Notice of Proposed Rulemaking and Notice of Public Hearing

Foreign Trusts That Have U.S. Beneficiaries

REG–209038–89

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations under section 679 of the Internal Revenue Code relating to transfers of property by U.S. persons to foreign trusts having one or more United States beneficiaries. The proposed regulations affect United States persons who transfer property to foreign trusts. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 6, 2000. Requests to speak (with outlines of oral comments) to be discussed at the public hearing scheduled for November 8, 2000,

at 10 a.m. must be submitted by October 18, 2000.

ADDRESSES: Send submissions to: CC:MSP:RU (REG–209038–89), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:MSP:RU (REG–209038–89), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Willard W. Yates at (202) 622-3880; concerning submissions and the hearing, Sonya M. Cruse, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 679 was added to the Internal Revenue Code (Code) by the Tax Reform Act of 1976 (1976 Act), Public Law 94-445, Sec. 1013(a), (90 Stat. 1614). Section 679 was amended significantly by the Small Business Job Protection Act of 1996 (1996 Act), Public Law 104-188, Secs. 1903(a)(1), 1903(a)(2), 1903(b), 1903(c) and 1903(f) (110 Stat. 1755).

1. Law Prior to 1976

Sections 671 through 678 (the grantor trust rules) treat grantors and other persons who hold certain powers or interests over a domestic or foreign trust as owners of the portion of the trust with respect to which they hold the powers or interests. If the grantor or other person is a U.S. citizen or resident, the grantor trust rules result in the taxation of the worldwide income of the trust (or portion thereof) to the grantor or other person.

Prior to the enactment of section 679, if a trust was not subject to the grantor trust rules (nongrantor trust), the income of the domestic or foreign trust generally was taxed to the trust to the extent the income was not currently distributed or required to be distributed to the beneficiaries of the trust. The income of a foreign nongrantor trust was taxed in basically the same manner as the income of a nonresident alien individual. Foreign trusts were subject to U.S. tax only on their U.S.-source income (other than capital gains) and on any income effectively connected with a U.S. trade or business (or treated as effectively connected with a U.S. trade or business). Like nonresident alien individuals, foreign nongrantor trusts were generally not subject to U.S. tax on foreign-source income.

Prior to the enactment of section 679, U.S. persons often established foreign nongrantor trusts that invested in assets that generated foreign-source income only. These foreign trusts avoided all U.S. tax on their income. In addition, these trusts generally invested in countries that did not tax interest or dividends paid to foreign investors, and the trusts generally were formed and administered in countries that did not tax trusts. Accordingly, in many cases these trusts paid no income tax anywhere in the world. Although U.S. beneficiaries were subject to U.S. tax when a foreign nongrantor trust distributed income to them, the use of foreign nongrantor trusts permitted tax-free accumulations of income, giving foreign trusts a significant advantage over domestic trusts.

2. Overview of 1976 Changes

Congress believed that allowing tax-free accumulation of income was inappropriate and provided an unwarranted advantage to foreign trusts over domestic trusts. Congress enacted section 679 as part of the 1976 Act to provide generally that where a U.S. person directly or indirectly transfers property to a foreign trust, the income of the foreign trust is taxable to the transferor if the trust has a U.S. beneficiary. Accordingly, the trust is treated as a grantor trust whether or not the transferor retains any power or interest with respect to the trust. Congress enacted exceptions for certain transfers for fair market value, for transfers by reason of death, and for transfers to certain employee benefit trusts.

3. Overview of 1996 Changes

Section 1903 of the 1996 Act made several changes to section 679. These changes focused primarily on areas where taxpayers could improperly avoid the application of section 679. For example, Congress was concerned that certain taxpayers attempted to come within the fair market value exception of section 679(a)(2), thereby avoiding the application of section 679(a)(1), by issuing trust obligations that might not be repaid. H.R. Rep. No. 542, 104th Cong., 2d Sess., pt. 2 at 25 (1996). Accordingly, the 1996 Act added new section 679(a)(3), which generally provides that obligations issued by the trust, by any grantor or beneficiary of the trust, or by any person related to any grantor or beneficiary are not taken into account in applying the fair market value exception except as provided in regulations.

The 1996 Act also added new sections 679(a)(4) and (5) to prevent taxpayers from improperly avoiding the application of section 679. Section 679(a)(4) ensures that certain foreign persons who transfer property to a foreign trust in anticipation of becoming U.S. persons (pre-immigration trusts) cannot avoid the rules of section 679 by transferring property, directly or indirectly, to a foreign trust and then becoming a resident of the United States within 5 years after the transfer. Section 679(a)(5) prevents U.S. individuals from circumventing section 679 by transferring property to a domestic trust and then causing the domestic trust to become a foreign trust.

In addition to the anti-avoidance measures, Congress added a new exception to the general rule of section 679(a)(1) for transfers of property to certain charitable trusts. Congress also enacted new section 679(c)(3), which provides that beneficiaries who first become U.S. persons more than 5 years after the date of a transfer are disregarded for purposes of applying section 679 with respect to that transfer.

The 1996 Act also amended section 6048 to expand the reporting requirements that apply to (i) a U.S. person who transfers property to a foreign trust, and (ii) a foreign trust that is treated as owned by a U.S. person under the grantor trust rules. The penalties under section 6677 for a failure to comply with these reporting requirements were also significantly increased. See Notice 97–34 (1997–1 C.B. 422) and Forms 3520 and 3520A.

In addition, a transfer of appreciated property by a U.S. person to a foreign

trust may trigger the immediate recognition of any gain in the property under section 684. A transfer to a foreign trust that is treated as owned by a U.S. person under section 679 generally is exempt from this requirement at the time of the transfer. However, if the trust subsequently ceases to be treated as owned by the U.S. person, the change in the status of the trust may trigger gain at the time of the change.

Section 679 applies only for income tax purposes. The estate and gift tax provisions of the Code determine whether a transfer to a foreign trust is subject to the federal gift tax, or whether the corpus of a foreign trust is included in the gross estate of the U.S. transferor.

Explanation of Provisions

§1.679–1: U.S. Transferor Treated as Owner of Foreign Trust.

Section 1.679–1(a) of the proposed regulations provides that a U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred during each taxable year that the trust is treated as having a U.S. beneficiary. This rule applies without regard to whether the U.S. transferor retains any power described in sections 673 through 677. If the U.S. transferor is treated as the owner of a portion of a trust, under section 671 all income, deductions, and credits attributable to that portion must be taken into account by the U.S. transferor in determining the U.S. transferor's tax liability.

The determination of whether a foreign trust is treated as having a U.S. beneficiary is made under the rules set forth in §1.679–2. Section 1.679–3 defines the term *transfer*. Section 1.679–4 provides exceptions to the general rule of §1.679–1. Section 1.679–5 provides special rules for pre-immigration trusts, and §1.679–6 describes the treatment of a domestic trust that becomes a foreign trust. Section 1.679–7 provides effective dates.

Congress intended section 679 to override section 678. H.R. Rep. No. 658, 94th Cong., 1st Sess., at 209 (1975). Accordingly, §1.679–1(b) provides that a U.S. transferor will be treated as the owner of the portion of a trust attributable to the property transferred to the trust by the U.S. transferor whether or not another person would be treated as the owner of the same portion of the trust under section 678.

Section 1.679–1(c)(1) defines the term *U.S. transferor* to mean any U.S. person who directly, indirectly, or constructively transfers property to a foreign trust.

Section 1.679–1(c)(2) defines the term *U.S. person* by reference to section 7701(a)(30). Accordingly, section 679 can apply not only to individuals, but also to entities. Section 1.679–1(c)(2) also provides that a U.S. person includes an individual who elects under section 6013(g) to be treated as a U.S. resident and an individual who is a dual resident taxpayer within the meaning of §301.7701(b)–7(a).

Sections 1.679–1(c)(3), (4), (5), and (6) define the terms *foreign trust*, *property*, *related person*, and *obligation*, respectively.

The proposed regulations do not provide specific guidance on the treatment of joint owners that transfer property to a foreign trust. Treasury and the IRS invite comments with specific examples of areas that may need 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 non-citizen spouses.

The rules of this section apply with respect to transfers to foreign trusts after August 7, 2000.

§1.679–2: Trusts Treated as Having a U.S. Beneficiary

The proposed regulations employ a broad approach in determining whether a foreign trust is treated as having a U.S. beneficiary. This broad approach is consistent with the legislative history of the 1976 Act. H.R. Rep. No. 658, 94th Cong., 1st Sess., at 210 (1975).

Under §1.679–2(a)(1), a foreign trust that has received property from a U.S. transferor is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor: (i) no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, either directly or indirectly, a U.S. person; and (ii) if the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, either directly or indirectly, a U.S. person. For purposes of section 679, foreign trusts generally are treated as having a U.S. beneficiary unless both of these requirements are satisfied.

Section 1.679–2(a)(2)(i) provides that, for purposes of applying these tests, income or corpus is considered to be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event.

The proposed regulations recognize that it may be possible for a U.S. person to obtain a future benefit from the trust under certain unexpected circumstances and that the possibility of such circumstances should not necessarily cause the foreign trust to be treated as having a U.S. beneficiary. Accordingly, §1.679–2(a)(2)(ii) provides a narrow exception to the general determination of whether a U.S. person can obtain a benefit under the foreign trust. Persons who are not named as possible beneficiaries and are not members of a class of beneficiaries as defined in the trust instrument (or other relevant agreements, understandings, records and documents, as described below) are not taken into consideration for purposes of applying the general rule of §1.679–2(a)(1) if the U.S. transferor demonstrates to the satisfaction of the Commissioner that their contingent interest in the trust is so remote as to be negligible. This exception does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or another person. For example, if the trust instrument provides that the trustee can distribute corpus to any of a large class of persons that could include U.S. persons, this exception would not apply.

The proposed regulations require an annual determination of whether a foreign trust is treated as having a U.S. beneficiary. Under §1.679–2(a)(3), the possibility that a beneficiary who is not a U.S. person could become a U.S. person will

not cause that beneficiary to be treated as a U.S. person for purposes of determining whether there is a U.S. beneficiary until the year in which the beneficiary actually becomes a U.S. person. However, if that non-U.S. beneficiary becomes a U.S. person for the first time more than 5 years after the date of the transfer, that beneficiary is not treated as a U.S. person for purposes of the U.S.-beneficiary determination even after the beneficiary actually becomes a U.S. person.

Section 1.679–2(a)(4) makes it clear that a trust may be treated as having a U.S. beneficiary not only by reference to the trust instrument, but also by reference to all other written and oral agreements and understandings relating to the trust. Also, a trust may be treated as having a U.S. beneficiary based on possible amendments to the trust instrument, possible application of local law that would require a U.S. beneficiary (unless the law is not reasonably expected to be applied under the facts and circumstances), or actual or reasonably expected disregard of the terms of the trust instrument by the parties to the trust.

A foreign trust is treated as having a U.S. beneficiary if it can benefit a U.S. person indirectly. Section 1.679–2(b) provides that an amount is treated as paid or accumulated to or for the benefit of a U.S. person if it can be paid to or accumulated for the benefit of a controlled foreign corporation (as defined in section 957(a)); a foreign partnership, if a U.S. person is a partner of such partnership; or a foreign trust or estate, if such trust or estate has a U.S. beneficiary. In addition, a foreign trust is treated as having a U.S. beneficiary if a U.S. person can benefit indirectly from the foreign trust by receiving distributions from the trust through an intermediary, such as an agent or nominee, through the use of a debit or credit card, or any other means where a U.S. person may obtain an actual or constructive benefit from the trust.

The proposed regulations anticipate situations where a foreign trust's status as having a U.S. beneficiary changes. Section 1.679–2(c)(1) provides that if a foreign trust does not have a U.S. beneficiary initially, but subsequently acquires a U.S. beneficiary, the U.S. transferor is treated as having additional income in the first taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary. The amount of the additional income is equal to the trust's undistributed net income, as defined in section 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of section 668, providing for an interest charge on accumulation distributions from foreign trusts.

Section 1.679–2(c)(2) provides that if a trust to which a U.S. transferor transferred property is initially treated as having a U.S. beneficiary, but subsequently ceases to be treated as having a U.S. beneficiary, the U.S. transferor is no longer treated as the owner beginning in the following taxable year (unless the U.S. transferor is otherwise treated as the owner under the grantor trust rules). The U.S. transferor is treated as making a transfer to the foreign trust that may be subject to the gain recognition rules of section 684.

The rules of this section apply with respect to transfers to foreign trusts after August 7, 2000.

§1.679–3 Transfers

Section 1.679–3(a) of the proposed regulations broadly defines the term transfer as any direct, indirect, or constructive transfer by a U.S. person to a foreign trust. The rules are generally consistent with the rules for determining whether a person is considered to be a grantor of a trust under §1.671–2(e).

Section 1.679–3(b) provides that a transfer of property to a foreign trust from either a domestic or foreign trust that is owned by a U.S. person under sections 673 through 679 is treated as a transfer from the owner of the transferor trust. For example, if a U.S. person is treated as the owner of a domestic trust under section 676, and that domestic trust transfers property to a foreign trust, the U.S. person is treated as having transferred the property to the foreign trust.

Section 1.679–3(c) provides rules for determining when there is an indirect transfer. Under §1.679–3(c)(1), a transfer to a foreign trust by any person to whom a U.S. person transfers property (referred to as an intermediary) is treated as an indirect transfer by a U.S. person if the transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of U.S. tax. Section 1.679–3(c)(2) deems a transfer to have been made pursuant to such a plan if the U.S. transferor is related to a U.S. beneficiary of the foreign trust, or has another relationship with the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust, and the U.S. person cannot demonstrate to the satisfaction of the Commissioner that:(i) the intermediary has a relationship with a U.S. beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust, (ii) the intermediary acted independently of the U.S. transferor, (iii) the intermediary is not an agent of the U.S. transferor under generally applicable United States agency principles, and (iv) that the intermediary timely complied with the reporting requirements of section 6048 (including Notice 97–34), if applicable. This test is consistent with the legislative history of the 1976 Act. H.R. Rep. No. 658, 94th Cong., 1st Sess., at 209 (1975). This test is also similar to the test in §1.643(h)–1(a), although the presumption in the proposed regulations applies without regard to the period of time between the transfer from the U.S. person to the intermediary and from the intermediary to the foreign trust.

Section 1.679–3(c)(3) explains that if a transfer is treated as an indirect transfer, the intermediary generally is treated as an agent of the U.S. transferor, and the property is treated as transferred to the foreign trust by the U.S. transferor in the year the property is transferred, or made available, by the intermediary to the foreign trust. The fair market value of the property transferred generally is determined as of the date of the transfer by the intermediary to the foreign trust. Although the intermediary is not treated as having transferred that property to the foreign trust for purposes of section 679, the intermediary must comply with the reporting requirements of section 6048, if applicable.

Section 1.679–3(d) provides that a constructive transfer includes any assumption or satisfaction of a foreign trust's obligation. For example, a U.S. transferor's payment of a foreign trust's obligation to a third party is treated as a constructive transfer.

Congress anticipated that guarantees of a trust obligation would be treated as transfers. H.R. Rep. No. 658, 94th Cong., 1st

Sess., at 209 (1975). Section 1.679–3(e) provides rules regarding the treatment of guarantees as transfers. If a foreign trust borrows money or other property from either a U.S. or non-U.S. person who is not a related person with respect to the trust (referred to as the lender), and a U.S. person who is a related person with respect to the trust (referred to as the U.S. guarantor) guarantees the foreign trust's obligation, the U.S. guarantor is treated as having made a transfer to the foreign trust. The amount deemed transferred is the guaranteed portion of the adjusted issue price of the obligation plus any accrued but unpaid stated interest. Payments of principal by the trust with respect to the obligation are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property deemed transferred.

Section 1.679–3(f) provides specific rules regarding transfers by a U.S. person to an entity owned by a foreign trust if the U.S. person is related to the foreign trust. The transfer is treated as a transfer from the U.S. person to the foreign trust, followed by a transfer from the foreign trust to the entity owned by the foreign trust, unless the U.S. person demonstrates to the satisfaction of the Commissioner that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity.

Sections 1.679–3 applies to transfers after August 7, 2000.

§1.679–4 Exceptions to General Rule

Pursuant to sections 679(a)(1) and (a)(2), §1.679–4(a) provides the following four exceptions to the general rule of §1.679–1: (i) transfers to a foreign trust by reason of the death of the transferor; (ii) transfers to a foreign trust described in sections 402(b), 404(a)(4), or 404A; (iii) transfers to a foreign trust that has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing the trust's tax exempt status under section 501(c)(3); and (iv) transfers to the extent they are for fair market value.

Section 1.679–4(b) provides rules for determining whether a transfer to a foreign trust is for fair market value. The rules generally follow the rules for determining fair market value under §1.671–2(e). For purposes of this determination, an interest in the trust is not considered to be property received from the trust. A distribution to a foreign trust with respect to an interest held by such trust in an entity other than a trust or in a trust described in §301.7701–4(c), (d), or (e) is considered to be a transfer for fair market value. For example, a dividend paid by a U.S. corporation to a foreign trust with respect to the foreign trust's stock ownership in the corporation is not a transfer that is subject to the general rule of section §1.679–1.

Section 679(a)(3) provides that in determining whether a transfer is for fair market value, obligations received from the trust or certain related persons are not taken into account, except to the extent provided in regulations. As noted above, this provision reflects Congress' concern that certain taxpayers may have attempted to take advantage of the fair market value exception to section 679 by transferring property to a foreign trust in exchange for obligations issued by the trust (or related persons) that might not be repaid. Congress intended Treasury and the IRS to exercise their regulatory authority to consider whether there is a reasonable expectation that an obligation of the trust would be repaid. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 335 (1996).

The proposed regulations, in exercising this authority, follow the approach in Notice 97–34 (1997–1 C.B. 422). The proposed regulations describe the circumstances under which an obligation of a foreign trust (or a person related to that trust) will be treated as a qualified obligation that is taken into account for purposes of determining whether a U.S. transferor received fair market value from a trust in exchange for a transfer by the U.S. transferor. If the U.S. transferor, in exchange for the property transferred, receives an obligation of the trust (or a related person) that is not a qualified obligation, the obligation is considered to have no value for purposes of determining whether the transferor received fair market value.

The term obligation is defined in §1.679–1(c)(6). Section 1.679–4(d) provides that to be treated as a qualified obligation, an obligation must be reduced to writing by an express written agreement. The obligation must have a term not in excess of five years. For purposes of determining an obligation's term, the obligation's maturity date is the last possible date it can be outstanding under the terms of the obligation. Accordingly, demand loans and private annuity transactions do not constitute qualified obligations. In addition, all payments on a qualified obligation must be denominated in U.S. dollars. The yield to maturity cannot be less than 100 percent of the applicable Federal rate and cannot be greater than 130 percent of the applicable Federal rate. The U.S. transferor must extend the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation. The extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year and is paid within such period. Finally, the U.S. transferor must report the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

Section 1.679–4(d) also incorporates other rules regarding qualified obligations from Notice 97–34. For example, under certain circumstances, the issuance of additional obligations by the foreign trust or a person related to the foreign trust may cause an obligation that had been a qualified obligation to lose such status. Renegotiation of the terms of the loan is treated as a new loan. If an obligation loses its status as a qualified obligation, the U.S. transferor is treated as making a transfer to the trust that may be subject to §1.679–1. Principal repayments with respect to obligations that are not qualified obligations are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property originally transferred.

The rules of this section generally apply with respect to transfers to foreign trusts after August 7, 2000. Special effective dates, based on the guidance set forth in Notice 97–34, are provided for the rules that apply to obligations.

§1.679–5 Pre–immigration Trusts

The 1996 Act added section 679(a)(4) to address the potential abuse of nonresi-

dent aliens establishing foreign trusts shortly before becoming U.S. persons. Section 1.679–5 provides that if a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after directly or indirectly transferring property to a foreign trust, the individual is deemed to transfer the property to the trust on the residency starting date. The amount deemed transferred is the portion of the trust attributable to the property transferred by the individual in the original transfer. Section 1.679–5(b) provides that if the nonresident alien individual is treated under the grantor trust rules as the owner of any portion of the trust and the individual ceases to be so treated, the 5-year period begins on the date the individual ceases to be so treated.

The property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in section 665(a), attributable to the property transferred. Undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the portion of the trust that is attributable to property transferred.

If an individual is treated as making a deemed transfer pursuant to this provision, the reporting requirements of section 6048 apply to the deemed transfer as of the residency starting date.

The rules of this section apply to persons whose residency starting date is after August 7, 2000.

§1.679–6 Outbound Migrations of Domestic Trusts

The proposed regulations implement section 679(a)(5), which addresses the situation where a trust that is a domestic trust becomes a foreign trust. If an individual who is a U.S. person transfers property to a trust that is not a foreign trust, and the trust becomes a foreign trust while the U.S. person is alive, the U.S. individual is treated as a U.S. transferor and is deemed to transfer the property to a foreign trust on the date the domestic trust becomes a foreign trust. The property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property previously transferred. Undistributed net income for periods prior to the trust migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the U.S. person.

If a U.S. person is treated as making a deemed transfer pursuant to this provision, the reporting requirements of section 6048 apply to the deemed transfer as of the date of the deemed transfer.

The rules of this section apply to trusts that become foreign trusts after August 7, 2000.

§1.679–7 Effective Dates.

This section of the proposed regulations provides effective dates with respect to §§1.679–1 through 1.679–6. These effective dates are discussed above in the context of each respective section. Notwithstanding the effective dates in the proposed regulations, the Internal Revenue Service may apply the effective dates that are applicable to section 679 of the Internal Revenue Code. In addition, the Internal Revenue Service is not restricted from applying general income tax principles to transactions prior to the effective dates of the proposed regulations to determine, for example, that a U.S. person has made a transfer to a foreign trust.

Certain Clarifications Regarding Section 958

The proposed regulations clarify that, under §1.958–1(b), a person who is treated as the owner of any portion of a trust under section 679 and the other grantor trust rules is treated as the owner of the stock owned by the trust with respect to that portion. This change is merely intended as a clarification of existing law.

Existing §1.958–2(c)(1)(ii)(b) provides that a person who is treated as the owner of any portion of a trust under sections 671 through 678 is treated as the owner of the stock owned by or for that portion of the trust for purposes of the constructive ownership rules of section 958(b). Because section 679 was not enacted until 1976, it is not referred to in the existing regulations, which were issued in 1966. The proposed regulations clarify that this treatment also applies to persons treated as the owner of any portion of a trust under section 679. This change is merely intended as a clarification of existing law.

Special Analyses

It has been determined that this notice of proposed rulemaking 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 Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 8, 2000, at 10 a.m. in room 3313, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC. Because of access restrictions, visitors will not be admitted beyond the Internal Revenue Building lobby more than 15 minutes before the hearing starts.

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

Persons that wish to present oral comments at the hearing must submit written comments by November 6, 2000, and submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by October 18, 2000.

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

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

Drafting Information

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

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Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.679–1 also issued under 26 U.S.C. 643(a)(7) and 679(d).

Section 1.679–2 also issued under 26 U.S.C. 643(a)(7) and 679(d).

Section 1.679–3 also issued under 26 U.S.C. 643(a)(7) and 679(d).

Section 1.679–4 also issued under 26 U.S.C. 643(a)(7), 679(a)(3) and 679(d).

Section 1.679–5 also issued under 26 U.S.C. 643(a)(7) and 679(d).

Section 1.679–6 also issued under 26 U.S.C. 643(a)(7) and 679(d). * * *

Par. 2. Sections 1.679–1, 1.679–2, 1.679–3, 1.679–4, 1.679–5, 1.679–6, and 1.679–7 are added under the undesignated center heading "Grantors and others treated as substantial owners" to read as follows:

§1.679–1 U.S. transferor treated as owner of foreign trust.

(a) *In general*. A U.S. transferor who transfers property to a foreign trust is treated as the owner of the portion of the trust attributable to the property transferred if there is a U.S. beneficiary of any portion of the trust, unless an exception in §1.679–4 applies to the transfer.

(b) *Interaction with sections 673 through 678*. The rules of this section apply without regard to whether the U.S. transferor retains any power or interest described in sections 673 through 677. If a U.S. transferor would be treated as the owner of a portion of a foreign trust pursuant to the rules of this section and another person would be treated as the owner of the same portion of the trust pursuant to section 678, then the U.S. transferor is treated as the owner and the other person is not treated as the owner.

(c) *Definitions*. The following definitions apply for purposes of this section and §§1.679–2 through 1.679–7:

(1) *U.S. transferor*. The term *U.S. transferor* means any U.S. person who makes a transfer (as defined in §1.679–3) of property to a foreign trust.

(2) *U.S. person*. The term *U.S. person* means a United States person as defined in section 7701(a)(30), a nonresident alien individual who elects under section 6013(g) to be treated as resident of the United States, and an individual who is a dual resident taxpayer within the meaning of §301.7701(b)–7(a) of this chapter.

(3) *Foreign trust*. Section 7701(a)(31)(B) defines the term *foreign trust*.

(4) *Property*. The term *property* means any *property* including cash.

(5) *Related person*. A person is a *related person* if, without regard to the transfer at issue, the person is—

(i) A grantor of any portion of the trust (within the meaning of §1.671–2(e)(1));

(ii) An owner of any portion of the trust under sections 671 through 679;

(iii) A beneficiary of the trust; or

(iv) A person who is related (within the meaning of section 643(i)(2)(B)) to any grantor, owner or beneficiary of the trust.

(6) *Obligation*. The term *obligation* means any bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other evidence of indebtedness, and, to the extent not previously described, any annuity contract.

(d) *Examples*. The following examples illustrate the rules of paragraph (a) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s father, who is a resident alien, *D* is *A*'s uncle, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Interaction with section 678. A creates and funds *FT*. *FT* may provide for the education of *B* by paying for books, tuition, room and board. In addition, *C* has the power to vest the trust corpus or income in himself within the meaning of section 678(a)(1). Under paragraph (b) of this section, *A* is treated as the owner of the portion of *FT* attributable to the property transferred to *FT* by *A* and *C* is not treated as the owner thereof.

Example 2. U.S. person treated as owner of a portion of FT. D creates and funds *FT* for the benefit of *B*. *D* retains a power described in section 676 and §1.672(f)–3(a)(1). *A* transfers property to *FT*. Under sections 676 and 672(f), *D* is treated as the owner of the portion of *FT* attributable to the property transferred by *D*. Under paragraph (a) of this section, *A* is treated as the owner of the portion of *FT* attributable to the property transferred by *A*.

§1.679–2 Trusts treated as having a U.S. beneficiary.

(a) *Existence of U.S. beneficiary*—(1) *In general*. The determination of whether a foreign trust has a U.S. beneficiary is made on an annual basis. A foreign trust is treated as having a U.S. beneficiary unless during the taxable year of the U.S. transferor—

(i) No part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, directly or indirectly, a U.S. person; and

(ii) If the trust is terminated at any time during the taxable year, no part of the income or corpus of the trust could be paid to or for the benefit of, directly or indirectly, a U.S. person.

(2) *Benefit to a U.S. person*—(i) *In general*. For purposes of paragraph (a)(1) of this section, income or corpus may be paid or accumulated to or for the benefit of a U.S. person during a taxable year of the U.S. transferor if during that year, directly or indirectly, income may be distributed to, or accumulated for the benefit of, a U.S. person, or corpus may be distributed to, or held for the future benefit of, a U.S. person. This determination is made without regard to whether income or corpus is actually distributed to a U.S. person during that year, and without regard to whether a U.S. person's interest in the trust income or corpus is contingent on a future event.

(ii) *Certain unexpected beneficiaries*. Notwithstanding paragraph (a)(2)(i) of this section, for purposes of paragraph (a)(1) of this section, a person who is not named as a beneficiary and is not a member of a class of beneficiaries as defined under the trust instrument is not taken into consideration if the U.S. transferor demonstrates to the satisfaction of the Commissioner that the person's contingent interest in the trust is so remote as to be negligible. The preceding sentence does not apply with respect to persons to whom distributions could be made pursuant to a grant of discretion to the trustee or any other person. A class of beneficia-

ries generally does not include heirs who will benefit from the trust under the laws of intestate succession in the event that the named beneficiaries (or members of the named class) have all deceased (whether or not stated as a named class in the trust instrument).

(iii) *Examples*. The following examples illustrate the rules of paragraphs (a)(1) and (a)(2) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s daughter, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Distribution of income to U.S. person. *A* transfers property to *FT*. The trust instrument provides that all trust income is to be distributed currently to *B*. Under paragraph (a)(1) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. *Income accumulation for the benefit of a U.S. person.* In 2001, *A* transfers property to *FT*. The trust instrument provides that from 2001 through 2010, the trustee of *FT* may distribute trust income to *C* or may accumulate the trust income. The trust instrument further provides that in 2011, the trust will terminate and the trustee may distribute the trust assets to either or both of *B* and *C*, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust assets must be distributed to *C*. Because it is possible that income may be accumulated in each year, and that the accumulated income ultimately may be distributed to *B*, a U.S. person, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of *A*'s tax years from 2001 through 2011. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 3. Corpus held for the benefit of a U.S. person. The facts are the same as in *Example 2*, except that from 2001 through 2011, all trust income must be distributed to *C*. In 2011, the trust will terminate and the trustee may distribute the trust corpus to either or both of *B* and *C*, in the trustee's discretion. If the trust terminates unexpectedly prior to 2011, all trust corpus must be distributed to *C*. Because during each of *A*'s tax years from 2001 through 2011 trust corpus is held for possible future distribution to *B*, a U.S. person, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of those years. This result applies even though no U.S. person may receive distributions from the trust during the tax years 2001 through 2010.

Example 4. Distribution upon U.S. transferor's death. *A* transfers property to *FT*. The trust instrument provides that all trust income must be distributed currently to *C* and, upon *A*'s death, the trust will terminate and the trustee may distribute the trust corpus to either or both of *B* and *C*. Because *B* may receive a distribution of corpus upon the termination of *FT*, and *FT* could terminate in any year, *FT* is treated as having a U.S. beneficiary in the year of the transfer and in subsequent years.

Example 5. Distribution after U.S. transferor's death. The facts are the same as in *Example 4*, except the trust instrument provides that the trust will not terminate until the year following *A*'s death. Upon termination, the trustee may distribute the trust assets to either or both of *B* and *C*, in the trustee's discretion. All trust assets are invested in the stock of *X*, a foreign corporation, and *X* makes no distributions to *FT*. Although no U.S. person may receive a distribution until the year after *A*'s death, and *FT* has no realized income during any year of its existence, during each year in which *A* is living corpus may be held for future distribution to *B*, a U.S. person. Thus, under paragraph (a)(1) of this section *FT* is treated as having a U.S. beneficiary during each of *A*'s tax years from 2001 through the year of *A*'s death.

Example 6. Constructive benefit to U.S. person. *A* transfers property to *FT*. The trust instrument provides that no income or corpus may be paid directly to a U.S. person. However, the trust instrument provides that trust corpus may be used to satisfy *B*'s legal obligations to a third party by making a payment directly to the third party. Under paragraphs (a)(1) and (2) of this section, *FT* is treated as having a U.S. beneficiary.

Example 7. U.S. person with negligible contingent interest. *A* transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *C*, and upon *C*'s death, all corpus is to be distributed to whomever of *C*'s three children is then living. All of *C*'s children are nonresident aliens. Under the laws of intestate succession that would apply to *FT*, if all of *C*'s children are deceased at the time of *C*'s death, the corpus would be distributed to *A*'s heirs. *A*'s living relatives at the time of the transfer consist solely of two brothers and two nieces, all of whom are nonresident aliens, and two first cousins, one of whom, *E*, is a U.S. citizen. Although it is possible under certain circumstances that *E* could receive a corpus distribution under the applicable laws of intestate succession, for each year the trust is in existence *A* is able to demonstrate to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that *E*'s contingent interest in *FT* is so remote as to be negligible. Provided that paragraph (a)(4) of this section does not require a different result, *FT* is not treated as having a U.S. beneficiary.

Example 8. U.S. person with non-negligible contingent interest. *A* transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *D*, *A*'s uncle, who is a nonresident alien, and upon *A*'s death, the corpus is to be distributed to *D* if he is then living. Under the laws of intestate succession that would apply to *FT*, *B* and *C* would share equally in the trust corpus if *D* is not living at the time of *A*'s death. *A* is unable to demonstrate to the satisfaction of the Commissioner that *B*'s contingent interest in the trust is so remote as to be negligible. Under paragraph (a)(2)(ii) of this section, *FT* is treated as having a U.S. beneficiary as of the year of the transfer.

Example 9. U.S. person as member of class of beneficiaries. *A* transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *D*, *A*'s uncle, who is a nonresident alien, and upon *A*'s death, the corpus is to be distributed to *D* if he is then living. If *D* is not then living, the corpus is to be distributed to *D*'s descendants. *D*'s grandson, *E*, is a resident alien. Under paragraph (a)(2)(ii) of this section, *FT* is treated as having a U.S. beneficiary as of the year of the transfer.

Example 10. Trustee's discretion in choosing beneficiaries. *A* transfers property to *FT*. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of, any person who is pursuing the academic study of ancient Greek, in the trustee's discretion. Because it is possible that a U.S. person will receive distributions of income or corpus, or will have income accumulated for his benefit, *FT* is treated as having a U.S. beneficiary. This result applies even if, during a tax year, no distributions or accumulations are actually made to or for the benefit of a U.S. person. *A* may not invoke paragraph (a)(2)(ii) of this section because a U.S. person could benefit pursuant to a grant of discretion in the trust instrument.

Example 11. Appointment of remainder beneficiary. *A* transfers property to *FT*. The trust instrument provides that the trustee may distribute current income to *C*, or may accumulate income, and, upon termination of the trust, trust assets are to be distributed to *C*. However, the trust instrument further provides that *D*, *A*'s uncle, may appoint a different remainder beneficiary. Because it is possible that a U.S. person could be named as the remainder beneficiary, and because corpus could be held in each year for the future benefit of that U.S. person, *FT* is treated as having a U.S. beneficiary for each year.

Example 12. Trust not treated as having a U.S. beneficiary. *A* transfers property to *FT*. The trust instrument provides that the trustee may distribute income and corpus to, or accumulate income for the benefit of *C*. Upon termination of the trust, all income and corpus must be distributed to *C*. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that *A* establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Because no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of, either directly or indirectly, a U.S. person, and if the trust is terminated no part of the income or corpus of the trust could be paid to or for the benefit of, either directly or indirectly, a U.S. person, *FT* is not treated as having a U.S. beneficiary.

Example 13. U.S. beneficiary becomes non-U.S. person. In 2001, *A* transfers property to *FT*. The trust instrument provides that, as long as *B* remains a U.S. resident, no distributions of income or corpus may be made from the trust to *B*. The trust instrument further provides that if *B* becomes a nonresident alien, distributions of income (including previously accumulated income) and corpus may be made to him. If *B* remains a U.S. resident at the time of *FT*'s termination, all accumulated income and corpus is to be distributed to *C*. In 2007, *B* becomes a nonresident alien and remains so thereafter. Because income may be accumulated during the years 2001 through 2007 for the benefit of a person who is a U.S. person during those years, *FT* is treated as having a U.S. beneficiary under paragraph (a)(1) of this section during each of those years. This result applies even though *B* cannot receive distributions from *FT* during the years he is a resident alien and even though *B* might remain a resident alien who is not entitled to any distribution from *FT*. Provided that paragraph (a)(4) of this section does not require a different result and that *A* establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no other U.S. persons

are reasonably expected to benefit from the trust, *FT* is not treated as having a U.S. beneficiary under paragraph (a)(1) of this section during tax years after 2007.

(3) *Changes in beneficiary's status*—(i) *In general*. For purposes of paragraph (a)(1) of this section, the possibility that a person that is not a U.S. person could become a U.S. person will not cause that person to be treated as a U.S. person for purposes of paragraph (a)(1) of this section until the tax year of the U.S. transferor in which that individual actually becomes a U.S. person. However, if a person who is not a U.S. person becomes a U.S. person for the first time more than 5 years after the date of a transfer to the foreign trust by a U.S. transferor, that person is not treated as a U.S. person for purposes of applying paragraph (a)(1) of this section with respect to that transfer.

(ii) *Examples*. The following examples illustrate the rules of paragraph (a)(3) of this section. In these examples, *A* is a resident alien, *B* is *A*'s son, who is a resident alien, *C* is *A*'s daughter, who is a nonresident alien, and *FT* is a foreign trust. The examples are as follows:

Example 1. Non-U.S. beneficiary becomes U.S. person. In 2001, *A* transfers property to *FT*. The trust instrument provides that all income is to be distributed currently to *C* and that, upon the termination of *FT*, all corpus is to be distributed to *C*. Assume that paragraph (a)(4) of this section is not applicable under the facts and circumstances and that A establishes to the satisfaction of the Commissioner under paragraph (a)(2)(ii) of this section that no U.S. persons are reasonably expected to benefit from the trust. Under paragraph (a)(3)(i) of this section, *FT* is not treated as having a U.S. beneficiary during the tax years of *A* in which *C* remains a nonresident alien. If *C* first becomes a resident alien in 2004, *FT* is treated as having a U.S. beneficiary commencing in that year under paragraph (a)(3) of this section. See paragraph (c) of this section regarding the treatment of *A* upon *FT*'s acquisition of a U.S. beneficiary.

Example 2. Non-U.S. beneficiary becomes U.S. person more than 5 years after transfer. The facts are the same as in *Example 1*, except *C* first becomes a resident alien in 2007. *FT* is treated as not having a U.S. beneficiary under paragraph (a)(3)(i) of this section with respect to the property transfer. However, if *C* had previously been a U.S. person during any prior period, the 5-year exception in paragraph (a)(3)(i) of this section would not apply in 2007 because it would not have been the first time *C* became a U.S. person.

(4) *General rules*—(i) *Records and documents*. Even if, based on the terms of the trust instrument, a foreign trust is not treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the trust may nevertheless be treated as having a U.S. beneficiary pursuant to paragraph (a)(1) of this section based on the following—

(A) All written and oral agreements and understandings relating to the trust;

(B) Memoranda or letters of wishes;

(C) All records that relate to the actual distribution of income and corpus; and

(D) All other documents that relate to the trust, whether or not of any purported legal effect.

(ii) *Additional factors*. For purposes of determining whether a foreign trust is treated as having a U.S. beneficiary within the meaning of paragraph (a)(1) of this section, the following additional factors are taken into account–

(A) If the terms of the trust instrument allow the trust to be amended to benefit a U.S. person, all potential benefits that could be provided to a U.S. person pursuant to an amendment must be taken into account;

(B) If the terms of the trust instrument do not allow the trust to be amended to benefit a U.S. person, but the law applicable to a foreign trust may require payments or accumulations of income or corpus to or for the benefit of a U.S. person (by judicial reformation or otherwise), all potential benefits that could be provided to a U.S. person pursuant to the law must be taken into account, unless the U.S. transferor demonstrates to the satisfaction of the Commissioner that the law is not reasonably expected to be applied or invoked under the facts and circumstances; and

(C) If the parties to the trust ignore the terms of the trust instrument, or if it is reasonably expected that they will do so, all benefits that have been, or are reasonably expected to be, provided to a U.S. person must be taken into account.

(iii) *Examples*. The following examples illustrate the rules of paragraph (a)(4) of this section. In these examples, A is a resident alien, B is A's son, who is a resident alien, C is A's daughter, who is a nonresident alien, and FT is a foreign trust. The examples are as follows:

Example 1. Amendment pursuant to local law. *A* creates and funds *FT* for the benefit of *C*. The terms of *FT* (which, according to the trust instrument, cannot be amended) provide that no part of the income or corpus of *FT* may be paid or accumulated during the taxable year to or for the benefit of any U.S. person, either during the existence of *FT* or at the time of its termination. However, pursuant to the applicable foreign law, *FT* can be amended to provide for additional beneficiaries, and there is an oral understanding between *A* and the trustee that *B* can be added as a beneficiary. Under paragraphs (a)(1) and (a)(4)(ii)(B) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. Actions in violation of the terms of the trust. *A* transfers property to *FT*. The trust instrument provides that no U.S. person can receive income or corpus from *FT* during the term of the trust or at the termination of *FT*. Notwithstanding the terms of the trust instrument, a letter of wishes directs the trustee of *FT* to provide for the educational needs of *B*, who is about to begin college. The letter of wishes contains a disclaimer to the effect that its contents are only suggestions and recommendations and that the trustee is at all times bound by the terms of the trust as set forth in the trust instrument. Under paragraphs (a)(1) and (a)(4)(ii)(C) of this section, *FT* is treated as having a U.S. beneficiary.

(b) *Indirect U.S. beneficiaries*—(1) *Certain foreign entities*. For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of—

(i) A controlled foreign corporation, as defined in section 957(a);

(ii) A foreign partnership, if a U.S. person is a partner of such partnership; or

(iii) A foreign trust or estate, if such trust or estate has a U.S. beneficiary (within the meaning of paragraph (a)(1) of this section).

(2) *Other indirect beneficiaries*. For purposes of paragraph (a)(1) of this section, an amount is treated as paid or accumulated to or for the benefit of a U.S. person if the amount is paid to or accumulated for the benefit of a U.S. person through an intermediary, such as an agent or nominee, or by any other means where a U.S. person may obtain an actual or constructive benefit.

(3) *Examples*. The following examples illustrate the rules of this paragraph (b). Unless otherwise noted, *A* is a U.S. resident alien. *B* is *A*'s son and is a resident alien. *FT* is a foreign trust. The examples are as follows:

Example 1. Trust benefitting foreign corporation. *A* transfers property to *FT*. The beneficiary of *FT* is *FC*, a foreign corporation. *FC* has outstanding solely 100 shares of common stock. *B* owns 49 shares of the *FC* stock and *FC2*, also a foreign corporation, owns the remaining 51 shares. *FC2* has outstanding solely 100 shares of common stock. *B* owns 49 shares of *FC2* and nonresident alien individuals own the remaining 51 *FC2* shares. *FC* is a controlled foreign corporation (as defined in section 957(a), after the application of section 958(a)(2)). Under paragraphs (a)(1) and (b)(1)(i) of this section, *FT* is treated as having a U.S. beneficiary.

Example 2. Trust benefitting another trust. *A* transfers property to *FT*. The terms of *FT* permit current distributions of income to *B*. *A* transfers property to another foreign trust, *FT2*. The terms of *FT2* provide that no U.S. person can benefit either as to income or corpus, but permit current distributions of income to *FT*. Under paragraph (a)(1) of this section, *FT* is treated as having a U.S. beneficiary and, under paragraphs (a)(1) and (b)(1)(iii) of this section, *FT2* is treated as having a U.S. beneficiary.

Example 3. Trust benefitting another trust after transferor's death. *A* transfers property to *FT*. The terms of *FT* require that all income from *FT* be accumulated during *A*'s lifetime. In the year following *A*'s death, a share of *FT* is to be distributed to *FT2*, another foreign trust, for the benefit of *B*. Under paragraphs (a)(1) and (b)(1)(iii) of this section, *FT* is treated as having a U.S. beneficiary beginning with the year of *A*'s transfer of property to *FT*.

Example 4. Indirect benefit through use of debit card. *A* transfers property to *FT*. The trust instrument provides that no U.S. person can benefit either as to income or corpus. However, *FT* maintains an account with *FB*, a foreign bank, and *FB* issues a debit card to *B* against the account maintained by *FT* and *B* is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, *FT* is treated as having a U.S. beneficiary.

Example 5. Other indirect benefit. *A* transfers property to *FT*. *FT* is administered by *FTC*, a foreign trust company. *FTC* forms *IBC*, an international business corporation formed under the laws of a foreign jurisdiction. *IBC* is the beneficiary of *FT*. *IBC* maintains an account with *FB*, a foreign bank. *FB* issues a debit card to *B* against the account maintained by *IBC* and *B* is allowed to make withdrawals. Under paragraphs (a)(1) and (b)(2) of this section, *FT* is treated as having a U.S. beneficiary.

(c) *Treatment of U.S. transferor upon foreign trust's acquisition or loss of U.S. beneficiary*—(1) *Trusts acquiring a U.S. beneficiary*. If a foreign trust to which a U.S. transferor has transferred property is not treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) for any taxable year of the U.S. transferor, but the trust is treated as having a U.S. beneficiary (within the meaning of paragraph (a) of this section) in any subsequent taxable year, the U.S. transferor is treated as having additional income in the first such taxable year of the U.S. transferor in which the trust is treated as having a U.S. beneficiary. The amount of the additional income is equal to the trust's undistributed net income, as defined in section 665(a), at the end of the U.S. transferor's immediately preceding taxable year and is subject to the rules of section 668, providing for an interest charge on accumulation distributions from foreign trusts.

(2) *Trusts ceasing to have a U.S. beneficiary*. If, for any taxable year of a U.S. transferor, a foreign trust that has received a transfer of property from the U.S. transferor ceases to be treated as having a U.S. beneficiary, the U.S. transferor ceases to be treated as the owner of the portion of the trust attributable to the transfer beginning in the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary (unless the U.S. transferor is treated as an owner thereof pursuant to sections 673 through 677). The U.S. transferor is treated as making a transfer of property to the foreign trust on the first day of the first taxable year following the last taxable year of the U.S. transferor during which the trust was treated as having a U.S. beneficiary. The amount of the property deemed to be transferred to the trust is the portion of the trust attributable to the prior transfer to which paragraph (a)(1) of this section applied. For rules regarding the recognition of gain on transfers to foreign trusts, see section 684.

(3) *Examples*. The rules of this paragraph (c) are illustrated by the following examples. *A* is a U.S. resident alien, *B* is *A*'s son, and *FT* is a foreign trust. The examples are as follows:

Example 1. Trust acquiring U.S. beneficiary. (i) In 2001, *A* transfers stock with a fair market value of $100,000 to *FT*. The stock has an adjusted basis of $50,000 at the time of the transfer. The trust instrument provides that income may be paid currently to, or accumulated for the benefit of, *B* and that, upon the termination of the trust, all income and corpus is to be distributed to *B*. At the time of the transfer, *B* is a nonresident alien. *A* is not treated as the owner of any portion of *FT* under sections 671 through 677. *FT* accumulates a total of $30,000 of income during the taxable years 2001 through 2003. In 2004, *B* moves to the United States and becomes a resident alien. Assume paragraph (a)(4) of this section is not applicable under the facts and circumstances.

(ii) Under paragraph (c)(1) of this section, *A* is treated as receiving an accumulation distribution in the amount of $30,000 in 2004 and immediately transferring that amount back to the trust. The accumulation distribution is subject to the rules of section 668, providing for an interest charge on accumulation distributions.

(iii) Under paragraphs (a)(1) and (3) of this section, beginning in 2005, *A* is treated as the owner of the portion of *FT* attributable to the stock transferred by *A* to *FT* in 2001 (which includes the portion attributable to the accumulated income deemed to be retransferred in 2004).

Example 2. Trust ceasing to have U.S. beneficiary. (i) The facts are the same as in *Example 1*. In 2008, *B* becomes a nonresident alien. On the date *B* becomes a nonresident alien, the stock transferred by *A* to *FT* in 2001 has a fair market value of $125,000 and an adjusted basis of $50,000.

(ii) Under paragraph (c)(2) of this section, beginning in 2009, *FT* is not treated as having a U.S. beneficiary, and *A* is not treated as the owner of the portion of the trust attributable to the prior transfer of stock. For rules regarding the recognition of gain on the termination of ownership status, see section 684.

§1.679–3 Transfers.

(a) *In general*. A transfer means a direct, indirect, or constructive transfer.

(b) *Transfers by certain trusts*—(1) *In general*. If any portion of a trust is treated as owned by a U.S. person, a transfer of property from that portion of the trust to a foreign trust is treated as a transfer from the owner of that portion to the foreign trust.

(2) *Example*. The following example illustrates this paragraph (b):

Example. In 2001, *A*, a U.S. citizen, creates and funds *DT*, a domestic trust. *A* has the power to revest absolutely in himself the title to the property in *DT* and is treated as the owner of *DT* pursuant to section 676. In 2004, *DT* transfers property to *FT*, a foreign trust. *A* is treated as having transferred the property to *FT* in 2004 for purposes of this section.

(c) *Indirect transfers*—(1) *Principal purpose of tax avoidance*. A transfer to a foreign trust by any person (intermediary) to whom a U.S. person transfers property is treated as an indirect transfer by a U.S. person to the foreign trust if such transfer is made pursuant to a plan one of the principal purposes of which is the avoidance of United States tax.

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

(i) The U.S. person is related (within the meaning of paragraph (c)(4) of this section) to a beneficiary of the foreign trust, or has another relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the U.S. transferor would make a transfer to the foreign trust; and

(ii) The U.S. person cannot demonstrate to the satisfaction of the Commissioner that—

(A) The intermediary has a relationship with a beneficiary of the foreign trust that establishes a reasonable basis for concluding that the intermediary would make a transfer to the foreign trust;

(B) The intermediary acted independently of the U.S. person;

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

(D) The intermediary timely complied with the reporting requirements of section 6048, if applicable.

(3) *Effect of disregarding intermediary*—(i) *In general*. Except as provided in paragraph (c)(3)(ii) of this section, if a transfer is treated as an indirect transfer pursuant to paragraph (c)(1) of this section, then the intermediary is treated as an agent of the U.S. person, and the property is treated as transferred to the foreign trust by the U.S. person in the year the property is transferred, or made available, by the intermediary to the foreign trust. The fair market value of the property transferred is determined as of the date of the transfer by the intermediary to the foreign trust.

(ii) *Special rule*. If the Commissioner determines, or if the taxpayer can demonstrate to the satisfaction of the Commissioner, that the intermediary is an agent of the foreign trust under generally applicable United States agency principles, the property will be treated as transferred to the foreign trust in the year the U.S. person transfers the property to the intermediary. The fair market value of the property transferred will be determined as of the date of the transfer by the U.S. person to the intermediary.

(iii) *Effect on intermediary*. If a transfer of property is treated as an indirect transfer under paragraph (c)(1) of this section, the intermediary is not treated as having transferred the property to the foreign trust.

(4) *Related parties*. For purposes of this paragraph (c), a U.S. transferor is treated as related to a U.S. beneficiary of a foreign trust if the U.S. transferor and the beneficiary are related for purposes of section 643(i)(2)(B), with the following modifications–

(i) 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

(ii) 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.

(5) *Examples*. The rules of this paragraph (c) are illustrated by the following examples:

Example 1. Principal purpose of tax avoidance. *A*, a U.S. citizen, creates and funds *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. In 2004, *A* decides to transfer an additional 1000X to the foreign trust. Pursuant to a plan with a principal purpose of avoiding the application of section 679, A transfers 1000X to I, a foreign person. *I* subsequently transfers 1000X to *FT*. Under paragraph (c)(1) of this section, *A* is treated as having made a transfer of 1000X to *FT*.

Example 2. U.S. person unable to demonstrate that intermediary acted independently. *A*, a U.S. citizen, creates and funds *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. On July 1, 2004, *A* transfers XYZ stock to *D*, *A*'s uncle, who is a nonresident alien. *D* immediately sells the XYZ stock and uses the proceeds to purchase ABC stock. On January 1, 2007, *D* transfers the ABC stock to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that *D* acted independently of *A* in making the transfer to *FT*. Under paragraph (c)(1) of this section, *A* is treated as having transferred the ABC stock to *FT*. Under paragraph (c)(3) of this section, *D* is treated as an agent of *A*, and the transfer is deemed to have been made on January 1, 2007.

Example 3. Indirect loan to foreign trust. A, a U.S. citizen, previously created and funded *FT*, a foreign trust, for the benefit of *A*'s children, who are U.S. citizens. On July 1, 2004, *A* deposits 500X with *FB*, a foreign bank. On January 1, 2005, *FB* loans 450X to *FT*. *A* is unable to demonstrate to the satisfaction of the Commissioner, pursuant to paragraph (c)(2) of this section, that *FB* has a relationship with *FT* that establishes a reasonable basis for concluding that FB would make a loan to *FT* or that *FB* acted independently of *A* in making the loan. Under paragraph (c)(1) of this section, *A* is deemed to have transferred 450X directly to *FT* on January 1, 2005. Under paragraph (c)(3) of this section, *FB* is treated as an agent of *A*. For possible exceptions with respect to qualified obligations of the trust, see §1.679–4.

Example 4. Loan to foreign trust prior to deposit of funds in foreign bank. The facts are the same as in *Example 3*, except that *A* makes the 500X deposit with *FB* on January 2, 2005, the day after *FB* makes the loan to *FT*. The result is the same as in *Example 3*.

(d) *Constructive transfers*—(1) *In general*. For purposes of paragraph (a) of this section, a constructive transfer includes any assumption or satisfaction of a foreign trust's obligation to a third party.

(2) *Examples*. The rules of this paragraph (d) are illustrated by the following examples. In each example, *A* is a U.S. citizen and *FT* is a foreign trust. The examples are as follows:

Example 1. Payment of debt of foreign trust. FT owes 1000X to *Y*, an unrelated foreign corporation, for the performance of services by *Y* for *FT*. In satisfaction of *FT*'s liability to *Y*, *A* transfers to *Y* property with a fair market value of 1000X. Under paragraph (d)(1) of this section, *A* is treated as having made a constructive transfer of the property to *FT*.

Example 2. Assumption of liability of foreign trust. *FT* owes 1000X to *Y*, an unrelated foreign corporation, for the performance of services by *Y* for *FT*. *A* assumes *FT*'s liability to pay *Y*. Under paragraph (d)(1) of this section, *A* is treated as having made a constructive transfer of property with a fair market value of 1000X to *FT*.

(e) *Guarantee of trust obligations*—(1) *In general*. If a foreign trust borrows money or other property from any person who is not a related person (within the meaning of §1.679–1(c)(5)) with respect to the trust (lender) and a U.S. person (U.S. guarantor) that is a related person with respect to the trust guarantees (within the meaning of paragraph (e)(4) of this section) the foreign trust's obligation, the U.S. guarantor is treated for purposes of this section as a U.S. transferor that has made a transfer to the trust on the date of the guarantee in an amount determined under paragraph (e)(2) of this section. To the extent this paragraph causes the U.S. guarantor to be treated as having made a transfer to the trust, a lender that is a U.S. person shall not be treated as having transferred that amount to the foreign trust.

(2) *Amount transferred*. The amount deemed transferred by a U.S. guarantor described in paragraph (e)(1) of this section is the guaranteed portion of the adjusted issue price of the obligation (within the meaning of §1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of §1.1273–1(c)).

(3) *Principal repayments*. If a U.S. person is treated under this paragraph (d) as having made a transfer by reason of the guarantee of an obligation, payments of principal to the lender by the foreign trust with respect to the obligation are taken into account on and after the date of the payment in determining the portion of the trust attributable to the property deemed transferred by the U.S. guarantor.

(4) *Guarantee*. For purposes of this section, the term guarantee–

(i) Includes any arrangement under which a person, directly or indirectly, assures, on a conditional or unconditional basis, the payment of another's obligation;

(ii) Encompasses any form of credit support, and includes a commitment to make a capital contribution to the debtor or otherwise maintain its financial viability; and

(iii) Includes an arrangement reflected in a comfort letter, regardless of whether the arrangement gives rise to a legally enforceable obligation. If an arrangement is contingent upon the occurrence of an event, in determining whether the arrangement is a guarantee, it is assumed that the event has occurred.

(5) *Examples*. The rules of this paragraph (e) are illustrated by the following examples. In all of the examples, *A* is a U.S. resident and *FT* is a foreign trust. The examples are as follows:

Example 1. Foreign lender. X, a foreign corporation, loans 1000X of cash to *FT* in exchange for *FT*'s obligation to repay the loan. *A* guarantees the repayment of 600X of *FT*'s obligation. Under paragraph (e)(2) of this section, *A* is treated as having transferred 600X to *FT*.

Example 2. Unrelated U.S. lender. The facts are the same as in *Example 1*, except *X* is a U.S. person that is not a related person within the meaning of §1.679–1(c)(5). The result is the same as in *Example 1*.

(f) *Transfers to entities owned by a foreign trust*—(1) *General rule*. If a U.S. person is a related person (as defined in §1.679–1(c)(5)) with respect to a foreign trust, any transfer of property by the U.S. person to an entity in which the foreign trust holds an ownership interest is treated as a transfer of such property by the U.S. person to the foreign trust followed by a transfer of the property from the foreign trust to the entity owned by the foreign trust, unless the U.S. person demonstrates to the satisfaction of the Commissioner that the transfer to the entity is properly attributable to the U.S. person's ownership interest in the entity.

(2) *Examples*. The rules of this paragraph (f) are illustrated by the following examples. In all of the examples, *A* is a U.S. citizen, *FT* is a foreign trust, and *FC* is a foreign corporation. The examples are as follows:

Example 1. A creates and funds *FT*. which is treated as having a U.S. beneficiary under §1.679–2. *FT* owns all of the outstanding stock of *FC*. *A* transfers property directly to *FC*. Because *FT* is the sole shareholder of *FC*, *A* is unable to demonstrate to the satisfaction of the Commissioner that the transfer is properly attributable to *A*'s ownership interest in *FC*. Accordingly, under this paragraph (f), *A* is treated as having transferred the property to *FT*, followed by a transfer of such property by *FT* to *FC*. Under §1.679–1(a), *A* is treated as the owner of the portion of *FT* attributable to the property treated as transferred directly to *FT*. Under §1.367(a)– 1T(c)(4)(ii), the transfer of property by *FT* to *FC* is treated as a transfer of the property by *A* to *FC*.

Example 2. The facts are the same as in *Example 1*, except that *FT* is not treated as having a U.S. beneficiary under §1.679– 2. Under this paragraph (f), *A* is treated as having transferred the property to *FT*, followed by a transfer of such property by *FT* to *FC*. *A* is not treated as the owner of *FT* for purposes of §1.679–1(a). For rules regarding the recognition of gain on the transfer, see section 684.

Example 3. A creates and funds *FT*. *FC* has outstanding solely 100 shares of common stock. *FT* owns 50 shares of *FC* stock, and *A* owns the remaining 50 shares. On July 1, 2001, *FT* and *A* each transfer 1000X to FC. *A* is able to demonstrate to the satisfaction of the Commissioner that *A*'s transfer to *FC* is properly attributable to *A*'s ownership interest in *FC*. Accordingly, under this paragraph (f), *A*'s transfer to *FC* is not treated as a transfer to *FT*.

§1.679–4 Exceptions to general rule.

(a) *In general*. Section 1.679–1 does not apply to—

(1) Any transfer of property to a foreign trust by reason of the death of the transferor;

(2) Any transfer of property to a foreign trust described in sections 402(b), 404(a)(4), or 404A;

(3) Any transfer of property to a foreign trust that has received a ruling or determination letter, which has been neither revoked nor modified, from the Internal Revenue Service recognizing the trust's tax exempt status under section 501(c)(3); and

(4) Any transfer of property to a foreign trust to the extent the transfer is for fair market value.

(b) *Transfers for fair market value*—(1) *In general*. For purposes of this section, 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. For purposes of this section, a distribution to a trust with respect to an interest held by such trust in an entity other than a trust or 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 is considered to be a transfer for fair market value.

(2) *Special rule*—(i) *Transfers for partial consideration*. For purposes of this section, if a person transfers property to a foreign trust in exchange for property having a fair market value that is less than the fair market value of the property transferred, the exception in paragraph (a)(4) of this section applies only to the extent of the fair market value of the property received.

(ii) *Example*. This paragraph (b) is illustrated by the following example:

Example. A, a U.S. citizen, transfers property that has a fair market value of 1000X to *FT*, a foreign trust, in exchange for 600X of cash. Under this paragraph (b), §1.679–1 applies with respect to the transfer of 400X (1000X less 600X) to *FT*.

(c) *Certain obligations not taken into account*. Solely for purposes of this section, in determining whether a transfer by a U.S. transferor that is a related person (as defined in §1.679–1(c)(5)) with respect to the foreign trust is for fair market value, any obligation (as defined in §1.679–1(c)(6)) of the trust or a related person (as defined in §1.679–1(c)(5)) that is not a qualified obligation within the meaning of paragraph (d)(1) of this section shall not be taken into account.

(d) *Qualified obligations*—(1) *In general*. For purposes of this section, an obligation is treated as a qualified obligation only if—

(i) The obligation is reduced to writing by an express written agreement;

(ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation);

(iii) All payments on the obligation are denominated in U.S. dollars;

(iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater that 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter));

(v) The U.S. transferor extends the period for assessment of any income or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation

(this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. transferor's taxable year and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to for purposes of §301.6501(c)–1(d) of this chapter; and

(vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for every year that the loan is outstanding.

(2) *Additional loans*. If, while the original obligation is outstanding, the U.S. transferor or a person related to the trust (within the meaning of §1.679–1(c)(5)) directly or indirectly obtains another obligation issued by the trust, or if the U.S. transferor directly or indirectly obtains another obligation issued by a person related to the trust, the original obligation is deemed to have the maturity date of any such subsequent obligation in determining whether the term of the original obligation exceeds the specified 5-year term. In addition, a series of obligations issued and repaid by the trust (or a person related to the trust) is treated as a single obligation if the transactions giving rise to the obligations are structured with a principal purpose to avoid the application of this provision.

(3) *Obligations that cease to be qualified*. If an obligation treated as a qualified obligation subsequently fails to be a qualified obligation (e.g., renegotiation of the terms of the obligation causes the term of the obligation to exceed five years), the U.S. transferor is treated as making a transfer to the trust in an amount equal to the original obligation's adjusted issue price (within the meaning of §1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of §1.1273–1(c)) as of the date of the subsequent event that causes the obligation to no longer be a qualified obligation. If the maturity date is extended beyond five years by reason of the issuance of a subsequent obligation by the trust (or person related to the trust), the amount of the transfer will not exceed the issue price of the subsequent obligation. The subsequent obligation is separately tested to determine if it is a qualified obligation.

(4) *Transfers resulting from failed qualified obligations*. In general, a transfer resulting from a failed qualified obligation is deemed to occur on the date of the subsequent event that causes the obligation to no longer be a qualified obligation. However, based on all of the facts and circumstances, the Commissioner may deem a transfer to have occurred on any date on or after the issue date of the original obligation. For example, if at the time the original obligation was issued, the transferor knew or had reason to know that the obligation would not be repaid, the Commissioner could deem the transfer to have occurred on the issue date of the original obligation.

(5) *Renegotiated loans*. Any loan that is renegotiated, extended, or revised is treated as a new loan, and any distribution of funds after such renegotiation, extension, or revision under a pre-existing loan agreement is treated as a transfer subject to this section.

(6) *Principal repayments*. The payment of principal with respect to any obligation that is not treated as a qualified obligation under this paragraph is taken into account on and after the date of the payment in determining the portion of the trust attributable to the property transferred.

(7) *Examples*. The rules of this paragraph (d) are illustrated by the following examples. In all of the examples, *A* is a U.S. resident and *FT* is a foreign trust. The examples are as follows:

Example 1. Demand loan. *A* transfers 500X to *FT* in exchange for a demand note that permits *A* to require repayment by *FT* at any time. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT*. Because *FT*'s obligation to *A* could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 500X transfer to *FT*.

Example 2. Private annuity. *A* transfers 4000X to *FT* in exchange for an annuity from the foreign trust that will pay *A* 100X per year for the rest of *A*'s life. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT*. Because *FT*'s obligation to *A* could remain outstanding for more than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 4000X transfer to *FT*.

Example 3. Loan to unrelated foreign trust. *B* transfers 1000X to *FT* in exchange for an obligation of the trust. The term of the obligation is fifteen years. *B* is not a related person (as defined in §1.679–1(c)(5)) with respect to *FT*. Because *B* is not a related person, the adjusted issue price of the obligation received by *B* is taken into account for purposes of determining whether *B*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section, even though the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section.

Example 4. Transfer for an obligation with term in excess of 5 years. *A* transfers property that has a fair market value of 5000X to *FT* in exchange for an obligation of the trust. The term of the obligation is ten years. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT*. Because the term of the obligation is greater than five years, the obligation is not a qualified obligation within the meaning of paragraph (d)(1) of this section and, pursuant to paragraph (c) of this section, it is not taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section. Accordingly, §1.679–1 applies with respect to the full 5000X transfer to *FT*.

Example 5. Transfer for a qualified obligation. The facts are the same as in *Example 4*, except that the term of the obligation is 3 years. Assuming the other requirements of paragraph (d)(1) of this section are satisfied, the obligation is a qualified obligation and its adjusted issue price is taken into account for purposes of determining whether *A*'s transfer is eligible for the fair market value exception of paragraph (a)(4) of this section.

Example 6. Effect of subsequent obligation on original obligation. *A* transfers property that has a fair market value of 1000X to *FT* in exchange for an obligation that satisfies the requirements of paragraph (d)(1) of this section. *A* is a related person (as defined in §1.679–1(c)(5)) with respect to *FT*. Two years later, *A* transfers an additional 2000X to *FT* and receives another obligation from *FT* that has a maturity date four years from the date that the second obligation was issued. Under paragraph (d)(2) of this section, the original obligation is deemed to have the maturity date of the second obligation. Under paragraph (a) of this section, *A* is treated as having made a transfer in an amount equal to the original obligation's adjusted issue price (within the meaning of §1.1275–1(b)) plus any accrued but unpaid qualified stated interest (within the meaning of §1.1273–1(c)) as of the date of issuance of the second obligation. The second obligation is tested separately to determine whether it is a qualified obligation for purposes of applying paragraph (a) of this section to the second transfer.

§1.679–5 Pre-immigration trusts.

(a) *In general*. If a nonresident alien individual becomes a U.S. person and the individual has a residency starting date (as determined under section 7701(b)(2)(A)) within 5 years after transferring property to a foreign trust (the original transfer), the individual is treated as having transferred to the trust on the residency starting date an amount equal to the portion of the

trust attributable to the property transferred by the individual in the original transfer.

(b) *Special rules*—(1) *Change in grantor trust status*. For purposes of paragraph (a) of this section, if a nonresident alien individual who is treated as owning any portion of a trust under the provisions of subpart E of part I of subchapter J, chapter 1 of the Internal Revenue Code, subsequently ceases to be so treated, the individual is treated as having made the original transfer to the foreign trust immediately before the trust ceases to be treated as owned by the individual.

(2) *Treatment of undistributed income*. For purposes of paragraph (a) of this section, the property deemed transferred to the foreign trust on the residency starting date includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred. Undistributed net income for periods before the individual's residency starting date is taken into account only for purposes of determining the amount of the property deemed transferred.

(c) *Examples*. The rules of this section are illustrated by the following examples:

Example 1. Nonresident alien becomes resident alien. On January 1, 2002, *A*, a nonresident alien individual, transfers property to a foreign trust, *FT*. On January 1, 2006, *A* becomes a resident of the United States within the meaning of section 7701(b)(1)(A) and has a residency starting date of January 1, 2006, within the meaning of section 7701(b)(2)(A). Under paragraph (a) of this section, *A* is treated as a U.S. transferor and is deemed to transfer the property to *FT* on January 1, 2006. Under paragraph (b)(2) of this section, the property deemed transferred to *FT* on January 1, 2006, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property originally transferred.

Example 2. Nonresident alien loses power to revest property. On January 1, 2002, *A*, a nonresident alien individual, transfers property to a foreign trust, *FT*. *A* has the power to revest absolutely in himself the title to such property transferred and is treated as the owner of the trust pursuant to sections 676 and 672(f). On January 1, 2008, the terms of *FT* are amended to remove *A*'s power to revest in himself title to the property transferred, and *A* ceases to be treated as the owner of *FT*. On January 1, 2010, *A* becomes a resident of the United States. Under paragraph (b)(1) of this section, for purposes of paragraph (a) of this section *A* is treated as having originally transferred the property to *FT* on January 1, 2008. Because this date is within five year's of *A*'s residency starting date, *A* is deemed to have made a transfer to the foreign trust on January 1, 2010, his residency starting date. Under paragraph (b)(2) of this section, the property deemed transferred to the foreign trust on January 1, 2010, includes the undistributed net income of the trust, as defined in section 665(a), attributable to the property deemed transferred.

§1.679–6 Outbound migrations of domestic trusts.

(a) *In general*. Subject to the provisions of paragraph (b) of this section, if an individual who is a U.S. person transfers property to a trust that is not a foreign trust, and such trust becomes a foreign trust while the U.S. person is alive, the U.S. individual is treated as a U.S. transferor and is deemed to transfer the property to a foreign trust on the date the domestic trust becomes a foreign trust.

(b) *Amount deemed transferred*. For purposes of paragraph (a) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property previously transferred. Undistributed net income for periods prior to the migration is taken into account only for purposes of determining the portion of the trust that is attributable to the property transferred by the U.S. person.

(c) *Example*. The following example illustrates the rules of this section. For purposes of the example, *A* is a U.S. resident alien, *B* is *A*'s son, who is a resident alien, and *DT* is a domestic trust. The example is as follows:

Example. Outbound migration of domestic trust. On January 1, 2002, *A* transfers property to *DT*, for the benefit of *B*. On January 1, 2003, *DT* acquires a foreign trustee who has the power to determine whether and when distributions will be made to *B*. Under section 7701(a)(3)(B) and §301.7701–7(d)(ii)(A), *DT* becomes a foreign trust on January 1, 2003. Under paragraph (a) of this section, *A* is treated as transferring property to a foreign trust on January 1, 2003. Under paragraph (b) of this section, the property deemed transferred to the trust when it becomes a foreign trust includes undistributed net income, as defined in section 665(a), attributable to the property deemed transferred.

§1.679–7 Effective dates.

(a) *In general*. Except as provided in paragraph (b) of this section, the rules of §§1.679–1, 1.679–2, 1.679–3, and 1.679–4 apply with respect to transfers after August 7, 2000.

(b) *Special rules*. (1) The rules of §1.679–4(c) and (d) apply to an obligation issued after February 6, 1995, whether or not in accordance with a pre-existing arrangement or understanding. For purposes of the rules of §1.679–4(c) and (d), if an obligation issued on or before February 6, 1995, is modified after that date, and the modification is a significant modification within the meaning of §1.1001–3, the obligation is treated as if it were issued on the date of the modification. However, the penalty provided in section 6677 applies only to a failure to report transfers in exchange for obligations issued after August 20, 1996.

(2) The rules of §1.679–5 apply to persons whose residency starting date is after August 7, 2000.

(3) The rules of §1.679–6 apply to trusts that become foreign trusts after August 7, 2000.

Par. 3. In §1.958–1, paragraph (b) is amended by adding a new sentence after the first sentence to read as follows:

§1.958–1 Direct and indirect ownership of stock.

* * * * *

(b) * * * For purposes of the preceding sentence, any person that is treated as the owner of any portion of a trust pursuant to sections 671 through 679 shall be treated as a beneficiary of the trust and shall be considered to own all of the stock owned directly or indirectly by or for such portion. * * *

* * * * *

§1.958–2 [Amended]

Par. 4. In §1.958–2, paragraph (c)(1)(ii)(b) is amended by removing the language "678" and adding "679" in its place.

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

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