Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: August 04, 2004

to: Rachel J. Zepeda
(CC:SB:5:PNX:1)

from: Elizabeth U. Karzon
(CC:INTL:Br1)

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subject: Application of I.R.C. § 679 To Certain Foreign Trusts

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Trust 1 =

Trust 2 =

Trust 3 =

Trust 4 =

Foundation 1 =

Foundation 2 =

Fund	=	
Corp A	=	
Corp B	=	
Trustee 1	=	
Trustee 2	=	
A	=	
B	=	
C	=	
D	=	
E	=	
F	=	
G	=	
H	=	
I	=	
J	=	
K	=	
L	=	
M	=	
Country A	=	
Country B	=	

POSTN-119372-04		3
Country C	=	
Address	=	
Date 1	=	
Date 2	=	
Date 3	=	
Date 4	=	
Date 5	=	
Date 6	=	
Date 7	=	
Date 8	=	
Date 9	=	
Date 10	=	
Date 11	=	
Date 12	=	
Date 13	=	
Date 14	=	
Date 15	=	
Date 16	=	
Date 17	=	
Date 18	=	
Date 19	=	
Year 1	=	
Year 2	=	

Year 3	=
Year 4	=
a	=
b	=
c	=
d	=
e	=
f	=
g	=
h	=
i	=
j	=
k	=
l	=
m	=
n	=
o	=
p	=
q	=
r	=
s	=
t	=
u	=

v	=
w	=
x	=
y	=
z	=
aa	=
bb	=
cc	=
dd	=
ee	=

ISSUES

Issue 1

Whether income realized on the sale of Corp A stock by Trust 1 on Date 1, is includible in the gross income of A as the owner of the trust, or whether Trust 1 was a nongrantor trust by reason of the amendments made to the trust documents on Date 2, and if so, the tax consequences of the conversion of the trust from grantor to nongrantor status?

Facts – Issue 1

On Date 3, the taxpayer, A, a U.S. citizen, founded Corp A, a domestic corporation. As founder of Corp A, A received shares of the company and has not established that his basis in those shares is other than zero.

On Date 4, A established Trust 1 under the laws of Country A. The originating trust document declared the trust to be a grantor trust under I.R.C. §§ 671 to 678, inclusive. See Exhibit 1 – Article IV: Situs, Irrevocability and Grantor Trust Status.

On the date the trust was established, A caused the Corp A to issue a shares of stock to the trust on behalf of A.

Schedule 2 of the trust instrument named two beneficiaries: B, A's wife (a nonresident alien), and Foundation 1, a Country B trust established by A that carried no restrictions as to whether U.S. charities could receive distributions from it. Although no other beneficiaries were named, Article I of the trust defines beneficiaries as the specified beneficiaries and those later added. A, in conjunction with the trustee, reserved the power to expand or contract the class of beneficiaries under Article VI (Powers Retained by Settlor).

On or about Date 5, A began negotiating to sell the Corp A to Corp B, a domestic corporation, with the signing of a confidentiality agreement. In mid-February Year 1 Corp B offered to acquire all of the shares of the Corp A. <u>See</u> page 3 of Exhibit 2.

On Date 2, A amended and restated Trust 1. Among the changes he made at that time were:

1. The original trustee, Trustee 1, was replaced with Trustee 2.
2. The trust was migrated from Country A to Country C.
3. Article IV of the trust document was amended. Previously, this article specified that the trust was a grantor trust. Article IV was changed to state: “it is the intention of the Settlor that this Settlement not be a grantor trust under I.R.C. §§ 671 through 679 (inclusive) of the Code and its provisions be construed accordingly.”
4. Clause 5.8 of Article V was amended to state:

   NOTWITHSTANDING ANY OTHER PROVISION HEREOF, no named beneficiary or other person who might be construed as a beneficiary or holder of a power or interest hereunder shall be a United States person as defined for purposes of I.R.C.§ 679 of the Code or a spouse described in I.R.C. §§ 672(e) or 677 of the Code and no part of the income or corpus of the trust shall be paid to or accumulated for the benefit of such person. Should either named beneficiary be disfranchised at any time by this Clause, the other shall take in her or its stead, and should both be so disfranchised, the Trustee shall expand the class of Beneficiaries to include one or more charitable organizations that are not U.S. persons, which charitable organization(s) shall be benefited or possessed of the subject power or interest.

The Date 2, amendments did not remove either Foundation 1 or B as beneficiaries of the trust.

On Date 1, Corp A was sold to Corp B for b per share. The provisions of the sale were for payment of c per share immediately and the remaining d to be paid within r months of the purchase. At the time of the Corp B purchase, Trust 1 directly held a shares of Corp A stock.

On Date 6, all of the assets of the amended and restated Trust 1 were distributed to B and the trust was terminated. <u>See</u> Exhibit 3. Also on Date 6, B created a new trust, the Trust 2. The first article of this trust instrument designates that B shall have the power at will to alter, amend, or revoke the trust instrument. The third article of this trust instrument designates that the trustee shall distribute funds as B directs. <u>See</u> Exhibit 4.

Issue 2

Whether income realized on the sale of Corp A stock by Trust 3 on Date 1, is includible in the gross income of A as the owner of the trust, or whether Trust 3 was a nongrantor trust by reason of the amendments made to the trust documents on Date 2, and if so, the tax consequences of the conversion of the trust from grantor to nongrantor status?

Issue 2 - Facts

On Date 4 A also established Trust 3. Trust 3 was initiated as a foreign trust under the laws of Country A. The originating trust document declared the trust to be a grantor trust under I.R.C. §§ 671 to 678, inclusive. See Exhibit 5 – Article IV: Situs, Irrevocability and Grantor Trust Status.

Clause 5.1 of the trust instrument provides that the trustee may, in the trustee's sole discretion, distribute net income and capital to the following named beneficiaries of the trust:

1. B (A's wife)
2. C (A's son)
3. D (A's daughter)
4. E (A's daughter)
5. F (resident of Germany)
6. G (resident of Germany)
7. H (resident of Germany)
8. I (U.S. resident)
9. J (U.S. resident)
10. K (U.S. resident)
11. A (the grantor)
12. Foundation 1 (Country B trust)

Also, on Date 4, A caused Corp A to issue e shares of Corp A shares to Trust 3 on his behalf. Clause 5.2 of Article V (Trust Distributions) of the trust instrument specified that a total of f shares of the e received were to be held by the trust for the exclusive benefit of certain specific beneficiaries. See Exhibit 6. These beneficiaries and the shares allocated to them are as follows:

1. g shares for Beneficiary F
2. h shares for Beneficiary G
3. h shares for Beneficiary H
4. g shares for Beneficiary I
5. g shares for Beneficiary J
6. h shares for Beneficiary K[1]

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1 Taxpayer has indicated that Beneficiaries F through K filed and paid tax on income earned by their respective shares. The Service has no information regarding whether these individuals filed and paid any such tax except that it did not occur in the years in question.

On or about Date 5, A began negotiating to sell Corp A to Corp B with the signing of a confidentiality agreement. On Date 7, the Trustee for Trust 3 entered into a limited partnership agreement, transferring to it i shares of Corp A stock. In mid-February Year 1 Corp B offered to acquire all of the shares of Corp A. See page 3 of Exhibit 7.

On Date 2, A amended and restated the Trust 3 instrument. Among the changes he made at that time were:

1. The original trustee, Trustee 1, was replaced with Trustee 2.
2. The trust migrated from Country A to Country C.
3. A new beneficiary was added, L, born Date 8, son of the grantor and, therefore, a U.S. citizen. See Exhibit 8 for the revised schedule of Beneficiaries.
4. Article IV of the trust document was amended. Previously this article specified that the trust was a grantor trust. Article IV was changed to state: "it is the intention of the Settlor that this Settlement not be a grantor trust under I.R.C. §§ 671 through 679 (inclusive) of the Code and its provisions be construed accordingly."
5. Clause 5.2 of Article V was amended with a declaration that the shares held for I, J and K constitute separate trusts.
6. The following Clause 5.13 was added to Article V:

> NOTWITHSTANDING ANY OTHER PROVISION HEREOF, with the exception of Beneficiaries No. 9, 10, and 11 as to whom Clause 5.2 pertains, no named beneficiary or other person who might be construed as a beneficiary or holder of a power or interest hereunder shall be a United States person as defined for purposes of I.R.C. § 679 of the Code or a spouse described in I.R.C. § 672(e) or I.R.C. § 677 of the Code and no part of the income or corpus of the trust shall be paid to or accumulated for the benefit of such person. Should any named beneficiary be disfranchised at any time by this Clause, the other beneficiaries shall take in such beneficiary's stead, and should all beneficiaries be so disfranchised, the Trustee shall expand the class of Beneficiaries to include one or more charitable organizations that are not U.S. persons, which charitable organization(s) shall be benefited or possessed of the subject power or interest.

On Date 1, Corp A was sold to Corp B for b per share. The provisions of the sale were for payment of c per share immediately and the remaining d to be paid within r months of the purchase. At the time of the Corp B purchase Trust 3 directly held j shares including the f shares designated for specific beneficiaries as listed above. Another i shares were held by the trust through Fund. Consideration of the tax treatment under I.R.C. §721(b) of the transfer of those shares by the trust to the foreign partnership is discussed under separate cover. To the extent that the transfer to the partnership is treated under I.R.C. § 721(b) as a taxable event to Trust 3 in the year of the transfer, the gain arising from the subsequent sale of Corp A stock by the partnership on Date 1, would be reduced accordingly, as would Trust 3's allocable share of that gain.

In August Year 1 all of the assets of Trust 3 were distributed to B and the trust was dissolved. See page 6 of Exhibit 9. B then created a new Trust 3 on Date 9 under the laws of Country C. The new trust instrument maintained the same 13 beneficiaries as had the previous instrument and declared, without explanation, that the new trust was a nongrantor trust.

Issue 3

Whether income realized by Foundation 1 on the sale of Corp A stock on Date 1 is includible in the gross income of A?

Issue 3 - Facts

On Date 4 A established Foundation 1 under the laws of Country B. Article VI of the trust instrument specifies that the principal and income of the trust shall be held in trust by the trustees for payment or distribution to charitable organizations and for charitable purposes. See Exhibit 10. In addition, the trust instrument provides that no part of the net earnings of the trust shall inure or be payable to or for the benefit of any private shareholder or individual. Article V states that it is anticipated that the trust may file an application to recognized as an exempt organization under United States tax law and that this filing might be made at a time when A's family's interest in Corp A is less than k%. See Exhibit 10. The trust instrument did not name beneficiaries and contained no restrictions regarding whether U.S. persons could benefit, directly or indirectly from the trust. Paragraph (a)(1) of Article VI of Foundation 1 trust instrument provides that the "trustee may also make payments or distributions of all or any part of the income or principal to states, territories, or possessions of the United States . . ." There were no specific charitable purposes stated, and the only potential charitable organizations even mentioned were Country B registered charities, with the requirement that each year, at least $o be paid for such one or more charitable purposes that are beneficial to the communities or inhabitants of Country B. Article VI(b). To comply with Country B law, the trust in all events must only commence operations prior to the greater of l years after the death of the Settlor (A) or m years after the date Foundation 1 was created. Article V(b).

On Date 4, A caused Corp A to issue n shares of Corp A stock to Foundation 1 on his behalf. On Date 15, A caused p shares to be transferred to another foreign trust, Trust 4 (discussed below). On Date 11, the trustees of Trust 4 agreed that q of these shares should be treated as owned by Foundation 1. It is not yet established whether the shares were transferred to Foundation 1 prior to the sale of Corp A stock to Corp B.

On Date 1, Corp A was sold to Corp B for b per share. The provisions of the sale were for payment of c per share immediately and the remaining d to be paid within r months of the purchase.

Assuming the shares had been transferred from Trust 4 as alleged, Foundation 1 would have owned at the time of the sale s shares of Corp A stock including n shares Foundation 1 received directly from A and q shares received from A through Trust 4.

On Date 12, the name of Foundation 1 was changed to Foundation 2. On Date 13 the Internal Revenue Service issued a determination letter stating that the trust was an organization described in I.R.C. § 501(c)(3). See Exhibit 11. On Date 14, the Internal Revenue Service advised the Foundation 2 that the letter of Date 13 remained in effect but, based on information subsequently submitted the organization is not classified as a private foundation. See Exhibit 12.

A did not include the proceeds of the sale of shares held by Foundation 1 in his Year 1 income tax return.

Issue 4

Whether income was realized by Trust 4 on the sale of Corp A stock, and if so, was it includible in the gross income of A?

Issue 4 - Facts

On Date 15 A established Trust 4 under the laws of Country B.

Clause 1.2 of Article I: Definitions of the trust instrument states:

> Beneficiaries means that certain employee compensation plan ("Plan") anticipated to be created by Corp A, Foundation 1, a Country B trust created under indenture dated this date, and those persons otherwise added as hereinafter set forth. No beneficiary shall be a United States person. It is anticipated that the Plan will take the form of a non-United States trust resident outside the United States.

Clause 4.3 of Article IV: Situs; Irrevocability; Prohibition On United States Beneficiaries; Status for United States Tax Purposes of the trust instrument states:

> No part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and should the trust be terminated at any time during the taxable year, no part of the income or corpus of the trust shall be paid to or for the benefit of a United States person.

The second schedule of the trust instrument specifies the beneficiaries of the trust to be:

> That certain employee compensation plan that is anticipated to be created by Corp A and Foundation 1, a trust organized and existing under the laws of Country B, currently with an address of M, Trustee, at Address, Country B.

On Date 15, A caused Corp A to issue p shares of Corp A stock to Trust 4. The employee compensation plan was adopted on Date 16, and contrary to expectations, it was not organized as a funded foreign trust, but rather as an unfunded Stock Option Plan of Corp A. See Exhibit 13. As evidenced by a Shareholders Agreement, dated 8 days prior to the closing of the transaction with Corp B, and with the consent of Corp B, the trustees of the Comp Trust agreed to transfer t shares of the p to Corp A to fund options granted under its Stock Option Plan, and another u shares to the corporation to be used for issuances for purposes deemed by the Board to be beneficial to the Company, including the funding of stock options. The remaining q shares were to be transferred to Foundation 1. According to the taxpayer, Trust 4 then ceased to exist for lack of assets, prior to the closing of the transaction with Corp B.

The rationale for the transfers were twofold: the fact that the Plan was not established as a foreign trust, which violated the intent of the terms of the trust, and the fact that "the Company, the other shareholders, Corp B, and especially the employees [of the Company] wanted to make sure that A and his family did not somehow, in any fashion, benefit from the shares that were in the Comp Trust." [Date 17 letter].

Issue 5

Whether A satisfied all the information reporting requirements with respect to his interests in Trust 1, Trust 3, Foundation 1, and Trust 4?

Issue 5 – Facts

A filed Forms 3520 for Trust 1 and Trust 3 for the Year 2 tax year. A Form 3520 was filed for Trust 3 for the Year 1 tax year. No other Forms 3520 or 926 were filed for Trust 1 and Trust 3 and no such forms or Form 3520-A were filed for Trust 4 and Foundation 1 for any taxable year.

CONCLUSIONS

Issue 1

Income realized on the sale of Corp A stock by Trust 1 on Date 1, is includible in the gross income of A either because he remained the owner of the trust following the amendments to the trust instruments dated Date 2,

1) Because his spouse, B, received the proceeds of the trust on dissolution of the trust, causing the trust to be a grantor trust under I.R.C. § 677, despite the amendments made to the trust;

2) Because Foundation 1, one of the named beneficiaries of the foreign trust, was itself a foreign trust that did not preclude the possibility of a U.S. beneficiary and was not otherwise an exempt transferee under I.R.C. § 6048(a)(3)(B)(ii)(II); or

3) Because A is treated as the owner of the trust for the entire year because he is treated as the owner of the trust for a portion of his taxable year.

Alternatively, if the trust became a nongrantor trust on Date 2,

1) A is required to include the amount subsequently realized by the trust 8 days after Date 2, based on the anticipatory assignment of income doctrine; or
2) A, as the owner of the trust immediately before that date, is treated as having transferred all the assets of the trust, in this case the stock of Corp A, to a new foreign nongrantor trust, and pursuant to I.R.C. § 684, is required to treat such transfer as a sale or exchange of all Corp A stock at its fair market value on that date.

Issue 2

Income realized on the sale of Corp A stock by Trust 3 on Date 1, is includible in the gross income of A, either because he remained the owner of the trust following the amendments to the trust instrument dated Date 2,

1) Because his spouse, B, received the proceeds of the trust on dissolution of the trust, causing the trust to be a grantor trust under I.R.C. § 677, despite the amendments made to the trust;

2) Because Foundation 1, one of the named beneficiaries of the foreign trust, was itself a foreign trust that did not preclude the possibility of a U.S. beneficiary and was not otherwise an exempt transferee under I.R.C. § 6048(a)(3)(B)(ii)(II); or

3) Because A is treated as the owner of the trust for the entire year because he is treated as the owner of the trust for a portion of his taxable year.

Alternatively, if the trust became a nongrantor trust on Date 2,

1) A is required to include the amount subsequently realized by the trust 8 days after Date 2, based on the anticipatory assignment of income doctrine; or

2) A, as the owner of the trust immediately before that date, is treated as having transferred all the assets of the trust, in this case the stock of Corp A, to a new foreign nongrantor trust, and pursuant to I.R.C. § 684, is required to treat such transfer as a sale or exchange of all the assets at their fair market value.

Issue 3

A is treated as the owner of Foundation 1 and is required to include in gross income the gain on the sale of Corp A stock realized by Foundation 1 on Date 1, because it was not described in I.R.C. § 6048(a)(3)(ii)(II). It did not notify the Service that it was applying for recognition of its status under I.R.C. § 508(a), nor did it obtain a determination letter that it was an organization described in I.R.C. § 501(c)(3) for the taxable period at issue, as required by Notice 97-34.

Issue 4

A is treated as the owner of Trust 4 and is required to include in gross income the gain on the sale of Corp A stock realized by Trust 4, because the trust had a U.S. beneficiary, a domestic employee stock option plan. If, however, the trust was dissolved prior to Date 1, and a portion of the stock of Corp A was in fact transferred to Foundation 1, then gain realized on the shares of Corp A stock held by Foundation 1 would be recognized by A, to the extent he is treated as owning Foundation 1.

Issue 5

A did not satisfy all of his information reporting requirements under I.R.C. § 6048, or alternatively under I.R.C. § 1492, and appropriate penalties under I.R.C. § 6677 may be asserted.

LAW

I.R.C. § 671 states, in part:

> Where it is specified in this subpart that the grantor or another person shall be treated as the owner of any portion of a trust there shall then be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust which are attributable to that portion of the trust to the extent that such items would be taken into account under this chapter in computing taxable income or credits against the tax of an individual.

I.R.C. § 679(a) provides that a United States person who directly or indirectly transfers property to a foreign trust shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust. I.R.C. § 7701(a)(30)(A) provides in part that the term "United States person" includes a citizen of the United States. Under I.R.C. § 679, the term "United States beneficiary" includes a trust beneficiary who is a United States person.

I.R.C. § 679(c)(1) states that a trust shall be treated as having a United States beneficiary for the taxable year unless –

(A) under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the taxable year to or for the benefit of a United States person, and
(B) if the trust were terminated at any time during the taxable year, no part of the income or corpus of such trust could be paid to or for the benefit of a United States person.

I.R.C. § 679(c)(2) provides:

> For purposes of paragraph (1), an amount shall be treated as paid or accumulated to or for the benefit of a United States person if such amount is paid to or accumulated for a foreign corporation, foreign partnership, or foreign trust or estate, and-- ....
>
> (C) in the case of a foreign trust or estate, such trust or estate has a United States beneficiary (within the meaning of paragraph (1)).

I.R.C. § 672(e) provides that for purposes of subpart E a grantor shall be treated as holding any power or interest held by any individual who was the spouse of the grantor at the time of the creation of such power or interest.

I.R.C. § 674(a) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

I.R.C. § 677 states that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under I.R.C. § 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be distributed to the grantor or the grantor's spouse.

I.R.C. § 684(a), effective for transfers after August 5, 1997, states that in the case of any transfer of property by a United States person to a foreign estate or trust, for purposes of this subtitle, such transfer shall be treated as a sale or exchange for an amount equal to the fair market value of the property transferred, and the transferor shall recognize as gain the excess of the fair market value of the property so transferred over the adjusted basis of such property in the hands of the transferor. I.R.C. § 684(b) provides that I.R.C. § 684(a) shall not apply to a transfer to a trust by a United States person to the extent that any United States person is treated as the owner of such trust under I.R.C. § 671.

ANALYSIS

It should be noted from the outset that although A did not transfer the Corp A stock directly to Trust 1, Trust 3, Trust 4 or Foundation 1, because A was the original founder and sole shareholder of Corp A at the time of the issuance of stock to the trusts (other than small amounts of stock issued to employees and others for past services) and because corporations do not ordinarily make gifts to trusts, the issuance of shares of Corp A stock to Trust 1, Trust 3, Trust 4 or Foundation 1 and Foundation 1 should be treated as an issuance of stock to A followed by a contribution of the stock by him to each trust. Accordingly, A is treated as the grantor of each of these trusts for purposes of I.R.C. § 671. See Epstein v. Commissioner, 53 T.C. 459 (U.S. Tax Ct. , 1969); Percy H. Clark, 31 B.T.A. 1082 (1935); Byers v. Commissioner, 199 F. 2d 273 (C.A. 8, 1952). The *Clark* case involved a corporate transfer of property to trusts created by a controlling stockholder for the benefit of his children. As to the issue of whether the transfer should be treated as a distribution to the controlling stockholder, the Court made the following disposition:

> The petitioner controlled the Willoughby Co. It acted solely to accommodate him in making the transfer. He enjoyed the use of the property by having it transferred for his own purposes. This was the use he wanted to make of the property. He would have enjoyed it no more had it been distributed to him directly.
>
> Clark, at 1084-1085
>
> See *also* Treas. Reg. § 1.671-2(e).

Issue 1

Grantor Trust Status Was Not Terminated

There is no disagreement that Trust 1 was a grantor trust from its inception on Date 4 until it was amended on Date 2, one week prior to the sale of Corp A to Corp B. Article IV of the initiating trust document plainly states: “it is the understanding of the Settlor that this Settlement as currently constituted shall be treated as a GRANTOR TRUST under I.R.C. §§ 671 to 678 (inclusive) of the Code." The trust was a grantor trust under I.R.C. §§ 672(e) and 677, because A's spouse was a beneficiary of the trust.

As originally constituted, it also was a grantor trust under I.R.C. § 679. Trust 1 was a foreign trust that did not prohibit U.S. beneficiaries. In fact, Article VI of the trust instrument provided that A, in conjunction with the trustee, reserved the power to expand or contract the class of beneficiaries. As owner of Trust 1, items of income of the trust were required to be included in A's taxable income under I.R.C. § 671.

The primary issue is whether the amendments of Date 2, to Trust 1, specifically the addition of Clause 5.8 of Article V, resulted in the termination of the trust as a grantor trust by removing all U.S. beneficiaries as well as A's spouse as a potential beneficiaries.

Clause 5.8 was clearly added to remove the taxpayer's spouse as a named beneficiary and to preclude the trust from ever having in the future a U.S. beneficiary for purposes of I.R.C. § 679. It is not clear whether there was any concern about Foundation 1 as a beneficiary, or any other foreign charitable trust, since the new clause provided that if any named beneficiaries were disfranchised, that the Trustee should expand the class of beneficiaries to include other foreign charitable organizations.

> *Should either named beneficiary be disfranchised at any time by this Clause, the other shall take in her or its stead, and should both be so disfranchised, the Trustee shall expand the class of Beneficiaries to include one or more charitable organizations that are not U.S. persons, which charitable organization(s) shall be benefited or possessed of the subject power or interest.*

It is now clear, however, based on a letter dated Date 17, that A takes the position that if a foreign charitable organization is a beneficiary of a foreign trust, it will not cause the foreign trust itself to have a U.S. beneficiary merely because the charitable organization is able to make grants directly or indirectly for the benefit of a U.S. person, provided such grants are made in a manner consistent with its charitable purpose. The taxpayer's representative wrote that "a prohibition on payments for the direct or indirect benefit of U.S. persons would have barred U.S. persons, including U.S. charities, from receiving grants, which obviously makes no sense whatsoever."

Taxpayer also appears to argue that Foundation 1 would not be a foreign trust to which I.R.C. § 679 should apply, because it is described in I.R.C. § 6048(a)(3)(B)(ii)(II) (a trust which is determined by the Secretary to be described in I.R.C. § 501(c)(3)) (to be discussed in Issue 3). Thus, regardless of whether Foundation 1 is treated as having a U.S. beneficiary, it cannot be a grantor trust for I.R.C. § 679 purposes, nor should it cause another foreign trust, of which it is a beneficiary, to be a grantor trust for I.R.C. § 679 purposes.

<u>I.R.C. § 679</u>

Whether Trust 1 remained a grantor trust under I.R.C. § 679 after Date 2, depends on whether the amendments effectively eliminated the possibility that the income or corpus of the trust could be paid or accumulated during the taxable year to or for the benefit of a U.S. person, or that, if the trust were terminated at any time during the taxable year, any of the income or corpus of the trust could be paid to or for the benefit of a U.S. person.

Although Clause 5.8 of Article V does not contain language identical to I.R.C. § 679(c)(1)(A) and (B), the substance of the language appears to eliminate the possibility of a U.S. person directly benefiting from the trust. And Clause 5.8 applies notwithstanding any other provision of the trust.

Under I.R.C. § 679(c)(2)(C), however, for purposes of determining whether a foreign trust has a U.S. beneficiary under I.R.C. § 679(c)(1), amounts paid or accumulated for another foreign trust will be treated as paid or accumulated for a U.S. beneficiary if that other foreign trust has a U.S. beneficiary. There is no exception for a trust that is described in I.R.C. § 6048(a)(3)(B)(ii)(II).

Regulations under I.R.C. § 679(c)(1) [2] provide as follows:

> 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. (Emphasis added.)

Treas. Reg. § 1.679-2(a)(2) provides further:

> <u>Benefit to a U.S. person</u>--(i) <u>In general</u>. 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. (Emphasis added.)

[2] Treas. Reg. § 1.679-2 (a)(1). In general, the regulations under I.R.C. § 679 apply with respect to transfers after August 7, 2000. Treas. Reg. § 1.679-7. However, the final regulations on this point reflect the statute as in effect since 1976.

Because Foundation 1, a Country A trust, was not clearly removed as a beneficiary of Trust 1, if Foundation 1 was able to pay to or accumulate income for the benefit of a U.S. person, it may be considered to have a U.S. beneficiary, thereby causing Trust 1 to have a U.S. beneficiary.

Foundation 1 had no named beneficiaries of any sort and prior to the sale of the stock of Corp A, it is assumed that no grants or distributions of any sort were made, since Foundation 1 had no other assets. For purposes of this advice, we assume the trust documents, at a minimum, comport with the boilerplate language necessary for the trust to be described in I.R.C. § 501(c)(3), including the required provisions prohibiting private inurement. We also assume that Foundation 1 trust document did not contain the specific language of I.R.C. § 679(c)(1)(A) and (B).

On its face, because the Foundation 1 trust document did not contain the specific language contained in I.R.C. § 679(c)(1)(A) and (B), the trust is treated as having a U.S. beneficiary. However, there is an argument that if Issue 3 is resolved in favor of the taxpayer, i.e., that if the original transfer of Corp A stock to Foundation 1 is treated as a transfer to a foreign charitable trust that is exempt from I.R.C. § 679, then Foundation 1 should not be treated as having a U.S. beneficiary for purposes of determining whether Trust 1 has a U.S. beneficiary. As will be discussed in Issue 3, however, Foundation 1 did not have a determination letter at the time of the sale of Corp A stock, nor may it have been described in I.R.C. § 501(c)(3).

Accordingly, the amendments to Trust 1 may not have eliminated the possibility that a U.S. person could benefit from it, if it can be established that, with respect to one of its named beneficiaries, Foundation 1, and there was no prohibition against it benefiting a U.S. person. In that event, the grantor trust status of Trust 1 would not have terminated as of Date 11.

I.R.C. §§ 672(e) and 677

The Date 2 amendments prohibited Trust 1 from treating B as a beneficiary. However, I.R.C. § 677 applies if there is a distribution to the grantor's spouse even if the trust instrument does not authorize such distribution to the grantor's spouse. See U.S. v. Rosales, 88 A.F.T.R. 2d 2001-5370. Therefore, if there was a distribution to B, A would be treated as the owner of Trust 1.

B is treated as the owner of Trust 2 under I.R.C. § 676 because she has the power to revoke the trust. The person treated as the owner of a trust is considered the owner of the assets in the trust. Rev. Rul. 85-13, 1985-1 C.B. 184. As a result, the transfer of the assets of Trust 1 to the Trust 2 is treated as a distribution to B. Therefore, there was a distribution to A's spouse and A is treated as the owner of Trust 1 under I.R.C. §§ 672(e) and 677 notwithstanding the Date 2 amendments.

In addition, the documents concerning the transfer of assets (Exhibits 3 and 4) indicate that the assets of Trust 1 were distributed to B and then contributed to Trust 2 by B.

Therefore, there was a distribution to A's spouse and A is treated as the owner of Trust 1 under I.R.C. §§ 672(e) and 677.

We note that the taxpayer has suggested that expert testimony regarding Country C law will show that no distribution was made to B under Country C law. However, U.S. tax principles, not foreign tax principles, govern the taxation of U.S. citizens (here, A) and under U.S. tax principles, B received a distribution of the assets of Trust 1. See Biddle v. Commissioner, 302 U.S. 573 (1938).

Conversion of the Trust to Nongrantor Status Was an Anticipatory Assignment of Income

Even assuming that the Date 2 amendments to Trust 1 successfully converted the trust to a nongrantor trust, A remains taxable on the proceeds of the sale of the Corp A stock under the doctrine of anticipatory assignment of income.

The first principle of taxation is that income must be taxed to him that earned it. See Commissioner v. Culbertson, 337 U.S. 733; Helvering v. Clifford, 309 U.S. 331 (1940); National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

This principle was well stated by the United States Supreme Court in Lucas v. Earl, 281 U.S. 111 (1930), as follows:

> But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Also, in Helvering v. Horst, 311 U.S. 112 (1940), the Supreme Court stated:

> The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.

The idea that anticipated earnings may not be assigned to another has been upheld in the courts in the transference of securities. See Hallowell v. Commissioner, 56 T.C. 600 (U.S. Tax Ct.,1971) , and Ferguson v. Commissioner, 174 F.3d 997 (U.S. App., 1999). In Ferguson, the Ninth Circuit Court of Appeals made the point with regard to securities as follows:

> Under the anticipatory assignment of income doctrine, once a right to receive income has "ripened" for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income.

Treas. Reg. § 1.671-1(c) also provides that a person who assigns his right to future income may be taxed on that income even though the assignment is to a trust over which the assignor has not maintained any of the controls specified in I.R.C. §§ 671 through 677.

In the present case, A began negotiating the sale of the stock of Corp A on or about Date 5, four months prior to the sale of the stock. About two months prior to the amendment of the terms of the trust, in mid-February Year 1, Corp B offered to purchase all of the shares of Corp A. See page 3 of Exhibit 2. Only seven days after the terms of the trust were amended, on Date 1, Corp B purchased all of the shares of Corp A, including the shares held by Trust 1.

Assuming that A successfully converted Trust 1 to nongrantor status, A was attempting to transfer a right to income that had “ripened”. The ripening is best evidenced by the fact that Corp B, in negotiating with A, had offered to purchase all shares of Corp A in mid-February and the sale occurred only seven days after he amended Trust 1 status. Under the provisions of Treas. Reg. § 1.671-1(c), A remains taxable on the assignment of his right to capital gain income on the sale of Corp A stock held by Trust 1. The amount of this capital gain income is v, calculated as a shares times c per share received in Year 1.

A Remains Taxable on Trust 1 Income Through Date 6.

Even assuming that the Date 2 amendments to Trust 1 successfully converted the trust to a nongrantor trust, A remains taxable on the proceeds of the sale of the Corp A stock because he is treated as the owner of the trust for the entire Year 1 taxable year.

As discussed earlier, Trust 1 was a grantor trust under the provisions of I.R.C. § 679 before it was amended on Date 2. I.R.C. § 679(a) states that a United States person who transfers property to a foreign trust shall be treated as the owner *for his taxable year* of the portion of such trust attributable to such property if *for such year* there is a United States beneficiary of any portion of such trust.

I.R.C. § 679(c) provides that a trust will be treated as having a U.S. beneficiary *for the taxable year* unless (1) under the terms of the trust no part of the income or corpus of the trust may be paid or *accumulated during the taxable year* to or for the benefit of a U.S. person, and (2) if the trust were 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 a U.S. person.

Thus, if on any day during the taxable year, income or corpus of a foreign trust may be paid or accumulated to or for the benefit of a U.S. beneficiary, the U.S. person who transfers property to that trust will be treated as the owner for his taxable year.

A's taxable year, as an individual, begins on January 1 and ends on December 31. The trust was treated as having a U.S. beneficiary through, at least, Date 11. Therefore, A is treated as the owner of the trust for his entire taxable year ending Date 6, even if the trust was successfully amended on Date 2 to exclude U.S. beneficiaries. Accordingly, income earned by the trust through Date 6 must be included in the taxable income of A. The amount of this long-term capital gain income is $v, calculated as a shares times c per share received in Year 1.

Taxpayer, through the Date 17 letter, argues that the trust should be considered a grantor trust only for the portion of the year up until Date 2, prior to the sale of Corp A stock by the trust. He takes the position that I.R.C. § 679 contemplates "split years" in I.R.C. § 679(a)(4), in the case of a foreign grantor who becomes a U.S. person during the taxable year. He also cites I.R.C. § 679(b), dealing with the situation where a trust acquires a U.S. beneficiary during the year, to support the notion that I.R.C. § 679 is silent on whether the trust is treated as a grantor trust for the entire year, or only upon acquiring the U.S. beneficiary. Taxpayer also argues that the principles set forth in final regulations, for example, Treas. Reg. § 1.679-2(c)(2), dealing with trusts ceasing to have a U.S. beneficiary, are not applicable to the taxable years at issue.

As noted above, the Service does not need to rely on the final regulations to reach its position. The general rule is that a U.S. person is treated as the owner of a trust under I.R.C. § 679 for his entire taxable year if there is a U.S. beneficiary for any portion of the trust on any day during the taxable year. When there is a statutory exception to this rule, as in I.R.C. § 679(a)(4), the statute identifies the date of the transfer and the amount transferred as of that date. In the case of I.R.C. § 679(b), which addresses trusts that acquire U.S. beneficiaries, the assumption is that that I.R.C. § 679(a) would either apply or not apply for the full taxable year or for the preceding taxable year. No split years appear to be contemplated.

A is Taxable Under I.R.C. §684 Due to the Conversion of Trust 1 to Nongrantor Status

Even assuming that the Date 2 amendments to Trust 1 successfully converted the trust to a nongrantor trust, A remains taxable under I.R.C. § 684 on the fair market value of the Corp A stock that he is treated as transferring on Date 2 to the trust after it ceased to be a grantor trust.

I.R.C. § 684 (a) specifies that a U.S. person that transfers property to a foreign trust shall recognize gain measured by the excess of the fair market value of the property over the transferor's adjusted basis in the property.

There is no dispute that Trust 1 was a grantor trust prior to Date 2 under the provisions of I.R.C. §§ 672(e), 677, and 679. Consequently, when the trust was formed on Date 4, there was no transfer for purposes of I.R.C. §1491 (relating to excise taxes on transfers of appreciated property by U.S. persons to foreign trusts, effective with respect to transfers prior to August 5, 1997). Rev. Rul. 87-61, 1987-2 C.B.219.

I.R.C. § 684 replaced I.R.C. § 1491 with respect to transfers to foreign trusts, when that section was repealed on August 5, 1997. I.R.C. § 684 functions in the same manner as I.R.C. § 1491 except that it imposes an income tax, in lieu of an excise tax, on the transfer of appreciated property to foreign nongrantor trusts.

If, as the taxpayer asserts, Trust 1 ceased to be a grantor trust on Date 2, then I.R.C. § 684(a) applies on the date the trust ceased to be a grantor trust, in the same manner that I.R.C. § 1491 applied when a foreign trust ceased to be a grantor trust. A, a U.S. person, is treated as having transferred property to a foreign trust, and such transfer is treated as a sale or exchange. The application I.R.C. § 684 in this case does not, as taxpayer suggests, depend on the regulations issued after the deemed transfer occurs.

The gain from the transfer to the nongrantor Trust 1 is calculated to be the fair market value of the stock on Date 2, the date of the change to nongrantor status, less A's adjusted basis of the stock. The fair market value on Date 1, seven days after the trust was amended, was b per share based on the sale of all shares of the company to Corp B on that date. Therefore, the value of the stock on Date 2 was also b per share. The long-term capital gain A is required to recognize on Date 2 is $w calculated as a shares times b per share, assuming A has a zero basis in the stock.

<u>Issue 2 - Analysis</u>

<u>Grantor Trust Status Was Not Terminated</u>

There is no disagreement that Trust 3 was a grantor trust from its inception on Date 4 until it was amended on Date 2. Article IV of the initiating trust document plainly states: "it is the understanding of the Settlor that this Settlement as currently constituted shall be treated as a GRANTOR TRUST under I.R.C. §§ 671 to 678 (inclusive) of the Code."

It was a grantor trust under I.R.C. § 679, because A is treated as having transferred e shares of the stock to a foreign trust and seven of the twelve named beneficiaries of the trust were United States beneficiaries.

It was a grantor trust under I.R.C. §§ 672(e) and 677 because the trustee of Trust 3 may, in the trustee's sole discretion, distribute net income and capital to A's wife, B.

Accordingly, A was the owner of Trust 3 at its inception. The question is whether the amendments of Date 2 resulted in the termination of the trust's status as a grantor trust.

Following the amendments, the revised list of beneficiaries continued to include U.S. citizens. The only change from the previous list of beneficiaries was the addition of a new son, L, also a U.S. citizen. See Exhibit 8. Accordingly, absent any other amendments to the trust instrument, I.R.C. § 679 would continue to apply to the trust.

However, there were other amendments. Article IV was changed. The previous Article IV declared that the trust was a grantor trust under I.R.C. §§ 671 to 678, inclusive. The new Article IV declared that "it is the intention of the Settlor that this Settlement not be a grantor trust under I.R.C. §§ 671 through 679 (inclusive) of the Code and its provisions be construed accordingly."

In addition, Clauses 5.13 and 5.2 were added to Article V. Clause 5.13 stated that no named beneficiary or holder of a power or interest shall be a United States person for purposes of I.R.C. §§ 679 or a spouse described in I.R.C. §§ 672(e) or 677. If any beneficiary shall be disfranchised by this clause then other non-U.S. beneficiaries will take their place.

Clause 5.2 designated that the shares that had previously been allocated to I, J and K were to be held by the trust as separate trusts.

The effect of Clause 5.13 was to terminate the grantor trust status of the trust, unless, as in the case of Trust 1, Foundation 1, one of the original twelve named foreign beneficiaries, could be viewed as a foreign trust that has a U.S. beneficiary.

A may claim that the effect of Clause 5.2 was to gift shares to I, J, and K and, therefore, I, J, and K were the grantors of their respective separate trusts. However, there is no documentary evidence to suggest that the shares were transferred to I, J, and K in a manner that would cause them to be the owners of the shares and thus be the grantors of their separate respective trusts. Therefore, A continues to be the grantor of Trust 3 and any successor trusts. Clause 5.2 gives I, J, and K the power to withdraw the assets from their respective separate trusts, which would cause I, J, and K to be treated as the owners of their respective separate trusts under I.R.C. § 678. However, I.R.C. § 678(b) provides that I.R.C. § 678 does not apply if the grantor is treated as the owner under I.R.C. § 679. Because A is treated as the owner of the trusts under I.R.C. § 679 I, J, and K are not treated as the owners of their respective trusts under I.R.C. § 678.

In addition, the trust should still be considered a grantor trust under I.R.C. §§ 672(e) and 677, since, despite the fact that B was nominally disfranchised, because she ultimately received the assets on dissolution of the trust in August of Year 1, four months after the sale of the Corp A stock, and she subsequently contributed them to a new Trust 3 on Date 9, in Country C. In the new trust instrument, she named the same 13 persons, including herself, A, and their four children as beneficiaries as had the previous Trust 3. This trust instrument, like the previous one, also declared that it was intended to be a nongrantor trust.

Thus, B, despite provisions in the trust instrument that prohibits her from being a beneficiary, not only received a distribution of all trust property resulting in the dissolution of the trust, but had the power to create a new trust with those same assets.

Therefore, considering all the facts and circumstances, Trust 3 remained a grantor trust under the provisions of I.R.C. §§ 672(e) and 677, even after the trust instrument was amended and revised on Date 2. A remained the owner of the entirety of Trust 3. The income of the trust in Year 1, including income from its allocable share of gain derived by Fund, was $x calculated as e shares times c cash per share received in Year 1. The character of this income is long-term capital gain. To the extent that A, as owner of the trust, is required to take into account gain under I.R.C. § 721(b) on the transfer by the trust of Corp A stock to the foreign partnership, that amount should reduce the amount required to be taken into account at the time of the sale of Corp A stock to Corp B.

Conversion of the Trust to Nongrantor Status Was an Anticipatory Assignment of Income

Even assuming that the Date 2 amendments to the Trust 3 successfully converted the trust to a nongrantor trust, A remains taxable on the proceeds of the sale of the Corp A stock under the doctrine of anticipatory assignment of income described as follows.

The first principle of taxation is that income must be taxed to him that earned it. Commissioner v. Culbertson, 337 U.S. 733; Helvering v. Clifford, 309 U.S. 331 (1940); National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

This principle was soundly stated by the United States Supreme Court in Lucas v. Earl, 281 U.S. 111 (1930), as follows:

> But this case is not to be decided by attenuated subtleties. It turns on the import and reasonable construction of the taxing act. There is no doubt that the statute could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Also, in Helvering v. Horst, 311 U.S. 112 (1940), the Supreme Court stated:

> The taxpayer has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them.

The idea that anticipated earnings may not be assigned to another has been upheld in the courts in the transference of securities. See Hallowell v. Commissioner, 56 T.C. 600 (1971), and Ferguson v. Commissioner, 174 F.3d 997 (1999). In Ferguson, the Ninth Circuit Court of Appeals made the point with regard to securities as follows:

> Under the anticipatory assignment of income doctrine, once a right to receive income has "ripened" for tax purposes, the taxpayer who earned or otherwise created that right, will be taxed on any gain realized from it, notwithstanding the fact that the taxpayer has transferred the right before actually receiving the income.

Treas. Reg. § 1.671-1(c) also provides that a person who assigns his right to future income may be taxed on that income even though the assignment is to a trust over which the assignor has not maintained any of the controls specified in I.R.C. §§ 671 through 677.

In the present case, A began negotiating the sale of the stock of Corp A on or about Date 5, four months prior to Date 2, when A amended the terms of Trust 3 to convert it to a nongrantor trust to separate himself from the gain he anticipated from the sale of the stock. About two months prior to the amendment of the terms of the trust, in mid-February Year 1, Corp B offered to purchase all of the shares of Corp A. <u>See</u> page 3 of Exhibit 2. Only seven days after the terms of the trust were amended, on Date 1, Corp B purchased all of the shares of Corp A, including the shares held by Trust 1.

If A successfully converted Trust 3 to a nongrantor trust, he transferred a right to income that had "ripened". The ripening is best evidenced by the fact that Corp B, in negotiating with A, had offered to purchase all shares of Corp A in mid-February and the sale occurred only seven days after he amended the terms of Trust 3 to make it a nongrantor trust. Under the provisions of Treas. Reg. §1.671-1(c), A remains taxable on the assignment of his right to capital gain income on the sale of Corp A stock held by Trust 3, either directly, or through an interest in a Country A partnership, Fund. The amount of this capital gain income is $x, calculated as e shares times c per share received in Year 1.

<u>A Remains Taxable on Trust 3 Income Through Date 6.</u>

Even assuming that the Date 2 amendments to Trust 3 successfully converted the trust to a nongrantor trust, A remains taxable on the proceeds of the sale of the Corp A stock because he is treated as the owner of the trust for the entire Year 1 taxable year.

I.R.C. § 679(a) states that a United States person who transfers property to a foreign trust shall be treated as the owner *for his taxable year* of the portion of such trust attributable to such property if *for such year* there is a United States beneficiary of any portion of such trust.

I.R.C. § 679(c) provides that a trust will be treated as having a U.S. beneficiary *for the taxable year* unless (1) under the terms of the trust no part of the income or corpus of the trust may be paid or *accumulated during the taxable year* to or for the benefit of a U.S. person, and (2) if the trust were 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 a U.S. person.

Thus, if on any day during the taxable year, income or corpus of a foreign trust may be paid or accumulated to or for the benefit of a U.S. beneficiary, the U.S. person who transfers property to that trust will be treated as the owner for his taxable year.

A's taxable year, as an individual U.S. taxpayer, begins on January 1 and ends on December 31. The trust was treated as having a U.S. beneficiary through, at least, Date 11. Therefore, A is treated as the owner of the trust for his entire taxable year ending Date 6. The income earned by the trust in Year 1 was $y calculated as j shares times c cash per share received in Year 1. The character of this income is long-term capital gain.

Taxpayer, through the Date 17 letter, argues that the trust should be considered a grantor trust only for the portion of the year up until Date 2, prior to the sale of Corp A stock by the trust. He takes the position that I.R.C. § 679 contemplates "split years" in I.R.C. § 679(a)(4), in the case of a foreign grantor who becomes a U.S. person during the taxable year. He also cites I.R.C. § 679(b), dealing with the situation where a trust acquires a U.S. beneficiary during the year, to support the notion that I.R.C. § 679 is silent on whether the trust is treated as a grantor trust for the entire year, or only upon acquiring the U.S. beneficiary. Taxpayer also argues that the principles set forth in final regulations, for example, Treas. Reg. § 1.679-2(c)(2), dealing with trusts ceasing to have a U.S. beneficiary, are not applicable to the taxable years at issue.

As noted above, the Service does not need to rely on the final regulations to reach its position. The general rule is that a U.S. person is treated as the owner of a trust under I.R.C. § 679 for his entire taxable year if there is a U.S. beneficiary for any portion of the trust. When there is a statutory exception to this rule, as in I.R.C. § 679(a)(4), the statute identifies the date of the transfer and the amount transferred as of that date. In the case of I.R.C. § 679(b), which addresses trusts that acquire U.S. beneficiaries, the assumption is that that I.R.C. § 679(a) would either apply or not apply for the full taxable year or for the preceding taxable year. No split years appear to be contemplated.

Therefore, by the operation of I.R.C. § 679, A remained the owner of Trust 3 through Date 6. If Trust 3 terminated its grantor status on Date 2 then income earned by the trust through Date 6 must be included in the taxable income of A.

<u>A is Taxable Under I.R.C. § 684 Due to the Conversion of Trust 3 to Nongrantor Status</u>

Even assuming that the Date 2 amendments to Trust 3 successfully converted the trust to a nongrantor trust, A remains taxable under I.R.C. § 684 on the fair market value of the Corp A stock that he is treated as transferring on Date 2 to the trust after it ceased to be a grantor trust.

I.R.C. § 684 (a) specifies that a U.S. person that transfers property to a foreign trust shall recognize gain measured by the excess of the fair market value of the property over the transferor's adjusted basis in the property.

There is no dispute that Trust 3 was a grantor trust prior to Date 2 under the provisions of I.R.C. §§ 672(e), 677 and 679. Consequently, when the trust was formed on Date 4, there was no transfer for purposes of I.R.C. § 1491 (relating to excise taxes on transfers of appreciated property by U.S. persons to foreign trusts, effective with respect to transfers prior to August 5, 1997). Rev. Rul. 87-61,1987-2 C.B. 219.

I.R.C. § 684 replaced I.R.C. § 1491 with respect to transfers to foreign trusts, when that section was repealed on August 5, 1997. I.R.C. § 684 functions in the same manner as I.R.C. § 1491 except that it imposes an income tax, in lieu of an excise tax, on the transfer of appreciated property to foreign nongrantor trusts.

If, as the taxpayer asserts, Trust 3 ceased to be a grantor trust on Date 2, then I.R.C. § 684(a) applies on the date the trust ceased to be a grantor trust, in the same manner that I.R.C. § 1491 applied when a foreign trust ceased to be a grantor trust. A, a U.S. person, is treated as having transferred property to a foreign trust, and such transfer is treated as a sale or exchange. The application I.R.C. § 684 in this case does not, as taxpayer suggests, depend on the regulations issued after the deemed transfer occurs.

The gain from the transfer to the nongrantor Trust 3 is calculated to be the fair market value of the stock on Date 2, the date of the change to nongrantor status, less A's adjusted basis in the stock. The fair market value on Date 1, seven days after the trust was amended, was b per share based on the sale of all shares of the company to Corp B on that date. Therefore, the value of the stock on Date 2 was also b per share. The long-term capital gain A is required to recognize on Date 2, including shares held indirectly by the trust through a foreign partnership is dd, calculated as b per share times c shares.

Issue 3 - Analysis

As previously discussed in Issue 1, income realized by Foundation 1 may be includible in the gross income of A under I.R.C. § 679(a), so long as the foundation does not satisfy the requirements of I.R.C. § 6048(a)(3)(B)(ii)(II). I.R.C. § 679 was amended to exempt transfers to certain charitable trusts effective with respect to transfers occurring after February 6, 1995.

I.R.C. § 6048(a)(3)(B)(ii) refers to trusts that have been "determined by the Secretary to be described in I.R.C. § 501(c)(3)". At no time during the period of Date 4, when the trust was established, through Date 1, when the trust realized income, did Foundation 1 apply, filing Form 1023 in accordance with I.R.C. § 508(a), or receive a determination from the Internal Revenue Service that it was described in I.R.C. § 501(c)(3). In fact, there was no certainty during this time period that Foundation 1 would even apply for or be recognized as a tax-exempt organization under U.S. law. Article V of the trust instrument specified that the trust might file an application when A's family's interest in Corp A became less than k%. See Exhibit 10.

The statutory requirement that the trust be "determined by the Secretary to be described in I.R.C. § 501(c)(3)" was interpreted in Section III.E of Notice 97-34, 1997-1 C.B. 422 (Deferred Compensation and Charitable Trusts), issued June 23, 1997. This section provides in pertinent part:

> Without regard to whether a transfer to a foreign trust is gratuitous or nongratuitous, transfers to foreign trusts described in sections 402(b), 404(a)(4), 404A, or 501(c)(3) are exempt from reporting under section 6048(a). Section 6048(a)(3)(B)(ii). For purposes of this provision, a trust will be considered described in section 501(c)(3) *only if it has a determination letter from the Service that has not been revoked recognizing its status as exempt from income taxation under section 501(a)*. [Emphasis added]

A, in contrast, finds support for his position in final regulations under I.R.C. § 679, issued July 20, 2001, effective for transfers after August 7, 2000, which exempt transfers that are merely described in I.R.C. § 501(c)(3) (without regard to the notification requirements in I.R.C. § 508(a)). Treas. Reg. § 1.679-4(a)(3).

A may not rely on the final regulations, however, because they were not in effect as of the date of the transfer of the stock to the trust, in Year 2, or on Date 2, the date of the sale of the stock. In fact, the original transfer occurred prior to the amendment to I.R.C. § 679(a) in August, Year 2, that created any exception for foreign charitable trusts. Thus, the statute and Notice alone controlled the treatment of the transfer of property to Foundation 1. The final regulations liberalized the rules, not to broaden the class of acceptable organizations, but rather because many foreign charitable organizations are not aware of or do not otherwise need to obtain a determination letter from the United States in order to carry out their charitable purpose. In contrast, this entity was formed by the same individual who funded the entity, and he has not established a reason for the delay in obtaining a determination, unless there was concern that one might not have been granted.

Eventually, after the sale of the Corp A stock, and after Foundation 1 changed its name to Foundation 2 on Date 19, a determination letter was issued to the Foundation 2 on Date 13, effective Date 18. This determination letter did not cover the taxable period at issue.

While the Date 17 letter submitted by A's representative claims that there were only clerical and conforming changes to the original trust agreement made to reflect the name change, there is some doubt as to whether Foundation 1 would have qualified for a determination letter at the time it was created. Foundation 1 was funded solely with stock of a closely held corporation owned primarily by the Settlor, A.

Thus, Foundation 1 did not qualify for the exception for charitable trusts under I.R.C. § 679(a)(1). It failed to notify the Service that it intended to apply for recognition of its tax exempt status and therefore, it was not "determined by the Secretary to be described in I.R.C. § 501(c)(3)". Since it could have benefited U.S. persons, it was a grantor trust under I.RC. § 679 from its inception. Accordingly, it was a grantor trust at the time of the sale of Corp A stock on Date 1.

On Date 1, Foundation 1 sold s shares of Corp A stock for b per share with c paid immediately and the balance within r months of the sale. A should have recognized the cash proceeds received by Foundation 1 during Year 1 of ee (s shares times c per share) in his Year 1 income tax return.

Issue 4 -Analysis

Income realized by Trust 4 is includible in the gross income of A.

Trust 4 comes within the purview of I.R.C. § 679 for two reasons. First, the trust had a U.S. beneficiary. Although Article I of the trust instrument contained a prohibition against U.S. beneficiaries, and the intent was for each of the named beneficiaries, Foundation 1 and the employee compensation plan to be foreign, when the employee compensation plan was adopted by the shareholders on Date 16, it was "created by a U.S. corporation under U.S. law and located in the United States", and some, if not all, of the beneficiaries of the plan were U.S. employees." Therefore, the trust instrument did not prevent a U.S. person from becoming a beneficiary.

As noted in Issue 1, if Foundation 1 is treated as a foreign trust with a U.S. beneficiary, this would provide another reason for I.R.C. § 679 to apply.

Thus, A should be treated as owning Trust 4 unless it is established that, in accordance with the shareholder agreement dated Date 11, that the trustees in fact distributed all the trust's shares in Corp A to either Foundation 1 or the corporation itself. There is no indication in the Corp A share transfer ledger, however, that these distributions were ever made. Therefore, A, the grantor, is treated as owning Trust 4 on Date 1, when the trust realized income from the sale of p shares of Corp A stock to Corp B. The income realized by Trust 4 was $aa with $bb to be received during Year 1 and the balance of $cc to be received during Year 3 and Year 4.

If it is ever established that the transfers were made, however, then with respect to amounts transferred to Foundation 1, A would realize the gain to the extent Foundation 1 is treated as a grantor trust.

Issue 5 – Analysis

A is treated as having transferred property on Date 4 to Trust 1, Trust 3, and Foundation 1. He is also treated as having transferred property to Trust 4 on Date 15.

Transfers to foreign trusts by U.S. persons prior to August 20, 1996 were reportable under I.R.C. § 6048, as it was in effect prior to its amendment by the Small Business Job Protection Act of 1996. Under I.R.C. § 6048 prior to its amendment there was no exception to reporting with respect to trusts "determined by the Secretary to be described in I.R.C. § 501(c)(3)." Penalties were governed by I.R.C. § 6677, prior to its amendment in 1996. A U.S. person creating or transferring property to a foreign trust was required to file Form 3520 (Creation of or Transfers to Foreign Trusts) with the Philadelphia Service Center within 90 days of the creation or transfer. The penalty for failure to file the return was 5% of the amount transferred, but not to exceed $1000, unless it is shown that such failure was due to reasonable cause. I.R.C. § 6677(a), as in effect prior to August 20, 1996. Thus, A should have reported the creation and transfer of property to each of the four trusts (not just Trust 1 and Trust 3) within 90 days of their creation.

In addition, if as A alleges, Foundation 1 was a foreign non-grantor trust described in I.R.C. § 501(c)(3), the transfer was subject to the excise tax imposed by I.R.C. § 1491, unless it was described in I.R.C. § 1492(1), which provides that I.R.C. § 1491 will not apply if the transferee is an organization exempt from income tax under part I of subchapter F of chapter 1 of the Code. Although I.R.C. §§ 1491-1494 were repealed effective August 5, 1997, the deemed transfer of Corp A stock to Foundation 1 occurred prior to that date. In order to qualify for this exemption, Treas. Reg. § 1.1494-1(b) requires the U.S. transferor (A) to file Form 926 and attach thereto:

> "a certificate establishing the exemption of the transferee under such part I. This certificate, which shall contain, or be verified by, a written declaration that is made under the penalties of perjury, shall contain complete information showing the character of the transferee, the purpose for which it is organized, its actual activities, the source of its income and the disposition of such income, whether or not any of its income is credited to surplus or may inure to the benefit of any private shareholder or individual and in general all facts relating to its operations which affects its right to exemption. To such certificate shall be attached a copy of the charter or articles of incorporation, the by-laws of the organization, and the latest financial statement showing the assets, liabilities, receipts, and disbursements of the organization.

We have no evidence at this point that a Form 926 or the attached statement was filed by A.

Furthermore, if Trust 1 and Trust 3 each ceased to be grantor trusts on Date 2, that would cause a separate and distinct transfer of the Corp A stock by A to each of these foreign trusts. In that event, since those transfers occurred after August 20, 1996, I.R.C. § 6048(a), as amended, and the penalties under I.R.C. § 6677, as amended, would apply to the fair market value of the property transferred. Thus, A would be required to file a Form 3520 (Annual Return To Report Transactions With Foreign Trusts And Receipt Of Foreign Gifts) for each both of these trusts (not just Trust 3) reporting the transfer of Corp A stock no later than the due date of his Form 1040 for Year 1, including extensions. If he failed to file those forms, the penalty under I.R.C. § 6677 would be 35% of the fair market value of the stock held by each of these trusts on Date 2.

With respect to the filing of Form 3520-A (Annual Information Return Of Foreign Trust With A U.S. Owner), I.R.C. § 6048(b), as amended in 1996, was effective for taxable years beginning after December 31, 1995. I.R.C. § 6048(b)(1) provides that if, *at any time during the taxable year,* a U.S. person is the owner of a foreign trust, that U.S. person is responsible for the trust filing a return which sets forth a full and complete accounting of all trust activities and operations *for the* year. In addition, under I.R.C. § 6048(b)(2), unless the trust authorizes a U.S. agent to act as the trust's limited agent for purposes of I.R.C. §§ 7602,7603 and 7604 with respect to any request by the Secretary to examine records or produce testimony related to the proper treatment of amounts required to be taken into account under the grantor trust rules, the Secretary may determine the amounts required to be taken into account with respect to the trust under the I.R.C. § 671.

Accordingly, for the taxable year beginning in Year 2 through Year 1, A was responsible for ensuring that Trust 1 and Trust 3 file Form 3520-A (Annual Return of Foreign Trust With U.S. Beneficiaries) by the 15th day of the 4th month following the end of the taxable year. The penalty for failure to file was 5% percent of the value of the trust corpus. I.R.C. § 6677 as amended. An additional penalty of $10,000 applies for each 30-day period (or fraction thereof) that the failure continues beyond 90 days after notice of failure. <u>See</u> also Notice 97-34, for certain extensions of time to file Form 3520 and 3520-A, prior to the forms being available to the public.

Moreover, unless the Forms 3520-A were filed in a timely manner (or in accordance with Notice 97-34) and a U.S. agent was authorized for purposes of I.R.C. § 6048(b)(2), the Secretary may determine the amounts required to be taken into account with respect to each trust under I.R.C. § 671.

Similar rules apply under I.R.C. § 6048(b)(2) with respect to the filing of Forms 3520-A by Foundation 1 and Trust 4, if they are treated as grantor trusts under I.R.C. § 679.

<u>CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS</u>

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Please call at) if you have any further questions.