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An Overview Concerning Certain Recent Changes for Foreign Compensatory Trusts: 402(b) Trusts, Grantor Trusts and “Rabbi” Trusts

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I. INTRODUCTION

Foreign companies and their U.S. subsidiaries employing U.S. persons have devised a wide range of executive and other deferred compensatory arrangements in order to be an incentive to their workforce. Because of matters relating to administrative ease, or in some cases, certain foreign legal or accounting issues, these incentive awards are often contributed to trusts by foreign employers or foreign parents of U.S. employers, and most notably foreign trusts described in section 7701(a)(31).

Under the Code, special rules govern the U.S. federal income taxation of trusts. In particular, under sections 671 through 679, a grantor of a trust who retains certain powers over or interest in the trusts is treated as the “owner” of the trust, with the result that all of the trust’s income is taxable to the owner. Certain special vehicles, so-called “rabbi trusts,” whose assets are subject to the claims of creditors of the employer, are also subject to these rules. Additionally, under section 402(b), certain compensatory trust arrangements result in a separate level of tax on the trust entity, along with the additional result that participants are often taxed on their vested interest in the trust.

In 1996, the Small Business Job Protection Act¹ amended portions of sections 672 and 679, among others, and in September of 1996, and again in June of 1997, the Internal Revenue Service (the Service) issued proposed regulations which dramatically affect the foreign trust deferred and incentive compensatory world. In February 1999, and again in August 1999, the Service issued certain final regulations affecting foreign trusts. The cumulative effects of the statutory and regulatory changes are broad, involving changes in the treatment of *both* “inbound” *and* “outbound” compensatory trust arrangements.

First, the changes alter the definition of “foreign trust.” Because special rules have traditionally applied to foreign trusts (and because the recent statutory and regulatory changes now impose *additional* special rules on foreign trusts) the classification of such entities forms an important first analytical step in examining many cross-border deferred or incentive compensatory arrangements. As described below, these statutory changes offer some much needed clarity on the demarcation between domestic and foreign trusts—an area which has often been riddled with ambiguity.

Second, some of the changes put forth are designed to preclude certain perceived abuses of foreign deferred compensation plans as tax shelters. Unchecked, these abuses might permit U.S. entities to protect income

1. Small Business Job Protection Act of 1996, Pub. L. No. 104-188, 110 Stat. 1755 (1996).

in offshore trusts. Prompted by concerns that U.S. persons were not paying their fair share on income attributable to foreign trusts, certain foreign affiliates of U.S. entities may now be treated as grantors on the overfunded portion of certain foreign compensatory trusts, and thus may be subject to U.S. federal income tax on the items of income produced by the trust, *regardless of whether the trust would otherwise be so treated under Subpart E of Subchapter J*. In particular, these rules are designed to curb abuses by plans maintained by U.S. sponsors as well as by: (a) controlled foreign corporations, (b) certain passive foreign investment companies and (c) certain foreign partnerships.

These rules, in particular, are potentially expansive in scope because arrangements of purely foreign entities which employ mostly foreign persons may now be subject to U.S. taxation even though the *only* United States nexus is through their affiliation with a U.S. entity. Accordingly, some practitioners have queried whether such a jurisdictional extension of U.S. taxing authority is appropriate. Equally notable from the policy standpoint is these proposed regulations' impact on the dividing line between "secular" section 402(b) arrangements and grantor trusts. Insofar as the rules apply to certain overfunded secular trusts, the Service appears to be departing from its established policy of treating section 402(b) "secular" trust arrangements as "fundamentally inconsistent" from grantor trusts—a distinction with potentially multiple consequences, as discussed below. Moreover, while the proposed changes affect many overfunded foreign arrangements, they leave open some issues as to *how and when* these foreign arrangements may be viewed as "overfunded." The rules of determining when a trust is overfunded, as described below, not only invoke practical concerns in measuring a trust's funding status, but also potentially raise several accounting translation issues between U.S. and foreign procedures and standards.

Third, the proposed changes alter the treatment of certain "outbound" compensatory trust arrangements (i.e., foreign trusts with a U.S. employer and U.S. beneficiaries). Section 679, as amended, now clarifies that U.S. grantors of "outbound" foreign trusts with U.S. beneficiaries will *not* be treated as owners of the trusts under that provision if the arrangement is considered to be covered by section 402(b). However, in spite of this statutory change, as described below, certain recently issued proposed regulations indicate that portions of "outbound" section 402(b) trusts *will* be subject to the grantor trust rules as a result of the application of the overfunding rules described above. These developments raise interesting questions as to the cumulative interpretation of these recent changes as well as to the underlying rationale of the proposed regulations and the recent changes in law.

Finally, the proposed regulations prompt certain basic questions about the treatment of deferred compensatory grantor trusts. The proposed changes raise the possibility that deferred compensatory arrangements that do not

qualify as rabbi trusts will *never* be treated as grantor trusts *even* if they would otherwise so qualify under sections 671 through 677. This is a potentially broad assertion and is especially important for those compensatory arrangements that fail to meet the requirements of Revenue Procedure 92-64—the Service’s safe harbor for favorable rabbi (grantor) trust treatment. Thus, both as a matter of practice and policy, these changes appear not only to redefine the boundaries between section 402(b) trusts and grantor trusts but also thus effect the line between section 402(b) arrangements and rabbi trusts themselves.

Consequently, this article seeks to describe some of the salient practical and policy issues confronting the foreign deferred compensatory trust world in light of the recent changes to the Code and the more recently issued proposed regulations. Part II first outlines some of the basic U.S. federal income tax considerations involved in trust-structured foreign deferred compensatory arrangements. Part II describes the conditions necessary for grantor trust treatment as well as the tax consequences associated with section 402(b) secular trust arrangements. Part II further discusses the recent changes in law refining the boundary between domestic and foreign trusts. Part III highlights “inbound” foreign grantor trusts, and discusses the recent proposed changes to section 672, and the potential consequences to foreign compensatory arrangements occasioned by the “overfunding” rules discussed above. Part III also examines changes with respect to the apparent demarcation between section 402(b) trusts and grantor trusts and further explores several potentially key consequences for rabbi trusts. Finally, Part IV examines “outbound” foreign grantor trusts including the recent effects of the changes in law on those arrangements.

II. STRUCTURAL CONSIDERATIONS

A. *Treatment of Grantor Trusts*

1. *Generally.*—Section 671 provides that if the grantor of a trust retains any of the rights of beneficial ownership enumerated in sections 673 through 677 with respect to property held in the trust, the grantor will be treated as the “owner” of the trust corpus and the trust will be “ignored” for certain U.S. federal income tax purposes. Accordingly, the grantor is taxed on all items of income of the trust, reduced by any ordinary and necessary deductions. The powers enumerated in sections 673 through 677 that will cause a grantor to be treated as the owner of the trust property are:

- (i) a reversionary interest in the principal or income of the trust, if that interest exceeds 5% of the value of the trust;²
- (ii) a power to control who is to receive beneficial enjoyment of the income or principal of trust;³
- (iii) certain administrative powers; e.g., powers to borrow from the trust, power to control investment decisions of the trust, and power to reacquire trust corpus by substituting property of equivalent value;⁴
- (iv) power to revoke the trust and regain title to trust property;⁵ and
- (v) power to distribute trust's income to grantor.⁶

Grantor trusts are a familiar component of the executive compensation landscape. Beginning in the early 1980s, and prior to further guidance issued by the Service in 1992, certain irrevocable deferred compensation arrangements that permit creditors of the employer access to the assets of the arrangement in the event of the employer's insolvency (so called "rabbi" trusts)⁷ relied on certain of the powers contained in the grantor trust rules to achieve grantor trust tax treatment.⁸ In particular, compensatory arrangements relied upon ensuring that the arrangement comported with the substance of Regulations section 1.677(a)-1(d), which provides that a trust will be treated as a grantor trust if the income of the trust is, or at the discretion of the grantor may be "applied in discharge of a legal obligation of the grantor."⁹ These early rabbi trust rulings also required that the arrangement in fact be subject to the claims of creditors of the employer; a fact dependent in part on federal and state law.¹⁰ Additionally, the Service in these early rulings indicated that because the assets of the employer were made available to creditors of the employer in the event of bankruptcy, the transfer of assets would not be a "transfer" of property to the trust within the meaning of Regulations section 1.83-3.¹¹

2. IRC § 673.

3. IRC § 674.

4. IRC § 675.

5. IRC § 676.

6. IRC § 677.

7. See Rev. Proc. 92-64, 1992-2 C.B. 422.

8. See, e.g., Priv. Ltr. Ruls. 92-06-019 (Nov. 8, 1991), 92-04-046 (Oct. 30, 1991), 91-51-010 (Sept. 18, 1991), 88-44-020 (Aug. 5, 1988), and 88-34-042 (May 27, 1988).

9. Regs. § 1.677(a)-1(d).

10. Priv. Ltr. Ruls. 91-50-043 (Sept. 17, 1991), 89-51-025 (Sept. 22, 1989), and 87-30-041 (Apr. 28, 1987).

11. See sources cited supra note 8.

In 1992, the Service released Revenue Procedure 92-64 which was intended to provide a safe harbor for rabbi trust arrangements. Assuming a trust complies with the revenue procedure's guidelines, the arrangement is assured of grantor trust treatment under the Code. As in the prior private letter rulings described above, Revenue Procedure 92-64 requires that the assets of the trust be available to creditors of the employer in the event of insolvency as a condition for favorable treatment under the safe harbor. The revenue procedure also states that the Service will issue rulings regarding unfunded deferred compensation trusts that do not conform to the requirements contained in the revenue procedure "only in rare and unusual circumstances,"¹² thus leaving open the question of whether deferred compensatory arrangements might otherwise qualify as grantor trusts under the Code outside the scope of the revenue procedure.¹³

2. *U.S. Taxation of Foreign Grantors.*—Assuming an arrangement qualifies for grantor trust treatment, a grantor of a trust, including a grantor of a compensatory rabbi trusts, is treated as the "owner" of the underlying trust assets. Under the grantor trust rules of subpart E of Subchapter J, as "owner" of the trust, the grantor is subject to U.S. federal income tax on all items of income from the trust. Where the grantor is a foreign person, taxation of the foreign grantor comports with the general scheme of taxation of non-U.S. persons. Nonresident aliens and foreign corporations are taxed by sections 871(b) and 882(a) at graduated rates on taxable income "effectively connected with the conduct of a trade or business within the United States." Neither the Code nor the regulations fully define the term "trade or business" and thus the inquiry is often fact specific.¹⁴ Similar principles apply in the case in which the foreign grantor can make use of an income tax treaty with the U.S., in which case the crucial inquiry is whether, under the provisions of the treaty, the foreign grantor is deemed to have a "permanent establishment" in the U.S. and whether the profits derived are "attributable" to this permanent establishment. In the event income of a foreign person is not effectively connected with a U.S. trade or business (or attributable to a U.S. permanent establishment) such income is exempt from U.S. taxation unless it is from U.S. sources and falls within certain classes of income that

12. See source cited supra note 7, at 423.

13. See Priv. Ltr. Rul. 92-35-006 (Dec. 4, 1991), which conferred rabbi trust treatment under the theory of § 675(4) where the grantor could, at any time, substitute assets held by the trust for other assets of equal fair market value. The ruling was later partially revoked. See Priv. Ltr. Rul. 96-09-010 (Nov. 20, 1995).

14. A discussion of whether a particular activity or series of activities rises to the level of a "trade or business" is beyond the scope of this article.

are “fixed or determinable annual or periodical” (FDAP).¹⁵ These instruments typically include annuities, interest payments on debt obligations and dividends on stock which are issued by or are the obligations of U.S. persons.

Consequently, if a foreign grantor of a compensatory trust is not engaged in a U.S. trade or business, its U.S. tax exposure from the income produced by the assets of the trust is limited to the trust’s U.S. source FDAP income. Assuming that the foreign grantor trust holds only *foreign source* property, income on the assets of the trust would escape taxation at the trust level *and* the grantor level. For example, if the foreign trust held only stock of a foreign parent, no tax would inure to the foreign parent grantor.¹⁶

Pursuant to section 404(a)(5), the contributions made to a grantor trust may be deducted at the time the employee is taxed on the contributions. Generally, in the case of rabbi trusts, this is at distribution. Additionally, the earnings of the trust may also be deducted by the employer at the time the employee is taxed on the earnings of the trust’s contributions. Again, this is most generally when there is a “completed transfer” of the contributed property for purposes of section 83 and there is considered to be constructive receipt for purposes of section 451.

B. Section 402(b) “Secular” Trusts

Section 404A of the Code applies to any *electing* U.S. taxpayer with foreign operations that maintains certain deferred compensation plans abroad for the benefit of nonresident alien individuals. Generally speaking, section 404A permits a deduction for contributions to a foreign branch’s plan or arrangement in the year paid, even if the conditions of section 404 (which apply to qualified plans) are not met, and permits in certain cases, reductions in earnings and profits for a foreign subsidiary of a U.S. company. Section 404A, which has had a textured history since its enactment in 1980, involves a highly complex set of rules, most of which are beyond the scope of this article. What is most important is the fact that section 404A arrangements, for various reasons, impose significant constraints in order to realize the benefits of the election.

First, as a condition for electing section 404A treatment for a funded arrangement, 90% or more of the amounts taken into account for any taxable year under the plan must be attributable to services performed by nonresident aliens whose compensation is not subject to U.S. federal income tax. Second,

15. IRC §§ 871(a)(1)(A).

16. This article does not discuss the implication of certain proposed regulations issued under § 1032 associated with the relief of certain U.S. federal income tax issues in the affiliated group environment regarding the so-called zero-basis issue.

deductions are subject to similar limits imposed by the rules applicable to U.S. tax qualified retirement plans. Third, deductions are permitted only if the trust (or the equivalent of a trust) “meets the requirements of Section 401(a)(2).”¹⁷ In many jurisdictions, the concept of a trust does not exist. Creating functional equivalents to a trust can sometimes be problematic under foreign law, since meeting the tests required by proposed regulations issued under section 404A for determining whether an arrangement is a functional equivalent of a trust often turns on foreign legal interpretations not necessarily suited to the task. Moreover, the use of such arrangements may often result in adverse tax consequences to participants under foreign law.

Equally problematic, even in jurisdictions which are home to trusts, is the “exclusive benefit” rule of section 401(a)(2) which mandates that no assets of the trust may be used other than for the “exclusive benefit” of the employee beneficiary. Proposed regulations issued under section 404A indicate that trusts which lend its assets back to the employer would not satisfy this requirement; nor will a reversion of plan assets to the benefit of the employer before the satisfaction of plan liabilities. Additionally, the proposed regulations indicate that one factor in satisfying the exclusive benefit rule is whether the trust has been engaged in any “prohibited transaction” under section 4975(c)(1). A legal regime that is unique to U.S. tax and pension law, these “prohibited transaction” rules are enormously complicated and can easily be violated by a foreign trust. In addition to being unfamiliar with the prohibited transaction regime, most foreign jurisdictions are unfamiliar with even the more general “exclusive benefit” concepts. Indeed, certain conditions which attach to this “exclusive benefit” rule may conflict with the rules in many foreign jurisdictions, for example the United Kingdom. Consequently, many foreign deferred compensatory arrangements may have difficulty satisfying the conditions of section 404A.

A foreign deferred compensation arrangement which does not or cannot rely on a section 404A election may be governed by section 402(b). Section 402(b), however, applies both to domestic and foreign arrangements, including plans of foreign companies that benefit U.S. persons, plans of U.S. subsidiaries of foreign companies as well as those plans of a U.S. company’s foreign operations. In effect, pursuant to sections 402(b)(1) and 83, employer contributions to a secular trust are taxed to the employee at the first time the employee’s rights therein are transferable or nonforfeitable, and the tax is on the value of his interest at that time. To the extent that amounts vest only some time after the related contribution is made, the employee’s inclusion in income is the value of his interest when that vesting event occurs. Upon distribution, benefits are generally taxed in accordance with section 402(b)(2),

17. IRC § 404A(b)(5)(A).

which provides for taxation under the provisions of section 72.¹⁸ Because the trust is treated as a separate entity and is, thus, taxed on earnings during the period of deferral pursuant to section 402(b)(3), under sections 402(b)(2) and 402(b)(3), earnings on employer contributions are taxed to the employee when distributed, even though they were previously taxed to the trust as a separate entity. Thus, section 402(b) arrangements are regimes of double taxation because investment income is first taxed to the trust, and after reduction by that first tax on the trust, is secondarily taxable to the employee upon distribution. In this regard, a grantor trust is often the preferred vehicle in deferred compensatory arrangements since, as described above, the income of the grantor trust is not separately taxable to the trust, and the employer receives a deduction when the benefits are distributed in an amount equal to the value of the distribution at that future time.

Highly compensated employees within the meaning of section 414(q) are treated more severely. Specifically, these employees are taxed each year on the excess of their vested accrued benefit over the "investment in the contract."¹⁹ This means that highly compensated employees are currently taxed on unrealized appreciation and on amounts otherwise not subject to tax, such as tax-exempt bonds. Section 404 provides that the employer is entitled to a deduction of an amount equal to the employer's *contribution* in the taxable year in which an amount attributable to the contribution is includable in the income of the beneficiary of the foreign trust.

Additional requirements are imposed under section 404(a)(5) regarding the employer's deduction. That provision requires that separate accounts for each individual participant must be maintained under the "secular" trust arrangement in order to provide the employer a deduction for its contributions. Pursuant to section 404(a)(5), the contributions may be deducted by the employer at the time the employee is taxed on the contribution. However, only the amount of the original contribution is deductible, not the value of the employee's interest at that time. Pursuant to section 402(b)(3), the trust (not the employer) is taxable as a separate entity (rather than as a grantor trust of the employer) and thus the employer receives no deduction for the earnings of the trust. In line with the statutory provision, Regulations section 1.404(a)-12(b)(1) further provides that an employer's

18. Section 72 provides general rules with respect to the treatment of annuities and certain proceeds of endowment and life insurance contracts, and further details that the employee's exclusion for these purposes is limited to the "investment in the contract." IRC § 72(c). For purposes of determining a participant's "investment in the contract," amounts previously taxed to the recipient under § 402(b) are classified as "premiums or other consideration paid for the contract," and thus are excludable from taxation. See, e.g., Priv. Ltr. Rul. 92-12-024 (Dec. 20, 1991).

19. IRC § 402(b)(4)(A).

deduction for contributions to a nonexempt employee's trust is restricted to the amount of the contribution and excludes any income received by the trust with respect to such contributed amounts.

The boundaries of section 402(b) arrangements have to some remained uncertain. One might think that section 402(b) itself might provide insights, but that section reads in relevant part:

(1) Contributions. Contributions to an employees' trust made by an employer during a taxable year of the employer which ends with or within a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 83 (relating to property transferred in connection with performance of services), except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property for purposes of applying such section.

(2) Distributions. The amount actually distributed or made available to any distributee by any trust described in paragraph (1) shall be taxable to the distributee, in the taxable year in which so distributed or made available, under section 72 (relating to annuities), except that distributions of income of such trust before the annuity starting date (as defined in section 72(c)(4)) shall be included in the gross income of the employee without regard to section 72(e)(5) (relating to amounts not received as annuities).²⁰

A facial reading of the statute does not define, describe or illuminate the scope of section 402(b). For example, is it intended to apply to *all* compensatory arrangements? Is it intended to apply solely to "failed" qualified plans? Are rabbi trusts covered by the language? Do these rules somehow "trump" the grantor trust rules? The statute and the legislative history do not themselves give many clues.

Section 402(b) originally was thought to apply to retirement plans or arrangements which, for one reason or another, failed to satisfy one of the statutory or regulatory discrimination tests to obtain tax qualified status.²¹ This reading appears to comport with the specific reference to "highly compensated" employees under section 402(b), since that term has particular

20. IRC § 402(b).

21. See IRC §§ 410(b), 401(a)(4).

meaning in the context of the qualified plan rules. However, the Service has apparently taken a somewhat expanded view, invoking section 402(b) not only in retirement arrangements which intend to qualify under section 401(a), but which nonetheless fail one of the tests for qualification, but also to other nonretirement deferred or incentive compensation arrangements which are not intended to implicate the nondiscrimination requirements of the Code. Additionally, in what has been an important policy statement in compensatory arrangements, the Service has taken the position in a number of private letter rulings that the rules of sections 402(b) and 404(a)(5) preclude a section 402(b) arrangement from being treated as owned by the employer under the grantor trust rules described above.²² Under section 404(a)(5), an employer's deduction for contributions to a section 402(b) arrangement over the life of the trust arrangement is limited to the amount of the employer's contribution to the trust, and can never include trust income. Application of the grantor trust rules by which the employer would be treated as grantor/owner of the trust would compel that employer to include income of the trust even though section 404(a)(5) bars the employer from ever deducting the trust's income. Furthermore, if the employer were to be treated as the grantor of a section 402(b) arrangement, the fact that the timing under section 404(a)(5) of the employer's deduction of the amount of the contributions matches the timing of the employee's inclusion in income would result in the employer deducting contribution amounts while the employer would still be considered to be the owner of the underlying assets for U.S. federal income tax purposes. Accordingly, the Service has taken the position that:

These tax consequences of a Section 402(b) employees' trust funding deferred compensation are *fundamentally inconsistent* with treatment of the employer as the owner of the trust under subpart E. Therefore, the provisions of subpart E *cannot apply* to treat the employer as the owner of any portion of a section 402(b) employees' trust funding deferred compensation. [Emphasis supplied]²³

While highlighting certain inconsistencies between the two regimes, as discussed in Part III.E, the Service's position is not necessarily the only possible outcome concerning the interaction of section 402(b) arrangements and grantor trusts. In any event, however, establishing that section 402(b) trusts are "fundamentally inconsistent" with the grantor trust rules, however

22. See, e.g., Priv. Ltr. Ruls. 92-12-024 (Dec. 20, 1991); 92-12-019 (Dec. 20, 1991); 92-07-010 (Nov. 12, 1991); 92-06-009 (Nov. 11, 1991). See also Priv. Ltr. Rul. 93-02-017 (Oct. 18, 1992).

23. See *id.*

expansive, does not necessarily demarcate the limits of section 402(b) *vis-à-vis* the grantor trust landscape. Accordingly, because the boundaries which define the section 402(b) set have not been entirely clear, the Service's position in these "fundamentally inconsistent" rulings has staked out only a portion of the scope of section 402(b)'s application.

C. *Situs of the Trust*

1. *Prior Law.*—As described above, the treatment of a person as a resident or nonresident in part determines which regime of taxation in the U.S. the person is subject to. The Code and the regulations also identify specific tax regimes for U.S. and foreign persons that are trusts. Prior to the recent statutory and regulatory changes in law, section 7701(a)(31) defined a foreign trust as "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includable in gross income under subtitle A."²⁴

While one can surmise under this definition that a foreign trust was akin to a nonresident alien individual, the language of the statute, taken by itself, left no bright line guidance. In interpreting this definition, cases and rulings focused on several factors, including looking to the country under whose laws the trust was created, the situs of the trust's corpus as well as the situs of the trust's administration, the nationality and residence of the trustee, and the nationality and residence of the grantor and beneficiaries. It is conceivable that the factors all pointed to one conclusion in a given case. However, where certain factors might have pointed towards a foreign jurisdictional nexus, and others pointed to domestic relationships, the conclusion was less certain, especially since no single factor is determinative under this test of nonresident alien status of the trust:

The Internal Revenue Code does not specify what characteristics must exist before a trust is treated as being comparable to a nonresident alien individual. However, Internal Revenue Service rulings and court cases indicate that this status depends on various factors, such as the residence of the trustee, the location of the trust assets, the country under whose laws the trust is created, the nationality of the grantor and the nationality of the beneficiaries. If an examination of these factors indicates that the trust has

24. Section 7701(a)(31), prior to the amendments effected by the Small Business Job Protection Act.

sufficient foreign contacts, it is deemed comparable to a nonresident alien individual and thus a foreign trust.²⁵

Courts therefore, were forced to rely on a variety of facts and circumstances to conclude whether a trust was considered a domestic or a foreign entity.²⁶ Accordingly, because matters were often so fact specific, certain trust arrangements faced considerable uncertainty in their classification for U.S. tax purposes.

2. *Recent Changes in Law.*—As a result of changes made by the Small Business Job Protection Act of 1996, a trust will be considered to be a U.S. entity only if it meets the definition of a domestic trust contained in section 7701(a)(30)(E). Section 7701(a)(30)(E) provides that a trust is considered to be a domestic trust if (i) a court within the United States is able to exercise primary supervision over the trust's administration and (ii) one or more United States fiduciaries have the ability to control all of the trust's substantial decisions. Section 7701(a)(31)(B) states that a "foreign trust" is any other trust not described in section 7701(a)(30)(E). The Taxpayer Relief Act of 1997 changed the reference to fiduciaries in clause (ii) above, to "persons."

While the statute itself does not directly define what a United States person is for purposes of this rule, the definition contained in section 7701(a)(30) makes most sense.²⁷ Under that provision, a U.S. person is a citizen or resident of the United States, a corporation, partnership or other entity created or organized in or under the laws of the United States or any political subdivision of the United States, an estate the income of which is subject to U.S. federal income taxation regardless of its source or any domestic trust described above, in section 7701(a)(30)(E).

In 1997, the Service issued proposed regulations clarifying when a court may be deemed to exercise primary supervision over the trust's administration for purposes of section 7701(a)(30)(E). In February 1999, the

25. S. Rep. No. 94-938, at 215 (1976), reprinted in 1976 U.S.C.C.A.N. 3439, 3645; H.R. Rep. No. 94-658, at 206 (1975), reprinted in 1976 U.S.C.C.A.N. 2897, 3101. See also Staff of the Joint Committee on Taxation, 94th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1976, p. 218 (1976).

26. See *B. W. Jones Trust v. Commissioner*, 46 B.T.A. 531 (1942), aff'd, 132 F.2d 914 (4th Cir. 1943); *Maximov v. United States*, 373 U.S. 49 (1963); Rev. Rul. 60-181, 1960-1 C.B. 257, modifying I.T. 1885, 23 C.B. II-2; Rev. Rul. 73-521, 1973-2 C.B. 209, superseding O.D. 743, 1920 C.B. 203; Rev. Rul. 70-242, 1970-1 C.B. 89.

27. The legislative history to § 7701 makes this somewhat clear. See H.R. Rep. No. 94-658, supra note 25, at 209, reprinted in 1976 U.S.C.C.A.N. at 3103; S. Rep. No. 94-938, supra note 25, at 218, reprinted in 1976 U.S.C.C.A.N. at 3648. See also, Prop. Regs. § 301.7701-7(d)(1)(i).

Service released final regulations, which are applicable to trusts for tax years ending after February 2, 1999.²⁸ The final regulations mirror the statutory changes by providing that a trust is a United States person if (1) a court within the United States is able to “exercise primary supervision over the administration of the trust”; and (2) one or more United States persons have the “authority to control all substantial decisions of the trust.”²⁹ For these purposes, the term “court” means any federal, state or local court, while the term United States includes the States and the District of Columbia.³⁰ The term “primary supervision” means that a court has or would have the authority over substantially all of the administrative issues associated with the trust.³¹ “[I]s able to exercise” means that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning the administration of the trust.³² “[A]dministration of the trust” means the carrying out of the duties imposed on a fiduciary by the terms of the trust instrument and applicable law, including maintaining the books and

28. See Regs. § 301.7701-7. The final regulations are also applicable to those trusts whose trustees elected to apply §§ 7701(a)(30) and 7701(a)(31) of the Code for taxable years ending after August 20, 1996. The Taxpayer Relief Act of 1997 gave the Treasury Department authority to establish a transitional relief rule pursuant to which certain trusts in existence prior to August 20, 1996, could elect to continue to be classified as a domestic trust under the rules in effect prior to the Small Business Job Protection Act. This relief has been granted provided that the trustee (1) filed an IRS Form 1041 and (2) had a reasonable basis that the trust was a domestic entity. This relief does not apply, however, to grantor trusts unless they were partially owned. Regs. § 301.7701-7(f). Trusts created after August 19, 1996, and before April 3, 1999, if satisfying the “control test” under the proposed regulations but not satisfying the “control test” under the final regulations (discussed in greater detail below in the text), may be modified by December 31, 1999, in order to meet the final regulations’ control test. If this modification is completed by December 31, 1999, the trust will be treated as satisfying the control test of the final regulations for taxable years beginning after August 20, 1996, (and for taxable years thereafter if an election under the Small Business Job Protection Act is made). Regs. § 301.7701-7(e)(2).

In the final regulations, the Service explicitly refused to grant additional grandfather treatment for pre-existing foreign trusts. One commentator had expressed concern that some trusts believed to be foreign trusts may in fact have been domestic trusts under prior law. If such trusts qualify as foreign trusts under new law, they will be considered to have changed their classification from domestic to foreign trusts on January 1, 1997, and may be subject to tax for a deemed transfer to a foreign trust under § 1491 (in effect prior to repeal in 1997), and subject to penalties for failure to report the transfer under § 6677. When the situs of the trust changes from domestic to foreign, the trust is treated as having made an “outbound” transfer of its assets on the date of the election, with the possibility of an excise tax under § 1491.

29. Regs. § 301.7701-7(a)(i), (ii).

30. Regs. § 301.7701-7(c)(3)(i), (ii).

31. Regs. § 301.7701-7(c)(3)(iv).

32. Regs. § 301.7701-7(c)(3)(iii).

records of the trust, filing tax returns, defending the trust from suits by creditors and determining the amount and timing of distributions.³³

Regulations section 301.7701-7(c)(1) provides a safe harbor in that a trust satisfies the “court test” above if (1) the trust instrument does not direct that the trust be administered outside the United States, (2) the trust is in fact administered exclusively in the United States and (3) the trust is not subject to an automatic migration provision. With respect to (1), above, an example in the final regulations provides that if a trust is in fact administered exclusively in the United States, it is not necessary that the trust instrument actually direct that the trust be administered in the United States. Additionally, with respect to (3), above, the proposed regulations had made clear that a court within the United States would not be considered to have primary supervision over the administration of the trust if the trust instrument provided that a United States court’s attempts to assert jurisdiction or otherwise supervise the trust directly or indirectly would cause the trust to migrate from the United States. The final regulations have clarified that this “automatic” migration provision does not apply, however, if the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States.³⁴

The proposed regulations had provided a more general safe harbor. Under that safe harbor, a trust was a domestic trust if, pursuant to the terms of the trust instrument, the trust had only United States fiduciaries which administered the trust exclusively in the United States and the trust was not subject to automatic migration provisions. In response to comments that underscored the proposed regulations’ potential bias in favor of foreign trust treatment, the preamble to the final regulations clarified the Service’s desire that this safe harbor should not be limited to trusts with only United States fiduciaries. Additionally, since the safe harbor was meant to address the complexities of whether a court of a particular state would assert primary supervision over the administration of a trust if the trust had never appeared before a court, the safe harbor in the final regulations is provided only in the context of the court test. A trust that satisfies this safe harbor, therefore, would still need to comply with the “control test.”

In addition to this “court test” safe harbor, the regulations also provide four examples, which are not intended to be exclusive, under which a court will be deemed to exercise primary supervision over the

33. Regs. § 301.7701-7(c)(3)(v).

34. Regs. § 301.7701-7(c)(4)(ii). Commentators had argued that an automatic migration clause should not cause a trust to be treated as a foreign trust if migration was triggered only by events that are not particular to a given trust arrangement, such as a foreign invasion.

administration of the trust: the trust is registered in a United States court pursuant to a state statute that has provisions substantially similar to the Uniform Probate Code, the trust is a testamentary trust and all fiduciaries have been qualified as trustees by a United States court, the trust is an *inter vivos* trust and the fiduciaries or beneficiaries take steps with a court within the United States that cause the administration of the trust to be subject to the primary supervision of the court, or a United States court and a foreign court are both able to exercise primary supervision over the administration of the trust.

The final regulations also speak to when the “control” branch of the statutory test will be deemed to be satisfied. “Control” for these purposes means having the power, by vote, or otherwise to make all of the substantial decisions of the trust, with no other person having the power to veto those substantial decisions.³⁵ “Substantial decisions” for these purposes refers to those decisions that persons are authorized or required to make under the terms of the trust instrument and applicable law which are not purely ministerial.³⁶ For example, substantial decisions include, but are not limited to, (1) whether and when to distribute income or corpus, (2) the amount of any distributions, (3) the selection of a beneficiary, (4) whether to terminate the trust, (5) whether a receipt is allocable to income or principal, (6) whether to arbitrate, compromise or abandon claims of the trust, (7) whether to remove add or replace a trustee, (8) whether to sue on behalf of the trust or defend suits against the trust, or (9) whether to appoint a successor trustee. The final regulations also clarify that if a United States person hires an investment advisor for the trust, the investment decisions made by the advisor will be considered “substantial decisions” controlled by the United States person if the United States person can terminate the investment advisor’s power to make investment decisions at will.³⁷

The proposed regulations had provided that substantial decisions did not include decisions exercisable by a grantor or a beneficiary (unless the beneficiary or grantor is acting as a fiduciary), that affected solely the portion of the trust in which the beneficiary has an interest.³⁸ The proposed regulations had provided the rule because the Code, prior to amendment by the Taxpayer Relief Act of 1997, stipulated that United States *fiduciaries* must control all substantial decisions of a domestic trust. The proposed regulations, therefore, ignored decision making powers held by nonfiduciaries. The Taxpayer Relief Act of 1997, however, substituted “persons” for “fiduciaries” in the control test. In light of the change in the statute,

35. Regs. § 301.7701-7(d)(1)(iii).

36. Regs. § 301.7701-7(d)(1)(ii).

37. Regs. § 301.7701-7(d)(1)(ii)(J).

38. Prop. Regs. § 301.7701-7(e)(1)(ii)(B).

commentators pointed out that there was no statutory basis for ignoring the powers held by grantors and beneficiaries for purposes of the "control" test. Accordingly, the final regulations change the rule contained in the proposed regulations and, for purposes of the control test, count all powers held by grantors and powers held by beneficiaries including those that affect solely the portion of the trust in which the beneficiary has an interest. Thus, all persons with any power over substantial decisions of the trust whether acting in a fiduciary capacity or not must be counted for purposes of the control test. The final regulations also provide that a trust is deemed to satisfy the control test if United States persons control all substantial decisions by a majority vote.

Under the proposed regulations, excluding grantors (and beneficiaries) from the control test would have allowed certain individual retirement accounts (IRAs) and other tax exempt trusts to continue to be treated as domestic trusts (and thus maintain their tax exempt status), even if the grantor or beneficiary were a foreign person. Because the Treasury Department and the Service view the Taxpayer Relief Act changes to the definition of a foreign trust as not affecting the tax exempt status of IRAs and other trusts where their tax-exempt status depends on their being classified as U.S. trusts, the final regulations provide a special rule pursuant to which these trusts will satisfy the control test as long as United States fiduciaries control all of the substantial decisions of the trust made by trust fiduciaries. This special rule reaches the same general result as was provided under the proposed regulations.³⁹

The final regulations make clear that United States persons are not considered to control all substantial decisions of the trust if an attempt by any governmental agency or creditor to collect information from or assert a claim against the trust would cause one or more substantial decisions of the trust to no longer be controlled by United States persons.

There may still continue to be some residual uncertainty over the treatment of trusts under these new tests. However, these changes in law generally help to create some greater sense of clarity in the evaluative process and also remove much of the facts and circumstances nature that pervaded the law prior to the revisions.

3. Reporting Requirements.—The recent statutory and regulatory changes have produced additional consequences concerning trust classification in the form of reporting requirements. Although a detailed discussion of these

39. An additional rule permits 12 months to correct an inadvertent change in fiduciary that might cause a change in residency for the trust. This is an extension of the 6-month period provided by the proposed regulation. Regs. § 301.7701-7(d)(2).

rules and the intricacies of their recent development is beyond the scope of this article, several points are briefly worth mentioning. First, under section 6048(c), as amended by the Small Business Job Protection Act, any U.S. person receiving distributions from a foreign trust must file a return with the Service identifying the trust, distributions received from the trust and other information prescribed by the Treasury Department. In addition, amended section 6048(a) requires that the creation of a foreign trust by a U.S. person and transfers of money or property other than for fair market value (either directly or indirectly) to a foreign trust (excluding, however, in either case, section 402(b) arrangements) by a U.S. person be reported. Moreover, U.S. persons who are treated as grantors over a foreign trust are charged with the responsibility of filing appropriate returns for the trust and with furnishing certain information to each U.S. grantor and beneficiary who receives a distribution from the trust. Under section 6048(b), unless the trustee of a foreign trust owned by a U.S. grantor designates a U.S. agent for service of process upon the trustee, the amount of income taxable to the U.S. grantor with respect to the trust may be determined by the Service, subject only to judicial review under an "arbitrary and capricious" standard.

Under section 6677, a U.S. person receiving a distribution from a foreign trust who fails to file the appropriate reports with the Service may be subject to a 35% penalty on the gross amount of the distribution. Similarly, a 35% penalty may be imposed on the gross amount of the value of the property transferred to the foreign trust, if the applicable reporting requirements are not satisfied. A 5% penalty is imposed with respect to the trust's year end assets deemed to be owned by a U.S. grantor if the trustee fails to file an appropriate return on behalf of a foreign trust. These violations may also be subject to additional penalties including \$10,000 for each uncorrected 30 day period following the 90 day period after which a notice of noncompliance is issued by the Service.

III. "INBOUND" GRANTOR TRUST RULES

A. *Prior Law*

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

would then earn income which could be allocated to the foreign owner. A distribution of income from the trust to the U.S. beneficiary was treated as a gift to the beneficiary and was not subject to U.S. federal income tax.⁴⁰ Thus, if the income of the trust was not taxable to the foreign grantor under section 871 and was also not taxable to either the grantor or the trust by the grantor's home jurisdiction, the income of the trust was never subject to taxation.

B. *Statutory and Regulatory Changes to Section 672(f)*

The Small Business Job Protection Act amended Code section 672(f) to ensure that U.S. persons who benefit from offshore trusts created by foreign persons pay an appropriate amount of U.S. federal income tax. Generally, the grantor trust rules now treat a person as the owner of a trust *only* to the extent the application of the grantor trust rules result, directly or indirectly, in an amount being currently taken into account in computing the income of a U.S. citizen or resident. In other words, to the extent that the grantor trust rules would result in income being taken into account by foreign persons, section 672(f) now prevents the grantor trust rules from applying. Section 672(f) now provides:

- (f) Subpart not to result in foreign ownership.
 - (1) In general. Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.
 - (2) Exceptions.
 - (A) Certain revocable and irrevocable trusts. Paragraph (1) shall not apply to any portion of a trust if -
 - (i) the power to revest absolutely in the grantor title to the trust property to which such portion is attributable is exercisable solely by the grantor without the approval or consent of any other person or with the consent

40. See Rev. Rul. 69-70; 1969-1 C.B. 182.

of a related or subordinate party who is subservient to the grantor, or (ii) the only amounts distributable from such portion (whether income or corpus) during the lifetime of the grantor are amounts distributable to the grantor or the spouse of the grantor.

(B) Compensatory trusts. Except as provided in regulations, paragraph (1) shall not apply to any portion of a trust distributions from which are taxable as compensation for services rendered.

(3) Special Rules. Except as otherwise provided in regulations prescribed by the Secretary –

(A) a controlled foreign corporation (as defined in Section 957) shall be treated as a domestic corporation for purposes of paragraph (1), and

(B) paragraph (1) shall not apply for purposes of applying Section 1297.⁴¹

On June 5, 1997, the Service issued proposed regulations under section 672(f). On August 5, 1999, the Service then released final regulations under section 672(f). The final regulations are effective for taxable years of a trust beginning after August 10, 1999. The proposed regulations⁴² described a two step analysis for implementing this principle. First, the grantor trust rules were applied to determine the “worldwide amount”⁴³ (i.e., the worldwide amount of trust income of all beneficiaries of the trust) and the “U.S. amount” (i.e., the amount of trust income being currently taken into account under the same rules by U.S. taxpayers).⁴⁴ Then the trust was treated as partially or wholly owned by a foreign person based on an annual

41. IRC § 672(f).

42. Prop. Regs. § 1.672(f)-1.

43. The proposed regulations define the “worldwide amount” as the net amount of income, gains, deductions and losses that would be taken into account for the current taxable year under the basic grantor trust rules in computing worldwide taxable income of any person, regardless of whether they are or are not a U.S. person.

44. The “U.S. amount” is defined as the net amount of income, gains, deductions and losses that would be taken into account for the current year under the basic grantor trust rules in computing the taxable income of a U.S. taxpayer. The U.S. amount also includes such amounts as interest from tax-exempt obligations which are ordinarily excluded from gross income.

year-end comparison of the worldwide amount and the U.S. amount. If the worldwide amount and the U.S. amount were the same, the basic grantor trust rules would continue to apply without the limitation of section 672(f). If the worldwide amount was greater than the U.S. amount, the proposed regulations under section 672(f) prevented the basic grantor trust rules from treating a person as the owner of that portion of the trust attributable to the excess of the worldwide income. In essence, to the extent that the basic grantor trust rules resulted in income being created which was not currently taxed to a U.S. taxpayer, the proposed rules would not apply to cause a foreign person to be viewed as the owner of the trust.

Under the proposed section 672 rules, and in particular, Proposed Regulations section 1.672(f)-2(a), a controlled foreign corporation (CFC) that created and funded a foreign trust was treated as a domestic corporation only to the extent that, if the basic grantor trust rules were applied, income earned by the trust would be Subpart F income to the trust for the taxable year to which the income relates and would be currently taken into account in computing the gross income of a U.S. citizen or resident or a domestic corporation. The proposed regulations made clear, therefore, that the CFC would not be treated as a domestic corporation for these purposes to the extent the income of the trust would not be considered Subpart F income, or to the extent it would be considered Subpart F income but would not currently increase a U.S. person's adjusted gross income. The proposed regulations also contained similar provisions for passive foreign investment companies (PFICs) and foreign personal holding companies. The proposed regulations in this regard also made it clear that for purposes of determining whether or not a given foreign entity is a PFIC, the grantor trust rules were to be applied as if section 672(f) had not come into effect. As a result, applying the proposed rules under section 672(f), a foreign corporation would not be able to avoid PFIC status merely by transferring its passive assets to a trust that would otherwise have been treated as a non-grantor trust.

Commentators had suggested that the two step analysis comparing the "worldwide amount" and the "U.S. amount" was unnecessarily complex. In response to these concerns, the final regulations now provide that the grantor trust rules of sections 671 through 677 and 679 other than section 672(f) must be applied first to determine whether, under these rules, a foreign person would be treated as owner of the trust. If under this analysis, a foreign person would be treated as an owner, the foreign person will be treated as a grantor *only* if the person is a CFC, PFIC or a foreign personal holding company. The final regulations, therefore, abandon the proposed regulations' condition that a CFC may only be treated as a domestic entity, and thus a grantor, to the extent that the trust income was Subpart F income currently taken into account in computing the gross income of a U.S. person. Consequently, a CFC, PFIC or foreign personal holding company will now generally be

treated as a grantor of a trust if it would be so treated under sections 673 through 677 and 679, regardless of the application of section 672(f).

While these recent statutory and regulatory changes are generally intended to apply to all trusts with foreign grantors, section 672(f)(2)(B) also provides that the special rules of section 672(f)(1) do *not* apply to certain revocable trusts as well as to “any portion of a trust distributions from which are taxable as compensation for services rendered.” Section 672(f)(2)(B)’s literal language, however, is ambiguous. Indeed, there was some debate among practitioners as to whether the statutory exception applied merely to rabbi trusts, or, jointly or alternatively, section 402(b) arrangements particularly given the Service’s position in prior rulings that grantor trusts and section 402(b) trusts are “fundamentally inconsistent” and, thus, should be taxed in different ways. Because of the statutory language that appears to concentrate on the fact that the compensation is taxable upon “distribution,” it would seem that rabbi trusts should be included within the statutory definition. However, it is unclear whether section 402(b) arrangements were also intended to be included. Even though a beneficiary of a section 402(b) arrangement is taxed when his rights in the trust property become transferable, there are also provisions for tax upon the distribution of that property in accordance with section 72.

While the Small Business Job Protection Act did not itself address the question, the proposed regulations issued in 1997, and the final regulations provide greater clarity. The proposed regulations (and their preamble) made clear, and the final regulations now make clear that *both* rabbi trust arrangements with foreign grantors and most secular trusts with foreign grantors are included within the statutory exception. In particular, Proposed Regulations section 1.672(f)-3(c)(2) defined a “compensatory trust” for purposes of section 672(f) not only as “[a] nonexempt employees’ trust described in section 402(b) (see Sections 1.671-1(g) and (h))” but also as “[a] trust that would be a nonexempt employees’ trust described in section 402(b) but for the fact that the trust’s assets are not set aside from the claims of creditors of the actual or deemed transferor” under section 1.83-3(e). The Service has clarified in the final regulations that such excluded compensatory arrangements include those plans that are created on behalf of self-employed individuals. Consequently, final Regulations section 1.672(f)-3(c) provides that the general rules of section 672(f) do not apply to (1) a nonexempt employees’ trust described in section 402(b), including a trust created on behalf of a self-employed individual; and (2) a trust, including a trust created on behalf of a self-employed individual, that would be a nonexempt employees’ trust described in section 402(b) but for the fact that the trust’s assets are not set aside from the claims of creditors of the actual or deemed transferor within the meaning of section 1.83-3. Consequently, under the final regulatory provision, foreign compensatory trusts are *not* generally subject to

section 672(f), and thus, ignoring any other provision of the regulations, foreign grantors will continue to be taxed as “owners” of the trust consistent with sections 671 through 677. In the case of foreign rabbi trusts, therefore, because the grantor presumably retains a power described under section 677, the foreign owner would be subject to tax on all items of income of the trust, depending again, for U.S. tax purposes, on the activity of the foreign owner and the source of the income. It is noteworthy, however, that the proposed regulations and the preamble to both the proposed and final regulations specifically make reference to Proposed Regulations sections 1.671-1(g) & (h) in the context of section 402(b) arrangements. These provisions are discussed in greater detail below.

C. Turning Foreign Section 402(b) Trusts into Grantor Trusts: The “Overfunded” Tests

1. *Requirements for Foreign Section 402(b) Non-Grantor Trust Treatment.*—Under proposed regulations issued under section 671 on September 27, 1996, certain foreign secular section 402(b) trusts are subject to additional rules. Assuming these proposed regulations are enacted in their currently proposed form, they will be effective with respect to taxable years ending after September 27, 1996. Proposed regulations section 1.671-1(h) states in relevant part:

[e]xcept as provided under section 679 or as provided under this paragraph (h)(1), an employer is not treated as an owner of any portion of a foreign employee’s trust (as defined in paragraph (h)(2) of this section) regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust.

Proposed Regulations section 1.671-1(h)(2) defines a “foreign employees’ trust” for these purposes as a nonexempt employees’ trust described in section 402(b) that is part of a deferred compensation plan and that is a foreign trust within the meaning of section 7701(a)(31). Thus, at first glance, the proposed regulations generally restate the Service’s long-standing position that section 402(b) deferred compensatory arrangements are “fundamentally inconsistent” with the grantor trust rules. This seemingly simplistic synopsis, however, may require additional elaboration. In particular, in order to secure such treatment, the proposed regulations require meeting five conditions.

First, the arrangement must be a trust. Most deferred compensation arrangements that intend to make use of trusts actually meet the formal requirements of using a trust. Pursuant to Regulations section 301.7701-4, however, certain arrangements that do not vest trustees with the responsibility

of protecting the trust's property on behalf of designated beneficiaries and which are more in the nature of associations or for-profit joint enterprises will not be considered trusts. Accordingly, such arrangements would not be considered to qualify under the proposed regulations. Nor, however, would they be likely to qualify as grantor trusts under Subpart E of Subchapter J of the Code.

Second, the arrangement must constitute a *foreign* trust. As discussed above, the new regulations clarify the classification of a trust either as domestic or foreign. A trust will be considered to be a U.S. entity only if it does not meet the definition of a domestic trust contained in section 7701(a)(30)(E). Section 7701(a)(30)(E) treats a trust as domestic if (1) a court within the United States is able to exercise primary supervision over the trust's administration and (2) one or more United States persons have the ability to control all of the trust's substantial decisions. This definition is discussed in greater detail in Part II.C.2.

Third, the trust must be part of a "deferred compensation plan." Trusts that are not considered deferred compensatory arrangements would technically not meet this definition. Presumably, this would exclude arrangements involving deferred benefits under section 404(b)(2). The proposed regulation does not provide further elaboration of the meaning of "deferred compensation."

Fourth, the trust must be a trust described in section 402(b). While this generally means that contributions to the trust must be considered to be transfers of property to participants within the meaning of Regulations section 1.83-3(e), as discussed above, the boundaries of section 402(b) remain unclear.

Finally, the fifth condition for non-grantor trust status is that the arrangement must not fall within any alternative treatment described in either section 679 or any other provision of Proposed Regulations section 1.671-1(h). It is this "exception" to the general rule that deserves greater discussion immediately below.

2. The "Exception" to the General Rule: Section 402(b) Overfunded "Grantor" Trusts.—As discussed above, in keeping with the "fundamentally inconsistent" standard, the general rule of Proposed Regulations section 1.671-1(h) is that no section 402(b) foreign trust is treated as a grantor trust. However, this general rule is subject to any alternative treatment in either section 679 or Proposed Regulations section 1.671-1(h). Despite the broadly stated general rule, under Proposed Regulations section 1.671-1(h)(2) and (h)(3), grantor trust status *is* imposed on certain section 402(b) arrangements involving CFCs and certain U.S.-related foreign partnerships with respect to a specified overfunded "fractional interest" of the trust as well as certain other

non-U.S. employers intending to avoid the PFIC rules.⁴⁵ This imputation of income is also applicable to section 404A arrangements. The potential policy considerations associated with each such entity is now briefly described below. The discussion of overfunded “fractional interests” then follows.

a. *Controlled Foreign Corporations.*—Under the proposed regulations, CFCs that maintain deferred compensation arrangements funded through a foreign employees’ trust are subject to the “fractional interest” rules described below. A CFC is a foreign corporation 50% or more of whose stock is owned by U.S. shareholders, each of which owning at least 10% of such stock.⁴⁶ Generally, certain U.S. shareholders of CFCs are currently taxed pro rata on their share of the CFC’s Subpart F income and income described in section 956. Subpart F income generally includes dividends, interest, income equivalent to interest, rents, royalties and annuities. The Service was apparently concerned that the CFC might be able to transfer Subpart F income to a funded foreign employees’ trust, since, without giving effect to rules like the ones contained in the proposed regulations, the income could escape taxation under Subpart F and under the other grantor trust rules. For example, the CFC could transfer Subpart F-type items to a foreign employees’ trust that is already sufficiently funded in order to protect its U.S. shareholders from the pro rata taxation that would otherwise be imposed.

b. *Passive Foreign Investment Companies.*—Under general U.S. tax principles, the anti-deferral regimes in sections 1291 through 1297 impose accelerated taxation on the income of certain foreign entities. The proposed regulations also apply the fractional amount anti-abuse rules for these non-CFC employer entities. The proposed regulations, however, make clear that these rules only apply in the case of PFICs where one of the principal motives of transferring assets to the trust is to avoid application of the PFIC rules.⁴⁷ Under Proposed Regulations section 1.1297-4, whether a principal purpose for the transfer is to reduce or eliminate tax under section 1291 or 1293 or is to avoid classification as a PFIC is determined on the basis of all the facts and circumstances, including whether the amount of assets held by the trust is reasonably related to the plan’s anticipated liabilities, taking into account any local law and practice relating to proper funding levels.⁴⁸

45. The Explanation of Provisions section of the proposed regulations implementing § 672(f) states that § 402(b) trusts will be treated as grantor trusts “only to the extent provided in proposed regulations § 1.671-1(g) and § 1.671-1(h).” 62 Fed. Reg. 30785, 30788 (1997).

46. IRC §§ 957(a), 951(b).

47. Prop. Regs. § 1.1297-4(a)(1).

48. Prop. Regs. § 1.1297-4(a)(2).

In general, a U.S. person that owns stock in a foreign company pays no income tax on the income earned by that company. However, in the case of PFICs, sections 1291 through 1297 provide that a U.S. person who is a direct or indirect shareholder of a PFIC is subject to a special tax regime upon either disposition of the PFIC's stock or the receipt of certain distributions. The PFIC rules were added by Congress in 1986 with the specific intention of targeting foreign mutual funds that avoided other anti-deferral rules through dispersal of, and limitations on, stock ownership by U.S. persons. Congress accordingly defined a "PFIC" as a foreign corporation where (1) 75% or more of its gross income for the taxable year is passive income, or (2) at least 50% of the value of its assets produce passive income or are held for that purpose. "Passive income" is generally defined as dividends, interest, income equivalent to interest, rents, royalties, and annuities.

If a foreign corporation is a PFIC, an interest charge is generally imposed on distributions from the PFIC to a U.S. person or upon a disposition of the PFIC's stock by a U.S. person regardless of that person's level of ownership. The interest charge is imposed on the distributed earnings that had the benefit of U.S. tax deferral. While a U.S. shareholder can avoid the charge by causing the entity to elect "qualified electing fund" status to include his pro rata share of includable PFIC income in the year in which the PFIC earns it, or, in certain cases by electing to "mark to market" the shares it owns in the PFIC,⁴⁹ the Service has expressed the concern that the PFIC may transfer passive income-producing assets to a foreign employees' trust, thereby either (1) divesting itself of a sufficient quantity of passive income to cease qualifying as a PFIC, or (2) minimizing the income a U.S. shareholder would need to declare where the U.S. shareholder made the previously-described income inclusion election. If the principal purpose of an asset transfer is to avoid classification as a PFIC or to reduce or eliminate taxation under sections 1291 or 1293, the grantor trust rules will apply to the fixed dollar amount in the trust that is equal to the fair market value of the property transferred to avoid such classification or to reduce or eliminate such taxes.

49. IRC § 1296. A U.S. shareholder of a PFIC may make a mark-to-market election with respect to the stock of the PFIC if such stock is regularly traded either on a national securities exchange registered with the Securities and Exchange Commission, the national market system established under § 11A of the Securities Exchange Act of 1934 or an exchange or market that the Service determines has rules sufficient to ensure that the market price represents a sound valuation. Under the election, any excess of the fair market value of the PFIC stock measured at the close of the tax year over the shareholder's adjusted basis in the PFIC stock is included in the income of the shareholder and, under certain circumstances, any excess of basis over fair market value is allowed as a deduction. See IRC § 1296.

c. *Foreign Partnerships.*—In addition to plans maintained by CFCs and plans maintained by PFICs, the proposed regulations stipulate that plans maintained by certain U.S.-related foreign partnership employers are also subject to the fractional amount rules. For these purposes, a U.S.-related foreign partnership is a foreign partnership in which a U.S. person or a CFC owns a partnership interest either directly or indirectly through one or more partnerships.

Under Subchapter K, a U.S. partner must include on his tax return his distributive share of the partnership's gain, loss, deduction or credit, whether the partnership is foreign or domestic.⁵⁰ Thus, a U.S. partner of a foreign partnership is subject to tax on its distributive share of the foreign partnership's gain, loss, deduction or credit. The Service has apparently been concerned that a foreign partnership could overfund a foreign employees' trust it maintains while retaining control over the excess assets. To the extent the foreign partnership is not viewed as the trust grantor, it would not have to include in its taxable income the items attributable to the excess assets, thereby precluding U.S. taxation of those amounts with respect to any related U.S. partners. In this respect, the preamble to the proposed regulations state:

If the grantor trust rules do not apply to any portion of a foreign employees' trust, a foreign partnership could fund a foreign employees' trust in excess of the amount needed to meet its obligations . . . and yet retain control over the excess amount. As a result, the foreign partnership would not have to include items in taxable income attributable to the excess amount, and consequently the U.S. partner or CFC would not have to include those items in its income.⁵¹

3. *Policy Considerations.*—As stated above, the underlying policy reason, apparently, for the exceptions in Proposed Regulations section 1.671-1 is the Service's broader concern that an employer will purposely overfund foreign employees' trusts (1) in the case of certain foreign partnerships, in order to avoid its distributive share of certain income (2) in the case of CFCs, in order to navigate past the anti-deferral rules of Subpart F and (3) in the case of certain other passive investment entities, in order to bypass the rules applicable to PFICs. Generally speaking, to the extent an employer/grantor (or its U.S. affiliate) is no longer to be taxed under sections 671 through 679 as the grantor with respect to the income on the assets of foreign employees'

50. Provided the entity is treated as a partnership for U.S. federal income tax purposes under § 7701(a)(2).

51. 61 Fed. Reg. 50778, 50780 (1996).

trusts, it potentially can defer tax on income simply by overfunding such a trust located in a jurisdiction with a lower or no tax. At some point, the sheltered income could be repatriated without adverse tax consequences.

At the outset, it is interesting to note that the imposition of grantor trust treatment in these cases appears to mark a departure from the Service's "fundamentally inconsistent" position. In this respect, it is interesting that the preamble released with these proposed regulations restates the established position, at least in the domestic context, without regard to the exceptions that are apparently being made to the general rule:

The rule in the proposed regulations is consistent with the holdings of a number of private letter rulings with respect to nonexempt employee's trusts and with the Service's treatment of trusts that no longer qualify as exempt under 501(a) (because they are no longer described in section 401(a)) as separate taxable trusts rather than as grantor trusts.⁵²

Having asserted that the proposed regulations in fact are consistent with this "fundamentally inconsistent" standard the preamble then later curiously states:

Under these proposed regulations, the grantor trust rules of subpart E do not apply to a foreign employees' trust with respect to a foreign employer *other than* a CFC or a U.S.-related foreign partnership, except for cases in which assets are transferred to a foreign employees' trust with a principal purpose of avoiding the PFIC rules.⁵³

Apparently, some within the Service advocated limiting the scope of the firewall between section 402(b) and grantor trusts to purely domestic situations.⁵⁴ However, the statement in the preamble quoted above does not appear to indicate the recognition of any such internal tension, if indeed it exists.

A broader point can be raised, however, when one considers the fact that section 671 itself does not apply to grantors unless they are otherwise treated as owners under the other grantor trust rules. Regulations section 1.671-1(a) makes this point by stating that sections 673 through 677 define

52. Id. at 50781 (citation omitted); see also Priv. Ltr. Ruls. 92-12-024 (Dec. 20, 1991); 92-07-010 (Nov. 12, 1991); 92-06-009 (Nov. 11, 1991).

53. 61 Fed. Reg. 50778, 50781 (1996) (emphasis added).

54. See William L. Sollee, *Overfunded Portion of Foreign Employees' Trust Treated as Grantor Trust*, 86 J. Tax'n 134, n.5 (1997).

the circumstances under which income of a trust is taxed to a grantor. Other than sections 679 and 672(f), no other grantor trust provision explicitly provides for foreign grantor trust compensatory arrangements. Moreover, as described in Part IV, section 679 does not apply to foreign section 402(b) arrangements. Additionally, section 672(f)(2)(B), (and Regulations section 1.672(f)-3(c)), as described above, appears to suggest that the grantor trust rules of section 671 through 677 continue to apply to foreign compensatory arrangements notwithstanding the general anti-foreign grantor rule now contained in section 672(f). Thus, for example, the exception for compensatory trusts in section 672(f) should permit foreign grantors of rabbi trusts to be treated as owners, since, presumably, per Revenue Procedure 92-64, they retain a power under section 677. However, the Service appears to have been motivated in the section 672(f) context more by the earlier released Proposed Regulations section 1.671-1 than any other statutory provision when it noted “[t]he IRS and Treasury contemplate that the [i.e., Section 402(b) trusts] nonexempt employees’ trusts . . . will be treated as grantor trusts *only* to the extent provided in proposed regulations § 1.671-1(g) and § 1.671-1(h).”⁵⁵

Potentially noteworthy also is the fact that the beginning of the preamble to Proposed Regulations section 1.671-1 appears to suggest that existing confusion from proposed regulations issued under section 404A was the underlying rationale for promulgation of Proposed Regulations section 1.671-1; the beginning of the preamble makes no reference of a need to clarify sections 673 through 677. That confusion resulted from certain 1993 proposed regulations which some commentators viewed as implying that grantor trust status is automatically accorded to foreign deferred compensatory trusts that do not or cannot elect section 404A status. Such a conclusion, if true, might not only implicate the “fundamentally inconsistent” standard but would, on a more practical level, result in a loss of reduction in earnings and profits for contributions *and* an increase in earnings resulting from the trust assets. While the proposed regulations and their preamble may serve to clarify that arrangements which fail to qualify as section 404A arrangements do not necessarily implicate the grantor trust rules, some have questioned whether any application of the grantor trust rules to section 404A arrangements (i.e., the overfunding rules) is appropriate. In any event, if the need to clarify existing uncertainty under section 404A is the primary motive behind the issuance of the proposed regulations, an argument could be made that applying the grantor trust rules to overfunded portions of compensatory arrangements may be in conflict with existing statutory law.

55. 62 Fed. Reg. 30785, 30788 (1997).

However, there may be evidence to the contrary in that the language of the proposed regulations may be meant to impose grantor status in such overfunded contexts only where the CFC, PFIC or foreign partnership otherwise maintains a power described in sections 673 through 677. Indeed, the preamble suggests “[s]uch an employer is treated as the owner of a portion of a foreign employees’ trust under these proposed regulations only if the employer retains a grantor trust power or interest over a foreign employees’ trust *and* has a specified ‘fractional interest’ in the trust.”⁵⁶ Moreover, Proposed Regulations section 1.1297-4 in the PFIC anti-abuse context states:

*If the foreign employer has a power or interest described in sections 673 through 677 over the trust, then the grantor trust rules of subpart E . . . will apply . . . to a fixed dollar amount in the trust that is equal to the fair market value of the property that is transferred for the purpose of avoiding classification as a passive foreign investment company.*⁵⁷

This language, however, is not directly incorporated in the CFC and foreign partnership overfunding provisions of Proposed Regulations section 1.671-1(h). Additionally, Proposed Regulations section 1.671-1(h)(8), examples 1 and 2, appear to conclude grantor trust status on a CFC by virtue of the existence of a “relevant amount,” without any mention of the existence of any other grantor power under sections 673 through 677. Without referring to the PFIC anti-abuse provisions, the preamble to those proposed regulations also later suggests “[t]he proposed regulations *provide Subpart E rules* for foreign employees’ trusts of CFCs . . . [and] foreign partnerships . . . that apply *for all federal income tax purposes.*”⁵⁸

As a practical matter, the exceptions to the general rule contained in Proposed Regulations section 1.671-1(h) are potentially expansive in their scope because arrangements of purely foreign entities which employ mostly foreign persons may now be subject to U.S. taxation even though the *only* nexus that the foreign entities have with the United States is through their affiliation with a U.S. entity. Because this affiliation may have nothing to do with the scope of an employee’s services or the locale in which they are performed for the foreign entity, this overfunding exception may be possibly regarded as overreaching. Some commentators have raised particular issues that the proposed regulations unfairly extend the reach of the U.S. taxing

56. 61 Fed. Reg. 50778, 50781 (1996) (emphasis added).

57. Prop. Regs. § 1.1297-4(a)(1) (emphasis added).

58. 61 Fed. Reg. 50778, 50781 (1996) (emphasis added).

authority,⁵⁹ in particular because the proposed regulations may unreasonably apply to plans that mostly cover nonresident alien employees. These foreign arrangements, for example, may be established, maintained and administered in a foreign jurisdiction. Moreover, funds for the plans may be invested solely or predominantly in the foreign jurisdiction. In most cases, the arrangement is invariably the subject of foreign regulation, and is thus usually subjected to foreign tax. In the face of such involved foreign regulation, one wonders whether U.S. taxation is appropriate where the trust's only connection with the U.S. may exist solely because a U.S. entity may be deemed to have an interest in the foreign employer that maintains the plan.

In addition, the proposed changes may in certain circumstances impose additional administrative and transactional costs, particularly by requiring that the foreign entity incorporate U.S. tax and financial accounting regimes with respect to calculating the overfunded "fractional amount" of the arrangement. Such computational requirements may be viewed as particularly intrusive especially where the arrangement is otherwise required to be subject to tax and accounting reporting under the host country's norms. Thus even though the trust may exist solely for the exclusive benefit of participants, and overfunding may result from foreign legal requirements, the proposed regulations may have the unintended effect of putting U.S. businesses at a competitive disadvantage *vis-à-vis* foreign competitors with no U.S. operations.

However, while some may make the case that these rules are overly burdensome, one could argue that if the income had been earned directly by the foreign entity (i.e., the CFC, PFIC or foreign partnership) it would have been taxed to the U.S. owner and that, therefore, the promulgation of these foreign grantor trust rule changes merely comport with that broad policy. From that vantage point, the Service's efforts may not be viewed as greatly expanding the U.S. tax authority's jurisdiction. Additionally, the statutory changes to section 672(f) also appear to confirm a more widespread anti-abuse approach which has been adopted by the Service. For example, that CFCs are now generally treated as U.S. persons for purposes of applying the grantor trust rules appears to be consistent with the Service's proposed regulations under section 671.

During the January 15, 1997, hearing on the proposed regulations, government representatives asserted a particular concern that certain

59. James R. Murray, Public Comments on Proposed Regulations Sections 1.671(g) & (h), 97 TNT 39-19 (Feb. 27, 1997) (LEXIS, FEDTAX library, TNT file); Paul T. Shultz, Public Comments on Proposed Regulations Sections 1.671-1(g) & (h), 97 TNT 4-20 (Jan. 7, 1997) (LEXIS, FEDTAX library, TNT file); John F. Woyke, Public Comments on Proposed Regulations Sections 1.671-1(g) & (h), 97 TNT 4-21 (Jan. 7, 1997) (LEXIS, FEDTAX library, TNT file).

jurisdictions may permit taxpayers to overfund their deferred compensatory arrangements and thus enable the taxpayers to shield income from assets that the trust may hold. Some practitioners have raised objections to this fear on the grounds that overfunding of foreign trusts results less from such deliberate “parking” of funds than from legitimate occurrences, such as downsizing or retirement which may cause shifts in the age of the population.⁶⁰ In addition, the excess funds are often used to reduce future contributions. Some have also objected to the Service’s concerns on the theory that it would make little business sense to transfer assets to a trust vehicle that is outside the employer’s control.⁶¹ Others have noted that certain jurisdictions, as a matter of law, directly forbid the reversion of plan assets, or otherwise impose limitations on tax deductions or impose unfavorable tax consequences on such reversions. In situations in which surplus assets may be unavailable for repatriation until plan liabilities have been satisfied, the potential for abuse perceived by the Service may be unwarranted.

In that context, it may make sense for the regulations to build in some flexibility that would ignore surpluses if the contribution may be otherwise compulsory or if reversions would face adverse consequences under foreign law. It will be interesting to see how the Service and the Treasury respond to such broader jurisdictional and administrative policy concerns in the final regulations.

In this regard, it is important to note that the Service has, on at least one occasion, tackled the issue of overfunded trusts in certain foreign situations. In Revenue Ruling 74-41,⁶² the Service examined the issue of whether investments by a trustee of a qualified trust under sections 401(a) and 501(a) which was maintained by a CFC constituted investments in U.S. property of the earnings of the CFC within the meaning of section 956 of the Subpart F rules. The Service held in Revenue Ruling 74-41 that because the trust in the ruling was a qualified trust, the stocks of domestic corporations as well as U.S. issued obligations held in trust should not be viewed as being held by the trustee on behalf of the CFC. The Service’s conclusion on this, however, rested on the fact that “none of [the CFC’s] contributions resulted in an overfunding of the trust (other than through an erroneous actuarial computation), and no amounts of trust income or corpus” were diverted to the CFC.⁶³

Revenue Ruling 74-41, therefore, appears to leave open the possibility that the foreign CFC could be treated as subject to tax on items of income of the trust if the trust were overfunded. While the Revenue Ruling would not,

60. See Murray, *supra* note 59, at ¶ 14.

61. *Id.*

62. 1974-1 C.B. 190.

63. *Id.* at 191.

assumably, treat the CFC as a grantor of the particular trust arrangement at issue because the trust involved was qualified under section 401(a) and Regulations section 1.641(a)-0 provides that the grantor trust rules do *not* apply to employees' trusts associated with qualified plans, the analytical principle remains the same. Accordingly, Revenue Ruling 74-41 may be viewed in some respects as the precursor of the proposed regulations. It is unclear, however, what the force of Revenue Ruling 74-41 may be if and when the proposed regulations are adopted in final form.

In any event, assuming these "overfunding" rules will be issued as final regulations in their currently proposed form, it is important to examine two other key aspects of the proposed regulations. The discussion that follows below first highlights the mechanics of determining how and when a trust may be viewed as "overfunded" for purposes of the Proposed Regulations section 1.671-1(h) rules. The discussion which follows in Part III.D explores some of the ambiguities and uncertainties occasioned by these overfunding rules, including certain considerations relating to the harmonization of foreign and U.S. computations of the funding of trusts, along with certain policy and administrative considerations raised by practitioners in the implementation of these rules. Finally, Part III.E, discusses the potential impact of Proposed Regulations section 1.671-1(h) on rabbi trusts and other non-rabbi compensatory trusts, explores the apparent shifts in the Service's traditional "fundamentally inconsistent" position, and examines the potential legal and policy considerations associated with foreign compensatory trust arrangements.

D. Fractional Amount Computation

In order to curtail the potential for the perceived foreign overfunding abuses in the CFC and foreign partnership arena, the proposed regulations now permit the Service to impute as income a specified percentage of the trust's assets that represents the surplus. In the PFIC context in which the funding of a foreign employees' trust stems from a "principal purpose" to reduce or eliminate taxation under sections 1291 or 1293 or to avoid classification as a PFIC, if the foreign owner has a power or interest described in sections 673 through 677 over the trust, then the provisions of Subpart E will apply to a fixed dollar amount in the trust that is equal to the fair market value of the property transferred for the purpose of reducing or eliminating taxation under sections 1291 or 1293 or avoiding classification as a PFIC. In the CFC and foreign partnership arenas, the proposed regulations generally require that the amount of the foreign employees' trust with respect to which the effected employer is treated as owner is equal to an undivided fractional interest in the trust's assets. It is important to note that aside from the potential application to foreign deferred compensatory

arrangements under section 404A and section 402(b), these “overfunding” rules would also apply to foreign nonqualified pension arrangements. The “fractional interest” is an undivided fractional interest equal to the “relevant amount” divided by the fair market value of trust assets.

More technically, the proposed regulations define the relevant amount for the employer’s taxable year as the amount, if any, by which the fair market value of trust assets, plus the fair market value of any assets available to pay plan liabilities that are held in the equivalent of a trust exceed the plan’s accrued liability, determined using a projected unit credit funding method that satisfies the requirements of Regulations section 1.412(c)(3)-1.⁶⁴ The preamble, however, to the proposed regulations also makes clear that accrued liability “is intended to track the method used for calculating pension costs under Statement of Financial Accounting Standards No. 87 (FAS 87).”⁶⁵

Under the proposed regulations, for a taxable year of the employer, the fair market value of trust assets, and the fair market value of retirement annuities or other assets held in the trust funding the foreign deferred compensatory arrangement equals the fair market value of those assets on the employer’s measurement date and the end of the employer’s taxable year. The fair market value of these assets is adjusted to include contributions made between the measurement date and the end of the employer’s taxable year.

Under the proposed regulations, the plan’s accrued liability for a taxable year of the employer is computed as of the measurement date for the employer’s taxable year using a projected funding method and taking into account only liabilities related to services performed for the employer or predecessor employer. The plan’s accrued liability is also reduced (but not below zero) by any liabilities that are provided for under annuity contracts held to satisfy the arrangement’s liabilities.

For purposes of these rules, a plan’s accrued liability must be calculated using an interest rate and other actuarial assumptions that the Commissioner determines to be reasonable. The proposed regulations stipulate that it is appropriate in determining this interest rate to look to available information about rates implicit in current prices of annuity contracts, and to look to rates of return on high-quality fixed-income investments currently available and expected to be available during the period prior to the maturity of the arrangement’s benefits. In the case of “qualified business units” that compute their income and earnings and profits in dollars pursuant to the dollar approximate separate transaction methods in Regulations section 1.985-

64. 61 Fed. Reg. 50778, 50782 (1996). This also includes amounts held under annuity contracts that exceed the amount needed to satisfy the liabilities provided for under those contracts. *Id.*

65. *Id.*

3, the employer must use an exchange rate that can be demonstrated to clearly reflect income, based on all relevant facts and circumstances, including appropriate rates of inflation and commercial practices.⁶⁶

The regulations do not themselves incorporate FAS 87, although, as described above, the preamble makes reference to it. Indeed, the Service also requested comments concerning the extent to which the proposed regulations are consistent with the procedures under FAS 87. Because the preamble specifically references Regulations section 1.412(c)(3)-1, some commentators have requested that the regulations should more directly incorporate the actuarial assumptions under FAS 87 either as a safe harbor or as an alternative to the “reasonable funding methods” prescribed by Regulations section 1.412(c)(3)-1, particularly since there are differences in the assumptions used in the two methods. For instance, commentators have noted in particular that, while Regulations section 1.412(c)(3)-1 might prohibit taking into account changes that may take place in the future, FAS 87 focuses on the benefits that are reasonably expected to be paid and are based on projected salary levels.⁶⁷ For example, in the United Kingdom, increases in certain post-retirement cost of living adjustments are apparently mandated by local law—under FAS 87, the anticipated increases would be part of the projected benefit obligation, while Regulations section 1.412(c)(3)-1 would not permit incorporating these increases.

In addition, many foreign companies are already performing valuations in accordance with U.S. Generally Accepted Accounting Principles (U.S. GAAP). By making FAS 87 a safe harbor, employers would have the advantage of avoiding the additional transactional costs of producing two sets of numbers.⁶⁸ Because of differences in legal and other practice and custom across borders, a good argument could be made for a FAS 87 safe harbor on the ground that it is more universal and comprehensive, particularly when viewed against an alternative that would require the host jurisdiction to import the technical funding rules prescribed by the Code that are generally of lesser applicability.

As described above, these overfunding rules would be particularly harsh if the overfunding resulted purely from appreciation in investments over the rate assumed in the funding calculations, or as to other forces over which

66. Sections 985 through 989 of the Code provide for the treatment of transactions in foreign currencies. Transactions are typically accounted for under these provisions in a taxpayer’s “functional currency,” which is effectively the currency used by a “qualified business unit.” A qualified business unit is a trade or business for which separate books are kept. A detailed discussion of these foreign currency translation rules is beyond the scope of this article. See IRC §§ 985 through 989.

67. See Woyke, *supra* note 59, at ¶¶ 27-28.

68. Murray, *supra* note 59, at ¶ 9; cf. Woyke, *supra* note 59, at ¶ 29.

the employer has little or no control. The proposed regulations provide that the "relevant amount" may be reduced to the extent that the taxpayer proves to the Commissioner that the funding mechanisms chosen are pursuant to a "reasonable funding method," or to experience that is favorable relative to actuarial assumptions used by the employer that the Commissioner determines to be reasonable. Thus the proposed regulations already contain at least some degree of flexibility. For these purposes, however, a funding method will be considered reasonable if the amount is contributed to a funding method permitted under section 412 (i.e., the entry age normal funding method) that is consistently used to determine plan contributions. Additionally, a funding method is only considered reasonable if the method provides for any initial unfunded liability to be amortized over a period of at least six years, and for any net change in accrued liability resulting from a change in funding method to be amortized over a period of at least six years. If there has been a change to one method from another funding method, an amount is considered contributed to a reasonable funding method only if the prior funding method is also a method that would be permitted under section 412. It is unclear how or under what circumstances a taxpayer may be able to prevail under such a showing. Moreover, some commentators have already voiced their opinions that such alternative calculations should not be confined to the methods permissible under section 412, and have suggested the use particularly of FAS 87 principles.⁶⁹ As an alternative, however, some have argued that the funding methods that are adopted by the plan pursuant to the norms adopted by the host jurisdiction should be able to satisfy this requirement since in many such jurisdictions, employers are required to make payments to their plan arrangements on a reasonable basis to protect workers' interests.⁷⁰

Under the "reasonable funding exception," the proposed regulations make clear that a CFC (and apparently, only a CFC) must affirmatively make an election signifying that it is relying on the exception. This has prompted some commentators to take exception on the grounds that the requirement will force companies to make protective elections on IRS Form 5471, even when no surplus currently exists.⁷¹

Finally, the proposed regulations have a *de minimis* exception. If the "relevant amount" would not otherwise be greater than the plan's normal cost for the plan year ending with or within the employer's taxable year, then the relevant amount is considered to be zero for purposes of the overfunding rules. As a transition rule, the relevant amount is also reduced (but not below

69. Murray, *supra* note 59, at ¶¶ 9-10, 12; cf. Woyke, *supra* note 59, at ¶¶ 27-29.

70. Murray, *supra* note 59, at ¶ 12. The proposed regulations concerning PFICs appear to acknowledge the use of local law and funding practices to reduce to determine whether there is a principal abuse motive involved.

71. Murray, *supra* note 59, at ¶ 16.

zero) by any "preexisting amount" (the relevant amount determined without regard to the *de minimis* exception, computed as of the measurement date that precedes September 27, 1996) multiplied by the "applicable percentage" (100% for the first tax year ending after the proposed regulations are adopted in final form, and reduced 10 percentage points every year thereafter) for a given year, with an affected employer's overfunding thus being taken into account over a ten year period. Additionally, there are special transition rules for corporations that become CFCs and for partnerships that become U.S. related partnerships after September 27, 1996.

E. Grantor "Secular" Trusts

1. *The "Fundamentally Inconsistent" Standard Revisited.*—As described in Part II, in interpreting section 402(b), the Service traditionally has insisted that section 402(b) arrangements and grantor trusts are "fundamentally inconsistent." In the private letter rulings that articulate the "fundamentally inconsistent" standard, the Service held that highly compensated employees were taxed under section 402(b)(2) principles under deferred compensatory arrangements that were not ever intended to meet the tax qualification tests of section 401(a).⁷² This broad position has made it possible for non-rabbi, nonretirement, incentive compensatory trusts to be taxed under the provisions of section 402(b). It has, however, continued to insulate rabbi grantor trusts from adverse section 402(b) treatment under Revenue Procedure 92-64.

Some practitioners, however, have questioned whether a compensatory arrangement could be treated as a grantor trust *without* being a rabbi trust, notwithstanding the Service's expansive view in the "fundamentally inconsistent" private letter rulings. In other words, given the uncertain limits of section 402(b), some practitioners have queried as to whether arrangements which for one reason or another fail the requirements of Revenue Procedure 92-64 (the safe harbor for rabbi trusts) may nonetheless be accorded grantor trust treatment provided that the employer retains one of the other powers described under the other grantor trust provisions of the Code.

In the noncompensatory arena, trusts which meet any of the grantor powers described in sections 673 through 677 are generally afforded grantor trust treatment. It has not been clear, therefore, why in the compensatory realm these powers might be trumped, especially where section 402(b) itself gives no such direct indication. Even in the original private letter rulings

72. See Priv. Ltr. Ruls. 92-12-024 (Mar. 20, 1992); 92-12-019 (Mar. 20, 1992); 92-07-010 (Feb. 14, 1992); 92-06-009 (Jan. 7, 1992).

which articulate the “fundamentally inconsistent” standard, the Service did not cite any direct authority to support the conclusion that any inconsistencies between section 402(b) and Subpart E necessarily mean that the grantor trust rules cannot apply. In fact, some within the Service have noted that the statutory intersection does not necessarily lead to an obvious result.⁷³ An alternative position could be taken, for example, that would permit the grantor trust rules to apply where any grantor power exists even if it produces inconsistent tax results relating to contributions and deductions. The inconsistency could be addressed by treating any income earned by the grantor-secular trust as immediately “recontributed” by the employer, thus ensuring that the income and the deduction would offset.⁷⁴ In any event, especially when viewed against the Service’s willingness to impose grantor trust status on otherwise “overfunded” section 402(b) arrangements, as discussed above, the strength of the purported analytical boundary between section 402(b) and the grantor trust rules, as pronounced in the earlier private letter rulings, may in fact be in question.

In this regard, it is interesting to note that the Service in at least one private letter ruling held that a deferred compensation arrangement qualified as a rabbi trust because the employer maintained a power described in sections 673 through 677 *other* than the power required by Revenue Procedure 92-64 or the one traditionally relied upon in pre-Revenue Procedure 92-64 private letter rulings.⁷⁵ The ruling appears to suggest that an arrangement may be treated as a compensatory grantor trust, as long as an employer maintains one of the powers described in section 673 through 677. Consequently, one may conclude that the Service’s position is that a compensatory arrangement may be treated as a grantor trust without the assistance of Revenue Procedure 92-64, and without encroaching upon the border established by the “fundamentally inconsistent” position adopted by the Service in the 1992 private letter rulings with regard to section 402(b).

However, this conclusion is not unassailable. For example, the Service appears to have taken a contrary position when it underscored its

73. See, 51 Tax Notes 1349 (Jun. 17, 1991) in which Internal Revenue Service Branch Chief A. Thomas Brisendine was queried about whether the grantor trust rules should override § 402(b). Brisendine was reported to have observed that there was no good answer to this question, but noted that the IRS leaned toward the view that § 402(b) should override the grantor trust rules.

74. *Deferred Compensation Arrangements*, 385 Tax Mgmt. 3d (BNA), at A-30(6) (Apr. 28, 1997).

75. See Rev. Proc. 92-64, 1992-2 C.B. 422. Specifically, as discussed above, Rev. Proc. 92-64 relies in substance on Regs. § 1.677(a)-1(d) by requiring that the assets of the trust be available to creditors of the employer in the event of insolvency. The private letter ruling under discussion relied instead on the grantor’s power to substitute trust property under § 675(4).

“fundamentally inconsistent” holding in Private Letter Ruling 93-02-017. In that ruling, the Service arguably reaffirmed its position that a grantor-secular trust cannot exist. Under the facts of that private letter ruling, an employer structured a compensatory trust so as to require the annual distribution of trust earnings to the employer, but then permitted the immediate recontribution of the earnings to the trust as an employer contribution. Under section 677(a)(2), a grantor is treated as the owner of any portion of a trust 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 held or accumulated for future distributions to the grantor. Even though the grantor of the compensatory trust in the ruling maintained this right, the Service flatly denied ruling that the employer-grantor be treated as an owner of the trust for purposes of Subpart E of Subchapter J. Furthermore, the 1993 ruling appeared to articulate the steps which will affirmatively result in section 402(b) treatment:

Under the terms of the Plan and the Trust Agreement, [Employer] . . . and its affiliates will make irrevocable contributions to the Trust for the exclusive purpose of providing benefits under the Plan to participating employees and their beneficiaries. The Trust’s assets are not subject to the claims of [the Employer’s] . . . or its affiliates’ creditors, and the Trust is not exempt from tax under section 501(a) of the Code. *Accordingly*, the rules of section 402(b) govern the taxation to participating employees of employer contributions to the Trust.⁷⁶

Additionally, while the Service in Private Letter Ruling 98-10-005 approved the use of a “three party” nonqualified deferred compensation arrangement, which it treated as a grantor trust, the Service squarely noted that it was not expressing any opinion as to the tax consequences of the arrangement under section 402(b). Under this arrangement, a tax exempt entity deferred service fees owed by it to another entity by contributing the fees to a trust over which it maintained a grantor power. The assets of the trust were not reachable by creditors of either the tax exempt entity or the service provider entity. Since the grantor was a tax-exempt entity, no tax was ever paid on the trust’s earnings, and the trust assets became taxable to the beneficiary entity only when there was no substantial risk of forfeiture and the trust property was paid to the beneficiary entity. The beneficiary entity then used the distributed assets, which it held in its general account, to pay

76. Priv. Ltr. Rul. 93-02-017 (Jan. 15, 1993) (emphasis added).

deferred compensation obligations owed to its employees. While under the trust in question, it was the employer that was viewed as the beneficiary, and not the contributor, as noted above, the Service has broadly construed the application of section 402(b) to funding arrangements involving deferred compensation. Thus, especially since the Service raised the possible application of section 402(b) in this case, it may be potentially instructive. However, it may be difficult to envision the application of section 402(b) to this particular trust arrangement since the employer never makes any contribution to the trust and the statutory language of section 402(b)(1) requires an *employer* contribution.

2. Proposed Regulations

The Proposed Regulations may now speak directly to the ongoing non-rabbi grantor-secular compensatory trust debate discussed above. Proposed Regulations section 1.671-1(g) in the domestic trust context now states:

An employer is not treated as an owner of any portion of a nonexempt employees' trust *described in Section 402(b)* that is part of a deferred compensation plan and that is not a foreign trust within the meaning of section 7701(a)(31), *regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust.*⁷⁷

Moreover, as described above, Proposed Regulations section 1.671-1(h) in the foreign trust context states:

Except as provided under section 679 or as provided under this paragraph (h)(1), an employer is not treated as an owner of any portion of a foreign employees' trust (as defined in paragraph (h)(2) of this section), *regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust.*⁷⁸

Proposed Regulations section 1.671-1(h)(2) defines a "foreign employees' trust" for these purposes as "a nonexempt employees' trust *described in*

77. Prop. Regs. § 1.671-1(g)(1) (emphasis added).

78. Prop. Regs. § 1.671-1(h)(1) (emphasis added).

section 402(b) that is part of a deferred compensation plan, and that is a foreign trust within the meaning of section 7701(a)(31)."⁷⁹

Read broadly, therefore, the proposed regulations pack some powerful punches. It appears that a literal reading of the proposed regulations indicates that *no* power in section 673 through 677 retained by the employer will be able to effect grantor trust tax treatment in the compensatory trust environment. Second, some practitioners have noted that the proposed regulations read literally *could* potentially be viewed to apply to rabbi trusts.⁸⁰ The preamble to Proposed Regulations section 1.672(f) adds further fuel to the controversy by stating that "[t]he IRS and Treasury contemplate that the nonexempt employees' trusts listed in category (iii) above [i.e., section 402(b) trusts] will be treated as grantor trusts *only* to the extent provided in proposed regulations § 1.671-1(g) and § 1.671-1(h). . . ."⁸¹ As described above, the *only* means by which a compensatory section 402(b) trust is treated as a grantor trust under Proposed Regulations sections 1.671-1(g) and 1.671-1(h) is in the CFC, PFIC and foreign partnership abuse paradigms.⁸² The final 1.672(f) regulations do not repeat the proposed regulations' preamble, however they do still refer to Proposed Regulations sections 1.671-1(g) and (h) for proposed rules describing *when* an employer will be treated as an owner of any portion of a nonexempt employees' trust that is part of a deferred compensation plan. Accordingly, the preambles to the proposed and final section 672(f)-1 regulations may lend further support for the proposition that a literal reading of the proposed regulations works to dismiss all compensatory trusts from the grantor trust rules, other than with respect to the overfunded portions of certain foreign trusts.

At least in the rabbi trust context, this result does not appear to make much sense, unless of course, the Service actually desired to treat all compensatory arrangements as section 402(b) arrangements. The preambles to Regulations section 1.672(f), and the preamble to Proposed Regulations section 1.671-1 do not otherwise give any evidence of such a far reaching retreat from Revenue Procedure 92-64, or an outright abandonment of rabbi trusts. In the absence of explicit authority to the contrary, the better reading is probably that the "described in section 402(b)" language in Proposed

79. Prop. Regs. § 1.671-1(h)(2) (emphasis added).

80. See George Strobel II, Public Comments on Proposed Regulations Section 1.671-1(g), 97 TNT 54-31 (Mar. 20, 1997) (LEXIS, FEDTAX library, TNT file); Woyke, *supra* note 59, at ¶¶ 7-9. As described above, the safe harbor of Rev. Proc. 92-64 relies upon a power or interest described in §§ 673 through 677 which the employer retains over any portion of the trust to accord rabbi-grantor trust treatment—namely, the substance of Regs. § 1.677(a)-1(d).

81. 62 Fed. Reg. 30785, 30788 (1997).

82. See also Part IV for one additional important paradigm.

Regulations section 1.671-1(h)(2) above does not include rabbi trusts. In particular, one may refer to Proposed Regulations section 1.672(f)-3(c)(2) and final Regulations section 1.672(f)-3(c) which make a distinction between section 402(b) arrangements and a trust that would be a nonexempt trust described in section 402(b) *but for* the fact that the trust's assets are not set aside from the claims of creditors of the actual or deemed transferor under Regulations section 1.83-3(e).

While Revenue Procedure 92-64 does not explicitly provide that a rabbi trust is not a section 402(b) trust, some additional relief may be gleaned from the language of section 402(b) itself as well as one of the proposed regulations' examples. Additionally, as described in Part IV, some of the statutory amendments to section 679 may have been effected in order to clarify the distinction between section 402(b) arrangements and rabbi trusts. The Proposed Regulations section 1.671-1(g)(2) example states:

Employer X provides nonqualified deferred compensation through Plan A to certain of its management employees. Employer X has created Trust T to fund the benefits under Plan A. Assets of Trust T may not be used for any purpose other than to satisfy benefits provided under Plan A until all plan liabilities have been satisfied. Trust T is classified as a trust under § 301.7701-4 of this chapter, and is not a foreign trust within the meaning of section 7701(a)(31). *Under Regulations § 1.83-3(e), contributions to Trust T are considered transfers of property to participants within the meaning of Section 83.* On these facts, Trust T is a nonexempt employees' trust described in section 402(b)⁸³

The example hints, consistent with both the statutory language of section 402(b) and with the pre-Revenue Procedure 92-64 rabbi trust rulings, that contributions of property to compensatory trusts that are not considered "transfers" under section 83 will *not* be treated as section 402(b) trusts. As described above, many of the pre-Revenue Procedure 92-64 private letter rulings reason that a compensatory trust will be treated as a rabbi trust, and hence a grantor trust per Regulations section 1.677(a)-1(d), if the contribution of property to the trust does not result in a "transfer" within the meaning of Regulations section 1.83-3(e). No such "transfer" occurs under those rulings because assets of the trust are made available to creditors in the event of employer insolvency. Regulations section 1.83-3(e) states:

83. Prop. Regs. § 1.671-1(g)(2) (emphasis added).

For purposes of section 83 and the regulations thereunder, the term “property” includes real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future. The term also includes a beneficial interest in assets (including money) which are transferred *or set aside from the claims of creditors of the transferor*. . . .⁸⁴

Even with the relevant provisions contained in sections 83 and 402(b) and possible inferences that may be drawn from section 679, it is not wholly evident, however, that the particular example cited in the proposed regulations was intended to address the potential rabbi trust concern. The preamble to Proposed Regulations sections 1.671-1(g) & (h), however, briefly notes “[I]f under these principles, no assets have been transferred to an employees’ trust for federal tax purposes, these proposed regulations do not apply.”⁸⁵ Thus, from the preamble and through a more seasoned reading of the broader provisions, rabbi trusts should not be viewed as subject to Proposed regulations section 1.671-1, although the Service may wish to more directly clarify its position in the body of the final regulations, when issued, to dispel completely any contrary reading.

In any event, as discussed above, in greater peril is the treatment of compensatory arrangements that seek grantor trust treatment on a basis *other* than that of Revenue Procedure 92-64. Because Proposed Regulations section 1.671-1(h)(1) states that “regardless of whether the employer has a power or interest described in sections 673 through 677 over any portion of the trust,” there is now significant doubt under the proposed regulations as to whether a compensatory trust that wishes to secure grantor trust treatment may do so as a result of maintaining a power *other* than the segregation of assets for the benefit of creditors in the event of insolvency. At least under a formalistic reading of the proposed regulations, a compensatory trust that does not satisfy Revenue Procedure 92-64 may be unlikely to get a “second bite” at the grantor trust apple even if in the noncompensatory setting, providing the grantor with one of the powers described in sections 671 through 677 would ordinarily result in grantor trust treatment.

Accordingly, under such a view, any compensatory arrangement making use of a trust which results in a transfer under section 83 may result in section 402(b) treatment. Because it may be possible for a trust to receive a transfer of property within the meaning of Regulations section 1.83-3(e) while still providing the grantor with one or more of the powers described in

84. Regs. § 1.83-3(e) (emphasis added).

85. 61 Fed. Reg. 50778, 50779 (1996).

sections 671 through 677, the fate of secular grantor compensatory trusts, other than in the overfunded context, may be in doubt under the proposed regulations. This may be the case, even though, curiously, the preamble to the proposed regulations explicitly recognizes that:

[e]ven if there has been a completed transfer of trust assets, the subpart E rules may apply to treat the grantor as the owner of a portion of the trust for federal income tax purposes.⁸⁶

The expansive “fundamentally inconsistent” position, therefore, may now be significantly elevated from a position articulated through several private letter rulings to that of potentially more universally applicable regulatory authority despite the fact that it may not be clear under a broader statutory analysis whether there may be a conflict with the grantor trust rules.⁸⁷ While unclear under the larger statutory scope of section 402(b), this outcome is apparently consistent with the reasoning reached in Private Letter Ruling 93-02-017, which held, despite any other grantor power maintained by the sponsor, that no grantor trust status may be concluded where there is a transfer of property under section 83 and where the assets of the trust are not available to the creditors of the employer. It is not certain whether the outcome of the proposed regulations may conflict with Private Letter Ruling 98-10-005, which, as described above, conferred grantor trust status in a three party non-rabbi trust deferred compensatory setting. However, since the “employer” under that arrangement never “contributed” property to the trust, section 402(b) may in fact not be implicated.

F. Summary

While there has historically been and continues to be uncertainty regarding the scope of section 402(b) arrangements, the proposed regulations have codified for the first time, other than through private letter rulings, a more universally applicable statement concerning the apparent relationship between section 402(b) arrangements and rabbi trusts and other purported compensatory grantor trusts. The proposed regulations formally sanction the conclusion that certain nonqualified deferred compensation plans are subject to taxation, a conclusion reached by the Service in various previous rulings concerning domestic secular trusts. Additionally, the proposed regulations

86. 61 Fed. Reg. 50778, 50779 (1996) (emphasis added).

87. See discussion *supra* Part III.E.1.

provide that an employer is not treated as the owner of a foreign employees' trust except to the extent there may be overfunding or abuse.

In so doing, the grantor trust rules' application to domestic section 402(b) arrangements is nullified. It is also effectively limited in inbound foreign section 402(b) and section 404A arrangements to the extent necessary to safeguard perceived abuses of foreign deferred compensation plans as tax shelters in which there may be overfunding or other abuses in the CFC, PFIC, or foreign partnerships context. Reading the literal language of Regulations section 1.672(f)-3(c), and the preamble to that provision, along with examples in Proposed Regulations section 1.671-1, compensatory trusts that *do not* make their assets available to creditors in the event of bankruptcy may be included in the section 402(b) universe—a potentially broad reaching development that may affect a variety of incentive and deferred compensatory structures. The proposed regulations thus appear to strike a compromise with the Service's "fundamentally inconsistent" position in the domestic and foreign contexts. While in the grantor "secular" arrangements, section 402(b) appears to take the more expansive role at the expense of the grantor trust rules, in the "overfunding" anti-abuse environment, the grantor trust rules appear to cause section 402(b) to yield in favor of perceived abuses which apparently dictate even larger policy considerations.

IV. OUTBOUND GRANTOR TRUST RULES

A. *The Scope of Section 679*

While section 672 governs "inbound" transactions, section 679 governs outbound trust transactions. Section 679(a), as amended by the Small Business Job Protection Act, states:

In General.—A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii)) 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.⁸⁸

The requirement in section 679(a)(1) that a U.S. person transfer property to a foreign trust is extremely broad, applying both to *direct and indirect transfers* of property. Moreover, the provision generally has only two exceptions: (1) transfers by reason of the death of the transferor and (2)

88. IRC § 679(a)(1).

transfers that result from a sale or exchange of the property for at least its fair market value.⁸⁹

Examples in the committee reports which accompanied the enactment of section 679 underscore the breadth of section 679's application:

Example: A U.S. person transfers property to a foreign person or entity that transfers the property (or its equivalent) to a foreign trust that has U.S. beneficiaries. The U.S. person is treated as having made a transfer to a foreign trust, unless it can be shown that the foreign person or entity's transfer to the trust was unrelated to the U.S. person's transfer.

Example: A U.S. person transfers property to a domestic trust or corporation that subsequently transfers the same or equivalent property to a foreign trust. The U.S. person may be treated as having made a transfer of property indirectly to the foreign trust.

Example: A U.S. person transfers property (or engages in certain deferred sales transactions) with a domestic trust which subsequently becomes a foreign trust. The U.S. person may be treated as having made an indirect transfer to a foreign trust.⁹⁰

Many U.S. companies may establish foreign compensatory trusts for either U.S. employees working abroad or foreign employees. In addition, in many deferred compensation arrangements, there may be funding, reimbursement or other arrangements between the foreign parent "funding" the arrangement and the U.S. subsidiary whose employees benefit under the plan. For example, it is common for employees of a U.S. subsidiary to be granted stock or stock-related rights tied to the equity of a foreign parent and for the U.S. employer to reimburse the foreign parent—directly or indirectly—for the costs of such compensation. Even though neither section 679 nor the accompanying legislative history appear to provide any guidance on the absolute measure of control a U.S. subsidiary would have to maintain over the foreign trust for that U.S. entity to be deemed an indirect transferor to the trust,⁹¹ some practitioners have considered the possibility that a subsidiary of the purported foreign grantor may be deemed to be an indirect grantor of the arrangement because of such direct or indirect reimbursements.

89. IRC § 679(a)(2).

90. See H.R. Rep. No. 94-658, at 209 n.10 (1975), reprinted in 1976 U.S.C.C.A.N. 2897, 3014; S. Rep. No. 94-938, pt. 1, at 219 n.8 (1976), reprinted in 1976 U.S.C.C.A.N. 3439, 3650-51.

91. This article does not address issues prompted by § 482.

For purposes of these outbound grantor trust rules, section 679(c) provides that a trust will be treated as having a U.S. beneficiary unless (1) the trust expressly provides that no part of the income or corpus of the trust may be paid or accumulated to or for the benefit of a U.S. person and (2) were the trust to terminate, no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person. Section 679(c)(2) also provides attribution rules pursuant to which an amount is treated as an “amount paid or accumulated to or for the benefit of a United States person” for purposes of clause (1), above, if an amount is paid or accumulated to or for the benefit of a CFC, or a foreign partnership with a U.S. partner. Accordingly, given the breadth of section 679’s statutory ambit, the possibility of a U.S. subsidiary being viewed as an “indirect” or “deemed” grantor of an outbound foreign trust arrangement was, in some circles, viewed as a real possibility.

B. Legislative Changes to Section 679 Occasioned by the Small Business Job Protection Act

Prior to the Small Business Job Protection Act, section 679(a) read in relevant part:

In General.—A United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in . . . [sections 404(a)(4) or 404A]) 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.⁹²

It was not clear under that definition what precisely section 404(a)(4) or section 404A trust arrangements included. For example, it was unclear whether that definition also was intended to include “secular” trusts described in section 402(b) or “rabbi” trusts, particularly since there had been some question regarding the relationship between grantor trusts and section 404A arrangements and also because the specific reference of section 404A without an accompanying reference to section 402(b) carried a potentially negative inference regarding the latter. Although section 404(a)(4) and section 404A trusts are compensatory arrangements, neither a section 402(b) plan nor a rabbi trust technically fit into either one of these in the strict sense.

The Small Business Job Protection Act amended section 679(a) by replacing the reference to sections 404(a)(4) and 404A with a reference to

92. IRC § 679(a) (prior to 1996 amendment, retroactively effective from Feb. 6, 1995).

trusts described in “section 6048(a)(3)(B)(ii).” Section 6048(a)(3)(B)(ii) refers to:

Deferred compensation [arrangements] and charitable trusts. Subparagraph A shall not apply with respect to a trust which is—(I) described in section 402(b), 404(a)(4) or 404A, or (II) determined by the Secretary to be described in section 501(c)(3).⁹³

These statutory amendments, therefore, make it clear that, along with section 404A arrangements, foreign section 402(b) trusts with U.S. grantors and U.S. beneficiaries are *not* subject to grantor trust treatment under section 679; a position which appears in line with the Service’s “fundamentally inconsistent” standard, and a position which appears to protect rabbi trusts from exclusion under the grantor trust rules.⁹⁴

C. Proposed Regulations

As described above, a formalistic reading of Regulations section 1.672(f)-1, as well as a literal reading of sections 402(b) and 83, appear to imply that rabbi trusts should not be section 402(b) trusts. Accordingly, it would make sense that such a literal reading is directly incorporated into the sections 679 and 6048 contexts. Indeed, a contrary reading would appear to make little policy sense under section 679 especially since without the application of section 679, rabbi trusts should already be treated as grantor trusts by reason of the fact that their assets are subject to the claims of creditors of the employer. It may not be as clear, however, what the precise interplay is intended between section 679 and grantor “secular” trusts that do not meet the conditions of Revenue Procedure 92-64 but which otherwise maintain a power described in sections 671 through 677 in favor of the grantor.

The source of regulatory uncertainty does not end, however, in determining whether or not for section 679 purposes grantor “secular” trusts may be equated with section 402(b) trusts. As described above in Part III, Proposed Regulations section 1.671-1(h) generally does not treat any section 402(b) compensatory arrangement as a grantor trust. In this vein, Proposed Regulations section 1.671-1(h) is entirely consistent with the Small Business

93. IRC § 6048(a)(3)(B)(ii).

94. Additionally, the Small Business Job Protection Act amended the Code to provide that transfers of property by U.S. persons to a foreign trust with U.S. beneficiaries will not result in the grantor being treated as the owner of the trust if the trust paid fair market value to the transferor for the property transferred.

Job Protection Act's revisions to section 679 since that provision now prevents the application of grantor trust status for outbound section 402(b) trusts.

However, as noted above in Part III, Proposed Regulations section 1.671-1(h) contains an important exception. That exception works to impose grantor trust treatment on certain "overfunded" arrangements of certain controlled foreign corporations, foreign partnerships and passive foreign investment companies. Proposed Regulations section 1.671-1(h), however, contains one additional exception to its general rule of excluding foreign section 402(b) arrangements from the grantor trust rules. That exception, which presumably is intended to stand for the same anti-abuse principles as the other exceptions, applies to U.S. persons and states as follows:

*If a United States person (as defined in section 7701(a)(30)) maintains a deferred compensation plan that is funded through a foreign employees' trust, then, with respect to the U.S. person, the provisions of subpart E apply to the portion of the trust that is the fractional interest that is described in paragraph (h)(3) of this section.*⁹⁵

Again, "[a] foreign employees' trust is a nonexempt employees' trust described in section 402(b) that is part of a deferred compensation plan, and that is a foreign trust within the meaning of section 7701(a)(31)."⁹⁶

This exception, then, requires foreign trusts with U.S. grantors to become subject to the grantor trust rules with respect to the "fractional amount." As discussed in Part III, Proposed Regulations section 1.671-1(h)(3) generally requires that the amount of the foreign employees' trust with respect to which the affected employer is treated as owner be equal to an undivided fractional interest in the trust's assets. The fraction consists of the "relevant amount" (the excess of the fair market value of the trust assets over the accrued liability using a projected unit credit funding method taking into account only liabilities relating to services performed for the employer or a predecessor employer) for the employer's taxable year.

This exception, therefore, may appear at odds with the statutory revisions made to section 679. The exception in Proposed Regulations section 1.671-1 is particularly curious because the preamble does not make particular reference to the case of a U.S. grantor and instead notes only that:

95. Prop. Regs. § 1.671-1(h)(1)(ii) (emphasis added).

96. Prop. Regs. § 1.671-1(h)(2) (emphasis added).

Under these proposed regulations, the grantor trust rules of subpart E do not apply to a foreign employees' trust with respect to a foreign employer *other than a CFC or a U.S.-related foreign partnership, except for cases in which assets are transferred to a foreign employees' trust with a principal purpose of avoiding the PFIC rules.*⁹⁷

Because section 679 is the only statutory provision that explicitly applies to foreign grantor trusts (other than section 672(f)), and because Congress specifically excluded section 402(b) arrangements from the application of section 679, one could read all of the provisions taken in their entirety to mean that Congress did not intend for the grantor trust rules to apply to foreign nonexempt employees' trusts at all. Such an interpretation would still appear to remain consistent with the current tax treatment of rabbi trusts since rabbi trusts (not being foreign nonexempt employees' trusts) would otherwise be treated as a grantor trust by virtue of the powers it retains under section 677. Similar interpretative concerns may arise with respect to overfunded section 404A arrangements in light of their specific exclusion under section 679.

Alternatively, read literally, section 679(a) does not itself provide that the U.S. sponsor of a foreign section 402(b) arrangement with U.S. beneficiaries will never be treated as a grantor. Instead, one could read section 679 merely as providing one mechanism by which a U.S. sponsor of a nonsection 402(b) arrangement would be treated as an owner under the grantor trust rules. In that case, the authority promulgated by Proposed Regulations section 1.671-1(h) could work to independently permit overfunded portions of foreign secular trust arrangements with U.S. sponsors to be taxed under the grantor trust rules. Under any reading, the proposed regulations do not appear directly in conflict with section 679 concerning U.S. sponsored foreign arrangements which do *not* benefit U.S. persons since section 679 does not apply to those arrangements.

Given the Service's position that, absent the overfunding rules, grantor compensatory trusts cannot exist without there being a rabbi trust, one might question under the above analysis how section 679 might otherwise have any bite to outbound compensatory arrangements. However, the conclusion that both section 679 and the proposed regulations under section 671 work independently could be consistent with the potential purpose behind the Small Business Job Protection Act's revisions to section 679 in the compensatory arena, which may have added the reference to section 402(b) merely to clarify that foreign rabbi trusts were not intended to be excluded

97. 61 Fed. Reg. 50778, 50781 (1996) (emphasis added).

from grantor trust treatment—a concern among some practitioners with respect to section 679 prior to the statutory amendments—giving credibility to the conclusion that the statutory changes should not be viewed as a broader statement on the border between the grantor trust rules and section 402(b). Under this view, the independent application of the proposed regulations may be seen as bolstering the Service's purported policy that section 402(b) arrangements, whether foreign or domestic, should not be treated as grantor trusts except to the extent needed to redress perceived abuses.⁹⁸ As discussed above, however, such an interpretation does not necessarily address whether the proposed regulations under section 671 themselves provide a permissible grantor power apart from the others prescribed by statute in sections 673 through 677.

Because of the potential ambiguity and the fact that the preamble to the proposed regulations do not address in great detail the interaction of the proposed regulations and section 679, it will be interesting to note the manner in which the Service seeks to provide further clarification.

V. CONCLUSION

The recent changes to the Code and proposed regulations dramatically affect many foreign trust based deferred compensatory arrangements. As discussed above, the changes alter the definition of "foreign trust" by adding some much needed clarity to the boundary between domestic and foreign trusts—an area which has often been filled with ambiguity. Additionally, prompted by concerns that U.S. persons were not paying their fair share on income attributable to foreign trusts, certain foreign affiliates of U.S. entities may now be treated as grantors of the overfunded portion of certain foreign compensatory trusts, and thus may be subject to U.S. federal income tax on the items of income produced by the trust, *regardless of whether the trusts would otherwise be so treated under Subpart E of the Code.*

In particular, these rules are designed to curb abuses by plans maintained by (1) CFCs, (2) certain PFICs and (3) certain foreign partnerships. As described above, these rules, in particular, are potentially expansive in their scope because arrangements of purely foreign entities which employ mostly foreign persons may now be subject to U.S. taxation even though the *only* nexus they have with the United States is through their affiliation with a U.S. entity. Equally important is the fact that by subjecting

98. While Congress may have added the statutory reference to § 402(b) to clarify that outbound rabbi trusts were not necessarily outside of the grantor trust rules, this "independent application" rationale, however, would appear to make such a clarification unnecessary since, presumably, as stated above, rabbi trusts would independently be treated as grantor trusts, exclusive of § 679, under Regs. § 1.677(a)-1(d).

these foreign trusts to the grantor trust rules, the Service appears to be departing from its long-standing policy of treating section 402(b) "secular" trust arrangements as "fundamentally inconsistent" from grantor trusts. This broad assertion is especially important for those compensatory arrangements which might fail to meet the requirements of Revenue Procedure 92-64—the Service's safe harbor for favorable rabbi (grantor) trust treatment. For determining when an arrangement may be viewed as overfunded these rules not only invoke practical concerns, but also potentially raise accounting translation issues between U.S. and foreign procedures and standards. Given the apparent shift in favor of section 402(b) in the case of failed rabbi trusts on the one hand, and the reliance on the grantor trust rules for certain foreign deferred compensatory arrangements on the other hand, it is not clear how consistent the "fundamentally inconsistent" distinction may remain.

Finally, section 679, as amended, now makes clear that U.S. grantors of "outbound" foreign trusts will *not* be treated as grantor trusts if the arrangement is considered to be covered by section 402(b) of the Code. However, in spite of this statutory change, certain recently issued proposed regulations now indicate that portions of "outbound" trusts *will* be subject to the grantor trust rules as a result of the application of the overfunding rules described above. These developments raise some interesting questions as to the practical cumulative effects and the intended spirit of the changes to both section 679 and the proposed regulations.

Accordingly, the foreign trust deferred compensatory world is rife with changes. Some of the changes are explainable—driven by policy concerns long felt unaddressed by Congress and the Service. However, some of these changes may produce unclear results. While the foreign trust arena requires effective policing, the Service may wish to think about the interaction of *all* of the legislative and regulatory changes in order to produce in the final regulations an even clearer picture of the tax treatment in certain ambiguous or uncertain cases. In short, therefore, the host of changes occasioned by the statutory and legislative changes dramatically alter the treatment of foreign trust based compensatory arrangements. However, the changes also in some instances mark changes in policy. How that policy will be best prosecuted in the aggregate within the limitations of each applicable provision remains to be seen.