Notice of Proposed Rulemaking and Notice of Public Hearing

Inbound Grantor Trusts With Foreign Grantors

REG–252487–96

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations implementing section 672(f) of the Internal Revenue Code, as amended by the Small Business Job Protection Act of 1996, which relates to the application of the grantor trust rules to certain trusts established by foreign persons. The proposed regulations affect primarily United States persons who are beneficiaries of trusts established by foreign persons. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by August 4, 1997. Requests to speak (with outlines of oral comments) to be discussed at the public hearing scheduled for August 27, 1997, at 10 a.m. must be submitted by August 6, 1997.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG–252487–96), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:R (REG–252487–96), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/prod/tax_regs/comments.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning § 1.671–2(e), James Quinn (202) 622–3060; concerning the remainder of these regulations, M. Grace Fleeman (202) 622–3850; concerning submissions and the hearing, Michael Slaughter (202) 622–7190 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

Section 1904 of the Small Business Job Protection Act of 1996 (the Act), Public Law 104–188, 110 Stat. 1755 (August 20, 1996), amended section 672(f) and certain other sections of the Internal Revenue Code (Code). The amendments affect the application of sections 671 through 679 of the Code (the grantor trust rules) to certain trusts created by foreign persons.

1. Prior law

Under prior law, a grantor of a trust generally was treated as the owner of any portion of the trust over which he retained any of the powers or interests described in sections 673 through 677 without regard to whether he was a domestic or foreign person. A special rule contained in prior section 672(f) generally provided that, if a U.S. beneficiary of a trust created by a foreign person transferred property to the foreign person by gift, the U.S. beneficiary was treated as the grantor of the trust to the extent of the transfer.

Under the prior rules, if a foreign person created a trust with one or more U.S. beneficiaries that was treated as a grantor trust with the foreign person as the grantor, a distribution of income from the trust to a U.S. beneficiary was treated as a gift and was not subject to U.S. income tax in the hands of the beneficiary. See Rev. Rul. 69–70 (1969–1 C.B. 182). If the income of the trust was not taxable to the foreign grantor under section 871 and also not taxable to either the grantor or the trust by either the grantor's country of residence or another foreign country, the income of the trust was, thus, not subject to tax by any jurisdiction.

A special rule contained in section 665(c) provided generally that intermediaries or nominees interposed between certain foreign trusts and their U.S. beneficiaries could be disregarded. However, that rule applied only to trusts created by U.S. persons.

2. Overview of changes

The changes made by section 1904 of the Act are designed to ensure that U.S. persons who benefit from offshore trusts created by foreign persons (inbound trusts) pay an appropriate amount of U.S. tax. Generally, the grantor trust rules now cause a person to be treated as the owner of a trust only to the

extent such application results, directly or indirectly, in an amount being currently taken into account in computing the income of a U.S. citizen or resident or a domestic corporation. Exceptions are provided for certain revocable trusts, for trusts from which the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse, and for certain compensatory trusts. There also are grandfather rules for certain trusts that were in existence on September 19, 1995.

As a result of the changes, many inbound trusts that were grantor trusts under prior law are now nongrantor trusts. Distributions of trust income to the U.S. beneficiaries of such trusts are now taxable to U.S. beneficiaries and may be subject to an interest charge on accumulation distributions.

Section 1904 of the Act also includes some special rules. Section 643(h), which replaces former section 665(c), treats any amount paid to a U.S. person that is derived directly or indirectly from a foreign trust of which the payor is not the grantor as if the amount is paid by the foreign trust directly to the U.S. person. Section 672(f)(4) allows the IRS to recharacterize a purported gift or bequest from a partnership or foreign corporation when necessary to prevent the avoidance of the purpose of section 672(f). Section 672(f)(5), which is an expansion of prior section 672(f), generally provides that if a U.S. beneficiary of a trust created by a foreign person transfers property to the foreign person, the U.S. beneficiary is treated as the grantor of the trust to the extent of the transfer.

Explanation of Provisions

1. § 1.643(h)–1: Distributions by certain foreign trusts through intermediaries

The proposed regulations describe the circumstances under which an amount of property that is derived, directly or indirectly, by a U.S. person from a foreign trust through an intermediary will be deemed to have been paid directly by the foreign trust to the U.S. person. This rule does not apply if the intermediary is the grantor of the portion of the trust from which the amount is distributed. The amount will be deemed to have been paid directly by the foreign trust if any one of the following conditions is satisfied: (1) the intermediary is related (as defined in the regulations) to either the U.S. person or the foreign trust and the intermediary transfers to the U.S. person either property that the intermediary received from the trust or proceeds from the property that the intermediary received from the trust; (2) the intermediary would not have transferred the property to the U.S. person (or would not have transferred the property on substantially the same terms) but for the fact the intermediary received property from the foreign trust; or (3) the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax.

The proposed regulations describe the effect of disregarding the intermediary. If the intermediary is an agent of either the foreign trust or the U.S. person under generally applicable agency principles (under the standards set forth in *Commissioner v. Bollinger*, 485 U.S. 340 (1988)), the amount is treated as paid by the foreign trust to the U.S. person in the year it would be so treated under the general principles. Thus, if the intermediary is an agent of the foreign trust, the amount is treated as paid to the U.S. person in the year it is paid by the intermediary to the U.S. person. If, however, the intermediary is an agent of the U.S. person, the amount is treated as paid to the U.S. person in the year it is paid by the foreign trust to the intermediary.

If the intermediary is not an agent of either the foreign trust or the U.S. person under generally applicable agency principles, the intermediary generally will be treated as an agent of the foreign trust, and the amount will be treated as paid by the foreign trust to the U.S. person in the year the amount is paid by the intermediary to the U.S. person. However, the district director may determine, based on all the relevant facts and circumstances, that the intermediary should be treated as the agent of the U.S. person.

The regulations provide a de minimis rule for distributions that do not exceed in the aggregate $10,000.

2. § 1.671–2(e): Definition of grantor

The proposed regulations provide a definition of grantor that applies for purposes of the grantor trust rules generally. A grantor is any individual, corporation, or other person to the extent such person (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. For purposes of the proposed regulations, a gratuitous transfer is any transfer other than a transfer for fair market value, or a corporate or partnership distribution. Treasury and the IRS request comments regarding the appropriate scope of gratuitous transfers.

A grantor includes a person who acquires an interest in a trust in a nongratuitous transfer from a person who is a grantor of the trust. A grantor also includes an investor who acquires an interest in a fixed investment trust from a person who had acquired his interest through a direct investment in the trust. Treasury and the IRS request comments on the appropriate scope of these rules as they affect fixed investment trusts.

If a person creates or funds any portion of a trust primarily as an accommodation for another person, the other person will be treated as a grantor with respect to such portion of the trust. See, e.g., *Stern v. Commissioner*, 77 T.C. 614 (1981), rev'd on other grounds, 747 F.2d 555 (9th Cir. 1984).

These regulations are not intended to change the result of existing law with respect to trusts used for business purposes. See § 301.7701–4(e) (environmental remediation trusts); Rev. Rul. 87–127, 1987–2 C.B. 156 (pre-need funeral trusts); Rev. Proc. 92–64, 1992–2 C.B. 422 (rabbi trusts). Treasury and the IRS request comments on the application of these new rules to trusts used for business purposes.

A grantor of a trust may or may not be treated as an owner of the trust under sections 671 through 677 and 679. A person other than a grantor of a trust may be treated as an owner of the trust under section 678.

3. § 1.672(f)–1: Foreign persons not treated as owners

The proposed regulations prescribe a two-step analysis for implementing the general rule of section 672(f). First, the grantor trust rules other than section 672(f) (the basic grantor trust rules) are applied to determine the worldwide amount and the U.S. amount. Then, the trust is treated as partially or wholly owned by a foreign person based on an annual year-end comparison of the worldwide amount and the U.S. amount.

The worldwide amount is defined as the net amount of income, gains, deductions, and losses that would be taken into account for the current year under the basic grantor trust rules in computing the worldwide taxable income of any person, whether or not such person

is a U.S. taxpayer (as defined in the regulation). The worldwide amount is determined in accordance with U.S. principles of income taxation, and includes amounts that would be attributable to foreign persons, without regard to whether such amounts are subject to U.S. income taxation.

The U.S. amount is defined as the net amount of income, gains, deductions, and losses that would be taken into account for the current year under the basic grantor trust rules (directly or through one or more entities) in computing the taxable income of a U.S. taxpayer. The U.S. amount includes amounts such as interest on state or local bonds that are not includible in gross income.

A U.S. taxpayer is defined as any person who is a U.S. citizen, a resident alien individual, a domestic corporation, a U.S. person who is treated as the owner of a trust under section 679, or a domestic trust to the extent such trust actually pays U.S. tax with respect to the income, gains, deductions, and losses.

If the worldwide amount and the U.S. amount are the same, the basic grantor trust rules continue to apply without the limitation of section 672(f). If the worldwide amount is greater than the U.S. amount, section 672(f) prevents the basic grantor trust rules from treating a person as the owner of that portion of the trust attributable to the excess of the worldwide amount over the U.S. amount.

4. § 1.672(f)–2: Trusts created by certain foreign corporations

Section 672(f)(3) provides in part that, except as otherwise provided in regulations, a controlled foreign corporation (CFC) shall be treated as a domestic corporation for purposes of section 672(f)(1). Under the proposed regulations, a CFC that creates and funds a trust will be treated as a domestic corporation to the extent that, if the basic grantor trust rules were applied, income earned by the trust for the taxable year would be subpart F income to the CFC that would be currently taken into account in computing the gross income of a U.S. citizen or resident or a domestic corporation. However, the CFC will not be treated as a domestic corporation to the extent the income of the trust would not be subpart F income or to the extent it would be subpart F income but would not be taken into account in computing the gross income of a U.S. citizen or resident or a domestic corporation (e.g., the CFC had no overall earnings and profits).

The proposed regulations include similar rules for trusts created by passive foreign investment companies (PFICs) or foreign personal holding companies.

Section 672(f)(3) also provides that the general rule of section 672(f)(1) shall not apply for purposes of section 1296. The proposed regulations implement this rule by providing that, for purposes of determining whether a foreign corporation is a PFIC, the grantor trust rules shall be applied as if section 672(f) had not come into effect. Consequently, a foreign corporation cannot avoid PFIC status by transferring passive assets to a trust that would be treated as a nongrantor trust if section 672(f) were applied.

5. § 1.672(f)–3: Exceptions to general rule

A. Certain revocable trusts

The proposed regulations provide that the general rule of § 1.672(f)–1 does not apply to any portion of a trust if the power to revest in the grantor title to such portion is exercisable solely by the grantor without the approval or consent of any other person. If the grantor can exercise the power only with the approval of a related or subordinate party who is subservient to the grantor, such power will be treated as exercisable solely by the grantor.

The exception will not apply unless the power to revest is exercisable for a period or periods aggregating 183 days or more during the taxable year of the trust. This rule is intended to provide a bright line rule for the benefit of both taxpayers and IRS examiners that addresses potentially abusive situations in which a power to revest is so limited that it is not likely to be exercised. The 183 days need not be consecutive; thus, a power to revest that is exercisable each year from January 1 through May 31 and again from September 1 through December 31 would be eligible for the exception.

Consistent with the statute, the proposed regulations provide a grandfather rule for a trust that was treated as owned by the grantor under section 676 on September 19, 1995. As long as such a trust would continue to be so treated under the basic grantor trust rules, the trust will be exempt from the general rule of section 672(f), except with respect to any portion of the trust attributable to transfers to the trust after September 19, 1995. Under the proposed regulations, separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof, as well as losses and distributions therefrom.

B. Certain other trusts

The proposed regulations provide that the general rule does not apply to any trust (or portion of a trust) if the only amounts distributable (whether income or corpus) from such trust (or portion of a trust) during the lifetime of the grantor are amounts distributable to the grantor or the grantor's spouse. For this purpose, payments of reasonable nongratuitous amounts, such as reasonable administrative expenses, are not considered to be amounts distributable from the trust.

The proposed regulations clarify that amounts distributable in discharge of a legal obligation of the grantor or the grantor's spouse will generally be treated as amounts distributable to the grantor or the grantor's spouse. Thus, it is expected that a reinsurance trust that would have been a grantor trust under prior law generally will continue to be a grantor trust. (No inference is intended as to whether a reinsurance trust constitutes a trust under regulation § 301.7701–4.) However, a legal obligation will not include an obligation to a person who is related (as defined in the regulations) to the grantor or the grantor's spouse, unless the obligation was entered into for adequate and full consideration in money or money's worth. Trusts from which distributions are taxable as compensation for services rendered generally will be covered by the exception for compensatory trusts, described below.

Amounts distributable to support a family member will be treated as amounts distributable to the grantor or the grantor's spouse only if certain requirements are satisfied. Although different jurisdictions have different requirements for support obligations, administrative simplicity is served by providing one uniform rule on this point. Under the proposed regulations, the family member must be an individual who would be treated as a dependent of the grantor or the grantor's

spouse under sections 152(a)(1) through (8), without regard to the requirement that half of the individual's support be received from the grantor or the grantor's spouse. In addition, the family member must be either permanently and totally disabled (within the meaning of section 22(e)(3)) or, in the case of a son, daughter, stepson, or stepdaughter, less than 24 years old.

Consistent with the statute, the proposed regulations provide a grandfather rule for a trust that was treated as owned by the grantor under section 677 (other than subsection (a)(3) thereof) on September 19, 1995. As long as such a trust would continue to be so treated under the basic grantor trust rules, the trust will be exempt from the general rule, except with respect to any portion of the trust attributable to transfers to the trust after September 19, 1995. Under the proposed regulations, separate accounting is required for amounts transferred to the trust after September 19, 1995, together with all income and gains thereof, as well as losses and distributions therefrom.

C. Compensatory trusts

The proposed regulations implement section 672(f)(2)(B), which provides that, except as provided in regulations, the general rule shall not apply to any portion of a trust from which distributions are taxable as compensation for services rendered. Tracking the language of the statute, the proposed regulations list categories of trusts that constitute compensatory trusts, without regard to whether they could be treated as grantor trusts under the basic grantor trust rules. This list is intended to be an exclusive list. However, the proposed regulations also provide that additional categories of compensatory trusts may be designated later in guidance published in the Internal Revenue Bulletin.

The following categories of trusts are classified as compensatory trusts: (i) qualified trusts described in section 401(a), (ii) trusts described in section 457(g), (iii) nonexempt employees' trusts described in section 402(b), (iv) individual retirement account (IRA) trusts that are either simplified employee pensions described in section 408(k) or simple retirement accounts described in section 408(p), (v) IRA trusts to which the only contributions are rollover contributions listed in section 408(a)(1), (vi) certain so–called rabbi trusts (see Rev. Proc. 92–64 (1992–2 C.B. 422)), and (vii) trusts that are welfare benefit funds described in section 419(e) (without regard to whether they provide taxable benefits).

The IRS and Treasury contemplate that the nonexempt employees' trusts listed in category (iii) above will be treated as grantor trusts only to the extent provided in proposed regulations § 1.671–1(g) and § 1.671–1(h), which were published in the **Federal Register** (61 FR 50778) on September 27, 1996.

IRAs that are excluded from the list of compensatory trusts because they are funded by individuals, rather than employers, are expected to be covered by one or both of the exceptions for revocable trusts or for trusts from which the only amounts distributable during the lifetime of the grantor are to the grantor or the grantor's spouse.

6. § 1.672(f)–4: Recharacterization of purported gifts

The proposed regulations implement the purported gift rule of section 672(f)(4), which was enacted as a backstop to section 672(f). See Staff of the Joint Committee on Taxation, 104th Cong., 2nd Sess., General Explanation of the Tax Legislation Enacted in the 104th Congress, at 271 (1996). The purported gift rule prevents taxpayers from avoiding the general rule of section 672(f) by using a partnership or a foreign corporation as a substitute for a trust.

As a general rule, if a U.S. donee receives a purported gift or bequest directly or indirectly from a partnership, the purported gift or bequest must be included in the U.S. donee's income as ordinary income. If a U.S. donee receives a purported gift or bequest directly or indirectly from a foreign corporation, the purported gift or bequest generally must be included in the U.S. donee's gross income as a distribution from the foreign corporation. In the latter case, the U.S. donee will not be treated as having basis in the foreign corporation, and the U.S. donee will be treated as having a holding period in the foreign corporation equal to the average holding period (using a weighted average) of the actual interest holders.

However, the gift or bequest will not be recharacterized if the donee can establish that a U.S. citizen or resident alien who directly or indirectly holds an interest in the partnership or foreign corporation treated the purported gift as a distribution from the partnership or foreign corporation and a subsequent gift to the donee. There also is an exception for charitable contributions to donees described in section 170(c).

The proposed regulations provide rules for gratuitous transfers to U.S. donees from trusts created by partnerships or foreign corporations. As a result, a partnership or foreign corporation cannot avoid the purported gift rule by creating a nongrantor trust that makes an immediate nontaxable distribution of trust corpus to a U.S. donee. Under the proposed regulations, if the partnership or foreign corporation is not treated under the grantor trust rules as the owner of the portion of the trust from which property is distributed to a U.S. donee in a gratuitous transfer, the distribution will be characterized as a distribution from the partnership or foreign corporation if such characterization results in a higher U.S. tax liability.

Notwithstanding any other provision, the proposed regulations provide that the district director may recharacterize a transfer that is subject to the rules of section 672(f)(4) to prevent the avoidance of U.S. tax or clearly to reflect income. For example, the district director may determine, based upon the facts and circumstances, that a distribution from a partnership or foreign corporation is more properly treated as a distribution from a trust.

The proposed regulations provide a de minimis rule for purported gifts or bequests that do not exceed in the aggregate $10,000.

7. § 1.672(f)–5: Special rules

A. Transfers by certain beneficiaries to foreign settlor

The proposed regulations provide that if, but for section 672(f)(5), a foreign person would be treated as the owner of any portion of a trust, any U.S. beneficiary of the trust will be treated as the owner of a portion of the trust to the extent the U.S. beneficiary directly or indirectly made transfers of property to such foreign person in excess of transfers to the U.S. beneficiary from the foreign person. (Such a transfer may also constitute an indirect transfer from a U.S. person to a foreign trust for purposes of section 679.) The U.S. beneficiary need not have been a U.S. person at the time of the transfer.

The proposed regulations do not specify a time period within which a transfer must have been made to trigger this rule. However, they do provide that

the rule will not apply to the extent the U.S. beneficiary can demonstrate that the transfer was wholly unrelated to any transaction involving the trust. In addition, consistent with the statute, the proposed regulations provide that a transfer of property does not include either a nongratuitous transfer or a gift that would be excluded from taxable gifts under section 2503(b).

B. Different taxable years

The proposed regulations provide that if a person has a different taxable year from the taxable year of the trust, an amount is currently taken into account in computing the income of such person for purposes of the general rule if the amount is taken into account for the taxable year of such person that includes the last day of the taxable year of the trust.

C. Entity characterization

The proposed regulations provide that entities generally will be characterized under U.S. income tax principles. See regulations §§ 301.7701–1 through 301.7701–4. However, an entity having a single owner could avoid the purported gift rule if it could elect to be disregarded as a separate entity, because the purported gift or bequest would then be received from the owner of the entity, rather than from the entity itself. Therefore, the proposed regulations provide that, for purposes of section 672(f)(4), a wholly owned business entity must be treated as a corporation, separate from its single owner.

8. § 301.7701–2(c)(2)(iii): Special rule for business entities that make purported gifts

As explained above, an entity having a single owner could avoid the purported gift rule if it elected to be disregarded as a separate entity under the existing entity classification regulations. Therefore, the proposed regulations add a new sentence to the existing regulations to provide that, for purposes of section 672(f)(4), a wholly owned business entity must be treated as a corporation, separate from its owner.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in EO 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, these regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are submitted timely to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for August 27, 1997, at 10 a.m., in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by August 4, 1997, and submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by August 6, 1997.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is M. Grace Fleeman of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.643(h)–1 also issued under 26 U.S.C. 643(a)(7).

Section 1.671–2(e) also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).

Section 1.672(f)–1 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6).

Section 1.672(f)–2 also issued under 26 U.S.C. 643(a)(7), 672(f)(3) and (6).

Section 1.672(f)–3 also issued under 26 U.S.C. 643(a)(7), 672(f)(2) and (6).

Section 1.672(f)–4 also issued under 26 U.S.C. 643(a)(7), 672(f)(4) and (6).

Section 1.672(f)–5 also issued under 26 U.S.C. 643(a)(7) and 672(f)(6). * * *

Par. 2. Section 1.643(h)–1 is added to read as follows: § 1.643(h)–1 Distributions by certain foreign trusts through intermediaries.

(a) *In general*. For purposes of sections 641 through 683, any amount of property that is derived, directly or indirectly, by a United States person from a foreign trust through another person (an intermediary) shall be deemed to have been paid directly by the foreign trust to the United States person if any one of the following conditions is satisfied—

(1) The intermediary is related (within the meaning of paragraph (e) of this section) to either the United States person or the foreign trust and the intermediary transfers to the United States person either property that the intermediary received from the foreign trust or proceeds from the property that the intermediary received from the foreign trust;

(2) The intermediary would not have transferred the property to the United States person (or would not have transferred the property to the United States person on substantially the same terms) but for the fact that the intermediary received property from the foreign trust; or

(3) The intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax.

(b) *Exception for grantor as intermediary*. Paragraph (a) of this section shall not apply if the intermediary is the grantor of the portion of the trust from which the amount is derived. For the definition of grantor, see § 1.671–2(e).

(c) *Effect of disregarding intermediary*. If an amount is treated as paid

directly by the foreign trust to a United States person pursuant to this section, one of the following rules shall apply:

(1) *Intermediary is agent under general principles*. If the intermediary is an agent of the foreign trust or the United States person under generally applicable agency principles, the payment shall be treated as paid by the foreign trust to the United States person in the year it would be so treated under such principles. Thus, if the intermediary is an agent of the foreign trust, the payment shall be treated as paid to the United States person in the year the amount is paid by the intermediary to the United States person. If, however, the intermediary is an agent of the United States person, the payment shall be treated as paid to the United States person in the year the amount is paid by the foreign trust to the intermediary.

(2) *Intermediary is not agent under general principles*—(i) *Agent of foreign trust*. Except as provided in paragraph (c)(2)(ii) of this section, if the intermediary is not an agent of the foreign trust or the United States person under generally applicable agency principles—

(A) The intermediary shall be treated as an agent of the foreign trust; and

(B) The payment shall be treated as paid by the foreign trust to the United States person in the year the amount is paid by the intermediary to the United States person.

(ii) *Agent of United States person.* The district director may determine, based on all the relevant facts and circumstances, that the intermediary should be treated as the agent of the United States person. If the intermediary is treated as the agent of the United States person pursuant to this paragraph (c)(2)(ii), the payment shall be treated as paid to the United States person in the year the intermediary receives the payment from the foreign trust.

(d) *De minimis exception*. This section shall not apply if, during the taxable year of the United States person, the aggregate amount that is transferred to such person from all foreign trusts through one or more intermediaries does not exceed $10,000.

(e) *Related parties*. For purposes of this section, an intermediary shall be treated as related to a United States person or foreign trust if the intermediary and the United States person or foreign trust are related within the meaning of section 643(i)(2)(B), with the following modifications:

(1) For purposes of applying section 267 (other than section 267(f)) and section 707(b)(1), ''at least 10 percent'' shall be substituted for ''more than 50 percent'' each place it appears;

(2) The principles of section 267(b)(10), substituting ''at least 10 percent'' for ''more than 50 percent,'' shall apply to determine whether two corporations are related; and

(3) The principles applicable to trusts shall apply to determine whether an estate is related to another person.

(f) *Examples*. The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust that is not treated as owned by any other person. The examples follow:

Example 1. Related intermediary. I, a nonresident alien who is not the grantor of FT, receives a distribution of stock from FT in the year 2001. In the year 2002, I sells the stock to an unrelated party for its fair market value of 100X and gives the 100X to his daughter, B, who is a U.S. resident. I is not an agent of either FT or B under generally applicable agency principles. Under paragraphs (a)(1) and (c)(2)(i) of this section, FT is deemed to have distributed 100X directly to B in the year 2002.

Example 2. "But for" condition. I, a foreign bank that is unrelated to any of the parties in these transactions, received a deposit of 500X from FT in the year 2001. In the year 2002, I transfers 400X to B, a United States person, in a transfer that it would not have made but for the fact that I had received 500X from FT. I is not an agent of either FT or B under generally applicable agency principles. Under paragraphs (a)(2) and (c)(2)(i) of this section, FT is deemed to have distributed 400X directly to B in the year 2002.

Example 3. Tax avoidance purpose. FT was created in 1980 by A, a nonresident alien. In the year 2001, FT's trustee, T, determines that 1000X of accumulated income should be distributed to A's U.S. granddaughter, B. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, T causes FT to distribute 1000X to I, an unrelated foreign person. I subsequently transfers 1000X to B in the year 2001. Under paragraph (a)(3) of this section, B is deemed to have received an accumulation distribution from FT in the year 2001.

Example 4. Amount not derived from foreign trust. W and her husband, H, are both nonresident aliens. W's son, S, is a U.S. resident. W receives annual income of 5000X from her own investments. Several years ago, H created and funded FT using his separate property. At the beginning of the year 2001, W receives a distribution of 100X from FT. There is no plan with a principal purpose of avoiding U.S. tax. At the end of the year 2001, W gives 100X of her investment income to S. None of the conditions in paragraph (a) of this section is satisfied. The transfer to S is treated as a nontaxable gift from W and not as an amount derived directly or indirectly from FT.

(g) *Effective date*. The rules of this section are applicable for transfers made by foreign trusts on or after August 20, 1996.

Par. 3. In § 1.671–2, paragraph (e) is revised to read as follows:

§ 1.671–2 Applicable principles.

* * * * *

(e)(1) For purposes of subchapter J of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of paragraph (e)(4)(i) of this section) of property to a trust.

(2) A grantor includes a person who acquires an interest in a trust from a grantor of the trust if either—

(i) The transfer is nongratuitous (within the meaning of paragraph (e)(4)(ii) of this section); or

(ii) The transfer is of an interest in a fixed investment trust.

(3) If one person creates or funds a trust (or portion of a trust) primarily as an accommodation for another person, the other person shall be treated as a grantor of the trust (or portion of the trust).

(4)(i) A gratuitous transfer is any transfer other than a transfer for fair market value, or a corporate or partnership distribution. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is a gift for gift tax purposes (see chapter 12 of subtitle B of the Internal Revenue Code).

(A) For purposes of this paragraph (e), a transfer for fair market value includes only transfers in consideration for property received from the trust, services rendered by the trust, or the right to use property of the trust. A transfer is for fair market value only to the extent that the value of the property received, services rendered, or the right to use property is equal to at least the fair market value of the property transferred. For example, rents, royalties, and compensation paid to a trust are transfers for fair market value only if the payments reflect an arm's length price for the use of the property of, or services rendered by, the trust. For purposes of this determination, if a person contributes property to a trust (or to another entity that subsequently transfers the property (or proceeds therefrom) to a trust) in exchange for any type of interest in the trust (or other entity), such interest in the trust (or other entity) shall be disregarded in determining whether fair market value has been received. In addition, a person shall not be treated as making a transfer for fair

market value merely because the transferor recognizes gain on the transaction. For example, if a taxpayer elects to treat a transfer of appreciated property to a foreign trust as a deemed sale under section 1057, such a transfer will not be treated as a transfer for fair market value because the transferor did not receive actual fair market value consideration pursuant to the deemed sale.

(B) For purposes of this paragraph (e), a transfer to a trust is a corporate distribution, and therefore not a gratuitous transfer, only if it is a distribution described in section 301, 302, 305, 355 or 356. Similarly, for purposes of this paragraph (e), a transfer to a trust is a partnership distribution, and therefore not a gratuitous transfer, only if it is described in section 731. A distribution from one trust to another trust that is a beneficiary of the first trust is a gratuitous transfer.

(C) Notwithstanding any other provision of this paragraph (e), the district director may determine, based upon the facts and circumstances, that a direct or indirect transfer to a trust is more properly characterized as a gratuitous transfer if the transfer was structured with a principal purpose of avoiding U.S. tax. See, e.g., sections 643(a)(7) and 679(d).

(ii) For purposes of this paragraph (e), any transfer other than a gratuitous transfer is a nongratuitous transfer.

(5) The following examples illustrate the rules of this paragraph (e):

Example 1. A creates and funds a trust, T, for the benefit of her children. Under paragraph (e)(1) of the section, A is a grantor of T.

Example 2. A makes an investment in a fixed investment trust, T, that is classified as a trust under § 301.7701-4(c)(1) of this chapter. B subsequently acquires A's entire interest in T for fair market value. Under paragraph (e)(2) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a trust, T, for the benefit of his client, B, and B's children. The trust instrument names A as the grantor. A funds T with a nominal contribution out of his own funds. A views the contribution as an investment in the generation of fees for future legal services. Under paragraph (e)(3) of this section, B is a grantor of T.

Example 4. A, a U.S. citizen, creates and funds a trust, T, for the benefit of B. B holds an unrestricted power to withdraw any amount contributed to the trust for a period of 60 days after the contribution is made. B is treated as an owner of T under section 678 as a result of the withdrawal power. However, B is not a grantor of T under paragraph (e)(1) of this section as a result of the withdrawal power, because B neither created T nor made a gratuitous transfer to T.

Example 5. A contributes cash to a trust, T, through a broker, in exchange for units in T. The value of the units in T is disregarded in determining whether A has received fair market value under paragraph (e)(4)(i)(A) of this section. Therefore, A has made a gratuitous transfer to T, and, under paragraph (e)(1) of this section, A is a grantor of T.

Example 6. A borrows cash from T, an unrelated trust. Arm's-length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(4)(i)(A) of this section. Therefore, under paragraph (e)(1) of this section, A is not a grantor of T with respect to the interest payments.

Example 7. A creates and funds a domestic trust, DT. After A's death, DT distributes cash to a foreign trust, FT, that is a beneficiary of DT. Under paragraph (e)(4)(i)(B) of this section, the trust distribution by DT is a gratuitous transfer. Therefore, under paragraph (e)(1) of this section, DT is a grantor of FT with respect to such transfer.

Example 8. A creates and funds a trust, T. T owns stock of C, a publicly traded company, that pays a dividend to its shareholders, including T. The dividend paid by C is a nongratuitous transfer under paragraph (e)(4)(i)(B) of this section. Therefore, C is not a grantor under paragraph (e)(1) of this section with respect to the dividend.

Example 9. A, a nonresident alien, creates a trust, T, for the benefit of her spouse, B, who is a U.S. citizen. T is not treated as owned by any other person. A sells property worth $1,000,000 to T in exchange for $100,000 in cash. Under paragraph (e)(4)(i)(A) of this section, the $900,000 excess is a gratuitous transfer by A. Therefore, A is a grantor of T under paragraph (e)(1) of this section with respect to such transfer.

(6) The rules of this paragraph (e) are applicable as of August 20, 1996.

Par. 4. Sections 1.672(f)–1, 1.672(f)–2, 1.672(f)–3, 1.672(f)–4, and 1.672(f)–5 are added to read as follows:

§ 1.672(f)–1 Foreign persons not treated as owners.

(a) *General rule.* Section 672(f)(1) provides that sections 671 through 679 (the grantor trust rules) shall cause a person to be treated as the owner of any portion of a trust only to the extent such application results in an amount (if any) being currently taken into account (directly or through one or more entities) in computing the income of a citizen or resident of the United States or a domestic corporation. Section 672(f)(1) may apply only to a trust that would be treated as owned, in whole or in part, by a foreign person under the grantor trust rules without regard to section 672(f). For rules describing the application of this section, see paragraph (b) of this section. For definitions regarding the rules of this section, see paragraph (c) of this section. For examples illustrating the application of this section, see paragraph (d) of this section. For the effective date of the rules of this section, see paragraph (e) of this section.

(b) *Application of general rule*—(1) *Initial determination.* To determine whether a trust is treated as owned by a foreign person, the taxpayer should first apply the grantor trust rules without regard to section 672(f) (the basic grantor trust rules) to determine the worldwide amount (as defined in paragraph (c)(1) of this section) and the U.S. amount (as defined in paragraph (c)(2) of this section).

(2) *Result.* The trust is treated as owned by a foreign person based on an annual comparison at the end of the trust's taxable year of the worldwide amount and the U.S. amount. If there is a worldwide amount and such amount is greater than the U.S. amount, under section 672(f) the foreign person shall not be treated as the owner of the portion of the trust attributable to the excess of the worldwide amount over the U.S. amount. Otherwise, the basic grantor trust rules shall apply without the limitation of section 672(f). For examples, see paragraph (d) of this section.

(c) *Definitions*—(1) *Worldwide amount.* The worldwide amount is the net amount of income, gains, deductions, and losses that would be taken into account for the current year under the basic grantor trust rules in computing the worldwide taxable income of any person, whether or not such person is a U.S. taxpayer (as defined in paragraph (c)(3) of this section). The worldwide amount is computed in accordance with U.S. principles of income taxation and includes amounts that would be attributable to foreign persons, without regard to whether such amounts are subject to U.S. income tax.

(2) *U.S. amount.* The U.S. amount is the net amount of income, gains, deductions, and losses that would be taken into account for the current year under the basic grantor trust rules (directly or through one or more entities) in computing the taxable income of a U.S. taxpayer (as defined in paragraph (c)(3)of this section). The U.S. amount includes amounts that would be attributable to the U.S. taxpayer even if the amount would not be includible in gross income (e.g., tax-exempt interest described in section 103(a)).

(3) *U.S. taxpayer.* A U.S. taxpayer is any person who is a U.S. citizen, a resident alien individual, a domestic corporation, a U.S. person who is treated as the owner of a trust under section 679, or a domestic trust to the extent such trust actually pays U.S. tax with respect to its income, gains, deductions, and losses.

(d) *Examples*. The following examples illustrate the rules of this section:

Example 1. U.S. amount equals worldwide amount. A, a citizen of the United States, creates and funds an irrevocable foreign trust, FT, for the benefit of his U.S. son, B. Under the basic grantor trust rules (see section 679), A would be treated as the owner of FT. For the taxable year ending December 31, 1999, FT has ordinary income of 100X, long-term capital gain of 200X, deductions of 20X, and short-term capital losses of 15X. Under paragraph (c)(1) of this section, the worldwide amount is 265X (100X + 200X – 20X - 15X). Under paragraph (c)(2) of this section, the U.S. amount also is 265X. Consequently, under paragraph (b)(2) of this section, because the worldwide amount is equal to the U.S. amount, the basic grantor trust rules apply without the limitation of section 672(f) to treat A as the owner of FT.

Example 2. No U.S. amount. A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his U.S. son, B. A has a reversionary interest within the meaning of section 673. If the basic grantor trust rules were applied, A would be treated as the owner of DT, and any distributions to B would be considered nontaxable gifts from A to B. Under paragraph (c)(2) of this section, there is no U.S. amount, because no amount is taken into account for the current year under the basic grantor trust rules in computing the taxable income of a U.S. taxpayer. Under paragraph (c)(1) of this section, the worldwide amount is equal to DT's net income. Under paragraph (b)(2) of this section, A is not treated as the owner of any portion of DT. Consequently, DT is a separate taxable entity, and distributions from DT to B must be taken into account in computing B's income.

Example 3. U.S. amount less than worldwide amount. FP is a foreign partnership for U.S. income tax purposes. FP has two partners: C, a nonresident alien, and D, a U.S. citizen. The partnership agreement provides that all income, gains, losses, deductions, and credits are allocated 50 percent to each partner. FP contributed cash to an irrevocable foreign trust, FT, primarily for the benefit of E, D's U.S. brother. FP can control the beneficial enjoyment of the trust assets within the meaning of section 674. If the basic grantor trust rules were applied, FT would be treated as the owner of FP. Because D's 50 percent distributive share of FP's income would be currently taken into account in computing the income of a U.S. citizen, the U.S. amount computed under paragraph (c)(2) of this section is equal to one half of the worldwide amount computed under paragraph (c)(1) of this section. Therefore, under paragraph (b)(2) of this section, FP is not treated as the owner of the portion of FT attributable to C's interest in FP. Such portion of FT will be treated as a separate taxable entity, and distributions by FT to E with respect to that portion of the trust will be considered distributions to E under section 662 and may be subject to the section 668 interest charge on accumulation distributions. (In addition, distributions from FP to E may be subject to recharacterization as purported gifts under § 1.672(f)–4.)

Example 4. No worldwide amount. USC is a U.S. corporation with a wholly owned foreign subsidiary, FC. USC funds an irrevocable foreign trust, FT, that cannot benefit any U.S. person. USC retains no power or interest that would cause it to be treated as the owner of FT under the basic grantor trust rules. However, FC is given a power of appointment such that FC would be treated as the owner of FT under section 678. FT acquires a note issued by FC. FT has no items of income, deduction, losses, or credit other than income from the note. Under U.S. income tax principles, if the basic grantor trust rules were applied, FC would be treated as the owner of FT. Thus, FC would be treated as both the debtor and the creditor with respect to the note, and the note would be disregarded. Under paragraph (c)(1) of this section, there is no worldwide amount. Under paragraph (c)(2) of this section, there is no U.S. amount. Consequently, under paragraph (b)(2) of this section, the basic grantor trust rules apply without the limitation of section 672(f) to treat FC as the owner of FT.

Example 5. Deemed contribution on effective date. Assume the same facts as in *Example 2*. DT was created in 1990. On August 20, 1996, DT held accumulated income. Prior to August 20, 1996, A was treated as the owner of DT. A is deemed to have contributed the assets that were held in DT on August 20, 1996 to a new trust on that date.

(e) *Effective date*. The rules of this section are applicable as of August 20, 1996.

§ 1.672(f)–2 Trusts created by certain foreign corporations.

(a) *Controlled foreign corporations*. A controlled foreign corporation (as defined in section 957) that creates and funds a trust shall be treated as a domestic corporation for purposes of §§ 1.672(f)–1 through 1.672(f)–5 to the extent that, if the grantor trust rules without regard to section 672(f) (the basic grantor trust rules) were applied, income earned by the trust for the taxable year would be currently taken into account pursuant to section 951 in computing the gross income of a citizen or resident of the United States or a domestic corporation.

(b) *Passive foreign investment companies*—(1) *In general*. A passive foreign investment company (as defined in section 1296) that creates and funds a trust shall be treated as a domestic corporation for purposes of §§ 1.672(f)–1 through 1.672(f)–5 to the extent that, if the basic grantor trust rules were applied, income earned by the trust for the taxable year would be currently taken into account pursuant to section 1293 in computing the gross income of a citizen or resident of the United States or a domestic corporation.

(2) *Application of section 1296*. For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1296, the grantor trust rules shall be applied as if section 672(f) had not come into effect.

(c) *Foreign personal holding companies*. A foreign personal holding company (as defined in section 552) that creates and funds a trust shall be treated as a domestic corporation for purposes of §§ 1.672(f)–1 through 1.672(f)–5 to the extent that, if the basic grantor trust rules were applied, income earned by the trust for the taxable year would be currently taken into account pursuant to section 551 in computing the gross income of a citizen or resident of the United States or a domestic corporation.

(d) *Examples*. The following examples illustrate the rules of this section. In each example, FT is an irrevocable foreign trust, and CFC is a controlled foreign corporation. The examples follow:

Example 1. Controlled foreign corporation without ultimate U.S. ownership. Two nonresident aliens, A and B, create a domestic partnership, DP. DP's only asset is all the stock of CFC. CFC creates and funds FT to benefit A's U.S. daughter, C. CFC retains an administrative power over the trust as described in section 675. Thus, if the basic grantor trust rules were applied, CFC would be treated as the owner of FT, and distributions from FT to C would not be taxed as distributions under section 662. However, under paragraph (a) of this section, CFC is not treated as a domestic corporation for purposes of § 1.672(f)–1. Although CFC is a controlled foreign corporation (because CFC is owned by DP, a domestic person), no income earned by CFC will be included in the income of a U.S. taxpayer. Consequently, there is no U.S. amount under § 1.672(f)–1(c)(2). Under § 1.672(f)–1(b)(2), the basic grantor trust rules do not apply to treat CFC as the owner of FT. Transfers from FT to C are considered to be distributions to C under section 662 and may be subject to the section 668 interest charge on accumulation distributions. (In addition, distributions to C from DP, CFC, or FT may be subject to recharacterization as purported gifts under § 1.672(f)–4.)

Example 2. Trust income is all subpart F income. CFC is wholly owned by USC, a domestic corporation. CFC creates and funds FT for the benefit of USC. CFC can control the beneficial enjoyment of the trust assets within the meaning of section 674. All of FT's income is of the type that is subpart F income (as defined in section 952). FT does not distribute any income. Without regard to income earned by FT, CFC has a significant amount of earnings and profits. If the basic grantor trust rules were applied, CFC would be treated as the owner of FT, and all items of income of FT would be currently taken into account in computing the income of USC, a domestic corporation. Consequently, under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of § 1.672(f)–1. Under § 1.672(f)–1(b)(2), the basic grantor trust rules apply without the limitation of section 672(f) to treat CFC as the owner of FT. Distributions from FT to USC are treated as distributions from CFC to USC.

Example 3. Portion of trust income is subpart F income. Assume the same facts as in *Example 2*, except that FT also owns all of the stock of S, a corporation that is incorporated in the same country as CFC and that uses a substantial part of its assets in a trade or business in such country. Thus, dividends from S are not subpart F income. In the taxable year ending December 31, 1999, FT's only

income is subpart F income of 200X and dividends from S of 50X. FT has no deductions or losses for 199X. Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of computing the U.S. amount under § 1.672(f)–1(c)(2) only to the extent FT's income is of the type that is subpart F income. Consequently, the U.S. amount is 200X. Under § 1.672(f)–1(c)(1), the worldwide amount is 250X. Under § 1.672(f)–1(b)(2), CFC is not treated as the owner of the portion of FT attributable to the excess of the worldwide amount over the U.S. amount. Such portion of FT will be treated as a separate taxable entity. Distributions to USP with respect to such portion of FT will be included in USP's income under section 662 and may be subject to the section 668 interest charge on accumulation distributions.

Example 4. Reduction in portion of trust treated as nongrantor trust. Assume the same facts as in *Example 3*. For each of the years 2001 through 2010, FT receives dividend income of 2X from S, none of which is distributed. In the year 2011, at a time when FT's basis in the stock of S is 80X, S sells its business and invests the proceeds in assets that generate subpart F income. CFC will now be treated as the owner of the portion of FT that had previously been treated as a separate taxable entity. FT will be deemed to have distributed 80X (the stock of S) to CFC. CFC will be required to include 20X of undistributed net income (2X a year for 10 years) in its income.

(d) *Effective date*. The rules of this section are applicable as of August 20, 1996.

§ 1.672(f)–3 Exceptions to general rule.

(a) *Certain revocable trusts*—(1) *In general*. The general rule of § 1.672(f)–1(a) shall not apply to any portion of a trust if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor without the approval or consent of any other person. If the grantor can exercise such power only with the approval of a related or subordinate party who is subservient to the grantor, such power will be treated as exercisable solely by the grantor. The grantor will be treated as having a power to revest only if the grantor has such power for a period or periods aggregating 183 days or more during the taxable year of the trust. See section 643(a)(7). For the definition of *grantor*, see § 1.671–2(e). For the definition of *related or subordinate party*, see § 1.672(c)–1. For purposes of this paragraph (a), a related or subordinate party is subservient to the grantor unless the presumption in the last sentence of § 1.672(c)–1 is rebutted by a preponderance of the evidence.

(2) *Grandfather rule*—(i) *In general*. The general rule of § 1.672(f)–1 shall not apply to a trust that was treated as owned by the grantor under section 676 on September 19, 1995, as long as the trust would continue to be so treated under the basic grantor trust rules. However, such a trust will be subject to the general rule of § 1.672(f)–1 with respect to any portion of the trust attributable to transfers to the trust after September 19, 1995.

(ii) *Separate accounting for transfers after September 19, 1995*. In the case of a revocable trust that contains both amounts held in the trust on September 19, 1995, and amounts that were transferred to the trust after September 19, 1995, paragraph (a)(2)(i) of this section shall apply only if the amounts that were held in the trust on September 19, 1995, together with all income, gains, and losses derived therefrom (less all post-September 19, 1995, distributions therefrom) are separately accounted for from the amounts that were transferred to the trust after September 19, 1995, together with all income, gains, and losses derived therefrom (less all distributions therefrom). If there is no separate accounting, the general rule of § 1.672(f)–1 shall apply to the trust. If there is separate accounting, the general rule of § 1.672(f)–1 shall not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(3) *Examples*. The following examples illustrate the rules of this paragraph (a):

Example 1. Owner is grantor. After September 19, 1995, FP1, a foreign person, creates and funds a revocable trust, T, for the benefit of FP1's children, who are U.S. residents. The trustee is a foreign bank, FB, that is owned and controlled by FP1 and FP2, who is FP1's brother. The power to revoke T and revest absolutely in FP1 title to the trust property is exercisable by FP1, but only with the approval or consent of FB. There are no facts that would suggest that FB is not subservient to FP1. Therefore, under paragraph (a)(1) of this section, T is not subject to the general rule of § 1.672(f)–1. FP1 is treated as the owner of T.

Example 2. Owner not grantor. Assume the same facts as in *Example 1*, except that FP1 dies. After FP1's death, FP2 has the power to withdraw the assets of T, but only with the approval of FB. There are no facts that would suggest that FB is not subservient to FP2. However, under paragraph (a)(1) of this section, T is now subject to the general rule of § 1.672(f)–1, because FP2 is not a grantor of T. FP2 is not treated as the owner of T.

Example 3. Trustee not related or subordinate party. Assume the same facts as in *Example 1*, except that neither FP1 nor any member of his family has any substantial ownership interest or other connection with FB. FP1 can remove and replace FB at any time for any reason. Although FP1 can replace FB if FB refuses to approve or consent to FP1's decision to revest the trust property in himself, FB is not a related or subordinate party. Therefore, under paragraph (a)(1) of this section, T is subject to the general rule of § 1.672(f)–1. FP1 will not be treated as the owner of T.

Example 4. Unrelated trustee will consent to revocation. FP, a foreign person, creates and funds an irrevocable trust, T. The trustee is a foreign bank, FB, that is not a related or subordinate party within the meaning of § 1.672(c)–1. FB has the discretion to distribute trust income or corpus to any person, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, under paragraph (a)(1) of this section, T is subject to the general rule of § 1.672(f)–1, because FP does not have the power to revoke T. FP will not be treated as the owner of T.

Example 5. Husband treated as holding power held by wife. H and his wife, W, both nonresident aliens, create and fund a trust, T, using community property. The power to revoke T and revest absolutely in H and W title to the trust property is exercisable either by W acting alone or by H with the consent of W. W has advised H that she will not consent to any decision by H to revoke T. Although W is a related or subordinate party to H within the meaning of § 1.672(c)–1, the presumption that W is subservient to H is rebutted by a preponderance of the evidence. However, pursuant to section 672(e), H is treated as holding the power to revest that is held by W. Therefore, under paragraph (a)(1) of this section, T is not subject to the general rule of § 1.672(f)–1. H and W are treated as the owners of T.

Example 6. U.S. grantor of trust revocable by foreign person. A, a nonresident alien, creates a revocable foreign trust, FT, and funds FT with $5,000 cash. The only possible beneficiary of FT is a foreign person. B, a U.S. citizen, contributes $1,000,000 of appreciated property to FT. B retains no powers that would cause B to be treated as an owner of any portion of FT under the grantor trust rules. Although A has the power to revest absolutely in itself title to the appreciated property, A is not a grantor of FT with respect to the appreciated property. See § 1.671–2(e). Therefore, under paragraph (a)(1) of this section, the portion of FT that is attributable to the appreciated property is subject to the general rule of § 1.672(f)–1. A is not treated as the owner of such portion.

(b) *Certain other trusts*—(1) *In general*. The general rule of § 1.672(f)–1(a) shall not apply to any trust (or portion of a trust) during the lifetime of the grantor if the only amounts distributable (whether income or corpus) from such trust (or portion of a trust) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor. This paragraph (b) shall not apply to that portion of a trust from which, at any time after October 20, 1996, any amounts are distributable to any person other than the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of nongratuitous amounts (within the meaning of § 1.671–2(e)(4)(ii)) will not be considered amounts distributable. For the definition of *grantor*, see § 1.671–2(e).

(2) *Amounts distributable in discharge of legal obligation*—(i) *In general*. Subject to the provisions of paragraph (b)(2)(ii) of this section, amounts

that are distributable from a portion of a trust in discharge of a legal obligation of the grantor or the spouse of the grantor shall be treated as amounts distributable to the grantor or the spouse of the grantor for purposes of paragraph (b)(1) of this section. For this purpose, an obligation is considered a legal obligation if it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) *Legal obligation to related person*. For purposes of paragraph (b)(2)(i) of this section, the term *legal obligation* does not include an obligation to a related person except to the extent the obligation was contracted bona fide and for adequate and full consideration in money or money's worth (see § 20.2043–1 of this chapter). For this purpose, a related person is a person described in § 1.643(h)–1(e).

(3) *Amounts distributable in discharge of support obligation*. Amounts that are distributable from a portion of a trust in discharge of the grantor's or the grantor's spouse's obligation to support a family member shall be treated as amounts distributable to the grantor or the spouse of the grantor only if the family member is an individual who would be treated as a dependent of the grantor or the grantor's spouse under sections 152(a)(1) through (8), without regard to the requirement that half of the individual's support be received from the grantor or the grantor's spouse, and the family member is either—

(i) Permanently and totally disabled (within the meaning of section 22(e)(3)); or

(ii) In the case of a son, daughter, stepson, or stepdaughter, less than 24 years old.

(4) *Grandfather rule*—(i) *In general*. The general rule of § 1.672(f)–1 shall not apply to a trust that was treated as owned by the grantor under section 677 (other than section 677(a)(3)) on September 19, 1995, as long as the trust would continue to be so treated under the basic grantor trust rules. However, such a trust will be subject to the general rule of § 1.672(f)–1 with respect to any portion of the trust attributable to transfers to the trust after September 19, 1995.

(ii) *Separate accounting for transfers after September 19, 1995*. In the case of a trust that contains both amounts held in the trust on September 19, 1995, and amounts that were transferred to the trust after September 19, 1995, paragraph (b)(4)(i) of this section shall apply only if the amounts that were held in the trust on September 19, 1995, together with all income, gains, and losses derived therefrom (less all post-September 19, 1995, distributions therefrom) are separately accounted for from the amounts that were transferred to the trust after September 19, 1995, together with all income, gains, and losses derived therefrom (less all distributions therefrom). If there is no separate accounting, the general rule of § 1.672(f)–1 shall apply to the trust. If there is separate accounting, the general rule of § 1.672(f)–1 shall not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(5) *Examples*. The following examples illustrate the rules of this paragraph (b):

Example 1. Amounts distributable only to grantor or grantor's spouse. H and his wife, W, are both nonresident aliens. H and W have a child, C, who is a U.S. resident. H creates and funds an irrevocable trust, FT, using only his separate property. The only amounts distributable (whether income or corpus) from FT as long as either H or W are alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. Under paragraph (b)(1) of this section, FT is not subject to the general rule of § 1.672(f)–1 during H's lifetime. H is treated as the owner of FT.

Example 2. Amounts temporarily distributable to person other than grantor or grantor's spouse. Assume the same facts as in *Example 1*, except that C is a 30-year old law student at the time FT is created, FT is created after October 20, 1996, and the trust instrument provides that as long as C is in law school amounts may be distributed from FT to pay C's expenses. Thereafter, the only amounts distributable from FT as long as either H or W are alive will be amounts distributable to H or W. C's expenses are not treated as legal obligations of H or W under paragraph (b)(2)(ii) of this section or as support obligations under paragraph (b)(3) of this section. Therefore, under paragraph (b)(1) of this section, FT is subject to the general rule of § 1.672(f)–1(a). H is not treated as the owner of FT. After C graduates from law school, the general rule of § 1.672(f)–1 still will be applicable, and H still will not be treated as the owner of FT.

Example 3. Grantor predeceases spouse. Assume the same facts as in *Example 1*. H predeceases W. Under paragraph (b)(1) of this section, FT will become subject to the general rule of § 1.672(f)–1 upon H's death, because W is not a grantor. Accordingly, FT will be treated as a separate taxable entity upon H's death.

Example 4. Effect of divorce. H creates and funds a trust, FT, from which the only amounts distributable are amounts distributable to himself and A. At the time FT is created, A is H's wife. However, the trust document refers to A only by her name. H and A divorce. Under paragraph (b)(1) of this section, FT will be subject to the general rule of § 1.672(f)–1 after the divorce, because amounts will still be distributable to A, and A will no longer be the spouse of the grantor. After the divorce, FT will be treated as a separate taxable entity.

Example 5. Fixed investment trust. FC, a foreign corporation, invests in a domestic fixed investment trust, DT, that is classified as a trust under § 301.7701–4(c)(1) of this chapter. The only amounts that are distributable from the portion of DT that is owned by FC are amounts distributable to FC. Under paragraph (b)(1) of this section, such portion of DT is exempt from the general rule of § 1.672(f)–1. FC is treated as the owner of its portion of DT.

Example 6. Reinsurance trust. A domestic insurance company, DI, reinsures a portion of its business with a foreign insurance company, FI. FI creates and funds an irrevocable domestic trust, DT, in the United States as security for its obligations under the reinsurance agreement. The trust funds are held by a U.S. bank and may be used only to pay claims arising out of the reinsurance policies. On the termination of DT, any assets remaining will revert to FI. The only amounts that are distributable from DT are distributable in discharge of FI's legal obligation. Therefore, under paragraph (b)(1) of this section, DT is exempt from the general rule of § 1.672(f)–1. FI is treated as the owner of DT.

Example 7. Asset securitization trust. A foreign corporation, FC, borrows money from a bank, B, to finance the purchase of an airplane. FC creates a foreign trust, FT, to hold the airplane as security for the loan from B. The only amounts that are distributable from FT are amounts distributable to B in the event that FC defaults on its loan from B. Thus, the only amounts distributable from FT are in discharge of FC's legal obligation to B. When FC repays the loan, the trust assets will revert to FC. Under paragraph (b)(1) of this section, FT is exempt from the general rule of § 1.672(f)–1. FC is treated as the owner of FT.

(c) *Compensatory trusts*—(1) *In general*. Except as provided in paragraph (c)(4) of this section, § 1.672(f)–1 does not apply to any portion of a trust distributions from which are taxable as compensation for services rendered. A trust described in this paragraph (c)(1) is referred to in this section as a compensatory trust.

(2) *Trusts classified as compensatory trusts*. The following types of trusts are the only types of trusts that shall be classified as compensatory trusts within the meaning of paragraph (c)(1) of this section—

(i) A qualified trust described in section 401(a) (but see § 1.641(a)–0(a));

(ii) A trust described in section 457(g);

(iii) A nonexempt employees' trust described in section 402(b) (see § 1.671–1(g) and (h));

(iv) A trust that is an individual retirement account described in section 408(k) or 408(p);

(v) A trust that is an individual retirement account the only contributions to which are rollover contributions listed in section 408(a)(1);

(vi) A trust that would be a nonexempt employees' trust described in section 402(b) but for the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of § 1.83–3(e); and

(vii) A trust that is a welfare benefit fund described in section 419(e).

(3) *Other individual retirement accounts*. For rules that apply to individual retirement accounts (within the meaning of section 408(a)) that are not compensatory trusts within the meaning of paragraph (c)(1) of this section, see paragraphs (a) and (b) of this section.

(4) *Exceptions*. The Commissioner may, in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin (see § 601.601(d)(2)-(ii)(b)), designate categories of compensatory trusts to which the general rule of paragraph (c)(1) of this section does not apply.

(d) *Effective date*. Except as provided in paragraph (b)(1) of this section, the rules of this section are applicable as of August 20, 1996.

§ 1.672(f)–4 Recharacterization of purported gifts.

(a) *In general*—(1) *Purported gifts from partnerships*. Except as provided in paragraphs (b) and (f) of this section, and without regard to the existence of any trust, if a United States person (U.S. donee) directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a partnership, the purported gift or bequest must be included in the U.S. donee's gross income as ordinary income.

(2) *Purported gifts from foreign corporations*. Except as provided in paragraphs (b) and (f) of this section, and without regard to the existence of any trust, if a U.S. donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from a foreign corporation, the purported gift or bequest must be included in the U.S. donee's gross income as if it were a distribution from the foreign corporation. For purposes of section 1012, the U.S. donee will not be treated as having basis in the foreign corporation. However, for purposes of section 1223, the U.S. donee will be treated as having a holding period in the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders.

(b) *Exceptions*—(1) *U.S. partner or shareholder treats transfer as distribution and gift.* Paragraph (a) of this section shall not apply if the U.S. donee can establish that a U.S. citizen or resident alien who directly or indirectly holds an interest in the partnership or foreign corporation treated the purported gift as a distribution to the U.S. partner or shareholder and a subsequent gift to the U.S. donee.

(2) *Charitable contributions*. Paragraph (a) of this section shall not apply to U.S. donees that are described in section 170(c).

(c) *Certain distributions from trusts created by partnerships or foreign corporations.* If a partnership or foreign corporation is treated as the owner, under sections 671 through 679, of a portion of a trust from which property is distributed to a U.S. donee in a gratuitous transfer, the U.S. donee must treat the amount as a distribution from the partnership or foreign corporation. If a partnership or foreign corporation is not treated as the owner, under sections 671 through 679, of the portion of a trust from which property is distributed to a U.S. donee in a gratuitous transfer, the U.S. donee shall be taxable in the manner provided in paragraph (a) of this section only if the U.S. tax computed under that section exceeds the U.S. tax that would be due if the U.S. donee treats the amount as a distribution from the trust.

(d) *Definition of purported gift or bequest.* For purposes of this section, a purported gift or bequest is any transfer by a partnership or foreign corporation (other than a transfer for fair market value) to a person who is not a partner in the partnership or shareholder of the foreign corporation.

(e) *Effect on U.S. partner or shareholder*. This section applies only to computations of the U.S. donee's gross income. This section does not affect the U.S. tax treatment of a U.S. partner in the partnership or a U.S. shareholder of the foreign corporation.

(f) *Recharacterization by district director*. Notwithstanding any other provision in this section, if a U.S. donee receives a transfer that is subject to the rules of this section, the district director may recharacterize such transfer to prevent the avoidance of U.S. tax or clearly to reflect income. For example, the district director may determine, based upon the facts and circumstances, that a distribution from a partnership or foreign corporation is more properly characterized as a distribution from a trust.

(g) *De minimis exception*. This section shall not apply if, during the taxable year of a U.S. donee, the aggregate amount of purported gifts or bequests that is transferred to such U.S. donee directly or indirectly from a partnership or foreign corporation does not exceed $10,000. The aggregate amount must include gifts or bequests from persons that the U.S. donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(h) *Examples*. The following examples illustrate the rules of this section:

Example 1. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC distributes property directly to A's U.S. daughter, B, purportedly as a gift. Under paragraph (a)(2) of this section, B must treat the distribution as a dividend from FC. (However, if B can establish that the distribution exceeded FC's earnings and profits, B must treat such excess as an amount received in excess of basis under section 301(c)(3).) If FC is a passive foreign investment company, B must treat the amount as a distribution under section 1291. B will be treated as having the same holding period as A.

Example 2. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC creates and funds a revocable foreign trust, FT, from which a gratuitous transfer is made immediately to A's U.S. daughter, B. Thus, the transfer is out of trust corpus. FC is not treated as the owner of FT under sections 671 through 679. Under paragraph (c) of this section, B must treat the transfer as a dividend from FC, rather than a distribution from FT, if such treatment results in a higher U.S. tax liability.

(i) *Effective date*. The rules of this section are applicable for any transfer by a partnership or foreign corporation on or after August 20, 1996.

§ 1.672(f)–5 Special rules.

(a) *Transfers by certain beneficiaries to foreign settlor*—(1) *In general*. If, but for section 672(f)(5), a foreign person would be treated as the owner of any portion of a trust, any U.S. beneficiary of such trust shall be treated as the owner of a portion of the trust to the extent the U.S. beneficiary directly or indirectly made transfers of property to such foreign person (without regard to whether the U.S. beneficiary was a U.S. beneficiary at the time of any transfer) in excess of transfers to the U.S. beneficiary from the foreign person. The rule of this paragraph will not apply to the extent the U.S. beneficiary can demonstrate to the satisfaction of the district director that the transfer by the U.S. beneficiary to the foreign person was wholly unrelated to any transaction in-

volving the trust. For purposes of this paragraph, a transfer of property does not include a nongratuitous transfer. See § 671–2(e)(4)(ii). In addition, a gift shall not be taken into account to the extent such gift would not be characterized as a taxable gift under section 2503(b). For a definition of *U.S. beneficiary*, see section 679.

(2) *Examples*. The following examples illustrate the rules of this section:

Example 1. A, a nonresident alien, contributes property to FC, a foreign corporation that is wholly owned by A. FC creates a foreign trust, FT, for the benefit of A and his children. FT is revocable by FC without the approval or consent of any other person. FC funds FT with the property received from A. A and his family move to the United States. Under paragraph (a)(1) of this section, A is treated as the owner of FT.

Example 2. B, a U.S. citizen, makes a gratuitous transfer of $1 million to his uncle, C, a nonresident alien. C creates a foreign trust, FT, for the benefit of B and his children. FT is revocable by C without the approval or consent of any other person. C funds FT with the property received from B. Under paragraph (a)(1) of this section, B is treated as the owner of FT. (B also would be treated as the owner of FT as a result of section 679.)

(b) *Different taxable years*. If a person has a different taxable year (as defined in section 7701(a)(23)) from the taxable year of the trust, an amount is currently taken into account in computing the income of such person for purposes of § 1.672(f)–1 if the amount is taken into account for the taxable year of such person that includes the last day of the taxable year of the trust.

(c) *Entity characterization*. Entities generally shall be characterized under U.S. income tax principles. See §§ 301.7701–1 through 301.7701–4 of this chapter. However, for purposes of § 1.672(f)–4, a transferor that is a wholly owned business entity shall be treated as a corporation, separate from its single owner. See § 301.7701–2(c)(2)(iii) of this chapter.

(d) *Effective date*. The rules of this section are generally applicable as of August 20, 1996. However, the rules in paragraph (c) of this section shall not be applicable until [date of publication as a final regulation in the **Federal Register**].

PART 301—PROCEDURE AND ADMINISTRATION

Par. 5. The authority citation for part 301 is amended by adding an entry in numerical order to read as follows:

Authority: 26 U.S.C. 7805 * * *

Section 301.7701–2(c)(2)(iii) also issued under 26 U.S.C. 643(a)(7), 672(f)(4) and (6).

Par. 6. Section 301.7701–2 is amended by adding paragraph (c)(2)(iii) to read as follows:

§ 301.7701–2 Business entities; definitions.

* * * * *

(c) * * *

(2) * * *

(iii) *Special rule for foreign business entities that make purported gifts.* For the purposes of applying the rules of section 672(f)(4), a wholly owned business entity shall be treated as a corporation, separate from its single owner.

* * * * *

Michael P. Dolan,
Acting Commissioner of Internal Revenue.

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