The Throwback Tax

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THE THROWBACK TAX [1]

This outline addresses the so-called "throwback tax" which may have harsh consequences for U.S. beneficiaries who receive distributions from foreign nongrantor trusts. Part I addresses when a trust will be a foreign nongrantor trust. Part II describes the throwback tax rules in detail. Part III describes approaches for managing the throwback tax.

I. FOREIGN NONGRANTOR TRUSTS

The throwback tax may apply to distributions to U.S. beneficiaries from foreign nongrantor trusts.[2] Part A below identifies the elements that determine whether a trust is a foreign trust or a domestic trust for U.S. federal tax purposes. Part B describes the circumstances in which a foreign trust will be a grantor trust or a nongrantor trust.

A. Determining Whether a Trust is a Foreign Trust or a Domestic Trust

Code §7701(a)(30)(E) and (31)(B) provide the definitions of U.S. and foreign trusts but do so in a way that creates a strong statutory bias in favor of foreign trust status.[3]

Under the sections, a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[4]

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:

 The authors wish to thank Dina Kapur Sanna for her very helpful edits to a prior version of this outline and wish to thank Chris Nason for his assistance with the preparation of this outline.

[2] The throwback tax previously applied to distributions from domestic trusts but was effectively repealed with respect to domestic trusts in 1997. As described below in part III.D, the throwback tax may apply in the case of domestic trusts that previously were foreign nongrantor trusts but were migrated to the U.S.

[3] References in this outline to "Code §" are to sections of the Internal Revenue Code, as amended (the "Code"). References to "Treas. Reg. §" are to sections of the Treasury regulations promulgated under the Code.

[4] The Administration's explanation of this rule issued in connection with its original proposal, which was enacted as part of the Small Business Job Protection Act of 1996, P.L. 104-188, 110 Stat. 1755 (1996), 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 when 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 on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 274. The Administration's intention is reflected in Treas. Reg. § 301.7701-7(d)(2). 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."

> **Example 1**: 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.

Despite its significant U.S. contacts, the law will treat Jenny's trust as a foreign trust since an obviously substantial decision is controlled by a foreign fiduciary.[5] The new definition fulfills the Treasury Department's goal, to

> "increase the flexibility of settlors and trust 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."[6]

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 U.S. and foreign institutions. Under the former definition, a foreign person who might have preferred 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 a foreign person can easily use a U.S. financial institution without creating a domestic trust.[7]

Although Code § 7701(a)(30)(E) and (31)(B) 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.

[5] 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 domiciliary of New York and has a New York trustee. N.Y. Tax Law § 605(b)(3).

[6] Treasury Department, "General Explanation of the Administration's Fiscal Year 1996 Revenue Proposals" 25 (February 7, 1995).

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

1. The Treasury Regulations

Some clarity is provided by Treas. Reg. § 301.7701-7, which is applicable to trusts for taxable years ending after February 2, 1999.[8] The regulations provide that a trust is a U.S. person on any day that the trust meets both the "court test" and the "control test."

2. The Court Test

The "court test" is the regulatory interpretation of the statutory requirement that "a court or courts within the United States is able to exercise primary supervision over administration of the trust." The final Treasury regulations provide a safe harbor for the court test. The safe harbor provides that a trust satisfies the court test if the following three requirements are met:

(1) The trust instrument does not direct that the trust be administered outside the U.S.;

(2) The trust in fact is administered exclusively in the U.S.; and

(3) The trust is not subject to an automatic migration provision described in Treas. Reg. § 301.7701-7(c)(4)(ii).

According to the preamble to the regulations, the Internal Revenue Service (the "IRS") included the court test safe harbor in the final regulations because it recognized the difficulty in determining whether the courts of a particular state would assert primary supervision over the administration of a trust if that trust had never appeared before any court in that state.

Treas. Reg. § 301.7701-7(c)(3) provides the following definitions critical to the application of the court test:

(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 . . . notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property."

(5) "Administration" means "the carrying out of the duties imposed by the terms of the trust instrument and applicable law, including

[8] Treas. Reg. § 301.7701-7 may be relied on by trusts for taxable years beginning after December 31, 1996 and by trusts whose trustees have elected under Code § 1907(a)(3)(B) of the 1996 Act to apply Code §§ 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996.

maintaining the books and records of the trust, filing tax returns, managing and investing the assets of the trust, defending the trust from suits by creditors, and determining the amount and timing of distributions."

Treas. Reg. § 301.7701-7(c)(4) describes four types of trusts that satisfy the court test and one that does not. The four types of trusts which satisfy the court test are:

(1) Trusts that are registered in a court within the U.S. 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 U.S.

(3) Intervivos trusts if the fiduciaries and/or beneficiaries take steps with a court in the U.S. 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 U.S. court and a foreign court.

This list of trusts that satisfy the court test is not intended to be an exclusive list. Thus, other types of trust may also satisfy the test.

A trust whose trust instrument contains a provision that would cause the trust to migrate from the U.S. if a U.S. court attempted to assert jurisdiction over it or otherwise attempted to supervise its administration, either directly or indirectly, does not satisfy the court test. However, a trust will not fail the court test solely because "the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States."[10]

3. The Control Test

The "control test" is the regulatory explanation of the statutory requirement that "one or more United States persons have the authority to control all substantial decisions of the trust." Treas. Reg. § 301.7701-7(d)(1)(ii) provides the following critical definitions.

(1) "United States person" means a U.S. person within the meaning of Code § 7701(a)(30).

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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 a state in which a trust is registered. At least sixteen states have adopted the Uniform Probate Code in its entirety (in some cases with significant modifications) : 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. 1998).

[10] Treas. Reg. § 301.7701-7(c)(4)(ii).

(2) "Substantial decisions" means, all decisions other than ministerial decisions that any person, whether acting in a fiduciary capacity or not, is authorized or required to make under the terms of the trust instrument or applicable law. Such decisions include, but are not limited to:

- The timing and amount of distributions;
- The selection of beneficiaries;
- The power to determine whether receipts are allocable to income or principal;
- The power to terminate the trust;
- 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;
- The power to remove, add or replace a trustee;
- The power to appoint a successor trustee (even if such power is not accompanied by an unrestricted power to remove a trustee) unless the appointment power is limited in such a way that it cannot be exercised in a manner that would alter the trust's residency; and
- The power to make investment decisions.[11]

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

(4) "Control" means "the power, by vote or otherwise, to make all of the substantial decisions of the trust, with no other person having the power to veto any of the substantial decisions."

B. Determining Whether a Foreign Trust is a Grantor Trust or a Nongrantor Trust

Because the throwback tax is potentially applicable only to distributions from foreign trusts that are nongrantor trusts, it is important to determine whether a foreign trust is a grantor trust or a nongrantor trust. This often will turn on whether the grantor is a U.S. person or a foreign person. The Treasury Regulations generally define the "grantor" as any person

[11] If a U.S. person hires an investment advisor on behalf of the trust and can terminate at will such advisor's power to make investment decisions, the U.S. person will be treated as retaining control over the investment decisions made by the investment advisor. Treas. Reg. § 301.7701-7(d)(1)(ii)(J).

(including an individual and a non-natural person) to the extent the person either creates a trust or directly or indirectly makes a "gratuitous transfer" of property to a trust.[12]

Part 1 below describes the circumstances in which a foreign trust that has a foreign grantor will be a grantor trust for U.S. federal income tax purposes. Part 2 describes the circumstances in which a foreign trust to which a U.S. person has transferred property will be a grantor trust for U.S. federal income tax purposes.

1. Grantor is a Foreign Person

Code § 672(f) limits the circumstances in which foreign persons will be treated as the deemed owner of trust assets under the grantor trust rules. As a general rule, the grantor trust rules will apply only to the extent the rules result in an amount (if the trust as any income) being currently taken into account in computing the income of a U.S. person.[13]

There are, however, several exceptions to this general rule. The two principal exceptions, discussed below, are for revocable trusts and for trusts that benefit only the grantor and the grantor's spouse. There also are exceptions for certain compensatory trusts and for certain trusts in existence on September 19, 1995 that are "grandfathered" from the application of current Code § 672(f)(1). [14]

a. Revocable Trust

A trust is exempt from Code § 672(f)(1) if it is revocable by the grantor alone or with the consent of a "related or subordinate party" as defined in Code § 672(c) who is subservient to the grantor.[15] In the event of the grantor's incapacity, the trust will continue to qualify as revocable if a guardian or other person has the power to revoke the trust on behalf of the grantor without the consent of any other person.

A related or subordinate party is a "nonadverse party" who is the grantor's parent, issue, sibling, employee, a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. A nonadverse party is a person who does not have a sufficient beneficial interest in the trust to be adverse to the exercise of the power of revocation. Therefore, the exception in Code § 672(f)(1) may not apply where the grantor needs a beneficiary's consent to revoke the trust, even if, without regard to the

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[12] Treas. Reg. § 1.671-2(e). For a more in-depth discussion of the definition of "grantor," see Ellen K. Harrison, Carlyn S. McCaffrey and Elyse G. Kirschner, "U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their Beneficiaries," Practicing Law Institute International Estate & Tax Planning 2015 (hereafter, "Harrison and McCaffrey") beginning at p. 93.

[13] See Code § 672(f)(1), which provides, "Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

[14] For additional detail regarding all of these exceptions, *see* Harrison and McCaffrey beginning at p 97.

[15] The trust need not expressly state that it is "revocable" as long as the grantor has the power to "revest absolutely in the grantor title to the trust property."

"nonadverse party" requirement, the beneficiary is a related or subordinate party. However, if the beneficiary whose consent is required is the grantor's spouse, the spouse's adverse interest should be disregarded because any power or interest held by the grantor's spouse is treated as if held by the grantor.[16] However, it is not clear whether Code § 672(f) overrides Code § 672(e).

Persons within the category of related or subordinate are presumed to be subservient to the grantor unless shown by a preponderance of the evidence to be not subservient.[17]

b. Trust for the Benefit of Grantor or Spouse

A trust that benefits *only* the grantor or the grantor's spouse during the lifetime of the grantor is exempt from Code § 672(f)(1). If any amount is distributable to another person, even temporarily, the trust will not be a grantor trust under this exception. For example, if a trust benefits only the grantor except that distributions may be made to the grantor's child during the period the child attends graduate school, the trust will not be a grantor trust even after the child graduates.[18]

This exception does not require that the grantor be a beneficiary of the trust. For example, a trust would qualify it that authorized distributions to the grantor's spouse and nobody else. However, if the grantor survives her spouse, distributions could not be made during the grantor's lifetime to anyone else. Similarly, a trust that directed all income be accumulated and no principal distributions be made during the lifetime of the grantor would qualify for this exception..

2. Grantor is a U.S. Person

As described above in part 1, a trust that has a foreign grantor will be a grantor trust under limited circumstances. In contrast, a foreign trust to which a U.S. person has transferred property often will be a grantor trust deemed owned by the U.S. transferor during the lifetime of the U.S. transferor.

a. Code § 679

Under Code § 679, if a U.S. person makes any direct, indirect or constructive gratuitous transfer to a foreign trust that has one or more U.S. beneficiaries, the trust will be a grantor trust deemed owned by the U.S. person to the extent of her transfer.[19]

A transfer is not a gratuitous transfer if it was made for full fair market value. For purposes of determining whether full fair market value has been received, if the transferor is the grantor or a beneficiary of the trust (or a person related within the meaning of Code § 643(i)(2)(B) to any grantor or beneficiary of the trust), any obligation issued by the trust (or by

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[16] Code § 672(e). If this subsection applies, then the trust would qualify as a grantor trust where the power of revocation was held by the grantor's spouse rather than by the grantor.

[17] Treas. Reg. § 1.672(f)-3.

[18] Treas. Reg. § 1.672(f)-3(b)(4), *Example 3*.

[19] Code § 679(a)(1). For a further discussion of Code § 679, see Harrison, McCaffrey and Kirschner.

certain related persons) is disregarded, except as provided in the regulations.[20] Treasury regulations provide that certain "qualified obligations" will be recognized as consideration.[21]

A trust is treated as having a U.S. beneficiary in any year in which income or corpus may be paid to or for the benefit of, or accumulated for future distribution to or for the benefit of, a U.S. person, or in any year in which, if the trust terminated, any part of the income or corpus could be paid to or for the benefit of a U.S. person.[22] According to the regulations Code § 679 applies even if no distribution may be made to a U.S. person until after the grantor's death or to a person who is a U.S. person until she ceases to be a U.S. person.[23] If the terms of the trust permit the trust to be amended to make a U.S. person a beneficiary, the trust will be treated as having a U.S. beneficiary.[24] For this purpose the term "U.S. person" includes a controlled foreign corporation as defined in Code § 957(a), a foreign partnership with one or more U.S. partners, and a trust or estate, one or more beneficiaries of which are U.S. persons.[25]

b. Other Grantor Trust Provisions

If a U.S. grantor makes a gratuitous transfer to a trust, whether domestic or foreign, the portion of the trust attributable to the transfer also may be deemed owned by the U.S. grantor as a result of Code §§ 673 through 677. These Code sections treat a U.S. grantor who transfers property to a trust as the deemed owner of a trust, or portion of a trust, as a result of beneficial interests in the trust held by the grantor or her spouse and as a result of powers over the trust held by the grantor, her spouse and certain other persons.

[20] Code § 679(a)(3)(A)(i).

[21] 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 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 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. transferor extends the period for assessment of any income tax or transfer tax attributable to the transfer 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 (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 is deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter; and (vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for each year that the loan is outstanding." Treas. Reg. § 1.679-4(d).

[22] Code § 679(c)(1). CCA 200445025 demonstrates how broadly the IRS construes the reach of this section. In that ruling, the IRS treated a U.S. grantor as the owner of a foreign trust under Code §679 even though the trust prohibited distributions to U.S. beneficiaries. The trust was considered to have a U.S. beneficiary because distributions could be made to a beneficiary of the trust which was a foreign charity and the foreign charity was not prohibited from making distributions to U.S. persons.

[23] Treas. Reg. § 1.679-2(a)(2), *Examples 4 and 13*.

[24] Treas. Reg. § 1.679-2(a)(4)(ii)(A).

[25] Code § 679(c)(2).

Examples of these powers and interests are described below, though in many cases, a foreign trust that will be a grantor trust as a result of one of these powers and interests also will be a grantor trust as a result of Code §679 (described above in part a)[26]:

- The grantor or her spouse is a trustee of the trust and has discretionary powers to distribute trust assets to beneficiaries.[27]

- More than half the trustees who have discretionary powers to distribute trust assets to beneficiaries are "related or subordinate" parties who are "subservient to the wishes" of the grantor. [28]

- Any person has a power to add to beneficiaries of the trust (other than after-born or after-adopted children. [29]

- The grantor has the power to reacquire assets of the trust by substituting property of an equivalent value, exercisable in a nonfiduciary capacity and without the approval or consent of any person in a fiduciary capacity.[30]

- The grantor or a "non-adverse party" (as described above in part 1.a) has the power to borrow the trust principal or income, directly or indirectly, without both adequate interest and adequate security.[31]

- The grantor or her spouse is a discretionary beneficiary of the trust.[32]

II. THE THROWBACK RULES

A. In General

If a foreign nongrantor trust makes distributions in excess of the trust's distributable net income ("DNI") for a particular year, the U.S. beneficiaries who receive the 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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[26] For a more detailed discussion of the powers and interests described in the text above that follows, see Alan S. Halperin and Amy E. Heller, Grantor Trusts: Take Nothing for Granted, Heckerling Institute on Estate Planning (2012)..

[27] See Code §§674 and 672(e).

[28] See Code §§674(c) and 672(c).

[29] See Code §674.

[30] See Code §675(4)(c). See also Priv. Ltr. Ruls. 199908002, 9810019 and 9713017, where the IRS ruled that the a power to substitute assets given to a third party was sufficient to cause grantor trust status.

[31] See Code §§675(2) and 672(c)

[32] See Code §677.

B. Distributable Net Income

Generally, the DNI of a domestic nongrantor trust for a particular year is equal to its taxable income for that year adjusted (i) 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 (ii) 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."[33]

The DNI of a foreign nongrantor trust includes its capital gains.[34] 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[35] and the amount that was excluded from its gross income by treaty under Code § 894.[36]

Consider the following example:

> **Example 2:** John is a U.S. beneficiary of FNT, a foreign nongrantor trust. During 2010 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.

The special calculation of DNI applicable to foreign trusts is not applicable to foreign estates. Capital gains and foreign source income are not included in the calculation of the DNI of a foreign estate. This rule should apply to a trust that elects to be treated and taxed as part of an estate.[37] In some cases the election to recognize gain permitted by § 643(e) on a distribution of appreciated property could produce a tax-free basis adjustment for the beneficiary.

C. Accumulation Distributions

1. In General

The throwback tax and its accompanying interest charge apply only if a foreign nongrantor trust makes 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

33 Code § 643(a)(3).

34 Code § 643(a)(6)(C).

35 Code § 643(a)(6)(A).

36 Code § 643(a)(6)(B).

37 Code §645.

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.[38]

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

2. Exceptions

a. 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.[39]

Consider the following example:

> **Example 3:** Pat is a U.S. beneficiary of FNT, a foreign nongrantor trust. 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 2014, 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. The result should be similar if the terms of the trust instrument of FNT require the trustees of FNT to pay the $1,000,000 sum to a particular trust held for the benefit of Pat (which may have terms different from FNT) on Pat's 30th birthday.

b. Distributions Not in Excess of Trust Accounting Income

Code § 643(b) provides that for purposes of rules applicable to the income taxation of nongrantor trusts, 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.[40]

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

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[38] Code § 665(b).

[39] Code § 663(a)(1). If the fixed amount exceeds the value of property contributed to the trust, such amount necessarily has to be paid partly from income.

[40] Code § 643(b).

with respect to investments in business or investment entities, interest, and rent. It generally excludes gains from the disposition of property. Trust provisions that define income in a manner that departs fundamentally from local law are not recognized for purposes of this definition.[41]

Based on Code § 665(b), 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 income of the trust for such year, there shall be no accumulation distribution for such year."[42]

This principle is illustrated by the following example:

> **Example 4:** Isaac is a U.S. beneficiary of FNT, a foreign nongrantor trust. 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 2010, FNT received $100,000 in dividends from foreign corporations. It paid trustee commissions of $60,000, $40,000 of which was allocable to principal and $20,000 of which was allocable to income. 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.

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:

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

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

(3) the amount of any taxes imposed on the trust that are attributable to its DNI for the year.[43]

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[41] Treas. Reg. § 1.643(b)-1.

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

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 allocable to the undistributed portion of the trust's DNI.[44] 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.[45] 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).[46] A distribution paid or used for charitable purposes within the meaning of Code § 642(c) is not treated as an accumulation distribution.[47] As a result, such distributions do not reduce UNI.

If distributions are made under the default method which in fact exceed DNI, do those distributions reduce UNI for purposes of determining whether there is an accumulation distribution in the final year of the trust if the trust then switches to the actual method? Consider the following example:

> **Example 5:** Trust worth $2,000X has $60x of UNI at the beginning of 2010. In 2010, the trust has gain of $100x which is distributed to beneficiaries. The trust has no DNI in any subsequent year, but distributes $41.67 in 2011 and $18.33 in 2012 using the default method so that there is no accumulation distribution. The trust terminates in 2013 and distributes the balance of the assets. If the distributions made under the default method carry out UNI (which the distributions would have had the default method not been used), then there is no accumulation distribution in 2013. This seems to be the correct result and the logical consequence of allowing trusts to revert to the actual method in the final year of the trust.

Footnote continued from previous page

[43] Code § 665(a).

[44] Code § 665(d).

[45] Code § 665(d)(2).

[46] Treas. Reg. § 1.665(a)-1A(c).

[47] Treas. Reg. § 1.665(b)-1A(c)(2).

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, 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.

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.[48] 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 6:** Michael is a U.S. beneficiary of FNT, a foreign nongrantor trust. FNT was created in 2007 by Michael's non-U.S. mother. FNT distributed $100,000 to Michael in 2014, 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:
>
> 2007 - $4,000
>
> 2008 - $20,000
>
> 2009 - $30,000
>
> 2010 through 2013 - $40,000
>
> Michael's $80,000 accumulation distribution is deemed to have been made $4,000 on the last day of 2007, $20,000 on the last day of 2008, $30,000 on the last day of 2009, and $26,000 on the last day of 2010.

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.[49] Such taxes include U.S. income taxes and foreign income, war profits and excess profits taxes.[50]

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[48] 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).

[49] Code § 666(b) and (c).

> **Example 7:** 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 2007, 2008, 2009 and 2010 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.[51] 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.[52]

> **Example 8:** 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 1997 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).

Step 4 -- Identify the beneficiary's computation years. The computation years are those three of the beneficiary's five immediately 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.[53]

> **Example 9:** Assume in the above example that Michael's taxable income in 2009 was $50,000, in 2010 was $100,000, in 2011 was $200,000, in 2012 was $150,000 and in 2013 was $175,000. The year of the highest taxable income, 2011, and the year of the lowest taxable income, 2009, are eliminated. Michael's three computation years are the remaining years, 2010, 2012 and 2013.

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

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Footnote continued from previous page

[50] Code § 665(d). If the beneficiary has received distributions from more than two trusts 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).

[51] Code § 667(b)(1)(A).

[52] Code § 667(b)(3).

[53] Code § 667(b)(1)(B).

deemed distributed) by the number of preceding years in which the distribution is deemed to have been made as determined under Step 3.[54]

> **Example 10:** 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.[55] 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.[56]

> **Example 11:** Assume that Michael's income tax would have been increased by $15,200, $16,500 and $16,600 in each of the three computation years.

Step 7 -- Determine the average tax increase by dividing the sum of the three increases by three.[57]

> **Example 12:** 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.[58]

> **Example 13:** Michael's average tax increase, $16,100, is multiplied by 3. The product is $48,300.

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[54] Code § 667(b)(1)(C).

[55] Code § 667(b)(1)(D). Code §1411, which was added to the Code by the 2010 Health Care Act as Amended by the 2010 Health Care Reconciliation Act, imposes an extra tax equal to 3.8 % of an individual's net investment income to the extent her modified adjusted gross income exceeds a threshold amount of $250,000 in the case of married individuals filing joint returns and $200,000 in the case of unmarried individuals. This new tax is effective for taxable years beginning after 2012. Because Code §667(b) calculates the throwback tax with reference to an individual's "taxable income," Code §1411 does not seem to apply to accumulation distributions. Treasury announced in the preamble to the final Code §1411 regulations that it is studying how the 3.8% tax should apply to accumulation distributions taken from foreign trusts. Until guidance on the subject is issued the 3.8% tax will not be applied to the accumulation distributions.

[56] Code § 667(d).

[57] *Id.*

[58] Code § 667(b)(1).

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.[59] The result is the amount of the beneficiary's throwback tax.

> **Example 14:** 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.

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.[60]

Under Code § 668, as amended by the Small Business Jobs Protection Act of 1996,[61] the interest rate charged on the tax imposed on distributions of accumulated income by foreign trusts will be the floating rates applied under Code § 6621 to underpayments of tax. Interest is compounded daily and calculated over a specially calculated number of years.[62] 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 UNI 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.[63]

For purposes of this calculation, an accumulation distribution is treated as having come proportionately from each year with respect to which there is UNI (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.

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[59] Code § 667(b).

[60] Code § 667(a)(3).

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

[62] Code § 668(a).

[63] Line 50, Internal Revenue Service Form 3520 (2005).

The process may be illustrated by the following example:

> **Example 15:** FNT, a foreign trust created in 1996, made no distributions before 2002. It had income of $0 in 2001, $60 in 2000, $124 in 1999, $87 in 1998, $54 in 1997, and $25 in 1996. Its total UNI in 2002 was the sum of these amounts or $350. It had no income in 2002 and distributed $286 in that year to its U.S. beneficiary, Tyler. FNT's weighted UNI is $1,260, as shown in the chart below:

[1]	[2]	[3]	[4]
Year	# of Years Since That Year	UNI From Each Year	Weighted UNI
			[2] x [3]
2001	1	$-	$-
2000	2	$60.00	$120.00
1999	3	$124.00	$372.00
1998	4	$87.00	$348.00
1997	5	$54.00	$270.00
1996	6	$25.00	$150.00
Totals		$350.00	$1,260.00

To determine the weighted number of years, the weighted UNI figure is divided by the total UNI figure, producing, in this example, a weighted number of years of 3.6, which is to be rounded to the nearest half year, or 3.5.[64]

Tyler's income tax on his accumulation distribution was $100. He will calculate his interest over a 3.5 year period ending on the applicable date. The applicable date, according to the instructions to Form 3520, is June 30th of the year in which the distribution was made.[65] Total interest is calculated in the manner illustrated by the chart below:

64 The figures in this example are derived from the instructions to Form 3520 (2002).

65 Alternatively, if the taxpayer received only one accumulation distribution during the year, she may use the date of the distribution as the applicable date.

From	To	Rate	# of Days	Interest	Interest
					+
					Principal
					$100.00
1-Jan-99	31-Mar-99	7.0%	90.00	$1.74	$101.74
1-Apr-99	31-Mar-00	8.0%	366.00	$8.50	$110.24
1-Apr-00	31-Mar-01	9.0%	365.00	$10.38	$120.62
1-Apr-01	30-Jun-01	8.0%	91.00	$2.43	$123.05
1-Jul-01	31-Dec-01	7.0%	184.00	$4.42	$127.47
1-Jan-02	30-Jun-02	6.0%	181.00	$3.85	$131.32
Total			1,277.00	$31.32	

Alternatively, Tyler may use a chart contained in the instructions to Form 3520 to calculate his interest. The chart produces total interest of only 29.998% rather than 31.32%.

The chart below shows the various Code § 6621 rates in effect from January 1, 1996 through December 31, 2014:[66]

From	Through	Rate
January 1, 1996	March 31, 1996	9%
April 1, 1996	June 30, 1996	8%
July 1, 1996	March 31, 1998	9%
April 1, 1998	December 31, 1998	8%
January 1, 1999	March 31, 1999	7%
April 1, 1999	March 31, 2000	8%
April 1, 2000	March 31, 2001	9%
April 1, 2001	June 30, 2001	8%
July 1, 2001	December 31, 2001	7%
January 1, 2002	December 31, 2002	6%
January 1, 2003	September 30, 2003	5%
October 1, 2003	March 31, 2004	4%
April 1, 2004	June 30, 2004	5%
July 1, 2004	September 30, 2004	4%
October 1, 2004	March 31, 2005	5%
April 1, 2005	September 30, 2005	6%
October 1, 2005	June 30, 2006	7%
July 1, 2006	December 31, 2007	8%
January 1, 2008	March 31, 2008	7%
April 1, 2008	June 30, 2008	6%
July 1, 2008	September 30, 2008	5%
October 1, 2008	December 31, 2008	6%
January 1, 2009	March 31, 2009	5%
April 1, 2009	December 31, 2010	4%
January 1, 2011	March 31, 2011	3%
April 1, 2011	September 30, 2011	4%
October 1, 2011	December 31, 2014	3%

[66] Rev. Rul. 2014-23, 2014-40 I.R.B. 575 (September 3, 2014).

Code § 668(b) limits the total interest charge to the excess of the amount of the taxed distribution over the tax charged on such distribution. 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.[67]

b. Observation

For families who view their trusts as semi-perpetual arrangements, the interest charge is not likely to be 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 the greater of the trust's trust accounting income or DNI in the year of distribution will not be treated as accumulation distributions and, therefore, the income tax they attract will not be subject to an interest charge.

6. Distributions of Income Accumulated Before Beneficiary Became a U.S. Resident

If a U.S. person receives an accumulation distribution that is attributable to periods before she became a U.S. resident, the interest charge on the accumulation distribution is computed by excluding the years in which she was a foreign person.[68] For example, if a trust accumulated $25,000 of income each year from 2010 to 2015, and a foreign person moved to the U.S. in 2014, and in 2016 receives an accumulation distribution of $125,000, the interest charge would apply only for 2014 and 2015.

However, a question arises as to whether the person who moved to the U.S. in 2014 should be taxed at all on the income accumulated prior to 2014, assuming it is not U.S. source income.[69] Code § 667(a) establishes the general rule that an accumulation distribution allocated to a particular preceding taxable year is to be taxed, when distributed, to the extent that the such amounts "would have been included in the income of such beneficiary under section 662(a)(2) (and, with respect to any tax exempt interest to which section 103 applies, under section 662(b)) if such total had been paid to such beneficiary on the last day of such preceding taxable year."

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[67] Code § 668(a)(6).

[68] Code § 668(a)(4).

[69] *See* Jose L. Nunez and Andrea L. Mirabito, *Just Off the Boat, Trust Fund in Hand*, Trusts & Estates, December 2005; *See also,* Norman H. Lane and Howard M. Zaritsky, *Federal Income Taxation of Trusts and Estates* (1993), Section 6.06(6)(b) (regarding the application of the throwback rules with respect to a beneficiary who was not taxable in some of the base period years).

This rule abandons the usual rule in Code § 662(b) that the character (and presumably the source) of income taxable to a beneficiary is determined by the source and character of the income of the trust, with the limited exception for tax exempt interest. If the character of the non-U.S. source income were preserved for purposes of computing the tax on an accumulation distribution made to a U.S. person, then the person who received an accumulation distribution attributable to non-U.S. source income accumulated in a year in which such person was not a U.S. person would not be subject to tax.

Unfortunately, Code § 667 does not expressly so provide, although it should as a matter of tax policy. Note that Code § 667(d) and (e) preserve the character rule for other purposes, namely, calculation of the allowable foreign tax credit and distributions from a foreign trust to a nonresident alien. Code § 667(e) appears to apply only if the person is a nonresident alien at the time of the distribution. Unless Code § 667(e) can be broadly interpreted to preserve the character rule for distributions to a U.S. person that are attributable to income accumulated in the foreign trust in years in which the U.S. taxpayer was a nonresident alien, then the U.S. immigrant is unfairly penalized for tax avoidance that did not occur.[70] The provisions of Code § 668(a)(2) (waiving the interest charge for distributions allocable to a year in which the beneficiary was not a U.S. person) would not be necessary if the accumulated income in the year were not subject to U.S. tax.

III. MANAGING THE THROWBACK TAX

A. Distributing all DNI

1. In general

A foreign nongrantor trust will not have UNI if all of its DNI is distributed each year. Suppose, for example, that from the inception of a foreign nongrantor trust (the "First Trust"), all of its DNI is distributed to a second trust. In this case, it should be possible to make distribution to U.S. beneficiaries of the First Trust without throwback tax consequences.

The Second Trust may be a domestic trust for U.S. federal income tax purposes, in which case it will be subject to U.S. federal income tax on all of the DNI that it receives from the First Trust each year and, in addition, on income earned on the trust fund each year. Alternatively, the Second Trust may be a foreign nongrantor trust like the First Trust. In this case, the Second Trust itself will not be a U.S. taxpayer, and the DNI received each year from the First Trust will accumulate in the Second Trust as UNI to the extent it is not distributed to beneficiaries of the Second Trust in the year received. Accordingly, distributions to U.S. beneficiaries from the

[70] The unfair application of the accumulation distribution rules is not limited to this situation. For example, suppose a typical Canadian marital trust pays all income to a Canadian widow and accumulates capital gain. Upon the widow's death, the trust terminates and distributes to U.S. children. The children will be taxed under the accumulation distribution rules on gains that were accumulated in the trust. Gains were not accumulated in the trust to avoid U.S. tax. Gains were accumulated to preserve principal and because distributions to anyone other than the spouse is prohibited in order to qualify under Canadian law to defer capital gains at death. Had the assets passed outright to the widow rather than to the marital trust, the children would not be taxed on the gains (realized or unrealized) that accrued as of the date of their mother's death.

Second Trust may be subject to the throwback tax. Distributions from the Second Trust to non-U.S. beneficiaries, however, will not be subject to the throwback tax.

2. 65 day rule

It is not always possible prior to the close of a taxable year to determine the amount of a nongrantor trust's DNI for the year. The trust may earn income or pay expenses right up to the close of the year, making it difficult to accurately determine let alone distribute all DNI by December 31.

Fortunately for a trustee that wishes to adopt an approach of distributing all of the DNI of a foreign nongrantor trust each year, 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.[71] The amount to which the election applies may not exceed the amount of income of the trust for the prior taxable year or the DNI for such year, if greater, reduced by amounts paid, credited or required to be distributed in such year calculated without regard to the election.[72] As a result, a distribution made within 65 days after the close of a year cannot be treated as a distribution of UNI made in the earlier year.

3. DNI that is not determinable within the 65 day period

In certain circumstances, a trustee may not be able to determine the DNI of a nongrantor trust within 65 days following the close of a taxable year. For example, if a trust holds investments in entities that are partnerships for U.S. federal income tax purposes (e.g., domestic hedge funds or private equity funds), the trust may not receive information about the share of the partnership's income allocable to the trust until September 15 of the following taxable year.[73]

There are several approaches that a trustee who wishes to avoid accumulating UNI in a foreign nongrantor may pursue in this case. First, if amendments are possible, the trustee may amend the trust agreement to require that all of the trust's DNI be distributed to a second trust by the close of each taxable year. Under Code § 661(a)(2), a distribution deduction is allowable to a nongantor trust for any amounts that "are required" to be distributed by the trust in a taxable year. Similarly, under Code § 662(a), a beneficiary is required to include in gross income amounts of DNI that are "required to be distributed" to the beneficiary during the taxable year. Accordingly, as long as the trust agreement of the First Trust requires that DNI be distributed to the Second Trust, UNI should not accumulate in the First Trust, even if DNI for a taxable year ultimately is not distributed by the close of the taxable year or the expiration of the 65 day period following the close of the taxable year.[74]

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[71] See Code § 663(b), which applies to nongrantor trusts generally and is not specific to foreign nongrantor trusts.

[72] Treas. Reg. § 1.663(b)-1(a)(2).

[73] Domestic partnerships generally may extend the date by which they must provide IRS Forms K-1 to their partners (reflecting partners' allocations of items of partnership income) until September 15 of the year following the close of the taxable year at issue.

[74] If income of the First Trust is required to be distributed from the First Trust to the Second Trust and the First Trust's DNI does not exceed its fiduciary accounting income (within the meaning of Code §643(b)) is, discretionary

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If it is not possible for the trust agreement of the First Trust to require that DNI be distributed to a Second Trust prior to the end of a taxable year, the trustee of the First Trust may nevertheless be able to avoid the accumulation of UNI in the First Trust by crediting the trust's DNI for the year to the Second Trust prior to the end of the year. Under Code § 661(a)(2), a distribution deduction is allowable to a nongrantor trust for any amounts that are "credited…for such taxable year." Similarly, under Code § 662(a), a beneficiary is required to include in gross income amounts of DNI that are "credited" to the beneficiary in the taxable year.[75]

Finally, a trustee of a foreign nongrantor trust who wishes to avoid the accumulation of UNI may choose to distribute to a Second Trust, either by the close of a taxable year or within the 65 day period after the close of the year, a promissory note having a face amount defined by reference to the First Trust's DNI for the taxable year. Once the DNI is known, cash can be distributed from the First Trust to the Second Trust in satisfaction of the promissory note. While there does not appear to be guidance that specifically addresses whether a distribution of a promissory note to a beneficiary of a trust will carry out DNI, this would seem to be the appropriate result.[76]

B. 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 or other fixed amount)[77] is the lesser of the trust's basis in the distributed 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.[78]

Consider the following example:

> **Example 16:** Jenny is a U.S. beneficiary of FNT, a foreign nongrantor trust. During 2014, the trustees of FNT distributed 100 shares of X

Footnote continued from previous page

distributions of principal to a U.S. beneficiary of the First Trust should not be taxable to him or her. See Code §662(a) and Treas. Reg. §1.665(a)-1A(c).

[75] It is not entirely clear what steps a trustee must take in order to properly "credit" amounts to a beneficiary. See e.g., *Alma Igoe*, 19 TC 913 (1953) and *Grant v. Nicholas*, 47 AFTR 40 (DC-CO 1955), both addressing taxable years that predate the enactment of current Code §§661 and 662.

[76] In addition, if the note is a demand note, an amount equal to the face value of the note may be viewed as being "credited" to the beneficiary, providing the trust with a distribution deduction and carrying out DNI to the beneficiary based on Code § 661(a)(2) (discussed above).

[77] The distribution of appreciated property by a trustee to a beneficiary in satisfaction of the beneficiary's right to receive trust accounting income or other fixed amount is a recognition event. *Kenan v. Commissioner*, 114 F.2d 217 (2d Cir. 1940); *Suisman v. Eaton*, 15 F.Supp. 113 (D. Conn. 1935), *aff'd per curiam*, 83 F.2d 1019 (2d Cir. 1936), *cert. denied*, 299 U.S. 573 (1936). Cf. Treas. Reg.§ 1.664-1(d)(5).

[78] See Code § 643(e), which applies to nongrantor trusts generally and is not specific to foreign nongrantor trusts.

> corporation stock to Jenny. 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 2014 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.

C. Default Method

The "default" method of calculating distributions from a foreign nongrantor trust may, under certain circumstances enable distributions of UNI to be made to U.S. beneficiaries without triggering a throwback tax.

Under Code § 6048(c)(2), a distribution of income or principal from a foreign trust to a U.S. beneficiary is treated as an accumulation distribution (and is thus subject to the throwback tax regime) if adequate records are not provided to the Secretary of the Treasury to determine the proper treatment of such distribution. Notice 97-34[79] provides that IRS Form 3520, which a U.S. beneficiary is required to file in any year in which he or she receives a distribution from a foreign trust, will allow the U.S. beneficiary to avoid treating the entire amount distributed as an accumulation distribution if the U.S. beneficiary can provide certain information regarding distributions from the foreign trust over the last three years. The Notice provides that Form 3520 will describe this "default treatment" in greater detail. The instructions to Form 3520 make it clear that the U.S. beneficiary may elect to use the default method whether or not adequate records are available.

Part III, Schedule A of Form 3520 outlines three simple steps for determining the amount of allowable non-accumulation distributions in a given year under the default method:

Step 1: The U.S. beneficiary enters the total distributions he or she received from the foreign trust in the 3 preceding tax years (or the number of years that the trust has been a foreign trust, if fewer than 3).

Step 2: The U.S. beneficiary multiplies that total by 1.25.

Step 3: The U.S. beneficiary divides the total in Step 2 by 3 (or by the number of years that the trust has been a foreign nongrantor trust, if fewer than 3).

As long as the amount of the actual distribution does not exceed the figure determined in Step 3, the distribution is treated as ordinary income. No part of the distribution is treated as an accumulation distribution.

Consider the following example:

> **Example 17:** Joshua is the beneficiary of FNT, a foreign nongrantor trust that has been in existence since 2002. At the end of 2010 the FNT had

[79] 1997-1 C.B. 422.

> assets worth $20,000,000. In each of the years 2002 through 2010, FNT earned $1,000,000. Assume FNT has no income in 2011, 2012, 2013 and 2014 and that FNT distributes $2,000,000 to Joshua in each such year. The amount of Joshua's accumulation distribution in each year would be $2,000,000 under Code § 665(b). His situation would be improved considerably by using the default method.
>
> In 2011, the accumulation distribution under the default method would be the full $2,000,000 because there were no distributions in any of the prior three years.
>
> In 2012, the amount of the accumulation distribution is reduced to $1,166,667 ($2,000,000 - ($2,000,000 X 1.25/3)).
>
> In 2013, the amount of the accumulation distribution is reduced to $333,333 ($2,000,000 - ($4,000,000 X 1.25/3)).
>
> In 2014, 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.

If the trustee of a foreign nongrantor trust could anticipate, at least three years in advance, when beneficiaries would need to begin receiving distributions from trust in excess of current DNI (the "Distribution Year"), in each of the three years prior to the Distribution Year, the trustees could distribute the entire current DNI to the beneficiaries. In the Distribution Year, the trustees would be able to distribute 125% of the average of the three prior years' DNI without attracting a throwback tax. If the trustees consistently distributed the maximum amount permitted under the default method without attracting a throwback tax, the amount they could distribute each year would continue to increase. The illustrations at Exhibit A show how the default method might be used to distribute nearly all of the UNI of a trust without throwback tax consequences.

Once the default method is chosen to calculate maximum allowable non-accumulation distributions, the default method would need to be used in all future years. Thus, even if a foreign nongrantor trust's actual DNI for a given year would allow larger non-accumulation distributions to beneficiaries, any distributions in excess of the allowable non-accumulation distributions calculated under the default method would be treated as accumulation distributions and, as such, would trigger a throwback tax.

D. Domestication

1. Domestication of foreign trusts in general

Part I.A above describes the elements that determine whether a trust is a foreign trust or a domestic trust for U.S. federal tax purposes. If the connections of a foreign nongrantor trust change in a way that causes the trust to satisfy the court test and the control test and thus to become a domestic trust, there should be no immediate U.S. income tax consequences. However, all income earned subsequent to the change in status will be subject to U.S. income tax in the same manner as a trust that has always been a U.S. trust.

Moreover, the domesticated trust's foreign taint continues indefinitely for purposes of the application of the throwback rules to future distributions to U.S. beneficiaries of income accumulated in a year prior to the year of distribution including income accumulated while the trust was a U.S. trust. The general repeal of the throwback rules to domestic trusts that occurred in 1997 does not apply to any domestic trust that was at one time a foreign trust.[80] Revenue Ruling 91-6 confirms that the throwback rules apply to a domestic trust's income accumulated while the trust was a foreign trust.[81] It also confirms that the tax on distributions of accumulated income from such trusts will be subject to the special interest charge imposed by §668 even though at the time of the distribution the trust is a domestic trust.[82]

2. Loans From and Use of Property of a Domesticated Trust

As described above in part 1, a domesticated trust's foreign taint continues indefinitely for purposes of the application of the throwback rules to future distributions to U.S. beneficiaries of income accumulated while the trust was a foreign nongrantor trust. However, what constitutes a "distribution" differs in in the case of a foreign trust and a domestic trust.

In particular, under Code § 643(i), a foreign trust's loan of cash or marketable securities to a U.S. beneficiary of the trust is treated as a distribution to the beneficiary.[83] Congress apparently intended that Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.[84] Although such regulations have yet to be issued, the IRS signaled its thinking on this subject in Notice 97-34.[85] 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."[86]

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[80] Code §665(c).

[81] Rev. Rul. 91-6, 1991-1 C.B. 89

[82] While there should be no immediate U.S. income tax consequences to the migration of a foreign trust to the U.S. as a result of changes to the trust's connections, there may be U.S. income tax consequences if the assets of a foreign nongrantor trust are distributed or decanted to a domestic trust.

[83] Code § 643(i). 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. Code § 643(i) does not seem to change this result. Thus, if a foreign nongrantor 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 (or is required to recognize gain in the case of a distribution to a covered expatriate). *See* Code § 877A(F)(1)(B).

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

[85] 1997-1 C.B. 422.

[86] 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

Footnote continued on next page

In 2010, Congress extended the reach of Code § 643(i).[87] The section now generally treats the use of trust property by a beneficiary as a distribution to the extent of the fair market value of the use of the property. In the case of a loan or use of property other than cash or marketable securities, the provision does not apply "to the extent that the trust is paid the fair market value of such use within a reasonable period of time of such use."[88]

Accordingly, if a foreign nongrantor trust that has accumulated income makes a loan to a U.S. beneficiary or permits the beneficiary to use trust property, including real estate or tangible personal property owned by the trust, there may be tax consequences to the U.S. beneficiary. On the other hand, if a foreign nongrantor that has accumulated income is domesticated, and the domesticated trust then makes a loan to a U.S. beneficiary or permits the beneficiary to use trust property, there should be no deemed distribution to the U.S. beneficiary and no throwback tax consequences to her. There is no general authority holding that a beneficiary's rent-free use of a residence or other asset owned by a trust is a constructive distribution to the beneficiary.[89] A specific amendment to the Internal Revenue Code was required to reach this result in the case of foreign nongrantor trusts.

E. Section 645 Election

As described above at part I.B.1.a, if a foreign trust is revocable by its grantor during her lifetime, the trust should be a grantor trust deemed owned by the grantor while she is living. In

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Footnote continued from previous page

obligation, the obligation's maturity date is the last 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."

[87] The tax-free use of tangible personal property or real estate owned by a foreign trust was identified as an abuse. "Loans that are treated as trust distributions under U.S. tax law should be expanded to include, not just cash and securities as under present law, but also loans of real estate and personal property of any kind, including artwork, furnishings and jewelry." "Tax Haven Abuses: The Enablers, the Tools and Secrecy," Minority & Majority Staff Report of the Permanent Subcommittee on Investigations, August 1, 2006 at page 10.

[88] Code § 643(i)(2)(E).

[89] *See, e.g., Commissioner v. Plant,* 76 F.2d 8 (2d Cir. 1935) (trust income expended for maintenance of property in which beneficiary resided held not income taxable to beneficiary); *Alfred I. duPont Testamentary Trust v. Commissioner*, 66 T.C. 761 (1976) *affirmed per curiam*, 574 F.2d 1332 (5th Cir. 1978) (same); *Sparrow v. Commissioner*, 18 B.T.A. 1 (1929) (on similar facts, allowing income tax deductions by trustees for cost of repairs to property on grounds that widow's right to occupy did not amount to a legal life estate). *See also*, IRS Notice 97-34 (discussing constructive distributions from foreign trusts to U.S. beneficiaries, but silent regarding the rent-free use of trust-owned assets).

this case, income accumulated during grantor's lifetime will not be UNI that is potentially subject to a throwback tax on eventual distribution to a U.S. beneficiary. Following the death of the foreign grantor, however, the trust will become a foreign nongrantor trust. DNI that is accumulated after this time generally will be UNI, potentially subject to throwback tax on eventual distribution to a U.S. beneficiary.

It may, however, be possible for the trustee of a foreign trust that is revocable by its grantor during the grantor's lifetime to postpone the date from which UNI will first accumulate in the trust for at least two years following the date of the grantor's death. This should be possible if an election is made under Code § 645 to treat the trust as a foreign estate following the death of the grantor. If the Code § 645 election is made, DNI that is not distributed during the period during which the election is in effect will not become UNI.[90]

To make the Code § 645 election, the executor of the decedent's estate and the trustee of the revocable trust (or, if there is no executor, just the trustee of the trust) must file Form 8855 with the IRS.[91] The election will remain in effect for two years after the date of the decedent's death, unless a U.S. estate tax return (IRS Form 706) is filed for the decedent's estate. If an estate tax return is filed, the election will remain in effect until six months after the date of the final determination of any U.S. estate tax liability.[92]

F. Changing the Grantor of a Trust

As described above in part E, if a Code §645 election is made following the death of the grantor of a foreign trust that was revocable by its grantor, it may be possible to prevent the accumulation of UNI for a period following the grantor's death.

Under certain circumstances, it may be possible to prevent the accumulation of UNI for a longer period of time following the death of a trust's grantor. This may be possible if another person is given a power to appoint the assets of the trust to other persons, including herself, her creditors, her estate or the creditors of her estate (a so-called "general power of appointment") and exercises this power in favor of a recipient trust that is a grantor trust deemed owned by the appointor. Assuming that the appointor is a foreign person,[93] as described above at part I.B, the recipient trust generally will be a grantor trust deemed owned by the foreign appointor only if (1)

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[90] The preamble to the Treasury Regulations under Code § 645 confirm that a Code § 645 can be made for a foreign trust as long as the trust is a "qualified revocable trust" or "QRT" within the meaning of Code § 645(b)(1) and Treas. Reg. §1.645-1(b)(1). See T.D. 9032, 2003-7 I.R.B. 471. A trust will be a QRT if it was a grantor trust deemed owned by the decedent under Code §676 by reason of the decedent's power to revoke the trust. Most trusts that are grantor trusts deemed owned by a foreign grantor under Code §672(f) by reason of the grantor's power to revest the assets of the trust in himself or herself also will be treated as revocable by the grantor under Code §676.

[91] *See* Treas. Reg. § 1.645-1(c) and IRS Form 8855 at http://www.irs.gov/pub/irs-pdf/f8855.pdf

[92] *See* Treas. Reg. § 1.645-1(f). The Regulation references only IRS Form 706, which is the estate tax return that must be filed by U.S. citizens and domiciliaries. Presumably, filing a form IRS 706-NA, the U.S. estate tax return applicable to an individual who is not a U.S. citizen or domiciliary, would similarly extend the effective date of the election until six months after the date of the final determination of any U.S. estate tax liability.

[93] If the appointor is a U.S. person, there could be adverse U.S. estate and gift tax consequences. In addition, the second trust is likely to be a grantor trust deemed owned by a U.S. persons, meaning that its worldwide income would be subject to U.S. income tax.

the trust is revocable by the appointor or (2) the appointor and her spouse are the sole beneficiaries of the trust during the appointor's lifetime.

This planning approach should not trigger U.S. adverse consequences as a result of the so-called "anti-intermediary rule" of Code § 643(h). Under Code § 643(h) and Treas. Reg. § 1.643(h)-1(a)(1), amounts transferred to a U.S. person that are derived directly or indirectly from a foreign trust of which the payor (the "intermediary") is not the grantor are treated as having been paid directly from the foreign trust to the U.S. person if the transfer was made pursuant to a plan one of the principal purposes of which was to avoid U.S. tax liability.[94] In the case the planning approach described above, where both the original trust and the recipient trust are grantor trusts, the anti-intermediary rule should not cause income inclusions to U.S. persons who might receive distributions from the recipient trust.

[94] Under Treas. Reg. § 1.643(h)-1(a)(2), transfers are deemed to have been made pursuant to a plan a principal purpose of which is tax avoidance if each of the following conditions apply:

> (1) the relationship between the U.S. person and the grantor of the trust establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person;
>
> (2) the intermediary made the transfer to the U.S. person less than two years after the intermediary received the transferred property (or related property) from the foreign trust; and
>
> (3) the taxpayer cannot demonstrate to the satisfaction of the Commissioner of the IRS that (i) the relationship between the intermediary and the U.S. person is such that there is a reasonable basis for concluding that the intermediary would make a gratuitous transfer to the U.S. person; (ii), the intermediary acted independently of the grantor and the trustee of the foreign trust; (iii) the intermediary is not an agent of the U.S. person under generally applicable U.S. agency principles; and (iv) if the intermediary is a foreign person, the U.S. person timely complied with reporting requirements of Code § 6039F.

EXHIBIT A

The illustrations below show how the default method can be used to distribute nearly all of the UNI of a trust without throwback taxes over the course of 10 to 20 years, depending on the trust's DNI in the three years prior to the year in which the default method is first used to calculate distributions.

In each illustration, year 4 is the first year that the default method is used to determine distributions.

Year	**Trust Capital**	**DNI (3%)**	**Distributions to Beneficiaries**
1	$10,000,000	$300,000	$300,000
2	$10,000,000	$300,000	$300,000
3	$10,000,000	$300,000	$300,000
4*	$10,000,000	$300,000	$375,000
5	$9,925,000	$297,750	$406,250
6	$9,816,500	$294,495	$450,521
7	$9,660,474	$289,814	$513,238
8	$9,437,051	$283,112	$570,837
9	$9,149,325	$274,480	$639,415
10	$8,784,390	$263,532	$718,121
11	$8,329,801	$249,894	$803,489
12	$7,776,207	$233,286	$900,427
13	$7,109,066	$213,272	$1,009,182
14	$6,313,156	$189,395	$1,130,457
15	$5,372,094	$161,163	$1,266,694
16	$4,266,563	$127,997	$1,419,305
17	$2,975,255	$89,258	$1,590,190
18	$1,474,322	$44,230	$1,781,745
19	($263,194)		

Year	**Trust Capital**	**DNI (5%)**	**Distributions to Beneficiaries**
1	$10,000,000	$500,000	$500,000
2	$10,000,000	$500,000	$500,000
3	$10,000,000	$500,000	$500,000
4*	$10,000,000	$500,000	$625,000
5	$9,875,000	$493,750	$677,083
6	$9,691,667	$484,583	$750,868
7	$9,425,382	$471,269	$855,396
8	$9,041,255	$452,063	$951,395
9	$8,541,922	$427,096	$1,065,691
10	$7,903,327	$395,166	$1,196,868
11	$7,101,626	$355,081	$1,339,148
12	$6,117,559	$305,878	$1,500,711
13	$4,922,726	$246,136	$1,681,969

Year	Trust Capital	DNI (5%)	Distributions to Beneficiaries
14	$3,486,893	$174,345	$1,884,095
15	$1,777,143	$88,857	$2,111,156
16	($245,157)		

Year	Trust Capital	DNI (8%)	Distributions to Beneficiaries
1	$10,000,000	$800,000	$800,000
2	$10,000,000	$800,000	$800,000
3	$10,000,000	$800,000	$800,000
4*	$10,000,000	$800,000	$1,000,000
5	$9,800,000	$784,000	$1,083,333
6	$9,500,667	$760,053	$1,201,389
7	$9,059,331	$724,746	$1,368,634
8	$8,415,443	$673,235	$1,522,232
9	$7,566,447	$605,316	$1,705,106
10	$6,466,656	$517,333	$1,914,988
11	$5,069,000	$405,520	$2,142,636
12	$3,331,884	$266,551	$2,401,138
13	$1,197,297	$95,784	$2,691,151
14	($1,398,070)		