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February 14, 2011

Hon. Douglas Shulman  
Commissioner  
Internal Revenue Service  
1111 Constitution Avenue, N.W.  
Washington, DC 20224

Re: Comments on the Foreign Account Tax Compliance Act ("FATCA") Offset Provisions of the HIRE Act Relating to Beneficiaries of Trusts

Dear Commissioner Shulman:

Enclosed are comments on Foreign Account Tax Compliance Act ("FATCA") offset provisions of the HIRE Act relating to beneficiaries of trusts. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

A handwritten signature in black ink, appearing to read "Charles H. Egerton".

Charles H. Egerton  
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury  
William J. Wilkins, Chief Counsel, Internal Revenue Service  
Jeffrey Van Hove, Acting Tax Legislative Counsel, Department of the Treasury

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**ABA SECTION OF TAXATION  
COMMENTS ON THE FOREIGN ACCOUNT  
TAX COMPLIANCE ACT (“FATCA”)  
OFFSET PROVISIONS OF THE HIRE ACT  
RELATING TO BENEFICIARIES OF TRUSTS**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Charles K. Kolstad of the Fiduciary Income Tax Committee of the Section of Taxation. Substantive contributions were made by Dyke Arboneaux, Laurin Johnson, Christopher Rascoe and Kurt Rademacher. The Comments were reviewed by Jeanne L. Newlon, Fiduciary Income Tax Committee Chair and Alan Appel, U.S. Activities of Foreigners and Tax Treaties Committee Chair. The Comments were also reviewed by John P. Barrie of the Section’s Committee on Government Submissions. The Comments were further reviewed by Mary Ann Mancini, Council Director for the Fiduciary Income Tax Committee and Joan Arnold, Council Director for the U.S. Activities of Foreigners and Tax Treaties Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject of these Comments.

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Date: February 14, 2010

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## Executive Summary

The Hiring Incentives to Restore Employment ("HIRE") Act of 2010 became law on March 18, 2010.<sup>1</sup> The HIRE Act included the Foreign Account Tax Compliance Act ("FATCA"), which added new sections 1471 through 1474 and 6038D to the Code.<sup>2</sup> The purpose of FATCA was to "detect, deter and discourage offshore tax evasion" by Americans and to close certain loopholes in reporting requirements that allowed U.S. persons to avoid reporting offshore assets and income.<sup>3</sup>

The Internal Revenue Service (the "Service") requested comments in both Announcement 2010-22<sup>4</sup> (the "Announcement") and Notice 2010-60<sup>5</sup> (the "Notice"). These Comments address how to determine whether a particular beneficiary of a foreign trust is a "substantial U.S. owner" under section 1473(2) for purposes of determining whether withholding is required under section 1472. These Comments also address whether a trust should be treated as a foreign financial institution ("FFI") or a non-financial foreign entity ("non-FFE") because such a determination affects the level of interest in a trust that is considered to be substantial. Finally, these Comments address how to determine a beneficiary's interest in a trust for purposes of the new reporting requirements under section 6038D.

We urge the Treasury Department ("Treasury") and the Service to balance the Congressional intent in enacting sections 1471, 1472 and 6038D with the interests of the non-U.S. settlors of foreign trusts in having undisclosed or completely discretionary beneficiaries so as not to discourage foreign trusts from continuing to invest in the U.S. securities markets. As discussed below, we urge that Treasury and the Service adopt or use as presumptions bright line rules to provide certainty on the application of this complex area of the law to foreign trusts.

### A. Lack of Relevant Guidance on Beneficiaries' Interest in a Trust in Other Provisions of the Code and Regulations

There is very little relevant guidance in other sections of the Code or the Regulations as to how to determine a beneficiary's interest in a trust. In some cases, actuarial life expectancies are used; in other cases a facts and circumstances approach is used; and in yet other cases a proportionality approach is used. Although we believe such approaches are appropriate in other cases, we also believe that such approaches are generally not helpful in determining which beneficiaries should be treated as (i) substantial U.S. owners under section 1472 or (ii) having an interest in a specified foreign financial asset ("SFFA") under section 6038D.

These Comments discuss alternative approaches under section 1473(2) for determining a U.S. beneficiary's interest in a grantor trust, a simple trust and a complex trust. In the case of a

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<sup>1</sup> Pub. L. No.111-147, 124 Stat. 71.

<sup>2</sup> References to a "section" are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

<sup>3</sup> Cong. Rec. S10785 (daily ed. Oct 27, 2009) (statement of Sen. Max Baucus, Chair, Sen. Comm. On Finance.)

<sup>4</sup> 2010-16 I.R.B. 602.

<sup>5</sup> 2010-37 I.R.B. 329.

grantor trust with a foreign grantor, we believe that generally none of the beneficiaries should be considered to be a substantial U.S. owner. In the case of a simple non-grantor trust, we believe the determination of whether a beneficiary is a substantial U.S. owner should be based on each current beneficiary's stated interest in the trust. In the case of a complex trust, we recommend that Treasury and the Service base the determination of substantiality on either (i) prior year actual distributions to beneficiaries, in cases in which distributions occur on some regular basis or (ii) a current beneficiary's pro-rata interest in the trust.

#### B. Trusts Should Generally be Classified as non-FFEs

Trusts hold many different classes of assets; some trusts invest in instruments that would constitute securities for purposes of section 1472, while others do not. We believe the Congressional intent in enacting sections 1471 and 1472, which we believe is to identify U.S. settlors and beneficiaries of foreign trusts,<sup>6</sup> would be given full deference if Treasury and the Service provide a rebuttable presumption under which a trust would be classified as a non-FFE rather than as a FFI even when the trust holds a substantial portfolio of securities because the trust would remain subject to withholding and reporting obligations under section 1472. In addition, from a practical perspective, we believe classifying all foreign trusts as FFIs rather than as non-FFEs would result in significant additional administrative burdens on the Service and withholding agents.

#### C. Trustee to Make Determination

The determination of who constitutes a substantial U.S. owner may be made either by the trustee of the trust or by the beneficiaries. For ease of administration and because many beneficiaries are not aware that they are beneficiaries of a trust or have very limited access to information about the trust and its other beneficiaries, we recommend that Treasury and the Service adopt rules under which the trustee makes the determination. Our recommendation is the same if the trustee is a foreign person because we also recommend that the trustee be required to provide Forms W-8BEN, Certificates of Foreign Status of Beneficial Owner for United States Tax Withholding, W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding, or W-9, Request for Taxpayer Identification Number and Certification, as appropriate, to the withholding agent.

#### D. Need Bright Line Test; not Facts and Circumstances Test

We believe that a bright line test should be provided for determining when a beneficiary is to be classified as a substantial U.S. owner. If Treasury and the Service provide a facts and circumstances test, a trustee may make a determination that is later challenged by the Service, possibly many years after a distribution has been made to the beneficiaries. The trustee may not be able to recoup from the beneficiaries any penalties imposed by the Service; indeed, the provisions of the trust instrument may not permit such recoupment. Finally, a beneficiary may assert that an incorrect determination by a trustee that results in U.S. tax withholding represents a breach of the trustee's fiduciary duty and that the tax should be paid by the trustee and not by the

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

trust itself. Accordingly, we recommend that Treasury and the Service adopt rules and rebuttable presumptions that make it simpler for a trustee to determine which beneficiaries, if any, constitute substantial U.S. owners.

#### E. Beneficial Interests for Purposes of Section 6038D

An interest in a foreign trust is a SFFA under the provisions of section 6038D(b)(2)(C). Accordingly, if a beneficiary has an interest of greater than \$50,000 in a foreign trust, the reporting requirements of section 6038D would apply to such beneficiary. We believe that rules similar to those discussed below in the section 1473(2) context should also apply for purposes of section 6038D. We recommend that Treasury and the Service require the trustee to determine the level of interest each beneficiary has in the foreign trust and provide each beneficiary with information to permit the beneficiary to file the new reporting Form required by section 6038D. We also recommend that the beneficiary not be required to file if the trustee does not provide the required information.

## COMMENTS

Section 501 of the HIRE Act, by adding sections 1471 through 1474<sup>7</sup> to the Code, imposes new information reporting regimes for certain payments made to foreign entities. The new reporting regimes are enforced through a new withholding tax regime on certain payments made to those entities. The reporting and withholding requirements are effective as of January 1, 2013. The new regimes apply to withholdable payments made to a foreign entity that is either a FFI or a non-FFE.

Both the Announcement and the Notice requested comments on the issues raised by the implementation of FATCA. These Comments are limited to the treatment of beneficiaries of foreign trusts; the ABA Section of Taxation has previously comments on other aspect of FATCA.<sup>8</sup>

### I. Is a Trust a FFI or a non-FFE?

It is important to determine whether a foreign trust is an FFI or a non-FFE because the determination of whether an interest is "substantial" depends on that characterization. In the case of an FFI that primarily holds securities, any ownership is considered substantial.<sup>9</sup> In the case of non-FFEs only a greater than ten percent interest is considered substantial. For the reasons set forth below, we recommend that the characterization of a foreign trust be based on the relationship of the beneficiaries to the trust and the activities of the trust.

#### A. Beneficiaries as Investors –Trust Classified as a Corporation is an FFI

If the beneficiaries have invested or otherwise made available their respective share of the trust assets to the trust and the trust is engaged in a trade or business with a view to sharing the profits from that trade or business with the trust beneficiaries, such as in the case of a business trust, then our view is that the trust generally would be classified as a corporation under the rules of section 7701 and the Regulations thereunder, absent an election to change that classification under the "check-the-box" rules. In such a case, if the trust otherwise satisfies the requirements of section 1471, we believe the trust should be classified as an FFI without regard to whether the trust makes a check-the-box election.

If the trustee of the trust is a trust company, which itself is an FFI, we do not believe the trust should automatically be classified as an FFI. The trust company and the trust are separate and distinct entities and we believe these entities should be separately tested and classified.

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<sup>7</sup> Collectively, section 1471 through 1474 comprise chapter 4 of subtitle A of the Code; these new reporting and withholding requirements are in addition, and not in lieu of, the existing reporting requirement of sections 1441 through 1446 which comprise chapter 3 of subtitle A of the Code.

<sup>8</sup> ABA Section of Taxation "Comments on Foreign Tax Compliance Offset Provisions of the HIRE Act, P.L. 111-147", available at

<http://www.americanbar.org/content/dam/aba/migrated/tax/pubpolicy/2010/081610comments.authcheckdam.pdf>.

<sup>9</sup> I.R.C. § 1473(2)(B).

## B. Non-Investor Beneficiaries – Trust Classified as a Trust is a non-FFE

In the more typical case, however, the settlor of the trust has provided the trust corpus and the beneficiaries are the recipients of promised potential future distributions from trust corpus and trust income. This type of trust does not accept deposits in the ordinary course of a banking business, is not holding financial assets for the account of others and is not engaged primarily in the business of investing in securities for the account of others. Accordingly, we recommend that this type of trust be classified as a non-FFE rather than as an FFI and thus be subject to section 1472 rather than section 1471.

The Notice appears to classify family trusts that hold securities as FFIs described in section 1471(d)(5)(C). Such trusts will be classified as "deemed compliant FFIs" if the withholding agent specifically identifies each individual, U.S. person or excepted non-FFE that has an interest in the trust, obtains certain identification information from those persons and reports the U.S. persons to the Service in the manner to be provided in future guidance.<sup>10</sup> We believe classifying a foreign trust as a deemed compliant FFI should obviate the need for the foreign trust to enter into an FFI agreement with the Service. Not being required to enter into an FFI agreement would simplify the U.S. tax reporting obligations of foreign trusts.

We believe, however, that this approach raises certain problems. First, it appears that withholding agents have the discretion to take the actions that would result in the foreign trust being classified as a deemed compliant FFI. We believe that many withholding agents will not be willing to work with foreign trusts to allow them to be classified as deemed compliant FFIs, so that, through no fault of their own, the foreign trusts will be subject to the full FFI withholding and reporting obligations. Second, we believe that the trustee should determine whether a person is a substantial U.S. owner and certify this determination to the withholding agent. Third, we believe that the approach discussed above for determining who provided the funds to the trust would provide the Service with an administrable approach to determining whether a foreign trust should be classified as an FFI. Fourth, beneficiaries of a trust classified as an FFI may not claim a refund of any withheld tax, whereas beneficiaries of non-FFEs may claim such a refund. Finally, we believe our suggested approach is consistent with Congressional intent because, if neither private family trusts nor the entities the Notice describes as "exempt NFFEs" are excluded from the application of the rules of section 1472, then it appears most types of entities will not be subject to section 1472.

## C. Classification of Offshore Private Foundations, etc. and Impact on Qualification as a non-FFE

In a number of foreign jurisdictions, foreign estate planners use private foundations, *stichtings*, *siftings* and other vehicles, rather than a trust established under the applicable foreign law. Frequently, such jurisdictions do not recognize the existence of a trust or do not have a separate trust law. The classification of such entities for U.S. tax purposes is often unclear and may result in the classification of the entity as a foreign corporation. If such an entity is used for estate planning purposes and the beneficiaries of the entity did not provide any of the funding for the entity, then we recommend that the entity also be treated as a non-FFE rather than as an FFI.

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<sup>10</sup> Notice 2010-60, § II.B.3.

## II. Is a Company Owned by a Trust a FFI or a non-FFE?

A foreign trust often establishes one or more wholly owned subsidiaries to hold trust assets, particularly if part or all of those assets are U.S. situs assets that could result in the settlor being subject to U.S. estate tax if held directly.

### A. If Trust is a Non-FFE, Then Company is non-FFE

Frequently, the assets of a subsidiary consist primarily of stocks and other securities. Accordingly, the company could be classified as an FFI. We believe, however, that if the subsidiary is wholly or primarily owned by a trust that qualifies as a non-FFE, then the subsidiary should also be classified as a non-FFE. This would be consistent with the treatment of group finance entities in the Notice.

### B. Impact of Check-the-Box Election?

We believe classifying these subsidiaries as non-FFEs is sensible because if the subsidiary is not a per se corporation under Regulation section 301.7701-2, then the trust may elect to classify the subsidiary as a disregarded entity. This election would convert the subsidiary from an FFI to a non-FFE because the assets of the subsidiary would be considered to be held by a non-FFE trust rather than by an FFI company. Accordingly, when an FFI may be converted to a non-FFE by filing a form, we believe the Service should not require the filing and should classify the subsidiary consistent with the classification of its trust owner.

## III. Substantial U.S. Owner of a Trust

Under section 1472, it is important to be able to identify the substantial U.S. owners of a trust, if any, because they must be reported to the withholding agent and to the Service to avoid withholding on withholdable payments.

### A. Who Makes the Determination?

The first issue to be resolved is who should decide whether a beneficiary of a trust is a substantial U.S. owner. We believe the trustee(s) of the trust should decide, rather than the beneficiaries. First, the withholdable payment is being made to the trust and not to the beneficiaries. Second, a beneficiary may not even know that he or she is a beneficiary of a trust, as the trustee may not have disclosed that fact to the beneficiary or have been required to do so. Finally, vesting trustees with this authority would allow the withholding agent to deal with one person, a trustee, rather than having to deal with a possibly large number of beneficiaries. The withholding agent would need to receive detailed information about the trust to make decisions as to which beneficiaries, if any, constitute substantial U.S. owners and requiring the beneficiaries to make this decision would place a significant additional burden on the beneficiaries.

## B. De Minimus Rule – Trust Assets Less Than \$250,000

Congress enacted section 1472 to assist the Service in identifying those U.S. persons who have foreign assets and to prevent U.S. persons from evading U.S. tax by shifting assets offshore.<sup>11</sup> We believe that, in the case of a trust with assets of less than \$250,000, it is unlikely that the trust is being established for abusive purposes. Given the costs to the beneficiaries and the trustee of identifying the substantial U.S. owners, if any, of a trust, we recommend that Treasury and the Service exempt trusts with total assets of less than \$250,000 from complying with the requirements of section 1472.

## C. Timing of the Determination?

### 1. Which Form to use?

The next issue to be addressed is which Form the trustee should use to notify the withholding agent that the trustee has ascertained that one or more of the beneficiaries are substantial U.S. owners. Presently, trustees and other recipients of payments are accustomed to filing a Form W-8IMY, Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding (in the case of a foreign grantor trust or foreign simple trust for which the trustee controls the funds, but is not the beneficial owner of the funds), or W-8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding (in the case of a foreign complex trust for which the trust itself is treated as the beneficial owner), to avoid or reduce withholding under sections 1441 and 1442. We recommend that the Service update Forms W-8IMY and W-8BEN to include the information necessary to evidence compliance with the requirements of section 1472 to avoid increasing the number of Forms that a recipient of a payment must file when paying the withholding tax and because payments subject to withholding under section 1472 generally will be subject to withholding under section 1441.

We believe the trustee should be able to satisfy the requirements of section 1472(b)(1)(B) by delivering a copy of the Form W-9, Request for Taxpayer Identification Number and Certification, received from each substantial U.S. owner of the trust. We recommend that a successor trustee be allowed to continue to rely on the information provided to the predecessor trustee by the beneficiaries to issue Forms W-8BEN and W-8IMY unless the successor trustee has actual knowledge that the situation of one or more of the beneficiaries of the foreign trust has changed. In the case of actual knowledge, we believe the successor trustee should be required to promptly provide updated information to the withholding agent(s).

### 2. How Frequently Should Form W-8 Be Provided?

Form W-8IMY is valid until such time as the status of the person who issued the Form has changed, while Form W-8BEN is valid for only a period extending until (i) the end of the third year after the year the Form was issued or (ii) there has been a change of circumstances. If both Forms are adapted to use in connection with withholding under section 1472, a trustee who knows that a beneficiary's status has changed, either to or from that of a substantial U.S. owner,

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<sup>11</sup> See *supra* note 3.

would be required to update the relevant Form. Therefore, we recommend that no changes be made to the existing rules as to when such Forms need to be submitted by the trustee to a withholding agent.

### 3. Prior to Each Withholdable Payment?

A large trust could receive numerous payments subject to withholding under sections 1441 and 1472 during the course of a year. We believe requiring the trustee to provide an updated Form W-8 to the withholding agent prior to each withholdable payment would be onerous and impractical. Accordingly, we recommend that the existing rules applicable to when a Form W-8 must be issued remain unchanged and that once a Form W-8 has been issued, the rules discussed above apply to the required updating of the Form.

### 4. Requirement to Update Form W-8?

As discussed above, each of the Forms W-8BEN and W-8IMY as presently in effect would require the trustee of a foreign trust to file an updated Form when the trustee becomes aware of a change in a beneficiary's status to or from that of being a substantial U.S. owner. Consistent with the inquiry provisions of the Notice, we believe a trustee of a foreign trust should inquire as to whether one or more beneficiaries of the trust qualifies as a substantial U.S. owner for all trusts in existence as of January 1, 2013, and for all foreign trusts formed after that date.

An issue to be considered is whether a trustee has an affirmative obligation to inquire and update its information as to the status of the beneficiaries of the trust on some regular periodic basis, such as when the Form W-8BEN expires, or whether the trustee may wait until such time as a beneficiary informs the trustee of a change in status. In the case of both Forms W-8BEN and W-8IMY, we believe that a trustee should not be required to inquire as to a change in a beneficiary's status until one or more facts come to the trustee's attention that suggest that a change in circumstances has occurred. We also believe that it is appropriate to require a trustee to have the affirmative obligation to inquire as to the status of the beneficiaries of the trust prior to issuing a new Form W-8BEN on the expiration of the old Form.

Finally, we believe that a trustee should have a duty to inquire and update the relevant Forms as necessary when the terms of the trust change to admit one or more new beneficiaries, when one or more new beneficiaries become eligible to receive distributions from the trust or when for any other reason there is a change in the number of current beneficiaries.

## D. U.S. v. non-U.S. owner

### 1. U.S. Beneficiary – Form W-9

The Service has long used Form W-9 for U.S. persons to identify themselves as such; we see no reason to change that policy in the case of a trustee seeking to identify which beneficiaries are U.S. persons.

Many foreign trusts provide for distributions of trust income and corpus to multiple beneficiaries, but provide that the trustee shall not disclose to a trust beneficiary either the existence of the trust or the beneficiary's status as a beneficiary until an actual distribution is made to the beneficiary. To comply with the wishes of the settlor that the trust beneficiary not know of his or her status as a beneficiary while satisfying the requirements of section 1472, we suggest that in the case of a beneficiary of such a quiet trust, the trustee be allowed to rely on the address the trustee has for the beneficiary. If the address is located in the U.S., then we believe the trustee should be able to certify to the withholding agent that the beneficiary is a U.S. person without having to contact the beneficiary.

## 2. Non-U.S. Beneficiary – Form W-8

Similarly, the Service has long used Form W-8 for foreign persons to identify themselves as such; we again see no reason to change that policy. Accordingly, we believe a trustee should be entitled to rely on the Forms W-9 and W-8 provided to it by the beneficiaries of the trust absent actual knowledge by the trustee that a particular Form is incorrect.

## 3. Presumption That Recalcitrant Beneficiaries are U.S. Persons

A recalcitrant beneficiary who is aware of his or her status as a substantial U.S. owner may refuse to provide a trustee with either a Form W-8 or W-9. In addition, a trustee may have difficulty locating a beneficiary. In such cases, we believe the beneficiary should be treated as a U.S. person and appropriate tax withheld from all withholdable payments. The trustee typically would be entitled to allocate any withheld tax to the account of the beneficiary and reduce the amounts otherwise distributable to the beneficiary.

In complex trusts with discretionary beneficiaries, however, we believe the issue becomes more complicated. A complex trust may have a recalcitrant beneficiary who might constitute a substantial U.S. owner under the rules discussed below. We believe that a trustee who makes a written determination not to make distributions to a recalcitrant beneficiary until the beneficiary is no longer recalcitrant should be entitled to treat the beneficiary as other than a substantial U.S. owner. Otherwise, tax would be withheld from funds that would otherwise be distributed to beneficiaries who have complied with the requirements to avoid withholding tax under section 1472, which seems to us to be an unfair result. We believe the trustee should not be entitled to make distributions to the recalcitrant beneficiary until the recalcitrant beneficiary has provided the trustee with either a Form W-8 or W-9.

If the trustee intends to make distributions to a recalcitrant beneficiary, then it seems to us appropriate to have U.S. tax withheld from the portion of the withholdable payment(s) that would be distributed to the recalcitrant beneficiary.

## E. Substantiality

### 1. Grantor Trust

#### a) Grantor should be the "owner"

In the case of a foreign trust in which a settlor or another person, whether U.S. or foreign, is treated as the owner of the trust, in part or in whole, under the rules of sections 671 through 679, our view is that such person should be treated as the substantial owner of the trust under section 1473(2)(A)(iii)(I). Accordingly, we believe the trustee should obtain the appropriate Forms from such person to provide required information to the withholding agent.

When the trust has a foreign settlor and U.S. beneficiaries, it is well established practice, to avoid withholding under section 1441, for the trustee to provide withholding agents with a Form W-8IMY for the trust and a Form W-8BEN for the foreign settlor and to provide no information, such as a Form W-9, as to its U.S. beneficiaries. We believe that such a foreign trust should be treated consistently for purposes of withholding under chapter 4 (sections 1471 through 1474) as well as under chapter 3 (sections 1441 through 1446) with reporting by the foreign grantor and not the U.S. beneficiaries.

When the settlor is a U.S. person, the trust generally would constitute a foreign grantor trust as to part or all of the trust under section 679, thus requiring the trust to file Form 3520-A, Annual Information Return of Foreign Trust With a U.S. Owner, as well.

#### b) When should beneficiaries be treated as owners

When one or more U.S. persons are treated as the owners of the trust under the grantor trust rules of sections 671 through 679, we believe that none of the beneficiaries, whether U.S. or foreign, should be considered to be substantial owners. We believe the information provided to the Service with respect to the persons treated as the owner(s) of the trust should provide the Service with sufficient information to determine that a foreign trust exists.

Under section 672(f), the provisions of sections 671 through 679 apply only if the result is to treat a U.S. person as the owner of the trust; the rules generally do not apply if the result would be to treat a foreign person as the owner of the trust. However, the grantor trust rules would apply to cause a foreign person to be the owner if (i) such foreign person has the right to reconstitute the trust property in his or her name or (ii) income and corpus of the trust is only distributable to the foreign person or such foreign person's spouse during the foreign person's lifetime.

### 2. Simple non-grantor trust

In the case of a simple non-grantor trust, in most cases the trust instrument provides the manner and percentages for allocating trust income and trust distributions to its beneficiaries. We believe the determination of whether a beneficiary is a substantial U.S. owner should be based on each beneficiary's current interest in the trust. If there is a change in a beneficiary's

interest in such a trust, for example, due to the birth of an additional beneficiary or the death of a prior beneficiary, then we believe the trustee should be required to redetermine which beneficiaries, if any, constitute substantial U.S. owners. If there is a change, then we believe the trustee should be required to provide updated Forms to the withholding agent(s) prior to the next payment of a withholdable payment.

### 3. Complex non-grantor trust

The treatment of complex trusts, which often are discretionary trusts, is more complicated than the treatment of the trusts discussed above. The discretionary nature of these trusts raises issues that do not arise in the case of grantor trusts or simple trusts. For example, many discretionary trusts have not made any distributions to their beneficiaries and may not plan on making distributions to their beneficiaries in the near future. In such cases, determining which beneficiary, if any, is a substantial U.S. owner is problematic. As discussed above, our view is that the rules for determining who is a substantial U.S. owner should provide a bright line test for the trustee rather than a facts and circumstances test.

#### a) Discretionary trusts

##### (1) Wholly discretionary beneficiaries as "substantial owners"?

The determination of what interest a beneficiary has in a discretionary trust, when distributions are wholly in the discretion of a trustee and may be made infrequently, if at all, is at best unclear under the Code and Regulations. A strong argument can be made that a wholly discretionary beneficiary has no interest at all in the trust income or corpus until an actual distribution occurs. This is particularly true when the trust instrument contains a "spendthrift" provision. We recognize, however, that such a position is inconsistent with the Congressional intent in adopting sections 1471 and 1472. Because many foreign trusts are wholly discretionary trusts, we believe that Treasury and the Service should provide guidance on how to treat certain discretionary beneficiaries as having a substantial interest in a discretionary trust without creating a methodology that is extremely time consuming, expensive and intrusive for the beneficiaries. We also believe Treasury and the Service should balance the wishes of the settlor that certain beneficiaries not know their status as beneficiaries with the rules of section 1472.

There is limited guidance in other sections of the Code regarding how to determine the level of a discretionary beneficiary's interest in a trust. There are a number of sections, such as sections 679 and 1374, for which the status of a beneficiary as a U.S. person is relevant; however, in those sections the level of "ownership interest" of the beneficiary is irrelevant. There are very few provisions of the Code for which identifying the "ownership interest" of a beneficiary of a trust is relevant. Two such sections are sections 958 and 1298; the relevant Regulations under section 1298 have not yet been issued while the Regulations under section 958 provide a facts and circumstances test for certain purposes and an actuarial interest test for other purposes.<sup>12</sup> The Regulations under section 958 provide one example<sup>13</sup> of how to apply the facts

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<sup>12</sup> Reg. § 1.958-1(b), -2(c)(ii).

<sup>13</sup> Reg. § 1.958-1(d), Example 3.

and circumstances test; that example, however, involves a trust divided into three equal shares rather than a complex discretionary trust.

We believe that for the sake of administrative convenience, different rules should apply depending on whether the trust has made distributions to one or more beneficiaries in prior years.

b) Prior year distributions

If a trust has made distributions to one or more beneficiaries in prior years, then we believe such beneficiaries should be treated as having an interest in the trust based on their relative interests in the distributions. Their interests in the distributions could be tested, for example, on a rolling three-year basis to even out changes from year to year or only the prior year if distributions were not made in each of the three prior years. This would be a simple determination and would avoid a facts and circumstances test, which would be far more complicated to administer and might subject the trustee to penalties if the Service challenged the trustee's determination.

c) Uncompensated use of trust assets

Another issue arises if one or more beneficiaries use trust assets without paying the trust for the benefit of such use. The HIRE Act amended section 643(i) to provide that uncompensated use of trust assets gives rise to a deemed distribution from the trust to the beneficiary. We believe such deemed distributions should be taken into account under subsection b) above.

d) No prior year distributions

If the trust has not made distributions during the three-year testing period or is a newly formed trust, then we are aware of two other methods for determining a beneficiary's interest in a trust.

(1) Actuarial interests

One method used in certain sections of the Code is the beneficiary's actuarial interest in the trust. This approach is used in section 4946 to determine a beneficiary's interest in a trust for purposes of the prohibited transaction rules. This approach is also used in section 2031 for valuation of annuities, interests for life or a term or years and remainder and reversionary interests. We believe that actuarial interests in a trust should not be used in this case because there is no direct linkage between distributions that might be made to a beneficiary and that beneficiary's age and life expectancy. This is consistent with the Regulations under section 2031, which provide that the actuarial interests are not to be used in cases of discretionary trusts. In addition, determining the actuarial interests of each beneficiary in a discretionary trust would be time consuming, expensive and could require the trustee to prematurely disclose the existence of the trust to a beneficiary who previously was not aware of the existence of the trust. The Service took a position consistent with this view in

FSA 199952014<sup>14</sup> in which the Service concluded that the actuarial interests of beneficiaries in a trust were not relevant facts and circumstances for purposes of determining a beneficiary's constructive interest in a trust under section 958.

(2) Pro-rata based on number of current beneficiaries

Another method, which is simplistic, but consistent with the Congressional intent behind the "substantial U.S. owner" identification requirement, would be to treat each beneficiary as owning their pro-rata interest in the trust based on the number of current beneficiaries for the year(s) in question. For example, if there were only three current beneficiaries, then each would be treated as owning 33.33% of the trust until the number of beneficiaries changes. Unlike the actuarial interest approach discussed above, this approach would have the benefit of ease of administration by the trustee.

e) Current, remainder, contingent and non-contingent beneficiaries

Not all beneficiaries of a trust are eligible to receive a current distribution of income or corpus from the trust. Current beneficiaries are the class of beneficiaries who are eligible to receive a distribution should the trustee, in its discretion, determine to make a distribution in the year in question. Remainder beneficiaries are generally not eligible to receive distributions until the class of current beneficiaries has died or otherwise become ineligible. Contingent beneficiaries are those who will not become eligible beneficiaries until one or more specified future events have occurred.

Under section 1361, only current beneficiaries are taken into account to determine if a trust is an electing small business trust. Our view is that only current beneficiaries should be taken into account in determining which beneficiaries are substantial U.S. owners under section 1473(2). We believe remainder and contingent beneficiaries should not be taken into account under section 1473(2) until they become current beneficiaries. This also is consistent with the Service's position in FSA 199952014.

4. Should Ownership be Attributed Between Beneficiaries for Purposes of the Ten Percent Determination?

Sections 1472 and 1473 do not specifically impose constructive ownership rules in determining whether a particular beneficiary is a substantial owner although section 1473(2) refers to direct or indirect ownership by a beneficiary. We do not believe that direct or indirect ownership should include constructive ownership. In other circumstances in which Congress has intended to apply constructive ownership rules, the statutory language has specifically included such rules. The Code includes a number of different sets of constructive ownership rules.<sup>15</sup> Accordingly, we believe that Treasury and the Service should not include constructive ownership rules in Regulations under section 1473(2) because Congress did not explicitly provide for constructive ownership rules to apply. This is consistent with the view of the Service as set out

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<sup>14</sup> Sept. 23, 1999.

<sup>15</sup> See, e.g., I.R.C. §§ 267(b), 318, 958(b).

in TAM 200733024,<sup>16</sup> which provided "[w]hen Congress intends constructive ownership rules to apply, it will expressly so state."

#### IV. Foreign Estates

##### A. Foreign Estate with U.S. Assets

The estate of a decedent who is not a U.S. person may be subject to U.S. estate tax, typically because the estate holds one or more U.S. situs assets. In such a case, the estate is viewed as the taxpayer and the beneficial owner of payments made to the estate and provides, if required, a Form W-8BEN to withholding agents.

The definition of a substantial U.S. owner in section 1473(2) does not reference estates. Accordingly, we recommend that Treasury and the Service clarify in Regulations that the beneficiaries of a foreign estate should not be treated as substantial U.S. owners for purposes of section 1472.

#### V. Reporting Under Section 6038D

Under section 6038D, any individual who has any interest in a SFFA is required to attach a statement to his or her income tax return setting out certain information regarding that SFFA if the aggregate value of the interest exceeds \$50,000. For these purposes, the term SFFA includes any interest in a foreign entity (as defined in section 1473). A foreign trust is included in the definition of foreign entity; this is confirmed, for example, by the cross reference in section 6662, as amended by FATCA, to section 6049, Information With Respect to Certain Foreign Trusts.

The information to be provided with respect to covered foreign trusts includes such information as is necessary to identify the trust, as well as the maximum value of the beneficiary's financial interest in the trust during the taxable year.<sup>17</sup>

These new reporting requirements raise a number of complex issues that are not raised by section 1472. We believe resolving these issues in a manner that respects the wishes of the settlor of the trust and the practical ability of the beneficiaries to gather the required information from the trustee(s), while at the same time providing the Service with the information Congress intends that the Service collect on such foreign trusts requires careful balancing.

We believe Treasury and the Service should provide a bright line test for a reportable "interest" in a trust and clear rules for valuation of that "interest" in view of the significant penalties imposed for failures to disclose the required information, which can be up to (i) \$60,000 per year under section 6038D for each year for which the new Form is not filed and (ii) under section 6662(j), 40% of the understatement for any taxable year that is attributable to any transaction involving an undisclosed foreign financial asset.

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<sup>16</sup> Aug. 17, 2007.

<sup>17</sup> I.R.C. § 6038D(c).

## A. Beneficiaries of a Quiet Trust

The first issue is how to deal with a quiet trust, the existence of which has not been disclosed to one or more of the beneficiaries. As noted above, in many cases a beneficiary may not be aware of the fact that he or she is a beneficiary of a trust. In determining whether a beneficiary is a substantial U.S. owner, we recommended that a trustee be allowed to certify whether a beneficiary of a quiet trust is a substantial U.S. owner based on the address of record for that beneficiary. We believe this approach would balance the Congressional intent behind section 1472 with the wishes of the settlor of the trust.

We believe, however, that in the case of reporting under section 6038D Treasury and the Service should adopt a different approach. We recommend that only current beneficiaries who have received a distribution from a trust in the taxable year in question be considered to have an interest in a foreign trust requiring compliance with section 6038D. This is consistent with trust law in many jurisdictions, both domestic and foreign, under which a discretionary beneficiary is not considered to have an enforceable interest in a trust until such time as an actual distribution is made to such beneficiary. We believe contingent beneficiaries, remainder beneficiaries and beneficiaries who have not received a distribution from a trust, should not be treated as having an interest in the foreign trust and thus should not be required to report under section 6038D.

## B. Requirement to Provide a Copy of the Trust Instrument

The second issue is whether Treasury and the Service should require each beneficiary who has the requisite interest in the trust to provide a copy of the trust instruments, amendments, schedules and exhibits to the Service as an attachment to the new form. Many beneficiaries do not have a copy of the trust instrument; in addition, the terms of the trust instrument may prohibit the trustee from providing a beneficiary with a copy of the trust instrument. Finally, a beneficiary may not have the right under applicable trust law to force the trustee(s) to provide a copy of the trust instrument to the beneficiary. Accordingly, we believe that the Regulations should require that a beneficiary provide only the name and address of the trust and the trustee(s) to the Service in the new reporting Form. The Service would then have the information to contact the trustee(s) of the trust if necessary.

## C. Requirement to Disclose Maximum Interest in the Trust

The third issue is how to determine a beneficiary's level of financial interest in a foreign trust. The beneficiary may be aware only of the fact that he or she and others, whose identities are possibly unknown to the beneficiary, are beneficiaries of a foreign trust. Many settlors do not want the beneficiaries to know the size of the trust corpus or any other financial details of the trust. Also, as discussed above, in the case of a complex, discretionary trust, the beneficiary may not have a quantifiable interest in the trust under the terms of the applicable trust law.

Accordingly, we recommend that Treasury and the Service provide in Regulations that the value of a beneficiary's interest in a trust for purposes of section 6038D is limited to the amount of actual distributions received by the beneficiary during the taxable year in question from a complex trust. As a result, in some years a particular beneficiary may be required to

report, while in other years reporting may not be required by that beneficiary because the beneficiary did not receive a distribution from the trust during such years.

#### D. Report Only Direct Interests in a Trust

Section 6038D requires individuals to report their interest in a foreign entity, which as noted above includes a foreign trust. Section 6038D does not include the phrase "directly or indirectly." When Congress intends to include indirect ownership of assets, Congress expressly so states.<sup>18</sup> Accordingly, we believe that the Regulations under section 6038D that the only SFFA to be reported by the beneficiaries of a foreign trust is the interest in the trust itself. We do not believe Treasury and the Service should impose a look through rule requiring the beneficiaries to also report their respective interests in any SFFAs held by the trust. We believe requiring disclosure of indirect interests would impose a significant burden on the trustees and might require information the trustee is otherwise precluded from disclosing to the beneficiaries.

#### E. Foreign Estates

An estate is not an entity and thus we believe the beneficiaries of an estate should not be required to report their interests in the estate under section 6038D. We recommend that Treasury and the Service clarify that estate beneficiaries are not required to report under section 6038D.

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<sup>18</sup> See, e.g., I.R.C. §§ 267(b)(8), 958(a)(2).