

[TEXT OF THE FATCA COMMENT LETTER SUBMITTED BY
THE SOCIETY OF TRUST AND ESTATE PRACTITIONERS]

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Re: *Announcement 2010-22 and Notice 2010 - 60* (FATCA Comments)

Dear Ladies and Gentlemen:

On behalf of the United States members of the Society of Trust and Estate Practitioners (STEP), a group whose more than 15,000 plus members worldwide are experienced trust and estate professionals representing the legal, private banking and accounting professions, we thank you for providing guidance regarding Foreign Account Tax Compliance Act ("FATCA"). We would like to offer some suggestions and comments regarding the above-noted announcement and notice regarding proposed regulations (the "Notices").

SUGGESTIONS, COMMENTS AND CLARIFICATION

Based on our understanding, A thirty percent withholding tax on all sources of U.S. income, except that which is income effectively connected with a United States ("U.S.") trade or business, will be levied on the gross payment ("Withholdable Payment" n1), whether subject to tax or not, due Foreign Financial Institutions ("FFI") and Non-Financial Foreign Entities ("NFE"), except those institutions which are deemed exempt by the Secretary of Treasury (the "Treasury"), that do not report the required United States ("U.S.") account holder information by way of written agreement with the U.S. Internal Revenue Service (the "IRS"), or do not sign an agreement with the IRS to make such reports. It is on this basis from which the below comments and suggestions are formed. It is further understood that use of foreign trust property will now be treated as a distribution and the reporting of cer-

tain financial assets will be required as a compliment to the Foreign Bank and Financial Account Report (TD F 90-22.1) under Title 31 of the U.S. Code.

I. FFI Withholding Tax Regime

Much of the comments and suggestions in the following paragraphs of this section are focused on establishing, which family trusts, insurance and pension plans should be exempt from the definition of FFI and the appropriate level of due diligence.

A FFI is broadly defined as a foreign entity, except an institution which is organized in a possession of the U.S. to the extent it is not an intermediary used for the purposes of tax avoidance as provided by the Treasury. FFI are further defined as those which accept deposits, substantially holds financial assets for the account of others, is engaged (or holds itself out) as being engaged in the business of investing, reinvesting, or trading of securities, partnership interests, commodities or similar financial assets, including foreign hedge and private equity funds. n2

At the same time, the Congressional Joint Committee on Taxation (“JCT”) did not intend for regulated insurance companies, holding companies, research and development subsidiaries, or financing subsidiaries within affiliated groups of non-financial operating companies to be included. n3

In essence, the definition of a FFI only intended to capture foreign entities and structures whose primary activity is that of financial services, and not that of wealth preservation.

A. Foreign Family Trusts

Based on the JCT legislative comments and the clear language of the statute, it appears very clear the intention to include banks, security firms, money services, currency exchange houses, hedge funds, private equity funds, commodity traders, derivative dealers, and other types of financial organizations that holds, invests, or trades assets on behalf of itself or another person, and not those whose primary, if not sole, activity is wealth preservation. Hence, they do not meet the definitional intention of the current FATCA legislation as their primary purpose is wealth preservation not the holding, investing or trading for profit.

In addition, foreign trusts and their related structures are heavily regulated under Code sections 672(f), 679, 6038, 6048, and 1291 through 1298, and their related Treasury Regulations. In essence, wealth preservation structures (including private trust companies) pose little threat of tax avoidance.

By way of taxation, the Code treats foreign trusts as ordinary trusts whether they are formed as common law trusts, civil law foundations or fideicomisos. Various court and private letter rulings have equated civil law foundations to that of a U.S. trust which is classified as a non-grantor or grantor trust arrangement as they have more similar characteristics of a domestic ordinary trust. It should be noted that the IRS has not commented in any authoritative fashion on Latin American Fideicomisos. Hence, the informal advice has been to treat these vehicles as ordinary trusts under the Code (sec. section 6038) to ensure avoidance of the foreign trust reporting penalties. Simply stated, the Code and

Treasury Regulations (“Reg.”) treat all foreign trust arrangements as ordinary trusts under *Reg. section 301.771-4(a)* without regard to the substance of the settlement transaction (preservation of wealth, business or investment activities).

As a general rule, it has been our experience that there are a very limited number of foreign jurisdictions that regard trusts as anything but wealth preservation mechanisms (ie., ordinary trusts). An ordinary trust is an arrangement created either by will or by inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. n4 Thus, the key elements of an ordinary trust are a gratuitous transfer for the protection or conservation of property for the benefit of others (i.e., wealth preservation).

If the Treasury cannot see its way to excluding foreign trusts from the definition of a FFI, we recommend the following reporting requirements which are in line with the overriding intent of FATCA. Such reporting will provide the IRS with the information necessary to detect tax evasion without overburdening administration.

Foreign trustee requirements should be limited to obtaining a U.S. tax identification number for trusts (grantor or non-grantor) where U.S. persons are owners or beneficiaries, and provide U.S. beneficial owner and U.S. grantor information. Many foreign trustees are familiar with the production of foreign non-grantor trust beneficiary statements and foreign grantor/owner statements. Thus, we would suggest a new annual information return (Form 3520-W, Annual Information Return of Foreign Trust to Report U.S. Owners and Beneficiaries) that would provide the following information. This new form, should Treasury still deem trusts to be FFIs after consideration of the above, will satisfy the FATCA reporting requirements while making administration easy and efficient. We would further suggest, should this form or any similar information return be adopted, that such return has an original filing date of March 15 following the calendar year-end with an automatic 6-month extension being allowed by filing U.S. tax form 7004.

Suggested Form 3520-W information requirements (see below example).

- Name and address of trust

- Name and address of trust company, if different from trust

- Date trust was established

- Legal jurisdiction of trust

- U.S. Owner Information
 - Names and addresses

- U.S. tax identification numbers
- U.S. Beneficiary Information
 - Names and addresses
 - U.S. tax identification numbers
- Books and records Information
 - Fiscal year of books and records
 - Dec 31 value of trust assets
 - Dec 31 distributable net income (including capital gains) or accounting income
 - Distributions to U.S. persons [Link-to-image-2010276181](#)

With regard to a safe harbor due diligence on the part of the foreign trustee, it should be limited to electronically, and non-electronically, searchable information maintained by the trustees, including if not already dictated by internal controls, copies of the settlors and then living beneficiaries passports, which is now the case in most foreign jurisdictions as a mechanism of their know-your-client (“KYC”) and anti-money laundering rules. If such persons are too young to have obtained a passport then, a birth certificate from the jurisdiction of birth or similar document proving nationality may be required. If the settlors and beneficiaries provide a non-U.S. passport with no other indication of being a U.S. person by way of U.S. address (residence, “in care of, “hold mail”, post office box, power of attorney or signature or other U.S. address), the trustees should be deemed to have exhausted their due diligence requirements unless there is reason to believe the information provided is not reliable or correct. We would further suggest that such files be updated by January 1 of 2014, one year from the effective date of the law (January 1, 2013) for existing clients and every three years thereafter. This should allow sufficient time before the general three year statute of limitations for examination of returns expires. For new clients, due diligence would be effective immediately but the trustee institution would have 9 months from the date of the account opening to obtain the required information to determine U.S. or non-U.S. status, and then every three years thereafter (January 1 of the third year following the last update). Again, this should allow sufficient time before the statute of limitations for examining returns expires.

Should the Treasury require reporting by the trustee, though we believe this should not be the case, then such information should not be required under the financial asset reporting requirements of the Code (6038D) as this would be duplicative and unnecessary as discussed later.

B. Cash Value Insurance Policies

As stated in *IRS Notice 2010-60*, there are insurance contracts (life and annuity) which provide both insurance and investment aspects. As these products are highly regulated in offshore jurisdictions (Bermuda, Bahamas, U.K., Switzerland, etc.), much like the U.S. products. In our experience, the primary use of contracts is estate planning (i.e., wealth preservation).

In addition, all offshore jurisdictions which accept U.S. persons as annuity or life insurance clients, they do so with products which meet the life insurance contract requirements of the Code (*sec. 7702*). Hence, there appears to be no apparent threat of tax evasion by way of any offshore annuity or life insurance contract or those insurance companies which sell them.

Therefore, we strongly suggest the Treasury use its regulatory authority to exclude insurance providers, including their products as FFIs and U.S. accounts.

Should the Treasury not agree with our suggestion we would recommend the reporting burden be on the owner of the insurance contracts and be reportable by way of the newly legislated foreign asset account reporting under Code *section 6038D* as discussed below.

C. Self-Employed Pension Plans

It has been our experience that most, if not all, the countries in which the U.S. has a comprehensive income tax treaty and/or information exchange agreement, the employer and self-employed retirement plans are highly regulated schemes. It should also be noted that most of our income tax treaties provide that pension and retirement income associated with employment or other remuneration in another contracting State, such pension and retirement income is taxable in that State. This means the FFI that administer the plans will be required to withhold tax from U.S. persons upon making distributions of said retirement income. Hence, the U.S. person will make a claim for foreign taxes paid under the Code (*sec. 901*) in order to avoid double taxation. Hence, there is an inherit tax reporting mechanism with regard to employer and other retirement plans. That being the case, along with home country regulation there is little risk of U.S. tax avoidance.

Should the Treasury feel strongly regarding the ability to know what foreign retirement plan income U.S. persons may have available to them we would suggest the reporting responsibility be on the U.S. taxpayer not the FFI administrator or sponsor, and the U.S. person be required to disclose such asset under the new foreign financial asset reporting requirements of the Code (*6038D*) as discussed later in section III.

D. U.S. Account Due Diligence

As discussed above, most FFI's require copies of account holders' passports and additional information not required by many U.S. financial institutions. That said, we strongly encourage the Treasury to allow a safe harbor rule which states that FFI's responsibility for determining U.S. accounts should not require them to search any further than their files, electronic and non-electronic, so long as they

follow their local jurisdictions KYC and anti-money laundering rules and can identify a customer's nationality by way of a copy of their passports. We further suggest that if FFI customer presents a foreign passport, though it is possible that a natural person have dual, and may be multiple nationalities, the FFI should be able to rely on such information presented to them so long as they are not aware that it is unreliable or incorrect and there are no other indications of a U.S. connection by way of a U.S. address ("in care of", "hold mail", P.O. box, Power of Attorney, signature, etc.). We would further suggest that, in conjunction with the above, the FFI require the account holder to sign the appropriate Form W-9 or W-8BEN which they will maintain for a period of three years in which time the FFI should revisit their files for reapplication of due diligence.

In application of the due diligence requirements we request FFI's ensure such documentation is received within 9 months of opening a new account, and then allowed a three year reapplication period thereafter to be in line with the statute of limitations for examination of returns. For existing accounts, we recommend the FFI be given one year after the date their IRS agreement is effective to have collected the appropriate documentation and allowed a three year window for reapplication thereafter. We further recommend these suggested rules apply to individual and entity accounts.

This proposed safe harbor rule will provide the IRS with the information required and confidence of said information while encouraging FFI's cooperation knowing their ability to capture U.S. account holders is reasonable and within their ability.

II. Use of Foreign Trust Property

It appears to be very clear that Congress and the Treasury wish to impose current income recognition when U.S. settlors and beneficiaries of foreign trusts, or related persons, have used property from a foreign trust. We believe such intention is not in line with the principles of income tax law. Hence, we recommend that income be recognized within such principles as discussed below.

A. Principles of law

The very basics of income recognition begin with the principle of "economic benefit" which basically states that income is recognized when net worth during a given period of time has changed. This basic principle, commonly known as the Haig-Simons definition was derived by the American economists Robert M. Haig and Henry Simons. This principle has been cited in various U.S. tax cases all the way from the U.S. Tax Court through the U.S. Supreme Court starting from the inception of the current income tax law first enacted after the ratification of the 16 Amendment in 1913. The law of that day, as well as the current Code, does not consider taxable income with changes in net worth resulting from gratuitous transfers such as gifts and bequests. Because of the difficulties of estimation, most accretions to wealth are ordinarily not included in a person's taxable income until they are realized (i.e., the principle of realization). The principle of "realization" is another fundamental institution within the fabric of the U.S. tax system. This principle states that income is not to be recognized until a change in wealth is convertible into cash or another form which is easily valued.

Based on the above principles of taxation Code *section 1015* states that the basis of property gratuitously transferred in trust or otherwise shall be the basis of the previous owner plus any gift tax paid. The basis carryover rule continues to apply when trust property is distributed unless the trustee elects to treat the distribution as a taxable gain in which case the basis of the property to the beneficiary would be the current market value. n5 Hence, transfers of property where the transaction has not been closed out or completed has not been converted into a form easily valued (i.e., closed and completed doctrine), therefore not realized.

The “closed and completed transaction” doctrine simply states income is not to be recognized until a transaction has come full circle (i.e., exchange for consideration easily valued).

Under these principles, the mere use of trust property would not constitute a realization event but rather a borrowing of property or in some cases the use of one’s own property. The principles of income recognition do not recognize borrowing as a realization event, so long as the property is returned within a reasonable period of time.

In light of the above principles of taxation, we request Treasury regulations be written to confirm that the use of foreign trust property be treated as a future, rather than a current income recognition event unless the trust has relinquished ownership.

B. Use of Property Distributions

Based on the above discussion, the mere use of property does not provide the beneficiary of a foreign trust sufficient property rights (i.e., control) for which they could dispose of property used. Without such power, current income recognition violates the principles of taxation. Therefore, it seems clear that the use of property in most circumstances would not constitute a current taxable transaction without election.

1. Gift

The Treasury Regulations to be written on this matter should reaffirm the following. The distribution of property from a foreign grantor trust which is revocable should constitute a gift when distributed to anyone other than the settlor and be subject to the gift tax rules if the grantor is a U.S. person. If the settlor is not domiciled in the U.S. then the gift would be reportable but not taxable pursuant to the Code (*section 6039F*), if made to a U.S. income tax resident.

The DNI and UNI rules should not apply to the mere use of property as the only current benefit received by the U.S. beneficiary is a partial gift, as noted

by way of the above principles of taxation. In such situation the use of the property should be recognized as reduction of the basis of the property, but not below zero. The reduction in basis will result in additional trust DNI, and/or UNI, recognized upon the disposition of the property which follows the principles of income recognition (realization, closed and completed transaction, etc.).

In order to maintain appropriate compliance it is suggested the beneficiary report any such use of property as a non-taxable distribution and provide an appropriate computation of the property's adjusted basis. If the property is later disposed of, or distributed this will result in the recognition of additional income under the foreign trust DNI rules n6 , therefore following the principles of taxation.

We would suggest the reduction in basis be computed as follows.

[Cost basis plus improvements/the depreciable life]

X Number of days of use

[365 days]

Example

A U.S. beneficiary or other related U.S. person, uses a \$ 5,000,000 Bahamian vacation home owned by the foreign non-grantor trust. The real property was purchased 5.5 years ago by the trust. The U.S. beneficiary uses the home for 25 days. The reduction in basis is computed as follows.

$\$ 5,000,000 / 40 \text{ year life (foreign residential property)} / 365 \text{ days} \times 25 \text{ days} = \$ 8,562 \text{ (rounded to the nearest dollar)}$

2. Distribution Subject to Subchapter J Rules

Should the trustee not desire to maintain, or be able to maintain, basis reduction computations or the beneficiary does not return such property by

the 65th day of the year following the close of the previous calendar year, the use of such property should be treated as a deemed distribution subject to the DNI and UNI rules of Subchapter J.

Should the use of property be treated as a taxable distribution the determination of the fair value of the distribution should be as discussed below.

We suggest the following elective method in determining fair value of any distribution, where readily available values are not easily ascertainable. Such election is objective and simple which provides ease of compliance.

An example of where values and costs will not be readily available is with wealthy families from emerging market countries. In such jurisdictions, India for example, a vast amount of assets which can make up a large portion of the family wealth consist of illiquid assets such as artwork, jewelry or other collectibles, or similar type property that was acquired by bartering and dowry (e.g., arranged marriage) transactions accumulated over multiple generations, sometimes dating back centuries. There was no legal or other requirement to maintain cost and valuation records for these types of transactions. In these situations it will be near impossible to ascertain reasonable valuations for the vast amounts of assets without exorbitant cost and time, thereby discouraging compliance and international wealth transfer which the U.S. will benefit.

Thus, the fair value of any property distribution received subject to the rules of Subchapter J (Code section 643(e)(3)) shall be computed as follows, where cost is ascertainable. The adjusted basis (cost plus improvements less any adjustments) increased by the long-term Applicable Federal Rates between 110% and 130% of the applicable monthly rate compounded for the holding period and reduced to a partial amount, if said distribution is not for the full value (i.e., deemed or elected distribution), by the quotient of the holding period and 365 days for each year in the holding period plus any days within a year

in which the property was not used for the full year.

Example

A U.S beneficiary uses a \$ 5,000,000 Bahamian vacation home owned by the foreign non-grantor trust. The real property was purchased 5.5 years ago by the trust. The U.S. beneficiary uses the home for 25 days. The applicable monthly long-term AFR rate is 3.04%.

The fair value of \$ 5,000,000 compounded at the applicable AFR rate for the holding period of 5.5 years is \$ 5,908,704.

Fair Value - \$ 5,908,704

Total holding period days - $5.5 \times 365 = 2,008$ days (rounded to nearest day)

Daily value - $\$ 5,908,704 / 2,008$ days = \$ 2,943 (rounded to nearest \$)

Total distribution value for 25 days = \$ 73,575

We further suggest that if the cost is not readily ascertainable, as is likely in multi-generation bartering and dowry transactions, regulations provide that the value of such distribution be determined by means which are reasonable, consistent and not tax motivated, and that records and other evidence of the derived value will be made available to the Secretary of Treasury.

Finally, we suggest that under a taxable distribution scenario the distribution received should constitute current gross income deemed received by the trust in an arm's length transaction, as such the principles of realization should not constitute UNI n7 unless the trustee makes a distribution less than DNI.

C. U.S. Trade or Business

It should be further explained within the Regulations that any income recognized by the trust in accordance with a use of property distribution shall not be treated as income effectively connected with a U.S. trade or business unless such transaction, or series of transactions along with the facts and circumstances would constitute a U.S. trade or business within the confines of the Code (*section 684*) and related Treasury Regulations.

In summary, to keep the confines of jurisprudence, the use of foreign trust property should first and foremost be deemed a gift of a future interest, and second as a distribution subject to the rules of Code *section 643(a)(6)* and *sections 655 through 668* if the beneficiary makes an explicit election or by deemed election if the property is not returned within 65-days after the end of the calendar year.

III. Foreign Financial Asset Reporting

We understand the aim of the foreign financial asset reporting section of the FACTA rules are intended to provide the IRS with Title 26 (*U.S. Code*) examining authority not provided under Title 31 of the *U.S. Code* (FBAR rules). With this objective in mind we offer the following suggestions and comments in relation to the disclosure of foreign financial assets and the reduction of duplicative reporting.

In the spirit of minimizing duplicative reporting we suggest Treasury Regulations make it clear that “specified foreign financial assets” incorporate the foreign financial account definitions of Title 31 regulations and provide an election to report such accounts under *IRC 6038D* where the total of all such accounts exceeds the threshold of \$ 10,000 but the taxpayers total foreign financial assets does not exceed the \$ 50,000 threshold. If such election is made, or the taxpayer must report their foreign financial accounts as a result of exceeded the \$ 50,000 foreign financial asset threshold, then the tax should not be required to complete Form TD F90-22.1 but rather attach Form 8939 to Form TD F 90-22.1 and file the FBAR by the original due date of June 30 or the extended due date of their income tax return.

We further suggest that only those assets, and their related income, not reported elsewhere (*Code sections 1298(f), 6038, 6039F, 6048 and 1474 through 1478*) are also required to be reported under *Code section 6038D*.

In summary, the assets to be reported under the *Code section 6038D* would be foreign financial accounts as well as the following assets which owned (directly or indirectly), or treated as being owned (e.g., foreign trust assets, as noted above), that are not reportable elsewhere in Title 26 of the Code.

- Less than 10% interest (direct or indirect) in a Controlled Foreign Corporation or Partnership as these items are exempt from reporting under section 6038
- Other foreign tangible, intangible or real property which may produce, or is intended to produce, passive investment income (e.g., life and annuity insurance contracts, pension and retirement plans, artwork and other collectibles, etc.)

The above suggestions eliminate the very small segment of foreign financial assets not already captured elsewhere. The reporting will ensure U.S taxpayers obtain the necessary information required or invest elsewhere, or face substantial penalties. It will also ensure foreign persons accepting U.S. investors produce appropriate reporting information or decide not to take U.S. investors. The ultimate result will be that U.S. persons will have limited reasonable cause for not appropriately reporting their

foreign financial assets, and associated income, not reported elsewhere under Title 26 of the Code which is the primary intention of the new provisions of Code *section 6038D*.

The method of determining the aggregate value of the reportable foreign financial assets in excess of \$ 50,000 should be based on the highest monthly balances, or less frequent reporting as applicable in the local jurisdiction for those assets which values are ascertainable. For those assets where an ascertainable value is not available the gross amount invested should be the amount used. In summary, we suggest the \$ 50,000 value be defined as the gross amount invested in assets with no ascertainable value plus the highest monthly value, or less frequent reporting required by the foreign jurisdiction, where ascertainable values are available by way of a recognized securities market.

Where a taxpayer meets the foreign financial asset reporting requirements we suggest a new form as shown below. [Image omitted]

CONCLUSION

Again, we applaud the Treasury and Service for their efforts in providing guidance related to FATCA and thank you for the opportunity to present our comments on the matter. It would be our pleasure to further discuss our thoughts with you or others at the Internal Revenue Service. Please feel free to contact myself or my esteemed colleague Mr. Lawrence Heller.

Sincerely,

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FOOTNOTES:

n1

IRC section 1473(1)(A)(i) - (ii), (B) - (C) 156 Cong. Rec. S1745, JCTE at 45

n2

IRC section 1471(d)(5) and JCTE at 44

n3

See fn. # 2

n4

Reg section 301.701-4(a) (last sentence)

n5

IRC section 643(e)(3)

n6

IRC 643(a)(6) and *(e)(3)*

n7

IRC sections 665 through 668