T.D. 8831

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Inbound Grantor Trusts With Foreign Grantors

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations implementing sections 672(f) and 643(h) of the Internal Revenue Code, as amended by the Small Business Job Protection Act of 1996, which relate to the application of the grantor trust rules to certain trusts established by foreign persons. These regulations affect primarily U.S. persons who are beneficiaries of trusts established by foreign persons. This document also contains temporary regulations defining the term *grantor* for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code. The text of these temporary regulations serves as the text of the proposed regulations set forth in the notice of proposed rulemaking published in REG–252487–96, on page 303.

DATES: *Effective Date:* These regulations are effective August 10, 1999.

Applicability Dates: For dates of applicability of §1.643(h)–1, see §1.643(h)–1(h). For dates of applicability of §1.671–2T(e), see §1.671–2T(e)(7). For dates of applicability of §§1.672(f)–1 through 1.672(f)–5, see §§1.672(f)–1(c), 1.672(f)–2(e), 1.672(f)–3(e), 1.672(f)–4(h), and 1.672(f)–5(c).

FOR FURTHER INFORMATION CONTACT: M. Grace Fleeman (202) 622-3880 concerning the regulations generally, and James A. Quinn (202) 622-3060 concerning §1.671–2T(e) and §1.672(f)–1 (not toll-free numbers).

SUPPLEMENTARY INFORMATION

Background

On June 5, 1997 (62 F.R. 37819) Treasury and the IRS published a notice of proposed rulemaking (REG–252487–96) under sections 643(h), 671, 672(f), and 7701 of the Internal Revenue Code (Code). Comments responding to the notice were received and a public hearing was held on August 27, 1997. After consideration of the comments, the proposed regulations under sections 643(h) and 672(f) are adopted as final regulations as revised by this Treasury decision. The proposed regulations under section 671 are issued as revised by this Treasury decision as temporary regulations. The revisions are discussed below. The proposed regulations under section 7701 are withdrawn. The temporary regulations under section 671 are also being issued as proposed regulations published in REG–252487–96, on page 303.

Explanation of Provisions and Revisions

1. *Comments and Changes to §1.643(h)–1: Distributions by Certain Foreign Trusts Through Intermediaries*

Under the proposed regulations, any amount that was derived, directly or indirectly, by a U.S. person from a foreign trust through an intermediary generally was deemed to have been transferred directly by the foreign trust to the U.S. person if any one of three specified conditions was satisfied. In cases where the transfer from the intermediary to the U.S. person did not occur in the same taxable year of the U.S. person as the transfer from the foreign trust to the intermediary, the proposed regulations looked to generally applicable agency principles to determine when the transfer to the U.S. person was deemed to occur.

Commenters said the proposed rules were too broad and could reach virtually any transfer made to a U.S. person by any person who has received a distribution from a foreign trust. They suggested that the basic requirement for treating a transfer to a U.S. person as a transfer directly from a foreign trust should be the existence of an intention to avoid U.S. tax. Alternatively, they said there should at least be a time limitation so that the rule would not apply to a transfer of property received from a foreign trust more than, for example, one year before the transfer to the U.S. person. In addition, they said the proposed rule relying on generally applicable agency principles for determining whether an intermediary is the agent of the foreign trust or of the U.S. person would be difficult to apply because different countries have different laws and the U.S. person should be taxed prior to receipt only if the intermediary is clearly a nominee or agent for the U.S. person.

In response to the comments, the final regulations treat any property (including cash) that is transferred to a U.S. person by an intermediary who has received property from a foreign trust as property transferred directly by the foreign trust to the U.S. person if 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. A transfer of property will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax if all of certain specified factors are present. However, the Commissioner may find that a transfer was made pursuant to a plan one of the principal purposes of which was the avoidance of U.S. tax whether or not any of the specified factors is present.

The factors that will cause a transfer to be deemed to have been made pursuant to

a plan one of the principal purposes of which was the avoidance of U.S. tax are the following: (i) the U.S. person is related to a grantor of the foreign trust or has another relationship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer to the U.S. person; (ii) the U.S. person receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and (iii) the U.S. person cannot demonstrate to the satisfaction of the Commissioner that (A) the intermediary has a relationship with the U.S. person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the U.S. person, (B) the intermediary acted independently of the grantor and the trustee, (C) the intermediary is not an agent of the U.S. person under generally applicable U.S. agency principles, and (D) the U.S. person timely complied with the reporting requirement of section 6039F, if applicable, if the intermediary is a foreign person. See Notice 97–34 (1997–1 C.B. 422).

The final regulations also have been modified with respect to the application of generally applicable agency principles. Under the final regulations, property is treated as transferred to the U.S. person in the year it is actually transferred to the U.S. person by the intermediary unless the Commissioner determines, or the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the U.S. person under generally applicable agency principles, in which case the property will be treated as transferred to the U.S. person by the trust in the year the property was transferred to the intermediary by the trust. As a corollary, the final regulations provide that the fair market value of the property is determined as of the date of the transfer to the U.S. person, unless the intermediary is treated as an agent of the U.S. person, in which case the fair market value will be determined as of the date of the transfer to the intermediary. Examples illustrate the effect of changes in the fair market value between the date of the transfer to the intermediary and the date of the transfer to the U.S. person.

The final regulations clarify that they apply only to gratuitous transfers. They also clarify that if property is treated as transferred directly by a foreign trust to a U.S. person pursuant to the regulations, the same property will not be taken into account in computing the gross income of the intermediary (if such property would otherwise be required to be so taken into account).

The final regulations under section 643(h) are applicable to transfers made to U.S. persons after August 10, 1999.

2. *Comments and Changes to §1.671– 2(e): Definition of Grantor*

The proposed regulations provided a definition of grantor for purposes of part I of subchapter J, chapter 1 of the Code. This document replaces the proposed regulations with temporary regulations that are effective August 10, 1999. These temporary regulations are also being issued as proposed regulations published elsewhere in this issue of the **Federal Register.** In accordance with section 7805(e)(2), the temporary regulations will expire before August 12, 2002.

Under the original proposed regulations, a grantor was defined to include any person to the extent such person either (i) creates a trust or (ii) directly or indirectly makes a gratuitous transfer to a trust. Commenters questioned why a nominal creator who has made no transfer to a trust should be treated as a grantor and asked for an explanation of the tax significance of such treatment.

Treating a nominal creator as a grantor ensures that someone will be responsible for reporting the creation of a foreign trust by a U.S. person even if the trust is not immediately funded. See section 6048(a)(3)(A)(i) and (a)(4)(A). At the same time, Treasury and the IRS believe that an accommodation grantor, such as an attorney who creates a trust on behalf of a client, (although a grantor) should not be treated as an owner of the trust. Accordingly, the temporary regulations provide that a person who either creates a trust, or funds a trust with an amount that is directly repaid to such person within a reasonable period of time, but who makes no other transfers to the trust that constitute gratuitous transfers, will not be treated as an owner of any portion of the trust under sections 671 through 677 or 679.

Commenters also questioned a provision in the proposed regulations that treated a distribution from one trust to another trust that is a beneficiary of the first trust as a gratuitous transfer, with the result that the first trust was a grantor of the second trust. Under the temporary regulations, if a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally is treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, such person is treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Code. (These rules do not affect the determination of whether or not the gratuitous transfer from the transferor trust is a distribution subject to sections 651 or 661.)

The proposed regulations provided that a person who acquires an interest in a fixed investment trust from a grantor of the trust also will be treated as a grantor of the trust. In response to comments received, the temporary regulations extend the same treatment to persons who acquire an interest in a liquidating trust or an environmental remediation trust.

The temporary regulations include a new section that applies to gratuitous transfers to trusts by partnerships and corporations. If the transfer is entered into for a business purpose of the partnership or corporation, the partnership or corporation, as the case may be, generally is treated as the grantor of the trust. However, if the transfer is not entered into for a business purpose of the partnership or corporation — for example, if it is for the personal purposes of one or more of the partners or shareholders — the transfer is treated as a constructive distribution to such partners or shareholders under federal tax principles, and the partners or shareholders, as the case may be, are treated as the grantors of the trust. See, for example, *Epstein v. Commissioner,* 53

T.C. 459 (1969), acq. on another issue, 1970–2 C.B. xix.

Commenters asked for guidance concerning the identification of the grantor when the property contributed to the trust is jointly owned. These temporary regulations do not provide specific guidance on the treatment of joint owners that contribute property to a trust. Treasury and the IRS invite comments with specific examples of areas that may need clarification, such as, for example, the treatment of community property or the joint ownership of property by noncitizen spouses.

3. *Comments and Changes to §1.672(f)–1: Foreign Persons Not Treated as Owners*

The proposed regulations prescribed 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) were applied to determine the worldwide amount and the U.S. amount. Then, the trust was 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. Commenters suggested that the two-step analysis was unnecessarily complex and questioned whether it might produce results that were unintended or inconsistent with the statute.

In response to these concerns, the final regulations provide that the grantor trust rules other than section 672(f) must be applied first to determine whether, under such rules, any portion of the trust would be treated as owned by a person other than a U.S. citizen or resident or domestic corporation. The determination of the portion of the trust that is treated as owned by a grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules as found in §1.671–1 et seq. If it is determined that any portion of the trust would be treated as owned by a person other than a U.S. citizen or resident or domestic corporation, such person will be treated as the owner of such portion only if such person is a foreign corporation described in §1.672(f)–2(a) or if such portion of the trust qualifies for one of the exceptions in §1.672(f)–3.

The final regulations under the general rule are generally applicable to taxable years of a trust beginning after August 10, 1999.

4. *Comments and Changes to §1.672(f)–2: Certain Foreign Corporations*

Under the proposed regulations, a controlled foreign corporation (CFC) that created or funded a trust was treated as a domestic corporation for purposes of section 672(f) only to the extent the trust's income was subpart F income that was currently taken into account in computing the gross income of a U.S. citizen, U.S. resident, or domestic corporation. There were similar rules for passive foreign investment companies (PFICs) and foreign personal holding companies (FPHCs). Commenters questioned whether the proposed rules were consistent with the statutory antideferral regime and the legislative history. There also were suggestions that the proposed rules should not apply where a CFC is wholly owned, directly or indirectly, by U.S. shareholders. In addition, there were requests for simplification of the rules pertaining to annual fluctuations in the portion of a trust that is treated as owned by the grantor.

In response to the comments, Treasury and the IRS have developed rules that are narrowly targeted to potentially abusive situations and therefore are not inconsistent with the antideferral regime. Under the final regulations, if the owner of a trust upon application of the grantor trust rules without regard to section 672(f) is a CFC, PFIC, or FPHC, the CFC, PFIC, or FPHC, as the case may be, will be treated as a domestic corporation for purposes of applying the general rule of §1.672(f)–1. Consequently, a CFC, PFIC, or FPHC generally will be treated as an owner of a trust if it would be so treated under sections 671 through 678 without regard to section 672(f). A CFC, PFIC, or FPHC will be treated as a domestic corporation solely for purposes of applying the general rule of §1.672(f)–1. Thus, a CFC, PFIC, or FPHC will be treated as a foreign corporation for purposes of §1.672(f)–4, which is discussed below in part 6 of this explanation.

If a trust to which a CFC, PFIC, or FPHC has made a gratuitous transfer makes a gratuitous transfer to a U.S. person, the CFC, PFIC, or FPHC, as the case may be, will be treated as a foreign corporation for purposes of determining how the transfer will be treated in the hands of the U.S. person, and the rules of §1.672(f)–4(c) will apply. If a trust that a CFC, PFIC, or FPHC is treated as owning under section 678 makes a gratuitous transfer to a U.S. person, the rules of §1.672(f)–4(c) will apply as if the CFC, PFIC, or FPHC had made a gratuitous transfer to the trust.

The final regulations for CFCs, PFICs, and FPHCs are generally applicable to taxable years of shareholders of CFCs, PFICs, and FPHCs beginning after August 10, 1999 and taxable years of CFCs, PFICs, and FPHCs ending with or within such taxable years of the shareholders.

5. *Comments and Changes to §1.672(f)–3: Exceptions To General Rule*

A. Certain Revocable Trusts

Under the proposed regulations, the general rule of §1.672(f)–1(a) did not apply to any portion of a trust if the power to revest absolutely in the grantor title to such portion was exercisable solely by the grantor without the approval or consent of any other person for a period or periods aggregating 183 days or more during the taxable year of the trust. The 183-day rule is targeted at potentially abusive situations in which a power to revest is so limited that it is not likely to be exercised.

In response to comments received, the final regulations clarify that if the first or last taxable year of the trust is less than 183 days, the revocable trust exception will apply if the grantor has a power to revest on each day of the first or last taxable year (including the year of the grantor's death), as the case may be. The final regulations also clarify that, consistent with the principle that statutory exceptions should be construed narrowly, if a trust fails to qualify for the revocable trust exception in a particular year, the exception cannot apply in a later year even if the requirements would otherwise be satisfied in such later year.

Commenters asked whether the revocable trust exception continues to apply if the grantor becomes incapacitated. The final regulations provide that the exception will continue to apply if, but only if, there is a guardian or other person who has unrestricted authority to exercise the necessary power on the grantor's behalf.

Some commenters disagreed with the result in §1.672(f)–3(a)(4) *Example 3* of the proposed regulations, which concluded that the revocable trust exception does not apply where the grantor of the trust can replace the trustee, who is not a related or subordinate party, at any time for any reason. They said the example was inconsistent with the existing grantor trust rules. See, e.g., §1.674(d)–2(a). After careful consideration, Treasury and the IRS have concluded that Example 3 is consistent with the purposes of section 672(f) and should be retained.

Commenters raised a number of issues concerning the grandfather rules in §1.672(f)–3(a)(2) and (b)(4) of the proposed regulations for certain trusts that were in existence on September 19, 1995. In response to the comments, the final regulations confirm that physical separation of amounts that were gratuitously transferred to the trust after September 19, 1995, is not required. The final regulations further provide that initial separate accountings may be prepared at any time up until the due date (including extensions) for the tax return for the first taxable year of the trust beginning after August 10, 1999. In response to requests for more specific guidance, the final regulations provide that the grandfather rules apply only if any amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of §1.671–3(a)(2).

B. Certain Trusts that Can Distribute Only to the Grantor or the Spouse of the Grantor

Under the proposed regulations, the general rule of §1.672(f)–1 did not apply if the only amounts distributable from a trust (or portion of a trust) during the lifetime of the grantor were amounts distributable to the grantor or the grantor's spouse. Treasury and the IRS contemplate that the fact that the grantor and his or her spouse might someday divorce or legally separate will be disregarded for purposes of determining whether the exception is applicable.

Under the proposed regulations, amounts distributable in discharge of a legal obligation of the grantor or the grantor's spouse generally were treated as amounts distributable to the grantor or the grantor's spouse. Commenters said these proposed rules were inconsistent with the manner in which distributions in discharge of obligations are treated in regulations promulgated under other provisions of the Code. For example, under sections 677(a) and 662(a)(2), there is no exception for obligations to family members that are not based on full and adequate consideration in money or money's worth. Commenters also said the proposed rules were likely to exclude most trusts from qualification for the exception because, in most jurisdictions, a trust provision that permits distributions to a particular person is construed to permit distributions to be made in satisfaction of that person's obligations, regardless of the source of the obligations.

Treasury and the IRS believe it is neither necessary nor appropriate for the regulations promulgated under the statutory exceptions to section 672(f) to be consistent with the regulations promulgated under other provisions of part I of subchapter J, chapter 1 of the Code. Section 672(f) reflects a policy determination that foreign persons should not be allowed "to affirmatively use the domestic anti-abuse rules concerning grantor trusts" to avoid U.S. tax on trust income distributed to U.S. beneficiaries. Dept. of the Treasury, General Explanations of the Administration's Revenue Proposals, at 12 (1995). Section 672(f) operates to implement that policy determination by providing that the grantor trust rules generally do not apply where their effect would be to treat a foreign person as the owner of any portion of a trust. S. Rep. No. 35, 104th Cong., 1st Sess. 161 (1995). The exceptions in section 672(f)(2) must be interpreted narrowly to preserve the primary operation of the general rule. See, for example, *Commissioner v. Clark*, 489 U.S. 726, 739 (1989) ("In construing provisions . . . in which a general statement of policy is qualified by an exception, we usually read the exception narrowly in order to preserve the primary operation of the provision.").

The final regulations continue to provide that a trust will not fail to qualify for the exception solely because amounts are distributable from the trust in discharge of a legal obligation of the grantor (or grantor's spouse). An obligation to a related person is not generally treated as a legal obligation unless it was contracted bona fide and for adequate and full consideration in money or money's worth. However, obligations to support certain individuals will be treated as legal obligations if the individual is either permanently and totally disabled or less than 19 years old. The final regulations expand the list of potentially eligible individuals to include certain individuals who are members of the grantor's (or grantor's spouse's) household and have as their principal place of abode the grantor's (or grantor's spouse's) home, but are not related to the grantor (or grantor's spouse) through one of the relationships listed in section 152(a)(1) through (8). The fact that amounts might become distributable from a trust to support an individual who is not described in the regulations will be disregarded if, at the time the applicability of the exception is being determined, the potential obligation is not reasonably expected to arise under the facts and circumstances.

Some commenters said the limitation in proposed §1.672(f)–3(b)(2)(ii) for legal obligations to related persons is not needed in the case of reinsurance trusts because, regardless of the sufficiency of the consideration for the reinsurance, the funds in a reinsurance trust can be utilized only to satisfy the legal obligations of the reinsurer (or will be distributed to the reinsurer). In addition, commenters pointed out that there already are other provisions, such as sections 482 and 845, that apply to related-party reinsurance arrangements.

The final regulations reserve on the application of the related-party rule to reinsurance trusts. Treasury and the IRS are looking carefully at this area, and they invite additional comments.

Commenters raised a number of issues concerning the grandfather rules in §1.672(f)–3(b)(4) of the proposed regulations. These issues are discussed above in connection with the grandfather rules under §1.672(f)–3(a)(2) of the proposed regulations.

C. Compensatory Trusts

The proposed regulations listed categories of trusts that constitute compensatory trusts, without regard to whether any portion of a particular trust would ever be treated as owned by the grantor or another person under the grantor trust

rules. Treasury and the IRS are concerned that some taxpayers may find such a comprehensive list confusing. Accordingly, the final regulations provide that the trusts to which the compensatory trust exception applies are those to which the application of section 672(f) is likely to be relevant: (i) nonexempt employees' trusts described in section 402(b) and (ii) so-called "rabbi" trusts. Treasury and the IRS believe the issue of whether tax-exempt compensatory trusts can be treated as owned by a foreign person is moot because there are special statutory rules that govern those trusts.

Treasury and the IRS contemplate that a nonexempt employees' trust described in section 402(b) will be treated as owned by a beneficiary of the trust only to the extent provided in regulations section 1.402(b)–1(b)(6). See also proposed regulations §1.671–1(g) and §1.671–1(h), which were published in the **Federal Register** (61 F.R. 50778) on September 27, 1996, for proposed rules describing when an employer will be treated as an owner of any portion of a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan.

The final regulations also provide that the Commissioner may designate additional categories of trusts to which the compensatory trust exception applies.

6. C*omments and Changes to §1.672(f)–4: Recharacterization of Purported Gifts*

The proposed regulations provided that a U.S. donee generally must treat a purported gift from a foreign corporation as a distribution from the foreign corporation unless the U.S. donee can establish that a U.S. citizen or resident alien is a shareholder of the transferor and that the U.S. citizen or resident took the amount into account for U.S. tax purposes and subsequently made a gift to the U.S. donee. Similar rules were proposed for purported gifts from partnerships (whether domestic or foreign). There were exceptions for charitable contributions to donees described in section 170(c) and for purported gifts that did not exceed $10,000.

Section 1.672(f)–4(c) of the proposed regulations provided rules for gratuitous transfers to U.S. donees from trusts created by partnerships or foreign corporations. Under the proposed regulations, if the partnership or foreign corporation was treated as the owner of the trust under the grantor trust rules, the transfer was treated as a purported gift from the partnership or foreign corporation. If the partnership or foreign corporation was not treated as the owner of the trust, the transfer was treated as an accumulation distribution from the trust unless the resulting U.S. tax liability was less than the U.S. tax that would be due if the transfer were treated as a purported gift from the partnership or foreign corporation.

Commenters said the proposed regulations were overly broad and exceeded the scope of the regulatory authority granted by Congress. They suggested that a purported gift from a partnership or foreign corporation should be treated as a deemed distribution to the partner or shareholder followed by a deemed transfer to the U.S. donee. Commenters also suggested that purported gifts should not be recharacterized as taxable distributions unless it appeared, based on all the facts and circumstances, that the partnership or foreign corporation was being used principally as a device to avoid U.S. tax.

Treasury and the IRS believe the basic approach taken by the proposed regulations is both necessary and appropriate to prevent the avoidance of the purposes of section 672(f). See Code section 672(f)(4) and (6). A rule that would recharacterize purported gifts only in situations where the partnership or foreign corporation was being used principally as a device to avoid U.S. tax would be unadministrable. It would place a nearly insurmountable burden on the IRS to obtain information, much of it outside the United States, and to establish that the partnership or foreign corporation was being used to avoid U.S. tax. Further, individuals do not normally receive gifts from partnerships and corporations. See, for example, *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

The final regulations leave the basic approach essentially unaltered, but expand the number of exceptions to the general rule. They retain the exception for cases where the U.S. donee can establish that a U.S. citizen or resident alien treated (and reported) the purported gift for U.S. tax purposes as a distribution from the partnership or foreign corporation and a subsequent gift to the donee. In response to the commenters' concerns, they provide an additional exception for cases where the U.S. donee can establish that a nonresident alien individual treated and reported the purported gift for purposes of the tax laws of the country in which the nonresident alien is resident as a distribution from the partnership or foreign corporation and a subsequent gift to the donee, provided the U.S. donee timely complied with the filing requirements of section 6039F, if applicable. Finally, they provide another new exception for purported gifts from domestic partnerships that are beneficially owned (within the meaning of §1.1441–1(c)(6)) exclusively by U.S. citizens or residents or domestic corporations.

In response to other comments, the final regulations clarify that a transfer to a U.S. donee that is a corporation will not be subject to the general rule of §1.672(f)–4(a) to the extent the donee can establish that the transfer was a contribution to capital. The final regulations also expand the scope of the charitable contribution exception to include a transfer from a transferor that has received a ruling or determination letter from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), provided that the transfer was made pursuant to the transferor's exempt purpose, the ruling or determination letter has not been revoked or modified, and there has been no material change, inconsistent with exemption, in the character, purpose, or method of operation of the organization.

The final regulations revise the rules for gratuitous transfers to U.S. donees from trusts to which partnerships or foreign corporations have made gratuitous transfers. The revisions reflect the fact that, under U.S. domestic law principles, the partners or shareholders might be treated as grantors of the trust. See §1.671–2T(e)(4).

The final regulations also clarify that if the transferring partnership or foreign corporation receives some consideration from the U.S. donee, but the consideration is less than the fair market value of the property transferred, only the excess will be treated as a purported gift. Further, no portion will be treated as a purported gift if the U.S. donee can establish that the U.S. donee is neither related to a

partner or shareholder of the transferor within the meaning of §1.643(h)–1(e) nor has another relationship with a partner or shareholder of the transferor such that there is a reasonable basis for concluding that the partner or shareholder would make a gratuitous transfer to the U.S. donee.

Commenters said the proposed regulations overturned an early Supreme Court decision, *Bogardus v. Commissioner*, 302 U.S. 34 (1937), which treated certain payments by an acquiring corporation in a reorganization that were paid at the instigation of former shareholders of the target corporation to employees and former employees of the target corporation as nontaxable gifts rather than as compensation. The result in *Bogardus* might well be different today under section 102(c)(1) (enacted in 1986), which provides that the exclusion from gross income for the value of property acquired by gift does not apply to any amount transferred by or for an employer to, or for the benefit of, an employee. Further, and more importantly, the payor corporation in *Bogardus* was a domestic corporation that did not treat the payments as a deductible expense and there was no avoidance of U.S. tax. Thus, *Bogardus* is distinguishable on its facts from a situation where a foreign corporation transfers property to a U.S. person who treats the transfer as a gift or bequest and there will be avoidance of U.S. tax if the purported gift is not recharacterized.

The final regulations for purported gifts are generally applicable to transfers made after August 10, 1999 by partnerships or foreign corporations, or by trusts to which partnerships or foreign corporations made gratuitous transfers after August 10, 1999.

7. *Comments and Changes to §1.672(f)–5: Special Rules*

Section 1.672(f)–5(b) of the proposed regulations provided that, for purposes of §1.672(f)–1, where the taxable year of a trust was different from the taxable year of a person who was taking an amount into account, the amount was taken into account for the taxable year of the person that included the last day of the taxable year of the trust. This rule was deleted from the final regulations, because it is no longer needed in light of the revisions to §1.672(f)–1, which are described above in part 3 of this explanation.

Section 1.672(f)–5(c) of the proposed regulations provided that, for purposes of §1.672(f)–4, a wholly owned business entity must be treated as a corporation, separate from its single owner. Absent this rule, an entity having a single owner could avoid the purported gift rule by electing to be disregarded, with the result that the purported gift would be received from the owner of the entity, rather than from the entity itself. The final regulations clarify that this special rule (renumbered as §1.672(f)–5(b)) applies solely for purposes of §1.672(f)–4. Thus, it does not apply for purposes of §§1.672(f)–1 through 1.672(f)–3 or §1.672(f)–5 or for purposes of any other provision of the Code or regulations.

Section 301.7701–2(c)(2)(iii) of the proposed regulations provided that, solely for purposes of applying the rules of section 672(f)(4), a wholly owned business entity will be treated as a corporation, separate from its owner. This provision, which repeated the rule in §1.672(f)–5(c) (renumbered as §1.672(f)–5(b)), is not included in the final regulations.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 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, the notice of proposed rulemaking preceding these regulations was submitted to the Small Business Administration for comment on the regulation's impact on small business.

Drafting Information

The principal authors of these regulations are M. Grace Fleeman of the Office of Associate Chief Counsel (International) and James A. Quinn of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is 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 in part as follows:

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

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

Section 1.671–2T 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) and 672(f)(3) and (6).

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

Section 1.672(f)–4 also issued under 26 U.S.C. 643(a)(7) and 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*—(1) *Principal purpose of tax avoidance.* Except as provided in paragraph (b) of this section, for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, and section 6048, any property (within the meaning of paragraph (f) of this section) that is transferred to a United States person by another person (an intermediary) who has received property from a foreign trust will be treated as property transferred directly by the foreign trust to the United States person if the intermediary received the property from the foreign trust pursuant to a plan one of the principal purposes of which was the avoidance of United States tax.

(2) *Principal purpose of tax avoidance deemed to exist.* For purposes of paragraph (a)(1) of this section, a transfer will be deemed to have been made pursuant to a plan one of the principal purposes of which was the avoidance of United States tax if the United States person–

(i) Is related (within the meaning of paragraph (e) of this section) to a grantor of the foreign trust, or has another rela-

tionship with a grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor of the foreign trust would make a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) to the United States person;

(ii) Receives from the intermediary, within the period beginning twenty-four months before and ending twenty-four months after the intermediary's receipt of property from the foreign trust, either the property the intermediary received from the foreign trust, proceeds from such property, or property in substitution for such property; and

(iii) Cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with the United States person that establishes a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the United States person;

(B) The intermediary acted independently of the grantor and the trustee of the foreign trust;

(C) The intermediary is not an agent of the United States person under generally applicable United States agency principles; and

(D) The United States person timely complied with the reporting requirements of section 6039F, if applicable, if the intermediary is a foreign person.

(b) *Exceptions*—(1) *Nongratuitous transfers.* Paragraph (a) of this section does not apply to the extent that either the transfer from the foreign trust to the intermediary or the transfer from the intermediary to the United States person is a transfer that is not a gratuitous transfer within the meaning of §1.671–2T(e)(2).

(2) *Grantor as intermediary.* Paragraph (a) of this section does not apply if the intermediary is the grantor of the portion of the trust from which the property that is transferred is derived. For the definition of grantor, see §1.671–2T(e).

(c) *Effect of disregarding intermediary*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, the intermediary is treated as an agent of the foreign trust, and the property is treated as transferred to the United States person in the year the property is transferred, or made available, by the intermediary to the United States person. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the United States person. For purposes of section 665(d)(2), the term taxes imposed on the trust includes any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred.

(2) *Exception.* If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the United States person under generally applicable United States agency principles, the property will be treated as transferred to the United States person in the year the intermediary receives the property from the foreign trust. The fair market value of the property transferred will be determined as of the date of the transfer by the foreign trust to the intermediary. For purposes of section 901(b), any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the intermediary with respect to the property transferred will be treated as having been imposed on the United States person.

(3) *Computation of gross income of intermediary.* If property is treated as transferred directly by the foreign trust to a United States person pursuant to this section, the fair market value of such property is not taken into account in computing the gross income of the intermediary (if otherwise required to be taken into account by the intermediary but for paragraph (a) of this section).

(d) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States person, the aggregate fair market value of all property transferred to such person from all foreign trusts either directly or through one or more intermediaries does not exceed $10,000.

(e) *Related parties.* For purposes of this section, a United States person is treated as related to a grantor of a foreign trust if the United States person and the grantor are related for purposes 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" is used instead of "more than 50 percent" each place it appears; and

(2) The principles of section 267(b)(10), using "at least 10 percent" instead of "more than 50 percent," apply to determine whether two corporations are related.

(f) *Definition of property.* For purposes of this section, the term *property* includes cash.

(g) *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 and the fair market value of the property that is transferred exceeds $10,000. The examples are as follows:

Example 1. Principal purpose of tax avoidance. FT was created in 1980 by A, a nonresident alien, for the benefit of his children and their descendants. FT's trustee, T, determines that 1000X of accumulated income should be distributed to A's granddaughter, B, who is a resident alien. Pursuant to a plan with a principal purpose of avoiding the interest charge that would be imposed by section 668, T causes FT to make a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) of 1000X to I, a foreign person. I subsequently makes a gratuitous transfer of 1000X to B. Under paragraph (a)(1) of this section, FT is deemed to have made an accumulation distribution of 1000X directly to B.

Example 2. United States person unable to demonstrate that intermediary acted independently. GM and her daughter, M, are both nonresident aliens. M's daughter, D, is a resident alien. GM creates and funds FT for the benefit of her children. On July 1, 2001, FT makes a gratuitous transfer of XYZ stock to M. M immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2002, M makes a gratuitous transfer of the ABC stock to D. D is unable to demonstrate that M acted independently of GM and the trustee of FT in making the transfer to D. Under paragraph (a)(2) of this section, FT is deemed to have distributed the ABC stock to D. Under paragraph (c)(1) of this section, M is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 3. United States person demonstrates that specified conditions are satisfied. Assume the same facts as in Example 2, except that M receives 1000X cash from FT instead of XYZ stock. M gives 1000X cash to D on January 1, 2002. Also assume that M receives annual income of 5000X from her own investments and that M has given D 1000X at the beginning of each year for the past ten years. Based on this and additional information provided by D, D demonstrates to the satisfaction of the Commissioner that M has a relationship with D that establishes a reasonable basis for concluding that M would make a gratuitous transfer to D, that M acted independently of GM and the trustee of FT, that M is not an agent of D under generally applicable United States agency principles, and that D timely complied with the reporting requirements of section 6039F. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to D.

Example 4. Transfer to United States person less than 24 months before transfer to intermediary.

Several years ago, A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. A has a close friend, C, who also is a nonresident alien. A's granddaughter, B, is a resident alien. On December 31, 2001, C makes a gratuitous transfer of 1000X to B. On January 15, 2002, FT makes a gratuitous transfer of 1000X to C. B is unable to demonstrate that C has a relationship with B that would establish a reasonable basis for concluding that C would make a gratuitous transfer to B or that C acted independently of A and the trustee of FT in making the transfer to B. Under paragraph (a)(2) of this section, FT is deemed to have distributed 1000X directly to B. Under paragraph (c)(1) of this section, C is treated as an agent of FT, and the distribution is deemed to have been made on December 31, 2001.

Example 5. United States person receives property in substitution for property transferred to intermediary. GM and her son, S, are both nonresident aliens. S's daughter, GD, is a resident alien. GM creates and funds FT for the benefit of her children and their descendants. On July 1, 2001, FT makes a gratuitous transfer of ABC stock with a fair market value of approximately 1000X to S. On January 1, 2002, S makes a gratuitous transfer of DEF stock with a fair market value of approximately 1000X to GD. GD is unable to demonstrate that S acted independently of GM and the trustee of FT in transferring the DEF stock to GD. Under paragraph (a)(2) of this section, FT is deemed to have distributed the DEF stock to GD. Under paragraph (c)(1) of this section, S is treated as an agent of FT, and the distribution is deemed to have been made on January 1, 2002.

Example 6. United States person receives indirect loan from foreign trust. Several years ago, A, a nonresident alien, created and funded FT for the benefit of her children and their descendants. A's daughter, B, is a resident alien. B needs funds temporarily while she is starting up her own business. If FT were to loan money directly to B, section 643(i) would apply. FT deposits 500X with FB, a foreign bank, on June 30, 2001. On July 1, 2001, FB loans 400X to B. Repayment of the loan is guaranteed by FT's 500X deposit. B is unable to demonstrate to the satisfaction of the Commissioner that FB has a relationship with B that establishes a reasonable basis for concluding that FB would make a loan to B or that FB acted independently of A and the trustee of FT in making the loan. Under paragraph (a)(2) of this section, FT is deemed to have loaned 400X directly to B on July 1, 2001. Under paragraph (c)(1) of this section, FB is treated as an agent of FT. For the treatment of loans from foreign trusts, see section 643(i).

Example 7. United States person demonstrates that specified conditions are satisfied. GM, a nonresident alien, created and funded FT for the benefit of her children and their descendants. One of GM's children is M, who is a resident alien. During the year 2001, FT makes a gratuitous transfer of 500X to M. M reports the 500X on Form 3520 as a distribution received from a foreign trust. During the year 2002, M makes a gratuitous transfer of 400X to her son, S, who also is a resident alien. M files a Form 709 treating the gratuitous transfer to S as a gift. Based on this and additional information provided by S, S demonstrates to the satisfaction of the Commissioner that M has a relationship with S that establishes a reasonable basis for concluding that M would make a gratuitous transfer to S, that M acted independently of GM and the trustee of FT, and that M is not an agent of S under generally applicable United States agency principles. FT will not be deemed under paragraph (a)(2) of this section to have made a distribution to S.

Example 8. Intermediary as agent of trust; increase in FMV. A, a nonresident alien, created and funded FT for the benefit of his children and their descendants. On December 1, 2001, FT makes a gratuitous transfer of XYZ stock with a fair market value of 85X to B, a nonresident alien. On November 1, 2002, B sells the XYZ stock to a third party in an arm's length transaction for 100X in cash. On November 1, 2002, B makes a gratuitous transfer of 98X to A's grandson, C, a resident alien. C is unable to demonstrate to the satisfaction of the Commissioner that B acted independently of A and the trustee of FT in making the transfer. Under paragraph (a)(2) of this section, FT is deemed to have made a distribution directly to C. Under paragraph (c)(1) of this section, B is treated as an agent of FT, and FT is deemed to have distributed 98X to C on November 1, 2002.

Example 9. Intermediary as agent of United States person; increase in FMV. Assume the same facts as in Example 8, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed 85X to C on December 1, 2001. C must take the gain of 15X into account in the year 2002.

Example 10. Intermediary as agent of trust; decrease in FMV. Assume the same facts as in Example 8, except that the value of the XYZ stock on November 1, 2002, is only 80X. Instead of selling the XYZ stock to a third party and transferring cash to C, B transfers the XYZ stock to C in a gratuitous transfer. Under paragraph (c)(1) of this section, FT is deemed to have distributed XYZ stock with a value of 80X to C on November 1, 2002.

Example 11. Intermediary as agent of United States person; decrease in FMV. Assume the same facts as in Example 10, except that the Commissioner determines that B is an agent of C under generally applicable United States agency principles. Under paragraph (c)(2) of this section, FT is deemed to have distributed XYZ stock with a value of 85X to C on December 1, 2001.

(h) *Effective date.* The rules of this section are applicable to transfers made to United States persons after August 10, 1999.

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

§1.671–2 Applicable principles.

* * * * *

(e) [Reserved] For further guidance, see §1.671–2T(e).

Par. 4. Section 1.671–2T is added to read as follows:

§1.671–2T Applicable principles (temporary).

(a) through (d) [Reserved] For further guidance, see §1.671–2(a) through (d).

(e)(1) For purposes of part I of subchapter J, chapter 1 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)(2) of this section) of property to a trust. For purposes of this section, the term *property* includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also §1.672(f)–5(a).

(2)(i) A gratuitous transfer is any transfer other than a transfer for fair market value. A transfer of property to a trust may be considered a gratuitous transfer without regard to whether the transfer is treated as a gift for gift tax purposes.

(ii) For purposes of this paragraph (e), a transfer is for fair market value only to the extent of the value of property received from the trust, services rendered by the trust, or the right to use property of the trust. For example, rents, royalties, interest, and compensation paid to a trust are transfers for fair market value only to the extent that the payments reflect an arm's length price for the use of the property of, or for the services rendered by, the trust. For purposes of this determination, an interest in the trust is not property received from the trust. In addition, a person will not be treated as making a transfer for fair market value merely because the transferor recognizes gain on the transaction. See, for example, section 684 regarding the recognition of gain on certain transfers to foreign trusts.

(iii) For purposes of this paragraph (e), a gratuitous transfer does not include a distribution to a trust with respect to an interest held by such trust in either a trust described in paragraph (e)(3) of this section or an entity other than a trust. For example, a distribution to a trust by a corporation with respect to its stock described in section 301 is not a gratuitous transfer.

(3) A grantor includes any person who acquires an interest in a trust from a grantor of the trust if the interest acquired is an interest in certain investment trusts described in §301.7701–4(c) of this chapter, liquidating trusts described in §301.7701-4(d) of this chapter, or environmental remediation trusts described in §301.7701–4(e) of this chapter.

(4) If a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is, e.g., for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

(5) If a trust makes a gratuitous transfer of property to another trust, the grantor of the transferor trust generally will be treated as the grantor of the transferee trust. However, if a person with a general power of appointment over the transferor trust exercises that power in favor of another trust, then such person will be treated as the grantor of the transferee trust, even if the grantor of the transferor trust is treated as the owner of the transferor trust under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code.

(6) The following examples illustrate the rules of this paragraph (e). Unless otherwise indicated, all trusts are domestic trusts and all other persons are United States persons. The examples are as follows:

Example 1. A creates and funds a trust, T, for the benefit of her children. B subsequently makes a gratuitous transfer to T. Under paragraph (e)(1) of this section, both A and B are grantors 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. A is a grantor of T. B subsequently acquires A's entire interest in T. Under paragraph (e)(3) of this section, B is a grantor of T with respect to such interest.

Example 3. A, an attorney, creates a foreign trust, FT, on behalf of A's client, B, and transfers $100 to FT out of A's funds. A is reimbursed by B for the $100 transferred to FT. The trust instrument states that the trustee has discretion to distribute the income or corpus of FT to B, and B's children. Both A and B are treated as grantors of FT under paragraph (e)(1) of this section. In addition, B is treated as the owner of the entire trust under section 677. Because A is reimbursed for the $100 transferred to FT on behalf of B, A is not treated as transferring any property to FT. Therefore, A is not an owner of any portion of T under sections 671 through 677 regardless of whether A retained any power over or interest in T described in sections 673 through 677. A also is not treated as an owner of any portion of T under section 679. Both A and B are responsible parties for purposes of the reporting requirements in section 6048.

Example 4. A creates and funds a trust, T. A is not treated as an owner of any portion of the trust under subpart E. B holds an unrestricted power, exercisable solely by B, to withdraw certain amounts contributed to the trust before the end of the calendar year and to vest those amounts in B. B is treated as an owner of the portion of T that is subject to the withdrawal power under section 678(a)(1). However, B is not a grantor of T under paragraph (e)(1) of this section because B neither created T nor made a gratuitous transfer to T.

Example 5. A transfers cash to a trust, T, through a broker, in exchange for units in T. The units in T are not property for purposes of determining whether A has received fair market value under paragraph (e)(2)(ii) 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, a trust. A has not made any gratuitous transfers to T. Arm's length interest payments by A to T will not be treated as gratuitous transfers under paragraph (e)(2)(ii) 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, B's brother, creates a trust, T, for B's benefit and contributes $50,000 to T. The trustee invests the $50,000 in stock of Company X. C, B's uncle, sells property with a fair market value of $1,000,000 to T in exchange for the stock when it has appreciated to a fair market value of $100,000. Under paragraph (e)(2)(ii) of this section, the $900,000 excess value is a gratuitous transfer by C. Therefore, under paragraph (e)(1) of this section, A is a grantor with respect to the portion of the trust valued at $100,000, and C is a grantor of T with respect to the portion of the trust valued at $900,000. In addition, A or C or both will be treated as the owners of the respective portions of the trust of which each person is a grantor if A or C or both retain powers over or interests in such portions under sections 673 through 677.

Example 8. G creates and funds a trust, T1, for the benefit of G's children and grandchildren. After G's death, under authority granted to the trustees in the trust instrument, the trustees of T1 transfer a portion of the assets of T1 to another trust, T2, and retain a power to revoke T2 and revest the assets of T2 in T1. Under paragraphs (e)(1) and (5) of this section, G is the grantor of T1 and T2. In addition, because the trustees of T1 have retained a power to revest the assets of T2 in T1, T1 is treated as the owner of T2 under section 678(a).

Example 9. G creates and funds a trust, T1, for the benefit of B. G retains a power to revest the assets of T1 in G within the meaning of section 676. Under the trust agreement, B is given a general power of appointment over the assets of T1. B exercises the general power of appointment with respect to one-half of the corpus of T1 in favor of a trust, T2, that is for the benefit of C, B's child. Under paragraph (e)(1) of this section, G is the grantor of T1, and under paragraphs (e)(1) and (5) of this section, B is the grantor of T2.

(7) The rules of this section are applicable to any transfer to a trust, or transfer of an interest in a trust, on or after August 10, 1999. In accordance with section 7805(e)(2), the rules of this section will expire before August 12, 2002.

Par. 5. 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*—(1) *Application of the general rule.* Section 672(f)(1) provides that subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code (the grantor trust rules) shall apply 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. Accordingly, the grantor trust rules apply to the extent that any portion of the trust, upon application of the grantor trust rules without regard to section 672(f), is treated as owned by a United States citizen or resident or do-

mestic corporation. The grantor trust rules do not apply to any portion of the trust to the extent that, upon application of the grantor trust rules without regard to section 672(f), that portion is treated as owned by a person other than a United States citizen or resident or domestic corporation, unless the person is described in §1.672(f)–2(a) (relating to certain foreign corporations treated as domestic corporations), or one of the exceptions set forth in §1.672(f)–3 is met, (relating to: trusts where the grantor can revest trust assets; trusts where the only amounts distributable are to the grantor or the grantor's spouse; and compensatory trusts). Section 672(f) applies to domestic and foreign trusts. Any portion of the trust that is not treated as owned by a grantor or another person is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(2) *Determination of portion based on application of the grantor trust rules.* The determination of the portion of a trust treated as owned by the grantor or other person is to be made based on the terms of the trust and the application of the grantor trust rules and section 671 and the regulations thereunder.

(b) *Example.* The following example illustrates the rules of this section:

Example. (i) A, a nonresident alien, funds an irrevocable domestic trust, DT, for the benefit of his son, B, who is a United States citizen, with stock of Corporation X. A's brother, C, who also is a United States citizen, contributes stock of Corporation Y to the trust for the benefit of B. A has a reversionary interest within the meaning of section 673 in the X stock that would cause A to be treated as the owner of the X stock upon application of the grantor trust rules without regard to section 672(f). C has a reversionary interest within the meaning of section 673 in the Y stock that would cause C to be treated as the owner of the Y stock upon application of the grantor trust rules without regard to section 672(f). The trustee has discretion to accumulate or currently distribute income of DT to B.

(ii) Because A is a nonresident alien, application of the grantor trust rules without regard to section 672(f) would not result in the portion of the trust consisting of the X stock being treated as owned by a United States citizen or resident. None of the exceptions in §1.672(f)–3 applies because A cannot revest the X stock in A, amounts may be distributed during A's lifetime to B, who is neither a grantor nor a spouse of a grantor, and the trust is not a compensatory trust. Therefore, pursuant to paragraph (a)(1) of this section, A is not treated as an owner under subpart E of part I, subchapter J, chapter 1 of the Internal Revenue Code, of the portion of the trust consisting of the X stock. Any distributions from such portion of the trust are subject to the rules of subparts A through D (641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code.

(iii) Because C is a United States citizen, paragraph (a)(1) of this section does not prevent C from being treated under section 673 as the owner of the portion of the trust consisting of the Y stock.

(c) *Effective date.* The rules of this section are applicable to taxable years of a trust beginning after August 10, 1999.

§1.672(f)–2 Certain foreign corporations.

(a) *Application of general rule.* Subject to the provisions of paragraph (b) of this section, if the owner of any portion of a trust upon application of the grantor trust rules without regard to section 672(f) is a controlled foreign corporation (as defined in section 957), a passive foreign investment company (as defined in section 1297), or a foreign personal holding company (as defined in section 552), the corporation will be treated as a domestic corporation for purposes of applying the rules of §1.672(f)–1.

(b) *Gratuitous transfers to United States persons*—(1) *Transfer from trust to which corporation made a gratuitous transfer.* If a trust (or portion of a trust) to which a controlled foreign corporation, passive foreign investment company, or foreign personal holding company has made a gratuitous transfer (within the meaning of §1.671–2T(e)(2)), makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation for purposes of §1.672(f)–4(c), relating to gratuitous transfers from trusts (or portions of trusts) to which a partnership or foreign corporation has made a gratuitous transfer.

(2) *Transfer from trust over which corporation has a section 678 power.* If a trust (or portion of a trust) that a controlled foreign corporation, passive foreign investment company, or foreign personal holding company is treated as owning under section 678 makes a gratuitous transfer to a United States person, the controlled foreign corporation, passive foreign investment company, or foreign personal holding company, as the case may be, is treated as a foreign corporation that had made a gratuitous transfer to the trust (or portion of a trust) and the rules of §1.672(f)–4(c) apply.

(c) *Special rules for passive foreign investment companies*—(1) *Application of section 1297.* For purposes of determining whether a foreign corporation is a passive foreign investment company as defined in section 1297, the grantor trust rules apply as if section 672(f) had not come into effect.

(2) *References to renumbered Internal Revenue Code section.* For taxable years of shareholders beginning on or before December 31, 1997, and taxable years of passive foreign investment companies ending with or within such taxable years of the shareholders, all references in this §1.672(f)–2 to section 1297 are deemed to be references to section 1296.

(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 are as follows:

Example 1. Application of general rule. CFC creates and funds FT. CFC is the grantor of FT within the meaning of §1.671–2T(e). CFC has a reversionary interest in FT within the meaning of section 673 that would cause CFC to be treated as the owner of FT upon application of the grantor trust rules without regard to section 672(f). Under paragraph (a) of this section, CFC is treated as a domestic corporation for purposes of applying the general rule of §1.672(f)–1. Thus, §1.672(f)–1 does not prevent CFC from being treated as the owner of FT under section 673.

Example 2. Distribution from trust to which CFC made gratuitous transfer. A, a nonresident alien, owns 40 percent of the stock of CFC. A's brother B, a resident alien, owns the other 60 percent of the stock of CFC. CFC makes a gratuitous transfer to FT. FT makes a gratuitous transfer to A's daughter, C, who is a resident alien. Under paragraph (b)(1) of this section, CFC will be treated as a foreign corporation for purposes of §1.672(f)–4(c). For further guidance, see §1.672(f)–4(g) *Example 2* through *Example 4*.

(e) *Effective date.* The rules of this section are generally applicable to taxable years of shareholders of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies beginning after August 10, 1999, and taxable years of controlled foreign corporations, passive foreign investment companies, and foreign personal holding companies ending with or within such taxable years of the shareholders.

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

(a) *Certain revocable trusts*—(1) *In general.* Subject to the provisions of paragraph (a)(2) of this section, the general rule of §1.672(f)–1 does not apply to any portion of a trust for a taxable year of the trust if the power to revest absolutely in the grantor title to such portion is exercisable solely by the grantor (or, in the event of the grantor's incapacity, by a guardian or other person who has unrestricted authority to exercise such power on the grantor's behalf) 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 is treated as exercisable solely by the grantor. For the definition of *grantor*, see §1.671–2T(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. A trust (or portion of a trust) that fails to qualify for the exception provided by this paragraph (a) for a particular taxable year of the trust will be subject to the general rule of §1.672(f)–1 for that taxable year and all subsequent taxable years of the trust.

(2) *183-day rule.* For purposes of paragraph (a)(1) of this section, the grantor is treated as having a power to revest for a taxable year of the trust only if the grantor has such power for a total of 183 or more days during the taxable year of the trust. If the first or last taxable year of the trust (including the year of the grantor's death) is less than 183 days, the grantor is treated as having a power to revest for purposes of paragraph (a)(1) of this section if the grantor has such power for each day of the first or last taxable year, as the case may be.

(3) *Grandfather rule for certain revocable trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)–1 does not apply to any portion of 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 thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

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

Example 1. Grantor is owner. FP1, a foreign person, creates and funds a revocable trust, T, for the benefit of FP1's children, who are resident aliens. 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. The trust instrument contains no standard that FB must apply in determining whether to approve or consent to the revocation of T. There are no facts that would suggest that FB is not subservient to FP1. Therefore, the exception in paragraph (a)(1) of this section is applicable.

Example 2. Death of 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, the exception in paragraph (a)(1) of this section is no longer applicable, because FP2 is not a grantor of T within the meaning of §1.671–2T(e).

Example 3. Trustee is not related or subordinate party. Assume the same facts as in Example 1, except that neither FP1 nor any member of FP1's 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 with a related or subordinate party 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, the exception in paragraph (a)(1) of this section is not applicable.

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 beneficiaries of T, including FP. Even if FB would in fact distribute all the trust property to FP if requested to do so by FP, the exception in paragraph (a)(1) of this section is not applicable, because FP does not have the power to revoke T.

(b) *Certain trusts that can distribute only to the grantor or the spouse of the grantor*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any trust (or portion of a trust) if at all times during the lifetime of the grantor the only amounts distributable (whether income or corpus) from such trust (or portion thereof) are amounts distributable to the grantor or the spouse of the grantor. For purposes of this paragraph (b), payments of amounts that are not gratuitous transfers (within the meaning of §1.671–2T(e)(2)) are not amounts distributable. For the definition of grantor, see §1.671–2T(e).

(2) *Amounts distributable in discharge of legal obligations*—(i) *In general.* A trust (or portion of a trust) does not fail to satisfy paragraph (b)(1) of this section solely because amounts are distributable from the trust (or portion thereof) in discharge of a legal obligation of the grantor or the spouse of the grantor. Subject to the provisions of paragraph (b)(2)(ii) of this section, an obligation is considered a legal obligation for purposes of this paragraph (b)(2)(i) if it is enforceable under the local law of the jurisdiction in which the grantor (or the spouse of the grantor) resides.

(ii) *Related parties*—(A) *In general.* Except as provided in paragraph (b)(2)(ii)(B) of this section, an obligation to a person who is a related person for purposes of §1.643(h)–1(e) (other than an individual who is legally separated from the grantor under a decree of divorce or of separate maintenance) is not a legal obligation for purposes of paragraph (b)(2)(i) of this section unless it was contracted bona fide and for adequate and full consideration in money or money's worth (see §20.2043–1 of this chapter).

(B) *Exceptions*—(1) *Amounts distributable in support of certain individuals.* Paragraph (b)(2)(ii)(A) of this section does not apply with respect to amounts that are distributable from the trust (or portion thereof) to support an individual who—

(*i*) Would be treated as a dependent of the grantor or the spouse of the grantor under section 152(a)(1) through (9), without regard to the requirement that over half of the individual's support be received from the grantor or the spouse of the grantor; and

(*ii*) Is either permanently and totally disabled (within the meaning of section 22(e)(3)), or less than 19 years old.

(*2*) *Certain potential support obligations.* The fact that amounts might become distributable from a trust (or portion of a trust) in discharge of a potential obligation under local law to support an individual other than an individual described in paragraph (b)(2)(ii)(B)(*1*) of this section is disregarded if such potential obligation is not reasonably expected to arise under the facts and circumstances.

(*3*) *Reinsurance trusts.* [Reserved]

(3) *Grandfather rule for certain section 677 trusts in existence on September 19, 1995.* Subject to the rules of paragraph (d) of this section (relating to separate accounting for gratuitous transfers to the trust after September 19, 1995), the general rule of §1.672(f)–1 does not apply to any portion of 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 thereafter. However, the preceding sentence does not apply to any portion of the trust attributable to gratuitous transfers to the trust after September 19, 1995.

(4) *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 is 70 years old, and W is 65. H and W have a 30-year-old child, C, a resident alien. There is no reasonable expectation that H or W will ever have an obligation under local law to support C or any other individual. H creates and funds an irrevocable trust, FT, using only his separate property. H is the grantor of FT within the meaning of §1.671–2T(e). Under the terms of FT, the only amounts distributable (whether income or corpus) from FT as long as either H or W is alive are amounts distributable to H or W. Upon the death of both H and W, C may receive distributions from FT. During H's lifetime, the exception in paragraph (b)(1) of this section is applicable.

Example 2. Effect of grantor's death. Assume the same facts as in *Example 1.* H predeceases W. Assume that W would be treated as owning FT under section 678 if the grantor trust rules were applied without regard to section 672(f). The exception in paragraph (b)(1) of this section is no longer applicable, because W is not a grantor of FT within the meaning of §1.671–2T(e).

Example 3. Amounts temporarily distributable to person other than grantor or grantor's spouse. Assume the same facts as in *Example 1,* except that C (age 30) is a law student at the time FT is created 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 is alive will be amounts distributable to H or W. Even assuming there is an enforceable obligation under local law for H and W to support C while he is in school, distributions from FT in payment of C's expenses cannot qualify as distributions in discharge of a legal obligation under paragraph (b)(2) of this section, because C is neither permanently and totally disabled nor less than 19 years old. The exception in paragraph (b)(1) of this section is not applicable. After C graduates from law school, the exception in paragraph (b)(1) still will not be applicable, because amounts were distributable to C during the lifetime of H.

Example 4. 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. Under the terms of DT, the only amounts that are distributable from FC's portion of DT are amounts distributable to FC. The exception in paragraph (b)(1) of this section is applicable to FC's portion of DT.

Example 5. Reinsurance trust. A domestic insurance company, DI, reinsures a portion of its business with an unrelated foreign insurance company, FI. To satisfy state regulatory requirements, FI places the premiums in an irrevocable domestic trust, DT. The trust funds are held by a United States bank and may be used only to pay claims arising out of the reinsurance policies, which are legally enforceable under the local law of the jurisdiction in which FI resides. On the termination of DT, any assets remaining will revert to FI. Because the only amounts that are distributable from DT are distributable either to FI or in discharge of FI's legal obligations within the meaning of paragraph (b)(2)(i) of this section, the exception in paragraph (b)(1) of this section is applicable.

Example 6. Trust that provides security for loan. FC, a foreign corporation, borrows money from B, an unrelated bank, 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 while the loan is outstanding are amounts distributable to B in the event that FC defaults on its loan from B. When FC repays the loan, the trust assets will revert to FC. The loan is a legal obligation of FC within the meaning of paragraph (b)(2)(i) of this section, because it is enforceable under the local law of the country in which FC is incorporated. Paragraph (b)(2)(ii) of this section is not applicable, because B is not a related person for purposes of §1.643(h)–1(e). The exception in paragraph (b)(1) of this section is applicable.

(c) *Compensatory trusts*—(1) *In general.* The general rule of §1.672(f)–1 does not apply to any portion of—

(i) A nonexempt employees' trust described in section 402(b), including a trust created on behalf of a self-employed individual;

(ii) A trust, including a trust created on behalf of a self-employed individual, 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

(iii) Any additional category of trust that the Commissioner may designate in revenue procedures, notices, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

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

(d) *Separate accounting for gratuitous transfers to grandfathered trusts after September 19, 1995.* If a trust that was treated as owned by the grantor under section 676 or 677 (other than section 677(a)(3)) on September 19, 1995, contains both amounts held in the trust on September 19, 1995, and amounts that were gratuitously transferred to the trust after September 19, 1995, paragraphs (a)(3) and (b)(3) of this section apply only if the amounts that were gratuitously transferred to the trust after September 19, 1995, are treated as a separate portion of the trust that is accounted for under the rules of §1.671–3(a)(2). If the amounts that were gratuitously transferred to the trust after September 19, 1995 are not so accounted for, the general rule of §1.672(f)–1 applies to the entire trust. If such amounts are so accounted for, and without regard to whether there is physical separation of the assets, the general rule of §1.672(f)–1 does not apply to the portion of the trust that is attributable to amounts that were held in the trust on September 19, 1995.

(e) *Effective date.* The rules of this section are generally applicable to taxable years of a trust beginning after August 10, 1999. The initial separate accounting required by paragraph (d) of this section must be prepared by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999.

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

(a) *In general*—(1) *Purported gifts from partnerships.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States person (United States 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 United States donee's gross income as ordinary income.

(2) *Purported gifts from foreign corporations.* Except as provided in paragraphs (b), (e), and (f) of this section, and without regard to the existence of any trust, if a United States donee directly or indirectly receives a purported gift or bequest (as defined in paragraph (d) of this section) from any foreign corporation, the purported gift or bequest must be included in the United States donee's gross income as if it were a distribution from the foreign corporation. If the foreign corporation is a passive foreign investment company (within the meaning of section 1297), the rules of section 1291 apply. For purposes of section 1012, the United States donee is not treated as having basis in the stock of the foreign corporation. However, for purposes of section 1223, the United States donee is treated as having a holding period in the stock of the foreign corporation on the date of the deemed distribution equal to the weighted average of the holding periods of the actual interest holders (other than any interest holders who treat the portion of the purported gift attributable to their interest in the foreign corporation in the manner described in paragraph (b)(1) of this section). For purposes of section 902, a United States donee that is a domestic corporation is not treated as owning any voting stock of the foreign corporation.

(b) *Exceptions*—(1) *Partner or shareholder treats transfer as distribution and gift.* Paragraph (a) of this section does not apply to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that either—

(i) A United States citizen or resident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for United States tax purposes as a distribution to such individual and a subsequent gift or bequest to the United States donee; or

(ii) A nonresident alien individual who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the nonresident alien individual's country of residence as a distribution to such individual and a subsequent gift or bequest to the United States donee, and the United States donee timely complied with the reporting requirements of section 6039F, if applicable.

(2) *All beneficial owners of domestic partnership are United States citizens or residents or domestic corporations.* Paragraph (a)(1) of this section does not apply to a purported gift or bequest from a domestic partnership if the United States donee can demonstrate to the satisfaction of the Commissioner that all beneficial owners (within the meaning of §1.1441–1(c)(6)) of the partnership are United States citizens or residents or domestic corporations.

(3) *Contribution to capital of corporate United States donee.* Paragraph (a) of this section does not apply to the extent a United States donee that is a corporation can establish that the purported gift or bequest was treated for United States tax purposes as a contribution to the capital of the United States donee to which section 118 applies.

(4) *Charitable transfers.* Paragraph (a) of this section does not apply if either—

(i) The United States donee is described in section 170(c); or

(ii) The transferor has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing its exempt status under section 501(c)(3), and the transferor made the transfer pursuant to an exempt purpose for which the transferor was created or organized. For purposes of the preceding sentence, a ruling or determination letter recognizing exemption may not be relied upon if there is a material change, inconsistent with exemption, in the character, the purpose, or the method of operation of the organization.

(c) *Certain transfers from trusts to which a partnership or foreign corporation has made a gratuitous transfer*—(1) *Generally treated as distribution from partnership or foreign corporation.* Except as provided in paragraphs (c)(2) and (3) of this section, if a United States donee receives a gratuitous transfer (within the meaning of §1.671–2T(e)(2)) from a trust (or portion of a trust) to which a partnership or foreign corporation has made a gratuitous transfer, the United States donee must treat the transfer as a purported gift or bequest from the partnership or foreign corporation that is subject to the rules of paragraph (a) of this section (including the exceptions in paragraphs (b) and (f) of this section). This paragraph (c) applies without regard to who is treated as the grantor of the trust (or portion thereof) under §1.671–2T(e)(4).

(2) *Alternative rule.* Except as provided in paragraph (c)(3) of this section, if the United States tax computed under the rules of paragraphs (a) and (c)(1) of this section does not exceed the United States tax that would be due if the United States donee treated the transfer as a distribution from the trust (or portion thereof), paragraph (c)(1) of this section does not apply and the United States donee must treat the transfer as a distribution from the trust (or portion thereof) that is subject to the rules of subparts A through D (section 641 and following), part I, subchapter J, chapter 1 of the Internal Revenue Code. For purposes of paragraph (f) of this section, the transfer is treated as a purported gift or bequest from the partnership or foreign corporation that made the gratuitous transfer to the trust (or portion thereof).

(3) *Exception.* Neither paragraph (c)(1) of this section nor paragraph (c)(2) of this section applies to the extent the United States donee can demonstrate to the satisfaction of the Commissioner that the transfer represents an amount that is, or has been, taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation. A transfer will be deemed to be made first out of amounts that have not been taken into account for United States tax purposes by a United States citizen or resident or a domestic corporation, unless the United States donee can demonstrate to the satisfaction of the Commissioner that another ordering rule is more appropriate.

(d) *Definition of purported gift or bequest*—(1) *In general.* Subject to the provisions of paragraphs (d)(2) and (3) of this section, *a purported gift or bequest* for purposes of this section is any transfer of property by a partnership or foreign corporation other than a transfer for fair market value (within the meaning of §1.671–2T(e)(2)(ii)) to a person who is not a partner in the partnership or a shareholder of the foreign corporation (or to a person who is a partner in the partnership or a shareholder of a foreign corporation, if the amount transferred is inconsistent with the partner's interest in the partnership or the shareholder's interest in the

corporation, as the case may be). For purposes of this section, the term *property* includes cash.

(2) *Transfers for less than fair market value*—(i) *Excess treated as purported gift or bequest.* Except as provided in paragraph (d)(2)(ii) of this section, if a transfer described in paragraph (d)(1) of this section is for less than fair market value, the excess of the fair market value of the property transferred over the value of the property received, services rendered, or the right to use property is treated as a purported gift or bequest.

(ii) *Exception for transfers to unrelated parties.* No portion of a transfer described in paragraph (d)(1) of this section will be treated as a purported gift or bequest for purposes of this section if the United States donee can demonstrate to the satisfaction of the Commissioner that the United States donee is not related to a partner or shareholder of the transferor within the meaning of §1.643(h)–1(e) or does not have another relationship with a partner or shareholder of the transferor that establishes a reasonable basis for concluding that the transferor would make a gratuitous transfer to the United States donee.

(e) *Prohibition against affirmative use of recharacterization by taxpayers.* A taxpayer may not use the rules of this section if a principal purpose for using such rules is the avoidance of any tax imposed by the Internal Revenue Code. Thus, with respect to such taxpayer, the Commissioner may depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance.

(f) *Transfers not in excess of $10,000.* This section does not apply if, during the taxable year of the United States donee, the aggregate amount of purported gifts or bequests that is transferred to such United States donee directly or indirectly from all partnerships or foreign corporations that are related (within the meaning of section 643(i)) does not exceed $10,000. The aggregate amount must include gifts or bequests from persons that the United States donee knows or has reason to know are related to the partnership or foreign corporation (within the meaning of section 643(i)).

(g) *Examples.* The following examples illustrate the rules of this section. In each example, the amount that is transferred exceeds $10,000. The examples are as follows:

Example 1. Distribution from foreign corporation. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer of property directly to A's daughter, B, who is a resident alien. Under paragraph (a)(2) of this section, B generally must treat the transfer as a dividend from FC to the extent of FC's earnings and profits and as an amount received in excess of basis thereafter. If FC is a passive foreign investment company, B must treat the amount received as a distribution under section 1291. B will be treated as having the same holding period as A. However, under paragraph (b)(1)(ii) of this section, if B can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B, B may treat the transfer as a gift (provided B timely complied with the reporting requirements of section 6039F, if applicable).

Example 2. Distribution of corpus from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien who is resident in Country C. FC makes a gratuitous transfer to a foreign trust, FT, that has no other assets. FT immediately makes a gratuitous transfer in the same amount to A's daughter, B, who is a resident alien. Under paragraph (c)(1) of this section, B must treat the transfer as a transfer from FC that is subject to the rules of paragraph (a)(2) of this section. Under paragraph (a)(2) of this section, B must treat the transfer as a dividend from FC unless she can establish to the satisfaction of the Commissioner that, for purposes of the tax laws of Country C, A treated (and reported, if applicable) the transfer as a distribution to himself and a subsequent gift to B and that B timely complied with the reporting requirements of section 6039F, if applicable. The alternative rule in paragraph (c)(2) of this section would not apply as long as the United States tax computed under the rules of paragraph (a)(2) of this section is equal to or greater than the United States tax that would be due if the transfer were treated as a distribution from FT.

Example 3. Accumulation distribution from trust to which foreign corporation made gratuitous transfer. FC is a foreign corporation that is wholly owned by A, a nonresident alien. FC is not a passive foreign investment company (as defined in section 1297). FC makes a gratuitous transfer of 100X to a foreign trust, FT, on January 1, 2001. FT has no other assets on January 1, 2001. Several years later, FT makes a gratuitous transfer of 1000X to A's daughter, B, who is a United States resident. Assume that the section 668 interest charge on accumulation distributions will apply if the transfer is treated as a distribution from FT. Under the alternative rule of paragraph (c)(2) of this section, B must treat the transfer as an accumulation distribution from FT, because the resulting United States tax liability is greater than the United States tax that would be due if the transfer were treated as a transfer from FC that is subject to the rules of paragraph (a) of this section.

Example 4. Transfer from trust that is treated as owned by United States citizen. Assume the same facts as in Example 3, except that A is a United States citizen. Assume that A treats and reports the transfer to FT as a constructive distribution to himself, followed by a gratuitous transfer to FT, and that A is properly treated as the grantor of FT within the meaning of §1.671–2T(e). A is treated as the owner of FT under section 679 and, as required by section 671 and the regulations thereunder, A includes all of FT's items of income, deductions, and credit in computing his taxable income and credits. Neither paragraph (c)(1) nor paragraph (c)(2) of this section is applicable, because the exception in paragraph (c)(3) of this section applies.

Example 5. Transfer for less than fair market value. FC is a foreign corporation that is wholly owned by A, a nonresident alien. On January 15, 2001, FC transfers property directly to A's daughter, B, a resident alien, in exchange for 90X. The Commissioner later determines that the fair market value of the property at the time of the transfer was 100X. Under paragraph (d)(2)(i) of this section, 10X will be treated as a purported gift to B on January 15, 2001.

(h) *Effective date.* The rules of this section are generally applicable to any transfer after August 10, 1999, by a partnership or foreign corporation, or by a trust to which a partnership or foreign corporation makes a gratuitous transfer after August 10, 1999.

§1.672(f)–5 Special rules.

(a) *Transfers by certain beneficiaries to foreign grantor*—(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 United States beneficiary of the trust is treated as the grantor of a portion of the trust to the extent the United States beneficiary directly or indirectly made transfers of property to such foreign person (without regard to whether the United States beneficiary was a United States beneficiary at the time of any transfer) in excess of transfers to the United States beneficiary from the foreign person. The rule of this paragraph (a) does not apply to the extent the United States beneficiary can demonstrate to the satisfaction of the Commissioner that the transfer by the United States beneficiary to the foreign person was wholly unrelated to any transaction involving the trust. For purposes of this paragraph (a), the term property includes cash, and a

transfer of property does not include a transfer that is not a gratuitous transfer (within the meaning of §1.671-2T(e)(2)). In addition, a gift is not taken into account to the extent such gift would not be characterized as a taxable gift under section 2503(b). For a definition of United States 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 A's 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 A's family move to the United States. Under paragraph (a)(1) of this section, A is treated as a grantor of FT. (A may also be treated as an owner of FT under section 679(a)(4).)

Example 2. B, a United States citizen, makes a gratuitous transfer of $1 million to B's uncle, C, a nonresident alien. C creates a foreign trust, FT, for the benefit of B and B's 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 a grantor of FT. (B also would be treated as an owner of FT as a result of section 679.)

(b) *Entity characterization.* Entities generally are characterized under United States tax principles for purposes of §§1.672(f)–1 through 1.672(f)–5. See §§301.7701–1 through 301.7701–4 of this chapter. However, solely for purposes of §1.672(f)–4, a transferor that is a wholly owned business entity is treated as a corporation, separate from its single owner.

(c) *Effective date.* The rules in paragraph (a) of this section are applicable to transfers to trusts on or after August 10, 1999. The rules in paragraph (b) of this section areapplicable August 10, 1999.

John M. Dalrymple,
Acting Deputy Commissioner of Internal Revenue.

Approved July 23, 1999.

Donald C. Lubick,
Assistant Secretary of the Treasury.

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