



Overfunded Portion of Foreign Employees' Trust Treated as Grantor Trust

PRACTICE AREAS

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The Service, worried about employee plan assets that are beyond its control, has issued Proposed Regulations that coordinate with those under Section 404A . The new rules provide that if an employer otherwise would be treated as the grantor of a foreign employees' trust, it will be deemed to be the owner of a fractional interest in the trust that is the equivalent of the overfunded portion.

Proposed Regulations under Sections 671 and 1297 (REG-209826-96, 9/26/96) would effectively tax U.S. multinationals on a portion or all of the earnings of the pension funds maintained by their foreign operations. Additionally, these Proposed Regulations would codify the Service's position that domestic secular trusts are not grantor trusts. They also provide that a person who is treated as the owner of any portion of a trust under Subpart E is considered to own the trust assets attributable to that portion of the trust for all federal income tax purposes.¹

The new rules are to be prospective only, applying to tax years of the affected corporation ending after 9/27/96. For tax years ending before 9/28/96, the Preamble states that employers generally would not be treated for federal income tax purposes as owning the assets of foreign nonexempt employees' trusts (except as provided under Section 679), consistent with the rules applying to domestic nonexempt employees' trusts. Until final Regulations are adopted, this



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rule would not be applicable.

These Proposed Regulations, which deal with the income and asset ownership rules relating to foreign deferred compensation trusts, are inextricably bound together with the rules being developed under Section 404A.² Those Proposed Regulations provide that Section 404A is the exclusive means by which an employer may take a deduction or reduce E&P for amounts used to fund deferred compensation in situations other than those in which a deduction or reduction of E&P is permitted under Section 404 (the "exclusive means" rule).

The Section 404A Proposed Regulations, however, did not provide rules regarding the treatment of income and ownership of assets of foreign trusts established to fund deferred compensation arrangements, but referred (ominously, in the eyes of some employers) to "other applicable provisions, which may include sections 61, 671 through 679, and 1001."³ The implication, which was confirmed in oral discussions with IRS personnel in 1993 and 1994, was that, if an employer cannot or does not elect Section 404A treatment for a foreign trust established to fund the employer's deferred compensation arrangements, the employer may be treated as the owner of the entire trust for purposes of Subtitle A of the Code under Sections 671 through 679 even though all or part of the trust assets are set aside for purposes of satisfying liabilities under the plan.

The Preamble to REG-209826-96 notes that many different rules, in addition to the grantor trust rules, potentially affect the taxation of foreign trusts established to fund deferred compensation arrangements. These rules include the nonexempt deferred compensation trust rules of Sections 402(b) and 404(a)(5), the partnership rules of Subchapter K, and the anti-deferral rules that include Subpart F and the passive foreign investment company (PFIC) rules of Sections 1291 through 1297. A not-too-subtle implication of these references is that one or more of these provisions could be applied by the Service (e.g., agents auditing returns) unless the Section 671 Proposed Regulations are adopted. Consequently, there may be some incentive for employers to suggest to the Service that these Regulations be finalized.

OVERVIEW

Confirming the Service's ruling position, the Proposed Regulations provide that an employer is not treated as an owner, for federal income tax purposes, of any portion of a domestic nonexempt employees' trust described in Section 402(b).⁴ The rationale given by the Service in these rulings and repeated in the Preamble to the Proposed Regulations is that Section 404(a)(5) and Reg. 1.404(a)-12(b) provide a deduction to the employer solely for contributions to a nonexempt employees' trust, and not for any income of the trust. According to the Service, this rule is inconsistent with treating the employer as owning any portion of a nonexempt employees' trust, which would require the employer to recognize the trust's income that it may not deduct under Section 404(a)(5). Thus, such a trust is treated as a separate taxable trust



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that is taxed under the rules of Section 641 et seq.

Resolving a controversy within the Service, the Proposed Regulations provide that, in general, an employer is not treated as the owner of any portion of a foreign nonexempt employees' trust for federal income tax purposes, except as provided under Section 679.⁵ In an exception to this general rule, the Proposed Regulations state that the grantor trust rules apply to determine whether an employer that is a controlled foreign corporation (CFC),⁶ a U.S. employer, or a foreign partnership with one or more partners that are U.S. persons or CFCs (U.S.-related partnership), is treated as the owner of a specified "fractional interest" in a foreign employees' trust.

A special rule is proposed by the Service to apply to a foreign employer other than a CFC or a U.S.-related foreign partnership. Under this special rule, the grantor trust rules of Subpart E will not apply except where assets are transferred to a foreign employees' trust with a principal purpose of avoiding the PFIC rules. According to the Preamble, the IRS will continue to consider whether additional anti-abuse rules may be necessary for other purposes, including calculating E&P, determining the foreign tax credit limitation, and applying the interest allocation rules of Reg. 1.882-5.

DOMESTIC NONEXEMPT EMPLOYEES' TRUST

Prop. Reg. 1.671-1(g)(1) provides that an employer is not treated as an owner of any portion of a nonexempt employees' trust described in Section 402(b)⁷ that is part of a deferred compensation plan, and that is not a foreign trust within the meaning of Section 7701(a)(31), regardless of whether the employer has a power or interest described in Sections 673 through 677 over any portion of the trust. There are four elements to this definition.

(1.) The arrangement must be a trust, presumably under Reg. 301.7701-4. This Regulation generally provides that an arrangement will be a trust if it can be shown that the purpose of the arrangement is to vest trustees with the responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility and, therefore, are not associates in a joint enterprise for the conduct of business for profit. If the arrangement does not satisfy this requirement, it would not be subject to the rules under Section 671.⁸

(2.) The trust must be one described in Section 402(b). Generally, this means that contributions to the trust must be considered transfers of property to participants within the meaning of Section 83 and Reg. 1.83-3(e). If the trust assets are subject to claims of the employer's creditors, there would be no transfer of property within the meaning of Section 83.⁹ A rabbi trust would not qualify as a Section 402(b) trust as the assets thereunder are subject to creditors' claims.¹⁰

(3.) The arrangement must be part of a deferred compensation plan. This would exclude an arrangement



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involving deferred benefits under Section 404(b)(2) . Thus, even though the taxation of the beneficiary of a deferred benefit trust would be governed by Section 402(b) (to the extent there was not a corresponding exclusion, such as Section 106), the Section 671 Proposed Regulations would not be applicable.¹¹

(4.) The trust must be a foreign trust within the meaning of Section 7701(a)(31) .

The example given in Prop. Reg. 1.671-1(g)(2) of a domestic employees' trust (which is generally known as a secular trust) is one where the assets of the trust may not be used for any purpose other than to satisfy deferred compensation benefits provided under a plan maintained by an employer until all plan liabilities have been satisfied.¹² This trust is a grantor trust presumably because of the reversionary interest.¹³ It also could be a grantor trust under Section 677 because the principal and income of the trust may be applied in discharge of legal obligations of the employer.¹⁴ Even where an employer does not retain a reversionary interest over the income or corpus of the trust, the deferred compensation trust would be a grantor trust as long as the employer could amend the plan thereunder to add beneficiaries, which is a common feature of most such trusts.¹⁵

According to the Preamble, the secular trust rule is "analogous to the rule set forth in 1.641(a)-0, which provides that subchapter J, including the grantor trust rules, does not apply to tax-exempt employees' trusts." Reg. 1.641(a)-0 states that "the provisions of Subchapter J do not apply to employees trusts subject to Subchapters D [relating to qualified plans] and F [relating to tax exempt trusts], Chapter 1 of the Code...." Tax-exempt employees' trusts under Sections 401(a) and 501(a) are typically grantor trusts, and it is permissible for such a trust to allow the employer to recover the surplus remaining in the trust after the satisfaction of all liabilities owing to participants and their beneficiaries on termination of the trust, provided the surplus is attributable to erroneous actuarial computations.¹⁶

This position appears in some respects to be contrary to Rev. Rul. 74-41, 1974-1 CB 190 , which deals with the issue of whether investments by a trustee of a trust qualified under Sections 401(a) and 501(a) that is maintained by a CFC constitute investments in earnings of U.S. property of the CFC within the meaning of Section 956 . The Service held that, since the trust in the Ruling was a qualified trust under Section 401(a), the stocks of domestic corporations and obligations of U.S. persons held in trust would not be deemed to be held by the trustee on behalf of the CFC within the meaning of Reg. 1.956-1(b)(3),¹⁷ "unless [the CFC's] contributions result in an over-funding of the trust (other than erroneous actuarial computation), or unless amounts of trust income or corpus are diverted to [the CFC]." In other words, in this Ruling the Service seems to state that, in certain situations, it would treat the grantor of a qualified deferred compensation trust as the owner of part of the trust. If the Section 671 proposals are adopted, presumably the Service will revoke Rev. Rul. 74-41.¹⁸

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The principle articulated in Rev. Rul. 74-41 is quite similar to the principle in the Section 671 Proposed Regulations insofar as nonexempt foreign deferred compensation trusts are concerned. That principle is that the earnings attributable to certain overfunded foreign deferred compensation trusts will be imputed to the U.S. parent or foreign branch that established the trust. While Rev. Rul. 74-41 does not treat the overfunded portion of a qualified trust as a grantor trust, which would be contrary to Reg. 1.641(a)-0, the effect of the Service's holding in that Ruling would appear to accomplish the same purpose.

FOREIGN NONEXEMPT EMPLOYEES' TRUST

Under Prop. Reg. 1.671-1(h)(1), subject to the exceptions explained below, the general rule is that an employer is not treated as an owner of any portion of a foreign employees' trust for federal income tax purposes (general noninclusion rule). A foreign employees' trust, according to Prop. Reg. 1.671-1(h)(2), is a nonexempt employees' trust described in Section 402(b)¹⁹ that is part of a deferred compensation plan, and that is a foreign trust within the meaning of Section 7701(a)(31). The income inclusion and asset ownership rules apply to the entity whose employees or independent contractors are covered under the deferred compensation plan (Prop. Reg. 1.671-1(h)(1)(v)).

Exceptions. The first exception to the general noninclusion rule relates to the application of Section 679, which generally treats a U.S. person transferring property to a foreign trust as the owner of the portion of the trust attributable to the transferred property for any tax year of that person for which there is a U.S. beneficiary of any portion of the trust. In general, a trust is treated as having a U.S. beneficiary for a tax year of the U.S. transferor unless, under the terms of the trust, no part of the income or corpus of the trust may be paid or accumulated during the year to or for the benefit of a U.S. person, and unless no part of the income or corpus of the trust could be paid to or for the benefit of a U.S. person if the trust were terminated at any time during the year. Section 679(a)(1) provides exceptions from the application of Section 679 for compensatory trusts described in Section 402(b), 2040(a)(4), or 404A. The workings of Section 679 before the Section 402(b) exception was added in 1996 is illustrated below.

Example: A U.K. subsidiary of a U.S. parent transferred one of its U.K. employees (X) to the U.S. parent for the year 1994, making X a resident alien for that year. X continued to participate in the U.K. subsidiary's money- purchase pension plan, and a vested contribution was made thereunder in 1994 of functional currency (FC) 1,000. The FMV of all of the assets in the plan as of 12/31/94 was FC 100,000. Before the Section 402(b) exception was adopted, Section 679 would have treated the trust under this plan as having a U.S. beneficiary (the transferred X) for 1994 and thus would have treated the U.S. parent as owning 1% of the trust for 1994.



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With the adoption of Section 402(b) as an exception to the application of Section 679, the trust in the example above would not be subject to Section 679. In fact, the addition of the Section 402(b) exception makes the exceptions for trusts under Sections 404(a)(4) and 404A appear to be superfluous. This would be true if every trust that qualifies under either Section 404(a)(4) or 404A also would qualify as a trust under Section 402(b), which seems likely.

Additional exceptions to the general noninclusion rule are provided for under Prop. Regs. 1.671-1(h)(1)(i) through (iv). If a CFC maintains a deferred compensation plan funded through a foreign employees' trust, then, with respect to the CFC, the provisions of Subpart E apply to the portion of the trust that is a defined "fractional interest" of the trust described in the Proposed Regulations. Similar rules apply to a U.S. employer and a U.S.-related foreign partnership. These rules apply whether or not the employer elects Section 404A treatment for the trust, and whether or not the employer retains a grantor trust power or interest over a foreign employees' trust.²¹ Finally, the Proposed Regulations provide that a foreign employer that is not a CFC is treated as an owner of a portion of a foreign employees' trust only as provided in the anti-abuse rule of Reg. 1.1297-4.

If an employer is treated as the owner of a portion of a foreign employees' trust for federal income tax purposes, it is considered to own the trust assets attributable to that portion of the trust for all federal income tax purposes. Thus, for example, if an employer is so treated, the trust income attributable to that portion increases the employer's E&P for purposes of Sections 312 and 964.

Fractional interest. The fractional interest of a foreign employees' trust is defined in Prop. Reg. 1.671-1(h)(3) as an undivided fractional interest in the trust for which the fraction is the relevant amount determined for the employer's tax year (see below) divided by the FMV of trust assets for that year. If a plan is funded through more than one foreign employees' trust, the fractional interest for each trust is determined by aggregating the assets of all of the trusts.

Relevant amount. The general rule is that the relevant amount for the employer's tax year is the amount, if any, by which the FMV of trust assets, plus the FMV of any assets available to pay plan liabilities (including any amount held under an annuity contract that exceeds the amount that is needed to satisfy the liabilities provided for under the contract) that are held in the equivalent of a trust²² within the meaning of Section 404A(b)(5)(A), exceed the plan's accrued liability, determined using a projected unit credit funding method.²³ If, for example, there are sufficient assets to provide for plan liabilities held pursuant to annuity contracts, the relevant amount would equal the FMV of trust assets. In that event, the entire trust corpus would be treated as owned by the CFC under the grantor trust rules.²⁴



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Reasonable funding exception. Under Prop. Reg. 1.671-1(h)(3)(iii) , the relevant amount is reduced to the extent the taxpayer demonstrates that it is attributable (1) to amounts that were properly contributed to the trust pursuant to a reasonable funding method, or (2) to experience that is favorable relative to any actuarial assumptions used that the IRS determines to be reasonable. An amount is considered contributed pursuant to a reasonable funding method if the amount is contributed pursuant to a funding method permitted to be used under Section 412 (e.g., the entry age normal funding method) that is consistently used to determine plan contributions.

In addition, if for purposes of Section 412 there has been a change to a reasonable funding method from another funding method, an amount is considered contributed pursuant to a reasonable funding method only if the prior funding method is also a reasonable funding method under Section 412 that was consistently used to determine plan contributions. A funding method is reasonable only if it provides for amortization over at least six years for (1) any initial unfunded liability and (2) any net change in accrued liability resulting from a change in funding method.

If an employer that is a CFC otherwise would be treated as the owner of a fractional interest in a foreign employees' trust, the taxpayer may rely on this exception only if it so indicates on a statement attached to a timely filed Form 5471.²⁵ This annual notification requirement differs from the rule applicable to qualified plans. In order to demonstrate that a pension plan is not overfunded, an employer may be asked to calculate the estimated accrued liability using valuation methods other than those used for calculating costs on which limitations on deductions for contributions are based. Reg. 1.404(a)-2(e) provides that the Service may require any further information it considers necessary.²⁶

De minimis exception. The relevant amount is considered to be zero under Prop. Reg. 1.671-1(h)(4) if it is not greater than the plan's normal cost for the plan year ending with or within the employer's tax year. For this purpose, the normal cost must be computed using by the method used to determine plan contributions, i.e., either (1) the projected unit credit funding method that satisfies the requirements of Reg. 1.412(c)(3)-1 , along with reasonable actuarial assumptions, or (2) another reasonable funding method acceptable to IRS under Prop. Reg. 1.671-1(h)(3)(iii) .

Transition rules. The relevant amount is reduced (but not below zero) by any transition amount described in the Proposed Regulations. In general, the transition amount is the preexisting amount multiplied by the applicable percentage for the year in which the employer's tax year begins. The preexisting amount is the relevant amount of the trust, determined without regard to the de minimis exception discussed below, computed as of the measurement date that immediately precedes 9/27/96, disregarding contributions to the trust made after the measurement date. For the employer's first tax year ending after the final Regulations are adopted, as well as for prior tax years of the employer, the applicable percentage is 100%. It is reduced (but not below zero) by ten percentage points for each subsequent tax year of the employer.

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The effect of the general transition rule is to require an affected employer to take any unacceptable overfunding (i.e., an overfunding that would, without the transition rule, be treated as being owned by the employer under the grantor trust rules of the Code) into account over a ten-year period.²⁷ There are special transition rules for a new CFC, i.e., a corporation that first becomes a CFC within the meaning of Section 957 after 9/27/96, and for a new U.S.-related foreign partnership employer. These special rules are not applicable if, prior to becoming a CFC or a U.S.-related foreign partnership employer, a corporation makes contributions to a foreign employees' trust with a principal purpose of obtaining tax benefits (by increasing the preexisting amount). In that situation, the applicable percentage with respect to those contributions is zero for all tax years of the new CFC employer.²⁸

FMV of assets. For a tax year of the employer, Prop. Reg. 1.671-1(h)(3)(v) provides that the FMV of trust assets (and the FMV of retirement annuities or other assets held in the equivalent of a trust) is that value as of the measurement date for the employer's tax year, adjusted to include contributions made between the measurement date and the end of that year.

Accrued liability determination. The plan's accrued liability for a tax year of the employer is computed as of the plan's measurement date for that year. That liability is determined using a unit credit funding method, taking into account only liabilities relating to services performed for the employer or a predecessor employer. In addition, the plan's accrued liability is reduced (but not below zero) by any liabilities that are provided for under annuity contracts held to satisfy plan liabilities. Because CFCs generally are required to determine their taxable income by reference to U.S. tax principles, the definition of a plan's "accrued liability" refers to Reg. 1.412(c)(3)-1.

According to the Service, this definition of accrued liability generally is intended to track the method used for calculating pension costs under Statement of Financial Accounting Standards (SFAS) No. 87, *Employers' Accounting for Pensions*. Under the method required to be used to calculate SFAS No. 87's projected benefit obligation (PBO), plan costs are based on projected salary levels. Because many taxpayers already compute PBO annually to determine the pension costs of their nonexempt employees' trusts for financial reporting, it is the stated IRS intention that the timing, interval, and method to compute plan liabilities under Prop. Reg. 1.671-1(h) should minimize taxpayer burdens.²⁹

EFFECT ON PFICS

For purposes of the rules under Sections 1291 through 1297, Prop. Reg. 1.1297-4(a) provides that a foreign employer that is not a CFC is generally not treated as the owner of any portion of a foreign employees' trust, regardless of whether the employer has a power or interest described in Sections 673 through 677 over any portion of the trust. There are two exceptions, however. If the foreign employer has a power or interest described in Sections 673 through 677 over the



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trust, the grantor trust rules of Subpart E will apply, for purposes of Sections 1291 through 1297, to a fixed dollar amount in the trust that equals the FMV of the property transferred for either of the following purposes, if it was a principal purpose for the transfer:

- (1.) Avoiding classification as a PFIC.
- (2.) Reducing or eliminating taxation under Section 1291 or 1293.

Whether the proscribed purpose was a principal purpose for the transfer will be determined using all of the facts and circumstances, including whether the amount of assets held by the foreign employees' trust is reasonably related to the plan's anticipated liabilities (taking into account any local law and practice relating to proper funding levels).

ANALYSIS

What is the effect of the exception to the noninclusion general rule respecting foreign employees' trusts? A grantor who is the owner of a trust under Subpart E is treated as the owner of the trust property for federal income tax purposes. 30 In Prop. Reg. 1.671-1(h)(8), Example 1, the fractional interest of the foreign employees' trust for the 1997 tax year is 16%. Consequently, the employer in the example is treated as the owner for federal income tax purposes of an undivided 16% interest in each of the trust's assets for the period from 1/1/97 through 12/31/97. As such, the employer must take into account a 16% pro rata share of each item of income, deduction, or credit of the trust during this period in computing its federal income tax liability. Deductions for benefits paid out of the trust, however, may not correspond to income inclusion where a foreign employees' trust is overfunded and a portion thereof is treated as owned by the grantor.

The proposed asset ownership rules relating to a foreign employees' trust apply whether or not the employer elects Section 404A treatment for the trust. For example, earnings attributable to an overfunded portion of a foreign employees' trust could be imputed to a CFC even where the trust is irrevocable since, as discussed above, such a trust is likely to have at least one characteristic of a grantor trust under the rules of Sections 673 through 677. Several witnesses at the IRS hearings on these Proposed Regulations suggested that the Service revise them to exclude from the grantor trust rules any trust for which a valid Section 404A election is made. Since such a trust would have to meet the exclusive benefit rule under Section 404A(b)(5), treating a qualified funded foreign plan like a qualified domestic plan as not being subject to the grantor trust rules appears reasonable.



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The Section 671 Proposed Regulations do not deal explicitly with the tax consequences under Section 1001 when a foreign employees' trust a portion of which is treated as a grantor trust becomes a foreign employees' trust no portion (or a lesser portion) of which is treated as a grantor trust. Under the Section 1001 Regulations, the amount realized on the disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the disposition. 31 Presumably, in the Section 671 Proposed Regulations the Service concluded that Section 1001 should not apply to foreign employees' trusts. If, however, a foreign rabbi trust were converted to a foreign employees' trust, it appears that the discharge of indebtedness rule could apply.

Are the partial inclusion rules proposed for CFCs and other employers with respect to overfunded foreign employees' trusts reasonable? The answer to this question is not obvious. It would appear, first of all, that the Service does have the statutory power to adopt these rules. But are they necessary or will they merely generate a significant amount of paperwork without raising a significant amount of revenue? Perhaps a better approach would be for the Service to apply the grantor trust rules only if it determines that a principal purpose of a transfer of property to a foreign employees' trust is to avoid the application of the rules governing CFCs. This is the approach proposed for PFICs (Prop. Reg. 1.1297-4(a)), so the question to ask is why a similar rule is not adequate for other foreign employees' trusts.

1

This rule is contrary to some court opinions. See, e.g., Rothstein, 54 AFTR 2d 84-5072 , 735 F2d 704 , 84-1 USTC 9505 , where the court held that the grantor trust in issue must continue to be viewed as a separate taxpayer. Rev. Rul. 85-13, 1985-1 CB 184 .

2

On 5/7/93, the IRS issued Proposed Regulations under Section 404A (EE-14-81). The Proposed Regulations under Sections 671 and 1297 are essentially anti-abuse rules.

3

Prop. Reg. 1.404A-6(f)(4)(v) .

4

See, e.g., Ltr. Ruls. 9417013 , 9305050 (welfare secular trust), and 9302017 . See also Rev. Rul. 74-299, 1974-1 CB 154 .

5



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Prior to the issuance of the Section 671 Proposed Regulations, there was internal disagreement within the IRS regarding the validity of the Service's secular trust ruling position. It is the author's understanding that there was a substantial body of opinion within the IRS that felt that the secular trust ruling policy would not be applied to foreign deferred compensation trusts. This view was based on the fact that secular trusts are in most instances grantor trusts within the meaning of Sections 671 through 679.

6

See Sections 951 through 964.

7

Reg. 1.402(b)-1(a)(1) provides that employer contributions to a nonexempt employees' trust are included as compensation in the employee's gross income for the tax year in which the contribution is made, but only to the extent that the employee's interest in the contribution is substantially vested under Reg 1.83-3(b).

8

The Preamble to REG-209826-96 comments as follows on this issue: "In certain situations, assets that are owned by a trust as a legal matter may be treated as owned by another person for tax purposes. Thus, assets may be treated as owned by a pension trust for non-tax legal purposes but not for tax purposes. This occurs, for example, if the person who has purportedly transferred assets to the trust retains the benefits and burdens of ownership. See, e.g., *Frank Lyon Co. v. United States*, 41 AFTR 2d 78-1142 , 435 US 561 , 55 L Ed 2d 550 , 78-1 USTC 9370 ; *Corliss v. Bowers*, 8 AFTR 10910 , 281 US 376 , 74 L Ed 916 , 2 USTC 525 ; *Grodt & McKay Realty, Inc. v. Commissioner*, 77 TC 1221 ; Rev. Proc. 75-21 (1975-1 C.B. 715) . If, under these principles, no assets have been transferred to an employees' trust for federal tax purposes, these proposed regulations do not apply."

9

For a discussion of what constitutes a Section 402(b) trust, see GCM 39230 (1984).

10

A rabbi trust is a grantor trust; see Rev. Proc. 92-64, 1992-2 CB 422 . The status of rabbi trusts, whether foreign or domestic, would not be changed by the Proposed Regulations under Section 671 .

11

In the Preamble to REG-209826-96, the IRS and Treasury solicited comments on the need for (and content of) income



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inclusion and asset ownership rules for foreign welfare benefit trusts.

12

The types of trusts covered by the rules discussed in the Section 671 Proposed Regulations generally are defined benefit plans. Trusts under defined contribution plans generally would not be subject to these rules if they could not be overfunded, i.e., if all amounts held in the trust were required to be irrevocably allocated to participants. It is the author's understanding that some foreign defined contribution plans do not provide for irrevocable allocations of all trust funds to participants. For instance, if there are limitations on the amount of benefits paid to a participant irrespective of the participant's account balance, such a trust could become overfunded. This type of trust could, therefore, be subject to the proposed Section 671 rules.

13

See Sections 673 and 676 .

14

Reg. 1.677(a)-1(d) provides that under Section 677 , 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.

15

See Section 674 and the Regulations thereunder.

16

Reg. 1.401-2(b)(1) .

17

This Regulation is now contained in Temp. Reg. 1.956-1T(b)(4)(i) , which provides in part that, for purposes of Reg. 1.956-1(b)(1) , a CFC will be considered to hold indirectly the investments in U.S. property held on its behalf by a trustee.

18

The Preamble notes that the Proposed Regulations provide Subpart E rules for foreign employees' trusts of CFCs, foreign partnerships, and U.S. employers that apply for all federal income tax purposes.



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19

The Preamble to REG-209826-96 notes that the rules of Section 402(b) apply to a beneficiary of a nonexempt employees' trust regardless of whether the trust is a domestic trust or a foreign trust.

20

The Section 402(b) exception was added by section 1903(b) of the Small Business Job Protection Act of 1996 (P.L. 104-188, 8/20/96).

21

In the Preamble to REG-209826-96, the IRS and Treasury solicited comments on whether these Regulations should provide a safe harbor rule for a U.S.-related foreign partnership that maintains a deferred compensation plan funded through a foreign employees' trust if U.S. or CFC partnership interests are de minimis, and specifically concerning the amount of U.S. or CFC partnership interests that would qualify as de minimis.

22

The Section 671 Proposed Regulations do not deal with the treatment of pension funding entities other than trusts, such as, for example, a foundation or corporation. If there are assets held in such a vehicle, however, the Proposed Regulations do require that those assets be taken into account in determining the overfunded status of the foreign employees' trust.

23

Prop. Reg. 1.671-1(h)(3)(ii). This method must satisfy the requirements of Reg. 1.412(c)(3)-1. Only liabilities that relate to services performed through the measurement date may be taken into account.

24

The tax treatment of the trust in that situation would be the same as if the trust were a rabbi trust.

25

Prop. Reg. 1.671-1(h)(3)(iii).

26

Rev. Rul. 69-255, 1969-1 CB 132.



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27

Prop. Regs. 1.671-1(h)(5) and (6).

28

Prop. Regs. 1.671-1(h)(6)(v) and (h)(7)(v).

29

The Preamble solicits comments regarding the extent to which the Proposed Regulations conform to existing procedures under SFAS No. 87 and applicable foreign law, and regarding appropriate conforming adjustments.

30

See Rev. Rul. 85-13 , supra Note 1 .

31

Reg. 1.1001-2(a) . See also Reg. 1.1001-2(c), Example (5) , Reg. 1.1001-2(c), Example (5) Reg. 1.1001-2(c), Example (5) , where a grantor trust is converted by action of the grantor into a taxable trust (upheld in *Madorin*, 84 TC 667). The Service referred to Section 1001 as being potentially applicable in Prop. Reg. 1.404A-6(f)(4)(v) .

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