

Except as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require.

A person who meets the reporting requirements of new Code § 1298(f) may also meet the reporting requirements of new Code § 6038D (enacted by Section 511 of the HIRE Act) requiring disclosure of information with respect to foreign financial assets. The legislative history of the HIRE Act states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.<sup>20</sup>

Although new Code § 1298(f) is effective on March 18, 2010, the date of enactment, Treasury promptly issued Notice 2010-34<sup>21</sup> postponing the new filing requirement until the IRS develops guidance *for tax years beginning before March 18, 2010*. Persons who were required to file Form 8621 prior to enactment of Code § 1298(f) would continue to be required to file.

Section 513(b) of the HIRE Act amended Code § 6501(c) (8) to add the reporting obligation under Code § 1298(f) to the list of information returns that must be filed before the statute of limitations will begin to run on assessments of tax with respect to any event or period to which such information relates until the information return is filed.

## **C. Recommendations**

1. We recommend that a *de minimis* rule be adopted exempting from the expanded reporting obligation shareholders who own less than a threshold amount of stock of a PFIC.<sup>22</sup> We note that under new Code § 6038D, a person whose beneficial interest in a foreign entity is less than 10 percent is not required to file information returns. The threshold would not affect shareholders who otherwise were required to file, e.g., because a taxable event had occurred or a QEF or mark to market election were in place.
2. A U.S. person who is a discretionary or remainder beneficiary of a foreign nongrantor trust may be treated as an indirect shareholder of a PFIC owned by the trust. A beneficiary is treated as the indirect owner of shares owned by a trust in proportion to his or her beneficial interest. Under Proposed Treasury Regulations,<sup>23</sup> a person's beneficial interest is determined based on all relevant facts and circumstances. Because the rules for determining indirect ownership are

vague, at least until clear guidance is issued to determine indirect ownership, a discretionary or remainder beneficiary of a foreign nongrantor trust that owns PFIC shares should not be required to file Form 8621 (or another information return under Code § 1298(f)), particularly if the beneficiary has not received distributions from the trust (and therefore may not be aware of the existence of the beneficial interest).

We recommend that the expanded reporting obligation under Code § 1298(f) not apply to a beneficiary of a trust that owns PFIC shares if such beneficiary is not required to file under Code § 6038D. *See* Recommendation at III.C.3 below.

3. Because a U.S. person who receives, or is deemed to receive, a distribution from a foreign trust is required to file Form 3520, we recommend that the expanded filing obligation a trust beneficiary may have with respect to PFIC shares owned by a foreign trust under Code § 1298(f) be included as part of Form 3520, and that the “beneficiary statements” that are required to be filed with Form 3520 be amended to clarify the disclosure required with respect to any PFIC income or gain that may be taxable to a beneficiary.<sup>24</sup> Currently, the explanation for line 30 of Form 3520 says that the statement should include “[a]n explanation of the appropriate U.S. tax treatment of any distribution or deemed distribution for U.S. tax purposes, or sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution for U.S. tax purposes.” This statement could be revised to specifically require whatever information is required under Code § 1298(f). Form 8621 still would be required if a taxable event occurred or a QEF or mark to market election were in place.
4. A beneficiary may not have information necessary to determine whether he or she should be reporting under Code § 1298(f). In recognition of this practical problem, Form 3520 allows the beneficiary who does not receive a beneficiary statement providing the information needed to calculate tax on a trust distribution to calculate tax using a so-called “default method” that mimics the PFIC tax rules. The filing required by Code § 1298(f) should address the alternatives available to a U.S. beneficiary who does not have information to satisfy his or her reporting obligation.
5. If the trustee of a foreign nongrantor trust, or a U.S. agent for the trustee, provides the information required by Code § 1298(f), a trust beneficiary should not be required to file such form. This is an approach adopted in proposed FBAR regulations.
6. If a trust is a U.S. nongrantor trust, the beneficiaries should not be required to file information returns under Code § 1298(f). Instead, the U.S. trustee should have the filing obligation. Filing by beneficiaries would be duplicative and unnecessary because any taxes imposed under the PFIC regime should be payable from the U.S. trust.

7. If a U.S. grantor or another U.S. person is treated as the owner of the PFIC shares under Subpart E of Subchapter J, the grantor or other owner (and not the trustee or another beneficiary of the trust) should be required to file the information required by Code § 1298(f).<sup>25</sup>
8. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 1298(f), nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.

## V. **New Code § 6038D**

Under current law, an individual who is a beneficiary of a foreign trust is obligated to report distributions received from the trust and may be required to file an FBAR if his or her beneficial interest is 50 percent or more. The HIRE Act expands the reporting obligations of beneficiaries of foreign trusts.

### A. ***Filing Threshold for Individuals***

Section 511 of the HIRE Act, provides:

Any individual who, during any taxable year, holds any interest in a specified foreign financial asset shall attach to such person's return of tax imposed by subtitle A for such taxable year the information described in subsection (c) with respect to each such asset if the aggregate value of all such assets exceeds \$50,000 (or such higher dollar amount as the Secretary may prescribe).

While the statute says that the threshold is met if “the aggregate value of all such assets exceeds \$50,000,” we believe that the clear intent of Congress was for the threshold to be met only if the aggregate value of *the individual's interests in* all such assets exceeds \$50,000. For instance, if an individual held a .00001 interest in a foreign mutual fund with total assets under management of \$1 billion, the individual's interest would be \$10,000 and he or she would have no filing requirement, even though the aggregate value of the foreign financial asset in which the individual has an interest exceeds the threshold. This should be clarified.

### B. ***Filing Rules Applicable to Beneficiaries of Foreign Trusts***

The Technical Explanation to the HIRE Act indicates that beneficiaries of foreign trusts must report their trust interests under the new law under the concept that a foreign trust is itself a “foreign financial asset”:

For example, a beneficiary of a foreign trust who is not within the scope of the FBAR reporting requirements because his interest in the trust is less than 50 percent may nonetheless be required to disclose the interest in the trust with his tax return under this provision if the value of his interest in the trust, together with the value of other specified foreign financial assets, exceeds the aggregate value threshold.<sup>26</sup> (Emphasis added.)

New Code § 6038D (b)(2) includes in the definition of Foreign Financial Assets “any interest in a foreign entity (as defined in section 1473).”

Code § 1473(5) provides that “[t]he term ‘foreign entity’ means any entity which is not a United States person.”

Therefore it appears that a foreign trust is itself a foreign financial asset, and the beneficiary of a foreign trust must report his interest if its value (i.e. the percentage interest of the beneficiary in the trust multiplied by the aggregate value of all assets of the foreign trust) exceeds the \$50,000 threshold, regardless of whether any of the assets of the foreign trust are themselves “foreign financial assets.”

### **C. Recommendations**

1. A beneficiary should not be required to report any foreign financial assets held by the foreign trust. It is the beneficiary’s interest in the trust itself, and not the trust’s assets, that gives rise to the filing requirement under Code § 6038D. Underlying financial accounts held in the trust would remain subject to the reporting requirements under Title 31 (the Bank Secrecy Act) of the United States Code<sup>27</sup> and Treasury Department Form TD F 90-22.1, “Report of Foreign Bank and Financial Accounts” (“FBAR”) as they pertain to trust beneficiaries.<sup>28</sup>
2. While foreign trustees are not obligated to file under Code § 6038D, it may sometimes be more convenient for the trustee to file, particularly if the trust has many U.S. beneficiaries. It should be clarified that if the trustee files, there is no requirement under Code § 6038D for each trust beneficiary to file as well. (A similar rule for avoidance of duplication is found in the Title 31 FBAR proposed regulations.) The Technical Explanation states that it is anticipated that the Secretary will exercise regulatory authority to avoid duplicative reporting.<sup>29</sup>
3. Questions arise as to how the interest of a beneficiary in a foreign trust should be computed. If the beneficiary has a fixed income interest or the current right to withdraw a percentage of the capital (an “ascertainable trust interest”), this is a relatively straightforward task. With a wholly discretionary trust, valuation is more problematic. Some foreign trusts may have dozens of permissible beneficiaries and the power in the trustee to add almost anyone as a beneficiary, and most of these potential beneficiaries will never receive a distribution. We believe that it would be reasonable and administratively workable to establish by regulation that an individual who is a potential discretionary beneficiary (current or contingent) of a foreign trust, or a potential appointee under a power of appointment held over a foreign trust, has no reportable interest in that trust under Code § 6038D until he or she receives a distribution. Once the first distribution has been made to that person, we suggest that the value of his or her interest be computed using a bright-line test based upon the value or average value of those distributions. We suggest that the beneficiary’s interest for any calendar year be equal to the greater of the amount distributed to her in such year or the amount of the average distributions she received in such calendar year and the prior 2 years.

4. If a U.S. grantor or another U.S. person is treated as the owner of the foreign trust under Subpart E of Subchapter J of the Code, the grantor or other owner (and not the trustee or another beneficiary of the trust), should be required to file the information required by Code § 6038D.<sup>30</sup>
5. If the grantor who is treated as the owner of the trust is a foreign person, such foreign grantor should not be required to file the information required by Code § 6038D, nor should the trustee or beneficiaries be required to file, except for a U.S. beneficiary who receives a distribution.
6. Code § 6038D applies only to individuals and not to domestic entities.<sup>31</sup> Thus, any obligation to report ownership of a foreign financial asset owned by a domestic trust should rest with the trustee and not with the individual trust beneficiaries. This should be true even if the domestic trust owns PFIC shares and the beneficiary's beneficial interest is ascertainable.
7. Clarification would be helpful that Code § 6038D does not apply to individuals who are not U.S. taxpayers.
8. Avoiding duplicate filings:
  - (i) We believe that it will be necessary for the IRS to introduce a new form to meet the reporting obligations for foreign financial assets under Code § 6038D. In the case of an individual with only foreign bank and financial accounts, both an FBAR filing and a filing under new Code § 6038D will be required (subject to the different thresholds), with the same information contained on both forms. A single form should be used to satisfy both filing obligations. Individuals should be given the option of filing the FBAR with their income tax return in satisfaction of their Code § 6038D reporting obligation.
  - (ii) A U.S. person who is treated as the owner of a foreign trust under the grantor trust rules for income tax purposes must file a report on Form 3520, which will contain the same information as the Code § 6038D filing. The Form 3520 filing (including the attached Form 3520-A signed by the foreign trustee) should be sufficient for Code § 6038D purposes.
  - (iii) Whether or not a trust is a grantor trust, if a U.S. individual receives a distribution, he or she must report the distribution on Form 3520. In order to avoid duplicative filing, the Code § 6038D reporting obligation for trust beneficiaries should be included as a new Part to Form 3520, and there should be no requirement of a separate filing on a different form.
  - (iv) We recommend that Form 3520 be amended to allow it to be used to satisfy the expanded filing obligations imposed by Code § 6038D so that all trust filing obligations can be consolidated. A U.S. individual may have a reporting obligation under Code § 6038D even if she does not have

an obligation under Code § 6048 to file Form 3520 (for example because she did not receive a distribution).

- (v) We suggest that a foreign trustee (although not obligated to file under Code § 6038D) be able to satisfy the Code § 6038D reporting requirement for all U.S. trust beneficiaries on Form 3520-A. We suggest that Form 3520-A be amended to permit such a report, in order to consolidate all foreign trust filing in one place.

9. Section 534 of the HIRE Act added language to Code § 6048 specifically imposing an obligation upon a U.S. person treated as the owner of a foreign trust under Subpart E of Subchapter J of the Code to “submit such information as the Secretary may prescribe with respect to such trust for such year...” This is in addition to the pre-HIRE § 6048 requirement that such a person “ensure” that the trust files Form 3520-A. Form 3520-A is signed by the trustee; however, a foreign trustee has no U.S. filing obligations. The new language provides an affirmative filing duty upon a U.S. owner of a foreign trust, presumably to encompass foreign trusts that are not filing Form 3520-A because the foreign trustee has no U.S. filing obligation and the U.S. owner has no control over the trustee to “ensure” filing. We recommend that the new language be interpreted to mean that the information required by the Secretary is the information required on Form 3520-A, and that all Code § 6048 filing obligations are satisfied if either the U.S. grantor or the foreign trustee files the form.
10. Finally, we suggest that Forms 3520 and 3520-A clarify that the filing deadlines prescribed on such Forms override the language in Code § 6048 requiring filing on or before the 90<sup>th</sup> day after any reportable event. Code § 6048 specifically gives the Secretary discretion to prescribe a different filing date. We also suggest that the due date for Form 3520-A be the same as the filing date for Form 3520 and that extensions of time to file Form 1040 also extend the time for filing Form 3520-A.

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<sup>1</sup> Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, 124 Stat. 71 (2010).

<sup>2</sup> *Id.* § 501, at 97.

<sup>3</sup> H.R. 3933, 111th Cong. (2009).

<sup>4</sup> S. 1934, 111th Cong. (2009).

<sup>5</sup> Cong. Rec. S10785 (daily ed. Oct. 27, 2009) (statement of Sen. Max Baucus, Chair, S. Comm. on Finance).

<sup>6</sup> Staff of the S. Perm. Subcomm. on Investigations, 109th Cong., Tax Haven Abuses: The Enablers, the Tools and Secrecy (Aug. 1, 2006).

<sup>7</sup> Withholding agent is defined broadly to include “all persons, in whatever capacity acting, having the control, receipt, custody, disposal, or payment of any withholdable payment.” See Hiring Incentives to Restore Employment Act, Pub. L. No. 111-147, § 501, 124 Stat. 71, 106 (2010).

<sup>8</sup> *Id.* § 501, at 97.

<sup>9</sup> *Id.* § 501, at 102.

<sup>10</sup> We do not think that trusts should be classified as FFIs. However, if Treasury does decide to treat trusts as FFIs, clarification of what constitutes a “small family trust” is needed.

<sup>11</sup> Treas. Reg. § 301.7701-4.

<sup>12</sup> *Morrissey v. Commissioner*, 296 U.S. 344 (1935).

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<sup>13</sup> Instructions to IRS Form 8621 state that reportable elections include the following: (i) an election to treat the PFIC as a QEF; (ii) an election to recognize gain on the deemed sale of a PFIC interest on the first day of the PFIC's tax year as a QEF; (iii) an election to treat an amount equal to the shareholder's post-1986 earnings and profits of a CFC as an excess distribution on the first day of a PFIC's tax year as a QEF that is also a controlled foreign corporation under section 957(a); (iv) an election to extend the time for payment of the shareholder's tax on the undistributed earnings and profits of a QEF; (v) an election to treat as an excess distribution the gain recognized on the deemed sale of the shareholder's interest in the PFIC, or to treat such shareholder's share of the PFIC's post-1986 earnings and profits as an excess distribution, on the last day of its last tax year as a PFIC under section 1297(a) if eligible; or (vi) an election to mark-to-market the PFIC stock that is marketable within the meaning of section 1296(e).

<sup>14</sup> Code § 1291.

<sup>15</sup> Code §§ 1293-1295.

<sup>16</sup> Code § 1296.

<sup>17</sup> Code § 1291(e) by reference to § 1246(f).

<sup>18</sup> Prop. Treas. Reg. § 1.1291-1(i).

<sup>19</sup> A PFIC generally is defined as any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or 50 percent or more of its assets consist of assets that produce, or are held for the production of, passive income. Code § 1297.

<sup>20</sup> Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 66.

<sup>21</sup> 2010-17 I.R.B. 612, 4/6/2010.

<sup>22</sup> Compare for example Code § 1246(f) prior to its repeal by the American Jobs Creation Act of 2004 (P.L. 108-357) which waived filing of information returns for shareholders of foreign investment companies if the shareholder did not own as much as 5 percent of the stock of the company. While the HIRE Act repeals the vestiges of § 1246(f) by amending Code § 1291(e) to delete references to subsection (f) of § 1246, some *de minimis* rule for filing information returns is appropriate.

<sup>23</sup> Proposed Treasury Regulation § 1.1291-1(b)(8).

<sup>24</sup> Clarification is needed as to how beneficiaries are appropriately taxed when a trust owns PFIC shares.

There is an overlap and lack of coordination between the trust and PFIC rules.

<sup>25</sup> Cf., Treasury Regulation § 1.958-1(b).

<sup>26</sup> Joint Committee Staff, Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, the Hiring Incentives to Restore Employment Act (JCX-4-10) 2/23/2010, p. 60.

<sup>27</sup> 31 U.S.C. 5311 et seq.

<sup>28</sup> The Technical Explanation specifically provides "Nothing in this provision is intended as a substitute for compliance with the FBAR reporting requirements, which are unchanged by this provision." Ibid.

<sup>29</sup> Technical Explanation at 66.

<sup>30</sup> In his comments to Congress, Senator Levin expressed that the purpose of Sections 531 through 535 of the HIRE Act is to "tighten U.S. tax rules for foreign trusts and address a variety of abuses...exposing how U.S. taxpayers use foreign trusts to evade their U.S. tax obligations." Until a trust beneficiary receives a distribution from a foreign nongrantor trust, he has no U.S. tax obligation. And if the foreign trust is a grantor trust with a U.S. grantor, it is already subject to U.S. reporting and income tax. Providing a clear formula for the computation of a beneficiary's interest in a wholly discretionary foreign trust, premised on the receipt of actual trust distributions, promotes the purpose of assuring that U.S. tax obligations are reported.

<sup>31</sup> The Technical Explanation states that "[section 6028D] permits the Secretary to issue regulations that would apply the reporting obligations to a domestic entity in the same manner as if such entity were an individual if that domestic entity is formed or availed of to hold such interests, directly or indirectly."