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Learning to Live with the New Foreign Nongrantor Trust Rules

Carlyn S. McCaffrey

LEARNING TO LIVE WITH THE NEW FOREIGN NONGRANTOR TRUST RULES *

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 My thanks to my colleague Elyse G. Kirschner for her patient assistance in the preparation of this outline.

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LEARNING TO LIVE WITH THE NEW FOREIGN NONGRANTOR TRUST RULES [1]

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I. BACKGROUND

The Small Business Job Protection Act of 1996 (the "1996 Act")[1] was intended to deal a heavy blow to the appeal of foreign trusts to U.S. persons. The results were mixed. On the one hand, the 1996 Act imposes an array of reporting requirements, imposes harsh penalties on failures to comply with these requirements, increases the interest charge imposed on taxes paid on distributions of accumulated income from foreign trusts, treats loans of cash from foreign trusts as distributions and expands the kinds of gifts that can be treated as indirect transfers from foreign trusts. On the other hand, curiously, the 1996 Act encourages the creation of foreign trusts by its adoption of a set of criteria for foreignness that is both more objective than the criteria formerly used and biased in favor of foreign status.

This outline discusses how to create foreign trusts, examines their exposure and the exposure of their U.S. beneficiaries to U.S. income tax and describes the reporting requirements imposed on their creators, their beneficiaries and the trusts themselves. In addition to explaining the rules, it also considers the extent to which foreign trusts continue to be useful planning tools for U.S. persons.

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1. My thanks to my colleague Elyse G. Kirschner for her patient assistance in the preparation of this outline.

1. The Small Business Job Protection Act of 1996 was enacted on August 20, 1996. P.L. 104-188, 110 Stat. 1755 (1996).

II. HOW TO CREATE A FOREIGN TRUST

A. How to Determine Whether a Trust is a Foreign Trust

1. Before the 1996 Act

Before the 1996 Act there was no clear standard for determining a trust's nationality. The former statutory definition consisted only of a statement that a foreign trust is a trust

> "the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A."[2]

This statement is merely descriptive of the consequences of foreign trust status and gives no guidance as to how to determine its existence.[3]

Judicial and administrative authority partially filled the definitional void by establishing a test that required weighing of a trust's foreign contacts against its U.S. contacts.[4] The guidance these authorities provided was of little help in determining the foreign or domestic status of trusts with both foreign and domestic contacts.

2. After the 1996 Act

New Code §§ 7701(a)(30)(E) and (31)(B) attempt to provide clarity, but do so in a way that creates a strong statutory bias in favor of foreignness.

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2. Code § 7701(a)(31) before amendment by the 1996 Act. References in this outline to "Code §" are to sections of the Internal Revenue Code of 1986, as amended (the "Code"). References to "Treas. Reg. §" are to sections of the Treasury regulations promulgated thereunder.

3. Curiously, the domestic or foreign status of an estate continues to be governed by the same provision. Code § 7701(a)(31)(A).

4. *See, e.g., B. W. Jones Trust v. Commissioner*, 132 F.2d 914 (4th Cir., 1943); *First National City Bank v. Internal Revenue Service*, 271 F.2d 616 (2d Cir., 1959), *cert. denied*, 361 U.S. 948 (1960); Rev. Rul. 60-181, 1960-1 C.B. 257.

Under new Code §§ 7701(a)(30)(E) and (31)(B), a trust is a foreign trust unless both of the following conditions are satisfied:

a. A court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and

b. One or more U.S. persons have the authority to control all substantial decisions of the trust.[5]

Under this test, a trust may be a foreign trust even if it was created by a U.S. person, all of its assets are located in the U.S., and all of its beneficiaries are U.S. persons. All it takes is one foreign person who has control over one "substantial" type of trust decision. Consider the following example:

> **Example:** Jenny, a U.S. citizen and resident of New York, created a trust for the benefit of her children, all of whom are U.S. citizens and residents. She named the Gotham Trust Company, a New York corporation, and her brother Pat, a citizen and resident of Ireland, as co-trustees. The trust instrument gave Pat the right to determine the ages at which each of the children would receive his or her share of the trust fund. It directed that the trust funds be maintained in the U.S. in the custody of Gotham and that the laws of the State of New York were to govern the trust's administration.

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5. The Administration's explanation of this rule issued in connection with its original proposal offered some protection from this harsh rule by expressing an intention that the Service would allow a trust "a reasonable period of time to adjust for inadvertent changes in fiduciaries (*e.g.*, a U.S. trustee dies or abruptly resigns where a trust has two U.S. fiduciaries and one foreign fiduciary)." Treasury Department, "General Explanations of the Administration's Revenue Proposals" 25 (February 7, 1995). The Joint Committee Explanation offers similar comfort. Joint Committee Explanation at 274. The Administration's intention is reflected in proposed regulation § 301.7701-7.

The Act's version of the definition referred to "fiduciaries" rather than persons. Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 changed the word "fiduciaries" to "persons."

Despite its significant U.S. contacts, the new law will treat Jenny's trust as a foreign trust since an obviously substantial decision is controlled by a foreign fiduciary.[6]

The new definition fulfills the Treasury Department's goal, to

> "increase the flexibility of settlors and trusts administrators to decide where to locate and in what assets to invest. For example, if the location of the administration of the trust were no longer a relevant criterion, settlors of foreign trusts would be able to choose whether to administer the trusts in the United States or abroad based on non-tax considerations."[7]

It is understood that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level the competitive playing field for trust business between United States and foreign institutions. Under the former definition, a foreign person who might have preferred to use a United States financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a United States domestic trust. Under the new law a foreign person can easily use a United States financial institution without creating a domestic trust.[8]

The new definition may level the competitive playing field for trust business between U.S. and foreign institutions. Under old law, a foreign person who would have liked to use a U.S. financial institution as trustee was generally reluctant to do so because of the likelihood that the trust would have been taxed as a U.S. domestic trust. Under the new law, she can easily use a U.S. financial institution without creating a domestic trust.

Although the new Code provision establishes a more objective method for determining whether a trust is domestic or foreign, it falls short of establishing the bright line test that was intended.

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6. A trust that is treated as a foreign trust for federal tax purposes under the new rule may continue to be a local trust for state income tax purposes. Jenny's trust, for example, although it may pay no federal income tax, will continue to be subject to New York State income tax because it was created by a resident of New York and has a New York trustee. N.Y. Tax Law § 605(b)(3).

7. Treasury Department, "General Explanation of the Administration's Revenue Proposals" 25 (February 7, 1995).

8. This understanding is based on conversations with David K. Sutherland, former Associate International Tax Counsel and a principal draftsperson of the new statutory definition.

3. The Proposed Regulations

a. The Safe Harbor

Some clarity is provided by proposed regulation § 301.7701-7. The proposed regulation creates a "safe harbor" that will ensure domestic trust status even if technical compliance with Code § 7701(a)(30)(E) has not been achieved. The safe harbor, which is described in paragraph (c) of the proposed regulation, provides that a trust is a domestic trust if the following three requirements are met:

(1) The trust has only United States fiduciaries as defined in paragraph (e) of the proposed regulation.

(2) The trust is administered exclusively within the United States pursuant to the terms of a trust instrument.

(3) The trust is not subject to an automatic migration provision described in paragraph (d)(2)(v) or (e)(3) of the proposed regulation.

Trusts that are not secure within the safe harbor must satisfy both the "court test" and the "control test" to be domestic trusts.

b. The Court Test

The "court test," which is described in paragraph (d) of the proposed regulation, is the regulatory explanation of the statutory requirement that "a court or courts within the United States must be able to exercise primary supervision over administration of the trust." The explanation provides the following critical definitions:

(1) "Court" includes federal as well as state and local courts.

(2) "United States" means the fifty states and the District of Columbia.

(3) "Is able to exercise" means "that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust."

(4) "Primary supervision" means the judicial "authority to determine substantially all issues regarding the administration of the entire trust . . . even if another court has jurisdiction over a trustee, a beneficiary, or trust property."

(5) "Administration" means "the carrying out of the duties imposed on a fiduciary by the terms of the trust instrument and applicable law, including maintaining the books and records of the trust, filing tax returns, defending the trust from suits by creditors, and determining the amount and timing of distributions."

Paragraph (d) of the proposed regulation describes four types of trusts that satisfy the court test and one that does not. The four types that satisfy the court test are:

(1) Trusts that are registered in a court within the United States by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.[9]

(2) Testamentary trusts if all fiduciaries of the trust have been qualified as trustees by a court within the United States.

(3) Inter vivos trusts if the fiduciaries and/or beneficiaries take steps with a court in the United States to cause the administration of the trust to be subject to the primary supervision of such court.

(4) Trusts that are subject to primary supervision with respect to their administration by a United States court and a foreign court.

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9. § 7-201 of the Uniform Probate Code gives exclusive jurisdiction over the internal affairs of a trust to the courts of the state in which a trust is registered. Sixteen states have adopted the Uniform Probate Code. They are Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota, and Utah. 8 Uniform Laws Annotated 1 (West Supp. 1996).

The type of trust that does not satisfy the court test is a trust whose trust instrument contains a provision that would cause the trust to migrate from the United States if a United States court attempted to assert jurisdiction over it or attempted to supervise its administration.

c. The Control Test

The "control test," which is described in paragraph (e) of the proposed regulation is the regulatory explanation of the statutory requirement that one or more United States fiduciaries must have the authority to control all substantial decisions of the trust. The explanation provides the following critical definitions:

(1) "Fiduciary" includes any person described in Code § 7701(a)(6) and Treas. Reg. § 301.7701-6(b). Code § 7701(a)(6) and its corresponding regulation define "fiduciary" as "a . . . trustee, . . . or any person acting in any fiduciary capacity for any person." In addition, the term includes any person, whether or not she is a fiduciary within the meaning of Code § 7701(a)(6), who has the power to control one or more substantial decisions of the trust, as defined below.[10]

(2) "United States fiduciary" means a fiduciary that is a United States person within the meaning of Code § 7701(a)(30), including, for example, individuals who are United States citizens or residents, domestic corporations, and domestic partnerships.

(3) "Substantial decisions" means, with an important exception described below, all decisions other than ministerial decisions that any person is authorized or required to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:

(a) The timing and amount of distributions;

(b) The selection of beneficiaries;

10. This definition of the term "fiduciaries" is no longer needed in view of § 1601(i)(3)(A) of the Taxpayer Relief Act of 1997, which changed the word "fiduciaries" to "persons."

(c) The power to make investment decisions;

(d) The power to determine whether receipts are allocable to income or principal;

(e) The power to terminate the trust;

(f) The power to compromise, arbitrate, or abandon claims of the trust and to decide whether to sue on behalf of or defend suits against the trust; and

(g) The power to remove, add or replace a trustee.

(4) Ministerial decisions "include decisions regarding details such as the bookkeeping, the collection of rents, and the execution of investment decisions made by the fiduciaries."

(5) A decision is not a substantial decision if it can be made by a grantor or, in the case of a decision that affects the portion of a trust in which a beneficiary has an interest, by that beneficiary, unless the grantor or the beneficiary, as the case may be, is acting as a fiduciary under Code § 7701(a)(6) (a Code "§ 7701(a)(6) fiduciary"). This means, for example, that the power to revoke a trust exercisable by an individual holding a power of appointment who is neither a beneficiary nor the grantor is the power to make a substantial decision, but that such a power held by the grantor is not.

(6) "Control" means the power to make all of the substantial decisions of the trust, with no other person having the power to veto such decisions other than the grantor or a beneficiary acting with respect to her interest in the trust (unless the grantor or beneficiary is acting as a Code § 7701(a)(6) fiduciary).

If an inadvertent change in fiduciaries would cause a trust to change residence, the proposed regulation permits the trust to retain its pre-change status if the fiduciaries are adjusted within six months of the inadvertent change.[11] Inadvertent changes include the death of a fiduciary or her abrupt resignation.

4. Election Available for Trusts in Existence on August 20, 1996

Section 1161 of the Taxpayer Relief Act of 1997 (the "1997 Act")[12] permits trusts that were in existence on August 20, 1996 and that were treated as domestic U.S. trusts on August 19, 1997 to elect to continue to be treated as U.S. trusts to the extent prescribed by regulations. The Internal Revenue Service (the "Service") has provided guidance as to the application of this provision in Notice 93-25.[13]

B. Creation of and Transfer of Property to a Foreign Trust by a U.S. Person

1. Tax Consequences of Creation and Transfer

No tax consequences are imposed on a U.S. person on account of her creation of a foreign trust, but, under some circumstances, income tax may be imposed on her transfer of property to a foreign trust, whether that trust was created by her or by another. Code § 684[14] treats a transfer of property by a U.S. person to a foreign trust as a sale or exchange for an amount equal to the fair market value of property transferred and requires that the transferor recognize gain on the excess of such fair market value over her basis in the transferred property. This rule does not apply to the extent that any person (including the transferor) is treated as the owner of such trust under Code § 671.

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11. Such a change can now result in immediate income tax liability under Code § 684 as enacted by § 1131(b) of the Taxpayer Relief Act of 1997. Under prior law, such a change could have resulted in immediate tax liability under § 1491 of the Code, which was repealed by § 1131(a) of the Taxpayer Relief Act of 1997.

12. P.L. No. 105-34, 111 Stat. 788 (1997). The 1997 Act was signed by President Clinton on August 5, 1997.

13. 1998-18 I.R.B. 11.

14. Code § 684 was added to the Code by the 1997 Act.

2. Tax Treatment During the Life of a U.S. Creator or Transferor

If a foreign trust to which a U.S. person has made any gratuitous transfers has one or more U.S. beneficiaries, Code § 679 treats the trust as a so-called "grantor trust" owned by the U.S. person within the meaning of Code § 671 to the extent of her transfer.

3. Tax Treatment at the Death of U.S. "Owner" of a Foreign Trust

The death of a U.S. person who was treated as the owner of a foreign trust during her lifetime may be a gain recognition event under Code § 684. Here's the argument for such treatment. Until the U.S. person's death, she was the owner of the property for U.S. income tax purposes under Code § 671. Her death is treated as a transfer because it terminates the trust's grantor trust status and, in effect, shifts ownership of the property from the deceased transferor to the trust.

Some suggest that this result will occur even if the property held in the foreign trust is included in the U.S. person's estate for estate tax purposes and receives a basis adjustment under Code § 1014.[15] Code § 1014, it is argued, does not provide the decedent with a basis adjustment. Instead, Code § 1014 seems to give the basis adjustment only to the recipient of the property. It is unlikely that this result is intended by Congress. If it were, it would apply not only to the treatment of U.S. persons whose death causes their foreign grantor trusts to become foreign nongrantor trusts but also to any U.S. person who owns or whose grantor trust owns at her death property, the transfer of which would result in gain recognition. For example, the death of a grantor whose revocable trust holds property subject to debt in excess of basis would trigger tax on the excess.

The risk of this result can be avoided in the case of a foreign grantor trust, by giving a U.S. person, perhaps a U.S. trust, the right to withdraw the foreign trust's property immediately upon the death of the U.S. person. The withdrawal power would give the deceased U.S. person the protection of Code § 684(b). Code § 684(b) excepts transfers to trusts to the extent such trusts are owned by any person (other than a foreign nongrantor trust) under Code § 871.

A transfer by the will of a U.S. decedent of property to a foreign nongrantor trust generally will not be subject to Code § 684. This is so because the estate will receive the property from the decedent with a basis adjustment under Code § 1014. If the estate transfers the property before any post-death appreciation occurs, there will be no gain to which Code § 684 can apply.

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15. Dudley and Karp, Continued Use of Foreign Trusts in U.S. Tax Planning, Trusts & Estates, June 1998, 36, 38.

4. Tax Treatment After Death of U.S. Person

After the death of the U.S. person who has made transfers to a foreign trust, the trust will no longer be subject to Code § 679 and will be treated as a foreign nongrantor trust.

5. Reporting Requirements

A U.S. person who creates a foreign trust or who transfers property to a foreign trust (other than a transfer in exchange for consideration equal to the full value of the transferred property) is required to report the creation or transfer on Form 3520.[16] Form 3520 is due at the same time as her income tax return is due for the year in which such creation or transfer took place. Failure to file may subject a transferor to a penalty equal to 35% of the amount transferred.[17]

A U.S. person who is treated as the owner, within the meaning of Code § 671, of a foreign trust is required to ensure that the trust files an annual return that sets forth a full accounting of all trust activities and operations for each year that she is treated as owner.[18] The U.S. "owner" is required to disclose on Form 3520 the existence of the trust, its taxpayer identification number, the names of other persons who are considered "owners" of the trust, the code section which causes the trust to be treated as owned by the U.S. person and others who are treated as owners, the country in which the trust was created and the date of creation. Form 3520 is due at the same time as the U.S. person's income tax return is due. The information required to be furnished by the trust must be disclosed on Form 3520A, which is due on each March 15 following the year for which reporting is required. If Form 3520A is not filed, the U.S. person who is treated as the owner may be liable for a penalty equal to 5% of the value of the trust assets that are treated as owned by her.[19]

The executor of the estate of a U.S. person who transfers property to a foreign trust at her death, who was treated as the owner of a foreign trust during her lifetime or whose estate includes, for estate tax purposes any portion of a foreign trust, must report the death and the

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16. Code § 6048(a).

17. Code § 6677(a).

18. Code § 6048(b).

19. Code § 6677(b).

transfers on Form 3520.[20] Form 3520 is due at the same time as the executor's income tax return is due for the year in which the decedent's death occurred. Failure to file may subject the executor to a penalty equal to 35% of the amount transferred.[21]

C. Treatment of Trusts That Become Foreign Trusts

1. In General

If a U.S. trust with U.S. beneficiaries becomes a foreign trust during the life of a U.S. person who has made gratuitous transfers to it, the trust and the U.S. person will be treated in the same manner as they would have been treated under Code § 679 if the trust had been a foreign trust when the transfers were made.

If a U.S. trust becomes a foreign trust (1) at a time when there is no living U.S. person who ever made a gratuitous transfers to it or if it has no U.S. beneficiaries, and (2) if it is not treated as owned by another person within the meaning of Code § 671, the trust will be treated as having transferred all of its assets to a foreign trust immediately before becoming a foreign trust.[22] As a result, Code § 684(a) will treat it as having sold all of its assets for an amount equal to their fair market value.

2. Reporting Requirements

A U.S. trust that becomes a foreign trust is required to report its change of status on Form 3520.[23] Form 3520 is due at the same time as the trust's income tax return is due for the year in which the transfer took place. Failure to file may subject a trust to a penalty equal to 35% of the amount transferred.[24]

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20. Code § 6048(a).

21. Code § 6677(a).

22. Code § 684(c).

23. Code § 6048(a).

24. Code § 6677(a).

D. Creation of a Foreign Trust by a Non-U.S. Person

Neither Code § 684(a) nor Code § 679 applies to a transfer to a foreign trust by a non-U.S. person. As a result, no U.S. income tax will be imposed on such transfer. The trust's income will be treated for U.S. income tax purposes as if earned by a foreign nongrantor trust unless Code § 672(f) applies to the trust. Prior to the 1996 Act, trusts created by non-U.S. persons were subject to the so-called "grantor trust" rules set forth in Code §§ 671 through 679 to the same extent as trusts created by U.S. persons. The application of the grantor trust rules shifted the trust's income, for virtually all U.S. income tax purposes, from the trust to its grantor.

Code § 672(f), which was added by the 1996 Act, denies grantor trust status to trusts with non-U.S. grantors unless:

1. the grantor retains the right, exercisable either unilaterally or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; or

2. the only amounts permitted to be distributed from the trust during the grantor's life are amounts distributable to the grantor or her spouse.[25]

III. TAX TREATMENT OF FOREIGN NONGRANTOR TRUSTS

A. In General

Nongrantor trusts calculate their taxable incomes in the same manner as individuals with certain modifications set forth in Code §§ 642, 643, 651, and 661. For this purpose,

25. Code § 672(f). Trusts with foreign grantors that were in existence on September 19, 1995 and that were treated as grantor trusts under Code § 676 (relating to trusts, the property of which may be returned to the grantor) or Code § 677 (relating to trusts the income from which may be paid to the grantor or her spouse) other than Code § 677(c) (relating to trusts the income from which may be used to pay life insurance premiums on the life of the grantor or her spouse) will continue to be treated as grantor trusts except to the extent transfers were made to such trusts after September 19, 1995. P.L. 104-188 § 1904(d)(2).

foreign nongrantor trusts are treated as nonresident individuals who are not present in the United States at any time.[26]

B. Gross Income

The gross income of a foreign nongrantor trust consists only of (1) gross income derived from sources within the U.S. that is not effectively connected with the conduct of a trade or business within the U.S., and (2) gross income that is effectively connected with the conduct of a trade or business within the U.S.[27]

Gross income from sources within the U.S. includes:

1. interest from the U.S. (or any of its agencies), the District of Columbia, from noncorporate residents of the U.S. and from domestic corporations;[28]

2. dividends from domestic corporations;[29]

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26. Code § 641(b). Code § 871(a)(2) provides that a nonresident alien individual who is present in the United States for a period of 183 days or more in a taxable year is subject to a 30 percent tax on her net capital gains allocable to sources within the United States. Under Code § 865(a)(1) income from the sale of personal property is generally sourced according to the residence of the seller. But, under Code § 865(e)(2)(A), a nonresident alien who maintains an office in the United States has United States source income to the extent she sells personal property attributable to that office. Prior to the 1997 Act, it was unclear whether a trust that was a foreign trust within the meaning of new Code § 7701(a)(31) but that had a United States trustee with an office in the United States would be treated as having United States source income to the extent that trustee directed the sale of personal property. See Schwab and Davies, Tax Risks When U.S. Fiduciary Acts as Trustee of Foreign Trust, New York Law Journal (January 7, 1997) 1. Section 641(b) was amended by the 1997 Act to provide that, in determining the income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the United States at any time.

27. Code § 872(a).

28. Code § 861(a)(1).

29. Code § 861(a)(2).

3. rentals and royalties from property located in the U.S. including rentals or royalties for the use in the U.S. of patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and the like; and[30]

4. gains from the disposition of U.S. real estate.[31]

C. Imposition of U.S. Income Tax

1. In General

Foreign nongrantor trusts are subject to U.S. income tax on the types of income described below:

a. Income Effectively Connected With U.S. Trade or Business

(1) General Rule

Foreign nongrantor trusts are taxable on taxable income which is effectively connected with the conduct of a trade or business within the U.S.[32]

Although it is unlikely that a foreign nongrantor trust would be engaged directly in a trade or business, some foreign trusts may have this type of income as a result of investments in partnerships that engage in U.S. trades or businesses. A foreign nongrantor trust that is a general or limited partner in a partnership engaged in a U.S. trade or business is deemed to be engaged in that trade or business.[33]

(2) Election With Respect to Income From Real Property

In addition, a foreign nongrantor trust that receives income from real property located in the U.S. may make an election to treat all such income as income effectively connected with

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30. Code § 861(a)(4).

31. Code § 861(a)(5).

32. Code § 871(b).

33. Code § 875(1); Rev. Rul. 91-32, 1991-1 C.B. 107; Rev. Rul. 85-60, 1985-1 C.B. 187.

a U.S. trade or business if the property is held for the production of income.[34] In the absence of such an election, such income would be taxed on the basis of gross receipts unreduced by any deductions.

(3) Disposition of United States Real Property Interests

A foreign nongrantor trust's gains from the disposition of "United States real property interests" are treated as income that is effectively connected with a U.S. trade or business.[35] For this purpose, a "United States real property interest" is "any interest, other than an interest solely as a creditor, in either:

i) real property located in the United States or the Virgin Islands, or

ii) a domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii)."[36]

For this purpose, the term "interests in real property" includes fee ownership and co-ownership of and leaseholds of land, improvements thereon, personal property associated with the use of real estate, and options to acquire such land, improvements, leaseholds, and personal property.[37]

A United States real property holding corporation is any corporation unless the value of its United States real property interests is less than 50% of the sum of the value of all of its real property interests plus the value of all of its assets that are used or held for use in its trade or business.[38]

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34. Code § 871(d)(1).

35. Code § 897(a).

36. Treas. Reg. § 1.897-1(c)(1); see Code § 897(c)(1).

37. Code § 897(c)(6).

38. Code § 897(c)(2). Shares of any class of securities that are regularly traded on an established securities market will not be treated as a United States real property interest except as to a person who holds more than 5% of the stock. Code § 897(c)(3).

A foreign nongrantor trust's receipt of consideration for the disposition of a partnership interest in a partnership that holds any United States real property interests is treated as consideration received for the disposition of a United States real property interest to the extent attributable to United States real property interests.[39]

b. Fixed or Determinable Annual or Periodic Income

Foreign nongrantor trusts are taxed on their U.S. source fixed or determinable annual or periodic income such as interest, dividends, rents, and annuities and the like.[40] They are also taxed on their U.S. source gains from certain timber, coal and iron ore transactions,[41] on their U.S. source gains from the sale or exchange of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises and similar property to the extent the gains are from payments which are contingent on the use of the transferred interest,[42] and, subject to the important exceptions described below, on their original issue discount from U.S. sources.[43] These types of income are all subject to the same type of taxation, except to the extent they are effectively connected with a U.S. trade or business. For convenience they are referred to in this outline as "fixed or determinable annual or periodic income."

c. Other Gains

Nonresident aliens who are present within the U.S. for more than 183 days in a particular taxable year are normally subject to tax on gains derived from sources within the U.S. from the sale of capital assets.[44] As discussed above, Code § 641(b) prevents this rule from applying to foreign nongrantor trusts. It provides that, for purposes of calculating the taxable income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the U.S. at any time. Thus, even though the trustees of a foreign

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39. Code § 897(g); Notice 88-72, 1988-2 C.B. 383.

40. Code § 871(a)(1)(A).

41. Code § 871(a)(1)(B).

42. Code § 871(a)(1)(D).

43. Code § 871(a)(1)(C).

44. Code § 871(a)(2). Income from the sale of personal property (other than inventory property) attributable to an office or other fixed place of business in the U.S. that is maintained by a nonresident in the U.S. is sourced in the U.S. Code § 865(e)(2).

nongrantor trust reside permanently in the U.S., the trust will be treated for U.S. income tax purposes as if the trustees had never been present in the U.S.

2. Exceptions

a. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of so-called "portfolio interest" unless such income is effectively connected with the conduct of a U.S. trade or business.[45] For this purpose, portfolio interest is interest (including original issue discount) which is paid on certain obligations of U.S. persons issued after July 18, 1984.

b. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of interest from a U.S. bank, savings and loan association, or similar institution unless such income is effectively connected with the conduct of a U.S. trade or business.[46]

c. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of original issue discount income on obligations that mature in 183 days or less from the date of original issue unless such income is effectively connected with the conduct of a U.S. trade or business.[47]

D. Deductions

1. Income Effectively Connected With U.S. Trade or Business

In computing a foreign nongrantor trust's taxable income that is effectively connected with the conduct of a trade or business within the U.S., the trust is entitled to reduce its gross income so connected (or treated as so connected) by the deductions that are "connected" with such income.[48] The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treas. Reg. § 1.873-1. In addition, it is also entitled to deduct against its effectively connected income the following:

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45. Code § 871(h).

46. Code § 871(i).

47. Code §§ 871(a)(1)(C), 871(g)(1).

48. Code § 873(a).

a. the deduction for losses allowed by Code § 165(c)(3) if the loss occurred with respect to property located in the U.S.;

b. the deduction for charitable contributions allowed by Code § 170; and

c. the deduction for personal exemptions allowed by Code § 151.[49]

Nothing in the Code or the Regulations indicates whether the distributions made to beneficiaries by a foreign nongrantor trust with income effectively connected with the conduct of a trade or business within the U.S. are connected with such income and, are therefore, deductible under Code §§ 651 and 661.

It is appropriate to permit a foreign nongrantor trust to deduct that portion of its distributions to beneficiaries that consist of effectively connected income. In determining the portion of a distribution that consists of effectively connected income, the distribution should be treated as consisting of the same portion of effectively connected income as the total of the trust's effectively connected income bears to the trust's total income. The Service seems to take this approach.[50]

2. Other Income

No deductions are permitted against U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business.

3. Foreign Tax Credit

A foreign nongrantor trust engaged in a trade or business within the U.S. (either directly or through investments in partnerships that are so engaged) that pays foreign income, war profits or excess profits taxes on income that is effectively connected with such trade or business may, subject to certain limitations, credit the foreign tax against its U.S. income tax liability.[51] Alternatively, it may deduct such taxes.[52]

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49. Code § 873(b).

50. See, e.g., Rev. Rul. 85-60, 1985-1 C.B. 187.

51. Code §§ 901(b)(4), 906(a).

The total amount of the credit:

a. is limited to the proportion of the U.S. tax against which such credit is taken as the trust's taxable income from foreign sources bears to its entire taxable income effectively connected with its U.S. trade or business;[53]

b. may not be used against any income tax imposed on income not effectively connected with such business;[54] and

c. is not allowed to the extent it is properly allocable under Code § 901(b)(5) to the trust's beneficiaries.[55]

In some cases foreign income, war profits or excess profits taxes will be imposed on the foreign grantor of a foreign nongrantor trust rather than on the trust itself. This would occur, for example, if the trust were treated as "owned" by its grantor under foreign tax rules similar to the so-called grantor trust rules set forth in Code §§ 671 through 679. There is no mechanism in the Code that permits the foreign nongrantor trust to credit the taxes paid by the grantor against the trust's U.S. income tax.

Until the 1997 Act's imposition of significant limitations on the availability of grantor trust status for trusts created by non-U.S. persons, the absence of a credit mechanism was unlikely to be a problem. This was so because the U.S. grantor trust system is so broad that any trust treated as owned by its grantor under foreign tax law was also likely to be treated as owned by its grantor under U.S. tax law. Under current U.S. law, the absence of a credit mechanism can result in serious foreign tax credit misallocations.

52. (...continued)
52. Code § 164(a)(3). If the trust claims the credit, the deduction is not permitted. Code § 275(a)(4).

53. Code §§ 904(a) and 906(b)(2).

54. Code § 906(b)(3).

55. Code § 642(a).

E. Tax Rates

1. Income Effectively Connected to a U.S. Trade or Business

This type of income is subject to the normal tax rates applicable to trusts under Code § 1(e).[56]

2. Other Income

U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business, is subject to tax at a flat rate of 30%.[57]

F. Withholding

1. Income Effectively Connected With U.S. Trade or Business

a. In General

Withholding is generally not required for income (including fixed or determinable annual or periodic income) to the extent it is effectively connected with a U.S. trade or business.

b. Partnership Withholding

Withholding obligations are, however, imposed on partnerships that have taxable income that is effectively connected (or treated as effectively connected) with the conduct of a U.S. trade or business if such income is allocable under Code § 704 to a foreign partner.[58] The withholding rate applicable to foreign nongrantor trusts that are partners in such partnerships is the highest rate of tax specified in Code § 1.[59]

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56. Code § 871(b)(1).

57. Code § 871(a).

58. Code § 1446(a). Such a partnership is required to file Form 8804 and to send Form 8805 to each such foreign partner.

59. Code § 1446(b).

c. United States Real Property Interests

The transferee of a disposition by a foreign person of a United States real property interest is required to withhold. The withholding rate is 10% of the amount realized.[60]

2. Fixed or Determinable Annual or Periodic Income

Code § 1441(a) requires any person paying any of the items of income listed in Code § 1441(b) to withhold a 30% tax to the extent such income constitutes gross income from U.S. sources of any nonresident alien individual or of any foreign partnership[61] unless such income is effectively connected with the conduct of a U.S. trade or business.[62] The income items listed in Code § 1441(b) are the various kinds of fixed or determinable annual or periodic income. Code § 1442 imposes a similar requirement with respect to the income of foreign corporations. Curiously, neither section refers to withholding with respect to the income of trusts. Nevertheless, the regulations state that income paid to a foreign fiduciary is subject to the withholding requirements of Code § 1441.[63] As discussed above, however, a foreign trust does not necessarily have nonresident alien trustees. Whether the withholding requirements apply to payments made to the U.S. trustees of a foreign nongrantor trust is not clear.

G. Effect of Tax Treaties

The principles described above may apply differently to foreign nongrantor trusts that are residents of countries with which the U.S. has an income tax treaty. For example, most income tax treaties to which the U.S. is a party reduce the tax imposed on dividends not effectively connected to a U.S. trade or business to 15% from 30%.

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60. Code § 1445(a). The transferee is required to file Form 8288 and to furnish Form 8288-A to the transferee.

61. The person withholding is required to file Form 1042 and to furnish Form 1042-S to the person from whom tax is withheld.

62. Code § 1441(c)(1).

63. Treas. Reg. § 1.1441-3(f). See also PLR 6306214990A (June 21, 1963).

H. Taxable Year and Estimated Tax Payments

Foreign nongrantor trusts must adopt a calendar taxable year and are required to make estimated income tax payments in the same manner as U.S. trusts.[64]

I. Reporting Requirements

1. U.S. Nonresident Alien Income Tax Return - Form 1040NR

The trustee of a foreign nongrantor trust is required to file Form 1040NR for a particular year if:

a. the trust was engaged in trade or business in the U.S. during such year even if no income was derived from such trade or business; or

b. the trust had income in such year that is subject to tax in the U.S. unless the trust's liability for such tax is fully satisfied by withholding.[65]

If a foreign nongrantor trust is required to file Form 1040NR for a particular year, the return must be filed by the 15th day of the 6th month following the close of the year if the trust does not have an office or place of business in the U.S. If the trust does have an office or place of business in the U.S., its Form 1040NR must be filed by the 15th day of the 4th month following the close of the year.[66]

2. Report of Foreign Bank and Financial Accounts - Form TD F 90-22.1

A U.S. trustee of a foreign nongrantor trust must file Form TD F 90-22.1 if she has a financial interest in or signature authority or other authority over any financial accounts, including bank, securities, or other types of financial accounts in a foreign country if the value of such accounts exceeds $10,000. A person has a financial interest in any such account if she has legal title to it. Trustees generally have legal title to accounts in which trust funds are invested. In addition, if legal title to an account is held by a corporation or partnership and the trustee owns more than 50% of the corporation or partnership, the trustee will be treated as

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64. Code §§ 664(a) and 6654(l); Notice 87-32, 1987-1 C.B. 477.

65. Treas. Reg. § 1.6012-1(b).

66. Treas. Reg. § 1.6072-1; T.D. 7426.

having a financial interest in such account. A person has signature authority over an account if she can control the disposition of account property by the delivery of a document signed by her and one or more other persons. A person has other authority over an account if she can control such disposition by direct communication to the person with whom the account is maintained.

Form TD F 90-22.1 must be filed by June 30th of the year following the year in which the U.S. person had such financial interest or signature or other authority.

J. Taxpayer Identification Numbers

Code § 6109 requires persons to obtain a U.S. identifying number to the extent required by regulations. Treas. Reg. § 301.6109-1(b) requires a foreign nongrantor trust (or any other nonresident alien) to obtain a U.S. taxpayer identification number if:

1. it has income effectively connected with a U.S. trade or business, it has a U.S. office or place of business;

2. it files a U.S. income tax return or refund claim; or,

3. after December 31, 1998, it furnishes a withholding certificate claiming a reduced tax rate under a treaty (other than for dividends and interest from stocks and debt that are actively traded and certain other securities), or an exemption from withholding from income that is effectively connected with a U.S. trade or business.

IV. TAX TREATMENT OF U.S. BENEFICIARIES OF FOREIGN NONGRANTOR TRUSTS

A. In General

U.S. taxpayers who are beneficiaries of foreign nongrantor trusts may be subject to U.S. income taxes on distributions of cash or other property received from such trusts. In some cases, loans made to them or to persons related to them from such trusts will be treated as distributions.

The determination of a U.S. beneficiary's U.S. tax liability depends on a number of factors, including whether the distribution was made during a year in which the foreign nongrantor trust earned income and the relationship between the size of that income and the value of the distributions made in that year to the U.S. beneficiary and to other trust beneficiaries, whether, if the amount of the trust's distributions exceeded the amount of its income for the year of distribution, the trust had undistributed income accumulated from prior years, and whether the trust previously paid U.S. income tax or foreign income tax.

The general framework is discussed below.

B. Distributions of Income in the Year Earned

1. General Rules

a. Distributable Net Income

A U.S. beneficiary of a foreign nongrantor trust is required to include in her gross income for any particular year:

(1) the amount of any trust income in such year required to be distributed to her from a so-called "simple trust" (whether or not actually distributed to her) to the extent of her share of the trust's distributable net income ("DNI") for the year;[67]

(2) the amount of any trust income required to be distributed to her in such year from any other foreign nongrantor trust, a "complex trust" (whether or not actually distributed to her) to the extent of her share of the trust's DNI for the year;[68] and

(3) any other amount required to be distributed to her (whether or not actually distributed to her) or properly and actually distributed to her from a foreign complex

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67. Code § 651(a). The term "simple trust" refers to a nongrantor trust that is not permitted to make payments to charity and that, in the year for which the characterization is made, makes no principal distributions.

68. Code § 662(a)(1). The term "complex trust" refers to a nongrantor trust other than a simple trust.

trust in a such year to the extent of her share of the trust's DNI for such year.[69]

b. Determining a Beneficiary's Share of DNI

In the case of a simple trust, if the amount of income distributions required to be made exceeds the trust's DNI, each beneficiary shares in the trust's DNI in the proportion that the amount of income required to be distributed to her bears to the amount of income required to be distributed to all beneficiaries.[70] The same rule applies to income distributions from complex trusts.[71]

If a complex trust's DNI exceeds the amount of income required to be distributed to its beneficiaries and if there are other amounts either required to be distributed or properly distributed to a beneficiary, that beneficiary will share in the trust's remaining DNI in the proportion that the amount of the trust's distribution (or required distribution) to her bears to the amount of all such distributions (or required distributions) to all beneficiaries.[72]

Consider the following example:

> **Example:** Kate is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). Under the terms of the trust all income is (and always has been) required to be distributed currently to Kate's mother, M, a nonresident alien. The trustees are permitted to make principal distributions to Kate. In 1997, the trust's income (and its DNI) consisted of $100,000 of dividends from foreign corporations, all of which were distributed to M. FNT has never had any income from capital gains. The trustees made a principal distribution of $100,000 to Kate. Kate is not required to include any portion of the $100,000 distribution in her gross income.

69. Code § 662(a)(2).

70. Code § 651(a).

71. Code § 662(a)(1).

72. Code § 662(a)(2).

c. Meaning of "Income"

For purposes of these rules, the term "income" (unless part of the phrase "taxable income," "distributable net income," "undistributed net income," or "gross income") means the amount of income for the taxable year of the trust determined under the terms of the governing instrument and applicable local law.[73] To avoid confusion, this outline refers to "income" as "trust accounting income." The term "income" or "trust accounting income" is generally used to describe for local law purposes the amount required or permitted to be distributed to current trust beneficiaries when the terms of the trust instrument require or permit trust income, but not trust principal, to be distributed to such beneficiaries. The items that are included in the term "income" or "trust accounting income" vary from jurisdiction to jurisdiction. There is no standard federal definition. The term generally includes items such as dividends and similar distributions made with respect to investments in business or investment entities, interest, and rent. It generally excludes gains from the disposition of property. Trust provisions whose definitions of income depart fundamentally from local law are not recognized for purposes of this definition.[74]

d. Sixty-Five Day Election

At the trustee's election, an amount that is properly paid to a beneficiary within 65 days after the end of a taxable year will be treated as having been paid to her within such taxable year.[75]

e. Specific Gifts

An amount that the trust instrument requires to be paid to a beneficiary as a gift of a specific sum of money or of specific property and which is actually paid to her all at once or in no more than three installments is not treated as a distribution and, therefore, is not included in the gross income of the U.S. beneficiary. This exception does not apply to amounts that can be paid only from trust income.[76]

Consider the following example:

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73. Code § 643(b).

74. Treas. Reg. § 1.643(b)-1.

75. Code § 663(b).

76. Code § 663(a)(1).

Example: Pat is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). The terms of the trust document require the trustees of FNT to pay Pat $1,000,000 on his 30th birthday. Pat reached age 30 during 1997, a year in which FNT's income and DNI exceeded $1,000,000. FNT's principal in that year was worth $10,000,000. Pat is not required to include the $1,000,000 paid to him by FNT in his gross income.

f. Distributions of Property Other Than Cash

The amount of any distribution to a beneficiary of property other than cash (other than a required distribution of trust accounting income) is the lesser of the trust's basis in the property or its value at the time of distribution unless the trustee makes an election to recognize gain on the distribution. If the trustee makes such an election, the amount of the distribution will be the value of the property. The trust will recognize gain equal to the excess of the value of the property over its basis. If the trustee does not make the election, the beneficiary's basis will be the same as the trust's basis.[77]

Consider the following example:

Example: Jenny is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). During 1997, the trustees of FNT distributed 100 shares of X corporation stock to her. The shares were worth $1,000,000 at the time of distribution. The trust's basis in the shares was $1,000. FNT's income and DNI in 1997 exceeded $1,000,000. The trustees did not make the election described above to recognize gain on the distribution. Jenny will not be required to include any amount in excess of $1,000 in her gross income on account of the distribution. Her basis in the X shares will be $1,000.

These general rules are no different than the rules that apply to U.S. beneficiaries of U.S. nongrantor trusts.

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77. Code § 643(e).

2. Special Rules for Foreign Nongrantor Trusts

a. Different Definition of Distributable Net Income

Generally, the DNI of a U.S. nongrantor trust for a particular year is equal to its taxable income for that year adjusted by adding to taxable income the amount deducted as a personal exemption, the amount of its tax exempt income, and the amount of the trust's deduction for distributions to beneficiaries and by subtracting from taxable income the trust's capital gains except to the extent such capital gains are "paid, credited or required to be distributed to any beneficiary during the taxable year."[78]

The DNI of a foreign nongrantor trust includes its capital gains.[79] In addition, a foreign nongrantor trust's DNI includes the amount of its income from non-U.S. sources reduced by amounts which would be deductible in connection with such income in the absence of Code § 265[80] and the amount that was excluded from its gross income by treaty under Code § 894.[81]

Consider the following example:

> **Example:** John is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). During 1997 the trust had foreign source dividend income of $10,000 and long term capital gain from the sale of securities of $10,000. Its U.S. gross income and taxable income is zero. The trust distributed $15,000 to John. It neither made nor was required to make distributions to any other beneficiary. The trust's DNI was $20,000. John's gross income from the trust, therefore, is $15,000. If FNT had been a U.S. trust, its DNI would have been only $10,000, and John's gross income on account of his distribution from the trust would have been $10,000.

78. Code § 643(a).

79. Code § 643(a)(6)(C).

80. Code § 643(a)(6)(A).

81. Code § 643(a)(6)(B).

b. Tax Character of Distributions

The tax character of distributions received by a beneficiary in a particular year reflects the character of the trust's income for that year proportionately.[82]

> **Example:** John, the U.S. taxpayer in the above example, who received a $15,000 distribution from FNT, which had dividend income of $10,000 and long term capital gains of $10,000, will be treated as having received ordinary income of $7,500 and long term capital gains of $7,500.

If the trust document or local law requires that particular types of trust income be allocated to particular beneficiaries and if such requirement has economic significance independent of the tax consequences, the character of the amounts received by the beneficiaries will reflect such required allocation.[83]

> **Example:** The terms of FNT, the foreign nongrantor trust described in the example above, required that all of FNT's dividend income be distributed annually to F, John's nonresident alien father. F will be treated as having received all of the ordinary income included in the trust's DNI. John's $15,000 distribution, therefore, will consist of $10,000 of long term capital gains. The balance of $5,000 will not be included in his gross income.

c. Credit for U.S. Withholding Tax

As discussed above, if the foreign nongrantor trust had fixed or determinable annual or periodic income or income from the disposition of U.S. real property interests, it is likely that the trust paid U.S. income tax on such income through withholding under Code § 1441 or Code § 1445. The Service takes the position that a U.S. beneficiary who receives a distribution from a foreign nongrantor trust that includes U.S. source income from which U.S. tax has been withheld must include in her gross income not only the amount she actually

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82. Code §§ 652(b) and 662(b).

83. Code §§ 652((b) and 662(b); Treas. Reg. §§ 1.652(b)-2(a) and 662(b)-1.

receives but also the amount of the withheld tax. She may then credit the withheld tax against her personal income tax liability.[84]

> **Example:** FNT, the foreign nongrantor trust described in the above example, had, in addition to its $10,000 of foreign source dividend income and $10,000 of long term capital gains, $10,000 of dividends on U.S. securities from which $3,000 of tax was withheld. FNT distributed $13,500 to John. John will be treated as having received a distribution of $15,000 consisting of foreign source dividend income of $5,000, long term capital gains of $5,000, and U.S. dividend income of $5,000. The U.S. dividend income has been "grossed-up" by his $1,500 share of the taxes withheld from it. The $1,500 will be credited against his U.S. income tax.

d. Credit for Foreign Income Taxes Paid by Trust

A U.S. person who pays income, war profits or excess profits tax to a foreign country may credit the amount of such taxes against her U.S. income tax liability or may claim such taxes as an itemized deduction.[85] The total amount of the credit is limited to the proportion of the tax against which such credit is taken as her taxable income from foreign sources bears to her entire taxable income.[86]

If a foreign nongrantor trust pays such foreign taxes, its U.S. beneficiaries who receive distributions of income on which such taxes have been paid may elect to take a credit for the share of foreign taxes attributable to their share of the income or a deduction.[87] The credit is subject to the limits described above.

Neither the Code nor the regulations explain whether the beneficiary must include in her gross income the amount of foreign taxes paid with respect to the income distributed to her

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84. Treas. Reg. §§ 1.1441-3(f) and 1.1462-1(b); Rev. Rul. 56-30, 1956-1 C.B. 646; Rev. Rul. 55-414, 1955-1 C.B. 385.

85. Code §§ 901(a) and 164(a)(3). An election to take the credit precludes the deduction. Code § 275(a)(4).

86. Code § 904(a).

87. Code § 901(b)(5).

if she elects to take the credit. The Service's internal position seems to require such inclusion. The current edition of the Service's foreign trust training manual provides the following guidance for its agents:

> "While many foreign trusts are established in countries having no income taxes, such as Bermuda or the Bahamas, some are established in countries with income taxes. Some also pay taxes to other countries where they have investments.
>
> In either case, a U.S. citizen or resident taxed on the income of such a trust may claim credit for his/her allocable share of foreign INCOME taxes paid by the trust. If the credit is claimed, the amount of income reported should be grossed up to include the foreign taxes paid.
>
> The taxpayer may deduct the taxes instead if he/she chooses. Failure to gross up trust income should be regarded as an election to take a deduction."[88]

If foreign income, war profits or excess profits taxes are imposed on a foreign nongrantor trust's non-U.S. grantor or on another non-U.S. person rather than on the trust itself and if the trust would have been treated as owned by the grantor or such other person under subpart E of the Code but for Code § 672(f), Code § 901(b)(5) may permit these taxes to be treated for foreign tax credit purposes as if they had been imposed on the trust. Unfortunately, the implementation of this portion of Code § 901(b)(5) appears to require regulatory action, which has not yet occurred.

C. Distribution of Income Accumulated in a Prior Year -- the "Throwback Rules"

1. In General

If a foreign nongrantor trust makes distributions in excess of its DNI for a particular year, the U.S. beneficiaries who receive such distributions are likely to be required to include such distributions in their gross incomes, may be required to calculate their U.S. income tax on such distributions under a complex rule generally referred to as the "throwback rule," and may be subject to interest on these taxes.

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88. "Foreign Trusts and the IRS," 1997 Training 3325-002 (05-97), 98 TNI 149-44. The manual cites no authority for this conclusion. Its discussion of the issue is quite similar to Howard Zaritsky's speculation as to how the issue should be resolved in Zaritsky, Foreign Trusts, Estates, and Beneficiaries, 854 T.M. A-32.

2. Accumulation Distributions

a. In General

The throwback rule and its accompanying interest charge apply only if the foreign nongrantor trust has made an "accumulation distribution." An accumulation distribution is a distribution under Code § 661(a)(2) (dealing with amounts properly paid or credited or required to be distributed other than trust accounting income required to be distributed currently) to the extent such distribution exceeds the trust's DNI for the year reduced (but not below zero) by trust accounting income required to be distributed currently.[89]

The following two important exceptions to this definition may be applicable to distributions from foreign nongrantor trusts:

b. Exceptions

(1) Specific Gifts

A distribution in satisfaction of a gift of a specific sum of money or of specific property described in Code § 663(a)(1) (described above) is not an accumulation distribution.[90]

> **Example:** FNT, the foreign nongrantor trust described above of which Pat is a beneficiary had no DNI in the year in which Pat reached age 30. The trustees distributed the sum of $1,000,000 to Pat as they were required to do under the terms of the trust instrument. The distribution to Pat is not an accumulation distribution.

(2) Distributions Not in Excess of Trust Accounting Income

Distributions that do not exceed trust accounting income in the year in which made are not accumulation distributions. The Code establishes this exception with the following text:

> "If the amounts properly paid, credited, or required to be distributed by the trust for the taxable year do not exceed the

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89. Code § 665(b).

90. Treas. Reg. § 1.665(b)-1A.

> income of the trust for such year, there shall be no accumulation distribution for such year."[91]

This principal is illustrated by the following example:

> **Example:** Isaac is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). The terms of the trust permit the trustees to distribute income and principal to any one or more beneficiaries at such times and in such amounts that they believe appropriate. In 1997, FNT received $100,000 in dividends from foreign corporations. It paid trustee commissions of $60,000, $40,000 of which was allocable to principal. Its trust accounting income for the year was $80,000, $100,000 reduced by the $20,000 of expenses chargeable to income. Its DNI was $40,000, $100,000 reduced by the total amount of the trustee commissions. The trustee distributed $80,000 to Isaac. The distribution is not an accumulation distribution because it is not in excess of trust accounting income.

c. Default Method of Calculating an Accumulation Distribution

In some cases the U.S. beneficiary of a foreign nongrantor trust will not have received sufficient information about her distribution and the trust to enable her to determine whether or not she has received an accumulation distribution. Notice 97-34[92] and the current version of Internal Revenue Service Form 3520 (1997) gives her a so-called "default" method of making this determination. A beneficiary is required to use this method if the trust did not provide her with a Foreign Nongrantor Trust Beneficiary Statement.[93]

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91. Code § 665(b). The word "income" in this quotation refers to "trust accounting income."

92. 1997-1 C.B. 422.

93. Internal Revenue Service Form 3520, Line 36 (1997). Presumably the Service's authority for enforcing this requirement is found in Code § 6048(c)(2)(A), which provides,

> "If adequate records are not provided to the Secretary to determine the proper treatment of any distribution from a foreign trust, such distribution shall be treated as an accumulation distribution includible in the gross income of the

(continued...)

The required steps of the default method are as follows:

Step 1 -- Calculate the total amount of distributions the beneficiary has received from the foreign nongrantor trust during the three prior years.

Step 2 -- Multiply the total by 1.25

Step 3 -- Divide the product determined in Step 2 by the lesser of 3 or the number of years the trust has been in existence (other than those years in which it was treated as a grantor trust).

The amount treated as a distribution of current income will be the smaller of the actual distribution or the amount determined in Step 3. The balance of the distribution will be treated as an accumulation distribution. If the default method is used, the number of years used for purposes of calculating the interest charge under Code § 688, as discussed below, will be one-half of the number of years the trust has been in existence.[94]

Consider the following example:

> **Example:** Andrew is the beneficiary of a foreign nongrantor trust ("FNT") that has been in existence for 10 years. At the end of 1997 the FNT had assets worth $20,000,000. In each of the 10 years 1988 through 1997, FNT has earned $1,000,000. Assume FNT has no income in 1998, 1999, 2000, and 2001 and that FNT distributes $2,000,000 to Andrew in each such year. The amount of Andrew's accumulation distribution in each year would be $2,000,000 under Code § 665(b). His situation is improved considerably by using the default method.
>
> In 1998, the accumulation distribution is the full $2,000,000 because there were no distributions in any of the prior three years.

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93. (...continued)
distributee under chapter 1."

The information that must be furnished in a Foreign Grantor Trust Beneficiary Statement is described below.

94. Code § 6048(c)(2)(B).

In 1999, the amount of the accumulation distribution is reduced to $1,166,667 ($2,000,000 - ($2,000,000 X 1.25/3)).

In 2000, the amount of the accumulation distribution is reduced to $333,333 ($2,000,000 - ($4,000,000 X 1.25/3)).

In 2001, the amount of the accumulation distribution is reduced to 0 ($2,000,000 - (6,000,000 X 1.25 /3).

Because the default method of calculating the amount of an accumulation distribution can have the effect of significantly reducing that amount, the use of this method can significantly reduce the interest imposed on the taxes paid on accumulation distributions. (See Appendices B1 and B2.)

3. Undistributed Net Income

a. In General

"Undistributed net income" ("UNI") limits the amount of an accumulation distribution that will be subject to tax. If a foreign nongrantor trust has no UNI, no tax will be imposed on its accumulation distributions. A trust's UNI for any particular year is equal to the amount by which its DNI for such year exceeds the sum of:

(i) the amount of trust accounting income required to be distributed in such year;

(ii) the amount of any other amount properly paid or credited or required to be distributed for such year; and

(iii) the amount of any taxes imposed on the trust that are attributable to its DNI for the year.[95]

b. Addition of Taxes

The taxes taken into account in the UNI calculation include U.S. income taxes and foreign income, war profits and excess profits taxes that are imposed on the trust and that are

95. Code § 665(a).

allocable to the undistributed portion of the trust's DNI.[96] In addition, if any such taxes are imposed on a foreign nongrantor trust's non-U.S. grantor or any other non-U.S. person and if that person would have been treated as the owner of the trust under the normal grantor trust rules but is prevented from being treated as the owner by Code § 672(f), these taxes may also reduce the trust's UNI.[97] Unfortunately, the effectiveness of the portion of the Code that permits such reduction appears to require regulatory action, which has not yet occurred.

c. Reduction of UNI

The original UNI for a particular year of a trust will be reduced by accumulation distributions made in later years to the extent that such distributions are deemed to have been made in such year under Code § 666(a).[98] A distribution paid or used for charitable purposes within the meaning of Code §642(c) is not treated as an accumulation distribution.[99] As a result, such distributions do not reduce UNI.

d. Default Method of Calculating UNI

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, the instructions to Internal Revenue Service Form 3520, in effect, require her to assume that the trust's UNI is at least equal to the amount of the accumulation distribution.

4. Calculation of Throwback Tax on an Accumulation Distribution

a. In General

If a beneficiary has received an accumulation distribution from a foreign nongrantor trust, her tax, the "throwback tax" on the distribution can be calculated by following the complex series of steps outlined below. The steps are intended to produce a rough approximation of the tax the beneficiary would have been required to pay if the foreign nongrantor trust had paid income to her in the year earned instead of accumulating it and paying it to her in a later year.

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96. Code § 665(d).

97. Code § 665(d)(2).

98. Treas. Reg. § 1.665(a)-1A(c).

99. Treas. Reg. § 1.665(b)-1A(c)(2).

b. The Steps

Step 1 -- Allocate the accumulation distribution among the preceding years of the trust for which there is any remaining UNI, starting with the earliest such year.[100] If the amount of the accumulation distribution exceeds the UNI for the earliest year, the excess is allocated to the next year for which there is any remaining UNI. The process continues in the same manner until all of the accumulation distribution has been allocated to a preceding year. Each portion of an accumulation distribution allocated to a particular preceding year is deemed to have been distributed on the last day of such year.

> **Example:** Michael is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). FNT was created in 1990 by Michael's non-U.S. mother. FNT distributed $100,000 to Michael in 1997, a year in which FNT's DNI and trust accounting income was $20,000. Therefore, $80,000 of the distribution is treated as an accumulation distribution. FNT's DNI, none of which was distributed, in each of its preceding years was as follows:
>
> 1990 - $4,000
> 1991 - $20,000
> 1992 - $30,000
> 1993 through 1996 - $40,000
>
> Michael's $80,000 accumulation distribution is deemed to have been made $4,000 on the last day of 1990, $20,000 on the last day of 1991, $30,000 on the last day of 1992, and $26,000 on the last day of 1993.

Step 2 -- Add to the amount deemed, under Step 1, to have been distributed on the last day of a preceding year the taxes that were imposed on such amounts in such year.[101] Such taxes include U.S. income taxes and foreign income, war profits and excess profits taxes.[102]

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100. Code § 666(a). If the trust's records are not sufficient to establish which years have UNI, the accumulation distribution will be allocated to the earliest year that the trust was in existence. Code § 666(d).

101. Code § 666(b) and (c).

102. Code § 665(d). If the beneficiary has received distributions from more than two trusts (continued...)

Example: Assume that FNT, the trust described in the preceding example, paid taxes in each of its preceding taxable years equal to 40% of its DNI. The total amount deemed to have been distributed to Michael on the last day of each of 1990, 1991, 1992 and 1993 will be \$5,600, \$28,000, \$42,000, and \$36,400, respectively. The total amount deemed distributed, or "thrown back" will be \$112,000.

Step 3 -- Determine the number of preceding taxable years in which a distribution is deemed to have been made.[103] For purposes of this calculation, if any year's deemed distribution is less than 25% of the total amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated, that year will not be included.[104]

Example: In the above example the number of preceding taxable years in which a distribution is deemed to have been made will be 3. The year 1990 is disregarded because the amount of the accumulation distribution allocated to that year (\$4,000) is less than 25% of the total accumulation distribution (\$80,000) divided by the number of years to which the distribution is deemed allocated (4).

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102. (...continued)
that are deemed to have been distributed to her on the last day of the same preceding taxable year, the taxes that were imposed on the third trust and any additional trusts on account of such amounts are not deemed to have been distributed to the beneficiary. Code § 667(c). This is detrimental to the beneficiary rather than beneficial because the consequence of the failure to treat taxes as having been distributed is the loss of the ability to use the taxes as a credit against the tax on the accumulation distribution. Code §§ 667(b) and 667(d). For purposes of this rule, a distribution from a trust deemed to have been distributed on the last day of a particular preceding year will be disregarded unless it, when added to any previous distributions for such year, equals or exceeds \$1,000. Code § 667(c)(2).

103. Code § 667(b)(1)(A).

104. Code § 667(b)(3).

Step 4 -- Identify the beneficiary's computation years. The computation years are those three of the beneficiary's five preceding taxable years left after eliminating the year in which her income was the highest and the year in which her income was the lowest.[105]

> **Example:** Assume in the above example that Michael's taxable income in 1992 was $50,000, in 1993 was $100,000, in 1994 was $200,000, in 1995 was $150,000, and in 1996 was $175,000. The year of the highest taxable income, 1994, and the year of the lowest taxable income, 1992, are eliminated. Michael's three computation years are the remaining years, 1993, 1995, and 1996.

Step 5 -- Determine the average annual distribution amount by dividing the amount deemed distributed (the amount of the accumulation distribution plus the amount of taxes deemed distributed) by the number of preceding years in which the distribution is deemed to have been made as determined under Step 3.[106]

> **Example:** In the above example, the amount deemed distributed is $112,000 and the number of preceding years in which the distribution is deemed to have been made is 3. The average annual distribution amount is $37,333.

Step 6 -- Determine the amount by which the beneficiary's income tax would have increased in each of the three computation years if the annual distribution amount had been added to her taxable income in each of such years.[107] In making this calculation, no differentiation is made among the various types of income that were included in the foreign nongrantor trust's UNI (other than tax-exempt income). Thus, for example, if a portion of the trust's UNI was long term capital gain, the beneficiary will not receive the advantage of the lower rate that generally applies to such gains. If any foreign income, war profits or excess profits taxes were added, in Step 2, to the amount deemed to have been distributed, the amount of such taxes may be allowed as a credit against the increase in tax calculated in this step.[108]

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105. Code § 667(b)(1)(B).

106. Code § 667(b)(1)(C).

107. Code § 667(b)(1)(D).

108. Code § 667(d).

> **Example:** Assume that Michael's income tax would have been increased by $15,200, $16,500, and $16,600 in each of the three calculation years.

Step 7 -- Determine the average tax increase by dividing the sum of the three increases by three.[109]

> **Example:** Michael's average tax increase is $16,100 ($48,300 divided by three).

Step 8 -- Multiply the average tax increase by the number of preceding taxable years in which the distribution is deemed to have been made as determined under Step 3.[110]

> **Example:** Michael's average tax increase, $16,100, is multiplied by 3. The product is $48,300.

Step 9 -- Subtract from the product obtained in Step 8 the amount of any U.S. income taxes that were added, in Step 2, to the amount deemed distributed to the beneficiary.[111] The result is the amount of the beneficiary's throwback tax.

> **Example:** Assume that $25,000 of the total taxes added to Michael's deemed distribution were U.S. income taxes. The $25,000 is subtracted from $48,300, leaving a throwback tax of $23,300.

c. Use of the Steps With the Default Method

If the U.S. beneficiary of a foreign nongrantor trust uses the default method of calculating her accumulation distribution, it is unclear how she would calculate her throwback tax using these 9 steps. The difficulty is that the default method contains no instructions for determining the number of years to which the distribution is to be thrown back. In the absence of detailed information, the appropriate approach might be to treat the distribution as having been thrown back in equal shares to one-half the total number of years the trust has been in

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109. Id.

110. Code § 667(b)(1).

111. Code § 667(b).

existence. This approach would be consistent with the method used to calculate the interest charge when the default method is used.

5. Calculation of the Interest Charge

a. In General

If a foreign nongrantor trust makes a distribution to a U.S. beneficiary that is subject to a throwback tax, the tax is increased by an interest charge determined under Code § 668.[112]

b. Before the 1996 Act

Before the 1996 Act, the throwback tax imposed on distributions from foreign trusts was subject to a 6% simple interest charge.[113] For purposes of the interest calculation, an accumulation distribution was deemed to have been made from the earliest period or periods with respect to which the trust had UNI. For example, if a foreign nongrantor trust made an accumulation distribution in 1992 of $25,000 and if its UNI for 1990 (after adjustment for any prior accumulation distributions) was $50,000, for purposes of the interest calculation the distribution would be deemed to have been made entirely from the income accumulated in 1990 and four years worth of interest would be charged. If the tax on the distribution was $10,000, the interest charge would have been $2,400. Code § 668(b) limited the total interest charge to the excess of the amount of the taxed distribution over the tax charged on such distribution. Thus, in this example, the interest charge could not exceed $15,000 ($25,000 (the amount of the distribution) reduced by $10,000 (the amount of the tax on the distribution).

c. After the 1996 Act

Code § 668, as amended by the 1996 Act, modified the interest rate charged on the tax imposed on distributions of accumulated income by foreign trusts and completely changed the calculation method. The interest rate will be the floating rates applied under Code § 6621 to underpayments of tax (currently 8%[114]). In addition, interest will be compounded daily and will be calculated over a specially calculated number of years rather than with reference to the

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112. Code § 667(a)(3).

113. Prior Code § 668.

114. Rev. Rul. 98-32, 1998-25 I.R.B. 4.

length of time between the year of the earliest undistributed accumulations and the year of distribution.[115]

The number of years over which interest is calculated is determined by the following rather complicated process designed to produce a "dollar-weighted" number of years.

> **Step 1** - the undistributed net income for each year must be multiplied by the number of years between such year and the year of the distribution (counting the year of the accumulation but not the year of distribution).
>
> **Step 2** - all products calculated in the first step must be added together.
>
> **Step 3** - the sum of such products calculated in the second step must be divided by the aggregate amount of the trust's undistributed income. The quotient is to be rounded to the nearest half-year.[116]

For purposes of this calculation, an accumulation distribution is treated as having come proportionately from each year with respect to which there is undistributed net income (other than a year during which the beneficiary was not a U.S. person) rather than from the earliest accumulation years. This change has the effect of reducing the interest charge on earlier distributions but will prevent the trustees from arranging for distributions from earlier years to be made to beneficiaries who are likely to pay less tax and, therefore, less interest.

The process may be illustrated by the following example.

> **Example:** FNT, a foreign trust, accumulated income of \$100,000 in 1996 and \$50,000 in 1997. On January 1, 2000, FNT distributed \$25,000 to Tyler, a U.S. person. Tyler's tax on this distribution was \$10,000. The number of years over which interest will be calculated is 3.67 determined as follows:
>
> **Step 1** - 100,000 X 4 = 400,000
> 50,000 X 3 = 150,000
>
> **Step 2** - 400,000 + 150,000 = 550,000

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115. Code § 668(a).

116. Line 54, Internal Revenue Form 3520 (1997).

Step 3 - 550,000 / 150,000 = 3.67

The 3.67 figure is rounded to the nearest half-year, or 3.5.

The Code § 6621 rate was 9% in 1996, in 1997, and in 1998 until April 1, 1998, when it dropped to 8%.

Total interest, if the Code § 6621 rate remains 8% through 1999, will be $3,913. This can be calculated using the following formula:

($10,000 X (1+(.09/365))^(1.75 X 365)) - 10,000 =
$1,706

$1,706 is the interest charge through March 1998. The balance of the interest charge through December 31, 1999 can be calculated using the following formula:

$11,706 X (1+(.08/365))^(1.75 X 365)) - $11,706 =
$1,759

The total interest charge on the $10,000 income tax will be $1,706 plus $1,759 or $3,465.[117]

For purposes of future interest calculations, 2/3 of the $25,000 distributions will be deemed to have come from 1996 accumulations and 1/3 from 1997 accumulations.

Code § 668(b) remains unchanged. Thus, total interest charges can never exceed the amount of the accumulation distribution reduced by the tax imposed on it.

If the interest calculation period includes any years before 1996, a possibility that will become increasingly unlikely given the peculiar method of determining the calculation period, the interest rate applicable to that period will be 6%. The interest will not be compounded except as to that portion of the interest calculation period after 1995.[118]

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117. The instructions to Internal Revenue Service Form 3520 (1997) contains a chart that can be used as a simpler method of calculating the interest charge.

118. Code § 668(a)(6).

d. The Default Method

If the U.S. beneficiary uses the default method of calculating her accumulation distribution, the period over which interest is calculated is one-half the number of years the trust has been in existence as a foreign nongrantor trust.[119]

e. Observation

The application of the new default interest rule can be draconian. If, for example, the interest rate on underpayments is 9% and if the U.S. beneficiary's tax rate is 40%, the entire amount of the distribution from a trust that has been in existence for 20 or more years will be consumed by taxes and interest.[120] The impact of the interest charge, however, can be mitigated by allocating distributions over a number of years and using the default method rather than the exact method of calculating accumulation distributions.

For families who view their trusts as semi-perpetual arrangements, the interest charge is likely to be less significant. Their trustees are likely to be able to arrange investment and distribution patterns in order to avoid accumulation distributions. No matter how many years a foreign nongrantor trust is permitted to accumulate income free of U.S. income tax, its U.S. beneficiaries will never be subject to an interest charge unless they receive an accumulation distribution. Distributions that do not exceed current income will not be treated as accumulation distributions and, therefore, the income tax they attract will not be subject to an interest charge.

This view is illustrated by the charts set forth in Appendix A to this outline. They illustrate how the U.S. beneficiaries of a foreign nongrantor trust may be better off economically than the beneficiaries of a similarly managed domestic trust when income is accumulated over a 20 year period and then distributed currently over the next 20 years.

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119. Internal Revenue Service Form 3520, Line 44 (1997). A similar rule exists under Code § 666(d). It provides that, if adequate records are not available to determine the years within which income was accumulated, a distribution of accumulated income shall be deemed to have come from income accumulated in the first year of the trust's existence. Presumably, the new rule in Code § 6048(c)(2)(B) supersedes Code § 666(d) for foreign trusts.

120. A 20 year trust requires that interest be calculated over a 10 year period. Interest calculated at a rate of 9% compounded daily on a tax of $40 (the assumed tax on a hypothetical distribution of $100) over a 10 year period will be approximately $60.

D. Loans Treated as Distributions

1. In General

Code § 643(i), which was added to the Code by the 1996 Act treats, except as provided in regulations, a foreign trust's loans of cash (including foreign currencies and cash equivalents) or marketable securities to any U.S. grantor or beneficiary of the trust or to any other U.S. person who is related to such a grantor or beneficiary as a distribution.[121] For this purpose, a person is related to another person if the relationship between them would result in loss disallowance under Code § 267 or Code § 707(b).

If the loan is made to a person who is not the grantor or a beneficiary, it is not treated as a distribution to the borrower, but, instead, is treated as a distribution to the grantor or beneficiary to whom the borrower is related.[122] The logic of this provision is difficult to discern. It has the effect of separating the tax consequences from the economic enjoyment of the deemed distribution.

Congress apparently intended that Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.[123] Although such regulations have yet to be issued, the Service signaled its thinking on this subject in notice 97-34.[124] The notice states that the regulations will provide that a loan to a U.S. beneficiary (or a U.S. person related to a beneficiary) will be treated as a distribution unless it is a "qualified obligation." An obligation is a qualified obligation only if:

> "(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last

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121. Code § 643(i). An earlier version of the foreign trust legislation would also have treated the loan of tangible property, such as vacation homes, automobiles, and boats, as distribution. H.R. 981 § 207.

122. A person is related to a grantor or beneficiary if their relationship would result, under Code § 267, in a disallowance of losses for transactions between them. For this purpose, Code § 267(c)(4) is to be applied as if the family of an individual includes the spouses of her family members. Code § 643(i)(2)(B).

123. H.R. Conf. Rep. No. 737, 104th Cong., 2d Sess. 334 (1996).

124. 1997-1 C.B. 422.

possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity of the obligation is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. person extends the period for assessment of any income tax attributable to the loan and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation issued in consideration for the loan (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period); when properly executed and filed, such an agreement will be deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d); and (vi) The U.S. person reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding."

2. Repayment of Loans

When a loan, which has been treated as a distribution under Code § 643(i) is repaid, Code § 643(i)(3) disregards the repayment for all purposes of "this title." More precisely,

> "any subsequent transaction between the trust and the original borrower regarding the principal of the loan (by way of complete or partial repayment, satisfaction, cancellation, discharge, or otherwise) shall be disregarded for purposes of this title."[125]

This is a curious provision. The "title" referred to includes not only the income tax provisions, but the estate, gift and generation-skipping transfer tax provisions as well. A literal application of this Code § 643(i)(3) would permit a foreign trust created by a U.S. person to make a loan to a grandchild beneficiary of the trust's creator and to subsequently cancel that loan without any generation-skipping transfer tax consequences. The loan itself would not be treated as a taxable distribution since it is offset by a corresponding obligation running from the grandchild to the trust. The trust's subsequent cancellation would not be treated as a taxable distribution because Code § 643(i)(3) requires that it be ignored. This provision should be amended to change its reference to "title" to "subtitle."

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125. Code § 643(i)(3).

3. Amount of the Distribution

In gauging the impact of the loan provision as it applies to loans of marketable securities, it is important to keep in mind how Code § 643(e) treats the distribution of property in kind. Under Code § 643(e), unless the trustee elects otherwise, the amount of a distribution other than cash is the lesser of the trust's basis in the distributed property or its fair market value. The new rule does not seem to change this result. Thus, if a foreign trust lends marketable securities with a basis of 10 and a fair market value of 100 to a U.S. beneficiary, the amount treated as a distribution under Code § 643(i) would be 10, not 100, unless the trustee elects to recognize gain on the distribution.

E. Indirect Transfers From Foreign Trusts

Code § 643(h), which was added by the 1996 Act, treats a U.S. person who receives property from a foreign person as having received the property directly from a foreign trust if the property she received was derived directly or indirectly from a foreign trust. This provision does not apply if the person from whom she received the property was the grantor of the trust. The intent of this provision is to prevent U.S. persons from avoiding income tax on their share of trust distributions by arranging for the distributions to be routed to them through a foreign beneficiary.

Since 1962 the Code has contained a rule intended to prevent the use of intermediaries as a means of circumventing the general rules which tax United States persons on distributions from foreign trusts created by United States persons. Former Code § 665(c) provided that:

> "For purposes of this subpart, any amount paid to a United States person which is from a payor who is not a United States person and which is derived directly or indirectly from a foreign trust created by a United States person shall be deemed in the year of payment to have been directly paid by the foreign trust."

The language of former Code § 665(c) was broader than needed to accomplish the statutory objective. The Treasury, however, perhaps in recognition of the unnecessary breadth of the provisions, brought it within reasonable boundaries by regulation. Treasury Regulation § 1.665(c)-1A(b) provided that the section would not apply

> "if the distribution is received by such beneficiary under circumstances indicating lack of intent on the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 . . . was enacted."

New Code § 643(h) extends the scope of the old rule (1) to amounts derived from trusts created by non-United States persons (other than amounts received from the grantor of certain foreign trusts that would have been so-called "grantor trusts" prior to the Act) and (2) to payments received from United States persons.

It provides as follows that,

"For purposes of this part, any amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payor is not the grantor shall be deemed in the year of payment to have been directly paid by the foreign trust to such United States person."

The expansion of the rule to trusts created by non-United States persons was presumably necessary to prevent what would otherwise have been a means of circumventing other provisions of the 1996 Act which enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts which are not taxed as grantor trusts under Code § 679 or otherwise.[126]

The reason for extending the rule to payments received from United States persons is less urgent. Foreign trust payments channeled through United States persons would, in the absence of new Code § 643(h), already have been exposed to United States taxation, and in the case of accumulation distributions, to the Act's additional costs imposed on the receipt of such distributions.

Treasury has issued proposed regulations under Code § 643(h).[127] They follow an approach opposite to the one reflected in the regulations promulgated under former Code § 665(c). Instead of protecting distributions that were not intended to circumvent U.S. taxation of foreign trust income, the proposed regulations provide two specific sets of circumstances in which the rule applies regardless of intent. It then provides that the rule will also apply to any other instance in which the intermediary who received property from the foreign trust received it "pursuant to a plan, one of the principal purposes of which was the avoidance of U.S. tax."

The two circumstances in which Code § 643(h) will apply under the proposed regulations, regardless of intention, are:

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126. See Section 668.

127. Proposed Regulation §1.643(h)-1.

"(1) The intermediary is related (within the meaning of paragraph (e) of this section,)[128] to either the United States person or the foreign trust and the intermediary transfers to the United States person either property that the intermediary received from the foreign trust or proceeds from the property received from the foreign trust;

(2) The intermediary would not have transferred the property to the United States person (or would not have transferred the property to the United States person on substantially the same terms) but for the fact that the intermediary received property from the foreign trust;"

In addition, the proposed regulations create a set of income timing rules that depend for their application on general concepts of agency law but give the district director the right to determine "based on all the relevant facts and circumstances that the intermediary should be treated as the agent of the United States person."

Finally, Proposed Regulation § 1.643-1(b) limits the statutory exception for payments made by the grantor of a foreign trust to payments made by such grantor to the extent such payments were derived from the portion of the trust as to which he or she is the grantor.

F. Reporting Requirements

1. In General

Code § 6048(c) requires that any U.S. person who directly or indirectly receives a distribution from a foreign trust is to file a return for the trust for the year in which she receives the distribution. The return must set forth:

a. The name of the trust;

b. the amount of the distributions received from the trust during the year; and

128. The proposed regulations expand the concept of "related" beyond the normal rules of Section 643(i)(2)(B) by generally substituting a 10% entity interest rule for the normal 50% rule and by extending the relationship rules that apply between trusts and beneficiaries to estates and beneficiaries. The latter extension is no longer necessary since Section 1308(a) of the Taxpayer Relief Act of 1997 accomplishes this by an amendment to Section 267, one of the sections on which Section 643(i)(2)(b) is based.

c. any other information Treasury requires.[129]

The obligation to report a distribution applies even if the trust is treated as owned by another person under the grantor trust rules.[130]

2. Notice 97-34

In Notice 97-34[131], the Service describes the additional required information. Such information is to be set forth in a Foreign Nongrantor Trust Beneficiary Statement. The statement must include the following information:

"1. Foreign Trust Background Information

A. Name, address and employer identification number ("EIN") of the trust

B. Name, address and taxpayer identification number ("TIN") (if any) of the trustee furnishing this statement

C. Method of accounting used by the trust (cash or accrual)

D. The taxable year of the foreign trust to which the statement applies

E. A statement identifying whether any grantor of the trust was a partnership or foreign corporation. If so, attach an explanation of the relevant facts.

2. U.S. Beneficiary Information

A. Name, address and TIN of U.S. Beneficiary

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129. Code § 6048(c)(1).

130. Code § 6048(d)(1).

131. 1997-1 C.B. 422.

B. A description of the property (including cash) distributed or deemed distributed to the U.S. person during the taxable year, and the fair market value of the property distributed.

3. Sufficient information to enable the U.S. beneficiary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes. Normally, information similar to the information required by Schedule K-1 of Form 1041 would be adequate for this purpose. If relevant, the trust must also provide the beneficiary with adequate information for the beneficiary to complete Forms 4970, 5471, and 8621.

4. Representation on Access to Books and Records

A. A statement that, upon request, the trust will permit either the Service or the U.S. beneficiary to inspect and copy the trust's permanent books of account, records, and such other documents that are necessary to establish the appropriate treatment of any distribution or deemed distribution for U.S. tax purposes; or

B. The name, address and EIN of the trust's U.S. agent."

3. Consequences of Failure to Supply Adequate Information

If Treasury does not receive sufficient records with respect to the treatment of a distribution received by a U.S. person from a foreign trust to enable it to determine the proper tax treatment of the distribution, the distribution will be treated as a distribution of accumulated income to the extent required by the default method described above.[132] This means that all of the distribution will be taxed as ordinary income despite the fact that a portion of such income might properly be treated as long term capital gain income. And, the number of years over which interest will be calculated under Code § 668 will be half the number of years the trust has been in existence.[133]

Treasury has the authority to issue regulations that will protect U.S. beneficiaries from this harsh rule if their foreign trust appoints a U.S. person to act as its agent for purposes of Code §§ 7602, 7603, and 7604 with respect to requests by Treasury to examine records or to

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132. Code § 6048(c)(2)(A).

133. Code § 6048(c)(2)(B).

produce testimony relating to the amounts that U.S. persons are required to include in calculating their incomes.

Appendix A - Forty Year Model

Assumptions		
Property is invested to earn annual income of		11.0000%
Tax Rate is		20.0000%
Initial Investment Fund is	$	1,000,000

The First Twenty Years

Foreign Trust

Year	Fund	Income @ 11.00%
1	$ 1,000,000	$ 110,000
2	$ 1,110,000	$ 122,100
3	$ 1,232,100	$ 135,531
4	$ 1,367,631	$ 150,439
5	$ 1,518,070	$ 166,988
6	$ 1,685,058	$ 185,356
7	$ 1,870,415	$ 205,746
8	$ 2,076,160	$ 228,378
9	$ 2,304,538	$ 253,499
10	$ 2,558,037	$ 281,384
11	$ 2,839,421	$ 312,336
12	$ 3,151,757	$ 346,693
13	$ 3,498,451	$ 384,830
14	$ 3,883,280	$ 427,161
15	$ 4,310,441	$ 474,149
16	$ 4,784,589	$ 526,305
17	$ 5,310,894	$ 584,198
18	$ 5,895,093	$ 648,460
19	$ 6,543,553	$ 719,791
20	$ 7,263,344	$ 798,968
	$ 8,062,312	

Domestic Trust

Fund	Income @ @ 11.00%	Income Tax @ 20.00%
$ 1,000,000	$ 110,000	$ 22,000
$ 1,088,000	$ 119,680	$ 23,936
$ 1,183,744	$ 130,212	$ 26,042
$ 1,287,913	$ 141,670	$ 28,334
$ 1,401,250	$ 154,137	$ 30,827
$ 1,524,560	$ 167,702	$ 33,540
$ 1,658,721	$ 182,459	$ 36,492
$ 1,804,689	$ 198,516	$ 39,703
$ 1,963,501	$ 215,985	$ 43,197
$ 2,136,289	$ 234,992	$ 46,998
$ 2,324,283	$ 255,671	$ 51,134
$ 2,528,820	$ 278,170	$ 55,634
$ 2,751,356	$ 302,649	$ 60,530
$ 2,993,475	$ 329,282	$ 65,856
$ 3,256,901	$ 358,259	$ 71,652
$ 3,543,508	$ 389,786	$ 77,957
$ 3,855,337	$ 424,087	$ 84,817
$ 4,194,606	$ 461,407	$ 92,281
$ 4,563,732	$ 502,011	$ 100,402
$ 4,965,340	$ 546,187	$ 109,237
$ 5,402,290		

The Next Twenty Years

Foreign Trust

Year	Income to B	Income Tax @ 20.000%	Net Income	CumulativePresent Value @ 8.80%
21	$ 886,854	$ 177,371	$ 709,483	$ 652,099
22	$ 886,854	$ 177,371	$ 709,483	$ 599,355
23	$ 886,854	$ 177,371	$ 709,483	$ 550,878
24	$ 886,854	$ 177,371	$ 709,483	$ 506,322
25	$ 886,854	$ 177,371	$ 709,483	$ 465,369
26	$ 886,854	$ 177,371	$ 709,483	$ 427,729
27	$ 886,854	$ 177,371	$ 709,483	$ 393,133
28	$ 886,854	$ 177,371	$ 709,483	$ 361,336
29	$ 886,854	$ 177,371	$ 709,483	$ 332,110
30	$ 886,854	$ 177,371	$ 709,483	$ 305,248
31	$ 886,854	$ 177,371	$ 709,483	$ 280,559
32	$ 886,854	$ 177,371	$ 709,483	$ 257,867
33	$ 886,854	$ 177,371	$ 709,483	$ 237,010
34	$ 886,854	$ 177,371	$ 709,483	$ 217,840
35	$ 886,854	$ 177,371	$ 709,483	$ 200,221
36	$ 886,854	$ 177,371	$ 709,483	$ 184,026
37	$ 886,854	$ 177,371	$ 709,483	$ 169,142
38	$ 886,854	$ 177,371	$ 709,483	$ 155,461
39	$ 886,854	$ 177,371	$ 709,483	$ 142,887
40	$ 886,854	$ 177,371	$ 709,483	$ 131,330
	NPV @	8.80%	$ 6,569,924	

Domestic Trust

Income to B	Income Tax @ 20.000%	Net Income	Cumulative Present Value Income @ 8.80%
$ 594,252	$ 118,850	$ 475,402	$ 436,950
$ 594,252	$ 118,850	$ 475,402	$ 401,608
$ 594,252	$ 118,850	$ 475,402	$ 369,125
$ 594,252	$ 118,850	$ 475,402	$ 339,270
$ 594,252	$ 118,850	$ 475,402	$ 311,829
$ 594,252	$ 118,850	$ 475,402	$ 286,607
$ 594,252	$ 118,850	$ 475,402	$ 263,426
$ 594,252	$ 118,850	$ 475,402	$ 242,119
$ 594,252	$ 118,850	$ 475,402	$ 222,536
$ 594,252	$ 118,850	$ 475,402	$ 204,537
$ 594,252	$ 118,850	$ 475,402	$ 187,993
$ 594,252	$ 118,850	$ 475,402	$ 172,788
$ 594,252	$ 118,850	$ 475,402	$ 158,813
$ 594,252	$ 118,850	$ 475,402	$ 145,967
$ 594,252	$ 118,850	$ 475,402	$ 134,161
$ 594,252	$ 118,850	$ 475,402	$ 123,310
$ 594,252	$ 118,850	$ 475,402	$ 113,336
$ 594,252	$ 118,850	$ 475,402	$ 104,169
$ 594,252	$ 118,850	$ 475,402	$ 95,744
$ 594,252	$ 118,850	$ 475,402	$ 88,000
NPV @	8.80%	$ 4,402,290	
Plus PV Original Principal		$ 1,000,000	
Total		$ 5,402,290	

Appendix B1 - Forty Year Model - Using Default Method and Gift of Specific Amount

Assumptions	
Property is invested to earn annual income of	11.0000%
Blended Tax Rate is	20.0000%
After Tax Discount Rate	8.800%
Initial Investment Fund is	$ 1,000,000

The First Twenty Years

Foreign Trust

Year	Fund	Income @ 11.00%
1	$ 1,000,000	$ 110,000
2	$ 1,110,000	$ 122,100
3	$ 1,232,100	$ 135,531
4	$ 1,367,631	$ 150,439
5	$ 1,518,070	$ 166,988
6	$ 1,685,058	$ 185,356
7	$ 1,870,415	$ 205,746
8	$ 2,076,160	$ 228,378
9	$ 2,304,538	$ 253,499
10	$ 2,558,037	$ 281,384
11	$ 2,839,421	$ 312,336
12	$ 3,151,757	$ 346,693
13	$ 3,498,451	$ 384,830
14	$ 3,883,280	$ 427,161
15	$ 4,310,441	$ 474,149
16	$ 4,784,589	$ 526,305
17	$ 5,310,894	$ 584,198
18	$ 5,895,093	$ 648,460
19	$ 6,543,553	$ 719,791
20	$ 7,263,344	$ 798,968
	$ 8,062,312	$ 7,062,312

Domestic Trust

Fund	Income @ 11.00%	Income Tax @ 20.0%
$ 1,000,000	$ 110,000	$ 22,000
$ 1,088,000	$ 119,680	$ 23,936
$ 1,183,744	$ 130,212	$ 26,042
$ 1,287,913	$ 141,670	$ 28,334
$ 1,401,250	$ 154,137	$ 30,827
$ 1,524,560	$ 167,702	$ 33,540
$ 1,658,721	$ 182,459	$ 36,492
$ 1,804,689	$ 198,516	$ 39,703
$ 1,963,501	$ 215,985	$ 43,197
$ 2,136,289	$ 234,992	$ 46,998
$ 2,324,283	$ 255,671	$ 51,134
$ 2,528,820	$ 278,170	$ 55,634
$ 2,751,356	$ 302,649	$ 60,530
$ 2,993,475	$ 329,282	$ 65,856
$ 3,256,901	$ 358,259	$ 71,652
$ 3,543,508	$ 389,786	$ 77,957
$ 3,855,337	$ 424,087	$ 84,817
$ 4,194,606	$ 461,407	$ 92,281
$ 4,563,732	$ 502,011	$ 100,402
$ 4,965,340	$ 546,187	$ 109,237
$ 5,402,290		

The Next Twenty Years

Foreign Trust

Year	Fund	Income @ 11.00%	Distribution to B $ 899,299	Portion Treated as Accumulation Distribution	Income Tax @ 39.6%	Income Tax on Accumulation	Interest @ 8.00%	Distribution Net of Taxes
21	8,062,312	886,854	$ 1,899,299	$ 899,299	$ 356,122	$ 356,122	$ 436,373	$ 1,106,803
22	7,049,867	775,485	$ 899,299	$ 524,591	$ 356,122	$ 207,738	$ 273,415	$ 269,761
23	6,926,054	761,866	$ 899,299	$ 149,883	$ 356,122	$ 59,354	$ 83,728	$ 459,448
24	6,788,621	746,748	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
25	6,636,071	729,968	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
26	6,466,740	711,341	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
27	6,278,782	690,666	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
28	6,070,150	667,716	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
29	5,838,567	642,242	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
30	5,581,511	613,966	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
31	5,296,179	582,580	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
32	4,979,460	547,741	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
33	4,627,902	509,069	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
34	4,237,672	466,144	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
35	3,804,517	418,497	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
36	3,323,715	365,609	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
37	2,790,025	306,903	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
38	2,197,629	241,739	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
39	1,540,070	169,408	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
40	810,179	89,120	$ 899,299	$ -	$ 356,122	$ -	$ -	$ 543,176
	0					NPV @	8.80%	$ 5,251,950

Domestic Trust

Fund	Income @ 11.00%	Distribution to B $ 565,265	Income Tax @ 20.0%	Net Income
$5,402,290	$ 594,252	$ 1,565,265	$ 118,850	$ 1,446,414
$4,431,277	$ 487,440	$ 565,265	$ 97,488	$ 467,777
$4,353,453	$ 478,880	$ 565,265	$ 95,776	$ 469,489
$4,267,068	$ 469,377	$ 565,265	$ 93,875	$ 471,389
$4,171,181	$ 458,830	$ 565,265	$ 91,766	$ 473,499
$4,064,746	$ 447,122	$ 565,265	$ 89,424	$ 475,840
$3,946,603	$ 434,126	$ 565,265	$ 86,825	$ 478,440
$3,815,464	$ 419,701	$ 565,265	$ 83,940	$ 481,325
$3,669,901	$ 403,689	$ 565,265	$ 80,738	$ 484,527
$3,508,325	$ 385,916	$ 565,265	$ 77,183	$ 488,082
$3,328,976	$ 366,187	$ 565,265	$ 73,237	$ 492,027
$3,129,898	$ 344,289	$ 565,265	$ 68,858	$ 496,407
$2,908,922	$ 319,981	$ 565,265	$ 63,996	$ 501,269
$2,663,639	$ 293,000	$ 565,265	$ 58,600	$ 506,665
$2,391,374	$ 263,051	$ 565,265	$ 52,610	$ 512,655
$2,089,161	$ 229,808	$ 565,265	$ 45,962	$ 519,303
$1,753,703	$ 192,907	$ 565,265	$ 38,581	$ 526,683
$1,381,346	$ 151,948	$ 565,265	$ 30,390	$ 534,875
$ 968,029	$ 106,483	$ 565,265	$ 21,297	$ 543,968
$ 509,248	$ 56,017	$ 565,265	$ 11,203	$ 554,061
$ 0		NPV @	8.80%	$ 5,402,290