U.S. Taxation of Foreign Trusts, Trusts with Non-U.S. Grantors and Their U.S. Beneficiaries*

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The Small Business Job Protection Act of 1996 (the "1996 Act")[1] made significant changes to the rules applicable to foreign trusts and trusts established by non-U.S. persons. The new rules were intended to prevent tax avoidance through the use of foreign trusts and the exploitation of the grantor trust rules. 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, expands the kinds of gifts that can be treated as indirect transfers from foreign trusts, limits the circumstances in which a non-U.S. person will be treated as the owner of a trust under the grantor trust rules and allows certain gifts to be recharacterized as taxable distributions from corporations, partnerships or trusts. Curiously, the 1996 Act encourages the creation of foreign trusts by its adoption of a set of criteria for foreignness that is both more objective than the criteria formerly used and biased in favor of foreign status.

This outline discusses how to create foreign trusts, examines their exposure and the exposure of their U.S. beneficiaries to U.S. income tax and describes the reporting requirements imposed on their creators, their beneficiaries and the trusts themselves, explains the new grantor trust rules applicable to non-U.S. persons and immigrants, and covers anti-avoidance provisions that require reporting of foreign gifts, redefines who is the grantor and recharacterizes purported gifts from "intermediaries" and from partnerships, foreign corporations and certain trusts. In addition to explaining the rules, it also considers the extent to which foreign trusts continue to be useful planning tools for U.S. persons.

I. HOW TO CREATE A FOREIGN TRUST

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

1. Before the 1996 Act

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

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

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

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

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

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

2. After the 1996 Act

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 Code § 7701(a)(30)(E) and (31)(B), a trust is a foreign trust unless both of the following conditions are satisfied: (i) a court or courts within the U.S. must be able to exercise primary supervision over administration of the trust; and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust.[5]

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

> **Example 1:** Jenny, a U.S. citizen and resident of New York, created a trust for the benefit of her children, all of whom are U.S. citizens and residents. She named the Gotham Trust Company, a New York corporation, and her brother Pat, a citizen and resident of Ireland, as co-trustees. The trust instrument gave Pat the right to determine the ages at which each of the children would receive his or her share of the trust fund. It directed that the trust funds be maintained in the U.S. in

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

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

[5] The Administration's explanation of this rule issued in connection with its original proposal offered some protection from this harsh rule by expressing an intention that the Service would allow a trust "a reasonable period of time to adjust for inadvertent changes in fiduciaries (*e.g.,* a U.S. trustee dies or abruptly resigns when a trust has two U.S. fiduciaries and one foreign fiduciary)." Treasury Department, "General Explanations of the Administration's Revenue Proposals" 25 (February 7, 1995). The Joint Committee Explanation offers similar comfort. Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 274. The Administration's intention is reflected in Treas. Reg. § 301.7701-7(d)(2). The Act's version of the definition referred to "fiduciaries" rather than persons. Section 1601(i)(3)(A) of the Taxpayer Relief Act of 1997 changed the word "fiduciaries" to "persons."

the custody of Gotham and that the laws of the State of New York were to govern the trust's administration.

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

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

It is understood that one of the principal objectives Treasury sought to achieve by implementing this new definition was to level the competitive playing field for trust business between 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.[8]

Although Code §7701(a)(30)(E) and (31)(B) establishes a more objective method for determining whether a trust is domestic or foreign, it falls short of establishing the bright line test that was intended.

a. The Treasury Regulations

Some clarity is provided by Treas. Reg. § 301.7701-7, which is applicable to trusts for taxable years ending after February 2, 1999.[9] The regulations provide that a trust is a U.S. person on any day that the trust meets both the "court test" and the "control test."

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

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

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

[9] Treas. Reg. § 301.7701-7 may be relied on by trusts for taxable years beginning after December 31, 1996 and by trusts whose trustees have elected under Code § 1907(a)(3)(B) of the 1996 Act to apply Code §§ 7701(a)(30) and (31) to the trusts for taxable years ending after August 20, 1996. Furthermore, a trust created after August 19, 1996 and before April 5, 1999 that satisfies the "control test" set forth in the proposed

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b. The Court Test

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

> (1) The trust instrument does not direct that the trust be administered outside the U.S.;
>
> (2) The trust in fact is administered exclusively in the U.S.; and
>
> (3) The trust is not subject to an automatic migration provision described in Treas. Reg. § 301.7701-7(c)(4)(ii).

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

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

> (1) "Court" includes federal as well as state and local courts.
>
> (2) "United States" means the fifty states and the District of Columbia.
>
> (3) "Is able to exercise" means "that a court has or would have the authority under applicable law to render orders or judgments resolving issues concerning administration of the trust."
>
> (4) "Primary supervision" means the judicial "authority to determine substantially all issues regarding the administration of the entire trust . . . notwithstanding the fact that another court has jurisdiction over a trustee, a beneficiary, or trust property."

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regulations but not the "control test" described in the final regulations may be modified to satisfy the final regulations by December 31, 1999. Such modified trust 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 Code § 1907(a)(3)(B) of the 1996 Act has been made for the trust).

(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."

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

(1) Trusts that are registered in a court within the U.S. by an authorized fiduciary under a state statute substantially similar to the Uniform Probate Code, Article VII, Trust Administration.[10]

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

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

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

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

A trust whose trust instrument contains a provision that would cause the trust to migrate from the U.S. if a U.S. court attempted to assert jurisdiction over it or otherwise attempted to supervise its administration, either directly or indirectly, does not satisfy the court test. However, a trust will not fail the court test solely because "the trust instrument provides that the trust will migrate from the United States only in the case of foreign invasion of the United States or widespread confiscation or nationalization of property in the United States."[11]

[10] § 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. Sixteen states have adopted the Uniform Probate Code in its entirety (in some cases with significant modifications). They are Alaska, Arizona Colorado, Florida, Hawaii, Idaho, Maine, Michigan, Minnesota, Montana, Nebraska, New Mexico, North Dakota, South Carolina, South Dakota and Utah. 8 Uniform Laws Annotated 1 (West Supp. 1998).

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

c. The Control Test

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

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

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

(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.[12]

(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.

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

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

Certain employee benefit trusts will be deemed to satisfy the control test as long as U.S. *fiduciaries* control all of the substantial decisions to be made by trust fiduciaries.[13]

d. Reversing an Unintended Loss of U.S. Status

If a trustee whose U.S. status caused a trust to be treated as a U.S. trust ceases to be a trustee or ceases to be a U.S. person, the regulations give the trust twelve months from the date of such cessation to make whatever changes are necessary to give control over all substantial decisions of the trust to U.S. persons.[14] If the change is made within this period of time, the trust will be treated as having maintained its U.S. status even during the time when one or more substantial decisions were not controlled by U.S. persons. If the change is not made within this time period, the trust will be treated as having lost its U.S. status on the date the trustee lost her U.S. status or ceased to serve as trustee. The appropriate district director has the power to extend this time period for reasonable cause.

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

Section 1161 of the Taxpayer Relief Act of 1997 (the "1997 Act")[15] 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.[16] According to Treas. Regs. § 301.7701-7(f), a trust is considered to have been treated as a domestic trust on August 19, 1996 if:

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[13] 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 (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.

[14] Treas. Reg. §301.7701-7(d)(2).

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

[16] Trusts that were wholly-owned by their grantors under the so-called "grantor trust" rules set forth in Code §§ 671 through 679 on August 20, 1996 may not make this election. Treas. Reg. § 301.7701-7(f). 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. *Id.*

(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.S. nonresident alien income tax return), for the period that includes August 19, 1996; and

(2) the trust had a reasonable basis (within the meaning of Code § 6662) under Code § 7701(a)(3), prior to amendment by the 1996 Act, for reporting as a domestic trust for that period.[17]

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 satisfy the second criteria and if they have a reasonable basis for filing neither form.[18]

Treas. Reg. § 301.7701-7(f)(3) details the procedure for making the election to remain a domestic trust. Once the election is made, it may only be revoked with the consent of the Service. 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).

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[19] treats a transfer of an item 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 gain (but not loss) on the excess of such fair market value over her basis in the transferred property. This rule does not apply to the extent that any person (including the transferor) is treated as the owner of such trust under Code § 671. For transfers in 2010, gain will be recognized if a U.S. person transfers appreciated property to a foreign trust unless a U.S. person is treated as the owner of the foreign trust under the grantor trust rules.[20]

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[17] The final regulations supersede Notice 98-25, 1998-18 I.R.B. 11, which provided guidance as to the application of § 1161 of the 1997 Act.

[18] Trusts that are not required to file include certain group trusts described in Revenue Ruling 81-100, 1981-1 C.B. 326, and domestic trusts that do not meet the income requirements for filing under Code § 6012(a)(4). Treas. Reg. § 301.7701-7(f)(2).

[19] Code § 684 was added to the Code by the 1997 Act.

[20] Section 542(e)(1) of the Economic Growth and Tax Relief Reconciliation Act of 2001. All provisions of that Act sunset on December 31, 2011.

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 direct or indirect 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.

A transfer is not a gratuitous transfer if it was made for full fair market value. For purposes of determining whether full fair market value has been received, if the transferor is the grantor or a beneficiary of the trust (or a person related within the meaning of Code § 643(i)(2)(B) to any grantor or beneficiary of the trust), any obligation issued by the trust (or by certain related persons) is disregarded, except as provided in the regulations.[21] Treasury regulations provide that certain "qualified obligations" will be recognized as consideration.[22] An obligation is a qualified obligation only if:

> "(i) The obligation is reduced to writing by an express written agreement; (ii) The term of the obligation does not exceed five years (for purposes of determining the term of an obligation, the obligation's maturity date is the last possible date that the obligation can be outstanding under the terms of the obligation); (iii) All payments on the obligation are denominated in U.S. dollars; (iv) The yield to maturity is not less than 100 percent of the applicable Federal rate and not greater than 130 percent of the applicable Federal rate (the applicable Federal rate for an obligation is the applicable Federal rate in effect under section 1274(d) for the day on which the obligation is issued, as published in the Internal Revenue Bulletin); (v) The U.S. transferor extends the period for assessment of any income tax or transfer tax attributable to the transfer and any consequential income tax changes for each year that the obligation is outstanding, to a date not earlier than three years after the maturity date of the obligation (this extension is not necessary if the maturity date of the obligation does not extend beyond the end of the U.S. person's taxable year and is paid within such period); when properly executed and filed, such an agreement is deemed to be consented to by the Service Center Director or the Assistant Commissioner (International) for purposes of § 301.6501(c)-1(d) of this chapter; and (vi) The U.S. transferor reports the status of the loan, including principal and interest payments, on Form 3520 for each year that the loan is outstanding."[23]

Section 679 applies to both direct and indirect transfers to foreign trusts. The regulations broadly define indirect transfers to include transfers made by a U.S. person through an intermediary if the U.S. person is related to a trust beneficiary (or has another relationship with a beneficiary that establishes a reasonable basis for the transferor making a gratuitous transfer to the foreign trust) and the U.S. person cannot demonstrate that (i) the intermediary has a relationship with a beneficiary that establishes a reasonable basis for the intermediary making a

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[21] Code § 679(a)(3)(A)(i).

[22] Treas. Reg. § 1.679-4(d).

[23] *Id.*

gratuitous transfer to the trust; (ii) the intermediary acted independently of the U.S. person; (iii) the intermediary is not an agent of the U.S. person; and (iv) the intermediary timely complied with the reporting requirements of section 6048 of the Code.[24] According to the regulations, if a bank loans money to a foreign trust and the loan would not have been made unless the U.S. person had deposited funds with the bank, the bank is an intermediary.[25]

Section 679 applies if a U.S. person makes a constructive transfer to a foreign trust.[26] A constructive transfer includes an assumption or satisfaction of a foreign trust's obligation to a third party. A U.S. person who is related to a beneficiary of a foreign trust and who guarantees a loan to the trust is treated as making a transfer to the foreign trust equal to the portion of the obligation guaranteed.[27] A guarantee includes any arrangement under which a person, directly or indirectly, assures on a conditional or unconditional basis, the payment of another person's obligation. A commitment to contribute capital to the debtor, or otherwise maintain its financial viability, is a guarantee even if the arrangement is not a legally binding obligation or is subject to a contingency that has not yet occurred.[28]

Transfers by U.S. persons to entities owned by a foreign trust are treated as transfers to the foreign trust followed by a transfer by the trust to the entity unless the U.S. person is not related to a trust beneficiary or the U.S. person demonstrates that the transfer is attributable to the U.S. person's ownership interest in the entity.[29] For example, if a foreign trust and a U.S. person jointly fund a corporation, each taking back stock proportionate to their transfers, Code § 679 is not applicable.

A trust is treated as having a U.S. beneficiary in any year in which income or corpus may be paid to or for the benefit of, or accumulated for future distribution to or for the benefit of, a U.S. person, or in any year in which, if the trust terminated, any part of the income or corpus could be paid to or for the benefit of a U.S. person.[30] According to the regulations Code § 679 applies even if no distribution may be made to a U.S. person until after the grantor's death or to a person who is a U.S. person until he or she ceases to be a U.S. person.[31] If the terms of the trust permit the trust to be amended to make a U.S. person a beneficiary, the trust will be treated as having a U.S. beneficiary.[32] For this purpose the term "U.S. person" includes a controlled

[24] Treas. Reg. § 1.679-3(c)(2)(i).

[25] Treas. Reg. 1.679-3(c)(5), Example 3.

[26] Treas. Reg. § 1.679-3(d).

[27] Treas. Reg. § 1.679-3(e)(4).

[28] *Id*.

[29] Treas. Reg. § 1.679-3(f).

[30] Code § 679(c)(1).

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

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

foreign corporation as defined in Code § 957(a), a foreign partnership with one or more U.S. partners, and a trust or estate, one of more beneficiaries of which are U.S. persons.[33]

A beneficiary who first became a U.S. person more than five years after a gratuitous transfer to a trust will not be treated as a U.S. person for purposes of that transfer.[34] The exception is not applicable if the person at any previous time had been a U.S. person.[35]

The test for determining whether a foreign trust has a U.S. beneficiary is done on a year by year basis. If a foreign trust has no U.S. beneficiaries in one year and acquires one in a subsequent year, the U.S. gratuitous transferor will be required to include in her gross income in such year, an amount equal to all the undistributed net income of the trust at the end of the prior year that is attributed to her transfer or transfers to the trust.[36] Code § 679 will cease to apply on January 1 of the year following the year when it no longer has U.S. beneficiaries. The grantor will be treated as transferring assets to the foreign trust on January 1 and Code § 684 will require the transferor to realize income and gain as if the assets had been sold.[37]

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

The death of a U.S. person who was treated as the owner of a foreign trust during her lifetime may be a gain recognition event under Code § 684. Here's the argument for such treatment. Until the U.S. person's death, she was the owner of the property for U.S. income tax purposes under Code § 671. Her death terminates the trust's grantor trust status. Treas. Reg. § 1.1001-2(c), Example 5, treats the termination of grantor trust status as a transfer of the trust property by the grantor.[38] If this regulation is applied to Code § 684, and if it applies to terminations caused by death, the deceased U.S. person will be treated as having made a transfer to a foreign trust at the moment of her death. Treasury Regulations under Code § 684 confirm this tax treatment for the U.S. owner, except that the regulations provide that the transfer to the foreign trust will be treated as having occurred *immediately before* the U.S. owner's death.[39] Treasury Regulations § 1.684-3(c) provides an exception to this gain recognition rule in instances where the trust property is included in the U.S. owner's gross estate for U.S. estate tax purposes and the basis of the assets of the property in the hands of the foreign trust is determined under Code § 1014(a).

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[33] Code § 679(c)(2).

[34] Code § 679(c)(3).

[35] Treas. Reg. § 1.679-2(a)(3), Example 2.

[36] Code § 679(b).

[37] Treas. Reg. § 1.679-2(c)(2).

[38] *See, also, Madorin v. Commissioner,* 84 T.C. 667 (1985) and Rev. Rul. 77-402, 1977-2 C.B. 222.

[39] Treas. Reg. § 1.684-2(e), Example 2.

The Economic Growth and Tax Relief Reconciliation Act repeals or suspends section 1014 in 2010 when the federal estate tax is not in effect. If the grantor of a foreign trust dies in 2010, this exception will not be applicable.

The risk that gain will be recognized upon the death of a foreign trust's U.S. owner can be avoided by giving a U.S. person, perhaps a U.S. trust, the right to withdraw the foreign trust's property immediately before the death of the U.S. person.[40] The withdrawal power would give the deceased U.S. person the protection of Code § 684(b). Code § 684(b) excepts transfers to trusts to the extent such trusts are owned by any person (other than a foreign nongrantor trust) under Code § 871.

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

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

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

5. Reporting Requirements

A U.S. person who creates a foreign trust or who transfers property to a foreign trust, other than a transfer in exchange for consideration equal to the full value of the transferred property, is required to report the creation or transfer on Form 3520.[41] For purposes of determining whether full consideration has been received, notes issued by the trust or related persons are to be disregarded to the same extent they are disregarded for purposes of Code § 679 (a)(3) as discussed above. Qualified obligations, as defined in Treas. Reg. § 1.679-4(d), will be treated as consideration, but an obligation will be treated as qualified only if reported.[42]

Form 3520 is due at the same time as the U.S. person's income tax return is due for the year in which such creation or transfer took place. Failure to file may subject a transferor to a penalty equal to 35% of the amount transferred.[43]

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

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[40] A trust will be treated as an owner of another trust to the extent it has the power to withdraw that trust's assets. Treas. Reg. § 1.671-2(e)(6), Example 8.

[41] Code § 6048(a); Notice 97-34, 1997-2 C.B. 422.

[42] Treas. Reg. § 1.679-4(d)(1)(vi).

[43] Code § 6677(a).

accounting of all trust activities and operations for each year that she is treated as owner.[44] The U.S. "owner" is required to disclose on Form 3520 the existence of the trust, its taxpayer identification number, the names of other persons who are considered "owners" of the trust, the code section which causes the trust to be treated as owned by the U.S. person and others who are treated as owners, the country in which the trust was created and the date of creation. Form 3520 is due at the same time as the U.S. person's income tax return is due. The information required to be furnished by the trust must be disclosed on Form 3520A, which is due on each March 15 following the year for which reporting is required. If Form 3520A is not filed, the U.S. person who is treated as the owner may be liable for a penalty equal to 5% of the value of the trust assets that are treated as owned by her.[45]

The executor of the estate of a U.S. person who transfers property to a foreign trust at her death, who was treated as the owner of a foreign trust during her lifetime or whose estate includes, for estate tax purposes any portion of a foreign trust, must report the death and the transfers on Form 3520.[46] Form 3520 is due at the same time as the executor's income tax return is due for the year in which the decedent's death occurred. Failure to file may subject the executor to a penalty equal to 35% of the amount transferred.[47]

6. Treatment of Trusts That Become Foreign Trusts

a. 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.[48]

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.[49] 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. Gain is recognized on an asset by asset basis, but losses are not deductible.[50]

[44] Code § 6048(b).

[45] Code § 6677(b).

[46] Code § 6048(a).

[47] Code § 6677(a).

[48] Code § 679(a)(5).

[49] Code § 684(c).

[50] Treas. Reg. § 1.684-1(a)(2).

b. Reporting Requirements

A U.S. trust that becomes a foreign trust is required to report its change of status on Form 3520.[51] Form 3520 is due at the same time as the trust's income tax return is due for the year in which the transfer took place. Failure to file may subject a trust to a penalty equal to 35% of the amount transferred.[52]

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

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

As discussed more fully below, Code § 672(f), which was added by the 1996 Act, denies grantor trust status to trusts with non-U.S. grantors unless (1) the grantor retains the right, exercisable either unilaterally or with the consent of another person who is a related or subordinate party who is subservient to the grantor, to revoke the trust; or (2) the only amounts permitted to be distributed from the trust during the grantor's life are amounts distributable to the grantor or her spouse.[53]

II. TAX TREATMENT OF FOREIGN NONGRANTOR TRUSTS

A. In General

Nongrantor trusts calculate their taxable incomes in the same manner as individuals with certain modifications set forth in Code §§ 642, 643, 651, and 661. For this purpose, foreign nongrantor trusts are treated as nonresident individuals who are not present in the U.S. at any time.[54]

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[51] Code § 6048(a).

[52] Code § 6677(a).

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

[54] Code § 641(b). Code § 871(a)(2) provides that a nonresident alien individual who is present in the United States for a period of 183 days or more in a taxable year is subject to a 30 percent tax on her net capital gains allocable to sources within the United States. Under

Footnote continued on next page

B. Gross Income

The gross income of a foreign nongrantor trust consists only of (1) gross income derived from sources within the U.S. that is not effectively connected with the conduct of a trade or business within the U.S., and (2) gross income that is effectively connected with the conduct of a trade or business within the U.S.[55]

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

- interest from the U.S. (or any of its agencies), the District of Columbia, from noncorporate residents of the U.S. and from domestic corporations;[56]
- dividends from domestic corporations;[57]
- rentals and royalties from property located in the U.S. including rentals or royalties for the use in the U.S. of patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and the like; and[58]
- gains from the disposition of U.S. real estate.[59]

C. Imposition of U.S. Income Tax

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

Footnote continued from previous page

Code § 865(a)(1) income from the sale of personal property is generally sourced according to the residence of the seller. But, under Code § 865(e)(2)(A), a nonresident alien who maintains an office in the United States has United States source income to the extent she sells personal property attributable to that office. Prior to the 1997 Act, it was unclear whether a trust that was a foreign trust within the meaning of new Code § 7701(a)(31) but that had a United States trustee with an office in the United States would be treated as having United States source income to the extent that trustee directed the sale of personal property. *See* Schwab and Davies, Tax Risks When U.S. Fiduciary Acts as Trustee of Foreign Trust, New York Law Journal (January 7, 1997). 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.

[55] Code § 872(a).

[56] Code § 861(a)(1).

[57] Code § 861(a)(2).

[58] Code § 861(a)(4).

[59] Code § 861(a)(5).

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

Foreign nongrantor trusts are taxable on taxable income which is effectively connected with the conduct of a trade or business within the U.S.[60]

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.[61]

2. Election With Respect to Income From Real Property

In addition, a foreign nongrantor trust that receives income from real property located in the U.S. may make an election to treat all such income as income effectively connected with a U.S. trade or business if the property is held for the production of income.[62] In the absence of such an election, such income would be taxed on the basis of gross receipts unreduced by any deductions.

3. Disposition of 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.[63] For this purpose, a "United States real property interest" is "any interest, other than an interest solely as a creditor, in either:

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

ii) a domestic corporation unless it is established that the corporation was not a U.S. real property holding corporation within the period described in section 897(c)(1)(A)(ii)."[64]

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.[65]

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[60] Code § 871(b).

[61] Code § 875(1); Rev. Rul. 91-32, 1991-1 C.B. 107; Rev. Rul. 85-60, 1985-1 C.B. 187. Treas. Reg. § 1.864-2(c)(2)(ii) excepts partnerships that trade in securities for their own accounts unless they are dealers.

[62] Code § 871(d)(1).

[63] Code § 897(a).

[64] Treas. Reg. § 1.897-1(c)(1); *see* Code § 897(c)(1).

[65] Code § 897(c)(6).

A U.S. real property holding corporation is any corporation unless the value of its U.S. real property interests is less than 50% of the sum of the value of all of its real property interests plus the value of all of its assets that are used or held for use in its trade or business.[66]

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.[67]

4. 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.[68] They are also taxed on their U.S. source gains from certain timber, coal and iron ore transactions,[69] on their U.S. source gains from the sale or exchange of patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises and similar property to the extent the gains are from payments which are contingent on the use of the transferred interest,[70] and, subject to the important exceptions described below, on their original issue discount from U.S. sources.[71] These types of income are all subject to the same type of taxation, except to the extent they are effectively connected with a U.S. trade or business. For convenience they are referred to in this outline as "fixed or determinable annual or periodic income."

5. Other Gains

Nonresident aliens who are present within the U.S. for more than 183 days in a particular taxable year are normally subject to tax on gains derived from sources within the U.S. from the sale of capital assets.[72] As discussed above, Code § 641(b) prevents this rule from applying to foreign nongrantor trusts. It provides that, for purposes of calculating the taxable income of a foreign trust, the trust shall be treated as a nonresident alien individual who is not present in the U.S. at any time. Thus, even though the trustees of a foreign nongrantor trust reside permanently in the U.S., the trust will be treated for U.S. income tax purposes as if the trustees had never been present in the U.S.

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

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

[68] Code § 871(a)(1)(A).

[69] Code § 871(a)(1)(B).

[70] Code § 871(a)(1)(D).

[71] Code § 871(a)(1)(C).

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

6. 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.[73] For this purpose, portfolio interest is interest (including original issue discount) which is paid on certain obligations of U.S. persons issued after July 18, 1984.

b. No U.S. income tax will be imposed on a foreign nongrantor trust's receipt of interest from a U.S. bank, savings and loan association, insurance company or similar institution unless such income is effectively connected with the conduct of a U.S. trade or business.[74]

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.[75]

D. Deductions

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

In computing a foreign nongrantor trust's taxable income that is effectively connected with the conduct of a trade or business within the U.S., the trust is entitled to reduce its gross income so connected (or treated as so connected) by the deductions that are "connected" with such income.[76] The proper apportionment and allocation of deductions for this purpose is determined in accordance with Treas. Reg. § 1.873-1. In addition, it is also entitled to deduct against its effectively connected income the following:

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

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

c. the deduction for personal exemptions allowed by Code § 151.[77]

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[73] Code § 871(h).

[74] Code § 871(i).

[75] Code §§ 871(a)(1)(C), 871(g)(1).

[76] Code § 873(a).

[77] Code § 873(b).

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

It is appropriate to permit a foreign nongrantor trust to deduct that portion of its distributions to beneficiaries that consist of effectively connected income. In determining the portion of a distribution that consists of effectively connected income, the distribution should be treated as consisting of the same portion of effectively connected income as the total of the trust's effectively connected income bears to the trust's total income. The Service seems to take this approach.[78]

2. Other Income

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

3. Foreign Tax Credit

A foreign nongrantor trust engaged in a trade or business within the U.S. (either directly or through investments in partnerships that are so engaged) that pays foreign income, war profits or excess profits taxes on income that is effectively connected with such trade or business may, subject to certain limitations, credit the foreign tax against its U.S. income tax liability.[79] Alternatively, it may deduct such taxes.[80]

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;[81]

b. may not be used against any income tax imposed on income not effectively connected with such business;[82] and

c. is not allowed to the extent it is properly allocable under Code § 901(b)(5) to the trust's beneficiaries.[83]

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[78] *See, e.g.*, Rev. Rul. 85-60, 1985-1 C.B. 187.

[79] Code §§ 901(b)(4), 906(a).

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

[81] Code §§ 904(a) and 906(b)(2).

[82] Code § 906(b)(3).

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 1996 Act's imposition of significant limitations on the availability of grantor trust status for trusts created by non-U.S. persons, the absence of a credit mechanism was unlikely to be a problem. This was so because the U.S. grantor trust system is so broad that any trust treated as owned by its grantor under foreign tax law was also likely to be treated as owned by its grantor under U.S. tax law. Under current U.S. law, the absence of a credit mechanism can result in serious foreign tax credit misallocations.[84]

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).[85]

2. Other Income

U.S. source fixed or determinable annual or periodic income, except to the extent such income is effectively connected to a U.S. trade or business, is subject to tax at a flat rate of 30%.[86] The recent reduction in the maximum tax rates applicable to dividend income to 15%[87] does not apply to income received by a foreign trust or any other nonresident alien.

F. Withholding

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

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. Withholding obligations are, however, imposed on partnerships that have taxable income that is

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Footnote continued from previous page

[83] Code § 642(a).

[84] _See_ discussion at III.B.2.d of credit that may be allowed to a foreign trust by regulation for foreign taxes imposed on its foreign grantor in certain circumstances.

[85] Code § 871(b)(1).

[86] Code § 871(a).

[87] § 302 of The Jobs and Growth Tax Relief Reconciliation Act of 2003 (Public Law No. 108-27) added paragraph (11) to § 1(h) of the Code. This paragraph provides that the term "net capital gain" means "net capital gain . . . increased by qualified dividend income."

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.[88] The withholding rate applicable to foreign nongrantor trusts that are partners in such partnerships is the highest rate of tax specified in Code § 1.[89]

2. 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. The withholding rate is 10% of the amount realized.[90]

3. Fixed or Determinable Annual or Periodic Income

Code § 1441(a) requires any person paying any of the items of income listed in Code § 1441(b) to withhold a 30% tax to the extent such income constitutes gross income from U.S. sources of any nonresident alien individual or of any foreign partnership[91] unless such income is effectively connected with the conduct of a U.S. trade or business.[92] The income items listed in Code § 1441(b) are the various kinds of fixed or determinable annual or periodic income. Code § 1442 imposes a similar requirement with respect to the income of foreign corporations. Curiously, neither section refers to withholding with respect to the income of trusts. Nevertheless, the regulations state that income paid to a foreign fiduciary is subject to the withholding requirements of Code § 1441.[93] As discussed above, however, a foreign trust does not necessarily have nonresident alien trustees. Whether the withholding requirements apply to payments made to the U.S. trustees of a foreign nongrantor trust is not clear.

G. Effect of Tax Treaties

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

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

[89] Code § 1446(b).

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

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

[92] Code § 1441(c)(1).

[93] Treas. Reg. § 1.1441-3(f). *See* also PLR 6306214990A (June 21, 1963).

H. Taxable Year; Reporting

1. 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.[94]

2. U.S. Nonresident Alien Income Tax Return – Form 1040NR

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

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

b. the trust had income in such year that is subject to tax in the U.S. unless the trust's liability for such tax is fully satisfied by withholding.[95]

If a foreign nongrantor trust is required to file Form 1040NR for a particular year, the return must be filed by the 15th day of the 6th month following the close of the year if the trust does not have an office or place of business in the U.S. If the trust does have an office or place of business in the U.S., its Form 1040NR must be filed by the 15th day of the 4th month following the close of the year.[96]

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

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

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

[95] Treas. Reg. § 1.6012-1(b).

[96] Treas. Reg. § 1.6072-1; T.D. 7426.

4. Taxpayer Identification Numbers

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

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

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

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

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

A. In General

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

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

U.S. 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;[97]

(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;[98] and

(3) any other amount required to be distributed to her (whether or not actually distributed to her) or properly and actually distributed to her from a foreign complex trust in a such year to the extent of her share of the trust's DNI for such year.[99]

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.[100] The same rule applies to income distributions from complex trusts.[101]

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.[102]

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[97] Code § 652(a). The term "simple trust" refers to a nongrantor trust that is not permitted to make payments to charity and that, in the year for which the characterization is made, makes no principal distributions.

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

[99] Code § 662(a)(2).

[100] Code § 652(a).

[101] Code § 662(a)(1).

[102] Code § 662(a)(2).

Consider the following example:

> **Example 2:** 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 2002, the trust's income (and its DNI) consisted of $100,000 of dividends from foreign corporations, all of which were distributed to M. FNT has never had any income from capital gains. The trustees made a principal distribution of $100,000 to Kate. Kate is not required to include any portion of the $100,000 distribution in her gross income.

c. Meaning of "Income"

For purposes of these rules, the term "income" (unless part of the phrase "taxable income," "distributable net income," "undistributed net income," or "gross income") means the amount of income for the taxable year of the trust determined under the terms of the governing instrument and applicable local law.[103] To avoid confusion, this outline refers to "income" as "trust accounting income." The term "income" or "trust accounting income" is generally used to describe for local law purposes the amount required or permitted to be distributed to current trust beneficiaries when the terms of the trust instrument require or permit trust income, but not trust principal, to be distributed to such beneficiaries. The items that are included in the term "income" or "trust accounting income" vary from jurisdiction to jurisdiction. There is no standard federal definition. The term generally includes items such as dividends and similar distributions made with respect to investments in business or investment entities, interest, and rent. It generally excludes gains from the disposition of property. Trust provisions that define income in a manner that departs fundamentally from local law are not recognized for purposes of this definition.[104]

d. Sixty-Five Day Election

At the trustee's election, an amount that is properly paid to a beneficiary within 65 days after the end of a taxable year will be treated as having been paid to her within such taxable year.[105]

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

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[103] Code § 643(b).

[104] Treas. Reg. § 1.643(b)-1.

[105] Code § 663(b).

the gross income of the U.S. beneficiary. This exception does not apply to amounts that can be paid only from trust income.[106]

Consider the following example:

> **Example 3:** Pat is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). The terms of the trust document require the trustees of FNT to pay Pat $1,000,000 on his 30th birthday. Pat reached age 30 during 2002, a year in which FNT's income and DNI exceeded $1,000,000. FNT's principal in that year was worth $10,000,000. Pat is not required to include the $1,000,000 paid to him by FNT in his gross income.

f. Distributions of Property Other Than Cash

The amount of any distribution to a beneficiary of property other than cash (other than a required distribution of trust accounting income or other fixed amount[107]) is the lesser of the trust's basis in the property or its value at the time of distribution unless the trustee makes an election to recognize gain on the distribution. If the trustee makes such an election, the amount of the distribution will be the value of the property. The trust will recognize gain equal to the excess of the value of the property over its basis. If the trustee does not make the election, the beneficiary's basis will be the same as the trust's basis.[108]

Consider the following example:

> **Example 4:** Jenny is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). During 2002, the trustees of FNT distributed 100 shares of X corporation stock to her. The shares were worth $1,000,000 at the time of distribution. The trust's basis in the shares was $1,000. FNT's income and DNI in 2002 exceeded $1,000,000. The trustees did not make the election described above to recognize gain on the distribution. Jenny will not be required to include any amount in excess of $1,000 in her gross income on account of the distribution. Her basis in the X shares will be $1,000.

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

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[106] Code § 663(a)(1).

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

[108] Code § 643(e).

2. Special Rules Applicable to Nongrantor Trusts That Are Foreign

a. Different Definition of Distributable Net Income

Generally, the DNI of a U.S. nongrantor trust for a particular year is equal to its taxable income for that year adjusted by adding to taxable income the amount deducted as a personal exemption, the amount of its tax exempt income, and the amount of the trust's deduction for distributions to beneficiaries and by subtracting from taxable income the trust's capital gains except to the extent such capital gains are "paid, credited or required to be distributed to any beneficiary during the taxable year."[109]

The DNI of a foreign nongrantor trust includes its capital gains.[110] In addition, a foreign nongrantor trust's DNI includes the amount of its income from non-U.S. sources reduced by amounts which would be deductible in connection with such income in the absence of Code § 265[111] and the amount that was excluded from its gross income by treaty under Code § 894.[112]

Consider the following example:

> **Example 5:** John is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). During 2001 the trust had foreign source dividend income of $10,000 and long term capital gain from the sale of securities of $10,000. Its U.S. gross income and taxable income is zero. The trust distributed $15,000 to John. It neither made nor was required to make distributions to any other beneficiary. The trust's DNI was $20,000. John's gross income from the trust, therefore, is $15,000. If FNT had been a U.S. trust, its DNI would have been only $10,000, and John's gross income on account of his distribution from the trust would have been $10,000.

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.[113]

> **Example 6:** John, the U.S. taxpayer in the above example, who received a $15,000 distribution from FNT, which had dividend income of $5,000, interest income of $5,000 and long term capital gains of $10,000, will be treated as having received dividend income of $3,750, interest income of $3,750, and long term capital gains of $7,500. The dividend income may be eligible for the new 15% maximum rate of tax on dividend income.

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[109] Code § 643(a).

[110] Code § 643(a)(6)(C).

[111] Code § 643(a)(6)(A).

[112] Code § 643(a)(6)(B).

[113] Code §§ 652(b) and 662(b).

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.[114]

> **Example 7:** The terms of FNT, the foreign nongrantor trust described in the example above, required that all of FNT's dividend and interest income be distributed annually to F, John's nonresident alien father. F will be treated as having received all of the ordinary income included in the trust's DNI. John's $15,000 distribution, therefore, will consist of $10,000 of long term capital gains. The balance of $5,000 will not be included in his gross income.

c. Credit for U.S. Withholding Tax

As discussed above, if the foreign nongrantor trust had fixed or determinable annual or periodic income or income from the disposition of U.S. real property interests, it is likely that the trust paid U.S. income tax on such income through withholding under Code § 1441 or Code § 1445. The Service takes the position that a U.S. beneficiary who receives a distribution from a foreign nongrantor trust that includes U.S. source income from which U.S. tax has been withheld must include in her gross income not only the amount she actually receives but also the amount of the withheld tax. She may then credit the withheld tax against her personal income tax liability.[115]

> **Example 8:** FNT, the foreign nongrantor trust described in the above example, had, in addition to its $10,000 of foreign source dividend income and $10,000 of long term capital gains, $10,000 of dividends on U.S. securities from which $3,000 of tax was withheld. FNT distributed $13,500 to John. John will be treated as having received a distribution of $15,000 consisting of foreign source dividend income of $5,000, long term capital gains of $5,000, and U.S. dividend income of $5,000. The U.S. dividend income has been "grossed-up" by his $1,500 share of the taxes withheld from it. The $1,500 will be credited against his U.S. income tax.

d. Credit for Foreign Income Taxes Paid by Trust

A U.S. person who pays income, war profits or excess profits tax to a foreign country may credit the amount of such taxes against her U.S. income tax liability or may claim such taxes as an itemized deduction.[116] The total amount of the credit is limited to the proportion of

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

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

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

the tax against which such credit is taken as her taxable income from foreign sources bears to her entire taxable income.[117]

If a foreign nongrantor trust pays such foreign taxes, its U.S. beneficiaries who receive distributions of income on which such taxes have been paid may elect to take a credit for the share of foreign taxes attributable to their share of the income or a deduction.[118] The credit is subject to the limits described above.

Neither the Code nor the regulations explain whether the beneficiary must include in her gross income the amount of foreign taxes paid with respect to the income distributed to her if she elects to take the credit. The Service's internal position seems to require such inclusion. The current edition of the Service's foreign trust training manual provides the following guidance for its agents:

> "While many foreign trusts are established in countries having no income taxes, such as Bermuda or the Bahamas, some are established in countries with income taxes. Some also pay taxes to other countries where they have investments.
>
> In either case, a U.S. citizen or resident taxed on the income of such a trust may claim credit for his/her allocable share of foreign income taxes paid by the trust. If the credit is claimed, the amount of income reported should be grossed up to include the foreign taxes paid.
>
> The taxpayer may deduct the taxes instead if he/she chooses. Failure to gross up trust income should be regarded as an election to take a deduction."[119]

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.

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117 Code § 904(a).

118 Code § 901(b)(5).

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

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.

2. Accumulation Distributions

a. In General

The throwback rule and its accompanying interest charge apply only if the foreign nongrantor trust has made an "accumulation distribution." An accumulation distribution is a distribution under Code § 661(a)(2) (dealing with amounts properly paid or credited or required to be distributed other than trust accounting income required to be distributed currently) to the extent such distribution exceeds the trust's DNI for the year reduced (but not below zero) by trust accounting income required to be distributed currently.[120]

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

b. Exceptions

(1) Specific Gifts

A distribution in satisfaction of a gift of a specific sum of money or of specific property described in Code § 663(a)(1) (described above) is not an accumulation distribution.[121]

> **Example 9:** FNT, the foreign nongrantor trust described above of which Pat is a beneficiary had no DNI in the year in which Pat reached age 30. The trustees distributed the sum of $1,000,000 to Pat as they were required to do under the terms of the trust instrument. The distribution to Pat is not an accumulation distribution.

(2) Distributions Not in Excess of Trust Accounting Income

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

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[120] Code § 665(b).

[121] Treas. Reg. § 1.665(b)-1A(c)(1).

> "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."[122]

This principle is illustrated by the following example:

Example 10: Isaac is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). The terms of the trust permit the trustees to distribute income and principal to any one or more beneficiaries at such times and in such amounts that they believe appropriate. In 2002, FNT received $100,000 in dividends from foreign corporations. It paid trustee commissions of $60,000, $40,000 of which was allocable to principal and $20,000 of which was allocable to income. Its trust accounting income for the year was $80,000, $100,000 reduced by the $20,000 of expenses chargeable to income. Its DNI was $40,000, $100,000 reduced by the total amount of the trustee commissions. The trustee distributed $80,000 to Isaac. The distribution is not an accumulation distribution because it is not in excess of trust accounting income.

(3) Default Method of Calculating an Accumulation Distribution

In some cases the U.S. beneficiary of a foreign nongrantor trust will not have received sufficient information about her distribution and the trust to enable her to determine whether or not she has received an accumulation distribution. Notice 97-34[123] and the current version of Internal Revenue Service Form 3520 (2002) gives her a so-called "default" method of making this determination. A beneficiary is required to use this method if the trust did not provide her with a Foreign Nongrantor Trust Beneficiary Statement.[124]

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.

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

[123] 1997-1 C.B. 422.

[124] Internal Revenue Service Form 3520, Line 29 (2002). Presumably the Service's authority for enforcing this requirement is found in Code § 6048(c)(2)(A), which provides,

> "If adequate records are not provided to the Secretary to determine the proper treatment of any distribution from a foreign trust, such distribution shall be treated as an accumulation distribution includible in the gross income of the distributee under chapter 1."

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

Step 2 -- Multiply the total by 1.25.

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

The amount treated as a distribution of current income will be the smaller of the actual distribution or the amount determined in Step 3. The balance of the distribution will be treated as an accumulation distribution. If the default method is used, the number of years used for purposes of calculating the interest charge under Code § 688, as discussed below, will be one-half of the number of years the trust has been in existence.[125]

Consider the following example:

> **Example 11:** Joshua is the beneficiary of a foreign nongrantor trust ("FNT") that has been in existence for 10 years. At the end of 1998 the FNT had assets worth $20,000,000. In each of the 10 years 1989 through 1998, FNT has earned $1,000,000. Assume FNT has no income in 1999, 2000, 2001 and 2002 and that FNT distributes $2,000,000 to Joshua in each such year. The amount of Joshua's accumulation distribution in each year would be $2,000,000 under Code § 665(b). His situation would be improved considerably by using the default method.
>
> In 1999, the accumulation distribution is the full $2,000,000 because there were no distributions in any of the prior three years.
>
> In 2000, the amount of the accumulation distribution is reduced to $1,166,667 ($2,000,000 - ($2,000,000 X 1.25/3)).
>
> In 2001, the amount of the accumulation distribution is reduced to $333,333 ($2,000,000 - ($4,000,000 X 1.25/3)).
>
> In 2002, the amount of the accumulation distribution is reduced to 0 ($2,000,000 - (6,000,000 X 1.25/3).

Because the default method of calculating the amount of an accumulation distribution can have the effect of significantly reducing that amount, the use of this method can significantly reduce the interest imposed on the taxes paid on accumulation distributions.

(4) 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

[125] Code § 6048(c)(2)(B).

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.[126]

(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.[127] 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.[128] Unfortunately, the effectiveness of the portion of the Code that permits such reduction appears to require regulatory action, which has not yet occurred.

(c) Reduction of UNI

The original UNI for a particular year of a trust will be reduced by accumulation distributions made in later years to the extent that such distributions are deemed to have been made in such year under Code § 666(a).[129] A distribution paid or used for charitable purposes within the meaning of Code § 642(c) is not treated as an accumulation distribution.[130] As a result, such distributions do not reduce UNI.

(d) Default Method of Calculating UNI

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

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[126] Code § 665(a).

[127] Code § 665(d).

[128] Code § 665(d)(2).

[129] Treas. Reg. § 1.665(a)-1A(c).

[130] Treas. Reg. § 1.665(b)-1A(c)(2).

(5) 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.[131] If the amount of the accumulation distribution exceeds the UNI for the earliest year, the excess is allocated to the next year for which there is any remaining UNI. The process continues in the same manner until all of the accumulation distribution has been allocated to a preceding year. Each portion of an accumulation distribution allocated to a particular preceding year is deemed to have been distributed on the last day of such year.

> **Example 12:** Michael is a U.S. beneficiary of a foreign nongrantor trust ("FNT"). FNT was created in 1995 by Michael's non-U.S. mother. FNT distributed $100,000 to Michael in 2002, a year in which FNT's DNI and trust accounting income was $20,000. Therefore, $80,000 of the distribution is treated as an accumulation distribution. FNT's DNI, none of which was distributed, in each of its preceding years was as follows:
>
> 1995 - $4,000
>
> 1996 - $20,000
>
> 1997 - $30,000
>
> 1998 through 2001 - $40,000
>
> Michael's $80,000 accumulation distribution is deemed to have been made $4,000 on the last day of 1995, $20,000 on the last day of 1996, $30,000 on the last day of 1997, and $26,000 on the last day of 1998.

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

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.[132] Such taxes include U.S. income taxes and foreign income, war profits and excess profits taxes.[133]

> **Example 13:** Assume that FNT, the trust described in the preceding example, paid taxes in each of its preceding taxable years equal to 40% of its DNI. The total amount deemed to have been distributed to Michael on the last day of each of 1995, 1996, 1997 and 1998 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.[134] For purposes of this calculation, if any year's deemed distribution is less than 25% of the total amount of the accumulation distribution divided by the number of preceding taxable years to which the accumulation distribution is allocated, that year will not be included.[135]

> **Example 14:** In the above example the number of preceding taxable years in which a distribution is deemed to have been made will be 3. The year 1995 is disregarded because the amount of the accumulation distribution allocated to that year ($4,000) is less than 25% of the total accumulation distribution ($80,000) divided by the number of years to which the distribution is deemed allocated (4).

Step 4 -- Identify the beneficiary's computation years. The computation years are those three of the beneficiary's five immediately preceding taxable years left after eliminating the year in which her income was the highest and the year in which her income was the lowest.[136]

> **Example 15:** Assume in the above example that Michael's taxable income in 1997 was $50,000, in 1998 was $100,000, in 1999 was $200,000, in 2000 was $150,000, and in 2001 was $175,000. The year of the highest taxable income,

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[132] Code § 666(b) and (c).

[133] Code § 665(d). If the beneficiary has received distributions from more than two trusts that are deemed to have been distributed to her on the last day of the same preceding taxable year, the taxes that were imposed on the third trust and any additional trusts on account of such amounts are not deemed to have been distributed to the beneficiary. Code § 667(c). This is detrimental to the beneficiary rather than beneficial because the consequence of the failure to treat taxes as having been distributed is the loss of the ability to use the taxes as a credit against the tax on the accumulation distribution. Code §§ 667(b) and 667(d). For purposes of this rule, a distribution from a trust deemed to have been distributed on the last day of a particular preceding year will be disregarded unless it, when added to any previous distributions for such year, equals or exceeds $1,000. Code § 667(c)(2).

[134] Code § 667(b)(1)(A).

[135] Code § 667(b)(3).

[136] Code § 667(b)(1)(B).

1999, and the year of the lowest taxable income, 1997, are eliminated. Michael's three computation years are the remaining years, 1998, 2000, and 2001.

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.[137]

Example 16: In the above example, the amount deemed distributed is $112,000 and the number of preceding years in which the distribution is deemed to have been made is 3. The average annual distribution amount is $37,333.

Step 6 -- Determine the amount by which the beneficiary's income tax would have increased in each of the three computation years if the annual distribution amount had been added to her taxable income in each of such years.[138] In making this calculation, no differentiation is made among the various types of income that were included in the foreign nongrantor trust's UNI (other than tax-exempt income). Thus, for example, if a portion of the trust's UNI was long term capital gain, the beneficiary will not receive the advantage of the lower rate that generally applies to such gains. If any foreign income, war profits or excess profits taxes were added, in Step 2, to the amount deemed to have been distributed, the amount of such taxes may be allowed as a credit against the increase in tax calculated in this step.[139]

Example 17: 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.[140]

Example 18: 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.[141]

Example 19: Michael's average tax increase, $16,100, is multiplied by 3. The product is $48,300.

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137 Code § 667(b)(1)(C).

138 Code § 667(b)(1)(D).

139 Code § 667(d).

140 *Id.*

141 Code § 667(b)(1).

Step 9 -- Subtract from the product obtained in Step 8 the amount of any U.S. income taxes that were added, in Step 2, to the amount deemed distributed to the beneficiary.[142] The result is the amount of the beneficiary's throwback tax.

> **Example 20:** Assume that $25,000 of the total taxes added to Michael's deemed distribution were U.S. income taxes. The $25,000 is subtracted from $48,300, leaving a throwback tax of $23,300.

(c) Use of the Steps With the Default Method

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

(6) 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.[143]

(b) Before the 1996 Act

Before the 1996 Act, the throwback tax imposed on distributions from foreign trusts was subject to a 6% simple interest charge.[144] For purposes of the interest calculation, an accumulation distribution was deemed to have been made from the earliest period or periods with respect to which the trust had UNI. For example, if a foreign nongrantor trust made an accumulation distribution in 1992 of $25,000 and if its UNI for 1990 (after adjustment for any prior accumulation distributions) was $50,000, for purposes of the interest calculation, the distribution would be deemed to have been made entirely from the income accumulated in 1990 and four years worth of interest would be charged. If the tax on the distribution was $10,000, the interest charge would have been $2,400. Code § 668(b) limited the total interest charge to the excess of the amount of the taxed distribution over the tax charged on such distribution. Thus, in this example, the interest charge could not exceed $15,000 ($25,000, the amount of the distribution), reduced by $10,000, the amount of the tax on the distribution.

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[142] Code § 667(b).

[143] Code § 667(a)(3).

[144] Prior Code § 668.

(c) After the 1996 Act

Code § 668, as amended by the 1996 Act, modified the interest rate charged on the tax imposed on distributions of accumulated income by foreign trusts and completely changed the calculation method. The interest rate will be the floating rates applied under Code § 6621 to underpayments of tax (currently 5%[145]). 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.[146] The number of years over which interest is calculated is determined by the following rather complicated process designed to produce a "dollar-weighted" number of years.

> **Step 1** - the undistributed net income for each year must be multiplied by the number of years between such year and the year of the distribution (counting the year of the accumulation but not the year of distribution).
>
> **Step 2** - all products calculated in the first step must be added together.
>
> **Step 3** - the sum of such products calculated in the second step must be divided by the aggregate amount of the trust's undistributed income. The quotient is to be rounded to the nearest half-year.[147]

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

The process may be illustrated by the following example:

Example 21: FNT, a foreign trust created in 1996, made no distributions before 2002. It had income of $0 in 2001, $60 in 2000, $124 in 1999, $87 in 1998, $54 in 1997, and $25 in 1996. Its total UNI in 2002 was the sum of these amounts or $350. It had no income in 2002 and distributed $286 in that year to its U.S. beneficiary, Tyler. FNT's weighted UNI is $1,260, as shown in the chart below:

[145] Rev. Rul. 2003-63, 2003-25 I.R.B. 1037.

[146] Code § 668(a).

[147] Line 50, Internal Revenue Form 3520 (2002).

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

To determine the weighted number of years, the weighted UNI figure is divided by the total UNI figure, producing, in this example, a weighted number of years of 3.6, which is to be rounded to the nearest half year, or 3.5.[148]

The chart in Appendix C to this outline shows the discrepancy between the interest amount that would have been calculated using the former method of calculation and the interest amount calculated under the new method over a 20 year period, assuming equal amounts of accumulations, a 35% income tax rate and a 6%, daily, compounding interest rate. As the chart shows, the longer the period of accumulation, the greater the advantage to the taxpayer of the method prescribed by the 1996 Act.

Tyler's income tax on his accumulation distribution was $100. He will calculate his interest over a 3.5 year period ending on the applicable date. The applicable date, according to the instructions to Form 3520, is June 30th of the year in which the distribution was made.[149] Total interest is calculated in the manner illustrated by the chart below:

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

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

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

Alternatively, Tyler may use a chart contained in the instructions to Form 3520 to calculate his interest. The chart produces total interest of only 29.998% rather than 31.12%.

The chart below shows the various Code § 6621 rates in effect from 1996 through September 2004:

From	Through	Rate
January 1, 1996	March 31, 1996	9%
April 1, 1996	June 30, 1996	8%
July 1, 1996	March 31, 1998	9%
April 1, 1998	December 31, 1998	8%
January 1, 1999	March 31, 1999	7%
April 1, 1999	March 31, 2000	8%
April 1, 2000	March 31, 2001	9%
April 1, 2001	June 30, 2001	8%
July 1, 2001	December 31, 2001	7%
January 1, 2002	December 31, 2002	6%
January 1, 2003	September 30, 2003	5%
October 1, 2003	March 31, 2004	4%
April 1, 2004	June 31, 2004	5%
July 1, 2004	September 30, 2004	4%

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

If the interest calculation period includes any years before 1996, a possibility that will become increasingly unlikely given the peculiar method of determining the calculation period, the interest rate applicable to that period will be 6%. The interest will not be compounded except as to that portion of the interest calculation period after 1995.[150]

[150] Code § 668(a)(6).

(d) The Default Method

If the U.S. beneficiary uses the default method of calculating her accumulation distribution, the period over which interest is calculated is one-half the number of years the trust has been in existence as a foreign nongrantor trust.[151]

The application of the new default interest rule can be draconian. If, for example, the interest rate on underpayments is 9% and if the U.S. beneficiary's tax rate is 40%, the entire amount of the distribution from a trust that has been in existence for 20 or more years will be consumed by taxes and interest.[152] Interest charges, however, can be reduced by spreading distributions over a number of years and using the default method rather than the exact method of calculating the amount of the accumulation distributions. As illustrated by Example 11, use of the default method will, with a pattern of equal annual distributions, eliminate accumulation distributions after a period of three years.

(e) Observation

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

D. Loans Treated as Distributions

1. In General

Code § 643(i), which was added to the Code by the 1996 Act treats, except as provided in regulations, a foreign trust's loans of cash (including foreign currencies and cash equivalents) or marketable securities to any U.S. grantor or beneficiary of the trust or to any other U.S. person

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[151] Internal Revenue Service Form 3520, Line 38 (2002). A similar rule exists under Code § 666(d). It provides that, if adequate records are not available to determine the years within which income was accumulated, a distribution of accumulated income shall be deemed to have come from income accumulated in the first year of the trust's existence. Presumably, the new rule in Code § 6048(c)(2)(B) supersedes Code § 666(d) for foreign trusts.

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

who is related to such a grantor or beneficiary as a distribution.[153] For this purpose, a person is related to another person if the relationship between them would result in loss disallowance under Code § 267 or Code § 707(b).

If the loan is made to a person who is not the grantor or a beneficiary, it is not treated as a distribution to the borrower, but, instead, is treated as a distribution to the grantor or beneficiary to whom the borrower is related.[154] The logic of this provision is difficult to see. It has the effect of separating the tax consequences from the economic enjoyment of the deemed distribution.

Congress apparently intended that Treasury would create regulatory exceptions to this rule to protect loans that are commercially reasonable.[155] Although such regulations have yet to be issued, the Service signaled its thinking on this subject in Notice 97-34.[156] The Notice states that the regulations will provide that a loan to a U.S. beneficiary (or a U.S. person related to a beneficiary) will be treated as a distribution unless it is a "qualified obligation." An obligation is a qualified obligation only if:

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

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

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

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

[156] 1997-1 C.B. 422.

> reports the status of the obligation, including principal and interest payments, on Form 3520 for each year that the obligation is outstanding."

2. Repayment of Loans

When a loan 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." 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."[157]

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

E. Indirect Transfers From Foreign Trusts

1. Distributions Through "Intermediaries"

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

[157] Code § 643(i)(3).

Since 1962 the Code has contained a rule intended to prevent the use of intermediaries as a means of circumventing the general rules which tax 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."

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

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

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

It provides as follows that,

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

The expansion of the rule to trusts created by non-U.S. persons was presumably necessary to prevent what would otherwise have been a means of circumventing other provisions of the 1996 Act which enhance the tax penalties imposed on the receipt of distributions of accumulated income from foreign trusts which are not taxed as grantor trusts under Code § 679 or otherwise.[158]

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.

Treasury has issued regulations under Code § 643(h).[159] The regulations treat distributions from trusts as made through intermediaries only if the transaction has a principal

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[158] *See* Code § 668.

[159] Treas. Reg. § 1.643(h)-1.

purpose of avoiding U.S. tax. The regulations create a presumption of tax avoidance if all of the following factors are present:

(a) The U.S. person who received property from the intermediary is related to the grantor of the foreign trust or has another relationship with the grantor of the foreign trust that establishes a reasonable basis for concluding that the grantor would make a gratuitous transfer to the U.S. person. For example, if the U.S. person is a child of the grantor of the foreign trust, this factor would be satisfied.

(b) An intermediary received a distribution from a foreign trust and within a four year period beginning two years before the distribution, transferred to a U.S. person: the same property; proceeds from the disposition of such property; or property "in substitution for" such property.

  (i) Example 5 of Treas. Reg. § 1.643(h)-1(g) illustrates a transfer of property to a U.S. person in substitution for property distributed to an intermediary. The substitute property was shares of stock of equivalent value to shares distributed from the trust, but in different companies.

  (ii) Example 6 of Treas. Reg. § 1.643(h)-1(g) demonstrates that a bank is viewed as an intermediary if it lends money to a U.S. person and the loan is secured by the trust´s deposit of funds in the bank if it can be shown that the bank would not have loaned funds to the U.S. person without the security interest in the trust's deposit. Note that the bank has not received a "distribution" from a foreign trust, but rather a deposit. However, the loan is deemed made from the trust.

(c) The U.S. person cannot demonstrate to the satisfaction of the Service that:

  (i) The intermediary has a relationship with the U.S. person that establishes a reasonable basis for concluding that the intermediary would also make a gratuitous transfer to the U.S. person;

  (ii) The intermediary acted independently of the grantor and the trustee of the foreign trust;

  (iii) The intermediary was not the agent of the U.S. person; and

  (iv) The U.S. person properly reported the gift under § 6049F (required if the gift was made by a foreign person).

Examples in the regulations indicate that a U.S. person who receives property from a nonresident alien parent who received a distribution from a foreign trust funded by a grandparent will have to demonstrate more than a family relationship to the intermediary to avoid the nonresident alien parent being treated as an intermediary. If there is a pattern of giving and if the intermediary has other sources of income from which the transfer may have derived, that, plus the family relationship, apparently will be sufficient to avoid the parent being treated as an intermediary.[160] Less evidence is required to show that a resident alien parent did not act as an intermediary.[161]

Example 2 of Treas. Reg. § 1.643(h)-1(g) demonstrates that a U.S. person who is treated as having received a distribution from a foreign trust through an intermediary need not be a beneficiary of the foreign trust. In that example, GM created a trust for her children. A distribution was made to the child, who was a non-resident alien. The beneficiary made a gift to her daughter who was a U.S. resident. The grantor's granddaughter was treated as having received a distribution from the foreign trust even through she was not a beneficiary.

2. The Grantor Is Not an "Intermediary"

Under the Code, a grantor is never an intermediary. Treas. Reg. § 1.643(h)-1(b)(2) limits the exception to instances in which "the intermediary is the grantor of the portion of the trust from which the amount is derived." The regulations do not discuss how the portion rules are to be applied in this context.

The portion rules apply to determine what portion of a trust a grantor is deemed to own for income tax purposes. The rules do not explain how one determines who is the grantor of a portion of a trust. Consider, for example, a trust created by gift of community property. If a distribution is made to just one of the spouses, will the distribution qualify in full for the exception to the intermediary rule? If the trustee separately accounts for trust shares, presumably the answer is yes.

If a person creates or nominally funds a trust on behalf of another person, both are considered "grantors" but the nominal grantor is not treated as the owner of any portion of the trust.[162] Although the intermediary regulations use the term "grantor" and not the term "owner", if nominal grantors were able to serve as intermediaries, the intermediary rule would be simple to circumvent.

It is not clear whether the grantor must actively participate in the transfer of funds in order for the exception to the intermediary rule to apply. For example, if the trust makes a distribution to an account in the joint names of the grantor and a beneficiary and the beneficiary withdraws funds, it would be reasonable to treat the distribution as made through the grantor because the bank should not be treated as an intermediary in this situation.

3. Agency Principles Control Issue of Timing and Amount of Income

Under the regulations, if a distribution is treated as made through an intermediary, the intermediary is considered to be the agent of the trust unless the facts show that the intermediary was the agent of the U.S. person. Where the intermediary is considered to be the agent of the

[160] *See* Treas. Reg. § 1.643(h)-1(g), Example 3.

[161] *See* Treas. Reg. § 1.643(h)-1(g), Example 7.

[162] Treas. Reg. § 1.671-2(e)(5).

trust, the U.S. person includes the cash or property he or she receives from the intermediary in income in the year in which the U.S. person receives the cash or property, even if the distribution was made to an intermediary in an earlier taxable year. If the property distributed from the foreign trust is worth more by the time the U.S. person receives it, the increased amount is included in income. If the property has declined in value, the U.S. person reports the lower value. If the intermediary has paid foreign taxes with respect to the cash or property distributed from the foreign trust, the U.S. person treats such taxes as if imposed on the trust for purposes of Code § 665(d)(2).[163]

If the intermediary is the agent of the U.S. person, the U.S. person includes the cash or property distributed to the intermediary in the U.S. person´s income when her agent receives the distribution. Any income accruing on such cash or property between the time the intermediary receives it and the time the U.S. person receives it is also taxable to the U.S. person. If any foreign taxes were owed by the intermediary with respect to such cash or property, the taxes are creditable by the U.S. person as if the taxes were imposed on the U.S. person. Usual agency principles are applied to determine whether the intermediary is the agent of the U.S. person.[164]

If a person who receives a distribution from a foreign trust is deemed to be an intermediary, the intermediary may exclude the distribution from gross income.[165] The regulations fail to exclude from the intermediary´s gross income any income accruing on the property distributed from the foreign trust before it is transferred to the U.S. person, although presumably this was intended.

A *de minimis* exception applies where the aggregate amount of distributions to a U.S. person in one taxable year that are made from foreign trusts, either directly or through one or more intermediaries, does not exceed $10,000.[166]

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. The CFC, FPHC and PFIC rules, also 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). These anti-deferral regimes require that certain types of passive income of CFCs, FPHCs

[163] Treas. Reg. § 1.643(h)-1(c)(1).

[164] Treas. Reg. § 1.643(h)-1(c)(2).

[165] Treas. Reg. § 1.643(h)-1(c)(3).

[166] Treas. Reg. § 1.643(h)-1(d).

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 50% (by vote or value) of its stock is owned by "United States shareholders."[167] For purposes of this definition, a "United States shareholder" is a United States person[168] who owns either directly, through one or more foreign entities,[169] or through the application of certain constructive ownership rules,[170] at least 10% of the total combined voting power of all classes of stock entitled to vote.[171]

A U.S. person who owns directly or through a foreign entity shares of a CFC must include in gross income for each year her pro rata share of the CFC's "Subpart F" income.[172] A shareholder's pro rata share of a CFC's Subpart F income is that amount which would have been distributed with respect to the stock which 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.[173] Subpart F income includes insurance income, foreign base company income, international boycott income and foreign bribe-produced income.[174] Special rules are provided for CFCs that have more than one class of stock with different dividend rights.[175]

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167 Code § 957(a).

168 The term "United States person" generally has the same meaning assigned to it by Code § 7701(a)(30). It includes individuals who are citizens or residents of the U.S., domestic partnerships, domestic corporations, and estates or trusts other than foreign estates and trusts.

169 Code § 958(a).

170 Code § 958(b).

171 Code § 951(b).

172 Code § 951(a).

173 Code § 951(a)(2).

174 Code § 952(a). 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. Code § 954(a).

175 Treas. Reg. § 1.951-1(e)(2).

b. Foreign Personal Holding Companies

A foreign corporation is a FPHC if (i) at least 60% of its gross income for the taxable year is foreign personal holding company income ("FPHCI") and (ii) at any time during the taxable year more than 50% (by vote or value) of its stock is owned by not more than five individuals who are citizens or residents of the U.S.[176] 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 50% or more of the gross income).[177] For purposes of determining whether not more than five U.S. individuals own 50% of the stock of a foreign corporation, an individual will be treated as owning her proportionate share of all stock owned directly or indirectly by a corporation, partnership, estate or trust in which she is a shareholder or partner or of which she is a beneficiary. She will also be treated as owning stock owned directly or indirectly by her family (siblings, spouse, ancestors, and descendants) and partners.[178]

Each U.S. person who owns, directly or through a foreign entity, shares of a FPHC 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.[179] The CFC rules take precedence over the FPHC rules; that is, if a shareholder could be taxed under either set of provisions, she will be taxed under the CFC rules.[180]

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) 75% 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 passive income is at least 50%.[181] Passive income generally means income which would be FPHCI under Subpart F.[182] 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.[183] 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

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[176] Code § 552(a). The minimum FPHCI is 50% of gross income after the first taxable year for which the corporation is a FPHC.

[177] Code § 553(a).

[178] Code § 554(a).

[179] Code § 551(b).

[180] Code § 951(d).

[181] Code § 1297(a).

[182] Code § 1297(b).

[183] Code § 1291.

the trust's U.S. beneficiaries. Similarly, a distribution of property from a PFIC to the foreign nongrantor trust may be treated as a distribution to its U.S. beneficiaries.[184] The specific tax consequences to a U.S. shareholder depends on whether or not she makes a "qualified electing fund" election.[185]

3. The Attribution, Indirect, and Constructive Ownership Rules

The CFC and FPHC regimes contain indirect and constructive ownership rules that are used to determine both whether a corporation is a CFC or an FPHC and the extent to which U.S. persons will be taxed on its income.[186] Similarly, the PFIC regime contains attribution rules that are used to determine the extent to which U.S. persons will be taxed on distributions and dispositions.[187] These rules provide that stock in a foreign corporation owned by a foreign nongrantor trust will be considered as owned proportionately by its beneficiaries.[188] When the beneficiaries of a foreign nongrantor trust have fixed interests in the trust, applying the constructive ownership rules is simple.

> **Example 21:** A foreign nongrantor trust established in 1998 (FNT) has three beneficiaries, Michael, Isaac and Tyler. Each beneficiary is entitled to 1/3 of FNT's income each year. At the end of 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 (80%) percent of 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 FC will be classified as a CFC and a FPHC. 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.[189]

Matters are more complicated when beneficial interests are divided temporally. Suppose, for example, that in Example 22, on the death of the first of Michael, Isaac and Tyler, the FNT was to terminate and all of its property was to be distributed to Cathlyn, a non-U.S. person. Suppose further that the actuarial value of the income interests in the trust were equal to 30% of

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[184] Code § 1298 (b)(5)(A).

[185] Code §§ 1293-1295.

[186] Code § 958(a) and (b); Code § 554(a).

[187] Code § 1298(a).

[188] Code § 958(a)(2) (CFC attribution rules); Code § 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. Code § 1298(a)(3).

[189] *See* Treas. Reg. § 1.958-1(d), Example 3; Treas. Reg. § 1.554-1; Treas. Reg. § 1.552-3; Treas. Reg. § 1.544-2.

the value of the trust and the actuarial value of the remainder interest, 70%. Do each of Michael and Isaac, the two U.S. persons, now indirectly own only 10% of FC?

The regulations under the FPHC rules deal only with trusts the beneficiaries of which own both present and future interests in equal shares.[190] The Service has ruled, however, that a beneficiary's proportionate ownership is to be determined with reference to her proportionate actuarial interest in the trust.[191] There are no final regulations interpreting the PFIC attribution rules. Proposed regulations suggest that the determination of a person's indirect ownership should be made on the basis of all the facts and circumstances.[192] The CFC regulations establish two different approaches. The first construes Code § 958(a), the subsection that determines both whether the beneficiary will be subject to tax on a CFC's income and whether the corporation whose shares are owned by the trust is a CFC. It states that the determination of a person's proportionate interest in a foreign trust will be made on the basis of all of the facts and circumstances.[193] The second construes Code § 958(b), the subsection that applies for purposes of determining whether a corporation is a CFC. It states that stock owned directly or indirectly by a trust will be considered as owned by its beneficiaries in proportion to the actuarial interests of such beneficiaries in the trust.[194]

The Service provided some guidance on this issue recently in Field Service Advice 199952014.[195] Without stating whether the actuarial allocation rule might simultaneously apply for purposes of Code § 958(b), it determined that, for purposes of Code § 958(a), the trust beneficiaries who were entitled to receive all current income should be treated as owning all of the stock owned by the trust. The remainder beneficiaries were treated as owning no stock.

In the personal holding company context, the Service has also provided some guidance as to discretionary trusts. 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.

In Private Letter Ruling 9024076,[196] the Service described several relevant facts and circumstances to be considered in determining the actuarial interest of a beneficiary in a discretionary trust for purposes of Code § 544 (concerning personal holding companies). 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. According to the Service, if it is possible to discern a pattern of past distributions, each

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[190] Treas. Reg. § 1.554-1; Treas. Reg. § 1.552-3; Treas. Reg. § 1.544-2.

[191] Rev. Rul. 62-155, 1962-2 C.B. 132.

[192] Prop. Reg. § 1.1291-1(b)(8)(i).

[193] Treas. Reg. § 1.958-1(c)(2).

[194] Treas. Reg. § 1.958-2(c)(1)(ii)(a).

[195] FSA 199952014 (September 23, 1999).

[196] PLR 9024076 (March 21, 1990).

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. 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.

4. Planning Techniques

If U.S. beneficiaries receive shares of FPHC's and CFC's their retention of the shares will subject them to current income tax at ordinary income tax rates on their pro rata share of corporate income whether or not the income is distributed to them. If, in order to avoid this result, they liquidate the corporation, they will be taxed on their share of the unrealized appreciation in the corporation's assets on liquidation and, if, their share of the value of the assets received on liquidation exceeds their basis in the stock of the corporation, on that gain as well.[197]

The tax on the unrealized appreciation in the corporation's assets can be avoided by using a combination of three foreign corporations to protect the nonresident alien's U.S. assets from U.S. estate tax, rather than one. The nonresident alien would own all of the shares of two of the foreign corporations. The two wholly owned foreign corporations would each own 50% of the shares of the third foreign corporation. The third foreign corporation would own the nonresident alien's U.S. assets. Each of the three foreign corporations must be one of the types of corporations that will be classified as a partnership for U.S. income tax purposes, if an appropriate election is made[198] and none of them would have any presence or business activities within the U.S.

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[197] If the liquidation takes place shortly after the death of the nonresident alien, the basis adjustment normally applicable under Code § 1014 will often eliminate the tax on the unrealized gain with respect to the shares of stock.

[198] Treas. Reg. § 301.7701-2 classifies, for U.S. income tax purposes, a foreign business entity, other than an entity that is automatically classified as a corporation under Treas. Reg. § 301.7701-2(b), as a partnership if it has more than one member at least one of which does not have limited liability, or as an association taxable as a corporation if all of its members have limited liability. If the entity has only one member and that member does not have limited liability, the entity is disregarded as an entity separate from its owner. A business entity is, generally, any entity other than an entity properly classified as a trust. Foreign entities that are automatically classified as corporations include the Societe Anonyme in Belgium, France, and Switzerland, the Aktiengellschaft in Austria, Germany and Switzerland, the Sociedad Anonima in Mexico and Spain, and the Public Limited Company in the United Kingdom. If a foreign entity is not automatically classified as a corporation, but is classified as an association taxable as a corporation because all of its members have limited liability, it may elect to be classified as a partnership by filing Form 8832 with the appropriate IRS service center. The election made on Form 8832 will be effective on the date specified on the form, provided that the effective date may not be more than 75 days prior to or more than 12 months after the form is filed.

Within 75 days after the death of the non-resident alien, the lower tier foreign corporation would file an election to be classified as a partnership for U.S. income tax purposes effective the day before the death of the nonresident alien. The effect of the election will be to treat the lower tier corporation as having distributed all of its assets and liabilities to its two shareholders in complete liquidation of the corporation on the day before the effective date of the election.[199] The lower tier corporation will be treated as recognizing gain to the extent the fair market value of its assets exceeds its basis in those assets,[200] but will not pay U.S. income tax on this gain because it is not subject to U.S. income tax. The basis of the lower tier corporation's assets in the hands of its corporate shareholders will be the fair market value of the assets on the day before the shareholder's death.[201] The deemed receipt by the upper tier corporations of the lower tier corporation's assets will be treated as amounts received in exchange for their stock in the lower tier corporation.[202] Any gain recognized, however, will not be subject to U.S. income tax since the corporations are not U.S. persons for U.S. income tax purposes.

After the lower tier corporation has made its election to be treated as a corporation, the two upper tier corporations would make the same election. In order to avoid partnership treatment on the date of her death and the uncertain U.S. estate tax consequences of that status, the effective date of the upper tier corporations' elections would be the day after the nonresident alien's death. The effect of the upper tier corporations' elections will be to treat them as having liquidated and as having distributed all of their assets to their shareholders, the nonresident alien's estate or her U.S. beneficiaries. Because the upper tier corporations' assets received a basis adjustment two days earlier as a result of the deemed liquidation of the lower tier corporation, the deemed liquidation of the upper tier corporations should produce minimal gain recognition. The shareholders of the upper tier corporations will be treated as having received the corporations' assets in exchange for their stock. If the nonresident alien's estate owns the stock, and if her estate is a foreign estate, there will be no U.S. income tax consequences. If the nonresident alien's U.S. beneficiaries own the stock, their gain on their deemed receipt of the corporations' assets should be minimal since their basis in the stock of the corporations will be the value as of the date of death of the nonresident alien.[203]

IV. TAX TREATMENT OF U.S. BENEFICIARIES OF GRANTOR TRUSTS WITH FOREIGN GRANTORS

A. Background

The 1996 Act limits the circumstances in which a person who is not a U.S. citizen or resident ("foreign person") will be treated as the owner of a trust under the grantor trust rules.

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[199] Treas. Reg. 301.7701-3(g)(1)(iii).

[200] Code § 311(b). U.S. income tax could be imposed, however, if the lower tier corporation owns U.S. real estate.

[201] Code § 334(a).

[202] Code § 331(a).

[203] Code§ 1014.

Under prior law, a foreign person would be treated as the owner of a trust under Code §§ 673 through 678 of the Code to the same extent as a U.S. person, whether the trust was foreign or domestic. Only Code § 679 was limited to U.S. grantors. If a foreign person were treated as the owner of the income, then (i) the foreign grantor-owner was taxed on such income only under the limited rules for taxing nonresident alien individuals and foreign corporations; and (ii) distributions from the trust to U.S. beneficiaries were treated as gifts from the foreign grantor-owner. Such gifts generally were not taxable to the U.S. beneficiary as income.[204] Gift tax would not be imposed so long as the subject matter of the gift was either intangible property or situated outside the U.S. or if the grantor-owner's gift to the trust had been a completed gift for gift tax purposes.

B. Limitation on Grantor Trusts

The new rules are designed to prevent the avoidance of U.S. income tax by limiting the circumstances in which foreign persons will be treated as the owner of trust assets under the grantor trust rules. Generally, under the new rules, the grantor trust rules will apply only to the extent the rules result in an amount (if the trust as any income) being currently taken into account in computing the income of a U.S. person.

C. Definition of "Grantor"

Treasury regulations define the term "grantor" as a person (which may include both an individual and a non-natural person) to the extent such person either creates a trust or directly or indirectly makes a "gratuitous transfer" of property to a trust. [205]

1. Accommodation Grantor

If a person creates or funds a trust on behalf of another person, both persons are treated as grantors, but only the person making gratuitous transfers may be treated as the owner of the trust. A person who is reimbursed for a gratuitous transfer is not treated as an owner of any portion of the trust. For example, if an attorney settles a trust for the benefit of a client's children, funds the trust with $5,000 and later receives reimbursement for such contribution, the attorney is a grantor who may have an obligation to report the creation of the foreign trust and the transfer of funds to the trust for purposes of Code § 6048, but the attorney is not treated as the owner of any portion of the trust. If an accommodation grantor, such as the attorney in the above example, were treated as the grantor for purposes of the exception to the intermediary rule, the intermediary rule would be easily circumvented. Distributions could be made from foreign trusts through accommodation grantors and such transfers would be tax-free gifts to the U.S. donees.

2. "Gratuitous Transfer"

A gratuitous transfer means a transfer other than a transfer made for fair market value or a distribution made by an entity, such as a corporation or partnership, in respect of an interest in

[204] Rev. Rul. 69-70, 1969-1 C.B. 182.

[205] Treas. Reg. § 1.671-2(e).

such entity owned by a trust. For example, dividends received from a corporation in which a trust owns stock are not gratuitous transfers. A transfer for fair market value means a transfer in consideration for and equal to the value of (i) property received from the trust (other than an interest in the trust); (ii) services rendered by the trust; or (iii) the right to use property owned by the trust. A transfer may be gratuitous without regard to whether it is a gift for gift tax purposes and without regard to whether gain is recognized on the transfer.

3. "Grantor" Includes Purchasers

A grantor includes a person who acquires a beneficial interest in a trust from the grantor if the trust is one of the following-- a fixed investment trust described in Treas. Reg. § 301.7701-4(c), a liquidating trust described in Treas. Reg. § 301.7701-4(d) or an environmental remediation trust described in Treas. Reg. § 301.7701-4(e).

4. Grantors Who Are Corporations or Partnerships

A corporation or partnership will be treated as the grantor of a trust established for a business purpose, such as to secure a legal obligation to an unrelated third party. However, if a corporation or partnership establishes a trust for a purpose other than a business purpose, the shareholder or partner on whose behalf the trust was deemed to have been established will be treated as constructively receiving the property and contributing it to the trust.

5. Trusts Established by Other Trusts

If a trust makes a gratuitous transfer to another trust, the grantor of the transferor trust is treated as the grantor of the transferee trust unless a person with a general power of appointment over the transferor trust exercises the power in favor of another trust, in which case the power holder is treated as the grantor of the transferee trust. This rule applies even if the grantor of the transferor trust is treated as the owner of the transferor trust. This rule creates significant planning opportunities.

A power of appointment exercisable with the consent of a person who is not the grantor or an adverse party may be a general power. For example, suppose that A creates a foreign trust which is treated as owned by A. Further suppose that B, who is a nonresident alien individual, has a general power of appointment over the trust exercisable with the consent of a protector who is related to A but who has no beneficial interest in the trust. If B exercises the power to appoint the trust assets to a new trust, B is treated as the grantor of the trust to which the assets have been appointed. Although B will not qualify as the owner of the trust unless the requirements of Code § 672(f)(2) are met, distributions through B may satisfy the exception to the intermediary rule in Code § 643(h) even if B is not treated as the owner of the trust.

Code § 672(f)(5) does not apply to make A the owner of the trust (even assuming that A were a beneficiary of the transferee trust) unless B would otherwise be treated as the owner of the trust.

Code § 679 treats A as the owner of the foreign transferee trust if A has transferred property to the trust, directly or indirectly, and the trust has a U.S. beneficiary, unless the transfer was for value. Has A indirectly transferred property to the trust established by B´s exercise of

B´s power of appointment? Does Treas. Reg. § 1.671-2(e)(5) affect the analysis? That regulation makes B, and not A, the grantor of the transferee trust. Does this regulation preclude A from being treated as the transferor of the transferee trust for purposes of Code § 679?

If B's power were a limited power of appointment, A would continue to be treated as the grantor of the trust to which the assets were appointed.

6. Code § 678 Powers

The regulations clarify that a person who has the right to withdraw assets from the trust is not a "grantor." Although such a person would be treated as the owner of the trust under Code § 678 if he or she were a U.S. person, a foreign person who has an unexercised Code § 678 power will not be treated as the owner of a trust.[206]

If the person who has the Code § 678 power exercises the power to create a new trust, then he or she will qualify as the grantor. Even if he or she will not qualify as the owner of the trust, distributions may be made through the new grantor. The grantor is never treated as the intermediary.

Reg. § 1.671-2(e)(5) provides that a person who funds a trust by exercising a general power of appointment is the grantor. The general power of appointment, but not the Code § 678 power, can be subject to limitations on exercise. Therefore, a power of appointment may be more useful for changing the grantor.

However, there is a risk that a nominal grantor will not be treated as the grantor for purposes of the intermediary rule. In some cases, the more conservative course may be to give the grantor control over assets before they are resettled in a new trust so that there is less argument for challenging his or her status as a real grantor.

D. Foreign Persons Not Treated as Owners

1. General Rule

Code § 672(f)(1) provides:

> Notwithstanding any other provision of this subpart, this subpart shall apply only to the extent such application results in an amount (if any) being currently taken into account (directly or through 1 or more entities) under this chapter in computing the income of a citizen or resident of the United States or a domestic corporation.

2. Exceptions to General Rule

Code § 672(f)(2) provides three exceptions to the general rule of Code § 672(f) - certain revocable trusts, trusts that benefit only the grantor and the grantor's spouse and compensatory

[206] Treas. Reg. § 1.671-2(e)(6), Example 4.

trusts. In addition, certain trusts in existence on September 19, 1995 are grandfathered from the new rules.

a. Revocable Trust

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

A related or subordinate party is a "nonadverse party" who is the grantor's mother, father, issue, sibling, employee, a corporation or employee of a corporation in which the stock holdings of the grantor and the trust are significant from the viewpoint of voting control, or a subordinate employee of a corporation in which the grantor is an executive. A nonadverse party is a person who does not have a sufficient beneficial interest in the trust to be adverse to the exercise of the power of revocation.

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

De facto control over the person who holds the consent power is not sufficient. Example 3 of Treas. Reg. § 1.672(f)-3(a)(4) provides that where an independent trustee has the power to revest assets in the grantor and the grantor has the power to replace an independent bank with a related or subordinate trustee, the nonresident alien grantor will not be treated as the owner of the trust. Example 1 reaches the opposite conclusion where the bank serving as trustee is owned and controlled by the grantor's brother. The regulations are not consistent with the Service rulings concerning when trustee powers are imputed to the grantor.[207] If the grantor has the power to remove the independent bank and appoint himself as trustee, the powers of the trustee should be imputed to the grantor, but the regulations suggest that the Service would not agree.

A trust revocable by the grantor with the consent of his/her spouse is treated as revocable by the grantor without anyone's consent. The consent of the grantor's spouse is disregarded because powers held by a spouse are attributed to the grantor under Code § 672(e).

Treas. Reg. § 1.672(f)-3(a)(2) requires that the revocation power must be exercisable for a period aggregating 183 days or more during the taxable year of the trust. If the year is less than 183 days, the 183 day requirement is met if the trust is revocable for each day of the short year.

Treas. Reg. § 1.672(f)-3(a)(1) provides that if a trust does not qualify for the limited exception for certain revocable trusts for a particular year, the trust will not qualify for the exception in any subsequent year even if the trust is later revocable by the grantor. The grantor could exercise the power and resettle the trust.

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[207] *See*, for example, Rev. Rul. 79-353, 1979-2 C.B. 325; as modified by Rev. Rul. 95-58, 1995-2 C.B. 191.

A beneficiary who has a withdrawal right is not treated as the de facto grantor. For example, a beneficiary who can withdraw all of the assets of a trust at any time is not defined as the grantor, and thus cannot be treated as the owner of the trust under Code § 672(f)(2)(A)(i). If the beneficiary actually withdrew trust assets and funded a new trust, the beneficiary would be treated as the grantor-owner if he or she retained the same right to withdraw the assets from the trust.

b. Trust for the Benefit of Grantor and Spouse

A trust that benefits only the grantor and his/her spouse during the lifetime of the grantor is exempt from Code § 672(f)(1). If any amount is distributable to another person, even temporarily, the trust will not be a grantor trust under this exception. For example, if a trust benefits only the grantor except that distributions may be made to the grantor's child during the period the child attends graduate school, the trust will not be a grantor trust even after the child graduates.[208]

The regulations treat certain amounts that are distributable to discharge a legal obligation of the grantor or the grantor's spouse as distributable to the grantor or the grantor's spouse for purposes of determining the applicability of this exception.[209] If the obligation is owed to a person not related to the grantor or the grantor's spouse, the exception is applicable so long as it is enforceable under the local law of the jurisdiction where the grantor or the grantor's spouse resides. If, however, the obligee is a related person (other than a spouse who is legally separated from the grantor under a decree of divorce or separate maintenance), the exception will not apply unless "it was contracted, bona fide and for adequate and full consideration in money or money's worth"[210] or unless the related person is an individual who would be treated as a dependent of the grantor or the grantor's spouse under Code § 152(a)(1) through (9) if the grantor or the grantor's spouse provided more than half of his or her support and that individual is either permanently disabled or younger than 19 years of age.

For this purpose, a person is related to the grantor or the grantor's spouse if the relationship between them would result in a disallowance of losses under Code § 267 or § 707(b) with the following expansions of the relationships described in those provisions:

- For purposes of applying the family relationship rules of Code § 267, the family of an individual includes the individual's spouse.

- For purposes of apply Code § 267 (other than Code § 267(f)) and Code § 707(b)(1), a 10%, rather than a 50% is interest, is required.

Under the proposed regulations, a trust might cease to be a grantor trust after the grantor´s divorce (unless another exception to Code § 672(f)(1) applies), but it was clear that it

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

[209] Treas. Reg. § 1.672(f)-(3)(b)(2)(i).

[210] Treas. Reg. § 1.672(f)-(3)(b)(2)(ii).

was not necessary that the trust provide *ab initio* that divorce terminates the spouse's interest in the trust.[211] The final regulations do not address divorce except to say that distributions pursuant to a decree of divorce or separate maintenance are deemed to satisfy the legal obligations of the grantor. It is uncertain whether a trust which fails to terminate the interest of the grantor´s spouse upon divorce will qualify for this exception to Code § 672(f)(1).

The exception in Code § 672(f)(2)(A)(ii) also applies to certain business trusts established by a corporation or other business entity. For example, a trust established by a corporation to secure a loan to finance an airplane will be a grantor trust under this exception if distributions may only be made to satisfy the legal obligations of the corporate grantor arising out of its loan.[212]

c. Certain Compensatory Trusts

Compensatory trusts are exempt from Code § 672(f)(1). The final regulations clarify that compensatory trusts include those for self employed persons (independent contractors) as well as employees.

d. Limited Grandfathering for Trusts Funded as of September 19, 1995

Code § 672(f)(1) does not apply to trusts that are grandfathered. Grandfathered trusts are trusts to the extent funded as of September 19, 1995 that were either:

> Treated as owned by the grantor because distributions could be made to the grantor or the grantor's spouse without the consent of an adverse party; or
>
> Treated as owned by the grantor because the trusts were revocable by the grantor without the consent of an adverse party. Unlike the exception in Code § 672(f)(2), the person whose consent is required to revoke can be independent and need not be related or subordinate.

According to the statute, grantor trust status continues as long as the trust otherwise would continue to be so treated under any of the basic grantor trust rules and only if any portion of the trust that is attributable to transfers to the trust that are made after September 19, 1995, are separately accounted for. The regulations clarify that physical separation is not required and give an extension of time to satisfy the separate accounting requirement. Separate accounting is satisfied if completed by the due date (including extensions) for the tax return of the trust for the first taxable year of the trust beginning after August 10, 1999. Such additions are not grandfathered.[213]

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

[212] Treas. Reg. § 1.672(f)-3(b)(4), Example 6.

[213] Treas. Reg. § 1.672(f)-3(d).

The statute says that the new grantor trust rules of Code § 672(f) do not apply to grandfathered trusts, with no requirement that the grandfathered trusts continue to satisfy the requirements for which grandfathered status was allowed. However, Treas. Reg. § 1.672(f)-3(a)(3) provides that a trust which was treated as owned by the grantor under Code § 676 on September 19, 1995, will no longer be grandfathered if it thereafter ceases to satisfy Code § 676. Similarly, Treas. Reg. § 1.672(f)-3(b)(3) provides that a trust that was treated as owned by the grantor under § 677(a)(1) or (2) on September 19, 1995 will no longer be grandfathered if it thereafter ceases to satisfy § 677(a)(1) or (2). The regulation suggests that a trust would not be grandfathered if it satisfied Code § 677 when it ceased to satisfy Code § 676 unless it also satisfied Code § 677 on September 19, 1995.

3. Trusts Created by Certain Foreign Corporations

Code § 672(f)(3) provides that the rules of Code § 672(f)(1) do not apply to a CFC or a PFIC. This prevents such corporations from using foreign trusts to avoid U.S. tax. Treas. Reg. § 1.672(f)-2 extends these rules to FPHCs.

CFCs, PFICs and FPHCs are treated as domestic corporations for purposes of the grantor trust rules but are treated as foreign corporations for purposes of Code § 672(f)(4). Code § 674(f)(4) gives the Service the authority to recharacterize purported gifts to U.S. persons that are made directly or indirectly from foreign corporations. The regulations treat gifts to U.S. persons that are made from a trust funded by a foreign corporation as if made indirectly by such corporation if that incurs more U.S. tax.

The regulations further provide that the rules of Code § 672(f)(4) also will apply if the CFC, PFIC or FPHC is not the grantor of a foreign trust but is treated as the owner of such trust under Code § 678. Purported gifts to U.S. persons from the foreign trust over which a CFC, PFIC or FPHC has a Code § 678 power will be treated as indirectly made by such CFC, PFIC or FPHC.

For purposes of determining whether the character of income and assets of a corporation qualifies it to be classified as a PFIC, the rules of Code § 672(f) are ignored. That is, the assets held in the trust are treated as held directly by the PFIC.

Treas. Reg. § 1.672(f)-2 is effective for tax years of shareholders of CFCs, PFICs and FPHCs beginning after August 10, 1999 and taxable years of CFCs, PFICs and FPHCs ending with or within such taxable years of the shareholders.

E. Consequences of Expatriation

Unless the foreign trust is a grantor trust under the rules of § 672(f), a U.S. person who expatriates at a time when she is treated as the owner of a foreign trust will cease to be treated as the owner of the trust under the grantor trust rules when she expatriates. If the grantor ceases to be treated as the owner of the foreign trust, the grantor will be treated as selling all of the assets of the trust immediately before the trust ceases to be a grantor trust and will be required to recognize gain but not loss.[214]

Example 23:

Joshua moved to the U.S. in 2000 for temporary employment. Joshua had established a foreign trust before becoming a U.S. resident. The trust owns securities worth $1 million that have a basis of $700,000. The trust is an irrevocable discretionary trust for the benefit of Joshua and his family and thus is not a grantor trust under § 672(f) while Joshua is not a U.S. person. However, while he is a U.S. person, the trust is a grantor trust. After two years, Joshua returns to his home in the U.K. The trust assets have appreciated to $1.2 million. Joshua will recognize at least $500,000 of gain immediately before he is no longer treated as the owner of the trust, that is, immediately before he ceases to be treated as a U.S. person. Depending upon the circumstances, this may occur when he departs on January 1 of the year following his departure. Joshua's gain includes appreciation that accrued before Joshua moved to the U.S. Because the gain accrues immediately before Joshua ceases to be a U.S. person, he cannot avoid tax on non-U.S. source gains.

Joshua could avoid gain if the trust continued to qualify as a grantor trust after his residency terminated. However, this solution will not be effective in 2010 because, under the Economic Growth and Tax Relief Reconciliation Act of 2001, Code § 684 will apply to impose gain in that year unless a U.S. person is treated as the owner of the foreign trust.[215]

Joshua could avoid gain if the trust terminated immediately before he expatriated.

F. Shifting the Identity of the Grantor

Code § 672(f)(5) provides that if a foreign person funds a trust which would be a grantor trust and a U.S. person who is a beneficiary made gratuitous transfers to such foreign person, the U.S. beneficiary will be treated as the grantor-owner of the trust. The rule applies whether or not the beneficiary was a U.S. person at the time of the transfer to the foreign person, but only if the U.S. person making the gratuitous transfer to the foreign person is a beneficiary. For example, if A transfers assets to a foreign corporation before becoming a U.S. person and the foreign corporation establishes a revocable trust for A and A's family, A will be treated as the grantor after she becomes a U.S. person.

Code § 672(f)(5) would not apply if A were not a beneficiary. For this purpose, however, the Service views a person who may be added as a beneficiary as a "beneficiary."

[214] Treas. Reg. § 1.684-2(e).

[215] Section 542(e)(1) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

Code § 672(f)(5) does not by its terms contain any time constraints on applying this rule. If the U.S. beneficiary can demonstrate that the transfer to the foreign person was wholly unrelated to the funding of the trust, Code § 672(f)(5) will not apply.[216]

Transfers not in excess of the amount not treated as taxable gifts under Code § 2503(b) are disregarded.[217]

G. Pre-immigration Trusts

1. Code §§ 679 and 6048 Extended to Immigrants

A foreign person who becomes a U.S. person will generally be treated as the owner, under the rules of Code § 679, of any property which he or she transferred to a foreign trust within the five-year period prior to his or her U.S. residency starting date. For purposes of both Code §§ 679 and 6048 - imposing reporting obligations on transfers to foreign trusts - the person will be treated as having transferred such property (together with any undistributed income, appreciation and gains thereon) to the trust on his or her U.S. residency starting date. Consequently, income accruing before the U.S. residency date will not be subject to U.S. tax (except to the extent that it is U.S. source income).

2. No U.S. Beneficiaries

Code § 679 will not apply, however, if the foreign trust does not have any U.S. beneficiaries after the grantor's U.S. residency starting date. For this purpose, potential beneficiaries and future beneficiaries are counted. For example, if the trust can be amended to add a U.S. person as a beneficiary, the trust will be taxable to the grantor.[218] However, if a foreign beneficiary first becomes a U.S. person more than five years after the trust is funded, the trust is not treated as having a U.S. beneficiary for purposes of Code § 679. The exception is not available if the individual had previously been a U.S. resident.[219]

3. Indirect Transfers

Code § 679 applies to indirect as well as direct transfers.[220] For example, if A gives assets to his brother before moving to the U.S. and A's brother funds a trust for A and A's family less than 5 years before A moves to the U.S., A will be treated as the owner of the trust unless A can show that A's brother was not acting as an intermediary as defined in Treasury Regulation § 1.679-3(c).

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[216] Treas. Reg. § 1.672(f)(5)(a).

[217] *Id.*

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

[219] Treas. Reg. § 1.679-2(a)(3), Example 2.

[220] Treas. Reg. § 1.679-3(c). *See*, Haeri v. Commissioner, T.C. Memo 1989-20 (Jan. 11, 1989).

4. Comparison of Code §§ 672(f)(5) and 679(a)(4)

Code § 679(a)(4) applies whether or not A's brother would be treated as the owner of the trust and whether or not A is a beneficiary of the trust. Code § 672(f)(5) has no time limit, but Code § 679(a)(4) does not apply if the trust is funded more than five years before immigration to the U.S. It is not clear whether Code § 679(a)(4) applies if A's transfer to his brother occurred more than 5 years before A moved to the U.S. but the trust was funded within the five-year period before U.S. residency commenced.

V. RECHARACTERIZATION OF PURPORTED GIFTS

A. Purported Gifts From Partnerships

Where a U.S. person receives a purported gift from a partnership (directly or indirectly), the entire amount must be included in the U.S. donee's gross income as ordinary income without regard to the amount of partnership income.[221]

B. Purported Gifts From Corporations

Where a U.S. person receives a purported gift from a foreign corporation (directly or indirectly), the amount must be included in the U.S. donee's income as if it were a distribution from the foreign corporation. The distribution will be taxed as a dividend to the extent of earnings and profits and as a redemption to the extent the amount exceeds earnings and profits. If the corporation is a PFIC, an interest charge may apply. If the distribution is taxed as a redemption, the donee's basis will be deemed to be zero. The donee's holding period for determining whether any gain is short or long term is equal to the weighted average of the holding periods of the actual shareholders. If the purported donee is a corporation, no "deemed paid" foreign tax credit will be allowed under Code § 902 to offset U.S. tax.

C. "Purported Gift"

A "purported gift or bequest" is any transfer, other than a transfer for fair market value, made from a corporation or a partnership to a person who is not a shareholder or a partner (or, if the purported donee is a shareholder or partner, a purported gift includes a distribution not consistent with the donee's interest in the partnership or corporation).[222]

D. Exceptions

There are the following exceptions to the above rules:

1. Donee has no Relationship to Partners or Shareholders

The purported gift rules do not apply if the U.S. person receiving the purported gift has no family or other relationship to a partner or shareholder that establishes a reasonable basis for

[221] Treas. Reg. § 1.672(f)-4.

[222] Treas. Reg. § 1.672(f)-4(d).

concluding that the partnership or foreign corporation would make a gratuitous transfer to the U.S. donee.[223]

2. U.S. Partnership Wholly Owned by U.S. Citizens or Residents or Domestic Corporations

If all beneficial owners of a U.S. partnership are U.S. citizens or residents or domestic corporations, the purported gift rules do not apply. This exception does not apply to foreign partnerships.

3. A U.S. Citizen or Resident Individual Owning the Shares or Interests Reports the Distribution and Gift

If a U.S. citizen or resident individual who directly or indirectly holds an interest in the partnership or foreign corporation treated the gift as a distribution to the U.S. partner or shareholder and as a subsequent gift by such partner or shareholder to the U.S. donee, then the gift will not be taxable to the donee. There is no similar exception where the owner of the interest is a non-natural person, such as a trust.

4. Foreign Individual Owning the Shares or Interests Reports the Distribution and Gift and U.S. Donee Reports the Gift

If a nonresident alien individual partner or shareholder reported the distribution from the entity and the gift for purposes of the tax laws of such individual's country of residence and the U.S. donee timely reported the gift in accordance with Code § 6039F, then the gift will not be taxable to the donee. Example 1 of Treas. Reg. § 1.672(f)-4(g) suggests that if reporting in the foreign country is "not applicable" under the laws of such country, the exception may still be available.

5. Capital Contributions

The purported gift rules do not apply to contributions to the capital of a U.S. corporation described in Code § 118.

6. Charities

The rule does not apply to payments made for an exempt purpose by donors who are charities and who have received determination letters of tax exempt status or to donees that are charities described in Code § 170(c).

7. Gifts Through Trusts Funded by Gratuitous Transfers from Partnerships or Foreign Corporations

If a partnership or foreign corporation creates and funds a trust, whether or not it is the entity or the partners or shareholders who are treated as the grantors of the trust (see Treas. Reg.

[223] Treas. Reg. § 1.672(f)-4(d)(2)(ii).

§ 1.671-2(e)(4) treating entities as the grantor of trusts established for business purposes and partners and shareholders as the grantor of trusts established for nonbusiness purposes), and then the trust makes a distribution to a U.S. person --

(a) The distribution is deemed made by the partnership or foreign corporation unless the rule in (b) applies.

(b) The distribution will be taxed as if it were made by the trust if the tax as so computed would be greater than the tax that would be imposed if it were treated as a distribution directly from the partnership or foreign corporation.[224]

(c) A distribution to a U.S. person from a trust funded by a foreign corporation or partnership will not be taxed as a purported gift by the entity or as a trust distribution if a U.S. donee demonstrates that the transfer has been taken into account for U.S. tax purposes by a U.S. citizen or resident or domestic corporation. No similar exception applies where a nonresident alien has reported the income. In Example 3 of Treas. Reg. § 1.672(f)-4(g), a purported gift to a U.S. person from a foreign trust funded by a foreign corporation is treated as subject to the accumulation distribution rules. The example does not mention whether a foreign shareholder reported the distribution and the gift. An inference can be drawn that the Service considered this fact immaterial, since this information was mentioned in Example 1, where the distribution was made directly from the foreign corporation.

E. Affirmative Use

Treas. Reg. § 1.672(f)-4(e) provides that a taxpayer may not use the rules under Code § 672(f)(4) affirmatively to reduce the taxpayer's tax liability. The regulation purports to give the Service authority to "depart from the rules of this section and recharacterize (for all purposes of the Internal Revenue Code) the transfer in accordance with its form or its economic substance."

F. De Minimis Rule

The purported gift rules do not apply if during the taxable year of a U.S. donee, the aggregate amount of gifts and bequests received directly or indirectly (such as from trusts) from all partnerships or foreign corporations that are related does not exceed $10,000.[225] The amount must include gifts or bequests from persons that the U.S. donee knows or has reason to know are related to the partnership or foreign corporation within the definition of "related" in Code § 643(i).

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[224] Treas. Reg. § 1.672(f)-4(c)(2).

[225] Treas. Reg. § 1.672(f)-4(f).

G. Anti-Avoidance Rule - Check the Box

The purported gift rules cannot be avoided by electing pass-through treatment for a single member entity. A single member entity that elects to be taxed as a sole proprietorship under the check the box regulations will be treated as a corporation for purposes of Treas. Reg. § 1.672(f)-4.[226] This rule gives the Service latitude to recharacterize purported gifts made by such entities.

VI. REPORTING OF DISTRIBUTIONS FROM FOREIGN TRUSTS AND GIFTS FROM FOREIGN PERSONS

A. Reporting by U.S. Beneficiaries of Foreign Trusts

A U.S. person (including a grantor) who receives, directly or indirectly, any distribution from a foreign trust must report to the Service information regarding the name of the trust, the amount of distributions received from the trust, and such other information as the Service may require.[227] Form 3520 is used to report distributions from foreign trusts.

In Notice 97-34,[228] the Service describes the additional required information. Such information is to be set forth in either a Foreign Grantor Trust Beneficiary Statement or a Foreign Nongrantor Trust Beneficiary Statement.

1. Nontaxable Distributions Are Reportable

Reporting is required even if the foreign trust is a grantor trust and whether or not Code § 663(a) applies to the distribution.

2. Only Gratuitous Transfers Are Reportable

All gratuitous transfers are reportable. Trustee fees, for example, are not reportable. However, if the trustee fees paid to a beneficiary/trustee are excessive, the distribution is reportable. The reporting obligation is waived if the payee reports the amount as taxable compensation for services rendered.

3. Constructive Distributions

Indirect and constructive distributions are reportable. For example, if a beneficiary uses a credit card and the trust guarantees or pays the invoice, the amount charged on the card is treated as a distribution. A beneficiary who draws a check on a trust account is in receipt of a distribution. A beneficiary who receives a payment for services or property in excess of the value of such services or property is deemed to have received a distribution.

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[226] Treas. Reg. §§ 1.672(f)-5(b).

[227] Code § 6048(c).

[228] 1997-1 C.B. 422.

4. Knowledge that Trust Is Foreign

Reporting is required only if the U.S. beneficiary knows or has reason to know that the trust is a foreign trust.

5. Information Required

a. Service Discretion to Determine Tax

Code § 6048(c) provides that if adequate records are not provided (by the beneficiary or some other person) to enable the Service to determine the proper tax treatment of any distribution received from a foreign trust, then the distribution will be treated as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax. For purposes of determining the interest charge on the throwback tax, the deemed accumulation period will be one-half of the years the trust has been in existence.

b. Appointment of Agent

To the extent provided in regulations, this rule will not apply if the foreign trust has appointed a U.S. agent for the purpose of responding to Service inquiries. Any U.S. person may serve as the agent of the trust, including a grantor or a beneficiary. While the appointment of a U.S. agent is not required, if an agent is not appointed the Service will have broad discretion to determine the amount of taxable income derived by the U.S. beneficiary from the trust. According to the "Blue Book" prepared by the staff of the Joint Committee on Taxation, Congress intended that the Service's exercise of this authority will be subject to judicial review under an "arbitrary and capricious" standard, which provides a high degree of deference to the Service.[229] A foreign trust which appoints such an agent will not be considered to have an office or permanent establishment in the United States, or to be engaged in a U.S. trade or business, solely because of the activities of the agent under Code § 6048. Notice 97-34 provides a form for the appointment of an agent.

c. Beneficiary Statements

A U.S. beneficiary may avoid treatment of a distribution as a taxable accumulation distribution from a foreign nongrantor trust, subject to the throwback tax, if with respect to the distribution, the beneficiary obtains from the foreign trust either (i) a Foreign Grantor Trust Beneficiary Statement to be attached to Form 3520, which would allow the beneficiary to treat the distribution as a nontaxable gift, (ii) a Foreign Nongrantor Trust Beneficiary Statement to be attached to Form 3520, or (iii) information regarding actual distributions from the trust for the prior three years ("default treatment"). Under the default treatment, a U.S. beneficiary will be allowed to treat a portion of the distribution as current income based on the average of distributions from the prior three years, with only the excess amount of the distribution treated as an accumulation distribution subject to the throwback tax. This rule is an adaptation of the rule

[229] *See* Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 104th Congress* (JCS-12-6), December 18, 1996, at 276.

for determining the interest charge on distributions from a passive foreign investment company.[230]

d. Exceptions

Beneficiaries need not report (i) distributions from trusts taxable as compensation for services rendered that are reported as such on the recipient's federal income tax return, or (ii) distributions from foreign trusts received by a U.S. charitable organization, provided that such organization has a determination letter from the Service (that has not been revoked) recognizing its tax-exempt status.

It is not clear whether loans from grantor trust are reportable. Notice 97-34 provides:

If a trust makes a loan to a grantor that causes the grantor to be treated as the owner of a portion of the trust under section 675(3), the loan will not be treated as a distribution under section 643(i) and will not be reportable under section 6048(c).

Code 643(i) treats loans as distributions for purposes of Subparts B, C and D. These Subparts do not apply to grantor trusts. Consequently, loans to any beneficiary from a grantor trust may not be reportable. However, Form 3520 does not "prompt" this result, and it is not clear why as a matter of policy an exception to the reporting requirements would be made for loans from grantor trusts when other distributions from grantor trusts are reportable.

e. Penalties for Nonreporting

A U.S. beneficiary who fails to report distributions from a foreign trust under Code § 6048(c) will be subject to a penalty equal to 35 percent of the amount distributed.[231] Additional penalties can be imposed for continuing noncompliance; however, the total penalties may not exceed the reportable amount. The Service is authorized to assess and collect these penalties without prior judicial review.

The Service is permitted to waive any penalty if the failure to file was due to reasonable cause and not due to willful neglect. The fact that a foreign jurisdiction would impose a civil or criminal penalty on any person for disclosing the required information will not be considered a reasonable cause for failure to file. Notice 97-34 clarifies that "reasonable cause" does not include refusal on the part of a foreign trustee to provide information. This is true whatever the reason, including difficulty in producing the required information or provisions in the trust instrument that prevent the disclosure of information.

These penalties generally apply to distributions received after August 20, 1996.

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[230] *See* Code § 1291(b).

[231] Code § 6677.

If penalties for nonreporting could apply under both Code §§ 6677 and 6039F, then the Code § 6677 penalty will be assessed and will reduce any penalty otherwise imposed under Code § 6039F.[232]

B. Reporting of Foreign Gifts

Code § 6039F imposes information reporting requirements on any U.S. person (other than certain tax-exempt organizations) who after August 20, 1996 receives, in the aggregate, foreign gifts in excess of $10,000 in any taxable year.[233] This $10,000 threshold is indexed for inflation after 1996. The 1997 threshold is $10,276; for 1998 the threshold is $10,557; for 1999 the threshold is $10,735; for 2000 the threshold is $10,931; for 2001 the threshold is $11,273; for 2002 the threshold is $11,642, for 2003 the threshold is $11,827; and for 2004 the threshold is $12,097.

1. Form 3520

Part IV of Form 3520 requires only a brief description of the property received, the fair market value of the property and the date of the gift where the donor is an individual or an estate. Form 3520 does not ask for the name and address of the donor except where the foreign donor is a corporation or a partnership. The identity of a foreign donor who is a corporation or a partnership must be disclosed. The form also asks whether the filer has any reason to believe that the foreign donor is acting as a nominee or intermediary for another person. Form 3520 does not indicate that a gift from a grantor should not be treated as gifts by an intermediary. Even though the identity of donors is not required in the case of donors who are individuals, it is important to note that upon request, the U.S. person may be required to provide additional information, including the identity of the donor.

2. Exceptions

Qualified tuition and medical payments are not taxable gifts under Code § 2503(e) and will not have to be reported. Distributions made from a foreign trust to a U.S. beneficiary, and which are reported by the U.S. beneficiary under Code § 6048(c), do not have to be reported again by the U.S. beneficiary under Code § 6039F.

3. Interaction of Codes §§ 6039F and 6048

U.S. beneficiaries who receive distributions from foreign trusts should report the amounts under the trust reporting rules Code § 6048(c) rather than the gift reporting rules of Code § 6039F. This is true even if the trust is grantor trust and the distribution is treated as a gift under principles of substantive law.

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[232] Notice 97-34.

[233] Code § 6039F.

4. Gifts to Trusts

U.S. beneficiaries are not required to report contributions by foreign persons to trusts in which the U.S. beneficiaries have an interest, unless the U.S. beneficiaries are treated as receiving the contribution in the year of transfer (*i.e.*, a U.S. beneficiary has a Code § 678 power). A domestic trust that receives a contribution from a foreign person must report the gift unless the trust is treated as owned by a foreign person (*e.g.*, a foreign person creates a U.S. revocable trust). According to Notice 97-34 and the instructions to Form 3520, a U.S. beneficiary who receives a distribution from a domestic grantor trust owned by a foreign grantor must report it under Code § 6039F as a gift from a foreign person (*i.e.*, the deemed foreign owner of the domestic trust).

5. Reporting Thresholds

a. Individuals and Estates

Notice 94-38 increases the statutory threshold for reporting gifts received from foreign individuals and foreign estates. The annual reporting threshold for the aggregate amount of gifts from a foreign individual or foreign estate is $100,000 with respect to that individual or estate. Once the $100,000 threshold is met, Form 3520 requires the U.S. donee to separately identify each gift in excess of $5,000; however, the U.S. donee is not required to identify the donor unless the Service requests this information.

b. Corporations and Partnerships

A U.S. person is required to report the receipt of purported gifts from foreign corporations and foreign partnerships if the aggregate amount of gifts from all such entities exceeds $10,000 (as adjusted for the cost of living under Code § 6039F(d)) in the taxable year. Once the $10,000 threshold is met, Form 3520 requires the U.S. donee to separately report all purported gifts from such entities, including the identity of the donor entity. Such purported gifts are subject to recharacterization under Code § 672(f)(4).

c. Aggregation Rules

In calculating the threshold amounts with respect to a particular foreign person, a U.S. donee must aggregate gifts from foreign persons that he or she knows, or should know, are related (under Code § 643(i)(2)(B)). If the relevant reporting threshold is exceeded, the donee must (i) separately report each aggregated gift in excess of $5,000 from a foreign individual or foreign estate without identifying the donor, and (ii) separately report each aggregated purported gift from a foreign corporation or foreign partnership, including the identity of the donor.

d. Examples.

Notice 97-34 provides two examples:

<u>Example 14</u>. If a U.S. person, A, receives $90,000 from his or her nonresident alien spouse, B, and the following amounts from the spouse's siblings:

Sibling C	$40,000
Sibling D	two gifts, $4,000 and $3,000
Sibling E	$4,000

The total of gifts from related foreign individuals is $141,000. Reporting is required because the total exceeds $100,000. A must separately identify the gifts from B and C. A must identify the receipt of $7,000 from D but is not required to separately list information about each transaction. A is not required to separately identify information about E's gift. None of the donors need be identified.

Example 15. If U.S. citizen, A, receives a gift of $6,000 from his or her nonresident alien spouse, B, and a purported gift of $8,000 from a foreign corporation wholly owned by B, A must report the gifts because A has reason to know that the donors are related and the aggregate amount, $14,000, exceeds the $10,000 threshold for gifts from foreign corporations. A must separately identify each gift.

6. Penalties for Nonreporting

A U.S. person who fails to report such foreign gifts will be subject to penalties equal to five percent of each gift for each month of noncompliance (not to exceed 25 percent of the aggregate foreign gifts). The Service is also authorized to determine the tax consequences of any unreported gift based on the information available to it. The Conference Report to the 1996 Act states that the Service's exercise of this authority will be subject to review under an "arbitrary and capricious" standard. These sanctions will not apply if the failure to file was due to reasonable cause and not due to willful neglect.

C. Unified Reporting Forms

Form 3520 ("Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts") allows U.S. persons generally to use a single form to comply with all the foreign trust and foreign gift reporting requirements. Form 3520-A is to be filed by U.S. grantor-owners of foreign trusts to report trust income.

Generally, to avoid the penalties for nonreporting under Code §§ 6039F or 6677, taxpayers must file Form 3520 with the Philadelphia Service Center by the due date of their income tax return (including extensions).

Form 3520-A must be filed in the Philadelphia Service Center by the fifteenth day of the third month following the end of the taxpayer's taxable year (*i.e.*, by March 15, in the case of a calendar year taxpayer) or later if an extension is granted. A separate form is required for each trust.