INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

October 26, 2006

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Date of Communication: October 26, 2006]

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CASE-MIS No.: TAM-162267-05

Group Specialty Manager

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification No

Year(s) Involved:
Date of Conference:

LEGEND:

Family =
Individual A =
Individual B =
Individual C =
Individual D =
Individual E =

Individual F =
Individual G =
Individual H =
Individual I =
Individual J =
Individual K =
Individual L =
Individual M =
State J =
Corp A =
Corp B =
Corp C =
Corp D =
Corp E =
Corp F =
Corp G =
Corp H =
Corp I =
Corp J =
Corp K =
Corp L =
Trustee A =
Trustee B =
Trustee C =

Trustee D =
Country Z =
Country Y =
Country Y Trust Law =
Country Y Act of Year 11 =
A Stock Exchange =
B Stock Exchange =
C Stock Exchange =
D Stock Exchange =
Article J =
Article K =
Article M =
Article N =
Article O =
Initials 01 =
a percent =
b percent =
c percent =
d percent =

e percent =
f percent =
g percent =
h percent =
i percent =
j percent =
k percent =
m percent =
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$F =
$G =
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Fund A =
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Date 39 =

ISSUES:

I. Application of sections 1291 through 1297

A. Was Corp J a PFIC as defined in I.R.C. section 1297?

B. Can the stock of Corp J owned by Individual A be attributed to Fund B for purposes of the look-through rule of I.R.C. section 1297(c)?

C. Would the application of the PFIC rules in this case be contrary to congressional intent?

D. If the PFIC rules are applicable, when was the taxable event for purposes of applying section 1291?

II. Application of section 1298

A. Can the PFIC tax and interest charge under section 1291 be imposed on the beneficiaries of Fund B in the absence of regulations under section 1298(b)(5)?

B. If so, was Taxpayers' method of applying section 1298(b)(5) reasonable?

C. If Taxpayers' method was not reasonable, what is a reasonable method of applying section 1298(b)(5)?

III. Application of subchapter J

A. Was Individual A the grantor of Trust 1 within the meaning of sections 671 through 677?

B. Was Individual A treated as the owner of any portion of Trust 1 within the meaning of sections 671 through 677 on or before August 20, 1996?

C. Was there a valid distribution to Trust 5 or the beneficiaries of Trust 5 in Year 9 under section 661?

D. Did Fund B consist of 2 substantially separate and independent shares within the meaning of section 663(c)?

CONCLUSIONS:

I. Application of sections 1291 through 1297

A. Corp J was a PFIC, as defined in section 1297(a), throughout Fund B's holding period in the stock of Corp J.

B. The constructive ownership rules do not apply for purposes of the look-through rule of section 1297(c). Section 1297(c) applies only to direct and indirectly held interests.

C. Application of the PFIC rules in this case would not be contrary to congressional intent

D. The taxable event was the commencement of the liquidating distribution from Corp J to Fund B on Date 26.

II. Application of section 1298

A. The language of section 1298(b)(5) is clear on its face and can be applied in the absence of enabling regulations. Furthermore, section 1298(a)(3), which treats stock owned by a trust as owned proportionately by its beneficiaries, provides an independent basis for treating the gain from the liquidating distribution to Fund B as an excess distribution to its U.S. beneficiaries.

B. Taxpayers' method of applying section 1298(b)(5) was not reasonable because it was contrary to a plain reading of the statute and resulted in the circumvention, rather than the preservation or triggering, of the PFIC tax and interest charge.

C. A reasonable method would have been to apply section 1298(a)(3) and section 1298(b)(5) to treat the U.S. beneficiaries of Fund B as receiving an excess distribution from Corp J when Corp J commenced a liquidating distribution on Date 26. Furthermore, in the absence of temporary or final regulations under section 1298(a)(3), a reasonable method of applying section 1298(a)(3) would be to adopt a facts and circumstances test similar to that used under the subpart F rules. See Treas. Reg. § 1.959-1(c)(2). Under a facts and circumstances test, each of the U.S. beneficiaries of Fund B should be treated as receiving an excess distribution equal to 16.66 percent (1/3 of 50%) of the gain from the liquidating distribution from Corp J to Fund B.

III. Application of subchapter J

A. Individual A should be treated as the grantor of the portion of Trust 1 that was held for the benefit of Individual A's living grandchildren on termination of the trust.

B. Individual A was not treated as an owner of any portion of Trust 1 within the meaning of sections 671 through 677 on or before August 20, 1996.

C. There was a valid distribution to Trust 5 in Year 9 under section 661.

D. Fund B consisted of 2 substantially separate and independent shares within the meaning of section 663(c).

FACTS:

Prior to Date 3, Corp A, Corp B, Corp C, Corp D, and Corp E, a group of foreign corporations (the "Predecessor Companies") were jointly owned by members of the Family: Individual A, Individual B, Individual C, Individual D, and Individual E, all descendants of Individual F and Individual G ("Grandparents").

Their ownership of the stock of the Predecessor Companies was governed by a consortium agreement, dated Date 1, (Consortium Agreement), as amended from time to time. The Consortium Agreement provided that ownership of the Predecessor Companies must be by descendants, or wives of descendants, of Grandparents. Upon the death of a Family member, his or her share would pass to his or her heirs. If one of the Family members wanted to sell his or her shares in the Predecessor Companies, the other Family members had the right to purchase such shares based on the proportion of shares they held. The purchase price was defined as the nominal value of the Family member's share for sale, plus pro-rated outstanding reserves and minus pro-rated losses according to the commercial balance sheet with certain specified adjustments for writeoffs, adjustments and reserves.

On Date 2, the Consortium Agreement was amended to allow the transfer of shares of the Predecessor Companies to a legal entity provided that the ownership of the legal entity was limited to the descendants of Grandparents, as provided in the Consortium Agreement.

In Year 1, Individual D advised the Family that he wished to dispose of his shares in the Predecessor Companies. On Date 3, Individual E, Individual A, Individual B and Individual C entered into an agreement (Date 3 Agreement) under which they waived their rights to purchase Individual D's share of the Predecessor Companies under the Consortium Agreement. The Date 3 Agreement further provided that Corp F, a Country Z corporation owned by Individual B, would purchase from Individual C all of the shares of Corp G, a Country Z corporation. Corp G would then purchase all of Individual D's shares in the Predecessor Companies. The Date 3 Agreement stated that Corp F was acting with regard to Corp G as a fiduciary and in the interest of Individual A, Individual B, and Individual C, but not Individual E who expressly agreed to forgo any claims related to Corp G's purchase of Individual D's share of the Predecessor Companies.

Pursuant to the Date 3 Agreement, on Date 5, Corp G purchased all of Individual D's shares in the Predecessor Companies. The purchase price of Corp A ($A, a percent of the total purchase price), Corp B ($B, b percent of the total purchase price) and Corp C ($C, c percent of the total purchase price) was payable in r annual installments, together with interest at a rate of d percent per annum, beginning on Date 6. The annual installments and interest were to be paid out of dividend earnings of the companies received by Corp G. Individual A "guaranteed" the annual payments for the purchase of Corp A and Individual B "guaranteed" the annual payments for the purchase of Corp B and Corp C.

A Public Certificate setting forth the terms of the "guarantee" with respect to the sale of Corp A was executed by Individual A on Date 4. Similar Public Certificates were executed by Individual B with respect to the sale of Corp B and Corp C on Date 5. Pursuant to the terms of the Public Certificate executed by Individual A, the net dividends (dividends minus taxes to be paid or withheld) distributed in each year by Corp A to Corp G or its legal successor would in fact be paid and forwarded to Individual D up to the amount of the amortization and interest installments (annuity payment) owed by Corp G to Individual D. The Public Certificate further provided that if Corp A distributed to Corp G a higher net dividend in a respective year than required to make the annuity payment by Corp G to Individual D by Date 33 of the same year and if Corp G did not make payment to Individual D, then Individual A would vouch in full for the annuity payment. If, in contrast, Corp A distributed to Corp G a lower net dividend than was sufficient to be able to make the annuity payment to Individual D for any given year, and if the corresponding annuity payment was not made by the purchaser, then it would be taken over by Individual A[1] up to e percent of the net profits of Corp A. Upon the payment of a sum in the amount of e percent of the net profit, Individual A would be considered free from his payment obligation with regard to the current annuity payment. The same terms were included in the Public Certificates executed by Individual B with respect to the other two companies.

Individual A did not pay anything to Individual D pursuant to the above Public Certificates. No additional documents concerning a "guarantee" by Individual A with respect to the purchase of Corp A have been presented.

The purchase price for Individual D's shares of Corp D ($D, f percent of the total purchase price) and Corp E ($E, q percent of the total purchase price) was paid in full on the date of purchase. Taxpayers represent that Individual A paid out of his own funds the purchase price for these shares. Although Taxpayers have not produced a loan agreement, they represent that Individual A borrowed a portion of the purchase price from Corp H for the purchase of these shares.[2]

[1] The submitted copy of the Public Certificate does not show the person's name, but presumably refers to Individual A.

[2] An Agreement dated Date 10, between Corp I, Trustee A and Individual A, referenced this loan and provided that the Settlor, Corp I, was directing the Trustee of the Trust 1 to make the payments on

Based on the Consortium Agreement, after Individual E declined to participate in the purchase of Individual D's shares, Individual A had the right to acquire g percent of Individual D's shares in the Predecessor Companies, which represented m shares of Corp G, and Individual B and Individual C, each, had the right to acquire h percent of such shares, which represented for each n shares of Corp G

On Date 7, Corp F transferred o shares of Corp G or i percent of such shares (representing Individual A's and Individual C's share of Individual D's interest in the Predecessor Companies) to Individual B, who in turn contributed those shares to another of his wholly-owned companies, Corp I, a Country Z corporation.

By trust agreement, dated Date 7, Corp I, as Settlor, formed Trust 1, a Country Y trust, and settled o shares of Corp G into the trust. Trustee A, a Country Y corporation, was named as trustee.

Trust 1 was formed for the benefit of the grandchildren of Individual A and Individual C. Under the trust agreement, upon the termination of Trust 1, the grandchildren of Individual A would receive approximately j percent of the assets and the grandchildren of Individual C would receive approximately k percent of the assets. The trust agreement provided that "grandchildren" means "the children living at the termination of the Trust of any now existing children of [Individual A] or [Individual C] respectively." The trust agreement further provided that such grandchildren "take equally per stirpes." If none of Individual A's grandchildren survived, the entire amount would go to Individual C's grandchildren, and vice versa. If neither set of grandchildren survived, the entire amount would go to the grandchildren of Individual B.

Under the trust agreement, Trust 1 would terminate s years after the death of the last of the children of Individual A and Individual C living at the time of the trust's creation or earlier if the trustee established that Corp G had paid Individual D all sums due for the purchase of three of the Predecessor Companies under the installment agreements. In any case, however, the trust would terminate upon three months written notice given by the Settlor or any company or individual designated by the Settlor to give such notice.

The trust agreement provided that the Trustee had the power to invest the Trust fund in stocks, shares, bonds, debentures of any company listed on the A Stock Exchange or the B Stock Exchange, or any other such security approved by the Settlor, and had the power to receive and reinvest the income, dividends and profits from such investments. It further provided that the Trustee could invest all income which it

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this loan (total sum $F as of Date 9, plus o percent per annum) out of Available Funds to Corp H. Available Funds are defined as a portion of the dividends (redemptions or otherwise) from Corp G.

received in investments with a maturity of not more than three months, unless otherwise directed by the Settlor.

The trust agreement provided that the Trustee had the power to "vote all shares and other securities held by it in such way as it deemed advisable having regard to the best interests of the beneficiaries."

The trust agreement provided that the Settlor, or any company or individual designated by the Settlor, retained the power to remove the Trustee and to appoint a new Trustee.

On Date 8, Corp I executed an irrevocable designation whereby it granted Individual A and Individual C, jointly and acting together, the power to terminate Trust 1 and the power to remove the trustee and appoint a new trustee in accordance with the terms of the Trust 1 agreement.

By letter dated Date 8, Corp I informed Corp E, one of the Predecessor Companies, that Corp I had agreed that Trustee A would vote the shares of Corp G in accordance with the instructions of Corp E. The letter further provided that if, at any meeting of the shareholders, it appeared that the way in which the shares of the Predecessor Companies owned by Corp G were voted would be decisive with regard to a shareholder resolution, then Corp E would direct Trustee A to cause Corp G to vote the shares of the Predecessor Companies with regard to the wishes of Individual A, as to g percent, Individual C, as to h percent, and Individual B as to h percent. Corp I was dissolved on Date 11. Trustee A did not sign the Date 8 letter. There is also an unsigned, undated memorandum with the Initials 01 which indicates that the Trustee will vote shares in accordance with the recommendations of Corp E. "Initials 01" is not identified.

A letter dated Date 12, from Trustee A, to Corp E, entitled "Trust 1," provides that the purpose of the letter is to confirm

> that [Trustee A], as Trustee of [Trust 1], will have regard to your recommendations when exercising its discretionary powers including but not limited to the powers of terminating the Trust and appointing new trustees above mentioned, whether conferred by the Trust Agreement or by law. [Trustee A] cannot however bind itself to act in accordance with your recommendations, as this would be contrary to its obligations as Trustee.

Trust 1 was subject to the Country Y Trust Law. The following provisions of the Country Y Trust Law are relevant and applied to the years at issue.

Article L of the Country Y Trust Law provides that where any property is held by trustees in trust for any person for any estate or interest whatsoever, whether vested or contingent, then, subject to any prior estates or interests or charges affecting that property –

(a) during the infancy of any such person, if his estate or interest so long continues, the trustees may, at their sole discretion, pay to his parent or guardian, if any, or otherwise apply for or towards his maintenance or education, or otherwise, apply for or towards his maintenance or education, or otherwise for his benefit, the whole or such part, if any, of the income of that property as may, in all the circumstances, be reasonable, whether or not there is—

(i) any other fund applicable to the same purpose; or

(j) any person bound by law to provide for his maintenance or education.

Article M provides that, in deciding whether to pay out amounts pursuant to Article L, the trustees shall have regard to the age of the infant and his or her requirements and generally to the circumstances of the case, and in particular to what other income, if any, is applicable for the same purposes; and where trustees have notice that the income of more than one fund is applicable for those purposes, then, so far as practicable, unless the entire income of the funds is paid or applied as provided in Article L or the court directs otherwise, a proportionate part only of the income of each fund shall be so paid or applied.

Article N of the Country Y Trust Law with regard to advancements provides that Trustees may at any time or times pay or apply any capital money subject to a trust, for the advancement or benefit, in such manner as they may, in their absolute discretion, think fit, of any person entitled to the capital of the trust property or of any share thereof, whether absolutely or contingently on his attaining any specified age or on the occurrence of any other event, or subject to a gift over on his death under any specified age or on the occurrence of any other event, and whether in possession or in remainder or reversion, and such payment, or application may be made notwithstanding that the estate or interest of such person is liable to be defeated by the exercise of a power of appointment or revocation, or to be diminished by the increase of the class to which he belongs so, however, that

(a) the money so paid or applied for the advancement or benefit of any person shall not exceed altogether the amount of the presumptive or vested share, estate or interest of that person in the trust property, and

(b) if that person is or becomes absolutely and indefeasibly entitled to a share in the trust property the money so paid or applied shall be brought into account as part of such share; and

(c) no such payment or application shall be made so as to prejudice any person entitled to any prior life or other estate or interest, whether vested or contingent, in the money paid or applied unless such person is in existence and of full age and consents in writing to such payment or application.

The Country Y Act of Year 11 added Article O which provides that for the avoidance of doubt, when exercising the power of advancement the trustees may –

(a) create any provisions, including –

(i) discretionary trusts and dispositive, administrative or managerial powers exercisable by any person;
(ii) the delegation of discretions and duties to any person; and

(b) provide that the capital money may become subject to the terms of any other trust,

provided that the requirements of Article N are satisfied.

In Year 2, the Predecessor Companies were reorganized under Corp L, a Country Y corporation. At that time, Corp L had p shares outstanding and Corp G owned q shares of Corp L.

In Year 6, disputes arose among the Corp L shareholders, and the Corp L Board of Directors voted to replace Individual A as Chairman of the Board. In a related shareholder vote, Trustee A, as Trustee of Trust 1, agreed with Corp L board members to replace Individual A as Chairman against his wishes.[3]

Commencing in late Year 7, actions were taken to separate the shares of stock held by Trust 1 for the benefit of Individual A's grandchildren from the shares of stock held for the benefit of Individual C's grandchildren. On Date 16, Corp G formed Corp J, a Country Z corporation and contributed to it a portion of the shares of Corp L corresponding to the proportion of shares in Corp G to which Individual A's grandchildren would be entitled on termination of Trust 1. Corp G distributed all of its shares of Corp J to Trust 1. (Taxpayers take the position that this transaction was a taxable redemption in exchange for the shares of Corp J held by Trust 1 that resulted in

[3] In addition, a legal dispute arose involving Trustee A, as Trustee to Trust 2 and Trust 3 (trusts for the benefit of Individual A's children other than Individual H and Individual I), involving the power of a protector to remove Trustee A as trustee of Trust 2 and Trust 3.

gain to Individual A and a corresponding increase in basis to the stock in Corp J held by Trust 1.) On Date 17, Trust 1 was reorganized, resulting in the creation of two sub-funds, referred to as Fund A, and Fund B. The shares of Corp J were then assigned to Fund B. Trustee B was appointed as the trustee of Fund B. By Circular Resolution, the directors of Corp J delegated all powers of daily management of Corp J to Individual A.

As of Year 9, Individual A had five children, two of whom had children of their own, Individual H and Individual I. Only Individual I's children were citizens or residents of the U.S.

Certain documents provided by Taxpayers' representatives indicate that Trust 1 and Fund B made certain distributions, between Year 3 and Year 9, for the benefit of the children of Individual H and Individual I. These documents reflect transfers to Individual H, for the benefit of his children, that were made on different dates and in different amounts than the transfers to Individual I, for the benefit of her children. However, these documents do not appear to reflect all of the transfers made of Trust 1 and Fund B assets. One of these documents, dated Date 34, is a memorandum from Individual L, who represented Family in the transmission of funds. The memorandum confirmed the receipt by Individual H of a check in the amount of $G for his children. The memorandum further noted that

> [t]he difference compared with the amount that went to [Individual I's] children about a year ago is explained by the fact that - due to the equal positions of all grandchildren – interest for the period from Date 14 through Date 35, still had to be added to the above amount because the . . . children [of Individual I] had already received the money as of Date 13.

In addition to Fund B of Trust 1, in Year 5 Individual A had established two other Country Y trusts for the benefit of his children and grandchildren, Trust 2 and Trust 3.

In a letter dated Date 18, Individual A informed his daughter, Individual I, that, although she would continue to receive her annuity payment from Trust 3, she would no longer be a beneficiary of Trust 2 or Trust 3. In the letter, Individual A further provided that he had taken steps to assure that Individual I's children and the children of his son, Individual H, would "be the only beneficiaries of the [Fund B] portion of [Trust 1] and to receive distributions from [Fund B] on a 50/50 basis." The letter also provided that, because of various changes in the law, Individual A would use his "best efforts to insure that the Board of Directors of Corp J and the trustee of the Fund B portion of Trust 1 . . . make full distributions from Fund B on a current basis. The letter noted that this represented an acceleration of the previous distribution policies of Fund B and required her to plan carefully how these amounts would be received by her children.

In a letter dated Date 20, Individual A, as Chairman of the Board of Corp J, summarized the Corp J board meeting of Date 19. The letter described actions that

must be taken "in view of changes in the U.S. income tax laws and regulations pertaining to foreign trusts."[4] The letter provided that "new U.S. legislation does not permit foreign funds to build up assets. Assets will have to be distributed and then are taxed as income in the U.S. Undistributed assets will be highly taxed on an assumed earnings basis." The letter noted that the reserves for annuities to pay off the debt to Individual D which the trust currently maintained would be segregated into a sinking fund.

On Date 21, Corp K, a Country Y corporation, entered into a stock purchase agreement to purchase the shares of Corp L for $H. The sale of Corp L was completed at a closing that occurred on Date 31.

Pursuant to the terms of the stock purchase agreement, the shareholders of Corp L, which are listed as Trustee C as Trustee for Trust 6, Trustee C as trustee for Trust 7, Corp G, Corp F, Trustee B, as trustee for Trust 2, Trustee B as trustee for Trust 3, Corp J, and Individual E, agreed to place all of Corp L shares into escrow. On Date 22, the shareholders of Corp L executed an escrow agreement (Escrow Agreement) and transferred all their shares to the Escrow Agent subject to the terms of the Escrow Agreement. The Escrow Agreement provided that it would be binding on the Buyer and the Sellers and their respective successors and assigns. It further provided that no party would assign the Escrow Agreement or any rights or obligations thereunder to any third party without the written consent of the other party thereto, which consent shall not be unreasonably withheld.

A letter, dated Date 23, from the Trustee of Trust 2 and Trust 3 and Fund B to Individual A, described plans for reorganizing the Family trusts. The letter provided that '[u]nder this new organization, which started last year, you suggested that [Individual J] and [Individual K] become members of the group of discretionary beneficiaries under [Trust 2] and [Trust 3] and that [Individual I] and [Individual H] be removed from the group of beneficiaries under [Trusts 2 and 3]." The letter further described Individual A's recommendation that the Trustee of Fund B distribute half of the present assets of the Fund B to a new trust for the benefit of Individual H's children and that the remaining half of the assets be irrevocably appointed to a State J situs trust, a domestic trust, for the benefit of Individual I's children.

By letters dated Date 24, Individual A informed Individual I and Individual H that he had requested the two of his children who were likely to have children of their own, Individual J and Individual K, to renounce any interest that they or their future children might have in Fund B. In return, Individual H and Individual I were asked to renounce any interest that they and their children might have in Trusts 2 and 3.

[4] The Small Business Job Protection Act of 1996, Pub. Law No. 104-188, 110 Stat. 1755, made amendments to the provisions governing foreign trusts including amendments to section 672(f) making it more difficult for a trust to be treated as owned by a foreign person under the grantor trust rules. The amendments were generally effective on August 20, 1996.

In these Date 24 letters, Individual A referred to his letters of Date 36, wherein he had noted that certain changes were made to the identity of the beneficiaries of Trusts 2 and 3. Individual A noted that "[t]his was done independent and way before the Corp K deal was even anticipated." He explained that his objective in making these changes was to segregate the assets set aside for Individual H's and Individual I's children from the assets set aside for Individual J and Individual K, who then had no children to benefit from Fund B.

Attached to the letters of Date 24, were copies of the agreement by which the children were to renounce their interests, and those of their children, in the respective trusts. The letters and agreement indicated that new trusts would be formed for the benefit of Individual H's and Individual I's children, that the assets of Fund B, which, at that time were approximately m percent of the stock of Corp L, would be split 50/50 between those two trusts, and that the new trusts would segregate the interests of the children of Individual H and Individual I's from the interests of any future unborn beneficiaries.

On Date 25, the Trustee of Fund B commenced liquidation of Corp J and the distribution of its assets (rights under the Escrow Agreement to 50 percent of the Corp L stock and other minor assets) to Fund B. On Date 26, Corp J assigned its rights under the Escrow Agreement to the Trustee of Fund B pursuant to an assignment agreement (Assignment Agreement) signed by all of the parties to the Escrow Agreement.

Also on Date 26, the Trustee of Fund B created Trust 5 under Country Y law for the benefit of the children of Individual H, all nonresident aliens for U.S. tax purposes.

On Date 27, the agreement attached to Individual A's Date 24 letters to Individual H and Individual I, whereby four of Individual A's children (those children who had, or who were expected to have, children) relinquished their rights in either Fund B or Trusts 2 and 3, was executed.

In a letter, dated Date 27, the Trustees of Fund B indicated that they had arranged to "make a distribution of the entire accrued income and a portion of the principal of the trust fund" to Trust 5. The letter noted that "[t]his transfer is first subject to each child's unrestricted right to appoint one-quarter (1/4) of the total distribution amount to any person including herself, her creditors, her estate or the creditors of her estate. . . ." It further provided that "[E]ach child's general power of appointment will lapse on [Date 30] . . . ." At that time, three of Individual H's children were under the age of 21 and thus required their parents' participation in the exercise or waiver of the power of appointment. Individual H executed waivers for his minor children on Date 29.

On Date 28, the Trustee of Fund B advanced one-half of Fund B's assets to Trust 5. Included in the assets advanced were beneficial but not record ownership of

Corp L and an immediate right to half of the cash held by the trustee of Fund B. A schedule to the Advancement Agreement dated Date 28, was amended on Date 37 to specifically include rights and obligations under the Stock Purchase Agreement dated Date 21, with Corp K and the related Escrow Agreement dated Date 22. There is no evidence that the trustee sought Corp K's consent to the advancement to Trust 5 as a party to the Escrow Agreement or that Corp K consented to the Advancement. The Advancement Agreement provided that it was contemplated that the Trustee would, following the sale to Corp K, advance substantially all of its then remaining assets and liabilities to a newly established State J situs irrevocable trust.

The Trustee of Fund B and the Trustee of Trust 5 also signed a Nominee Agreement dated Date 28, which references the advancement of half of the stock of Corp L to Trust 5 and provides that the Trustee of Fund B will be the registered owner of the Corp L stock until the sale of the stock to Corp K is closed and will hold the stock as the nominee of Trust 5. The Nominee Agreement provides that Trust 5 will have all the benefits and burdens of ownership of the Corp L stock and the powers to exercise all of the rights of ownership of such stock. The children of Individual H who were the beneficiaries of Trust 5 were also granted the power in Month B of Year 9, to withdraw within 30 days their respective shares of the assets transferred to Trust 5.

On Date 32, Trust 4, a U.S. trust, was established under State J law by Fund B, with Individual I and her husband as trustees and funded with U.S. Treasury Bills that Fund B had purchased with the proceeds from the sale of Fund B's share of Corp L stock, which represented the remaining half of the assets held by Fund B after the transfer to Trust 5.

The sole beneficiaries of Trust 4 are the children of Individual I, all U.S. citizens. Pursuant to Article K of the Country Y Trust Law and the terms of Trust 4 and the Trust 1, and consistent with the representations made in the letters and agreement from Year 9, the assets of Trust 4 were divided up into 3 equal shares for the benefit of Individual I's 3 living children. The Trust 4 agreement also provided that if any child of Individual I was born after Date 32, the trustees would create a separate trust for the benefit of such afterborn child and transfer a proportionate share of the principal of the other separate trusts created under the trust instrument to the separate trust for the afterborn child (such that equal shares would be held in each separate trust).

LAW AND ANALYSIS:

I. Application of sections 1291 through 1297

A. Was Corp J a PFIC as defined in I.R.C. section 1297?

The passive foreign investment company (PFIC) rules (§§1291-1298) impose certain tax and interest charges on excess distributions received by a U.S. person in

respect of stock in a PFIC. Section 1297(a) defines a PFIC as any foreign corporation if 75 percent or more of the gross income of such corporation for the taxable year is passive or if the average percentage of assets held by such corporation during the taxable year that produce passive income, or that are held for the production of passive income, is at least 50 percent. Section 1297(b)(1) defines passive income, for purposes of section 1297(a), as any income that would be foreign personal holding company income (FPHCI), as defined in section 954(c). Under section 954(c)(1)(A), FPHCI includes dividends.

From its formation on Date 16 until the commencement of its liquidation on Date 25, Corp J held only assets that produce passive income, its principal asset being m percent of the stock of Corp L. Accordingly, Corp J satisfied the definition of a PFIC under section 1297(a).

B. Can the stock of Corp J owned by Individual A be attributed to Fund B for purposes of the look-through rule of I.R.C. section 1297(c)?

Taxpayers take the position that Corp J nevertheless is not a PFIC because of the look-through rule of section 1297(c). Section 1297(c) provides that if a foreign corporation owns, directly or indirectly, at least 25 percent (by value) of the stock of another corporation, for purposes of determining whether such foreign corporation is a PFIC, such foreign corporation shall be treated as if it (1) held its proportionate share of the assets of such other corporation, and (2) received directly its proportionate share of the income of such other corporation.

Taxpayers assert that the look-through rule of section 1297(c) applies with respect to Corp J's ownership of Corp L. If the look-though rule applied in this case, Corp J would be treated as holding its proportionate share of the assets, and receiving its proportionate share of the income, of Corp L. Taxpayers represent that, under these circumstances, Corp J would not be treated as a PFIC. Although Corp J directly owns only m percent of Corp L, Taxpayers take the position that the constructive ownership rules of section 318 apply for purposes of the look-through rule to treat Corp J as owning the p percent interest in Corp L owned by Individual A[5] because Individual A influenced the voting of the shares of Corp L that were held by Corp J.

Section 1297(c), by its terms, applies only to stock owned "directly or indirectly" by the foreign corporation that is being tested for PFIC status. "Direct or indirect" ownership does not include constructive ownership. When Congress intends constructive ownership rules to apply, it will expressly so state. For example, section 318 provides that, under certain circumstances, stock "directly or indirectly" owned by one person will be considered to be owned by another person. Section 1297(c) does not contain constructive ownership rules and does not incorporate the constructive

[5] It has not been established that Individual A owned p percent of Corp L.

ownership rules of section 318. Thus, it is not necessary to address whether, under constructive ownership rules, the stock of Individual A would be attributed to Corp J.

C. Would the application of the PFIC rules in this case be contrary to congressional intent?

Taxpayers argue that the PFIC regime was enacted to target U.S. taxpayers who were intentionally investing in a foreign holding company for tax-deferral or tax avoidance purposes and that PFIC tax should not be imposed as a matter of policy where there is no such purpose. Taxpayers represent that the formation of Corp J was not for tax-deferral or tax avoidance purposes. Furthermore, Taxpayers argue that it would be inappropriate to impose a PFIC tax upon the beneficiaries of Fund B because they did not choose to own an interest in a PFIC.

Taxpayers cite to Marsman v. Commissioner, 205 F.2d 335 (4th Cir. 1953), aff'd, 216 F.2d 7 (1954), cert. denied, 348 U.S. 943 (1955), as authority for the proposition that a literal application of a statute is not appropriate when such an application is at odds with the congressional intent underlying the enactment of that statute. Marsman v. Commissioner involved the application of the foreign personal holding company statutory rules, which like the PFIC rules, are anti-deferral rules applicable to certain foreign corporations. In Marsman, the United States shareholder of the foreign personal holding company was a nonresident alien for a portion of the year. The court acknowledged that a literal reading of section 337 of the Internal Revenue Code (as in effect during the years at issue) would cause the inclusion in the United States shareholder's gross income of such shareholder's share of the undistributed net income of the foreign corporation for the entire taxable year. The court nevertheless concluded that the income inclusion under section 337 should be reduced to exclude income of the foreign corporation earned during that portion of the taxable year during which such United States shareholder was a nonresident alien. In reaching this conclusion, the court reasoned that the statute should not be applied literally without reference to the purpose for which it was enacted and that "Congress did not intend to reach the income of persons, such as alien nonresidents, which was not subject to the laws of the United States when it was received by them or by a holding company subject to their control." Id. at 340. Taxpayers claim that the present situation is almost identical to Marsman v. Commissioner and that no PFIC tax or interest charge should be imposed as a result of the liquidation of Corp J.

In Marsman v. Commissioner, the court's concern was that the shareholder of a foreign corporation not be subject to tax on its share of undistributed net income of the foreign corporation attributable to the portion of the year during which the shareholder was a nonresident alien. That concern is already addressed under the PFIC rules. Treas. Reg. § 1.1291-9(j)(1) limits the time during which a corporation is considered a PFIC to the portion of a shareholder's holding period during which that shareholder was a U.S. person. The deferred tax amount under section 1291 is therefore determined

based on the portion of an excess distribution attributable to the period during which the shareholder was a U.S. person. Furthermore, when Corp J was formed on Date 16, Individual I's children, the only U.S. grandchildren of Individual A, were already beneficiaries of Fund B. Therefore, the factual and legal issues that caused the court to set aside a literal reading of the statute in Marsman v. Commissioner are not present here.

Further, whether Corp J was originally set up for the purpose of avoiding U.S. tax is irrelevant. The PFIC regime was enacted to counteract the perceived advantage of tax deferral achieved by investing through a foreign holding company, regardless of whether investment through that foreign holding company was explicitly for the purpose of achieving tax deferral. See H.R. Conf. Rep. No. 99-841, 639, 641(1986) (stating that "[t]he conferees believe that eliminating the economic benefits of deferral is necessary to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic funds."). Intent is not a factor to be considered in applying the PFIC rules. Elimination of tax deferral is appropriate whenever the taxpayer's passive investments are held in a foreign corporation so that the taxpayer does not obtain an unfair advantage over taxpayers whose investments are held domestically.

Finally, it is clear from the language of section 1298(a)(3) and from its legislative history that Congress intended the PFIC regime to apply to beneficiaries of a trust, despite the fact that beneficiaries often have no role in the formation of a trust and no ability to control distributions from it. See Joint Comm. On Taxation, General Explanation of the Tax Reform Act of 1986, 1020, 1032 (J. Comm. Print 1987) (stating that "[i]n attributing stock owned by a trust, it is intended that the general rules of subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, *and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust*.") (emphasis added).

D. When was the taxable event for purposes of applying section 1291?

Section 1291(a)(2) treats any gain recognized on the disposition of a PFIC as an excess distribution subject to section 1291(a)(1). Section 331 provides that amounts received in a distribution in complete liquidation of a corporation are treated as in full payment in exchange for the stock of such corporation. The liquidation of Corp J was commenced on Date 25, and, Corp J's rights under the Escrow Agreement, its predominant asset, were assigned to the trustee of Fund B on Date 26. Given the commencement of liquidation, the assignment of Corp J's escrow rights to the trustee for Fund B constituted a liquidating distribution which generated an excess distribution for purposes of section 1291(a)(2) equal to the difference between Fund B's basis in its Corp J stock and the value of the rights under the Escrow Agreement (roughly equal to the value of the Corp L stock held in escrow) on Date 26 when they were transferred.

II. Application of section 1298

A. Can the PFIC tax and interest charge under section 1291 be imposed on the beneficiaries of Fund B in the absence of regulations under section 1298(b)(5)?

Taxpayers take the position that, even if Corp J is a PFIC and the gain from the liquidation of Corp J is an excess distribution, Individual I's children, as beneficiaries of a trust that owns the PFIC stock, are not subject to tax under section 1291.

Section 1298(a)(3) states that: "[s]tock owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries." Section 1298(b)(5) states that:

> *Under regulations*, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a)—any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock . . . shall be treated as a disposition by . . . the United States person with respect to the stock in the passive foreign investment company.

(Emphasis added). Proposed regulations have been issued under section 1291 (57 F.R. 11024) which provide general rules governing the application of section 1298(b)(5). The proposed regulations generally apply the excess distribution regime of section 1291 to indirect holders. However, no temporary or final regulations have been issued, and the proposed regulations reserve on the treatment of estates, trusts and beneficiaries. Taxpayers argue that because section 1298(b)(5) begins with the phrase "under regulations" and because no temporary or final regulations have been issued under section 1298(b)(5), section 1298(b)(5) cannot be applied and the tax and interest charge under section 1291 cannot be imposed upon the beneficiaries as a result of the liquidation of Corp J.

It is the position of the Service that the absence of regulations should not prevent the application of section 1298(b)(5) because the intended application of the statute is clear. Furthermore, even if section 1298(b)(5) were held to be inapplicable in the absence of enabling regulations, PFIC tax should nevertheless be imposed on the beneficiaries as a result of the application of sections 1291 and 1298(a)(3)

As to the issue of the lack of existing regulations under section 1298(b)(5), courts have demonstrated a willingness to apply statutes that direct that regulations be promulgated, even in the absence of such regulations, and even when application of the

statute imposes results that are not taxpayer favorable such as the imposition of a tax or the disallowance of a credit.

In Pittway Corporation v. United States, 102 F.3d 932 (7th Cir. 1996), the Seventh Circuit considered the applicability of a statute that, like section 1298(b)(5), began with the words "under regulations," and for which no regulations had yet been promulgated. The Service was seeking to apply the statute to impose tax. The taxpayer argued that it could not be applied in the absence of regulations. The code section at issue, section 4661(a) stated that:

> *Under regulations prescribed by the Secretary*, methane or butane shall be treated as a taxable chemical only if it is used otherwise than as a fuel or in the manufacture or production of any motor fuel, diesel fuel, aviation fuel, or jet fuel (and, for purposes of section 4661(a), the person so using it shall be treated as the manufacturer thereof).

(Emphasis added). The Seventh Circuit noted that "[m]ore than fifteen years after the statute's passage, there are no regulations." Id. at 935. The court nevertheless held that the statute could be applied in the absence of regulations, reasoning that:

> The plain meaning of legislation should be conclusive . . . In this case, the language directs us to a single conclusion: that Pittway, as the user of butane, is the manufacturer responsible for the excise tax imposed on the butane. Even if there were regulations, we would have to question them if they suggested a different result.

Id. at 936. The Pittway court acknowledged the existence of a single exception to the plain meaning rule: "rare cases [in which] the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters." Id. The Pittway court, however, was not persuaded by the taxpayer's arguments that the case at issue constituted such a "rare case."

Similarly, in International MultiFoods Corporation and Affiliated Companies v. Commissioner, 108 T.C. 579 (1997), the Tax Court, holding for the Commissioner, applied section 865(j)(1) in the absence of enabling regulations to source taxpayer's loss on a sale of stock in the United States for purposes of determining petitioner's foreign tax credit limitation under section 904(a). Section 865 provides that income realized from the sale of non-inventory personal property is generally sourced at the residence of the seller. Section 865(j)(1) provides that "[t]he secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purpose of this section, including regulations * * * relating to the treatment of losses."

The court noted that the purpose behind section 865(j)(1) is reflected in the General Explanation of the Tax Reform Act of 1986:

> The Act provides that regulations are to be prescribed by the Secretary carrying out the purposes of the Act's source rule provisions, including the application of the provisions to losses from sales of personal property * * *. It is anticipated that regulations will provide that losses from sales of personal property *generally* will be allocated consistently with the source of income that gains would generate *but that variations of this principle may be necessary*. * * *

108 T.C. at 587 (quoting Joint Comm. On Taxation, General Explanation of the Tax Reform Act of 1986, at 922-923 (J. Comm. Print 1987) (emphasis added)). The court interpreted the language of the statute in the light of its general purpose, stating: "[s]ection 865(j)(1) directs the Secretary to promulgate regulations to carry out the purpose of section 865; i.e., that gains and losses on the sale of noninventory personal property generally are sourced at the residence of the seller." 108 T.C. at 589.

The taxpayer in International MultiFoods argued that the statute could not be applied in the absence of regulations. However, despite the absence of temporary or final regulations under section 865(j)(1), and despite the fact that Congress anticipated exceptions to the rule to be articulated by regulations, the court held that section 865(j)(1) could be applied to allocate losses to the same jurisdiction as the gain, reasoning that:

> When Congress directs that regulations be promulgated to carry out a statutory purpose, the fact that regulations are not forthcoming cannot be a basis for thwarting the legislative objective. It is well established that the absence of regulations is not an acceptable basis for refusing to apply the substantive provisions of a section of the Internal Revenue Code.

108 T.C. at 587. The International MultiFoods court then went on to cite to its previous opinion in Occidental Petroleum Corp. v. Commissioner, 82 T.C. 819 (1984) in which it stated: "[t]he failure to promulgate regulations can hardly render the new provisions of section 58(h) inoperative. *We must therefore do the best we can with these new provisions. Certainly we cannot ignore them*." Id. at 587 (emphasis added). The International MultiFoods court concluded that there was no basis for precluding the application of the general rule articulated in section 865(a) to the facts of the case.

Following Pittway and International MultiFoods, in the absence of regulations, the general statutory rule should be applied if it is determined that the statute sets forth a clear rule and the literal application of the statute will not produce a result demonstrably at odds with congressional intent. The code section at issue in this case, section 1298(b)(5), sets forth a clear rule:

> Under regulations, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of

> subsection (a)—any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock . . . shall be treated as a disposition by . . . the United States person with respect to the stock in the passive foreign investment company.

The application of section 1298(b)(5) is particularly clear as applied to the facts of this case, the disposition of a PFIC by a pass-through entity. Where the PFIC is owned indirectly through a pass-through entity, the income of the pass-through entity is ultimately the income of the indirect holder to the extent of that indirect holder's allocable share of the pass-through entity's income. The indirect holder's excess distribution amount should therefore be determined based on the indirect holder's proportionate share of the income of the pass-through entity.

Applying a plain reading of section 1298(b)(5) to the facts of this case, the disposition of the PFIC, Corp J, by the pass-through entity, Fund B, should therefore be treated as a disposition of the PFIC by the indirect U.S. holders, the U.S. beneficiaries of Fund B.

In this case, as in International MultiFoods, the legislative history contemplates that regulations may vary the general rules of the statute:

> The act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent the circumvention of the interest charge. . . . Another instance where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules attribute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. *Congress intended, however, that regulations treat the disposition of the interest in the intervening entity as a disposition of the PFIC stock in the appropriate cases. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.*

Joint Comm. On Taxation, General Explanation of the Tax Reform Act of 1986, at 1032 (J. Comm. Print 1987) (emphasis added).

Although the General Explanation contemplates regulations applying the general rule in "appropriate cases," the fact pattern at issue in this case, the disposition of a PFIC by an intermediary, is not one identified as specifically requiring regulations. Instead, regulations were specifically contemplated that would address cases to which

the PFIC rules technically may not have applied prior to the enactment of section 1298(b)(5): the disposition of an intermediary that is not a PFIC by a U.S. person that is an indirect owner of a PFIC through that intermediary, and a distribution from a PFIC to an intermediary.

By contrast, even prior to the enactment of section 1298(b)(5), the statutory scheme would have supported the application of section 1291 to an indirect holder of a PFIC upon the disposition of the PFIC. Section 1298(a) treats the owner of an interest in an intermediary that owns an interest in a PFIC as an owner of that PFIC. A disposition of the PFIC by the intermediary would therefore be considered a disposition of the PFIC by the indirect holder, thereby triggering section 1291(a)(2). Section 1291(a)(2), in turn, treats gain recognized on the disposition of a PFIC as an excess distribution under section 1291(a)(1). Consequently, the indirect holder's pro rata share of the gain recognized by the intermediary upon the disposition of the PFIC would have been an excess distribution with respect to that indirect holder under section 1291(a)(1).

In any case, since there is no indication that Congress intended the general rule of section 1298(b)(5) to be circumscribed in its application to a disposition of a PFIC by an intermediary and given the appropriateness of the statute's application in the case of a disposition of a PFIC by a pass-through intermediary, section 1298(b)(5) should be applied to the facts of this case notwithstanding the absence of regulations. [6]

B. Was Taxpayers' method of applying section 1298(b)(5) reasonable?

[6] Courts have, in certain cases, applied a "how" vs. "whether" test for determining whether a statute that contemplates regulations is self-executing in the absence of enabling regulations. In Estate of Neumann v. Commissioner, 106 T.C. 216 (1996) the Tax Court summarized the test, stating: "issuance of regulations is to be considered a precondition to the imposition of a tax where the applicable provision directing the issuance of such regulations reflects a "whether" characterization . . . and not where the provision simply reflects a "how" characterization"). A "how" characterization generally applies to statutes that contemplate regulations providing technical details about the application of the rule set forth in the statute, whereas a "whether" characterization generally applies to statutes that contemplate regulations explaining when the statute is to apply. However, although used in Estate of Neumann, the "how" vs. "whether" test was not explicitly used by the Seventh Circuit in Pittway later that year, or by the Tax Court in International MultiFoods the following year. Instead, the Pittway and International MultiFoods courts chose to find the statute self-executing in the absence of regulations when a clear general rule could be discerned. Like the statute in Pittway, section 1298(b)(5) sets forth a straightforward rule on its face. Further, as in International MultiFoods, the rule set forth in section 1298(b)(5) should be imposed despite the existence of language in the Joint Committee General Explanation indicating that the general rule may not apply in all cases, since this is a straightforward case where it was presumably intended to apply. However, even under a "how" vs. "whether" test, the statute should be held to be self-executing. Following the test as summarized by the Tax Court in Estate of Neuman, section 1298(b)(5), on its face, directs the issuance of regulations reflecting a "how" rather than a "whether" characterization, as it sets forth a clear rule that is to be applied "in any case in which a United States person is treated as owning a [PFIC]." Although the Joint Committee General Explanation does contemplate that regulations will apply the rule in "appropriate cases," the absence of regulations should not prohibit the application of the rule to the facts of this case, since in this case the application of the rule is both clear and appropriate.

The proposed regulations issued under section 1291, Prop. Treas. Reg. §1.1291-3(e), adopt rules that mirror the language of the statute, generally requiring an excess distribution to be taken into account by the indirect holder when the PFIC makes a distribution to an intermediate entity or when the indirect holder ceases to have an ownership interest in the PFIC. However, the proposed regulations specifically reserve on the taxation of trusts, estates and their beneficiaries. The preamble to the proposed regulations states that -

> [t]he regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or indirectly owns stock of a section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and subchapter J in a reasonable manner that triggers or preserves the interest charge.

Notice of Proposed Rulemaking (Treatment of Shareholders of Certain Passive Foreign Investment Companies) (INTL-941-86, INTL-656-7, INTL-704-87), 1992-1 C.B. 1124, 1127.

Taxpayers argue that, if section 1298(b)(5) is operative in the absence of temporary or final enabling regulations, then they are permitted to rely on the preamble to the proposed regulations and may apply the PFIC rules and subchapter J in any reasonable manner that triggers or preserves the interest charge. Taxpayers argue that their adopted method of applying the trust distributable net income ("DNI") rules to preserve the PFIC excess distribution at the trust level and carry it out upon a subsequent distribution from the trust to the foreign beneficiaries is one such reasonable manner. Under Taxpayers' DNI method, the entire amount of the excess distribution resulting from the gain on the liquidating distribution from Corp J would have been carried out to the beneficiaries of Trust 5, along with all of the DNI of Fund B, on Date 28 when Fund B advanced half of its assets to Trust 5. Since Trust 5 has no U.S. beneficiaries, the excess distribution would result in the imposition of no PFIC tax. The distribution of the other half of the assets from Fund B to Trust 4 in the following year, on Date 32, would correspondingly result in no PFIC tax as there would be no excess distribution amount remaining in that year.

Taxpayers point specifically to the reference to subchapter J in the preamble to the proposed section 1291 regulations. Taxpayers argue that, since DNI is an integral part of the taxation of trusts and beneficiaries under subchapter J and since the utilization of the DNI rules results in the preservation of tax at the trust level in the form of DNI, their method is a reasonable manner of applying section 1298(b)(5).

It is the Service's position that Taxpayers' DNI approach is unreasonable because it fails to actually preserve any of the PFIC interest charge. To the contrary, it facilitates the avoidance of the interest charge altogether by allowing the entire excess distribution amount to be carried out to foreign beneficiaries who are not subject to the

PFIC regime. The purpose of section 1298(a)(3) and (b)(5) is to insure that the PFIC tax is not circumvented by the imposition of a foreign pass-through entity such as a partnership or trust in an ownership chain between a U.S. person and a PFIC. Taxpayers' method of applying section 1298(b)(5) would make a trust with both U.S. and foreign beneficiaries an effective vehicle for circumvention of the PFIC regime because the PFIC tax and interest charge could be carried out to the foreign beneficiaries by manipulating the timing of distributions from the trust, as Taxpayers have done here. Taxpayers' method represents neither a reasonable nor a good faith attempt to implement the statute in light of its language and purpose.

The preamble language of the proposed section 1291 regulations does contemplate the possibility that, in the trust context, the interest charge might be preserved rather than triggered under certain circumstances and does require that taxpayers implement section 1298(b)(5) in a manner consistent with the principles of subchapter J. Therefore, a method that preserves the interest charge at the trust level and later carries it out to the beneficiaries is not per se unreasonable. However, Taxpayers' method circumvents the purpose of the PFIC rules and neither triggers nor preserves an interest charge for the U.S. beneficiaries despite the fact that, under section 1298(a)(3), U.S. beneficiaries indirectly owned 50 percent of a PFIC prior to its liquidation and subsequently received a distribution of 50 percent of the liquidation proceeds of that PFIC.

In this case, Fund B's primary asset from its creation until it was effectively terminated by the creation and funding of Trust 4 and Trust 5, was its 50 percent interest in Corp J. Trust 4 and Trust 5 were each funded with roughly 50 percent of the assets received in the liquidating distribution made from Corp J to Fund B. The liquidating distribution from Corp J fixed the time and amount of the excess distribution. Since 50 percent of this liquidating distribution was earmarked for the U.S. beneficiaries of Fund B and subsequently distributed within a matter of months to Trust 4 for the benefit of those U.S. beneficiaries, 50 percent of the gain on the liquidating distribution should be an excess distribution that is either taxed to the existing U.S. beneficiaries of Fund B in the year of the liquidating distribution from Corp J or preserved in some manner for taxation to Trust 4 upon its funding with the U.S. Treasury Bills from Fund B in Year 10.

C. What is a reasonable method of applying section 1298(b)(5)?

Since Taxpayers have failed to use a reasonable method to trigger or preserve the PFIC tax and interest charge it falls to the Service to apply a reasonable method in this case. It is the position of the Service that a reasonable method of implementing sections 1298(a)(3) and 1298(b)(5) in the absence of temporary or final regulations would include the method that comports with a plain reading of these statutes. This method would treat the beneficiaries as themselves receiving an excess distribution

equal to their pro rata share of the gain recognized by Fund B upon receipt of the liquidating distribution from Corp J.

Although this method will result in the imposition of tax on the beneficiaries prior to their receipt of the sale proceeds, that result is consistent with the legislative purpose of the attribution rules of sections 1298(a)(3) and 1298(b)(5), to prevent U.S. taxpayers from circumventing the PFIC tax and interest charge by interposing a foreign pass-through entity in the PFIC ownership chain**.**

Section 1298(a)(3) states that "[s]tock owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries. No temporary or final regulations have been promulgated under section 1298(a)(3). However, unlike section 1298(b)(5), section 1298(a)(3) contains no language contemplating the promulgation of regulations and there is therefore no ambiguity with regard to its applicability.

Regulations have been issued under subpart F, another anti-deferral regime, that provide a method of allocating subpart F income to the beneficiaries of a trust that holds an interest in a controlled foreign corporation. Treas. Reg. § 1.958-1(c)(2) states that -

> [t]he determination of a person's proportionate interest in a foreign corporation, foreign partnership, foreign trust, or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) and this section are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person. However, any arrangement which artificially decreases a United States person's proportionate interest will not be recognized. See §§ 1.951-1 and 1.957-1.

Example 3 of Treas. Reg. § 1.958-1(c)(2) illustrates the application of this rule to the beneficiaries of a trust, and reads as follows:

> Foreign trust Z was created for the benefit of United States persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary's share of

> the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E, and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

In the absence of temporary or final regulations under section 1298(a)(3), the Service proposes to determine the beneficiaries' proportionate share of the stock of Corp J by applying a facts and circumstances analysis, following the method imposed under the subpart F regulations.

In this case, the facts and circumstances indicate that the U.S. beneficiaries each owned an equal share of 50 percent of Fund B on Date 26 when the PFIC, Corp J, made a liquidating distribution of its rights under the Escrow Agreement.

The terms of the Trust 1 agreement provided that the grandchildren of Individual A would receive j percent of the assets of the trust and the grandchildren would "take equally per stirpes." The term "grandchildren" was an open class that included "the children living at the termination of the trust of any now existing children of Individual A and Individual C." Although, on Date 7, when Trust 1 was formed, the beneficiaries could not be determined with certainty, during the years at issue, the beneficiaries became more identifiable. On Date 16, when the PFIC, Corp J, was formed and capitalized with the assets of Trust 1 that were held for the benefit of individual A's grandchildren and dropped into Fund B, Individual A had five children, only two of whom, Individual H and Individual I, had children of their own. Individual I had three children, all of whom were U.S. persons. None of Individual H's children were U.S. persons.

Fund B was administered in a manner consistent with Individual I's children each owning equal portions of a collective 50 percent interest in Fund B. First, distributions from the trust historically were made in equal amounts to the children of Individual H and Individual I. This is evidenced by the memorandum dated Date 34 from Individual L in which an uneven distribution to the beneficiaries of Fund B was explained as follows:

> The difference compared with the amount that went to [Individual I's] children about a year ago is explained by the fact that – *due to the equal positions of all grandchildren* – interest for the period from Date 14 through Date 35, still had to be added to the above amount because the . . . children [of Individual I] had already received the money as of Date 13.

(Emphasis added). The memorandum evidences the fact that efforts were taken to insure that each beneficiary received an equal share of the distributions from Fund B.

Second, as of Date 18, documents explicitly evidenced Individual A's intent to divide up Fund B's assets and to provide separate distinct shares of equal proportion to the beneficiaries alive on that date. In a letter dated Date 18, Individual A informed his daughter, Individual I, that he had taken steps to assure that Individual I's children and the children of his son, Individual H, would "be the only beneficiaries of the [Fund B] portion of [Trust 1] and to receive distributions from [Fund B] on a 50/50 basis." The letter also provided that, because of various changes in the law, Individual A would use his "best efforts to insure that the Board of Directors of Corp J and the trustee of the Fund B portion of Trust 1 . . . make full distributions from Fund B on a current basis.

Third, this documented intent was carried out on Date 28 and Date 34 by the forming of Trust 5 and Trust 4 for the benefit of the children of Individual H and Individual I respectively, and the funding of each trust with 50 percent of the assets of Fund B.

Therefore, as of Date 26 when Corp J made a liquidating distribution to Fund B, the children of Individual H and the children of Individual I each collectively had a 50 percent share in Fund B. Correspondingly, 1/6th (1/3rd of 50 percent) of the gain recognized by Fund B on the receipt of the liquidating distribution from Corp J on Date 26 should be an excess distribution considered to be received by each of the three children of Individual I on that date.

III. Application of subchapter J

A. Was Individual A the grantor of Trust 1 within the meaning of sections 671 through 677?

Taxpayers argue that Individual A should be treated as the grantor of the portion of Trust 1 that was held for the benefit of his living grandchildren at the termination of Trust 1.

Taxpayers argue that even though in form Corp I is listed as the Settlor of Trust 1, in substance Individual A should be treated as the grantor because the facts and circumstances indicate that Individual A was the true grantor of the relevant portion of Trust 1. Taxpayers argue that Corp I was acting on behalf of Individual A (and Individual C) when the stock of Corp G was transferred to Trust 1 on Date 7 by Corp I.

Taxpayers have cited Treas. Reg. § 1.671-2(e) in support of their position that Individual A should be treated as the true grantor of the portion of Trust 1 benefiting his grandchildren and point out that the regulations are consistent with the case law that

applied when Trust 1 was funded. The regulations do not apply to the funding of Trust 1 on Date 7 because they are effective for transfers to trusts on or after August 10, 1999.[7]

Taxpayers have also cited case law that in determining the true grantor of a trust, one must "look beyond the named grantors to the economic realities." Zmuda v. Commissioner, 79 T.C. 714 720 (1982), aff'd 731 F.2d 1417 (9th Cir. 1984). See also Weigl v. Commissioner, 84 T.C. 1192 (1985); Stern v. Commissioner, 77 T.C. 614 (1981), Investment Research Assocs., Ltd. v. Commissioner, T.C. Memo. 1999-407 (1999).

Accordingly, pursuant to the applicable law, depending on the facts and circumstances, Individual A may be the true grantor of a portion of the trust even though he is not named as the Settlor of Trust 1.

Although Taxpayers have not provided a written nominee or agency agreement establishing that Individual B, Corp G, Corp F and/or Corp I were acting as Individual A's nominee when the stock in the Predecessor Companies was purchased from Individual D and subsequently transferred to Trust 1, they have provided the following information in support of this position.

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[7] Treas. Reg. § 1.671-2(e)(1) of the Income Tax Regulations provides that for purposes of part I of subchapter J, chapter 1 of the Internal Revenue Code, a grantor includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer (within the meaning of Treas. Reg. § 1.671-2 (e)(2)) of property to a trust. For purposes of Treas. Reg. § 1.671-2, the term property includes cash. If a person creates or funds a trust on behalf of another person, both persons are treated as grantors of the trust. (See section 6048 for reporting requirements that apply to grantors of foreign trusts.) However, a person who creates a trust but makes no gratuitous transfers to the trust is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. Also, a person who funds a trust with an amount that is directly reimbursed to such person within a reasonable period of time and who makes no other transfers to the trust that constitute gratuitous transfers is not treated as an owner of any portion of the trust under sections 671 through 677 or 679. See also Treas. Reg. § 1.672(f)-5(a).

Treas. Reg. § 1.671-2(e)(4) provides that if a gratuitous transfer is made by a partnership or corporation to a trust and is for a business purpose of the partnership or corporation, the partnership or corporation will generally be treated as the grantor of the trust. For example, if a partnership makes a gratuitous transfer to a trust in order to secure a legal obligation of the partnership to a third party unrelated to the partnership, the partnership will be treated as the grantor of the trust. However, if a partnership or a corporation makes a gratuitous transfer to a trust that is not for a business purpose of the partnership or corporation but is for the personal purposes of one or more of the partners or shareholders, the gratuitous transfer will be treated as a constructive distribution to such partners or shareholders under federal tax principles and the partners or the shareholders will be treated as the grantors of the trust. For example, if a partnership makes a gratuitous transfer to a trust that is for the benefit of a child of a partner, the gratuitous transfer will be treated as a distribution to the partner under section 731 and a subsequent gratuitous transfer by the partner to the trust.

The Date 3 Agreement provided that Individual E, Individual A, Individual B and Individual C waived their rights to purchase Individual D's share of the Predecessor Companies directly or indirectly under the Consortium Agreement. The Date 3 Agreement stated that Corp F was acting with regard to Corp G as a fiduciary and in the interest of Individual A, Individual B and Individual C, but not Individual E who expressly agreed to forgo any claims related to Corp G's purchase of Individual D's share of the Predecessor Companies. Individual A and Individual C have provided affidavits that Corp G was acting as their and Individual B's nominee when Corp G purchased the stock from Individual D in the Predecessor Companies. Their affidavits also provide that Corp I was acting as a nominee for Individual A and Individual C when Corp I funded Trust 1 with i percent of Corp G shares (representing Individual A's and Individual C's respective shares) for the benefit of Individual A's and Individual C's living grandchildren on termination of Trust 1 in the stated proportions listed in the trust agreement. Corp I was a holding company that did not conduct any business aside from holding the stock in Corp G and acting as the nominal grantor. The transfer to Trust 1 did not satisfy any business purpose of Corp I but carried out the personal intentions of Individual A and Individual C.

Taxpayers also assert that Individual A should be treated as having made three different gratuitous transfers to Trust 1: (1) he transferred a valuable property right by permitting Corp G to purchase the stock at a bargain price in the Predecessor Companies (which was transferred to Trust 1); (2) he "guaranteed" the amounts to be paid to Individual D with respect to one of the Companies; and (3) he provided the cash for a portion of the purchase price with respect to two of the Predecessor Companies.

Although the information provided is not entirely complete and unambiguous, based on the facts presented and representations made, we conclude that Individual A should be treated as the grantor of the portion of Trust 1 that was held for the benefit of his living grandchildren on termination of the trust.

B. Was Individual A the owner of any portion of Trust 1 within the meaning of sections 671 through 677 on or before August 20, 1996?[8]

[8] We briefly note the tax consequences of Trust 1 not being treated as a grantor trust. In 1996, the stock of Corp L was transferred from Corp G to Trust 1 in redemption of a portion of the stock which Trust 1 held in Corp G and then transferred to Corp J. The redemption of the stock in Corp G would have resulted in gain to Trust 1 (although not taxable in the U.S. in 1996 because Trust 1 was a foreign trust with no U.S. source income), a basis step up for the amount of that gain in the Corp L stock, and undistributed net income UNI to Trust 1 which would result in tax consequences to the US beneficiaries in 1998 under the throw-back rules (regardless of whether or not the Service prevails on the other issues). Taxpayers concede and we agree that Trust 1 was not a grantor trust in any part after August 20, 1996.

Taxpayers assert that, as the grantor of the portion of Trust 1 that is held for the benefit of his living grandchildren upon the termination of the Trust, Individual A should be treated as the owner of that portion of Trust 1 under section 674, section 675, and section 677.

Taxpayers argue that Individual A should be treated as the owner under section 674(a) because, under the terms of the trust agreement and relevant Country Y Law, the trustee had complete discretion to accumulate or distribute corpus or income to or for the beneficiaries of Trust 1 (by establishing a further trust with different terms and possibly new beneficiaries).

Taxpayers note that if this power were held by an independent trustee, Individual A would not be treated as the owner of the trust. See section 674(c). However, because Individual A (together with Individual C) had the power to remove the trustee and replace the trustee with any person, including himself, the exception to section 674(a) in section 674(c) does not apply, and Individual A should be treated as the owner of the trust under section 674(a).

Taxpayers also argue that Individual A should be treated as the owner of Trust 1 under section 674 because Individual A and the Trustee had a power of disposition over the beneficial enjoyment of the corpus and income of the trust because they retained the power to eliminate the interests of any after-born grandchildren by terminating the trust and distributing the trust assets to the then living grandchildren.

For purposes of section 675(4), Taxpayers argue that the combined holdings of Trust 1 and Individual A in Corp L were significant from the viewpoint of voting control. Taxpayers assert that Individual A indirectly owned p percent and that Trust 1 owned m percent equaling k percent of the stock of Corp L, which is enough to veto any significant corporate act of Corp L.

In addition, the Trust 1 agreement grants the “Settlor” the power to veto Trust 1 investments. Taxpayers argue that because Individual A should be treated as the grantor of Trust 1 for federal tax purposes, he should be treated as the Settlor under the trust agreement and therefore be treated as holding the power to veto trust investments [redacted].

Taxpayers assert that Individual A should be treated as having the power to vote the stock held by the Trust because the Trustee had agreed to vote the stock as he directed. In addition, Taxpayers argue that Individual A had the power to remove the Trustee and that the Trustee consistently followed his directions. Individual A was also the Chairman of the Board of Corp J giving him additional practical control.

Additionally, Taxpayers argue that Individual A should be treated as the owner of Trust 1 under section 677 because the Trustee agreed to pay off Individual A's debt that he owed to Corp H.

Under section 674(a), the grantor is treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Although the language in section 674(a) is very broadly worded, it is subject to a number of exceptions that prevent the grantor from being treated as an owner of the trust. The exceptions contained in section 674(b) address powers held by any person (including the grantor). The exceptions contained in section 674(c) and (d) address powers held by trustees.

Section 672(a) provides that the term "adverse party" means any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust.

Section 672(b) provides that the term "nonadverse party" means any person who is not an adverse party.

Section 674(b)(2) provides that section 674(a) shall not apply to a power (regardless of by whom held) the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Section 673(a) provides that the grantor shall be treated as the owner of any portion of a trust in which the grantor has a reversionary interest in either the corpus or the income therefrom, if, as of the inception of that portion of the trust, the value of such interest exceeds 5 percent of the value of such portion.

Section 674(b)(5)(B) provides that section 674(a) shall not apply to a power (regardless of by whom held) to distribute corpus to or for any current income beneficiary, provided that the distribution of corpus must be chargeable against the proportionate share of corpus held in trust for the payment of income to the beneficiary as if the corpus constituted a separate trust. Section 674(b)(5) further provides that a power does not fall within the powers described in section 674(b)(5) if any person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

Section 674(b)(6) provides that section 674(a) shall not apply to a power to distribute or apply income to or for any current income beneficiary or to accumulate the income for him, provided that any accumulated income must ultimately be payable (A) to the beneficiary from whom distribution or application is withheld, or (B) on termination of the trust, or in conjunction with a distribution of corpus which is augmented by such accumulated income, to the current income beneficiaries which have been irrevocably specified in the trust instrument. Section 674(b)(6) further provides that accumulated income shall be so payable although it is provided that if any beneficiary does not survive a date of distribution which could reasonably be expected to occur within the beneficiary's lifetime, the share of the deceased beneficiary is to be paid to his appointees or to one or more designated alternate takers (other than the grantor or the grantor's estate) whose shares have been irrevocably specified. A power does not fall within the powers described in section 674(b)(6) if any person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

Section 674(b)(7) provides that section 674(a) shall not apply to a power exercisable only during (A) the existence of a legal disability of any current income beneficiary, or (B) the period during which any income beneficiary shall be under the age of 21 years, to distribute or apply income to or for such beneficiary or to accumulate and add the income to corpus. A power does not fall within the powers described in section 674(b)(7) if any person has the power to add to the beneficiary or beneficiaries or to a class of beneficiaries designated to receive the income or corpus, except where such action is to provide for after-born or after-adopted children.

Treas. Reg. § 1.674(b)-1(b)(7) explains that section 674(b)(7) provides an exception for a power which, in general, will permit ordinary income to be withheld during the legal disability of an income beneficiary or while he is under 21. Specifically, there is excepted a power, exercisable only during the existence of a legal disability of any current income beneficiary or the period during which any income beneficiary is under the age of 21 years, to distribute or apply ordinary income to or for that beneficiary or to accumulate the income and add it to corpus. To qualify under this exception it is not necessary that the income ultimately be payable to the income beneficiary from whom it was withheld, his estate, or his appointees; that is, the accumulated income may be added to corpus and ultimately distributed to others. For example, the grantor is not treated as an owner under section 674 if the income of a trust is payable to his son for life, remainder to his grandchildren, although he reserves the power to accumulate income and add it to corpus while his son is under 21.

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Supreme Court considered whether a state trial court's characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a trial court as to an underlying issue of state law should not be

controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is a decision by that court, then the federal authority must apply what it finds to be state law after giving "proper regard" to the state trial court's determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

In the present situation, Taxpayers have not presented the decision of any Country Y court interpreting Article J and Article K of the Country Y Trust Law. Instead, Taxpayers have presented an opinion of a Country Y law firm which interprets the provisions of the Country Y statute and the governing trust agreement. According to the Country Y law firm, under Article J, the Trustee of Trust 1 had the power to distribute any amount of the trust income (any amount from 0 percent to 100 percent in aggregate) to any one or none of the living contingent beneficiaries during their minority. Further, under Article K, the Trustee could distribute any current or accumulated income, as well as trust principal, into a further trust. Country Y counsel contends that such new trust could include new beneficiaries or a class of beneficiaries designated by the Trustee, in addition to Individual A's grandchildren. Country Y counsel contends that the terms of such new trust could specify that, on termination of the trust, all of the accumulated income and principal of the new trust could be distributed to any one or more of the then living beneficiaries, as the trustee decides in its absolute discretion, in entirely different proportions, to the exclusion of all other beneficiaries.

However, with respect to an outright advancement of accumulated income or principal, the Country Y counsel states that the children of Individual H had one per stirpital share and the children of Individual I had the other per stirpital share. Accordingly, because these per stirpital shares are subject to the presumptive share rule under Article K, each share was entitled to 50 percent of the principal and accumulated income of Fund B and accordingly no more than that could have been applied for the benefit of each share.

Country Y counsel has indicated that it is unaware of any Country Y court opinion interpreting the provisions of Article J and Article K. In addition, the opinion of Country Y counsel does not explain how its interpretation of Article J and Article K is supported by the specific language in those articles. Accordingly, we must examine the relevant provisions of the trust agreement and Article J and Article K to make our own determination of their meaning in order to apply the Internal Revenue Code provisions at issue. See Estate of Bosch.

As indicated above, Trust 1 was formed for the benefit of the grandchildren of Individual A and Individual C. Under the trust agreement, upon the termination of Trust 1, the grandchildren of Individual A would receive approximately j percent of the assets and the grandchildren of Individual C would receive approximately k percent of such assets. The trust agreement provided that "grandchildren" means "the children living at

the termination of the Trust of any now existing children of [Individual A] or [Individual C] respectively." The trust agreement further provided that such grandchildren "take equally per stirpes." If none of Individual A's grandchildren survived, the entire amount would go to Individual C's grandchildren, and vice versa. If neither set of grandchildren survived, the entire amount would go to the grandchildren of Individual B.

With respect to the Trustee's powers to distribute income to beneficiaries during their minority under Article J, Taxpayers ignore the language in Article L which provides that the payment or the application of the income of the trust is "subject to any prior estates or interests or charges affecting that property." In the present situation, Trust 1 had several living beneficiaries, each having per stirpital interests in the property of the trust under the provisions of the trust agreement.[9]

Accordingly, we disagree with Taxpayers' interpretation of Article J that the trustee could distribute up to 100 percent of the current income of Trust 1 to a minor beneficiary without regard to the interests of the other beneficiaries of the trust. A more plausible interpretation of Article J is that the trustee could distribute up to 100 percent of a minor beneficiary's share of the trust but no more than that beneficiary's share because the exercise of the power is subject to prior estates or interests or charges affecting the trust property. Accordingly, the trustee's power to distribute the current income to a minor beneficiary is within the exceptions in section 674(b)(6) and (7).[10]

With respect to the trustee's power to distribute any accumulated income and principal to a new trust as discussed above, we disagree with Taxpayers' interpretation of Article K. Although the amendment in 1999 in Article O would appear to apply to years subsequent to the years in issue in the present case, even if it applied to the years in issue, the amendment does not support Taxpayers' argument that a transfer to a new trust could eliminate the beneficiaries' presumptive shares whereas an outright distribution to a beneficiary would have to take into account the beneficiaries'

[9] Furthermore, Article 23 requires that the amount of income paid or applied for the minor must "in all the circumstances, be reasonable." Article 23(2) directs the trustee to take into account the age and requirements of the minor and generally to the circumstances of the case including what other income is available to the minor.

[10] We also note that even if Taxpayers' interpretation regarding the payment or application of income of the trust is correct and, accordingly, that Individual A would be treated as the owner of the income portion of the trust, the reference to income in Article J would not include any capital gains resulting from a sale of stock held by the trust or resulting from the redemption of stock held by the trust. The Country Y Law provides that "income includes rents and profits." Generally, income for fiduciary accounting purposes does not include capital gains except as specifically provided otherwise in the trust agreement. The Trust 1 Agreement does not provide that income includes capital gains. Therefore, Individual A would not be treated as the owner of the portion of the trust that would include any capital gains. See section 1.643(b)-1 relating to the definition of income and section 1.671-3 for the discussion of tax items attributable to an owned portion of a trust.

presumptive shares. The amendment to Article O clarified that advancements could be made to a new trust rather than outright to a beneficiary, but the flush language in Article O provides that the requirements of Article N must be satisfied in such a case. Accordingly, any advancement to a new trust would have to take into account the respective beneficiaries' presumptive shares in the trust just as an outright advancement would have to take into account the beneficiaries' presumptive shares. Any advancement under Article K prior to the Country Y Act of Year 11 to a new trust rather than outright to a beneficiary would likewise have to satisfy the requirement that the beneficiaries' presumptive shares in the trust be taken into account. Taxpayers have not offered any legal support for their contention that the beneficiaries' presumptive shares in the trust could be defeated by making a distribution to a new trust instead of making an outright distribution to a beneficiary. Such an interpretation of Article K would leave grantors of trusts formed in Country Y with no assurance that those that they intend to benefit when establishing a trust in that jurisdiction would in fact benefit from the trust because the trustee would always be able to defeat the intended beneficiaries' interests by establishing a new trust with substantially different terms including adding new unintended beneficiaries who may not even be Family members. In addition, the fact that the distributions that were made in 1997 and 1998 to the respective trusts (Trust 5 and Trust 4) were made 50 percent to each trust based on the per stirpital interests of each family is entirely consistent with our interpretation of the trust agreement and Article K.

Trustee's powers to advance income or corpus to the beneficiaries of the trust under the trust agreement and the Country Y Trust Law are within the section 674(b)(5), section 674(b)(6) and section 674(b)(7) exceptions to section 674(a). Any distribution of corpus to a beneficiary is chargeable against such beneficiary's presumptive or vested share under Article K of the Country Y Trust Law. Under the trust agreement, any accumulated income is added to trust corpus and distributed to the living grandchildren per stirpes on the termination of the trust.

Taxpayers also argue that the power of the Trustee to eliminate the interests of the unborn beneficiaries in the trust by paying the current income under Article J or advancing the accumulated income and principal under Article K to a living beneficiary is a power to control the beneficial enjoyment of the trust within the meaning of section 674(a). Taxpayers also note that Individual A had the power to eliminate the interests of the unborn beneficiaries because of his power to terminate the trust which would result in per stirpes distributions to the then living grandchildren only.

The Trustee's and Individual A's power to prevent any unborn beneficiaries from receiving a distribution from the trust could only be accomplished by making distributions from the trust to the current income beneficiaries, that is, to the living grandchildren at the time of the distributions. Such distributions are within the exceptions to section 674(a) found in sections 674(b)(5) and (6). Therefore, because these powers are within the exceptions set forth in section 674(b), these powers are

outside of section 674(a) and the grantor is not treated as an owner of the trust even if an incidental effect of their exercise is to eliminate the contingent interests of unborn beneficiaries.[11]

Taxpayers cite Commissioner v. Buck, 120 F.2d 775 (2d Cir. 1941), and Hash v. Commissioner, 4 T.C. 878 (1945), aff'd 152 F.2d 722 (4th Cir. 1945), cert. denied, 328 U.S. 838 (1946) as support for their position that Individual A was the owner of the trust because of the power to eliminate the interests of unborn beneficiaries. These cases are distinguishable from the present situation because in the cited cases the grantor retained the power to eliminate the interests of living beneficiaries who otherwise held vested interests in the trusts.

Therefore, Individual A was not treated as an owner of any portion of Trust 1 under section 674(a).

Section 675(4) provides that the grantor shall be treated as the owner of any portion of a trust in respect of which a power of administration is exercisable in a nonfiduciary capacity by any person without the approval or consent of any person in a fiduciary capacity. For purposes of section 675(4), the term "power of administration" means (A) a power to vote or direct the voting of stock or securities of a corporation in which the holdings of the grantor and the trust are significant from the viewpoint of voting control, or (B) a power to control the investment of the trust funds either by directing investments or reinvestments, or by vetoing proposed investments or reinvestments, to the extent that the trust funds consist of stock or securities of corporations in which the holdings of the grantor and the trust are significant from the viewpoint of voting control.

Treas. Reg. § 1.675-1(b)(4) (flush language) provides that if a power is exercisable by a person as trustee, it is presumed that the power is exercisable in a fiduciary capacity primarily in the interests of the beneficiaries. This presumption may be rebutted only by clear and convincing proof that the power is not exercisable in the interests of the beneficiaries. If a power is not exercisable by a person as trustee, the determination of whether the power is exercisable in a fiduciary or nonfiduciary capacity

[11] Furthermore, even if Individual A had a direct power to eliminate the interests of unborn beneficiaries without causing a distribution that is within the exceptions set forth in section 674(b)(5), and (6), such a power should not be treated as a power to control the beneficial enjoyment of the trust within the meaning of section 674(a) because such a power may be within the exception to section 674(a) set forth in section 674(b)(2). The exercise of the power would only affect the beneficial enjoyment of the income for a period commencing after such an unborn beneficiary was born. Determining the actuarial value of an unborn beneficiary's interest in the trust may not be possible and therefore may be treated as having no value for purposes of section 673 and section 674(b)(2). Compare Estate of Cardeza v. U.S. 261 F.2d 423 (3d Cir. 1958) (reversion dependent on failure of issue is not susceptible to valuation using actuarial principles and thus is considered to have no value); Robinette v. Helvering, 318 U.S. 184 (1943).

depends on all the terms of the trust and the circumstances surrounding its creation and administration.

Although Individual A (jointly with Individual C) had the power to remove the trustee and appoint a subordinate trustee, or presumably even appoint himself as the trustee of the trust, any person so appointed as trustee would be required to exercise the voting powers or investment powers in accordance with the trust agreement and Country Y law. Accordingly, these powers would have to be exercised in a fiduciary capacity rather than in a nonfiduciary capacity. See Cushman v. Commissioner, 153 F.2d 510 (2d Cir. 1946); Fruehauf v. Commissioner,12 T.C. 681 (1949). Country Y is a common law jurisdiction; Taxpayers have not provided any information that suggests that a trustee of a Country Y trust may act in other than a fiduciary capacity in the interests of the beneficiaries of the trust. Furthermore, there is nothing in the trust agreement indicating that anyone can act in a nonfiduciary capacity with respect to the trust property.

Article 6(i) of the Trust 1 Agreement provides that the Trustee shall have the power to invest the Trust fund in stocks, shares, bonds, debentures or any company listed on the A Stock Exchange or the B Stock Exchange, or any other such security approved by the Settlor, and shall have the power to receive and reinvest the income, dividends and profits from such investments.

Article 6(ii) provides that the Trustee shall vote all shares and other securities held by it in such way as it deems advisable having regard to the best interests of the beneficiaries.

Article 6(iii) provides that the Trustee may invest all income which it receives in investments with a maturity of not more than three months unless otherwise directed by the Settlor.

Because section 675(4) causes a grantor to be treated as an owner of the trust only if the investment power or voting power is exercisable in a nonfiduciary capacity, Individual A would not be treated as an owner under these facts.

Taxpayers have not provided any information to demonstrate that the voting power and investment powers vested in the trustee of the trust were exercisable in other than a fiduciary capacity and in the interests of the beneficiaries. The facts show the opposite in that the trustee of Trust 1 acted independently and with due regard to its fiduciary obligations.

For example, the Date 12 letter from Trustee A, as “sole Trustee of [Trust 1] under the Trust Agreement dated [Date 7]...”, to Corp L, ends by stating that “[Trustee A] cannot however bind itself to act in accordance with your recommendations, as this would be contrary to its obligations as Trustee.”

Furthermore, during Year 7, disputes arose among the Corp L shareholders, and the Corp L Board of Directors voted to replace Individual A as Chairman. In a related shareholder vote, Trustee D, as the Trustee of Trust 1, sided with the Corp L Board members against Individual A.

The power in Article 6(i) of the trust agreement to "veto" certain investments is provided to the Settlor of the trust. The Settlor of the trust is defined in the trust agreement as Corp I, not Individual A.[12] No delegation of this power was made to Individual A. Corp I was liquidated in Year 9, so it is unlikely that this power could be exercised by anyone once Corp I was liquidated without some written document delegating the power. Corp I specifically delegated the power to terminate Trust 1 and delegated the power to appoint a new Trustee to Individual A and Individual C pursuant to Articles 8, 10, and 11 of the trust agreement by written declaration dated Date 8. If Individual A and Individual C had qualified as the "Settlors" of the trust under the trust agreement and local law, a written declaration would not have been required delegating these powers to them. Individual A (and Individual C) would have already had these powers as Trust 1's Settlors. Accordingly, it follows that any delegation of the veto power (if permissible under the trust agreement and local law) would also require a written delegation to the new power-holder. However, the terms of the trust agreement do not specifically allow a delegation of this "veto" power (unlike the removal power and the power to appoint a new trustee where the trust agreement specifically provides for delegation) so any delegation of this power would have been invalid even with a written delegation order.

Assuming the "veto" power was operative in Year 8, a careful reading of the trust agreement indicates that it would only apply if the trustee decided to invest in stock, debentures or securities or similar investments traded outside of the A Stock Exchange or B Stock Exchange. Therefore, the "veto" power is not a true veto power within the meaning of section 675(4) that would allow the holder to control the trust investments. It is more of a power to allow investments within another broad class of similar investments with the Settlor's approval if the trustee decided to, for example, invest in large company stocks traded on the C Stock Exchange or D Stock Exchange. The decision to invest outside the A Stock Exchange or B Stock Exchange, and which stock or securities to invest in once approval to invest in stock traded on another similar exchange was received, would be up to the trustee to be exercised in its fiduciary capacity. The investment power is still substantially within the control of the trustee. Also, there is nothing specifically indicating that this "veto" power could be exercised in a nonfiduciary capacity in the terms of the trust, circumstances surrounding the creation of the trust, or its administration.

[12] The fact that we conclude under Issue 1 that Individual A should be treated as the grantor of the portion of Trust 1 for his grandchildren for purposes of the grantor trust rules does not mean that Individual A is the "Settlor" of Trust 1 under the terms of the trust agreement and applicable Country Y Law and therefore is entitled to exercise the powers reserved for the "Settlor" under the trust agreement..

Taxpayers argue that Individual A's and the trust's holdings in Corp L were significant from the viewpoint of voting control within the meaning of section 675(4). Taxpayers assert that Individual A directly and indirectly owned p percent of Corp L. However, the relevant documents including the Escrow Agreement do not list individual A as owning p percent of the Corp L stock directly, and Taxpayers have not provided any information showing how Individual A owned p percent of the stock indirectly. Taxpayers also note that Individual A was the Chairman of the Board of Corp J which was wholly owned by Trust 1 and which held m percent of the stock of Corp L. Taxpayers point out that Individual A was also delegated the daily management of Corp J by a circular resolution signed by the Corp J directors (which included Individual A and his lawyers). Taxpayers argue that this delegation included the power to vote the stock of Corp L. Assuming that Taxpayers can provide satisfactory evidence to demonstrate that Individual A in fact owned p percent of the stock of Corp L, the purported ownership of k percent of the stock of Corp L (m percent held by Trust 1 through Corp J and an additional p percent owned by Individual A through various indirect ownership arrangements including other Family trusts) would not be "significant from the viewpoint of voting control" within the meaning of section 675(4) under the facts presented. The Code and regulations do not provide specific guidance as to determining when the holdings of the grantor and the trust are significant from the viewpoint of voting control under section 675(4). However, case law prior to the 1954 Code provides some guidance on this issue.

For example, in Kohnstamm v. Pedrick, 153 F.2d 506 (2d Cir. 1945), the court held that the grantor who retained the power to vote the shares of a corporation held by the trust and had certain other powers over the trust was not treated as the owner of the trust. The trust held about 23 percent of the stock of the corporation of which the grantor was the president. In Hemphill v. Commissioner, 8 T.C. 257 (1947), the court held that the grantor was not treated as the owner of the trust of which he was the trustee where the grantor was an officer and member of the board of directors of the corporation and the grantor's holdings and the trust's holdings combined were not a majority interest. However, in Joseloff v. Commissioner, 8 T.C. 213 (1947), the court held that the grantor was treated as the owner of the trust where the grantor retained the power to direct the trustee and the grantor held 73 percent of a personal holding company in which a large part of the trust was invested. Taxpayers cite Fruehauf v. Commissioner, 12 T.C. 681 (1949), in support of the position that there is no prescribed yardstick by which voting control is to be measured. Taxpayers note that the Tax Court in Fruehauf stated that where shares are listed on a stock exchange and apparently widely scattered, a single block as large as 23.47 percent might constitute voting control of the corporation.

Taxpayers have cited Rentschler v. Commissioner, 1 T.C. 814 (1943), in support of their position that the purported combined ownership of k percent of Corp L by Trust 1 and Individual A should be treated as significant from the viewpoint of voting control

under the facts presented. In the Rentschler case, the grantor was the chairman of the board of directors of the United Aircraft Co. and the combined holdings of the grantor and his family and the trust amounted to a little over 2 percent of the stock of the corporation. The court held that the grantor should be treated as the owner of the trust income under section 22(a) of the Revenue Act of 1936 and noted that under the facts of that case the grantor would not be indifferent to what was done with the United Aircraft stock transferred to the trust. We agree with Taxpayers that section 675(4) does not apply a strict mechanical or numerical test in determining whether the holdings of the grantor and the trust are significant from the viewpoint of voting control. Furthermore, a less than majority interest in the stock or securities of a corporation may be significant from the viewpoint of voting control depending on the totality of the facts and circumstances presented. However, the Rentschler case is distinguishable from the present situation. In Rentschler, the court noted that although the stock did not represent a mathematically substantial portion of the stock of United Aircraft, the corporation was publicly traded on the New York Stock Exchange with approximately 33,000 stockholders who held on average 80 shares per stockholder. The grantor was also chairman of the board of that corporation. In addition, the grantor in Rentschler held very broad powers to direct the actions of the trustees including the power to make loans to the grantor with or without security, the power to purchase property from the grantor and use the trust income to pay his support obligations. The trust agreement also provided that the trustees would incur no liability for any actions taken or not taken pursuant to the grantor's direction.

In the present situation, the remaining j percent of the stock of Corp L was closely held by other Family members who could (and did in the past) act contrary to Individual A's wishes (unlike the widely-held corporation with many small stockholders considered in Rentschler). The facts indicate that the j percent of the stock of Corp L held by other Family members and Family trusts was not within Individual A's control. Therefore, assuming that it is established that Individual A and Trust 1 combined held k percent of Corp L, Individual A and the Trust 1 may have had a veto power over certain significant corporate actions, but this did not amount to having voting control of Corp L within the meaning of section 675(4). Although Individual A was the chairman of the board of Corp J, which held m percent of the Corp L stock, there is no indication that he held a similar position in Corp L after being removed as chairman of the board in Year 7 (which is the relevant corporation to be considered for purposes of section 675(4)). Taxpayers assert that as part of Individual A's daily management powers he could vote the stock of Corp L held by Corp J. However, any such voting power held by Individual A was subject to the ultimate control of the Trustee of Fund B, which owned 100 percent of the stock of Corp J. As owner of 100 percent of the stock of Corp J, the Trustee of the Fund B had the power to remove Individual A as the chairman of the board of Corp J and revoke any daily management powers that Individual A held if it chose to do so as part of its fiduciary duties in managing the trust property. Accordingly, we conclude that the purported k percent would not be significant from the viewpoint of voting control of

Corp L under these facts. For the reasons set forth above, we conclude that Individual A was not treated as an owner of any portion of Trust 1under section 675(4).

Section 677(a) provides that the grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be (1) distributed to the grantor or the grantor's spouse; (2) held or accumulated for future distribution to the grantor or the grantor's spouse; or (3) applied to the payment of premiums on policies of insurance on the life of the grantor or the grantor's spouse (except policies of insurance irrevocably payable for a purpose specified in section 170(c) (relating to definition of charitable contributions)). Section 677(a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the occurrence of an event such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the occurrence of the event unless the power is relinquished.

Treas. Reg. § 1.677(a)-1(d) provides that, under section 677(a), a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a nonadverse party, or both, may be applied in discharge of a legal obligation of the grantor (or his spouse in the case of property transferred in trust by the grantor after October 9, 1969).

Taxpayers argue that because the Trustee, on Date 10, agreed to pay the remaining balance of the loan that Individual A owed to Corp H (Date 10 Agreement), Individual A should be treated as the owner of the portion of Trust 1 that benefited his grandchildren under section 677. Taxpayers argue that the agreement to pay Individual A's loan demonstrates that the Trustee, a nonadverse party, had the discretion to pay Individual A's legal obligations and thereby benefit Individual A within the meaning of section 677. The Trust 1 agreement has no provisions permitting the Trustee to pay Individual A's legal obligations. Individual A is not named as one of the beneficiaries of the trust. Therefore, absent specific provisions in the Trust Agreement or the applicable Country Y Law authorizing it, the Trustee, as a fiduciary, would not generally have the authority to pay Individual A's legal obligations. Furthermore, the Date 10 Agreement to pay the Corp H loan references the fact that the Trustee was to pay certain amounts related to the purchase of the assets used to settle the trust. The loan from Corp H related to Individual A's cash payment for certain of the assets that were transferred to the trust. Thus, the Trustee's agreement to pay this loan amount is in connection with the initial settlement of the Trust and does not indicate that the Trustee had authority to pay Individual A's legal obligations. Based on the loan terms set forth in the Schedule to the Date 10 Agreement and the relatively small amount of this loan in relation to the size of the trust, this loan would have been paid off prior to the years in issue (before 1996). Therefore, Individual A was not an owner of any portion of Trust 1 under section 677.

C. Was there a valid distribution to Trust 5 or the beneficiaries of Trust 5 in Year 9?

Taxpayers argue that the beneficiaries of Trust 5 were in constructive receipt of the advancement amounts because of the withdrawal (Crummey) powers granted to the beneficiaries of Trust 1 prior to the end of Year 9.

Taxpayers also argue that the amounts advanced pursuant to the Advancement Agreement and related documents to Trust 5 should be treated as a distribution to the beneficiaries of Trust 5 based on application of the economic benefit doctrine which applies to cash basis taxpayers. Taxpayers argue that under applicable local law, following the advancement by Fund B to Trust 5, the advanced amounts were no longer subject to the claims of the creditors of Fund B.

Therefore, the amounts advanced should be treated as properly paid or credited within the meaning of section 661(a)(2) to the beneficiaries of Trust 5 in Year 9. Alternatively, Taxpayers argue that the amounts advanced should be treated as properly paid or credited to a separate trust (Trust 5) which was a beneficiary of Fund B in Year 9. [13]

Section 661(a)(2) provides that in the taxable year there shall be allowed as a deduction in computing taxable income of an estate or trust, any amounts properly paid or credited or required to be distributed for such taxable year.

The standard to be applied to determine whether an amount has been properly credited to a beneficiary has been explained as follows:

> *The income must be so definitively allocated to the legatee as to be beyond recall*; 'credit' for practical purposes is the equivalent of 'payment.' Therefore, a mere entry on the books of the fiduciary will not serve unless made in such circumstances that it cannot be recalled. If the fiduciary's account be stated inter partes, that would probably be enough * * * But the unilateral act of entering items in the account is not conclusive. * * *

Commissioner v. Stearns, 65 F.2d 371, 373 (2d Cir. 1933), cert. denied sub nom Stearns v. Burnet, 290 U.S. 670 (1933) (emphasis added).

[13] As a result, the Taxpayers take the position that the distribution to Trust 5 of half of the assets of Fund B "carried out all of the DNI (distributable net income) and UNI (undistributed net income) then held in [Fund B]." Because the Year 9 distribution carried out all of the DNI (and any UNI), the distribution to Trust 4 in Year 10 did not create any U.S. tax liability because there was no UNI left in Trust 1. The distribution was only taxable to Trust 4 to the extent of the DNI for the Year 10 taxable year, which was minimal.

The Trustee of Fund B and the Trustee of Trust 5 signed an Advancement Agreement dated Date 28, which under Article K of Country Y Trust Law, transfers beneficial ownership of half of the assets of Fund B to Trust 5 including half of the beneficial ownership of the Corp L stock. The Trustee of Fund B and the Trustee of Trust 5 also signed a Nominee Agreement dated Date 28, which references the advancement of half of the stock of Corp L to Trust 5 and provides that the Trustee of Fund B will be the registered owner of the Corp L stock until the sale of the stock to Corp K is closed and will hold the stock as the nominee of Trust 5. The Nominee Agreement provides that Trust 5 will have all the benefits and burdens of ownership of the Corp L stock and the powers to exercise all of the rights of ownership of such stock. The children of Individual H who were the beneficiaries of Trust 5 were also granted the power in Month B of Year 9, to withdraw within 30 days their respective shares of the assets transferred to Trust 5.

The Schedule to the Advancement Agreement failed to include the rights and obligations in the Escrow Agreement, which the Corp L stock was subject to, until the Schedule was amended in Month A of Year 10. However, the information submitted by Taxpayers indicate that this was a clerical error and that the trustees intended to include the rights and obligations in the Escrow Agreement when including beneficial ownership in the Corp L stock. There is also no indication that Corp K, as the other party to the Escrow Agreement, consented to the transfer. However, the Escrow Agreement provides that Corp K's consent to a transfer of rights and obligations in the Escrow Agreement could not be unreasonably withheld.

Accordingly, we conclude that the Trustee of Fund B properly credited 50 percent of the assets of Fund B, including 50 percent of the stock held in Corp L, to Trust 5 in Year 9. The Advancement Agreement and the Nominee Agreement were binding agreements signed by both parties as opposed to a mere unilateral notation by the Trustee of Fund B on its accounts. The agreements indicate that the Trustee of Trust 5 had all the benefits and burdens of ownership of 50 percent of the Corp L stock as of Date 28. Although the Corp L stock was subject to the Escrow Agreement, there is no apparent substantive obstacle that would have prevented Trust 5 from acquiring rights and obligations in the Escrow Agreement once the beneficial ownership of the stock was transferred to Trust 5 by the Year 9 agreements. Therefore, Fund B distributed 50 percent of its assets to Trust 5 in Year 9 and is entitled to deduct the amounts advanced under section 661(a)(2).

D. Did Fund B consist of 2 substantially separate and independent shares within the meaning of section 663(c)?

Taxpayers maintain that Trust 1 did not consist of substantially separate and independent shares within the meaning of section 663(c).

Taxpayers' view is that Fund B was a discretionary trust under Country Y law such that it did not consist of separate shares. In support of this position, Taxpayers cite the legal opinions provided by Country Y Counsel dated Date 38, and Date 39, which conclude that, based on its analysis of certain trust documents and Country Y law, "none of the grandchildren of [Individual A] has a fixed beneficial interest, entitlement or share in the Trust or the Fund." Therefore, the children of Individual H and the children of Individual I did not have 50 percent per stirpital shares in Fund B.

Taxpayers argue that, under the terms of Trust 1, the beneficiaries of Fund B "included the unborn grandchildren of three of [Individual A's] daughters." Because there was always the possibility of additional grandchildren being born prior to the termination of Trust 1, none of the existing grandchildren had a substantially separate and independent share of the trust. Therefore, the children of Individual H and the children of Individual I did not have 50 percent per stirpital shares in Fund B because the children of Individual A, other than Individual H and Individual I, might have children and thus create other per stirpital shares.

Section 663(c) provides that for the sole purpose of determining the amount of distributable net income (DNI) in the application of sections 661 and 662, in the case of a single trust having more than one beneficiary, substantially separate and independent shares of different beneficiaries in the trust shall be treated as separate trusts.

The section 663(c) regulations cited below are applicable to Year 9 and Year 10 trust taxable years.

Treas. Reg. § 1.663(c)-1(a) provides that if a single trust has more than one beneficiary, and if different beneficiaries have substantially separate and independent shares, their shares are treated as separate trusts for the sole purpose of determining the amount of distributable net income allocable to the respective beneficiaries under sections 661 and 662. Application of this rule will be significant in, for example, situations in which income is accumulated for beneficiary A but a distribution is made to beneficiary B of both income and corpus in an amount exceeding the share of income that would be distributable to B had there been separate trusts. In the absence of a separate share rule B would be taxed on income which is accumulated for A. The division of distributable net income into separate shares will limit the tax liability of B. Section 663(c) does not affect the principles of applicable law in situations in which a single trust agreement creates not one but several separate trusts, as opposed to separate shares in the same trust within the meaning of section 663(c).

Treas. Reg. § 1.663-1(c) provides that the separate share rule may be applicable even though separate and independent accounts are not maintained and are not required to be maintained for each share on the books of account of the trust, and even though no physical segregation of assets is made or required.

Treas. Reg. § 1.663(c)-1(d) provides that separate share treatment is not elective. Thus, if a trust is properly treated as having separate and independent shares, such treatment must prevail in all taxable years of the trust unless an event occurs as a result of which the terms of the trust agreement and the requirements of proper administration require different treatment.

Treas. Reg. § 1.663(c)-3(a) provides that the applicability of the separate share rule provided by section 663(c) will generally depend upon whether distributions of the trust are to be made in substantially the same manner as if separate trusts had been created. Thus, if an agreement directs a trustee to divide the testator's residuary estate into separate shares (which under applicable law do not constitute separate trusts) for each of the testator's children and the trustee is given discretion, with respect to each share, to distribute or accumulate income or to distribute principal or accumulated income, or to do both, separate shares will exist under section 663(c). In determining whether separate shares exist, it is immaterial whether the principal and any accumulated income of each share is ultimately distributable to the beneficiary of such share, to his descendants, to his appointees under a general or special power of appointment, or to any other beneficiaries (including a charitable organization) designated to receive his share of the trust and accumulated income upon termination of the beneficiary's interest in the share. Thus, a separate share may exist if the agreement provides that upon the death of the beneficiary of the share, the share will be added to the shares of the other beneficiaries of the trust.

Treas. Reg. § 1.663(c)-3(b) provides that separate share treatment will not be applied to a trust or portion of a trust subject to a power to—

(1) Distribute, apportion, or accumulate income, or
(2) Distribute corpus

to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing agreement) so that substantially separate and independent shares exist.

Treas. Reg. § 1.663-3(c) provides that a share may be considered as separate even though more than one beneficiary has an interest in it. For example, two beneficiaries may have equal, disproportionate, or indeterminate interests in one share which is separate and independent from another share in which one or more beneficiaries have an interest. Likewise, the same person may be a beneficiary of more than one separate share.

Treas. Reg. § 1.663-3(d) provides that separate share treatment may be given to a trust or portion of a trust otherwise qualifying under Treas. Reg. § 1.663-3 if the trust or portion of a trust is subject to a power to pay out to a beneficiary of a share (of such trust or portion) an amount of corpus in excess of his proportionate share of the corpus of the trust if the possibility of exercise of the power is remote. For example, if the trust is subject to a power to invade the entire corpus for the health, education, support, or maintenance of A, separate share treatment is applied if exercise of the power requires consideration of A's other income which is so substantial as to make the possibility of exercise of the power remote. If instead it appears that A and B have separate shares in a trust, subject to a power to invade the entire corpus for the comfort, pleasure, desire, or happiness of A, separate share treatment shall not be applied.

As indicated above, Trust 1 was formed for the benefit of the grandchildren of Individual A and Individual C on a per stirpital basis. Under the trust agreement, upon the termination of Trust 1, the grandchildren of Individual A would receive approximately j percent of the assets and the grandchildren of individual C would receive approximately k percent of such assets. Article 9 of the trust agreement provided that "grandchildren" means "the children living at the termination of the Trust of any now existing children of [Individual A] or [Individual C] respectively." The trust agreement further provided that such grandchildren "take equally per stirpes." If none of Individual A's grandchildren survived, the entire amount would go to Individual C's grandchildren, and vice versa. If neither set of grandchildren survived, the entire amount would go to the grandchildren of Individual B.

As noted above in the discussion of the grantor trust issue, the Service disagrees with Taxpayers' (and Country Y counsel's) interpretation of the trust agreement and Article J and Article K of the Country Y Trust law. Any distribution from Trust 1 would have to have been in accordance with presumptive shares held by the beneficiaries, which as indicated above consisted of a 50 percent per stirpital share for the living children of Individual H and a 50 percent per stirpital share for the living children of Individual I. We disagree with Taxpayers' (and Country Y counsel's) assertion that the presumptive shares created under the trust agreement could be disregarded or eliminated by the mechanism of an advancement to a successor trust with different terms and potentially different beneficiaries but could not be disregarded or eliminated in the case of an outright advancement to the trust beneficiaries. In neither situation, could the presumptive shares created under Article 9 of the trust agreement be disregarded or eliminated. Therefore, Trust 1 was not, as is in effect asserted by Taxpayers, a wholly discretionary trust that would permit the Trustee to make distributions without regard to the presumptive shares held by the beneficiaries.

Furthermore, the potential that an additional grandchild may be born after a trust is established who would become a beneficiary of a per stirpital share of the trust upon birth does not prevent separate share treatment under section 663(c). The birth of an

additional grandchild (to a child of Individual A other than Individual H or Individual I) who would be entitled to a per stirpital share of the trust would affect the number of substantially separate and independent shares of the trust when and if such additional grandchild were to be born. The purpose of the separate share rule is to make sure a beneficiary is not taxed on income which relates to another beneficiary's share of the trust. This is achieved by computing the DNI of the trust with respect to each separate share as though it were a separate trust. DNI of the trust must be computed for each taxable year of a trust in order to determine how the beneficiaries and the trust are taxed for each taxable year.

Section 663(c) requires "substantially separate and independent shares" to apply separate share treatment, not absolutely separate and independent shares.[14] For example, the regulations under section 663(c) allow for disproportionate distributions so long as the possibility of such distributions is remote.

The regulations under section 663(c) also provide that if a beneficiary dies prior to distribution of the trust assets, amounts may go to other trust beneficiaries (that is, not necessarily to the decedent's estate or appointees) and the trust may still have separate shares. Accordingly, determining whether a trust has separate shares and what each beneficiary's share consists of requires a year by year determination. For example, a trust may provide that the trust assets are to be held for A, B, and C equally and, if any one of them dies prior to termination of the trust, the trust assets will be held for the survivors equally. In Year 1, if A, B, and C are alive, the trust would have 3 substantially separate and independent shares under section 663(c). In Year 2, if C dies, the trust would have 2 substantially separate and independent shares after C's death. The beneficiaries and the trust would be taxed accordingly in Year 1 and Year 2.[15]

Article 9 of the Trust 1 agreement states that the trust assets are to be distributed to the grandchildren of Individual A upon termination of the trust. Grandchildren are defined as "the children living at the termination of the Trust of any now existing children of [Individual A]." It further provides that "such grandchildren shall take equally per stirpes." The trust agreement does not provide for current distributions of income or corpus. Thus, any current distribution of income or corpus would be governed by Article J and Article K of the Country Y Trust Law. As noted above, Article J and Article K permit a trustee to make certain advancements of income or principal from a trust

[14] See Lane & Zaritsky, Federal Income Taxation of Estates and Trusts §4.05[2] (2005).

[15] Note that current Treas. Reg. § 1.663(c)-2(a) (effective for taxable years of trusts beginning after December 28, 1999) provides that a separate share comes into existence upon the earliest moment that a fiduciary may reasonably determine, based upon the known facts, that a separate economic interest exists.

provided that the interests of the all of the beneficiaries are protected as set forth therein.

In addition, Individual A (together with Individual C) had the delegated power to terminate Trust 1 and thereby cause a distribution which, pursuant to the terms of the trust agreement, would have had to have been per stirpes to any living grandchildren. Consequently, any grandchildren born after such termination of the trust would not have received anything from the trust.

Accordingly, in Year 9 (ignoring the share of Trust 1 for Individual C's grandchildren, that is, Fund A which is not under our consideration), under Article 9 of the Trust 1 agreement and the applicable Country Y Trust Law, Fund B consisted of 2 separate per stirpital shares, one 50 percent per stirpital separate share for the living children of Individual H and another 50 percent per stirpital share for the living children of Individual I. Under the trust agreement, prior to the agreements whereby Individual A's other children who were likely to have children renounced their interests in Fund B, there was the possibility that additional separate shares may have arisen if Individual A's other children had living children. It was also possible that the trust would have consisted of fewer separate shares if any of the living grandchildren had died. However, in determining the separate shares of the trust for purposes of section 663(c) and therefore for purposes of determining the amount of DNI in the application of sections 661 and 662, we must determine the substantially separate and independent shares based on the facts for each taxable year. At the end of Year 9, it was clearly established that Fund B consisted of 2 equal per stirpital shares, one share for Individual I's U.S. living children and one share for Individual H's living children.[16] First, Individual A's other children (aside from Individual H and Individual I) did not have children. Second, in a letter dated Date 18 from Individual A to his daughter, Individual I, he states "[h]owever, I have taken steps to insure that your children and the children of [Individual H] will be the only beneficiaries of the [Fund B] portion of [Trust 1] and to receive distributions from [Fund B] on a 50/50 basis" Third, in response to Individual A's proposals, Individual A's other children (who were expected to have children of their own) waived any claim to the assets of Fund B prior to the end of Year 9 by written agreement. Finally, the Advancement Agreement dated Date 28, states that an advancement will be made to Trust 4 following the sale to Corp K of all remaining assets of Fund B. Because Fund B consisted of 2 equal per stirpital shares for the respective benefit of Individual H's children and Individual I's children, it consisted of 2 substantially separate and independent shares under section 663(c) when the distribution was made to Trust 5 for the Year 9 taxable year.

[16] Trust 5, which was intended to be a separate trust and had a different trustee from Trust 1, was established under Country Y law for the benefit of Individual H's children in Year 9. Trust 4, which was intended to be a separate trust and had a different trustee from Trust 1, was established under New York law for the benefit of Individual I's children in Year 10.

Accordingly, because Fund B consisted of 2 substantially separate and independent shares, the DNI of the trust is computed separately for each separate share as though it were a separate trust. The distribution of 50 percent of the assets to Trust 5 for the benefit of Individual H's children in Year 9 under section 661 carried out 50 percent of the DNI of Fund B. The other 50 percent of the DNI remained in Fund B. The UNI of Fund B under section 665(a) is determined based on the 50 percent of the DNI retained by Fund B. The distribution in Year 10 to Trust 4 was an accumulation distribution and, based on the UNI of the trust, was taxable to Trust 4 under the throwback rules of sections 665 through 668 (including any applicable interest charge).

A copy of this technical advice memorandum is to be given to the taxpayers. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.