

Taxes and Social Policy

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Introduction

Effective August 5, 1997, the throwback rules were repealed for U.S. domestic trusts, but not for foreign non-grantor trusts.¹ With certain exceptions, the rules formerly applied to domestic trusts required that distributions made from accumulated income be included in the distributee's income if his or her average marginal tax rate over the previous five years was higher than that of the trust. Also repealed was the rule requiring any gain on the sale of appreciated property contributed to a trust be taxed at the contributor's marginal tax rates if the property were sold within two years of its contribution.

The compressed tax rates currently applicable to retained earnings of a domestic trust (39.6% on the excess income over \$7,500 adjusted annually for inflation) discourage strategies aimed at using trusts as income-shifting devices. Repeal of the throwback rules simplified trust tax reporting and reflected in major part a Congressional view that the compressed tax rates for trusts encourage distribution of income.

Given the punitive tax on distributions of accumulated income by foreign non-grantor trusts to U.S. beneficiaries, should not the same remedy be employed? The point of this article is that the throwback rules for foreign non-grantor trusts should be repealed for the same policy reasons as those supporting repeal of the rules for domestic trusts.

Taxation of Foreign Non-Grantor Trusts, Simplified

Definitions. Foreign *grantor* trusts may be viewed in three categories: (1) those for which the settlor is a non-resident, non-citizen alien and the trust has U.S. beneficiaries, (2) those for which the settlor is a U.S. person and the trust has U.S. beneficiaries, and (3) those for which the settlor is a U.S. person and the trust has *no* U.S. beneficiaries.

Since 1996, if the non-resident, non-citizen settlor reserves the power to revoke the trust or keeps the income for self or spouse, that settlor was the deemed owner and responsible for reporting the trust income, deductions and credits under the grantor trust rules.² But since the settlor is beyond the tax jurisdiction of the U.S., no tax is imposed and the U.S. beneficiaries receive trust distributions tax-free. This remains the result notwithstanding substantial narrowing of the conditions under which grantor trust classification is recognized. If the foreign trust falls short of either criterion, the non-resident, non-citizen settlor is treated as the owner only to the extent such application results in some amount being currently taken into income of a U.S. citizen or resident or corporation.³ As a result, the general application of the new rules leaves no non-

U.S. person or entity deemed to be the owner, making the trust – in substance – a foreign *non*-grantor trust, with distributions to U.S. beneficiaries taxed to them as such.⁴

As to the second (subject to some exceptions not here relevant), the U.S. settlor is generally the deemed owner and must report the trust income, deductions and credits.⁵

As to the third, the tax treatment depends on the existence of grantor trust powers.⁶ If reserved, the U.S. settlor is the deemed owner and must report the trust income, deductions and credits. If not, the U.S. settlor has made a potentially reportable gift.

The income tax classification of the foreign trust may *change*. For example, on death of the U.S. settlor of a foreign trust having U.S. beneficiaries – a foreign grantor trust – there is no longer *both* a U.S. settlor and U.S. beneficiaries: only the latter. Therefore, the trust becomes a foreign *non*-grantor trust.⁷ In another example, a non-resident, non-citizen who moves from abroad who settled a trust reserving the powers described above (power to revoke or retained income) will see no change if more than five years elapse between the date the trust was settled and the date of immigration, but will see it reclassified as a foreign grantor trust if sooner.⁸

In order to focus this discussion, the applicable law is here presented in the context of:

- a foreign settlor,
- who becomes a U.S. resident,
- in a manner leaving his or her trust classified as a foreign non-grantor trust.

Income Taxation of Distributions, Generally. *Current* income of the trust distributed to the U.S. beneficiary in the year of receipt retains its character as ordinary, tax-exempt or capital gain.⁹ Realized capital gains of foreign non-grantor trusts are included in trust *income* for purposes of establishing distributable net income (DNI).¹⁰ Distributions of principal are untaxed, of course, but required distributions which are not actually distributed to U.S. beneficiaries are nonetheless included in the gross income of those beneficiaries.¹¹

Accumulations. If the trustee accumulates income, the trust pays no U.S. income tax other than that withheld on certain U.S.-source income. This is because the trust is beyond U.S. jurisdiction for taxation or for any other purpose. There is also no income tax owed by any U.S. beneficiary in the absence of an actual distribution, unless income distributions are required. (See preceding paragraph.) The accumulation of trust income, however, presents tax consequences if distributed to a U.S. beneficiary in a future year.

The Throwback Rules. If the distributions in any particular year do not exceed that year's trust income, the tax treatment is almost the same as if it were a domestic trust; *i.e.*, the character of the income distributed retains its character in the hands of the trust as ordinary, tax-exempt or capital gain.¹² It is when distributions *exceed* that year's income in a year in which there is

income accumulated in the trust from prior years that the throwback rules are applied.¹³ Accumulated income distributed to U.S. beneficiaries carries out the following negative consequences:

– Capital gains from prior years which were added to principal (or “accumulated,” since they are characterized as “income”) are taxed to the U.S. beneficiary as ordinary income, rather than at the more favorable capital gain rate.¹⁴

– An interest charge is imposed on the tax owed by the U.S. beneficiary on that part of the distribution attributable to trust accumulations, calculated for each year from the one in which the trust earned the item to the year of distribution.¹⁵ Prior to 1997, the charge was 6% simple interest: Under the *Tax Relief Act of 1997*, it is now set at the underpayment rate (presently about 9%), and is compounded daily.¹⁶

– The throwback rules apply the tax bracket of the U.S. beneficiary in the year in which the trust earned the income item, not that for the year of distribution.¹⁷

The Use of Intermediaries

As the reader will quickly surmise, the tax and interest may quickly reach 100% of the distribution. For example, a married (filing jointly) U.S. beneficiary with total income of \$140,000 in the year the trust earns the income item is in the 36% federal income tax bracket at the margin. A \$50,000 distribution 10 years later is subject to an \$18,000 tax and an interest charge capped at 100% of the balance (\$32,000) is imposed, leaving nothing for the beneficiary.¹⁸

Because of these consequences, trustees will seek ways in which to avoid them. One is to make the distribution to a foreign intermediary (usually a corporation), which then forwards it to the U.S. beneficiary recharacterized as current income, a principal distribution or as a gift. IRS blocked this avenue with *Proposed Treasury Regulation 1.643(h)1*. It sets out the circumstances under which such intermediaries are disregarded. In sum, a trust distribution made through the intermediary is treated as made directly from the foreign trust if any *one* of these conditions is satisfied:

– The intermediary is “related” to either the U.S. beneficiary or the trust, as that term is defined in the Code¹⁹ and the intermediary distributes property or its proceeds to the U.S. beneficiary.

– The intermediary would not have transferred the property or its proceeds to the U.S. beneficiary unless it first *received* that property or proceeds from the trust.

– The intermediary received the property or proceeds from the trust as part of a plan to avoid U.S. taxes.²⁰

The timing depends on characterization of the relationship. If the intermediary can be viewed as agent of the trust, the distribution is deemed made when it passes from the intermediary to the U.S. beneficiary. If instead the intermediary can be viewed as agent of the U.S. beneficiary, the distribution is deemed made when the property or proceeds pass from the trust to the intermediary.

Notwithstanding these rules, the use of intermediaries remains a useful planning device; *e.g.*, if a trust with accumulated income distributes to a non-U.S. person or trust an amount equal to the accumulated income, the original trust loses its “taint” and may make a large principal distribution to a U.S. beneficiary without carrying out accumulated income. The question remains what to do with the “tainted” funds if added to another trust. This is no problem of those funds remain with non-U.S. beneficiaries, but only with great difficulty will they find their way to any U.S. beneficiaries without running afoul of the intermediary rules. Fact patterns vary widely, so each must be carefully analyzed.

Loans from Foreign Trusts

Another idea thought to avoid the unhappy consequences of the throwback rules is *borrowing* from the foreign non-grantor trust. The Congressional response to that is Code Section 643(i). There, if a non-U.S. settlor establishes a foreign non-grantor trust which then loans cash or marketable securities to a U.S. beneficiary or settlor or to a U.S. relative of the settlor, the loan is characterized as a trust distribution to the person receiving it, with taxation accordingly. It matters not that the loan is later repaid.

The U.S. Treasury Department issued a notice in 1997,²¹ carving out an exception to this rule. It permits a foreign trust to lend money to a U.S. beneficiary without distribution characterization if it is a “qualified obligation.” To be a “qualified obligation,” the transaction must satisfy *all* the following requirements:

- It must be expressed in a legally sufficient writing.
- The term of the obligation may not exceed five years.
- All payments on the obligation must be expressed in U.S. dollars.
- The yield to maturity of the obligation may be no less than 100% and no more than 130% of the applicable federal rate²² for the day on which the obligation is issued.

– The U.S. beneficiary/borrower must extend the period for assessment of any income tax attributable to the transaction and any consequential income tax changes for each year that the obligation remains outstanding to a date no earlier than three years after the maturity date of the obligation.

– The U.S. beneficiary/borrower must report the status of the obligation – including all principal and interest payments – each year on IRS' *Form 3520* until the obligation is fully repaid.

Congress considered imposing these loan rules on *all* trust property used by a U.S. beneficiary. Fortunately, the end result was limited to cash and marketable securities. That, for example, leaves the trust able to own residential real property and permit the U.S. beneficiary to use it. It remains unclear whether such use of property held by a trust-owned corporation will be treated as a constructive dividend.

Reporting Requirements

All distributions from a foreign non-grantor trust to a U.S. beneficiary must be reported on IRS *Form 3520A* on or before March 15 of the year following. The form calls for the name of the trust, the total distributions received during the taxable year, and the tax characterization of the distribution as ordinary, exempt or capital gain. The report is required irrespective of the classification claimed for the foreign trust as grantor or non-grantor; all that is needed to require reporting is knowledge that it is a *foreign* trust.²³

If the U.S. beneficiary fails to file the *Form 3520*, the penalty imposed is 35% of the gross amount of the distribution.²⁴ Moreover, the distribution may be recharacterized and taxed to the non-filing U.S. beneficiary as ordinary income, even if it is properly classed as a tax-free distribution from a foreign grantor trust.

IRS will seek the appointment of a U.S. agent for the trust with responsibility for obtaining records sufficient to permit accurate characterization of the distributions for tax purposes. The data is provided by the trustee on one of two IRS forms, *Foreign Grantor Trust Beneficiary Statement* or a *Foreign Non-Grantor Trust Beneficiary Statement*. An alternative, if the trustee refuses and local secrecy law prevent access to the information by other means, is for the U.S. beneficiary to provide IRS with characterization information for the three preceding years, permitting default characterization by extension; *i.e.*, the U.S. beneficiary is allowed to treat a portion as the distribution of current trust income based on the average of those from the three prior years, with only the excess (if any) taxed under the throwback rules as accumulation distributions.²⁵ If not provided, IRS may treat the entire amount as an accumulation distribution. If so, the assumed date of receipt by the trust will be backed up from the date of distribution to the half-way point in the period of time the trust existed.²⁶

Conclusion

As noted, the compressed tax rates currently applicable to the retained income of domestic trusts discourages strategies aimed at using trusts as income-shifting devices. Repeal of the throwback rules for domestic trusts simplified trust tax reporting and encourages the distribution of income. Thus, the punitive impact of the throwback rules was rendered unnecessary for domestic trusts.

For foreign non-grantor trusts, however, the very real prospect of a 100% tax on foreign trust accumulation distributions where the trust receipt dates back -- or is *deemed* to date back -- 10 years or more is the *enemy* of any rational tax enforcement policy.

Like it or not, many taxpayers do not subscribe to blind obedience of laws seen as devoid of a moral or ethical purpose. While there is a presumption of regularity that must obtain in *any* law legitimately enacted and without which no government could function, most people in general and Americans in particular reserve to themselves a sense of personal responsibility, free will and the rule of reason. They will not cross the line of *malum in se* (evil in and of itself) or irrationality, but will readily undertake an act deemed *malum prohibitum* (wrong only because of the existence of a law prohibiting it). An example of the former would be the sexual assault of a child. Any civilized society would recognize such an act as wrong. An example of the latter is driving through a boulevard stop sign without coming to a complete halt. Absent a law compelling drivers to stop for boulevard stop signs, it is a morally indifferent act. Precious few of us will take a public position on such matters, but it remains a fundamental part of the human psyche. It takes no elaborate analysis to conclude that, faced with being hammered by this punitive tax regime, the resources of those taking up residence in the U.S. will quietly disappear into the misty corners of the night, far beyond the reach of the IRS to discover, much less appropriate.

Tax enforcement policy should be aimed at encouraging voluntary compliance. Instead, the throwback rules for foreign non-grantor trusts make felony tax evasion an option.

The throwback rules should be repealed for policy reasons similar to those supporting their repeal for domestic trusts; they do not encourage distribution; rather, they encourage evasion. Their repeal would place taxation of distributions from foreign non-grantor trusts on the same footing as domestic trusts. That does not address the option to accumulate without penalty, but it does avoid making this a nation of scofflaws.

Endnotes

¹ 1. Section 507(a) of the *Taxpayer Relief Act of 1997* (Act) amended *Internal Revenue Code* (Code) Section 665(b) and added Section 665(c). Act Section 507(b) struck Code Section 644, redesignating Code Section 645 as 644 and amending Code Section 706(b)(5). See also the Committee Report at ¶10,415.

² 2. Under *IRC* §672(f) (amended in 1996 under the *Small business Job Protection Act of 1996*, PL #104-188), a trust having a non-resident or foreign corporate grantor is considered a grantor trust only if:

– a power to revest title to trust property in the grantor exists which is exercisable solely by the grantor without the consent of any other person or with the consent of a related or subordinate party subservient to the grantor (the legislative history used the term “revocable” rather than “revest” in describing this power; see *Conference Report and Statement of the Managers*, HR Rep #3448, 104th Congress 2d Session (1996)); or

– the only amounts distributable (whether income or corpus) during the lifetime of the grantor are distributable to the grantor or his spouse (*IRC* §672(f)(2)(A)).

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⁴ 4. If the deemed owner of the trust, determined by applying the grantor trust rules without regard to *IRC* §672(f) is a controlled foreign corporation (CFC), a passive foreign investment company (PFIC), or a foreign personal holding company (FPHC), it will be treated as a domestic corporation for purposes of applying the test under Reg 1.672(f)-1. If a trust to which a CFC, PFIC or FPHC has made a gratuitous transfer makes a gratuitous transfer to a U.S. person, the CFC, PFIC or FPHC, as the case may be, will be treated as a foreign corporation for purposes of determining how the U.S. person will be treated with respect to the property transferred. If a trust or a portion of a trust which a CFC, PFIC or FPHC is treated as owner under Section 678 (beneficiary-controlled trust) makes a gratuitous transfer to a U.S. person, that entity is treated as a foreign corporation making a gratuitous transfer to the trust or portion thereof. In addition, for purposes of determining whether a foreign corporation is characterized as a PFIC, the grantor rules apply as if Section 672(f) did not exist.

⁵ *IRC* §679(a)(1).

⁶ *IRC* §§671-678.

7 7. *IRC* §679(a). In *United States vs. Byrum*, 408 U.S. 125 (1972), the court addressed this point:

"It has been represented [to the court] that the trust is a foreign trust. If that is so, the trust will be treated as a grantor trust under Section 679 [of the *Internal Revenue Code*], and each settlor will, for the taxable year in which the trust is funded and in each succeeding taxable year during his or her life in which the trust continues to have a United States beneficiary, be treated as the owner of a portion of the trust income and corpus. That portion shall be determined in accordance with the principles of *Treas. Reg. §1.671-3*, and each settlor shall be required to take into account, in computing his or her federal income tax liability that settlor's appropriate portion of the trust's items of income, deductions and credits."

The court went on to say:

"Section 679(a)(2)(A) provides that the rules of Section 679(a)(1) do not apply to 'a transfer by reason of the death of the transferor.' While Section 679(a)(2)(A) does not expressly address the tax consequences of the termination of foreign grantor trust status by reason of the grantor's death, the legislative history of the enactment of Section 679 (*H.R. Rep. Number 658, 94th Cong., 1st Sess. at 209 (1975); S. Rep. Number 938, 94th Cong., 2d Sess. at 218 (1976)*) provides that 'an *inter vivos* trust which is treated as owned by a U.S. person under [Section 679] is not treated as owned by the estate of that person upon his death.' Accordingly, any portion of the trust that is treated as owned by a settlor under the rules of Section 679 shall cease to be so treated upon that settlor's death."

8 *IRC* §679(a)(4).

9 *IRC* §652(b).

10 *IRC* §643(a)(6)(C).

11 *IRC* §652(a).

12 *IRC* §§652(b), 661(b).

13 *IRC* §661.

14 14. *IRC* §667(a). Only tax-exempt interest retains its character as an accumulation distribution.

15 *IRC* §668.

16 *Ibid.* at subsection (a)(1).

17 *IRC* §667(b)(1).

18 *IRC* §668(b).

19 *IRC* §643(i)(2)(B), with certain modifications.

20 20. *IRC* 643(h) enacted as part of the *Small Business Job Protection Act of 1996*, Pub Law 104-188. The relevant provision from the act provides as follows:

“[A]ny amount paid to a United States person which is derived directly or indirectly from a foreign trust of which the payer 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.”

Concurrently with adoption, the act repealed *IRC* §665(c), which on its face was more narrow and rendered redundant. This latter provision adopted as part of the *Revenue Act of 1962* applied to indirect accumulation distributions from certain foreign trusts.

21

22 See *IRC* 1274(d).

23 *IRC* §6048(c).

24 *IRC* §6677(a).

25 *Notice 97-34, ibid.*

26 *IRC* §6048(c)(2).