INTERNAL REVENUE
BULLETIN

HIGHLIGHTS OF THIS ISSUE

Bulletin No. 2025–9
February 24, 2025

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

EMPLOYEE PLANS, EXCISE TAX

REG-110878-24, page 979.

This document withdraws a notice of proposed rulemaking that appeared in the Federal Register on October 28, 2024, regarding coverage of certain preventive services under the Affordable Care Act.

ESTATE TAX, GIFT TAX

T.D. 10027, page 897.

The final Treasury Decision provides guidance for section 2801, which was added to the Internal Revenue Code by section 301 of the Heroes Earnings Assistance and Relief Tax Act of 2008, Public Law 110–245 (122 Stat. 1624), effective June 17, 2008. Section 2801, which is the sole section of new Chapter 15 of subtitle B (relating to taxes on transfers of property), imposes a transfer tax on U.S. citizens and residents, including trusts, who receive, directly or indirectly, covered gifts and covered bequests from covered expatriates.

INCOME TAX

REG-107895-24, page 972.

These proposed regulations provide guidance regarding the base erosion and anti-abuse tax imposed on certain large corporate taxpayers with respect to certain payments made to foreign related parties. The proposed regulations would affect corporations with substantial gross receipts that make payments to foreign related parties.

T.D. 10026, page 878.

This document contains final regulations regarding certain disregarded payments that give rise to deductions for foreign tax purposes and potential double non-taxation of income. The final regulations affect domestic corporate owners that make or receive such payments. This document also announces additional transition relief for the application of the dual consolidated loss ("DCL") rules to certain foreign taxes that are intended to ensure that multinational enterprises pay a minimum level of tax.

T.D. 10029, page 936.

This document contains final regulations that identify transactions that are the same as, or substantially similar to, certain micro-captive transactions as listed transactions, a type of reportable transaction, and certain other micro-captive transactions as transactions of interest, another type of reportable transaction.

Finding Lists begin on page ii.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I

T.D. 10026

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 301

Rules Regarding Certain Disregarded Payments and Dual Consolidated Losses

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final rule.

SUMMARY: This document contains final regulations regarding certain disregarded payments that give rise to deductions for foreign tax purposes and avoid the application of the dual consolidated loss ("DCL") rules. The final regulations affect domestic corporate owners that make or receive such payments. This document also announces additional transition relief for the application of the DCL rules to certain foreign taxes that are intended to ensure that multinational enterprises pay a minimum level of tax.

DATES: *Effective date:* These regulations are effective on January 10, 2025.

Applicability dates: For dates of applicability, *see* §§ 1.1503(d)-8(b)(11), (15), (17), and (18), and 301.7701-2(e)(10).

FOR FURTHER INFORMATION CONTACT: Andrew L. Wigmore at (202) 317-5443 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document contains amendments to 26 CFR parts 1 and 301 (the "final regulations") under sections 1503(d) and 7701 of the Internal Revenue Code (the "Code"). The final regulations are issued pursuant to the express delegations of authority under section 7805(a), which authorizes the Secretary of the Treasury (the "Secretary") to "prescribe all needful rules and regulations for the enforcement" of the Code, section 1503(d)(2)(B), which authorizes the Secretary to provide exceptions to the term "dual consolidated loss," and section 1503(d)(3), which authorizes the Secretary to address losses of "separate units."

Background

On December 11, 2023, the Department of Treasury ("Treasury Department") and the IRS released Notice 2023-80, 2023-52 IRB 1583, which, among other things, described the interaction of the DCL rules with model rules published by the OECD/G20 Inclusive Framework on BEPS (the "GloBE Model Rules")[1] and requested comments on such interaction. The notice also announced limited transition relief from the application of the DCL rules to the GloBE Model Rules for "legacy DCLs," which in general are DCLs incurred before the effective date of the GloBE Model Rules.

On August 7, 2024, the Treasury Department and the IRS published proposed regulations (REG-105128-23) in the **Federal Register** (89 FR 64750) under sections 1502, 1503(d), and 7701 of the Code, with a correction published in the **Federal Register** on September 3, 2024 (89 FR 71214) (the "2024 proposed regulations"), that would address certain issues arising under the DCL rules. In general, the 2024 proposed regulations would clarify how the DCL rules interact with the intercompany transaction rules in § 1.1502-13, modify how items arising from stock ownership are taken into account when computing the amount of a DCL, and address the application of the DCL rules to foreign taxes that are based on the GloBE Model Rules. The 2024 proposed regulations also included disregarded payment loss ("DPL") rules, under which domestic corporations would be required to include amounts in income in certain cases involving disregarded payments. Further, the 2024 proposed regulations included an anti-avoidance rule applicable for both DCL and DPL purposes.

This document finalizes certain rules from the 2024 proposed regulations. These rules and related comments received in response to the 2024 proposed regulations are discussed in the Summary of Comments and Explanation of Revisions section of this preamble. All comments are available at *https://www.regulations.gov* or upon request. A public hearing was held on the 2024 proposed regulations on November 22, 2024, but the speaker requesting to testify did not attend the hearing. The Treasury Department and the IRS intend to finalize, in future guidance, the remaining rules from the 2024 proposed regulations.

This document also announces additional transition relief for the application of the DCL rules to foreign taxes that are based on the GloBE Model Rules. This relief is discussed in the Additional Transition Relief with respect to the GloBE Model Rules section of this preamble.

Summary of Comments and Explanation of Revisions

I. *Scope*

This document finalizes the rules from the 2024 proposed regulations that relate to DPLs, including portions that are also relevant for DCLs, such as the anti-avoidance rule and the deemed ordering rule. The document retains the basic approach and structure of these rules, with certain revisions.

Part II of the Summary of Comments and Explanation of Revisions summarizes the DPL rules, including the purposes and general approach of the rules under the 2024 proposed regulations, and discusses related comments and revisions. Part III discusses comments and revisions related to rules applicable to both DCLs

[1] *See* OECD/G20, Tax Challenges Arising from the Digitalisation of the Economy Global Anti-Base Erosion Model Rules (Pillar Two). As the context requires, references to the GloBE Model Rules include references to a foreign jurisdiction's legislation implementing the GloBE Model Rules. Capitalized terms used in this preamble, but not defined herein, have the meanings ascribed to such terms under the GloBE Model Rules.

and DPLs. Part IV discusses applicability dates of the final regulations.

II. *DPL Rules*

A. *Overview*

The DPL rules are a component of the entity classification regulations under §§ 301.7701-1 through 301.7701-3 (the "check-the-box regulations"). The check-the-box regulations were intended to bring simplicity and administrability to entity classifications under section 7701. They permit certain business entities to be classified for U.S. tax purposes as entities disregarded as separate from their owners. The classification may be determined either pursuant to default rules or by election. However, the application of these regulations to foreign entities, particularly where a foreign entity is treated as a disregarded entity, has led to unintended tax consequences, including avoidance of international provisions of the Code. The purpose of the DPL rules is to prevent certain arrangements involving disregarded entity classifications from avoiding the DCL rules.

As an example, when a domestic corporation borrows from a bank and on-lends the loan proceeds to its foreign disregarded entity, the single economic borrowing could give rise to deductions under both U.S. tax law (for interest payments to the bank) and foreign tax law (for interest payments to the domestic corporation). As a result, if the U.S. deduction is used to offset U.S. income that is not subject to foreign tax, and the foreign tax deduction generates a foreign loss that is used to offset foreign income that is not subject to U.S. tax (for example under a consolidation regime), then the single economic borrowing would give rise to a double deduction outcome. Such double deduction outcome, however, would not be addressed by the existing DCL rules because the loss of the disregarded entity would not be recognized for U.S. tax purposes. Conversely, if the disregarded entity's interest payments were regarded for U.S. tax purposes (for example, if the arrangement involved direct financing of the disregarded entity by the bank), the loss would be subject to the existing DCL rules. This avoidance of the DCL rules is an unintended consequence of the check-the-box regulations which, as noted above, were issued for the simplification and administrability of entity classification determinations.

The DPL rules are intended to address these concerns by (i) tracking whether certain payments involving a disregarded entity and its owner give rise to potential double deduction outcomes, and (ii) neutralizing any resulting double deduction outcome through an income inclusion similar to the one that that the owner would have had with respect to the payments had the payments been regarded for U.S. tax purposes (that is, had the classification as a disregarded entity under the check-the-box regulations not been taken into account). As revised under the final regulations, the DPL rules also treat the income inclusion as giving rise to a deduction, the use of which is suspended until the entity takes into account certain disregarded income, with the result that the rules are consistent with what would have occurred if certain disregarded payments were regarded for U.S. tax purposes (as discussed in part II.F of the Summary of Comments and Explanation of Revisions). In this way, the check-the-box regulations continue to permit certain entities to be disregarded for U.S. tax purposes (including by election), but such classifications are subject to new (targeted) rules that prevent the classifications from giving rise to avoidance of the DCL rules. Alternative approaches to addressing these concerns would include more broadly restricting disregarded entity classifications (for example, by requiring a foreign entity to be classified as an association for U.S. tax purposes if the entity is a foreign tax resident, or classifying single-owner foreign entities as associations in all cases).

Under the 2024 proposed regulations, the DPL rules would apply with respect to a domestic corporation and a disregarded entity of the domestic corporation (or a disregarded entity in which the domestic corporation indirectly owns an interest) if transactions involving the entity and domestic corporation are deductible under a foreign tax law, such as where the entity is a tax resident of a foreign country. *See* proposed § 301.7701-3(c)(4). In these cases, the 2024 proposed regulations described the domestic corporation as consenting to such application of the DPL rules (generally by reason of the entity's check-the-box election) and generally referred to the disregarded entity and the domestic corporation as a disregarded payment entity ("DPE") and specified domestic owner, respectively. *See* proposed §§ 1.1503(d)-1(d)(1) and 301.7701-3(c)(4). This document retains the nomenclature of the 2024 proposed regulations, with certain simplifications or other modifications, such as referring to a specified domestic owner as a DPE owner and eliminating references to consent (discussed in part II.B.2 of the Summary of Comments and Explanation of Revisions).[2]

Under the proposed DPL rules, the DPE owner would monitor whether the DPE incurs a DPL or derives disregarded payment income ("DPI"). *See* proposed § 1.1503(d)-1(d)(1). A DPL or DPI would be determined by taking into account only certain items under the relevant foreign tax law (generally interest or royalties) that are not regarded for U.S. tax purposes. *See* proposed § 1.1503(d)-1(d)(6)(ii). The DPE would have a DPL to the extent that, under the foreign tax law, its deductions for such items exceed its income from such items, and it would have DPI to the extent the reverse is true. *See id.* Under the 2024 proposed regulations, a DPE's cumulative amounts of DPL and DPI would be tracked in the DPE's "DPL cumulative register" through negative and positive adjustments, respectively, to the register. *See* proposed § 1.1503(d)-1(d)(5)(ii).

In the case of a DPL, the DPE owner generally would disclose the DPL on an initial certification statement and file annual certifications for a 60-month period affirming that the DPL has not been put to a foreign use. *See* proposed § 1.1503(d)-1(d)(1). A failure to comply with this certification requirement,

[2] The final regulations also clarify that the DPL rules address the avoidance of the DCL rules, which has been described differently in prior guidance. *See, for example,* REG-104352-18, 83 FR 67612, 67624 (noting that the DCL regulations do not apply to DPL structures, and that such structures give rise to outcomes similar to "D/NI outcomes…and double-deduction outcomes…") and REG-105128-23, 89 FR 64750, 64762 (noting that an income inclusion under the proposed DPL rules "generally neutralizes the D/NI outcome").

or a foreign use of the DPL within the certification period (each, a "triggering event"), would require the DPE owner to include in gross income the DPL inclusion amount. *See* proposed § 1.1503(d)-1(d)(1) and (3). The DPL inclusion amount would be equal to the amount of the DPL, reduced by the positive balance (if any) in the DPL cumulative register. *See* proposed § 1.1503(d)-1(d)(2) through (5). Requiring the DPL inclusion amount in the year of the triggering event (rather than the year in which the DPL is incurred) would be consistent with the approach under the current DCL rules and avoids any administrative or compliance burdens that could result by instead requiring taxpayers to extend the statute of limitations and amend tax returns upon a triggering event of the DPL.

B. *Rulemaking authority*

1. In general

Comments asserted that the DPL rules do not reflect a proper exercise of the Treasury Department and the IRS's rulemaking authority for a variety of reasons. Some comments claimed that Congress has not expressed a concern with deduction/no inclusion outcomes arising from disregarded payments because those types of outcomes are not explicitly described in sections 245A(e), 267A, or 1503(d), the Code's anti-hybrid provisions. These comments asserted that the DPL rules in effect implement the recommendations from the OECD reports[3] relating to disregarded payments but noted that Congress has not adopted those recommendations—whereas Congress did adopt other OECD recommendations in enacting sections 245A(e) and 267A. The comments accordingly argued that the 2024 proposed regulations inappropriately circumvent Congress by implementing OECD policies that Congress has rejected.

Other comments asserted that the DPL rules have no basis in section 1503(d), because section 1503(d) operates by disallowing a domestic corporation's net operating loss. These comments contended that the DPL rules go beyond what section 1503(d) permits because they impose an income inclusion (rather than deny a loss) based on disregarded transactions that cannot give rise to a net operating loss (which is computed by reference to regarded items only). Comments similarly argued that section 7701 provides no basis for the DPL rules because section 7701 pertains to an entity's tax classification and does not authorize income inclusions. One comment also contended that the Treasury Department and the IRS cannot rely on section 7805(a)'s general grant of rulemaking authority for the DPL rules because section 7805(a) authorizes the Secretary to issue regulations "for the enforcement" of the Code, and, according to the comment, the DPL rules do not relate to any Code provision.

Another set of comments argued that the DPL rules are arbitrary and capricious. According to the comments, the DPL rules address the erosion of foreign tax bases and thus are not in furtherance of any recognized U.S. tax policy, which, one comment stated, has historically permitted taxpayers to reduce their foreign tax liability. One comment further argued that taxpayers have a reliance interest on the certainty afforded by the check-the-box regulations, which, according to the comment, Congress has impliedly endorsed by leaving the regulations undisturbed since their issuance in 1996. The comment stated that the Treasury Department and the IRS cannot upset those reliance interests by adding the DPL rules to the check-the-box regime and asserted that changes to the regime to address hybridity-related concerns should not be made absent direction from Congress. The comment referred to Notice 98-11, 1998-1 C.B. 433, and the temporary and proposed regulations issued under the notice that treated a disregarded entity that engaged in certain transactions as a foreign corporation for purposes of subpart F of the Code. The Senate Finance Committee proposed a six-month moratorium on implementing the regulations to provide Congress time to consider the issues. *See* S. Rept. 105-174, at 107-110 (1998).

The Treasury Department and the IRS disagree with these comments. The DPL rules prevent certain disregarded entity classifications from giving rise to avoidance of the DCL rules (as discussed in part II.A of the Summary of Comments and Explanation of Revisions). Because these classifications arise under the check-the-box regulations, revising the regulations to prevent abuse, other misuse, or unintended consequences that only arise due to the classification rules under the check-the-box regime is an appropriate exercise of the authority underlying the regulations, including the express delegation of authority under section 7805(a) of the Code. These revisions generally produce outcomes consistent with what would have occurred if certain disregarded payments were regarded for U.S. tax purposes (as discussed in part II.F of the Summary of Comments and Explanation of Revisions).

As a limitation on disregarded entity classifications, the DPL rules are consistent with other special rules in the check-the-box regulations that regard an entity for certain limited purposes, while generally retaining the entity's disregarded entity classification. For example, disregarded entity status is not respected for purposes of certain rules related to banking, federal tax liabilities, and employment and excise taxes. *See* § 301.7701-2(c)(2)(ii) through (v). Similarly, § 301.7701-2(c)(2)(vi) treats certain domestic disregarded entities as corporations for purposes of section 6038A to provide the IRS with access to information to satisfy its obligations under international agreements and strengthen the enforcement of U.S. tax laws.

When the check-the-box regulations were issued, the preamble made clear that additional rules may be required to prevent inappropriate outcomes. TD 8697 (61 FR 66584, 66585) (describing that, in light of the increased flexibility under an elective regime for entity classifications, the Treasury Department and the IRS will monitor for, and take appropriate action to address, results that are inconsistent with the policies and rules of particular Code provi-

[3] *See* OECD/G20, Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2: 2015 Final Report (October 2015) ("Hybrid Mismatch Report") and OECD/G20, Neutralising the Effects of Branch Mismatch Arrangements, Action 2: Inclusive Framework on BEPS (July 2017) ("Branch Mismatch Report").

sions). Further, the history of Notice 98-11 and the regulations issued thereunder do not support the conclusion that the Treasury Department and the IRS lack authority for the DPL rules. In fact, the Senate report specifically stated that the proposed moratorium on the regulations described in Notice 98-11 should not be interpreted as the Treasury Department and the IRS lacking authority to impose limitations on disregarded entity classifications. *See* S. Rept. 105-174, at 110 (1998).

Moreover, the DPL rules are a reasonable response to significant policy concerns resulting from the check-the-box regulations. Addressing these concerns by requiring an income inclusion (that neutralizes the double deduction outcome by, in effect, offsetting the related deduction that would otherwise be allowed for U.S. tax purposes) prevents taxpayers from circumventing the DCL rules through the artifice of causing payments to be disregarded. The approach in this rulemaking maintains the simplicity and flexibility (including the electivity component) of the check-the-box regulations while preventing inappropriate outcomes through new rules with narrow application. Further, taxpayers that prefer to avoid the application of the DPL rules can do so by restructuring to avoid these inappropriate outcomes, as illustrated in § 1.1503(d)-7(c)(45) (Example 45). *See also* parts II.D.1, II.D.2, II.F, and G.1 of the Summary of Comments and Explanation of Revisions (discussing certain revisions in response to comments, which have the effect of further narrowing and deferring the application of the DPL rules). Thus, by preventing the check-the-box regulations from enabling inappropriate outcomes, the DPL rules are a reasonable modification of the regulations. Furthermore, the Treasury Department and the IRS disagree that DPL rules inappropriately promote the policy underlying the OECD recommendations to address double non-taxation resulting from hybridity. Instead, the DPL rules promote the U.S. tax policy underlying section1503(d), which was enacted in 1986 (and modified in a technical correction in 1988), to prevent double deduction outcomes; the OECD policy that was set forth in the Hybrids Mismatch Report and Branch Mismatch Report, issued in 2015 and 2017, respectively, is simply consistent with the existing, longstanding U.S. policy.

Finally, the Treasury Department and the IRS have consistently raised the concern that the check-the-box regulations could expand the use of hybrid structures. This concern was identified in Notice 95-14, 1995-14 IRB 7, which first announced that an elective entity classification regime was under consideration and solicited comments on the propriety of extending an elective regime to foreign entities, noting the increased potential for hybrid entities. Since then, the check-the-box regime has increased the prevalence of hybrid structures to an extent not initially foreseen, and many of these structures are designed for tax avoidance. The Treasury Department and the IRS have addressed this avoidance through targeted rules where feasible. *See, for example*, § 1.894-1(d)(2)(ii) and TD 8999 (67 FR 40157) (relating to the use of domestic reverse hybrid entities to obtain inappropriate treaty benefits); §§ 1.1503(d)-1(c) and 301.7701-3(c)(3) (relating to the use of domestic reverse hybrid entities to obtain double-deduction outcomes). Taxpayers therefore should not have an expectation that a disregarded entity classification can be used to circumvent the DCL rules, and in any case, the Treasury Department and the IRS are of the view that any such expectations would not constitute a significant reliance interest that would caution against this rulemaking, given the limited extent to which the DPL rules impose a condition on certain payments involving disregarded entities. Reliance interests, if any, are significantly outweighed by the need to prevent inappropriate results.

2. Default disregarded entity status and non-consolidated DPE owners

Comments also asserted that the Treasury Department and the IRS do not have authority to apply the DPL rules in specific fact patterns. According to these comments, the DPL rules should not apply where no entity classification election is made under § 301.7701-3, such as where a foreign entity defaults to disregarded entity classification, because in these cases there is no affirmative act by reason of which the taxpayer consents to the application of the DPL rules. Another comment claimed that the DPL rules should not apply where the DPE owner is not part of a group that files a consolidated return, asserting that sections 1502 and 1503(d) cannot apply to a corporation that is not a member of a consolidated group.

The Treasury Department and the IRS disagree with these comments. As discussed in part II.B.1 of the Summary of Comments and Explanation of Revisions, the DPL rules are a component of the check-the-box regime. Under the check-the-box regulations, promulgated in 1996, the Treasury Department and the IRS permit certain entities with a single owner to choose whether or not to be treated as disregarded as separate from their owner for most federal income tax purposes. However, even entities that choose to be disregarded as separate from their owner for most Federal income tax purposes are not disregarded for all purposes. For example, these entities are regarded for purposes of federal income tax liability, excise taxes, and employment taxes. *See* § 301.7701-2(c)(2). The treatment of an entity as disregarded for some purposes and regarded for other purposes under § 301.7701-2(c)(2) does not depend on whether the entity is treated as disregarded pursuant to the default rules or by election.

Like the other rules in § 301.7701-2(c)(2) and as discussed in part II.F of the Summary of Comments and Explanation of Revisions, the DPL regulations effectively provide that a DPE is regarded for purposes of recognizing certain interest and royalty payments between a DPE and its owner or between a DPE and other disregarded entities. However, for purposes of administrability, these rules do not regard the payment more broadly or require the filing of amended returns to reflect the revocation of a disregarded entity classification.

Further, the check-the-box regime is an elective regime that allows eligible entities to choose their entity classification. The check-the-box regulations provide default classification rules that aim to match taxpayers' expectations and thus reduce the number of elections that taxpayers must file to select their entity classification of choice. *See* TD 8797 (61 FR 66584). Thus, through the check-the-box regulations, an eligible entity chooses to be classified as a disregarded entity, regardless of whether

that choice occurs by accepting the default classification (that is, by choosing not to elect an alternative treatment) or by filing an election; it is merely the mechanics of obtaining a disregarded entity classification that differ. On the other hand, absent regulations under section 7701, no foreign business entity would generally be treated as a disregarded entity.

Moreover, applying the DPL rules without regard to whether disregarded entity classification is obtained by election or pursuant to the default rules ensures consistency. Otherwise, similarly situated taxpayers could have different outcomes based solely on whether the entity they choose to use is an entity that satisfies the default rule to be treated as a disregarded entity rather than requiring an election to achieve that result.

Lastly, the DPL rules are not issued under section 1502 authority (and section 1503(d) is not limited in application to consolidated groups). The DPL rules are issued under the authority of sections 1503(d), 7701, and 7805(a) and are located under section 1503(d) because the rules leverage concepts from, and prevent the avoidance of, the DCL rules.

C. Integration of DPL and DCL regimes

As discussed in part II.C of the Explanation of Provisions of the 2024 proposed regulations, the DPL rules operate independently of the DCL rules. For example, only items that are regarded for U.S. tax purposes are taken into account in computing a DCL (or the DCL cumulative register), and only items that are disregarded for U.S. tax purposes would be taken into account in computing a DPL (or the DPL cumulative register). The view of the Treasury Department and the IRS as expressed in the 2024 proposed regulations was that integrating the two regimes would result in considerable complexity and administrative burden. For example, fully integrating the regimes would likely require a significantly broader scope of the DPL rules to take into account all disregarded payments (consistent with the scope of the DCL rules, which take into account all regarded payments) and to take into account all of the triggering events that apply with respect to DCLs (rather than only two triggering events that apply under the DPL rules).

Comments requested integration or coordination of the DPL rules and DCL rules, suggesting that an integrated or coordinated set of rules could ensure consistent treatment of similar transactions (regardless of whether regarded or disregarded for U.S. tax purposes) and simplify compliance. For example, one comment proposed withdrawing the DPL rules and revising the DCL rules to ignore disregarded and intercompany transactions (as defined in § 1.1502-13(b)(1)) in calculating the amount of a DCL, while at the same time taking such transactions into account under a modified DCL register. Specifically, under this approach, a separate unit would calculate its income or loss both with and without disregarded and intercompany transaction items that offset in amount, with the smaller amount of income being dual income and thus increasing the DCL register, or with the smaller amount of loss being a dual loss and thus a DCL. The difference between the with-and-without calculation in a year would be tracked as an attribute — excess income or excess loss — for purposes of applying the with-and-without calculation in subsequent years. The comment stated that this approach would provide parity between disregarded and intercompany transactions, parity between calculation of a DCL register and the amount of a DCL, and parity between different types of items.

The final regulations do not adopt these comments because the Treasury Department and the IRS remain of the view that integration or other coordination would result in considerable complexity and administrative burden. Additionally, the with-and-without approach proposed by a comment would not address the double deduction outcome arising from a disregarded entity classification in a prototypical case involving a DPL arising from back-to-back financing where the disregarded entity does not also incur a DCL – that is, the excess loss carried forward for purposes of the with-and-without calculation would be relevant only to the extent that the disregarded entity's regarded items of deduction or loss in a year exceed the regarded items of income or gain in that year.

Another comment suggested that the DPL rules be replaced with an approach that would treat a disregarded entity as a regarded pass-through entity (for example, a one-partner partnership) solely for purposes of the DCL rules, citing section 1503(d) as authority for such an approach. The comment noted that the application of the DPL rules to a disregarded entity can be avoided by introducing another owner (thereby converting the entity to a partnership) and that the suggested approach avoids the administrative complexity of this type of restructuring. The final regulations do not adopt this approach because it would require broader changes to check-the-box regulations (for example, by creating a new type of regarded pass-through entity), and it could increase complexity and compliance or administrative burden as a result of regarding items that are outside the scope of the DPL rules, such as payments for services and property transactions giving rise to ordinary income or loss.

Lastly, a comment suggested that because the DPL rules were issued as part of a notice of proposed rulemaking that also addresses the DCL rules and those would operate independently of each other, the DPL rules should be withdrawn and issued as a standalone notice of proposed rulemaking. According to the comment, this approach would afford taxpayers a more adequate notice-and-comment period and more clearly signal to affected taxpayers the standalone nature of the DPL rules. The Treasury Department and the IRS have determined that finalizing the DPL rules is appropriate regardless of whether the proposed version of the rules was included in a notice of proposed rulemaking that included other concepts and that the proposed version of the rules provided sufficient notice-and-comment, including about the standalone nature of the DPL rules.

D. *Scope of DPL rules*

1. In general

Under the 2024 proposed regulations, the DPL or DPI of a DPE would be determined by taking into account only items that both (i) give rise to deductions or income of the DPE under a foreign tax

law (in the case of deductions, determined with regard to any application of foreign hybrid mismatch rules), and (ii) are disregarded for U.S. tax purposes but would be interest, structured payments, or royalties if the items were regarded.[4] *See* proposed § 1.1503(d)-1(d)(6)(ii) and (d)(7)(v). This limited application of the DPL rules would address transactions that are likely structured to avoid the DCL rules.

Comments suggested narrowing the scope of the DPL rules in several respects (and not expanding the rules to cover other payments such as for disregarded services), so that the rules better address transactions likely to give rise to double non-taxation and minimize compliance burden. Some comments suggested that the DPL rules not apply to royalties, or at least royalties paid pursuant to a license executed before the date of the 2024 proposed regulations. A comment asserted that most foreign entities enter into intercompany licensing arrangements for non-tax business reasons and that restructuring these licenses is not always easy or feasible, including because of legal restrictions or foreign tax costs. Other comments asserted that the licenses generally create substantial dual inclusion income (either through exploiting the intangible property or sub-licenses) and, therefore, do not give rise to double non-taxation; one of these comments, however, noted that absent at least partial integration of the DCL and DPL regimes, the dual inclusion income attributable to a license agreement could be double counted by both reducing a DPL and a DCL.

Comments also suggested not applying the DPL rules to payments that are subject to tax in another foreign country (for example, payments between DPEs that are tax residents of different foreign countries), or possibly only to the extent that the other foreign country has a sufficiently high statutory or effective tax rate. A comment noted that an effective tax rate analysis for purposes of such an exception could rely on existing methods, like the GloBE Model Rules or the GILTI high-tax exception in § 1.951A-2(c)(7) but acknowledged resulting compliance and administrative burdens. Comments also suggested not applying the DPL rules if the disregarded entity has net income for foreign tax purposes (for example where the DPE's net regarded income or net disregarded services income exceeds its DPL), asserting that, absent such an exception, the entity classification regime would be more complex to administer and taxpayers would be incentivized to restructure in a manner that is adverse to U.S. tax policy and results in additional foreign tax and, in turn, additional foreign tax credits. Further, comments recommended not applying the DPL rules to payments subject to hybrid mismatch rules in the payor jurisdiction, contending that such jurisdiction has taken the necessary steps to address erosion of its tax base.

The final regulations generally do not adopt these specific comments. The Treasury Department and the IRS have determined that excluding all royalties from the DPL rules could incentivize new licensing structures intended to give rise to avoidance of the DCL rules given the ease with which licenses can be put in place.

The Treasury Department and the IRS have also determined that a deduction in both the United States and a foreign country is not adequately neutralized by an income inclusion in another foreign country. Additionally, to the extent that taxpayers generally minimize payments from entities in low-tax countries to related entities in high-tax countries, an exception for payments taxed at a sufficiently high tax rate would likely have limited effect while adding significant complexity.

Further, the Treasury Department and the IRS have determined that an exception under which the DPL rules do not apply if the disregarded entity has net income for foreign tax purposes would be contrary to the approach of maintaining separate DCL and DPL rules, and give rise to inappropriate results, as discussed in parts II.C and III.B of the Summary of Comments and Explanation of Revisions, respectively. Also, taking into account the application of foreign hybrid mismatch rules in determining a DPL or DPI will in many cases limit the application of the DPL rules to DPEs subject to foreign hybrid mismatch rules. Moreover, if there is no foreign use of a DPL and annual certification requirements are satisfied, the DPL rules have no further effect. The Treasury Department and the IRS remain of the view that the filing of certification requirements is necessary, even in situations where there may not be a net loss for foreign tax purposes in that particular year, to ensure that any deduction or loss composing a DPL is not put to a foreign use during the certification period. Moreover, this approach is consistent with the requirement in the DCL rules that a domestic use agreement be filed (to put a DCL to a domestic use) even in cases where it may be unlikely that a DCL can be put to a foreign use in a particular year, such as due to disregarded income that is not taken into account for DCL purposes.

Finally, structures involving hybridity that produce double deduction outcomes are contrary to the U.S. tax policies underlying section 1503(d). Consistent with the current DCL rules, the DPL rules apply even in circumstances where the absence of DPL rules could reduce the amount of foreign income tax that would otherwise be creditable for U.S. tax purposes or where the adoption of such rules may cause some taxpayers to restructure in a manner that increases the amount of creditable foreign income tax.

However, in response to these comments, the final regulations provide a de minimis exception and (consistent with a comment) do not apply the DPL rules to royalties paid pursuant to a license agreement executed before the date of the 2024 proposed regulations. *See* § 1.1503(d)-1(d)(5)(ii)(E) and (d)(6)(vii). Together, these modifications are intended to further limit application of the DPL rules to cases that are likely structured to produce double deduction outcomes. The Treasury Department and the IRS have determined that this approach strikes an appropriate balance between that goal and considerations like those discussed in the preceding paragraphs, while also eliminating compliance burden in certain cases.

Under the de minimis exception, a DPL with respect to a DPE and a foreign taxable year is deemed to be zero if it is incurred in connection with the conduct of an active trade or business (based on

[4] References to interest throughout this preamble include a reference to a structured payment, as the context requires.

rules set forth under § 1.367(a)-2(d)), and the amount of the DPL is less than the lesser of $3 million or 10 percent of the aggregate amount of all items of the DPE that are deductible under a foreign tax law. *See* § 1.1503(d)-1(d)(6)(vii). This de minimis threshold is determined based on the foreign tax law and, therefore, takes into account items regardless of whether regarded or disregarded for U.S. tax purposes.

2. Types of DPEs and Minority Interests

In addition to certain disregarded entities, the 2024 proposed regulations would treat certain foreign branches and dual resident corporations as DPEs. *See* proposed § 1.1503(d)-1(d)(1). This is because a payment treated as made by a foreign branch of a domestic corporation, including a dual resident corporation, under foreign tax law to a disregarded entity of the corporation could give rise to a deduction for foreign tax purposes without an inclusion for U.S. tax purposes, and any resulting double deduction generally would not occur if the payee were regarded for U.S. tax purposes. Further, where a DPE is owned through a partnership, the DPL rules would apply as to a DPE owner on a proportionate basis, based on the percentage of interests (by value) of the DPE that the DPE owner indirectly owns. *See* proposed § 1.1503(d)-1(d)(7)(ii).

Comments expressed concerns about applying the DPL rules to minority interests in DPEs, contending that such interests do not present the same related-party tax structuring concerns that the DPL rules are intended to address, and noting that a foreign use triggering event under the DPL rules requires a use by a person related to the DPE owner. The comments further noted that the DPE combination rule would exacerbate these concerns because, for example, a DPE owner's inability to comply with certification requirements with respect to a minority interest in a DPE could cause a triggering event with respect to a DPL attributable to that DPE and other DPEs in the same foreign country. Accordingly, the comments recommended applying the DPL rules with respect to a DPE owner and DPE only if the entities are related (determined under section 954(d)(3), for instance). A comment also asserted that applying the DPL rules on a proportionate basis by reference to the value of a partnership interest is burdensome because it requires an annual valuation of the partnership, and the comment suggested retaining this approach only to the extent that other partnership rules require similar valuations.

The Treasury Department and the IRS agree that the DPL rules should not apply to minority interests. Accordingly, the final regulations revise the DPE definition to exclude entities that are not related, within the meaning of section 954(d)(3), to a DPE owner. *See* § 1.1503(d)-1(d)(5)(i). In addition, where a DPE owner indirectly owns less than all the interests (but more than a minority interest) in a DPE, the final regulations remove the requirement in the 2024 proposed regulations that would apply the DPL rules on a proportionate basis based on value, because the Treasury Department and the IRS have determined that a DPE owner's proportionate interest can be determined under other reasonable methods.

Further, the final regulations clarify that a foreign branch owned by a domestic corporation through one or more partnerships may be a DPE. *See* § 1.1503(d)-1(d)(5)(i)(B). Thus, if a partnership makes a payment to a disregarded entity of the partnership and the payment is attributed to a foreign branch under foreign tax law, then (because the foreign branch may be a DPE) a domestic corporate partner's proportionate share of a resulting deduction under the foreign tax law can give rise to a DPL. *See* § 1.1503(d)-1(d)(6)(ii). Similarly, to address deductions arising under foreign tax law by reason of the partnership being a tax resident of a foreign country (rather than by reason of the partnership having a foreign branch), the final regulations provide that an entity that is treated as a partnership for U.S. tax purposes, but is a foreign tax resident, may be a DPE. *See* § 1.1503(d)-1(d)(5)(i)(C).

3. "True" foreign branches

Because the DPL rules are a component of the check-the-box rules, the rules do not apply with respect to deductions resulting under a foreign tax law from payments treated as made between a "true" foreign branch (that is, a foreign taxable presence not conducted through a disregarded entity) and its owner. One comment expressed concerns with disparate treatment resulting from this limitation, asserting that it would incentivize structures involving true foreign branches.

The Treasury Department and the IRS have determined that this concern does not detract from the utility of the DPL rules. To the extent disregarded entity classifications facilitate structures intended to give rise to avoidance of the DCL rules, addressing those structures through new rules is appropriate regardless of whether the new rules would also address structures that are less common or more burdensome to implement.

E. *Foreign use issues*

1. "All or Nothing" Principle

Under the 2024 proposed regulations, a foreign use of a DPL would be determined under the principles of the rules determining the foreign use of a DCL, which are in § 1.1503(d)-3. *See* proposed § 1.1503(d)-1(d)(3)(i). Thus, for example, under the so-called "made available" standard, a foreign use of a DPL would occur if any portion of a deduction taken into account in computing the DPL is made available under a relevant foreign tax law to offset an item of income that, for U.S. tax purposes, is an item of income of a foreign corporation that is related to the DPE owner. Generally, a foreign use of a DPL (or DCL) would occur as a result of structures intended to avoid the application of the DCL rules.

The concept of the entirety of a DPL (or DCL) being put to a foreign use by reason of the availability under a relevant foreign tax law of any portion of a deduction composing the DPL (or DCL) is, in conjunction with the "made available" standard, referred to as the "all or nothing" principle. *See* TD 9315 (72 FR 12902, 12910-11). As indicated in the preamble to the 2024 proposed regulations, the all or nothing principle addresses a concern of the Treasury Department and the IRS that alternative approaches, such as treating a foreign use as occurring only to the extent that a deduction actually offsets income of a foreign corporation, would lead to sig-

nificant administrative complexity and the need for detailed ordering rules.

A comment recommended against the all or nothing principle, asserting that the administrability concerns underlying the principle in the DCL context are not applicable in the DPL context because a DPL is defined only by reference to certain deductions existing for foreign tax purposes and, thus, the DPL rules do not require an analysis of whether an item that exists for U.S. tax purposes composes an item that exists for, and has been made available for use under, a foreign tax law. Additionally, the comment stated that the all or nothing principle is inconsistent with OECD reports and can give rise to inappropriate outcomes.

The Treasury Department and the IRS remain of the view that departing from the all or nothing principle in the DPL context would (like in the DCL context) give rise to significant administrability and compliance concerns. *See also* TD 9315, 72 FR 12902, 12911 ("The IRS and Treasury Department continue to believe that, even under the approaches suggested by these commentators, departing from the all or nothing principle would lead to substantial administrative complexity.") For example, specific rules would be needed to address a situation where portions of each of a DPL and a non-DPL loss are shared through foreign tax consolidation or a similar regime, as well as a situation where a foreign corporation has a net operating loss that forms part of a net operating loss carryforward that includes the DPL. Additionally, the Treasury Department and the IRS have determined that consistency is needed between the DCL rules and DPL rules because the DPL rules are intended to prevent the avoidance of the DCL rules. Accordingly, the final regulations do not adopt the comment.

2. Carrybacks and Carryforwards of Losses Under Foreign Tax Law

A comment stated that a foreign use of a DPL can occur only if, under a foreign tax law, deductions composing a DPL are included in a net operating loss that is carried forward or carried back to another taxable year, and the comment suggested that the DPL certification rules should be limited to monitoring whether such a carryover occurs. According to the comment, the scenarios presenting the risk of a foreign use of a DPL are more limited than the scenarios presenting the risk of a foreign use of a DCL because, unlike DCLs, DPLs do not give rise to timing differences between U.S. and foreign tax systems.

The Treasury Department and the IRS agree that a foreign use of a DPL may occur through carryforwards or carrybacks of losses but have determined that a foreign use would more commonly occur in the year in which the DPL is incurred. A foreign use could also result from a merger or similar transaction (such as the transfer of the interests in the DPE that incurs the DPL to a related CFC). Accordingly, the final regulations do not adopt this comment.

3. Mirror Legislation Rule

The final regulations narrow the definition of a foreign use for DPL purposes by excluding the deemed foreign use that may occur under the mirror legislation rule. *See* § 1.1503(d)-3(e)(4). This exception, which is consistent with the exception in § 1.1503(d)-3(e)(3) for domestic consenting corporations, clarifies that any denial of a deduction for a disregarded payment under foreign hybrid mismatch rules is not treated as giving rise to a DPL or a foreign use of a DPL. *See also* § 1.1503(d)-1(d)(6)(v) (coordination with foreign hybrid mismatch rules).

F. *DPL cumulative register and deduction for a DPL inclusion*

The 2024 proposed regulations would provide that a DPL cumulative register with respect to a DPE is, for each foreign taxable year of the DPE, increased by the DPE's DPI or decreased by its DPL. *See* proposed § 1.1503(d)-1(d)(5)(ii). When a DPL of the DPE is triggered, any positive balance in the cumulative register would be applied to the DPL and, accordingly, would reduce the amount that the DPE owner must include in income with respect to the DPE under the DPL rules. *See* proposed § 1.1503(d)-1(d)(2) and (5).

Comments recommended that the DPL cumulative register be adjusted to include a DPL inclusion amount that has been included in the DPE owner's gross income. The comments noted that, without such an adjustment, a single DPL could be included in the DPE owner's income more than once. Comments also recommended treating a DPL inclusion as giving rise to a deduction (or similar offset) of the DPE owner in subsequent taxable years to prevent the DPL rules from permanently increasing U.S. taxable income. These comments suggested allowing such a deduction (or similar offset) once the DPE has sufficient DPI or "dual inclusion income" (determined as the lesser of certain foreign taxable income and certain U.S. taxable income) in subsequent years. Further, a comment recommended treating the deduction as having the same U.S. tax characteristics (for example, character and source) as the DPL inclusion.

The Treasury Department and the IRS agree with these comments. The final regulations thus modify the determination of a DPL cumulative register so that a DPL does not decrease the register, thereby preventing a negative balance in the register. *See* § 1.1503(d)-1(d)(2)(iii); *see also* § 1.1503(d)-7(c)(42) (example illustrating this rule). This approach generally achieves the same outcomes as those recommended by comments, while also facilitating the application of any positive register balance to a triggered DPL in cases where there are multiple DPLs but not all the DPLs are triggered.

Additionally, to reflect a DPL inclusion (and consistent with comments), the final regulations provide the DPE owner a deduction (not to exceed the DPL inclusion) to the extent that the DPE derives DPI in a year following the year of the DPL inclusion. *See* § 1.1503(d)-1(d)(1) and (d)(2)(ii). Regardless of the extent to which the DPI is derived from interest or royalties, the deduction has the same character and source as the DPL inclusion to which it relates. *See* § 1.1503(d)-1(d)(2)(iv)(B). In this way, the DPE owner's items of income and deduction under the DPL rules are similar to the items that the DPE owner would have had if the payments composing the DPL were regarded for U.S. tax purposes. To illustrate, consider a case where a disregarded entity makes a payment to its domestic corporate owner and the payment gives rise to an interest deduction under foreign tax law

that is put to a foreign use in the current year. If the payment were instead regarded for U.S. tax purposes (for example, if the payment were instead a § 1.1502-13 intercompany transaction), the payment would give rise to an income inclusion in the current year and a deduction, the use of which generally would be suspended under the DCL rules until there is sufficient income in subsequent years. The DPL rules produce a similar outcome.

Finally, to prevent a single DPL from giving rise to more than one DPL inclusion, the final regulations terminate the certification period with respect to a DPL as a result of a DPL inclusion. *See* § 1.1503(d)-1(d)(6)(iii).

G. *Computation of a DPL or DPI for partial-year DPE status*

Comments requested clarification on how to compute a DPL or DPI for the first foreign taxable year in which an entity or branch is treated as a DPE of a DPE owner. In such a case, some comments suggested a rule pursuant to which the DPL or DPI would be computed without regard to items incurred (or allocable to, including under the principles of § 1.1502-76(b)) during the portion of the foreign taxable year that precedes the first day that the DPL rules apply with respect to the DPE owner and DPE.

The Treasury Department and the IRS agree with these comments, and the final regulations therefore clarify that items incurred or derived in the portion of a foreign taxable year that an entity or foreign branch is not a DPE are not taken into account for purposes of calculating DPI or DPL. *See* § 1.1503(d)-1(d)(5)(ii). On the other hand, if an entity or foreign branch is a DPE at all times during the foreign taxable year, this pro-ration rule does not apply even though the DPE owner's U.S. taxable year may differ from the DPE's foreign taxable year.

H. *Additional reporting and documentation*

One comment supported the DPL rules, noting that closing this existing loophole and providing clarity is important to ensure tax fairness, prevent abuse, and provide consistency. The comment also suggested that the rules provide detailed guidance on the documentation and reporting requirements for disregarded payments, such as specifying that taxpayers must maintain detailed records and submit these records as part of their tax filings.

The Treasury Department and the IRS have determined that the documentation and reporting requirements in the proposed regulations, as modified in these final regulations (such as to require additional reporting in § 1.1503(d)-1(d)(4)(iv) related to the suspended deduction), are sufficient for the IRS to administer the rules effectively. Further, the IRS may request additional information regarding DPLs on audit, as necessary. Accordingly, this comment is not adopted.

III. *Rules that Apply to both DCLs and DPLs*

A. *Anti-avoidance rule*

The 2024 proposed regulations would include an anti-avoidance rule that applies with respect to both DCLs and DPLs. This rule generally would provide that appropriate adjustments may be made with respect to a transaction, series of transactions, plan, or arrangement that is engaged with a view to avoid the purposes of section 1503(d) and the regulations thereunder. *See* proposed § 1.1503(d)-1(f). The preamble to the 2024 proposed regulations noted that the anti-avoidance rule could address new avoidance structures or interpretations, rather than continuing to address these transactions on a case-by-case basis through the adoption of new rules. *See* part I.C. of the Explanation of Provisions of the 2024 proposed regulations.

Some comments asserted that the application of the anti-avoidance rule is unclear and should therefore be withdrawn. Other comments requested that, rather than applying the anti-avoidance rule based on whether there is "a view" to avoid the purposes of section 1503(d) and the regulations thereunder, it should apply based on the more common principal purpose-based standard, or if the taxpayer is attempting to "evade" the purposes of section 1503(d). Comments also requested additional examples illustrating the application or nonapplication of the anti-avoidance rule, including examples that would clarify that the anti-avoidance rule does not apply if taxpayers restructure their operations to avoid the application of the DPL rules. Finally, one comment requested that, consistent with the general approach in the DCL rules to calculate the amount of a DCL based on U.S. tax items, the anti-avoidance rule should be revised to ignore the treatment of items under foreign law.

In response to the comments, the anti-avoidance rule is modified to make clear that the purpose of section 1503(d) and the regulations thereunder is to prevent double deduction and similar outcomes. Thus, if taxpayers restructure their arrangements to avoid the application of the DPL rules or the DCL rules, such as by converting disregarded payments into regarded payments or terminating agreements that give rise to disregarded payments, the anti-avoidance rule does not apply if the restructured arrangement does not give rise to the potential for two deductions – one for foreign tax purposes, and one for US. tax purposes. *See* § 1.1503(d)-1(f). The final regulations also provide additional examples that illustrate the application, and nonapplication, of the anti-avoidance rule. *See* § 1.1503(d)-7(c)(44) and (45). The Treasury Department and the IRS continue to study how the intercompany transaction rules of § 1.1502-13 would apply to the facts such as those presented in the example in § 1.1503(d)-7(c)(44).

The final regulations add certain exceptions to the application of the anti-avoidance rule, as it applies to DCLs, for transactions or interpretations that would be addressed by rules in the 2024 proposed regulations. *See* § 1.1503(d)-1(f)(2). For example, the anti-avoidance rule does not apply to structures that may reduce or eliminate a DCL by reason of items of income arising from the ownership of stock and taken into account under § 1.1503(d)-5(b)(1) or (c)(4)(iv) (the "stock ownership rule"). This exception is intended to make clear that the anti-avoidance rule does not apply in such a case even though the 2024 proposed regulations would eliminate the stock ownership rule (other than with respect to certain portfolio interests) and the preamble to the 2024 regulations states that taxpayers may be affirmatively structuring into the rules to produce inappropriate double-deduction outcomes.

The Treasury Department and the IRS have determined that the anti-avoidance rule should not apply in such cases at this time, despite the policy concerns underlying the transactions, because the substantive rules that would address the transactions have not yet been finalized. These exceptions to the anti-avoidance rule would be removed or modified if, after taking into account comments, the corresponding rules in the 2024 proposed regulations are finalized in a subsequent guidance project. The non-application of the anti-avoidance rule in these cases does not affect the potential application of other rules or judicial doctrines, such as the substance-over-form or step-transaction doctrines. The Treasury Department and the IRS request comments on the modification or removal of these exceptions upon finalization of the corresponding proposed rules.

In light of the additional certainty and clarity provided by the modification to the rule and the additional examples, these final regulations do not adopt the recommendations to withdraw the anti-avoidance rule or employ a new standard based on a principal purpose or evasion. Finally, because the anti-avoidance rule applies with respect to the DPL rules, which are premised on the treatment of items under foreign law, these final regulations do not adopt the recommendation to ignore foreign law treatment in applying the anti-avoidance rule.

B. *Deemed ordering rule*

In determining the foreign use of a DPL, the 2024 proposed regulations would provide that the principles of the exceptions in § 1.1503(d)-3(c) apply, which include the deemed ordering rule under § 1.1503(d)-3(c)(3). *See* proposed § 1.1503(d)-1(d)(3)(i). This rule generally would provide that if losses or deductions are available under foreign law both to offset income that would constitute a foreign use and income that would not constitute a foreign use, and the foreign law does not provide applicable rules for determining which income is offset by the losses or deductions, then the losses or deductions are first deemed to be available to offset the income that would not constitute a foreign use, to the extent thereof, before being considered to be made available to offset the income that would constitute a foreign use. *See* § 1.1503(d)-3(c)(3).

In cases where a DPE has both a DPL and income that is not DPI, such as items of income other than interest and royalties that are disregarded for U.S. tax purposes or income that is regarded for U.S. tax purposes, comments asserted that the application of the deemed ordering rule is unclear, and that income that is not DPI should be taken into account in determining whether the exception prevents a foreign use of the DPL (or, alternatively, prevents the creation of a DPL). Under this approach, a DPL would be treated as first offsetting the DPE's income under the foreign tax law, regardless of whether that income is regarded or disregarded. Accordingly, no foreign use of a DPL would generally occur if the DPE has net positive income under the foreign tax law.

The Treasury Department and the IRS disagree with these comments. The deemed ordering rule is related to, and therefore must apply in a manner consistent with, the rules that calculate a DCL or DPL and related cumulative register. Thus, because the calculation of a DCL and DCL cumulative register only takes into account regarded items, the deemed ordering rule as applied to DCLs also must only take into account such items. Similarly, because the calculation of a DPL and DPL cumulative register only takes into account disregarded interest and royalties, so too should the deemed ordering rule only take such items into account. This consistent approach promotes coordinated outcomes, ensures that all relevant items are appropriately taken into account, and avoids double-counting concerns. A partial integration of the DCL and DPL rules only in the deemed ordering rule would not be appropriate without providing comprehensive rules to address, for example, the opposite fact pattern where regarded items of deduction or loss could be viewed as offsetting disregarded interest and royalty income and thereby creating or increasing the amount of a DPL that is put to a foreign use.

One comment requested clarification regarding the condition that the deemed ordering rule applies only if the laws of the foreign country do not provide applicable rules for determining which income is offset by the losses or deductions. The comment noted, as an example, that such uncertainty can arise in connection with the steps required in applying the GloBE Model Rules. It has also been observed that the method by which the foreign country takes into account items that would, or would not, give rise to a foreign use likely would not change the arithmetic result of determining taxable income under foreign law or otherwise have economic significance. Further, there is no similar condition in the rules that determine a DCL or DPL, or the related cumulative registers, and as noted above these regimes should operate in a consistent manner. As a result, the final regulations eliminate this condition from the deemed ordering rule for purposes of both the DPL and DCL rules. *See* § 1.1503(d)-3(c)(3).

IV. *Applicability Dates*

A. *DPL rules*

The 2024 proposed regulations would apply the DPL rules as of the date those regulations were filed with the **Federal Register** (August 6, 2024), subject to a one-year delay for certain entities in existence on that date. *See* proposed § 301.7701-3(c)(4)(vi). Comments requested a deferred application of the DPL rules, with some suggesting specific dates (such as taxable years beginning after publication of final regulations) and others generally suggesting additional time for taxpayers to implement new processes and systems or undertake restructurings to avoid the application of the DPL rules. Comments also requested clarification on when the DPL rules would apply in cases like one where a domestic corporation owns multiple disregarded entities that are tax residents of foreign countries, with some (but not all) formed or acquired after August 6, 2024, but before August 6, 2025.

The Treasury Department and the IRS agree with the suggestions to defer application of the DPL rules. Accordingly, the final regulations apply the DPL rules to taxable years of DPE owners beginning on or after January 1, 2026. *See* §§ 1.1503(d)-8(b)(11) and 301.7701-2(e)(10). This use of a single applicability date obviates the need for additional rules

clarifying application of the DPL rules in cases like ones where a domestic corporation owns multiple disregarded entities.

B. *Other rules*

The final regulations apply the anti-avoidance rule to DCLs incurred in taxable years ending on or after August 6, 2024, consistent with the approach in the 2024 proposed regulations. *See* § 1.1503(d)-8(b)(15). Further, consistent with the applicability date of the DPL rules, the anti-avoidance rule applies to DPLs for taxable years beginning on or after January 1, 2026. *See id*. Additionally, the final regulations apply revisions to the deemed ordering rule in § 1.1503(d)-3(c)(3) to DCLs incurred in taxable years beginning on or after January 1, 2026, and to DPLs in taxable years beginning on or after January 1, 2026 (each consistent with the applicability date of the DPL rules). *See* § 1.1503(d)-8(b)(17). Finally, the final regulations apply the rule regarding the non-application of the sixty-month limitation for an entity that, absent an election to change its classification, would become a DPE as of August 6, 2024. *See* § 301.7701-2(e)(10).

Additional Transition Relief with respect to the GloBE Model Rules

As noted in the Background of this preamble, the 2024 proposed regulations would address the application of the DCL rules to the GloBE Model Rules. For example, the 2024 proposed regulations would provide that an IIR or QDMTT may be an income tax for purposes of the DCL rules.[5] The 2024 proposed regulations also would address the effect of an IIR or a QDMTT on certain entities and foreign business operations, the application of the DCL rules to the Transitional CbCR Safe Harbour, and the interaction of the duplicate loss arrangement rules with the mirror legislation rule under § 1.1503(d)-3(e). In addition, the 2024 proposed regulations would extend and broaden, the transition relief announced in Notice 2023-80 such that the DCL rules (including the DPL rules) would generally apply without taking into account QDMTTs or Top-up Taxes collected under an IIR or UTPR with respect to losses incurred in taxable years beginning before August 6, 2024. *See* proposed § 1.1503(d)-8(b)(12). This extension, and broadening, would provide taxpayers more certainty, allow for further consideration of the proposed regulations and related comments, and allow for consideration of further developments at the OECD.

Several comments requested additional transition relief for the application of the DCL rules and DPL rules to the GloBE Model Rules. For example, comments suggested that the applicability date be delayed until taxable years beginning on or after January 1, 2025, or through 2026; another comment suggested that the rules not apply until there are final DCL rules and final GloBE Model Rules. Some comments requested additional transition relief because the GloBE Model Rules are still evolving, and relief would allow for additional time to take into account additional OECD guidance and legislation enacted by jurisdictions to incorporate the GloBE Model Rules. One comment stated that if the DCL rules and DPL rules apply with respect to UTPRs that transition relief be provided for such application for at least 2025. Finally, one comment requested clarification that the transition relief is also available with respect to DPLs.

The Treasury Department and the IRS agree that additional transitional relief is warranted. As some comments noted, such relief would allow additional time to consider future OECD guidance and legislation enacted by foreign jurisdictions that would implement the GloBE Model Rules. Accordingly, when the 2024 proposed regulations addressing the application of the DCL rules to the GloBE Model Rules are finalized, the applicability date set forth in the 2024 proposed regulations will be modified. The final regulations will provide that the DCL rules will apply without taking into account QDMTTs or Top-up Taxes collected under an IIR or UTPR incurred in taxable years beginning before August 31, 2025. The additional transition relief does not affect the application of the DPL rules because the DPL rules do not apply until taxable years beginning on or after January 1, 2026. Taxpayers may rely on the guidance described in this paragraph until final regulations are published in the **Federal Register**. The transition relief is limited to an additional year to minimize the double deduction outcomes that may result.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The Paperwork Reduction Act of 1995 (44 U.S.C. 3501-3520) ("PRA") requires that a Federal agency obtain the approval of the OMB before collecting information from the public, whether such collection of information is mandatory, voluntary, or required to obtain or retain a benefit. Section 1.1503(d)-1(d)(4) of these regulations requires the collection of information.

As discussed in part II.B.3 of the Explanation of Provisions of the 2024 proposed regulations, to avoid or reduce a DPL inclusion amount certain taxpayers are required to make certifications, for example, that no foreign use has occurred with respect to a disregarded payment loss. The IRS will use this information to determine the extent to which these taxpayers need to recognize income under these final regulations.

The reporting burden associated with this collection of information will be reflected in the PRA submissions associated with Form 1120 (OMB control number 1545-0123). The Treasury Department and the IRS do not have readily available data to determine the number of taxpayers

[5] The Qualified Domestic Minimum Top-up Tax ("QDMTT"), IIR (also referred to as the income inclusion rule), and UTPR (also referred to as the under-taxed profits rule) are defined in Article 10 of the GloBE Model Rules.

affected by this collection of information because no reporting module currently identifies these types of disregarded payments.

III. *Regulatory Flexibility Act*

When an agency issues a rulemaking proposal, the Regulatory Flexibility Act (5 U.S.C. chapter 6) ("RFA") requires the agency to prepare and make available for public comment an initial regulatory flexibility analysis that will describe the impact of the proposed rule on small entities. *See* 5 U.S.C. 603(a). Section 605 of the RFA provides an exception to this requirement if the agency certifies that the proposed rulemaking will not have a significant economic impact on a substantial number of small entities. A small entity is defined as a small business, small nonprofit organization, or small governmental jurisdiction. *See* 5 U.S.C. 601(3) through (6).

The Treasury Department and the IRS do not expect that these final regulations will have a significant economic impact on a substantial number of small entities. However, because there is a possibility of significant economic impact on a substantial number of small entities, an initial regulatory flexibility analysis was provided in the 2024 proposed regulations. No comments were received in response to the request for comments concerning the number of small entities that may be impacted and whether that impact will be economically significant.

A. *Reasons why action is being considered*

As explained in part II.A of the Explanation of Provisions of the 2024 proposed regulations, the disregarded payment loss rules in these final regulations address certain hybrid payments that can give rise to double deduction outcomes.

B. *Objectives of, and legal basis for, the 2024 proposed regulations*

The disregarded payment loss rules in these final regulations require an income inclusion for U.S. tax purposes to prevent the avoidance of the DCL rules that would otherwise arise from certain disregarded payments. Sections 1503(d)(2)(B) and (d)(3), 7701, and 7805 of the Code are the legal basis for these regulations.

C. *Small entities to which these regulations will apply*

Because an estimate of the number of small businesses affected is not currently feasible, this regulatory flexibility analysis assumes that a substantial number of small businesses will be affected. The Treasury Department and the IRS do not expect that these final regulations will affect a substantial number of small nonprofit organizations or small governmental jurisdictions.

D. *Projected reporting, recordkeeping, and other compliance requirements*

The final regulations impose a certification requirement that is filed with a domestic corporation's tax return, and to comply with that requirement the domestic corporation may need to keep records such as its DPL cumulative register as defined in § 1.1503(d)-1(d)(2)(iii). *See* § 1.1503(d)-1(d)(4)(iii).

E. *Duplicate, overlapping, or relevant Federal rules*

The Treasury Department and the IRS are not aware of any Federal rules that duplicate, overlap, or conflict with these final regulations.

F. *Alternatives considered*

These final regulations address policy concerns that are similar to the concerns underlying the enactment of section 1503(d), which applies uniformly to large and small business entities. The Treasury Department and the IRS have determined that these final regulations should generally apply without regard to the size of the corporation – a small business exception would undermine the anti-hybridity policies underlying these regulations. Accordingly, there is no viable alternative to these final regulations for small entities. The Treasury Department and the IRS expect that the revisions in these final regulations to apply a de minimis threshold, and exclude royalties from pre-August 6, 2024, licenses and minority interests, will reduce any economic impact that the regulations could have on small entities.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 ("UMRA") requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final rules do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of Executive Order 13132. The final rules do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of Executive Order 13132.

Effect on Other Documents

Section 3 of Notice 2023-80 (2023-52 IRB 1583) is obsolete as of August 6, 2024.

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in the Internal Revenue Bulletin or Cumulative Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

Drafting Information

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

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR parts 1 and 301 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by removing the entry for § 1.1503(d) and adding entries for §§ 1.1503(d)-1 through 1.1503(d)-8 in numerical order to read as follows:

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

* * * * *

Sections 1.1503(d)-1 through 8 also issued under 26 U.S.C. 953(d), 1502, 1503(d) and (d)(2)(B), (d)(3), and (d)(4), and 7701.

* * * * *

Par. 2. Section 1.1503(d)-1 is amended by:

1. Revising the section heading;
2. Revising and republishing paragraph (a);
3. Redesignating paragraph (d) as paragraph (e);
4. Adding a new paragraph (d);
5. Revising the paragraph heading for newly redesignated paragraph (e);
6. In newly redesignated paragraphs (e)(1) through (3), removing the language “section 1503(d) and these regulations” in each place it appears and adding the language “this section and §§ 1.1503(d)-2 through 1.1503(d)-8” in its place; and
7. Adding paragraph (f).

The revisions and additions read as follows:

§ 1.1503(d)-1 Definitions, special rules, and filings.

(a) *In general.* This section and §§ 1.1503(d)-2 through 1.1503(d)-8 provide rules concerning the determination and use of dual consolidated losses pursuant to section 1503(d). Paragraph (b) of this section provides definitions that apply for purposes of this section and §§ 1.1503(d)-2 through 1.1503(d)-8. Paragraph (c) of this section provides rules for a domestic consenting corporation. Paragraph (d) of this section provides rules for disregarded payment losses. Paragraph (e) of this section provides relief for certain compliance failures due to reasonable cause, and a signature requirement for filings. Paragraph (f) of this section provides an anti-avoidance rule.

* * * * *

(d) *Disregarded payment loss (DPL) rules*—(1) *In general.* The disregarded payment loss rules of this paragraph (d) only apply to a domestic corporation (including a dual resident corporation) that directly or indirectly owns an interest in a disregarded entity, regardless of whether the disregarded entity is domestic or foreign (such a domestic corporation, a *disregarded payment entity owner*, or *DPE owner*). If these rules apply to a DPE owner, then the DPE owner determines disregarded payment income or disregarded payment loss of its disregarded payment entities (if any) described in paragraph (d)(5)(i)(A), (B), (C), or (D) of this section in accordance with paragraph (d)(5)(ii) of this section and, in the case of a disregarded payment loss for which a triggering event occurs under paragraph (d)(3) of this section, includes an amount equal to the DPL inclusion amount in gross income and establishes a suspended deduction in accordance with paragraph (d)(2) of this section. The inclusion required under this paragraph (d)(1) and paragraph (d)(2)(i) of this section is included in the taxable year of the DPE owner in which the triggering event occurs, and the corresponding suspended deduction under this paragraph (d)(1) and paragraph (d)(2)(ii) of this section is established in the subsequent taxable year of the DPE owner. See § 1.1503(d)-7(c)(42) for an example illustrating the application of the disregarded payment loss rules.

(2) *DPL amounts*—(i) *DPL inclusion amount*. A *DPL inclusion amount* means, with respect to a disregarded payment loss as to which a triggering event occurs during the DPL certification period, an amount equal to the disregarded payment loss. Such amount is reduced (but not below zero) to the extent of the balance in the DPL cumulative register of the disregarded payment entity if the certification requirement under paragraph (d)(4)(iii) of this section is satisfied.

(ii) *Suspended deduction.* With respect to a DPL inclusion amount, a DPE owner establishes a suspended deduction in an amount equal to the DPL inclusion amount. The suspended deduction is allowed as a deduction under the principles of § 1.1503(d)-6(h)(6) by treating the suspended deduction as if it were a reconstituted net operating loss that becomes deductible only to the extent of disregarded payment income derived in the taxable year in which the suspended deduction is established or subsequent taxable years (as measured by the disregarded payment entity’s DPL cumulative register), provided that the certification requirement under paragraph (d)(4)(iv) of this section is satisfied.

(iii) *DPL cumulative register*. The term *DPL cumulative register* means, with respect to the disregarded payment entity, an account the balance of which is computed at the end of each foreign taxable year of the entity, and which is—

(A) Increased by the amount of disregarded payment income of the entity for the foreign taxable year, and then, after determining the DPL inclusion amount for the year,

(B) Decreased by the amount of the cumulative register balance that is used under paragraph (d)(2)(i) or (ii) of this section.

(iv) *Character and source*—(A) *DPL inclusion amount.* A DPE owner’s income inclusion for a DPL inclusion amount is, for all U.S. tax purposes, treated as ordinary income, and characterized and

sourced, including for purposes of sections 904(d) and 907, in the same manner as if the disregarded payment entity were a foreign corporation and the amount were interest or royalty income paid by the foreign corporation (taking into account, for example, section 904(d)(3) if such foreign corporation would be a controlled foreign corporation). For these purposes, the DPL inclusion amount is considered comprised of interest or royalty income based on the proportion of interest or royalty deductions taken into account, respectively, in computing the disregarded payment loss relative to all the deductions taken into account in computing the disregarded payment loss. Further, for these purposes, a deduction attributable to a structured payment or a deduction with respect to equity is treated as an interest deduction.

(B) *Suspended deduction*. A DPE owner's deduction with respect to a suspended deduction is, for all U.S. tax purposes, characterized and sourced in the same manner as the income for the DPL inclusion amount to which it relates. If the income from the DPL inclusion amount is assigned to multiple statutory and residual groupings, the deduction is allocated and apportioned to each grouping in the same proportions as the DPL inclusion amount.

(3) *Triggering events*. An event described in paragraph (d)(3)(i) or (ii) of this section is a triggering event with respect to a disregarded payment loss of a disregarded payment entity.

(i) *Foreign use*. A foreign use of the disregarded payment loss. For this purpose, a foreign use is determined under the principles of § 1.1503(d)-3 (including the exceptions in § 1.1503(d)-3(c)), by treating the disregarded payment loss as a dual consolidated loss, treating the disregarded payment entity as a separate unit (or, in the case of a disregarded payment entity that is a dual resident corporation, by treating the disregarded payment entity as a dual resident corporation), and, in § 1.1503(d)-3(a)(1)(i) and (ii), only taking into account a person that is related to the DPE owner of the disregarded payment entity. Thus, for example, a foreign use of a disregarded payment loss occurs if, under a relevant foreign tax law, any portion of the foreign law deduction taken into account in computing the disregarded payment loss is made available (including by reason of a foreign consolidation regime or similar regime, or a sale, merger, or similar transaction) to offset an item of income that, for U.S. tax purposes, is an item of a foreign corporation, but only if such foreign corporation is related to the DPE owner of the disregarded payment entity. When applying the principles of the deemed ordering rule in § 1.1503(d)-3(c)(3), items of income or gain are taken into account only to the extent such items are described in paragraph (d)(5)(ii)(D) of this section; thus, for example, such items include items of income that are or would be taken into account in determining the amount of disregarded payment loss or disregarded payment income, and exclude items that are regarded for U.S. tax purposes.

(ii) *Failure to comply with certification requirements*. A failure by the DPE owner of the disregarded payment entity to comply with the certification requirements of paragraphs (d)(4)(i) and (ii) of this section.

(4) *Certification requirements*. Except as otherwise provided in publications, forms, instructions, or other guidance, a DPE owner of a disregarded payment entity is subject to the certification requirements of this paragraph (d)(4) with respect to a disregarded payment loss of the disregarded payment entity.

(i) For its taxable year that includes the date on which the foreign taxable year in which a disregarded payment loss is incurred ends, the DPE owner must attach with its timely filed tax return a certification labeled "Initial Disregarded Payment Loss Certification Under Section 1503(d)," which must contain—

(A) The information set forth in § 1.1503(d)-6(c)(2)(ii) (determined by substituting the phrase "disregarded payment entity" for the phrase "separate unit");

(B) A statement of the amount of the disregarded payment loss; and

(C) A statement that a foreign use of the disregarded payment loss has not occurred during the DPL certification period.

(ii) During the DPL certification period, for each of its taxable years after the taxable year described in paragraph (d)(4)(i) of this section that includes a date on which a foreign taxable year ends, the DPE owner must attach with its timely filed tax return a certification labeled "Annual Disregarded Payment Loss Certification Under Section 1503(d)" and satisfying the requirements of this paragraph (d)(4)(ii). Certifications with respect to multiple disregarded payment losses may be combined in a single certification, but each disregarded payment loss must be separately identified. To satisfy the requirements of this paragraph (d)(4)(ii), the certification must—

(A) Identify the disregarded payment loss to which it pertains by setting forth the foreign taxable year in which the disregarded payment loss was incurred and the amount of such disregarded payment loss;

(B) State that there has been no foreign use of the disregarded payment loss; and

(C) Warrant that arrangements have been made to ensure that there will be no foreign use of the disregarded payment loss and that the DPE owner will be informed of any such foreign use.

(iii) If a disregarded payment entity has a balance in its DPL cumulative register upon a DPL triggering event and the DPE owner includes in gross income a DPL inclusion amount that is less than the amount of the disregarded payment loss, the DPE owner of the disregarded payment entity must attach a statement labeled "Reduction of Disregarded Payment Loss Amount Under Section 1503(d)" to its income tax return for the taxable year in which the triggering event occurs and provide any other information as requested by the Commissioner. The statement must show the disregarded payment income or disregarded payment loss of the disregarded payment entity for each foreign taxable year (other than a foreign taxable year where the entity or branch is not a disregarded payment entity) up to and including the foreign taxable year with respect to which the triggering event occurs.

(iv) If a DPE owner claims an allowed deduction with respect to a suspended deduction, the DPE owner must attach a statement labeled "Release of Suspended Deduction Under Section 1503(d)" to the income tax return for the taxable year in which the deduction is allowed and provide any other information as requested by the Commissioner, including in regulations, forms, instructions or other guidance. The statement must describe the

DPE owner's DPL inclusion amount to which the suspended deduction relates and show the disregarded payment income or disregarded payment loss of the disregarded payment entity for each foreign taxable year up to and including the foreign taxable year during which the deduction is allowed.

(5) *Definitions*. The following definitions apply for purposes of this paragraph (d).

(i) The term *disregarded payment entity* means, with respect to a DPE owner, any entity, foreign branch, or dual resident corporation described in paragraph (d)(5)(i)(A), (B), (C) or (D) of this section.

(A) A disregarded entity that is a foreign tax resident and related to the DPE owner, provided that the DPE owner directly or indirectly owns interests in the disregarded entity.

(B) A foreign branch of the DPE owner and a foreign branch of an entity that is related to the DPE owner and in which the DPE owner directly or indirectly owns an interest.

(C) An entity that is treated as a partnership for U.S. tax purposes that is a foreign tax resident and related to the DPE owner, provided that the DPE owner directly or indirectly owns an interest in the entity.

(D) The DPE owner itself if it is a dual resident corporation.

(ii) The terms *disregarded payment income* and *disregarded payment loss* have the meanings set forth in this paragraph (d)(5)(ii). For purposes of computing the disregarded payment income or disregarded payment loss of a disregarded payment entity, a DPE owner takes into account the disregarded payment income or disregarded payments loss of each disregarded payment entity for each foreign taxable year that ends with or within its U.S. taxable year and an item is taken into account only if it gives rise to income or a deduction under the relevant foreign tax law during the portion of the foreign taxable year in which the entity or foreign branch is a disregarded payment entity; for purposes of allocating an item to a period, the principles of § 1.1502-76(b) apply. Thus, for example, if a DPE owner with a calendar U.S. taxable year becomes subject to the disregarded payment loss rules for the U.S. taxable year beginning on January 1, 2026, the disregarded payment income or disregarded payment loss of a disregarded payment entity of the DPE owner with a foreign taxable year ending on June 30, 2026, excludes items allocated (under the principles of § 1.1502-76(b)) to the pre-January 1, 2026, portion of that foreign taxable year. Items taken into account in computing disregarded payment income or disregarded payment loss are calculated in the currency used to determine tax under the relevant foreign tax law. See § 1.1503(d)-7(c)(46) for an example illustrating items that are taken into account in determining disregarded payment income or disregarded payment loss.

(A) *Disregarded payment income*. Disregarded payment income means, with respect to a disregarded payment entity and a foreign taxable year of the entity, the excess (if any) of the sum of the items described in paragraph (d)(5)(ii)(D) of this section over the sum of the items described in paragraph (d)(5)(ii)(C) of this section.

(B) *Disregarded payment loss*. Subject to the de minimis rule set forth in paragraph (d)(6)(vii) of this section, a disregarded payment loss means, with respect to a disregarded payment entity and a foreign taxable year of the entity, the excess (if any) of the sum of the items described in paragraph (d)(5)(ii)(C) of this section over the sum of the items described in paragraph (d)(5)(ii)(D) of this section.

(C) *Items of deduction*. With respect to a disregarded payment entity and a foreign taxable year of the entity, an item is described in this paragraph (d)(5)(ii)(C) to the extent that it satisfies all of the requirements set forth in paragraphs (d)(5)(ii)(C)(*1*) through (*3*) of this section. In addition, an item of a disregarded payment entity described in paragraph (d)(5)(i)(A) of this section is described in this paragraph (d)(5)(ii)(C) if, under the relevant foreign tax law, it is a deduction with respect to equity (including deemed equity) allowed to the entity in such taxable year (for example, a notional interest deduction) or a deduction for an imputed interest payment with respect to a debt instrument (such as a deduction for an imputed interest payment with respect to an interest-free loan).

(*1*) Under the relevant foreign tax law, the disregarded payment entity is allowed a deduction in such taxable year for the item.

(*2*) The payment, accrual, or other transaction giving rise to the item is disregarded for U.S. tax purposes as a transaction between a disregarded entity and its tax owner or between disregarded entities with the same tax owner (for example, a payment by a disregarded entity to its tax owner or to another disregarded entity owned by its tax owner, a payment from a dual resident corporation or partnership to a disregarded entity it owns, or a payment from the home office of a foreign branch to a disregarded entity the home office owns that is attributable to the foreign branch).

(*3*) If the payment, accrual, or other transaction were regarded for U.S. tax purposes, it would be interest, a structured payment, or a royalty within the meaning of § 1.267A-5(a)(12), (b)(5)(ii), or (a)(16), respectively.

(D) *Items of income*. With respect to a disregarded payment entity and a foreign taxable year of the entity, an item is described in this paragraph (d)(5)(ii)(D) to the extent that it satisfies all of the requirements set forth in paragraphs (d)(5)(ii)(D)(*1*) through (*3*) of this section.

(*1*) Under the relevant foreign tax law, the disregarded payment entity includes the item in income in such taxable year.

(*2*) The payment, accrual, or other transaction giving rise to the item is disregarded for U.S. tax purposes as a transaction between a disregarded entity and its tax owner or between disregarded entities with the same tax owner (for example, because it is a payment to a disregarded entity from the disregarded entity's tax owner or from another disregarded entity of its tax owner, a payment to a dual resident corporation or partnership from a disregarded entity it owns, or a payment from a disregarded entity to the home office of a foreign branch that is attributable to the foreign branch).

(*3*) If the payment, accrual, or other transaction were regarded for U.S. tax purposes, it would be interest, a structured payment, or a royalty with the meaning of § 1.267A-5(a)(12), (b)(5)(ii), or (a)(16), respectively.

(E) *Translation into U.S. dollars.* The amount of disregarded payment income or disregarded payment loss with respect to a

foreign taxable year of a disregarded payment entity is translated into U.S. dollars using the yearly average exchange rate (within the meaning of § 1.987-1(c)(2)) for that foreign taxable year.

(F) *Royalties under pre-August 6, 2024 licenses excluded*. Royalties paid or accrued pursuant to a license agreement entered into before August 6, 2024, are not taken into account when determining the amount of disregarded payment income or disregarded payment loss. The preceding sentence ceases to apply with respect to any such agreement upon the significant modification of any terms of the agreement, such as a change in the licensor or licensee or a significant modification of the rights in consideration for which the royalties are paid. In such case, any amounts paid or accrued on or after the date of the significant modification are taken into account when determining the amount of disregarded payment income or disregarded payment loss. Termination of a license agreement and re-entry into a license agreement between the same parties and with the same terms (other than the term governing the period covered by the agreement), an extension of the period covered by a license agreement without modification of other terms, or an alteration of a legal right or obligation that occurs by operation of the terms of the license agreement (for example, where the license agreement provides for updating the royalty based on updated transfer pricing studies), will not be considered a significant modification of the first license agreement. For purposes of this paragraph (d)(5)(ii)(F), a combined disregarded payment entity is treated as a single licensor or licensee, as the case may be.

(iii) The term *DPL certification period* includes, with respect to a disregarded payment loss, the foreign taxable year in which the disregarded payment loss is incurred, any prior foreign taxable years, and, except as provided in paragraph (d)(6)(iii) of this section, the 60-month period following the foreign taxable year in which the disregarded payment loss is incurred.

(iv) The term *foreign branch* means a branch (within the meaning of § 1.267A-5(a)(2)) that gives rise to a taxable presence under the tax law of the foreign country where the branch is located.

(v) The term *foreign taxable year* means, with respect to a disregarded payment entity, the entity's taxable year for purposes of a relevant foreign tax law.

(vi) The term *foreign tax resident* means a tax resident (within the meaning of § 1.267A-5(a)(23)(i)) of a foreign country.

(vii) The term *related* has the meaning provided in this paragraph (d)(5)(vii). A person is related to a DPE owner if the person is a related person within the meaning of section 954(d)(3) and the regulations thereunder, determined by treating the person as the "controlled foreign corporation" referred to in that section. In addition, for purposes of determining relatedness, a disregarded entity is treated as a corporation.

(viii) The term *relevant foreign tax law* means, with respect to a disregarded payment entity, any tax law of a foreign country of which the entity is a tax resident (within the meaning of § 1.267A-5(a)(23)(i)) or, in the case of a disregarded payment entity that is a foreign branch, the tax law of the foreign country where the branch is located.

(ix) The term *DPE owner* has the meaning provided in paragraph (d)(1) of this section, and includes any successor to the corporation described paragraph (d)(1) of this section.

(6) *Special rules*—(i) *Disregarded payment entity combination rule*. For purposes of this paragraph (d), disregarded payment entities for which the relevant foreign tax law is the same (for example, because the entities are tax residents of the same foreign country) are combined and treated as a combined disregarded payment entity under the principles of paragraph (b)(4)(ii) of this section, provided that the entities have the same foreign taxable year and are owned, or interests in which are directly or indirectly owned, either by the same DPE owner or by DPE owners that are members of the same consolidated group. However, this paragraph (d)(6)(i) does not apply with respect to a dual resident corporation treated as a disregarded payment entity pursuant to paragraph (d)(5)(i)(D) of this section. In determining the disregarded payment income or disregarded payment loss of a combined disregarded payment entity, the principles of § 1.1503(d)-5(c)(4)(ii) apply. Thus, for example, if multiple individual disregarded payment entities are treated as a combined disregarded payment entity pursuant to this paragraph (d)(6)(i), then the combined disregarded payment entity has either a single amount of disregarded payment income or a single amount of disregarded payment loss.

(ii) *Partial ownership of disregarded payment entity*. If a DPE owner of a disregarded payment entity indirectly owns through a partnership less than all the interests in that disregarded payment entity, then the rules of this paragraph (d) are applied based on the DPE owner's proportionate interest in the disregarded payment entity. In such a case, as to the DPE owner, only a proportionate share of the disregarded payment entity's items of deduction or income are taken into account in computing disregarded payment income or disregarded payment loss of the entity. In addition, with respect to the disregarded payment loss as so computed, the DPE owner must comply with the certification requirements of paragraph (d)(4) of this section and, upon a triggering event, directly include in gross income an amount equal to the DPL inclusion amount.

(iii) *Termination of DPL certification period*. With respect to a disregarded payment loss of a disregarded payment entity, the DPL certification period does not include any date after the end of the DPE owner's taxable year during which the DPE owner, or a person related to the DPE owner, no longer owns directly or indirectly any of the interests in the disregarded payment entity, or, in the case of a disregarded payment entity that is a foreign branch, substantially all of the assets of the foreign branch. In such a case, the DPE owner ceases to be subject to the rules of paragraph (d) of this section with respect to the disregarded payment loss; thus, for example, after the end of such taxable year the DPE owner is not subject to the certification requirements of paragraph (d)(4)(ii) of this section with respect to the loss, and will not be required to include in gross income the DPL inclusion amount with respect to such loss. The DPL certification period will also terminate with respect to a disregarded pay-

ment loss upon a DPE owner's inclusion of the DPL inclusion amount attributable to the disregarded payment loss.

(iv) *Agent for a consolidated group*. If a DPE owner is a member of a consolidated group, see § 1.1502-77 for agent of the group rules (generally treating the common parent as the agent of its consolidated group).

(v) *Coordination with foreign hybrid mismatch rules*. Whether a disregarded payment entity is allowed a deduction under a relevant foreign tax law is determined with regard to hybrid mismatch rules, if any, under the relevant foreign tax law. Thus, for example, if a relevant foreign tax law denies a deduction for an item to prevent a deduction/no-inclusion outcome (that is, a payment that is deductible for the payer jurisdiction and is not included in the ordinary income of the payee), the item is not taken into account for purposes of computing the amount of disregarded payment income or disregarded payment loss. For this purpose, the term *hybrid mismatch rules* has the meaning provided in § 1.267A-5(a)(10).

(vi) *DPL inclusion amount and suspended deduction not taken into account for dual consolidated loss purposes*. A DPL inclusion amount included in the gross income of a DPE owner, and any allowed amount of a suspended deduction attributable to a DPL inclusion amount, are not taken into account for purposes of determining the income or dual consolidated loss of the dual resident corporation, or the income or dual consolidated loss attributable to the separate unit, under § 1.1503(d)-5(b) or (c).

(vii) *De minimis rule*. A disregarded payment entity will be deemed to have no disregarded payment loss with respect to a foreign taxable year in which the conditions in paragraphs (d)(6)(vii)(A) and (B) of this section are satisfied.

(A) The items that compose the disregarded payment loss are incurred in connection with the conduct of an active trade or business (within the meaning of § 1.367(a)-2(d)(2) and (3), but for this purpose treating the disregarded payment entity as the foreign corporation referenced therein) carried on by the disregarded payment entity. For purposes of the preceding sentence, the determination of whether items are incurred in connection with an active trade or business is made under § 1.367(a)-2(d)(5), but for this purpose by treating the property received by the disregarded payment entity pursuant to the arrangement that gave rise to the item (such as cash or the rights to use the intangible property) as the property described in such section.

(B) The amount of the disregarded payment loss is less than the lesser of $3 million or 10 percent of the aggregate amount of all the items of the disregarded payment entity for the foreign taxable year that satisfy the condition described in paragraph (d)(5)(ii)(C)(1) of this section. For this purpose, the items of the disregarded payment entity may include, for example, items that are regarded for both U.S. and foreign tax purposes, or foreign law items that if regarded for U.S. tax purposes would not be treated as interest, a structured payment, or a royalty within the meaning of § 1.267A-5(a)(12), (b)(5)(ii), or (a)(16), respectively.

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(e) *Special rules for filings.* * * *

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(f) *Anti-avoidance rule*—(1) *In general*. Except to the extent provided in paragraph (f)(2) of this section, if a transaction, series of transactions, plan, or arrangement is engaged in with a view to avoid the purposes of the rules in this section and §§ 1.1503(d)-2 through 1.1503(d)-8, then appropriate adjustments will be made. A transaction, series of transactions, plan, or arrangement (including an arrangement to reflect, or not reflect, items on books and records) is engaged in with a view to avoid the purposes of this section and §§ 1.1503(d)-2 through 1.1503(d)-8 only if it results in a double deduction or similar outcome (for example, by putting an item of deduction or loss that composes (or would compose) a dual consolidated loss to both a domestic use and a foreign use (determined under §§ 1.1503(d)-2 and 1.1503(d)-3, respectively) or putting a foreign law item of deduction or loss that is disregarded for U.S. tax purposes to a foreign use). The appropriate adjustments may include adjustments to disregard the transaction, series of transactions, plan, or arrangement, or adjustments to modify the items that are taken into account for purposes of determining the income or dual consolidated loss of or attributable to a dual resident corporation or a separate unit, or for purposes of determining income or loss of an interest in a transparent entity under § 1.1503(d)-5. See § 1.1503(d)-7(c)(43) through (45) for examples illustrating the application of this paragraph (f).

(2) *Exceptions*. The anti-avoidance rule in paragraph (f)(1) of this section does not apply to a reduction or elimination of a dual consolidated loss solely by reason of intercompany transactions as described in § 1.1502-13, items of income arising from the ownership of stock and taken into account under § 1.1503(d)-5(b)(1) or (c)(4)(iv), or the attribution to a hybrid entity separate unit or an interest in a transparent entity of items that have not been and will not be reflected on the entity's books and records. The anti-avoidance rule in paragraph (f)(1) of this section also does not apply with respect to the application of the dual consolidated loss rules to the GloBE Model Rules, or to cause a foreign use of a dual consolidated loss to occur solely in a period before the taxable year in which such loss was incurred.

* * * * *

Par. 3. Section 1.1503(d)-3 is amended by:

1. Revising and republishing paragraph (c)(3).
2. Adding paragraph (e)(4).

The revision and addition read as follows:

§ 1.1503(d)-3 Foreign use.

* * * * *

(c) * * *

(3) *Deemed ordering rule*—(i) *In general*. This paragraph (c)(3) applies if the losses or deductions composing the dual consolidated loss are made available under the laws of a foreign country both in part to offset income or gain that would constitute a foreign use and in part to offset income or gain that would not constitute a foreign use. In such a case, the losses or deductions shall be deemed to be made available to offset the income or gain that does not constitute a foreign use, to the extent of such income or gain, before being considered to be made available to offset the income or gain that does constitute a foreign use. See § 1.1503(d)-7(c)(11) (*Example 11*).

(ii) *Limitation*. For purposes of applying this paragraph (c)(3), items of income or gain are taken into account only to the extent such items are or would be taken into account in determining the amount of income or dual consolidated loss under § 1.1503(d)-5(b) or (c). Thus, for example, this paragraph does not apply with respect to items of income or gain that are otherwise disregarded for U.S. tax purposes. But see § 1.1503(d)-1(d)(3)(i), which provides that when applying the principles of this rule for purposes of the disregarded payment loss rules, the only relevant items are those that are or would be taken into account for purposes of determining a disregarded payment loss or disregarded payment income.

* * * * *

(e) * * *

(4) *Exception for disregarded payment losses*. Paragraph (e)(1) of this section will not apply so as to deem a foreign use of a disregarded payment loss (within the meaning of § 1.1503(d)-1(d)(5)(ii)(B)).

Par. 4. Section 1.1503(d)-7 is amended by:

1. Adding a sentence after the first sentence in paragraph (c)(6)(iii)(B);
2. Revising the (c)(11) paragraph heading;
3. Removing the last sentence in paragraph (c)(11)(i);
4. In the first sentence of paragraph (c)(11)(ii), removing the language “§1.1503(d)-3(c)(3)” and adding in its place the language “§ 1.1503(d)-3(c)(3)(i)”.
5. Adding a sentence after the third sentence in paragraph (c)(23)(ii).
6. In paragraph (c)(25)(ii)(B), adding a sentence after the fifth sentence.
7. Adding paragraphs (c)(42) through (c)(46).

The revisions and additions read as follows:

§ 1.1503(d)-7 Examples.

* * * * *

(c) * * *

(6) * * *

(iii) * * *

(B) * * * But see § 1.1503(d)-1(d), which takes into account certain payments that are otherwise disregarded for purposes of section 1503(d) and the regulations thereunder. * * *

* * * * *

(11) *Example 11. No foreign use—deemed ordering rule.* ***

*****

(23) * * *

(ii) * * * But see § 1.1503(d)-1(d), which takes into account certain payments that are otherwise disregarded for purposes of section 1503(d) and the regulations thereunder. * * *

* * * * *

(25) * * *

(ii) * * *

(B) * * * But see § 1.1503(d)-1(d), which takes into account certain payments that are otherwise disregarded for purposes of section 1503(d) and the regulations thereunder. * * *

* * * * *

(42) *Example 42. Disregarded payment loss rules – triggering event resulting in DPL inclusion amount and suspended deduction*—(i) *Facts*. P owns DE1X, and DE1X owns FSX. In year 1, DE1X pays $100x to P pursuant to a note. For U.S. tax purposes, the payment is disregarded as a transaction between DE1X and P, but if the payment were regarded it would be interest within the meaning of § 1.267A-5(a)(12). Under Country X tax law, the $100x is interest for which DE1X is allowed a deduction in year 1. In year 1, pursuant to a Country X group relief regime, DE1X’s $100x deduction is made available to offset income of FSX. At the end of year 1, DE1X extinguishes the note by repaying the outstanding principal. In year 2, P enters into a licensing arrangement with DE1X pursuant to which P makes a $60x payment to DE1X in each of years 2 and 3. For U.S. tax purposes, the payment is disregarded as a transaction between DE1X and P, but if the payment were regarded it would be a royalty within the meaning of § 1.267A-5(a)(16). Under Country X tax law, the $60x is a royalty and included in the income of DE1X in years 2 and 3.

(ii) *Result*.—(A) *Year 1*. Because P owns all of the interests in DE1X, a disregarded entity, P is a DPE owner. See § 1.1503(d)-1(d)(1). In addition, DE1X, a disregarded payment entity with respect to P, incurs a $100x disregarded payment loss with respect to its Country X taxable year for year 1. See § 1.1503(d)-1(d)(5)(i)(A) and (d)(5)(ii)(B). DE1X’s $100x deduction being made available to offset income of FSX pursuant to the Country X group relief regime constitutes a foreign use of, and thus a triggering event with respect to, the disregarded payment loss during the DPL certification period. See § 1.1503(d)-1(d)(3)(i) and (d)(5)(iii). As a result, in year 1, P must include in gross income $100x, the DPL inclusion amount with respect to the disregarded payment loss. See § 1.1503(d)-1(d)(1) and (d)(2)(i). The $100x DPL inclusion amount is treated for U.S. tax purposes as ordinary interest income, the source and character of which is determined as if DE1X were a foreign corporation, and the amount were interest income paid by the foreign corporation to P. See § 1.1503(d)-1(d)(2)(iv)(A). The result would be the same if DE1X recognized income in year 1 that was regarded for both U.S. and Country X tax purposes, or if P made payments (other than interest, structured payments, or royalties) to DE1X that were disregarded for U.S. tax purposes but regarded for Country X tax purposes. See § 1.1503(d)-1(d)(3)(i) (describing the application of the principles of the deemed ordering rule in § 1.1503(d)-3(c)(3)).

(B) *Years 2 and 3*. In year 2, P establishes a suspended deduction of $100x related to the year 1 DPL inclusion amount. See § 1.1503(d)-1(d)(1) and (d)(2)(ii). In each of years 2 and 3, DE1X derives $60x of disregarded payment income with respect to its Country X taxable year. See § 1.1503(d)-1(d)(5)(ii)(A). For year 2, P is allowed a $60x deduction with respect to the suspended deduction, and $40x remains suspended. See § 1.1503(d)-1(d)(2)(ii). For year 3, P is allowed a $40x deduction with respect to the suspended deduction. See *id.* Thus, in years 2 and 3 P is allowed a $60x deduction and $40x deduction, respectively, with respect to the suspended deduction relating to the year 1 DPL inclusion amount. The deductions are treated as interest deductions the source and character of which are determined in the same manner as the income for the DPL inclusion amount to which they relate. See § 1.1503(d)-1(d)(2)(iv)(B). At the end of year 3, the DPL cumulative register is $20x (that is, the $120x of disregarded payment income for years 2 and 3, less the $100 of DPL cumulative register that is used under § 1.1503(d)-1(d)(2)(ii) in years 2 and 3). See § 1.1503(d)-1(d)(2)(iii).

(43) *Example 43. Income from U.S. business operations to avoid the purposes of the dual consolidated loss rules*—(i) *Facts*. P owns DE1X. DE1X owns FSX. DE1X and FSX file a consolidated tax return for Country X tax purposes such that deductions and losses of DE1X are available to offset income of FSX. P conducts business operations in the United States that are expected to generate items of income or gain (U.S. business operations). With a view to avoid the purposes of the rules under §§ 1.1503(d)-1 through 1.1503(d)-8 by eliminating what would otherwise be a dual consolidated loss and obtaining a double deduction outcome, P transfers the U.S. business operations to DE1X. But for P’s items of income or gain from the U.S. business operations (held indirectly through DE1X), there would be a dual consolidated loss attributable to P’s interest in DE1X and a foreign use of that dual consolidated loss (as a result of the Country X consolidation regime). For purposes of determining taxable income under the income tax laws of Country X, items of income, gain, deduction, and loss attributable to a permanent establishment (or similar taxable presence) in another country, which would include the U.S. business operations, are not taken into account.

(ii) *Result*. Because P transferred the U.S. business operations to DE1X with a view to avoid the purposes of the rules under §§ 1.1503(d)-1 through 1.1503(d)-8, and the transfer would otherwise result in a double deduction outcome (that is, in effect putting DE1X’s items of deduction or loss that would compose a dual consolidated loss to both a domestic use and a foreign use), the anti-avoidance rule in §

1.1503(d)-1(f)(1) applies. As a result, the income or gain that P takes into account from the U.S. business operations (held indirectly through DE1X) is not taken into account for purposes of determining the amount of income or dual consolidated loss attributable to P's interest in DE1X under § 1.1503(d)-5(c). The result would be the same if, instead of the income tax laws of Country X not taking into account the items of income, gain, deduction, and loss attributable to a permanent establishment (or similar taxable presence) in another country for purposes of determining taxable income, the income tax laws of Country X took such items into account for this purpose but provided a foreign tax credit with respect to taxes paid on the taxable income determined by taking such items into account.

(44) *Example 44*. *Disallowed interest deductions*—(i) *Facts*. P owns S. S owns DE1X, a disregarded entity and, thus, is a DPE owner. See § 1.1503(d)-1(d)(1). DE1X owns FSX. DE1X and FSX file a consolidated tax return for Country X tax purposes such that deductions and losses of DE1X are available to offset income of FSX. With a view to avoid the purposes of the rules under §§ 1.1503(d)-1 through 1.1503(d)-8, and obtain a double deduction or similar outcome, P transfers cash to DE1X in exchange for an interest-bearing note. Under the terms of the note, payments of interest are made in cash or, at the option of DE1X, in stock of S. In year 1, DE1X accrues $100x of interest expense under the note. The taxpayer takes the position that for U.S. tax purposes, the interest expense deductions are disallowed under section 163(l) because DE1X has the option to pay the interest with S stock. Further, because S's interest expense deductions on the note held by P are disallowed, the taxpayer takes the position that P's interest income on the loan is treated as tax-exempt income under the intercompany transaction rules in § 1.1502-13. In year 1, DE1X is allowed a $100x interest expense deduction for Country X tax purposes; the $100x deduction is available to offset FSX's income for Country X tax purposes.

(ii) *Result*. DE1X issued the note to P in exchange for cash with a view to avoid the purposes of §§ 1.1503(d)-1 through 1.1503(d)-8. Moreover, under the taxpayer's position, the issuance would otherwise result in a double deduction or similar outcome (that is, a foreign use of DE1X's $100x interest expense deduction where P does not recognize a corresponding income inclusion for U.S. tax purposes). Accordingly, the anti-avoidance rule in § 1.1503(d)-1(f)(1) applies. As a result, adjustments are made such that the $100x interest expense deduction is treated as a disregarded payment loss of DE1X, a disregarded payment entity. This is the case even though the $100x interest payment is not disregarded for U.S. tax purposes as a transaction between a disregarded entity and its tax owner or between disregarded entities with the same tax owner under § 1.1503(d)-1(d)(5)(ii)(C)(*2*). Because the $100x disregarded payment loss is made available under the Country X consolidation regime to offset income of FSX, a foreign corporation, a foreign use triggering event (within the meaning of § 1.1503(d)-1(d)(3)(i)) occurs. As a result, S includes in income a $100x DPL inclusion amount in year 1 and establishes a suspended deduction of $100x in year 2. See § 1.1503(d)-1(d)(1), (d)(2)(i), and (d)(2)(ii).

(45) *Example 45*. *Restructuring to avoid the application of the DPL rules*—(i) *Facts*. P owns DE1X and S. DE1X owns FSX. DE1X and FSX file a consolidated tax return for Country X tax purposes such that deductions and losses of DE1X are available to offset income of FSX. P holds an interest-bearing note issued by DE1X. For U.S. tax purposes, interest accrued and paid on the note is disregarded. For Country X tax purposes, DE1X is allowed a $100x interest expense deduction each year for interest accrued under the note. At the end of year 1, and with a view to avoid the application of the disregarded payment loss rules under § 1.1503(d)-1(d) in year 2, P transfers the note to S. In year 2, DE1X is allowed a $100x interest expense deduction for Country X tax purposes. For U.S. tax purposes, the $100x interest expense deduction in year 2 gives rise to a dual consolidated loss attributable to P's interest in DE1X, a hybrid entity separate unit, and that loss is subject to the domestic use limitation rule of § 1.1503(d)-4(b).

(ii) *Result*. Although P transferred the note to S with a view to avoid the application of the disregarded payment loss rules under § 1.1503(d)-1(d), the anti-avoidance rule in § 1.1503(d)-1(f)(1) does not apply with respect to the transfer. This is because the resulting year 2 $100x dual consolidated loss is subject to the domestic use limitation rule of § 1.1503(d)-4(b) (or the terms of a domestic use agreement, if a domestic use election were to be made) and thus cannot be put to both a domestic use and a foreign use (that is, it does not result in a double deduction or similar outcome). The same result would obtain if, instead of P transferring the note to S at the end of year 1, DE1X extinguished the note at the end of year 1 such that there are no disregarded payments in year 2 and, thus, no double non-taxation outcome.

(iii) *Alternative facts*. The facts are the same as in paragraph (c)(45)(i) of this section, except that P does not transfer the note to S in year 1. Instead, with a view to prevent a foreign use of a disregarded payment loss attributable to DE1X, at the end of year 1 FSX distributes all its property to DE1X in a complete liquidation described in section 332. The anti-avoidance rule in § 1.1503(d)-1(f)(1) does not apply because the disregarded payment loss is not put to a foreign use (that is, there is no double deduction or similar outcome).

(46) *Example 46. Disregarded payment loss rules – scope*—(i) *Facts*. P owns DE1X. DE1X owns FBZ. FBZ is a foreign branch, within the meaning of § 1.1503(d)-1(d)(5)(iv), located in Country Z. DE1X makes a $10x payment to P, which, under the laws of Country Z, gives rise to a $10x deduction allowable to FBZ. If such payment were regarded for U.S. tax purposes, it would be interest within the meaning of § 1.267A-5(a)(12). In addition, under the laws of Country Z, FBZ is allowed a $60x interest deduction for an accrual or other transaction between FBZ and DE1X, and if such item were regarded for U.S. tax purposes, it would be interest within the meaning of § 1.267A-5(a)(12).

(ii) *Result*. P is a DPE owner because it owns DE1X, a disregarded entity. See § 1.1503(d)-1(d)(1). As such, P determines disregarded payment income or disregarded payment loss of DE1X, a disregarded payment entity described in § 1.1503(d)-1(d)(5)(i)(A), and of FBZ, a disregarded payment entity described in § 1.1503(d)-1(d)(5)(i)(B). See § 1.1503(d)-1(d)(1). The payment from DE1X to P is disregarded for U.S. tax purposes as a transaction between a disregarded entity (DE1X) and its tax owner (P) and therefore satisfies the condition in § 1.1503(d)-1(d)(5)(ii)(C)(*2*). The payment also satisfies the conditions described in § 1.1503(d)-1(d)(5)(ii)(C)(*1*) and (*3*) because FBZ is allowed a deduction under Country Z law for a payment that, if regarded for U.S. tax purposes, would be interest within the meaning of § 1.267A-5(a)(12). As such, the $10x deduction attributable to the payment from DE1X to P is taken into account in determining whether FBZ has disregarded payment income or a disregarded payment loss under § 1.1503(d)-1(d)(5)(ii)(A) and (B), respectively. The $60x item of deduction allowed to FBZ, however, does not satisfy the condition described in § 1.1503(d)-1(d)(5)(ii)(C)(*2*), because the accrual or other transaction giving rise to the deduction is not between a disregarded entity and its tax owner (here, P), or between disregarded entities with the same tax owner. Accordingly, the $60x item of deduction is not taken into account in determining whether FBZ has disregarded payment income or a disregarded payment loss. The result would be the same with respect to the $60x deduction allowed to FBZ under the laws of Country Z if, instead of P owning FBZ indirectly through DE1X, P owned FBZ directly and the accrual or other transaction giving rise to the deduction is between FBZ and P.

* * * * *

Par. 5. Section 1.1503(d)-8 is amended by:

1. Revising the section heading;
2. Removing the reserved paragraph (b)(2); and
3. Adding paragraphs (b)(9) through (17).

The revision and additions read as follows:

§ 1.1503(d)-8 Applicability dates.

* * * * *

(b) * * *

(9) [Reserved].

(10) [Reserved].

(11) *Disregarded payment loss rules*. Section 1.1503(d)-1(d) applies to taxable years beginning on or after January 1, 2026. See also § 301.7701-2(e)(10) of this chapter (applicability dates for the entity classification provisions relevant to the disregarded payment loss rules).

(12) [Reserved].

(13) [Reserved].

(14) [Reserved].

(15) *Anti-avoidance rule*. Section 1.1503(d)-1(f) applies to dual consolidated losses incurred in taxable years ending on or after August 6, 2024, and to disregarded payment losses in taxable years beginning on or after January 1, 2026.

(16) [Reserved].

(17) *Deemed ordering rule*. Section 1.1503(d)-3(c)(3) applies to dual consolidated losses incurred in taxable years beginning on or after January 1, 2026, and to disregarded payment losses in taxable years beginning on or after January 1, 2026. For the application of the deemed ordering rule to dual consolidated losses incurred in taxable years beginning before January 1, 2026, but on or after April 18, 2007, see § 1.1503(d)-3(c)(3) as contained in 26 CFR part 1 revised as of April 1, 2024.

(18) *Exception to mirror legislation rule for disregarded payment losses*. Section 1.1503(d)-3(e)(4) applies to taxable years beginning on or after January 1, 2026.

PART 301—PROCEDURE AND ADMINISTRATION

Par. 6. The authority citation for part 301 is amended by adding an entry for § 301.7701-2 to read as follows:

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

* * * * *

Section 301.7701-2 also issued under 26 U.S.C. 7701.

* * * * *

Par. 7. Section 301.7701-2 is amended by:

1. In the last sentence of paragraph (a), removing the language "(vi)" and adding in its place the language "(vii)";
2. Adding paragraph (c)(2)(vii); and
3. Adding paragraph (e)(10).

The additions read as follows:

§ 301.7701-2 Business entities; definitions.

* * * * *

(c) * * *

(2) * * *

(vii) *Special rules for certain disregarded payments*—(A) *Disregarded payment loss rules*. To the extent provided in § 1.1503(d)-1(d) of this chapter, certain payments involving a business entity that, under paragraph (c)(2)(i) of this section is otherwise disregarded as an entity separate from its owner, are in effect taken into account as if the entity were regarded and the deduction was denied, and therefore give rise to an income inclusion, and corresponding suspended deduction, to the entity's owner.

(B) *Non-application of the sixty-month limitation*. If an eligible entity that is disregarded as an entity separate from its owner would become a disregarded payment entity (within the meaning of § 1.1503(d)-1(d)(5)(i)(A) of this chapter) when this paragraph (c)(2)(vii) applies, the sixty-month limitation under § 301.7701-3(c)(1)(iv) does not apply with respect to an election by such eligible entity to change its classification to an association effective before January 1, 2026 (such that it would not become a disregarded payment entity).

* * * * *

(e) * * *

(10) Paragraph (c)(2)(vii) of this section (special rules for certain disregarded payments) applies to taxable years beginning on or after January 1, 2026, except that paragraph (c)(2)(vii)(B) of this section (non-application of sixty-month limitation) applies as of August 6, 2024.

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: January 2, 2025

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register January 10, 2025, 11:15 a.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3003)

T.D. 10027

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 28

Guidance under Section 2801 Regarding the Imposition of Tax on Certain Gifts and Bequests from Covered Expatriates

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide guidance on the application of a tax on United States citizens and residents, as well as certain trusts, that receive, directly or indirectly, gifts or bequests from certain individuals who relinquished United States citizenship or ceased to be lawful permanent residents of the United States. The final regulations also provide guidance on the method of reporting and paying this tax. The final regulations primarily affect United States citizens and residents, as well as certain trusts, that receive one or more such gifts or bequests.

DATES: *Effective Date*: These regulations are effective January 14, 2025.

Applicability Dates: For dates of applicability, see §§28.2801-1(b), 28.2801-2(n), 28.2801-3(g), 28.2801-4(g), 28.2801-5(f), 28.2801-6(e), 28.2801-7(d), 28.6001-1(c), 28.6011-1(c), 28.6060-1(b), 28.6071-1(d), 28.6081-1(e), 28.6091-1(b), 28.6107-1(b), 28.6109-1(b), 28.6151-1(b), 28.6694-1(b), 28.6694-2(b), 28.6694-3(b), 28.6694-4(b), 28.6695-1(b), 28.6696-1(b), and 28.7701-1(b).

FOR FURTHER INFORMATION CONTACT: Mayer R. Samuels, Daniel J. Gespass, or Karlene M. Lesho at (202) 317-6859 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document contains additions and amendments to 26 CFR part 28 (Imposition of Tax on Gifts and Bequests from Covered Expatriates) addressing the application of section 2801 of the Internal Revenue Code (Code) and related provisions (the "final regulations"). The additions and amendments are issued under sections 2801, 6001, 6011, 6060, 6071, 6081, 6091, 6101, 6107, and 6109 pursuant to the express delegations of authority provided under those sections. The express delegations relied upon are referenced in the Background section of this preamble and in the Summary of Comments and Explanation of Revisions describing the individual sections of the final regulations. The final regulations are also issued under the express delegation of authority under section 7805 of the Code.

Background

This document amends subchapter B of 26 CFR chapter 1 (Estate and Gift Taxes) by adding part 28 under section 2801 and by expanding several existing regulations to also apply to the filing and furnishing of returns and payment of the tax imposed by section 2801 (section 2801 tax). Section 301 of the Heroes Earnings Assistance and Relief Tax Act of 2008 (HEART Act), Public Law 110-245, 122 Stat. 1624 (2008), added chapter 15 (Gifts and Bequests from Expatriates) to subtitle B of the Code (subtitle B), effective June 17, 2008. Before the addition of chapter 15, subtitle B contained chapters 11 through 14 relating to the estate tax, the gift tax, and the generation-skipping transfer (GST) tax, as well as special valuation rules applicable for purposes of subtitle B. Chapter 15 consists solely of section 2801 and imposes the section 2801 tax on certain transfers of property by gift (covered gifts) and on certain transfers of property by bequest (covered bequests) from certain individuals who expatriate on or after June 17, 2008 (covered expatriates).

The section 2801 tax is imposed on each United States (U.S.) citizen or resident receiving a covered gift or covered bequest (U.S. recipient). For this purpose, domestic trusts and foreign trusts that elect to be treated as domestic trusts solely for purposes of section 2801 (electing foreign trusts) are included in the definition of a U.S. citizen. Foreign trusts that do not elect to be treated as domestic trusts for purposes of section 2801 (non-electing foreign trusts) are not U.S. citizens or residents and, therefore, do not become subject to the section 2801 tax upon receipt of covered gifts and covered bequests. Instead, the beneficiaries of non-electing foreign trusts who are U.S. citizens or residents (U.S. citizen or resident beneficiaries) become subject to the section 2801 tax upon their receipt of a distribution from a non-electing foreign trust that is attributable to covered gifts and covered bequests made to that non-electing foreign trust.

The section 2801 tax will be computed on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, on which a U.S. recipient will report covered gifts and covered bequests received during the calendar year. If the aggregate value of the covered gifts and covered bequests received by the U.S. recipient during the calendar year exceeds the amount of the inflation-adjusted annual exclusion under section 2503(b) of the Code ($18,000 for 2024), the section 2801 tax is computed by multiplying the excess by the highest estate tax rate specified in section 2001(c) of the Code in effect on the date of receipt, and then reducing the product by any gift or estate taxes paid to a foreign country with respect to the covered gifts and covered bequests. The value of each covered gift and covered bequest is its fair market value as of the date of its receipt.

On September 10, 2015, a notice of proposed rulemaking and a notice of public hearing (REG-112997-10) were published in the *Federal Register* (80 FR 54447) proposing rules related to the section 2801 tax (proposed regulations). A total of sixteen comments on the proposed regulations were received and are available at https://www.regulations.gov or upon request. A public hearing on the proposed regulations was held on January 6, 2016. After consideration of all the comments, this Treasury decision adopts the proposed regulations, with revisions, as final regulations. The revisions are discussed in the following *Summary of Comments and Explanation of Revisions* section. Unless otherwise indicated in the *Summary of Comments and Explanation of Revisions*, provisions of the proposed regulations for which no comments were received are adopted without substantive change. The final regulations include non-substantive modifications, including modifications that promote consistency across definitions, rules, and examples and improve the overall clarity of the guidance. Such modifications are not addressed in the *Summary of Comments and Explanation of Revisions*.

Summary of Comments and Explanation of Revisions

1. General Comments on Section 2801 and the Tax-Neutral Objective

The Department of the Treasury (Treasury Department) and the IRS received several general comments on section 2801. One comment objects to the enactment of section 2801, opining that the section 2801 tax is unnecessary, infringes on privacy rights, and unfairly applies to former long-term permanent residents. Other comments object by pointing out several ways in which the statutory provisions of section 2801 are not tax neutral, treat expatriates more harshly than if they had remained subject to U.S. gift and estate taxes, and thus violate what the commenters described as the intent of Congress in enacting section 2801 to make expatriation a tax-neutral event with regard to U.S. transfer taxes. Some comments request changes and additions to the proposed regulations to create a more tax-neutral outcome than under the statute.

The Background section of the preamble of the proposed regulations describes the history of the addition of chapter 15 and section 2801 to the Code and references the idea, as explained in a report of the House Ways and Means Committee regarding an earlier, pre-HEART Act, bill to enact chapter 15 and section 2801, that the decision to relinquish citizenship ought to be "tax neutral." *See* H.R. Rep. No. 110-431, at 113 (2007). More specifically, the report states that an individual's decision to relinquish citizenship or terminate long-term residency should not affect the total amount of taxes imposed; that is, the decision should be "tax neutral." The report further states that, if U.S. estate or gift taxes are avoided with respect to a transfer of property to a U.S. person by reason of the expatriation of the donor, it is appropriate for the recipient to be subject to a tax similar to the transfer tax that the donor or donor's estate would have been subject to, had the donor not expatriated. *Id.* at 114.

Despite the language in the report, section 2801 imposes a tax on the receipt by a U.S. citizen or resident of certain gifts or bequests which does not equal, and in some cases is not similar to, the tax that would have been imposed on the transfer of such gifts or bequests by a U.S. transferor (that is, one who had not expatriated), as illustrated by a comparison of the relevant statutory provisions of chapter 11 (estate tax), chapter 12 (gift tax), and chapter 13 (GST tax), with chapter 15 (section 2801 tax). Obvious dissimilarities between section 2801 and the provi-

sions of chapters 11 through 13 include the absence in chapter 15 of an applicable credit amount that can be applied to offset or reduce the estate or gift tax liability (see sections 2010 and 2505 of the Code, for which transfers of up to $13.99 million (the 2025 inflation-adjusted amount) over a lifetime may be offset for purposes of gift and estate taxes) and the absence of a GST tax for covered gifts and covered bequests to a U.S. recipient who is a skip person (see section 2601 of the Code, imposing an additional transfer tax on GSTs). There are many other dissimilarities between section 2801 and the other transfer tax provisions.

The role of the Treasury Department and the IRS is to implement section 2801, as enacted by the HEART Act. Thus, to the extent the comments suggest changes to the statutory text of chapter 15 and section 2801, the Treasury Department and the IRS do not further address those comments in this preamble. To the extent the comments suggest changes or additions to the proposed regulations to create a more tax-neutral outcome, the Treasury Department and the IRS have responded to specific comments as the relevant issues are discussed in this preamble, and in doing so considered both the statutory language of section 2801 and the scope of regulatory authority granted by Congress.

2. Definitions

A. Expatriate and covered expatriate

Section 2801(f) and proposed §28.2801-2(h) define the term *covered expatriate* by reference to section 877A(g)(1) of the Code. Proposed §28.2801-2(h) defines the term *expatriate* by reference to section 877A(g)(2). Proposed §28.2801-2(h) further provides that, if an expatriate meets the definition of a covered expatriate, the expatriate is considered a covered expatriate for purposes of section 2801 at all times after the expatriation date, except during any period beginning after the expatriation date during which such individual is subject to United States estate or gift tax (estate or gift tax) as a U.S. citizen or resident. For this exception, the proposed regulations cite to section 877A(g)(1)(C) of the Code, which indicates that an individual will not be treated as a covered expatriate for certain purposes during the time that they are subject to tax as a U.S. citizen or resident.

Section 877A relies on the income tax definition of the term *resident* as described in section 7701(b)(1)(A). Section 28.2801-2(b) of the proposed regulations, however, applies the estate and gift tax rules under chapters 11 and 12 of subtitle B to define U.S. resident for purposes of section 2801, which also is in subtitle B, thereby providing consistency across the provisions.

One comment suggests that the exception in proposed §28.2801-2(h), which excludes an expatriate from being treated as a covered expatriate during any period in which the expatriate is subject to estate or gift tax, creates a coherent structure for purposes of section 2801, but leaves open the possibility that an individual could be a covered expatriate for purposes of section 877A but not for purposes of section 2801 and vice versa. The comment states that this result seems to conflict with sections 2801(f) and 877A(g)(1)(C) and suggests that the final regulations provide that an expatriate who is deemed to be an income tax resident of the U.S. will be deemed not to be a covered expatriate. Another comment expresses support for the rule in proposed §28.2801-2(h) as arguably necessary because applying sections 2801(f) and 877A(g)(1)(C) using the income tax definition of U.S. resident would create a convenient and simple way to avoid imposition of the section 2801 tax. For instance, a covered expatriate could become an income tax resident in one year during which such person does not also satisfy the transfer tax definition of *resident*. During that year, the covered expatriate could make gifts that would not be subject to gift tax. The following year, the covered expatriate could terminate the covered expatriate's income tax residency, thereby allowing the gifts to completely escape transfer taxation. The Treasury Department and the IRS agree with the latter comment that using the transfer tax definition of *resident* for the exception in proposed §28.2801-2(h) avoids creating an opportunity to circumvent the section 2801 tax. Further, section 2801 is a transfer tax and is part of subtitle B; section 7701(b) of the Code specifically provides that the definitions in section 7701(b)(1) do not apply for purposes of subtitle B. Accordingly, applying the definition of *resident* under subtitle B for purposes of this transfer tax under section 2801 and the corresponding regulations is consistent with the purpose of the statute. Moreover, as one comment acknowledges, the use of the transfer tax definition is consistent with the concept of neutrality because it eliminates the avoidance of estate and gift tax that otherwise would result from expatriation. For these reasons, the final regulations adopt the transfer tax definition of U.S. resident without change.

One comment points out that the date on which a person loses U.S. citizenship was changed by the HEART Act. The comment explains that this change could create ambiguity as to the exact date of a taxpayer's expatriation under certain circumstances. The comment requests clarification of how that date is determined for persons who had determined that they had expatriated before the effective date of the HEART Act, and for those with dual citizenship under section 7701(a)(50)(B). The Treasury Department and the IRS agree that such clarification would be both appropriate and helpful. Such clarification, however, would impact significantly more issues than those related to the section 2801 tax, and would be better addressed in guidance under sections 877A and 7701, rather than in regulations under section 2801. This issue is, therefore, beyond the scope of these final regulations. Accordingly, the final regulations adopt the language in proposed §28.2801-2(h) without change.

B. Foreign trust and domestic trust

Section 2801(a) provides that the section 2801 tax is imposed on a covered gift or covered bequest received by a U.S. citizen or resident. Section 2801(e)(4)(A) and (B)(iii) explains that a domestic trust or an electing foreign trust that receives a covered gift or covered bequest is treated as a U.S. citizen for the purposes of section 2801. If a covered gift or covered bequest is received by a non-electing foreign trust, however, section 2801(e)(4)(B)(i) provides that the section 2801 tax is imposed on any distribution attributable to the covered gift or covered bequest from the

trust to a U.S. citizen or resident. Therefore, it is important to properly classify a trust receiving a covered gift or covered bequest as either a domestic or foreign trust in order to determine the identity of the U.S. citizen or resident liable for, and the timing of, payment of the section 2801 tax. Section 28.2801-2(c) and (d)(1) of the proposed regulations defines the terms *domestic trust* and *foreign trust* by reference to section 7701(a)(30)(E) and (31)(B), respectively. No comments were received regarding the definitions of domestic trust or foreign trust. These final regulations maintain the same definitions as in the proposed regulations.

C. Covered bequest

Section 2801(e)(1)(B) defines a covered bequest as any property acquired directly or indirectly by reason of the death of an individual who, immediately before such death, was a covered expatriate. The proposed regulations define covered bequest in section 28.2801-2(f) and confirm that this definition includes any property acquired directly or indirectly by reason of the death of a covered expatriate, regardless of the situs of such property and whether such property was acquired by the covered expatriate before or after the covered expatriate's expatriation from the United States. Proposed §28.2801-3(b), which contains additional rules and exceptions applicable to covered bequests, provides that property acquired by reason of the death of a covered expatriate for purposes of the definition of covered bequest in §28.2801-2(f) includes any property that would have been includible in the gross estate of the covered expatriate under chapter 11 of subtitle B had the covered expatriate been a U.S. citizen at the time of death.

One comment acknowledges that including property that would have been includible in the gross estate of the covered expatriate had the covered expatriate been a U.S. citizen at the time of death appears to be consistent with legislative intent. However, the comment expresses concern that the definition of covered bequest in §28.2801-2(f), which includes all property passing by reason of the decedent's death, was too broad. The comment points out that not all property passing by reason of a decedent's death would be includible in the decedent's gross estate. The comment provides, as an example, property passing to a child from a trust created by a grandparent after a term measured by a now deceased parent's life. The comment suggests revising the definition of covered bequest in §28.2801-2(f) to include property acquired by reason of the death of a covered expatriate, but only to the extent the property would have been included in the gross estate of the covered expatriate had the covered expatriate been a United States citizen immediately before death.

The comment correctly observes that including any property acquired directly or indirectly by reason of the death of a covered expatriate may inappropriately subject property to section 2801 tax, such as in the example provided by the comment (assuming the facts do not support an indirect gift). However, the suggestion to limit the definition of covered bequest to property acquired by reason of the death of a covered expatriate that would have been included in the gross estate of the covered expatriate is too narrow. Such a definition, for example, would wrongly exclude property that would otherwise be included in the gross estate of a covered expatriate even though the property was not acquired on the death of the covered expatriate (for example, under section 2035, which increases the gross estate by the value of certain property transferred within the 3-year period ending on the date of the covered expatriate's death). The comment's suggested definition also would exclude all distributions made by reason of the death of a covered expatriate from non-electing foreign trusts to the extent the distributions are attributable to covered gifts and covered bequests made to the foreign trust on or after June 17, 2008. Under section 2801(e)(4)(B)(i), a distribution from a non-electing foreign trust that is attributable to a covered gift or covered bequest made to the trust is subject to section 2801 tax in the same manner as if the distribution were a covered gift or covered bequest. When such a distribution is made by reason of a death of a covered expatriate, the distribution is more similar to a covered bequest described in section 2801(e)(1)(B) than a covered gift described in section 2801(e)(1)(A) and, therefore, is appropriately classified as a covered bequest.

To address the concern expressed in the comment as to property that would not have been included in the gross estate of the decedent, the definition of covered bequest in the final regulations instead describes three categories of property that are included in the definition of covered bequest. The first category includes in the definition of covered bequest property acquired by a recipient on or after June 17, 2008, directly or indirectly by reason of the death of a covered expatriate but only to the extent the property would have been included in the covered expatriate's gross estate if the covered expatriate had been a U.S. citizen immediately before death. The second category includes in the definition property received from a covered expatriate that would have been included in the covered expatriate's estate, even if not acquired directly or indirectly by reason of the death of a covered expatriate, for example property includible under section 2035. The third category includes in the definition distributions made by reason of the death of a covered expatriate from a non-electing foreign trust to the extent the distributions are attributable to covered gifts and covered bequests made to the foreign trust on or after June 17, 2008.

D. Indirect acquisition of property

A covered gift or covered bequest is defined in section 2801(e) as any property acquired directly or indirectly by gift from or by reason of the death of a covered expatriate. Using transfer tax principles, §28.2801-2(i) of the proposed regulations identifies the transfers that constitute indirect acquisitions of property, to include property (1) acquired through ownership of an interest in a corporation or other entity, (2) acquired through one or more foreign trusts, entities, or persons not subject to the section 2801 tax, (3) paid in satisfaction of a debt or liability, (4) acquired through a power of appointment over property not in trust granted by a covered expatriate to a non-covered expatriate, and (5) acquired as a result of any other indirect transfer by a covered expatriate. Comments were received with respect to each example.

One comment states that the examples of an indirect acquisition of property in §28.2801-2(i)(2) and (3) of the proposed regulations go too far in that they are not limited by the extent to which the interest indirectly received is attributable to a covered gift or covered bequest. Although these examples illustrate the definition of "indirect acquisition of property" for purposes of the 2801 tax, this definition is relevant only to the extent that the indirect acquisition is of an interest in a covered gift or covered bequest. When the definition of indirect acquisition is applied in relation to a covered gift or covered bequest, the appropriate limitation is applied. As a result, no change is needed in the final regulations to achieve the limitation sought by the commenter.

Several comments observe that the rule in §28.2801-2(i)(1) of the proposed regulations is consistent with the rule in §25.2511-1(h)(1) of the Gift Tax Regulations, which describes the gift tax consequences of a transfer made to a corporation. One comment requests that proposed §28.2801-2(i)(1) be revised to clarify the metrics used for determining a U.S. citizen or resident owner's share of a covered gift or covered bequest made to the entity. For instance, the commenter noted that an owner of an interest in an entity could have a mix of interests and/or rights in capital, profits, voting, distribution, liquidation, etc., and suggested that the final regulations permit taxpayers to use any reasonable method to account for these interests and rights. The Treasury Department and the IRS note that this issue is not unique to section 2801; the same issue arises in the gift tax context under chapter 12. *See, e.g.*, §25.2511-1(h)(1) (extent of a shareholder's interest relevant to determine the gift tax consequences of a transfer made by a corporation to another shareholder). Given the broader, more factual nature of determining the extent of an owner's interest and rights in an entity, this issue is better addressed under the Gift Tax Regulations, and therefore is beyond the scope of these final regulations. As a result, this suggestion is not adopted.

Several comments state that the illustrations in proposed §28.2801-2(i)(2), (3), and (5) are overbroad. In particular, the comments state that the illustrations in §28.2801-2 (i)(2) (regarding property acquired through one or more persons not subject to the section 2801 tax) and (3) (regarding property paid in satisfaction of a debt or liability) are not tethered to any consideration of timing or gratuitous intent. One comment observes that the proposed definition would require a recipient to trace a potentially long chain of title to determine whether the property received would be a covered gift or covered bequest to that recipient. Another comment states that a non-covered expatriate family member of the covered expatriate and the U.S. recipient should not be considered an intermediary of the covered expatriate if that family member had dominion and control over the property and acted independently of the covered expatriate. Two comments suggest replacing §28.2801-2(i)(2) and (5) of the proposed regulations with a rule that would include, as an indirect acquisition, only property acquired pursuant to a plan, one of the principal purposes of which is the avoidance of transfer tax, similar to the rules in §§1.643(h)-1 and 1.679-3(c) of the Income Tax Regulations. The rules in §§1.643(h)-1 and 1.679-3(c) employ a substance over form approach with respect to certain transfers made through an intermediary.

These final regulations modify, in part, the definition of indirect acquisition of property to address some of the concerns regarding proposed §28.2801-2(i)(2), (3), and (5) as expressed in the comments. The Treasury Department and the IRS agree that the illustrations in §28.2801-2(i)(2) and (5) of the proposed regulations may capture transfers that, in some cases, are not truly indirect transfers and should not be subject to tax under section 2801. Thus, the final regulations replace the rules in proposed §28.2801-2(i)(2) and (5) with a single illustration that refers to an acquisition that is, in substance, a covered gift or covered bequest from a covered expatriate. In addition, the final regulations add a more general description of property that is gratuitously passed from or conferred by the covered expatriate through another person or entity, and the rules in proposed §28.2801-2(i)(1) through (5) are converted in the final regulations to a nonexclusive list of illustrations describing the application of the definition for purposes of section 2801. The suggestion is not adopted to replace the rule in proposed §28.2801-2(i)(2) and (5), applicable to acquisitions of property, with a rule that would add a principal purpose of tax avoidance test applicable to distributions from and to foreign trusts, similar to the rules in §§1.643(h)-1 and 1.679-3(c). As with other interpretations of terms in section 2801 (for example, U.S. resident), applying transfer tax principles to section 2801 is the better interpretation of the statute both because section 2801 is a transfer tax, and the intent of the transferor generally is irrelevant for transfer tax purposes.

Finally, comments recommend narrowing the scope of proposed §28.2801-2(i)(4) to include only property acquired pursuant to a non-covered expatriate's non-general power of appointment (as opposed to all types of powers of appointment) granted by a covered expatriate over property not in trust. Such a change would ensure that the exercise, release, or lapse of a non-covered expatriate's general power of appointment over property not in trust would not be a covered gift or covered bequest, which the commenters contend is consistent with the general gift tax treatment of the holder of a general power of appointment as the owner of the property subject to the power. If the commenters' recommendation were adopted, it would allow a covered expatriate to avoid the section 2801 tax by granting a general power of appointment over non-trust property to a person who is neither a covered expatriate nor a U.S. citizen or resident, but who will exercise or release the power or allow it to lapse in favor of a U.S. citizen or resident. Thus, the final regulations continue to describe the acquisition of property pursuant to a non-covered expatriate's power of appointment (whether general or non-general) granted by a covered expatriate over property not in trust as an example of an indirect acquisition of property for purposes of section 2801. The final regulations clarify, however, that acquiring property pursuant to a power of appointment means as the result of an exercise, release, or lapse of that power, without regard to the de minimis exceptions in section 2041(b)(2) or 2514(e). This latter clarification is necessary because section 2801(c) provides the only *de minimis* exception to the imposition of section 2801 tax.

E. Other definitions

Several comments suggest other revisions to §28.2801-2 of the proposed regulations to make the regulations more user friendly, including using consistent terminology. Those suggestions include the replacement of *citizen or resident of the United States* with the term used in the statute, *U.S. citizen or resident*, the addition of a definition of the term *non-electing foreign trust*, and the correction of the reference in the definition of the term *general power of appointment* to section 2041(b)(1) (rather than section 2041(b)) to clarify that the exclusions for lapses and certain pre-1943 powers under section 2041(b)(2) and (3), respectively, do not apply for purposes of section 2801. These suggestions have been adopted and the appropriate changes are reflected in the final regulations. The suggestion that other terms (such as *gift* and *charitable remainder trust*) used throughout the proposed regulations, as well as other terms unique to section 2801 that are defined elsewhere in the proposed regulations (in the particular section where each is relevant), either be defined in §28.2801-2 or referred to by cross-references, has not been adopted. Several such terms are defined elsewhere in the Code or in the corresponding regulations, and those that are specific to a particular issue under section 2801 are defined and applied in the discussion of that particular issue in the relevant section of the regulations in an effort to make the regulations more readily understood.

3. Exceptions to Definitions of Covered Gift and Covered Bequest

A. Transfers otherwise subject to gift or estate tax

Section 2801(e)(2)(A) and (B) excepts from the definitions of covered gift and covered bequest, respectively, any taxable gift by a covered expatriate and any property included in the gross estate of a covered expatriate, if such property is reported on a timely filed gift or estate tax return (timely filed requirement).

One comment suggests that a covered expatriate be allowed to treat transferred property as a transfer of a U.S. situs asset, report the transfer on a timely filed gift or estate tax return, and thereby avoid the transfer being a covered gift or covered bequest. By reducing the effective tax rate on the transfer, the comment states that this approach would be consistent with the tax neutrality intended at enactment of section 2801.[1] These final regulations do not adopt the commenter's suggestion, because it is inconsistent with section 2801. Additionally, if adopted, such a filing in effect would override the provisions of sections 2511(a) (applying the gift tax only to transfers by nonresident, noncitizens of property situated within the United States) and 2103 (including in the gross estate of nonresident, noncitizens only that part of property that is situated within the United States at the time of death) for certain transfers by covered expatriates, a result not contemplated by the statutory language of section 2801. While section 2801 allows a foreign trust to elect to be treated as a domestic trust, there is no indication that Congress intended to allow other elections that would operate in the way suggested by this commenter.

i. Timely Paid Requirement

For property reported on the covered expatriate's gift or estate tax return to be excluded from the definition of a covered gift or covered bequest, §28.2801-3(c)(1) and (2) of the proposed regulations requires not only the timely filing of that return, but also the timely payment of the tax shown on that return (timely paid requirement).

Comments state that the timely paid requirement should be eliminated because there is no statutory basis for imposing that requirement. Comments also note that the timely paid requirement would cause a double tax to be imposed on a single transfer if the gift or estate tax is not timely paid: gift or estate tax due from the covered expatriate or covered expatriate's estate, as well as section 2801 tax due from the U.S. recipient of that property. As to the latter comment, the Treasury Department and the IRS note that the potential for imposing tax on both the covered expatriate or the covered expatriate's estate and the U.S. citizen or resident receiving the covered gift or covered bequest is already created by the timely filed requirement under section 2801(e)(2)(A) and (B), which would deny the exception if the gift or estate tax return is filed late. Like the timely filed requirement, the timely paid requirement limits the potential for tax avoidance by ensuring that an excepted transfer is timely reported and that the tax on such excepted transfer is timely paid by the covered expatriate, over whom it may be difficult for the IRS to assert jurisdiction to enforce that tax liability.

Providing a timely paid requirement is not beyond the Treasury Department and IRS's general regulatory authority to implement the Congressional mandate of section 2801, including addressing compliance concerns. However, the Treasury Department and the IRS have considered other existing gift and estate tax enforcement mechanisms which also could address compliance concerns, such as under subtitle F of the Code and the ability of the IRS to collect the tax liability of the covered expatriate or covered expatriate's estate from any transferee of the property. See section 6324 of the Code (establishing special estate and gift tax liens that are separate and distinct from the general tax lien) and section 6901 of the Code (providing transferee gift tax or estate tax liability is to be assessed, paid, and collected in the same manner and subject to the same provisions and limitations as the tax imposed on the decedent or donor). Further, a timely paid requirement could present administrability and finality challenges – for example, when the amount paid with the return differs from the amount that is ultimately owed due to a valuation change or other adjustment after examination. In view of the above, the final regulations adopt the commenters' suggestion to eliminate the timely paid requirement as it relates to this exception from the definitions of covered gift and covered bequest.

ii. Both Section 2801 Tax and Gift or Estate Tax on Same Transfer.

As discussed in part 3.A.i. of the *Summary of Comments and Explanation of*

[1] For a discussion of the "tax neutral" objective stated in H.R. Rep. No. 110-431 with regard to an earlier, pre-HEART Act, bill, see part 1 of the *Summary of Comments and Explanation of Revisions* section of this preamble.

Revisions section of this preamble, a late filing of a gift or estate tax return by a covered expatriate or covered expatriate's estate prevents the transferred property from being excluded from the definition of a covered gift or covered bequest and may lead to the imposition of gift or estate tax as well as the imposition of the section 2801 tax on the same transfer of that property. Further, both the gift or estate tax and the section 2801 tax ultimately may be payable by the U.S. citizen or resident if transferee liability is imposed if the covered expatriate or covered expatriate's estate fails to pay the gift or estate tax due. See sections 6324(a)(2) and (b) and 6901.

Comments suggest that the final regulations provide a remedy to avoid the payment, on the same transfer, of both gift or estate tax by the covered expatriate or covered expatriate's estate and the section 2801 tax by the U.S. citizen or resident receiving the covered gift or covered bequest. The comments suggest alternative proposals to be added to the final regulations, including (a) providing for a refund to a U.S. citizen or resident who paid the section 2801 tax when gift or estate tax has been paid by a covered expatriate or covered expatriate's estate; (b) providing a credit or refund to the U.S. citizen or resident, or the covered expatriate or covered expatriate's estate, of whichever of those taxes is paid last; and (c) eliminating the timely filed requirement if the gift or estate tax is paid by the covered expatriate or the covered expatriate's estate prior to the due date of Form 708.

Section 2801(e)(2)(A) and (B) excepts from the definitions of covered gift and covered bequest, and thus from liability for the section 2801 tax, property reported on a timely filed gift or estate tax return. These sections explicitly provide an exception only for property shown on a timely filed return, and any exception from tax for covered gifts or covered bequests not reported on a timely return would ignore and give no meaning to the timely filed language in section 2801. Accordingly, eliminating liability for the section 2801 tax when the transfer of such property is not timely reported by a covered expatriate or covered expatriate's estate on a gift or estate tax return is contrary to the statute. Thus, despite the potential for the imposition of either estate or gift tax on the transfer of such property as well as the imposition of the section 2801 tax on the recipient's acquisition of such property, these final regulations do not adopt the suggestions of the comments.

Similarly, one comment suggests that a recipient who paid the U.S. gift or estate tax liability of the donor or decedent due to transferee liability should have a credit for those taxes against the recipient's section 2801 tax liability. These final regulations do not adopt this comment for the following reasons. First, a credit given to the recipient for gift or estate tax paid pursuant to transferee liability could incentivize the transferor subject to gift or estate tax to resist payment and force collection from the recipient. Second, section 2801 (unlike section 1446(d) of the Code,[2] for example) does not provide for such a credit.

Finally, in response to a comment, *Example 2* in proposed §28.2801-3(f) is updated in the final regulations to clarify that, under the facts of the example, the covered expatriate's estate must file an estate tax return (Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return*, *Estate of nonresident not a citizen of the United States*), and pay the estate tax with respect to certain property, despite the requirement that the son of the covered expatriate in that example file Form 708 and pay the section 2801 tax with respect to the same property.

B. Property subject to section 2801 tax both as covered gift and as covered bequest

Noting that a U.S. citizen or resident may receive property that constitutes a covered gift and, subsequently, a covered bequest, a comment suggests that the definition of covered bequest should exclude any property treated as acquired by reason of the death of a covered expatriate if the property previously was subject to the section 2801 tax as a covered gift from the same covered expatriate. For instance, when a covered expatriate transfers a remainder interest in real property to a U.S. recipient and retains a life estate, the value of the remainder interest is a covered gift, and the value of the entire real property is a covered bequest at the covered expatriate's death. See section 2036(a)(1).

The Treasury Department and the IRS are sympathetic to the commenter's concern that the same property could be subject to section 2801 tax first as a covered gift and subsequently as a covered bequest acquired from the same covered expatriate, and agree there should be no such duplication of the liability under section 2801. However, rather than excluding from the definition of covered bequest any property previously subject to the section 2801 tax as a covered gift, it is appropriate and more in line with the structure of the transfer tax system to exclude instead the value of the covered gift that was previously subject to section 2801 tax from the value of the covered bequest of that same property. In this way, similar to the way that section 2001(b) does not subject to estate tax the value of a gift that was previously subject to gift tax, the value already subjected to section 2801 would not be retaxed and the computation of the section 2801 tax would be able to properly take into account the post-gift appreciation in the value of the transferred property through the U.S. persons' receipt of the covered bequest. Accordingly, §28.2801-3(c)(3) of the final regulations includes a rule that limits the value of a covered bequest to the amount that exceeds the value of the covered gift to which the section 2801 tax previously applied.

C. Transfers to spouse

Section 2801(e)(3) excepts from the definitions of covered gift and covered bequest a gift or bequest that would qualify for a marital deduction under section 2056 or 2523 if the donor or decedent were a U.S. person.

i. QDOT and QTIP Elections for Non-U.S. Situs Property

Under proposed §28.2801-3(c)(4), the exception to the definitions of covered

[2] Section 1446(d) provides a credit under section 33 of the Code for a foreign partner's share of the withholding tax paid by the partnership under section 1446.

gift and covered bequest for transfers to a spouse that are dependent upon the making of a qualified terminable interest (QTIP) or qualified domestic trust (QDOT) election only applies if a valid QTIP or QDOT election in fact is made. Because these are elective choices with different tax consequences, the desire to make the election cannot be presumed in all cases.

Many of the comments received on the proposed rule requiring the making of a valid QTIP or QDOT election concern non-U.S. situs property. The comments received generally fall into two categories: those comments that conclude that a covered expatriate or a covered expatriate's executor may make a valid QTIP or QDOT election with respect to only U.S. situs property; and those comments that conclude that a QTIP or QDOT election also may be made with respect to non-U.S. situs property and request guidance on how such an election might be made with respect to non-U.S. situs property. With respect to the former, the comments state that a covered expatriate or a covered expatriate's estate is limited to making a QTIP or QDOT election with respect to U.S. situs property because only the transfer of U.S. situs property by a covered expatriate is subject to U.S. gift and estate taxation under sections 2511(a) and 2103. With respect to the latter, different comments suggest various methods of allowing a QTIP or QDOT election to be made with respect to non-U.S. situs property, including on a Form 706-NA filed by a trust, on a Form 708 filed by a U.S. recipient, and by a trust that is a U.S. recipient of a foreign non-electing trust.

The Treasury Department and the IRS agree with the comments in the first category that, for the exception to the definitions of covered gift and covered bequest to apply under section 2801(e)(3), a covered expatriate or a covered expatriate's estate is limited to making a QTIP or QDOT election with respect to only U.S. situs property. Section 2801(e)(3) provides no basis for allowing a QTIP or QDOT election to be made for property that is not subject to U.S. gift or estate tax, and, furthermore, it provides no mechanism for making the election and no indication that the IRS should create such a mechanism through regulations. In addition, adopting the position of the latter comments and providing a method to make a QTIP or QDOT election for non-U.S. situs property (in addition to U.S. situs property) would be inconsistent with the QTIP and QDOT statutory provisions that defer, but do not eliminate, transfer tax on property qualifying for the marital deduction. If such a rule were adopted so that such property would not be subject to section 2801 tax upon the initial gift or bequest by the covered expatriate, such property also would not be subject to gift or estate tax under section 2519, 2044, or 2056A(b) upon any disposition or distribution or on the death of the covered expatriate's spouse. Consequently, covered expatriates and the estates of covered expatriates would be afforded more favorable transfer tax treatment than that available to U.S. citizens. The Treasury Department and the IRS also note that a covered expatriate may obtain the benefits of the exception in section 2801(e)(3) with respect to non-U.S. situs property by making an outright gift or bequest of that property to a U.S. citizen spouse, or a bequest to a trust described in section 2056(b)(5) that provides the surviving spouse with both a life estate and a general power of appointment. For these reasons, the final regulations retain the proposed rule that requires a valid QTIP and/or QDOT election in order for property to qualify for this exception to the definitions of covered gift and covered bequest, and the regulations further clarify that such an election can be made only with respect to property subject to gift or estate tax, that is, only with respect to U.S. situs property.

ii. Distributions from Non-Electing Foreign Trusts

Transfers from a covered expatriate to a non-electing foreign trust are covered gifts or covered bequests, but are not subject to the tax under section 2801 until a distribution is made from that trust. Specifically, section 2801 imposes the tax on distributions from that trust to a U.S. recipient to the extent those distributions are attributable to the covered gifts or covered bequests contributed to the trust.

A few comments suggest that, for transfers to a non-electing foreign trust, section 2801(e)(4)(B)(i) supports applying the marital exception at the time of the distribution from the non-electing foreign trust to the U.S. spouse, because that is when tax under section 2801 tax is imposed. Recognizing that the marital deduction is applied at the time of the transfer giving rise to gift or estate tax, these comments contend that this approach would be consistent with transfer tax principles. These comments also state that this approach would be consistent with the goal of tax neutrality as applied to surviving spouses, in that the imposition of the section 2801 tax should not depend upon whether a non-electing foreign trust (that would qualify for the marital deduction) is interposed between the donor or decedent and the receipt by the surviving spouse. See part 1 of the *Summary of Comments and Explanation of Revisions* section of this preamble for a discussion of the "tax neutral" objective stated in H.R. Rep. No. 110-431 with regard to an earlier, pre-HEART Act, bill. The comments acknowledge that, under their interpretation, a transfer of property to a non-electing foreign trust would be treated differently than a transfer of property to a domestic trust or an electing foreign trust; however, they posited that the difference is justified by the timing of the transfer taxable under section 2801. Specifically, the comments point out that by its express terms, the statute treats a non-electing trust differently with regard to the timing of the imposition of the tax and the payee of that tax.

The Treasury Department and the IRS have carefully considered the merits and implications of the suggestion to apply the marital exception at the time of the distribution from the non-electing foreign trust. The proper interpretation of section 2801(e)(3) and (4)(B)(i), however, does not permit the creation of a special rule for non-electing foreign trusts that would provide an opportunity for a marital exception at the time of a distribution from the trust. Unlike the marital deduction for estate and gift taxes, the exception for marital transfers under section 2801 is an exception to the definitions of covered gift and covered bequest. Those definitions apply to determine whether a contribution to a non-electing foreign trust is a covered gift or covered bequest, and thus the availability of that exception is determined as of the time of the covered expatriate's funding of the non-electing foreign

trust. For this reason, even though the U.S. spouse's receipt of property attributable to the covered gift or covered bequest occurs and becomes taxable under section 2801 only upon its distribution out of the trust, the availability of the marital exception cannot be applied instead at the time of the distribution from that trust.

Two other comments suggest that a distribution from a non-electing foreign trust to a U.S. citizen or resident spouse should be treated as an indirect gift or bequest to which the exception could be applied. However, to do so would imply that all trust distributions are indirect transfers, which would go too far. In addition, if such an indirect transfer would have qualified for the transfer tax marital deduction at all, it effectively would override section 2801(e)(4), would confer a tax advantage on a covered expatriate that is unavailable to a U.S. person, and would be (as one comment concludes) overly generous. For example, a transfer of non-U.S. situs property by a covered expatriate at death outright to the covered expatriate's U.S. citizen spouse is not a covered bequest, because such transfer would have qualified for the estate tax marital deduction if the covered expatriate were a U.S. person. Similarly, a transfer of non-U.S. situs property by a covered expatriate at death to a non-electing foreign trust that qualifies for the estate tax marital deduction under section 2056(b)(5) is not a covered bequest because such transfer would have qualified for the estate tax marital deduction if the covered expatriate were a U.S. person. In these situations, because the contributions to the trust are not covered bequests, not only are distributions from the non-electing foreign trust to the covered expatriate's U.S. citizen spouse not subject to the section 2801 tax pursuant to the exception in section 2801(e)(3), but distributions to the remainder beneficiary upon such spouse's death also are not subject to the section 2801 tax. By contrast, a transfer of non-U.S. situs property from a covered expatriate at death to a trust for the benefit of the covered expatriate's U.S. citizen spouse and U.S. citizen children is a covered bequest because such transfer would not have qualified for the estate tax marital deduction if the covered expatriate were a U.S. person. If such trust is a non-electing foreign trust, the section 2801 tax is not payable until there is a distribution to a U.S. citizen or resident. When the trust makes a distribution to the covered expatriate's U.S. citizen spouse, that spouse is liable for the section 2801 tax because the distribution is attributable to a covered bequest and is taxed "in the same manner as if such distribution were a covered gift or covered bequest." Section 2801(e)(4)(B)(i).

These final regulations explicitly address the application of the section 2801(e)(3) exception to the definition of covered gift or covered bequest in §28.2801-3(c)(5) and in *Example 2* to §28.2801-5(e).

D. Transfers to charity

To the extent a gift or bequest would qualify for a charitable deduction under section 2055 or 2522 if the donor or decedent were a U.S. citizen or resident, such gift or bequest is excepted under section 2801(e)(3) and §28.2801-3(c)(3) of the proposed regulations from the definitions of covered gift and covered bequest. Regarding distributions to qualifying charitable organizations from a non-electing foreign trust, a few comments assert that section 2801(e)(4)(B)(i) supports applying the exception at the time of distribution and explain that this would avoid imposing the section 2801 tax on a U.S. charity. The comments explain that their analysis regarding the marital exception, which is set forth in part 3.C.ii. of the *Summary of Comments and Explanation of Revisions* section of this preamble, applies equally to the charitable exception. Because this exception depends upon the contribution to the trust being eligible for a transfer tax charitable deduction, and for the reasons described in part 3.C.ii. of the *Summary of Comments and Explanation of Revisions* section of this preamble, these final regulations have not adopted the interpretation advanced by the comments.

Section 28.2801-4(a)(2)(iii) of the proposed regulations provides that a domestic trust qualifying as a charitable remainder trust (as that term is defined in §1.664-1(a)(1)(iii)(*a*)) is subject to section 2801 when it receives a covered gift or covered bequest, and that the charitable remainderman's share of each transfer to the charitable remainder trust is not a covered gift or covered bequest. The proposed regulations further provide that, to compute the amount of covered gifts and covered bequests taxable to the charitable remainder trust for a calendar year, the charitable remainder trust will (A) calculate, in accordance with the regulations under section 664 and as of the date of the trust's receipt of the contribution, the value of the remainder interest in each contribution received in such calendar year that would have been a covered gift or covered bequest without regard to section 2801(e)(3), (B) subtract the remainder interest in each such contribution from the amount of that contribution to compute the annuity or unitrust (income) interest in that contribution, and (C) add the total of such income interests, each of which is the portion of the contribution that constitutes a covered gift or covered bequest to the trust.

One comment notes that the proposed regulations do not indicate whether the payment of section 2801 tax by a charitable remainder trust is disregarded in computing the amount of annuity or unitrust distributions and in determining whether the 10 percent minimum remainder requirement in section 664(d)(1)(D) and (2)(D) and the probability of exhaustion test described in Rev. Rul. 70-452, 1970-2 C.B. 199, are satisfied. The comment observes that, if the tax imposed by section 2801 were considered in determining whether the 10 percent minimum remainder requirement and probability of exhaustion tests are satisfied, then most trusts that owe tax under section 2801 are likely to be disqualified as a charitable remainder trust. The comment also observes, however, that, if the tax is not considered in determining the annuity amount, then the charitable remainder will be overvalued.

One comment points out that the proposed regulations do not provide guidance on whether a charitable remainder trust's payment of section 2801 tax should be allocated to income or principal for the purpose of determining the character of distributions under section 664(b) and §1.664-1(d)(2).

The proposed regulations also do not contain any guidance on how a domestic trust or electing foreign trust that qualifies as a charitable lead trust under section 2055(e)(2)(B) or 2522(c)(2)(B) is to compute the 2801 tax. Several comments

suggest that the final regulations provide that a charitable lead trust should compute the section 2801 tax in a similar manner to a charitable remainder trust, such that the charitable lead interest could be subtracted from the total value of the covered gift or bequest to determine the amount that is subject to the section 2801 tax.

As the comments note, the proposed regulations do not provide any rules on the effect of a charitable remainder trust's tax payment on the trust's qualification under section 664. This is a complex and foundational issue, such that final rules regarding charitable remainder trusts should not be promulgated without further consideration and an opportunity for notice and comment. Additionally, as the comments point out, the proposed regulations do not provide any rules on charitable lead trusts, and, therefore, final rules regarding charitable lead trusts should not be promulgated without further consideration and an opportunity for notice and comment. Accordingly, §28.2801-4(a)(2)(iii) of the final regulations is reserved for these purposes.

4. Computation of Section 2801 Tax

Under section 2801(a) and (c), the section 2801 tax is determined by reducing the total value of covered gifts and covered bequests received by a U.S. recipient during the calendar year by the dollar amount of the per-donee exclusion in effect under section 2503(b) for that calendar year ($18,000 in 2024) (section 2801(c) amount), and then multiplying the net amount by the highest estate or gift tax rate in effect during that calendar year (40 percent in 2024). The reference in section 2801(c) to section 2503(b) has the sole purpose of defining the amount by which to reduce the aggregate value of covered gifts and covered bequests received by a U.S. citizen or resident during the calendar year, as acknowledged in the comments. Under section 2801(d), the resulting tax then is reduced by any estate or gift tax paid to a foreign country with regard to such covered gifts and covered bequests. Section 28.2801-4(b) (on the computation of the section 2801 tax) and 28.2801-4(e) (on the reduction of the section 2801 tax for foreign gift or estate tax paid) of the proposed regulations are consistent with these statutory rules.

A. Effective tax rate

Several comments note that the effective tax rate of the section 2801 tax on a covered gift is much higher than the effective tax rate for a gift subject to gift tax because the base on which the section 2801 tax is imposed includes the amount of the section 2801 tax payable by the U.S. recipient (making it "tax inclusive") while the base on which the gift tax is imposed does not include the amount of the gift tax payable by the donor (making it "tax exclusive"). These comments contend that this result is a deviation from Congress' stated goal of tax neutrality, and one comment suggests that the final regulations allow a covered expatriate instead to elect to treat a gift as a transfer of U.S. situs property, to reduce the effective section 2801 tax rate on the covered gift.

As discussed in part 1 of the *Summary of Comments and Explanation of Revisions* section of this preamble, section 2801 imposes a tax that does not equal, and in some cases is not similar to, the tax that would have been imposed on the same transfer by a U.S. transferor. The effective tax rate on covered gifts under section 2801 as compared to the effective tax rate on taxable gifts under chapter 12 is another example of this. While Congress could have allowed a covered expatriate to elect to treat a covered gift of non-U.S. situs property as a transfer of U.S. situs property, it did not do so. (But see section 2801(e)(4)(B)(iii) allowing foreign trusts to elect to be treated as a domestic trust for purposes of section 2801). The statute does not provide any reasonable regulatory interpretation that the section 2801 tax on covered gifts should be levied on less than the entire amount of the covered gift, and the statute does not contemplate a regulatory rule allowing for a deduction or exclusion to estimate a tax exclusive section 2801 tax rate. Accordingly, these final regulations do not adopt the commenters' suggestion as it would be contrary to the statute.

B. Section 2801(c) amount

Section 28.2801-3(d) of the proposed regulations provides that the recipient of a covered gift or covered bequest made to a trust is the trust and not any individual who holds a general power of appointment or power of withdrawal over trust property. Several comments recommend that the final regulations treat a transfer to a trust as a transfer to an individual to the extent of the individual's general power or withdrawal right. The comments acknowledge that this would increase the section 2801(c) amount available to shield a covered gift or covered bequest from the section 2801 tax when multiple individuals have withdrawal rights, but state this treatment is consistent with the treatment of withdrawal rights under gift tax principles and thus furthers the statutory goal of tax neutrality. See part 1 of the *Summary of Comments and Explanation of Revisions* section of this preamble for a discussion of the "tax neutral" objective stated in H.R. Rep. No. 110-431 with regard to an earlier, pre-HEART Act, bill. One comment suggests that there is no authority to deny the status of recipient to the holder of a withdrawal right. For the reasons stated below, these final regulations do not adopt the commenters' recommendation.

The holder of a withdrawal right over trust property is the holder of a general power of appointment. For gift tax purposes, neither the grant nor the receipt of a general power of appointment is treated as a taxable gift; rather, it is the possession of such a power at death, or the exercise or release of such a power that is a taxable event for gift and estate tax purposes. Thus, the proposed treatment of a general power of appointment – that is, not as the receipt of a covered gift or bequest – is consistent with transfer tax principles. In addition, while section 2801 is silent on the treatment of general powers of appointment, section 2801(e)(4) provides specific rules applicable to a covered gift or covered bequest made to a domestic or electing foreign trust: specifically, the section 2801 tax is imposed on the recipient trust. Implementing the recommendation proposed by the commenters would violate the provisions of section 2801(e)(4)(A)(ii) requiring that the tax imposed on a covered gift or covered bequest made to a domestic trust be paid by that trust. By, in effect, defining the donee domestic trust as the recipient of the covered gift or covered bequest, the statute imposes the filing and tax payment obligations on the domestic trust, regardless of the identity and rights

of the trust beneficiaries. As a result, the receipt of property by the domestic trust does not have to be reported by and taxed to both the trust and each holder of a general power of appointment or withdrawal right over trust property. Treating each such power holder as an additional recipient at the time of the trust contribution would add administrative complexity and burden both to taxpayers and the IRS.

Similarly, under section 2801(e)(4)(B), it is the recipient of a distribution from a non-electing foreign trust who is treated as the recipient of the covered gift or covered bequest to the trust. No section 2801 tax is imposed on covered gifts or covered bequests to a non-electing foreign trust until a trust distribution is made to a U.S. recipient. It is the property distribution pursuant to the exercise, release, or lapse of a general power of appointment over such a trust, rather than the grant of such a power, that is a distribution triggering the imposition of the section 2801 tax.

As a result, in the case of a transfer to a trust, a domestic trust is the recipient who is entitled to reduce the value of a covered gift or covered bequest received during the calendar year by the section 2801(c) amount. These rules also apply to an electing foreign trust.

Finally, comments request guidance for trusts in the potential situation where a domestic trust or an electing foreign trust may be unable to pay the section 2801 tax upon the exercise of an individual withdrawal right. Such a situation, where the trustee is faced with balancing the obligation to satisfy tax obligations with the duty to make distributions as directed by the trust instrument, is not unique to the section 2801 tax (for example, an obligation to satisfy an estate tax obligation may conflict with a specific bequest, or an obligation to satisfy a GST tax obligation may conflict with a distribution provision to a trust beneficiary). Given the broader issues concerning a trustee's duty to administer a trust, such issues are better addressed in more comprehensive regulations and are therefore beyond the scope of these final regulations.

C. Foreign gift or estate tax

Consistent with section 2801(d), §28.2801-4(e) of the proposed regulations provides that the section 2801 tax is reduced by the amount of any gift or estate tax paid to a foreign country with respect to a covered gift or covered bequest. Pointing to section 2014(a), which allows a credit against estate tax for any estate, inheritance, legacy, or succession taxes paid to any foreign country, two comments suggest that, in the interest of tax neutrality, these final regulations also allow a reduction for any foreign tax imposed on a covered gift or covered bequest that is similar to, but imposed in lieu of, a gift or estate tax, such as an inheritance tax or a deemed capital gains tax. See part 1 of the *Summary of Comments and Explanation of Revisions* section of this preamble for a discussion of the "tax neutral" objective stated in H.R. Rep. No. 110-431 with regard to an earlier, pre-HEART Act, bill. These final regulations do not adopt the commenters' suggestion, because the plain language of section 2801(d) unambiguously limits the reduction to the amount of gift or estate tax paid to a foreign country with respect to a covered gift or covered bequest and does not contain the kind of statutory language that appears in section 2014.

A comment also suggests that these final regulations allow a refund of the section 2801 tax if foreign gift or estate tax is paid after payment of the section 2801 tax. In such a scenario, a refund is available under section 6511 if the U.S. recipient files a claim for refund or a protective claim for refund on or before the expiration of the applicable period of limitations. To confirm the U.S. recipient's ability to file a protective claim for refund, paragraph (e)(2) is added to §28.2801-4 of the final regulations.

5. Value of a Covered Gift or Covered Bequest

Section 28.2801-4(c) of the proposed regulations defines value using transfer tax principles, including the special valuation rules of chapter 14 (sections 2701 through 2704). Several comments recommend that the final regulations be amended to disregard chapter 14. Alternatively, the comments suggest that the value of a covered gift should be determined by subtracting from the value of the covered gift the total value of any interest retained by a covered expatriate donor, without regard to section 2701 or 2702. The comments posit that, because the section 2801 tax is payable by the recipient, unlike the gift and estate taxes that are payable by the donor or decedent's estate, the requested deviation from the usual gift tax valuation rules is necessary. However, like the gift and estate taxes, the section 2801 tax is a transfer tax. The transfer tax valuation rules, therefore, including the special valuation rules of chapter 14, apply to value the property subject to section 2801. The section 2801 tax is imposed on transfers that otherwise would have escaped gift or estate taxation as a consequence of the donor's or decedent's expatriation. Revising the section 2801 regulations in the suggested manner would decrease the value of a covered gift to which sections 2701 and 2702 apply below what otherwise would have been its gift tax value had the covered expatriate been a U.S. citizen. This result is inconsistent with the intended purpose of section 2801, and Congress did not provide an exception for the special valuation rules. Thus, the requested revisions are not adopted.

One comment suggests that sections 2701 and 2702 should not apply in determining the tax liability of a covered bequest, because those sections have no applicability to the estate tax. While the Treasury Department and the IRS acknowledge that sections 2701 and 2702 generally apply only to inter vivos transfers, section 2701(d) provides in certain circumstances for a potential increase in the taxable estate of a transferor. Accordingly, the final regulations provide that the special valuation rules under chapter 14 apply only to the extent those rules are applicable to the specific transfer.

6. Date of Receipt of a Covered Gift or a Covered Bequest

Under §28.2801-4(d)(2) of the proposed regulations, the date of receipt of a covered gift, which is the date the section 2801 tax is imposed, generally is determined by reference to the date of the gift under chapter 12 principles, as if the covered expatriate had been a U.S. citizen at the time of the transfer. In the event of a transfer of assets by a covered expatriate to a domestic revocable trust, proposed

§28.2801-4(d)(2) provides that the date of receipt of the transfer is the date the covered expatriate relinquishes the right to revoke the trust. Proposed §28.2801-4(d)(3) provides that the date of receipt of a covered bequest generally is the date the property is distributed from the covered expatriate's estate or revocable trust, unless the interest passes by operation of law or beneficiary designation, in which case the date of receipt is the date of the decedent's death. Comments recommend changing the rules regarding the date of receipt for both covered gifts and covered bequests.

With respect to the date of receipt of a covered gift, comments point out that the date on which a covered expatriate makes a gift often is not the same date on which the property is received by the U.S. citizen or resident donee. A discrepancy between those dates can impact a recipient's ability to pay the section 2801 tax liability because the recipient may not yet have received the economic benefit of the gifted property. Comments suggest different methods of determining the date of receipt: (1) the date of "actual" receipt; (2) the date an interest in property becomes possessory; or (3) the date of distribution to the U.S. citizen or resident. The third method is intended to be comparable to the proposed rule for the date of receipt of a covered bequest. A few comments also suggest that the rule determining the date of receipt for purposes of the section 2801 tax should distinguish between receipt of a present interest in property and receipt of a future interest in property. Finally, a comment requests that the final regulations further elaborate on the date of receipt when a transfer of assets to a domestic revocable trust is an incomplete gift, pointing out that relinquishment of the right to revoke the trust may not be the trigger that completes the gift.

With respect to the date of receipt of a covered bequest, some comments object to treating interests passing by operation of law or beneficiary designation as received on the date of death, rather than on the date property is distributed to the recipient. Comments note that a decedent's property devolves to heirs at death by operation of law in civil law jurisdictions, even though significant time may elapse before the heirs' interests become possessory. Again, this delay could impact a recipient's ability to pay the section 2801 tax. To address these concerns, a few comments suggest defining the date of receipt of a covered bequest as the date of actual receipt by the recipient, whether a distribution from a decedent's estate or revocable trust or the transfer of property by operation of law, beneficiary designation, or other contractual arrangement. Another comment suggests that, if the date of receipt of a covered bequest is not changed from that identified in the proposed regulations, the final regulations should include an election to defer payment of the section 2801 tax and interest until the recipient's interest becomes possessory. Still another comment suggests that, because a date of death valuation is likely to be performed on inherited assets for non-section 2801 purposes, recipients should be able to elect to treat a covered bequest as received as of the date of death rather than the date of actual distribution to avoid the need for additional appraisals.

Defining the date of receipt of both a covered gift and a covered bequest as the date on which the recipient obtains actual receipt or a possessory interest in the transferred property would eliminate the concern regarding the recipient's ability to pay the section 2801 tax, particularly in civil law jurisdictions where property passes by operation of law to heirs at death but distribution is delayed for a period during administration of the decedent's estate. However, such a definition outside of the context of a distribution from a decedent's estate or revocable trust would raise other issues and administrability concerns. For instance, in some cases it may be difficult to determine the date of actual receipt of a covered gift or covered bequest, such as the receipt of a remainder interest in property or, in the case of a delay in distribution of property after title has vested in a civil law jurisdiction during the period of administration. In cases where property is distributed or an interest becomes possessory long after the transfer by the covered expatriate, it may be difficult for the recipient to obtain the information needed to determine whether the transfer is subject to the section 2801 tax and otherwise comply with reporting and paying the section 2801 tax. Further, such a definition could open the door to possible manipulation of the date of receipt and potential abuse, such as planning designed to ensure a covered gift or covered bequest is considered non-possessory for an extended period to delay and possibly defeat any section 2801 tax liability.

In most instances, the lengthy amount of time between the date of receipt and the due date of the return and payment of the section 2801 tax, which generally is 17.5 months after the close of the year in which the covered gift or covered bequest is received, should be sufficient to allow a U.S. recipient to make necessary arrangements to timely report and pay any section 2801 tax liability. See §28.6071-1(a). Moreover, the rules for transfers in trust satisfactorily resolve the potential problems for many situations of deferred possession.

However, for future interests in property that are not held in a trust (for example, a remainder interest in real property), the Treasury Department and the IRS appreciate the administrative and valuation concerns with the proposed definitions of the date of receipt. In view of these concerns, §28.2801-4(d)(8)(i) of the final regulations includes a special rule providing that the date of receipt of a covered gift or covered bequest of a future interest in property that is not held in trust is the earlier of (1) the date the future interest is disposed of by the U.S. recipient or (2) the date that is the later of the date that the interest vests in the U.S. recipient or the date that the last term interest in the property held by an intervening recipient terminates. Further, to assist recipients both in achieving finality regarding the section 2801 tax liability and in avoiding the potential for administrative hurdles caused by a long delay in receipt, §28.2801-4(d)(8)(ii) of the final regulations provides that the U.S. recipient of a covered gift or covered bequest of a future interest in property not held in trust may elect to treat the covered gift or covered bequest as having been received on the date of receipt of the gift or on the covered expatriate's date of death, respectively. To the extent a domestic or electing foreign trust receives or may eventually receive a covered gift or covered bequest that is a future interest in property that is not in trust, such domestic or electing foreign trust may take advantage of this election.

Finally, to provide further clarification on the date of receipt of a transfer to a domestic trust or an electing foreign trust that is an incomplete gift, a new paragraph is added in §28.2801-4(d)(4) of the final regulations. In the event of a transfer by a covered expatriate to a revocable domestic trust or electing foreign trust, the date of receipt by the trust is the later of (1) the date the right to revoke the trust is relinquished or extinguished and (2) the date of extinguishment of all powers over or interests in the trust that would prevent the transfer from being a competed transfer for gift tax purposes. In the event of a transfer by a covered expatriate to an irrevocable domestic trust or electing foreign trust over or in which the covered expatriate retains powers or interests that prevents the transfer from being complete, the trust receives the transfer on the date all of such powers or interests are extinguished.

7. Non-Electing Foreign Trusts

The section 2801 tax applies to a distribution attributable to a covered gift or covered bequest to a U.S. citizen or resident from a non-electing foreign trust. See section 2801(e)(4)(B)(i).

A. Distributions

Section 28.2801-5(b) of the proposed regulations defines the term *distribution* broadly to include any direct, indirect, or constructive transfer from a non-electing foreign trust, including each disbursement from such non-electing foreign trust pursuant to the exercise, release, or lapse of a power of appointment. In response to some comments, the final regulations clarify that a distribution includes a transfer to the extent made for less than full and adequate consideration in money or money's worth.

Several comments request clarification as to whether the uncompensated use of trust property by, or a loan from a non-electing foreign trust to, a U.S. citizen or resident would constitute a distribution for section 2801 tax purposes and point out that these are treated as distributions for income tax purposes under section 643(i). The comments recommend that neither one be treated as a distribution for purposes of section 2801 and request that the final regulations explicitly state that the deemed distribution rules of section 643(i) do not apply for purposes of section 2801. The comments suggest that, because there is no specific statutory direction to vary from the ordinary definition of distribution, the deemed distribution rules of section 643(i) should not be used to interpret the term as used in section 2801. The Treasury Department and the IRS agree with the latter recommendation to clarify that the deemed distribution rules of section 643(i) are not adopted as part of the definition of a distribution for purposes of section 2801(e)(4)(B)(i). However, that does not mean that a loan or use of property cannot be a distribution and thus a covered gift. To the extent that a loan from, or the use of property of, a non-electing foreign trust constitutes a gift under chapter 12 of the Code, then the portion of that loan or use received by a U.S. recipient constitutes a distribution and thus a covered gift to the extent of the trust's section 2801 ratio. The final regulations include this clarification.

One comment recommends that the final regulations provide that a loan from a foreign trust which is a qualified obligation under section 643(i) and Notice 97-34, 1997-1 C.B. 422, should not be treated as a distribution for section 2801 tax purposes (even if it otherwise would be treated as a distribution using gift tax principles). The final regulations provide, as other comments suggest, that distribution should not be interpreted using principles from section 643(i), because Congress did not indicate that such standards should be used. Consistent with this approach of not using section 643(i) principles, the suggestion to exclude from the definition of a covered gift or bequest this particular category of loans described in section 643(i) is not adopted. Comments also recommend that the final regulations clarify that the uncompensated use of trust property that is de minimis, whether determined by duration or value, does not constitute a distribution, noting that it is costly, impractical, and time-consuming to value the use of property. Because foreign trusts with U.S. beneficiaries already must determine these values for income tax purposes (given that there is no de minimis exception under section 643(i)), taxpayers are not subject to any additional administrative burden. Accordingly, this recommendation has not been adopted.

B. Section 2801 ratio

Section 28.2801-5(c) of the proposed regulations provides that the amount of the distribution attributable to a covered gift or covered bequest is determined by multiplying the distribution by a ratio (section 2801 ratio) that is redetermined after each contribution to the non-electing foreign trust. The proposed regulations explain how to compute the section 2801 ratio and provide that each distribution from the non-electing foreign trust is considered to be made proportionally, without any tracing to particular property.

i. Calculating the Section 2801 Ratio

While acknowledging that the proposed method for determining the section 2801 ratio is based on the existing method for determining the inclusion ratio of a trust for GST tax purposes, several comments nonetheless object to this methodology, saying that its complexity, particularly the requirement to revalue trust property at each contribution, would discourage compliance. Comments offer multiple suggestions to avoid the complications of a section 2801 ratio of more than zero but less than one. Some suggestions involve recognizing separate accounting or separate shares within, or the severance of, a single trust so that separate section 2801 ratios could apply to the separate shares. For instance, such an approach could allow a non-electing foreign trust to utilize separate accounting for the portion of the trust that consists of only covered gifts and covered bequests (similar to separate accounting in the GST context under section 2654(b) and §26.2654-1(a)(2) of the Generation-Skipping Transfer Tax Regulations for portions of a trust attributable to transfers from different transferors). Another approach could allow a non-electing foreign trust to treat a covered gift or covered bequest earmarked for a particular beneficiary as a separate share with a distinct section 2801 ratio (similar to separate share rules utilized for other tax purposes such as §26.2654-1(a)(1) and §§1.672(f)-3(b)(3) and (d) and 1.663(c)-3

of the Income Tax Regulations). Another approach could allow the trustee to sever a trust with a mixed section 2801 ratio into two separate trusts, each with a section 2801 ratio of either zero or one, using the same method provided for qualified severances in section 2642(a)(3) and §26.2642-6.

The Treasury Department and the IRS recognize that, in the absence of an election by the foreign trust to be treated as an electing foreign trust, computing and re-computing the section 2801 ratio in the event of additional contributions may pose challenges to U.S. distributees unless the non-electing foreign trust has a section 2801 ratio of either one or zero. Nevertheless, a rule recognizing separate section 2801 ratios in the event of separate accounting, separate shares, or a severance of a single non-electing foreign trust presents administrability and enforcement concerns. For instance, because of the lack of jurisdiction over a foreign trust, it will be difficult to verify whether a single trust consists of substantially separate and independent shares with no commingling of trust assets and whether a qualified severance was done in a manner that complies with rules similar to §26.2642-6. Although certain reporting and other administrative requirements are imposed in order for separate accounting, separate shares, and qualified severances to be recognized, no similar reporting or other administrative requirements could be enforced against the trustee of a non-electing foreign trust. Furthermore, the proposal to allow for separate accounts that are not actually separated into different shares or trusts similar to section 2654(b) would not eliminate the need for revaluation at each contribution, because revaluation would be necessary after each contribution in order to determine the portion of the trust allocable to each account. See §26.2654-1(a)(2)(ii) (requiring the computation of a fraction that utilizes fair market valuations of the trust as well as of the portions treated as separate trusts). Accordingly, the final regulations do not adopt the commenters' suggestions related to separate accountings similar to that provided in section 2654(b) and §26.2654-1(a)(2), separate shares similar in concept to those recognized in §26.2654-1(a)(1) and §§1.672(f)-3(b)(3) and (d) and 1.663(c)-3, or severance of a single trust similar to qualified severances described in section 2642(a)(3) and §26.2642-6.

Another comment suggests allowing a non-electing foreign trust to treat as a separate share gifts and bequests received prior to the effective date of section 2801. As is explained in part 7.B.ii. of the *Summary of Comments and Explanation of Revisions* section of the preamble, such receipts are not included in the definition of a covered gift or covered bequest. Because the final regulations provide that such receipts are merely another example of noncovered receipts, this suggestion is not adopted for the same administrability concerns identified in the prior paragraph. See §28.2801-2(f) and -2(g) and *Example 3* of §28.2801-5(e) of these final regulations.

One comment suggests that separate accounting for the purpose of recognizing separate section 2801 ratios be permitted in the event a covered expatriate's contributions to a non-electing foreign trust can be traced to specific assets. Another comment recommends that the final regulations adopt a rule that would treat a distribution from a non-electing foreign trust as made either first or last from a covered gift or covered bequest, similar to the income tax treatment of certain inventory under sections 471 and 472, or in a manner analogous to the tiers applicable to distributions from a charitable remainder trust. Requiring the tracing or tracking of specific trust assets has the potential to be more onerous to administer than the section 2801 ratio, especially as trust property produces income, is reinvested, or otherwise changes form over time, and to the extent it is commingled or reinvested with other assets. Additionally, because the IRS has no jurisdiction over the foreign trustee, it would be difficult to verify that the assets were being traced or tracked properly. Given these administrability concerns, these suggestions are not adopted.

One comment suggests that the final regulations permit a non-electing foreign trust to use the value of each contribution to the trust as of the date of its contribution to compute the section 2801 ratio, thus eliminating the need for revaluations at the time of each subsequent contribution. However, as the comment acknowledges, computing the section 2801 ratio using contributed values is a less desirable alternative because, although simpler to administer, it would be far from accurate, so this suggestion has not been adopted.

The Treasury Department and the IRS recognize that calculation of a foreign trust's section 2801 ratio may be complicated when a single trust receives contributions attributable to both covered gifts or covered bequests and non-covered gifts or non-covered bequests at different points in time. In some circumstances, the complexity can be eliminated by establishing separate trusts and making covered gifts or covered bequests to one trust and non-covered gifts and non-covered bequests to the other trust. The Treasury Department and the IRS recognize that this might not always be possible or practical, particularly in the event of one or more transfers to a non-electing foreign trust as a result of the death of a covered expatriate. However, for the reasons previously stated, the final regulations retain the section 2801 ratio concepts enumerated in the proposed regulations.

ii. Inadequate Information to Calculate Section 2801 Ratio

Section 28.2801-5(c)(3) of the proposed regulations provides that, if the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio, or if the U.S. recipient is unable to obtain the necessary information with regard to the foreign trust, the U.S. recipient must proceed upon the assumption that the entire distribution for purposes of section 2801 is attributable to a covered gift or covered bequest. Some comments object to this assumption, contending that it is unduly harsh in that U.S. recipients of foreign trust distributions may be unable to determine the section 2801 ratio despite their best efforts. Comments also suggest applying a presumption under which property acquired by a non-electing foreign trust prior to June 17, 2008, would be presumed not to be a covered gift or covered bequest, and property acquired on or after that date would be presumed to be a covered gift or covered bequest.

The Treasury Department and the IRS are persuaded that the entire trust should

not be assumed to have a section 2801 ratio of one merely because the U.S. recipient cannot determine whether certain transfers are attributable to covered gifts and covered bequests. Accordingly, the final regulations retain the rule in the proposed regulations, but clarify that the assumption applies only to the extent the section 2801 ratio cannot be substantiated. See §28.2801-5(c)(3) of these final regulations. For instance, even if the U.S. recipient lacks adequate information to determine whether certain transfers to a non-electing foreign trust are covered gifts or covered bequests, the U.S. recipient can still treat other transfers to the non-electing foreign trust as not being covered gifts or covered bequests if the U.S. recipient has adequate information to show that those transfers are not covered gifts or covered bequests. Additionally, the final regulations clarify that the assumption that a distribution is attributable to a covered gift or covered bequest can be rebutted to the extent the taxpayer can supply information sufficient to persuade the Commissioner that the assumption is not correct.

As to the suggestion to apply a presumption about property acquired by a non-electing foreign trust prior to the effective date of section 2801, the Treasury Department and the IRS agree that the final regulations should clarify the status of pre-enactment contributions to non-electing foreign trusts. However, rather than a presumption, the final regulations update the definitions of covered gift and covered bequest to clarify that such terms include only gifts and bequests made to the non-electing foreign trust after the effective date of section 2801. Thus, property attributable to a covered gift or covered bequest does not include pre-section 2801 contributions to the non-electing foreign trust. See §28.2801-2(f) and -2(g) and *Example 3* of §28.2801-5(e) of these final regulations.

Other comments propose that a U.S. recipient of a distribution from a non-electing foreign trust may use any reasonable method to estimate the section 2801 ratio based on the information available, such as affidavits from persons with relevant knowledge and reasonable assumptions regarding growth rates, contributions, and other pertinent information. The adequacy of the method and information used to compute the section 2801 ratio to avoid application of the assumption is most appropriately determined on a case-by-case basis. Accordingly, these final regulations do not contain a detailed list of the types of information, and the combinations thereof, that may be used to calculate the section 2801 ratio and rebut the presumption in §28.2801-5(c)(3) of the final regulations.

One comment suggests that the burden to establish the section 2801 ratio should shift to the IRS if the U.S. recipient (i) affirms under penalties of perjury that best attempts were made to obtain necessary information, (ii) discloses all relevant information that the U.S. recipient has to the IRS, and (iii) identifies parties believed to have the necessary information. The Treasury Department and the IRS acknowledge that U.S. recipients of distributions from non-electing foreign trusts whose trustees do not keep proper records, or who do not cooperate with the U.S. recipients, may end up computing their section 2801 tax using an overstated section 2801 ratio. However, because all the information is in the hands of the trustees of the foreign trust (over which the IRS is unlikely to have any jurisdiction) and the IRS has limited ability to independently determine the section 2801 ratio of a non-electing foreign trust, leaving the burden of proof with the U.S. recipient more likely ensures that section 2801 tax is levied on all covered gifts and covered bequests. Accordingly, the final regulations do not adopt the suggestion to shift the burden in establishing the section 2801 ratio to the IRS.

iii. Impact of Section 2801(c) Amount on Section 2801 Ratio

One comment requests clarification on when a section 2801 tax is deemed to have been paid and suggests that an example be added to the final regulations. Section 28.2801-5(c)(2) of the proposed regulations provides that, once a section 2801 tax has been timely paid on property that thereafter remains in a foreign trust, that property is no longer considered to be, or to be attributable to, a covered gift or covered bequest to the foreign trust for purposes of determining the trust's section 2801 ratio. Section 28.2801-5(c)(2) of the proposed regulations further provides that a section 2801 tax is deemed to have been timely paid on amounts for which no section 2801 tax was due as long as those amounts were reported as a covered gift or covered bequest on a timely filed Form 708. The final regulations clarify in §28.2801-5(c)(1) that, because a non-electing foreign trust itself is not taxed on its receipt of covered gifts and covered bequests, the trust is not entitled to the exclusion under section 2801(c); instead, the section 2801(c) exclusion is allowed to the U.S. recipient with regard to distributions from the non-electing foreign trust. In addition, the final regulations expand an example to illustrate this situation. See *Example 4* of §28.2801-5(e) of the final regulations. In addition, section 28.2801-5(c)(2) of the final regulations also is modified to provide that section 2801 tax is deemed to have been timely paid on amounts for which no section 2801 tax was due as a result of the section 2801(c) amount, whether or not those amounts were reported as a covered gift or covered bequest on a timely filed Form 708.

C. Income tax deduction for section 2801 tax on certain distributions

Section 2801(e)(4)(B)(ii) allows a U.S. recipient of a distribution from a non-electing foreign trust to deduct under section 164 the section 2801 tax imposed on the portion of the distribution included in the U.S. recipient's gross income for the year. Section 28.2801-4(a)(3)(ii) of the proposed regulations provides instructions for calculating the amount of this deduction. That income tax deduction is available for the year in which the section 2801 tax is paid. Commenters questioned whether an accumulation distribution, taxable to a U.S. person in a given year, is to be included in this reference to "gross income" when computing this deduction.

Section 662(a), in effect, determines how to determine the portion of a trust's distributable net income (DNI) that is taxable to each beneficiary of the trust in a given year. That section provides that the gross income of a beneficiary of a complex trust includes both amounts required to be distributed to the beneficiary and

amounts properly distributed to the beneficiary. That section and §1.662(a)-3(c) provide that a beneficiary receiving such a distribution in a given year will recognize the distribution as gross income only to the extent the distribution is made out of the trust's DNI for the year.

Under section 665, a foreign trust's distribution to a beneficiary of income that exceeds that trust's DNI for the year is a distribution of income earned by the trust in a prior year, which is an accumulation distribution that is comprised of undistributed net income (UNI). That amount, therefore, would not be included in the reference to gross income as used in section 662(a).

Section 667(a) provides that a beneficiary receiving such an accumulation distribution must include that distribution as income in the year the distribution is received but must compute the tax on that distribution (to the extent it would have been included in the beneficiary's income under section 662) as though it had been received in a preceding taxable year. Section 667 provides the mechanism to compute the applicable income tax and interest charge on the distribution (throwback tax).

One comment suggests that the final regulations permit a deduction under section 164 of the full amount of the section 2801 tax paid on an accumulation distribution. The comments observe that, if any portion of a distribution from a non-electing foreign trust is attributable to a covered gift or covered bequest and is an accumulation distribution, the aggregate amount of the section 2801 tax and the throwback tax might exceed the amount of the distribution.

Other comments suggest limiting the total tax liability under section 2801 and the throwback tax on a specific distribution to the amount of the distribution. One comment suggests this might be achieved by reducing the amount of the distribution that is treated as an accumulation distribution. The final regulations do not adopt the commenters' suggestions that involve limiting the total tax liability, other than through a deduction under section 164 as provided in section 2801(e)(4)(B)(ii) and described above. There is no mechanism under the income tax rules to re-classify an accumulation distribution as DNI because an accumulation distribution is, by definition, income in excess of DNI. Section 2801 does not limit the total tax liability under that section or the throwback tax.

Although section 2801(e)(4)(B)(ii) uses the term *gross income*, that section merely limits the available tax deduction to tax paid on income that was subjected to income tax. The reference to gross income does not reference any particular definition of that term and thus does not appear to create a distinction between different types of taxable income. For that reason, the final regulations provide that the reference to gross income in this section includes all forms of income subject to income tax in that year, including an accumulation distribution.

Section 28.2801-4(a)(3)(ii) of the proposed regulations provides that the deduction under section 164 provided in section 2801(e)(4)(B)(ii) is available in the year in which the tax is paid or accrued. As a result, a cash method taxpayer will be entitled to the deduction only in the tax year in which the section 2801 tax is paid. Several comments suggest that the deduction instead should be available to a cash method taxpayer in the year the distribution is received and subject to income tax. The final regulations do not adopt this suggestion for the following reasons. Both section 2801(e)(4)(B)(ii) and section 164(a) allow the deduction only in the year in which the tax is paid or accrued, and references in the Code to items accrued generally do not apply to cash basis taxpayers. Congress has not provided a special rule (such as section 164(b)(4)(B) or 691(c), for example) allowing the deduction in the year of the distribution. Additionally, allowing the deduction in the year of the distribution for cash method taxpayers would be administratively difficult because the section 2801 tax for a distribution from a non-electing foreign trust attributable to a covered gift or covered bequest generally is due in the calendar year after the income tax attributable to that distribution is due (17.5 months after the close of the calendar year of receipt versus 3.5 months after the close of the calendar year). Although the deduction for section 2801 tax paid cannot be taken against the income carried out from the distribution attributable to the covered gift or bequest, the deduction can be taken against income in the year the section 2801 tax is paid (including against distributions of accumulated income). Accordingly, the final regulations retain the rule in the proposed regulations that the deduction under section 164 is available only in the year the section 2801 tax is paid or accrued.

8. Election by Foreign Trust to be Treated as Domestic Trust

Section 2801(e)(4)(B)(iii) allows a foreign trust to elect to be treated as a domestic trust solely for purposes of section 2801. That election may be revoked with the consent of the Secretary of the Treasury or her delegate, but also may be terminated by the trust's failure to comply with the requirements for maintaining a valid election. An election to be treated as a domestic trust causes the electing foreign trust to become liable for the section 2801 tax liability on covered gifts and covered bequests received by the trust, thus relieving each U.S. citizen or resident receiving a trust distribution attributable to such covered gifts or bequests from that tax liability.

A. Reporting requirements

Section 28.2801-5(d)(4) of the proposed regulations provides that the trustee of an electing foreign trust must file a timely Form 708 annually either to report and pay the section 2801 tax on all covered gifts and covered bequests received by the trust during the calendar year, or to certify that the electing foreign trust did not receive any covered gifts or covered bequests during the calendar year. One comment requests that the final regulations eliminate the requirement to file a Form 708 for years in which no covered gift or covered bequest was received. The Treasury Department and the IRS agree that the trustee's requirement to certify annually that the electing foreign trust did not receive any covered gifts or bequests creates a burden that outweighs the benefit to the enforcement and administration of the section 2801 tax. Accordingly, the final regulations do not require annual reporting for electing foreign trusts. Instead, reporting will be required only by an electing foreign trust for years in which

the total value of the covered gifts and covered bequests received by the electing foreign trust in that year exceeds the section 2801(c) amount for that year.

Section 28.2801-5(d)(3)(ii) of the proposed regulations details the requirements for a valid election. Among these is the requirement to notify and provide to the IRS information on each U.S. citizen or resident who is a permissible distributee of the trust. For this purpose, a permissible distributee is a U.S. citizen or resident who either may or must receive trust distributions, has a right (whether current or future) to withdraw income or principal from the trust, or would have been so described if either the trust or the interest of all persons so described had just terminated. Comments observe that this requirement is burdensome, infringes upon disclosure and privacy standards, and requests information that is not required to ensure that the tax is adequately administered. One comment suggests revising the requirements for making the election to be treated as a domestic trust so that only beneficiaries that have received distributions during the relevant period must be identified on Form 708. Another comment suggests adopting the standards devised for the Foreign Account Tax Compliance Act (FATCA) information reporting under sections 1471 and 1472, so that only beneficiaries who actually receive a distribution or who have a mandatory payment right during the relevant period must be identified on Form 708.

It is necessary for the trustee to provide information to the IRS on all U.S. citizens or residents who may receive distributions from the trust, because those persons may have to pay tax under section 2801 if the election terminates. Although the Treasury Department and the IRS are sensitive to the policy concerns of the commenters, this concern is outweighed by the IRS's need to obtain information from the trustee that would be necessary to assure the collection of tax should the election terminate. Additionally, because the final regulations do not require annual filings in the absence of the receipt of a covered gift or covered bequest by the electing foreign trust, as the proposed regulations did, an electing foreign trust's most recent return may be filed many years before the termination of the election (for example, if the election terminates for failure to pay 2801 tax or to file a return in a year that a contribution is made to the trust). In that event, the commenter's request would deprive the IRS of needed information about the actual distributees in the year of the termination of the election. Accordingly, the final regulations retain the definition of permissible distributee under the proposed regulations.

Section 28.2801-5(d)(3)(iv) of the final regulations confirms that the appointment of the required U.S. agent is made by filing Form 2848, *Power of Attorney and Declaration of Representative*, or as may be directed otherwise in IRS forms or publications. Merely confirming the name and identifying information of that agent on the electing trust's Form 708 is not sufficient for this purpose.

B. Termination of electing foreign trust status

Under §28.2801-5(d)(5)(ii) of the proposed regulations, an election to be treated as a domestic trust is terminated by the failure of the foreign trust to timely file Form 708 or timely pay any required section 2801 tax. The termination is effective as of the first day of the calendar year for which the failure occurs.

A comment suggests that the trustee of an electing foreign trust should be permitted to cure the late filing of Form 708 and/or late payment of the section 2801 tax to avoid the retroactive termination of the foreign trust's election to be treated as a domestic trust for purposes of the section 2801 tax. The comment contends that an opportunity to cure is needed to avoid placing a reporting burden on a U.S. citizen or resident who received a distribution during the year for which the election is being terminated.

As provided in paragraph 8.A. of the *Summary of Comments and Explanation of Revisions* section of this preamble, the final regulations do not require annual filings for electing foreign trusts for years in which the electing foreign trust receives no covered gifts or covered bequests. Accordingly, under the final regulations, an electing foreign trust's election will not terminate for the failure to file a Form 708 for such a year. The final regulations, however, require that, unless the total value of the covered gifts and covered bequests received by the electing foreign trust in a calendar year does not exceed the section 2801(c) amount, the trustee of an electing foreign trust must report all covered gifts and covered bequests received during that calendar year on a timely filed Form 708 and timely pay the section 2801 tax in full. Because the IRS may lack jurisdiction to assess tax on a foreign trustee, voluntary payment by the foreign trustee is the only way to ensure collection of section 2801 tax on an electing foreign trust. If the foreign trustee fails to pay the section 2801 tax, then the section 2801 tax must be collected from the U.S. recipient to ensure collection. Providing a grace period to file a return and make a payment of tax beyond the original due date of the required return to provide the suggested opportunity to cure is not tenable because the identity of the taxpayer during this period would be uncertain, creating confusion and delaying finality as to whether the U.S. beneficiaries of the trust or the trustee of the trust is responsible for the payment of the section 2801 tax. In addition, providing such a grace period could encourage trustees to delay payment to the end of the grace period, notwithstanding that the original due date for such payment already is more than 17.5 months after the close of the year in which the covered gift or covered bequest was received. For these reasons, the regulations provide that, unless the total value of the covered gifts and covered bequests received by the electing foreign trust in a calendar year does not exceed the section 2801(c) amount, the failure to report all covered gifts and covered bequests received on a timely filed Form 708 or to timely pay the section 2801 tax in full will result in the termination of the foreign trust's election. The final regulations in §28.2801-5(d)(5)(ii)(A)(*3*) further provide a method for the trust to affirmatively terminate its election to be treated as a domestic trust for purposes of section 2801.

C. Dispute as to amount of section 2801 tax owed

Section 28.2801-5(d)(6)(i) of the proposed regulations describes the process for resolving or otherwise accounting for proposed adjustments to the amount of the

section 2801 tax owed by an electing foreign trust. The proposed procedure entails the IRS notifying the trustee of the foreign trust of the additional tax due, including any penalties and interest, and the due date of payment. If the trustee of the electing foreign trust and the IRS are unable to come to an agreement and the trustee fails to timely pay the additional tax and other asserted amounts by the stated due date, then the election is terminated retroactively, effective as of January 1 of the year for which the Form 708 was filed and is converted as of that same date to an imperfect election. Any additional value determined by the IRS on which the foreign trust did not timely pay the section 2801 tax then is treated as a covered gift or covered bequest to the trust and should be taken into account as a covered gift or covered bequest by a U.S. recipient in computing the section 2801 ratio applicable to any distribution from the trust, although that valuation adjustment is an issue that may be challenged or otherwise resolved on examination of that U.S. recipient's Form 708 reporting a distribution.

Comments suggest that the final regulations provide the same opportunity, procedures, and rights to the electing foreign trust as are applicable to any other U.S. taxpayer, with regard to any challenge to the IRS's determination of value. One comment recommends that the IRS issue a statutory notice of deficiency to make possible these administrative and judicial review processes. Another comment suggests that allowing the electing foreign trust to resolve these valuation issues with the IRS would avoid the possibility that different trust beneficiaries might reach different resolutions of the same issue as their individual Forms 708 are separately examined by the IRS.

Establishing a statutory notice of deficiency process for resolving or otherwise addressing proposed adjustments to the amount of the section 2801 tax owed by an electing foreign trust would have a harmful effect on the IRS's ability to collect any unpaid deficiency, even a deficiency that has been reduced to judgment, given the IRS's lack of jurisdiction over the trustees and assets of a foreign trust. Additionally, if the foreign trust in such a situation refuses to pay the deficiency, it is not clear that the IRS would have the ability to assert transferee liability against a U.S. citizen or resident receiving distributions from the trust under section 6901 or 31 U.S.C. 3713. Therefore, allowing the continued validity of the election despite an unresolved dispute or unpaid tax and issuing a statutory notice of deficiency would jeopardize the IRS's ability to collect the unpaid deficiency from either the foreign trust or the U.S. recipient of a trust distribution.

Given the jurisdictional limitations and because the statute contemplates that the section 2801 tax will be paid by the electing foreign trust, the proposed procedures for handling disputes involving electing foreign trusts are the practical approach and strike the appropriate balance of fairness, administrability, and enforcement of the section 2801 tax. However, the final regulations improve administrability by clarifying in §28.2801-5(d)(6)(i) that the payment of any additional amount of section 2801 tax must be made either by the due date specified in the letter or the due date otherwise agreed to by the Commissioner. Note that the procedures as finalized also include the availability of a reasonable cause defense to the imposition of failure to file and failure to pay penalties under section 6651 on the U.S. recipient's obligations with regard to distributions made from the trust. See, for example, §28.2801-5(d)(6)(iii)(C) of the final regulations. Thus, the request of the commenters is not adopted.

9. Income Tax Effects of Section 2801 Tax

A. Income tax basis

Section 28.2801-6(a) of the proposed regulations provides that the recipient's basis in property received as a covered gift is determined under section 1015. The proposed regulations further provide that section 1015(d) does not apply to increase the basis in a covered gift by the amount of the section 2801 tax paid with respect to that covered gift. Several comments state that a basis increase should be allowed for the section 2801 tax paid with respect to a covered gift based on simple fairness and to serve the statutory goal of tax neutrality. One comment acknowledges that section 1015(d) is inapplicable to section 2801 because section 1015(d) applies only to gift taxes paid under chapter 12 of the Code, not to the taxes on covered gifts defined in chapter 15. However, this comment states that section 164 does apply to increase basis in property received as a covered gift by the amount of the section 2801 tax paid because section 164(a) treats taxes that have been paid but are not deductible under section 164 as part of the acquisition cost of the property. As such, the comment concludes that payment of the section 2801 tax does increase the recipient's basis in the property.

The comment is correct that the basis adjustment available under section 1015(d) is applicable only to gift tax paid under chapter 12. Section 2801 does not apply the rule of section 1015(d) to the section 2801 tax, which is in chapter 15 of subtitle B of the Code. However, neither does section 164 provide for an increase in the basis of property received as a covered gift by the amount of the section 2801 tax paid. The flush language in section 164(a) clarifies the treatment of certain taxes (other than those enumerated in section 164(a)) that are incurred in a trade or business or in an income-producing activity and are connected with the acquisition or disposition of property. Specifically, such taxes are treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition. *See* H. Conf. Rept. 99-841 (Vol. 2), at II-20 (1986), 1986-3 C.B. 20 (Vol. 4); *Sleiman v. Commissioner*, T.C. Memo. 1997-530 at 10. The section 2801 tax paid on the receipt of a covered gift or covered bequest does not come within this description because, by its nature, it is not a tax that is incurred in a trade or business or an income-producing activity.

The Treasury Department and the IRS understand the general proposition of the commenters that allowing a basis increase for the section 2801 tax paid with respect to a covered gift would be consistent with the rule in section 1015(d) that takes gift tax paid into account and thus would further serve the goal of tax neutrality and that such a rule might more fairly represent the acquisition cost of property received in a covered bequest. However, in order to create a special rule for an adjustment to the basis in property subject to the section

2801 tax, a statutory amendment to section 1015, 2801, or other statutory authority would be needed.

B. Deduction for portion of section 2801 tax paid attributable to income in respect of a decedent

Section 691(c)(1) provides that a person who includes an amount of income in respect of a decedent (IRD) in gross income under section 691(a) is allowed as an income tax deduction, for the same taxable year, a portion of the estate tax paid by reason of the inclusion of that IRD in the decedent's gross estate. A comment likens the estate tax paid to the section 2801 tax paid and suggests that, in the interest of tax neutrality, the final regulations should allow a U.S. recipient to deduct from gross income the portion of the section 2801 tax paid with respect to an item of IRD, when the amount of IRD is included in the U.S. recipient's gross income for the same taxable year.

Although estate tax may be similar to section 2801 tax on the receipt of a covered bequest, in section 691(c)(2)(A), Congress explicitly defined the term *estate tax* for purposes of that section as the tax imposed on the estate of a decedent under section 2001 or 2101, and did not include analogous taxes imposed under other sections of the Code such as section 2801. Furthermore, where Congress believed that a deduction for section 2801 taxes paid is appropriate, it provided for that deduction explicitly. While section 2801(e)(4)(B)(ii) provides for an income tax deduction under section 164 for a certain amount of section 2801 tax imposed on a distribution from a non-electing foreign trust included in gross income that is attributable to a covered gift or covered bequest, Congress did not provide an income tax deduction under section 691(c) for section 2801 tax that is attributable to IRD.

Additionally, the method for computing the deduction under section 691(c)(2) for estate taxes paid uses variables that are not applicable to the tax under section 2801. For instance, section 691(c)(1)(A) provides a deduction based on the "net value" for estate tax purposes of all items of IRD described in section 691(a). Section 691(c)(2)(C) provides that the net value shall be an amount equal to the excess of the estate tax over the estate tax computed without including in the gross estate such net value. Therefore, there would be no way to calculate the amount of an IRD deduction for section 2801 tax paid using the rules provided under section 691. Accordingly, in order to establish a similar regime for section 2801, the final regulations would need to contain a new set of comprehensive rules for determining the amount of a deduction against items of IRD for section 2801 tax paid.

For these reasons, adopting the commenter's suggestion would be both impractical and beyond what is provided by statute.

10. Information Reporting Under Sections 6039F and 6048(c)

Generally, sections 6039F and 6048(c), respectively, require each U.S. person (as defined for income tax purposes) who receives a gift or bequest from a foreign person or a distribution from a foreign trust to report such receipt or transaction by filing Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*. However, §28.2801-6(c)(1) and (2) of the proposed regulations provides that, for purposes of the information reporting provisions of sections 6039F and 6048(c), *U.S. person* is defined to include a U.S. citizen or resident, as that term is defined in proposed §28.2801-2(b), which adopts the gift and estate tax meaning of the term resident under subtitle B, based on domicile.

Several comments request that the final regulations revise the rule in §28.2801-6(c) of the proposed regulations to reflect that the reporting requirements under sections 6039F and 6048(c) apply to U.S. residents as the term *U.S. person* is defined for income tax purposes. See section 7701(a)(30) and (b)(1)(A). Under this suggestion, the scope of the reporting requirements on Form 3520 would not be expanded to individuals who are U.S. residents for transfer tax purposes but not for income tax purposes. The comments point out that these taxpayers who are U.S. residents only for transfer tax purposes are the same persons (other than an electing foreign trust) who will be required to file a Form 708 to report the receipt of a covered gift or covered bequest and thus that the proposed expanded scope of the reporting requirements would be duplicative and would serve no tax enforcement purpose. Consequently, the comments contend that the expanded scope of the reporting requirements would serve only to add complexity and burden to information reporting and to increase the risk of the imposition of penalties.

The Treasury Department and the IRS agree that the definition of U.S. person under section 7701(b)(1)(A) is the appropriate definition for purposes of the information reporting requirements under sections 6039F and 6048. Accordingly, the final regulations provide that the information reporting requirements in sections 6039F and 6048(c) apply only to U.S. persons within the meaning of section 7701(a)(30), and thus only apply to recipients of a covered gift or covered bequest who are U.S. persons for income tax purposes. See §28.2801-6(c)(1) and (2) of the final regulations. This will include all U.S. citizens and domestic trusts receiving covered gifts and covered bequests, as well as U.S. residents as defined for income tax purposes.

11. Determining Responsibility under Section 2801

The proposed regulations confirm, in §28.2801-7(a), that it is the responsibility of the U.S. recipient of a gift or bequest from an expatriate, or a distribution from a trust funded at least in part by an expatriate, to determine whether the expatriate is a covered expatriate and whether the gift or bequest is a covered gift or covered bequest. Proposed §28.2801-7(b)(1) further provides that, in some circumstances to be described in IRB guidance, the IRS may be permitted to disclose return or return information of the donor or decedent expatriate upon the request of a U.S. citizen or resident in receipt of a gift or bequest from such expatriate. In the event of a living donor expatriate, §28.2801-7(b)(2) of the proposed regulations creates a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift if donor does not authorize the disclosure of the donor's relevant return information.

The proposed rule further provides that a recipient may file a protective Form 708 in accordance with procedures set forth in proposed §28.6011-1(b), to start the running of the period of limitations for the assessment of any section 2801 tax in the event the recipient reasonably concludes that a gift or bequest is not subject to section 2801.

Several comments request guidance and suggest additional rules as to how a U.S. citizen or resident receiving a gift or bequest may avoid penalties and interest for nonpayment or underpayment of the section 2801 tax if the U.S. recipient incorrectly concludes that section 2801 does not apply. The comments ask how a recipient can satisfy its responsibility to ascertain whether the donor or decedent is a covered expatriate, and how to determine whether the gift or bequest is a covered gift or covered bequest. These comments note that the ability to comply is based on access to a donor's private information that the IRS may not be able to provide. These comments predict that the U.S. recipient of a gift or bequest may encounter significant impediments to gathering the necessary information about the donor or decedent. Thus, the comments request that the rebuttable presumption be eliminated, and that the final regulations provide a safe harbor for making covered expatriate determinations based on facts reasonably available to the recipient.

Comments also request that the final regulations elaborate on the acceptable criteria necessary to satisfy the due diligence requirement for filing a protective Form 708 as set forth in §28.6011-1(b) of the proposed regulations, to start the running of the period of limitations for the assessment of any section 2801 tax, and to avoid penalties. For instance, some comments suggest that reliance on a certification as to covered expatriate status provided by the living donor or the decedent's estate should be sufficient, unless the U.S. recipient has reason to believe the certification is false. Alternatively, the comment suggests that the expatriate be required, on the Form 8854, *Initial and Annual Expatriation Statement,* filed at the time of expatriating, to authorize the IRS to disclose the relevant return information to each U.S. recipient of a gift from that expatriate. Another comment suggests that requesting certain information from the IRS and carrying out a background check on the donor or decedent should be sufficient for these purposes. Comments also suggest the creation of a searchable database of Forms 8854 that would allow the identification of covered expatriates. One comment suggests requiring the IRS to have a good faith basis for alleging that a donor or decedent is a covered expatriate before assessing a section 2801 tax because, otherwise, the IRS would be forcing recipients to prove a negative even where the IRS may have actual evidence to the contrary. Finally, another comment suggests creating a presumption in the final regulations that a donor is not a covered expatriate if the donor files a Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return* and provides a copy to the U.S. recipient.

The Treasury Department and the IRS carefully considered during the development and drafting of the proposed regulations the potential difficulty a U.S. recipient may face in obtaining the information necessary to determine whether it has a tax obligation under section 2801. For the reasons stated below, the final regulations do not adopt the commenters' suggestions.

Regarding a certification as to covered expatriate status or a background check to establish that a gift or bequest is not a covered gift or covered bequest from a covered expatriate, requesting information from the donor or decedent's estate and the IRS is the most tenable option because of the factual nature of the determination and jurisdictional limitations with respect to the expatriate. For instance, although a certification from the donor or the decedent's estate provides some evidence of covered expatriate status, the particular facts in a given situation may cause the IRS to require corroborating information (for example, in the event of conflicting information discovered during examination or otherwise). As to the relevance of the filing of a Form 709 by an expatriate, the filing of a Form 709 does not suggest a determination as to covered expatriate status, although a timely filing supports a determination that a gift or bequest is excepted from the definition of a covered gift or covered bequest.

A comment suggests eliminating the rebuttable presumption in proposed §28.2801-7(b)(2) based on the contention that neither section 2801 nor the general rule-making authority provided in section 7805(a) authorize creating a rule that requires U.S. recipients of gifts and bequests to demand proof of a living donor's status. The Treasury Department and the IRS do not agree that providing a rebuttable presumption that, in certain circumstances, a living donor is a covered expatriate is beyond its regulatory authority for implementing the Congressional mandate of section 2801. A rebuttable presumption is not a mandate or final determination. Rather, a rebuttable presumption provides an opportunity and an incentive for the recipient to overcome the presumption through the exercise of due diligence. It is the recipient's responsibility to determine whether section 2801 tax liability applies to a transfer received from a donor or decedent's estate. In the absence of evidence sufficient to allow the recipient to determine whether the donor is a covered expatriate, if the living donor refuses to cooperate or otherwise fails to authorize the disclosure of relevant return information, the presumption is reasonable.

Finally, additional comments suggest that the IRS take action beyond issuing final regulations to make the information about the covered expatriate status of the donor or decedent more readily accessible. Specifically, comments suggest creating and administering a searchable and secure registry or database of expatriates and covered expatriates; modifying certain IRS forms (for example, Forms 8821, *Tax Information Authorization*, or Form W-8 BEN, *Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding and Reporting (Individuals)*), or creating new ones, to ensure only limited information relevant to the covered expatriate status of the donor or decedent is provided to the recipient. This would require the reconsideration of the retention policies and procedures of certain tax forms because section 2801 could require access to decades-old tax information.

The Treasury Department and the IRS understand the potential difficulties underlying the commenters' concerns.

However, the resolution of these concerns also must take into account both the IRS's resource constraints and disclosure and privacy concerns. Additional procedures, as requested by the commenters, may be forthcoming in guidance published in the Internal Revenue Bulletin.

12. *Recordkeeping Requirements*

Section 28.6001-1 of the proposed regulations provides that all documents and vouchers used in preparing the Form 708 must be retained by the person required to file the return so as to be available for inspection whenever required. A comment suggests that this retention standard be clarified, because it is open-ended and appears not to bear any relation to the three-to-six-year period of limitations for assessment for such return prescribed in section 6501.

The retention standard in §28.6001-1(a) of the proposed regulations is the same as the retention standard for both the estate and gift taxes under §§20.6001-1(a) and 25.6001-1(a), respectively. This expansive standard is appropriate for estate and gift tax, because the records associated with estate and gift tax returns can be relevant many years later in the context of a GST tax return, a surviving spouse's gift and/or estate tax return, and income tax basis, well after the period of limitations for assessment under section 6501 has expired for such returns. Additionally, because the gift tax and estate tax computations are cumulative in nature, the records associated with gift tax returns filed during life may be relevant many years later in the preparation and filing of the estate tax return.

The section 2801 tax is less likely than the estate and gift taxes to have application for as long a period of time after the period of limitations for assessment has expired. Therefore, upon consideration of the comments, the Treasury Department and the IRS agree that a less expansive retention standard is appropriate for the section 2801 tax. Accordingly, the final regulations adopt the more limited income tax retention standard under §1.6001-1(e), which requires documentation be retained so long as the contents thereof may become material in the administration of any internal revenue law.

13. Miscellaneous

A. Power of appointment over property not in trust

Various sections of the proposed regulations refer to a power of appointment over property that is not in trust. Multiple comments request an example, explaining that a power of appointment typically is over trust property. For purposes of the Code, the classification of an arrangement as a trust is determined under §301.7701-4 rather than under local law. Consequently, an arrangement that is classified as a trust under local law may not be a trust under the Code. Such an arrangement may include a grant of a power to an individual that is in substance a power of appointment but, because the arrangement does not constitute a trust under the Code, the power of appointment is over property that is not in trust. This is merely one example but, given the variety of arrangements worldwide that are available to a covered expatriate seeking to transfer property by gift or by reason of death, there may be several others. Because the determination of whether a certain arrangement is a power of appointment not in trust is fact specific, the final regulations do not include specific examples of a power of appointment over property that is not in trust.

B. Estate and gift tax treaties

The proposed regulations do not address the effect of estate and gift tax treaties on the section 2801 tax, except to explicitly state in several examples that the covered expatriate in the example resides in a non-treaty country. Several comments request guidance on the application of estate and gift tax treaties to section 2801 when a gift or bequest is made by a covered expatriate domiciled in a treaty country. One comment requests that the final regulations provide that section 2801 does not apply to property transfers by covered expatriates domiciled in a treaty country.

Neither the statutory language nor the legislative history of section 2801 provides any indication of Congressional intent concerning the effect of existing estate and gift treaties on the application of section 2801. In the absence of specific language overriding treaties, statutes generally are to work in harmony with existing treaties but, with the exception of certain treaty obligations in effect on August 16, 1954, neither the treaty nor the statute has preferential status. See section 7852(d). The U.S. currently has estate and gift tax treaties with Australia, Austria, Denmark, France, Germany, Japan, and the United Kingdom and estate tax-only treaties with Finland, Greece, Ireland, Italy, the Netherlands, South Africa, and Switzerland. There are also estate tax provisions in the U.S.-Canada income tax treaty. The effect of a particular treaty on the application of section 2801 to a gift or bequest by a covered expatriate in a treaty country must be evaluated on a case-by-case basis when a particular transfer falls within the reach of both section 2801 and an estate or gift tax treaty. Any unresolved issue at that time as to the effect of a particular treaty may be elevated under the competent authority procedures. In view of the above, the final regulations do not include guidance on the effect of existing gift and estate tax treaties on the application of section 2801.

C. Correction in §28.2801-6(b)

Section 28.2801-6(b) of the proposed regulations clarifies the applicability of the GST tax to certain section 2801 transfers. A comment points out that the last sentence of §28.2801-6(b) of the proposed regulations mistakenly refers to the failure to timely file and pay the section 2801 tax and suggests this language be replaced with a reference to the failure to timely file and pay the estate or gift tax under chapters 11 and 12, respectively. In the final regulations, the last sentence of §28.2801-6(b) is revised to refer to the failure to timely file an estate or gift tax return. See §28.2801-3(c)(1) and (2) of the final regulations and part 3.A.i. of the *Summary of Comments and Explanation of Revisions* section of this preamble (discussing the accepted recommendation of commenters to remove the timely paid requirement from these final regulations).

Effect on Other Documents

Announcement 2009-57, 2009-29 I.R.B. 158, is obsolete as of January 14, 2025.

Special Analyses

1. Regulatory Planning and Review

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

2. Paperwork Reduction Act

The collection of information contained in these final regulations under section 2801 is reported on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, and has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2309. The collection of information in these final regulations is in §§28.2801-4(e), 28.2801-5(d), 28.6001-1, and 28.6011-1.

The collection of information in §28.2801-4(e) is required to enable the IRS to verify that the U.S. citizens or residents who receive covered gifts and covered bequests are entitled to reduce the section 2801 tax by certain foreign taxes paid with respect to such gifts and bequests and, if so, the amount of the reduction. The collection of information is required to obtain a benefit. The likely respondents are individuals, domestic trusts, and electing foreign trusts.

The collection of information in §28.2801-5(d) is required to notify the IRS and certain U.S. citizen or resident beneficiaries of a foreign trust that the foreign trust is electing to be treated as a domestic trust for purposes of section 2801. It also is required for the IRS to verify the proper amount of the section 2801 tax due. This alerts the IRS and the U.S. citizen or resident beneficiaries that the foreign trust will be liable for payment of the section 2801 tax while the election is in effect. This collection of information is necessary for the proper performance of IRS functions in the collection of the section 2801 tax. This collection of information is required to obtain a benefit. The likely respondents are foreign trusts.

The collection of information in §28.6001-1 is required for the IRS to verify the books and records pertaining to covered gifts and covered bequests and for the proper performance of IRS functions in the collection of the section 2801 tax. It also is required to verify the receipt of covered gifts and covered bequests by U.S. citizens or residents and the value of such gifts and bequests. This collection of information is mandatory. The likely respondents are individuals and trusts.

The collection of information in §28.6011-1 is required for the IRS to verify the receipt of covered gifts and covered bequests and other information relevant to the tax imposed under section 2801. This collection of information is necessary for the proper performance of IRS functions in the collection of the section 2801 tax. This collection of information is mandatory. The likely respondents are individuals and trusts.

Estimated total annual reporting burden: 6,000 hours.

Estimated average annual burden hours per respondent: 1 hour to prepare and attach documentation to Form 708 for the reduction of the section 2801 tax for foreign taxes paid; 2 hours to elect to treat a foreign trust as a domestic trust and notify the U.S. citizen or resident beneficiaries; 1 hour to notify the U.S. citizen or resident beneficiaries that the election is terminated; and 2 hours to prepare taxpayer records and the Form 708 to report the section 2801 tax.

Estimated number of respondents: 1,000.

Estimated annual frequency of responses: Annually or less.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number.

Books and records relating to a collection of information must be retained as long as their contents might become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

3. Regulatory Flexibility Act

It is hereby certified that the collection of information contained in these regulations will not have a significant economic impact on a substantial number of small entities. These regulations do not affect small entities because they apply to individuals and certain trusts. Thus, the number of affected small entities is not substantial.

4. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The final regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

5. Executive Order 13132: Federalism

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. These proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive Order.

6. Congressional Review Act

Pursuant to the Congressional Review Act (5 U.S.C. 801 *et seq.*), the Office of Information and Regulatory Affairs designated this rule as not a major rule, as defined by 5 U.S.C. 804(2).

Availability of Documents

IRS Revenue Procedures, Revenue Rulings, Notices, and other guidance cited in this document are published in

the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at https://www.irs.gov.

Drafting Information

The principal authors of these regulations are Mayer R. Samuels, Daniel J. Gespass, and S. Eva Wolf of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 28

Taxes, Expatriate gifts and bequests, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR subchapter B as follows:

Paragraph 1. Part 28 is added to read as follows:

PART 28—IMPOSITION OF TAX ON GIFTS AND BEQUESTS FROM COVERED EXPATRIATES

Authority: 26 U.S.C. 7805.
Section 28.2801-0 through 28.2801-7 also issued under 26 U.S.C. 2801.
Section 28.6001-1 also issued under 26 U.S.C. 6001.
Section 28.6011(a)-1 also issued under 26 U.S.C. 6011 and 6011(a).
Section 28.6060-1 also issued under 26 U.S.C. 6060 and 6060(a).
Section 28.6071(a)-1 also issued under 26 U.S.C. 6071 and 6071(a).
Section 28.6081-1 also issued under 26 U.S.C. 6081 and 6081(a).
Section 28.6091-1 also issued under 26 U.S.C. 6091 and 6091(a).
Section 28.6101-1 also issued under 26 U.S.C. 6101.
Section 28.6107-1 also issued under 26 U.S. C. 6107 and 6107(c).
Section 28.6109-1 also issued under 26 U.S.C. 6109 and 6109(a).
Section 28.6151-1 also issued under 26 U.S.C. 6151.
Section 28.6694-1 through 28.6694-4 also issued under 26 U.S.C. 6694.
Section 28.6695-1 also issued under 26 U.S.C. 6695.
Section 28.6696-1 also issued under 26 U.S.C. 6696 and 6696(c).
Section 28.7701-1 also issued under 26 U.S.C. 7701.

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28.6060-1 Reporting requirements for tax return preparers.
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28.6091-1 Place for filing returns.
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28.6107-1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.
28.6109-1 Tax return preparers furnishing identifying numbers for returns or claims for refund.
28.6151-1 Time and place for paying tax shown on returns.
28.6694-1 Section 6694 penalties applicable to return preparer.
28.6694-2 Penalties for understatement due to an unreasonable position.
28.6694-3 Penalty for understatement due to willful, reckless, or intentional conduct.
28.6694-4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.
28.6695-1 Other assessable penalties with respect to the preparation of tax returns for other persons.
28.6696-1 Claims for credit or refund by tax return preparers and appraisers.
28.7701-1 Tax return preparer.

PART 28—IMPOSITION OF TAX ON GIFTS AND BEQUESTS FROM COVERED EXPATRIATES

§28.2801-0 Table of contents.

This section lists the headings in §§28.2801-1 through 28.2801-7.

§28.2801-1 Tax on certain gifts and bequests from covered expatriates.

(a) In general.
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§28.2801-2 Definitions.

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(g) Covered gift.
(h) Expatriate and covered expatriate.
(i) Indirect acquisition of property.
(j) Power of appointment.
(k) Section 2801 tax.
(l) Section 2801(c) amount.
(m) Statutory references.
(1) Code.
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§28.2801-3 Rules and exceptions applicable to covered gifts and covered bequests.

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(c) Exceptions to covered gift and covered bequest.
(1) Reported taxable gifts.
(2) Property reported as subject to estate tax.
(3) Covered bequest previously subject to section 2801 tax as a covered gift.
(4) Transfers to charity.
(5) Transfers to spouse.
(6) Qualified disclaimers.

(d) Covered gifts and covered bequests made in trust.
(e) Powers of appointment.
(1) Covered expatriate as holder of power.
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(f) Examples.
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§28.2801-4 Liability for and payment of tax on covered gifts and covered bequests; computation of tax.

(a) Liability for tax.
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(6) Powers of appointment.
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(7) Indirect receipts.
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(e) Reduction of tax for foreign gift or estate tax paid.
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(1) Section 2801 ratio.
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(ii) Computation.
(2) Effect of reported transfer and tax payment.
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(1) Election required.
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(3) Time and manner of making the election.
(i) When to make the election.
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(iv) Designation of U.S. agent.
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(C) Notice requirements upon termination.
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(1) Gifts and bequests.
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(3) Penalties and use of information.
(d) Application of penalties.
(1) Accuracy-related penalties on underpayments.
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§28.2801-7 Determining responsibility under section 2801.

(a) Responsibility of U.S. citizens or residents receiving gifts or bequests from expatriates.
(b) Disclosure of return and return information.
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(2) Rebuttable presumption.
(c) Protective return.
(d) Applicability date.

§28.2801-1 Tax on certain gifts and bequests from covered expatriates.

(a) *In general*. Section 2801 of the Internal Revenue Code (Code) imposes a tax (section 2801 tax) on covered gifts and covered bequests, including distributions attributable to covered gifts and covered bequests from non-electing foreign trusts, received by a U.S. citizen or resident from a covered expatriate during a calendar year. Domestic trusts, as well as electing foreign trusts, are subject to tax under section 2801 in the same manner as if the trusts were U.S. citizens. *See* section 2801(e)(4)(A)(i) and (B)(iii). Accordingly, the section 2801 tax is paid by the U.S. citizen or resident, domestic trust, or electing foreign trust that receives the covered gift or covered bequest, including distributions attributable to covered gifts and covered bequests from non-electing foreign trusts. For purposes of the regulations in this part 28 (26 CFR part 28), references to U.S. citizens are considered to include domestic trusts and electing foreign trusts.

(b) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.2801-2 Definitions.

(a) *Overview*. This section provides definitions of terms applicable solely for

purposes of section 2801 of the Code and the regulations in this part 28.

(b) *U.S. citizen or resident*. A *U.S. citizen or resident* is an individual who is a citizen or resident of the United States for purposes of chapter 11 or 12 of subtitle B, as the case may be, at the time of receipt of the covered gift or covered bequest. Furthermore, references to a U.S. citizen also include a domestic trust, as well as an electing foreign trust. See §28.2801-1(a).

(c) *Domestic trust*. The term *domestic trust* means a trust defined in section 7701(a)(30)(E) of the Code. References to a domestic trust include an electing foreign trust.

(d) *Foreign trust*—(1) *In general*. The term *foreign trust* means a trust defined in section 7701(a)(31)(B).

(2) *Electing foreign trust*. The term *electing foreign trust* means a foreign trust that has in effect a valid election to be treated as a domestic trust for purposes of section 2801. *See* §28.2801-5(d).

(3) *Non-electing foreign trust*. The term *non-electing foreign trust* means any foreign trust other than an electing foreign trust described in paragraph (d)(2) of this section.

(e) *U.S. recipient*. The term *U.S. recipient* means a U.S. citizen or resident, a domestic trust, or an electing foreign trust that receives a covered gift or covered bequest, whether directly or indirectly, during the calendar year. The term U.S. recipient includes a U.S. citizen or resident receiving a distribution from a non-electing foreign trust if the distribution is attributable (in whole or in part) to one or more covered gifts or covered bequests received by the non-electing foreign trust. *See* §28.2801-5(c) to determine the amount of a distribution attributable to covered gifts and covered bequests. This term also includes the U.S. citizen or resident shareholders, partners, or other interest-holders, as the case may be (if any), of a business entity that receives a covered gift or covered bequest.

(f) *Covered bequest*. The term *covered bequest* means any property acquired by a recipient on or after June 17, 2008, directly or indirectly by reason of the death of a covered expatriate, regardless of the situs of the property and of whether such property was acquired by the covered expatriate before or after expatriation from the United States, but only to the extent the property would have been included in the covered expatriate's gross estate for Federal estate tax purposes if the covered expatriate had been a U.S. citizen immediately before death. See paragraph (i) of this section for guidance in determining when property is acquired indirectly for purposes of this paragraph (f). The term *covered bequest* also includes any other property that would have been included in the covered expatriate's gross estate for Federal estate tax purposes (for example, under section 2035 of the Code) if the covered expatriate had been a U.S. citizen immediately before death, as well as distributions made by reason of the death of a covered expatriate from a non-electing foreign trust to the extent the distributions are attributable to covered gifts and covered bequests made to the non-electing foreign trust on or after June 17, 2008. *See* §28.2801-3 for additional rules and exceptions applicable to the term *covered bequest*.

(g) *Covered gift*. The term *covered gift* means any property acquired by a recipient on or after June 17, 2008, by gift directly or indirectly from an individual who is a covered expatriate at the time the property is received by the recipient, regardless of the situs of such property and of whether such property was acquired by the covered expatriate before or after expatriation from the United States. See paragraph (i) of this section for guidance in determining when property is acquired indirectly for purposes of this paragraph (g). The term *covered gift* also includes distributions made, other than by reason of the death of a covered expatriate, from a non-electing foreign trust to the extent the distributions are attributable to covered gifts and covered bequests made to the non-electing foreign trust on or after June 17, 2008. *See* §28.2801-3 for additional rules and exceptions applicable to the term covered gift.

(h) *Expatriate and covered expatriate*. The term *expatriate* has the same meaning for purposes of section 2801 as that term has in section 877A(g)(2) of the Code. The term *covered expatriate* has the same meaning for purposes of section 2801 as that term has in section 877A(g)(1). The determination of whether an individual is a covered expatriate is made as of the expatriation date as defined in section 877A(g)(3), and if an expatriate meets the definition of a covered expatriate, the expatriate is a covered expatriate for purposes of section 2801 at all times after the expatriation date. However, an expatriate is not treated as a covered expatriate for purposes of section 2801 during any period beginning after the expatriation date during which such individual is subject to United States estate or gift tax (chapter 11 or chapter 12 of subtitle B) as a U.S. citizen or resident. *See* section 877A(g)(1)(C). An individual's status as a covered expatriate will be determined as of the date of the most recent expatriation, if there has been more than one.

(i) *Indirect acquisition of property*. For purposes of paragraphs (f) and (g) of this section, an indirect acquisition of property means the receipt of an interest in property, gratuitously passed from or conferred by the covered expatriate, by or on behalf of the recipient through another person, or by a trust or entity in which the recipient has an interest, regardless of the means or device employed. Such an indirect acquisition includes but is not limited to—

(1) Property acquired by a recipient through a transfer to a corporation or other entity other than a trust or estate, to the extent of the ownership interest of the recipient in that corporation or other entity;

(2) Money paid or property distributed by a covered expatriate, or distributed from a non-electing foreign trust that received a covered gift or covered bequest, in satisfaction of a debt or liability of the recipient, regardless of the payee of that payment or distribution;

(3) Property acquired by or on behalf of a recipient pursuant to the exercise, release, or lapse (without regard to the exception in section 2041(b)(2) or 2514(e) of the Code) of a non-covered expatriate's power of appointment granted by a covered expatriate over property not in trust, unless the property previously was subjected to section 2801 tax upon the grant of the power or the covered expatriate had no more than a non-general power of appointment over that property; and

(4) Property acquired through or from any person not subject to the section 2801 tax that is, in substance, a covered gift or covered bequest from a covered expatriate.

(j) *Power of appointment*. The term *power of appointment* refers to both a general and non-general power of appointment, except as expressly limited to one or the other in a particular provision of the regulations in this part 28. The term *general power of appointment* has the same meaning as in sections 2041(b)(1) and 2514(c). The term *non-general power of appointment* means any power of appointment that is not a general power of appointment. For purposes of section 2801, the term *power of appointment* is defined without regard to the exception in section 2041(b)(2) or 2514(e).

(k) *Section 2801 tax*. The term *section 2801 tax* has the meaning provided in §28.2801-1(a).

(l) *Section 2801(c) amount*. The term *section 2801(c) amount* is the dollar amount of the per-donee gift tax exclusion in effect under section 2503(b) for that calendar year.

(m) *Statutory references*—(1) *Code*. The term *Code* means the Internal Revenue Code.

(2) *Subtitle B*. The term *subtitle B* means subtitle B of the Code.

(n) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.2801-3 Rules and exceptions applicable to covered gifts and covered bequests.

(a) *Covered gift*. Subject to the provisions of paragraphs (c) through (e) of this section, the term *gift* as used in the definition of *covered gift* in §28.2801-2(g) has the same meaning as in chapter 12 of subtitle B, but without regard to the exceptions in section 2501(a)(2), (4), and (5) of the Code, the per-donee exclusion under section 2503(b) of the Code for certain transfers of a present interest, the exclusion under section 2503(e) for certain educational or medical expenses, and the waiver of certain pension rights under section 2503(f).

(b) *Covered bequest*. Subject to the provisions of paragraphs (c) through (e) of this section, property acquired *by reason of the death of a covered expatriate* (one of the types of transfers defined as a covered bequest in §28.2801-2(f)) includes any property that would have been includible in the gross estate of the covered expatriate under chapter 11 of subtitle B if the covered expatriate had been a U.S. citizen at the time of death. Therefore, property acquired by reason of a covered expatriate's death includes, without limitation, property or an interest in property acquired by reason of a covered expatriate's death—

(1) By bequest, devise, trust provision, beneficiary designation, or other contractual arrangement, or by operation of law, to the extent the property would have been includible in the covered expatriate's gross estate if the covered expatriate had been a U.S. citizen at death;

(2) That was transferred by the covered expatriate during life, either before or after expatriation, and that would have been includible in the covered expatriate's gross estate under section 2036, 2037, or 2038 of the Code had the covered expatriate been a U.S. citizen at death;

(3) That was received for the benefit of a covered expatriate from such covered expatriate's spouse, or predeceased spouse, for which a valid qualified terminable interest property (QTIP) election was made on such spouse's, or predeceased spouse's, Form 709, *United States Gift (and Generation-Skipping Transfer) Tax Return*, Form 709-NA, *United States Gift (and Generation-Skipping Transfer) Tax Return of Nonresident Not a Citizen of the United States,* Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*, or Form 706-NA, *United States Estate (and Generation-Skipping Transfer) Tax Return, Estate of nonresident not a citizen of the United States*, which would have been includible in the covered expatriate's gross estate under section 2044 of the Code if the covered expatriate had been a U.S. citizen at death; or

(4) That otherwise passed from the covered expatriate by reason of his or her death, such as—

(i) Property held by the covered expatriate and another person as joint tenants with right of survivorship or as tenants by the entirety, but only to the extent such property would have been includible in the covered expatriate's gross estate under section 2040 of the Code if the covered expatriate had been a U.S. citizen at death;

(ii) Any annuity or other payment that would have been includible in the covered expatriate's gross estate if the covered expatriate had been a U.S. citizen at death;

(iii) Property subject to a general power of appointment held by the covered expatriate at death that would have been includible in the covered expatriate's gross estate under section 2041 if the covered expatriate had been a U.S. citizen at death; or

(iv) Life insurance proceeds payable upon the covered expatriate's death that would have been includible in the covered expatriate's gross estate under section 2042 of the Code if the covered expatriate had been a U.S. citizen at death.

(c) *Exceptions to covered gift and covered bequest*. Notwithstanding the definitions of *covered gift* and *covered bequest* in §28.2801-2(f) and (g), respectively, as further described in paragraphs (a) and (b) of this section, the terms *covered gift* and *covered bequest* do not include property described in paragraphs (c)(1) through (6) of this section.

(1) *Reported taxable gifts*. Property transferred as a taxable gift under section 2503(a) that is reported on the donor's timely filed Form 709 or Form 709-NA is not a covered gift. However, property excluded from the definition of a taxable gift, such as a present interest not in excess of the annual exclusion amount under section 2503(b), is not excluded from the definition of a covered gift under this paragraph (c)(1) even if reported on the donor's Form 709 or Form 709-NA.

(2) *Property reported as subject to estate tax*. Property that is includible in the gross estate of the covered expatriate and is reported on a timely filed Form 706, Form 706-NA, or Form 706-QDT, *U.S. Estate Tax Return for Qualified Domestic Trusts*, or any successor form, is not a covered bequest. Thus, if the covered expatriate's gross estate is not of sufficient value to require the filing of a Form 706-NA, for example, and no Form 706-NA is timely filed, the property passing from that covered expatriate is not excluded from the definition of a covered bequest under the rule of this paragraph (c)(2). Further, this exclusion does not apply to the property not reported on such a form, whether or not subject to United States estate tax (that

is, non-U.S. situs property that passes to U.S. citizens or residents).

(3) *Covered bequest previously subject to section 2801 tax as a covered gift*. If a covered bequest from a covered expatriate previously constituted a covered gift from that covered expatriate (for example, because of a retained power or right described in section 2036), the property is a covered bequest only to the extent that the value of the covered bequest exceeds the value of the covered gift that was subject to section 2801.

(4) *Transfers to charity*. A gift to a donee described in section 2522(b) of the Code or a bequest to a beneficiary described in section 2055(a) of the Code is not a covered gift or covered bequest to the extent a charitable deduction under section 2522 or 2055 would have been allowed if the covered expatriate had been a U.S. citizen at the time of the transfer.

(5) *Transfers to spouse*. Property transferred from a covered expatriate to the covered expatriate's spouse generally is not a covered gift or covered bequest to the extent a marital deduction under section 2523 or 2056 of the Code would have been allowed if the covered expatriate had been a U.S. citizen at the time of the transfer. To the extent that a gift or bequest of property to a trust (or to a separate share of the trust) would qualify for the marital deduction, the property transferred in the gift or bequest is not a covered gift or covered bequest. To the extent the gift or bequest of property to the trust (or to a separate share of the trust) would not qualify for the marital deduction, the property transferred in the gift or bequest is a covered gift or covered bequest to the trust, and in the case of a non-electing foreign trust, distributions attributable to such gift or bequest will subject the U.S. citizen or resident spouse receiving such distributions to the section 2801 tax. *See* §§28.2801-4(a)(3) and 28.2801-5(a). For qualified terminable interest property (QTIP) described in section 2056(b)(7) and for property in a qualified domestic trust (QDOT) described in section 2056A of the Code, a valid QTIP and/or QDOT election must be made by the covered expatriate or covered expatriate's estate in order for the gift or bequest of such property to qualify for the marital exclusion under section 2801(e)(3), and, thus not be a covered gift or covered bequest under this paragraph (c)(5). Such an election can be made only with respect to the transfer of property subject to gift or estate tax under section 2511(a) or 2103 of the Code. Furthermore, to exclude from covered bequests property in a QDOT for the benefit of a covered expatriate, funded pursuant to a bequest by the covered expatriate's predeceased spouse who also was a covered expatriate, a valid QDOT election must have been made in the predeceased covered expatriate's estate.

(6) *Qualified disclaimers*. Property transferred pursuant to a covered expatriate's qualified disclaimer, as defined in section 2518(b) of the Code, is not a covered gift or covered bequest from that covered expatriate.

(d) *Covered gifts and covered bequests made in trust*. For transfers of property to a trust that are covered gifts or covered bequests as described in §§ 28.2801-2 and 28.2801-3, the property is treated as a covered gift or covered bequest to the trust without regard to the beneficial interests in the trust or whether any person has a general power of appointment or a power of withdrawal over trust property. Accordingly, the rules in section 2801(e)(4) and §28.2801-4(a) apply to determine liability for payment of the section 2801 tax. The U.S. recipient of a covered gift or a covered bequest made to a domestic trust or to an electing foreign trust is the domestic or electing foreign trust, and the U.S. recipient of a covered gift or a covered bequest made to a non-electing foreign trust is each U.S. citizen or resident receiving a distribution from the non-electing foreign trust (without regard to whether that distribution is or is not pursuant to the exercise or release of a general power of appointment). *See* §28.2801-2(e) for the definition of a U.S. recipient.

(e) *Powers of appointment*—(1) *Covered expatriate as holder of power*. The exercise or release of a general power of appointment held by a covered expatriate over property, whether or not in trust (even if that covered expatriate was a U.S. citizen or resident when the general power of appointment was granted), for the benefit of a U.S. citizen or resident is a covered gift or covered bequest. For this purpose, the lapse of a general power of appointment held by a covered expatriate is treated as a release to the extent provided in sections 2041(b)(2) and 2514(e) of the Code. Furthermore, the exercise of a power of appointment by a covered expatriate that creates another power of appointment as described in section 2041(a)(3) or 2514(d) for the benefit of a U.S. citizen or resident is a covered gift or a covered bequest.

(2) *Covered expatriate as grantor of power*. The grant by a covered expatriate to an individual who is a U.S. citizen or resident of a general power of appointment over property not held in trust is a covered gift or covered bequest to the powerholder. For the rule applying to the grant by a covered expatriate of a general power of appointment over property in trust, see paragraph (d) of this section.

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

(1) *Example 1*: *Transfer to spouse*. In Year 1, CE, a covered expatriate domiciled in Country F, a foreign country with which the United States does not have a gift tax treaty, gives $300,000 cash to his wife, W, a U.S. resident and citizen of Country F. Under paragraph (c)(5) of this section, the $100,000 exclusion for a noncitizen spouse, as indexed for inflation in Year 1, is excluded from the definition of a covered gift under section 2801 because only that amount of the transfer would have qualified for the gift tax marital deduction if CE had been a U.S. citizen at the time of the gift. *See* sections 2801(e)(3), 2523(i), and 2503(b). The remaining amount ($300,000, less the $100,000 exclusion for a noncitizen spouse, as indexed for inflation) is a covered gift from CE to W. W must timely file Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, and timely pay the tax. See §§28.6011-1(a), 28.6071-1(a), and 28.6151-1(a). W also must report the transfer on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*, and any other required form. *See* §28.2801-6(c)(1).

(2) *Example 2*: *Reporting property as subject to estate tax*—(i) *Year 1*. CE, a covered expatriate domiciled in Country F, a foreign country with which the United States does not have an estate tax treaty, owns a condominium in the United States with son, S, a U.S. citizen. CE and S each contributed their actuarial share of the purchase price when purchasing the condominium and own it as joint tenants with rights of survivorship. On December 14, Year 1, CE dies. At the time of CE's death, the fair market value of CE's share of the condominium, $250,000, is included in CE's gross estate under sections 2040 and 2103.

(ii) *Year 2*. On September 14 of the following calendar year, Year 2, the executor of CE's estate timely files a Form 4768, *Application for Extension of Time to File a Return and/or Pay U.S. Estate (and Generation-Skipping Transfer) Taxes,* requesting a 6-month extension of time to file Form 706-NA, and a 1-year extension of time to pay the estate tax. The

Internal Revenue Service grants both extensions, but CE's executor fails to file the Form 706-NA until after March 14 of Year 3.

(iii) *Analysis*. S learns that the executor of CE's estate did not timely file Form 706-NA. CE's estate remains liable for estate tax on CE's interest in the condominium. In addition, because CE is a covered expatriate and CE's estate failed to timely file the tax return reporting the transaction, S received a covered bequest as defined in §28.2801-2(f) and paragraph (b) of this section and must timely file Form 708 and pay the section 2801 tax. See §§28.6011-1(a), 28.6071-1(a), and 28.6151-1(a). S also must file Form 3520 to report a large gift or bequest from a foreign person and any other required form. *See* §28.2801-6(c)(1).

(3) *Example 3*: *Covered gift in trust with grant of general power of appointment over trust property*—(i) *Facts*. On October 20, Year 1, CE, a covered expatriate domiciled in Country F, a foreign country with which the United States does not have a gift tax treaty, transfers $500,000 in cash from an account in Country F to an irrevocable foreign trust created on that same date. The foreign trust does not elect to be treated as a domestic trust for purposes of section 2801. Under section 2511(a), no gift tax is imposed on the transfer and thus, CE is not required to file a U.S. gift tax return. Under the terms of the foreign trust, A, CE's child and a U.S. resident, and Q, A's child and a U.S. citizen, may receive discretionary distributions of income and principal during life. At A's death, the assets remaining in the foreign trust will be distributed to B, CE's other U.S. resident child, or if B is not living at the time of A's death, then to CE's then-living issue, per stirpes. The terms of the foreign trust also allow A to appoint trust principal and/or income to A, A's estate, A's creditors, the creditors of A's estate, or A's issue at any time. On March 5, Year 2, A exercises this power to appoint and causes the trustee to distribute $100,000 to Q.

(ii) *Effects on Q*. On October 20, Year 1, the irrevocable, non-electing foreign trust receives a covered gift for purposes of section 2801, but no section 2801 tax is imposed at that time. On March 5, Year 2, when Q receives $100,000 from the irrevocable foreign trust pursuant to the exercise of A's power of appointment, Q receives a distribution attributable to a covered gift and section 2801 tax is imposed on Q. *See* §28.2801-4(d)(5). Q must timely file Form 708 to report the covered gift from a foreign person (specifically, from CE). *See* section 6039F(a) and §§28.6011-1(a), 28.6071-1(a), and 28.6151-1(a). Furthermore, because the $100,000 is being distributed from a foreign trust, Q must report the gift on a Form 3520 as a distribution from a foreign trust. *See* §28.2801-6(c)(2).

(iii) *Effects on A*. Although A has no section 2801 reporting requirement, under section 2501, A makes a taxable gift to Q of $100,000 when A exercises the general power of appointment for Q's benefit. *See* section 2514(b). Accordingly, A must report A's $100,000 gift to Q on a timely filed Form 709. *See* section 6019. Because A is considered the transferor of the $100,000 for gift and GST tax purposes, the distribution to Q is not a generation-skipping transfer under chapter 13. *See* §26.2652-1(a)(1) of this chapter.

(4) *Example 4*: *Lapse of power of appointment held by covered expatriate*. A, a U.S. citizen, creates an irrevocable domestic trust for the benefit of A's issue, CE, and CE's children. CE is a covered expatriate, but CE's children are U.S. citizens. CE has the right to withdraw $5,000 in each year in which A makes a contribution to the trust, but the withdrawal right lapses 30 days after the date of the contribution. In Year 1, A funds the trust, but CE fails to exercise CE's right to withdraw $5,000 within 30 days of the contribution. The $5,000 lapse is not considered to be a release of the power by CE, so it is neither a gift for U.S. gift tax purposes, nor a covered gift for purposes of section 2801 under paragraph (e)(1) of this section.

(5) *Example 5*: *Property subject to section 2801 tax as a covered gift and as a covered bequest*. F, a CE, transfers an income interest in property to A, a U.S. citizen, while retaining the remainder interest. F was not required to, and did not, file a gift tax return. Upon F's death, A receives full title to the property. The initial transfer of the income interest was a covered gift valued at $1,000,000, upon which A paid the section 2801 tax. The value of the property at F's death is $4,500,000. Because the full value of the property would have been included in F's gross estate if F had died as a U.S. citizen, there is a covered bequest at F's death. The covered bequest is subject to section 2801 tax on the excess of the value of the covered bequest over the value of the covered gift ($4,500,000 minus $1,000,000), or $3,500,000.

(g) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.2801-4 Liability for and payment of tax on covered gifts and covered bequests; computation of tax.

(a) *Liability for tax*—(1) *U.S. citizen or resident*. A U.S. citizen or resident who receives a covered gift or covered bequest is liable for payment of the section 2801 tax.

(2) *Domestic trust*—(i) *In general*. A domestic trust that receives a covered gift or covered bequest is treated as a U.S. citizen and is liable for payment of the section 2801 tax. *See* section 2801(e)(4)(A)(i) and §28.2801-2(b).

(ii) *Generation-skipping transfer tax*. A trust's payment of the section 2801 tax does not result in a taxable distribution under section 2621 of the Code to any trust beneficiary for purposes of the generation-skipping transfer tax to the extent that the trust, rather than the beneficiary, is liable for the section 2801 tax.

(iii) [Reserved].

(iv) *Migrated foreign trust*. A non-electing foreign trust that has previously received a covered gift or covered bequest and that subsequently becomes a domestic trust as defined under section 7701(a)(30)(E) of the Code (migrated foreign trust), must file a timely Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, for the taxable year in which the trust becomes a domestic trust. The section 2801 tax, if any, must be paid by the due date of that Form 708. On that Form 708, the section 2801 tax is calculated in the same manner as if such trust were making an election under §28.2801-5(d) to be treated as a domestic trust solely for purposes of the section 2801 tax. Accordingly, the trustee must report and pay the section 2801 tax on all covered gifts and covered bequests received by the trust during the year in which the trust becomes a domestic trust, as well as on the portion of the trust's value at the end of the year preceding the year in which the trust becomes a domestic trust that is attributable to all prior covered gifts and covered bequests. Because the migrated foreign trust will be treated for purposes of section 2801 as a domestic trust for the entire year during which it became a domestic trust, distributions made to U.S. citizens or residents during that year but before the date on which the trust became a domestic trust will not be subject to section 2801.

(3) *Foreign trust*—(i) *In general*. A foreign trust that receives a covered gift or covered bequest is not liable for payment of the section 2801 tax unless the trust makes an election to be treated as a domestic trust solely for purposes of section 2801 as provided in §28.2801-5(d). Absent such an election, each U.S. recipient is liable for payment of the section 2801 tax on that person's receipt, either directly or indirectly, of a distribution from the foreign trust to the extent that the distribution is attributable to a covered gift or covered bequest made to the foreign trust. *See* §28.2801-5(b) and (c) regarding distributions from non-electing foreign trusts.

(ii) *Income tax deduction*. The U.S. recipient of a distribution from a non-electing foreign trust is allowed a deduction against income tax under section 164 in the calendar year in which the U.S. recipient paid or accrued the section 2801 tax. Thus, for cash method

taxpayers, the calendar year in which the payment of the section 2801 tax occurs is later than the year in which the distribution is received and becomes subject to income tax. The amount of the deduction is equal to the portion of the section 2801 tax attributable to such distribution, but only to the extent that portion of the distribution is included in the U.S. recipient's gross income (which, for this purpose, also includes accumulation distributions under section 665(b)). The amount of the deduction allowed under section 164 is calculated as follows:

(A) First, the U.S. recipient must determine the total amount of distribution(s) from all non-electing foreign trusts treated as covered gifts and covered bequests received by that U.S. recipient during the calendar year to which the section 2801 tax payment relates.

(B) Second, of the amount determined in paragraph (a)(3)(ii)(A) of this section, the U.S. recipient must determine the amount that also is included in the U.S. recipient's gross income for that calendar year. For purposes of this paragraph (a)(3)(ii)(B), distributions from non-electing foreign trusts included in the U.S. recipient's gross income are deemed first to consist of the portion of those distributions, if any, that are attributable to covered gifts and covered bequests.

(C) Finally, the U.S. recipient must determine the portion of the section 2801 tax paid for that calendar year that is attributable to the amount determined in paragraph (a)(3)(ii)(B) of this section, the covered gifts and covered bequests received from non-electing foreign trusts that also are included in the U.S. recipient's gross income. This amount is the allowable deduction. Thus, for a calendar year taxpayer, the deduction is determined by multiplying the section 2801 tax paid during the calendar year by the ratio of the amount determined in paragraph (a)(3)(ii)(B) of this section to the total covered gifts and covered bequests received by the U.S. recipient during the calendar year to which that tax payment relates (that is, 2801 tax liability x [non-electing foreign trust distributions attributable to covered gifts and covered bequests that are also included in gross income / total covered gifts or covered bequests received]).

(b) *Computation of tax*—(1) *In general*. The section 2801 tax is computed by multiplying the net covered gifts and covered bequests (as defined in paragraph (b)(2) of this section) received by a U.S. recipient during the calendar year by the highest rate of estate tax under section 2001(c) in effect for that calendar year. See paragraph (f)(1) of this section (*Example 1*).

(2) *Net covered gifts and covered bequests*. The net covered gifts and covered bequests received by a U.S. recipient during the calendar year is the total value of all covered gifts and covered bequests received by that U.S. recipient during the calendar year, less the section 2801(c) amount, which is the dollar amount of the per-donee exclusion in effect under section 2503(b) for that calendar year. The total value of all covered gifts and covered bequests received by a U.S. recipient during the calendar year includes distributions made from a non-electing foreign trust to the extent the distributions are attributable to covered gifts or covered bequests made to the foreign trust on or after June 17, 2008.

(c) *Value of covered gift or covered bequest*. The value of a covered gift or covered bequest is the fair market value of the property as of the date of its receipt by the U.S. recipient. See paragraph (d) of this section regarding the determination of the date of receipt. As in the case of chapters 11 and 12, the fair market value of a covered gift or covered bequest is the price, as of the date of receipt, at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts. The fair market value of a covered gift is determined in accordance with the Federal gift tax valuation principles of section 2512 and chapter 14 and the corresponding regulations. The fair market value of a covered bequest is determined by applying the Federal estate tax valuation principles of section 2031 and chapter 14, to the extent applicable, and the corresponding regulations, but without regard to sections 2032 and 2032A.

(d) *Date of receipt*—(1) *In general*. The section 2801 tax is imposed upon the receipt of a covered gift or covered bequest by a U.S. recipient.

(2) *Covered gift*. The date of receipt of a covered gift is the same as the date of the gift for purposes of chapter 12 of subtitle B as if the covered expatriate had been a U.S. citizen at the time of the transfer (subject to the other provisions of this paragraph (d)). For example, for a gift of stock, if the covered expatriate delivers a properly endorsed stock certificate to the U.S. recipient, the date of delivery is the date of receipt for purposes of this section. Alternatively, if the covered expatriate delivers the stock certificate to the issuing corporation or its transfer agent in order to transfer title to the U.S. recipient, the date of receipt is the date the stock is transferred on the books of the corporation. However, for an asset or property interest subject to a claim of right of another involving a bona fide dispute, the date of receipt is the date on which such claim is extinguished.

(3) *Covered bequest*. The date of receipt of a covered bequest is the date of distribution from the estate or the decedent's revocable trust rather than the date of death of the covered expatriate (subject to the other provisions of this subparagraph (d)). However, the date of receipt for property passing on the death of the covered expatriate by operation of law, or by beneficiary designation or other contractual agreement, is the date of death of the covered expatriate. Notwithstanding the previous sentences, for an asset subject to a claim of right of another involving a bona fide dispute, the date of receipt is the date on which such claim is extinguished.

(4) *Domestic trusts and electing foreign trusts*. The U.S. recipient of a covered gift or covered bequest made to a domestic trust or an electing foreign trust is the trust. For a lifetime transfer of assets by a covered expatriate to a domestic trust or an electing foreign trust, the date of receipt of the covered gift is the date of the gift for purposes of chapter 12 of subtitle B, determined as if the covered expatriate had been a U.S. citizen at the time of the transfer. For example, in the event of a transfer by a covered expatriate to a revocable trust, the date of receipt is the later of the date the right to revoke the trust is relinquished or extinguished and the date when all powers over or interests in the trust (if any) that would prevent the transfer from being a completed transfer

for gift tax purposes (determined as if the covered expatriate had been a U.S. citizen) are extinguished. Similarly, in the event of a transfer by a covered expatriate to an irrevocable domestic trust or electing foreign trust over or in which the covered expatriate retains powers or interests that would prevent the transfer from being a completed gift for gift tax purposes (determined as if the covered expatriate had been a U.S. citizen), the date of receipt by the trust is the date all such powers or interests are extinguished. Additionally, if before the relinquishment of the right to revoke the trust or relinquishment of some other powers or interests that would render the gift incomplete (determined as if the covered expatriate had been a U.S. citizen), such trust distributes property to a U.S. recipient not in discharge of a support or other obligation of the donor, then the U.S. recipient of that distribution receives a covered gift on the date of that distribution.

(5) *Non-electing foreign trusts*. A U.S. citizen or resident is treated as receiving a covered gift or covered bequest on the date that person receives a distribution from a non-electing foreign trust attributable to a covered gift or covered bequest that was received by the trust. The date of such a receipt by a U.S. citizen or resident is the date of each distribution from the non-electing foreign trust. In the event of a sale, encumbrance, monetization, or other disposition of a U.S. recipient's interest in a non-electing foreign trust, the date of receipt is the date of such sale, encumbrance, monetization, or other disposition of the interest.

(6) *Powers of appointment*—(i) *Covered expatriate as holder of power*. In the case of the exercise, release, or lapse of a power of appointment held by a covered expatriate that is a covered gift pursuant to §28.2801-3(e)(1), the date of receipt is the date of the exercise, release, or lapse of the power. In the case of the exercise, release, or lapse of a power of appointment held by a covered expatriate that is a covered bequest pursuant to §28.2801-3(e)(1), the date of receipt is the date the property subject to the power is distributed from the decedent's estate or any trust if the power of appointment is over property in such estate or trust, or the date of the covered expatriate's death if the power of appointment is over property passing on the covered expatriate's death by operation of law, or by beneficiary designation, or other contractual agreement.

(ii) *Covered expatriate as grantor of power*. The date of receipt of property subject to a general power of appointment granted by a covered expatriate to a U.S. citizen or resident over property not transferred in trust that constitutes a covered gift or covered bequest pursuant to §28.2801-3(e)(2) is the first date on which both the general power of appointment is exercisable by the U.S. citizen or resident and the property subject to the general power of appointment has been irrevocably transferred by the covered expatriate. The date of receipt of property subject to a general power of appointment over property in a domestic trust or an electing foreign trust is determined in accordance with paragraphs (d)(2) through (4) of this section, and over property in a non-electing foreign trust is determined in accordance with paragraph (d)(5) of this section. See §28.2801-3(d) for the rule applying to covered gifts and covered bequests made in trust.

(7) *Indirect receipts*. The date of receipt by a U.S. recipient of a covered gift or covered bequest received indirectly from a covered expatriate is the date of its receipt, as determined under this paragraph (d), by the U.S. citizen or resident who is the first recipient of that property from the covered expatriate to be subject to section 2801 with regard to that property. For example, the date of receipt of property subject to a non-general power of appointment over property not held in trust given by a covered expatriate to a foreign person (other than another covered expatriate) is the date that property is received by the U.S. recipient in whose favor the power was exercised. Further, the date of receipt of property received through one or more entities not subject to section 2801 is the date of its receipt by the U.S. recipient from a conduit entity.

(8) *Future interest in property not in trust*—(i) *Date of receipt*. The date of receipt by a U.S. recipient (including a domestic trust or an electing foreign trust) of a future interest in property not held in trust is the earlier of the date such interest may be transferred by the U.S. recipient and the date that is the later of the date that such interest vests in the U.S. recipient or the date that the last intervening interest in the property is extinguished. For this purpose, a transfer includes a sale, encumbering, monetization, or other disposition of the interest.

(ii) *Date-of-receipt election for future interest in property not in trust*. A U.S. recipient of a covered gift or covered bequest that is a future interest in property not held in trust instead may elect to treat the date of receipt as the date of the donor's transfer of that future interest in the event of a covered gift, or as the date of death of the covered expatriate in the event of a covered bequest. Such an election will be made on Form 708 for the year in which this elective date of receipt occurs, in accordance with the instructions for such form.

(e) *Reduction of tax for foreign gift or estate tax paid*—(1) *In general*. The section 2801 tax is reduced by the amount of any gift or estate tax paid to a foreign country with respect to the covered gift or covered bequest. For this purpose, the term *foreign country* includes territories and political subdivisions of foreign states. However, no reduction is allowable for interest and penalties paid in connection with those foreign taxes. To claim the reduction of section 2801 tax, the U.S. recipient must attach to the Form 708 a copy of the foreign gift or estate tax return and a copy of the receipt or cancelled check for payment of the foreign gift or estate tax. The U.S. recipient also must report on an attachment to the Form 708:

(i) The amount of foreign gift or estate tax paid with respect to each covered gift or covered bequest and the amount and date of each payment thereof;

(ii) A description and the value of the property with respect to which such taxes were imposed;

(iii) Whether any refund of part or all of the foreign gift or estate tax has been or will be claimed or allowed, and the amount of such refund; and

(iv) All other information necessary for the verification and computation of the amount of the reduction of section 2801 tax.

(2) *Protective claim for refund*. A protective claim for refund under this section may be filed to preserve the U.S. recipi-

ent's right to claim a refund in the event any gift or estate tax with respect to the covered gift or covered bequest is owed but not yet paid to a foreign country until after the expiration of the period of limitation for filing a claim for refund. Such a protective claim may be filed at any time before the expiration of the period of limitation prescribed in section 6511(a) for the filing of a claim for refund and shall be made in accordance with the usual procedures for filing a claim for refund. *See* https://www.irs.gov and Form 843, *Claim for Refund and Request for Abatement*, and its instructions. Action on a protective claim will proceed after the U.S. recipient has notified the Internal Revenue Service within a reasonable period that the gift or estate tax with respect to the covered gift or covered bequest has been paid to a foreign country.

(f) *Examples*. The provisions of this section are illustrated by the following examples.

(1) *Example 1*: *Computation of tax*. In Year 1, A, a U.S. citizen, receives a $50,000 covered gift from B and an $80,000 covered bequest from C. Both B and C are covered expatriates. In Year 1, the highest estate tax rate is 40 percent and the section 2801(c) amount is $16,000. A's section 2801 tax for Year 1 is computed by multiplying A's net covered gifts and covered bequests by 40 percent. A's net covered gifts and covered bequests for Year 1 are $114,000, which is determined by reducing A's total covered gifts and covered bequests received during Year 1, $130,000 ($50,000 + $80,000), by the section 2801(c) amount of $16,000. A's section 2801 tax liability then is reduced by any foreign gift or estate tax paid under paragraph (e) of this section. Assuming A, B, and C paid no foreign gift or estate tax on the transfers, A's section 2801 tax liability for Year 1 is $45,600 ($114,000 x 0.4).

(2) *Example 2: Deduction of section 2801 tax for income tax purposes*. In Year 1, B receives a covered bequest of $25,000. Also in Year 1, B receives an aggregate $500,000 of distributions from a non-electing foreign trust of which $100,000 was attributable to a covered gift. In Year 1, the highest estate and gift tax rate is 40 percent and the section 2801(c) amount is $16,000. Based on information provided by the trustee of the non-electing foreign trust, B includes $50,000 of the aggregate distributions from the non-electing foreign trust in B's gross income for Year 1. Under paragraph (a)(3)(ii) of this section, B (a cash basis taxpayer) is entitled to an income tax deduction under section 164 for the calendar year in which the section 2801 tax is paid. In Year 2, B timely reports the distributions from the non-electing foreign trust and pays $43,600 in section 2801 tax (($125,000 - $16,000) x 0.4). In Year 2, B is entitled to an income tax deduction because B paid the section 2801 tax in Year 2 on the Year 1 covered gift and covered bequest. B's Year 2 income tax deduction is computed as follows:

(i) $100,000 of B's total covered gifts and covered bequests of $125,000 received in Year 1 consisted of the portion of the distributions from the non-electing foreign trust attributable to covered gifts and covered bequests received by the trust. See paragraph (a)(3)(ii)(A) of this section.

(ii) $50,000 of the $500,000 of trust distributions were includible in B's gross income for Year 1. This amount is deemed to consist first of distributions subject to the section 2801 tax ($100,000). Thus, the entire amount included in B's gross income ($50,000) also is subject to the section 2801 tax, and is used in the numerator to determine the income tax deduction available to B. See paragraph (a)(3)(ii)(B) of this section.

(iii) The portion of B's section 2801 tax liability attributable to distributions from a non-electing foreign trust that are both covered gifts or covered bequests and includible in B's taxable income is $17,440 ($43,600 x ($50,000/$125,000)). Therefore, B's deduction under section 164 is $17,440. See paragraph (a)(3)(ii)(C) of this section.

(3) *Example 3: Date of receipt; bona fide claim*. On October 10, Year 1, CE, a covered expatriate, died testate as a resident of Country F, a foreign country with which the United States does not have an estate tax treaty. CE designated his son, S, as the beneficiary of CE's retirement account. S is a U.S. citizen. CE's wife, W, who is a citizen and resident of Country F, elects to take her elective share of CE's estate under local law. S contests whether the retirement account is property subject to the elective share. S and W agree to settle their respective claims by dividing CE's assets equally between them. On December 15 of Year 2, Country F's court enters an order accepting the terms of the settlement agreement and dismissing the case. Under paragraph (d)(3) of this section, S received a covered bequest of one-half of CE's retirement account on December 15, Year 2, when W's claim of right was extinguished.

(g) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.2801-5 Foreign trusts.

(a) *In general*. The section 2801 tax is imposed on a U.S. recipient who receives distributions, whether of income or principal, from a non-electing foreign trust to the extent the distributions are attributable to one or more covered gifts or covered bequests made to that foreign trust. See paragraph (d) of this section regarding a foreign trust's election to be treated as a domestic trust for purposes of section 2801.

(b) *Distribution defined*. For purposes of determining whether a U.S. recipient has received a distribution from a non-electing foreign trust, the term *distribution* means any direct, indirect, or constructive transfer from a non-electing foreign trust, including a transfer to the extent made for less than full and adequate consideration in money or money's worth. Although section 643(i) of the Code does not apply for the purpose of defining a distribution under this section, certain loans from or uncompensated use of property held by a non-electing foreign trust nevertheless may satisfy the definition of a distribution under this paragraph if the loan or use of trust property would be a gift as defined for purposes of chapter 12 of subtitle B. For purposes of determining whether a U.S. recipient has received a distribution from a non-electing foreign trust, the term *distribution* also includes each distribution from a non-electing foreign trust pursuant to the exercise, release, or lapse (without regard to the exception in section 2041(b)(2) or 2514(e) of the Code) of a power of appointment, whether or not such power is a general power of appointment. In addition, the term *distribution* also includes the domestication of a foreign trust, and any sale, encumbering, monetization, or other disposition by the U.S. recipient of the recipient's interest in the trust to the extent of that disposition. *See* §28.2801-4(a)(2)(iv). The determination of whether a U.S. recipient has received a distribution is made without regard to whether any portion of the non-electing foreign trust is treated as owned by the U.S. recipient or any other person under subpart E of part I, subchapter J, chapter 1 of the Code (pertaining to grantors and others treated as substantial owners), and without regard to whether the U.S. recipient of the transfer is designated as a beneficiary by the terms of the trust. A U.S. recipient receiving a distribution for purposes of this section must determine whether the information reporting requirements of section 6048(c) apply. *See* §28.2801-6(c)(2).

(c) *Amount of distribution attributable to covered gift or covered bequest*—(1) *Section 2801 ratio*—(i) *In general*. A foreign trust may have received covered gifts and covered bequests as well as contributions that were not covered gifts or covered bequests. Under such circumstances, the fair market value of the foreign trust at any time consists, in part, of a portion of the trust attributable to the covered gifts and covered bequests it has received (covered portion) and in part of a portion of the trust attributable to other

contributions (non-covered portion). The covered portion of the trust includes the ratable portion of appreciation and income that has accrued on the foreign trust's assets from the date of the contribution of the covered gifts and covered bequests to the foreign trust. For purposes of section 2801, the amount of each distribution from the foreign trust, whether made from the income or principal of the trust, that is considered attributable to the foreign trust's covered gifts and covered bequests is determined on a proportional basis, by reference to the section 2801 ratio (as described in paragraph (c)(1)(ii) of this section), and not by the identification or tracing of particular trust assets. Specifically, this portion of each distribution is determined by multiplying the distributed amount by the percentage of the trust that consists of its covered portion immediately prior to that distribution (section 2801 ratio). Thus, for example, the section 2801 ratio of a foreign trust whose assets are comprised exclusively of covered gifts or covered bequests and the income and appreciation thereon, would be one and the full amount of each distribution from that foreign trust to a U.S. citizen or resident would be attributable to the foreign trust's covered gifts and covered bequests and subject to the imposition of section 2801 tax. Because the non-electing foreign trust itself is not taxed on its receipt of covered gifts and covered bequests, the trust is not entitled to an annual exclusion pursuant to section 2801(c); that exclusion is available only in computing the section 2801 tax payable by the U.S. recipient filing a Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*.

(ii) *Computation*. The section 2801 ratio, which must be redetermined after each contribution to the foreign trust, is computed by using the following fraction:

$$\text{Section 2801 ratio} = \frac{(X + Y)}{Z}$$

Where,

X = The value of the trust attributable to covered gifts and covered bequests, if any, immediately before the contribution (pre-contribution value); this value is determined by multiplying the fair market value of the trust assets immediately prior to the contribution by the section 2801 ratio in effect immediately prior to the current contribution. This amount will be zero for all years prior to the year in which the foreign trust receives its first covered gift or covered bequest;

Y = The portion, if any, of the fair market value of the current contribution that constitutes a covered gift or covered bequest; and

Z = The fair market value of the trust immediately after the current contribution. See paragraph (e)(1) of this section (*Example 1*), for an illustration of this computation.

(2) *Effect of reported transfer and tax payment*. With regard to the value of property on which a section 2801 tax has been timely paid, even though that property thereafter remains in a non-electing foreign trust, that value no longer is considered to be, or to be attributable to, a covered gift or covered bequest to that foreign trust for purposes of the computation described in paragraph (c)(1)(ii) of this section. For purposes of the prior sentence, a section 2801 tax is deemed to have been timely paid on amounts for which no section 2801 tax was due, provided those amounts were reported as a covered gift or covered bequest on a timely filed Form 708 or the total covered gifts and covered bequests received in a calendar year do not exceed the section 2801(c) amount. An amount for which no section 2801 tax was due refers to the amount of a covered gift or covered bequest received by an electing foreign trust not in excess of the section 2801(c) amount. *See* §28.2801-5(e) (*Example 4*).

(3) *Inadequate information to calculate section 2801 ratio*. A U.S. citizen or resident receiving a distribution from a non-electing foreign trust must proceed upon the assumption that the distribution is attributable to a covered gift or covered bequest to the extent the trustee of the foreign trust does not have sufficient books and records to calculate the section 2801 ratio or the taxpayer is unable to obtain the necessary information regarding the foreign trust to calculate the section 2801 ratio. The assumption is rebuttable to the extent the taxpayer can supply information sufficient to persuade the Internal Revenue Service (IRS) that the distribution is not entirely attributable to covered gifts and covered bequests.

(d) *Foreign trust treated as domestic trust*—(1) *Election required*. To be considered an electing foreign trust, so that the foreign trust is treated as a domestic trust solely for purposes of the section 2801 tax, a valid election is required.

(2) *Effect of election*—(i) A valid election subjects the electing foreign trust to the section 2801 tax on all covered gifts and covered bequests received by the foreign trust during that calendar year, the portion of the trust attributable to covered gifts and covered bequests received by the trust in prior years, as determined in paragraph (d)(3)(iii) of this section, and all covered gifts and covered bequests received by the foreign trust during calendar years subsequent to the first year in which the election is effective, unless and until the election is terminated. To the extent that covered gifts and covered bequests are subject to the section 2801 tax under the prior sentence, those trust receipts are no longer treated as a covered gift or covered bequest for purposes of determining the portion of the trust attributable to covered gifts and covered bequests. Therefore, upon making a valid election, the foreign trust's section 2801 ratio described in paragraph (c)(1)(ii) of this section will be zero until the effective date of any termination of the election and the subsequent receipt of any covered gift or covered bequest, and a distribution made from the foreign trust while this election is in effect is not taxable under section 2801 to the U.S. recipient.

(ii) This election has no effect on any distribution from the foreign trust that was made to a U.S. recipient in a calendar year prior to the calendar year for which the election is made. Thus, even after a valid election is made, a distribution to a U.S. recipient in a calendar year prior to the calendar year for which the election is made that was attributable to one or more covered gifts or covered bequests continues to be a distribution attributable to one or more covered gifts or covered bequests and the section 2801 ratio in place at the time of the distribution continues to apply to that distribution. Furthermore, an election under this section does not relieve the U.S. recipient from the information reporting requirements of section 6048(c). *See* §28.2801-6(c)(2).

(3) *Time and manner of making the election*—(i) *When to make the election*. The election is made on a timely filed Form 708 for the calendar year for which the foreign trust seeks to subject itself to the section 2801 tax as described in paragraph (d)(2)(i) of this section. The election may be made for a calendar year whether or not the foreign trust received a covered gift or covered bequest during that calendar year. *See* §28.6071-1.

(ii) *Requirements for a valid election*. To make a valid election to be treated as a domestic trust for purposes of section 2801, the foreign trust must timely file a Form 708 and must, on such form—

(A) Make the election, timely pay the section 2801 tax, if any, as determined under paragraph (d)(3)(iii) of this section, and include a computation illustrating how the trustee of the foreign trust calculated both the section 2801 ratio described in paragraph (c)(1)(ii) of this section and the section 2801 tax;

(B) Designate and authorize a U.S. agent as provided in paragraph (d)(3)(iv) of this section;

(C) Agree to timely file Form 708 to report each covered gift and bequest made to the trust in accordance with §28.2801-5(d)(4);

(D) Identify the amount and year of all prior distributions attributable to covered gifts and covered bequests made to a U.S. recipient, and provide the name, address, and taxpayer identification number of each U.S. recipient;

(E) Provide a copy of the governing instrument of the trust and provide the name, address, and taxpayer identification number of each permissible distributee described in paragraph (d)(3)(ii)(F) of this section; and

(F) Affirm under penalties of perjury that each permissible distributee was notified that the trustee is making (or has made) the election, effective as of January 1 of the calendar year for which the Form 708 on which the election is made is filed. For this purpose, a permissible distributee is any U.S. citizen or resident who:

(*1*) Currently may or must receive distributions from the trust, whether of income or principal;

(*2*) May withdraw income or principal from the trust during that year or in a future year, regardless of whether the right arises or lapses upon the occurrence of a future event; and

(*3*) Would be described in either or both of paragraphs (d)(3)(ii)(F)(*1*) and (*2*) of this section upon an immediate termination of either the trust or the interest of any person described in either or both of paragraphs (d)(3)(ii)(F)(*1*) and (*2*) of this section.

(iii) *Section 2801 tax payable with the election*. To make a valid election to be treated as a domestic trust for purposes of section 2801, the electing foreign trust must timely pay the section 2801 tax on all covered gifts and covered bequests received by the electing foreign trust in the calendar year for which the Form 708 is being filed. In some cases, an electing foreign trust may have received covered gifts or covered bequests in prior calendar years during which no such election was in effect. In those cases, the trustee must also, at the same time, report and pay the tax on the fair market value, determined as of the last day of the calendar year immediately preceding the year for which the Form 708 is being filed, of the portion of the trust attributable to covered gifts and covered bequests received by such trust in prior calendar years (except as provided in paragraph (d)(6)(iii) of this section with regard to an imperfect election). That portion is determined by multiplying the fair market value of the trust, as of the December 31 immediately preceding the year for which the election is made, by the section 2801 ratio in effect on that date, as calculated under paragraph (c)(1)(ii) of this section. The trustee must proceed upon the assumption that the corpus and undistributed income are attributable to covered gifts and covered bequests to the extent the trustee does not have sufficient books and records to determine what amount of the corpus and undistributed income is attributable to prior covered gifts and covered bequests. The assumption is rebuttable by the taxpayer's furnishing information sufficient to persuade the IRS that corpus and undistributed income is not attributable to prior covered gifts or covered bequests. See paragraph (c)(3) of this section.

(iv) *Designation of U.S. agent*—(A) *In general*. The trustee of an electing foreign trust must designate and authorize a U.S. person, as defined in section 7701(a)(30) of the Code, to act as an agent for the trust for purposes of section 2801. The designation and authorization are made on a duly filed Form 2848, *Power of Attorney and Declaration of Representative*, or as may be directed otherwise in IRS forms or publications. By designating a U.S. agent, the trustee of the trust agrees to provide the agent with all information necessary to comply with any information request or summons issued by the Secretary of the Treasury or her delegate (Secretary) that is relevant to the collection or determination of tax under section 2801. Such information may include, without limitation, copies of the books and records of the trust, financial statements, and appraisals of trust property.

(B) *Role of designated agent*. Acting as an agent for an electing foreign trust for purposes of section 2801 includes serving as the trust's agent for purposes of section 7602 of the Code (*Examination of books and witnesses*), section 7603 of the Code (*Service of summons*), and section 7604 of the Code (*Enforcement of summons*) with respect to—

(*1*) Any request by the Secretary to examine records or produce testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the foreign trust and distributions of such contributions and the income therefrom; and

(*2*) Any summons by the Secretary for records or testimony related to the proper identification or treatment of covered gifts or covered bequests contributed to the foreign trust and distributions of such contributions and the income therefrom.

(C) *Effect of appointment of agent*. An electing foreign trust that appoints such an agent is not considered to have an office or a permanent establishment in the United States, or to be engaged in a trade or business in the United States, solely because of the agent's activities as an agent pursuant to this section.

(4) *Filing requirement*. The trustee of an electing foreign trust must timely file a Form 708 to report and pay the section 2801 tax on all covered gifts and covered bequests received by the trust during the calendar year. *See* §28.6071-1. Nevertheless, the trustee of an electing foreign trust is not required to file Form 708 for a calendar year in which either the trust received no covered gifts or covered bequests, or

the total fair market value of all covered gifts and covered bequests received by the electing foreign trust during that calendar year is less than or equal to the section 2801(c) amount.

(5) *Duration of status as electing foreign trust*—(i) *In general*. A valid election (one that meets all of the requirements of paragraph (d)(3) of this section) is effective as of January 1 of the calendar year for which the Form 708 on which the election is made is filed. The election, once made, applies for all calendar years until the election is terminated as described in paragraph (d)(5)(ii) of this section.

(ii) *Termination*—(A) *Manner of termination*. An election to be treated as a domestic trust for purposes of section 2801 is terminated by—

(*1*) A failure of the foreign trust to timely file a required Form 708 and timely pay the section 2801 tax, as required by paragraph (d)(4) of this section;

(*2*) A failure of the foreign trust to enter into a closing agreement and to timely pay any additional amount of section 2801 tax (in accordance with the requirements of paragraph (d)(6)(i) of this section) with respect to recalculations described in paragraph (d)(6) of this section (a termination that also results in the conversion of the trust's election to an imperfect election); or

(*3*) An affirmative revocation of the election made in accordance with the instructions for Form 708.

(B) *Effective date of termination*. The effective date of the termination of an election to be treated as a domestic trust for purposes of section 2801 is as follows:

(*1*) For a termination described in paragraph (d)(5)(ii)(A)(*1*) of this section, the termination is effective as of the first day of the calendar year for which the Form 708 was required under paragraph (d)(4) of this section.

(*2*) For a termination described in paragraph (d)(5)(ii)(A)(*2*) of this section, the termination is effective as of the first day of the calendar year for which the Form 708 was filed with respect to which the additional amount of section 2801 tax is claimed to be due by the IRS.

(*3*) For a termination described in paragraph (d)(5)(ii)(A)(*3*) of this section, the termination is effective as of the first day of the calendar year for which a Form 708 was filed to affirmatively revoke the election.

(C) *Notice requirements upon termination*. In the case of a termination of the election, the trustee should notify promptly each permissible distributee of the trust, as defined in paragraph (d)(3)(ii)(F) of this section and determined as of the effective date of the termination of the election, that the foreign trust's election was terminated (or terminated and converted to an imperfect election) and the effective date of the termination, and that each U.S. recipient of a distribution made from the foreign trust on or after the effective date of that termination is subject to the section 2801 tax on the portion of each such distribution that is attributable to covered gifts and covered bequests. See paragraph (d)(6)(iii)(B) of this section for an additional notification requirement in the case of an imperfect election.

(iii) *Subsequent elections*. If a foreign trust's election is terminated under paragraph (d)(5)(ii) of this section, the foreign trust is not prohibited from making another election in a future year, subject to the requirements of paragraph (d)(3) of this section.

(6) *Dispute as to amount of section 2801 tax owed by electing foreign trust*—(i) *Procedure*. If the IRS disputes the value of a covered gift or covered bequest, or otherwise challenges the computation of the section 2801 tax, that is reported on the electing foreign trust's timely filed Form 708 for any calendar year, the IRS will issue a letter (but not a notice of deficiency as defined in section 6212 of the Code) to the trustee of the trust and the appointed U.S. agent that details the disputed information and the proper amount of section 2801 tax as recalculated. The trustee of the foreign trust must pay the additional amount of section 2801 tax including interest and penalties, if any, on or before the due date specified in the letter (or other date agreed to by the IRS) and enter into a closing agreement with the IRS as described in section 7121 to maintain its election.

(ii) *Effect of compliance*. If the trustee of the foreign trust complies with the requirements of paragraph (d)(6)(i) of this section, then the foreign trust's election to be treated as a domestic trust under paragraph (d) of this section remains in effect. In the absence of fraud, malfeasance, or misrepresentation of a material fact, any value determined in the closing agreement will be deemed to be final and binding on both the IRS and the foreign trust. Subsequently, the IRS will not challenge the amount of section 2801 tax due from either the foreign trust or any of its distributees who are U.S. citizens or residents for the year for which that Form 708 was filed by the foreign trust, except with respect to any covered gifts or covered bequests not reported on that return. In addition, neither the foreign trust nor any of its distributees will be able to file a claim for refund with respect to section 2801 tax paid by the foreign trust on the covered gifts and covered bequests reported on that Form 708.

(iii) *Effect of failing to comply (imperfect election)*—(A) *In general*. If the foreign trust fails to enter into the closing agreement and to timely pay any of the additional amount of section 2801 tax (with interest and penalties, if any) determined to be due by the IRS in accordance with the procedure in paragraph (d)(6)(i) of this section, then the foreign trust's valid election is terminated and is converted to an imperfect election. The conversion to an imperfect election is retroactive to the first day of the calendar year (subject year) for which the Form 708 was filed with respect to which the additional amount of section 2801 tax is claimed to be due by the IRS. The trust will be a non-electing foreign trust for the subject year and for each subsequent year until another valid election (if any) is made by the trust. However, the value the foreign trust reported on the Form 708 for the subject year and each other year during the interim period described in paragraph (d)(6)(iii)(D) of this section, and on which the trust paid the section 2801 tax, is no longer considered to be attributable to covered gifts or covered bequests when computing the section 2801 ratio (described in paragraph (c)(1)(ii) of this section) that will be applicable to distributions made by the foreign trust to U.S. recipients during the subject year and thereafter until the effective date of any subsequent election meeting the requirements of paragraph (d)(3) of this section. The U.S. recipients of distributions from the foreign trust, however, should take into consideration the

additional value determined by the IRS, on which the foreign trust did not timely pay the section 2801 tax, when computing the section 2801 ratio to be applied to a distribution from the trust. See paragraph (c) of this section. Any disagreement with regard to that additional value will be an issue to be resolved as part of the review of that U.S. recipient's own Form 708 reporting a distribution.

(B) *Notice to permissible distributees*. If the trustee of the foreign trust fails to enter into the closing agreement and to remit, by the due date specified or otherwise agreed to by the IRS, the additional section 2801 tax, including all interest and penalties, in accordance with the procedure in paragraph (d)(6)(i) of this section, the trustee should notify promptly each permissible distributee, as defined in paragraph (d)(3)(ii)(F) of this section:

(*1*) That the foreign trust's election was terminated and the effective date of the termination (see paragraph (d)(5)(ii)(B)(*2*) of this section);

(*2*) Of the amount of additional value on which the foreign trust did not timely pay the section 2801 tax as determined or otherwise agreed to by the IRS, which value the IRS thus deems to be attributable to covered gifts and covered bequests; and

(*3*) That each U.S. recipient of a distribution made from the foreign trust on or after that termination date is subject to the section 2801 tax on the portion of each such distribution attributable to covered gifts and covered bequests.

(C) *Reasonable cause*. If a U.S. recipient received a distribution from the foreign trust on or after January 1 of the year for which the election was terminated and the election became an imperfect election, provided the U.S. recipient files a Form 708 and pays the section 2801 tax within a reasonable period of time after being notified by the trustee of the foreign trust or otherwise becoming aware that a valid election was not in effect when the distribution was made, the U.S. recipient's failure to timely file and pay are due to reasonable cause and not willful neglect for purposes of section 6651. For this purpose, a reasonable period of time is not more than six months after the U.S. recipient is notified by the trustee or otherwise becomes aware that a valid election is not in effect.

(D) *Interim period*. If a foreign trust's valid election is terminated and becomes an imperfect election, there is a period of time (interim period) that begins on the effective date of the termination of the election (see paragraph (d)(5)(ii)(B) of this section) during which both the foreign trust and its U.S. beneficiaries are likely to continue to comply with section 2801 as it applies to an electing foreign trust with a valid election in place. The interim period ends on the earlier of December 31 of the calendar year during which the additional amount of section 2801 tax was due to be paid, as described in paragraph (d)(6)(i) of this section, or the effective date of a subsequent valid election to be treated as a domestic trust for purposes of section 2801. As described in paragraph (d)(6)(iii)(A) of this section regarding imperfect elections, the value of the covered gifts and covered bequests received by the foreign trust during this interim period, which the foreign trust has reported on one or more filed Forms 708 and on which the foreign trust has paid the section 2801 tax, is no longer considered to be attributable to covered gifts and covered bequests for purposes of computing the section 2801 ratio described in paragraph (c)(1)(ii) of this section as it applies to distributions made by non-electing foreign trusts to their U.S. beneficiaries. In addition, each distribution made by the foreign trust to a U.S. citizen or resident during this interim period must be reported on that U.S. recipient's Form 708 by applying the section 2801 ratio to that distribution. If, once the interim period has ended, the foreign trust has no election in place, the rules of section 2801(e)(4)(B)(i) will apply until the foreign trust subsequently (if ever) makes another valid election to be treated as a domestic trust for purposes of section 2801.

(7) *No overpayment caused solely by virtue of defect in election*. Any remittance of section 2801 tax made by an electing foreign trust does not become an overpayment solely by virtue of a defect in the election. Instead, if at some subsequent time the IRS determines that the election was not in fact a valid election, then the election shall be considered valid only with respect to the value of the covered gifts or covered bequests on which the section 2801 tax was paid by the foreign trust and such value on which the section 2801 tax has been paid is no longer treated as attributable to a covered gift or covered bequest for purposes of determining the portion of the foreign trust attributable to covered gifts and covered bequests. See paragraphs (d)(2)(i) and (6)(iii) of this section.

(e) *Examples*. The provisions of this section are illustrated by the following examples.

(1) *Example 1: Computation of section 2801 ratio*. A and B each contribute $100,000 to a new foreign trust. A (but not B) is a covered expatriate and A's contribution is a covered gift. The trustee of the trust does not make a valid election to have the trust treated as a domestic trust for purposes of section 2801. The section 2801 ratio immediately after these two contributions is 0.50, computed as follows: the pre-contribution value of the trust ($0) multiplied by the pre-contribution section 2801 ratio (0), plus the current covered gift ($100,000), divided by the post-contribution fair market value of the trust ($200,000). *See* §28.2801-5(c). Therefore, 50 percent of each distribution from the trust to a U.S. recipient is subject to the section 2801 tax until the next contribution is made to the trust. If the trustee distributes $40,000 to C, a U.S. citizen, before the trust receives any other contributions, then $20,000 ($40,000 x 0.5) is a covered gift to C.

(2) *Example 2: Distribution to spouse*. In Year 1, A contributes $300,000 to a foreign trust. A is a covered expatriate. B, A's U.S. citizen spouse, and A's issue may receive discretionary distributions of income and principal. The transfer would not have qualified for the gift tax marital deduction if A had been a U.S. citizen or resident at the time of the gift; therefore, A's contribution is a covered gift. *See* sections 2801(e)(3) and 2523. No one pays foreign gift taxes on A's contribution. The trustee of the trust does not make a valid election to have the trust treated as a domestic trust for purposes of section 2801. The section 2801 ratio immediately after A's contribution is one. The highest gift tax rate is 40 percent, and the section 2801(c) amount is $17,000. The trustee distributes $200,000 to B in Year 1. The entire amount is a covered gift to B. *See* section 28.2801-3(c)(5). This is the only covered gift B receives in Year 1. B receives no covered bequests in Year 1. B's section 2801 tax for Year 1 is computed by multiplying B's net covered gift by 40 percent. B's net covered gift for Year 1 is $183,000, which is determined by reducing B's covered gift received during Year 1 by the section 2801(c) amount. B's section 2801 tax liability for Year 1 is $73,200 ($183,000 x 0.4).

(3) *Example 3*: *Computation of section 2801 ratio when multiple contributions are made to foreign trust*. (i) In 2005, A, a U.S. citizen, established and funded an irrevocable foreign trust with $200,000. On January 1 of each of the following three years (2006 through 2008), A contributed an additional $100,000 to the foreign trust. A reported A's contributions to the foreign trust as completed gifts on timely filed Forms 709, for calendar years 2005 through 2008. None of these contributions is a covered gift because the gifts predated the effec-

tive date of section 2801. On August 8, 2008, a date after the effective date of section 2801 (June 17, 2008), A expatriated and became a covered expatriate. On January 1 of a year after 2008 (Year X), A makes an additional $100,000 contribution to the trust. The aggregate $600,000 contributed to the trust by A, both before and after expatriation, are the only contributions to the trust. The trustee of the foreign trust does not make a valid election to have the trust treated as a domestic trust for purposes of section 2801. Each year, the trustee of the foreign trust provides beneficiary B, a U.S. citizen, with an accounting of the trust showing each receipt and disbursement of the trust during that year, including the date and amount of each contribution by A.

(ii) The fair market value of the trust was $610,000 immediately prior to A's contribution to the trust on January 1, Year X. Therefore, upon the Year X contribution of A's first and only covered gift, the portion of the trust attributable to covered gifts and covered bequests (covered portion) changed from zero to 0.14 ([(section 2801 ratio of 0 x $610,000 fair market value pre-contribution) plus the $100,000 covered gift]/ $710,000 fair market value post-contribution). See paragraph (c) of this section.

(iii) In February of Year X, B received a distribution of $225,000 from the foreign trust. Although A contributed a total of $600,000 to the foreign trust, only $100,000 of that total was a covered gift, being the only contribution made by A both after the enactment of section 2801 and after A's expatriation. Under paragraph (c) of this section, the portion of the $225,000 distribution from the foreign trust attributable to a covered gift is $31,500 ($225,000 x 0.14 (section 2801 ratio)) because the distribution is made proportionally from the covered and non-covered portions of the trust. See paragraph (c)(1) of this section. Accordingly, B received a covered gift of $31,500.

(iv) Pursuant to the terms of the foreign trust, the trust made a terminating distribution on August 5, Year X, when B turned 35, and B received the balance of the appreciated trust, $505,000. The portion of this distribution attributable to covered gifts and covered bequests is $70,700 ($505,000 x 0.14). Therefore, B has received covered gifts from the foreign trust during Year X in the total amount of $102,200 ($31,500 + $70,700).

(4) *Example 4: Termination of election*. (i) In Year 1, A contributes $200,000 and B contributes $100,000 to Trust, a foreign trust. A and B are covered expatriates. A's and B's contributions are covered gifts. No one pays foreign gift taxes on A's and B's contributions. The trustee of Trust makes a valid election to have Trust treated as a domestic trust for purposes of section 2801. The highest gift tax rate is 40 percent, and the section 2801(c) amount is $17,000. The section 2801 tax for Year 1 is computed by multiplying the net covered gifts and covered bequests by 40 percent. The net covered gifts and covered bequests for Year 1 total $283,000, determined by reducing the covered gifts and covered bequests received by Trust during Year 1, $300,000, by the section 2801(c) amount, $17,000. Trust's 2801 tax liability for Year 1 is $113,200 ($283,000 x 0.4). Any distributions made to U.S. recipients before the trust receives another contribution have a section 2801 ratio of zero and are not subject to the section 2801 tax. See paragraph (d)(2)(i) of this section.

(ii) In Year 2, A contributes $100,000 to Trust, all of which is a covered gift. The trustee of Trust fails to timely file a Form 708 for Year 2 and timely pay the section 2801 tax. The fair market value of Trust was $400,000 immediately prior to A's contribution. The section 2801 ratio immediately after A's contribution is 0.20, computed as follows: the pre-contribution value of Trust ($400,000) multiplied by the section 2801 ratio in effect immediately prior to the Year 2 contribution (0), plus the fair market value of the Year 2 contribution that constitutes a covered gift ($100,000), divided by the fair market value of Trust after the Year 2 contribution ($500,000). See paragraph (c)(1) and (2) of this section. If the trustee distributes $40,000 to C, a U.S. citizen, after the contribution in Year 2, then $8,000 ($40,000 x 0.20) is a covered gift to C. In Year 2, C also receives a covered gift of $50,000 directly from B. No one pays foreign gift taxes on B's covered gift. C receives no covered bequests in Year 2. C's section 2801 tax for Year 2 is computed by multiplying C's net covered gifts and covered bequests by 40 percent. C's net covered gifts and covered bequests for Year 2 total $41,000, determined by reducing the covered gifts and covered bequests received by C during Year 2, $58,000 ($8,000 + $50,000), by the section 2801(c) amount, $17,000. C's section 2801 tax liability for Year 2 is $16,400 ($41,000 x 0.4).

(5) *Example 5: Imperfect election of foreign trust*. (i) In Year 1, CE, a covered expatriate, gives a 20 percent limited partnership interest in a closely held business to a foreign trust created for the benefit of CE's child, A, who is a U.S. citizen. The limited partnership interest is a covered gift. The trustee of the foreign trust makes a valid election to have the trust treated as a domestic trust for purposes of section 2801, trustee timely files a Form 708, reports the fair market value of the covered gift as $500,000, and timely pays the section 2801 tax on the reported fair market value of the covered gift. Later in Year 1, the trust makes a $100,000 distribution to A.

(ii) In Year 2, CE contributes $200,000 in cash to the foreign trust. The cash is a covered gift. The trustee of the foreign trust timely files a Form 708 reporting the transfer and pays the section 2801 tax. The trust does not make a distribution to any beneficiary during Year 2. In Year 3, the IRS disputes the reported value of the partnership interest transferred in Year 1 and determines that the proper valuation on the date of the gift was $800,000. In Year 3, the IRS issues a letter to the trustee of the foreign trust detailing its finding of the increased valuation and of the resulting additional section 2801 tax including accrued interest, if any, due on or before a later date in Year 3 specified in the letter. The foreign trust fails to pay the additional section 2801 tax liability on or before that due date.

(iii) Under paragraph (d)(6)(iii) of this section, the foreign trust's election for Year 1 is terminated and converted into an imperfect election as of January 1 of Year 1. In computing the foreign trust's section 2801 ratio for Year 1, the $500,000 of value on which the section 2801 tax was timely paid is no longer considered to be attributable to a covered gift. See paragraph (d)(6)(iii) of this section. When the trustee advises A of the letter from the IRS, A must file a late Form 708 reporting the portion of the Year 1 distribution attributable to covered gifts and covered bequests. Although A may owe section 2801 tax and interest, A will not owe any penalties under section 6651 as long as A files the Form 708 and pays the tax within six months after A receives notice of the termination of the election from the trustee of the foreign trust or otherwise becomes aware of the termination of the election. See paragraph (d)(6)(iii)(C) of this section.

(iv) When A files a Form 708 to report the Year 1 distribution, the IRS will verify whether A treated the $300,000 undervaluation claimed by the IRS as a covered gift in computing the section 2801 ratio. As with any other item reported on that return, A has the burden to prove the value of the covered gift to the foreign trust, and the IRS may challenge that value. If A treats the $300,000 as a covered gift to the trust, under paragraph (c)(1)(ii) of this section, the section 2801 ratio after the Year 1 contribution is 0.375 ($0 + ($300,000)/$800,000)). Thus, 37.5 percent of all distributions made to A from the foreign trust during Year 1 are subject to the section 2801 tax (plus interest from the due date of the tax as if reported on a Form 708 that was timely filed as to Year 1).

(v) Although the foreign trust timely filed the Form 708 for Year 2 and timely paid the section 2801 tax shown on that return, and although the foreign trust's election had not yet been terminated and converted into an imperfect election during Year 2, the foreign trust nevertheless did not have a valid election for Year 2 because the trust did not timely pay the section 2801 tax on all covered gifts and covered bequests received in prior years as required in paragraph (d)(3) of this section, specifically, the tax on the additional $300,000 of value of the Year 1 transfer. However, under paragraph (d)(6)(iii)(D) of this section, because the foreign trust timely filed the Form 708 and paid the section 2801 tax on the Year 2 covered gift of $200,000, the $200,000 amount is no longer considered a covered gift for purposes of computing the section 2801 ratio after that contribution.

(6) *Example 6: Subsequent election after termination of election*. The facts are the same as in paragraph (e)(5) of this section (*Example 5*). In Year 3, the foreign trust does not receive a covered gift or covered bequest. However, the trustee decides that making another election to be treated as a domestic trust would be in the best interests of the trust's beneficiaries. Accordingly, by the due date for the Form 708 for Year 3, the trustee timely files the return and pays the section 2801 tax on the portion of the trust attributable to covered gifts and covered bequests. See paragraph (d)(5)(iii) of this section. The trustee calculates the portion of the trust attributable to covered gifts and covered bequests received by the trust in prior calendar years by multiplying the fair market value of the trust on December 31, Year 2, by the section 2801 ratio in effect on that date. See paragraph (d)(3)(iii) of this section. The foreign trust is an electing foreign trust in Year 3.

(f) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.2801-6 Special rules and cross-references.

(a) *Determination of basis*. For purposes of determining the U.S. recipient's basis in property received as a covered gift or covered bequest, see sections 1015 and 1014 of the Code, respectively. However, the basis adjustment provided in section 1015(d) does not apply to increase the basis in a covered gift to reflect the tax paid under this section.

(b) *Generation-skipping transfer tax*. Transfers made by a nonresident not a citizen of the United States (NRNC transferor) are subject to generation-skipping transfer (GST) tax only to the extent those transfers are subject to Federal estate or gift tax as described in §26.2652-1(a)(2) of this chapter. In applying this rule, taxable distributions and taxable terminations are subject to the GST tax only to the extent the NRNC transferor's contributions to the trust, as defined in §26.2652-1(b)(1) of this chapter, were subject to Federal estate or gift tax as described in §26.2652-1(a)(2) of this chapter. *See* §26.2663-2 of this chapter. A transfer is subject to Federal estate or gift tax, regardless of whether a Federal estate or gift tax return reporting the transfer is timely filed and regardless of whether chapter 15 of the Code applies because of a covered expatriate's failure to timely file an estate or gift tax return.

(c) *Information returns*—(1) *Gifts and bequests*. Pursuant to section 6039F of the Code and any corresponding regulations and Form 3520, Part IV, each U.S. person who treats an amount received from a foreign person (other than through a foreign trust) as a gift or bequest (whether or not a covered gift or covered bequest) must report such gift or bequest on Part IV of Form 3520 if the value of the total of such gifts and bequests exceeds a certain threshold. For purposes of this provision, a U.S. person is as defined in section 7701(a)(30) of the Code and includes a U.S. resident within the meaning of section 7701(b)(1)(A) of the Code.

(2) *Foreign trust distributions*. Pursuant to section 6048(c) of the Code and the corresponding regulations, and to the extent provided in Notice 97–34 and Part III of Form 3520 and its Instructions, a U.S. person must report each distribution received during the taxable year from a foreign trust on Part III of Form 3520. Under section 6677(a) of the Code, a penalty of the greater of $10,000 or 35 percent of the gross value of the distribution may be imposed on a U.S. person who fails to timely report the distribution. For purposes of this provision, the term *U.S. person* is as defined in section 7701(a)(30) and includes both U.S. citizens and U.S. residents within the meaning of section 7701(b)(1)(A).

(3) *Penalties and use of information*. The filing of Form 706, Form 706-NA, Form 706-QDT, Form 708, Form 709, or Form 709-NA, or any successor form, does not relieve a U.S. citizen or resident who is required to file Form 3520 from any penalties imposed under section 6677(a) for failure to comply with section 6048(c), or from any penalties imposed under section 6039F(c) of the Code for failure to comply with section 6039F(a). Pursuant to section 6039F(c)(1)(A), the Secretary of the Treasury or her delegate may determine the tax consequences of the receipt of a purported foreign gift or bequest.

(d) *Application of penalties*—(1) *Accuracy-related penalties on underpayments*. The section 6662 accuracy-related penalty may be imposed upon any underpayment of tax attributable to—

(i) A substantial valuation understatement under section 6662(g) of a covered gift or covered bequest; or

(ii) A gross valuation misstatement under section 6662(h) of a covered gift or covered bequest.

(2) *Penalty for substantial and gross valuation misstatements attributable to incorrect appraisals*. The section 6695A penalty for substantial and gross valuation misstatements attributable to incorrect appraisals may be imposed upon any person who prepares an appraisal of the value of a covered gift or covered bequest.

(3) *Penalty for failure to file a return and to pay tax*. See section 6651 for the application of a penalty for the failure to file Form 708, or the failure to pay the section 2801 tax.

(e) *Applicability date*. This section applies on and after January 14, 2025.

§28.2801-7 Determining responsibility under section 2801.

(a) *Responsibility of U.S. citizens or residents receiving gifts or bequests from expatriates*. It is the responsibility of the taxpayer (in this case, the U.S. citizen or resident receiving a gift or bequest from an expatriate or a distribution from a foreign trust funded at least in part by an expatriate) to ascertain the taxpayer's obligations under section 2801 of the Code, which includes making the determination of whether the transferor is a covered expatriate and whether the transfer is a covered gift or covered bequest.

(b) *Disclosure of return and return information*—(1) *In general*. In certain circumstances, the Internal Revenue Service (IRS) may be permitted, upon request of a U.S. citizen or resident in receipt of a gift or bequest from an expatriate, to disclose to the U.S. citizen or resident return or return information of the donor or decedent expatriate that may assist the U.S. citizen or resident in determining whether the donor or decedent was a covered expatriate and whether the transfer was a covered gift or covered bequest. *See* section 6103 of the Code. The U.S. citizen or resident may not rely upon this information, however, if the U.S. citizen or resident knows, or has reason to know, that the information received from the IRS is incorrect or incomplete. The circumstances under which such information may be disclosed to a U.S. citizen or resident, the process for authorizing disclosures, and the procedures for requesting such information from the IRS, will be as provided by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(2) *Rebuttable presumption*. Unless a living donor expatriate authorizes the disclosure of the donor expatriate's relevant return or return information to the U.S. citizen or resident receiving the gift, there is a rebuttable presumption that the donor is a covered expatriate and that the gift is a covered gift.

(c) *Protective return*. A taxpayer who reasonably concludes that a gift or bequest is not subject to section 2801 may file a protective Form 708 to start the period of limitations for the assessment of any section 2801 tax. See §28.6011-1(b) that provides safe harbor procedures for filing a protective Form 708.

(d) *Applicability date*. This section applies on and after January 14, 2025.

§28.6001-1 Records required to be kept.

(a) *In general*. Every U.S. recipient (as defined in §28.2801-2(e)) subject to taxation under chapter 15 of subtitle B must keep, for the purpose of determining the total amount of covered gifts and covered bequests, such permanent books of account or records as are necessary to establish the amount of that person's aggregate covered gifts and covered bequests, and the other information required to be shown on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, or any successor form. All documents and vouchers used in preparing Form 708 must be retained by the person required to file the return so as to be available for inspection so long as the contents thereof may become material in the administration of any internal revenue law.

(b) *Supplemental information*. The U.S. recipient, as defined in §28.2801-2(e), must furnish such supplemental information as may be deemed necessary by the Internal Revenue Service (IRS) to allow the IRS to determine the correct amount of tax. Therefore, the U.S. recipient must furnish, upon request, copies of all documents relating to the covered gift or covered bequest, appraisals of any items included in the aggregate amount of covered gifts and covered bequests, copies of balance sheets and other financial statements obtainable by that person relating to the value of stock or other property constituting the covered gift or covered bequest, and any other information obtainable by that person that may be necessary in the determination of the tax. See section 2801 of the Code and the corresponding regulations. For every policy of life insurance listed on the return, the U.S. recipient must procure a statement from the insurance company on Form 712, *Life Insurance Statement,* or any successor form, and file it with the IRS office where the return is filed. If specifically requested by the IRS, the insurance company must file this statement directly with the IRS.

(c) *Applicability date*. This section applies on and after January 14, 2025.

§28.6011-1 Returns.

(a) *Return required*. The return of any section 2801 tax imposed by chapter 15 of subtitle B of the Internal Revenue Code (Code) must be made on Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, in accordance with the instructions applicable to the form (or on such other form as may be provided in future guidance or instructions). With respect to each covered gift and covered bequest received during the calendar year, the U.S. recipient as defined in §28.2801-2(e) must include on Form 708 the information set forth in §25.6019-4 of this chapter. The U.S. recipient must file Form 708 for each calendar year in which the U.S. recipient receives a covered gift or covered bequest. The U.S. recipient who receives the covered gift or covered bequest during the calendar year is the person required to file the return. A U.S. recipient is not required to file such form, however, for a calendar year in which the total fair market value of all covered gifts and covered bequests received by that person during that calendar year is less than or equal to the section 2801(c) amount (as defined in §28.2801-2(l)).

(b) *Protective return safe harbor*. A U.S. citizen or resident (as defined in §28.2801-2(b)) who receives a gift or bequest from an expatriate and reasonably concludes that the gift or bequest is not a covered gift or a covered bequest from a covered expatriate may file a protective Form 708 to start the running of the period of limitations for assessment of tax. Under the safe harbor procedure of this paragraph (b), a Form 708 will start the running of the period of limitations for assessment of tax if the return includes all of the information otherwise required on Form 708, along with an affidavit, signed under penalties of perjury, setting forth the information on which the U.S. citizen or resident has relied in concluding that the donor or decedent, as the case may be, was not a covered expatriate, or that the transfer was not a covered gift or a covered bequest, as well as that person's efforts to obtain other information that might be relevant to these determinations. For purposes of this safe harbor, if the U.S. citizen or resident has obtained, and is permitted to rely on, information from the Internal Revenue Service (IRS) (as described in §28.2801-7(b)(1)), the U.S. citizen or resident must attach a copy of such information to the protective return. For purposes of this safe harbor, the U.S. citizen or resident also must attach a copy of a completed Part III of Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts,* for all trust distributions, or Part IV of Form 3520 for all gifts and bequests, if applicable.

(c) *Applicability date*. This section applies on and after January 14, 2025.

§28.6060-1 Reporting requirements for tax return preparers.

(a) *In general*. A person that employs one or more signing tax return preparers to prepare a return or claim for refund of section 2801 tax, other than for that person, at any time during a return period, must satisfy the recordkeeping and inspection requirements in the manner stated in §1.6060-1 of this chapter.

(b) *Applicability date*. This section applies with regard to returns and claims for refund filed on or after January 14, 2025.

§28.6071-1 Time for filing returns.

(a) *In general*—(1) *Due Date.* A U.S. recipient, as defined in §28.2801-2(e), must file Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, or any substitute or successor form specified in guidance or instructions, on or before the fifteenth day of the eighteenth calendar month following the close of the calendar year in which the covered gift or covered bequest was received. Notwithstanding the preceding sentence, the due date for a Form 708 reporting a covered bequest that is not received on the decedent's date of death under §28.2801-4(d)(3) is the later of—

(i) The fifteenth day of the eighteenth calendar month following the close of the calendar year in which the covered expatriate died; or

(ii) The fifteenth day of the sixth month of the calendar year following the close of the calendar year in which the covered bequest was received.

(2) If a U.S. recipient receives multiple covered gifts and covered bequests during the same calendar year, the rule in para-

graph (a)(1) of this section may result in different due dates and the filing of multiple returns reporting the different transfers received during the same calendar year.

(b) *Migrated foreign trust*. The due date for a Form 708 for the year in which a foreign trust becomes a domestic trust is the fifteenth day of the sixth month of the calendar year following the close of the calendar year in which the foreign trust becomes a domestic trust.

(c) *Certain returns by foreign trusts with election under §28.2801-5(d) for calendar year in which no covered gift or covered bequest received*. A foreign trust making an election to be treated as a domestic trust for purposes of section 2801 under §28.2801-5(d) (electing foreign trust) for a calendar year in which the foreign trust received no covered gifts or covered bequests must file a Form 708 on or before the fifteenth day of the sixth month of the calendar year following the close of the calendar year for which the election is made.

(d) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.6081-1 Extension of time for filing returns reporting gifts and bequests from covered expatriates.

(a) *In general*. A U.S. recipient as defined in §28.2801-2(e) may request an extension of time to file a Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, by filing an appropriate form for extension as specified by guidance or instructions. A U.S. recipient must include on the form for extension an estimate of the amount of section 2801 tax liability and must file the form for extension with the Internal Revenue Service in the manner designated in the instructions issued with respect to such form.

(b) *Automatic extension*. A U.S. recipient as defined in §28.2801-2(e) will be allowed an automatic six-month extension of time beyond the date prescribed in §28.6071-1 to file Form 708 if the form for extension is filed on or before the due date for filing Form 708 in accordance with the procedures under paragraph (a) of this section.

(c) *No extension of time for the payment of tax*. An automatic extension of time for filing a return granted under paragraph (b) of this section will not extend the time for payment of any tax due with such return.

(d) *Penalties*. See section 6651 of the Code regarding penalties for failure to file the required tax return or failure to pay the amount shown as tax on the return.

(e) *Applicability date*. This section applies on and after January 14, 2025.

§28.6091-1 Place for filing returns.

(a) *In general*. A U.S. recipient, as defined in §28.2801-2(e), must file Form 708, *United States Return of Tax for Gifts and Bequests Received from Covered Expatriates*, with the Internal Revenue Service in the manner prescribed by the instructions issued with respect to that form.

(b) *Applicability date*. This section applies on and after January 14, 2025.

§28.6101-1 Period covered by returns.

See §28.6011-1 for the rules relating to the period covered by the return.

§28.6107-1 Tax return preparer must furnish copy of return or claim for refund to taxpayer and must retain a copy or record.

(a) *In general*. A person who is a signing tax return preparer of any return or claim for refund of any section 2801 tax must furnish a completed copy of the return or claim for refund to the taxpayer and retain a completed copy or record in the manner stated in §1.6107-1 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed on or after January 14, 2025.

§28.6109-1 Tax return preparers furnishing identifying numbers for returns or claims for refund.

(a) *In general*. Each tax return or claim for refund of the section 2801 tax prepared by one or more signing tax return preparers must include the identifying number of the preparer required by §1.6695-1(b) of this chapter to sign the return or claim for refund in the manner stated in §1.6109-2 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed on or after January 14, 2025.

§28.6151-1 Time and place for paying tax shown on returns.

(a) *In general*. The section 2801 tax shown on the return must be paid at the time prescribed in §28.6071-1 for filing the return, and in the manner prescribed in §28.6091-1 for filing the return.

(b) *Applicability date*. This section applies to covered gifts or covered bequests received on or after January 1, 2025.

§28.6694-1 Section 6694 penalties applicable to return preparer.

(a) *In general*. For general rules regarding penalties under section 6694 of the Code applicable to preparers of returns or claims for refund of the section 2801 tax, see §1.6694-1 of this chapter.

(b) *Applicability date*. This section applies with regard to returns and claims for refund filed, and advice provided, on or after January 14, 2025.

§28.6694-2 Penalties for understatement due to an unreasonable position.

(a) *In general*. A person who is a tax return preparer of any return or claim for refund of any section 2801 tax is subject to penalties under section 6694(a) of the Code in the manner stated in §1.6694-2 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed, and advice provided, on or after January 14, 2025.

§28.6694-3 Penalty for understatement due to willful, reckless, or intentional conduct.

(a) *In general*. A person who is a tax return preparer of any return or claim for refund of any section 2801 tax is subject to penalties under section 6694(b) of the Code in the manner stated in §1.6694-3 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed, and advice provided, on or after January 14, 2025.

§28.6694-4 Extension of period of collection when tax return preparer pays 15 percent of a penalty for understatement of taxpayer's liability and certain other procedural matters.

(a) *In general*. For rules relating to the extension of the period of collection when a tax return preparer who prepared a return or claim for refund of the section 2801 tax pays 15 percent of a penalty for understatement of taxpayer's liability, and for procedural matters relating to the investigation, assessment, and collection of the penalties under section 6694(a) and (b) of the Code, the rules under §1.6694-4 of this chapter apply.

(b) *Applicability date*. This section applies to returns and claims for refund filed, and advice provided, on or after January 14, 2025.

§28.6695-1 Other assessable penalties with respect to the preparation of tax returns for other persons.

(a) *In general*. A person who is a tax return preparer of any return or claim for refund of any section 2801 tax is subject to penalties for failure to furnish a copy to the taxpayer under section 6695(a) of the Code, failure to sign the return under section 6695(b), failure to furnish an identification number under section 6695(c), failure to retain a copy or list under section 6695(d), failure to file a correct information return under section 6695(e), and negotiation of a check under section 6695(f), in the manner stated in §1.6695-1 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed on or after January 14, 2025.

§28.6696-1 Claims for credit or refund by tax return preparers and appraisers.

(a) *In general*. With respect to claims for credit or refund by a tax return preparer who prepared a return or claim for refund for any section 2801 tax, or by an appraiser that prepared an appraisal in connection with such a return or claim for refund under section 6695A of the Code, the rules under §1.6696-1 of this chapter will apply.

(b) *Applicability date*. This section applies to returns and claims for refund filed, appraisals, and advice provided, on or after January 14, 2025.

§28.7701-1 Tax return preparer.

(a) *In general*. For the definition of the term *tax return preparer*, see §301.7701-15 of this chapter.

(b) *Applicability date*. This section applies to returns and claims for refund filed, and advice provided, on or after January 14, 2025.

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: December 23, 2024.

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register January 10, 2025, 8:45 a.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3376)

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26 CFR 1.6011-10: Micro-captive listed transaction.; 26 CFR 1.6011-11: Micro-captive transaction of interest.

T.D. 10029

DEPARTMENT OF THE TREASURY
Internal Revenue Service
6 CFR Part 1

Micro-captive Listed Transactions and Micro-captive Transactions of Interest

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final rule.

SUMMARY: This document contains final regulations that identify transactions that are the same as, or substantially similar to, certain micro-captive transactions as listed transactions, a type of reportable transaction, and certain other micro-captive transactions as transactions of interest, another type of reportable transaction. Material advisors and certain participants in these listed transactions and transactions of interest are required to file disclosures with the IRS and are subject to penalties for failure to disclose. The final regulations affect participants in these transactions as well as material advisors.

DATES: *Effective date*: These regulations are effective on January 14, 2025.

Applicability date: For dates of applicability, *see* §§1.6011-10(h) and 1.6011-11(h).

FOR FURTHER INFORMATION CONTACT: Allan H. Sakaue, (202) 317-6995 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Authority

This document amends the Income Tax Regulations (26 CFR part 1) by adding final regulations under section 6011 of the Internal Revenue Code (Code) to identify certain micro-captive transactions and substantially similar transactions as listed transactions and certain other micro-captive transactions as transactions of interest, each a type of reportable transaction (final regulations). These regulations are issued pursuant to the authority conferred on the Secretary of the Treasury or her delegate (Secretary) under the following provisions of the Code:

Section 6001, which requires every taxpayer to keep the records, render the statements, make the returns, and comply with the rules and regulations that the Secretary deems necessary to demonstrate tax liability and prescribes, either by notice served or by regulations;

Section 6011, which requires every taxpayer to "make a return or statement according to the forms and regulations prescribed by the Secretary" and "include therein the information required by such forms or regulations";

Section 6707A(c)(1), which states that "[t]he term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion"; and

Section 6707A(c)(2), which states that, "[t]he term 'listed transaction' means a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011."

Reportable transactions are described in §1.6011-4 and include listed transactions, confidential transactions, transactions with contractual protection, loss transactions, and transactions of interest. *See* §1.6011-4(b)(2) through (6). Section 1.6011-4(b)(2) defines a "listed transaction" as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has determined to be a tax avoidance transaction and identified by notice, regulation, or other form of published guidance as a listed transaction. Section 1.6011-4(b)(6) defines a "transaction of interest" as a transaction that is the same as or substantially similar to one of the types of transactions that the IRS has identified by notice, regulation, or other form of published guidance as a transaction of interest.

The final regulations are also issued under the express delegation of authority under section 7805(a) of the Code.

Background

I. *Section 831(b)*

As enacted by section 1024 of the Tax Reform Act of 1986, Public Law 99-514, 100 Stat. 2085, 2405 (October 22, 1986), section 831(a) of the Code generally imposes tax on the taxable income (determined under the special rules for calculating taxable income of insurance companies in part II of subchapter L of chapter 1 of the Code) of every insurance company other than a life insurance company (nonlife insurance company), for each taxable year computed as provided in section 11 of the Code. However, certain small nonlife insurance companies may elect to be subject to the alternative tax imposed by section 831(b).

Upon election by an eligible nonlife insurance company (eligible electing company) to be taxed under section 831(b), in lieu of the tax otherwise imposed by section 831(a), section 831(b) imposes tax on the company's income computed by multiplying the taxable investment income of the eligible electing company (determined under section 834 of the Code) for the taxable year by the rates provided in section 11(b) of the Code. Thus, an eligible electing company pays no tax on its underwriting income, including amounts paid as premiums, for taxable years for which its election is in effect.

Congress enacted section 333 of the Protecting Americans from Tax Hikes Act of 2015 (PATH Act), div. Q. of Public Law 114-113, 129 Stat. 2242, 3040 (December 18, 2015), to both tighten and expand the requirements for qualifying under section 831(b), effective for taxable years beginning after December 31, 2016. As amended by the PATH Act, section 831(b) requires an eligible electing company to be an insurance company (within the meaning of section 816(a) of the Code) having net written premiums or, if greater, direct written premiums, for the taxable year not exceeding $2.2 million as adjusted for inflation (net written premium limitation) and to meet the diversification requirements of section 831(b)(2)(B). The last sentence of section 831(b)(2)(A) provides that an election under section 831(b) applies to the taxable year for which it is made and all subsequent taxable years for which the net written premium limitation and the diversification requirements are met and may be revoked only with the Secretary's consent. In addition, section 831(d) requires every eligible electing company that has a section 831(b) election in effect to furnish to the Secretary "at such time and in such manner as the Secretary shall prescribe such information for such taxable year as the Secretary shall require with respect to" the diversification requirements of section 831(b)(2)(B).

To qualify as an insurance company pursuant to section 816(a), a requirement to elect section 831(b) taxation, more than half of the business of the entity during the taxable year must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. An insurance contract must meet all four prongs of the test for insurance set forth by the courts: risk shifting, risk distribution, insurable risks, and insurance in the commonly accepted sense. *See Helvering v. Le Gierse*, 312 U.S. 531, 539 (1941) (both risk shifting and risk distribution must be present); *Allied Fidelity Corp. v. Commissioner*, 572 F.2d 1190, 1193 (7th Cir. 1978) (the risk transferred must be risk of economic loss); *Commissioner v. Treganowan*, 183 F.2d 288, 290-91 (2d Cir. 1950) (the risk must contemplate the fortuitous occurrence of a stated contingency); *Rent-A-Center, Inc. v. Commissioner*, 142 T.C. 1, 13 (2014) (the arrangement must constitute insurance in the commonly accepted sense); *see also* Rev. Rul. 2007-47, 2007-2 C.B. 127 (the risk must not be merely an investment or a business risk). To determine whether an arrangement is insurance in the commonly accepted sense, courts consider several non-exclusive factors including (1) whether the company was organized, operated, and regulated as an insurance company; (2) whether the company was adequately capitalized; (3) whether the policies were valid and binding; (4) whether premiums were reasonable and the result of arm's length transactions; (5) whether claims were paid; (6) whether the policies cover typical insurance risks; and (7) whether there was a legitimate business reason for acquiring insurance from the captive. *Avrahami v. Commissioner*, 149 T.C. 144, 191 (2017).

II. *Notice 2016-66 and Notice of Proposed Rulemaking ("NPRM")*

On November 21, 2016, the Treasury Department and the IRS published Notice 2016-66, 2016-47 I.R.B. 745, which identified certain micro-captive transactions as transactions of interest. On January 17, 2017, the Treasury Department and the IRS published Notice 2017-08, 2017-3 I.R.B. 423, which modified Notice 2016-66 by providing for an extension of time for participants and material advisors to file their disclosures.

Notice 2016-66 alerted taxpayers and their representatives pursuant to §1.6011-

4(b)(6) and for purposes of §1.6011-4(b)(6) and sections 6111 and 6112, that the Treasury Department and the IRS identified as transactions of interest certain micro-captive transactions in which a taxpayer attempts to reduce the aggregate taxable income of the taxpayer, related persons, or both, using contracts that the parties treat as insurance contracts and a related company that the parties treat as an insurance company. Notice 2016-66 also alerted persons involved with the identified transactions that certain responsibilities may arise from their involvement.

The Treasury Department and the IRS issued proposed regulations under section 6011 (REG-109309-22) in an NPRM published in the **Federal Register** (88 FR 21547) on April 11, 2023 (proposed regulations). That NPRM obsoleted Notice 2016-66. The Treasury Department and the IRS considered comments received in response to Notice 2016-66 in developing the proposed regulations.

The proposed regulations would identify taxpayers who file returns reflecting the tax benefits of a transaction described at §1.6011-10(a) as participants in a listed transaction ("Micro-captive Listed Transaction"). The proposed regulations would identify taxpayers who file returns reflecting the tax benefits of a transaction described at §1.6011-11(a) as participants in a transaction of interest ("Micro-captive Transaction of Interest"). Generally, a Micro-captive Listed Transaction is a transaction in which an Owner (as defined in proposed §1.6011-10(b)(6)) of an Insured (as defined in proposed §1.6011-10(b)(4)) holds the necessary interest described in proposed §1.6011-10(b)(1)(iii) (the "20 Percent Relationship Test") in Captive (as defined in proposed §1.6011-10(b)(1)), Captive meets the definition provided in proposed §1.6011-10(b)(1), and Captive provides financing as described in proposed §1.6011-10(c)(1) (the "Financing Factor"), determined over the Financing Computation Period defined in proposed §1.6011-10(b)(2)(i), or has less than a 65 percent loss ratio (the "Loss Ratio Factor") as described in proposed §1.6011-10(c)(2), determined over the Loss Ratio Computation Period defined in proposed §1.6011-10(b)(2)(ii).

A Micro-captive Transaction of Interest is a transaction in which an Owner (as defined in proposed §1.6011-11(b)(6)) of an Insured (as defined in proposed §1.6011-11(b)(4)) holds the necessary interest in Captive (as defined in proposed §1.6011-11(b)(1)), Captive meets the definition provided in proposed §1.6011-11(b)(1), and Captive has less than a 65 percent loss ratio, as described in proposed §1.6011-11(c), determined over the Transaction of Interest Computation Period defined in proposed §1.6011-11(b)(2).

Participants in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest, and material advisors with respect to Micro-captive Listed Transactions and Micro-captive Transactions of Interest, would be required file disclosure statements as set forth in proposed §§1.6011-10(f) and 1.6011-11(f). The Treasury Department and the IRS developed these objective factors to ensure administrability and clarity for taxpayers whose transactions are identified in the regulations, so taxpayers can clearly determine whether they are participants or material advisors, and thus be on clear notice of their obligations.

The Treasury Department and the IRS received 110 public comments in response to the proposed regulations and notice of public hearing that are the subject of this final rulemaking. The comments are available for public inspection at *https://www.regulations.gov* or upon request. A public hearing on the proposed regulations was held by teleconference on July 19, 2023, at 10 a.m. Eastern Time, at which six speakers provided testimony.

The Summary of Comments and Explanation of Revisions of these final regulations summarizes the proposed regulations, which are described in greater detail in the preamble to the proposed regulations. After full consideration of all the comments received and the testimony provided, these final regulations adopt the proposed regulations with the modifications described in the Summary of Comments and Explanation of Revisions.

Summary of Comments and Explanation of Revisions

This Summary of Comments and Explanation of Revisions summarizes all significant comments addressing the proposed regulations, and describes and responds to comments concerning: (1) the authority to issue the proposed and final regulations generally; (2) the Loss Ratio Factor described in proposed §§1.6011-10(c)(2) and 1.6011-11(c); (3) the Financing Factor described in proposed §1.6011-10(c)(1); (4) the exception for certain consumer coverage arrangements described in proposed §§1.6011-10(d)(2) and 1.6011-11(d)(2); (5) requests for safe harbors from either identification as a reportable transaction or from the reporting requirements upon identification as a reportable transaction; and (6) other matters including clarifications and changes not specifically related to the identified factors already addressed. This Summary of Comments and Explanation of Revisions also explains revisions adopted by the final regulations in response to those comments. Comments outside the scope of this rulemaking are generally not addressed.

As an initial matter, the final regulations incorporate non-substantive changes to the description of the election under section 831(b) at proposed §1.6011-10(b)(1)(i) (defining in part the term Captive) to better reflect the text of the statute. *See* §1.6011-10(b)(1)(i) of the final regulations.

Furthermore, §§1.6011-10(e) and 1.6011-11(e) are added to the final regulations, to provide more clarity on when a transaction is considered substantially similar as defined in §1.6011-4(c)(4) to the identified transactions. The term "Substantially Similar" has also been defined in the final regulations by cross-reference to §1.6011-4(c)(4).

I. *Comments on Authority to Issue the Proposed Regulations*

A. *The McCarran-Ferguson Act*

Several commenters argued that the proposed regulations implicate "the business of insurance" under the McCarran-Ferguson Act, 15 U.S.C. 1011 *et. seq.* ("McCarran-Ferguson"). In addition, commenters argued that sections 6011, 6111, and 6112 do not explicitly reference insurance, and thus McCarran-Ferguson prohibits the application of the proposed regulations thereunder. Commenters also asserted that the inclusion of a Loss Ratio

Factor and a Financing Factor in the proposed regulations will invalidate, impair, or supersede State law governing insurance companies. For example, commenters contended that because State regulators must approve related-party financing transactions entered into by insurance companies, State law to that effect will preempt identification of a captive insurance transaction involving related-party financing as a reportable transaction. Similarly, commenters contended that because State regulators establish solvency requirements for insurers licensed in their domicile, State laws regarding premium pricing will preempt identification of a captive insurance transaction as a reportable transaction based on the Loss Ratio Factor. Commenters also asserted that the Loss Ratio Factor, by encouraging payment of policyholder dividends, impacts the insurer and policyholder relationship and therefore implicates McCarran-Ferguson.

Contrary to the commenters' arguments, and as discussed in more detail in the following paragraphs, McCarran-Ferguson does not apply to these regulations for two primary reasons: first, because the regulations do not invalidate, impair, or supersede State law, and second, because the regulations do not implicate the business of insurance.

First, the proposed regulations do not "invalidate, impair, or supersede" any State law. As relevant here, McCarran-Ferguson provides that "[n]o Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance." 15 U.S.C. 1012(b). In other words, McCarran-Ferguson prohibits application of Federal law not specifically relating to the business of insurance if it would invalidate, impair, or supersede State laws enacted for the purpose of regulating the business of insurance. *Humana Inc. v. Forsyth*, 525 U.S. 299, 307 (1999). Courts have uniformly upheld Code provisions pertaining to the taxation of insurance companies in the face of a McCarran-Ferguson challenge. *See*, *e.g.*, *Modern Life & Acc. Ins. Co. v. Commissioner*, 420 F.2d 36, 37 (7th Cir. 1969) (*holding* that taxpayer did not show that Commissioner's determination of taxpayer's status under the Internal Revenue Code "will interfere with the choice made by [State]."); *Indust. Life Ins. Co. v. United States*, 344 F. Supp. 870, 875 (D.S.C. 1972), *aff'd*, 481 F.2d 609 (4th Cir. 1973) (*holding* that Congress did not give up the right to tax by passing McCarran-Ferguson); *Hanover Ins. Co. v. Commissioner*, 65 T.C. 715, 722 (1976) ("Congress did not, under the McCarran-Ferguson Act, surrender to the States the power of the Federal Government to tax insurance companies and to issue regulations implementing the taxing statute.").

Moreover, McCarran-Ferguson was enacted to prevent inadvertent Federal intrusion on the State's rights to regulate insurance. *See Barnett Bank of Marion Cty. v. Nelson*, 517 U.S. 25, 39. McCarran-Ferguson does not prevent the Federal Government from issuing insurance regulations. *Id*. The Supreme Court has stated that McCarran-Ferguson does not "cede the field of insurance regulation to the States, saving only instances in which Congress expressly orders otherwise." *Humana*, 525 U.S. at 308; *see also SEC v. Nat'l Sec., Inc.*, 393 U.S. 453, 459-60 (1969) ("The [McCarran-Ferguson Act] did not purport to make the States supreme in regulating all the activities of insurance companies."); *Modern Life & Acc. Ins. Co.*, 420 F.2d at 37-38; *Indust. Life Ins. Co.*, 344 F. Supp. at 875; *Hanover Ins. Co.*, 66 T.C. at 721-22. The Supreme Court also stated that "[t]he term 'invalidate' ordinarily means 'to render ineffective, generally without providing a replacement rule or law…[a]nd the term 'supersede' ordinarily means 'to displace (and thus render ineffective) while providing a substitute rule." *Humana*, 525 U.S. at 307 (citations omitted). The Supreme Court relied on the dictionary definition of "impair," which is "[t]o weaken, to make worse, to lessen in power, diminish, or relax, or otherwise affect in an injurious manner." *Humana*, 525 U.S. at 309-10 (*citing* Black's Law Dictionary 752 (6th ed. 1990)). Thus, "[w]hen federal law does not directly conflict with state regulation, and when the application of federal law would not frustrate any declared state policy or interfere with a State's administrative regime, the McCarran-Ferguson Act does not preclude its application." *Humana*, 525 U.S. at 310.

The proposed regulations do not render ineffective any State law, nor do they displace or diminish any State regulator's ability to regulate the insurers within their jurisdiction. Rather, the proposed regulations run parallel to the State laws. Identification of a transaction as a listed transaction or a transaction of interest, solely for Federal tax purposes, does not in any way invalidate, impair, supersede, or affect State insurance laws. As in *United States v. Redcorn*, "state insurance regulations remain fully in force." 528 F.3d 727, 736 (10th Cir. 2008) (*holding* that prosecution under 18 U.S.C. 669 ("Theft or embezzlement in connection with health care") did not conflict in any way with state insurance law for purposes of McCarran-Ferguson); *see also United States v. Del. Dep't of Ins.*, 66 F.4th 114, 132 (3d Cir. 2023) (*holding* that Delaware State law prohibiting the Delaware Department of Insurance from disclosing certain information about captive insurance companies to anyone, including the Federal Government, did not, under McCarran-Ferguson, override the IRS's statutory authority to issue summonses to the Department and have them enforced).

Commenters cite to *United States Dep't of Treasury v. Fabe*, 508 U.S. 491 (1993), to support their argument that the proposed regulations violate McCarran-Ferguson, but the proposed regulations can be readily distinguished from the Federal statute at issue in *Fabe*. In *Fabe*, a State preference for distributions to policyholders for claims and expenses incurred in the administration of insolvency proceedings was found to be the "business of insurance." The Supreme Court found that the Ohio statute at issue in *Fabe* was "aimed at protecting or regulating, directly or indirectly, the relationship between the insurance company and its policyholders." *Fabe*, 508 U.S. at 491-92 (*citing SEC v. Nat'l Sec., Inc.*, 393 U.S. at 460). Considering the relationship between the insurer and the insured, the Supreme Court held that, to the extent (1) the State law at issue in *Fabe* protected policyholders and (2) the Federal priority statute under 31 U.S.C. 3713(a)(1)(A)(iii) would impair that relationship, Federal law did not preempt State law. The Court in *Fabe*

had to choose between Federal and State statutes because they were in direct conflict. Conversely, the proposed regulations are not in conflict with any State regulations; the relationship between insurer and insured is in no way impacted. Taxpayers remain free to enter into captive insurance transactions in any State and to structure such transactions within the confines of State regulations, and States remain free to regulate such transactions. However, if such structure is described in §1.6011-10 or §1.6011-11, participants must disclose information about the arrangement to the IRS. In other words, the proposed regulations attach specific tax obligations (in the form of disclosure) to specific acts (in the form of participating in a transaction described in §1.6011-10 or §1.6011-11), but the proposed regulations do not change how those acts are done.

Second, the act of disclosing a transaction to the tax authorities is not the "business of insurance." The threshold question under 15 U.S.C. 1012(a), in determining whether the anti-preemption mandate of 15 U.S.C. 1012(b) applies, is whether the challenged conduct broadly constitutes the "business of insurance" in the first place. If the contested activities are wholly unrelated to the insurance business, then McCarran-Ferguson has no place in analyzing Federal regulation because only when "[insurance companies] are engaged in the 'business of insurance' does the act apply." *Sabo v. Metropolitan Life Ins. Co.*, 137 F.3d 185, 190 (3d Cir. 1998) (*citing SEC v. Nat'l Sec., Inc.*, 393 U.S. at 459-60); *see also United States v. Del. Dep't of Ins.*, 66 F.4th at 125 (reaffirming the threshold inquiry precedent set in *Sabo*). The "core of 'the business of insurance'" is "[t]he relationship between insurer and insured, the type of policy which could be issued, its reliability, interpretation and enforcement." *United States v. Del. Dep't of Ins.*, 66 F.4th at 130 (*citing SEC v. Nat'l Sec., Inc.*, 393 U.S. at 460). The "business of insurance" is also understood to be "[an]other activity of insurance companies [that] relate[s] so closely to [their] status as reliable insurers that [it] must be placed in the same class." *Id*. The conduct at issue in the proposed regulations is the filing of disclosure statements upon identification as participants in or material advisors of a transaction that, for Federal tax purposes, either is a listed transaction or a transaction of interest. Like the information gathering conduct via the summonses at issue in the *United States v. Del. Dep't of Ins.*, the disclosure requirements in the proposed regulations are not "the business of insurance." The final regulations do not adopt any changes based on these comments.

B. *Federalism Implications*

Commenters also argued that the proposed regulations have federalism implications and fail to satisfy Executive Order 13132 (Federalism). Executive Order 13132 generally provides that an agency is prohibited from publishing any rule that has federalism implications if the rule imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or if the rule preempts State law, unless the agency satisfies, among other things, the consultation and federalism summary impact statement requirements of section 6 of the Executive order.

The proposed regulations do not have federalism implications, and the requirements in section 6 of Executive Order 13132 to consult with State and local officials and issue a federalism impact statement do not apply. As described in this preamble, the proposed regulations do not preempt State law, nor do they impose substantial, direct compliance costs on State and local governments, as there is no obligation created by the regulations with which any State or local agency may need to comply. The final regulations do not adopt any changes based on these comments.

C. *Constitutionality, Fairness, and Retroactivity*

Commenters contended that the proposed regulations are unconstitutional for a number of reasons. First, commenters argued that requiring participants to disclose transactions they participated in, even if such taxpayers were examined for one or more years for which reporting would be required and for which the IRS did not make any adjustments to the taxpayers' returns, is unconstitutional and retroactive in nature. Second, commenters argued that the proposed regulations are intended to shut down the captive insurance industry and may constitute a "taking" under the Fifth Amendment of the U.S. Constitution, by restricting the rights of taxpayers to engage in captive insurance transactions.

With respect to the first argument, commenters did not specify what provision of the Constitution is allegedly violated by the potential need to disclose participation in a transaction after an examination resulted in no change to the examined returns, and the Treasury Department and the IRS are not aware of any Constitutional provision that would be violated. In addition, any such disclosure requirement in these regulations is not retroactive in nature; the final regulations will be effective January 14, 2025. To the extent the final regulations result in a disclosure obligation with respect to transactions occurring in prior taxable years for which the statute of limitations on assessment has not expired, such obligation is a current reporting obligation that arises after January 14, 2025.

With respect to the comment about reporting requirements for taxpayers whose returns have been examined, the reporting rules are outside the scope of these final regulations, which merely identify a listed transaction and a transaction of interest, respectively. The reporting rules for listed transactions and transactions of interest are found in §1.6011-4, which was issued pursuant to notice and comment and finalized most recently on August 3, 2007, in TD 9350 (72 FR 43146), and which is not amended by these regulations. However, there are tax administration reasons to maintain these reporting requirements. Most importantly, initial disclosures of reportable transactions are filed with the Office of Tax Shelter Analysis (OTSA) to ensure that all information is collected in one place. The OTSA's mission is, among other things, to ensure that the IRS has the information necessary to detect abusive tax shelters and identify issues of significant compliance risk to tax administration. The OTSA collects and analyzes information about abusive tax shelters and reportable transactions to identify trends and disseminates the results to those in a position to take appropriate action. In order to iden-

tify participants and promoters of tax avoidance transactions, the OTSA needs to receive and review Forms 8886 in a timely and efficient manner. Limiting disclosure to a subset of transaction participants (such as taxpayers whose examinations have been closed) would provide an incomplete picture of the transaction and hinder the OTSA's efforts. Accordingly, the final regulations do not adopt any changes based on these comments.

The commenters' second Constitutional argument, under the Fifth Amendment, is also without merit. As relevant here, the Fifth Amendment provides, in addition to the other limitations on government power, that "private property [shall not] be taken for public use, without just compensation." The proposed regulations identify a transaction as a listed transaction or a transaction of interest for Federal tax purposes and require the filing of disclosures with the IRS and the OTSA. Requiring disclosure of participation in these transactions does not implicate the Fifth Amendment; no property interest is taken for public use by the government under the proposed regulations necessitating compensation.

Taxpayers remain free to engage in any captive insurance transaction, regardless of whether such transaction is identified in §1.6011-10 or §1.6011-11, respectively; however, there may be Federal tax consequences if the transaction is not a valid captive insurance transaction. As there is no limitation on participation in any transaction by operation of the proposed regulations, there is no "taking" for Fifth Amendment purposes.

D. *The Administrative Procedure Act*

Commenters argued that the proposed regulations lack legal foundation and assert that the regulations will be challenged and set aside just as Notice 2016-66 was set aside in *CIC Services, LLC v. IRS*, 592 F.Supp.3d 677 (E.D. Tenn. 2022). In *CIC Services*, the district court followed the analysis in *Mann Construction, Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022), *rev'g* 539 F.Supp.3d 745 (E.D. Mich. 2021), which held that the identification of a listed transaction must follow the notice-and-comment procedures of the Administrative Procedure Act ("APA"). The district court in *CIC Services* held that Notice 2016-66 should be vacated because the IRS did not follow the APA's notice-and-comment procedures. The district court held in the alternative that the IRS acted arbitrarily and capriciously based on the administrative record. *CIC Services*, 592 F.Supp.3d at 687.

In light of the decision by the district court in *CIC Services* and other judicial decisions, the Treasury Department and the IRS published the proposed regulations and obsoleted Notice 2016-66. The NPRM provided for a comment period from April 11, 2023, through June 12, 2023, and more than 100 comment letters were received. The Treasury Department and the IRS conducted a public hearing on July 19, 2023, providing further opportunity for taxpayers to comment on the proposed regulations. The APA notice-and-comment procedures have been followed.

Some commenters suggested that the IRS's purpose for publishing the proposed regulations is to harass otherwise valid businesses, but the purpose is simply to require disclosures with respect to transactions described in §§1.6011-10 and 1.6011-11, in the interest of tax administration. Examinations of taxpayers and promoters have helped to clarify the Treasury Department's and the IRS's understanding of micro-captive transactions, including the scope of participation. The factors used to identify the Micro-captive Listed Transaction and the Micro-captive Transaction of Interest are neither arbitrary nor capricious. They reflect the IRS's long-standing positions with respect to abusive micro-captives as made public in annual Dirty Dozen tax schemes publications and case law. The factors are objective and reasonably determined, based on relevant factors in existing statutory provisions, on available industry data, and on a careful review of case law and examination information. The objectivity and reasonableness of each factor is discussed more fully throughout this Summary of Comments and Explanation of Revisions, notably in part II. (Loss Ratio Factor); part III. (Financing Factor); and part VI.B. (20 Percent Relationship Test). The existing case law with respect to micro-captives demonstrates the commonalities in the fact patterns in these transactions, which is relevant to the development of the transaction fact patterns identified in these regulations. The Tax Court has consistently determined in its section 831(b) decisions issued to date that taxpayers in the relevant micro-captive transactions remitted amounts treated as premiums for something other than insurance. *See Avrahami*, 149 T.C. at 197-98; *Syzygy v. Commissioner*, T.C. Memo. 2019-34, at *45; *Caylor Land & Dev., Inc. v. Commissioner*, T.C. Memo. 2021-30, at *48-49; *Keating v. Commissioner*, T.C. Memo. 2024-2, at *64; *Swift v. Commissioner*, T.C. Memo. 2024-13, at *44-45; *Patel v. Commissioner*, T.C. Memo. 2024-34, at *51-52; and *Royalty Mgmt. Ins. Co., Ltd. v. Commissioner*, T.C. Memo. 2024-87, at *49-50. Current examinations and litigation also are relevant, as they demonstrate consistency with the transaction fact patterns identified in these regulations.

Section 6707A(c) delegates to the IRS the authority to promulgate regulations pursuant to section 6011 identifying reportable transactions. Specifically, section 6707A(c)(1) states that "[t]he term 'reportable transaction' means any transaction with respect to which information is required to be included with a return or statement because, as determined under regulations prescribed under section 6011, such transaction is of a type which the Secretary determines as having a potential for tax avoidance or evasion." Section 6707A(c)(2) defines the term "listed transaction" as "a reportable transaction which is the same as, or substantially similar to, a transaction specifically identified by the Secretary as a tax avoidance transaction for purposes of section 6011." Section 6707A(a) provides that "[a]ny person who fails to include on any return or statement any information with respect to a reportable transaction which is required *under section 6011* to be included with such return or statement shall pay a penalty in the amount determined under subsection (b)" (*emphasis* added). Under section 6011(a), returns and statements, including disclosures, should be filed "according to the forms and regulations prescribed by the Secretary." The proposed regulations do not create any law that is contrary to any statute; rather, the proposed regulations identify transactions that must be disclosed per the existing rules under the Code with respect to reportable transac-

tions, as sections 6707A(c) and 6011 prescribe.

In addition, the Secretary has general regulatory authority under section 7805(a) to "prescribe all needful rules and regulations for the enforcement of" the Code. The Treasury Department and the IRS have clear authority to issue the proposed regulations and have followed the procedural requirements of the APA. As explained more fully throughout this Summary of Comments and Explanation of Revisions, these final regulations are based on consideration of comments in response to the proposed regulations, case law, and the IRS's years of experience with abusive micro-captives.

E. *Definition of Insurance for Federal Tax Purposes*

Commenters also argued that by identifying a micro-captive transaction as a listed transaction or a transaction of interest on the basis of a Loss Ratio Factor, a Financing Factor, or both, the proposed regulations define insurance for Federal tax purposes in a manner inconsistent with case law. Commenters cited a number of cases, including *Reserve Mech. Corp. v. Commissioner*, 34 F.4th 881 (10th Cir. 2022), *aff'g*, T.C. Memo. 2018-86; *United Parcel Service of America, Inc. v. Commissioner*, 254 F.3d 1014 (11th Cir. 2001); *Harper Grp. v. Commissioner*, 979 F.2d 1341 (9th Cir. 1992), *aff'g*, 96 T.C. 45 (1991); *Sears Roebuck & Co. v. Commissioner*, 972 F.2d 858 (7th Cir. 1992); *AMERCO v. Commissioner*, 96 T.C. 18 (1991); *Humana, Inc. v. Commissioner*, 881 F.2d 247 (6th Cir. 1989); *Caylor*, T.C. Memo. 2021-30; *Syzygy*, T.C. Memo. 2019-34; *Avrahami*, 149 T.C. 144 (2017); *R.V.I. Guar. Co. v. Commissioner*, 145 T.C. 209 (2015); *Rent-A-Center*, 142 T.C. 1 (2014); and *Securitas Holdings, Inc. v. Commissioner*, T.C. Memo. 2014-225. Additionally, several commenters pointed to the IRS's concession in *Puglisi v. Commissioner*, 2021 WL 7162530 (T.C. Oct. 29, 2021), as proof that the IRS has accepted facts similar to those described in the proposed regulations as insurance for Federal tax purposes, and therefore, the apparent attempt by the proposed regulations to redefine insurance for Federal tax purposes is contrary to established precedent.

The proposed regulations do not redefine insurance for Federal tax purposes by identifying the specific fact patterns set forth in §§1.6011-10 and 1.6011-11 as listed transactions or transactions of interest, respectively. The proposed regulations identify fact patterns that are consistently present in the micro-captive cases tried on their merits and the examined cases with respect to which the IRS has determined that the transaction at issue lacked the necessary characteristics, based on the specific facts in each case, to qualify as insurance for Federal tax purposes under existing caselaw. (Although section 6103 prohibits the IRS from disclosing specific taxpayer information, it does not preclude the IRS from identifying consistent fact patterns based on specific taxpayer information.)

For specific cases with respect to which the IRS received comments, section 6103 of the Code prohibits the IRS from discussing taxpayer return information. However, section 6103(b)(2) clarifies that the IRS is not prohibited from disclosing information to the extent it is "in a form which cannot be associated with, or otherwise identify, directly or indirectly, a particular taxpayer," such as, for example, fact patterns based on specific taxpayer return information. In general, there are a variety of reasons why certain examined cases may have conceded an otherwise valid challenge to the taxpayer's position, either by the IRS Independent Office of Appeals (Appeals) or in litigation.

Several commenters incorrectly assumed that the proposed regulations declare all entities electing the alternative tax under section 831(b) as tax avoidant or potentially tax avoidant, contrary to Congressional intent to encourage the use of small captives by enacting section 831(b) and subsequent amendments thereof, including section 333 of the PATH Act. This assumption is incorrect for several reasons. First, the proposed regulations identify a specific fact pattern involving related parties, including a Captive, at least 20 percent of the voting power or the value of the outstanding stock or equity interest of which is owned, directly or indirectly, by an Insured, an Owner, or persons Related to Insured or an Owner (as such terms are defined in §1.6011-10(b)). The definition of Captive includes the section 831(b) election, but there are several other factors that must be met before the transaction is described as a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. The closely held nature of the arrangement coupled with the section 831(b) election and the use of premiums for personal investments or for related-party financing and not to pay losses are what renders these transactions appropriate subjects of disclosure as tax avoidance transactions or transactions of interest.

Second, Congress enacted section 831(b) in the interest of simplifying the Code, not to encourage the use of small captive insurance companies. H.R. Rep. No. 99-426, at 678 (1985) ("The present law applicable to small and certain ordinary mutual companies is inordinately complex and should be simplified."). Congress amended section 831(b) to provide that the election may be revoked only with the consent of the Secretary, with the clear intent "that the election not be used as a means of eliminating tax liability (e.g., by making the election only for years when the taxpayer does not have net operating losses), but rather as a simplification for small companies." H.R. Rep. No. 100-795, at 121 (1988); S. Rep. No. 100-445, at 127 (1988). Nothing in the statutory language or the legislative history of section 831(b) suggests that Congress intended to provide the benefits of section 831(b) to companies that do not qualify as insurance companies for Federal tax purposes.

Third, the Code does not permit a current deduction for amounts set aside for self-funding of future losses. *See*, *e.g.*, *Harper Grp*, 96 T.C. at 46 n.2 (1991) ("Losses incurred by the self-insured taxpayer are deductible (if at all) only in the year paid out from the reserve fund."), *aff'd*, 979 F.2d 1341 (9th Cir. 1992); *Stearns-Roger Corp. v. United States*, 774 F.2d 414, 415 (10th Cir. 1985) ("Payments [for self-insurance] are not deductible as insurance premiums"). The transactions described in §1.6011-11 have many of the characteristics of self-insurance, and as such, taxpayers who deduct amounts paid to captives in such transactions may be engaged, as a matter of substance, in self-insurance, but more information is needed to determine if that is the case.

F. *Small and Mid-sized Businesses and the Captive Industry*

A number of commenters suggested that the proposed regulations discriminate against small and mid-sized businesses by designating certain micro-captive transactions as listed transactions, and certain other micro-captive transactions as transactions of interest. Commenters also stated that the proposed regulations will impermissibly chill the captive insurance industry. Although it may be the case that many small and mid-sized businesses utilize captive insurance entities that make an election under section 831(b), the proposed regulations do not discriminate against such businesses on the basis of their size by identifying their captive as a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. Regarding Insureds, there is no specific size of company at issue; large and small businesses alike may engage in a captive insurance transaction, but if such transaction meets the description of a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest, the participants in and material advisors thereof must file disclosure statements. The Treasury Department and the IRS do not intend to discourage the use of section 831(b) by entities that qualify for the election, nor should these regulations be construed as intending to discourage the use of section 831(b) by such entities. These regulations do not hinder the formation of valid captive insurance companies, as discussed more fully at parts VI.C. and H. of the Summary of Comments and Explanation of Revisions.

II. *Comments and Changes Relating to the Loss Ratio Factors as Described in Proposed §§1.6011-10(c)(2) and 1.6011-11(c)*

A. *Overview of Comments Relating to the Loss Ratio Factors*

Commenters expressed a number of concerns about the Loss Ratio Factors and Computation Periods. In response to these concerns, the final regulations significantly narrow the scope of the Micro-captive Listed Transaction description by providing that transactions are identified as listed transactions under the final regulations only if both the Financing Factor and the Loss Ratio Factor tests are met. The final regulations also lower the Loss Ratio Factors for both Micro-captive Listed Transactions and Micro-captive Transactions of Interest in response to comments. With respect to the proposed Loss Ratio Computation Period set forth at proposed §1.6011-10(b)(2)(ii) and the proposed Transaction of Interest Computation Period set forth at proposed §1.6011-11(b)(2) (collectively, the "Computation Periods"), as further discussed in this part II. of the Summary of Comments and Explanation of Revisions, the final regulations make no substantive changes to the Loss Ratio Computation Period but do extend the Transaction of Interest Computation Period to a period of up to ten years.

Many of the comments related to the Loss Ratio Factors in the proposed regulations raised multiple concerns that were not clearly delineated from other comments or recommendations. For clarity, comments received with respect to the Loss Ratio Factors are addressed categorically in the remaining subparts of this part II. of the Summary of Comments and Explanation of Revisions.

B. *Tax Avoidance or Potential for Tax Avoidance Identified by Loss Ratio Factors*

Several commenters suggested that the Loss Ratio Factors as set forth at proposed §§1.6011-10(c)(2) and 1.6011-11(c) are inappropriate metrics for the captive insurance industry and should not be determinative of whether a transaction is a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. Some cited *Puglisi*, 2021 WL 7162530, for support, suggesting that the IRS conceded the case because the captive at issue, which had a loss ratio below 65 percent, was not participating in a tax avoidance transaction. Commenters also argued that the IRS is treating similarly situated taxpayers differently, by predicating whether a micro-captive transaction involving an entity electing the alternative tax under section 831(b) is a reportable transaction using the Loss Ratio Factors but not doing the same for entities that do not make the section 831(b) election. Other commenters asserted that the Loss Ratio Factors were inappropriate because captives may recover funds through reinsurance, which would have the effect of lowering loss ratios.

In the context of closely held section 831(b) entities, the Loss Ratio Factors generally identify transactions involving circumstances inconsistent with insurance for Federal tax purposes, including excessive pricing of premiums and artificially low or nonexistent claims activity. The Loss Ratio Factor measures whether the amount of liabilities incurred for insured losses and claims administration expenses is significantly less than the amount of premiums earned, adjusted for policyholder dividends. The primary purpose of premium pricing is to ensure funds are available should a claim arise. The pricing of premiums should naturally reflect the economic reality of insurance operations, to ensure that policies are "price[d] in such a way that the premiums brought in cover losses and the insurer's business expenses with enough profit left over to keep investors happy." *Avrahami*, 149 T.C. at 152. Typically, actuaries establish a policy rating scheme and classify risks "'to allow credible statistical inferences regarding expected outcomes.'" *Id*. (*quoting* Actuarial Standard of Practice No. 12: Risk Classification (for All Practice Areas), sec. 3.3 (Actuarial Standards Bd. 2005). The work should be reproducible and permit "another actuary qualified in the same practice area [to] make an objective appraisal of the reasonableness of the actuary's work." Actuarial Standard of Practice No. 41: Actuarial Communications, sec. 3.2 (Actuarial Standards Bd. 2010), *https://www.actuarialstandardsboard.org/standards-of-practice/* (last visited Jan. 6, 2025). Pricing premiums far in excess of what is reasonably needed to fund insurance operations results in a lower loss ratio and remains a strong indicator of tax avoidance. Further, while amounts paid for insurance may be deductible business expenses, amounts set aside in a loss reserve as a form of self-insurance are not. *See, e.g.*, *Harper Grp.*, 96 T.C. at 46 n.2; *Stearns-Roger Corp.*, 774 F.2d at 415.

With respect to comments suggesting that the outcome of specific examined cases (such as *Puglisi*, 2021 WL

7162530) demonstrates the impropriety of using Loss Ratio Factors generally, or that determinations in such cases demonstrate that the Service is treating similarly situated taxpayers differently, section 6103 prohibits the IRS from disclosing specific taxpayer information. However, as discussed in part I.E. of this Summary of Comments and Explanation of Revisions, section 6103 does not preclude the IRS from identifying consistent fact patterns based on specific taxpayer information. The IRS's decision to concede or settle a given case in no way alters these findings and conclusions, nor are these findings and conclusions altered by the examination of entities that do not fit the identified fact pattern.

Further, commenters suggested that the inclusion of a section 831(b) election as an identifying factor in the proposed regulations but not doing the same for entities that do not make a section 831(b) election means similarly situated taxpayers are being treated differently. However, an entity that does not make a section 831(b) election is not similarly situated. An insurance company taxed under section 831(a) has a corresponding income recognition for amounts paid as insurance premiums, lessening the potential of ongoing tax deferral present in the transactions identified by these regulations.

In response to the commenters who asserted that reinsurance would have the effect of lowering loss ratios, the Treasury Department and the IRS respectfully disagree. Any reinsurance obtained by the Captive for risks attributable to direct written coverage would tend to reduce the premiums earned by the Captive (as most if not all amounts attributable to the reinsurance would typically be ceded to the reinsurer and deducted from premiums earned), thereby increasing the Captive's Loss Ratio Factor percentage and making it less likely that such transaction would be described in the regulations. The final regulations do not eliminate the Loss Ratio Factors based on these and similar comments.

C. *Potential to Capture Transactions that are not Tax Avoidance Transactions as Listed Transactions*

Commenters asserted that micro-captive transactions that are not tax avoidance transactions may have loss ratios that fall below the threshold established by the Loss Ratio Factors. Commenters opined that a loss ratio factor of 65 percent leaves determination of whether a transaction is a listed transaction up to "random chance," because future loss experience cannot be known when premiums are set, which makes the Loss Ratio Factors inappropriate for identifying tax avoidance transactions or transactions of interest. Commenters stated that premiums are intentionally set at high rates for long periods of time to ensure that there are adequate reserves to pay claims in case of catastrophic loss. Some suggested that transactions meeting the proposed 65 percent Loss Ratio Factor using a ten-year Loss Ratio Computation Period be identified as Micro-captive Transactions of Interest instead of Micro-captive Listed Transactions. Commenters expressed concern that transactions that are not tax avoidance transactions would be captured if the Loss Ratio Factors are retained, arguing that limited loss history does not mean that risks are not present, or that premiums are overpriced. Commenters pointed to a governmental program that provides reimbursement coverage for certain losses attributable to acts of terrorism set forth in the Terrorism Risk Insurance Act of 2002 ("TRIA") as an example for why a loss ratio well below the proposed 65 percent is not inherently indicative of tax avoidance. Several commenters pointed to the Tax Court's holdings in *R.V.I. Guar. Co., Ltd. & Subs. v. Commissioner*, 145 T.C. 209 (2015), as support for why the proposed 65 percent for a loss ratio is too high.

With respect to concerns that transactions that are not tax avoidance transactions could be identified as Micro-captive Listed Transactions based on a ten-year Loss Ratio Computation Period and proposed 65 percent Loss Ratio Factor, the IRS recognizes that low loss ratios may be the result of coverage of low-frequency, high-severity risks. Inherent in insurance underwriting is the concept that by assuming numerous independent risks that will occur randomly, losses will become more predictable over time, and pricing should reflect those anticipated losses. *See*, *e.g.*, *Clougherty Packing Co., Inc. v. Commissioner*, 811 F.2d 1297, 1306 (9th Cir. 1987) ("The likelihood that a loss will occur is of uncertain but predictable magnitude; the size of the loss is similarly uncertain but predictable."). This concept is notably absent from the micro-captive cases tried to date, as premiums were consistently priced to meet the target threshold under section 831(b) without regard to reasonable estimates for loss experience. *See Avrahami*, 149 T.C. at 194-98; *Syzygy*, T.C. Memo. 2019-34, at *33-34; *Caylor*, T.C. Memo. 2021-30, at *45-47; *Keating*, T.C. Memo. 2024-2, at *59-61; *Swift*, T.C. Memo. 2024-13, at *40-42; *Patel*, T.C Memo. 2024-34, at *48-50; and *Royalty Mgmt.*, T.C. Memo. 2024-87, at *23, 46-48; *see also Reserve Mech.*, 34 F.4th at 891-94. The Loss Ratio Factor percentage is not intended to act as a proxy for the actuarial basis of premium pricing, as such a basis would be too fact specific to establish an administrable test that would adequately put all relevant taxpayers on notice of their obligations under the Code in accordance with every taxpayer's right to be informed. *See Taxpayer Bill of Rights*, *https://www.irs.gov/taxpayer-bill-of-rights* (last visited Jan. 6, 2025).

Commenters identifying loss ratios at issue in specific Tax Court cases did not specify what the loss ratios would be in those cases if computed as set forth in the proposed regulations over the proposed ten-year Loss Ratio Computation Period, nor did they specify an administrable metric that would enable better identification of tax avoidance transactions. The inclusion of a ten-year Loss Ratio Computation Period is intended to allow a Captive significant time to develop a reasonable loss history that supports the use of a micro-captive for legitimate insurance purposes. The final regulations retain the ten-year Loss Ratio Computation Period in the proposed listed transaction regulations, but in response to concerns that the proposed Loss Ratio Factors are nevertheless set too high and will capture transactions that are not tax avoidance transactions, the final regulations lower the Loss Ratio Factor for purposes of designating a listed transaction under §1.6011-10 to 30 percent.

The percentage was selected in response to comments indicating that the Tax Court's holding in *R.V.I.* supports a lower loss ratio. *R.V.I.* is the one case

cited by commenters that analyzed loss ratios for time periods corresponding to the Loss Ratio Computation Period for the Micro-captive Listed Transaction. In *R.V.I.*, the Tax Court listed the captive's loss ratios from 2000 through 2013. *R.V.I.*, 145 T.C. at 216. The listed loss ratios ranged from a low of 0.2 percent (2012) to a high of 97.9 percent (2008). *Id*. As the Tax Court found, when considered in their totality, these ratios reflect "significant claims and…. significant insurance losses." *Id.* at 215. The average loss ratio in *R.V.I.* for the five ten-year periods analyzed by the Tax Court (2000 through 2009; 2001 through 2010; 2002 through 2011; 2003 through 2012; and 2004 through 2013) themselves ranged from a low of 28 percent (2000 through 2009) to a high of 35 percent (2004 through 2013). Taking the average of those five ten-year periods, the average ten-year loss ratio in the *R.V.I.* case was 32 percent. This amount is rounded down to 30 percent in the final regulations.

Further, to better target those transactions that are properly identified as listed transactions rather than as transactions of interest, the final regulations require that the transaction meet both the Loss Ratio Factor and the Financing Factor (a conjunctive test) to be designated as a listed transaction, as explained more fully in part III. of this Summary of Comments and Explanation of Revisions. This change to a conjunctive test, coupled with the lower Loss Ratio Factor percentage for Micro-captive Listed Transactions, significantly narrows the scope of the Micro-captive Listed Transaction in the final regulations and should provide adequate relief for taxpayers who suggested comparisons to specific business line loss ratios, as well as for taxpayers who expressed concerns about the breadth of the Micro-captive Listed Transaction under the proposed regulations or who requested that transactions that would have met the proposed 65 percent Loss Ratio Factor be identified as transactions of interest instead. Although the example of the TRIA's loss experience is not strictly relevant (that is, because the TRIA is a governmental relief program, not an insurance company) the significantly narrowed scope of the Micro-captive Listed Transaction is intended to respond to concerns that lower losses do not necessarily mean risks were not present or that premiums were overpriced.

For clarity, the proposed Loss Ratio Computation Period is retitled as the "Listed Transaction Loss Ratio Computation Period" and the proposed Transaction of Interest Computation Period is retitled as the "Transaction of Interest Loss Ratio Computation Period". The final regulations generally retain the substance of the proposed Computation Periods except the Transaction of Interest Loss Ratio Computation Period is increased in the final regulations from a Captive's nine most recent taxable years to its ten most recent taxable years (or all taxable years of the Captive's existence if it has been in existence for less than ten taxable years) as discussed more fully in part II.D. of this Summary of Comments and Explanation of Revisions. If an established transaction that is otherwise described in the final regulations has not had adequate time to develop a ten-year loss history, the transaction may only be designated as a transaction of interest rather than a listed transaction. In addition, the Loss Ratio Factor for identification as a transaction of interest is also lowered from 65 percent to 60 percent in the final regulations, as described in part II.D. of this Summary of Comments and Explanation of Revisions.

D. *Comparison to National Averages*

The proposed Loss Ratio Factors were generally formulated by using the medical loss ratio in section 833 of the Code, to inform the original loss ratio factor in Notice 2016-66, and by using national data for commercial property and casualty insurers, to inform the proposed regulations. A number of commenters contended that these metrics are inappropriate because section 831(b) captive insurers are materially different from commercial insurers due to the different types of coverage offered by commercial and captive insurers. For example, several commenters asserted that the inclusion in national averages of certain lines of coverage (identified by one commenter as private passenger auto liability, commercial auto liability, and accident and health coverage lines) that captives do not typically write, or may not be permitted to write, may tend to skew industry-wide loss ratios higher. Another commenter relatedly suggested that the Loss Ratio Factor's reliance on data from the National Association of Insurance Commissioners (NAIC) as a benchmark was inappropriate because the data does not include the experience of the vast majority of captive insurance companies, including those which have elected to be taxed under section 831(b). One commenter asserted that the national industry average relied upon in the proposed regulations lacks an actuarial basis, and another commenter stated that aggregated data of the U.S. property-casualty insurance industry would reflect more risk diversification and geographic diversity than would be present in a typical micro-captive arrangement.

As noted in the preamble to the proposed regulations, the Loss Ratio Factors are modified loss ratios spread out over the course of many years, unlike the single-year NAIC averages, and are also lower than the NAIC industry averages. The NAIC industry averages ranged between 67.2 and 76.2 percent per year from 2012 to 2021. *See Insurance Industry Snapshots and Analysis Reports*, *https://naic.soutronglobal.net/ Portal/ Public/en-US/RecordView/Index/26555* (last visited Jan. 6, 2025). In the latest published NAIC industry report, national averages ranged between 69.0 and 76.4 percent per year from 2014 to 2023. *See 2023 Annual Property & Casualty Insurance and Title Insurance Industries Analysis Report*, *https://naic.soutronglobal.net/Portal/ Public/en-US/RecordView/Index/26555* (last visited Jan. 6, 2025). Accordingly, even a Captive electing the alternative tax under section 831(b) that has a loss ratio below the industry-wide average for property and casualty companies in a given year will not necessarily have a loss ratio that causes it to be a participant to a transaction identified by the regulations.

With respect to concerns that the use of NAIC data as a benchmark for the Loss Ratio Factor is inappropriate because the NAIC does not capture micro-captive data, the commenter did not identify any alternative published data set that would capture the experience of "the vast majority of captive insurance companies, including micro-captive insurance companies," nor

are the Treasury Department and the IRS aware of one. The commenter included a table illustrating the distribution of AM Best Company's average loss and loss administration expenses ratios for small insurance companies, described as insurers grouped by capital and surplus up to $10 million, but this data set is inappropriate. As the commenter noted, the AM Best Company's data set includes "vastly different claims characteristics than micro-captives" covering risks that micro-captives are not generally permitted to cover, such as personal automobile liability and homeowner's liability. The NAIC data, conversely, represents industry averages generally applicable to all nonlife insurers, and, accordingly, was relied upon in the proposed regulations as a starting point, which was modified by the inclusion of policyholder dividends in the computation and by the application of an extended Computation Period. Further, as previously discussed in part II.C. of this Summary of Comments and Explanation of Revisions, the threshold for the Loss Ratio Factor for identification of a Micro-captive Listed Transaction has been lowered significantly in the final regulations.

The comments regarding the lines of coverage included in the NAIC averages provide support for a reduction to the proposed Loss Ratio Factor for identification as a transaction of interest. The specific business lines identified by the commenters would, based on the NAIC Profitability Study provided by one of the commenters, result in an average nine-year loss ratio of approximately 59 percent. However, there are other high frequency, low severity coverages and other business lines that captives are unlikely to cover in the data provided by the commenter that the commenter failed to mention: private passenger auto physical damage, homeowners' multiple peril, and mortgage guaranty lines. Removing these lines from the data set provided by the commenter would reduce the average nine-year loss ratio percentage from 65 percent identified in the proposed regulations to slightly over 60 percent.

However, this relies on the national average computation of loss ratios, which as commenters pointed out, is not the modified computation set forth in the proposed regulations. The modified computation ratio in the final regulations would potentially be lower, in part because policyholder dividend payments reduce the ratio. To determine what the average loss ratio would be using the modified loss ratio computation set forth in the proposed regulations, the IRS considered the annual NAIC Report on Profitability by Line by State for each year from 2013 through 2022 to understand a typical property and casualty company loss ratio. *See*, *e.g.*, *2013 Report on Profitability by Line by State*, Center for Insurance Policy & Research, *https://naic.soutronglobal.net/Portal/ Public/en-US/RecordView/Index/7008* (last visited Jan. 6, 2025). By removing the high frequency, low severity coverages that captives are unlikely to cover for each year from 2013 through 2022 from the annual data and computing the comparison of liabilities incurred for insured losses and claim administration expenses to premiums earned less policyholder dividends as set forth in the regulations, the average nine-year modified loss ratio is approximately 66 percent, which is slightly higher than the proposed 65 percent established in the proposed regulations. The average ten-year modified loss ratio is also slightly higher, at approximately 67 percent.

In light of commenters' concerns that the proposed 65 percent modified loss ratio is still too high, the Loss Ratio Factor percentage for identification of a transaction of interest in these regulations is lowered to 60 percent. This amount represents a discount from the lowest loss ratio supported by available data. The Loss Ratio Factor percentage for identification as a listed transaction has been reduced much more substantially to 30 percent, for other reasons, as described in part II.C. of this Summary of Comments and Explanation of Revisions. In the interest of ensuring all taxpayers can easily determine their status under the regulations, the Loss Ratio Factor remains based on the aggregated NAIC average as modified in the final regulations; although commenters were critical of the aggregated data provided by the NAIC, commenters did not point to, and the IRS and Treasury Department are not aware of, an alternative publicly-available data set that would be more appropriate.

Further, the Treasury Department and the IRS considered alternative Computation Periods and determined that a difference of one year in the Computation Periods between the Micro-captive Listed Transaction and the Micro-captive Transaction of Interest when the loss ratio thresholds are different adds unnecessary complexity and burden to affected taxpayers. The Transaction of Interest Loss Ratio Computation Period is accordingly increased to a period of up to ten years, or if the Captive has not been existence for ten full years, all years of the Captive's existence. This change will afford affected taxpayers more time to develop a loss history and will enable the computation of one ratio when affected taxpayers are considering if they need to report under §1.6011-10 or §1.6011-11.

E. *Proposed Alternatives to the Loss Ratio Factors*

Commenters suggested alternatives to the Loss Ratio Factors including: (1) evaluating the methodology used to price premiums to ensure the premiums either are priced commensurate with commercial insurance market premiums, or are priced at arm's length, given that several Code sections (such as section 482) and the regulations thereunder place strict limitations on what may be considered arm's length in a given industry; (2) applying the definition of a qualified insurance company (QIC) set forth in the passive foreign investment company rules; (3) comparing micro-captives to commercial carriers and special markets, such as commercial excess and surplus lines ("E&S") carriers; (4) comparing micro-captives to county mutual insurance companies, which commenters said have loss ratios of 40 percent and frequently make section 831(b) elections; or (5) establishing variations of the Loss Ratio Factors for specific regions or States. These recommendations are addressed in turn in this part II.E. of the Summary of Comments and Explanation of Revisions.

1. *Premium Pricing Methodology*

Many commenters stated that they believe a better standard for assessing whether a micro-captive transaction should be identified as a listed transaction is to evaluate whether an indepen-

dent, licensed actuary annually determines the premiums. Some commenters suggested that the IRS's real concern is whether premiums are priced fairly, and that if taxpayers can demonstrate that the premiums were priced by a credentialed actuary, employing actuarial techniques to establish premium rates that appropriately reflect the risk of loss and applicable costs, the transaction should be of no concern to the IRS.

The determination of whether a transaction is insurance for Federal tax purposes is based on the totality of the circumstances, but these regulations are not defining insurance for either Federal or State law purposes. Rather, these regulations identify a set of recurring and consistent fact patterns indicating the lack of a non-tax business purpose in related-party transactions that purport to offer insurance for Federal tax purposes. In related party transactions, the lack of arm's length dealing is often a source of abuse. In the micro-captive cases tried to date, the participation of an actuary or other professional in the computation of the premiums (and the taxpayer's insistence that pricing was at arm's length) was not sufficient to make the premiums reasonable, as is necessary for a valid insurance transaction for Federal tax purposes. *See*, *e.g.*, *Avrahami*, 149 T.C. at 196; *Syzygy*, T.C. Memo. 2019-34, at *34-36; *Caylor*, T.C. Memo. 2021-30, at *45-47; *Keating*, T.C. Memo. 2024-2, at *61-62; *Swift*, T.C. Memo. 2024-13, at *41-44; *Patel*, T.C. Memo. 2024-34, at *49-50; and *Royalty Mgmt.*, T.C. Memo. 2024-87, at *46-47; *see also Reserve Mech.*, T.C. Memo. 2018-86, at *55-56, 61; *cf. Harper Grp.*, 96 T.C. at 59 (premiums were stipulated to be priced at arm's length); *Securitas*, T.C. Memo. 2014-225, at *12 n.4 ("Respondent does not challenge the reasonableness of premiums.").

For example, in *Avrahami*, the premiums were priced by a credentialed actuary. The Tax Court was unpersuaded that the actuary's involvement resulted in reasonable premiums and found that the actuary's "calculations [were] aimed not at actuarially sound decision-making but at justifying total premiums as close as possible to $1.2 million—the target—without going over." 149 T.C. at 196. The Tax Court expressed similar skepticism in subsequent micro-captive cases. *See*, *e.g.*, *Syzygy*, T.C. Memo. 2019-34, at *17-18, 34-36 (finding that premiums were not actuarially determined after concluding that there was no evidence demonstrating that actuarial methods were followed; that a feasibility study completed by an actuarial consulting firm and an actuarial review completed by the State of Delaware Department of Insurance were focused on solvency, not the reasonableness of premiums; and that the advice of a credentialed actuary was ignored regarding the allocation of premiums between layers in a layered reinsurance arrangement); *Caylor*, T.C. Memo. 2021-30, at *45-47 (finding that a captive manager's pricing methodology was not actuarially sound); *Keating*, T.C. Memo. 2024-2, at *30 n.30 (actuary's opinion that pricing methodology was reasonable did not address specific policies). Further, while section 482 and the regulations thereunder provide standards for when a transaction between related parties is considered arm's length, such determination is wholly fact specific to each arrangement and thus inappropriate as a metric for identifying reportable transactions.

Accordingly, the final regulations do not adopt the commenters' recommendation to replace the Loss Ratio Factors with a metric evaluating pricing methodology. While commenters were critical of the Loss Ratio Factors and suggested that the IRS evaluate pricing methodology, they provided no specific pricing methodology or reliable commercial market source that would enable the IRS to better distinguish between transactions that are or may be tax avoidance transactions and those that are not. The final regulations do not adopt any changes based on this recommendation.

2. *Qualified Insurance Company Rules*

Section 1297 of the Code sets forth the rules for determining whether a foreign corporation is a passive foreign investment company (PFIC), which can result in adverse Federal tax consequences to a U.S. shareholder of that corporation. Generally, pursuant to section 1297(a), a foreign corporation is a PFIC if: (1) 75 percent or more of its gross income for the taxable year is passive income or (2) the average percentage of assets held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. However, section 1297(b)(2)(B) provides that passive income does not include income derived in the active conduct of an insurance business by a QIC. Generally, to be a QIC, the foreign insurer must: (1) be a corporation that would be subject to tax under Subpart L if it were a domestic corporation and (2) have "applicable insurance liabilities" (AILs) that exceed 25 percent of its total assets, as provided in section 1297(f)(1), which is referred to as the "AIL test" in this preamble.

The commenter stated that QIC status creates a rebuttable presumption that the purported insurer is a bona fide insurance company and that applying the same QIC test to domestic insurers that have elected to be taxed under section 831(b) should create a similar rebuttable presumption in these regulations.

The Treasury Department and the IRS have determined that QIC status is not appropriate for determining whether a micro-captive transaction is a tax avoidance transaction or has the potential to be a tax avoidance transaction. Foremost, QIC status does not create a rebuttable presumption that the foreign company is a bona fide insurance company. Rather, QIC status depends on the foreign company being a bona fide insurance company, as that is a prerequisite to satisfying the first prong of the QIC test, that it would be subject to tax under subchapter L (that is, would be taxable as an insurance company for Federal tax purposes) if it were a domestic corporation. The commenter's proposed test is unworkable because it is circular. Further, the entities identified as Captives by the proposed and final regulations claim eligibility to be taxed under section 831(b) of subchapter L and therefore would presumably take the position that they are subject to tax under subchapter L. However, as discussed more fully in parts I.E. and VI.C. of this Summary of Comments and Explanation of Revisions, litigation and audit experience demonstrate that many micro-captive transactions do not meet the requirements for taxation as insurance under the Code.

Nor is the second prong of the QIC test, the AIL test, suitable for determining whether a company is a bona fide insurance company or for identifying micro-captive listed transactions or transactions of interest. The AIL test is based on the ratio of a foreign corporation's applicable insurance liabilities to its total assets as reported on the foreign insurance company's applicable financial statement for a taxable year, as those terms are defined in §1.1297-4.

The AIL test is appropriate in the PFIC context because the objective of the PFIC provisions generally, that is, independent of insurance considerations, is identifying foreign companies with U.S. shareholders that are predominately passive investment vehicles focused on holding investment assets and earning investment income. The AIL test achieves this objective by identifying foreign insurance companies that, though they are engaged in the active conduct of an insurance business, are nevertheless predominantly passive investment vehicles because they have a very large amount of total assets compared to their insurance liabilities. By failing the AIL test, such foreign insurance companies do not constitute QICs and therefore do not qualify for the PFIC insurance exception under section 1297(b)(2)(B).

The AIL test is not part of the determination of whether a foreign corporation would be an insurance company taxable under subchapter L if it were a domestic company. Further, a foreign insurance company that fails the AIL test would still be a PFIC even if it is a bona fide insurance company and is engaged in the active conduct of an insurance business. It is thus inappropriate to use the AIL test in determining if a company is a bona fide insurance company or to identify micro-captive listed transactions or transactions of interest. Instead, the Loss Ratio Factors are appropriate for this purpose, in part because one indicium of tax avoidance in a micro-captive transaction is excessive premium payments (which taxpayers claim are deductible to the Insured and not taxable to the Captive pursuant to the section 831(b) election) when compared to liabilities incurred for insured losses and claim administration expenses.

3. *Commercial and Special Markets Comparison*

Commenters compared micro-captives to commercial carriers and special markets, such as commercial E&S (excess and surplus lines) carriers. Commenters pointed out that many commercial insurance business lines and geographical locations consistently have loss ratios of less than 65 percent, and some recommended the loss ratio percentage be based on each line of coverage written by the Captive or similar coverages written by commercial carriers. One commenter identified specific commercial lines of coverage, including Boiler & Machinery, Burglary & Theft, Earthquake, Fidelity, Surety, and Other Liability-Claims Made, as examples of lines of coverage that many micro-captives offer and stated that micro-captives therefore have similar loss and loss ratio distributions to these commercial lines.

Generally, commercial E&S carriers cover risks that are too uncommon, too large, or too unquantifiable to be insured by admitted carriers. In a commercial E&S market, multiple financial backers, grouped in syndicates, come together to pool and spread diversified risks that are placed with the syndicates through authorized brokers. Certain Captives may share some similarities with a commercial E&S carrier, but as a general matter, a typical micro-captive does not comport itself consistently with insurers operating in the commercial E&S market. For example, the risks covered by a micro-captive are often those of relatively few insureds who are concentrated in a small geographic region. *See*, *e.g.*, *Caylor*, T.C. Memo. 2021-30, at *38 (risks were concentrated in a group operating in a specific geographic location); *Swift*, T.C. Memo. 2024-13, at *31 (risks were concentrated in a specific industry in a small geographical area). Commenters did not explain what aspect of a commercial E&S carrier's loss ratio is substantially comparable to the average loss ratio for a typical micro-captive or how a more reliable metric to identify tax avoidant micro-captives can be derived from a commercial E&S carrier's loss ratio. Thus, loss ratio comparisons between micro-captives and commercial E&S carriers would not constitute an improvement over the current Loss Ratio Factors.

With respect to comments suggesting alternatives based on comparable commercial lines, the Treasury Department and the IRS have determined sufficient relief is afforded by the reductions to the Loss Ratio Factors for both Micro-captive Listed Transactions and Micro-captive Transactions of Interest, as discussed further in parts II.C. and II.D. of this Summary of Comments and Explanation of Revisions. With respect to comments suggesting comparison to certain business lines, the Treasury Department and the IRS are not persuaded that the few specific lines identified by the commenters better represent the variety of lines offered by micro-captives than the case law and national averages for property and casualty companies (excluding certain consumer and business lines), as discussed further in parts II.C. and II.D. of this Summary of Comments and Explanation of Revisions. The final regulations do not adopt any changes based on these recommendations.

4. *County Mutual Insurance Company Comparisons*

A commenter suggested comparing micro-captives to county mutual insurance companies, which the commenter said have loss ratios of 40 percent and frequently make section 831(b) elections. Like commercial E&S and special markets, county mutual insurance companies are similarly inappropriate for comparison. Although they may also cover risks concentrated in a small geographical area, county mutual insurance companies are subject to different incentives and constraints compared to micro-captive insurance companies because they are wholly owned by their many unrelated policyholders in a manner that does not resemble the closely held nature of micro-captive insurance companies. For example, if premiums collected by a county mutual insurance company are not used to pay claims, the unrelated policyholders would expect that the county mutual insurance company will reduce future premiums or return some portion of the excess funds to the owners as a dividend or return premiums. Micro-captive insurance companies, on the other hand, face no such expectation. The final regulations do not adopt

any changes based on this recommendation. However, for the reasons described in part II.C. of this Summary of Comments and Explanation of Revisions, and consistent with the request by commenters regarding the loss ratios of county mutual insurance companies, the final regulations lower the Loss Ratio Factor for purposes of identification as a listed transaction under §1.6011-10 to 30 percent.

5. *Variations for Regions or States*

Some commenters recommended establishing variations of the Loss Ratio Factors for specific regions or States. Accounting for disparities in loss experience from region to region would not be administrable, and, within a given region, different coverages would be subject to different disparities, which would further complicate the analysis. The final regulations do not adopt any changes based on this recommendation because the Treasury Department and the IRS have determined that sufficient relief is afforded by the changes to the Loss Ratio Factors described in parts II.C. and II.D. of this Summary of Comments and Explanation of Revisions.

F. *Inclusion of Policyholder Dividends in Loss Ratio Factor Computation*

Commenters expressed concerns about the inclusion of policyholder dividends in the computation, indicating that issuance of policyholder dividends may require regulatory approval and is not a common practice of micro-captives, thereby situating a micro-captive to fail the test for insurance in the commonly accepted sense. The Loss Ratio Factors are modified loss ratios, determined for Federal tax purposes, and the inclusion of policyholder dividends in the computation is intended to afford taxpayers a means of correcting inappropriately accumulated premiums, thereby avoiding characterization of their micro-captive arrangements as "transactions of interest" or "listed transactions." The Loss Ratio Factors have no other purpose or relevance and do not in any way affect or impede the functioning of a Captive. Further, removing policyholder dividends from the computation would unfairly disadvantage Captives that choose to use policyholder dividends to correct overpriced policies. The Treasury Department and the IRS are not persuaded that the issuance of policyholder dividends by itself would cause a transaction to fail the commonly accepted sense prong of the four-prong test for insurance for Federal tax purposes described in part I. of the Background of this Preamble. Courts consider many factors to determine whether an arrangement constitutes insurance in the commonly accepted sense, including whether policies are valid and binding, whether premiums were reasonable and the result of arm's length transactions, and whether claims were paid, and no one factor within the commonly accepted sense prong is dispositive. *See*, *e.g.*, *Avrahami*, 149 T.C. at 191-97; *Caylor*, T.C. Memo. 2021-30, at *41-48; and *Keating*, T.C. Memo. 2024-2, at *53-64. The final regulations do not modify the Loss Ratio Factors in response to these comments.

G. *Solvency Concerns*

Some commenters protested that establishing a minimum loss threshold by application of the Loss Ratio Factors would negatively impact solvency for captives, by requiring artificially low premiums or imprudent issuance of policyholder dividends. This concern is misplaced. Captive insurers would avoid insolvency in the same way they always have; that is, by insuring risks that are selected and duly reserved for in accordance with sound business judgement and the regulatory requirements of their domicile. Nothing in these regulations requires, encourages, or allows micro-captives to make contractual promises that exceed risk-bearing capabilities. The final regulations do not modify the Loss Ratio Factors in response to these comments.

H. *Clarifications Regarding Computation of Loss Ratio Factors*

Commenters argued that it may not be possible to calculate a loss ratio applicable to a given taxable year because losses under a policy may not be resolved for years (for example, long-tail coverage), and sought some clarification in the computation of the Loss Ratio Factors. For example, commenters asked whether the "liabilities incurred for insured losses" amount used in the Loss Ratio Factors computations includes losses incurred through participation in pooling arrangements, reinsurance agreements, and retrocession agreements, how micro-captives should compute the applicable loss ratio for long-tail coverage, and whether the current taxable year is included in the number of years being counted for the Computation Periods.

The Computation Periods of ten years for Micro-captive Listed Transactions and up to ten years for Micro-captive Transactions of Interest, respectively, are intended to accommodate the existence of potential long-tail coverage. These commenters appear to contemplate situations in which a Captive incurs losses but for which claims have not been reported (incurred but not reported, or IBNR) or are undergoing further development (incurred but not enough reported, or IBNER). To clarify, the Loss Ratio Factor is computed using the amount of liabilities incurred for insured losses as such term is applied under the relevant accounting method used by the participant taxpayer, as of the end of the relevant taxable year(s). *See*, *e.g.*, §1.446-1(c)(1)(ii) (defining when a liability is considered incurred for accrual method taxpayers). The final regulations do not adopt any changes based on these comments.

With respect to whether the Loss Ratio Factors include losses incurred through pooling arrangements, reinsurance agreements, and retrocession agreements, the final regulations place no limitation on the source of losses incurred by the Captive. The Computation Periods as set forth in §§1.6011-10(b)(2)(i) and (ii) and 1.6011-11(b)(2)(i) and (ii) include the most recent concluded taxable year in accordance with §1.6011-4(e)(2), Rev. Proc. 2005-26, 2005-17 I.R.B. 965, and the Instructions to Form 8886.

III. *Comments and Changes Relating to the Financing Factor as Described in Proposed §1.6011-10(c)(1)*

A few commenters argued that the Financing Factor should be removed as a factor for identifying listed transactions and transactions of interest. As proposed,

such commenters assert that the Financing Factor fails to consider the circumstances for the financing, suggesting that a better measure of a transaction's potential for tax avoidance is whether the financing reflects an overconcentration in illiquid assets. One commenter stated that nothing in the Code or existing precedent treats related-party financing that is arm's length as abusive. Commenters noted that State regulators generally must approve financing in related-party transactions, and if approved by the State, financing should not be of concern to the IRS.

One of the key abuses seen in micro-captive transactions is the indefinite deferral of tax. Such abuses may be compounded by the use of tax-deferred income for the personal benefit of the related persons involved. *See*, *e.g.*, *Avrahami*, T.C. 149 at 169-71 (portions of premiums paid made available as loans to related real estate holding company); *Swift*, T.C. Memo. 2024-13, at *18-19 (portions of premiums paid made available to invest in real estate and limited liability companies for the direct or indirect benefit of petitioners); and *Patel*, T.C. Memo. 2024-34, at *11 (portions of premiums paid made available to invest in life insurance for the direct or indirect benefit of petitioners). In an abusive micro-captive transaction, an Insured entity deducts amounts paid directly or indirectly to the Captive that the parties treat as insurance premiums in an arrangement that does not constitute insurance for Federal tax purposes. Captives then exclude those amounts from taxable income under section 831(b). When a financing arrangement is involved, such Captives return some portion of those tax-deferred amounts directly or indirectly to the Insured or related parties via a loan, capital contributions to a special purpose vehicle, or other financing arrangement for which a current tax does not apply. Thus, in a financing arrangement involving an abusive micro-captive transaction, amounts paid as premiums have not only avoided ordinary taxation but have continued to avoid tax while back in the hands of the related parties who caused the premiums to be paid and deducted. This deliberate, continuing avoidance of income tax using benefits to which the participants are not entitled is abusive and identifying transactions with similar fact patterns as listed transactions is consistent with the IRS's pronouncements with respect to micro-captives since before the publication of Notice 2016-66. *See*, *e.g.*, "Captive Insurance," IR-2015-19 (Feb. 3, 2015), *https://www.irs.gov/newsroom/abusive-tax-shelters-again-on-the-irs-dirty-dozen-list-of-tax-scams-for-the-2015-filing-season* (last visited Jan. 6, 2025.)

Several commenters noted that related-party financing such as the arrangements described by the Financing Factor can be subject to substantial scrutiny, to the extent that State insurance regulators will permit such financing only after an extensive approval process. *See*, *e.g.*, *Avrahami*, 149 T.C. at 170 ("Insurance regulators often raise bureaucratic eyebrows at related-party dealings."). Even so, the IRS has seen multiple transactions for which approval was required but not sought, or for which approval may have been granted but, nevertheless, the parties' treatment of the financing arrangement did not comport with industry standards. Based on its experience, the IRS maintains that, in transactions structured as described in the proposed regulations, financing arrangements that create a tax-deferred circular flow of funds are indicative of tax avoidance.

One commenter argued that inclusion of specific factors, such as the Loss Ratio Factor and the Financing Factor, improperly assumes insurance company status can be determined by reference to a single factor. However, the proposed regulations neither define insurance for Federal tax purposes nor identify transactions by a single factor. As discussed more fully in part I.E. of this Summary of Comments and Explanation of Revisions, these regulations do not presume to define insurance for Federal tax purposes; rather, the regulations identify fact patterns that are consistently associated with transactions that are or may be tax avoidance transactions. Regarding commenters' suggestions that the liquidity of a captive is a better measure than the Financing Factor, the commenters did not specify what potential measure of liquidity (such as the character of assets, amount of assets, or comparison of assets to Captive's liabilities) would better identify micro-captive transactions that are or may be tax avoidance transactions. Further, regardless of the specific measure of liquidity used, determinations thereof would be too fact-specific (and dependent upon individual policy terms and jurisdictional requirements) to be administrable. The use of amounts paid as premiums in a tax-preferred manner, and the return of such amounts directly or indirectly to the related parties who benefitted from the original tax deduction, is the tax avoidance addressed by the Financing Factor. While some participants may have obtained regulatory approval to issue the related-party financing, from a Federal tax perspective, the approval of a regulatory body does not answer the question of whether the transaction as a whole should be respected for Federal tax purposes. The final regulations therefore retain the Financing Factor.

However, the Treasury Department and the IRS agree that the presence of related-party financing in a micro-captive transaction by itself may not rise to the level of tax avoidance, as it may be that such financing was determined at arm's length or otherwise treated as a bona fide financing arrangement between the related parties. *See Avrahami*, 149 T.C. at 199-204 (finding that the economic reality of the related-party financing at issue, while a close question, could be treated as a bona fide debt obligation, notwithstanding the court's determination that the Avrahami's captive transaction was not insurance for Federal tax purposes). The concern with respect to financing arrangements is the continuing deferral of tax. Such deferral should not be considered tax avoidance unless coupled with the continued accumulation of tax-deferred amounts in a transaction involving circumstances inconsistent with insurance for Federal tax purposes, including the excessive pricing of premiums and artificially low or nonexistent claims activity. Accordingly, the final regulations have revised the factors identifying a listed transaction to reflect a conjunctive test: taxpayers who are engaged in a transaction described by the regulations that meets the Financing Factor as described in §1.6011-10(c)(1), in conjunction with the Loss Ratio Factor as described in §1.6011-10(c)(2), are identified as listed transactions in the final regulations. This change, to require both the Financing Factor and the Loss Ratio Fac-

tor in the identification of Micro-captive Listed Transactions, should provide substantial relief to taxpayers participating in transactions with loss ratios below 30 percent but for which the Financing Factor is not met.

Because the potential for tax avoidance still exists when there is related-party financing, the final regulations include the Financing Factor in the identification of a Micro-captive Transaction of Interest. Taxpayers who are engaged in a transaction described by the regulations that meets the Financing Factor as described in §1.6011-11(c)(1), the Loss Ratio Factor as described in §1.6011-11(c)(2), or both, are identified as participating in a transaction of interest in the final regulations. The Financing Computation Period for Micro-captive Transactions of Interest is the same as the Financing Computation Period for Micro-captive Listed Transactions.

IV. *Comments and Changes Relating to the Consumer Coverage Exception as Described in §1.6011-10(d)(2)*

A "Consumer Coverage Arrangement" as described in the proposed regulations includes certain arrangements in which a service provider, automobile dealer, lender, or retailer ("Seller") sells contracts that the parties treat as insurance contracts ("Contracts" as defined in proposed §1.6011-10(b)(3)) either issued or reinsured by a Captive related to the Seller ("Seller's Captive") to its Unrelated Customers (as defined in proposed §1.6011-10(b)(11)) in connection with the products or services being sold. As noted in the preamble to the proposed regulations, as a general matter, participation in this type of reinsurance arrangement is neither a Micro-captive Listed Transaction nor a Micro-captive Transaction of Interest under the proposed regulations because the insured is not sufficiently related to the Seller's Captive. Generally, in a Consumer Coverage Arrangement, the Insureds under the Contracts that are issued or reinsured by the Seller's Captive are Unrelated Customers of Seller, and these Unrelated Customers, their owners, and persons related to the Unrelated Customers or their owners do not directly or indirectly own at least 20 percent of the voting power or value of the outstanding stock of any entity issuing or reinsuring the Contract.

Nonetheless, the proposed regulations would provide relief from identification as either a Micro-captive Listed Transaction or as a Micro-captive Transaction of Interest under §§1.6011-10(d)(2) and 1.6011-11(d)(2) ("Consumer Coverage Exception") for certain Consumer Coverage Arrangements that would otherwise be Micro-captive Listed Transactions or Micro-captive Transactions of Interest. The proposed exception would apply to arrangements in which the following criteria are met: (1) the arrangement involves a Seller's Captive (meaning a Captive related to Seller as defined in proposed §1.6011-10(b)(10)); (2) Seller's Captive insures or reinsures some or all of the Contracts sold by Seller; (3) 100 percent of the business of the Seller's Captive is insuring or reinsuring Contracts in connection with products or services being sold by the Seller or persons related to Seller; and (4) commissions or remunerations paid for the sale of such Contracts, as a percentage of the premiums paid by the Seller's customers, is at least the greater of: (a) 50 percent; or (b) the unrelated commission percentage (meaning the highest commission for the sale of Contracts connected to Seller's products that are not issued or reinsured by Seller's Captive). Proposed §1.6011-10(d)(2)(iv)(B) is referred to as the "Unrelated Commissions Test"; proposed §1.6011-10(d)(2)(iv)(A) and (B) are collectively referred to as the "Commissions Test."

As further discussed in this part IV. of the Summary of Comments and Explanation of Revisions, commenters expressed appreciation for the inclusion of the Consumer Coverage Exception but requested clarification of the Consumer Coverage Exception provisions and recommended changes to the exception, particularly with respect to the Commissions Test.

A. *The Commissions Test*

Several commenters recommended that the Commissions Test be eliminated from the Consumer Coverage Exception. One commenter recommended that if the Commissions Test is not eliminated from the Consumer Coverage Exception altogether, it should at least be eliminated for commercial insurers acting as Intermediaries (as such term is defined in proposed §1.6011-10(b)(5)). Several commenters specifically requested the elimination of the Unrelated Commissions Test set forth at proposed §1.6011-10(d)(2)(iv)(B), expressing concern about the ability of taxpayers to comply with the provision as written.

To explain why the Commissions Test should be eliminated, one commenter argued that commissions seemingly have no applicability to the validity of the insurance arrangement. Two commenters remarked on the lack of a basis for the 50 percent threshold in the Commissions Test, as set forth in proposed §1.6011-10(d)(2)(iv)(A). The commenters suggested that use of this percentage to determine "abusiveness" of the transactions does not necessarily have any substantive connection to the economic realities of the transaction, which is negotiated at arm's length between customers and Sellers. Commenters noted that customers negotiate the purchase price of consumer coverage with Sellers without regard to the tax implications of Sellers' participation in the underwriting profit of the consumer coverage, and Sellers sometimes agree to lower prices and lower commissions, not for any tax-motivated reason, but because otherwise the customer will not buy the product. One of these commenters said that, as a result, the Commissions Test sets an "arbitrary" standard. The other commenter suggested that the proposed regulations would injure consumers by essentially requiring Sellers to caution their salespeople not to offer discounts, for fear of losing the Consumer Coverage Exception and triggering "transaction of interest" status. A third commenter noted that, for standard types of coverage written by commercial insurers, such as automobile service contracts, the market is strongly competitive, and the effect of the proposed regulations would be to reduce that competition by requiring consumers to pay a commission mark-up on consumer coverage of at least 100 percent of the net premium charged by the insurer.

One of the commenters remarked that the 50 percent threshold in the Commissions Test would only make sense if the IRS had reason to believe that the sale of

products at a lower rate is an indication of a non-market driven effort to artificially transfer otherwise taxable revenue to the micro-captive. The commenter asserted that, in over 30 years, the commenter had never seen this issue raised in examination, read cases of this happening, or heard that the IRS has actual evidence that it in fact occurs. The commenter further asserted that Consumer Coverage Arrangements "have already been examined, and deemed not to justify listed transaction treatment," as evidenced by the listing of certain consumer coverage transactions in Notice 2002-70, 2002-2 C.B. 765, and subsequent "de-listing" of those transactions in Notice 2004-65, 2004-2 C.B. 599. The commenter distinguished Consumer Coverage Arrangements from the micro-captive transactions determined by the Tax Court in recent cases not to be insurance for Federal tax purposes. To the extent the IRS has had successful Tax Court outcomes in the micro-captive area, the commenter asserted, those cases all concerned enterprise risk; none were concerned with unrelated third-party consumer risk arrangements.

Another commenter called the Commissions Test "vague, unworkable, anti-consumer and anti-competitive," asserting that the IRS should not be requiring, or even encouraging, payment of high commission rates as a condition of the exception. The commenter observed that the Commissions Test seems to be based upon section 482 of the Code transfer-pricing concerns rather than failure of risk transfer and risk distribution and lack of arm's-length dealing and sound business practices, the issues identified by the preamble to the proposed regulations as the focus of the proposed regulations. The commenter asserted that the real concern of the regulations should be to ensure that the net premiums paid to the Captive are not excessive. The commenter observed that commercial insurers writing consumer coverage for sale through dealers typically specify a schedule listing various products and the applicable net premium for each (that is, after the dealer's withheld commission) payable to the insurer for each, and that these net premiums are set by the commercial insurer based upon actuarial analysis of the risks to be covered. The commenter further observed that the gross amount paid by the customer (including the amount above the specified net premium that the dealer retains as a commission) is subject to negotiation by each customer, and the commercial insurer may not be informed of the commission or who earns it.

To address this commercial insurer scenario, the commenter proposed a safe harbor from material advisor and participant status for commercial insurers acting as Intermediaries (as defined in proposed §1.6011-10(b)(5)) in transactions that do not involve the payment of excessive premiums to the captive. However, because the proposed safe harbor would be for any commercial insurer acting as an Intermediary in a micro-captive transaction, unless the commercial insurer (or related company) retrocedes risks with respect to consumer products and pays a reinsurance premium in excess of an arm's length amount, the effect of this safe harbor would not be limited to Consumer Coverage Arrangements. Because the proposed safe harbor has implications beyond Consumer Coverage Arrangements, it is discussed in part V.B. of this Summary of Comments and Explanation of Revisions.

Commenters also remarked that elimination of the Commissions Test would make application of the Consumer Coverage Exception more streamlined and efficient and less burdensome. One of the commenters expressed concern that not all Sellers capture information about sales and commissions in a way that will facilitate calculation of "the fee, commission, or other remuneration earned by any person or persons, in the aggregate, for the sale of the Contracts, described as a percentage of the premiums paid by the Seller's customers." The commenter asserted that this additional cost and effort is not justified "to guard against a theoretical abuse in an industry where the Service has already found that insufficient evidence of abuse exists to justify listed transaction treatment."

After careful consideration of the comments received generally requesting the elimination of the Commissions Test and specifically requesting the elimination of the Unrelated Commissions Test, the Treasury Department and the IRS are persuaded that elimination of the Commissions Test in the Consumer Coverage Exception is appropriate. The tax avoidance or potential for tax avoidance that the Commissions Test intended to identify is distinguishable from the closely held arrangements associated with the fact patterns identified in §§1.6011-10(a) and 1.6011-11(a); for example, the ultimate policyholders are commonly Unrelated Customers in Consumer Coverage Arrangements. Accordingly, the Commissions Test is eliminated from the Consumer Coverage Exception in the final regulations.

One commenter also sought clarification of certain aspects of the Commissions Test. However, because the Commissions Test is eliminated from the Consumer Coverage Exception in the final regulations, no further explanation is necessary.

B. *Restricting Consumer Coverage Arrangements Identified as Reportable Transactions through Clarification of Defined Terms*

The definition of "Insured" set forth in proposed §1.6011-10(b)(4) and incorporated in proposed §1.6011-11(b)(4) is "any person that conducts a trade or business, enters into a Contract with a Captive or enters into a Contract with an Intermediary that is directly or indirectly reinsured by a Captive, and treats amounts paid under the Contract as insurance premiums for Federal income tax purposes." One commenter on the Consumer Coverage Exception recommended that the final regulations clarify that this definition is not intended to include someone who is only covered by the policy for a momentary period of time during which the underlying sales transaction is being finalized. The commenter noted that the preamble appears to indicate that guaranteed asset protection (GAP) products are an example of a "dealer obligor" arrangement in which a Seller could be considered the Insured for a short transitory time period occurring between the time the covered product is delivered to the Unrelated Customer of Seller and the financing to purchase the product is finalized for the Unrelated Customer. The commenter asserted that such situations should not trigger a reporting obligation since this is a temporary condition arising solely from

an administrative need to allow third parties to process paperwork.

Another commenter asked that the final regulations clarify that a Seller that only directly or indirectly reinsures Contracts that ultimately benefit Unrelated Customers, such as GAP contracts, is not an Insured, even if the Seller is technically a transitory or residual obligor under the contract. The commenter suggested that if this recommendation is not adopted, the definition of "Captive" set forth in proposed §1.6011-10(b)(1) and incorporated in proposed §1.6011-11(b)(1), should be modified to exclude any entity that only issues Contracts to Insureds, where the ultimate beneficiaries of such contracts are Unrelated Customers, to the extent that the total percentage of issued and reinsured GAP and similar Contracts provided to Insureds of such entity do not exceed 25 percent of the total issued and reinsured Contracts for such entity. The commenter noted that this definition would remove burdensome compliance data collection from what is essentially a minority of the entity's contracts and would permit the IRS to focus on situations where there is greater potential for tax avoidance.

The final regulations make no change to the definitions of Insured and Captive in response to these comments. A Seller is an Insured only if it "enters into a Contract with a Captive or enters into a Contract with an Intermediary that is directly or indirectly reinsured by a Captive." A Seller is not an Insured if it facilitates an Unrelated Customer entering into a Contract with Seller's Captive or an Intermediary but is not itself a party to the Contract. A Seller is an Insured only if it treats amounts paid under the Contract as insurance premiums for Federal tax purposes. To the extent a Seller receives and makes payments under a Contract as an agent of a party or parties to the Contract, the Seller would not treat amounts paid under a Contract as insurance premiums for Federal tax purposes. As a general matter, therefore, a Seller that only facilitates the direct or indirect insurance or reinsurance of Contracts that ultimately benefit Unrelated Customers, such as GAP contracts, and does not reflect the tax benefits of participating in a purported insurance transaction in its filed returns, will not be an Insured that is a participant under these regulations. A Seller that satisfies all the requirements of the definition of Insured is appropriately considered an Insured. However, in recognition of concerns expressed by commenters that such situations could potentially arise, the final regulations retain the Consumer Coverage Exception, which may prevent a Consumer Coverage Arrangement in which a Seller (or related person) is an Insured from being identified as a Micro-captive Listed Transaction or Micro-Captive Transaction of Interest.

C. *Revising Definition of Seller to Permit De Minimis Sales to Related Persons*

The definition of "Seller" set forth in proposed §1.6011-10(b)(9) and incorporated in proposed §1.6011-11(b)(8) is "a service provider, automobile dealer, lender, or retailer that sells products or services to Unrelated Customers who purchase insurance contracts in connection with those products or services." A commenter recommended modification of this definition to prevent an occasional sale of an automobile and insurance contract to a related party from disqualifying a Seller's Captive from the Consumer Coverage Exception. The commenter also stated it is important to clarify that it is not a requirement for all purchasers of insurance contracts to be Unrelated Customers for the dealer to be a Seller. The commenter asserted that there is a low risk of tax avoidance if a majority of the Contracts being insured or reinsured by a Seller's Captive are either directly sold to an Unrelated Customer or are for the ultimate benefit of an Unrelated Customer. The commenter suggested a de minimis exception for related party sales by establishing a five percent threshold for such transactions.

In response to these comments, §1.6011-10(b)(9) of the final regulations clarify that a Seller is a service provider, dealer (including an automobile dealer), lender, wholesaler, or retailer that sells products or services to customers who purchase insurance contracts in connection with those products or services provided no more than five percent of all its sales of products or services to persons who purchase insurance contracts in connection with those products or services are to customers other than Unrelated Customers. Additionally, the Consumer Coverage Exception in §§1.6011-10(d)(2) and 1.6011-11(d)(2) of the final regulations is modified to require that no more than five percent of the Seller's Captive's business is issuing or reinsuring Contracts purchased by persons other than Unrelated Customers in connection with products or services sold by the Seller or persons Related (as defined in §1.6011-10(b)(8) of the final regulations) to the Seller.

D. *Other Requests for Clarification*

A commenter asked for clarification of whether the Consumer Coverage Exception applies when the Seller's Captive neither assumes reinsurance from an unrelated fronting company, nor cedes reinsurance to an unrelated insurer. The Consumer Coverage Exception set forth in proposed §1.6011-10(d)(2) and incorporated in proposed §1.6011-11(d)(2) requires that "Seller's Captive issue or reinsure some or all of the Contracts sold to Unrelated Customers in connection with the products or services being sold by the Seller," that "100 percent of the business of the Seller's Captive is insuring or reinsuring Contracts in connection with products or services being sold by the Seller or persons Related to the Seller," and that the Commissions Test set forth in proposed §1.6011-10(d)(2)(iv) is met with respect to "the Contracts issued or reinsured by the Seller's Captive." The involvement of an unrelated fronting company or other unrelated insurer is not required.

The commenter also asked if the Consumer Coverage Exception is intended to apply if Seller's Captive directly insures an entity related to or affiliated with Seller for certain contracts described in the proposed regulations but without fronting or reinsurance attached. The Consumer Coverage Exception set forth in the proposed regulations would not apply in these circumstances because the Seller's Captive is insuring an entity related to or affiliated with Seller (rather than Unrelated Customers of Seller). This would be the case whether or not a fronting company or reinsurer were involved. However, as discussed in part IV.C. of this Summary

of Comments and Explanation of Revisions, under §§1.6011-10(d)(2)(iv) and 1.6011-11(d)(2) of the final regulations, the Consumer Coverage Exception may apply when a Seller's Captive issues or reinsures Contracts purchased by persons other than Unrelated Customers in connection with products or services sold by the Seller or persons related to Seller, provided that no more than five percent of the Seller's Captive's business is issuing or reinsuring such Contracts. Accordingly, the Consumer Coverage Exception set forth in the final regulations would potentially apply in the circumstances described by the commenter.

A commenter suggested that "coverage for incurring diminished value" should be considered a type of consumer coverage. The preamble to the proposed regulations explains that a "Consumer Coverage contract generally provides coverage for repair or replacement costs if the product breaks down or is lost, stolen, or damaged; coverage for the customer's payment obligations if the customer dies or becomes disabled or unemployed; coverage for the difference between all or a portion of the value of the product and the amount owed on the product's financing, including a lease, if the product suffers a covered peril; or a combination of one or more of the foregoing types of coverage." However, this is a non-exclusive list. The Consumer Coverage Exception may apply when a Seller's Captive issues or reinsures Contracts in connection with the products or services being sold by the Seller. Such Contracts could include those providing coverage for incurring diminished value.

Another commenter noted that warranty products are also widely sold and reinsured outside the automotive space and often in the business-to-business environment, suggesting that this should be taken into account when drafting terminology in the final regulations related to consumer products and seller captive concepts. The description of the Consumer Coverage Exception and related definitions use generic terms intended to encompass a broad range of products and services, not limited to automotive products and services. Nonetheless, in response to this commenter's apparent concern that the Consumer Coverage Exception as proposed may exclude arrangements "in the business to business environment," the final regulations clarify that the term Seller includes a wholesaler that sells products or services to customers who purchase insurance contracts in connection with those products or services.

Finally, one commenter asked that the final regulations apply prospectively to Seller's Captives, meaning reporting would be required with respect to Seller's Captives only for taxable years subsequent to the effective date of the final regulations, because otherwise a number of legitimate captives would be subjected to very burdensome information gathering, testing, and reporting for a very small amount of premium income per captive. The commenter suggested that changes such as a 50 percent commission threshold should be applied on a prospective basis only to provide notice to taxpayers. As discussed in the preamble to the proposed regulations, as a general matter, participation in Consumer Coverage Arrangements is neither a Micro-captive Listed Transaction nor a Micro-captive Transaction of Interest because the insured is not sufficiently related to the insurer or any reinsurer. The proposed regulations were not intended to change this, but nonetheless provide a potential exception for taxpayers considered to be participating in a reportable Consumer Coverage Arrangement. The clarifications and changes to the proposed regulations described in this part of the Summary of Comments and Explanation of Revisions are only intended to provide further reassurance that Consumer Coverage Arrangements generally do not give rise to a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. Further, if the Consumer Coverage Exception for Seller's Captives applied only to taxable years after the regulations are effective as suggested by the commenter, then the exception would not apply to otherwise open taxable years for which reporting would be required. This would disadvantage taxpayers who otherwise may have qualified for the Consumer Coverage Exception in open taxable years. Consequently, the final regulations do not adopt any changes in response to this comment.

V. *Comments and Changes Relating to Identification as Reportable Transactions and Reporting Requirements*

A. *Comments Relating to Safe Harbors from Identification as Reportable Transactions*

1. *Proposed Safe Harbors for Amended Returns*

A commenter requested a change to the proposed regulations that would allow taxpayers who file amended returns that remove tax benefits previously recognized from participation in the micro-captive transaction to not be designated as participating in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. Taxpayers who file amended returns after the due date, including extensions, are considered participants in the transaction if their transaction otherwise meets the description of a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest because their original return reflects the tax benefits of participation. In order for the IRS to obtain a complete picture of participation in these transactions, such taxpayers must file disclosures. However, a taxpayer whose timely-filed amended return is treated as the original return for the taxable year (that is, a superseding return) is not considered to have filed a return reflecting the tax benefits of participation in the transaction and would not be required to file disclosures under the final regulations. Further, whether amended returns determine participation is outside the scope of these regulations and the final regulations do not adopt any changes based on this request.

Several commenters expressed concern that the proposed regulations would require taxpayers to amend returns for approximately three to four taxable years prior to the promulgation of these regulations as final regulations. The regulations do not require taxpayers to file an amended return or an Administrative Adjustment Request (AAR) for certain partnerships. The proposed regulations would require taxpayers whose transactions are described in either §1.6011-10(c) or §1.6011-11(c) to file a disclosure statement in the form and manner prescribed

by §1.6011-4. The preamble to the proposed regulations acknowledged that because the IRS will take or may take a position that taxpayers are not entitled to the purported tax benefits, taxpayers who have filed tax returns taking such positions should consider filing an amended return or AAR. The preamble to the proposed regulations provided a method for filing such amended returns or AARs, if so desired. The final regulations do not adopt any changes pursuant to these comments.

2. *Proposed Safe Harbors for Captives with Certain Features*

Commenters requested that the IRS clarify whether taxpayers who issue premium refunds or policyholder dividends to meet the Loss Ratio Factor will be designated as participating in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. As described more fully in part II. of this Summary of Comments and Explanation of Revisions, the Loss Ratio Factors compare the amount of liabilities incurred for insured losses and claim administration expenses to the premiums earned less policyholder dividends paid by the Captive, over the course of the defined Computation Periods. Thus, if a taxpayer issues premium refunds or policyholder dividends, either of which would reduce the amount to which liabilities for insured losses and claim administration expenses over the relevant Computation Period are compared, the relevant loss ratio for purposes of identification as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest will be higher. Further, as described more fully in parts II.B. and III. of this Summary of Comments and Explanation of Revisions and as clarified in the bright-line rules of §1.6011-10(e) of the final regulations, only taxpayers participating in a transaction that (1) involves a Captive that elects under section 831(b) to include in taxable income only taxable investment income (defined in section 834) in lieu of the tax imposed under section 831(a) (that is, to exclude premiums from taxable income) and (2) meets both the Financing Factor and the Loss Ratio Factor, will be designated as participating in a Micro-captive Listed Transaction under the final regulations. That is, if Captive's loss ratio is 30 percent or more for the Listed Transaction Loss Ratio Computation Period, or if the Captive does not meet the Financing Factor, the transaction is not identified as a Micro-captive Listed Transaction. With respect to Micro-captive Transactions of Interest, if the taxpayer does not meet the Financing Factor, and has effectively lowered the percentage of premiums earned as compared to liabilities incurred for claims and administration by issuing policyholder dividends, the transaction is not identified as a Micro-captive Transaction of Interest under the final regulations. That is, if Captive's loss ratio is 60 percent or more for the Transaction of Interest Loss Ratio Computation Period as set forth in §1.6011-11(b)(2) and Captive has not made Captive's capital available in a way that furthers the deferral of tax, the taxpayer is already not a participant in a Micro-captive Transaction of Interest. This is clarified in the final regulations setting forth the bright-line rules at §1.6011-11(e).

One commenter recommended that a transaction should not be designated as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest if the Captive has paid claims in any amount, there is an annual rate and reserve study conducted by a qualified actuary, and there is commercial coverage available for the risks covered by the Captive. The commenter indicated that all of these factors together should be sufficient to demonstrate that a micro-captive transaction was not entered into for tax avoidance purposes. Several other commenters asserted that taxpayers who can demonstrate that the premiums charged in their transaction were actuarially determined by a credentialed actuary should not be designated as participating in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest. Additional commenters suggested that the existence of a feasibility study prepared by a credentialed actuary, or a third-party transfer pricing memorandum certifying the transaction, would provide better metrics for identification as a listed transaction or transaction of interest, and transactions for which such feasibility studies or third-party transfer pricing memoranda have been prepared should not be designated as participating in a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest.

With respect to proposed safe harbors involving claims, the Treasury Department and the IRS are aware of promoters encouraging the filing of claims under contracts that the parties treat as insurance contracts to establish the appearance of a legitimate insurance arrangement, regardless of business need. Because these transactions involve closely held related entities, there is little to no barrier to the manufacture of claims in these arrangements. Further, in many of the micro-captive cases tried to date, the handling of claims was atypical of valid insurance arrangements, with claims paid despite lacking in substantiation and under the direction of the Insured or its Owners without regard to the validity of the claim. *See*, *e.g.*, *Caylor*, T.C. Memo. 2021-30, at *42-43; *Keating*, T.C. Memo. 2024-2, at *63-64. The existence of paid claims in any amount is therefore not a viable metric for distinguishing between transactions that are or may be tax avoidance transactions and those that are not.

With respect to the involvement of an actuary or other professional in the transaction, as observed in *Avrahami* and discussed more fully at part II.E.1. of this Summary of Comments and Explanation of Revisions, such involvement does not establish that the arrangement is not, and does not have the potential to be, a tax avoidance transaction, and further is not dispositive of a valid transaction for Federal tax purposes.

Similarly, with respect to Captives covering risks for which commercial coverage is available, the presence of such risks is not dispositive of the validity of a transaction. Many abusive micro-captive transactions involve purported risks that would be a typical insurance risk for another company but would be inappropriate for the Insured to purchase given the nature of the Insured's business, such as construction coverage for an entity that "wasn't constructing anything." *Avrahami*, 149 T.C. at *196.

In all micro-captive cases tried to date, courts have found the arrangement at issue not to be insurance for Federal tax purposes even though the factors identified by the commenters as appropriate for safe harbors were present – claims were

paid; an actuary or other professional prepared pricing reports, feasibility studies, or the like in the transaction; and the captive covered some typical insurance-type risks. *See Avrahami*, 149 T.C. at *149-52, 167, 186-87, 195-97; *Syzygy*, T.C. Memo. 2019-34, at *15-17, 35, 44; *Caylor*, T.C. Memo. 2021-30, at *14, 19-23, 25-26, 48-49; *Keating*, T.C. Memo. 2024-2, at *14, 20-25, 30, 33, 35, 63-64; *Swift*, T.C. Memo. 2024-13, at *12, 15-17, 44; *Patel*, T.C. Memo. 2024-34, at *9, 14-22, 29-30, 50-51; *Royalty Mgmt.*, T.C. Memo. 2024-87, at *16-17, 21, 47; *see also Reserve Mech.*, T.C. Memo. 2018-86, at *9, 11-20, 47-48, 61. Accordingly, the final regulations provide no exclusion from identification as a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest in response to these comments.

One commenter argued that if the following facts are present, the transaction should be excepted from identification as either a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest: (a) 90 percent of the coverage written is coverage that is commercially available, (b) Insureds purchase or have purchased such coverage from commercial carriers in a similar amount to what is now purchased from the Captive, (c) the commercial carrier has credible loss experience for the types of coverage in the Insured's location, and (d) commercial rates are used to extrapolate the Captive's premiums, taking into account the Captive's expenses and layers written.

As discussed in this part V.A.2. of the Summary of Comments and Explanation of Revisions, the coverage of risks for which commercial coverage is available does not guarantee the validity of the transaction. The Tax Court has held multiple arrangements did not qualify as insurance arrangements for Federal tax purposes despite purporting to cover such risks. *See*, *e.g.*, *Avrahami*, 149 T.C. at 150, 153-56, 159, 197 (administrative actions and employee fidelity); *Keating*, T.C. Memo. 2024-2, at *20-27, 64 (workers' compensation); *Swift*, T.C. Memo. 2024-13, at *7-8, 12, 14-15, 44 (medical malpractice and terrorism); *Patel*, T.C. Memo. 2024-34, at *15-20, 51 (business interruption and regulatory). Further, Insureds' purchase of such coverage from commercial carriers in a similar amount to what is now purchased from the Captive does not guarantee the validity of the transaction. The availability of commercial coverage may indicate a lack of a business need for captive coverage. *See*, *e.g.*, *Keating*, T.C. Memo. 2024-2, at *59-60 (petitioners provided no credible evidence of a business need for captive coverage in light of comprehensive commercial coverage). Additionally, the commenter did not clarify whether the purchase of coverage from commercial carriers in a similar amount to what is now purchased from the Captive would include duplicative coverage, coverage of different layers of risk, or both. The commenter did not specify what commercial markets or rates are relevant nor what constitutes a "similar amount" or a "credible loss experience" sufficient to exempt the participant's identification under these regulations. Nor did the commenter explain how the experience of a commercial insurer would be known to the participants in the micro-captive transaction. The suggested factors are too subjective and complex to be administrable, and sufficient relief is afforded by the changes to the Loss Ratio Factors described in parts II.B. and II.C. of this Summary of Comments and Explanation of Revisions.

One commenter recommended that transactions with Captives that have been rated highly by an independent third-party credit or rating agency specializing in insurance should not be designated as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest. In general, such agencies rate the financial strength of Captives, that is, the ability to pay claims should they arise. Thus, their ratings are not informative regarding the nature of an entity or a transaction for Federal tax purposes. This recommendation is not adopted in the final regulations.

A commenter suggested that transactions with Captives that are licensed or domiciled in a jurisdiction that regulates many Captives should not be designated as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest. The commenter also suggested that taxpayers whose Captive uses template insurance policies accepted by the State regulator, or whose Captive offers coverage that has been accepted as adequate proof of insurance by other State or Federal agencies, should not be designated as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest. Another commenter recommended a broader exception for all State-licensed domestic captives.

However, whether a captive is regulated in a given domicile does not determine whether a transaction is abusive or has the potential for abuse for Federal tax purposes. *See*, *e.g.*, *Avrahami*, 149 T.C. at 192 (captive regulated in St. Kitts); *Syzygy*, T.C. Memo. 2019-34, at *38 (captive regulated in Delaware); *Caylor*, T.C. Memo. 2021-30, at *41 (captive regulated in Anguilla); *Keating*, T.C. Memo. 2024-2, at *53 (captive regulated in Anguilla); *Swift*, T.C. Memo. 2024-13, at *37 (captive regulated in St. Kitts); *Patel*, T.C. Memo. 2024-34, at *46 (captives regulated in St. Kitts and Tennessee, respectively); *cf. Royalty Mgmt*., T.C. Memo. 2024-87, at *43-44 (no regulatory oversight in Tribal domicile). As each micro-captive case describes, whether a company is organized and regulated as an insurance company is not the end of the inquiry, as courts "must look beyond the formalities and consider the realities of the purported insurance transaction." *Hospital Corp. of Am. v. Commissioner*, T.C. Memo. 1997-482, 1997 WL 663283, at *24 (*citing Malone & Hyde, Inc. v. Commissioner*, 62 F.3d 835, 842-43 (6th Cir. 1995)). In the micro-captive transactions identified as transactions that are or may be tax avoidance transactions, the realities of the purported insurance transaction, including the closely held nature of the arrangement, the section 831(b) election, and the use of premiums primarily for investment or related-party financing (rather than to pay losses) indicate tax avoidance or the potential for tax avoidance. Further, a safe harbor identifying a specific domicile or specific domiciles would require the IRS to evaluate the manner in which the respective domicile regulates insurance, which would be administratively burdensome and inject uncertainty. Accordingly, the final regulations do not adopt these suggestions.

A commenter indicated that taxpayers whose Captive covers risks with a specified number of Insureds or risk units, or pools risk with a specified distribution of the risk of loss, should not be designated as participating in a Micro-captive Listed

Transaction or Micro-captive Transaction of Interest. However, these aforementioned factors only relate to the degree to which a transaction distributes risk. Risk distribution is just one of the four prongs used by the courts in determining whether an arrangement qualifies as insurance for Federal tax purposes and does not alone establish that a transaction has no potential for tax avoidance. *See* part I. of the Background section of this Preamble for further explanation of the four-prong test. The final regulations do not adopt these suggestions.

3. *Captives Providing Certain Types of Coverage or Serving Certain Industries*

Other commenters suggested that taxpayers who can demonstrate that the Captive directly or indirectly reinsures contracts issued by a commercial carrier should not be designated as participants in a Micro-captive Listed Transaction or Micro-captive Transaction of Interest. The final regulations do not adopt this suggestion. First, as discussed in part V.A.2. of this Summary of Comments and Explanation of Revisions, the involvement of commercially covered risks in the transaction does not guarantee the validity of the transaction. The commenter did not specify what commercial carriers are relevant nor what portion of reinsurance would be sufficiently significant to exempt the participants from identification under these regulations. Second, if the entirety of a captive's business is the reinsurance of a commercially rated program, it is less likely that the transaction would be described by these regulations, as the individuals or entities insured would not be sufficiently related to the captive to meet the 20 Percent Relationship Test. Accordingly, a safe harbor based on a Captive's direct or indirect reinsurance of contracts issued by a commercial carrier is not appropriate.

A commenter recommended that taxpayers who operate as risk retention groups pursuant to the Federal Liability Risk Retention Act (FLRRA), 15 U.S.C. 3901, *et. seq.*, should not be designated as participating in a Micro-captive Listed Transaction or Micro-captive Transaction of Interest because the FLRRA establishes that a risk retention group licensed in one State can transact business as an insurance company in every State, and the IRS does not have the authority to repeal the FLRRA. A risk retention group is "a group-owned insurer organized for the purpose of assuming and spreading the liability risks to its members." *NAIC Glossary of Insurance Terms*, *https://content.naic.org/glossary-insurance-terms* (last visited Jan. 6, 2025). Risk retention groups formed pursuant to the FLRRA are unlikely to be described by the proposed regulations as they would have too many member-owners to satisfy the 20 Percent Relationship Test. Further, the proposed regulations do not repeal the FLRRA. By identifying certain micro-captive transactions as reportable transactions, the proposed regulations impose disclosure requirements and provide notice that the tax treatment of the transactions will or may be challenged by the IRS. They do not in any way prevent any taxpayer from transacting business as an insurance company. The final regulations do not adopt this recommendation.

Commenters expressed concern that community banks in particular will be negatively impacted by the proposed regulations to the detriment of their communities. Commenters recommended that community banks as a whole be exempted from identification as a Micro-captive Listed Transaction. Regardless of the industry, taxpayers engaged in transactions identified as listed transactions or transactions of interest in the final regulations must disclose such participation. There is no one industry whose constituents should be categorically exempted from identification as a Micro-captive Listed Transaction or as a Micro-captive Transaction of Interest. Adverse impacts to individual taxpayers or specific industries consequent to implementation of these regulations are limited to disclosure and recordkeeping requirements and are outweighed by the public interest in sound tax administration. Accordingly, the final regulations do not adopt any changes in response to this concern.

A commenter argued for an exception for any micro-captive that "writes 'deductible reimbursement' policies for the deductible or self-insured retention ('SIR') layer(s) underlying policies issued by Licensed Insurers and uses comparable rates taking into account the layer written and [the] micro-captive's expenses." The commenter did not provide any additional explanation, including why such an exception was appropriate. To the extent a transaction involving a Captive writing such policies otherwise falls within the description of Micro-Captive Listed Transaction or Micro-Captive Transaction of Interest, the transaction remains one that is or may be a tax avoidance transaction. The final regulations do not adopt any changes based on this comment.

B. *Comments Relating to Reporting Required Under Proposed §§1.6011-10(g) and 1.6011-11(g), Pursuant to §1.6011-4(d) and (e)*

With respect to Micro-captive Listed Transactions, proposed §1.6011-10(g) would provide that participants must disclose their participation in the transaction pursuant to §1.6011-4(d) and (e). Similarly, with respect to Micro-captive Transactions of Interest, proposed §1.6011-11(g) would provide that participants must disclose their participation in the transaction pursuant to §1.6011-4(d) and (e).

Section 1.6011-4(d) and (e) provides that the disclosure statement—Form 8886 (or successor form)—must be attached to the taxpayer's tax return for each taxable year for which a taxpayer participates in a reportable transaction. A copy of the disclosure statement must be sent to the OTSA at the same time that any disclosure statement is first filed by the taxpayer pertaining to a particular reportable transaction. Section 1.6011-4(e)(2)(i) provides that if a transaction becomes a listed transaction or a transaction of interest after the filing of a taxpayer's tax return reflecting the taxpayer's participation in the transaction and before the end of the period of limitations for assessment for any taxable year in which the taxpayer participated in the transaction, then a disclosure statement must be filed with the OTSA within 90 calendar days after the date on which the transaction becomes a listed transaction or transaction of interest. This requirement extends to an amended return and exists regardless of whether the taxpayer participated in the transaction in the year the transaction became a listed transaction or transaction of interest.

Proposed §§1.6011-10(g)(2) and 1.6011-11(g)(2) would provide relief from disclosure for participants in Micro-captive Listed Transactions and Micro-captive Transactions of Interest, respectively, who have finalized settlement agreements with the IRS with respect to the transaction. Such taxpayers do not need to disclose their participation in the transaction for years covered by the settlement agreement. Proposed §1.6011-11(g)(2) provides similar relief for participants in a Micro-captive Transaction of Interest who disclosed their participation in the transaction under Notice 2016-66 and file no more returns reflecting participation in the transaction after the final regulations are finalized.

One commenter expressed concern that settlements in litigation are not covered by the disclosure relief for taxpayers who have finalized settlement agreements that would be provided in proposed §§1.6011-10(g)(2) and 1.6011-11(g)(2). This provision in the proposed regulations is intended to cover settlement agreements with respect to the transaction reached in litigation or during the course of examination. The final regulations clarify this provision by explicitly referencing litigation. *See* §§1.6011-10(h)(2) and 1.6011-11(h)(2) of the final regulations.

Another commenter argued that excusing taxpayers from filing disclosure statements if they have finalized a settlement agreement with the IRS is an illusory reporting exemption because the IRS effectively requires Captives to wind up and liquidate as part of certain private settlement agreements. However, if this provision was removed from the regulations, taxpayers who had conclusively settled taxable years under audit that would otherwise be subject to the reporting requirements in the regulations would be forced to disclose for those years. It may not be clear that such disclosure would be unnecessary and, accordingly, the final regulations retain the exception.

One commenter stated that reporting more than once is unjust to taxpayers and suggested that Form 8886 should only have to be filed with the IRS once with respect to each Micro-captive Listed Transaction or Micro-captive Transaction of Interest. Consistent with §1.6011-4, participation in a listed transaction that involves a purported insurance arrangement means that the taxpayer is claiming tax benefits each year to which the taxpayer is not entitled. Similarly, participation in a transaction of interest that involves a purported insurance arrangement means that the taxpayer may be claiming tax benefits each year to which the taxpayer may not be entitled (that is, the IRS needs more information to determine whether the transaction is a tax avoidance transaction). As discussed in part I.C. of this Summary of Comments and Explanation of Revisions, the reporting rules for listed transactions and transactions of interest under §1.6011-4 are outside the scope of these final regulations. The final regulations do not adopt any changes based on this comment; taxpayers must disclose their participation for each year in which such tax benefits are claimed unless otherwise relieved of the obligation in the regulations.

A commenter requested an expansion of the proposed safe harbors set forth at §§1.6011-10(e)(2) and 1.6011-11(e)(2) ("Disclosure Safe Harbor for Owners"), which provide that an Owner of an Insured is not required under §1.6011-4 to file a disclosure statement with respect to a Micro-captive Listed Transaction or Micro-captive Transaction of Interest provided that person receives written or electronic acknowledgment that Insured has or will comply with its separate disclosure obligation under §1.6011-4(a) with respect to the transaction. The preamble to the proposed regulations explained that the receipt of an acknowledgment that Insured has or will comply with its disclosure obligation does not relieve the Owners of Insured of their disclosure obligations if Insured fails to disclose the transaction in a timely manner. The commenter requested that an Owner that relies on an acknowledgement pursuant to this safe harbor should be allowed to rely solely on the acknowledgement and should not also need to confirm that the Insured actually timely disclosed the transaction. However, such a position could result in non-filing by both an Owner and the Insured. To ensure that Insureds file, or Owners file if the Insured fails to do so, the final regulations do not adopt this recommendation.

Commenters also requested that the final regulations expand the Disclosure Safe Harbor for Owners to all Insured entities for transactions in which the Captive entity reported, or to all Captive entities for transactions in which the Insured reported. The final regulations do not adopt this request because unlike Owners, who must only disclose the information required by §1.6011-10(g)(1), Captives and Insureds must also provide the information required by §1.6011-10(g)(2) and (3), respectively. *See* §§1.6011-10(g) and 1.6011-11(g) of the final regulations.

Commenters suggested that transactions for which disclosure statements were filed under Notice 2016-66 should not be required to report under the proposed regulations. Proposed §§1.6011-10(g)(2) and 1.6011-11(g)(2) already limit the disclosure requirements to taxpayers who have filed a tax return (including an amended return) reflecting their participation in a Micro-captive Listed Transaction or Micro-Captive Transaction of Interest prior to January 14, 2025, and who have not finalized a settlement agreement with the IRS with respect to the transaction. Additionally, proposed §1.6011-11(g)(2) already provides that taxpayers who have filed a disclosure statement regarding their participation in a transaction identified by the proposed regulations as a Micro-captive Transaction of Interest with the OTSA pursuant to Notice 2016-66, will be treated as having made the disclosure pursuant to the final regulations for the taxable years for which the taxpayer filed returns before January 14, 2025. Similar relief should not be extended with respect to any transaction identified by the proposed regulations as a Micro-captive Listed Transaction because disclosure statements filed under Notice 2016-66 do not identify participation in a listed transaction. The final regulations do not adopt any changes based on this comment.

One commenter stated that the requirement that taxpayers participating in transactions that become listed transactions under the proposed regulations must file again under the final regulations, even if they already filed Forms 8886 pursuant to Notice 2016-66, is duplicative and a waste of taxpayers' time because the IRS already has most of the necessary

information about these transactions, and there is little marginal value to the IRS in obtaining another round of filings. The commenter suggested that there is no justification for this other than a transparent effort by the Treasury Department and the IRS to extend the applicable statute of limitations period under section 6501(c)(10) unilaterally for years where the limitations period has expired or is about to (such as 2021, for instance) and that requiring material advisors to file Forms 8918 with the OTSA, again irrespective of whether they previously filed under Notice 2016-66, is similarly unnecessary. The commenter asserts that both these duplicate filing requirements run contrary to the Paperwork Reduction Act (44 U.S.C. 3507(c)) and are themselves abusive.

This additional disclosure for listed transactions is needed because Notice 2016-66 only identified transactions of interest, so disclosure pursuant to Notice 2016-66 does not disclose that a transaction meets the threshold for listed transactions under the proposed regulations. Further, for Micro-captive Transactions of Interest, there are differences between the proposed regulations and Notice 2016-66 in both the scope of transactions identified and the information required to be disclosed. The final regulations also significantly narrow the scope of transactions identified as Micro-captive Listed Transactions compared to the proposed regulations, as further discussed in part II. of this Summary of Comments and Explanation of Revisions. Accordingly, disclosure under the final regulations will provide the IRS with new information, including identifying transactions that are now listed, and will not create unnecessary duplicative reporting requirements. The final regulations do not adopt any changes based on this comment.

Commenters asserted that the requirement in §1.6011-4(e)(2)(i) (to report to the OTSA) is unfair because it will require some taxpayers who were already subject to audits that closed without adjustment (to Captive) to report under this provision. Similarly, other commenters suggested that taxpayers who are under examination should not have to disclose because the IRS will have access to detailed taxpayer records through the examination process and should not need Form 8886 disclosures to identify participation in the transaction. The Form 8886 disclosure statements to the OTSA and the IRS are necessary, even if a taxpayer is in examination for the reporting year or was examined in an earlier year. While the IRS endeavors to resolve all tax issues in a given examination, examination may be specific to a given issue or return that does not clearly address the tax benefits of participating in a Micro-captive Listed Transaction or a Micro-captive Transaction of interest. The final regulations do not adopt these suggested changes.

A commenter requested that taxpayers who are commercial insurers acting as Intermediaries (as defined in proposed §1.6011-10(b)(5)) and material advisors to such commercial insurers be excepted from reporting because commercial insurers ceding risks to a reinsurer need to be certain that the reinsurer will satisfy its financial obligations to the ceding company, a need that is generally met by requiring that the reinsurer provide security. With security in place, the commenter states that there is no business reason for the ceding company to investigate the reinsurer's ownership, tax status, overall loss ratio (including any other business the reinsurer may write), or financing practices. The final regulations do not adopt this suggestion. Commercial insurers acting as Intermediaries should know as part of their due diligence the nature of the entity with which they have contracted. The material advisors to such commercial insurers, similarly, should know as part of their due diligence the nature of the transaction about which they are providing advice. Also, as a general matter, the most likely type of micro-captive transaction involving a commercial insurer is a Consumer Coverage Arrangement. The final regulations have significantly broadened the reporting exception set forth in the proposed regulations for Consumer Coverage Arrangements to eliminate their possible identification as a Micro-captive Listed Transaction, as discussed more fully at part IV. of this Summary of Comments and Explanation of Revisions, which should afford sufficient relief to commercial insurers acting as Intermediaries.

VI. *Other Comments and Requested Changes to the Proposed Regulations*

In addition to comments on the authority of the Treasury Department and the IRS to issue the proposed regulations, specific comments on the Loss Ratio Factor and the Financing Factor, comments on the Consumer Coverage Exception, and comments seeking safe harbors from identification as or disclosure of a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest, commenters expressed additional concerns, sought clarification, and recommended additional changes to the proposed regulations.

A. *Request for Clarification Regarding Effect on Cannabis Businesses*

One commenter stated that because the sale of cannabis constitutes "trafficking in controlled substances" under section 280E, cannabis businesses may not claim deductions for amounts paid or incurred during the taxable year, including amounts paid for insurance premiums. The commenter asked for guidance on how the proposed regulations will impact the cannabis industry. A cannabis business that enters into a Contract with a Captive would be an Insured under the proposed regulations if it treats amounts paid under the Contract as insurance premiums for Federal income tax purposes, even if it cannot deduct such amounts. Accordingly, a transaction between a cannabis business and Captive may meet the definition of a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest under the proposed regulations. Any taxpayer engaged in such a transaction would be subject to the disclosure requirements set forth in the proposed regulations, except as otherwise provided therein, if their returns reflect the tax consequences of participation in the transaction. The tax return of an Insured that cannot deduct an amount paid or incurred for purported insurance payments by operation of section 280E is not likely to reflect the tax consequences of participation in a Micro-captive Listed Transaction or Micro-captive Transaction of Interest, and therefore, the Insured will likely not be a "participant" in the transaction under these regulations. However, others involved in the transaction, such

as Captive, which generally will exclude amounts received as premiums from income based on the position that it is an insurance company, would therefore reflect the tax consequences of participation in their returns, and may nonetheless be considered “participants” subject to the disclosure requirements set forth in these regulations.

B. *Comments Regarding the 20 Percent Relationship Test*

Some commenters suggested that the 20 Percent Relationship Test set forth in proposed §1.6011-10(b)(1)(iii) and incorporated in proposed §1.6011-11(b)(1) is inconsistent with the diversification requirements of section 831(b)(2)(B) as enacted pursuant to the PATH Act. One part of the PATH Act diversification requirements is based on the percentage of premiums from related insureds, requiring that no more than 20 percent of net written premiums (or if greater, direct written premiums) for a taxable year is attributable to any one policyholder. The other part is based on the relative concentration of ownership in an insurance company and its policyholders. An insurance company must meet one of the PATH Act diversification requirements to make a section 831(b) election. However, the PATH Act diversification requirements are not sufficient to eliminate the possibility that a transaction is or may be a tax avoidance transaction. The final regulations describe fact patterns that strongly indicate tax avoidance or the potential for tax avoidance by entities that make a section 831(b) election and share a concentration in ownership with any policyholder that exceeds the 20 Percent Relationship Test. The final regulations do not adopt any changes based on these comments.

Another commenter requested clarification regarding what kinds of derivatives will cause a taxpayer to meet the 20 Percent Relationship Test. The commenter expressed concern that as risk management vehicles, derivatives are not comparable to ownership of an entity through stock. To be clear, any derivative that is derived from a direct or indirect interest in the assets held by the Captive or the Captive’s stock is included in the definition of Owner for the Captive. Any derivative that is derived from a direct or indirect interest in the assets held by the Insured or the Insured’s stock is included in the definition of Owner for the Insured. While the commenter asserted that derivatives are generally used for risk management, the Treasury Department and the IRS are aware of promoters of abusive micro-captive transactions using derivatives to replicate ownership interests, specifically in response to Notice 2016-66. For example, a taxpayer may enter into a derivative contract such as a tracking stock warrant with respect to a Captive’s stock. Such a contract would lack the voting rights or equity interest considered ownership under Notice 2016-66, but the taxpayer is provided with the same or similar economic benefits as owning the Captive directly through its eligibility to exercise the warrant to obtain one or more shares in the Captive. The final regulations do not adopt any changes based on this comment.

One commenter argued that the 20 Percent Relationship Test is contrary to the micro-captive concept, asserting that micro-captives are typically structured with a single owner, who has a single business, that is also the sole policyholder of the micro-captive. The commenter appeared to suggest that section 831(b) was intended specifically for the benefit of such micro-captives, but this is not consistent with the history of section 831(b). Section 831(b) arose out of tax laws specific to certain small and mutual insurers, which are traditionally held by their members in a given geographical location “solely for the protection of their own property and not for profit.” Revenue Act of 1914, Public Law 63-217, 38 Stat. 745, 762. These small insurers, including groups of farmers and fire associations, were exempt from ordinary income tax laws and were understood to collect funds only up to what was needed for losses and expenses. *See* H.R. Rep. No. 69-1, at 9 (1925). Under the current Code, these and other types of small insurers use section 831(b) to exclude premiums from taxable income. Accordingly, while the Code does contemplate small insurers, such contemplation is not specific to a single captive covering a sole policyholder. The inclusion of the 20 Percent Relationship Test in the proposed regulations was intended to exclude entities such as the mutual insurers, which are more likely to have diversified ownership and thus have significantly reduced potential for tax avoidance. The final regulations do not adopt any changes based on this comment.

C. *Recommendations to Eliminate or Delay Some or All of the Proposed Regulations*

Commenters recommended that the proposed regulations identifying Micro-Captive Listed Transactions should not be finalized. Commenters noted that captive transactions can differ significantly from one transaction to the next and because the test for whether a transaction is insurance for Federal tax purposes is a totality of the circumstances inquiry, it is unreasonable to designate any category of transactions as transactions known to be abusive. The final regulations do not adopt this recommendation. However, the final regulations significantly narrow the scope of §1.6011-10 to decrease the likelihood that transactions that are not tax avoidance transactions are identified as listed transactions. As commenters noted, the IRS has received information on micro-captive transactions, whether in response to Notice 2016-66 or as part of examinations or litigation, for many years. The IRS is confident from its review of examinations and case law that the fact pattern described in the final regulations is a fact pattern that consistently gives rise to tax avoidance.

Commenters recommended that finalization of these regulations be postponed until a decision is reached in *Loper Bright Enterprises v. Raimondo*, Sup. Ct. Dkt. No. 22-451 (*certiorari* granted on the question of “[w]hether the Court should overrule *Chevron* or at least clarify that statutory silence concerning controversial powers expressly but narrowly granted elsewhere in the statute does not constitute an ambiguity requiring deference to the agency”). The Supreme Court issued its decision in this case on June 28, 2024, and as such, this recommendation is moot. *Loper Bright Enterprises v. Raimondo*, 144 S.Ct. 2244 (2024). Further, as described more fully in the Authority section of this preamble, sections 6011 and 7805(a) provide express delegations of authority to the Secretary to identify the form and manner of taxpayer filing requirements and

make rules, respectively. Section 6707A provides an express delegation of authority to identify reportable transactions. The final regulations do not adopt any changes based on these comments.

Commenters recommended modification of Form 1120-PC, *U.S. Property and Casualty Insurance Company Tax Return*, to capture the information required to be reported by Captives in the proposed regulations, in lieu of finalizing the proposed regulations. This recommendation was not adopted for the reasons explained in the preamble to the proposed regulations. Changes to the Form 1120-PC would at a minimum impact all nonlife insurance companies that make section 831(b) elections, not only participants in the micro-captive transactions described in these regulations. Some of the requested information is not readily available from filed Forms 1120-PC, such as the descriptions of the types of coverages provided by a Captive and the name and contact information of any actuary or underwriter who assisted Captive in the determination of amounts treated as premiums. Additionally, limiting the collection of information to only those entities filing the Form 1120-PC would be insufficient to gather relevant information, including information regarding Insureds and promoters of the transactions. Reporting for the specific transactions identified in these regulations is best captured in the manner of all reportable transactions, by requiring disclosure on Form 8886, for consistency in enforcement of the reportable transaction regime.

Commenters expressed concern that the IRS should have sufficient information on micro-captives in the responses filed to Notice 2016-66 and thus the regulations are not needed. Commenters stated the IRS should not require any further reporting. As commenters also noted, the IRS has received information on micro-captive transactions for several years. The IRS is confident from its review of examinations and case law that the fact pattern described in the regulations is a fact pattern that consistently gives rise to tax avoidance or otherwise potentially gives rise to tax avoidance. However, promoters continue to promote participation in these transactions, and the IRS is aware of new entrants to these transactions. Thus, despite information collected to date, the IRS needs to continue collecting information to identify who the participants are and the nature of their transactions. The final regulations do not adopt any changes based on these comments.

Commenters recommended that the proposed regulations be withdrawn in their entirety and that guidance be issued instead on what would make a micro-captive arrangement an insurance arrangement for Federal tax purposes in the IRS's estimation. As the Tax Court explained in *Syzygy*, "[a]n inherent requirement for a company to make a valid section 831(b) election is that it must transact in insurance." T.C. Memo. 2019-34, at *28; *see also Reserve Mech.*, 34 F.4th at 904. Like any insurance transaction, a valid micro-captive arrangement for Federal tax purposes is one that meets the four-prong test of insurance as detailed by the courts in a significant body of case law. *See Le Gierse*, 312 U.S. at 539; *see also Avrahami*, 149 T.C. at 181 (*citing Rent-A-Center*, 142 T.C. at 13-14) (additional citations omitted); *Syzygy*, T.C. Memo. 2019-34, at *29; *Caylor*, T.C. Memo. 2021-30, at *31-32; *Keating*, T.C. Memo. 2024-2, at *51-52; *Swift*, T.C. Memo. 2024-13, at *27; *Patel*, T.C. Memo. 2024-34, at *37-38; *Royalty Mgmt.*, T.C. Memo. 2024-87, at *35. The IRS has issued guidance regarding what makes a captive insurance arrangement an insurance arrangement for Federal tax purposes that is applicable to all insurance companies, including those making section 831(b) elections. *See*, *e.g.*, Rev. Rul. 2002-89, 2002-2 C.B. 984; Rev. Rul. 2002-90, 2002-2 C.B. 985; Rev. Rul. 2002-91, 2002-2 C.B. 991; Rev. Rul. 2005-40, 2005-2 C.B. 4; Rev. Rul. 2007-47, 2007-2 C.B. 127; Rev. Rul. 2008-8, 2008-1 C.B. 340; and Rev. Rul. 2009-26, 2009-38 I.R.B. 366. Nonetheless, in many micro-captive transactions, the manner in which the contracts are interpreted, administered, and applied is inconsistent with arm's length transactions, actuarial standards, and sound business practices. The captive typically does not behave as an insurance company commonly would, indicating that the captive is not issuing insurance contracts and the transaction does not constitute insurance for Federal tax purposes. The final regulations therefore do not adopt any changes based on these comments.

D. *Requests for Clarification Regarding Revoked or Inapplicable Section 831(b) Elections*

Commenters requested clarification whether reporting is still required for years in which a Captive's section 831(b) election has been revoked or is otherwise inapplicable for a given taxable year. Under section 831(b)(2)(A), a section 831(b) election, once made, may be revoked only with the consent of the Secretary. Once an election is made, the alternative tax under section 831(b) applies only if the net written premiums (or, if greater, the direct written premiums) for the taxable year do not exceed the threshold set forth in section 831(b)(2)(A)(i) (as adjusted for inflation) and if the electing entity meets the diversification requirements set forth in section 831(b)(2)(B), for that taxable year.

Under proposed §§1.6011-10(b)(1)(i) and 1.6011-11(b)(1), an entity would be a Captive only if it elects under section 831(b) to exclude premiums from taxable income. Under proposed §§1.6011-10(a) and 1.6011-11(a), a transaction would be a Micro-Captive Listed Transaction or Micro-captive Transaction of Interest only if it involves a Captive. Separately, pursuant to §1.6011-4(a), the disclosure requirements for reportable transactions apply to a taxpayer that is a participant in a reportable transaction for taxable years in which the taxpayer's filed return reflects the tax consequences of participation in the transaction, as set forth in §1.6011-4(c)(3)(i)(A).

An entity that revokes its section 831(b) election would not be a Captive under the proposed regulations beginning in the year of revocation. Similarly, for taxable years after a Captive has filed its final return, it has effectively revoked its section 831(b) election. *See* §1.6011-10(b)(1)(i); *but see* §§1.6011-10(b)(2)(iv) and 1.6011-11(b)(2)(iii) (regarding successor corporations). Accordingly, for taxable years in which a Captive's section 831(b) election has been revoked or the Captive has previously filed its final return, the arrangement generally is not a Micro-Captive Listed Transaction or Micro-Captive Transaction

of Interest under the proposed regulations in that taxable year.

However, if the alternative tax under section 831(b) is inapplicable (either because premiums exceed the threshold or the entity fails the diversification requirements set forth in section 831(b)(2)(B) for that year), because the section 831(b) election remains in effect, the entity may still be a Captive under the proposed regulations. Thus, in taxable years in which a Captive's section 831(b) election is inapplicable but has not been revoked, and the arrangement is otherwise described in the regulations, the arrangement would still be a Micro-Captive Listed Transaction or Micro-Captive Transaction of Interest under the proposed regulations. The potential of using of the section 831(b) election for tax avoidance is not eliminated until the election is revoked. Taxpayers must disclose the transaction in such years if their returns reflect the tax consequences of participation.

The effect of revocation or inapplicability of the section 831(b) election, as described with respect to the proposed regulations, is retained in the final regulations. However, in the interest of limiting the reporting required by these regulations, the final regulations provide transition relief for section 831(b) revocations. Specifically, if the Captive in a transaction identified as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest in §§1.6011-10(a) and 1.6011-11(a) of the final regulations requests the Secretary's consent to revoke its section 831(b) election on or before the date by which the participants' disclosures must be filed with the OTSA, the transaction will not be identified as a Micro-captive Listed Transaction or Micro-captive Transaction of Interest for taxable years ending before January 1, 2026, pursuant to §§1.6011-10(h)(1) and 1.6011-11(h)(1).

Additionally, the final regulations provide certainty regarding the disclosure obligations of taxpayers who have participated in a Micro-captive Listed Transaction or Micro-captive Transaction of Interest involving a Captive that has subsequently revoked its section 831(b) election and therefore ceased to be a Captive. With respect to taxable years in which the section 831(b) revocation is effective, §§1.6011-10(f)(3) and 1.6011-11(f)(3) of the final regulations provide taxpayers involved in the transaction with a safe harbor from identification as participants in that transaction.

Commenters also requested a streamlined method by which taxpayers could obtain the Secretary's consent to revoke section 831(b) elections. Currently, consent is obtained through the private letter ruling procedures, published annually. *See*, *e.g.*, Rev. Proc. 2024-1, 2024-1 I.R.B. 1. The IRS intends to issue a Revenue Procedure that describes a simplified process for revocation of section 831(b) elections.

E. *Request for Clarification Regarding the Definition of Intermediary*

A commenter requested clarification on whether the defined term "Intermediary," as described in proposed §§1.6011-10(b)(5) and 1.6011-11(b)(5), includes fronting companies. Generally, "fronting" is "an arrangement in which a primary insurer acts as the insurer of record by issuing a policy, but then passes the entire risk to a reinsurer in exchange for a commission. Often, the fronting insurer is licensed to do business in a state or country where the risk is located, but the reinsurer is not." *NAIC Glossary of Insurance Terms*, *https://content.naic.org/glossary*-insurance-terms (last visited Jan. 6, 2025). The term "Intermediary" as defined in the proposed regulations means an entity that issues Contracts to an Insured, which are then reinsured, directly or indirectly, by a Captive. A "fronting" company would fall within the definition of "Intermediary" if it issues Contracts to an Insured, which are then reinsured, directly or indirectly, by a Captive.

F. *Recommendation to Limit the Effective Period of Section 831(b) Elections for Companies that Do Not Meet Loss Ratio Threshold*

A commenter recommended that no loss ratio factor apply for the first five years of a section 831(b) election, after which any entity that elected the alternative tax under section 831(b) would automatically revert to an entity taxable under section 831(a) unless it meets a loss ratio threshold. The commenter did not specify what an appropriate loss ratio threshold would be, but implied that the loss ratio threshold should be lower than the Loss Ratio Factor percentages set forth in the proposed regulations.

An automatic conversion to a taxable insurance company under section 831(a) would be inconsistent with the statutory language of section 831(b). Valid insurers who rely on the section 831(b) election would be impermissibly harmed by this recommendation. To the extent the commenter intended to recommend a five-year grace period from formation of a Captive to identification as either a Micro-captive Listed Transaction or a Micro-captive Transaction of Interest, this could enable participants in micro-captive arrangements that are or may be tax avoidance transactions to permanently avoid reporting that would otherwise be required by, for instance, setting up a new Captive every five years. The final regulations do not adopt any changes based on this comment.

G. *Comments Regarding Constitutionality of Potential Adjustments if Transaction Examined*

Commenters expressed concern that the potential adjustments applicable to abusive transactions, as described in the preamble to the proposed regulations, are unconstitutional as double tax. Specifically, the preamble to the proposed regulations noted that examinations may result in adjustments including full disallowance of claimed micro-captive insurance premium deductions and the inclusion in income of amounts received by the Captive. These adjustments are consistent with the adjustments sustained against taxpayers in the relevant micro-captive court cases. *See Avrahami*, 149 T.C. at 199 (disallowed premium deductions), *Syzygy*, T.C. Memo. 2019-34, at *45-46 (disallowed premium deductions and required income inclusion by the Captive), *Caylor*, T.C. Memo. 2021-30, at *48-53 (disallowed premium deductions and penalties); *Keating*, T.C. Memo. 2024-2, at *65-66, 77 (disallowed premium deductions and penalties); *Swift*, T.C. Memo. 2024-13, at *44-50 (disallowed premium deductions and penalties); *Patel*, T.C. Memo. 2024-34, at *52 (disallowed premium deductions), and *Royalty Mgmt.*, T.C. Memo. 2024-87, at *49-50,

52-53 (disallowed premium deductions and required income inclusion by the Captive); *see also Reserve Mech.*, T.C. Memo. 2018-86, at *62-64 (income to a tax-exempt entity under section 501(c)(15)). Further, while the IRS may challenge the tax benefits claimed in these transactions, adjustments will be asserted only to the extent warranted by the facts, following examination by the IRS. The final regulations do not adopt any changes based on these comments.

H. *Comments Regarding Impact on the Captive Insurance Industry*

Commenters expressed concern that the proposed regulations will negatively impact the captive insurance industry and would eliminate many benefits to its participants. Commenters stated that the benefits of captives include the following: providing coverage that is either unavailable or prohibitively expensive commercially, providing entry to reinsurance markets that are otherwise unavailable to participants, allowing for competition with commercial insurers, and serving to manage catastrophic risks for many businesses, such as the risks arising under the Coronavirus Disease 2019 (COVID-19) pandemic. These benefits are available to all section 831(a) captives and to those section 831(b) captives that are not engaged in transactions that are tax avoidance transactions. These regulations do not hinder the formation of valid captives. Accordingly, the final regulations do not adopt any changes based on these comments.

I. *Comments Regarding Compliance Concerns*

Some commenters argued that the proposed regulations are retroactive in nature, that there would be no way for an existing micro-captive to "come into compliance with the proposed regulation," and that there would be no way for a taxpayer to know whether they are entering into a reportable transaction. As previously stated in part I.C. of this Summary of Comments and Explanation of Revisions, the proposed regulations are not retroactive in nature; the final regulations will be effective as of January 14, 2025. Section 1.6011-4(e)(2)(i) is clear that reporting is required for transactions entered into and reflected on a tax return for a year prior to the publication of guidance identifying a transaction as a listed transaction or a transaction of interest, if the statute of limitations is still open on the effective date of the listing. While the disclosures mandated by §1.6011-4 may be with respect to prior periods, if the period of limitations on assessment for such periods has not expired, the disclosure obligation is itself not retroactive - it is a current reporting obligation. The comments regarding an impermissible retroactive burden are without merit and outside the scope of these final regulations.

Moreover, existing participants in transactions identified under the final regulations as a Micro-Captive Listed Transaction or a Micro-Captive Transaction of Interest may successfully comply by fulfilling their reporting obligations as set forth in the final regulations at §§1.6011-10(g) and 1.6011-11(g). Lastly, taxpayers are encouraged to make informed decisions and seek independent tax advice before entering into any transaction. Taxpayers have been placed on notice of the IRS's concern with abuse of the section 831(b) election since at least 2015 when the IRS first identified micro-captive transactions on its annual Dirty Dozen list. The final regulations do not adopt any changes based on these comments.

J. *Comment Expressing Concerns about Access to Administrative Appeals*

Finally, a commenter expressed concern that taxpayers whose micro-captive transactions are examined do not have access to good faith administrative appeals. Appeals is an independent office of the IRS. Section 7803(e)(3) of the Code provides that it is the function of Appeals to resolve Federal tax controversies without litigation on a basis which is fair and impartial to both the Government and the taxpayer, and promotes a consistent application and interpretation of, and voluntary compliance with, the Federal tax laws. The Appeals resolution process is generally available to all taxpayers. Appeals endeavors to be consistent in its approach with the goal of making a fair and reasoned determination on each case presented to it, considering the facts of the case and existing case law. Taxpayers concerned about their specific case and the handling thereof should raise the matter to the appropriate authorities within Appeals.

Special Analyses

I. *Regulatory Planning and Review*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

The collection of information contained in the final regulations is reflected in the collection of information for Forms 8886 and 8918 that have been reviewed and approved by OMB in accordance with the Paperwork Reduction Act (44 U.S.C. 3507(c)) under control numbers 1545-1800 and 1545-0865. To the extent there is a change in burden as a result of these regulations, the change in burden will be reflected in the updated burden estimates for the Forms 8886 and 8918. The requirement to maintain records to substantiate information on Forms 8886 and 8918 is already contained in the burden associated with the control numbers for the forms and is unchanged.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by OMB.

III. *Regulatory Flexibility Act*

The Regulatory Flexibility Act (RFA) (5 U.S.C. part I, chapter 6) requires agencies to "prepare and make available for public comment an initial regulatory flexibility analysis," which will "describe the impact of the rule on small entities." 5 U.S.C. 603(a). Section 605(b) of the RFA allows an agency to certify a rule if the rulemaking is not expected to have a significant economic impact on a substantial number of small entities.

The Secretary of the Treasury hereby certifies that the final regulations will not have a significant economic impact on a substantial number of small entities pursuant to the RFA. The basis for these final regulations is Notice 2016-66, 2016-47 I.R.B. 745 (as modified by Notice 2017-08, 2017-3 I.R.B. 423). The following chart sets forth the gross receipts of respondents to Notice 2016-66, based on data for taxable year 2022:

Notice 2016-66 Respondents by Size		
Receipts	**Firms**	**Filings**
Under 5M	74.45%	70.87%
5M to 10M	7.17%	7.56%
10M to 15M	4.36%	4.76%
15M to 20M	2.49%	2.80%
20M to 25M	1.87%	2.24%
Over 25M	9.66%	11.76%
TOTAL	100%	100%

This chart shows that the majority of respondents to Notice 2016-66 reported gross receipts under $5 million. Even assuming that these respondents constitute a substantial number of small entities, the final regulations will not have a significant economic impact on these entities because the final regulations implement sections 6111 and 6112 and §1.6011-4 by specifying the manner in which and time at which an identified Micro-captive Listed Transaction or Micro-captive Transaction of Interest must be reported. Accordingly, because the regulations are limited in scope to time and manner of information reporting and definitional information, the economic impact of the final regulations is expected to be minimal.

Further, the Treasury Department and the IRS expect the reporting burden to be low; the information sought is necessary for regular annual return preparation and ordinary recordkeeping. The estimated burden for any entity required to file Form 8886 (as revised Oct. 2022) is approximately 10 hours, 16 minutes for recordkeeping; 4 hours, 50 minutes for learning about the law or the form; and 6 hours, 25 minutes for preparing, copying, assembling, and sending the form to the IRS. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $73.48 (2022 dollars) per hour. Thus, it is estimated that a respondent will incur costs of approximately $1,581.05 per filing. Disclosures received to date by the Treasury Department and the IRS in response to the reporting requirements of Notice 2016-66 indicate that this small amount will not pose any significant economic impact for those taxpayers now required to disclose under the final regulations. The Treasury Department and the IRS have concluded that the cost of filing the disclosure statements required by these regulations will not pose any significant economic impact.

Some commenters expressed concern that the cost of filing disclosure statements is too onerous for taxpayers. Specifically, commenters stated that they incurred significant costs in responding to Notice 2016-66 and will again face those costs if new disclosures are required. In response to comments on Notice 2016-66 and the proposed regulations, the final regulations narrow the scope of transactions described in §§1.6011-10(h) and 1.6011-11(h). New disclosures are needed to identify participants in these transactions, but the final regulations provide in §1.6011-11(h)(2) that taxpayers who have filed a disclosure statement regarding their participation in a transaction that is the same as, or substantially similar to, the transaction described in §1.6011-11(a) with the OTSA pursuant to Notice 2016-66, will be treated as having made the disclosure pursuant to the final regulations for the taxable years for which the taxpayer filed returns before January 14, 2025.

One commenter asserted that the reporting obligations would be particularly onerous for arrangements using a pooled reinsurance structure with numerous participants and likened the cost of filling out a Form 8886 to effectively imposing a tax on the entire community of captive insurers electing the alternative tax under section 831(b). Taxpayer compliance burden is not equivalent to a tax, and the Instructions to Forms 8886 and 8918 make clear that the time needed to complete and file such forms will vary depending on individual circumstances.

Two commenters indicated that the $77.50 (2020 dollars) wage rate per hour used to approximate the total cost of preparing and filing a Form 8886, as referenced in the proposed regulations, is too low. One of these commenters implied that the applicable average wage rate per hour is closer to $268.50. Given the availability of more recent data, the hourly rate estimate is revised in the final regulations to $73.48 (2022 dollars). This updated figure does not address the substantial difference from the commenter's estimate. The difference is likely attributable to the different methodologies used. The commenter likely used the hourly rate that an independent professional would charge a retail customer to prepare a Form 8886.

These commenters also expressed disagreement with the estimated average amounts of time required to complete Forms 8886 and 8918, as indicated in the instructions to each of those forms. One commenter described the estimate of 21.5 hours to comply as "significantly underestimated." However, the commenter did not elaborate on the amount of time actually required for the commenter. Additionally, the Instructions to Forms 8886 and

8918 make clear that the time needed to complete and file such forms will vary depending on individual circumstances. One of the commenters stated that based on a survey of 2,397 respondents, the average amount of time spent by each respondent "for compliance" under Notice 2016-66 (using it as a proxy for these final regulations) was 50.97 hours, which the commenter noted is above the estimated average amounts of time for completion indicated in the instructions to each of those forms. However, based on the information provided by this commenter regarding the same survey, the total number of hours spent on "compliance" by all respondents was 121,755 hours, and the total number of Forms 8886 and 8918 completed by respondents for this "compliance" was 15,021. Consequently, the average amount of time spent per form by these respondents appears to be approximately 8.11 hours (that is, approximately 8 hours, 6 minutes). This amount falls below the estimated average time of 21 hours, 31 minutes for Form 8886 (as revised Oct. 2022) and 14 hours, 31 minutes for Form 8918 (as revised Nov. 2021) as provided in the instructions to those forms, respectively.

For the reasons stated, a regulatory flexibility analysis under the RFA is not required. Pursuant to section 7805(f)(1), the notice of proposed rulemaking preceding the final regulations was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. This final rule does not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

V. *Executive Order 13132: Federalism*

Executive Order 13132 (Federalism) prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order. *See also* part I.B. of the Summary of Comments and Explanation of Revisions.

VI. *Congressional Review Act*

Pursuant to the Congressional Review Act (5 U.S.C. 801 *et seq*.), the Office of Information and Regulatory Affairs has designated this rule as not a "major rule," as defined by 5 U.S.C. 804(2).

Drafting Information

The principal author of these regulations is Allan H. Sakaue, Office of Associate Chief Counsel (Financial Institutions and Products), IRS. However, other personnel from the Treasury Department and the IRS participated in their development.

Availability of IRS Documents

The notices cited in this preamble are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at *https://www.irs.gov*.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, the Treasury Department and the IRS amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries for §§ 1.6011-10 and 1.6011-11 in numerical order to read in part as follows:

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

* * * * *

Section 1.6011-10 also issued under 26 U.S.C. 6001 and 6011.

Section 1.6011-11 also issued under 26 U.S.C. 6001 and 6011.

* * * * *

Par. 2. Section 1.6011-10 is added to read as follows:

§ 1.6011-10 Micro-captive listed transaction.

(a) *Identification as listed transaction.* Transactions that are the same as, or Substantially Similar to, transactions described in paragraph (c) of this section are identified as listed transactions for purposes of § 1.6011-4(b)(2), except as provided in paragraph (d) of this section.

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of this section:

(1) *Captive*. The term *Captive* means any entity that is described in each of the paragraphs (b)(1)(i), (ii), and (iii) of this section.

(i) The entity elects under section 831(b) of the Internal Revenue Code (Code) to include in taxable income only taxable investment income (defined in section 834 of the Code) in lieu of the tax imposed under section 831(a).

(ii) The entity issues a Contract to an Insured, reinsures a Contract of an Insured issued by an Intermediary, or both.

(iii) At least 20 percent of the entity's assets or the voting power or value of its outstanding stock or equity interests is directly or indirectly owned, individually or collectively, by an Insured, an Owner, or persons Related to an Insured or an Owner. For purposes of this paragraph (b)(1)(iii), the rules of paragraph (b)(1)(iii)(A) or (B) of this section apply to the extent application of a rule (or rules) would increase such direct or indirect ownership.

(A) A person that holds a derivative is treated as indirectly owning the assets referenced by the derivative.

(B) The interest of each beneficiary of a trust or estate in the assets of such trust or estate must be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the trust's or estate's interest in the company to satisfy the interests of such beneficiary.

(2) *Computation periods*—(i) *Financing Computation Period.* The term *Financing Computation Period* means the most recent five taxable years (including the most recent concluded taxable year) of a Captive (or all taxable years of a Captive if the Captive has been in existence for less than five taxable years).

(ii) *Listed Transaction Loss Ratio Computation Period.* The term *Listed Transaction Loss Ratio Computation Period* is the most recent ten taxable years (including the most recent concluded taxable year) of Captive. A Captive that does not have at least ten taxable years cannot have a Listed Transaction Loss Ratio Computation Period, and therefore is not described in paragraph (c)(2) of this section.

(iii) *Taxable years.* For purposes of paragraphs (b)(2)(i) and (ii) of this section:

(A) Each short taxable year is a separate taxable year.

(B) If the Captive is a successor to one or more other Captives, taxable years of each such other Captive are treated as taxable years of the Captive.

(iv) *Successors*. The term *successor* means any entity described in paragraph (b)(2)(iv)(A), (B), or (C) of this section.

(A) A successor corporation as defined in § 1.382-2(a)(5).

(B) An entity that, directly or indirectly, acquires (or is deemed to acquire) the assets of another entity and succeeds to and takes into account the other entity's earnings and profits or deficit in earnings and profits.

(C) An entity that receives (or is deemed to receive) any assets from another entity if such entity's basis in such assets is determined, directly or indirectly, in whole or in part, by reference to the other entity's basis in such assets.

(3) *Contract*. The term *Contract* means any contract that is treated by a party to the contract as an insurance contract or reinsurance contract for Federal income tax purposes.

(4) *Insured*. The term *Insured* means any person that conducts a trade or business, enters into a Contract with a Captive or enters into a Contract with an Intermediary that is directly or indirectly reinsured by a Captive, and treats amounts paid under the Contract as insurance premiums for Federal income tax purposes.

(5) *Intermediary*. The term *Intermediary* means any entity that issues a Contract to an Insured or reinsures a Contract that is issued to an Insured, and such Contract is reinsured, directly or indirectly, by a Captive. A transaction may have more than one Intermediary.

(6) *Owner*. The term *Owner* means any person who, directly or indirectly, holds an ownership interest in an Insured or its assets. For purposes of this paragraph (b)(6), the rules of paragraph (b)(6)(i) or (ii) of this section apply to the extent application of a rule (or rules) would increase such direct or indirect ownership.

(i) The interest of a person that holds a derivative must be determined as provided in paragraph (b)(1)(iii)(A) of this section.

(ii) The interest of each beneficiary of a trust or estate in the assets of such trust or estate must be determined as provided in paragraph (b)(1)(iii)(B) of this section.

(7) *Recipient*. The term *Recipient* means any Owner, Insured, or person Related to an Owner or an Insured engaged in a transaction described in paragraph (c)(1) of this section.

(8) *Related*. The term *Related* means having a relationship described in one or more of sections 267(b), 707(b), 2701(b)(2)(C), and 2704(c)(2) of the Code.

(9) *Seller*. The term *Seller* means a service provider, dealer (including an automobile dealer), lender, wholesaler, or retailer that sells products or services to customers who purchase insurance contracts in connection with those products or services and at least 95 percent of sales of products or services by Seller for the taxable year to persons who purchase such insurance contracts are sales to Unrelated Customers.

(10) *Seller's Captive*. The term *Seller's Captive* means a Captive Related to Seller, an owner of Seller, or individuals or entities Related to Seller or owners of Seller.

(11) *Substantially Similar*. The term *Substantially Similar* is defined in § 1.6011-4(c)(4).

(12) *Unrelated Customers*. The term *Unrelated Customers* means persons who do not own an interest in, and are not wholly or partially owned by, Seller, an owner of Seller, or individuals or entities Related to Seller or owners of Seller.

(c) *Transaction description.* A transaction is described in this paragraph (c) if the transaction is described in both paragraphs (c)(1) and (2) of this section.

(1) The transaction involves a Captive that, at any time during the Captive's Financing Computation Period, directly or indirectly, engages in a transaction described in paragraph (c)(1)(i) of this section, taking into account paragraph (c)(1)(ii) of this section.

(i) The Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient, in a transaction that did not result in taxable income or gain to the Recipient, in whole or in part, any portion of the amounts received under a Contract, such as through a guarantee, a loan, or other transfer of Captive's capital, or made such financings or conveyances prior to the Financing Computation Period that remain outstanding or in effect at any point in the taxable year for which disclosure is required.

(ii) Any amounts that a Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient are presumed to be portions of the amounts received under a Contract to the extent that such amounts, when made available or conveyed, are in excess of Captive's cumulative after-tax net investment earnings minus any outstanding financings or conveyances.

(2) The transaction involves a Captive for which the amount described in paragraph (c)(2)(i) of this section is less than 30 percent of the amount described in paragraph (c)(2)(ii) of this section.

(i) The amount of liabilities incurred for insured losses and claim administration expenses during the Listed Transaction Loss Ratio Computation Period.

(ii) The amount equal to premiums earned by the Captive during the Listed Transaction Loss Ratio Computation Period, less policyholder dividends paid by the Captive during the Listed Transaction Loss Ratio Computation Period.

(d) *Exceptions.* A transaction described in paragraph (c) of this section is not iden-

tified as a listed transaction for purposes of this section and § 1.6011-4(b)(2) if the transaction:

(1) Provides insurance for employee compensation or benefits and is one for which the Employee Benefits Security Administration of the U.S. Department of Labor has issued a Prohibited Transaction Exemption under the procedures provided at 29 CFR 2570.30 through 2570.52; or

(2) Is an arrangement in which a Captive meets all of the requirements described in this paragraph (d)(2).

(i) The Captive is a Seller's Captive.

(ii) The Seller's Captive issues or reinsures some or all of the Contracts purchased by Unrelated Customers in connection with the products or services being sold by the Seller.

(iii) 100 percent of the business of the Seller's Captive is issuing or reinsuring Contracts in connection with products or services being sold by the Seller or persons Related to the Seller.

(iv) At least 95 percent of the Seller's Captive's business for the taxable year is issuing or reinsuring Contracts purchased by Unrelated Customers in connection with products or services sold by Seller or persons Related to Seller.

(e) *Bright-line rules.* A transaction is not considered Substantially Similar (as defined in paragraph (b)(11) of this section) to the listed transaction identified in this section if the transaction:

(1) Does not involve an entity that has elected under section 831(b) to include in taxable income only taxable investment income (defined in section 834) in lieu of the tax imposed under section 831(a); or

(2) Involves a Captive for which the amount described in paragraph (c)(2)(i) of this section is 30 percent or more of the amount described in paragraph (c)(2)(ii) of this section.

(f) *Special participation rules*—(1) *In general.* Whether a taxpayer has participated in the listed transaction identified in paragraph (a) of this section, including Substantially Similar transactions, will be determined under § 1.6011-4(c)(3)(i)(A). Participants include, but are not limited to, any Owner, Insured, Captive, or Intermediary with respect to the transaction whose tax return reflects tax consequences or a tax strategy identified in paragraph (a), except as otherwise provided in paragraphs (f)(2) and (3) of this section.

(2) *Disclosure safe harbor for Owners.* An Owner who, solely by reason of the Owner's direct or indirect ownership interest in an Insured, has participated in the listed transaction described in this section will not be required to disclose participation in the transaction under section 6011(a) of the Code, notwithstanding § 1.6011-4(c)(3), if the Owner receives acknowledgement, in writing or electronically, from the Insured that the Insured has or will comply with the Insured's separate disclosure obligation under § 1.6011-4 with respect to the transaction and the Insured discloses the transaction in a timely manner. The acknowledgment can be a copy of the Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), filed (or to be filed) by the Insured and must be received by the Owner prior to the time set forth in § 1.6011-4(e) in which the Owner would otherwise be required to provide disclosure. Owners who meet the requirements of the safe harbor in this paragraph (f)(2) will not be treated as having participated in an undisclosed listed transaction for purposes of § 1.6664-2(c)(3)(ii) or as having failed to include information on any return or statement with respect to a listed transaction for purposes of section 6501(c)(10) of the Code.

(3) *Disclosure safe harbor for taxpayers in transactions with revoked section 831(b) elections*. If the Captive has revoked its section 831(b) election, taxpayers who participated in the listed transaction with respect to that Captive, including any Insureds, Owners, and Intermediaries, will not be considered participants in the transaction under section 6011(a), notwithstanding § 1.6011-4(c)(3), for any taxable year in which the section 831(b) revocation is effective, provided that a successor Captive has not been established as described in paragraph (b)(2)(iv) of this section. In addition, if the Captive has revoked its section 831(b) election, taxpayers who meet the requirements of this safe harbor, for any taxable year in which the section 831(b) revocation is effective, will not be treated as having participated in an undisclosed listed transaction for purposes of § 1.6664-2(c)(3)(ii) or as having failed to include information on any return or statement with respect to a listed transaction for purposes of section 6501(c)(10).

(g) *Disclosure requirements*—(1) *Information required of all participants.* Participants must provide the information required under § 1.6011-4(d) and the Instructions to Form 8886 (or successor form). For all participants, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) when, how, and from whom the participant became aware of the transaction, and how the participant participated in the transaction (for example, as an Insured, a Captive, or other participant). Paragraphs (g)(2) and (3) of this section describe additional information required of a Captive and an Insured, respectively.

(2) *Additional information required of a Captive.* For a Captive, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) the items described in each of the paragraphs (g)(2)(i) through (v) of this section.

(i) All the type(s) of policies issued or reinsured by the Captive during the year of participation or each year of participation (if disclosure pertains to multiple years).

(ii) The amounts treated by the Captive as premiums written for coverage provided by Captive during the year of participation or each year of participation (if disclosure pertains to multiple years).

(iii) The name and contact information of each and every actuary or underwriter who assisted in the determination of the amounts treated as premiums for coverage provided by the Captive during the year or each year of participation (if disclosure pertains to multiple years).

(iv) The total amounts of claims paid by the Captive during the year of participation or each year of participation (if disclosure pertains to multiple years).

(v) The name and percentage of interest directly or indirectly held by each person whose interest in the Captive meets the 20 percent threshold or is taken into account in meeting the 20 percent threshold under paragraph (b)(1)(iii) of this section.

(3) *Additional information required of Insured.* For Insured, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886

(or successor form) the amounts treated by Insured as premiums paid for coverage provided to Insured, directly or indirectly, by the Captive or by each Captive (if disclosure pertains to multiple Captives) during the year or each year of participation (if disclosure pertains to multiple years), as well as the identity of all persons identified as Owners to whom the Insured provided an acknowledgment described in paragraph (f)(2) of this section.

(h) *Applicability date*—(1) *In general.* This section identifies transactions that are the same as, or Substantially Similar to, the transactions identified in paragraph (a) of this section as listed transactions for purposes of § 1.6011-4(b)(2), effective January 14, 2025, except as otherwise provided in this paragraph (h)(1). If, on or before the date prescribed for filing disclosure statements with the Office of Tax Shelter Analysis under § 1.6011-4(e), the Captive involved in the transaction has requested the consent of the Secretary to revoke its section 831(b) election, the transaction is not identified as a listed transaction for purposes of this section and § 1.6011-4(b)(2) for taxable years ending before January 1, 2026.

(2) *Obligations of participants with respect to prior periods.* Pursuant to § 1.6011-4(d) and (e), taxpayers who have filed a tax return (including an amended return) reflecting their participation in transactions described in paragraph (a) of this section prior to January 14, 2025, must disclose the transactions as required by § 1.6011-4(d) and (e) provided that the period of limitations for assessment of tax (as determined under section 6501, including section 6501(c)) for any taxable year in which the taxpayer participated has not ended on or before January 14, 2025, except as otherwise provided in this paragraph (h)(2). Taxpayers who have finalized a settlement agreement with the Internal Revenue Service with respect to the transaction, in examination or litigation, will be treated as having made the disclosure for years subject to that agreement.

(3) *Obligations of material advisors with respect to prior periods.* Material advisors defined in § 301.6111-3(b) of this chapter who have previously made a tax statement with respect to a transaction described in paragraph (a) of this section have disclosure and list maintenance obligations as described in §§ 301.6111-3 and 301.6112-1 of this chapter, respectively. Notwithstanding § 301.6111-3(b)(4)(i) and (iii) of this chapter, material advisors are required to disclose only if they have made a tax statement on or after the date that is six years before January 14, 2025. Material advisors that are uncertain whether the transaction they are required to disclose should be reported under this section or § 1.6011-11 should disclose under this section and will not be required to disclose a second time if it is later determined that the transaction should have been disclosed under § 1.6011-11.

Par. 3. Section 1.6011-11 is added to read as follows:

§ 1.6011-11 Micro-captive transaction of interest.

(a) *Identification as transaction of interest.* Transactions that are the same as, or Substantially Similar to, transactions described in paragraph (c) of this section are identified as transactions of interest for purposes of § 1.6011-4(b)(6), except as provided in paragraph (d) of this section.

(b) *Definitions.* The definitions in this paragraph (b) apply for purposes of this section.

(1) *Captive*. *Captive* has the same meaning as provided in § 1.6011-10(b)(1).

(2) *Computation periods*—(i) *Financing Computation Period*. *Financing Computation Period* has the same meaning as provided in § 1.6011-10(b)(2)(i).

(ii) *Transaction of Interest Loss Ratio Computation Period*. The term *Transaction of Interest Loss Ratio Computation Period* means—

(A) The most recent ten taxable years of a Captive; or

(B) In the case of a Captive that has been in existence for less than ten taxable years, all taxable year(s) of the Captive.

(iii) *Rules for computation periods*. The rules provided in § 1.6011-10(b)(2)(iii) and (iv) for computation periods apply for purposes of this paragraph (b)(2).

(3) *Contract*. *Contract* has the same meaning as provided in § 1.6011-10(b)(3).

(4) *Insured*. *Insured* has the same meaning as provided in § 1.6011-10(b)(4).

(5) *Intermediary*. *Intermediary* has the same meaning as provided in § 1.6011-10(b)(5).

(6) *Owner*. *Owner* has the same meaning as provided in § 1.6011-10(b)(6).

(7) *Recipient*. *Recipient* has the same meaning as provided in § 1.6011-10(b)(7).

(8) *Related*. *Related* has the same meaning as provided in § 1.6011-10(b)(8).

(9) *Seller*. *Seller* has the same meaning as provided in § 1.6011-10(b)(9).

(10) *Seller's Captive*. *Seller's Captive* has the same meaning as provided in § 1.6011-10(b)(10).

(11) *Substantially Similar*. *Substantially Similar* has the same meaning as provided in § 1.6011-10(b)(11).

(12) *Unrelated Customers*. *Unrelated Customers* has the same meaning as provided in § 1.6011-10(b)(12).

(c) *Transaction description.* A transaction is described in this paragraph (c) if the transaction is described in paragraph (c)(1) of this section, paragraph (c)(2) of this section, or both.

(1) The transaction involves a Captive that, at any time during the Captive's Financing Computation Period, directly or indirectly, engages in a transaction described in paragraph (c)(1)(i) of this section, taking into account paragraph (c)(1)(ii) of this section.

(i) The Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient, in a transaction that did not result in taxable income or gain to the Recipient, in whole or in part, any portion of the amounts received under a Contract, such as through a guarantee, a loan, or other transfer of Captive's capital, or made such financings or conveyances prior to the Financing Computation Period that remain outstanding or in effect at any point in the taxable year for which disclosure is required.

(ii) Any amounts that a Captive made available as financing or otherwise conveyed or agreed to make available or convey to a Recipient are presumed to be portions of the amounts received under a Contract to the extent such amounts, when made available or conveyed are in excess of a Captive's cumulative after-tax net investment earnings minus any outstanding financings or conveyances.

(2) The transaction involves a Captive for which the amount described in para-

graph (c)(2)(i) of this section is less than 60 percent of the amount described in paragraph (c)(2)(ii) of this section.

(i) The amount of liabilities incurred for insured losses and claim administration expenses during the Transaction of Interest Loss Ratio Computation Period.

(ii) The amount equal to premiums earned by the Captive during the Transaction of Interest Loss Ratio Computation Period, less policyholder dividends paid by the Captive during the Transaction of Interest Loss Ratio Computation Period.

(d) *Exceptions.* A transaction described in paragraph (c) of this section is not identified as a transaction of interest for purposes of this section and § 1.6011-4(b)(6) if the transaction:

(1) Is described in § 1.6011-10(d)(1);

(2) Is described in § 1.6011-10(d)(2); or

(3) Is identified as a listed transaction in § 1.6011-10(a), in which case the transaction must be reported as a listed transaction under § 1.6011-10.

(e) *Bright-line rules.* A transaction is not considered Substantially Similar (as defined in paragraph (b)(11) of this section) to the transaction of interest identified in this section if the transaction:

(1) Does not involve an entity that has elected under section 831(b) of the Internal Revenue Code (Code) to include in taxable income only taxable investment income (defined in section 834 of the Code) in lieu of the tax imposed under section 831(a); or

(2) Involves a Captive for which the amount described in paragraph (c)(2)(i) of this section is 60 percent or more of the amount described in paragraph (c)(2)(ii) of this section.

(f) *Special participation rules*—(1) *In general.* Whether a taxpayer has participated in the transaction of interest identified in paragraph (a) of this section, including Substantially Similar transactions, will be determined under § 1.6011-4(c)(3)(i)(E). Participants include, but are not limited to, any Owner, Insured, Captive, or Intermediary with respect to the transaction whose tax return reflects tax consequences or a tax strategy identified in paragraph (a), except as otherwise provided in paragraphs (f)(2) and (3) of this section.

(2) *Disclosure safe harbor for Owners.* An Owner who, solely by reason of the Owner's direct or indirect ownership interest in an Insured, has participated in the transaction of interest described in this section will not be required to disclose participation in the transaction under section 6011(a), notwithstanding § 1.6011-4(c)(3), if the Owner receives acknowledgment, in writing or electronically, from the Insured that the Insured has or will comply with Insured's separate disclosure obligation under § 1.6011-4 with respect to the transaction and the Insured discloses the transaction in a timely manner. The acknowledgment can be a copy of the Form 8886, *Reportable Transaction Disclosure Statement* (or successor form), filed (or to be filed) by the Insured and must be received by the Owner prior to the time set forth in § 1.6011-4(e) in which the Owner would otherwise be required to provide disclosure.

(3) *Disclosure safe harbor for taxpayers in transactions with revoked section 831(b) elections*. If the Captive has revoked its section 831(b) election, taxpayers who participated in the transaction of interest with respect to that Captive, including any Insureds, Owners, and Intermediaries, will not be considered participants in the transaction under section 6011(a), notwithstanding § 1.6011-4(c)(3), for any taxable year in which the section 831(b) revocation is effective, provided that a successor Captive has not been established as described in paragraph (b)(2)(iii) of this section (referencing § 1.6011-10(b)(2)(iii) and (iv)).

(g) *Disclosure requirements.* Participants must provide the information required under § 1.6011-4(d) and the Instructions to Form 8886 (or successor form). For all participants, describing the transaction in sufficient detail includes, but is not limited to, describing on Form 8886 (or successor form) when, how, and from whom the participant became aware of the transaction, and how the participant participated in the transaction (for example, as an Insured, a Captive, or other participant). A Captive and an Insured must also provide the information required in § 1.6011-10(g)(2) and (3), respectively.

(h) *Applicability date*—(1) *In general.* This section identifies transactions that are the same as, or Substantially Similar to, the transaction identified in paragraph (a) of this section as transactions of interest for purposes of § 1.6011-4(b)(6) effective January 14, 2025, except as otherwise provided in this paragraph (h)(1). If, on or before the date prescribed for filing disclosure statements with the Office of Tax Shelter Analysis under § 1.6011-4(e), the Captive involved in the transaction has requested the consent of the Secretary to revoke its section 831(b) election, the transaction is not identified as a transaction of interest for purposes of this section and § 1.6011-4(b)(6) for participants with respect to that Captive for taxable years ending before January 1, 2026.

(2) *Obligations of participants with respect to prior periods.* Pursuant to § 1.6011-4(d) and (e), taxpayers who have filed a tax return (including an amended return) reflecting their participation in transactions described in paragraph (a) of this section prior to January 14, 2025, must disclose the transactions as required by § 1.6011-4(d) and (e) provided that the period of limitations for assessment of tax (as determined under section 6501 of the Code, including section 6501(c)) for any taxable year in which the taxpayer participated has not ended on or before January 14, 2025, except as otherwise provided in this paragraph (h)(2). Taxpayers who have finalized a settlement agreement with the Internal Revenue Service with respect to the transaction, in examination or litigation, will be treated as having made the disclosure for years subject to that agreement. Taxpayers who have filed a disclosure statement regarding their participation in the transaction with the Office of Tax Shelter Analysis pursuant to Notice 2016-66, 2016-47 I.R.B. 745, will be treated as having made the disclosure pursuant to the final regulations for the taxable years for which the taxpayer filed returns before January 14, 2025. If a taxpayer described in the preceding sentence participates in the Micro-captive Transaction of Interest in a taxable year for which the taxpayer files a return on or after January 14, 2025, the taxpayer must file a disclosure statement with the Office of Tax Shelter Analysis at the same time the taxpayer files their return for the first such taxable year.

(3) *Obligations of material advisors with respect to prior periods.* Material advisors defined in § 301.6111-3(b) of this chapter who have previously made a tax statement with respect to a transaction described in paragraph (a) of this section have disclosure and list maintenance obligations as described in §§ 301.6111-3 and 301.6112-1 of this chapter, respectively. Notwithstanding § 301.6111-3(b)(4)(i) and (iii) of this chapter, material advisors are required to disclose only if they have made a tax statement on or after the date that is six years before January 14, 2025. Material advisors that are uncertain whether the transaction they are required to disclose should be reported under this section or § 1.6011-10 should disclose under § 1.6011-10 and will not be required to disclose a second time if it is later determined that the transaction should have been disclosed under this section.

Douglas W. O'Donnell,
Deputy Commissioner.

Approved: January 3, 2025.

Aviva R. Aron-Dine,
Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register January 10, 2025, 4:15 p.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3534)

Part IV

Notice of Proposed Regulation

Base Erosion and Anti-Abuse Tax Rules for Qualified Derivative Payments on Securities Lending Transactions

REG-107895-24

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking

SUMMARY: This document contains proposed regulations regarding the base erosion and anti-abuse tax imposed on certain large corporate taxpayers with respect to certain payments made to foreign related parties. The proposed regulations relate to how qualified derivative payments with respect to securities lending transactions are determined and reported. The proposed regulations would affect corporations with substantial gross receipts that make payments to foreign related parties.

DATES: Written or electronic comments and requests for a public hearing must be received by April 14, 2025.

ADDRESSES: Commenters are strongly encouraged to submit public comments electronically via the Federal eRulemaking Portal at *https://www.regulations.gov* (indicate IRS and REG-107895-24) by following the online instructions for submitting comments. Requests for a public hearing must be submitted as prescribed in the "Comments and Requests for a Public Hearing" section. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comments submitted to the IRS's public docket. Send paper submissions to: CC:PA:01:PR (REG-107895-24), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Sheila Ramaswamy at (202) 317-6938; concerning submissions of comments, requests for a public hearing, and access to a public hearing, Publications and Regulations Section at (202) 317-6901 (not toll-free numbers) or by e-mail to *publichearings@irs.gov* (preferred).

SUPPLEMENTARY INFORMATION:

Authority

This document contains proposed additions and amendments to 26 CFR part 1 (Income Tax Regulations) under sections 59A and 6038A of the Internal Revenue Code (Code). The proposed additions and amendments are issued pursuant to the express delegations of authority to the Secretary of the Treasury (or her delegate) provided under sections 59A(i) and 6038A(b)(2). The proposed regulations are also issued under the express delegation of authority under section 7805(a) of the Code.

Background

I. *Statutory Framework*

The base erosion and anti-abuse tax ("BEAT") of section 59A imposes on each applicable taxpayer a tax equal to the base erosion minimum tax amount for the taxable year. For taxable years after 2018 and before 2026, the base erosion minimum tax amount for the taxable year is the excess of ten percent of the modified taxable income of the applicable taxpayer minus the applicable taxpayer's regular tax liability under section 26(b) reduced (but not below zero) by certain credits. *See* section 59A(b)(1) and (2). To be an applicable taxpayer, generally the taxpayer must meet the following three requirements: (1) the taxpayer must be a corporation which is not a regulated investment company, a real estate investment trust, or an S corporation; (2) the taxpayer must have average annual gross receipts for the three-taxable-year period ending with the preceding taxable year that are at least $500 million; and (3) the taxpayer generally must have a base erosion percentage for the taxable year of at least three percent (or two percent for banks and registered securities dealers). *See* section 59A(e).

The applicable taxpayer determines its modified taxable income by computing its taxable income without regard to any base erosion tax benefit with respect to any base erosion payment or the base erosion percentage of any net operating loss deduction allowed under section 172 for the taxable year. *See* section 59A(c)(1). Generally, a base erosion payment is any deductible amount paid or accrued by an applicable taxpayer to a foreign person as defined in section 6038A(c)(3) that is a related party of the applicable taxpayer. *See* section 59A(d)(1) and (f). The base erosion tax benefit is the deduction allowed under Chapter 1 for the taxable year for the base erosion payment. *See* section 59A(c)(2). Qualified derivative payments ("QDPs") are not treated as base erosion payments if they are properly reported to the IRS. *See* section 59A(h)(1) and (h)(2)(B).

II. *Guidance Addressing the BEAT*

On December 6, 2019, the Treasury Department and the IRS published final regulations (TD 9885) under sections 59A, 383, 1502, 6038A, and 6655 (the "2019 final regulations") in the **Federal Register** (84 FR 66968). On October 9, 2020, the Treasury Department and the IRS also published final regulations (TD 9910) under sections 59A and 6031 in the **Federal Register** (85 FR 64346). In a series of notices, the Treasury Department and the IRS announced the intention to defer the applicability date of §1.6038A-2(b)(7)(ix) (regarding the reporting requirements for QDPs) until taxable years beginning on or after January 1, 2027. *See*, *e.g.*, Notice 2024-43, 2024-25 IRB 1737.

Explanation of Provisions

These proposed regulations provide guidance under section 59A that would modify the rules set forth in the final regulations relating to how to determine QDPs in connection with securities lending transactions. Part A of this Explanation of Provisions summarizes the QDP exception. Part B of this Explanation of Provisions explains the reporting requirements for QDPs, particularly with respect to securities lending and borrowing transactions. Part C of this Explanation of Provisions describes the proposed amendment to the reporting requirements for QDPs.

A. Overview of Qualified Derivative Payments

Section 59A and the final regulations thereunder provide a number of exceptions to base erosion payments. One exception relevant to these proposed regulations is in section 59A(h), which provides that QDPs are not base erosion payments. Section 59A(h)(2)(A) defines a QDP as any payment made by a taxpayer pursuant to a derivative with respect to which the taxpayer—

(i) Recognizes gain or loss as if such derivative were sold for its fair market value on the last business day of the taxable year (and additional times as required under a statute or the taxpayer's method of accounting),

(ii) Treats any gain or loss recognized as ordinary, and

(iii) Treats the character of all items of income, deduction, gain, or loss with respect to a payment pursuant to the derivative as ordinary.

Section 59A(h)(2)(B) provides that a payment is not a QDP unless the taxpayer satisfies certain reporting requirements. Section 1.59A-6(b)(2)(i) provides that a payment is not a QDP unless the taxpayer reports the information required by §1.6038A-2(b)(7)(ix), which includes: (a) the aggregate amount of QDPs for the taxable year and (b) a representation that all payments satisfy the requirements of §1.59A-6(b)(2). The aggregate amount of QDPs is reported on the Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*. Under §1.59A-6(b)(2)(ii), if a taxpayer fails to satisfy the reporting requirement with respect to a payment, that payment is ineligible for the QDP exception to base erosion payment status, unless another exception applies. However, until §1.59A-6(b)(2)(i) is applicable, §1.59A-6(b)(2)(ii) will not apply to a taxpayer who reports the aggregate amount of QDPs in good faith. §1.59A-6(b)(2)(iv). Section 1.6038A-2(b)(7)(ix) initially applied to taxable years beginning on or after June *7,* 2021, as a result of which §1.59A-6(b)(2)(i) did not apply until taxable years beginning on or after June 7, 2021. §1.6038A-2(g). Therefore, for taxable years beginning before June 7, 2021, taxpayers could satisfy the reporting requirements for QDPs by reporting the aggregate amount of QDPs in good faith. §§ 1.59A-6(b)(2)(iv) and 1.6038A-2(g). As described in more detail below, the Treasury Department and the IRS have announced the intention to defer the applicability date of §1.6038A-2(b)(7)(ix) to taxable years beginning on or after January 1, 2027. *See*, *e.g*., Notice 2024-43, 2024-25 IRB 1737. This means that §1.59A-6(b)(2)(i) will not apply until taxable years beginning on or after January 1, 2027.

Once §1.6038A-2(b)(7)(ix) becomes applicable, the reporting requirements for QDPs will no longer be satisfied by reporting the aggregate amount of QDPs in good faith. Instead, taxpayers must correctly report the aggregate amount of QDPs on Form 8991 to satisfy the reporting requirements and only those payments for which the reporting requirements have been satisfied will qualify for the QDP exception. The Treasury Department and the IRS are considering requiring taxpayers to report additional information on the Form 8991 or a schedule thereto to assist the IRS in verifying that taxpayers have accurately reported the payments that qualify for the QDP exception. Before modifications are made to the information required to reported on Form 8991 or a schedule thereto, the IRS expects to make a draft available with the proposed changes so that taxpayers may submit comments.

The aggregate amount of QDPs is defined under §1.59A-6(b)(2)(iii) and (b)(3) to incorporate §1.59A-2(e)(3)(vi) (the "BEAT Netting Rule"). The BEAT Netting Rule provides that for any position with respect to which the taxpayer applies a mark-to-market method of accounting, the taxpayer must determine its gain or loss with respect to that position for any taxable year by combining all items of income, gain, loss, or deduction arising with respect to the position during the taxable year, such as from a payment, accrual, or mark. The BEAT Netting Rule was adopted to ensure that only a single deduction is claimed with respect to each transaction that is marked to market and to prevent distortions in deductions from being included in the denominator of the base erosion percentage, including as a result of the use of an accounting method that values a position more frequently than annually. *See* Preamble to the 2019 final regulations, 84 FR 66971. For example, when a taxpayer is a party to an interest rate swap with a foreign related party, the BEAT Netting Rule ensures that the periodic payments made by the taxpayer to the foreign related party give rise to only a single deduction in a taxable year regardless of whether the taxpayer marks to market the swap more frequently than annually.

B. Reporting and determining QDPs

A comment recommended modifying the 2019 final regulation to provide that mark-to-market gains and losses with respect to the securities leg of a cross-border securities lending or borrowing transaction with a related party (an "intercompany securities lending transaction") are not subject to the QDP reporting requirements. The Treasury Department and the IRS agree that mark-to-market gains and losses with respect to intercompany securities lending transactions should not be subject to the QDP reporting requirements; however, the Treasury Department and the IRS do not agree with the rationale suggested by the comment. Part B.1 of this Explanation of Provisions describes intercompany securities lending transactions and the QDP rules applicable to those transactions as provided by the 2019 final regulations. Part B.2 of this Explanation of Provisions summarizes the comment requesting changes to the QDP reporting requirements with respect to mark-to-market gains and losses on intercompany

securities lending transactions. Part B.3 of this Explanation of Provisions describes the proposed modifications to the QDP reporting requirements and explains why the Treasury Department and the IRS disagree with the rationale generally offered in the comment.

1. Application of QDP reporting to securities lending or borrowing transactions

After the publication of the 2019 final regulations, comments requested clarification as to how the QDP reporting requirements apply to mark-to-market gains and losses with respect to the securities leg of an intercompany securities lending transaction. The Treasury Department and the IRS subsequently issued three notices announcing the intent to defer the applicability date of the reporting rules of §1.6038A-2(b)(7)(ix) while the Treasury Department and the IRS studied whether further guidance was appropriate regarding the interaction of the QDP exception, the BEAT Netting Rule, and the QDP reporting requirements with respect to intercompany securities lending transactions. *See* Notice 2021-36, 2021-26 IRB 1227; Notice 2022-30, 2022-28 IRB 70. The most recent notice, Notice 2024-43, announced the intent to defer the applicability date to taxable years beginning on or after January 1, 2027. Notice 2024-43, 2024-25 IRB 1737.

In a typical intercompany securities borrowing transaction, a taxpayer may borrow securities, such as stock, from a foreign related party. The terms of the securities loan agreement will require the taxpayer to return identical securities to the foreign related party and to pay amounts equivalent to all interest, dividends, and other distributions that the foreign related party would be entitled to receive during the term of the lending transaction if it had not loaned the securities (substitute payments). The securities borrower may also be required to pay a separately stated borrow fee. Additionally, under normal market terms in the United States, the securities borrower will provide cash collateral and receive interest (the cash amount of which may be reduced by an embedded borrow fee) on that collateral. A taxpayer may also lend securities to a foreign related party under similar terms. For ease of discussion, both such transactions generally are referred to in this Explanation of Provisions as a securities lending transaction. Under a taxpayer's method of accounting, intercompany securities lending transactions may be marked to market on the last business day of its taxable year.

Section 1.59A-6(d) defines a derivative, for purposes of the QDP rules, as any contract the value of which, or any payment or transfer with respect to which, is determined by reference to, among other items, any share of stock of a corporation or any evidence of indebtedness. Special rules apply to securities lending transactions, pursuant to which a derivative does not include the cash collateral component of the transaction. §1.59A-6(d)(2)(iii)(B). Accordingly, only the securities leg of a securities lending transaction–that is, the part of the contract providing for the borrowing and return of the securities, without regard to any obligation to provide cash collateral–may be treated as a derivative for purposes of the QDP rules.

Like other derivatives, the amount of any QDP arising from a securities lending transaction is excluded from the numerator and the denominator of the base erosion percentage. Section 59A(h)(1); §1.59A-6(b)(3)(i). The aggregate amount of QDPs is determined as provided by the BEAT Netting Rule. §1.59A-6(b)(2)(iii). For intercompany securities lending transactions, however, the cash collateral component of a securities lending transaction, and the payment of interest thereon, are not taken into account for purposes of the BEAT Netting Rule. §1.59A-6(b)(3)(ii) and (d)(2)(iii)(B).

2. Comments Requesting Modifications to the QDP Reporting Requirements

A comment on the QDP reporting requirements of the regulations discussed the treatment of gains and losses on the securities leg of intercompany securities lending transactions. When the taxpayer is the securities borrower, the securities leg can result in deductions with respect to substitute payments or other payments made to the securities lender and, if the taxpayer marks to market the securities lending transaction, deductions for mark-to-market losses on the obligation to return the borrowed securities if the value of the borrowed securities increases. A transaction in which a U.S. taxpayer lends securities to a foreign related party also can give rise to a deduction for mark-to-market losses on the right to the return of the loaned securities if the value of the loaned securities decreases.

The comment agreed that substitute payments should be reported under the QDP reporting requirements but asserted that mark-to-market gains and losses on intercompany securities lending transactions should not be required to be reported. The comment noted that the language in the preamble to the 2019 final regulations stated that "a mark-to-market loss arising from a deemed sale or disposition of a third-party security held by a taxpayer is not within the general definition of a base erosion payment because the loss is not attributable to any payment made to a foreign related party. Rather, the mark-to-market loss is attributable to a decline in the market value of the security." *See* Preamble to the 2019 final regulations, 84 FR 66972 (noting "that the BEAT Netting Rule will apply primarily for purposes of determining the amount of deductions that are taken into account in the denominator of the base erosion percentage"). The comment viewed this statement as applicable not only to mark-to-market losses on third-party securities held by the taxpayer but also to mark-to-market losses on intercompany securities lending transactions. The comment asserted that that treatment would be correct as a legal matter, arguing that mark-to-market losses on derivatives with a related party are not payments to a related party. The comment supported this conclusion on the basis of legislative history to section 475 stating that mark-to-market gains or losses on a security that is a contract with a related party are treated as arising from a sale to an unrelated party.

The comment stated that mark-to-market losses should not be captured by the QDP reporting requirement because these losses should not be considered base erosion payments, and the QDP exception is predicated on an amount being a base erosion payment. The comment noted that including mark-to-market gains and losses on intercompany securities lending transactions in the amount of QDPs reported on Form 8991 could result in a QDP number

that is either over- or under-inclusive of what the comment considered to be the correct aggregate QDP amount, depending upon the facts. For example, a taxpayer that has a mark-to-market gain for the year on an intercompany securities borrowing that exceeds the amount of substitute payments it makes would report no QDPs on the transaction by operation of the BEAT Netting Rule even though, in the view of the comment, the actual amount of QDPs should equal the amount of the substitute payments. The comment requested that the regulations under section 59A be revised to provide that mark-to-market gains and losses for the securities leg of an intercompany securities transaction are not payments to foreign related parties and should not be included in QDP reporting.

The same stakeholder also submitted a comment requesting that the applicability date of the reporting rules of §1.6038A-2(b)(7)(ix) be deferred for another two years because financial institutions (a) do not have systems that maintain records of intercompany securities transactions from which mark-to-market gains or losses can be determined, including whether a particular securities lending transaction is cross-border; and (b) need certainty regarding the QDP reporting rules before building compliance systems. The stakeholder also commented that, while it believes mark-to-market amounts on other derivatives also are not base erosion payments, it is appropriate to apply the BEAT Netting Rule to the reporting of QDPs relating to those derivatives for practical reasons, including that taxpayers have the necessary information on their books and records to apply the BEAT Netting Rule to the QDP determination.

3. Changes to the rule for determining QDPs

While the Treasury Department and the IRS agree with the recommendation suggested by the comment, the Treasury Department and the IRS do not agree with the commenter's more general assertion that mark-to-market payments on derivatives with a foreign related party are not, or should not be, treated as base erosion payments. Payments on derivatives made to a foreign related party are base erosion payments, unless they qualify as QDPs. Sections 59A(d)(1) and 59A(h). They must be taken into account for BEAT purposes either when paid or when otherwise taken into account for U.S. Federal income tax purposes. If the commenter's position were correct, payments on derivatives to a foreign related party would be required to be taken into account for BEAT purposes when paid or accrued, which would deviate from when such payments are taken into account for other Federal income tax purposes for taxpayers that mark those payments to market.

For derivatives, the effect of the BEAT Netting Rule generally is to aggregate all items of income, gain, loss, or deduction to ensure that a single deduction is claimed with respect to each transaction that is marked to market. Because a derivative must be marked-to-market for tax purposes in order for a payment on the derivative to qualify as a QDP, it is appropriate to determine the aggregate amount of QDPs by reference to the BEAT Netting Rule. Section 59A(h)(2)(A)(i).

The QDP exception eliminates most mark-to-market gain or loss from derivative transactions from being characterized as base erosion payments. In those situations for which the QDP exception does not apply, mark-to-market losses on derivative contracts with foreign related parties generally are properly treated as base erosion payments. However, the Treasury Department and the IRS agree that it is appropriate to propose a special rule for mark-to-market losses (and gains) on intercompany securities lending transactions. Securities lending transactions have different characteristics from other derivative transactions such that it is appropriate to provide for a different treatment under the QDP rules. Unlike other derivative contracts such as forward contracts, options or notional principal contracts, securities lending transactions require the lender to transfer the securities to the borrower at the inception of the transaction and the borrower is required to return those securities (or identical securities) to the lender when the securities lending transaction is terminated. While other derivative transactions may provide either for physical delivery of a security or for cash settlement, those transactions typically function as a risk-shifting mechanism, whereas securities lending transactions are generally entered into to temporarily acquire or lend the securities. Additionally, a loss recognized on the sale or transfer of property, including securities, that results in a deduction is generally not a base erosion payment. §1.59A-3(b)(2)(ix). As stated in the preamble to the 2019 final regulations, a mark-to-market loss from a deemed disposition of a third-party security is not a base erosion payment because the loss is not attributable to any payment made to a foreign related party; that loss is instead attributable to a decline in the market value of the security. 84 FR 66968, 66972. If the taxpayer sold the stock or debt to a foreign related party, loss on sale of the stock or debt generally would not be a deduction that would cause the payment to be treated as a base erosion payment under §1.59A-3(b)(2)(ix).

If a taxpayer borrows securities from a foreign related party, and the security rises in value during the term of the intercompany securities lending transaction, the taxpayer has an economic loss on its contractual obligation to return the securities. In some cases (for example, if the intercompany securities lending transaction is part of a short sale transaction), the taxpayer also might have a tax loss when it returns the security to the foreign related party. Similarly, if a taxpayer lends securities to a foreign related party and the security falls in value, the taxpayer would have an economic loss on its contractual right to the return of the security. If the taxpayer sold the returned security, the taxpayer would recognize that loss for tax purposes. Marking to market the securities lending transaction in these circumstances accelerates the recognition of the tax loss attributable to the transaction.

For example, assume that a taxpayer that applies mark-to-market accounting for U.S. Federal income tax purposes borrows stock from a foreign related party pursuant to an intercompany securities lending transaction on September 1, when the value of the stock is $100x. The taxpayer sells the stock for $100x on September 1. The intercompany securities lending transaction is outstanding on December 31, when the value of the stock is $106x, and a $1x dividend is paid on the stock by the issuer after September 1 and prior to December 31. The taxpayer will make a $1x substitute dividend payment to the

foreign related party. Under the BEAT Netting Rule, the taxpayer will have a $7x loss on this transaction ($7x) = (($100x - $106x) - $1x). The substitute dividend payment is a $1x base erosion payment on a stand-alone basis that is eligible for the QDP exception assuming all the requirements of section 59A and the regulations are met. The $6x mark-to-market loss on the securities leg of intercompany securities lending transaction is a loss on a derivative that requires the delivery of the stock at the termination of the transaction, and arises because the increase in value of the stock makes it more expensive for the taxpayer to satisfy its obligation to deliver the stock to the foreign related party. If, hypothetically, the intercompany securities lending transaction were not marked to market, and the taxpayer realized a $6x loss on the delivery of the stock to the foreign related party at the termination of the transaction, that $6x loss would not be a base erosion payment.

Alternatively, if the value of the stock were $94x on December 31, the taxpayer would have a gain of $5x on the transaction $5x = (($100x - $94x) - $1x)) under the BEAT Netting Rule. The taxpayer would have a $6x mark-to-market gain on the securities leg of the intercompany securities lending transaction, which would arise because the decrease in value of the stock makes it less expensive for the taxpayer to satisfy its obligation to deliver the stock to the foreign related party. If, hypothetically, the intercompany securities lending transactions were not marked to market, and the taxpayer realized a $6x gain on the delivery of the stock to the foreign related party at the termination of the transaction, that $6x gain would not be a base erosion payment. The substitute dividend payment is a $1x base erosion payment that is eligible for the QDP exception assuming all the requirements of section 59A and the regulations are met.

Accordingly, the Treasury Department and the IRS are of the view that the BEAT regulations should be revised to provide that mark-to-market gains and losses on the securities leg of a securities lending transactions with a foreign related party are not treated as a QDP. Consequently, only substitute payments and other payments made to a foreign related party under an intercompany securities lending transaction that are not payments of cash collateral or interest thereon would be QDPs.

The proposed regulations would provide that mark-to-market gains and losses on the securities leg of an intercompany securities lending transaction are not treated as QDPs and therefore are not netted with QDPs nor required to be included in QDP reporting. Proposed §1.59A-6(b)(3)(iii)(A). Mark-to-market gains and losses on other derivative transactions (including other derivative transactions that provide for physical delivery) must be included in QDP reporting. The proposed regulations would not alter the rule that substitute payments and other payments to foreign related parties must be reported under §§1.59A-6(b)(2)(i) and 1.6038A-2(b)(7)(ix). Those amounts must be taken into account on a consistent basis when determining the amount of the taxpayer's base erosion payment, for example on a cash, accrual or mark-to-market basis, in a manner that does not omit or duplicate any payment. Proposed §1.59A-3(b)(2)(iv)(B). Furthermore, the proposed rule achieves the compliance objectives of the QDP reporting requirement without imposing additional burden on taxpayers to create new systems to track mark-to-market gains and loss with respect to intercompany securities lending transactions.

Proposed §1.59A-3(b)(2)(iv) would provide a conforming amendment to the definition of a base erosion payment in the context of the securities leg of a securities lending transaction to provide that the BEAT Netting Rule under §1.59A-2(e)(3)(vi) does not apply to net QDPs with mark-to-market gains and losses on securities lending transactions. Consequently, only amounts paid to a foreign related party under a securities lending transaction that do not qualify as a QDP will be taken into account for purposes of the numerator of the base erosion perentage, such as in the case where a taxpayer lends securities and pays or accrues interest to a foreign related party with respect to the cash leg of a securities lending transaction. The BEAT Netting Rule continues to apply to determine the deductions attributable to securities lending transactions for purposes of the denominator of the base erosion percentage. §1.59A-2(e)(3)(vi).

C. Rule for determining the recipient of a substitute payment

Comments suggested that it may be challenging for a financial institution to determine whether it has borrowed a security from a foreign related party or an unrelated third-party customer. According to the comments, when a U.S. broker-dealer enters into securities lending transactions with third-party customers, the broker-dealer may borrow the securities required to execute the trade from a pool of available securities owned by other customers, some of which are U.S. customers, and some of which are foreign customers who have accounts with a foreign affiliate of the U.S. broker-dealer. If the borrowed security is owned by a foreign customer, the comments indicated that the U.S. broker-dealer may be treated as having entered into a securities borrowing transaction with its foreign affiliate who has the relationship with the foreign customer, who in turn borrowed the security from its foreign customer. However, the U.S. broker-dealer may not determine from which specific customer it has borrowed a security or whether it has entered into an intercompany securities borrowing transaction with its foreign affiliate. The U.S. broker-dealer may determine its counterparty only when a substitute dividend is required to be paid (for example, on the dividend record date), and only for purposes of determining the recipient of the substitute payment for U.S. Federal income or withholding tax purposes.

To address this concern, the proposed regulations would provide that a taxpayer may report the amount actually paid to foreign related parties for QDP reporting purposes if the taxpayer can associate the substitute payment on securities borrowed and other payments made pursuant to a securities loan (such as borrow fees) with a specific recipient. The "lottery" method of §1.6045-2(f)(2)(ii) is not applicable for this purpose. In response to the challenges that may exist in determining whether the recipient of a substitute payment and other payments is a foreign related party of the taxpayer, proposed §1.59A-6(b)(3)(iv) would provide an alternative rule that treats the substitute payments that a taxpayer pays with respect to borrowed securities as having been paid first to foreign

related parties (but not in excess of the amount of the payments received by the foreign related parties).

Proposed Applicability Date

Proposed §§1.59A-3(b)(2)(iv) (application of BEAT netting rule to securities lending transactions) and 1.59A-6(b)(3)(iii) and (iv) (QDP rules relating to securities lending transactions) would apply to taxable years beginning on or after the date that final regulations are filed with the **Federal Register**. Proposed §1.6038A-2(b)(7)(ix) (rules relating to QDP reporting) would apply to payments made in taxable years beginning on or after January 1, 2027.

Special Analysis

I. *Regulatory Planning and Review – Economic Analysis*

Pursuant to the Memorandum of Agreement, Review of Treasury Regulations under Executive Order 12866 (June 9, 2023), tax regulatory actions issued by the IRS are not subject to the requirements of section 6 of Executive Order 12866, as amended. Therefore, a regulatory impact assessment is not required.

II. *Paperwork Reduction Act*

These proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements, or third-party disclosure statements. However, a taxpayer will continue to be required to report on Form 8991, *Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts*, the aggregate amount of QDPs.

For purposes of the Paperwork Reduction Act, the reporting burden associated with the collections of information with respect to section 59A will be reflected in the Paperwork Reduction Act Submission associated with Form 8991 (OMB control number 1545-0123). The overall burden estimates associated with the OMB control number 1545–0123 is an aggregate number related to the entire package of forms associated with the applicable OMB control number and will include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of these proposed regulations. These numbers are therefore not specific to any burden imposed by these proposed regulations. The burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions before Tax Cuts and Jobs Act, Public Law 115-97 (2017) (the "Act"). No burden estimates specific to the forms affected by the proposed regulations are currently available. For the OMB control number discussed in this paragraph, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type-basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize paperwork burden. In addition, when available, drafts of IRS forms are posted at *https://www.irs.gov/draft-tax-forms*, and comments may be submitted at *https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications*. Final IRS forms are available at *https://www.irs.gov/forms-instructions*. Forms will not be finalized until after they have been approved by OMB under the PRA.

III. *Regulatory Flexibility Act*

Generally, the proposed regulations affect only aggregate groups of corporations with average annual gross receipts of at least $500 million and that make payments to foreign related parties. Generally, only large businesses have both substantial gross receipts and make payments to foreign related parties. In accordance with the Regulatory Flexibility Act (5 U.S.C. 601 *et seq*.) the Secretary hereby certifies that these proposed regulations will not have a significant economic impact on a substantial number of small entities.

IV. *Section 7805(f)*

Pursuant to section 7805(f) of the Code, these proposed regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

V. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a State, local, or Tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. The proposed regulations do not include any Federal mandate that may result in expenditures by State, local, or Tribal governments, or by the private sector in excess of that threshold.

VI. *Executive Order 13132: Federalism*

Executive Order 13132 (entitled "Federalism") prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on State and local governments, and is not required by statute, or preempts State law, unless the agency meets the consultation and funding requirements of section 6 of the Executive order. The proposed regulations do not have federalism implications and do not impose substantial direct compliance costs on State and local governments or preempt State law within the meaning of the Executive order.

Comments and Request for Public Hearing

Before these proposed amendments to the final regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in this pream-

ble under the **ADDRESSES** heading. Any comments submitted will be made available at *https://www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person who timely submits written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of the proposed regulations are D. Peter Merkel and Sheila Ramaswamy of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, the Treasury Department and IRS propose to amend 26 CFR part 1 as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

* * * * *

Par. 2. Section 1.59A-2 is amended by removing the language "§1.59A-3(b)(2)(iii)" from the last sentence of paragraph (e)(3)(vi) and adding the language "§1.59A-3(b)(2)(iv)" in its place.

Par. 3. Section 1.59A-3 is amended by revising paragraph (b)(2)(iv) to read as follows:

§1.59A-3 Base erosion payments and base erosion tax benefits.

* * * * *

(b) * * *

(2) * * *

(iv) *Amounts paid or accrued with respect to mark-to-market position—(A) In general.* For any transaction with respect to which the taxpayer applies the mark-to-market method of accounting for U.S. Federal income tax purposes, the rules set forth in § 1.59A-2(e)(3)(vi) apply to determine the amount of the base erosion payment.

(B) *Application of BEAT netting rule to securities lending transactions*. Notwithstanding paragraph (b)(2)(iv)(A) of this section, mark-to-market gains and losses from a securities lending transaction described in §§1.861-2(a)(7) and 1.861-3(a)(6) are not taken into account when applying §1.59A-2(e)(3)(vi) for purposes of determining the amount of a taxpayer's base erosion payment. When determining the amount of the taxpayer's base erosion payment, substitute payments and other amounts that relate to the securities lending transaction must be taken into account on a consistent basis that does not result in the duplication or omission of these amounts. For purposes of the immediately preceding sentence, the term "other amounts that relate to the securities lending transaction" does not include delivery of the securities to, or receipt of securities from, the lender. This paragraph (b)(2)(iv)(B) applies to a taxpayer that is either the borrower or lender with respect to the securities lending transaction.

* * * * *

Par. 4. Section 1.59A-6 is amended by adding paragraphs (b)(3)(iii) through (iv) to read as follows:

§1.59A-6 Qualified derivative payment.

* * * * *

(b) * * *

(3) * * *

(iii) *Special rule for mark-to-market gains and losses on the securities leg of a securities lending transaction—(A) In general*. The amount of any qualified derivative payment with respect to the securities leg component of a securities lending transaction as defined in §§1.861-2(a)(7) and 1.861-3(a)(6) that is excluded from the denominator of the base erosion percentage is determined under §1.59A-3(b)(2)(iv)(B). Gains and losses on a security leg of a securities lending transaction are not included in determining the amount of the qualified derivative payment with respect to that security. The gain or loss with respect to the security leg for purposes of determining the amount of the qualified derivative payment is determined by combining only other items of income, gain, loss, or deduction during the taxable year, such as substitute payments and borrow fees, that arise from a payment or accrual to a foreign related party.

(*B*) The following examples illustrate the application of this paragraph (b)(3)(iii).

(*1*) *Example 1: Securities loan—(i) Facts*. Foreign Parent (FP) is a foreign corporation that owns all of the stock of domestic corporation (DC). FP is a foreign related party of DC under §1.59A-1(b)(12). DC is a registered securities dealer. On September 1 of year 1, DC enters into a securities lending transaction with FP in which it borrows stock from FP. DC provides cash collateral for the loan and receives interest on that collateral from FP. On September 1, year 1, the stock has a value of $100x. On November 1, year 1, a dividend of $1x is paid by the issuer on the stock. DC pays a substitute dividend of $1x to FP on November 1, year 1 under the terms of the security loan. There are no other payments made or received in year 1. On December 31, year 1, the stock has a value of $106x. DC is required to mark-to-market the securities leg of securities lending transaction for U.S. Federal income tax purposes. DC is a calendar year taxpayer.

(*ii*) *Analysis*. DC has a deduction of $1x as a result of the substitute dividend it pays to FP. Assuming that the securities lending transaction otherwise meets the requirements of this section (including reporting the information required by §1.6038A-2(b)(7)(ix)), the amount of DC's qualified derivative payment with respect to the securities lending transaction is $1x. Payments with respect to the cash collateral are not treated as part of the securities lending transaction. *See* paragraph (d)(2)(iii)(B) of this section. With respect to the securities leg of the securities lending transaction, DC has a mark-to-market loss of ($6x). Under paragraph (b)(3)(iii)(A) of this section, the amount of this mark-to-market loss is not included when determining the amount of the qualified derivative payment. Under §1.59A-3(b)(2)(iv)(B), DC's ($6x) mark-to-market loss on the securities leg of the securities lending transaction also is not taken into account in determining the base erosion tax benefit amount for purposes of the numerator of the base erosion percentage. The ($6x) loss is taken into account in the denominator of the base erosion percentage, while the $1x substitute dividend payment is not taken into account for that purpose because it is a qualified derivative payment. See §1.59A-2(e)(3)(vi) and (e)(3)(ii)(C).

(*2*) *Example 2: Securities loan*. The facts are the same as in paragraph (b)(3)(iii)(B)(*1*) of this section (*Example 1)* except that on December 31, year 1, the stock has a value of $94x. With respect to the securities leg of the securities lending transaction, DC has a mark-to-market gain of $6x. Under paragraph (b)(3)(iii)(A) of this section, the amount of this mark-

to-market gain is not included when determining the amount of the qualified derivative payment. DC has a deduction of $1x as a result of the substitute dividend payment it makes to FP. Assuming that the securities lending transaction otherwise meets the requirements of this section (including reporting the information required by §1.6038A-2(b)(7)(ix)), the amount of DC's qualified derivative payment with respect to the securities lending transaction is $1x. Neither the $6x gain nor the $1x substitute dividend payment, which is a qualified derivative payment, are taken into account in the denominator of the base erosion percentage.

(iv) *Rule for determining the amount of substitute payments and other payments paid to foreign related parties with respect to a securities lending transaction--(A) In general*. When a taxpayer makes a substitute payment or other payment with respect to a securities lending transaction, the taxpayer must determine whether the substitute payment or other payment paid with respect to the securities lending transaction is paid to a foreign related party. The amount of substitute payments or other payments paid by the taxpayer to a foreign related party is determined under paragraph (b)(3)(iv)(B) or (C) of this section.

(B) *Specific identification method*. The taxpayer may determine the amount of substitute payments or other payments that it has paid to a foreign related party by using the amount actually paid by the taxpayer to the foreign related party if the taxpayer can specifically identify each recipient of the substitute payment or other payment.

(C) *Alternative method*. If the taxpayer has paid substitute payments or other payments but cannot determine the recipients of those payments, the taxpayer must use the methodology provided in this paragraph (b)(3)(iv)(C) to determine whether the recipient is a foreign related party.

(*1*) *Step 1: Determining the total amount of substitute payments and other payments received by foreign related parties*. The taxpayer must determine the total amount of substitute payments and other payments described in paragraph (b)(3)(iii) of this section received by all foreign related parties of the taxpayer during the taxable year.

(*2*) *Step 2: Determining the total amount of substitute payments and other payments paid by taxpayer.* The taxpayer must determine the total amount of substitute payments and other payments described in paragraph (b)(3)(iii) of this section paid by the taxpayer during the taxable year.

(*3*) *Step 3: Determining the amount of substitute payments and other payments paid by taxpayer to foreign related parties*. The amount of substitute payments and other payments described in paragraph (b)(3)(iii) of this section paid by the taxpayer is treated as being paid first to foreign related parties of the taxpayer up to the total amount of substitute payments and other payments received by foreign related parties. Any amount of substitute payments and other payments paid by the taxpayer that exceeds the amount of substitute payments and other payments received by foreign related parties is treated as paid to unrelated parties for purposes of this paragraph (b)(3)(iv)(C)(*3*).

* * * * *

Par. 5. Section 1.59A-10 is amended by revising paragraph (a) and adding paragraph (c) to read as follows:

§1.59A-10 Applicability date.

(a) *General applicability date*. Sections 1.59A-1 through 1.59A-9, other than the provisions described in the first sentence of paragraph (b) of this section or in paragraph (c) of this section, apply to taxable years ending on or after December 17, 2018. However, taxpayers may apply these regulations in their entirety for taxable years beginning after December 31, 2017, and ending before December 17, 2018. In lieu of applying the regulations referred to in the first sentence of this paragraph (a), taxpayers may apply the provisions matching §§ 1.59A-1 through 1.59A-9 from the Internal Revenue Bulletin (IRB) 2019-02 (*https://www.irs.gov/irb/2019-02_IRB*) in their entirety for all taxable years beginning after December 31, 2017, and ending on or before December 6, 2019.

* * * * *

(c) *Additional applicability dates*. Sections 1.59A-3(b)(2)(iv) and 1.59A-6(b)(3) (iii) through (iv) apply to taxable years beginning on or after January 10, 2025.

Par. 6. Section 1.6038A-2 is amended by revising the third sentence of paragraph (g) to read as follows:

§1.6038A-2 Requirement of return.

* * * * *

(g) * * * Paragraph (b)(7)(ix) of this section applies to payments made in taxable years beginning on or after January 1, 2027. * * *

Douglas W. O'Donnell,
Deputy Commissioner.

(Filed by the Office of the Federal Register January 10, 2025, 4:15 p.m., and published in the issue of the Federal Register for January 14, 2025, 90 FR 3085)

Notice of Proposed Rulemaking

Enhancing Coverage of Preventive Services Under the Affordable Care Act

REG-110878-24

AGENCY: Internal Revenue Service, Department of the Treasury; Employee Benefits Security Administration, Department of Labor; Centers for Medicare & Medicaid Services, Department of Health and Human Services.

ACTION: Withdrawal of notice of proposed rulemaking.

SUMMARY: This document withdraws a notice of proposed rulemaking that appeared in the **Federal Register** on October 28, 2024, regarding coverage of certain preventive services under the Affordable Care Act.

DATES: As of January 15, 2025, the notice of proposed rulemaking that appeared in the **Federal Register** on October 28, 2024, at 89 FR 85750 is withdrawn.

FOR FURTHER INFORMATION CONTACT: Regan Rusher, Internal Revenue Service, Department of the Treasury, at (202) 317-5500. Matthew Meidell, Employee Benefits Security Administration, Department of Labor, at (202) 693-8335. Rebecca Miller, Employee Benefits Security Administration, Department of Labor, at (202) 693-8335. Geraldine Doetzer, Centers for Medicare & Medicaid Services, Department of Health and Human Services at (667) 290-8855.

SUPPLEMENTARY INFORMATION:

Section 2713 of the Public Health Service Act (PHS Act), as added by the Affordable Care Act and incorporated into the Employee Retirement Income Security Act and the Internal Revenue Code, requires non-grandfathered group health plans and health insurance issuers offering non-grandfathered group or individual health insurance coverage to provide coverage of certain recommended preventive services without imposing any cost-sharing requirements. Section 2715A of the PHS Act provides that non-grandfathered group health plans and health insurance issuers offering non-grandfathered group or individual health insurance coverage must comply with section 1311(e)(3) of the Affordable Care Act, which addresses transparency in health coverage and imposes certain reporting and disclosure requirements for health plans that are seeking certification as qualified health plans to be offered on an American Health Benefits Exchange (generally referred to as an Exchange).

On October 28, 2024, the Departments of the Treasury, Labor, and Health and Human Services (collectively, the Departments) issued proposed rules under PHS Act sections 2713 and 2715A titled, "Enhancing Coverage of Preventive Services Under the Affordable Care Act."[1] The proposed rules sought to address ongoing complaints and reports of noncompliance with section 2713 of the PHS Act and its implementing regulations. These complaints and reports indicate that participants, beneficiaries, and enrollees face barriers when attempting to use their coverage to access recommended preventive services without cost sharing. As a result of these concerns, the Departments proposed to amend the regulations governing coverage of recommended preventive services to ensure that participants, beneficiaries, and enrollees would be able to access the full range of recommended preventive services to which they are entitled, with particular focus on strengthening coverage requirements with respect to recommended contraceptive items for women.

The proposed rules would have required plans and issuers that utilize reasonable medical management techniques with respect to any recommended preventive services to provide an easily accessible, transparent, and sufficiently expedient exceptions process that allows an individual to receive coverage without cost sharing for the preventive service according to the frequency, method, treatment, or setting that is medically necessary for them, as determined by the individual's attending provider. The proposed rules would also have required plans and issuers to cover certain recommended over-the-counter contraceptive items without requiring a prescription and without imposing cost-sharing requirements. In addition, the proposed rules would have required plans and issuers to cover certain recommended contraceptive items that are drugs and drug-led combination products without imposing cost-sharing requirements, unless a therapeutic equivalent of the drug or drug-led combination product is covered without cost sharing. Finally, the proposed rules would have required plans and issuers to provide a disclosure pertaining to coverage and cost-sharing requirements for recommended over-the-counter contraceptive items in plans' and issuers' Transparency in Coverage internet-based self-service tools or, if requested by the individual, on paper.

The Departments requested comments on all aspects of the proposed rules, as well as on a number of specific issues. The comment period on the proposed rules closed on December 27, 2024, and the Departments received 268 comments to review. The comments addressed a range of issues, including operational and cost issues related to the Departments' contraceptive coverage proposals.

The Departments have determined it is appropriate to withdraw the proposed rules at this time, focusing instead on other matters. For example, the Departments have identified Cost Sharing Under the Affordable Care Act (RIN 0938-AV59); Requirements Related to Advanced Explanation of Benefits and Other Provisions Under the Consolidated Appropriations Act, 2021 (RIN 0938-AU98); Independent Dispute Resolution Operations (RIN 0938-AV15); Requirements Related to Air Ambulance Services, Agent and Broker Disclosures, and Provider Enforcement (RIN 0938-AU61); and Provider Nondiscrimination Requirements for Group Health Plans and Health Insurance Issuers in the Group and Individual Markets (RIN 0938-AU64) in their respective Fall 2024 Regulatory Agendas, as potential matters on which to focus. Moreover, should the Departments decide in the future that it is a priority to move forward with rulemaking regarding all or a subset of the preventive services coverage requirements of PHS Act section 2713, the Departments want to ensure that they will have the benefit of the most up-to-date facts and information on the basis of any specific proposals that they determine to put forward at such time. For these independently sufficient reasons, the Departments are withdrawing the proposed rules, and may propose new rules in the future, as appropriate to meet these goals.

This withdrawal action does not limit the Departments' ability to make new regulatory proposals in the areas addressed by the withdrawn proposed rules, including new proposals that may be substantially identical or similar to those described therein. In addition, this withdrawal action does not affect the Departments' ongoing application of existing statutory and regulatory requirements or their responsibility to faithfully administer the statutory requirements the proposed rules would have implemented if finalized.

Douglas W. O'Donnell,
Deputy Commissioner,
Internal Revenue Service

Lisa M. Gomez,
Assistant Secretary,
Employee Benefits Security Administration,
Department of Labor

Xavier Becerra,
Secretary,
Department of Health and Human Services

(Filed by the Office of the Federal Register January 13, 2025, 4:15 p.m., and published in the issue of the Federal Register for January 15, 2025, 90 FR 3728)

[1] 89 FR 85750 (Oct. 28, 2024).

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

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[1] A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2024–27 through 2024–52 is in Internal Revenue Bulletin 2024–52, dated December 23, 2024.

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