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Learning to Live with the New Foreign Nongrantor Trust Rules

Carlyn S. McCaffrey

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Learning to Live with the New Foreign Nongrantor Trust Rules

Carlyn S. McCaffrey*
Elyse G. Kirschner**

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I. INTRODUCTION

The Small Business Job Protection Act of 1996 (the 1996 Act)¹ was intended to deal a heavy blow to the appeal of foreign

1. The Small Business Job Protection Act of 1996 was enacted on August 20, 1996. Pub. L. No. 104-188, 110 Stat. 1755 (1996).

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.² 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 more biased in favor of foreign status.³

This Article 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, this Article also considers the extent to which foreign trusts continue to be useful planning tools for U.S. persons.

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."⁴ This statement is merely descriptive of the consequences of foreign trust status and gives no guidance on how to determine its existence.⁵

Judicial and administrative authority partially filled the definitional void by establishing a test that required weighing the

2. *See id.* §1907, 110 Stat. at 1916-17.

3. *See id.*

4. I.R.C. § 7701(a)(31) (1994 & Supp. II 1996).

5. Curiously, the domestic or foreign status of an estate continues to be governed by the same provision. *See id.*

trust's foreign contacts against its U.S. contacts.⁶ 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. 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.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."⁸

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 United States, 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.

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 United States in the custody of Gotham and that

6. See, e.g., *B. W. Jones Trust v. Commissioner*, 132 F.2d 914, 916-17 (4th Cir. 1943); *First Nat'l City Bank v. IRS*, 271 F.2d 616, 618-19 (2d Cir. 1959), cert. denied, 361 U.S. 948 (1960); Rev. Rul. 60-181, 1960-1 C.B. 257.

7. I.R.C. §§ 7701(a)(30)(E), 7701(a)(31)(B) (Supp. II 1996). 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 (Feb. 7, 1995). The Joint Committee Explanation offers similar comfort. Joint Committee Explanation at 274. The Administration's intention is reflected in Treas. Reg. § 301.7701-7 (1999).

8. Taxpayer Relief Act of 1997 § 1601(i)(3)(A), Pub. L. No. 105-34, 111 Stat. 788 (1997).

the laws of the State of New York were to govern the trust's administration.

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.⁹

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.¹⁰

It is understood that one of the principal objectives the 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.¹¹ Thus, the new definition may level the competitive playing field for trust business between U.S. and foreign institutions. But, 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.

3. The Treasury Regulations

Some clarity is provided by Treasury Regulation § 301.7701-7, which is applicable to trusts for taxable years ending after February 2, 1999.¹² The regulations provide that a trust is a U.S.

9. 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 the property in the trust belonged to a resident of New York and has a New York trustee. N.Y. TAX LAW § 605(b)(3) (McKinney 1988).

10. Treasury Department, *General Explanation of the Administration's Revenue Proposals* 25 (Feb. 7, 1995).

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

12. See Treas. Reg. § 301.7701-7(c)(1) (1999). Newly-adopted Treasury Regulation § 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

person on any day that the trust meets both the "court test" and the "control test."¹³

a. The Court Test

The "court test" is the regulatory explanation of the statutory requirement that "[a] court within the United States is able to exercise primary supervision over the administration of the trust."¹⁴ The final regulations provide a safe harbor for the court test.¹⁵ 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 of the United States;
- (2) The trust in fact is administered exclusively in the United States; and
- (3) The trust is not subject to an automatic migration provision described in (c)(4)(ii) of § 301.7701-7.¹⁶

According to the preamble to the regulations, the Internal Revenue Service (the Service) 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 a court" in that state.¹⁷

Treasury Regulation § 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."

section 1907(a)(3)(B) of the 1996 Act to apply new Code §§ 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996. *Id.* Furthermore, a trust created after August 19, 1996 and before April 5, 1999 that satisfies the "control test" set forth in the proposed regulations but not the "control test" described in the final regulations may be modified to satisfy the final regulations by December 31, 1999. *Id.* § 301.7701-7(e)(2). Such modified trusts will be treated as satisfying the control test set forth in the final regulations for taxable years beginning after December 31, 1996 (or for taxable years ending after August 20, 1996 if the election under section 1907(a)(3)(B) of the 1996 Act has been made for the trust). *See id.*

13. *Id.* § 301.7701-7(a)(2).

14. *Id.* § 301.7701-7(a)(1)(i).

15. *See id.* § 301.7701-7(c)(1).

16. *Id.*

17. Explanation of Provisions, Treas. Reg. § 301.7701, 64 Fed. Reg. 4967-68 (1999).

- (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 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."¹⁸

Treasury Regulation § 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 United States by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.¹⁹
- (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 U.S. court and a foreign court.²⁰

This list of trusts that satisfy the court test is not intended to be an exclusive list.²¹ Thus, other types of trust may also satisfy the test.

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 U.S. court attempted to assert jurisdiction over it or otherwise attempted to supervise its administration, either directly or indirectly.²² However, a trust will not fail the court test solely because "the trust instrument provides that the trust will migrate from the

18. See Treas. Reg. §301.7701-7(c)(3) (1999).

19. Section 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. UNIF. PROBATE CODE § 7-201, 8 U.L.A. 491 (1998). Sixteen states have adopted at least part of the Uniform Probate Code. See *id.* at 1. They are Alaska, Arizona, Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota, and Utah. See *id.*

20. See Treas. Reg. § 301.7701-7(c)(4).

21. See *id.*

22. See *id.* § 301.7701-7(c)(4)(ii).

United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States."²³

b. The Control Test

The "control test" is the regulatory explanation of the statutory requirement that "[o]ne or more United States persons have the authority to control all substantial decisions of the trust."²⁴ Treasury Regulation § 301.7701-7(d)(1) provides the following critical definitions:

- (1) "United States person" means a U.S. person within the meaning of Code § 7701(a)(30).²⁵
- (2) "Substantial decisions" means 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.²⁶ Such decisions include, but are not limited to:
 - (a) The timing and amount of distributions;
 - (b) The selection of beneficiaries;
 - (c) The power to determine whether receipts are allocable to income or principal;
 - (d) The power to terminate the trust;
 - (e) 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;
 - (f) The power to remove, add or replace a trustee;
 - (g) 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
 - (h) The power to make investment decisions.²⁷
- (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.²⁸
- (4) "Control" means "the power, by vote or otherwise, to make all of the substantial decisions of the trust, with

23. *Id.*

24. *Id.* § 301.7701-7(a)(1)(ii).

25. *Id.* § 301.7701-7(d)(1)(i).

26. *Id.* § 301.7701-7(d)(1)(ii).

27. *See id.* 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. *See id.* § 301.7701-7(d)(1)(ii)(J).

28. *Id.* § 301.7701-7(d)(1)(ii).

no other person having the power to veto any of the substantial decisions.²⁹

Certain employee benefit trusts will be deemed to satisfy the control test as long as U.S. *fiduciaries* control all of the substantial decisions made by the trustees.³⁰

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

Section 1161 of the Taxpayer Relief Act of 1997 (the 1997 Act)³¹ permits nongrantor trusts that were in existence on August 20, 1996 and that were treated as domestic trusts on August 19, 1996 to elect to continue to be treated as U.S. trusts notwithstanding the new criteria for qualification as a U.S. trust.³² According to Treasury Regulations §301.7701-7(f), a trust is considered to have been treated as a domestic trust on August 19, 1996 if

- (1) the trustee filed on behalf of the trust a Form 1041 (U.S. Income Tax Return for Estates and Trusts), and not a Form 1040NR (U. Nonresident Alien Income Tax Return), for the period that includes August 19, 1996; and
- (2) the trust had a reasonable basis³³ under Code § 7701(a)(30), prior to amendment by the 1996 Act, for reporting as a domestic trust for that period.³⁴

Trusts that are not required to file either the Form 1041 or the Form 1040NR will be considered to have been treated as a domestic trust on August 19, 1996 if they did not file a Form

29. *Id.* § 301.7701-7(d)(1)(iii).

30. *See id.* § 301.7701-7(d)(2)(iv). Such employee benefit trusts include qualified trusts described in Code § 401(a); trusts described in Code § 457(g); trusts that are individual retirement accounts described in Code § 408(a); trusts that are individual retirement accounts described in §§ 408(k) or 408(p); trusts that are Roth IRAs described in Code § 408A; trusts that are educational retirement accounts described in Code § 530; trusts that are voluntary employees' beneficiary associations described in Code § 501(c)(9); and such additional categories of trusts designated by the Service. *See id.*

31. Pub. L. No. 105-34, 111 Stat. 788 (1997). The 1997 Act was signed by President Clinton on August 5, 1997. *Id.*

32. *Id.* § 1161, 111 Stat. at 987. Trusts that were wholly-owned by their grantors under the so-called "grantor trust" rules set forth in subpart E, part I, subchapter J, chapter I, of the Code on August 20, 1996 may not make this election. *See* Treas. Reg. § 301.7701-7(f)(1) (1999). However, this election is available to a trust if only a portion of the trust was treated as owned by the grantor on August 20, 1996; in this instance, the election is effective for the entire trust. *See id.*

33. This reasonable basis must be within the Meaning of I.R.C. § 6662. *See* Treas. Reg. § 301.7701-7(f)(2)(i).

34. *See id.* The final regulations supersede Notice 98-25, 1998-18 I.R.B. 11, which provided guidance as to the application of section 1161 of the 1997 Act. *See* Effect on Documents, Treas. Reg. 301.7701-7, 64 Fed. Reg. 4970 (1999).

1041 or a Form 1041NR and if they have a reasonable basis for being treated as a domestic trust.³⁵

Treasury Regulation § 301.7701-7(f)(3) details the procedure for making the election to remain a domestic trust.³⁶ Once the election is made, it may only be revoked with the consent of the Service.³⁷ However, an election will terminate if changes are made to the trust after the effective date of the election that cause the trust to no longer have a reasonable basis for being treated as a domestic trust under old Code § 7701(a)(30).³⁸

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 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 the property transferred" and requires that the transferor recognize as gain the excess of such fair market value over her adjusted basis in the transferred property.³⁹ This rule does not apply to the extent that any person (including the transferor) is treated as the owner of such trust under Code § 671.⁴⁰

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.⁴¹

35. See Treas. Reg. § 301.7701-7(f)(2)(ii) (1999). Trusts that are not required to file include certain group trusts described in Rev. Rul. 81-100, 1981-1 C.B. 326, and domestic trusts that do not meet the income requirements for filing under Code § 6012(a)(4). See *id.*

36. *Id.* § 301.7701-7(f)(3).

37. See *id.* § 301.7701-7(f)(4)(i).

38. See *id.* § 301.7701-7(f)(4)(ii).

39. I.R.C. § 684(a)(1)-(2) (West Supp. 1998).

40. See *id.* § 684(b).

41. *Id.* § 679 (Supp. II 1996).

3. Tax Treatment at the Death of a 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 § 684.⁴² Until the U.S. person's death, she was the owner of the property for U.S. income tax purposes under Code § 671.⁴³ 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 § 1014.⁴⁴ It is argued that Code § 1014 does not provide the decedent with a basis adjustment.⁴⁵ Instead, Code § 1014 seems to give the basis adjustment only to the recipient of the property. It is unlikely that this is the result Congress intended. 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 property at her death, 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.⁴⁶ The withdrawal power would give the deceased U.S. person the protection of Code § 684(b).⁴⁷ 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 § 671.⁴⁸

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 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.

42. *Id.* § 684 (West Supp. 1998).

43. *Id.* § 671 (1994).

44. See Spottswood P. Dudley & Joel J. Karp, *Continued Use of Foreign Trusts in U.S. Tax Planning*, TR. & EST., June 1998, at 36, 38.

45. See *id.*

46. See *id.*

47. I.R.C. § 684(b) (West Supp. 1998).

48. *Id.*

4. Tax Treatment After Death of a 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 3520.⁴⁹ 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.⁵⁰ Failure to file may subject a transferor to a penalty equal to thirty-five percent of the amount transferred.⁵¹

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.⁵² 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.⁵³ Form 3520 is due at the same time as the U.S. person's income tax return is due.⁵⁴ 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.⁵⁵ If Form 3520A is not filed, the U.S. person who is treated as the owner may be liable for a penalty equal to five percent of the value of the trust assets that are treated as owned by her.⁵⁶

49. See I.R.C. § 6048(a) (Supp. II 1996); I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

50. See I.R.C. § 6048(a); Instructions, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

51. See I.R.C. § 6677(a) (Supp. II 1996).

52. See *id.* § 6048(b).

53. I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

54. See Instructions, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

55. See I.R.S. Form 3520A and Instructions (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

56. See I.R.C. § 6677(b) (Supp. II 1996).

The executor of the estate of a U.S. person who transfers property to a foreign trust at her death and 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 transfers on Form 3520.⁵⁷ 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.⁵⁸ Failure to file may subject the executor to a penalty equal to thirty-five percent of the amount transferred.⁵⁹

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.⁶⁰

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.⁶¹ 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.⁶²

2. Reporting Requirements

A U.S. trust that becomes a foreign trust is required to report its change of status on Form 3520.⁶³ 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.⁶⁴ Failure to file may subject a

57. See *id.* § 6048(a)(3)(A)(iii).

58. See *id.* §§ 6048(a)(3)(A)(iii), 6048(a)(4); Instructions, I.R.S. Form 3520, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

59. See I.R.C. § 6677(a) (Supp. II 1996).

60. See *id.* § 679(a)(5).

61. See *id.* § 684(c) (West Supp. 1998).

62. *Id.* § 684(a).

63. See *id.* § 6048(a)(3)(A)(i) (Supp. II 1996).

64. See *id.* § 6048(a)(1); Instructions, I.R.S. Form 3520, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

trust to a penalty equal to thirty-five percent of the amount transferred.⁶⁵

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.⁶⁶ As a result, no U.S. income tax will be imposed on such a 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.⁶⁷ 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 that 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.⁶⁸

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

65. See I.R.C. § 6677(a) (Supp. II 1996).

66. *Id.* §§ 684(a), 679 (West Supp. 1998).

67. See *id.* §§ 671-79 (1994, Supp. II 1996, & West Supp. 1998).

68. See *id.* § 672(f) (Supp. II 1996). 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. *Id.* § 643 (note on Effective Date of 1996 Amendment).

in Code §§ 642, 643, 651, and 661.⁶⁹ For this purpose, foreign nongrantor trusts are treated as nonresident individuals who are not present in the U.S. at any time.⁷⁰

B. Gross Income

The gross income of a foreign nongrantor trust consists only of "(1) gross income which is derived from sources within the United States and which is not effectively connected with the conduct of a trade or business within the United States, and (2) gross income which is effectively connected with the conduct of a trade or business within the United States."⁷¹

Gross income from sources within the United States includes:

1. interest from the U.S. (or any of its agencies), the District of Columbia, from noncorporate residents of the United States and from domestic corporations;⁷²
2. dividends from domestic corporations;⁷³
3. rentals and royalties from property located in the United States including rentals or royalties for the use in the United States of patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and the like;⁷⁴ and
4. gains from the disposition of U.S. real estate.⁷⁵

69. *Id.* §§ 642, 643, 651, 661 (1994, Supp. II 1996 & West Supp. 1998).

70. *See id.* § 641(b) (West Supp. 1998). I.R.C. § 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 thirty percent tax on her net capital gains allocable to sources within the United States. *Id.* § 871(a)(2) (1994). Under I.R.C. § 865(a) income from the sale of personal property is generally sourced according to the residence of the seller. *Id.* § 865(a). But, under I.R.C. § 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. *Id.* § 865(e)(2)(A). Prior to the 1997 Act, it was unclear whether a trust that was a foreign trust within the meaning of new I.R.C. § 7701(a)(31) (Supp. II 1996) 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* Eileen Caulfield Schwab & Dyke M. Davies, *Tax Risks When U.S. Fiduciary Acts as Trustee of Foreign Trust*, N.Y.L.J., Jan. 7, 1997, at 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. I.R.C. § 641(b) (West Supp. 1998).

71. *Id.* § 872(a) (1994).

72. *See id.* § 861(a)(1).

73. *See id.* § 861(a)(2).

74. *See id.* § 861(a)(4).

75. *See id.* § 861(a)(5).

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 that is effectively connected with the conduct of a trade or business within the United States.⁷⁶ 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.⁷⁷

(2) Election With Respect to Income From Real Property

In addition, a foreign nongrantor trust that receives income from real property located in the United States may make an election to treat all such income as income effectively connected with a U.S. trade or business if the property is held for the production of income.⁷⁸ In the absence of such an election, income would be taxed on the basis of gross receipts unreduced by any deductions.⁷⁹

(3) Disposition of U.S. 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.⁸⁰ 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

76. See *id.* § 871(b) (West Supp. 1998).

77. See *id.* § 871(c) (1994).

78. See *id.* § 871(d)(1).

79. See *id.* § 871 (b)(1).

80. *Id.* § 897(a).

corporation within the period described in section 897(c)(1)(A)(ii).⁸¹

Also, 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.⁸²

A U.S. real property holding corporation is any corporation unless the value of its U.S. real property interests is less than fifty percent 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.⁸³

A foreign nongrantor trust's receipt of consideration for the disposition of a partnership interest in a partnership that holds any U.S. real property interests is treated as consideration received for the disposition of a U.S. real property interest to the extent attributable to U.S. real property interests.⁸⁴

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.⁸⁵ They are also taxed on their U.S. source gains from certain timber, coal, and iron ore transactions,⁸⁶ 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 that are contingent on the use of the transferred interest,⁸⁷ and, subject to the important exceptions described below, on their original issue discount from U.S. sources.⁸⁸ 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.⁸⁹ For convenience, this Article refers to them as "fixed or determinable annual or periodic income."

81. Treas. Reg. §1.897-1(c)(1); see I.R.C. §897(c)(1) (1994).

82. I.R.C. § 897(c)(6) (1994).

83. See *id.* § 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 five percent of a given stock. See *id.* § 897(c)(3).

84. See *id.* § 897(g); I.R.S. Notice 88-72, 1988-2 C.B. 383.

85. See I.R.C. § 871(a)(1)(A) (1994).

86. See *id.* § 871(a)(1)(B).

87. See *id.* § 871(a)(1)(D).

88. See *id.* § 871(a)(1)(C).

89. See *id.* § 871(a)(2).

c. Other Gains

Nonresident aliens who are present within the United States for more than 183 days in a particular taxable year are normally subject to tax on gains derived from sources within the United States from the sale of capital assets.⁹⁰ As discussed above, Code § 641(b) prevents this rule from applying to foreign nongrantor trusts.⁹¹ 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 United States at any time.⁹² Thus, even though the trustees of a foreign nongrantor trust reside permanently in the United States, the trust will be treated for U.S. income tax purposes as if the trustees had never been present in the United States.

2. Exceptions

However, there are several 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.⁹³ Portfolio interest is interest (including original issue discount) that is paid on certain obligations of U.S. persons issued after July 18, 1984.⁹⁴
- 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.⁹⁵
- 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.⁹⁶

90. See *id.* Income from the sale of personal property (other than inventory property) attributable to an office or other fixed place of business in the United States that is maintained by a nonresident in the United States is sourced in the United States. See *id.* § 865(e)(2).

91. I.R.C. § 641(b) (West Supp.1998).

92. See *id.*

93. *Id.* § 871(h) (1994).

94. See *id.*

95. See *id.* § 871(i).

96. See *id.* §§ 871(a)(1)(C), 871(g)(1).

D. Deductions and Credits

1. Income Effectively Connected With a 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 United States, 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.⁹⁷ The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treasury Regulation § 1.873-1.⁹⁸ In addition, the trust is also entitled to deduct from its effectively connected income the following:

- a. the deduction for losses allowed by Code § 165(c)(3) if the loss occurred with respect to property located in the United States;
- b. the deduction for charitable contributions allowed by Code § 170; and
- c. the deduction for personal exemptions allowed by Code § 151.⁹⁹

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 United States are connected with such income and, 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.¹⁰⁰

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.¹⁰¹

97. See *id.* § 873(a).

98. Treas. Reg. § 1.873-1 (1960).

99. See I.R.C. § 873(b) (1994).

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

101. See I.R.C. § 837 (1994).

3. Foreign Tax Credit

A foreign nongrantor trust engaged in a trade or business within the United States (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.¹⁰² Alternatively, it may deduct such taxes.¹⁰³

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;¹⁰⁴
- b. may not be used against any income tax imposed on income not effectively connected with such business;¹⁰⁵ and
- c. is not allowed to the extent it is properly allocable under Code § 901(b)(5) to the trust's beneficiaries.¹⁰⁶

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 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.

102. See *id.* §§ 901(b)(4), 906(a).

103. See *id.* § 164(a)(3). If the trust claims the credit, the deduction is not permitted. See *id.* § 275(a)(4).

104. See *id.* § 906(a).

105. See *id.* § 906(b)(3).

106. See *id.* § 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).¹⁰⁷

2. Other Income

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 thirty percent.¹⁰⁸

F. Withholding

1. Income Effectively Connected With a 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.¹⁰⁹

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.¹¹⁰ The withholding rate applicable to foreign nongrantor trusts that are partners in such partnerships is the highest rate of tax specified in Code § 1.¹¹¹

107. See *id.* § 871(b)(1) (West Supp. 1998).

108. See *id.* § 871(a) (1994).

109. See generally *id.* §§ 1441-46 (1994, Supp. II 1996 & West Supp. 1998).

110. See *id.* § 1446(a) (1994). Such a partnership is required to file Form 8804 and to send Form 8805 to each such foreign partner. See Instructions, I.R.S. Forms 8804, 8805, 8813, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

111. See I.R.C. § 1446(b) (1994).

c. U.S. Real Property Interests

The transferee of a disposition by a foreign person of a U.S. real property interest is required to withhold.¹¹² The withholding rate is ten percent of the amount realized.¹¹³

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 thirty percent tax to the extent such income constitutes gross income from U.S. sources of any nonresident alien individual or of any foreign partnership¹¹⁴ unless such income is effectively connected with the conduct of a U.S. trade or business.¹¹⁵ The income items listed in Code § 1441(b) are the various kinds of fixed or determinable annual or periodic income.¹¹⁶ Code § 1442 imposes a similar requirement with respect to the income of foreign corporations.¹¹⁷ 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 § 1441.¹¹⁸ As discussed above, however, a foreign trust does not necessarily have nonresident alien trustees.¹¹⁹ 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 United States has an income tax treaty. For example, most income tax treaties to which the United States is a party

112. See *id.* § 1445(a) (West Supp. 1998).

113. See *id.* The transferee is required to file Form 8288 and to furnish Form 8288-A to the transferee. See I.R.S. Forms 8288, 8288A, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

114. The person withholding is required to file Form 1042 and to furnish Form 1042-S to the person from whom tax is withheld. See I.R.S. Forms 1042, 1042-S, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

115. See I.R.C. § 1441(c)(1) (1994).

116. *Id.* § 1441(b).

117. *Id.* § 1442(a).

118. See Treas. Reg. § 1.1441-3(f) (as amended 1995). See also Priv. Ltr. Rul. 6306214990A (June 21, 1963).

119. See *supra* note 9 and accompanying text.

reduce the tax imposed on dividends not effectively connected to a U.S. trade or business from thirty percent to fifteen percent.¹²⁰

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.¹²¹

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 United States during such year even if no income was derived from such trade; or
- b. the business or trust had income in such year that is subject to tax in the United States unless the trust's liability for such tax is fully satisfied by withholding.¹²²

If a foreign nongrantor trust is required to file Form 1040NR for a particular year, the return must be filed by the fifteenth day of the sixth month following the close of the year if the trust does not have an office or place of business in the United States.¹²³ If the trust does have an office or place of business in the United States, its Form 1040NR must be filed by the fifteenth day of the fourth month following the close of the year.¹²⁴

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 \$10,000.¹²⁵ A person has a financial interest in any such

120. See, e.g., Income Tax Treaty Between the United Kingdom and the United States (Article 10).

121. See I.R.C. §§ 6654(a) and 6654(f) (1994); I.R.S. Notice 87-32, 1987-1 C.B. 477 (particularly Q-13 at 480).

122. See Treas. Reg. § 1.6012-1(b)(1)(i) (as amended 1986).

123. See Treas. Reg. § 1.6072-1(c) (as amended 1980).

124. See *id.* § 1.6072-1(a); T.D. 7426, 1976-2 C.B. 394.

125. See 1297 I.R.S. Form TD F 90-22.1, available at <<http://www.irs>.

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 fifty percent of the corporation or partnership, the trustee will be treated as 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.¹²⁶

J. Taxpayer Identification Numbers

Code § 6109 requires persons to obtain a U.S. identifying number to the extent required by regulations.¹²⁷ Treasury Regulation § 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;
2. it has a U.S. office or place of business; 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; or an exemption from withholding from income that is effectively connected with a U.S. trade or business.¹²⁸

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

A. In General

Taxpayers who are beneficiaries of foreign nongrantor trusts may be subject to U.S. income taxes on distributions of cash or

ustreas.gov> (visited Mar. 29, 1999).

126. See 1297 Form TD F 90-22.1 and Instructions, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

127. I.R.C. § 6109(a) (1994).

128. Treas. Reg. §301.6109-1(b)(2) (as amended 1998). Other than for dividends and interest from stocks and debt that are actively traded and certain other securities. See *id.* § 1.1441-6(b)(2)(ii) (as amended 1997).

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 with respect to distributions and loans depends on a number of factors, including: (1) 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; (2) 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 (3) whether the trust previously paid U.S. income tax or foreign income tax.

Beneficiaries of foreign trusts may also be subject to tax on income earned by certain corporations whose shares are owned by the trust. The types of corporations that are the source of such potential liability are controlled foreign corporations, foreign personal holding companies and passive foreign investment companies. This subject is discussed more fully 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;¹²⁹
- (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;¹³⁰ and
- (3) any other amount required to be distributed to her (whether or not actually distributed to her) or properly

129. I.R.C. § 651(a) (1994). 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. *See id.*

130. *See id.* § 662(a)(1). The term "complex trust" refers to a nongrantor trust other than a simple trust.

and actually distributed to her from a foreign complex trust in a such year to the extent of her share of the trust's DNI for such year.¹³¹

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.¹³² The same rule applies to income distributions from complex trusts.¹³³

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.¹³⁴

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. The 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.

c. The 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.¹³⁵ To avoid confusion, this Article refers to "income" as "trust accounting income." The term "income" or "trust accounting

131. See *id.* § 662(a)(2).

132. See *id.* § 652(a).

133. See *id.* § 662(a)(1).

134. See *id.* § 662(a)(2).

135. See I.R.C. § 643(b).

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.¹³⁶

d. Sixty-Five Day Election

At the trustee’s election, an amount that is properly paid to a beneficiary within sixty-five days after the end of a taxable year will be treated as having been paid to her within such taxable year.¹³⁷

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.¹³⁸ This exception does not apply to amounts that can be paid only from trust income.¹³⁹

Example: Pat is a U.S. beneficiary of a foreign nongrantor trust. The terms of the trust document require the trustees of the FNT to pay Pat \$1,000,000 on his 30th birthday. Pat reached age 30 during 1997, a year in which the FNT’s income and DNI exceeded \$1,000,000. The 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 the 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

136. See Treas. Reg. § 1.643(b)-1 (1960).

137. See I.R.C. § 663(b) (West Supp. 1998).

138. See *id.* § 663(a)(1) (1994).

139. See *id.*

accounting income or other fixed amount) 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.¹⁴⁰ If the trustee makes such an election, the amount of the distribution will be the fair market value of the property.¹⁴¹ The trust will recognize gain equal to the excess of the value of the property over its basis.¹⁴² If the trustee does not make the election, the beneficiary's basis will be the same as the trust's basis.¹⁴³

Example: Jenny is a U.S. beneficiary of a foreign nongrantor trust. During 1997, the trustees of the 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. The 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.

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:

- (1) 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
- (2) 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."¹⁴⁴

The DNI of a foreign nongrantor trust includes its capital gains.¹⁴⁵ 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

140. See *id.* § 643(e).

141. See *id.* § 643(e)(3)(A)(iii).

142. See *id.* § 643(e)(3)(A)(ii).

143. See *id.* § 643(e)(1).

144. *Id.* § 643(a)(3)(A); see *id.* §§ 643(a)(6)(A)-(C).

145. See *id.* § 643(a)(6)(C).

income in the absence of Code § 265¹⁴⁶ and the amount that was excluded from its gross income by treaty under Code § 894.¹⁴⁷

Example: John is a U.S. beneficiary of a foreign nongrantor trust. 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 the 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.

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.¹⁴⁸

Example: John, the U.S. taxpayer in the above example, who received a \$15,000 distribution from the 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.¹⁴⁹

Example: The terms of the FNT, the foreign nongrantor trust described in the example above, required that all of the 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

146. See *id.* § 643(a)(6)(A).

147. See *id.* § 643(a)(6)(B).

148. See *id.* §§ 652(b), 662(b).

149. See *id.*; Treas. Reg. §1.652(b)-2 (1992); Treas. Reg. §662(b)-1 (as amended 1973).

under Code § 1441 or Code § 1445.¹⁵⁰ 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 receives but also the amount of the withheld tax.¹⁵¹ She may then credit the withheld tax against her personal income tax liability.¹⁵²

Example: The FNT 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. The 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.¹⁵³ 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.¹⁵⁴

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 either a credit for the share of foreign taxes attributable to their share of the income or a deduction.¹⁵⁵ The credit is subject to the limits described above.¹⁵⁶

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 if she elects to take the credit. The Service's internal position

150. See *supra* notes 109-19 and accompanying text.

151. See Treas. Reg. § 1.1441-3(f) (as amended 1995); *id.* § 1.1462-1(b) (as amended 1984); Rev. Rul. 56-30, 1956-1 C.B. 646; Rev. Rul. 55-414, 1955-1 C.B. 385.

152. See Treas. Reg. §§ 1.1441-3(f), 1.1462-1(b).

153. See I.R.C. §§ 164(a)(3), 901(a) (1994). An election to take the credit precludes the deduction. See *id.* § 275(a)(4).

154. See *id.* § 904(a).

155. See *id.* § 901(b)(5) (Supp. II 1996).

156. See *id.* § 901(b) (1994).

seems to require such inclusion.¹⁵⁷ 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.¹⁵⁸

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.

157. See *"Foreign Trusts and the IRS" Training Manual (Part 1)*, TAX NOTES TODAY, Aug. 4, 1998, (Doc. 98-23906), available in WESTLAW, 98 TNT 149-20.

158. *Id.* at paras. 107-09. 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 Howard M. Zaritsky, [Est., Gifts & Tr. Portfolios] Tax Mgmt. (BNA), No. 854, at A-32 (May 11, 1998).

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."¹⁵⁹ An accumulation distribution is a distribution under Code § 661(a)(2)¹⁶⁰ 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.¹⁶¹

The following two important exceptions to this definition may be applicable to distributions from foreign nongrantor trusts: specific gifts and distributions not in excess of trust accounting income.

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.¹⁶²

Example: The FNT 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 by stating: "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."¹⁶³

159. See I.R.C. §§ 665, 666, 668 (1994 & West Supp. 1998).

160. *Id.* § 661(a)(2) (1994) (dealing with amounts properly paid or credited or required to be distributed other than trust accounting income required to be distributed currently).

161. See *id.* § 665(b).

162. See Treas. Reg. § 1.665(b)-3 (as amended 1980).

163. I.R.C. § 665(b) (1994). The word "income" in this quotation refers to "trust accounting income."

This principal is illustrated by the following example:

Isaac is a U.S. beneficiary of 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 1997, the 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 the distribution and the trust to enable the beneficiary to determine whether or not she has received an accumulation distribution. Notice 97-34¹⁶⁴ and the current version of Internal Revenue Service Form 3520 (1998) gives the beneficiary a so-called "default" method of making this determination.¹⁶⁵ A beneficiary is required to use this method if the trust did not provide her with a Foreign Nongrantor Trust Beneficiary Statement.¹⁶⁶ The information that must be furnished in a Foreign Grantor Trust Beneficiary Statement is described below.

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

164. I.R.S. Notice 97-34, 1997-1 C.B. 422.

165. Schedule A, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

166. See *id.* at Line 36. Presumably the Service's authority for enforcing this requirement is found in I.R.C. § 6048(c)(2)(A), which provides, "[i]f 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 distributee under chapter 1." I.R.C. § 6048(c)(2)(A) (Supp. II 1996).

been in existence (other than those years in which it was treated as a grantor trust).¹⁶⁷

The amount treated as a distribution of current income will be the smaller of the actual distribution or the amount determined in Step 3.¹⁶⁸ The balance of the distribution will be treated as an accumulation distribution.¹⁶⁹ If the default method is used, the number of years used for purposes of calculating the interest charge under Code § 668, as discussed below, will be one-half of the number of years the trust has been in existence.¹⁷⁰

Example: Andrew is the beneficiary of a foreign nongrantor trust that has been in existence for ten years. At the end of 1997, the FNT had assets worth \$20,000,000. In each of the ten years 1988 through 1997, the FNT has earned \$1,000,000. Assume the FNT has no income in 1998, 1999, 2000, and 2001 and that the 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 as shown below.

In 1998, the accumulation distribution is the full \$2,000,000 because there were no distributions in any of the prior three years.

In 1999, the amount of the accumulation distribution is reduced to \$1,166,667 ($\$2,000,000 - (\$2,000,000 \times 1.25/3)$). In 2000, the amount of the accumulation distribution is reduced to \$333,333 ($\$2,000,000 - (\$4,000,000 \times 1.25/3)$).

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

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.¹⁷¹

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

167. See Schedule A, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

168. See *id.* at Line 42.

169. See *id.* at Line 43.

170. See I.R.C. § 6048(c)(2)(B) (Supp. II 1996).

171. See *infra* Appendices B1-B2.

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.¹⁷²

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.¹⁷³ 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.¹⁷⁴ 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 § 666.¹⁷⁵ A distribution paid or used for charitable purposes within the meaning of Code § 642(c) is not treated as an accumulation distribution.¹⁷⁶ 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,

172. See I.R.C. § 665(a) (1994).

173. See I.R.C. § 665(d) (1994 & Supp. II 1996).

174. See I.R.C. § 665(d)(2) (Supp. II 1996).

175. See Treas. Reg. § 1.665(a)-1(c) (1969).

176. See *id.*

require her to assume that the trust's UNI is at least equal to the amount of the accumulation distribution.¹⁷⁷

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.

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.¹⁷⁸ 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.¹⁷⁹ The process continues in the same manner until all of the accumulation distribution has been allocated to a preceding year.¹⁸⁰ 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.¹⁸¹

Example: Michael is a U.S. beneficiary of a foreign nongrantor trust. The FNT was created in 1990 by Michael's non-U.S. mother. The FNT distributed \$100,000 to Michael in 1997, a year in which the FNT's DNI and trust accounting income was \$20,000. Therefore, \$80,000 of the distribution is treated as an accumulation distribution. The FNT's DNI, none of which was distributed, in each of its preceding years was as follows:

- \$4,000
- \$20,000

177. See Instructions for Schedule A, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

178. See I.R.C. § 666(a) (1994). 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. See *id.* § 666(d).

179. See *id.* § 666(a).

180. See *id.*

181. See *id.*

- \$30,000
through 1996 - \$40,000

Michael's \$80,000 accumulation distribution is deemed to have been made as follows: \$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.¹⁸² Such taxes include U.S. income taxes and foreign income, war profits, and excess profits taxes.¹⁸³

Example: Assume that the FNT, the trust described in the preceding example, paid taxes in each of its preceding taxable years equal to forty percent 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.¹⁸⁴ For purposes of this calculation, if any year's deemed distribution is less than twenty-five percent 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.¹⁸⁵

Example: In the above example, the number of preceding taxable years in which a distribution is deemed to have

182. See *id.* § 666(b)-(c).

183. See *id.* § 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. See *id.* § 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. See *id.* §§ 667(b), 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, when added to any previous distributions for such year, it equals or exceeds \$1,000. See *id.* § 667(c)(2).

184. See *id.* § 667(b)(1)(A).

185. See *id.* § 667(b)(3).

been made will be three. The year 1990 is disregarded because the amount of the accumulation distribution allocated to that year (\$4,000) is less than twenty-five percent of the total accumulation distribution (\$80,000) divided by the number of years to which the distribution is deemed allocated (four).

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 the beneficiary's income was the highest and the year in which income was the lowest.¹⁸⁶

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 3.¹⁸⁷

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 three. 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 the beneficiary's taxable income in each of such years.¹⁸⁸ 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).¹⁸⁹ 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

186. See *id.* § 667(b)(1)(B).

187. See *id.* § 667(b)(1)(C).

188. See *id.* § 667(b)(1)(D).

189. See *id.* § 667(b)(1).

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.¹⁹⁰

Example: For the purpose of Step 6, 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.¹⁹¹

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 3.¹⁹²

Example: Michael's average tax increase, \$16,100, is multiplied by three. 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.¹⁹³ 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 accumulation distribution, it is unclear how she would calculate her throwback tax using these nine 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-

190. See *id.* § 667(d).

191. See *id.* § 667(b)(1)(D).

192. See *id.* § 667(b)(1).

193. See *id.*

half the total number of years the trust has been in 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 § 668.¹⁹⁴

b. Before the 1996 Act

Before the 1996 Act, the throwback tax imposed on distributions from foreign trusts was subject to a six percent simple interest charge.¹⁹⁵ 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.¹⁹⁶ 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.¹⁹⁷ 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

As amended by the 1996 Act, Code § 668 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,

194. See *id.* §§ 667(a)(3), 668 (1994 & Supp. II 1996).

195. See *id.* § 668(a) (1994).

196. See *id.*

197. See *id.* § 668(b).

currently eight percent.¹⁹⁸ In addition, interest will be compounded daily and will be calculated over a specially calculated number of years, rather than with reference to the length of time between the year of the earliest undistributed accumulations and the year of distribution.¹⁹⁹ 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).²⁰⁰

Step 2: All products calculated in the first step must be added together.²⁰¹

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.²⁰²

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.²⁰³ 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:

FNT, a foreign trust, accumulated income of \$100,000 in 1996 and \$50,000 in 1997. On January 1, 2000, the 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

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

199. See I.R.C. § 668(a) (Supp. II 1996).

200. See *id.* § 668(a)(3)(B); Line 52 Instructions, I.R.S. Form 3520, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

201. See I.R.C. § 668(a)(3)(A)(i); Line 52 Instructions, I.R.S. Form 3520, available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

202. See I.R.C. § 668(a)(3)(A); Line 53 Instructions, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

203. See I.R.C. § 668(a)(4) (Supp. II 1996).

Step 2: $400,000 + 150,000 = 550,000$

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 floating interest rate was nine percent in 1996, in 1997, and in 1998 until April 1, 1998, when it dropped to eight percent.

Total interest, if the Code § 6621 rate remains eight percent through 1999, will be \$3,913. This is calculated using the following formula:

$$(\$10,000 \times (1 + (.09/365))^{(1.75 \times 365)}) - 10,000 = \$1,706$$

\$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:

$$X (1 + (.08/365))^{(1.75 \times 365)} - \$1,706 = \$1,759$$

The total interest charge on the \$10,000 income tax will be \$1,706 plus \$1,759 or \$3,465.²⁰⁴

For purposes of future 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.²⁰⁵

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 six percent.²⁰⁶ The interest will not be compounded except as to that portion of the interest calculation period after 1995.²⁰⁷

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.²⁰⁸

204. The instructions to Internal Revenue Service Form 3520 (1998) contain a chart that can be used as a simpler method of calculating the interest charge. See Table B, Schedule C Instructions, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999).

205. See I.R.C. § 668(b) (1994).

206. See *id.* § 668(a)(6) (Supp. II 1996).

207. See *id.*

208. See Line 44, I.R.S. Form 3520 (1998), available at <<http://www.irs.ustreas.gov>> (visited Mar. 29, 1999). A similar rule exists under

e. Observation

The application of the new default interest rule can be draconian. If, for example, the interest rate on underpayments is nine percent and if the U.S. beneficiary's tax rate is forty percent, the entire amount of the distribution from a trust that has been in existence for twenty or more years will be consumed by taxes and interest.²⁰⁹ 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 Article. 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 twenty year period and then distributed currently over the next twenty years.

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 the regulations, a foreign trust's loans of cash (including foreign currencies and cash equivalents)

I.R.C. § 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. See I.R.C. § 666(d) (1994). Presumably, the new rule in I.R.C. § 6048(c)(2)(B) supersedes I.R.C. § 666(d) (1994) for foreign trusts. I.R.C. § 6048(c)(2)(B) (Supp. II 1996).

209. A twenty year trust requires that interest be calculated over a ten 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 ten year period will be approximately \$60.

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.²¹⁰ 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).²¹¹

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.²¹² 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 the Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.²¹³ Although such regulations have yet to be issued, the Service signaled its thinking on this subject in Notice 97-34.²¹⁴ 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."²¹⁵ 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 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

210. See I.R.C. § 643(i)(1) (Supp. II 1996). 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 a distribution. See H.R. 981 § 207.

211. See I.R.C. § 643 (i)(2)(B)(i) (Supp. II 1996).

212. See *id.* § 643(i)(1). A person is related to a grantor or beneficiary if their relationship would result, under I.R.C. § 267, in a disallowance of losses for transactions between them. See *id.* § 643(i)(2)(B)(i). For this purpose, I.R.C. § 267(c)(4) is to be applied as if the family of an individual includes the spouses of her family members. See *id.*

213. See, e.g., H.R. REP. NO. 104-737, at 334 (1996) (stating, for example, that the Treasury is expected to provide an exception for loans with arms'-length terms).

214. I.R.S. Notice 97-34, 1997-1 C.B. 422.

215. *Id.* at 424.

- obligation is issued, as published in the Internal Revenue Bulletin);
- (v) The U.S. transferor extends the period for assessment of any income 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 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. transferor reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding.²¹⁶

2. Repayment of Loans

When a loan that 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."²¹⁷ 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."²¹⁸

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."

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

216. *Id.*

217. I.R.C. § 643(i)(3) (Supp. II 1996).

218. *Id.*

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.²¹⁹ The new rule does not seem to change this result. Thus, if a foreign trust lends marketable securities with a basis of ten and a fair market value of one-hundred to a U.S. beneficiary, the amount treated as a distribution under Code § 643(i) would be ten, not one-hundred, 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 received was derived directly or indirectly from a foreign trust.²²⁰ This provision does not apply if the person from whom the property was received 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 that intended to prevent the use of intermediaries as a means of circumventing the general rules which tax U.S. persons on distributions from foreign trusts created by U.S. 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.²²¹

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.²²² 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

219. I.R.C. § 643(e)(2) (1994).

220. *Id.* § 643(h) (Supp. II 1996).

221. *Id.* § 665(c) (West 1988) (amended in 1997).

222. *See* Treas. Reg. § 1.665(c)-1A (1972).

the part of the parties to circumvent the purposes for which section 7 of the Revenue Act of 1962 was enacted."²²³

New Code § 643(h) extends the scope of the old rule to include: (1) to amounts derived from trusts created by non-U.S. 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) payments received from U.S. persons. It provides 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.²²⁴

The expansion of the rule to trusts created by non-U.S. persons was presumably necessary to prevent what would otherwise have been a means of circumventing other provisions of the 1996 Act that enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts that are not taxed as grantor trusts under Code § 679 or otherwise.²²⁵

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

The Treasury has issued proposed regulations under Code § 643(h).²²⁶ 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.²²⁷ It then states 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."²²⁸

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

223. Treas. Reg. § 1.665(c)-1A(b) (citation omitted).

224. I.R.C. § 643 (h) (Supp. II 1996).

225. See *id.* § 668.

226. Prop. Treas. Reg. § 1.643(h)-1, 62 Fed. Reg. 30785 (1997).

227. See *id.* §§ 1.643(h)-1(a)(1), 1.643(h)-1(a)(2), 62 Fed. Reg. at 30790.

228. *Id.* § 1.643(h)-1(a)(3), 64 Fed. Reg. at 30790.

- (1) the intermediary is related (as defined in the regulations)²²⁹ to either the U. S. person or the foreign trust and the intermediary transfers to the U. S. person either property that the intermediary received from the trust or proceeds from the property that the intermediary received from the foreign trust;
- (2) the intermediary would not have transferred the property to the U. S. person (or would not have transferred the property on substantially the same terms) but for the fact that the intermediary received property from the foreign trust.²³⁰

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 U.S. person."²³¹ 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 she is the grantor.²³²

*F. Treatment of Income of Controlled Foreign Corporations,
Foreign Personal Holding Companies, and
Passive Foreign Investment Companies*

1. In General

The U.S. beneficiaries of a foreign nongrantor trust may be subject to tax on income earned by controlled foreign corporations (CFCs), foreign personal holding companies (FPHCs), and passive foreign investment companies (PFICs) whose shares are held by the trust.²³³ The CFC, FPHC, and PFIC rules, also

229. See *id.* § 1.643(h)-1(a)(1), 64 Fed. Reg. at 30790. The proposed regulations expand the concept of "related" beyond the normal rules of section 643(i)(2)(B) by generally substituting a ten percent entity interest rule for the normal fifty percent rule and by extending the relationship rules that apply between trusts and beneficiaries to estates and beneficiaries. See *id.* at § 1.643(h)-1(e), 64 Fed. Reg. at 30790. The latter extension is no longer necessary since section 1308(a) of the Taxpayer Relief Act of 1997 accomplishes this by an amendment to I.R.C. § 267, one of the sections on which section 643(i)(2)(b) is based. I.R.C. § 267 (West Supp. 1998).

230. See Prop. Treas. Reg. §§ 1.643(h)-1(a)(1), 1.643(h)(1)(a)(2), 64 Fed. Reg. at 30790.

231. *Id.* § 1.643(h)-1(c)(2)(ii), 64 Fed. Reg. at 30790; see *id.* § 1.643(h)-1(c)(1), 64 Fed. Reg. at 30790.

232. See *id.* § 1.643(h)-1(b), 64 Fed. Reg. at 30790.

233. See I.R.C. §§ 951(a), 951(d), 951(f) (West Supp. 1998).

called the "anti-deferral regimes," eliminate the deferral of U.S. income tax that generally exists for U.S. shareholders of domestic corporations (i.e., shareholders are not subject to income tax on corporate income until dividends are paid to them).²³⁴ These anti-deferral regimes require that certain types of passive income of CFCs, FPHCs, or PFICs be taxed to their U.S. shareholders currently, whether or not distributions are made to them.

2. The Anti-Deferral Regimes

a. Controlled Foreign Corporations

A foreign corporation is a CFC if over fifty percent (by vote or value) of its stock is owned directly or indirectly by U.S. persons who own (outright or by attribution) ten percent or more of the total combined voting power of all classes of stock entitled to vote.²³⁵ For this purpose, a person is a U.S. person if he, she, or it is a citizen or resident of the U.S., a domestic partnership, a domestic corporation, or any estate or trust other than a foreign estate or trust.²³⁶

A U.S. person who owns directly or through a foreign entity shares of a foreign corporation that is a CFC must include in gross income for each year her or its pro rata share of the CFC's "Subpart F" income earned by the CFC.²³⁷ A shareholder's pro rata share of Subpart F income is that amount which would have been distributed with respect to the stock that such shareholder directly or indirectly (but not constructively) owns if, on the last day of the taxable year, the CFC had distributed all of its Subpart F income pro rata to its shareholders.²³⁸ Subpart F income includes insurance income, foreign base company income, international boycott income, and foreign bribe-produced income.²³⁹

234. See generally *id.* § 301.

235. See *id.* § 957(a) (1994) (defining controlled foreign corporation); I.R.C. § 951(b) (1994) (defining U.S. shareholder).

236. See *id.* § 957(c) (referencing I.R.C. § 7701(a)(30)).

237. See *id.* § 951(a) (West Supp. 1998).

238. See *id.* § 951(a)(2).

239. See I.R.C. § 952(a) (1994). Generally, foreign base company income includes, among other things, dividends, interest, royalties, rents, annuities, gains from the sale or exchange of certain types of property, gains from commodities, foreign currency gains, profits from the certain purchases and sales of certain types of personal property, and income from the performance of certain services for or on behalf of a related person outside the CFC's country of incorporation. See *id.* § 954(a).

b. Foreign Personal Holding Companies

A foreign corporation is an FPHC if: (1) at least sixty percent of its gross income for the taxable year is foreign personal holding company income (FPHCI); and (2) at any time during the taxable year more than fifty percent (by vote or value) of its stock is owned directly or indirectly by or for not more than five individuals who are citizens or residents of the U.S.²⁴⁰ FPHCI is that portion of the corporation's gross income which includes dividends, interest, royalties, annuities, gains from the sale or exchange of stock or securities, personal service income from services performed by a shareholder, and rents (unless rents constitute fifty percent or more of the gross income).²⁴¹

If a foreign corporation is an FPHC, each U.S. person who owns, directly or through an entity, shares of it must include in her gross income, as a dividend, the amount she would have received as a dividend if, on the last day of the taxable year, the FPHC distributed all of its undistributed income for the taxable year.²⁴² Note that the CFC rules take precedence over the FPHC rules; that is, if a shareholder could be taxed under either set of provisions, they will be taxed under the CFC rules.²⁴³

c. Passive Foreign Investment Companies

A U.S. shareholder who is not subject to current tax under the CFC or FPHC regimes may still be subject to the PFIC regime. A foreign corporation is a PFIC if: (1) seventy-five percent or more of its gross income for the taxable year is passive income; or (2) the average percentage of assets (by value) held by the corporation for the production of income is at least fifty percent.²⁴⁴ Passive income generally means income that would be FPHCI under Subpart F.²⁴⁵ Generally, a U.S. person who owns any interest in a PFIC will be subject to ordinary income tax on gain from disposing of PFIC stock and will be subject to an interest charge on the income tax imposed on such gain and on distributions from the PFIC.²⁴⁶ For purposes of this provision, a disposition of shares in a PFIC by a foreign nongrantor trust may be treated as a disposition of PFIC stock by the trust's U.S. beneficiaries. The specific tax

240. See *id.* § 552(a). The minimum FPHCI is fifty percent of gross income after the first taxable year for which the corporation is a FPHC. See *id.*

241. See *id.* § 553(a).

242. See *id.* § 551(b).

243. See *id.* § 951(d).

244. See *id.* § 1297(a) (West Supp. 1998).

245. See *id.* § 1297(b).

246. See *id.* § 1291.

consequences to a U.S. shareholder depends on whether she makes a "qualified electing fund" election.²⁴⁷

3. The Attribution Rules

The CFC and FPHC regimes discussed above contain constructive ownership rules that are used to determine both whether or not a foreign corporation is a CFC or an FPHC and the extent to which U.S. persons will be taxed on its income.²⁴⁸ These rules provide that stock in a foreign corporation owned by a foreign nongrantor trust will be considered as being owned proportionately by its beneficiaries for purposes of determining whether the corporation is a CFC or an FPHC.²⁴⁹ When the beneficiaries of a foreign nongrantor trust have fixed interests in the trust, applying the constructive ownership rules is simple.

Example: A foreign nongrantor trust established in 1998 has three beneficiaries, Michael, Isaac, and Tyler. Each beneficiary is entitled to one-third of the FNT's income each year. At the end of the FNT's ten-year term, the trust fund will be distributed equally among the three beneficiaries. Michael and Tyler are U.S. persons; Isaac is not. The FNT holds 100% of the stock of a foreign corporation (FC). In 1998, eighty percent of the FC's gross income is FPHCI. Under the attribution rules discussed above, Michael, Isaac, and Tyler will each be considered as owning 33 1/3% of the shares of FC. As a result, in 1998 the FC will be classified as a CFC and an FPHC. The FC will also be a PFIC because of its percentage of passive income. Michael and Tyler, however, will be taxed only under the CFC regime, which takes precedence over the other two.

Applying the attribution rules in the context of a foreign nongrantor trust becomes more difficult when the trust is a discretionary trust. The trustees of such a trust have complete discretion to distribute income and/or principal among the beneficiaries. The beneficiaries do not have fixed interests in the trusts that can be easily calculated. Generally, the determination of a beneficiary's proportionate interest in a foreign trust for

247. *Id.* §§ 1293-1295 (1994 & West Supp. 1998). See I.R.C. § 1293 (West Supp. 1998), for details of the current taxation of income from qualified electing funds. See I.R.C. § 1294 (1994), for a description of the election to extend time for payment of tax on undistributed earnings. See I.R.C. § 1295 (1994), for a definition of the qualified electing fund.

248. See *id.* § 958 (1994 & Supp. 1996).

249. *Id.* § 958(a)(2) (1994) (CFC attribution rules); *id.* § 554(a)(1) (foreign personal holding company attribution rules). The PFIC regime contains constructive ownership rules that apply to determine the extent to which U.S. persons will be treated as owning its stock. See, e.g., *id.* § 1298(a)(3) (stating that "[s]tock owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries.").

purposes of the anti-deferral regimes is required to be made on the basis of the facts and circumstances of each case.²⁵⁰

In Private Letter Ruling 90-24-076 (March 21, 1990), the Service offered several relevant facts and circumstances to be considered in determining the actuarial interest of a beneficiary in a discretionary trust for purposes of section 544 (concerning personal holding companies).²⁵¹ These facts include: (1) the pattern of past distributions; (2) appropriate mortality assumptions; (3) the trustee's fiduciary duties; and (4) the relationships among the trustees and beneficiaries.²⁵² According to the Service, if it is possible to discern a pattern of past distributions, each beneficiary receiving distributions under such pattern will be deemed to own an income interest in the trust in the same proportion that the amount of distributions she receives bears to the total amount of the distribution.²⁵³ Each beneficiary's income interest can then be determined on an actuarial basis with reference to the mortality tables as if the trustees were required to distribute the income to such beneficiary over the remainder of her life.²⁵⁴

G. 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.²⁵⁵ 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
- c. any other information Treasury requires.²⁵⁶

The obligation to report a distribution applies even if the trust is treated as owned by another person under the grantor trust rules.²⁵⁷

250. See Treas. Reg. § 1.958-1(c)(2) (as amended 1983) (CFC regime); Prop. Treas. Reg. § 1.1291-1(b)(8)(i), 57 Fed. Reg. 11024 (1992) (PFIC regime).

251. Priv. Ltr. Rul. 90-24-076 (Mar. 21, 1990).

252. See *id.*

253. See *id.*

254. See *id.*

255. I.R.C. § 6048(c) (Supp. II 1996).

256. See *id.* § 6048(c)(1).

257. See *id.* § 6048(d)(1).

2. Notice 97-34

In Notice 97-34,²⁵⁸ the Service describes the additional required information. Such information is to be set forth in a Foreign Nongrantor Trust Beneficiary Statement.²⁵⁹ 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 and if so, an attached explanation of the relevant facts.
2. U.S. Beneficiary Information
 - A. Name, address, and TIN of U.S. Beneficiary;
 - 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. This information includes: 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.²⁶⁰

258. See I.R.S. Notice 97-34, 1997-1 C.B. 422.

259. See *id.* at 426.

260. See *id.* at 426-27.

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.²⁶¹ 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.²⁶²

The 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 produce testimony relating to the amounts that U.S. persons are required to include in calculating their incomes.²⁶³

V. CONCLUSION

The 1996 Act significantly altered the tax treatment of foreign trusts and their U.S. beneficiaries. For many U.S. persons, foreign trusts are now much less attractive than domestic trusts. But, for the reasons discussed above, the new foreign nongrantor trust rules should not be a complete deterrence to the use of foreign trusts. In some cases U.S. beneficiaries of foreign trusts are still better off economically than the U.S. beneficiaries of domestic trusts. United States persons who are considering foreign trusts should arm themselves with qualified tax planners before entering the foreign trust arena.

261. See I.R.C. § 6048(c)(2)(A) (Supp. II 1996).

262. See *id.* § 6048(c)(2)(B).

263. See *id.* § 6048(c)(2)(A).

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 | \$1,367,531 | \$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 | |

Appendix A - Forty Year Model (continued)

The Next Twenty Years

Foreign Trust

| Year | Income to B | Income Tax @ 20.000% | Net Income | Cumulative Present 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 | 20.00% |
| After Tax Discount Rate | 8.8000% |
| 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 |
| | \$5,402,390 | |

**Appendix B1 - Forty Year Model (continued)
Using Default Method and Gift of Specific Amount**

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 | \$1,446,415 |
| \$4,431,277 | \$487,440 | \$565,265 | \$97,458 | \$467,777 |
| \$4,353,453 | \$478,860 | \$565,265 | \$95,776 | \$469,489 |
| \$4,267,057 | \$469,377 | \$565,265 | \$93,875 | \$471,390 |
| \$4,171,180 | \$458,830 | \$565,265 | \$91,766 | \$473,499 |
| \$4,064,745 | \$447,122 | \$565,265 | \$89,424 | \$475,841 |
| \$3,946,601 | \$434,126 | \$565,265 | \$86,825 | \$478,440 |
| \$3,815,463 | \$419,701 | \$565,265 | \$83,940 | \$481,325 |
| \$3,669,898 | \$403,689 | \$565,265 | \$80,738 | \$484,527 |
| \$3,508,322 | \$385,915 | \$565,265 | \$77,183 | \$488,082 |
| \$3,328,973 | \$366,187 | \$565,265 | \$73,237 | \$492,028 |
| \$3,129,895 | \$344,288 | \$565,265 | \$68,858 | \$496,407 |
| \$2,908,918 | \$319,981 | \$565,265 | \$63,956 | \$501,269 |
| \$2,663,634 | \$293,000 | \$565,265 | \$58,600 | \$506,665 |
| \$2,391,369 | \$263,051 | \$565,265 | \$52,610 | \$512,665 |
| \$2,089,155 | \$229,807 | \$565,265 | \$45,961 | \$519,304 |
| \$1,753,697 | \$192,907 | \$565,265 | \$38,581 | \$526,684 |
| \$1,381,338 | \$151,947 | \$565,265 | \$30,389 | \$534,876 |
| \$958,020 | \$106,482 | \$565,265 | \$21,296 | \$543,969 |
| \$509,238 | \$56,016 | \$565,265 | \$11,203 | \$554,062 |
| \$- | | NPV @ | 8.80% | \$5,402,292 |

**Appendix B2 - Forty Year Model
Using Default Method and Gift of Specific Amount**

Assumptions

Property is invested to earn annual income of
Blended Tax Rate is 29.80%
After Tax Discount Rate 7.722%
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 @ 29.8% |
|-------------|--------------------|-----------------------|
| \$1,000,000 | \$110,000 | \$32,780 |
| \$1,077,220 | \$118,494 | \$35,311 |
| \$1,160,403 | \$127,644 | \$38,038 |
| \$1,250,009 | \$137,501 | \$40,975 |
| \$1,346,535 | \$148,119 | \$44,139 |
| \$1,450,514 | \$159,557 | \$47,548 |
| \$1,562,523 | \$171,878 | \$51,220 |
| \$1,683,181 | \$185,150 | \$55,175 |
| \$1,813,156 | \$199,447 | \$59,435 |
| \$1,953,168 | \$214,849 | \$64,025 |
| \$2,103,992 | \$231,439 | \$68,969 |
| \$2,266,462 | \$249,311 | \$74,295 |
| \$2,441,478 | \$268,563 | \$80,032 |
| \$2,630,009 | \$289,301 | \$86,212 |
| \$2,833,099 | \$311,641 | \$92,869 |
| \$3,051,871 | \$335,706 | \$100,040 |
| \$3,287,536 | \$361,629 | \$107,765 |
| \$3,541,400 | \$389,554 | \$116,087 |
| \$3,814,867 | \$419,685 | \$125,051 |
| \$4,109,450 | \$452,040 | \$134,708 |
| | \$4,426,782 | |

Appendix B2 - Forty Year Model (continued)
Using Default Method and Gift of Specific Amount

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 | 582,560 | \$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 @ | 7.72% | \$5,665,766 |

Domestic Trust

| Domestic Trust Fund | Income @ 11.00% | Distribution to B \$442,765 | Income Tax @ 29.8% | Net Income |
|---------------------|-----------------|-----------------------------|--------------------|-------------|
| \$4,426,782 | \$486,946 | \$1,442,765 | \$145,110 | \$1,297,655 |
| \$3,470,964 | \$381,806 | \$442,765 | \$113,778 | \$328,987 |
| \$2,410,905 | \$375,101 | \$442,765 | \$111,780 | \$330,985 |
| \$1,342,340 | \$367,657 | \$442,765 | \$109,562 | \$333,203 |
| \$267,233 | \$359,396 | \$442,765 | \$107,100 | \$335,665 |
| \$3,183,864 | \$350,225 | \$442,765 | \$104,367 | \$338,398 |
| \$2,988,605 | \$328,747 | \$442,765 | \$101,394 | \$341,431 |
| \$2,991,324 | \$340,046 | \$442,765 | \$97,966 | \$344,798 |
| \$2,874,587 | \$316,205 | \$442,765 | \$94,229 | \$348,536 |
| \$2,748,027 | \$302,283 | \$442,765 | \$90,080 | \$352,684 |
| \$2,607,548 | \$286,830 | \$442,765 | \$85,475 | \$357,289 |
| \$2,451,610 | \$269,677 | \$442,765 | \$80,364 | \$362,401 |
| \$2,278,522 | \$250,637 | \$442,765 | \$74,690 | \$368,075 |
| \$2,086,395 | \$229,503 | \$442,765 | \$68,392 | \$374,373 |
| \$1,873,133 | \$206,045 | \$442,765 | \$61,401 | \$381,363 |
| \$1,636,413 | \$180,005 | \$442,765 | \$53,642 | \$389,123 |
| \$1,373,654 | \$151,102 | \$442,765 | \$45,028 | \$397,736 |
| \$1,081,991 | \$119,019 | \$442,765 | \$35,468 | \$407,297 |
| \$758,245 | \$83,407 | \$442,765 | \$24,855 | \$417,910 |
| \$398,887 | \$43,878 | \$442,765 | \$13,076 | \$429,689 |
| \$0 | | NPV @ | 7.72% | \$4,426,782 |